EDITORIAL

Monetary policy is supporting economic recovery — but the outlook for employment remains weak

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The lockdown measures introduced to contain the global health crisis posed by the coronavirus pandemic led to a sharp contraction in economic activity during the second quarter of 2020. The world economy has already entered a fragile recovery, but one that will take a long time.

The euro area has already passed its deepest slump. Yet its recovery has slowed after an initial spurt, and uncertainty remains high. The euro area has so far avoided a surge in unemployment thanks to furloughs and government aid, but bankruptcies and unemployment are now expected to rise.

While the corona crisis has slowed inflation, we have been able to stave off the risk of outright deflation, i.e. a downward spiral in prices in the economy, thanks to the swift and determined action of central banks. Monetary and fiscal policies are working in tandem to alleviate the damages wrought by the crisis.

Economic policy has responded to the corona crisis on a broad front. Based on the lessons of past crises, the monetary policy of the European Central Bank is now strongly expansionary, as are the fiscal policies of countries in the euro area. The policy response has supported purchasing power and safeguarded households’ and firms’ access to finance, helping them over the worst of the crisis.

In the early spring, the coronavirus crisis almost threated to precipitate a new financial crisis, which was successfully prevented by measures taken by central banks. At the same time, monetary policy has provided strong support to lending, output and employment – and thus price stability.

The ECB has used a variety of instruments to ensure that financing conditions remain accommodative. These include the Pandemic Emergency Purchase Programme (PEPP), longer-term refinancing operations and – via US dollar liquidity swap arrangements between the US Federal Reserve and the ECB – safeguarding US dollar funding of European banks.

In its forward guidance on its expected monetary policy path, the Governing Council of the ECB has communicated clearly that it stands ready to do everything within its mandate to support economic activity – households and firms – in Europe in these difficult times.

Many have expressed concerns about the consequences of expansionary monetary policy. There is a fear of runaway inflation, hyperinflation. However, there are no signs of this. On the contrary — euro area inflation has persistently lingered too low, and there is a risk that this trend will continue. The task of monetary policy is to prevent this threat. Ample monetary stimulus remains necessary to support the economy and employment and to achieve the price stability objective.

All in all, the economic policy measures aim to stabilise the economy, support growth and employment and ensure that inflation returns to its target level. The robust policy response will increase government debt and central banks’ balance sheets in 2020, while safeguarding the economy's output potential and conditions for recovery. From the perspective of servicing rising levels of public debt, it is of key importance that Europe is able to channel its current stimulus efforts towards economic reform and investments that support long-term growth and employment. The fiscal stance of the euro area must take into account the public finances of each individual euro area country.

The ECB has restarted its review of its monetary policy framework, postponed in the spring by six months due to the coronavirus pandemic. The US Federal Reserve System has similarly recently reviewed its monetary policy strategy by considering changes in the economic environment. A comprehensive review of the monetary policy framework is now even more necessary in the euro area too, particularly due to persistently low inflation. The strategy review was triggered particularly by changes in the relationship between economic slack and inflation and the decline in the natural rate of interest (equilibrium real interest rate). In light of these changes in economic fundamentals, it is estimated that the space for monetary policy has shrunk over time and the risk of high inflation has decreased.

My interpretation of the Fed’s strategy review is that in future, the Fed’s monetary policy will respond more emphatically to inflation rates which lie below the target level of 2% and to increased downside risks to inflation. On the other hand, the Fed is expected to respond more moderately to risks signalling a rise in inflation, as their probability, and thus harmfulness, has decreased. The Fed's new strategy will inevitably also have an impact on the operating environment of the ECB's monetary policy – we are not operating in a vacuum.

The ECB's strategy review is thus even more necessary than before because of persistently low inflation and the damages wrought by the coronavirus pandemic. It is the task of the ECB — without prejudice to price stability — to strive to support the other economic objectives of the union with greater effect, so that the economy may recover and its long-term growth prospects improve.

Ample monetary stimulus and the EU's common fiscal measures have opened up space for other economic policies. It is important that this space is put to effective use to reform the economy all throughout the euro area, including Finland. With the substantial rise of public sector debt in the euro area, the significance of structural reforms in labour and product markets and the importance of growth-friendly investments are only elevated. Growth in productivity and employment are ultimately determined by our ability to reform.

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Tags

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