EDITORIAL

Monetary policy normalisation to proceed carefully and with measured pace

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The world economy is expected to maintain strong growth, albeit with a slightly moderated outlook compared with the spring and increasing divergence between countries. The global economic upswing has passed its peak in most of the major economies. Rising interest rates in the United States, capital outflows out of emerging economies, and concerns of trade war have all reflected on global financial markets during the past six months. In the euro area, political uncertainty in Italy has raised yields on the country's sovereign bonds.

The euro area's growth rate is set to moderate to approximately 2%. A reduction in unemployment has created suitable conditions for accelerated wage growth and a return in the path of inflation to the policy objective of below, but close to, 2%. At its monetary policy meeting in June 2018, the Governing Council of the ECB took policy decisions spanning a period of over one year, at least through the summer of 2019. The Governing Council announced that monetary policy will continue to remain accommodative for an extended period, even if monetary policy has entered a path of gradual normalisation.

The conduct of monetary policy will continue to involve both interest rate policy and non-standard measures. The Eurosystem will continue its asset purchases for an extended period, even if its net holdings do not increase due to maturation. Key interest rates will remain at their present levels at least until September 2019, and low-cost loans such as those made available to banks will continue until March 2021.

When monetary policy is normalised, forward guidance and non-standard policy measures will feature less prominently in the conduct of policy. The Governing Council elects its policy stance on the basis of the price stability objective and will similarly determine an appropriate pace for monetary policy normalisation with this objective in mind. June's monetary policy decisions, which the Governing Council confirmed in September, alleviated market uncertainty surrounding the future policy path. As it stands, financial market expectations concerning the timing of the first interest rate rise are consistent with the Governing Council's statements.

Monetary policy normalisation should be pursued at a judicious, measured pace for multiple reasons. Firstly, monetary policy that is accommodative to employment and growth is still needed to ensure that inflation remains on a path consistent with the price stability objective. Secondly, market inflation expectations are still low and economic forecasts have consistently overestimated the development of inflation. Thirdly, the dynamic between inflation and economic slack appears to have changed; closing the output gap no longer seems to accelerate the rate of inflation as it once did. Moreover, the effects of non-standard policy measures remain subject to considerable uncertainty. Following a gradual discontinuation of non-standard policy measures will allow for the close assessment and avoidance of unforeseen negative effects.

Finally, the economy's natural rate of interest may have declined. An increase in the demand for saving might have resulted in a relative excess of savings over investment. Growth in the economy's appetite for savings could be the effect of a variety of factors, such as worldwide population ageing. Because of the decline in the natural rate, monetary policy is tighter than what a historical overview of nominal interest rates might otherwise suggest.

Focus in the analysis and conduct of monetary policy has shifted from envisioning new policy solutions to assessing the impact of discontinuing non-standard measures. The economy will continue to demonstrate business cycles in the future. Next time around, however, prevailing non-standard policy measures will prove to be slightly more conventional. This will help facilitate the conduct of monetary policy when constrained by the zero lower bound.

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Olli Rehn
Governor of the Bank of Finland

Tags

global economy, inflation, interest rates, monetary policy