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EDITORIAL

Ukraine war blurring economic outlook – ECB monetary policy normalisation continues

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Russia's cruel and senseless war in Ukraine is causing great destruction and suffering. The war's impacts are being felt around the world, and people are having to pay higher prices for energy and food. Growth in Finland's economy is slowing, and even a recession cannot be ruled out. Key ECB interest rates will be raised in July and a further hike is expected in September. The aim is to ensure that inflation stabilises at its 2% target over the medium term. In fiscal policy it is now time to refrain from new measures aimed at stimulating aggregate demand and instead to focus on strengthening the sustainability of Finland's public finances.

Russia's war in Ukraine is weakening the economic outlook and further fuelling the rise in prices. Above all, it is causing untold suffering to the Ukrainian people. As the war drags on, the strong focus on supporting Ukraine must be maintained.

Growth in the economy is slowing as a consequence of the war. The rekindled level of consumer confidence among Finns at the start of the year was quickly dampened by the war. The uncertainty surrounding the scale, duration and impact of the war is being felt in the economy more extensively, too. Business confidence is weakening as well, although survey results suggest that companies are still optimistic about the opportunities for finding new markets to replace lost trade with Russia. Not all companies will be able to replace lost markets, and uncertainty is not an incentive to invest. The risk that Finland's economic performance will fall short of the forecast is now significant, and if this materialises, a recession is even possible.

Prices were already rising before Russia's invasion of Ukraine. Energy prices have been a major contributor to inflation, although considerable swings in these have been seen before. Supply chain and logistics problems caused by the pandemic, combined with a refocus of consumer demand from services to products, has led to widespread shifts in relative prices. However, Russia's war and its consequences have further tightened energy and raw material markets.

Inflation in recent months has been climbing faster than anticipated. Major increases in energy and raw material prices are also being transmitted more broadly to the prices of other products and services.

The powerful surge in inflation calls for monetary policy normalisation to be expedited. The European Central Bank is proceeding with determination and on a proactive basis. At the latest meeting of the Governing Council of the ECB we took the decision to end net purchases under the extensive APP asset purchase programme at the start of July 2022. Key ECB interest rates will be raised in July and a further hike is expected in September. The primary objective of monetary policy is to ensure that inflation stabilises at 2% over the medium term.

The sharp rise in consumer prices is currently weakening the purchasing power of households, which has led to calls for the Government and employers to act. The rising costs of filling up the petrol tank or the shopping trolley are very real. It is difficult to compromise over essential spending. Many countries, including Finland, have sought to soften the impact of rising energy prices for households through various support measures. Such measures must be targeted effectively at those most in need. By disengaging from the use of Russian fossil fuel, we can cease funding Russia's war and at the same time accelerate significantly the green transition that lies ahead. The impact of price signals on fossil fuel demand should not be dispelled completely.

Household purchasing power was growing for a number of years prior to the pandemic, and wages were rising at a rate that was higher than inflation, but now the situation is different. The rate at which pay has been rising has so far been moderate, but pressures are growing for the next wage bargaining rounds. If these turn out to produce major pay increases, this will feed through to consumer prices. A vicious circle of rising prices and wages would be disastrous for the economy.

Based on the moderate pay rises seen early in the year, Finnish companies are, for the time being, retaining their competitiveness in relation to peer countries. The next wage bargaining rounds will be of greater significance in terms of competitiveness. If we have the patience to look beyond the inflation spike, then the competitiveness of Finnish labour and production can be retained and the purchasing power of employees can be strengthened sustainably in future years. But if the situation intensifies into one of wage competition, as it did before the global financial crisis, then competitiveness could be quickly eroded, especially if the economic circumstances are challenging. Tackling a loss of cost competitiveness takes a long time and is considerably more difficult than losing such competitiveness.

Competitiveness is important when replacement markets are being sought to counter the loss of Russian markets. Raw materials imported from Russia will be replaced with other sources, but the price may be higher. The prices of production inputs are currently rising rapidly in any case, and so increases in the prices of end products can be expected. Cost competitiveness will therefore be a significant element in the new competitive environment.

In the labour market there is again demand for skilled workers, and many sectors are struggling with labour shortages. With the unemployment rate still exceeding 6%, it is apparent that there are considerable regional and occupational mismatch problems in the Finnish labour market. This is why investment is needed for skills development in secondary and tertiary education and among businesses. The shortage of skilled and educated labour will become more acute in the future, and in the longer term this will also restrict growth in the Finnish economy. Finland also needs skilled people from abroad.

The employment rate has increased quickly, but nationally the number of hours worked is still less than the level reached before the pandemic. The increase in part-time work is to an extent a natural step, and for many it can be a suitable solution for their own particular situation. But if the higher rate of employment continues in future to derive mainly from an increase in part-time work, the achievement of the employment rate objective will not in itself be sufficient to balance the public finances.

Urgently managing the COVID-19 crisis placed a considerable burden on the public finances. The problem lies not so much with the amount of debt in relation to the size of Finland's economy, but the path which that debt is taking. The debt ratio will grow further in the immediate years ahead, because fiscal policy is still expansionary. The imbalance in the public finances will not correct itself, however. In an environment of rising interest rates, achieving a balance will require a more sharply focused scrutiny of public revenues and expenditure. A comprehensive and regular spending review would support the needs of decision-makers in this.

The crises of recent years have demonstrated the importance of sustainable general government finances. Securing ecological sustainability will call for profound changes across society. Without sustainable public finances, it will not be possible to use public funds to lessen the negative effects on households and businesses of the changes taking place, which may threaten social sustainability. These long-term challenges are already requiring increasing attention in current decision-making.

It is important to make sure Finland has enough skilled workers and to ensure there are sufficient incentives to work. With the right skills we can carry out high-quality research and product development, although hastening R&D work might also need a nudge from the government sector. In unstable times, companies value a stable operating environment, sensible regulation and smoothly functioning permit processes. A competitive domestic market will prepare companies for international markets and will keep price rises in check.

We are, regrettably, living through exceptional times. Geopolitics is rearing up and shaking the economy, and this is now affecting daily lives here in Finland, too, and the view ahead is uncertain. The situation calls for resilience and patience – and a robust spirit of togetherness.

The ECB's monetary policy will underpin Europe's ability to cope in this changing world. The same kind of resolve is needed extensively across society. If the COVID-19 pandemic and Russia's war in Ukraine have shown us anything, it is at least that we in Finland still have the ability to roll up our sleeves and set to work when confronted with difficult problems. It is certainly a long time since this ability has been in such high demand, in the field of security and in the economy.

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Tags

Ukraine, forecast, economic growth, Russia, war, inflation, monetary policy