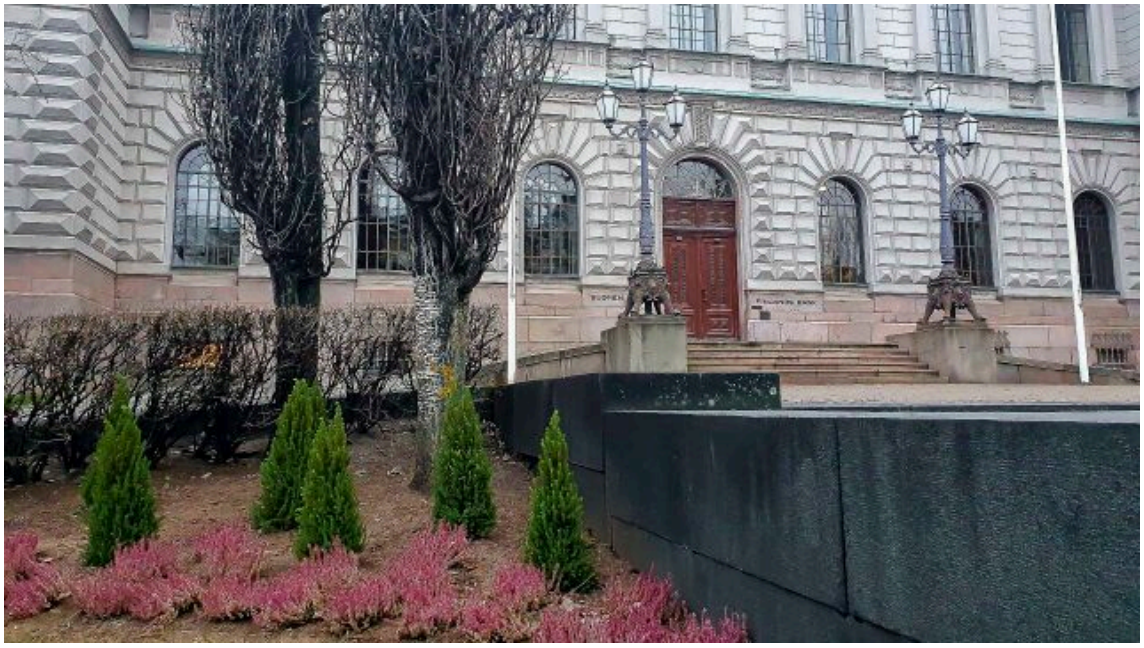
Editorial

Economic policy must live in two time frames at once

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Economic policy in Finland must now find a way to live in two time periods at once. While we are currently combating an acute crisis, we must at the same time direct our thinking strongly towards the economic challenges of the post-crisis years. It is essential to both support businesses, households and economic recovery, while at the same time strengthening the conditions for sustainable, balanced economic growth and improved employment in the years ahead.



Economic policy during the COVID-19 crisis has been a matter of rapid reaction on a broad front both within Finland and across the euro area as a whole. Many people have lost their jobs, and many companies' operations have been severely hampered. Without the rapid and extensive economic policy measures introduced, the economic damage wrought by the pandemic would have been considerably more severe even than those we have actually experienced.

The most important thing has been and still is to effectively mitigate the spread of the pandemic by such means as do not unnecessarily restrict economic activity and people's everyday lives. At the same time, the authorities have given financial support to businesses and households. In addition, central banks and banking and macroprudential supervisors have ensured the availability

of finance.

Last spring, the spread of the pandemic even posed the danger of a new financial crisis, but the central banks managed to forestall this by taking rapid and substantial actions. All in all, the European Central Bank's monetary policy has been strongly supportive of growth during the crisis.

In addition to the euro area's common monetary policy, the Bank of Finland has supported the functioning of the Finnish financial markets through measures at national level. The Bank has purchased Finnish commercial papers in its investment activities and relaxed the collateral requirements for central bank financing.

The central bank has thus responded to both the current crisis and the weak inflation outlook. Inflation has already for several years been mostly below target, and a similar trend is likely for the next few years.

The economic crisis caused by the pandemic is exceptional in the sense that the measures taken to mitigate the spread of the virus and the caution people have exercised have directly restricted output in many sectors of the economy, and especially in private services. Although monetary policy is unable to prevent such effects, it can nevertheless help businesses and households survive the worst phase of the crisis and support the post-crisis economic recovery.

The role of monetary policy in this situation is to continue financial conditions supportive of growth for long enough to support the sprouts of growth and gradually boost inflation, which has been too slow in terms of the price stability objective. Monetary policy and the fiscal policy stimulus are now mutually supportive in the euro area.

To date this year the European Central Bank has succeeded in repelling the threats of a crisis in the financial system and a self-reinforcing deflationary spiral. In Finland, too, monetary policy has supported the economy, and the financial system has managed to operate without serious problems. Together with other economic policy measures, this has prevented realisation of the worst fears from the spring regarding the contraction in the economy and rising unemployment.

Recent weeks have brought positive news on vaccines, which has strengthened expectations that the pandemic will recede during the course of 2021. This news has reduced the threat of a prolongation of the COVID-19 crisis and brightened the outlook for the future.

On the other hand, the health situation and the economic outlook in respect of the winter we are now entering are weak both in the euro area and here in Finland. With the health crisis yet to recede, there remains the risk that the crisis will inflict longer-term damage on employment and

productivity. Although there is already light on the horizon, there is still also the threat that banks' loan losses from corporate loans could grow.

The Finnish economy has suffered less in the COVID-19 crisis than most other advanced economies. According to the Bank of Finland forecast, Finland's economy will also recover from the crisis faster than from the international financial crisis of a few years ago. However, after the current crisis our longer-term economic and employment problems will still be the same as before, if more difficult.

According to the forecast, Finland's public debt will grow in 2020 to 68% relative to annual GDP, and the debt ratio will continue to grow in the coming years unless new corrective measures are introduced. Finland's public finances already had a significant sustainability gap prior to the COVID-19 crisis, and now it has simply grown. The new estimate of its size is 5½% of GDP.

The current growth in the public debt is a consequence of the essential measures needed to support the economy. As far can be discerned at the moment, the economy will still require strong support from the public authorities in 2021. Once the acute crisis is over, however, there will need to be a return to spending limits in order to bring the public finances onto a sustainable footing.

At the same time as the pandemic has been a blow to the public finances and employment, the outlook for labour productivity and investment has also weakened. These were already developing weakly before the crisis, which has simply exacerbated the situation further.

There is now an even greater need for decisions on structural reforms to improve the long-term outlook. Especially with regard to improving employment, most important are reforms that research suggests would make the greatest impact. Another key factor is to improve the conditions for growth in labour productivity.

Regarding productivity growth, there is a major role for research and development work and other output-related investments. Our companies are the motors of productivity growth. Government can enhance the environment in which innovation can take place, and in which innovations made elsewhere can be adopted for use.

There is reason to expect that funding channelled into public research and development will improve the conditions for productivity growth, especially when there are qualified people available to carry out the work. In the overall picture of innovation policy, the development of competences and education policy are, in fact, of major significance. Also important is how easily companies can recruit foreign experts into Finland. Such people will be important both for the innovation process itself and for the emergence of new companies.

A public input into the funding of innovation work may be particularly justifiable during an economic crisis. At such a time, companies will often find it hard to access funding for projects with uncertain returns. At the same time, the need for projects aimed at renewal can be particularly acute, as economic crises are generally followed by restructuring in the economy. The possibilities offered by the EU recovery fund should be exploited for use in such projects with potential long-term benefits.

Competence development and research and development finance should not be expected to generate quick returns. Research indicates that the productivity impacts of such investments are felt in their full force only after several years. It is therefore essential to decide on such investments without unnecessary delay.

In economic policy, the focus must now be directed towards both the immediate problems of today and the longer-term capacity of the economy for renewal, employment and productivity growth as well as strengthening the sustainability of the public finances. It is vital that people's immediate incomes are not severely impacted and also that confidence in the long-term outlook for the economy is not shaken.

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Keywords

COVID-19 crisis, innovation policy, monetary policy, sustainability gap