Blog

Better now to keep interest rates unchanged

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You don't have to be much of a fortune-teller to note that there is continuing uncertainty both in the Finnish summer and in the global economy. On a chilly summer's day like the one we've experienced this week, a Finn can simply stoke a fire in the sauna stove – problem solved. Unfortunately, there is no silver bullet to economic uncertainty. Rather than fanning the flames, we need to keep a cool head.

We also noted this at the ECB Governing Council meeting in Frankfurt this week, where the effects of the protracted conflict in the Middle East on inflation and economic growth obviously dominated the discussion.

We decided this time to keep interest rates unchanged. Our key policy rate therefore stays at 2.25%.

Uncertainty remains high

The global market price of crude oil fell sharply in June following the memorandum of understanding between the United States and Iran. But it has risen again in recent weeks as attacks have resumed. Shipping is once again unable to pass through the Strait of Hormuz.

According to the Eurosystem's latest forecast, published in June, the energy shock will boost inflation to nearly 3.5% by the turn of the year. It is projected, however, to fall next year back to around the ECB's 2% target.

Uncertainty is exceptionally high. If hostilities continue which seems probable, energy prices may rise further and bring upside risks to inflation. If, on the other hand, the United States and Iran were to reach even a somewhat tenable ceasefire agreement and oil shipments from the Gulf to increase, inflation could remain significantly lower than forecast.

The growth outlook for the euro area is currently not simple to interpret. Indicators mainly point to zero growth or mildly positive development. But it is not difficult to imagine why growth could be weaker than forecast.

Economic analyses tends to refer to economic fundamentals. In the era of geopolitics, it is at least as important to identify and interpret political fundamentals.

In my view, the political fundamentals of the Iran war indicate that the interests and goals of the key actors in the conflict – the Iranian Revolutionary Guard Corps and the Trump administration – are just about incompatible. I am referring to both control of the Strait of Hormuz and the curtailing of Iran's nuclear programme. Neither side is particularly known for solving problems through negotiation – they operate with a very different rationality than normal international diplomacy.

Recent weeks have shown that there is no simple and quick solution for the conflict deadlocked by such political fundamentals. We should therefore be prepared for a protracted, prolonged conflict. The likelihood of the Strait of Hormuz opening fully this year has recently decreased. The possible closure of the Bab el-Mandeb Strait in the Red Sea further darkens the outlook.

So the energy crisis is not yet over. The global market price of crude oil is indeed lower than last spring, but higher refining margins and transportation costs are increasing consumer prices of fuels. The price of natural gas has risen significantly again.

Higher energy prices are reflected in other prices. It is necessary to monitor closely the extent to which companies' increased costs are passed into the prices of final products. This will be influenced by the cyclical and competitive situation.

From the price stability perspective, it is encouraging that there are, at least for the time being, no signs of second-round effects of the energy shock. Wage pressures currently seem to be moderate. The labour market has continued to cool, and there has been no acceleration in wages in the agreements concluded since the start of the Middle East crisis. Longer-term inflation expectations have remained close to the ECB's 2% target, which helps to prevent the emergence of a harmful price-wage spiral.

Crisis monitoring will continue

Given that the current outlook for growth and inflation is highly uncertain, and that no data has emerged since our June meeting to alter our assessment of the situation, we concluded that it is now appropriate to monitor how the crisis unfolds and await the ECB's forecast and new analysis, due to be published in September. We will continue to make decisions meeting by meeting, based on the latest data and analyses, and always based on our overall assessment.

The goal, in any case, is crystal-clear: the Governing Council of the ECB is committed to stabilising inflation at around 2% over the medium term.

Keywords

monetary policy in the euro area