Andres Lipstok: Monetary policy will not become a prisoner

Article by Mr Andres Lipstok, Governor of Bank of Estonia, published in the newspaper *Postimees* on 24 March 2011.

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Governor of Eesti Pank and member of the Governing Council of the European Central Bank Andres Lipstok says that avoidance of excessive inflation in the euro area and alleviation of inflation expectations are the best measures that the Eurosystem's central banks can take to support the economy.

Estonia has been a full member of the euro area for almost three months now. The adoption of the euro in Estonia was technically smooth and the society's approval of the changeover has increased. The smooth changeover created suitable grounds for paying attention to what really matters – how to help ensure the stability of the euro in the future. In other words, the focus is now on the key issue – maintaining price stability in the euro area.

Euro-area price stability is not an abstract and foreign concern for us. We were aware of how the reference interest rate on housing loans or the euro's exchange rate against the dollar influence our daily lives already before the changeover. However, what people have not realised is how much the general inflation developments in the euro area affect the society's behaviour on the whole. Surveys indicate that general developments in the euro area have a greater impact on the inflation expectations of people who live in the single currency area than one might assume. For instance, in one year the inflation rate of Slovenia and Austria may differ greatly due to changes in taxes or differences in the economic cycle, but the long-term price expectations of people still remain quite similar in these countries.

This is logical. In the monetary union, it is natural that there occur differences in the inflation rate across regions, but these cannot last very long. Otherwise, the competitiveness of the country with the faster inflation rate will suffer: in the best case, the country's economic growth will slow down gradually, but in the worst case the country will have to adjust through a difficult crisis similar to the situation in Greece. One way or another – eventually, this entails a decrease in demand and price growth will be forced back to its "correct" level.

For us, not much has changed after joining the monetary union. Inflation in Estonia was affected by euro-area price stability already under the fixed exchange rate system. Though for a short while, Estonia's inflation greatly exceeded that of Europe, long-term and excessive deviations were corrected by the economy. Otherwise, it would have started pressuring the credibility of the fixed exchange rate.

While in the previous monetary system, more fretful analysts might have speculated that the economy would be adjusted through devaluation – the weakening of the currency's value – which would have allowed inflation to remain higher, luckily this is not an option in the monetary union.

There is a greater concern upon making long-term economic decisions in the monetary union: whether the euro area's central banks (that is, the Eurosystem as a whole) are able to keep the pan-European average inflation rate at a suitable level. This means that in the medium term, the inflation rate has to remain below but close to 2%. While in Austria or Slovenia, or in Estonia for that matter, inflation may temporarily differ from that of the euro area, we have to look at the whole picture when making decisions.

The ability of the euro area to keep inflation close to 2% over the entire past decade has inspired confidence. The average inflation rate has remained slightly below 2% throughout the history of the single currency and annual inflation has mostly ranged within 1.5–2.5%. However, we must not be distracted by our success. The euro area's inflation indicator was over 2% at the beginning of this year, and, most recently 2.4%. This is worrying.

The more detailed picture is, of course, more diverse and future monetary policy measures will also have to take that diversity into account.

On the one hand, the European economy is just recovering from a deep economic recession. Unemployment is higher than usual, the relatively high debt burden is inhibiting borrowing activity in many countries and the majority of the recent price hike stems from global factors, such as the price growth of energy and food on the global market. The prices of other goods and services, on the other hand, have been posting quite modest growth rates. Therefore, the inflation expectations of entrepreneurs and consumers have remained close to the historical average. If the price hike of commodities stops, the increase in the euro area's prices could remain below 2% already next year.

However, looking at the data from another angle, we can find proof to arguments which insist that the current euro-area interest rate level is not suitable for guaranteeing the low inflation rate that corresponds to the price stability goal. Although the general public focuses on the debt crisis of certain European countries, the developments of the economy itself have, on the whole, exceeded expectations. Economic growth has remained above average and the utilisation of production capacity no longer resembles a crisis situation. Though unemployment is still high, it is decreasing and the indicators of the industrial and service sectors are posting quite high results from the historical perspective.

If we add here the fact that global price rise pressures have been annoyingly enduring and do not show any signs of abatement, the risk of a persistently higher inflation rate in the euro area has increased. Therefore, at the press conference after the most recent meeting of the Governing Council of the European Central Bank it was pointed out that, to withstand this threat, the Eurosystem might increase the price of money in the markets earlier than expected, maybe already in April. The mandate of the euro area's central banks is clear on this subject and there is no reason to think that some other stray thoughts would let us deviate from our key goal. It should be stressed that the Governing Council of the European Central Bank is monitoring the economic situation very carefully and will not commit to future decisions in a form that would render the Council a prisoner of their own words.

Public discussions include two extraneous arguments, based on which it has been claimed that the hands of the euro area's central banks are tied and therefore they cannot fulfil their primary goal properly.

Firstly, it has been presumed that banks' situation in Europe is so weak that we cannot abandon the extraordinary monetary policy measures that made money supply easier for banks during the crisis. Secondly, it is claimed that until the fiscal situation of some euro area countries is not firmly under control and the new financial control mechanisms have not been implemented, central banks do not dare to focus on the threat of inflation.

I do not wish to underestimate either argument. The situation in global money markets, including Europe, is not entirely risk-free yet and the leaders of Europe's public financing are struggling to ensure that the amended fiscal framework would help avoid crises in the future.

However, upon fulfilling their main goal, the euro area's central banks are not limited by these concerns to the extent that they could or should ignore the price stability goal. The prevention of excessive inflation and the alleviation of inflation fears is the best that a central bank can do to support long-term economic growth.

As for money market liquidity and extraordinary crisis measures, they do not hinder the pursuance of the necessary interest rate policy. If it is necessary to continue fixed rate tender procedures with full allotment to guarantee the normal operation of the money market, it may also be a reasonable move when the monetary policy interest rates are already on the rise. In this case, one does not hinder the other.

It must also be pointed out that contrary to the popular misbelief, general monetary growth in Europe has not been very rapid after the introduction of extraordinary measures. Recent data indicate that it amounts to only a couple of per cent a year, which is too little rather than too much. Meanwhile, extraordinary instruments in the market do not mean that the money market environment is too lenient, because the European central banks have performed monetary policy transactions to curb liquidity according to need. Naturally, if the arrangement principles of such tender procedures become obsolete, they should be reviewed immediately.

The same principle applies to the impact of the state budget on monetary policy. The situation of the state budget undoubtedly has a great influence on economic developments and it plays a great role in the analysis of the economic situation. However, this analysis does not give the Governing Council of the European Central Bank cause to worry excessively about the debt servicing costs of the whole euro area or its member states. Instead of monetary policy interest rates, the debt servicing costs of countries are still primarily influenced by the credibility of their fiscal policies – this is also reflected by the very different interest rates of public debts within the euro area.

The government bond purchase programme that started last spring may understandably cause concern regarding the goals of central banks. However, that step had a specific goal, which was related to the situation in the financial market and not to fiscal policy. Central banks are not allowed to finance the state budget and no such financing has occurred within the Eurosystem during the crisis. It must also be emphasised that the liquidity provided to the markets as a result of these purchases has been eliminated by opposite transactions throughout the entire period. This also indicates that the euro area's central banks regard the key monetary policy goal – price stability – as superior. Although the reorganisation of the state budget is a serious challenge for many European countries, there are other people and measures for solving this problem. Monetary policy will not be imprisoned by it.

In conclusion, the containment of inflation is the only goal of the euro area's central banks in shaping their monetary policy. Adhering to this principle is the key to how monetary policy can support the correction of economic discords.