EDITORIAL

Continued accommodative monetary policy supports the return of the inflation rate towards the price stability objective

27 Mar 2018 – Editorial – Monetary policy , International economy

Recent developments in the euro area and global economy have been favourable. In the euro area, economic growth is strong and broad-based, which is also reflected in decreasing unemployment. The output gap has closed in most euro area countries on the back of economic growth. Inflation remains still subdued, but confidence in inflation converging towards the ECB's objective has strengthened. Despite current favourable developments, the lessons learned from the financial and euro crises must not be forgotten.

Financial crises leave a deep imprint. For the euro area, the moment of truth came in 2010–2011: after recovering from the collapse in global trade, a return to the earlier growth path seemed possible. The depth of the euro area sovereign debt crisis could not be anticipated at that time, but shortcomings in the Monetary Union gradually began to surface.

Indeed, the feedback loop between banks and their sovereigns caused the financial crisis to escalate into a sovereign debt crisis within the euro area. In several countries, the problems arose out of large-scale growth in banks' lending, as well as from poor risk management. Substantial public financial assistance was necessary in order to prevent a collapse of the banking sector which would have shaken the entire financial system. In other countries, the root cause of the problems was excessive government indebtedness, and domestic banks ultimately ensured their sovereign's access to financing.

Reforming the euro area is a necessary, gradual process. Banking Union already includes single supervisory and crisis resolution mechanisms. From the monetary policy perspective, complementing this with a common deposit guarantee scheme, as well as developing a Capital Markets Union, are key to ensuring the transmission of the single monetary policy across the whole euro area.

The period of the financial crisis has also coincided with other major shifts in the global economy. Productivity growth has decelerated. The population is ageing. Taken together, these trends have slowed economic growth and lowered the long-term real equilibrium interest rate in the advanced economies. In addition, a strong increase in saving in emerging economies has contributed to a decrease in real interest rates.

During the financial crisis, monetary policy hit the so-called zero lower bound. This meant that there was no more room for significant interest rate cuts, although the economic situation and inflation outlook deteriorated further. On a global scale, the liquidity trap turned out to pose an even more severe and persistent problem from the monetary policy perspective than what had been feared. In the euro area, interest rates have been close to or even below zero since the end of 2011.

Central banks have not remained passive in the face of these novel challenges. Especially in the euro area, where the room for manoeuvre is structurally more limited than in other currency areas, monetary policy emerged as the central element accelerating the recovery from the financial crisis. In July 2012, the ECB's President Mario Draghi held his – epochal, as it turned out – speech in which he said that the ECB would do within its mandate whatever it takes to preserve the euro. The non-standard monetary policy measures, including forward guidance and quantitative easing, were incorporated in central banks' monetary policy toolkit. These tools proved to be efficient in preventing deflationary threats in the euro area. Inflation remains subdued, but confidence in attaining the objective has strengthened.

Three factors may, however, cause inflation and in particular underlying inflation to remain lower than expected. Firstly, the link between inflation and the degree of economic slack has weakened. It seems that a reduction in economic slack no longer leads to an increase in inflation in the same way as in the past. This phenomenon may, however, be linked to increasing productivity and the difficulty of estimating the magnitude of available capacity within the labour force. It may also relate to the early stages of an upswing and therefore be transitory.

Secondly, inflation expectations have remained low – especially those derived from market data. This might arise from persistently low inflation. If inflation expectations cease to be forward-looking, the attainment of price stability is delayed.

Thirdly, owing to the financial crisis and persistently sluggish growth, it is more difficult than in the past to estimate the potential growth rate of the economy and the amplitude of unused capacity. If the assessments regarding the closing of the output gap turn out to be excessively optimistic, the increase in prices will be slower than expected.

Owing to these uncertainties, the conduct of monetary policy in the euro area rests on patience, persistence and prudence. Monetary policy must be forward-looking, and the lessons learned from the financial crisis must be kept in mind. Olivier Blanchard, former chief economist of the International Monetary Fund (IMF), has said that unemployment in the euro area could decrease more than we believe without causing inflation to rise. This would be positive from the perspective of longer-term economic growth. A gradual tightening of monetary policy will rest on a more solid basis when indications of inflation rates to potentially temporarily exceed two per cent become more prominent in inflation expectations. This way can we ensure that the Eurosystem's price stability objective of below, but close to, 2% is symmetrical and can be attained in a sustainable manner even without additional support from monetary policy.

Helsinki, 26 March 2018

Erkki Liikanen
Governor of the Bank of Finland

Tags

financial crisis, inflation, monetary policy