EDITORIAL

Editorial: Recovery continues – monetary policy under conflicting pressures

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Economic recovery in the euro area and Finland is continuing, although the most rapid phase of growth is beginning to fade. Finland has come through the COVID-19 pandemic better than initially feared, thanks largely to the focus on behaving responsibly towards each other. Bringing the pandemic under control remains central, both in terms of people's health and for the economy. Nevertheless, the pandemic will continue to strongly influence our lives, and we will still need to exercise responsibility in the future.

Vaccine coverage in Finland is still insufficiently high, lagging behind e.g. Spain and Portugal, and it needs to be raised further. Broader use of the COVID certificates would also help to suppress the pandemic. As well as health, preventing infections will also safeguard economic recovery.

In the early phase of the COVID-19 crisis, the rapid and extensive response of economic policy succeeded in preventing mass unemployment and a wave of bankruptcies in Finland and other advanced economies. Both fiscal policy and monetary policy strongly supported growth and employment.

A different situation applies when the worst phase of the pandemic's economic effects is over.

Central banks' monetary policies can begin to be gradually normalised as the economy recovers and the inflation outlook changes.

In the area of fiscal policy, using public funds to support the economy cannot go on for ever. When the economy stands on firm ground, there is good reason to change direction in order to make provision for an ageing population and future crises.

In Finland such preparation is particularly important, as the proportion of elderly people in the population is growing exceptionally rapidly and our economy is already moving into higher gear. During an upswing, an expansionary fiscal policy becomes less effective in supporting growth and employment. It could instead lead to an increase in public procurement costs and a general rise in costs and prices, in addition to increasing the level of public debt.

The changing state of the economy and the factors pulling it in different directions should now be taken into account in economic policy. The pandemic is not yet over, and the road ahead could be very bumpy. Moreover, the effects of the COVID-19 crisis are still being felt strongly across the economy, and this includes rising inflation.

When the COVID-19 crisis began, there was a substantial slowdown in the pace of inflation, including in the euro area. For a period, average consumer prices actually fell. During the second half of 2021, inflation has gathered pace and has turned out to be faster than previously forecast. In the euro area, faster inflation than in recent years also looks set to continue longer than previously forecast, although many of the factors driving inflation are by their nature transitory.

As consumer and investment demand have grown in various countries since the acute phase of the crisis, inflation has been driven by the production bottlenecks caused by the pandemic. Many raw material prices have risen and the availability of components has weakened. This has been reflected in prices rises and difficulties in meeting orders in many sectors of the economy.

Characteristic of recent months has been the rise in energy prices, which has also been felt in Finland. In addition to oil and electricity, the prices of natural gas and coal have also risen. The background to this has been strong global demand for energy, the supply side's slow response and exceptional weather conditions.

The price of energy could stay high for a prolonged period, and the production bottlenecks will not disappear overnight. However, by themselves they will not lead to a prolonged rise in inflation, unless they cause significant second-round effects and a wage-price spiral. Wage inflation in the euro area has so far been moderate. However, in the current exceptional circumstances, inflation forecasts are attended by a large measure of uncertainty.

In the Governing Council of the European Central Bank (ECB) we are constantly assessing the inflation outlook and the factors that affect it. The ECB has a symmetric inflation target of 2% over the medium term.

For several years, until last summer, euro area inflation was below target. The recent turnaround has caused concern over too rapid inflation. If inflation threatens to climb too high, the ECB's monetary policy will work to prevent this by reducing the purchase programmes and refinancing operations as well as by raising policy interest rates. This is how an independent central bank that has been set the primary objective of price stability operates.

Inflation in Finland has risen less than the euro area average. In 2022 as well, Finland's inflation is forecast to continue slower than across the euro area, averaging around 2% when measured by the annual change in the harmonised index of consumer prices (HICP inflation). The main difference in the recent pick-up in inflation has been in energy prices: although energy prices have also risen in Finland, the rise has been less than the euro area average.

Although the rise in inflation has been relatively moderate in Finland compared with many other countries, it is clear that an individual's everyday experience of inflation may differ from this. For example, they may have noticed a substantial increase in the litre price at the petrol pumps. And the experience of individuals is important in the formation of inflation expectations. These expectations then influence how labour, goods and services are priced in the economy, and in this way influence inflationary pressures.

The COVID-19 crisis has substantially increased Finland's public debt. In 2020, the debt ratio relative to GDP grew by 10 percentage points. It is good news that the debt ratio seems to be contracting somewhat in 2021, with the recovery in output. In the immediate years ahead, however, public debt is forecast to grow again relative to GDP. This is due both to an increase in health and social care costs for an ageing population and developments in regard to other public expenditure items.

When Finland's general government finances are in deficit even in a favourable cyclical phase, corrective measures are called for. Economic research and international experience suggest that fiscal policy rules will support the sustainability of public finances. In Finland there is good reason to return as soon as possible to the sort of central government spending limits that can bring us closer to balanced public finances.

There is also a need to consider strengthening the national system for managing public finances. We could look at the Swedish example, for instance, which includes a system with clear numerical targets for public debt and for balancing the general government finances, and a reporting obligation on the Government regarding achievement of these targets.

As expenditure related to an ageing population continues to grow, it would be beneficial in bringing Finland's public finances onto a sustainable footing to explore in detail where we can cut public expenditure. In this task, decision-makers could be supported by a comprehensive, regularly prepared expenditure review that critically examines each expenditure item.

Such a review would best be prepared centrally under the direction of the Ministry of Finance or an independent expert body. An expenditure review would be most meaningful if linked into the decision-making process and if it has the support of decision-makers and is commissioned by them.

Although measures are needed to consolidate the public finances, strengthening their sustainability will also require continuation of the reforms to enhance the prospects for employment and growth. At the same time, these will also directly support people's economic wellbeing. Demographic changes and the trend in skills and education among the population will be of particular importance in the decades ahead.

According to the Bank of Finland's new long-term assessment, economic growth in Finland will average 1.2% per annum over the next 20 years. The population will decline, and labour productivity growth is estimated to be slower than in previous decades. In Finland, the outlook for productivity is dampened by the prospect that the rise in the average educational level of the population will come to a halt in the decades ahead.

Prospects for economic growth can be supported by investing in education and training, and by improving opportunities for work-based immigration. Strengthening incentives for employment will also be important, as will a broader reform of innovation policy.

Thus, responsible behaviour will still be needed in the Finland of the future. We must achieve a rapid reduction in COVID-19 infections, and in the economic sphere we should concentrate on solving our major longer-term problems.

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Key words

COVID-19, COVID-19 pandemic, Finnish economy, inflation, monetary policy