EDITORIAL

Editorial: Monetary policy tightening to bring inflation down to target – Managing energy crisis takes key role

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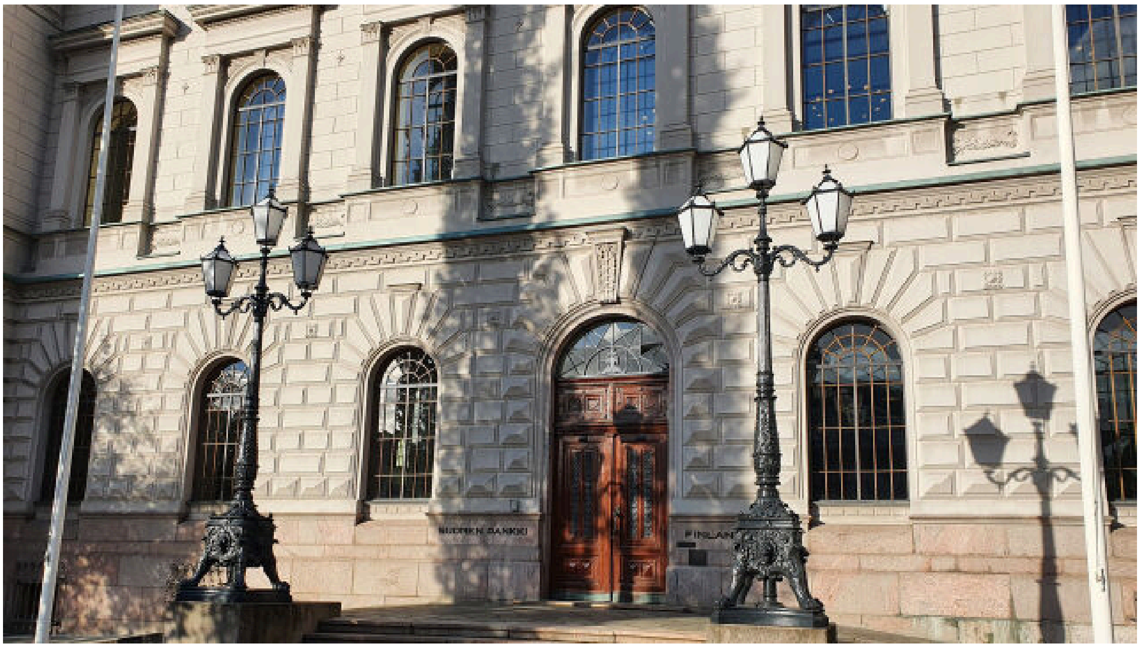
Russia's war in Ukraine is stifling the economy's promising recovery following two years of the COVID-19 pandemic. The war has not only shaken the foundations of Europe's security order but has also considerably weakened the economic outlook. Inflation has soared to exceptional levels.



Energy has been the biggest factor driving inflation: in the euro area it has accounted directly for half of the headline inflation rate of roughly 9%, and indirectly for an even higher proportion. Inflationary pressures expanded during the summer, and the prices of many goods and services have risen significantly.

Bringing inflation to its targeted level is the job of monetary policy, but movements in the general price level are the sum of many different factors. Typically, inflation rises when there is excess demand in the economy, causing it to overheat. Rising inflation may also occur when there is upward pressure on costs. Cost pressures can be generated by energy price shocks or by wages rising at too high a pace. If monetary or fiscal policy is too accommodative in relation to cyclical conditions, it may also push up inflation.

While the ability of monetary policy to influence energy prices directly is very limited, monetary policy measures are deployed to respond to a surge in the general level of prices. Since inflation is already far too high and is likely to stay above target for an extended period, the ECB Governing Council began a tightening cycle in July 2022. In September, we raised the policy rates by an additional 0.75 percentage points, and we can assume further rises going forward. We will be making decisions meeting by meeting on the basis of incoming data, guided by the Governing Council's current monetary policy strategy.

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The energy crisis and swings in the economy are now affecting everyday life for all of us, and the outlook is unclear. In Europe, natural gas and electricity in particular have risen sharply in price and there is an energy shortage as well. The European Commission has published its proposals on exceptional measures that seek to alleviate the situation in the gas and electricity markets. The EU must bring order to its ranks so that this energy crisis can be resolved.

The impact of the energy crisis on inflation may recede gradually once energy prices have peaked. A key question is whether there are signs that demand-side factors are also starting to generate further upward pressure on prices.

Looking further ahead, wage inflation will have a key role to play. If inflation is leaving a dent in people's wallets at the petrol pump and the supermarket till, it is understandable that a loss of purchasing power among employees will lead to calls for higher pay rises across Europe. However, wage costs work their way back to prices, creating the risk of an inflation-fuelling wage-price spiral.

To avoid such an inflationary spiral it is essential to keep near-term inflation expectations anchored. Wage rises negotiated in various euro countries in recent months have been slightly higher than before, but wages are nevertheless not rising as fast in the euro area as in the United States.

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Frequent crises over the past 15 years have challenged public finances across Europe and in Finland too, and the current energy crisis is no exception. Public finances at the euro area level have over the years generally been in deficit, but differences between euro area countries have been moderately large.

According to the most recent fiscal sustainability report, for 2021, the sustainability risks to the public finances of nine of the euro area countries are high for the coming 10–15-year period. Over a longer timespan of decades, the fiscal sustainability risks were high in seven euro area countries. The main factor driving the sustainability risks over the interval of decades is the additional costs brought by the ageing of the population – this applies to Finland too.

The report's assessments of debt sustainability are based on the economic situation in late October 2021 and the forecasts available at that time. This is why the report's scenarios and assumptions appear significantly more positive than the current economic circumstances would suggest. A major shift has also occurred in interest rates, increasing debt-servicing costs.

In the prevailing economic circumstances, monetary and fiscal policy should proceed hand in hand so that the battle against inflation being presently waged by monetary policy is not thwarted by fiscal policy that is too accommodative, or loose. Fiscal policy should in any case accentuate the importance of debt sustainability.

This is also relevant for managing the energy crisis. The efforts of EU countries to identify ways to limit household energy bills are understandable, but a large-scale and indiscriminate increase in expenditure would not be, and would not help in the fight against inflation. It would instead be right to balance out the effects of the rise in prices through tailored, temporary, precision measures carefully targeted at the most vulnerable households. In Finland the situation is eased by the fact that many social benefits are increased automatically in line with the cost of living.

Bringing inflation down to its 2% target over the medium term will require avoiding a detrimental wage-price spiral, keeping inflation expectations anchored and improving the debt sustainability of countries in the euro area. In the face of substantial challenges, resilience, resolve and unity are greatly needed throughout Europe in these present times.

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Key words

energy, energy crisis, euro area, inflation, monetary policy, Ukraine