Editorial

Editorial: Inflation outlook requires accommodative monetary policy

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The slowdown in the growth rates of world trade and the emerging economies as well as increased financial market uncertainties have overshadowed euro area economic activity. World trade growth is dampened particularly by weaker growth in the emerging economies, including China. In the euro area, growth continues to rest on domestic demand. In view of the weakened economic and inflation outlook, the Governing Council of the ECB decided in March 2016 on several measures in the pursuit of its price stability objective. Other significant factors with worldwide effects extending far into the future include management of climate change, large fluctuations in commodity prices and a considerable increase in population migration.



The outlook for the global economy has clearly deteriorated at the beginning of 2016, and downside risks have increased. Growth is being dampened by both short-term uncertainties and important longer-term issues.

Firstly, uncertainty has increased on the financial markets and affected the banking sector. However, from the perspective of the transmission of monetary policy it is important for banks to be able to avail themselves of the ECB's advantageous longer-term refinancing and to grant new loans to their customers, thereby supporting growth in the real economy.

Efforts have been made in the euro area to reduce the volume of non-performing loans, which have been seen as posing problems for banks' operational capacity, and economic growth has, in fact, picked up, particularly in those countries where the problems were addressed promptly. However, much remains to be done, as progress in reducing the share of non-performing loans has been uneven and their share remains large in some countries. Even so, rapid reductions in non-performing loans are key to the maintenance of banks' capacity to extend credit and the transmission of monetary policy, as monetary policy in the euro area feeds through to the real economy mainly via the banks. A stable and well-functioning banking sector is essential for economic recovery.

Secondly, behind the weakening growth prospects lies the deceleration of growth in the emerging economies. Notably, China's switch from an investment- and industry-driven economy to a consumption- and services-oriented one has affected its prospects. According to the forecast of Bank of Finland economists, China's economic growth will slow to around 5% in the immediate years ahead. Although a consumption- and services-driven economy cannot be regulated by centrally planned policies in the same way as could investment- and industry-based growth, the Chinese authorities stand a good chance of developing their country and softening the short-term effects of structural change with other economic policy measures.

Thirdly, significant factors with worldwide effects extending far into the future include management of climate change, large fluctuations in commodity prices and a considerable increase in population migration. These phenomena are also associated with issues relevant for the financial markets and financial stability. In addition, their macroeconomic and price-related implications need to be monitored closely.

The impact of such diverse uncertainties is already reflected in the deceleration of the global economy and world trade. Global growth edged down to around 3% in 2015, the slowest rate since the financial crisis year 2009. Bank of Finland economists foresee ongoing global growth of around 3% throughout the forecast horizon 2016–2018.

The euro area inflation outlook has also changed towards a slower rate of inflation. In 2015, euro area inflation remained at 0%, which is the lowest average annual outcome since the start of Monetary Union. The slow pace of inflation has mainly reflected the low price of oil. In February 2016, inflation was –0.2%. The slowdown in inflation has been broadly based and is set to continue

in the near term.

In view of the weakened economic and inflation outlook, the Governing Council of the ECB decided in March 2016 on several measures in pursuit of its price stability objective. These measures included lowering all key ECB interest rates, extending the asset purchase programme to cover debt securities issued by the corporate sector and expanding the volume of monthly asset purchases, the latter also being linked to forward guidance. In addition, with the aim of further incentivising bank lending to the real economy, banks can obtain very long-term loans in targeted longer-term refinancing operations.

Furthermore, the Governing Council of the ECB announced that it expected the key ECB interest rates to remain at present or lower levels for an extended period of time and, taking into account the current outlook for price stability, well past the horizon of net asset purchases.

The monetary policy package and the related forward guidance constitute a comprehensive and balanced set of measures in the pursuit of the price stability objective. It is calibrated to further ease euro area financing conditions and stimulate new credit provision, reinforce the momentum of the euro area's economic recovery and accelerate the return of inflation to levels below, but close to, 2% over the medium term.

The accommodative stance of monetary policy is gradually increasing demand in euro area countries, which will also help Finland. The low level of interest rates is reflected in low rates on corporate loans and housing loans. As these loans mainly bear a variable rate and the banking system is in good shape, the transmission of monetary policy is particularly effective in Finland. Turning the Finnish economy onto a solid growth track requires improved cost-competitiveness and structural reforms. As this creates a need for firms to expand production, the improved financing conditions engendered by the accommodative monetary policy will support firms' decisions to invest and create jobs.

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