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EDITORIAL

Inflation outlook requires accommodative monetary policy

22 MAR 2016 1:40 PM • BANK OF FINLAND BULLETIN 1/2016 • EDITORIAL

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.

21 March 2016

Erkki Liikanen

Governor of the Bank of Finland

Tags

- global economy
- inflation
- monetary policy
- world trade

Euro area growth dependent on domestic demand

21 MAR 2016 11:00 AM • BANK OF FINLAND BULLETIN 1/2016 • MONETARY POLICY

The Governing Council of the ECB decided on an expanded asset purchase programme (EAPP) in January 2015. Purchases have thus far been conducted to a total value of almost EUR 780 billion. At its monetary policy meeting in March 2016, the Governing Council decided to further ease the monetary policy stance. Accordingly, markets expect monetary policy to remain accommodative for a prolonged period.

The euro area economy continued to recover in 2015. GDP grew at a rate of 1½% and the unemployment rate decreased by one percentage point, to stand at 10½%. However, in 2016–2018, growth will rest more than before on domestic demand. The outlook for export market growth has deteriorated, and the contribution of net exports to growth will be negligible over the forecast period.

Despite positive developments in the real economy, the annual average inflation rate in the euro area was zero in 2015, the lowest outcome since the start of Monetary Union. The low inflation rate mainly reflected developments in the price of oil, which decreased further in the course of 2015. The underlying inflation rate (which excludes oil and food price changes), while remaining more stable, has also been low and hovered around only 1%. The pick-up in inflation is forecast to be moderate over the entire forecast horizon. It is supported by stabilisation of the oil price, the continued accommodative stance of monetary policy, and the narrowing of the negative output gap.

Euro area growth is exposed to both external and internal risks. The most important external risk relates to a broad-based strong slowdown of the global economy, which would dampen both growth and inflation in the euro area. Another risk is that the strong fall in oil prices and the slowdown of global economic activity could end up having nonlinear effects, as the balance sheets of highly indebted economies can no longer bear the ever weakening situation.

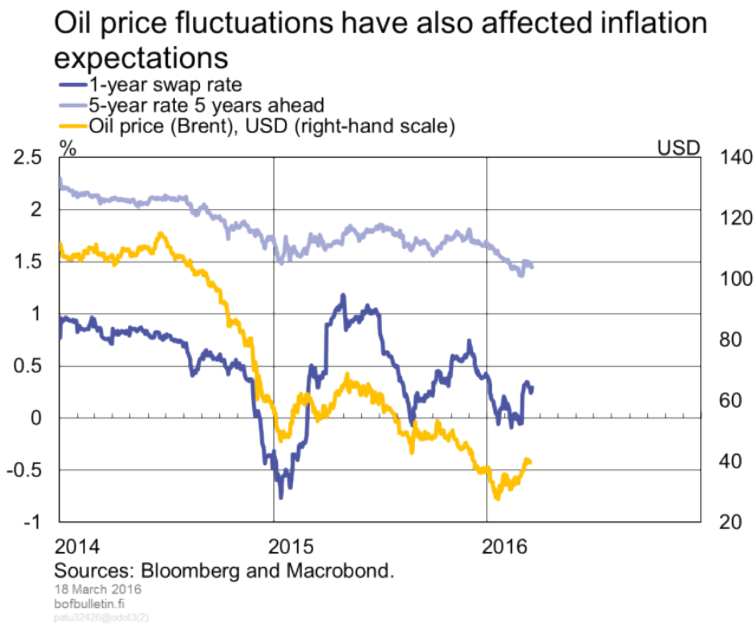
Internal risks relate to the fact that the recovery in the euro area economy is still fragile. The protracted nature of the crisis is visible across a range of factors, as illustrated by the persistently sluggish capital investment and high levels of long-term and youth unemployment. The refugee crisis represents a new shock to the euro area, and its effects are surrounded by a high degree of uncertainty. Political uncertainty in Europe is further compounded by the upcoming referendum on the UK's EU membership.

ECB adopted extensive additional measures

In 2015, the real economy in the euro area continued to recover. During the year, GDP grew at a rate of 1½% and the unemployment rate decreased by one percentage point, to stand at 10½%. Despite these positive economic developments, the euro area inflation rate remained at zero. 2015 was already the third consecutive year in which the inflation rate remained well below 2%, thereby falling short of the price stability objective.

The sluggish inflation rate can mainly be explained by the path of the oil price, which started to decline again after mid-2015. Besides lowering the actual inflation rate, this dip in oil prices has also dampened inflation expectations over the short – but also longer – term (see Chart 1). The uncertainty surrounding the global economic outlook has increased since the beginning of 2016, leading to a substantial increase in financial market volatility. These factors have weakened the outlook for growth and price stability in the euro area.

Chart 1.

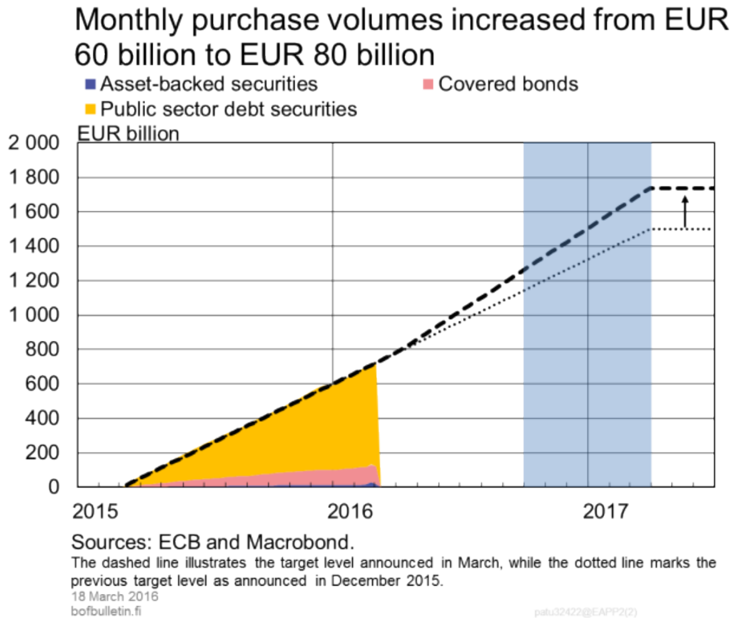


At its meeting in March 2016, the Governing Council of the ECB therefore decided on a comprehensive package which will further ease the monetary policy stance. Firstly, the Governing Council decided to decrease all key ECB interest rates: the rate on the main refinancing operations was lowered by 0.05 of a percentage point to 0.00% and the rate on the marginal lending facility also by 0.05 of a percentage point to 0.25%, while the rate on the deposit facility was cut by 0.10 of a percentage point to –0.40%. Secondly, the asset purchase programme was further extended to cover debt securities issued by the non-bank corporate sector, and the monthly volume of asset purchases was increased. Starting from April 2016, purchases will be conducted at a monthly pace of EUR 80 billion. Thirdly, the Eurosystem will in June launch a series of targeted longer-term refinancing operations, the loan conditions of which are linked to additional lending to the corporate sector.

Asset purchase programme eases monetary conditions

The Governing Council decided on an expanded asset purchase programme (EAPP) in January 2015. At that time, it was decided that purchases would be conducted as of March 2015 for a monthly volume of EUR 60 billion and that these monthly purchases would run until at least September 2015, leading to an aggregate purchase volume of EUR 1,140 billion. Implementation of the programme has proceeded as announced, with debt securities issued by euro area governments constituting the majority of the purchased securities (see Chart 2).

Chart 2.



In December 2015, the asset purchase programme was extended to run at least until the end of March 2017 (see the shaded area in Chart 2). The Governing Council also decided that the principal payments on maturing securities would be reinvested for as long as necessary. This means that the combined volume of the purchases will remain at targeted levels even if the monthly purchases were to be discontinued (see the horizontal portion of the dotted line in Chart 2).

At its meeting in March, the Governing Council decided to expand the monthly purchases from EUR 60 billion to EUR 80 billion (see the differential between the dashed line and the dotted line in Chart 2). As a result, the overall volume of the programme will increase to at least EUR 1,740 billion. In addition, investment-grade euro-denominated bonds issued by non-banking sector corporations established in the euro area were included in the list of assets eligible for purchase.

These asset purchases ease monetary conditions in the euro area in three ways.

Firstly, the duration of the purchase programme illustrates the Governing Council's commitment to maintaining interest rates at low levels for an increasingly long period (the signalling effect). This effect is also supported by forward guidance, according to which the Governing Council expects key interest rates to remain at present or lower levels well past the horizon of the Eurosystem's net asset purchases.

Secondly, the programme creates additional demand for the securities covered by it, thus reducing the risk premia related to these securities. This translates into lower yields and thereby lower interest rate levels in the economy.

Thirdly, in addition to these direct effects, the sellers of securities covered by the purchase programme are likely to substitute the sold securities with other, riskier assets, thereby also narrowing the risk premia related to these assets. This increase in the demand for securities not covered by the purchase programme, and its broader positive impact on the capital market, is known as the portfolio balancing effect.

All in all, the purchase programme lowers the level of interest rates in the economy.[1] The decrease in interest rates creates incentives to consume and invest and has the potential to induce a depreciation of the exchange rate. These factors increase aggregate demand and, over time, also the inflation rate.

Targeted longer-term refinancing operations enhance the effectiveness of monetary policy

In the current situation, the rate on the deposit facility in effect constitutes the ECB's policy rate. This is due to the fact that the sizeable asset purchases conducted by the central bank have created an ample supply of liquidity (or reserves) exceeding the corresponding demand. This excess supply pushes down the Eonia rate. Given that excess liquidity (or reserves) is remunerated by the central bank at the rate on the deposit facility – which is the minimum rate at which banks are willing to lend to each other – Eonia has recently closely mirrored the deposit rate, with a very small difference.

The immediate reaction of longer-term market rates to a decrease in the deposit rate (or policy rate) depends on the prevailing expectations regarding monetary policy. In an environment of low interest rates, a decrease in the deposit rate may have unusual effects. When the expected path of short-term rates is, into the distant future, limited to its lower bound (that is, to the expected level of the deposit rate), a decrease in the deposit rate results in a decrease in the expected path of short-term interest rates over a long time horizon. As long-term interest rates can be expressed as the average of short-term rates, long-term rates also decrease. Hence, a decrease in the deposit rate may have a stronger impact on long-term market rates.

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1. For an analysis of the impact of the asset purchase programme on the level of interest rates, see Alta villa et al., (2015), ECB Working Paper Series, No 1864.

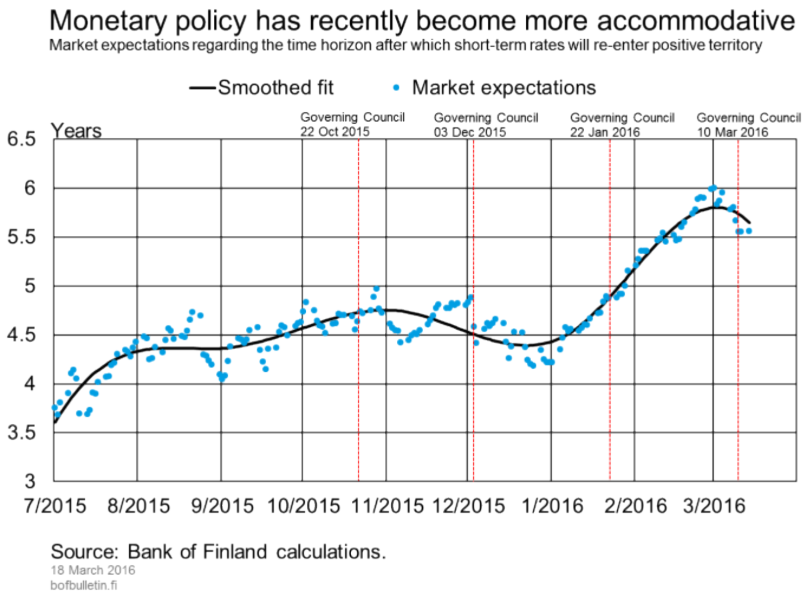
The Governing Council decided in March on a series of four new targeted longer-term refinancing operations (TLTRO II) to be conducted on a quarterly basis between June 2016 and March 2017. In these operations with a maturity of four years, banks will be entitled to borrow up to 30% of their stock of eligible loans as at 31 January 2016. The interest rate applied in these operations will be fixed at the rate on the main refinancing operations. However, for banks whose eligible lending to corporations and households (excluding loans for house purchase) exceeds a certain threshold, the interest rate will be lower and can be as low as the rate on the deposit facility at the time of take-up.

With the decrease in key interest rates and the EAPP, market rates have been pushed down to very low levels. The TLTROs enhance the transmission of monetary policy to the real economy. In this way, the various monetary policy measures included in the package reinforce each other.

Markets expect interest rates to remain low for an extended period

One way to assess the monetary policy stance in an environment of low interest rates is to examine changes in market expectations regarding the time span after which short-term rates will turn positive.[2]

Chart 3.



In July 2015, market expectations suggested that it would take some 3.5 years, or until early 2019, for short-term rates to return to positive territory (see Chart 3). Thereafter, economic developments and the ECB's forward guidance pushed back the expected

2. The dates (see Chart 3) should be regarded as indicative. They have been calculated under the assumption of risk neutrality which, in the current situation, may result in an overestimation of the expected date. Furthermore, any interpretation should take into account that the expectations reflect the view of the market, which may differ from that of the central bank.

turning point farther still, by approximately one year, as the market expected a further easing of monetary policy. Following the Governing Council meeting in December 2015, market expectations regarding the end of the period of negative short-term rates were brought forward by approximately half a year. In December, however, the expected monetary policy stance was more accommodative than, say, in July 2015. Since the beginning of 2016, the fall in oil prices, the uncertainty surrounding global economic developments, the increase in financial market volatility as well as the Governing Council's forward guidance have led to an adjustment in market expectations towards a more accommodative monetary policy stance. The markets expect short-term rates to turn positive in the first half of 2022.

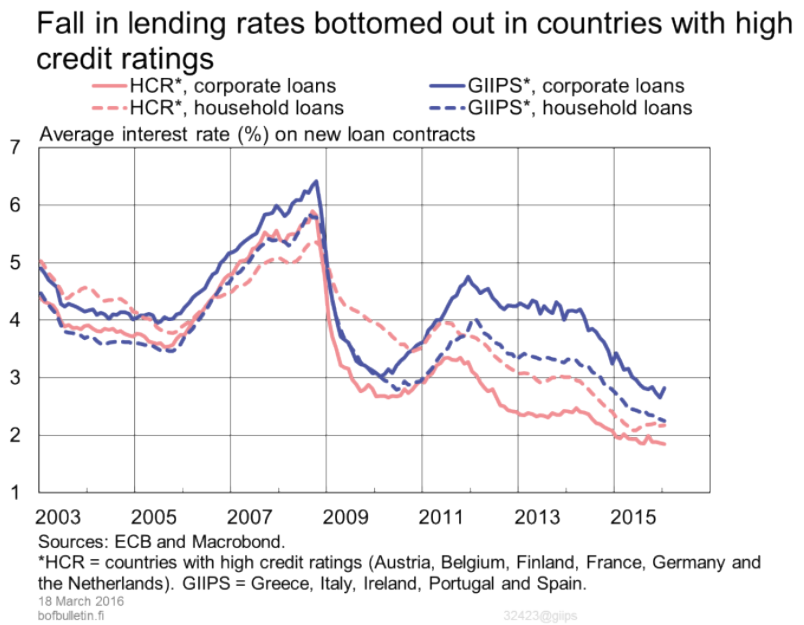
After the monetary policy meeting in March 2016, and in line with the Governing Council's forward guidance, markets expect interest rates to remain low beyond the announced horizon of the asset purchase programme. All in all, during the past six months, the monetary policy stance has been substantially adjusted towards more accommodation.

Lending rates keep decreasing in GIIPS countries

In the euro area, monetary policy feeds through to the real economy primarily via the banks. An easing of monetary policy leads to a decrease in market rates, and this decrease is reflected in banks' lending rates.

Interest rates on corporate loans have decreased in the euro area since summer 2014. In countries with high credit ratings (here: Austria, Belgium, Finland, France, Germany and the Netherlands), the decrease bottomed out in the course of 2015 (see Chart 4). In GIIPS countries (Greece, Italy, Ireland, Portugal and Spain), the fall in average rates on new loans has continued, but these rates still remain higher than the euro area average.

Chart 4.



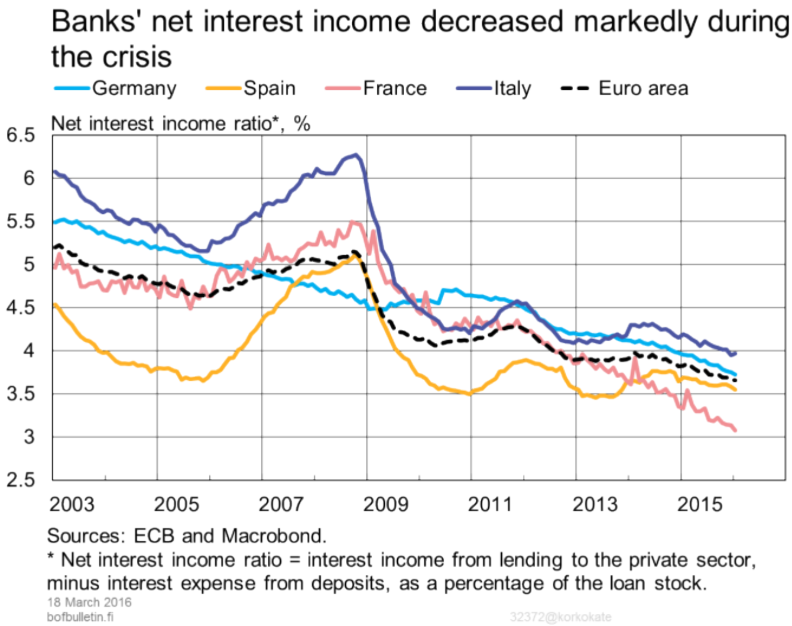
The bottoming out of lending rates observed in countries with high credit ratings is the result of several factors. The fall in reference rates decreases net interest income, thereby weakening banking profitability, unless the fall in interest rates is compensated for by increasing the margins added to the reference rates. At the same time, while also generating profits for their owners, banks have to increase their capital ratios in response to tightening regulation. In addition, demand for loans is picking up in countries with high credit ratings, which may result in a bottoming out of the fall in interest rates. As regards financing costs, and in particular deposit rates, there is little margin left for rate decreases, unless euro area banks pass on the negative rate on the deposit facility to their retail customers. On the other hand, in Germany and France, fixed-rate loans accounted for a notably larger share of new loan contracts in 2015 than in the previous year. Interest rates on fixed-rate loans were, on average, half a percentage point higher than those on variable-rate loans, thereby increasing the average interest rate.

In GIIPS countries, in contrast, the conditions exist for further decreases in lending rates, especially in Spain and Ireland. Interest rates are being pressed down by the competition for customers and the sluggish (at best) growth in the loan stock. Furthermore, banks' financing costs have decreased in GIIPS countries proportionally more than in countries with high credit ratings, which boosts their net interest income. In January 2016, however, the protracted decrease in corporate lending rates came to a halt in the GIIPS countries as well. This partly reflected an increase in uncertainty in the banking sector, especially in Italy and Portugal. In addition, the persistently high share of non-performing loans in these countries weakens banking profitability and may dampen the decrease in lending rates.

A decrease in banks' net interest income

Monetary policy measures are aimed at keeping short-term interest rates at low levels for a protracted period while also further depressing longer-term rates. Although low interest rates stimulate economic activity, they also have an inadvertent negative impact on banks' net interest income.

Chart 5.



Interest income accounts for some 65% of banks' earnings in the euro area. On average, deposits from and loans to the private sector make up some 60% of the euro area banking sector's assets and liabilities, respectively. When the level of interest rates in an economy falls and the difference between short-term and longer-term rates decreases, banks' interest income diminishes. For this analysis, the imputed net interest income shown in Chart 5 is only indicative, as banks' other interest income and interest expenses are not included. Nonetheless, it points in the right direction, given that retail banking accounts for a significant share of banking sector earnings in the euro area. In recent years, the interest paid by banks on their bonds has mirrored the fall in other market rates, which has decreased the cost of banks' market-based debt. However, the role of bonds as a source of banks' funding has, on average, diminished in the euro area.

As the extended asset purchase programme exerts downward pressure on the interest rates on debt securities, profits generated from the sale of these securities, as well as valuation gains which are partly reflected in the balance sheet, contribute to an increase in banks' capital. By supporting economic growth, the low interest rate level decreases credit risk and credit losses and leads to a decrease in the share of non-performing loans. In this way, the low level of interest rates also underpins banks' profitability.

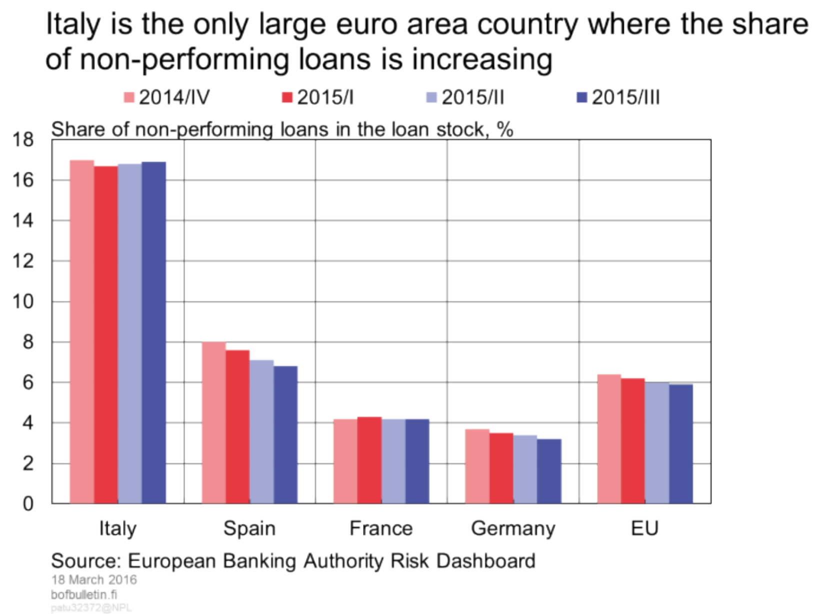
Increase in non-performing loans is a problem for just a few countries

The share of non-performing loans remains relatively large in Europe and will decline only slowly. In the third quarter of 2015, non-performing loans (meaning loans with payments more than 90 days overdue) accounted for some 6% of the loan stock in EU countries (see Chart 6).

In the comprehensive assessment of banks conducted by the ECB in 2014, the definitions of non-performing loans were harmonised. As a result, some 15% of the loan contracts of

Italian banks had to be reclassified as non-performing. Despite a number of tax and law reforms, the share of non-performing loans in Italy had not begun to decline by the end of the third quarter of 2015. In January 2016, the Italian government negotiated an agreement with the EU which allows it under certain conditions to grant state guarantees for non-performing loans sold by banks, with the aim of attracting more investors.

Chart 6.



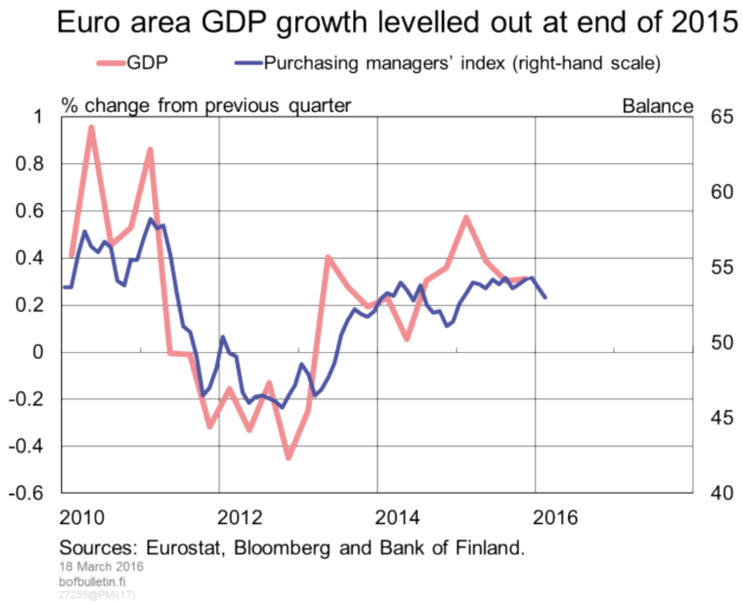
At the beginning of 2016, a new single crisis resolution framework came into force, emphasising the responsibilities of creditors in regard to troubled banks. The new framework will increase consistency and predictability in every EU country, thereby decreasing investor uncertainty over the longer term.

Although the introduction of the framework in January 2016 was no surprise to the markets, it may have contributed at least partially to the decline observed in banks' share prices in early 2016. Last year's bank restructuring measures adopted in Italy and Portugal also added to the uncertainty.

Growth of the real economy rests on domestic demand

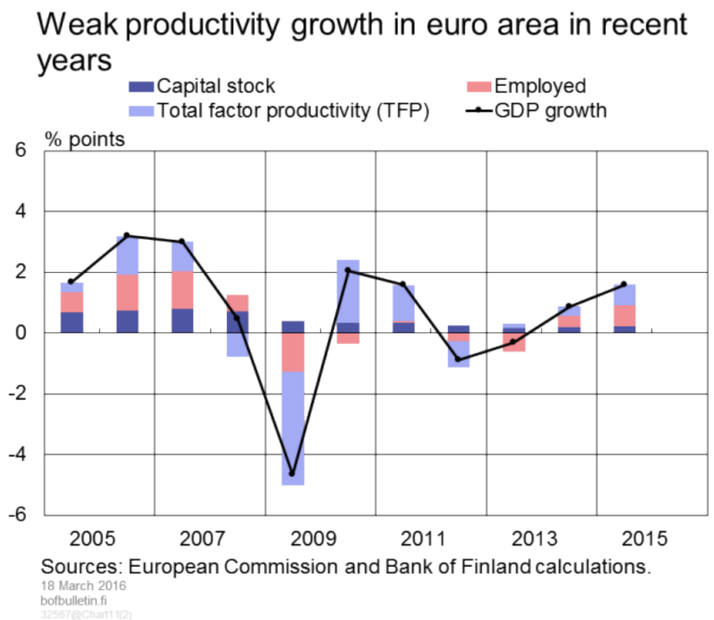
In the second half of 2015, GDP growth in EU22 countries (euro area, UK, Sweden and Denmark) fell slightly short of the Bank of Finland's September forecast, as growth in exports and investment was more sluggish than expected. This reflected a slowdown in the growth rate of emerging economies and global trade, as well as an increase in financial market volatility.

Chart 7.



However, the internal fundamentals of the **euro area** economy have not changed during the past six months and continue to support growth. In 2008–2014, the heavy debt servicing burden of the private sector, tight fiscal policies and weak labour market developments dampened growth in domestic demand, but this dampening effect is now receding. However, in 2016–2018, euro area growth will rest on domestic demand more heavily than before. The outlook for export market growth has worsened, and the contribution of net exports to euro area growth will be negligible over the forecast period. Moreover, financial market turbulence at the beginning of the year has created uncertainty and tightened access to market-based equity financing and debt financing.

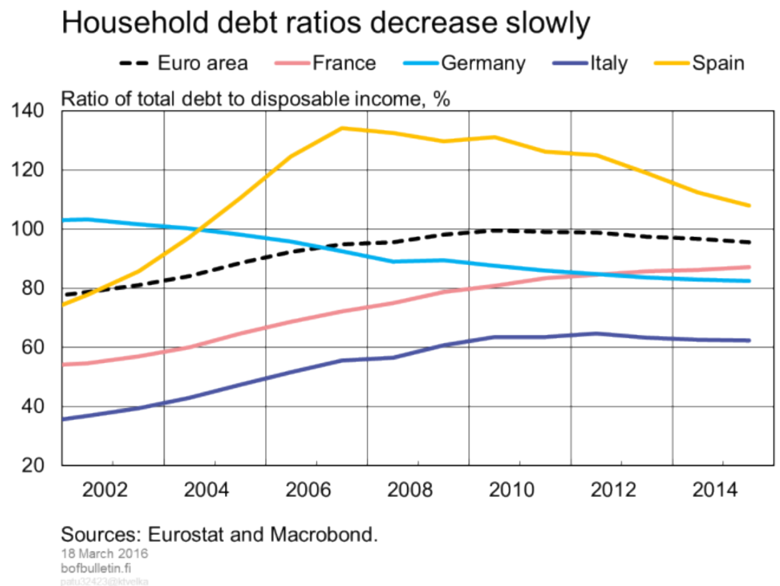
Chart 8.



In 2015, of all components of aggregate demand, **private consumption** contributed most to euro area GDP growth. Its value has increased steadily since the beginning of 2014, as the employment situation has improved and the decrease in the prices of energy products has supported an increase in real disposable income. Growth in private consumption is expected to continue over the entire forecast horizon, reflecting a rising employment rate and persistently low interest rates.

Average annual growth in loans to euro area households strengthened steadily in the course of 2015. Nonetheless, the rate of this growth remains modest in comparison with pre-crisis levels, and the ratio of total household debt to disposable income continues to decrease slowly in the euro area (see Chart 9).

Chart 9.



Of the large euro area countries, in Italy and France households' debt-servicing costs remain above their long-term average, which may limit growth in private consumption in the next few years. Especially in France, household indebtedness has been increasing continuously since 2002, although e.g. house prices have followed a downward path since 2012. In Germany, the household sector balance sheet has enough margin for manoeuvre for a further increase in private consumption in the coming years. Households' debt servicing costs are steadily decreasing in Germany, the loan stock is gradually growing and house price increases remain moderate. In Spain, balance sheet adjustment in the household sector is still ongoing and the stock of loans to households decreasing, albeit at a steadily decreasing pace.

Investment growth remains sluggish

The value of **private capital investment** has increased in the euro area since the beginning of 2014. However, investment activity has recovered only slowly. It has been dampened by low profitability, often weak competitiveness and ample unused production capacity. Financial market uncertainty increased in the second half of 2015, and the beginning of

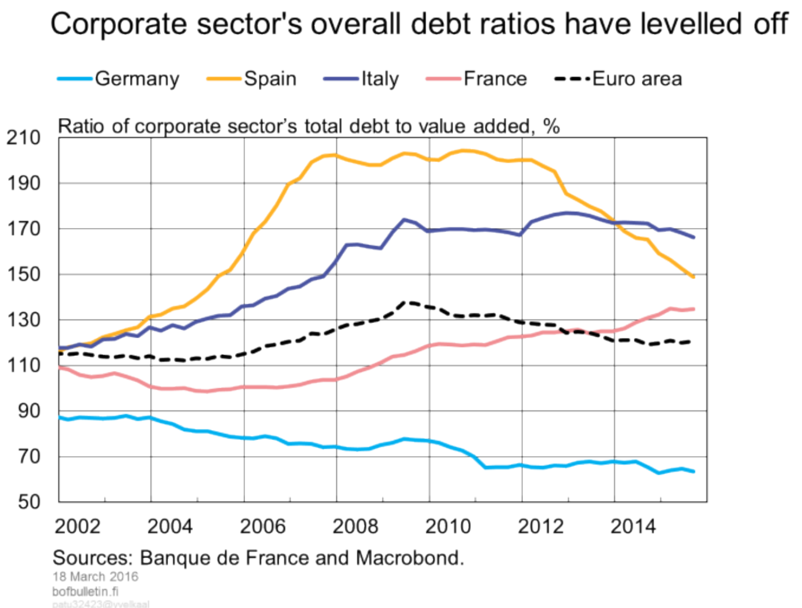
2016 saw a correction taking place, for instance on the equity markets. As a result, the pick-up in investment in 2016 is expected to remain weaker than anticipated. Looking ahead, however, the persistently low interest rate level should facilitate debt-servicing in the corporate sector and support investment growth.

The stock of corporate loans has displayed positive growth figures in the euro area since July 2015. At the beginning of 2016, however, differences between large euro area countries in the growth path of the corporate loan stock remained significant. In Spain, the annual growth rate of the corporate loan stock remains negative, but the contraction is bottoming out, although loan redemptions still exceeded loan drawdowns in 2015. Meanwhile in Italy, corporate loan growth returned to levels below zero in December. In France, in contrast, growth in the corporate loan stock has been much stronger than the euro area average.

All in all, the growth in debt financing slowed in the corporate sector in the course of 2015. In particular, the issuance of corporate bonds saw a decline towards the end of the year. For small and medium-sized enterprises (SMEs), access to finance from non-bank sources is still difficult in the euro area. Despite this, the results of euro area corporate surveys suggest that the availability of funding is now only a minor problem for companies of all sizes. Companies still consider lack of demand their most pressing problem.

In the euro area, the corporate sector's overall debt ratios (against value added) have remained almost unchanged from the year before, despite some variation across countries (see Chart 10).

Chart 10.



In Spain, the progress of the balance sheet adjustment process remains rapid as the corporate sector continues to deleverage. Low interest rate levels and the pick-up in economic activity make it possible to reduce the share of non-performing loans and thereby improve Spanish banks' future lending capacity. In Germany, the overall corporate debt ratio has remained below the euro area average, although investment dynamics have been markedly stronger. In France, corporate indebtedness has increased alongside household indebtedness. Nonetheless, the ratio of debt-servicing costs to net corporate earnings shows a downward trend in France, and capital investment increased towards the end of 2015.

Situations differ across large euro area countries

Germany's GDP grew by 1.7% in 2015. The country's economic fundamentals remain solid, with strong competitiveness, moderate household debt levels and one of the lowest unemployment rates in the euro area. Thanks to a balanced fiscal position and the lowest debt ratio among euro area countries, German public finances are well equipped to accommodate the refugee crisis. In the next few years, the German economy will grow at a rapid pace 2%.

The **French** economy grew by 1.2% in 2015, indicating a clear improvement from developments in previous years. Growth is projected to pick up further over the forecast horizon, driven by private consumption, which in turn is boosted by an increase in households' disposable income, partly on the back of low oil prices. Favourable monetary conditions also support growth. Export growth is projected to be sustained, thanks to the depreciation of the euro, the ongoing improvement in the competitiveness of French industries and the improvement in the economic performance of Southern European countries important for French exports. Fixed capital investment is projected to gradually improve over the coming years. The high ratio of public expenditure to GDP has edged down, but fiscal adjustment is progressing sluggishly. The high unemployment is projected to persist.

In **Italy**, preliminary data suggests that GDP grew by 0.8% in 2015, having previously contracted for three consecutive years. Growth has been based on positive developments in exports and private consumption, but investment also increased in early 2015. Private consumption has been supported by improvements in employment and the resulting very high level of consumer confidence. Italy’s GDP growth rate is projected to be around 1% over the next few years. Downward risks in Italy still relate to the banking system.

Spain's economy grew by 3.2% in 2015. Looking ahead, growth is expected to continue at a strong, albeit slightly decreasing pace. The unemployment ratio has declined to around 21%, having peaked at 27% in early 2013. Economic growth is supported by a significant easing of financing conditions and the improvement in employment. The ongoing growth, in turn, is leading to an improvement in the public finances, such that government indebtedness will edge down after peaking in 2016 (at approximately 100% of GDP).

UK will vote on EU membership

The **UK's** economy grew by 2.2% in 2015, and growth is projected to continue on a favourable path over the forecast horizon 2016–2018. The labour market situation has further improved, the employment rate has already clearly exceeded pre-crisis levels, and private sector confidence has remained strong. Although overall inflation hovered around zero in 2015 on the back of decreasing oil and commodity prices, service price inflation remained above 2% and underlying inflation also edged up during the year. The UK will organise a referendum on its EU membership on 23 June 2016, which is likely to increase uncertainty especially on the financial markets. Despite continued favourable investment developments and a positive outlook for industrial sectors, the biggest downward risks to the UK's economic outlook are exogenous and come from a potential weakening of global economic activity.

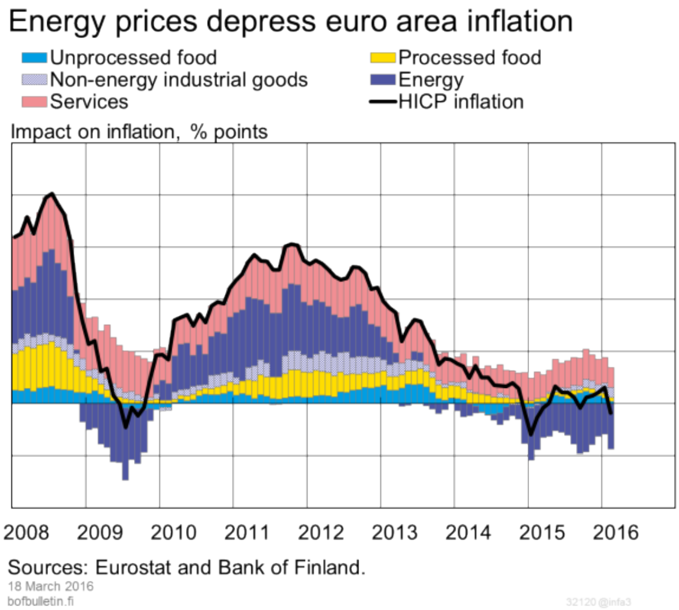
Sweden's economy grew by 4.1% in 2015, exceeding expectations, thanks especially to strong developments in private consumption and housing investment. Sweden's labour market displays positive developments, even if the unemployment rate will not decrease much over the forecast horizon due to recent immigrant inflows. Housing market developments and the related indebtedness remain the biggest risks to economic stability. The increase in house prices and household indebtedness are approaching worrying levels. Without new macroeconomic tools, Sweden's economic imbalance will keep growing, although the introduction of new macroeconomic tools may dampen growth in domestic demand over the short term.

In **Denmark**, the economy grew by 1.2% in 2015. Labour market conditions and real income have continued to develop favourably, strengthening growth in private consumption over the forecast horizon. The biggest downward risk relates to weaker than expected global growth, suggesting slower than expected growth in exports. On the other hand, following a reduction in labour market slack and a protracted deleveraging process, growth in private consumption may well exceed expectations.

Oil prices main cause of sluggish inflation

Inflation developments in EU22 countries (euro area, UK, Sweden and Denmark) have been sluggish. In 2015, the annual average rate of inflation in the euro area was zero, the lowest outcome since the start of Monetary Union. After a dip in January 2015, inflation picked up and was in May nearly one percentage point higher, only to slow down during the summer back to levels close to zero. After standing at –0.1% in September, the rate increased without pause towards the end of the year and stood at 0.3% in January 2016. Inflation was again negative in February (–0.2%). Inflation was also zero in the UK, 0.7% in Sweden and 0.2% in Denmark.

Chart 11.

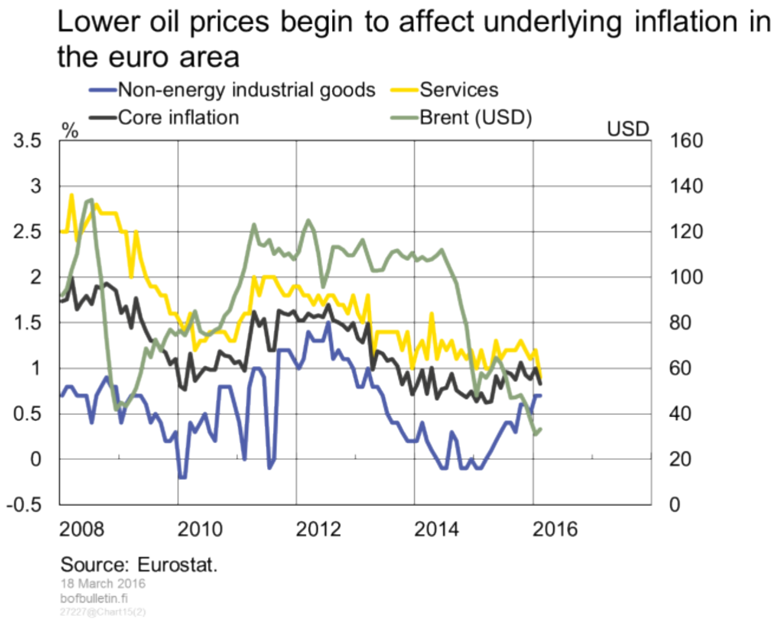


The low inflation rate mainly reflected developments in oil prices, which decreased further in the course of 2015. After a modest recovery during the spring, oil prices in US dollars fell again from USD 65 per barrel to USD 30 per barrel. The lowest prices, USD 28 per barrel, were seen in January 2016, but in the course of February and March oil prices have recovered to levels close to USD 40.

The fall in oil prices has a direct impact on the prices of energy products, which make up some 10% of the consumer price index. However, the impact of changes in oil prices are relative: the lower the oil price, the smaller the impact of a 50% oil price fall on the prices of energy products. In addition, especially for transport fuels, fixed taxes constitute a large share of the price, which dampens the impact on consumer prices. In 2015, energy components pushed down consumer price inflation by 0.7 of a percentage point on average.

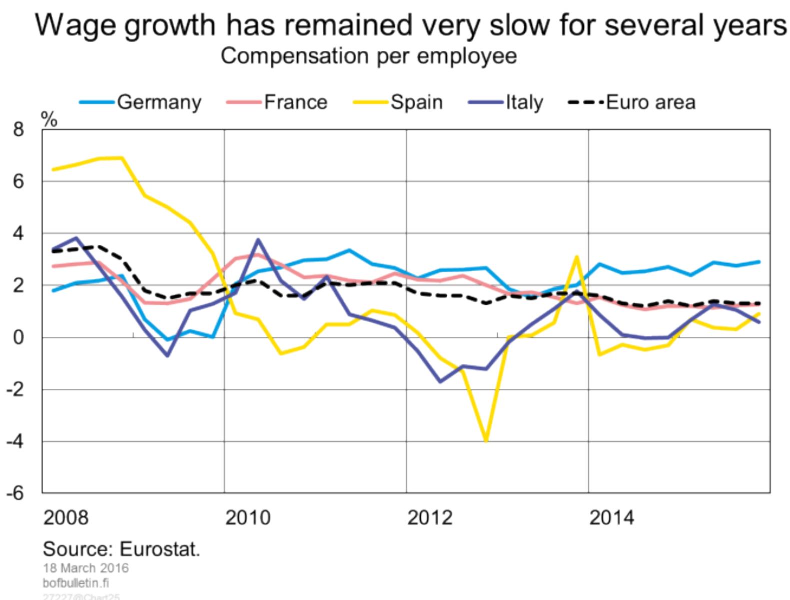
Changes in oil prices also have an indirect but immediate effect on the economy more broadly. Lower energy prices push down production costs and the prices of end products. This impact can be observed in underlying inflation – that is, inflation which excludes the contribution of energy and food prices. Compared with consumer price inflation, underlying inflation has remained more stable in the euro area, standing close to 1% towards the end of 2015. As regards the main components of underlying inflation, services prices have remained almost unchanged despite the fall in oil prices, and the prices of non-energy industrial goods rose markedly in the course of 2015. In February 2016, however, underlying inflation decreased by 0.2 percentage points to 0.7%, which implies that the immediate indirect effects of lower oil prices are starting to be reflected in consumer prices. It should be noted, however, that an observation based on a single month is surrounded by considerable uncertainty.

Chart 12.



More than oil prices, sluggish underlying inflation reflects weak developments in euro area wages. Wage growth has remained very slow for several years in the euro area. Wage inflation has been dampened in particular by developments in Spain and Italy, where adjustment measures have been taken, but wage growth has decelerated in France, too. Among large euro area countries, only Germany has seen somewhat positive wage developments. The deceleration of wage inflation in the euro area in recent years has reflected a weakening of productivity, which constrains possibilities for wage increases.

Chart 13.



The immediate effects of oil price changes are one-off by their very nature. Lower oil prices push down the general price level, but the change has no lasting impact on inflation (as measured by the change in consumer prices over 12 months). Even if oil prices were to remain permanently at current levels of USD 30–40, instead of increasing, the inflation effect of the price fall would disappear after one year.

Therefore, as such, changes in oil prices are not a concern over the price stability-relevant medium term. On the contrary, low oil prices increase consumers' purchasing power and consumption in the euro area, promote economic growth and thereby, ultimately, push up inflation.

However, the fall in oil prices may also have longer-lasting, indirect effects that manifest themselves via inflation expectations.

Oil price developments reflected in inflation expectations

The anchoring of longer-term inflation expectations to the objective of price stability is of paramount importance. As the price of oil crashed towards the end of 2014, inflation expectations also weakened, and longer-term inflation expectations have remained at lower levels. The recent fall in oil prices to around USD 30 has further depressed inflation expectations, and long-term expectations (five-year rate five years ahead) have now reached historic lows. This is worrying, as changes in oil prices should not affect long-term inflation expectations, which rather reflect views on inflation developments over the economic cycle. The weakening of market-based inflation expectations may, however, also result from the fact that spreads on inflation-linked swaps have increased. Survey-based (SPF) long-term inflation expectations have remained broadly stable.

According to the Bank of Finland's forecast, the EU22 inflation rate will be only 0.2% in 2016. Thereafter, inflation is projected to increase to 1.2% in 2017 and reach 1.6% in 2018.

The projected increase in inflation will be dampened by the (gradually waning) impact of oil price developments. Oil prices are estimated to have nearly bottomed out and, on the basis of futures prices, they should start slowly increasing. The increase in inflation will remain moderate over the entire forecast horizon, as EU22 countries still experience a clearly negative output gap which, according to IMF calculations, will close only slowly. Moreover, wage developments and the short-term outlook for wages are both moderate.

The pick-up in inflation will be further supported by the sustained accommodative monetary policy stance and the resulting low exchange rate for the euro. Moreover, the downward trend in EU22 countries' unemployment rates continues, and the capacity utilisation rate has gradually increased.

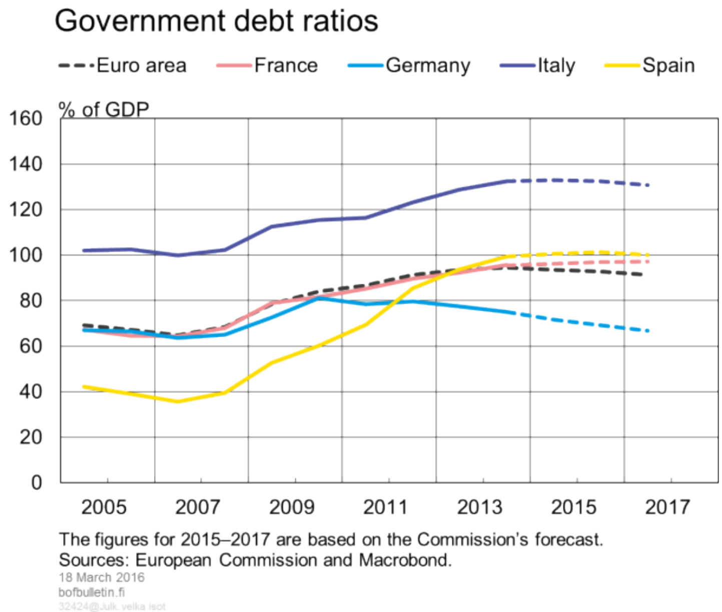
Refugee crisis – a question mark for fiscal policy

The financial crisis resulted in a sharp increase in euro area government deficits. Thereafter, fiscal balances have gradually improved as a result of discretionary fiscal measures and improved cyclical conditions. In 2015, the euro area government debt ratio decreased for the first time since 2007.

The overall general government deficit is projected to decrease in 2016 and stand at levels close to 2% of GDP. This rather favourable trend is likely to continue also in the next few years, and the deficit ratio is projected to decline to around 1% in 2018. There are, however, significant differences between countries.

Among large euro area countries, Germany's and Italy's debt ratios will improve in 2016, whereas Spain will not see an improvement before 2017. In France, the debt ratio keeps increasing, albeit very slowly. These forecasts are, however, very uncertain, in particular for countries with slow growth and a high debt ratio.

Chart 14.



The state of, and outlook for, the public finances are affected by the prevailing level of interest rates, cyclical conditions and discretionary fiscal measures.

Interest payments on government debt are decreasing, as countries can substitute maturing debt securities with new debt securities with lower yields. During the turbulence of the sovereign debt crisis, some euro area countries were obliged to issue debt securities with sometimes very high yields.

The general government primary balance will improve mainly on the back of favourable cyclical conditions. In previous years, the euro area general government primary balance improved following fiscal consolidation measures. Although expense cuts are still being introduced, in some euro area countries they are being counterbalanced by a partial repealing of past tax increases. Despite the fact that many euro area countries are still far from reaching the 60% of GDP threshold for government debt ratios, as required by the Stability and Growth Pact, a clear easing of fiscal policies from previous years' levels has taken place since 2015. Certain countries are seeking to move from adjustment towards growth and employment-enhancing structural reforms which can, to some extent, be used to replace adjustment measures in accordance with the fiscal policy rules for the euro area.

Euro area fiscal policies are also being eased by the increase in public expenditure resulting from the refugee crisis. According to IMF estimates[3], however, this impact will be relatively small at the EU level in 2016 (some 0.1% of GDP). In individual countries, the impact may be far more pronounced. In Germany, for example, the IMF estimates it to be around 0.3% of GDP. However, these estimates are surrounded by a significant degree of uncertainty.

In order to enhance implementation of the fiscal policy rules, and as suggested by President of the Commission, Jean-Claude Juncker in his Five Presidents' Report on the development of EMU, the European Commission decided in October 2015 to establish an independent advisory body, the European Fiscal Board (EFB)[4]. It is meant to become fully operational in the course of 2016. This new body is tasked with assessing implementation of the fiscal policy rules, especially its consistency, as well as serious cases of infringement and the appropriateness of fiscal policy stances. The European Fiscal Board is also meant to cooperate with national fiscal councils.

Balance sheet resilience under test

Euro area faces both external and internal risks

The most important external risk facing the euro area relates to a broad-based strong slowdown of the global economy, which would dampen both growth and inflation in the euro area. Such a development could be triggered if strong adverse effects resulting from the sharp decline in oil prices were to be compounded with an abrupt standstill of growth in China. The sharp and protracted fall in oil prices has deeply distressed countries, such as Russia, which are dependent on oil production. The concern is that more countries end up in a similar situation, which would also be conducive to greater political uncertainty. Moreover, several companies whose business relies on oil and other commodities are struggling to service their debt, and some have already gone bankrupt.

The situation is aggravated by the high level of USD-denominated private sector debt in several emerging economies. In countries whose currencies have depreciated, exports in commodities generate more income in the domestic currency. At the same time, however, the value in the domestic currency of foreign-denominated debt increases as the currency depreciates. A crisis in countries with high levels of foreign-denominated debt and heavy reliance on the production of commodities might have unforeseen consequences.

The risk is that the protracted fall in oil prices and the sharp slowdown of the global economy will have nonlinear effects, as the balance sheets of highly indebted economies can no longer bear the ever-weakening situation. In several countries the high levels of public and private sector indebtedness already mean that balance sheets cannot withstand a heavy shock. Once the buffers have been exhausted, the consequences may be greater than expected. In such a situation, the adverse effects on economic growth and inflation could be broad-based and surprisingly heavy, in which case even financial

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3. See https://www.imf.org/external/pubs/ft/sdn/2016/sdn1602.pdf.
4. See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015D1937.

stability could be jeopardised. In a worst-case scenario, this could mean a 'third wave' of financial crisis.

Unresolved problems may halt recovery

The recovery in the euro area economy is still fragile. Public sector indebtedness remains considerable, and in some countries the banking sector struggles to cope with the high level of non-performing loans. Greece's financial problems persist, and economic activity remains very sluggish also in Portugal and Italy.

At the beginning of 2016, the financial markets became increasingly concerned about the state of the banking sector. Attention was focused, in particular, on a few large banks which had reported heavy losses. In Europe, the strong reactions were partly explained by the new bail-in rules which had entered into force at the beginning of the year. As the rules increase creditor involvement, investors may be more prone to react when problems are revealed. However, the fall in bank share prices was broad-based across regions and different types of banks.

Despite improvements in many respects, the protracted nature of the crisis is visible in a number of ways: the growth outlook is dampened by persistently sluggish capital investment and high levels of long-term and youth unemployment. Several countries have seen changes in their government, which gives rise to concerns about a receding pace of reform and backward steps on the necessary adjustment path. Hence, the euro area crisis is not yet fully over, and an escalation in the situation could halt euro area recovery. Political uncertainty in Europe is also compounded by the upcoming referendum, to be held on 23 June, on the UK's membership of the EU. An exit of the UK from the EU would have adverse consequences for the whole of Europe.

The refugee crisis represents a new shock to the fragile situation of the euro area and could, at worst, jeopardise the area's recovery, should the scope and adverse effects of the crisis increase. Already now, the number of refugees Europe has had to cope with has been a shock, and its effects are surrounded by a high degree of uncertainty.

To ensure successful reception and integration of refugees and positive long-term effects, the number of arrivals should be reasonable and evenly shared among EU countries. Under such circumstances, the resulting pick-up in public spending would create a positive impact on growth over the short-term and the increase in the working-age population would impact growth positively over the long term.

If refugee inflows continue to be unevenly shared and focused on certain countries which already consider the situation to be challenging, sentiment may deteriorate, with unforeseen consequences. Sentiment is being affected, among others, by side-effects of the refugee situation, such as human trafficking and fears of terrorism. If the refugee crisis were to escalate and lead to a suspension of the functioning of the Schengen area and to ever greater restrictions on free movement across borders, the result would be an increase in growth-hampering uncertainty. A strong increase in the number of refugees, combined with an uneven allocation of refugees or a tighter closure of borders, would increase uncertainty regarding the EU's future. The attractiveness of Europe as a place to invest will decrease if common solutions cannot be found to common problems.

Tags

- economic growth
- global economy
- inflation
- monetary policy

FORECAST FOR THE GLOBAL ECONOMY

Difficulties in emerging economies weigh on global growth

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

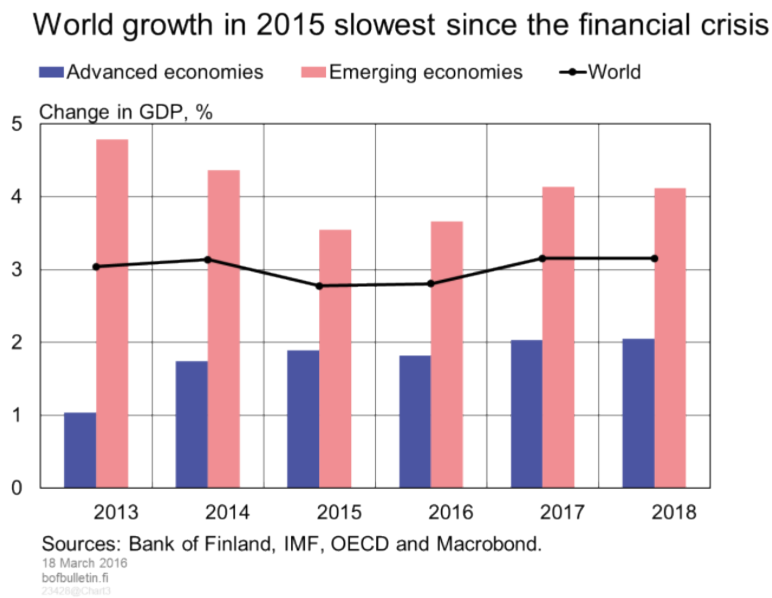
The Bank of Finland forecasts a global growth rate of 2.8% in 2016, rising only slightly to 3.2% in 2017–2018. The growth pick-up reflects a recovery of the emerging economies suffering from the recession. World trade growth in the forecast period will be close to world GDP growth.The forecasts for the United States and the EU22 are more moderate than previously, but growth should still exceed the estimated potential growth rate. The growth forecast for China in 2016–2017 remains at 6%, from which it is expected to slow to 5% in 2018.

2015 a good year for advanced economies

2015 was a good year for the advanced economies. In the United States, GDP growth slightly exceeded estimates of the growth rate of potential output. Employment increased and unemployment fell to around 5%. However, exports and private fixed investment increased only modestly.

For the euro area, 2015 was definitely strong. The area's GDP improvement exceeded estimates of potential growth by more than in the United States. Euro area growth was based on domestic demand, in particular. The unemployment rate declined by one percentage point, but is still over 10%. Investment growth also remained subdued in the euro area.

Chart 1.



The deceleration of world growth was due to difficulties in the emerging economies. Accordingly, the year 2015 was marked by concerns about the Chinese economy. While global economic growth has slowed as expected, it is structural changes in the economy and high debt levels resulting from expansionary policies following the financial crisis that are adding to the uncertainty. The Russian and Brazilian economies have slipped into deep recession. Of the BRICS (Brazil, Russia, India, China, South Africa) countries, which were the growth miracles at the beginning of the new millennium, only India's prospects have not deteriorated.

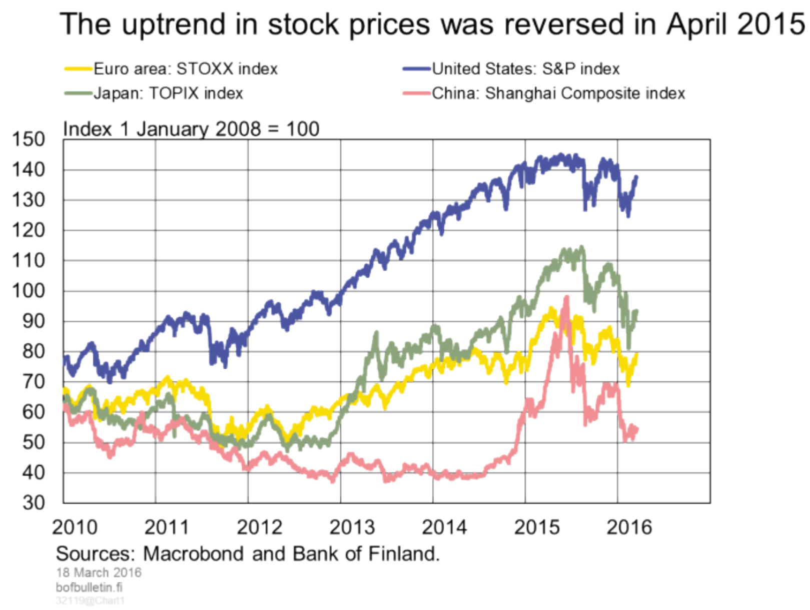
Growth in the United States, the euro area and China has been driven by the domestic markets. While consumption and services developed favourably, industrial production and investment were lacklustre. Against a backdrop of subdued industrial production, world trade growth remained exceptionally sluggish.

The weakness of world trade and the emerging economies is due partly to the price of oil, which has plunged twice since mid-2014. This is attributable to both demand and supply factors. Slower world growth and more efficient overall use of energy have reduced the demand for oil, while supplies have remained abundant.

Although there have been cutbacks in investment, the impact on oil production will take some time. In the United States, shale oil production has been surprisingly resilient to the low oil prices, and the removal of economic sanctions on Iran is increasingly boosting oil supplies on the world market.

Financial market uncertainties have also had an impact on oil price movements: daily fluctuations have been so large that they cannot be explained solely by changes in expected demand or supply. Some factors are pushing in the opposite direction. The liabilities of energy sector companies are the assets of financial sector companies.

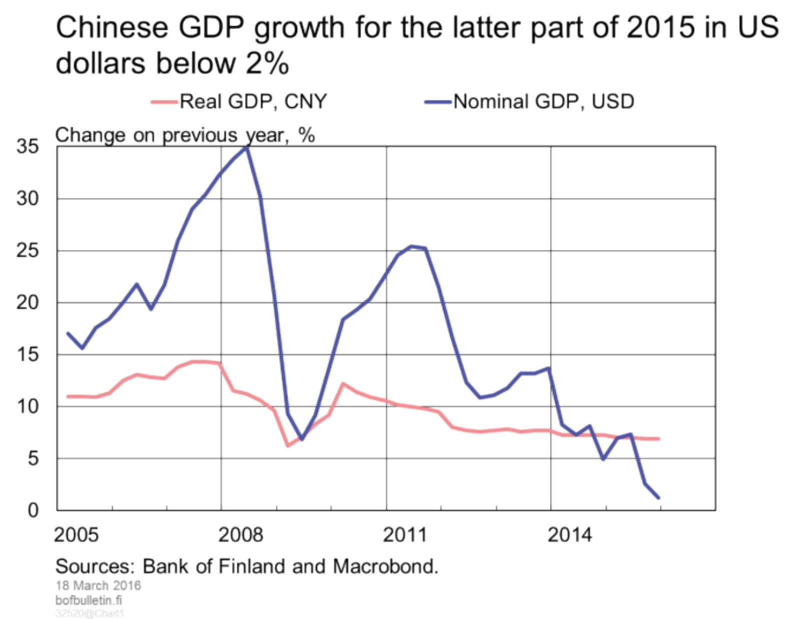
Chart 2.



Financial market valuations peaked in spring 2015 and by late April were trending downward. Stock prices reflect expectations of future growth and interest rates.

Growth forecasts for the world economy have already remained below previous projections for several years, and the secular stagnation thesis is now a hot topic of discussion. If a low level of interest rates mirrors expectations of accommodative monetary policy, stock prices should respond positively to further monetary stimulus; but if it is a reflection of secular stagnation, stock prices are likely to decline.

Chart 3.

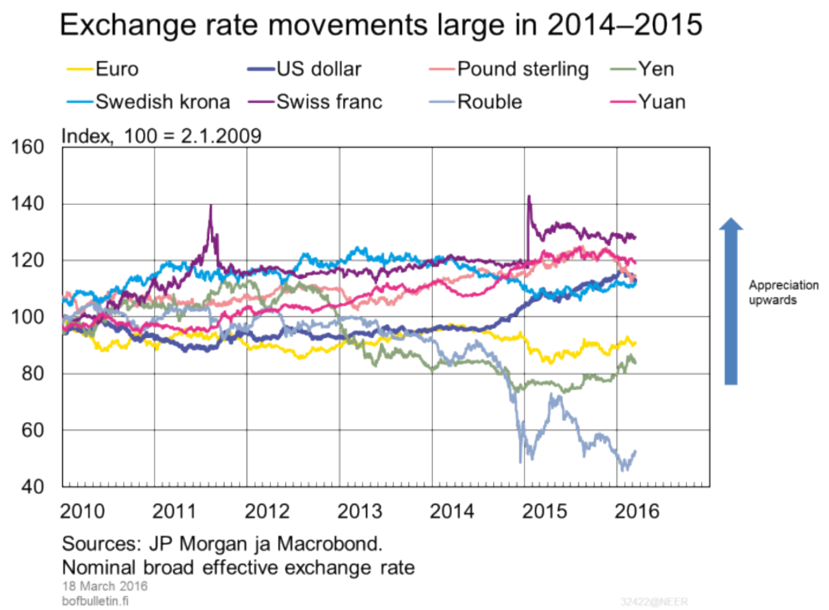


In August 2015, there was a stock market correction, which was seen to derive from uncertainty about the Chinese econonomy. Another correction occurred in January 2016. Although China's real GDP in yuan terms grew at an annual rate of just under 7% in the latter half of 2015, the growth rate as measured in current US dollar terms was just under 2%. One year earlier, these two growth figures were virtually equal. The main currency on international financial markets is the US dollar, which helps explain strong reactions in international markets to the Chinese situation since summer 2015.

The outlook for monetary policy is polarised: The US Federal Reserve made its first interest rate hike in December 2015, whereas the euro area and Japan increased the level of accommodation. Inflation is muted in all the main economic regions. The price of oil has a large impact on short-term changes. However, underlying inflation (which excludes the impact of energy prices) is also subdued. In the wake of the financial crisis, it is increasingly difficult to estimate the size of the output gap and its effect on the tightness of the labour market and wage inflation. China's low inflation environment is also a reflection of over-supply and production restructuring.

Trade-weighted exchange rates in the main economic regions have undergone wide fluctuations in recent years. However, the strengthening of the US dollar and the Chinese yuan has subsided at least for the time being.

Chart 4.



Growth and trade will remain sluggish

The Bank of Finland foresees global growth continuing at a rate of around 3% throughout the forecast period 2016–2018. Growth forecasts for the United States and the EU22 are more moderate than previously.

The situation for net exporters of oil and several other emerging economies is currently difficult. The pick-up in growth mainly reflects a recovery of economies now suffering from recession.

Table 1.

World trade growth held back by srtuctural factors

% change on previous year

(below previous forecast in brackets)

GDP	**2015**	**2016f**	**2017f**	**2018f**
United States	2.4	2.2	2.3	2.2
	(2.6)	*(3.0)*	*(2.8)*	
EU22	1.5	1.4	1.7	1.7
	(1.7)	*(1.8)*	*(1.9)*	
Japan	0.5	0.4	0.7	1.2
	(0.6)	*(1.1)*	*(1.0)*	
China	7	6	6	5
	(7)	*(6)*	*(6)*	
Russia	–4	–3	0	1
	(–4)	*(–2)*	*(1)*	
World	*2.8*	*2.8*	*3.2*	*3.2*
	(3.0)	*(3.2)*	*(3.5)*	
World trade	1.4	2.7	3.8	4.0
	(1.8)	*(3.7)*	*(4.5)*	

f = forecast

EU22 = Euro area, Sweden, Denmark and the UK.

Source: Bank of Finland.

World trade growth is being held back by a number of more permanent structural factors (see 'Why has world trade slowed?'). The most important of these is the change in

China's growth model, which entails a decline in its propensity to import. World trade growth in the forecast period will thus remain close to world GDP growth.

Table 2.

The impact of the oil price broadly reflected in the inflation outlook

% change on previous year

(below previous forecast in brackets)

Inflation	2015	2016f	2017f	2018f
EU22	0	0.2	1.2	1.6
	(0)	(1.1)	(1.7)	
United States	0.1	1	2.3	2.2
	(0.2)	(1.6)	(2)	
Japan	0.8	0.2	1.5	1.4
	(0.4)	(1.1)	(1.6)	

f = forecast

EU22 = Euro area, the UK, Sweden and Denmark.

Sources: National statistical authorities and calculations by the Bank of Finland.

In the EU22, private consumption set to expand

In the next few years, economic growth in the EU22 (euro area, UK, Sweden and Denmark) will depend mainly on private consumption. Investment growth will only slowly gain momentum.The export outlook is clouded by weakening growth prospects for the emerging economies and for world trade. The low oil price and monetary policy will support growth and fiscal policies will also be mildly expansionary.

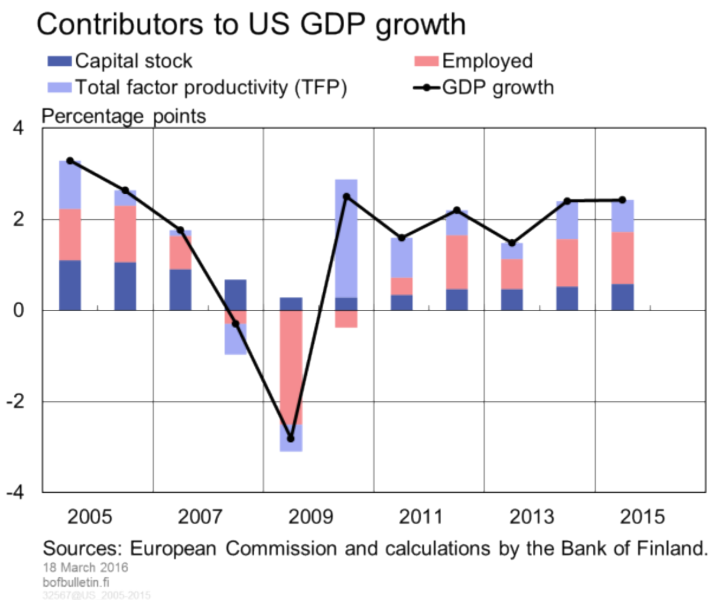
In the euro area, the problmes of private sector debt-servicing, which has been a barrier to domestic demand growth; fiscal tightening; and weakness in the labour markets are all easing. With the low price of oil underpinning real earnings growth, the employment situation continuing its slow recovery, and financial conditions remaining favourable, private consumption will continue to strengthen throughout the forecast period. Investment growth will not begin to regain strength until the latter part of the period.

An acceleration of inflation in the EU22 during the forecast period 2016–2018 will be supported by a halting of the fall in oil prices, the ongoing accommodative stance of monetary policy, and the narrowing of the output gap. Unemployment will continue to decrease, and the capacity utilisation rate will rise gradually. The risks to the forecast are on the downside. (See 'Why can't Finland keep up with its peers?')

The US economy subject to both upside and downside risks

The Bank of Finland's revised forecast sees a lower US growth rate. This is due to a slowing of international trade growth, the downward impact of the already stronger dollar on export competitiveness, and continued lacklustre growth of private fixed investment. During the forecast period, economic growth will be close to potential output growth.

Chart 5.



The main driving force of the US economy during the forecast period will continue to be private consumption, bolstered by good employment dynamics. Developments in disposable real income will also be buttressed by moderate inflation and particularly by low fuel prices.

Industries' confidence in the United States weakened in 2015. This is largely ascribable to the challenging situation in the oil sector. Against a backdrop of modest perspectives in industry, expansion in private fixed investment has receded. In contrast, residential investment has posted a robust performance.

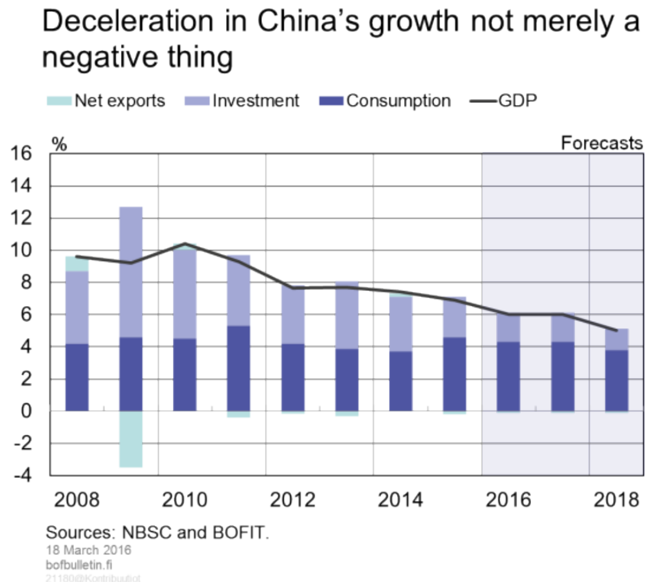
US fiscal policy is predicted to be somewhat more expansionary, especially in 2016, than in the previous years.

China’s growth model changing

In accordance with the previous Bank of Finland forecast, Chinese growth is projected to slow to around 6% in 2016 and 2017. In 2018, growth will continue to decline, to about 5%.

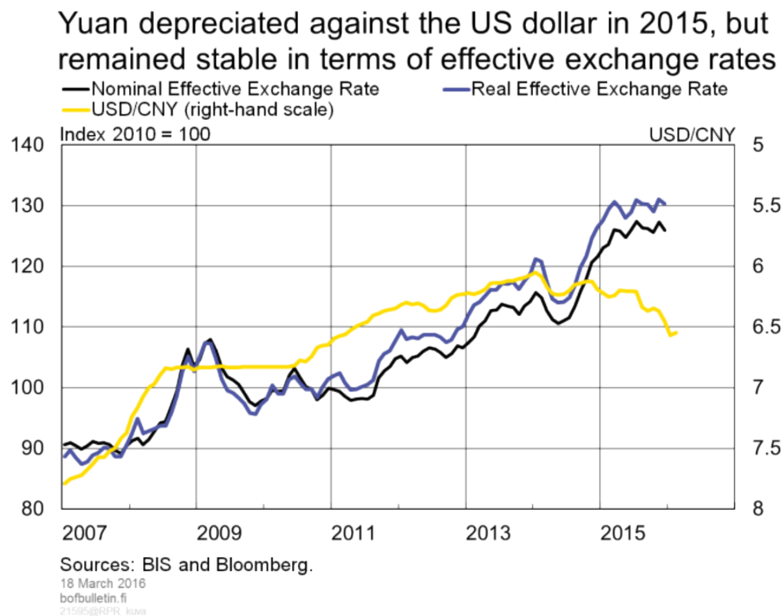
The envisaged deceleration in growth is not merely a negative thing. The Chinese economy has become so large that the rate of growth must inevitably subside. At the same time, the country’s growth model is being transformed by economic reforms and structural changes. In 2015, the service sector already comprised more than half of the economy. With investment growth slowing and heavy industry suffering from weak demand and considerable overcapacity, the service sector and domestic consumption will assume expanding roles as drivers of growth.

Chart 6.



The biggest risk is the inability to keep the rapid debt build-up in check. China’s debt ratio (excl. financial sector debt) has already risen to approximately 250% of GDP, which is exceptionally high compared with that of countries with corresponding earnings levels. As problems accumulate, there is another risk that well-intended reforms will remain on the back burner. (See ‘Rising indebtedness increases risks in China’)

Chart 7.



The rise in consumer prices has remained at about 2%, but producer prices have fallen for four years. Negative price developments in industry are also mirrored in the evolution of the GDP deflator, which also turned negative in 2015. Although, based on price developments, there would be room for monetary stimulus, expansion in domestic debt levels and pressures related to currency depreciation and accelerating capital outflows are holding back any extensive stimulus.

In Japan, growth still anaemic and inflation low

Japanese economic growth is projected to be close to ½% in the current year. Going forward, growth will pick up to about 1%, i.e. close to its potential growth rate. Active monetary policy and the resultant persistently weak yen will give traction to exports in the near term. The low price of oil will benefit consumers, thereby stimulating private consumption.

The labour market is tight. In 2015, slight pay increases were already discernible, and wage negotiations suggest that further rises can be expected. The corporate tax cut and record corporate results in recent years are boosting the appetite for investment. However, given that structural reforms are still pending, the growth outlook for the immediate years ahead remains muted.

Despite monetary policy measures, the inflation rate has been low. The Bank of Finland foresees inflation in Japan remaining around zero in 2016. Looking ahead, inflation will pick up to around 1½%. Fiscal consolidation is projected to continue, but at a slower pace than in previous years. (See 'Abenomics: three years – a big ship turns slowly')

The Russian economy will continue to deteriorate substantially in 2016

In 2015, Russia saw all domestic demand components contract, and there are no clear signs of an end to the declines. The surge of inflation in winter 2014–2015 brought prices in 2015 up to a level over 15% higher than in 2014. This depressed private consumption which, in particular, decreased by a tenth (by more than in the 2009 slump).

According to the Bank of Finland autumn 2015 forecast, the sharp drop in the price of oil in the latter half of 2014 will continue to cause a contraction of Russian GDP as late as 2016. Now that the oil price is assumed to be significantly lower in 2016 than in 2015, the estimate of GDP contraction has been revised to approximately 3% and GDP is envisaged to remain unchanged in 2017. Imports may decline by about 10% in 2016 and remain flat in 2017.

The mild rise in the oil price will gradually push the Russian economy onto an upward trajectory in 2018, which will cause imports to recover little by little. However, growth will be tepid, as long-term GDP growth estimates are largely within a range of 1–1.5% p.a.

The risks to the forecast are still high. Potential deviations of the oil price from its assumed path would naturally affect the economy and the rouble, inflation and imports. Geopolitical tensions may change. Despite objectives for cuts in government expenditure, public spending increases cannot be ruled out with the approach of Duma elections in September 2016 and presidential elections in March 2018. (See 'Russia's economy and imports to contract further')

Tags

- global economy
- gross domestic product
- inflation
- forecast

Why is Finland trailing its peers?

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK • PETRI MÄKI-FRÄNTI, LAURI VILMI

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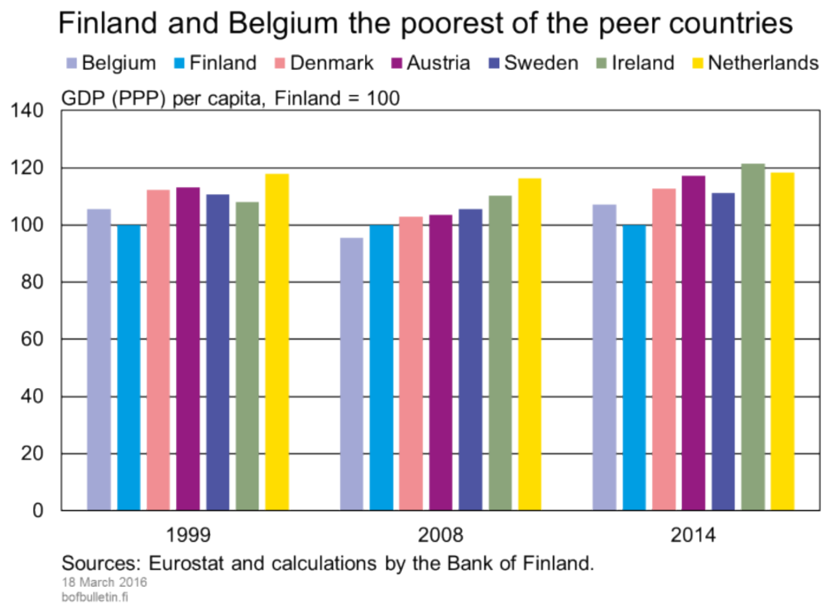
  Senior Economist
- Lauri Vilmi
  Senior Economist

In Finland, economic growth has been weak since the onset of the financial crisis. According to the most recent forecast by the European Commission, GDP growth in Finland is expected to remain among the slowest in the euro area in the coming years – alongside Greece. The factors underlying the subdued development in GDP can be examined by comparing Finland with other small EU countries, i.e. the Netherlands, Belgium, Ireland, Austria, Sweden and Denmark. These countries constitute a meaningful peer group because they are relatively open economies with a similar degree of development.

The late 1990s saw Finland recover rapidly from the recession of the early part of the decade, led by the Nokia-driven ICT industry. But, in 1999, the standard of living in Finland, measured by purchasing-power-parity-adjusted GDP per capita (GDP (PPP) per capita), was still the lowest among our group of peer countries (Chart 1).

In the first years of the new millennium, the Finnish economy however continued to grow at a brisk pace, and of the peer countries, only in Ireland was economic growth significantly stronger than in Finland. Also in terms of standard of living, Finland caught up somewhat with its peers, and overtook Belgium.

Chart 1.



Following the recent financial crisis, the steepest decline in GDP in 2009 was witnessed in Finland; however, the impact of the crisis was of a similar scale in Sweden, Denmark and Ireland. Recovery from the recession has nevertheless been divergent. In Finland, the Netherlands and Denmark, GDP per capita began to decline again significantly after 2011, and, in Finland, the decline was still continuing in 2014. In contrast, Ireland seems to be returning to its pre-recession growth path. Moreover, Finland's catch-up with the standard of living of its peers has halted. The standard of living in Finland, measured by purchasing-power-parity-adjusted GDP per capita, is again clearly the weakest in the peer group.

Consumption's share of aggregate demand has increased

The recession in the Finnish economy is above all related to the collapse of the export sector. In 2007, the structure of the Finnish economy was similar to that of its peers (Chart 2). At that time, private and public consumption accounted for around 70% of Finnish aggregate demand, whereas the share of net exports and investment was just under a third.

Reflecting the protracted weak performance of the economy and sector-specific difficulties, the share of net exports has decreased, as a result of which economic growth has in recent years depended mainly on private consumption. The GDP share of private consumption has, in Finland, increased from the pre-financial-crisis level of below 50%, to over 55% of GDP, i.e. the highest share in the peer group. In several other peer countries the share has remained stable, at clearly below 50% of GDP.[1] In Sweden, for example, the GDP share of private consumption is only about 45%. Nevertheless, the

1. The share of private consumption is typically even higher in many emerging countries and large developed economies, such as the United Kingdom and the United States.

rapid expansion in domestic demand largely explains the higher GDP growth rate in Sweden compared with Finland in recent years. In addition to private demand, net exports also continue to make a significant positive contribution to GDP growth in Sweden.

Chart 2.

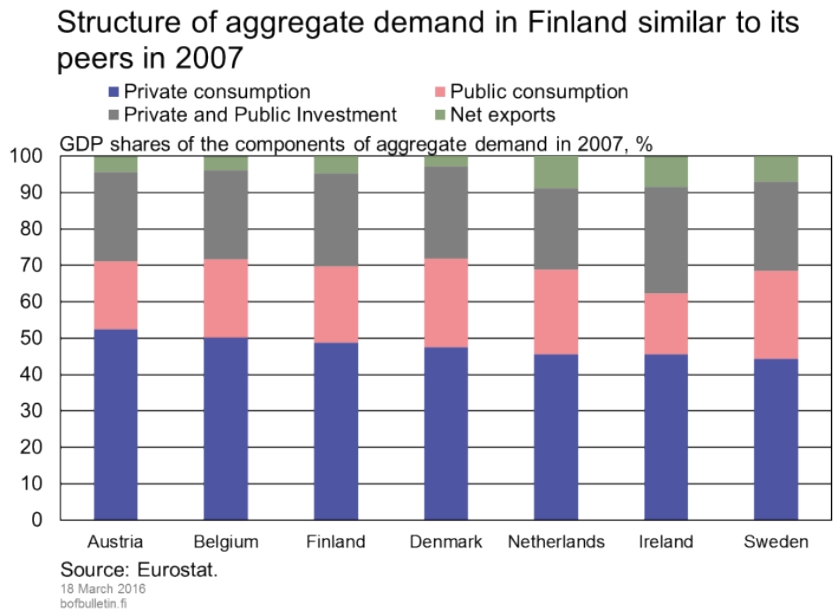
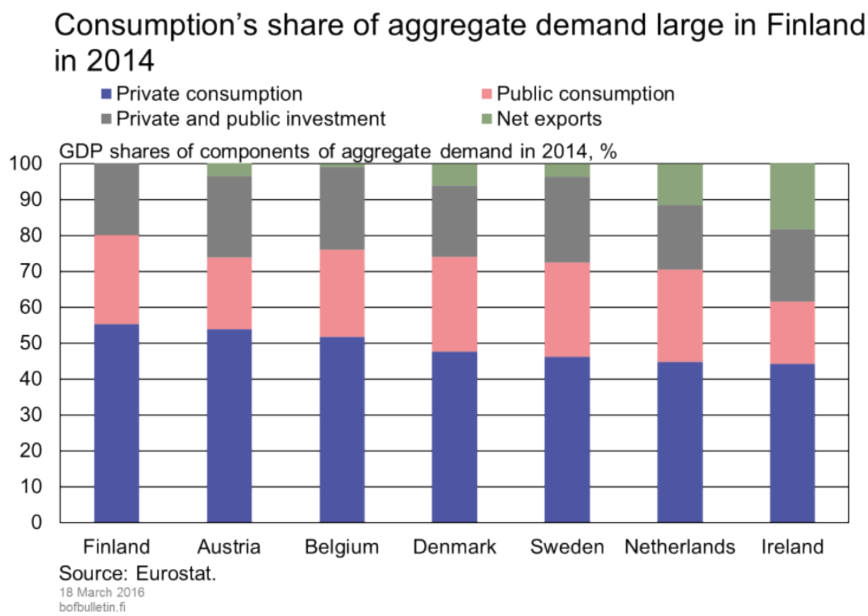


Chart 3.



In Finland, fixed investment has not tracked growth in consumption. In recent years, the volume of fixed investment has been modest in advanced economies,[2] but the rate in

2. Hukkinen et al. (2015) Mistä investointien vaimeus johtuu? (What explains the sluggishness of investment?) Analysis article, in Finnish only. Eurojatalous.fi website.

Finland has been even weaker than its peers. In addition, Finland has not attracted foreign direct investment.[3]

In Finland, disposable household income has grown at a slower pace than consumption. The gross savings ratio for the economy as a whole has fallen from 25% to the lowest level in the group, i.e. below 20%. Due to the low savings ratio, Finnish households' debt-to-disposable income ratio increased in 1999–2015, from 65% to around 125%. Yet in 2014, only Belgium and Austria had lower household debt-to-income ratios than Finland. In the peer group, the households with the highest debt ratios are to be found in Denmark, the Netherlands and Ireland, with ratios above 200% of disposable income. Indebtedness has, however, decreased in these countries since the financial crisis.

Both private and public consumption have been supported by the accumulation of public debt. Finland's cyclically adjusted deficit is currently at the average level for the peer group, but over the period 2007–2014 it weakened most in Finland. Due to the protracted period of central and local government deficit, Finland's public debt-to-GDP ratio increased nearly 1.5 times in 1999–2014. The debt ratio is however still reasonable, particularly compared with Ireland and Belgium, where the level of public debt exceeds annual GDP.

The current account describes the rate of debt build-up for the economy as a whole. During the recession, Finland's sizeable current account surplus turned into a deficit, and now it is broadly in balance. However, risks relating to the pick-up in the growth of external debt and the sustainability of the public finances limit the possibilities to revive the economy via demand stimulation.[4] For all comparison countries, the surplus is larger than in Finland. In Ireland, too, the deficit recorded in the crisis years has turned into a surplus of approximately 3%. Finland's current account is depressed not only by the services account, which is weakest in the comparison, but also by the balance of trade (0%), which is among the weakest in the group, along with that of Austria and Belgium.

Finland's export problems are largely sector-specific. In addition to difficulties in the ICT and forest industries, exports have been dampened by problems in the shipbuilding industry and the sluggishness of trade with Russia. If these problem sectors are not taken into account, the volume of Finnish exports grew in 2007–2014 by over 5%, which is not significantly slower than export growth in the peer countries. For example, Sweden's goods exports have recorded a slower pace of growth. The sectors facing difficulties however account for a significant share of Finnish exports.

Finland a more closed economy than its peers

The success of the ICT industry and the rapid rate of global economic growth in the first post-millennium decade masked a group of structural problems in Finnish exports. These problems hamper the adjustment of the export industry to sector-specific changes.

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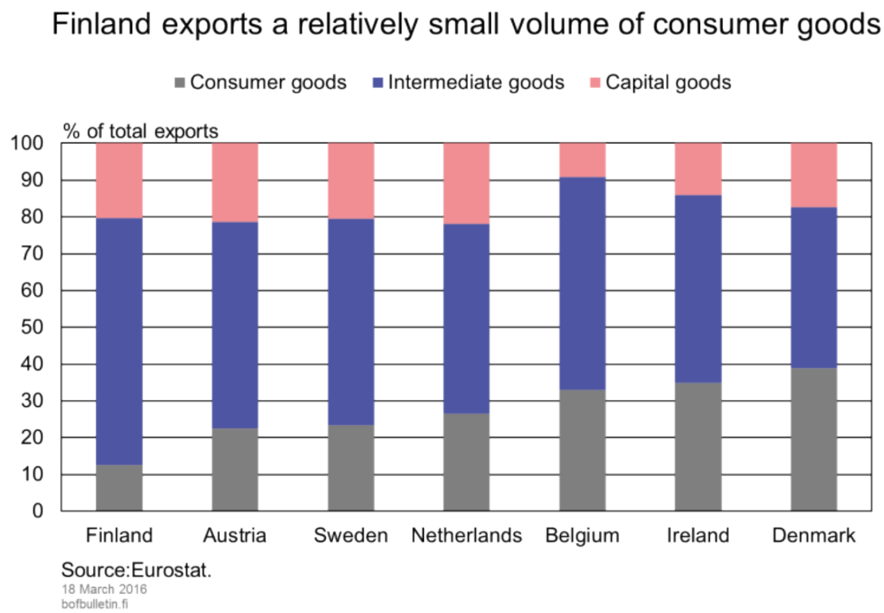
3. Leino (2015) Suomi jäänyt muista Pohjoismaista ulkomaisissa investoinneissa. (Finland lagging behind the other Nordic countries in foreign investment) Analysis article, in Finnish only. Eurojatalous.fi website.
4. The corporate sector has in recent years been the only sector in the Finnish economy that has posted a financial surplus. Without the corporate sector surplus, the pace of debt accumulation in the Finnish economy would be significantly higher. See e.g. Bank of Finland Bulletin 5/2015.

Finland is a more closed economy than its peers: the ratio of combined exports and imports to GDP is below 80%, whereas in e.g. Ireland, it is significantly above 100%. Of the other peer countries, also Sweden is a more closed economy, but the ratio is nearly ten percentage points higher than in Finland. In Belgium and the Netherlands, the openness of the economy is partly explained by the large commercial ports.

The small volume of Finnish exports is mainly due to the smaller volumes of exports to the EU's internal market. For example, the volume of Sweden's goods exports to the EU, relative to GDP, is more than one percentage point higher than Finland's. Compared to the other countries, the difference is even more pronounced. In contrast, in terms of the volume of extra-EU foreign trade, Finland does not seem to lag significantly behind its peers.

A sector-specific examination shows that Finland exports relatively large volumes of intermediate goods, such as metal and forest industry products, whereas in the large consumer goods items and particularly in the manufacture of food products, basic pharmaceutical products, motor vehicles and small electronic products, export volumes are low (Chart 4). The low volume of consumer goods exports increases Finland's vulnerability to global cyclical fluctuations because the demand for capital goods reacts more strongly to global business cycle fluctuations.

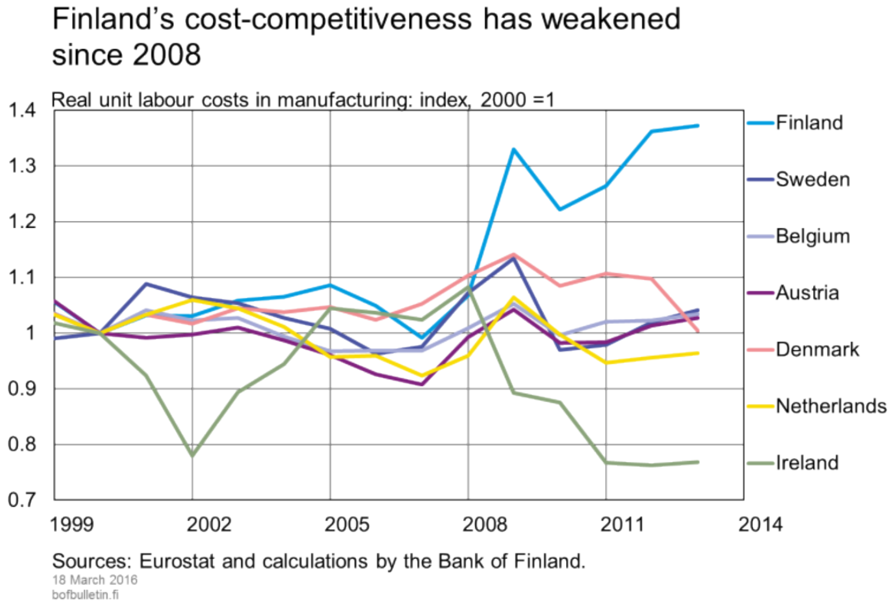
Chart 4.



The creation of new possibilities for exports may have been hampered by the fact that in Finland labour costs have outpaced productivity growth since 2008. This is reflected e.g. in the weakening of manufacturing competitiveness relative to the peer countries (Chart 5). In Finland, the weakening of productivity in the manufacturing sector is partly due to the aforementioned problems in the export industries, but at the same time, wage growth has remained strong. This may have slowed the creation of new jobs in manufacturing and also in other sectors of high productivity growth. During the recession, employment growth has been strongest in public services, where productivity developments are typically very weak. Opposing developments in unit labour costs have been witnessed in

Ireland where sluggish growth in wages since the economic crisis has been accompanied by strong improvements in productivity. In Ireland, productivity has been supported particularly by the creation of new jobs in high-productivity international companies.

Chart 5.



Potential output has weakened in Finland at a faster pace than in the peer countries

In examining differences between the peer countries in terms of long-term economic developments, it is of key importance to analyse the supply-side factors, i.e. differences in the available labour force, the tangible and intangible capital stock, and particularly in labour productivity. The longer-than-expected recession, the slow pace of structural changes in manufacturing as well as further accumulation of public debt have weakened Finland's growth potential in terms of all the growth factors. According to a Bank of Finland estimate in 2015, GDP per capita should grow by 0.5–1.0% per annum in 2015–2035.[5] Corresponding rates of other Finnish economic forecasters are between 0.7 and 1.6%.

Population ageing most rapidly in Finland

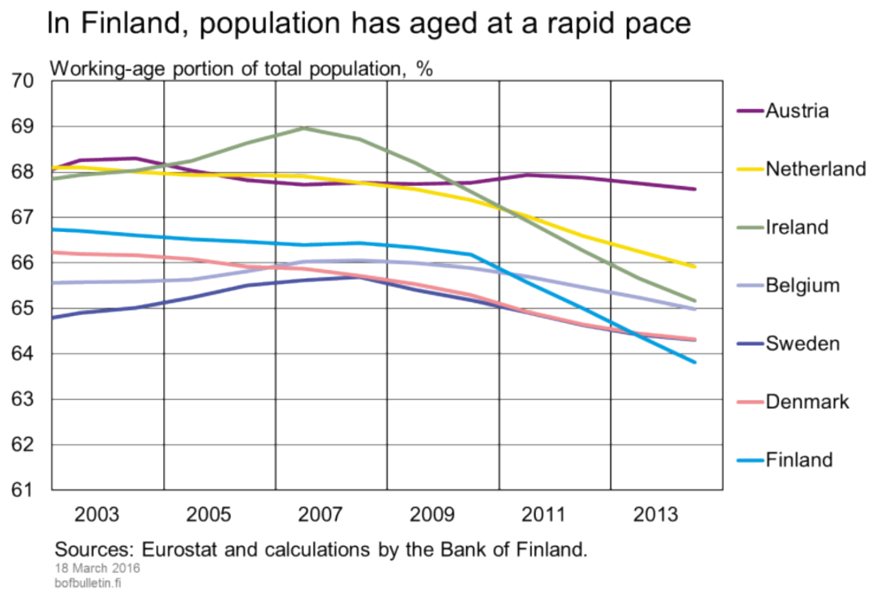
The developments in the potential labour force in Finland and its peer countries will depend in the near future mainly on population ageing. The size of the working-age population (15–64-year-olds) will shrink due to, in particular, the retirement of the baby-boomers, which has commenced at a slightly faster pace in Finland than in the peer countries. This partly reflects the relatively low retirement age of the male population. The average effective retirement age in Finland in 2009–2014 was 61.9 years, whereas

5. See Mäki-Fränti, P (2015) Rakenteelliset tekijät hidastavat pitkän aikavälin talouskasvua (Structural factors dampen long-term economic growth). The Finnish Economic Journal 111, 3/2015, p. 306–311 (in Finnish only).

the average for the whole peer group was a year higher. The retirement age of Finnish women, 62.3 years, is a year higher than the average (61.6 years).

The most rapid contraction in the size of the working-age population has in recent years been witnessed in Ireland, where the shrinking of the working-age population reflects not only ageing but also emigration during the financial crisis and the recession. In Finland, the population is ageing at a rapid pace (Chart 6). Between the start of the millennium and the year 2010, the proportion of the working-age population of the total population in Finland (just under 67%) was still close to the average in the peer group and higher than e.g. in Sweden and Denmark. As a result of the rapid pace of retirement of the baby-boomers since the turn of the decade, the proportion of the working-age population in Finland has decreased to ca 64%, the lowest in the peer group.

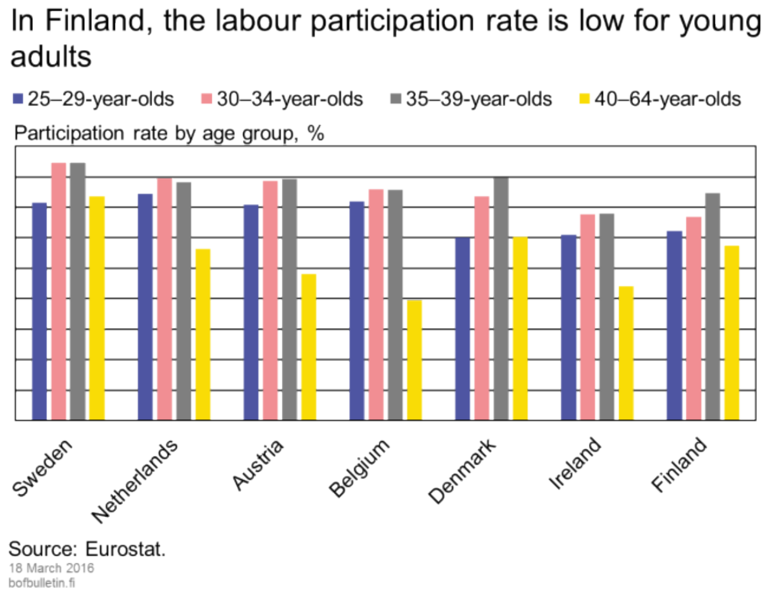
Chart 6.



In addition to the contraction in the working-age population, the labour supply in Finland is weakened by the relatively low labour force participation rate among the working-age population (Chart 7). The labour force participation rate was in Finland ca 75%, i.e. close to the level in Austria and the third weakest in the peer group, after Ireland and Belgium. In contrast, in Sweden, which has the highest labour force participation rate in the group, the effects of population ageing are dampened. In Sweden, just under 82% of the working-age population is available for the labour market. In Finland, the average participation rate is depressed mainly by the labour participation rate of men, which particularly in the older age groups, is low compared to the peer countries. The rate is depressed also by the low level of labour participation by persons of prime working age (about 30–40 years), particularly women. In contrast, in the older age groups, the participation rate is in Finland fairly high and close to that in Denmark and the Netherlands.

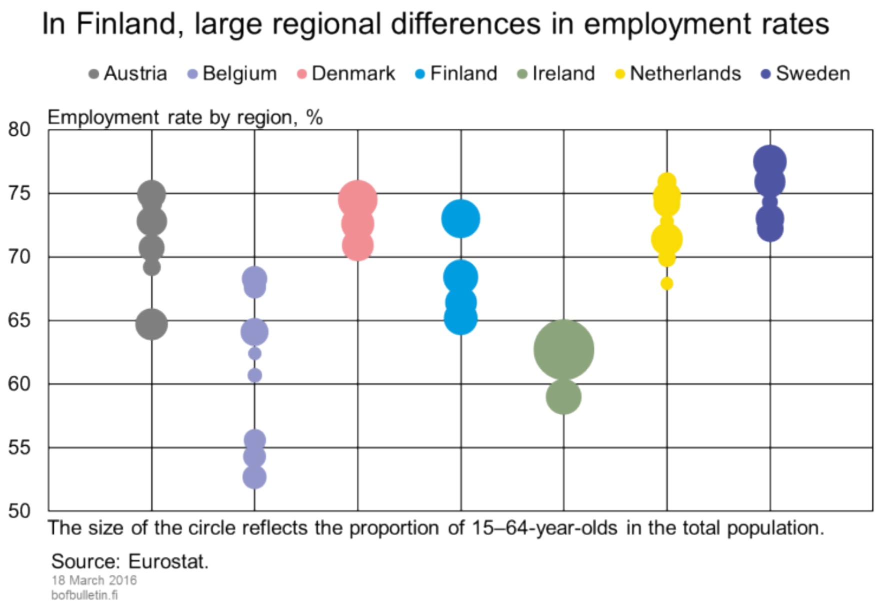
In addition to the labour force participation rate the employment rate in Finland is also lower than in most of the peer countries. The employment rate in Finland (ca 75%) is nearly 5 percentage points lower than in Sweden, which is similar to Finland in terms of labour market institutions. In Finland, the lower employment rate of women compared to the peer countries is due, in particular, to the mothers of children under 6 years of age, as their employment rate is the lowest in the peer group, despite the high overall employment rate of women. In the Netherlands, ca 80% of the mothers of the under 6-year-olds are employed, whereas in Finland and in Ireland, the corresponding figure is only ca 60%. A special feature in Finland is that compared to the other countries, highly-educated mothers, in particular, are more often out of work.

Chart 7.



The countries also have regional differences in employment (Chart 8). Particularly in Sweden, the majority of the population lives in regions with a high employment rate, and even at its weakest, the employment rate matches that found in Finland only in the southern county of Uusimaa. In Finland, a large share of the population lives in regions with low employment rates, whereas in the other countries, with the exception of some French-speaking regions of Belgium and in Austria in the Vienna region, the employment rate does not differ as much between areas with high or low population density. Cross-country differences in urbanisation are however not large if we look at how the population is distributed among cities, population centres and the countryside. In Finland, the majority of the population in the countryside lives far away from areas with high concentrations of workplaces.

Chart 8.



Capital stock drying up in Finland

Private fixed investment contracted during the financial crisis in 2008 and 2009 in all the developed economies, and even since the crisis, such investment has been sluggish. In Finland, developments in the capital stock have since 2008 been even weaker than in most of the peer countries.

The capital intensity of production is a measure of the amount of material and immaterial productive capital per person employed in the economy.[6] From the start of the millennium until the financial crisis, the capital intensity of manufacturing was the lowest in Finland among all the peer countries except for Austria. The pace of increase in capital intensity was however about the same in all the countries.

Since 2010, the capital stock has remained virtually unchanged in Finland, whereas in the comparison countries, it has typically started to increase again. A particularly strong increase in capital intensity has been witnessed in Sweden.

In the private sector, developments in the net capital stock of manufacturing, in particular, has been weak in Finland. In 2013, it was some 12% lower than in 2008. The erosion of the capital stock is largely due to the collapse of the ICT industry and the shutting down of forest industry facilities. It may also reflect the adjustment of the capital stock to a weaker outlook for growth.[7]

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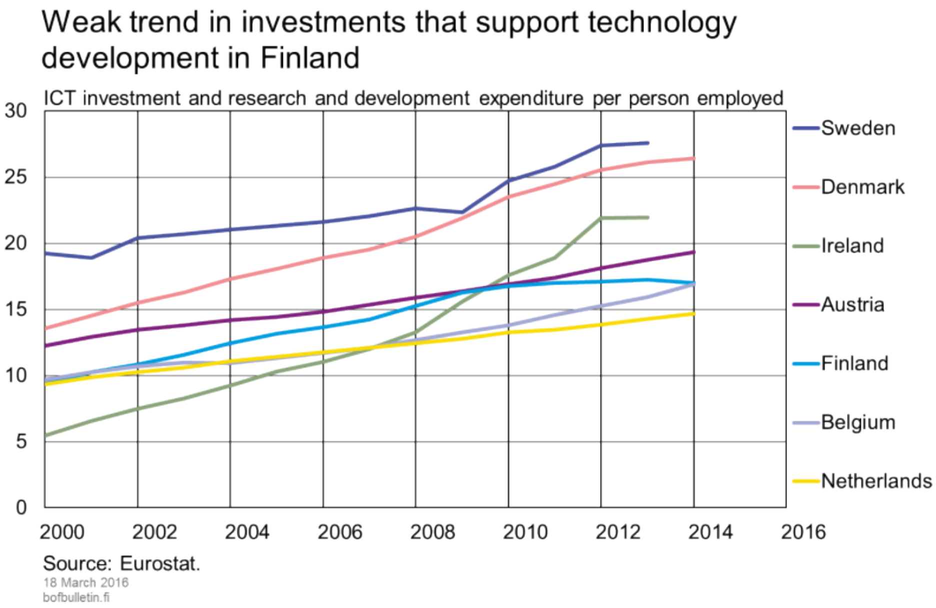
6. According to traditional neoclassical growth theory, an increase in the amount of capital improves labour productivity. However, after a certain point, productivity can be increased effectively only by raising the efficiency of capital usage, but not by increasing the amount of capital.
7. Itkonen, J. – Mäki-Fränti, P. (2016) Kuihtuva pääoma (Shrinking capital). Analysis article, in Finnish only. Eurojatalous.fi website.

The contraction of the Finnish ICT industry has been reflected in investments that promote the introduction and utilisation of new technology. The capital stock, which has accumulated as a result of investments in ICT technology as well as immaterial capital, has increased in the peer countries since the financial crisis, but in Finland it has stagnated; measured per person employed, it is now close to the level in Belgium (Chart 9).

Chart 9.



Productivity in Finland among the weakest in the peer group

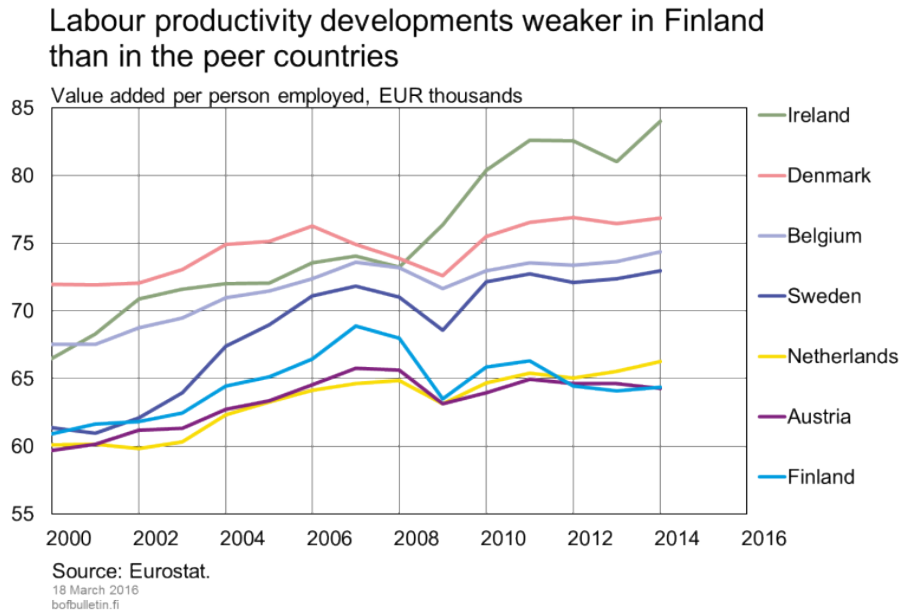
Due to the weak developments in both the potential labour force and the capital stock in Finland, the improvement of the economy in the next couple of decades is likely to depend almost entirely on the growth of total factor productivity. [8] In recent years, growth in total factor productivity has however been subdued in both Finland and the EU countries in general, and it is not expected to pick up rapidly. For example, according to projections by the European Commission, total factor productivity growth in 2013–2060 will be only 0.8% on average in the EU countries and 0.7% in Finland.[9]

If productivity is measured roughly by value added per person employed, Finland throughout the first post-millennium decade was at the bottom of the peer group, along with Austria and the Netherlands (Chart 10). From the start of the millennium until the financial crisis, Finland on the heels of Sweden, gained ground on Belgium, Denmark, and Ireland. During the recession, productivity in Finland descended sharply, as output fell, especially in manufacturing, faster than the decline in employment.

8. Total factor productivity refers to the growth in labour productivity that is not directly due to increases in inputs, e.g. labour and capital, but the result of their more efficient use.
9. European Commission (2015) The 2015 Ageing Report. European Economy 3/2015.

The weak developments in productivity in Finland since the drastic drop in GDP in 2009 are explained by structural changes in the economy and by the replacement of high-productivity industrial jobs by low-productivity jobs, particularly in public services. However, productivity developments within a number of individual sectors in Finland have also been among the weakest in the peer group.

Chart 10.



Both weaknesses and strengths in the structures of the economy

The World Economic Forum (WEF) Competitiveness Index describes the most important factors shaping the outlook for economic growth. Finland has for several years ranked high in the index; in the 2015 index, Finland's ranking was 8th. Of the peer countries, only the Netherlands ranked higher, and all the peer countries ranked very high, among the top 24 economies. Finland has several strengths that support competitiveness and in which it ranks number one among the peer countries and in the world.

Table.

Finland’s competitiveness index: strengths and weaknessess

Finland’s strengths			Finland’s weaknesses		
	Finland’s ranking in the index	Finland’s ranking in the peer group		Finland’s ranking in the index	Finland’s ranking in the peer group
Institutions	1.	1.	Market size	59	7
Health and primary education	1.	1.	Labour market efficiency	26	5
Higher education and training	2.	1.	Goods market efficiency	21	6
Innovations	2.	1.	Business sophistication	14	6
Financial market development	6.	1.			

Source: World Economic Forum.

The WEF report also points out several well-known weaknesses of Finland (Table). Finland is a closed economy, intensity of competition in the goods market is low, and there is room for improvement in the functioning of the labour market. A more interesting finding is that these factors are some of the competitiveness advantages of the richest countries in the peer group.

A clear weakness of the Finnish economy is the lack of competition. The best of the peer countries are among the top 10 economies in the world based on the competitiveness indicators, whereas Finland's ranking in, for example, the intensity of competition and the number of local subcontractors is close to 90th. Moreover, the number of companies with strong market dominance is higher in Finland.

Ireland and the Netherlands are more open economies than Finland. They have a high prevalence of foreign ownership and direct investment, and they attract international experts. In all these subcomponents Finland's ranking is below 50, among the 140 economies examined. Labour market efficiency is one of the strengths of Denmark, whereas Sweden is one of the best in terms of production process sophistication.

The level of labour market efficiency in Finland is around the average for the peer group, whereas Belgium and Austria rank considerably lower than Finland. The competitiveness index shows that the problems in the labour market are related to flexibility of wage determination (poorest in the peer group) and cooperation in labour-employer relations (2nd weakest after Belgium).

The low level of goods market efficiency in Finland reflects, in part, the low level of entrepreneurial intention among Finns. In the Global Entrepreneurship Monitor study, only about one-third of Finns considered entrepreneurship a relevant career choice. This is reflected also as a lower level of early-stage entrepreneurial activity. The popularity of entrepreneurship is higher in the Netherlands and Ireland than in the other countries. The survey also reflects Finnish entrepreneurs' weak international aspirations and growth expectations, which are partly in line with the fact that Finland is a relatively closed economy with a low level of competition.

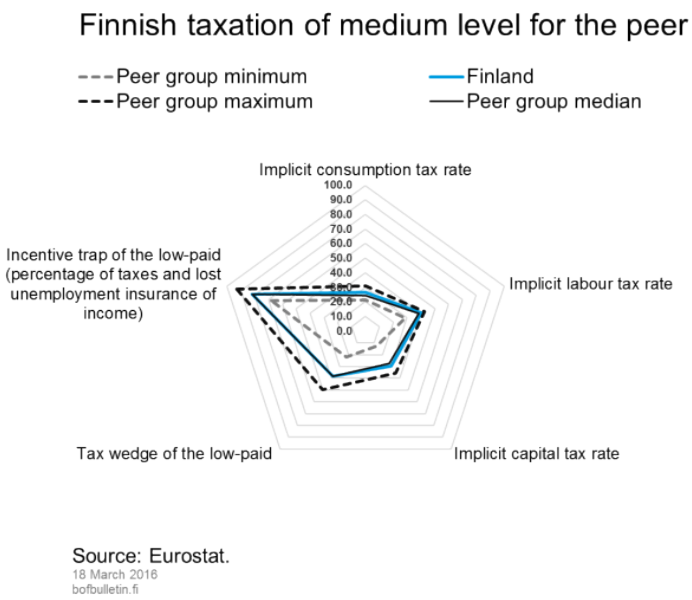
High level of taxation in several peer countries

The tax rates in Finland are close to the median for the peer group for consumption, capital and labour (Chart 11). The difference in the tax rate in Finland versus the lowest tax rate in the peer group is most significant in the taxation of capital. Capital taxation is low particularly in the Netherlands and Ireland where the implicit tax rate on capital is ca 13%, whereas in for example Sweden and Finland, it is ca 30% and in Belgium even higher. Consumption is heavily taxed in all the Nordic countries, and labour taxation is relatively high not only in Finland but also in Belgium, Austria, the Netherlands, and Sweden.

In terms of labour taxation, the size of the work incentive traps and tax wedge for the low-paid employees is also important from the perspective of labour supply. In Finland, the tax wedge is of medium size among the peer group, together with Denmark (Chart 11) and slightly narrower than e.g. in Sweden and Austria where the employment rate is higher than in Finland. In contrast, in Ireland the tax wedge for the low-paid employees is approximately 15 percentage points narrower than in Finland.

The work incentive traps for the low-pay industries (defined as the share of unemployment insurance in net wages and salaries of those earning 67% of the median) are in Finland of the average size (80%), together with the Netherlands. The work incentive traps are ca 10 percentage points smaller in Ireland, Austria and Sweden. In contrast, in Belgium the low-pay industries' work incentive trap (93%) and tax wedge (50%) are significant, which may partly explain the low employment rate in Belgium.

Chart 11.



Finland's big challenge: to catch up with the others

Finland's slower economic growth relative to the peer countries since 2007 is largely explained by difficulties in the forest and ICT industries, which escalated simultaneously with the weakening of international business conditions.

The small size of the domestic market, low intensity of competition in the goods markets and problems in the labour market have slowed the changes in the structure of production. The weakening of export industry competitiveness in the first years of the recession has also slowed down the creation of new jobs in high-productivity industries.

In the pre-recession period, Finland was still catching up with the wealthiest small economies, but now it is falling further behind. Population ageing, low level of investment and the protracted stagnation in productivity growth may restrict the growth potential of Finland more than that of the peer countries also in the immediate years ahead. Finland's traditional strengths are its efficient institutions and high level of education, but these alone are hardly sufficient for catching up with the most advanced economies.

Tags

- capital stock
- consumption
- employment
- EU
- gross domestic product
- productivity
- structure of economy

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Euro area banking sector gathers strength

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

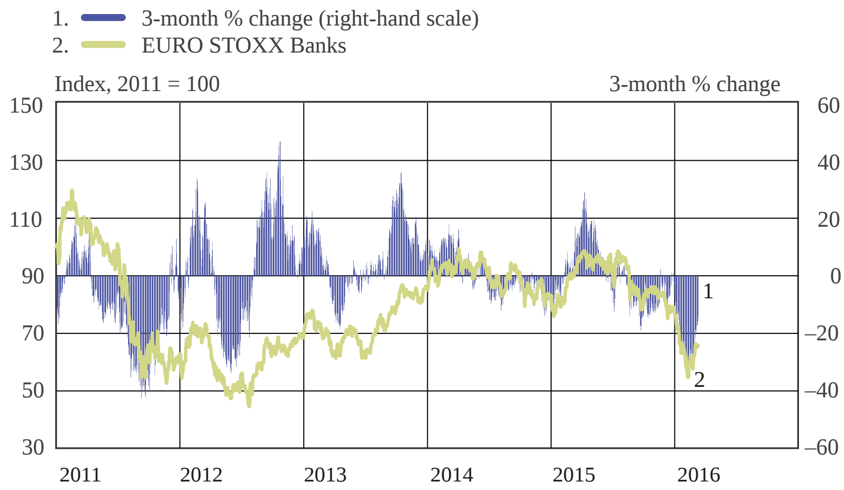
Increasing market uncertainty over the condition of banks in early 2016 was not due solely to concerns about global economic growth but also above all reflected concerns about banks' non-performing loans and declining profitability amid low interest rates and subdued growth. Nonetheless, the condition of the European banking sector is gradually improving, despite major cross-country differences. Notwithstanding the positive developments, banks nevertheless remain vulnerable to deteriorations in the operating environment.

The instability of markets has reflected concerns springing from the global growth outlook. Market fluctuations have been reinforced by mounting credit risks in the energy sector, weak market liquidity, which intensifies price movements, and uncertainty over whether economic growth can be supported by monetary and economic measures.

At the end of January 2016 large falls were witnessed in bank share prices, globally. The lack of confidence in the condition of banks was heightened by concerns about the amount of non-performing loans held by European banks and the profitability outlook for the banks. Market sentiment was also adversely affected by negative earnings shocks from some large banks. The heightened market stress increased doubts over the level of risk resilience of market-sensitive investment banks in adverse market conditions.

Chart.

Early-year market turbulence hit bank shares



Source: Bloomberg.
17.3.2016
bofbulletin.fi

Although there are many factors underlying market concerns, the euro area banking sector has strengthened in recent years and improved its resilience to deteriorating conditions. Banks' profitability and capital adequacy have improved, on average, and the liquidity position has been strengthened. The condition of European banks remains challenging, however, as the average figures conceal fluctuations across countries and banks. Problems still remain, notably in those countries that were hardest hit by the sovereign debt crisis, with the large amounts of non-performing loans and loan losses eroding the profitability of banks.

The large amount of non-performing loans presents a burden for banks in many respects. Non-performing loans erode banks' profitability, as banks have to make provision for future losses. Banks also do not accrue any earnings from the non-performing assets shown on the balance sheet. Furthermore, the portion of non-performing assets not covered by technical provisions tie up capital because of the higher risk weights applied to bad loans. Such encumbered assets are not available for new lending and, consequently, the banks' ability to provide credit to the real economy has weakened (See Inflation outlook requires accommodative monetary policy -article chart 6).

Several measures have been attempted to solve the problem of banks' non-performing assets. There is no single solution at hand; measures must be extensive, also considering the restrictions imposed by the new resolution legislation and government support.

The current operating environment also creates challenges in respect of banks' profitability outlook, with subdued credit growth and low interest rates weighing on net interest income. Net interest income has been bolstered by the measures of the European Central Bank, which reduced banks' market-based funding costs. The ECB's measures have also enabled banks to obtain valuation gains on their securities holdings. Improvements in the profitability outlook are also supported by the gradual recovery of

European economic conditions, banks' cost-cutting measures and rationalisation of operations, as well as reductions in high-risk balance sheet assets.

There is a strong connection between the condition of the banking sector and the real economy. A deterioration in the real economy would weigh on the banking sector's operating capacity, as loan losses would begin to increase again, while a weak banking sector would impair the recovery of the real economy. On the other hand, it takes a sound banking sector to ensure smooth financial intermediation to satisfy the needs of the real economy. Day-to-day measures contribute to achieving this.

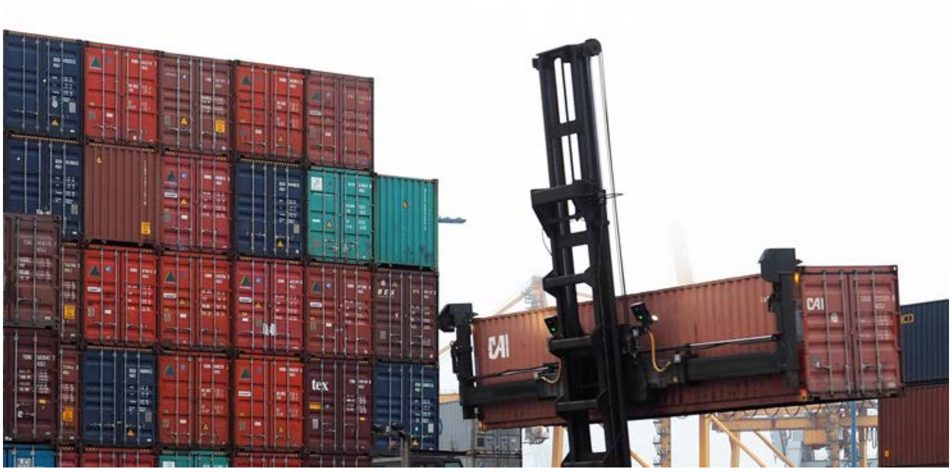
Tags

- banking sector
- euro area
- market turbulence

Why has world trade slowed?

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

World trade grew for decades considerably faster than global GDP. In recent years, the growth of international trade has slowed to the level of the GDP growth rate. Is the most hectic phase of globalisation already history? It would seem that, in the latter part of the first post-millennium decade, it was for the most part permanent structural factors that took centre stage, while transitory cyclical factors played only a minor role. Forecasts suggest world trade growth relative to global GDP is not likely to gain significant momentum in the immediate years ahead.



World trade growth relative to global GDP growth has already been weak for nearly ten years, but trade growth has been particularly muted since 2010. Is this a passing phenomenon? The subsiding of world trade is related in part to cyclically-driven, in part to structural and other factors.

The cyclical factors can be considered to include the fading of intra-EU trade, the deceleration of Chinese growth, the sluggishness of investment activity in the advanced economies and the low level of commodity prices. Structural factors encompass, among other things, the end of the most frenetic phase of integration of China and Eastern and Central European countries, the end of the fastest growth phase in the fragmentation of production, expansion in digitalisation and, additionally, various governments' increased action to safeguard domestic production.

Why is trade growth desirable?

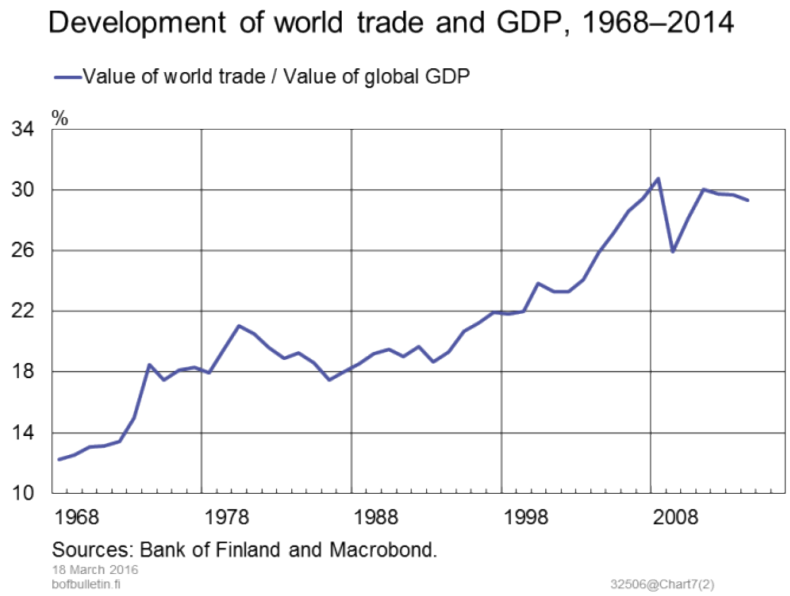
The relationship between world trade and global GDP can be seen as representing a measure of specialisation of production: the more trade relative to production, the more division of labour and specialisation. Division of labour and specialisation of production are desirable, as these enhance the spreading of knowhow, lead to an efficient use of resources in accordance with the principle of relative advantage and, by extension, also to stronger growth in both the economy and wellbeing.

In Finland, for example, the heyday of electronics and forest industries in the 1990s would not have been possible without brisk international trade. Trade growth has also added to equality between countries by helping to reduce poverty in emerging economies, boost average per capita income and upgrade skills. Moreover, from the perspective of shorter-term economic activity, world trade growth outstripping GDP growth contributes to higher levels of employment and income for small, open economies, in particular.

Decades of growth

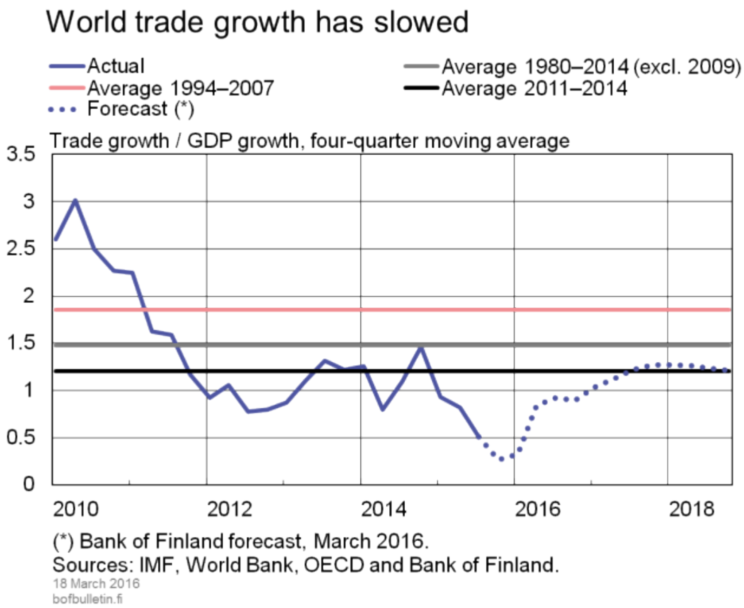
World trade expanded very strongly from 1986 to 2007. During this period, the global economy was affected by two geopolitical developments and one economic trend: 1) the integration of Eastern and Central European countries into Western Europe, 2) China's integration into the global economy and 3) the fragmentation of production (i.e. the rapid expansion of value chains) in the economy. Against the backdrop of these factors, world trade increased by substantially more than global GDP. However, world trade growth has been slack since the onset of the financial crisis in 2007 (Chart 1).

Chart 1.



World trade grew on average about twice as rapidly as global GDP in 1980–2007. Trade growth was only slightly faster than GDP growth in 2011–2014, and trade has recently evolved at the same pace as GDP. The easing of world trade growth reflects, in part, temporary cyclical factors, but also more permanent structural factors.

Chart 2.



Temporary cyclical factors

Consumption and investment in the advanced economies have been sluggish to recover since the 2007–2008 financial crisis. Deleveraging has weighed on households' purchasing power and balance sheet repair has eroded non-financial corporations' investment appetite, notably in Europe. On the other hand, the moderation of the rate of growth in the emerging economies, particularly China, has been instrumental in depressing the improvement in world trade.

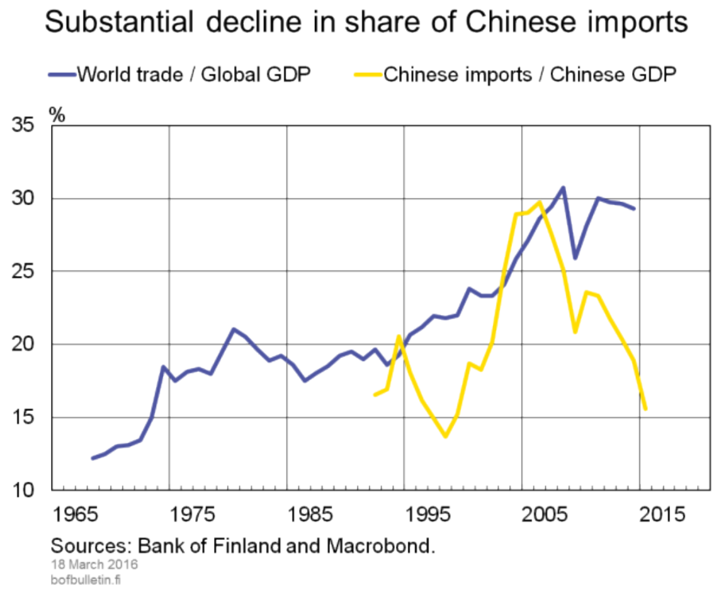
Forecasts by international organisations foresee more lively consumption and investment activity in the advanced economies in the immediate years ahead. This will support world trade growth in the near term, but the pick-up in trade will nevertheless remain considerably more muted than in 1980–2007, due to a variety of permanent structural factors that lie behind trade growth (Chart 2).

Permanent structural factors

The share of industrial goods in world trade is contracting, while the share of services is increasing. The manufacture of industrial goods, capital goods and consumer durables is highly trade-intensive, partly on account of the expansion of value chains, whereas service production is less trade-intensive. With demand growth increasingly focusing on services, world trade relative to GDP is not expanding with the same vigour as before.

The second and most important permanent structural factor is the maturing of the integration process of Eastern and Central European countries, and particularly of China. The shift in China's growth model from exports to domestic demand means a decline in the country's propensity to import. Imports accounted for about 30% of China's GDP in 2006, but the share halved to approximately 15% in 2015. This is the largest single factor in explaining why the world trade growth rate has converged towards global GDP growth (Chart 3).

Chart 3.



The third more permanent structural factor relates to the slackening pace of expansion of production value chains. A fourth factor that in part supports the third is economic policy aimed at promoting domestic production and employment, while digitalisation ranks fifth. Although no reliable statistical evidence on factors four and five is available, tax reliefs and other subsidies for domestic production are widely used economic policy tools in many countries, and digitalisation is indisputable.

Is the slowing of trade a passing phenomenon?

On the basis of forecasts by international organisations, slower growth in international trade than witnessed in 1986–2007 is not a passing phenomenon, although the sharpest downtrend in world trade growth is already over.

The cyclical situation will improve on the back of a predicted boost in domestic demand – consumption and investment – in the advanced economies. Even so, the structural factors underlying slower trade growth do not appear to be dissipating. The shift in China's growth model is permanent. More significant trade growth would require, among other things, that India and African countries experience a strong upswing and such integration into the world economy as seen in China.

Tags

- globalisation
- world trade
- gross domestic product

Rising indebtedness increases risks in China

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK • JUUSO KAARESVIRTA

- Juuso Kaaresvirta
  Economist

The total amount of public and private debt in China has increased rapidly since the financial crisis. The country's debt-to-GDP ratio has already reached the level seen in many advanced economies. The rapid rise in debt in many countries has led to financial sector problems and to a marked slowing of economic growth. Sustainable management of the economy in China would require a slowdown in the debt build-up. There are no indications of this as yet. Curbing debt accumulation would require China's readiness to accept lower growth targets.

China's strong stimulus based on borrowed money

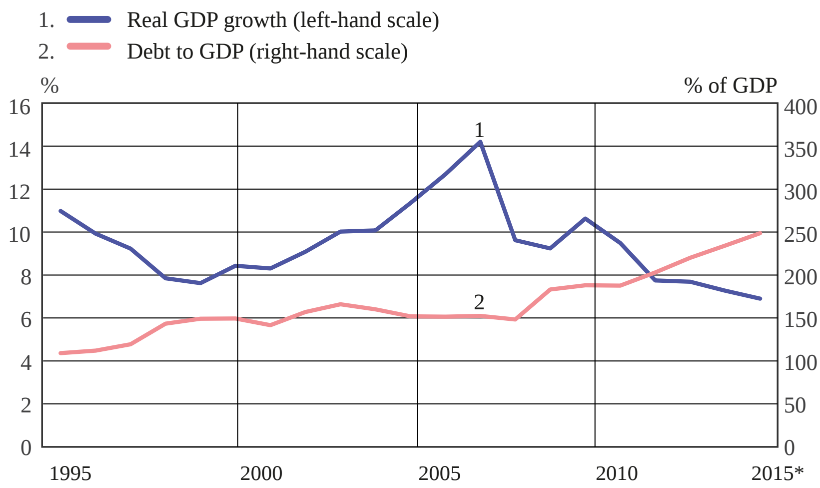
The Chinese economy has been growing vigorously for more than 30 years. A large part of this growth has stemmed from increased investment: firms have modernised their production, and rapid urbanisation and integration into the global economy have required substantial construction and infrastructure investments. The financing of these projects has traditionally come from the mainly state-owned banking sector, whose operations the government has steered via tight regulation. It has been easy for banks to obtain financing, as a scarcity of investment opportunities of the Chinese people has maintained the popularity of bank deposits, despite the often very low rates of interest paid. Consequently, it has been easy to finance investment-driven growth.

In the wake of the Asian financial crisis, the Chinese banking sector faced major problems with non-performing assets, which led to extensive recapitalisation of banks. The authorities thus began to closely monitor credit growth. Banks' loan quotas were strictly adhered to, and in 1998–2008 indebtedness grew at roughly the same pace as the economy. Debt relative to GDP remained at 150%.[1]

Following the onset of the global financial crisis in 2008, China feared an abrupt slowdown in economic growth. The country's political leadership decided to provide a strong stimulus to the economy, as did many other countries. A sizeable two-year stimulus package of CNY 4,000 billion (over EUR 430 billion, 12% of GDP) was allocated mainly for investment purposes. Restrictions on bank lending were relaxed. The state-owned banking sector and other government-related businesses were eager to respond to policy-makers' calls for stimulus. In 2009, a huge number of new investment projects were launched, and the stock of credit grew by 30 percentage points to 180% of GDP during the year (Chart 1). These actions helped to maintain robust economic growth, and GDP expanded by more than 9% in 2009. Measured by the change in the outstanding debt, the actual stimulus was more than twice as large as announced in the official stimulus programme and was realised in one year instead of two. The stimulus was thus exceptionally large compared with any other country.

Chart 1.

China's debt-to-GDP ratio up sharply since financial crisis



*Debt for 2015 in an estimate.
Sources: BIS, National Bureau of Statistics of China and BOFIT.

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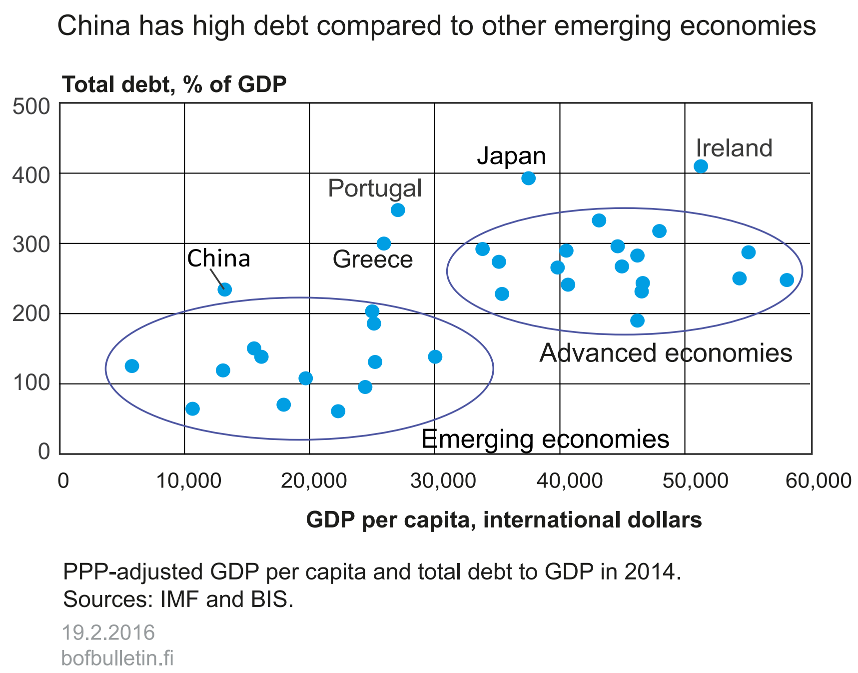
China's credit stock relative to GDP resumed its upward trend in 2012, in response to a further relaxation of direct regulation of bank lending. The authorities have not reined in credit growth, given their desire to keep economic growth on target and prevent an excessively rapid slowdown. Estimated debt at the end of 2015 was about 250% of GDP,

1. In examining total debt, this article uses BIS debt statistics, which are comparable with other countries. Recourse to other sources gives slightly different debt levels, but the magnitude is roughly the same. Total debt includes domestic and foreign debt for the public-sector, non-financial corporations and households but excludes financial sector liabilities.

and Chinese statistics also point to continued rapid credit growth in early 2016. The total debt has grown by approximately 100 percentage points relative to GDP since the financial crisis. Compared with other countries, the level of China's debt is very high. It is of the same order of magnitude as in many advanced economies and distinctly higher than in the other emerging economies (Chart 2).

Chart 2.



Mixing of private sector debt and government debt

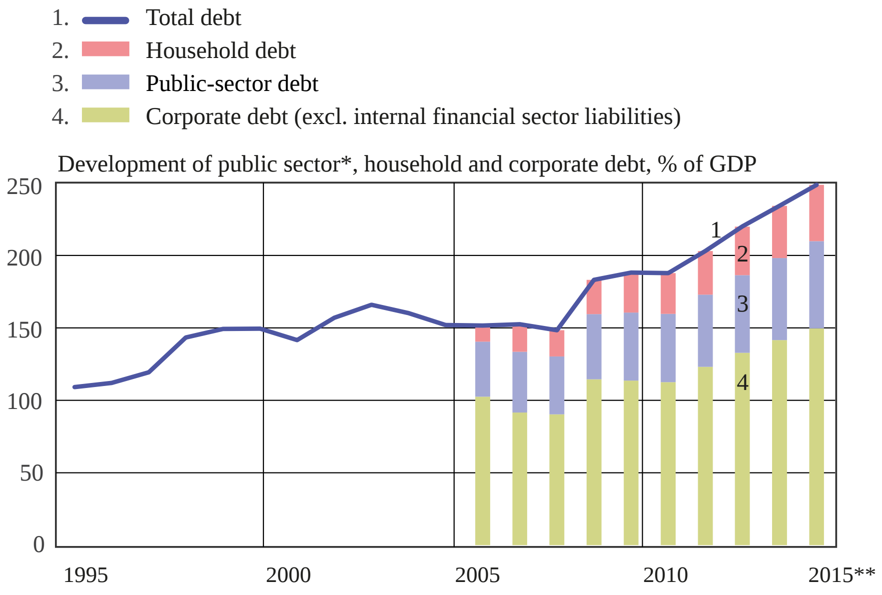
There are many problems with the measurement of the amount of China's debt. One of the greatest difficulties is posed by the assessment of public-sector debt, as activity in the public sector is, in part, statistically recorded as private sector activity. The roots of the problem largely go back to the stimulus measures.

At the end of 2008, responsibility for implementation of the stimulus policies was mainly assigned to local governments. But they had to address the problem of where to get money quickly for the realisation of the projects. Local governments have limited scope for boosting tax revenues and, on the other hand, additional income received through changes in taxation only comes after a time lag. Moreover, local governments were not allowed to incur debt, as they had a statutory balanced-budget obligation. The problem was, however, known to local policy-makers, and they had come up with a solution for it long ago. Enterprises for organising project finance via bank loans were established off budget – and hence outside the public sector. During the stimulus phase, these off-budget public projects and the underlying loans snowballed. What was actually public stimulus was thus moved off the public budget.

As Chinese public-sector debt prior to 2009 was generally estimated at 20% of GDP, it was very small by international standards. However, the estimate only included central government debt, not local government liabilities. Based on current statistics, the country's public-sector debt accounts for about 43% of GDP, of which half relates to the central government and half to local governments. The IMF estimates local governments' off-budget liabilities at approximately 20% of GDP and total public-sector debt at about 60% of GDP (Chart 3). Considerably higher estimates have also been suggested.

Chart 3.

Chinese debt growing rapidly across all sectors



*IMF estimate, taking off-budget local government liabilities into account.
**Debt for 2015 is an estimate.
Sources: BIS, IMF and BOFIT.
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At the end of 2011, a pilot scheme for public sector financing was carried out in China, whereby some cities were allowed to issue bonds. The scheme has subsequently been expanded, and local governments have to some extent repaid off-budget bank loans with proceeds from bond sales. Consequently, public-sector liabilities have been partly brought back from corporate debt to public debt.

Given the government's extensive activity in the corporate sector, actual corporate indebtedness is difficult to assess. If local government liabilities are excluded from corporate debt, non-financial corporations' accumulated debt amounts to around 150% of GDP. Debt accumulation has been significant especially among real estate and construction companies. Based on IMF estimates, indebtedness within sectors is quite heavily concentrated in certain companies that are generally owned by the state or local governments. Compared with any other country, Chinese firms have very high debt levels. According to BIS, the debt ratio in major and medium-sized emerging economies is typically about 50% of GDP.

Thrifty Chinese households have traditionally had little debt. However, consumer credit has become considerably more extensive, the outstanding amount having grown annually by several tens of percent in recent years. Housing loans have also become more common, as housing prices have risen and house purchase on borrowed money has been made easier. Even so, the Chinese continue to pay a large part of the house price in cash. The down-payment requirement for a first-time homebuyer is at least 20% of the house price and for other buyers 30%. Total cash payment for a house is not highly unusual.

Liberalisation of capital restrictions in China has increased borrowing from abroad, albeit external debt remains relatively small. As reported by China's State Administration of Foreign Exchange (SAFE), there was over USD 1,500 billion of debt, i.e. 14% of GDP, at the end of September 2015.[2] Of this amount, nearly half (46%) was financial sector debt. Public-sector debt accounted for around 10% and other sectors for approximately a third of the total. Slightly over 10% represented inter-company loans. In the course of 2015, the depreciation of the yuan and the expected continuation of the currency's slide led market participants to reduce their holdings of external debt by more than USD 100 billion. According to SAFE, about half of the external debt was denominated in yuan at the end of 2014; the other half was largely USD-denominated.

An increasingly large share of financing from the shadow banking sector

In China, it has often been much more difficult for private companies to obtain bank credit than it is for state-owned enterprises. During the last 10 years, private firms have increasingly turned to the shadow banking sector for financing (Chart 4).[3] This has been enabled by the liberalisation and development of the financial sector. On the other hand, the shadow banking sector's activities have always expanded rapidly when authorities have curbed bank lending. Already in 2006–2007, the share of financing provided by the shadow banking sector broadly doubled to nearly 10% of total domestic financing. During the course of 2011, the sector's share grew to 15%, thereafter remaining at 15–18%.

Investors have been interested in using the shadow banking sector, as it has often offered much better returns than bank deposits. Commercial banks and other financial intermediaries have packaged shadow banking loans into asset management products. Investors have not always been aware of or understood the risks involved in different investments. Shadow banking credit has also been channelled to companies that have not always been able to repay their loans. Accumulated losses for the time being total at least tens of billions of yuan. However, the risk realisations have not hit the investors; instead, the central and local governments have so far assumed the bulk of the losses.

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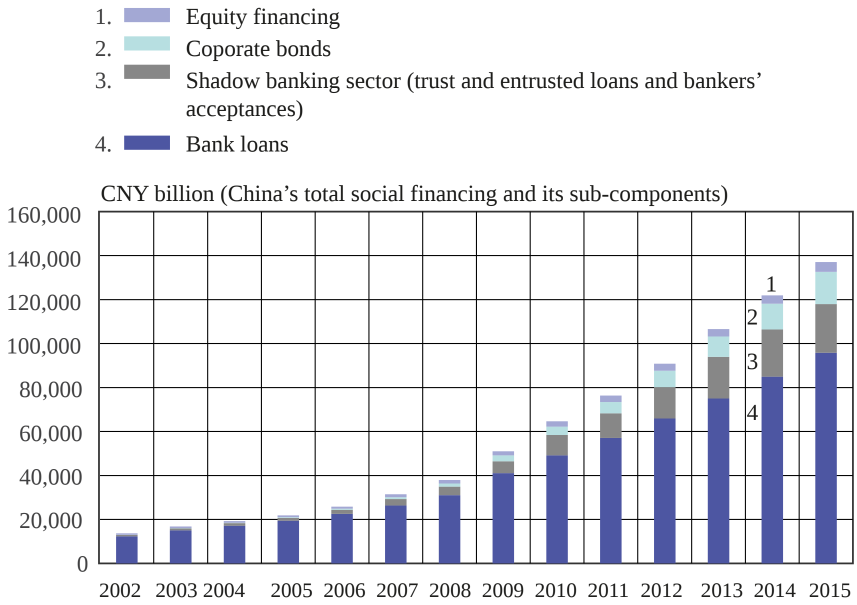
2. China altered its statistical compilation of external debt at the beginning of 2015. Prior to 2015, external debt included only foreign-currency debt, but after the change it also includes external debt denominated in yuan.
3. As the activities of the financial sector have diversified since the beginning of the first post-millennium decade, China has begun to publish its own indicator for overall financing in the economy, i.e. total social financing (TSF). It seeks to cover all financing provided to the domestic corporate sector (excl. the financial sector) and households. It includes bank loans, bankers' acceptances, trust and entrusted loans and equity and debt issues. In this article, the shadow banking sector includes bankers' acceptances and trust and entrusted loans.

Chart 4.

The shadow banking sector has come to play a major role



Source: People's Bank of China.

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As total financing has grown quickly, the risk of financing unprofitable projects has increased. To date, according to official statistics, the levels of commercial banks' non-performing loans, while rising, have remained moderate, averaging less than 2% of the outstanding amount of credit. In addition, as indicated by official statistics, nearly 4% of the loans are in danger of becoming problem loans. On the basis of many independent assessments, the actual proportion is, however, considerably higher. Banks are assumed to grant new credit for repayment of old loans, although the future repayment ability of firms is dubious. This applies, in particular, to state- and local government-owned enterprises. Also of some concern is the slowing of corporate profit growth and the corporate sector's weakened ability to handle its commitments. Moreover, China's efforts to close down production facilities in sectors with excess capacity is likely to increase non-performing loans in the years to come.

China has experience of managing banking sector problems. Following the Asian financial crisis at the end of the 1990s, commercial banks' non-performing assets were estimated at 40–50% of the outstanding amount of credit. After the 1998 Asian financial crisis, the government provided support to the banking sector on several occasions amounting to hundreds of billions of euros. In addition to capital injections, the government transferred commercial banks' non-performing loans to asset management companies. These banks succeeded relatively poorly in realising non-performing assets, but the significance of these assets has diminished over time, as the economy has grown rapidly and inflation has reduced the value of money.

Is China willing to break the debt spiral?

China's rapid increase in indebtedness causes concern, as similar developments in many countries have led to problems in the financial sector and to a prompt slowing of economic growth. Nor does the rush to indebtedness show signs of easing off. Moreover, financing from the shadow banking sector appears to increase in China whenever lending by the banking sector is tightened. This shows that steering the financial markets by old tools based on regulations and quotas for the banking sector does not work; such guidance should be based more on the price of money.

Despite the involvement of foreign strategic investors in large banks, it seems that the banks' governance methods still leave much to be desired. The huge role of the government as both the organiser and recipient of financing is highly problematic. Improvement of banks' risk management and allocation of finance according to more market-based criteria require a downsizing of the government's role in the operation of the financial markets.

As was the case at the turn of the millennium, possible restructuring in the Chinese banking sector is likely to end up being financed by the government and, in the last resort, by ordinary people. In its stress scenario, the IMF estimated in summer 2015 that the Chinese general government debt-to-GDP ratio would rise by about 20 percentage points if 10% of bank assets were restructured. However, the IMF considers the public sector's current debt sustainability to be good. A large part of the debt is domestically-held and, compared with many other countries, China has exceptionally large buffers. The government has abundant resources (e.g. holdings in state-owned enterprises) and the banks' reserve deposits in the central bank are abundant. Sizeable foreign exchange reserves provide protection against external risks.

If China adheres to its objective of doubling its GDP per capita in 2020 compared to 2010, this will require ongoing economic growth nearly at a current pace. However, the contracting labour force and slower productivity growth point to a continuously weakening trend in growth fundamentals in the years ahead. Maintaining economic growth at current levels appears to require continuing growth in debt accumulation. It is another question how appropriate it is to continue at the current growth rate if the labour market would be able to withstand a slower but otherwise in all respects more sustainable rate of growth. Unsustainable financial praxis can be costly.

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Tags

- indebtedness
- China
- BOFIT

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Abenomics: three years – the big ship turns slowly

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • MONETARY POLICY •
SAMI OINONEN

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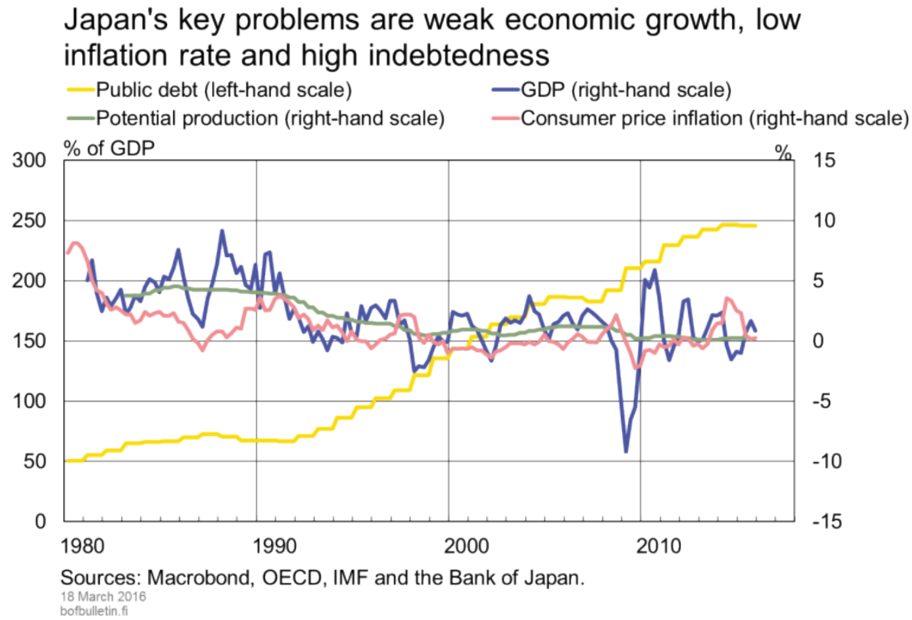
For the past three years or so, Japan has pursued an economic policy named after Prime Minister Abe as abenomics, with the intention of putting the country back on a path of sustainable economic growth via expansionary monetary and fiscal policy and structural reforms. These goals have not yet been achieved, but there has already been some progress. For the time being, economic growth has been sluggish, but the deflationary trend has been halted and structural reforms have moved forward. The preconditions for success of the programme are in place.

After World War II, Japan swiftly emerged to become one of the leading economic powers in the world. Its annual GDP growth rate over 1955--1970 was approximately 10%, and towards the end of 1980 it was still about 5%. The robust growth ended when the financial and real estate bubble, which had been expanding over a long period of time, finally burst at the end of the 1980s. Ever since, the economy has grown at an annual rate of about one per cent. Moreover, at the beginning of the 1990s, Japan sunk into a deflationary spiral, from which it is still trying to escape once and for all.

Japan's population is ageing at a rapid pace, while the birth rate is decreasing. As a consequence, the national support ratio is stretched, which is giving rise to increased public expenditures. The weak economic growth has also exacerbated the financial situation, as government tax revenues have decreased while public expenditures have increased. As a result, Japan has run up considerable debt in the past two decades (Chart 1). At present, government debt amounts to approximately 240% of GDP, and the budget has been in deficit ever since the early 1990s. The rise of the debt ratio was boosted further by a protracted period of low inflation, which lowered nominal GDP and slowed economic growth.

Chart 1.



The main challenge for the Japanese economy at present is debt sustainability. So far, Japan has been able to cope with its huge debt burden because the debt servicing costs are exceptionally low due to the low level of interest rates. In addition, about 90% of the country's public debt is domestic, so that the foreign exchange risk is minimal. However, Japan remains highly exposed to an increase in the level of interest rates, which will be in the offing when the central bank at some point begins to normalise its monetary policy. An increase in interest rates would increase the debt servicing costs and further expand the amount of debt. Furthermore, decisive and determined actions are required to halt the negative trend due to increased social expenditures resulting from population ageing and the concurrent downsizing of potential economic output.

Japan has fallen into a difficult spiral where an ageing population and growing deficit and debt ratios generate uncertainty and pessimism across the economy. This leads to a slowdown of economic growth and low inflation. As a consequence of the low inflation, wage growth is also slowing, which erodes consumers' purchasing power and reduces aggregate demand. All of this ultimately leads to an even greater budgetary deficit and increasing indebtedness.

Towards the rising sun – the three arrows of abenomics

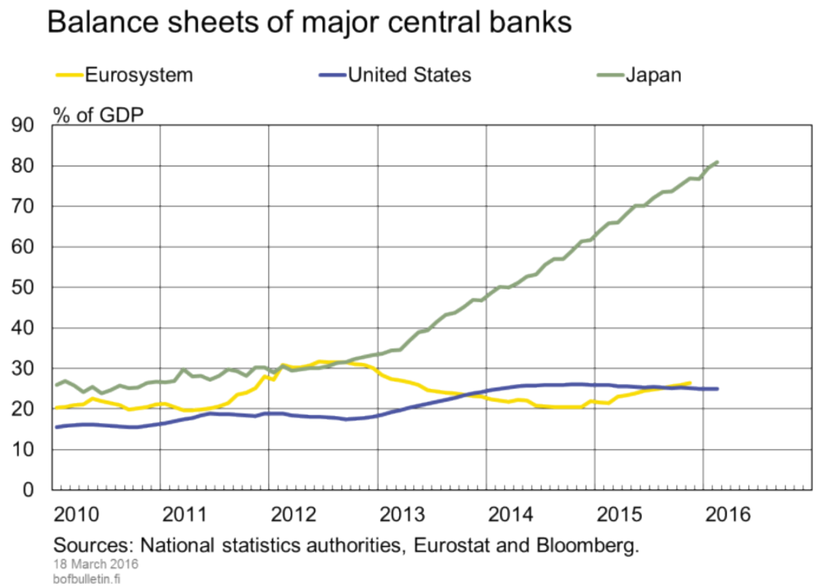
In 2013, Prime Minister Shinzo Abe launched the economic recovery policy known as abenomics. The objective is to stop the protracted deflation which has been weighing on Japan, and to put the national economy on a sustainable growth path. Ultimately, the goal is to reverse the rise of government debt. Abenomics is divided into three focal areas (arrows): 1) monetary easing, 2) fiscal stimulus and 3) structural reforms. The purpose of the monetary easing and fiscal stimulus is to boost inflation, so as to lower the level of interest rates and cause a depreciation of the yen. This is hoped to revive economic growth through the growth of investments, consumption and exports. The structural reforms are geared to bolstering business and consumer confidence and restructuring the Japanese economy to achieve sustainable economic growth also in the long run.

Tackling the deflation bogeyman with monetary policy

Monetary easing is intended to break the deflationary spiral in prices and to achieve a stable inflation rate in line with the price stability target. This is not the first time Japan has tried to prevent deflation by unconventional monetary policy measures. In 2001–2006 and 2007–2013, the Bank of Japan eased its monetary policy by expanding the monetary base, but the targets and amounts of the Quantitative Easing programmes (QE) were too small and so failed to get the desired outcome. In January 2013, the central bank set the new target for consumer price inflation at 2%, which was to be achieved by April 2015. In April 2013, the Bank of Japan launched an extensive securities purchase programme (Quantitative and Qualitative Easing, QQE), aimed at doubling the monetary base of the country by the end of 2014 (to approximately 50% of GDP) by acquiring government bonds of medium-term maturity. Due to the weak economic situation, the central bank announced in October 2014 that it would further expand the purchase program (QQE2). The size of the government bond purchase programme was increased to JPY 80 tr and the average maturity of the bonds purchased was extended to 7–10 years. The central bank has announced that the programme would be extended as much as it takes to reach the inflation target on a sustainable basis.

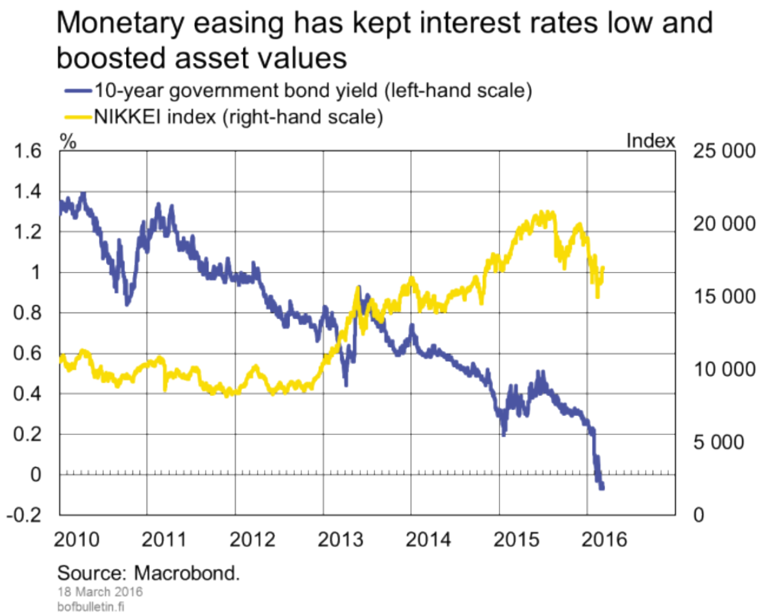
The size of the Japanese purchase programme is in a league of its own compared to the stimulation packages of the other main economic areas (Chart 2). Since the launch of the programme, the balance sheet of the Bank of Japan relative to the GDP has increased to almost 80%. The central bank is increasing its ownership in government bonds at an annual rate of 10%, and by the end of 2015, it already held a good 30% of the government debt.

Chart 2.



The purchase programme seeks to achieve the inflation target through three impact channels: lower interest rates (interest rate channel), encouragement of investment in higher-return assets (portfolio rebalancing channel), and an increase in inflation expectations (expectations channel). So far, the impacts have been bipolar. Long-term interest rates are very low, the external value of the yen has decreased clearly since the launch of the program, and equity prices have increased (Chart 3). However, inflation expectations, and consequently also actual inflation, remain sluggish.

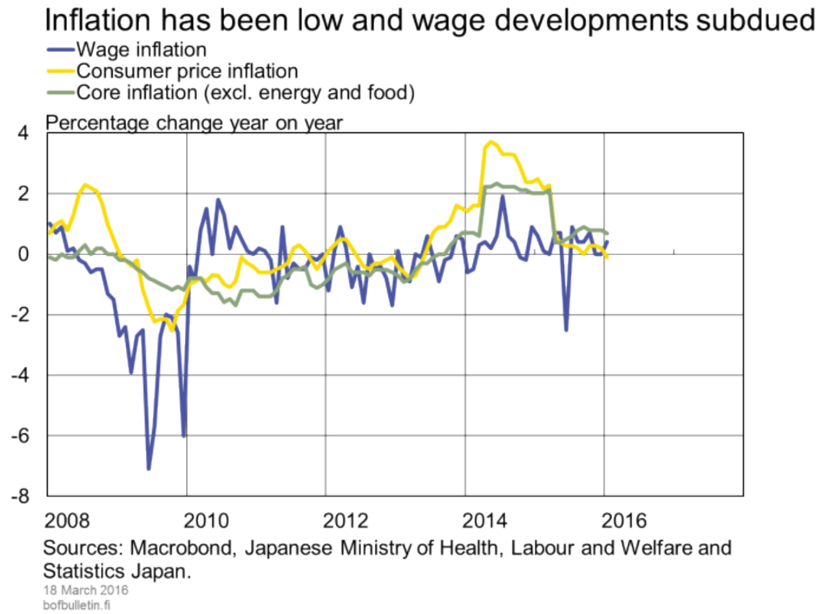
Chart 3.



In accord with the target of the central bank, inflation began to accelerate after the launch of the programme, reaching approximately 1.5% by the start of 2014 (Chart 4).

The increase in the consumption tax implemented in April 2014 first supported price increases, but gradually inflation slowed down to around zero. The low inflation recently is largely due to the impact of oil prices. Core inflation (excluding energy and food prices) accelerated in 2015 to about one per cent and is now at the same level as before the increase in the consumption tax. This generates the expectation that, once the temporary impact of the decline of oil prices gradually dissipates, the inflation target can be achieved via the QQE programme.

Chart 4.



However, inflation expectations are still far from the target of 2 per cent set by the central bank. At first, inflation expectations turned positive on the back of the purchase program and inflation was expected to accelerate both in the short run and long run. Recently, the expectations have however dampened. During the last year and a half, short-term expectations have fluctuated largely in response to the decline in oil prices. In addition, longer-term expectations have dampened, and therefore expectations of Japanese inflation in the medium and long term continue to be sluggish. From the point of view of the credibility of the monetary policy program and monetary policy, it is paramount that long-term inflation expectations are anchored to the inflation target. This leads to wage increases which are necessary for achieving the inflation target on a sustainable basis. Wage growth sustains domestic demand and increases economic growth, which is ultimately also reflected in the price level and in higher inflation rates. For the time being, the rate of wage growth has been very muted, but on the basis of recent wage-setting negotiations and the tightness of the labour markets, an upturn seems to be in the offing.

The slowdown in inflation and sluggish inflation expectations induced the central bank to respond with additional measures. In December 2015, the Bank of Japan fine-tuned its purchase programme by extending the average maturity of bonds to be purchased to 7–12 years. In addition, the central bank expanded its toolbox in its December meeting by lowering the policy rate for the first time in its history below zero, to –0.1 per cent. As regards the purchase programme, the now-prevailing mood in the market is that we are close to the limits. The central bank is already the largest holder of government bonds, owning a good 30% of the country's sovereign debt. If the current level of purchases were sustained until 2020, the central bank's ownership of government bonds would rise to about 65 per cent.

Belt-tightening and debt resuscitation – the challenges of fiscal policy

With the second pillar of abenomics, fiscal policy, the government seeks, in the short-term, to revive and accelerate economic growth and pursue expansionary fiscal policy. At the same time, the longer-term objective is to halve the public-sector deficit relative to the GDP from 6.6 per cent in 2010 and to reach budgetary balance by 2020, and thereafter to seek to lower the debt ratio. Balancing public finances requires a significant reform of budgetary policy. Cuts are needed urgently especially in social expenditures, which have ballooned due to the rapidly ageing population. In other respects, the potential for cost-cutting is relatively limited. The reform pressures are therefore mounting on increasing government revenues, in which tax reform is key. Increases in the consumption tax are a step in the right direction.

The consumption tax rate in Japan is very low. In order to boost its tax revenues, the government hiked the consumption tax by 3 percentage points to 8 per cent in spring 2014. The intention was to raise the rate by a further 2 percentage points in October 2015, but the first tax hike immediately led to a contraction of GDP and pushed the economy into a so-called technical recession. Therefore, the next tax hike was postponed to April 2017, which is good for economic growth but will slow down the achievement of the fiscal policy objectives of the government. Delay of the tax base broadening hinders the achievement of a surplus budget by 2020. In order to alleviate the growth-contracting impact of the 2014 consumption tax hike, the government increased the budget deficit further by announcing a revival package of JPY 5,5 tr, and yet another package amounting to JPY 3,5 tr towards the end of the year (Table).

Table.

Japan's public budgetary expenditures			
	A	B	A + B
JPY trillion	Supplementary budget	Government budget (% fiscal year, annual growth)	Total public expenditures
2013	10.3 (2% of GDP)	92.6 (+2.5%)	102.9
2014	5.5 (1% of GDP)	95.9 (+3.5%)	101.4 (–1.5)
2015	3.5 (0.7 % of GDP) and approx. 3.0 (Total : approx 6.5 > 1.3% GDP)	96.3 (+0.5%)	99.8 (–1.5) (over 102,8 (approx. +1,4)

Source: Ministry of Finance, budget statistics.

Government expenditures have grown further in the period of abenomics, and the budget announced for 2016 is record large. At the same time, however, tax revenues have also increased. Since 2013, they have exceeded the value of government bonds issued. Hence, the Abe government has succeeded in increasing the general government primary balance. According to an estimate made by the government in January 2016, the target of cutting the deficit in half by fiscal year 2015 will materialise, but balancing of the budget by fiscal year 2020 is not possible. The calculation by the government is based on an assumption that real GDP growth of a good 2 per cent is achieved from 2018 onwards, which seems overly optimistic in light of the current economic situation. In addition, the achievement of the objective is hindered by the exclusion of food from the consumption tax hikes of 2017. This will reduce the tax revenues generated by the hike, and in the longer term, consumption taxes will probably have to be increased further.

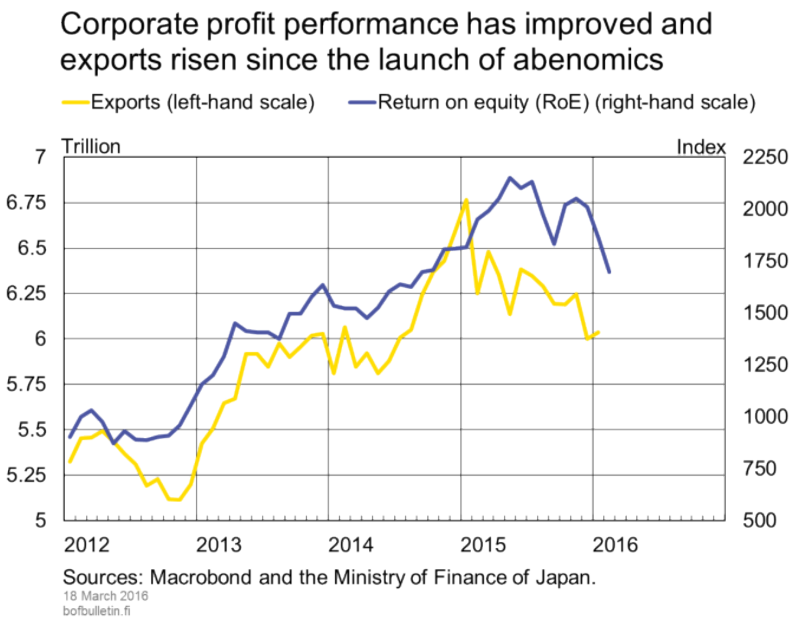
Structural reforms are key to sustainable growth

Monetary and fiscal policy revival can help with the start-up of economic growth and bring the deflationary trend to a halt. However, in order to reach a sustainable growth path and reduce indebtedness, Japan must make significant structural reforms, which are the third and most important pillar of abenomics.

The structural reform package was announced in June 2013, and it was further specified in June 2014. The objective of the reform was to achieve an annual real GDP growth of 2 per cent by 2022. The objective of the growth strategy is to 1) improve the effectiveness of ownership control of companies, reallocate the government pension insurance fund (GPIF) investment strategy to higher-return instruments, develop an atmosphere more favourable for entrepreneurship, reform corporate taxation and develop innovation, 2) increase women's participation in the labour force, reward work results rather than time spent working, attract foreign labour and 3) renew the energy sector, create a growth industry out of agriculture, and strengthen the health industry. The key reforms comprise the improvement of companies' profitability and operating environment, and labour market reform.

The reform of the corporate sector seeks to improve the efficiency of companies' activities and to encourage more investment by companies. The long-term rate of return of Japanese companies has been relatively low. In order to improve the profitability of companies, the Abe government has worked at reducing regulation, increasing the number of external directors, encouraging transparency and reporting to the owners, and increasing the influence of company owners. In addition, a decision has been made to gradually lower the country's burdensome corporate tax rate to less than 30 percent, which better corresponds to tax levels in rival countries – China and South Korea in particular. Furthermore, in January 2014, a programme was set up to encourage companies to invest by reducing their tax burden.

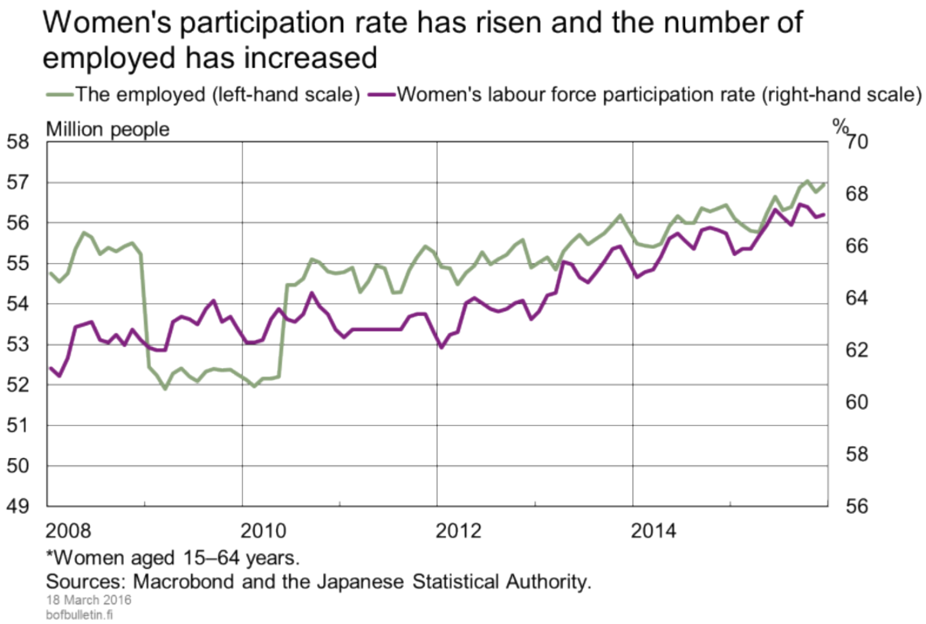
Chart 5.



The start of the corporate sector reforms has been promising (Chart 5). Corporate profitability has improved. For example, the return on equity has risen clearly since 2012. The efficiency improvements in corporate activities are also promoted by the free trade agreements sought after in the context of the reform. If these agreements materialise, they will open Japan's relatively closed markets and force companies to improve their productivity in order to be more competitive. In autumn 2015, Japan and the United States, together with ten other countries, signed the Trans-Pacific Partnership (TPP). The opening of the markets will also benefit the Japanese export sector, which has already grown markedly due to the depreciation of the yen.

As the population ages, the number of working-age (15–64) people in Japan has decreased considerably. The working-age population peaked at 87 million in 1995. By 2015, the number had contracted by a good 11 per cent to EUR 77 million. The most important challenge in the labour markets is indeed to increase women's labour force participation rate, which is one of the lowest among the OECD countries. Women's entry into working life is being made easier, among other things, by increasing the number of day care facilities and providing more flexible working hours, which enables and facilitates the reconciliation of work and family life. The government also encourages companies to appoint women to managerial and supervisory positions. In addition, the labour force is being increased by attracting more foreign workers, who are currently in short supply in Japan. The requirements for immigration have been eased, and the induction and training of foreign employees has been increased.

Chart 6.



Women's labour force participation rate has increased from 2012 onwards, and the decline in the total number of the employed has been halted (Chart 6). However, increasing the foreign labour force has been ineffective. For example, the quota of the programme attracting top professionals is 1,500 persons, which is indicative of the modest scope of the initiative. In addition, for example in the construction sector, which suffers from a labour shortage, the proportion of foreign workforce is only about 2 per cent. Hence, the government needs to take stronger measures to increase work-based immigration, and to change the overall attitude, which is negative towards immigration.

Despite the improvement in employment, there is the problem that the majority of job increases has been in part-time and fixed-term work. These jobs tend to be compensated clearly weaker in Japan compared to regular employment relationships. This undermines the economic growth potential, since a lower earnings level reduces the purchasing power of the consumers. An even bigger problem for the longer-term development of the economy is the development of the economy's aggregate wages. Contraction of the working-age population decreases the total of wages and reduces its growth potential. This impact is further amplified by the fact that an older working population on average has a higher earning level than a younger one. Therefore, as the ageing population retires, the wages of the replacing younger generation are not enough to compensate for the lost wages of retired workers. Therefore in order for purchasing power to remain unchanged, wages need to increase clearly in the future.

All hope is not yet lost

All in all, abenomics had a promising start in Japan. Optimism for the economic outlook was successfully brought about, the price level began to rise and economic growth picked up. However, the favourable development stopped with the consumption tax hike of spring 2014, as a consequence of which economic growth came to a halt and inflation also dropped back to around zero. Hence the 2% growth rates for inflation and real GDP targeted by the government have so far not been reached, and the country has continued to incur more debt. This reflects partly the recent sluggish development of the global economy and deterioration of the outlook of global economic growth, but the main challenge for achieving Japan's economic goals continues to be the implementation of structural reforms.

Even if the objectives of abenomics have still not been achieved, there are some signs of success. The core inflation has accelerated from the average level of –1 per cent at the beginning of the decade close to 1 percent, that is by nearly 2 percentage points, and the budget deficit has been successfully reduced. Companies have improved their profitability, and the decline in the number of the employed has been successfully slowed down by increasing women's labour force participation rate. This creates a solid foundation for wage growth, acceleration of inflation and ultimately also for more robust economic growth, which has so far remained sluggish. If the challenging and time-consuming structural reforms can be decisively put in place, the government still has a chance to achieve its objectives and enable the people of Japan to once again bask in the rising sun.

Tags

- monetary policy
- Japan
- economic growth
- inflation
- abenomics

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Russia's economy and imports to contract further

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

In the wake of a second export price shock late last year, the Bank of Finland now expects Russian GDP to contract 3% in 2016. Our new forecast assumes the price of oil averages slightly over $40 a barrel this year, about 60% below the 2014 average. With the economy shrinking and depressed export earnings, Russian imports should fall another 10% this year.

Following the collapse in oil prices in 2014, Russia's domestic demand last year fell by about 10%, while gross domestic product contracted 3.7%. Oil prices fell again in the second half of 2015. Russian imports slumped by 30% in 2014–2015.

With relatively high inflation eating away at purchasing power, we see domestic demand shrinking substantially in 2016, including a reduction in government spending in real terms.

While a gradual rise in oil prices will bring economic respite and revive imports in 2018, economic growth remains low due to uncertainties and Russia's poor business environment. The central risks in the forecast involve oil prices and changes in imports.

Domestic demand and imports hit hard last year

Besides dealing with the existing burdens of systemic deficiencies and uncertainties, the Russian economy had to start digesting a major export price shock in the second half of 2014. The price of oil was halved, dragging down export prices of oil products and natural gas along with it. Russian export prices in 2015 declined about 30% y-o-y in dollar terms and 20% in euro terms. Due largely to these events, the ruble fell sharply. While the ruble's decline cushioned the impact of the oil price shock, it stoked inflation in winter 2014–2015 to its highest pace since 1999, lifting average prices last year to a level 15–16% higher than in 2014. High inflation eroded purchasing power in both the private and public sectors.

Domestic demand fell in every category last year (and there have yet to emerge any clear signals this year that the contraction is ending). Besides high inflation, Russians saw a tame rise in private sector wages, while public sector wage growth ceased due to wage restrictions and wage freezes. Real household incomes declined (Chart 1). Meagre wage growth combined with a sharp rise in household savings to drive down private consumption by 10% last year, a markedly steeper decline than during the 2009 recession.

Public consumption shrank 2% last year, while fixed investment slumped nearly 8% (even if growth in investment in oil & gas production remained strong). As in the 2009 recession, inventories fell considerably. Among the main categories of demand, only export volumes increased in 2015 as exports of oil and oil products defied expectations and rose significantly. Gas exports also began a sharp recovery last summer.

Russian GDP contracted 3.7% last year. However, oil sector exports and growth of defence spending (which soared to nearly 30% in nominal rubles and some 10–15% in real terms) supported domestic production. High growth in government spending faded over the course of the year, and spending in real terms was down substantially for the year as a whole.

The 25% drop in imports last year (down 6% in 2014) was exceptionally steep relative to the economic contraction overall. The fall in imports mainly reflected the ruble's collapse in winter 2014–2015. Ruble depreciation was significantly larger than in the 2009 recession (the ruble's average nominal exchange rate in 2015 was about 25% lower than in 2014, while the real exchange rate was down about 15% against the euro and the Central Bank of Russia's trade-weighted currency basket). Falling export prices severely cut into Russia's export earnings (down 20% in euro terms). Outflows of private capital were substantially larger than capital flows into Russia, even if the difference narrowed considerably from 2014.

Chart 1.

Further contraction in economy and imports this year

Growth in world trade will improve during the 2016–2018 forecast period. We assume no change in geopolitical tensions related to Russia's actions involving Ukraine, the consequent foreign sanctions, Russian counter-sanctions and other concrete restrictions on market function, as well as the resulting uncertainty they generate and other uncertainties specific to the Russian economy.

The oil price is the most significant factor by far in our forecast – especially this year. In our September 2015 forecast, we noted that the impact on the Russian economy from the large drop in the oil price in the second half of 2014 would extend beyond a year (the assumed 2015 average price was $54 a barrel, or 45 % below the 2014 average). With that oil price assumption, our forecast was that GDP would diminish 2% in 2016, which was based on the results generated by BOFIT's Russia model.[1] The oil price fell again in the second half of 2015, and, as in our previous forecast, our assumption is that the oil price will rise only gradually during the forecast period. Thus, we now assume the oil price this year to average just over $40 a barrel (or 23% below the 2015 average and nearly 60% below the 2014 price) and $49 a barrel in 2018.

Applying this revised assumption, the forecast GDP contraction becomes slightly more severe in 2016 (around 3%) and GDP growth is essentially zero in 2017 (Chart 2).

1. Jouko Rautava: Oil Prices, Excess Uncertainty and Trend Growth.

Thereafter, as the impact of the drop in the oil price fades and the price gradually rises, the economy recovers, albeit slowly due to uncertainties and Russia's weak business environment. If our forecast and various estimates for Russia's long-term GDP growth (1–1.5% a year) materialise, Russian GDP in 2020 would be about 3% less than in 2014.

With a contracting economy and falling export earnings, Russia's imports are projected to decline about 10% this year and return to slight growth towards the end of the forecast period. Imports this year would be 37% below their 2013 level and several per cent above their level during the 2009 recession.

The volume of Russian exports is expected to increase slowly during the forecast period. Domestic demand should fall significantly in 2016, both with regards to private consumption, public consumption, fixed investment and inventories. For this year at least, government spending is set to contract substantially in real terms.

Chart 2.

Inflation and weakened government finances reduce demand

Given higher inflation projections for 2016 (consumer price inflation raised to around 8%), the erosion of purchasing power will be slightly more severe than in our earlier forecast. Moreover, the economic contraction hurts corporate profitability and reduces the ability of companies to raise wages. Freezes and other restrictions on public sector wages will remain in place. Russia's leaders have even lowered the slated 2016 pension increase to 4% – with no increase for working pensioners (official figures estimate working pensioners represent over 35% of Russia's roughly 40 million pensioners).

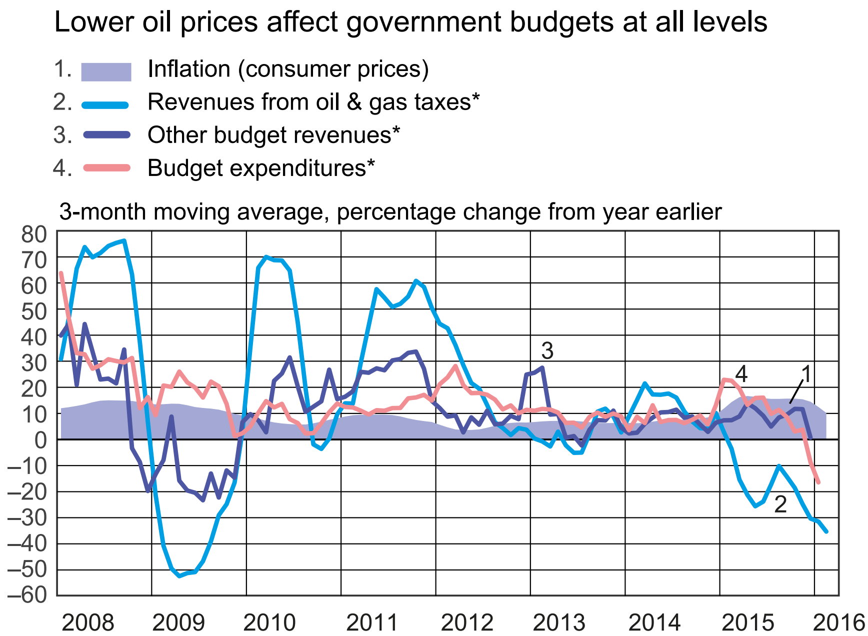
The decline in employment will be reflected as increases in unemployment and/or underemployment. Households are not expected to change their emphasis from saving to borrowing any time soon.

Government spending this year will fall substantially in real terms. Because lower oil prices reduce revenues in real terms, Russia's leaders are considering further spending reductions (Chart 3). New cuts would further depress public consumption.

Given that key experts predict growth in oil sector export volumes will plateau this year and then start to decline, any increase in Russian total export volume will likely be quite modest. A recovery in exports outside the oil & gas sector from last year's dip should partly shore up the situation.

Fixed investment should continue to decrease due to idle capacity, falling demand and uncertainty clouding corporate planning. The government also will have less money for investment. Inventories, which traditionally contract sharply in Russia during a recession, should continue to shrink.

Chart 3.



* Consolidated government budget (includes federal, regional and municipal budgets plus state social funds)
Sources: Russian Ministry of Finance and Rosstat.

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Tensions persist for imports

Along with economic contraction per se, a sensitive chain of other effects powerfully influences the outlook for imports. The oil price, Russian export earnings and capital flows in and out of Russia all affect the ruble's exchange rate. The ruble's exchange rate, in turn, affects imports directly and indirectly via inflation and domestic demand.

While imports will still decline this year, economic recovery will gradually set the stage for higher imports. A moderate rise in the oil price increases Russia's export earnings, creating space for import growth. International financial sanctions will limit the rise in imports, however. Import growth is also limited by the ratio of imports to GDP, which last year (despite dramatically lower import volumes) was the highest since 2003 as the value of imports in ruble terms has risen faster than GDP. The ruble's real exchange rate will appreciate gradually as inflation remains higher in Russia than in countries supplying goods and services to Russia (the inflation gap between Russia and its main trading partners was 6% in the first two months of this year).

Little room to manoeuver in economic policy

Banks amassed considerable household and corporate deposits last year, while the amount banks owe to the central bank fell substantially. Banks directed their lending in roughly equal measure on financing the public and corporate sectors. Lending to corporations actually diminished significantly from 2014.

Firms have cut back their investment plans and increasingly finance investments out of pocket. The impact of monetary policy on corporate borrowing remains unclear. Although 12-month inflation moderated this winter from 15% to 8%, the central bank has kept its benchmark "key rate" unchanged at 11% since August.

The government faces increasingly tighter fiscal constraints. With revenues essentially unchanged last year in nominal ruble terms (including a 20% drop in oil & gas tax revenues), real revenues were down substantially. The government deficit increased to over 3.5% of GDP, even if spending also fell in real terms. The budget outlook for this year is nearly as austere as last year if our oil price assumption and GDP projection hold. Based on the finance ministry's latest spending estimate, the deficit should increase to nearly 4% of GDP this year.

The government is attempting to raise revenues through a variety of measures that include hikes in minor taxes and dividends of state enterprises, as well as selling off stakes in state firms. Higher taxation of oil companies has also been under consideration. Russia's leaders have reduced targets for government spending (which notably exclude social spending, the biggest spending category by far). Their decisions are expected before summer. The fiscal outlook for 2017 is somewhat better – even if there is still a slight deficit if nominal government spending remains unchanged from this year. There is little room, however, for real stimulus in the public sphere during the forecast period.

The government will likely not need to exhaust the Reserve Fund this year to cover the deficit. In the worst-case scenario, it has been suggested that unallocated National Welfare Fund assets could be used to cover part of the deficit (some National Welfare Fund assets have already been allocated or distributed for bank subsidies and loans granted to investment projects and corporations). With these financing options available, the government might avoid the need to borrow.

Forecast risks remain substantial

The oil price remains an important risk factor in our forecast. Deviations from the assumed price track will naturally impact economic growth, the ruble's exchange rate, inflation and imports.

Shifts in geopolitical tensions could also occur, either positive with rather slow effects or negative with more rapid impact. There is also the risk from unexpected events that could cause capital outflows from Russia to surge, thereby depressing the ruble and imports.

If households make a turnaround from last year's savings binge, private consumption already this year would start to outperform the forecast. Despite the government's declared reduction targets, supplemental budget spending is not out of the question with the approach of Duma elections in September 2016 and the presidential election in March 2018. Such spending would boost the economy temporarily but would eventually require greater budget cuts to deal with the country's fiscal adjustment needs.

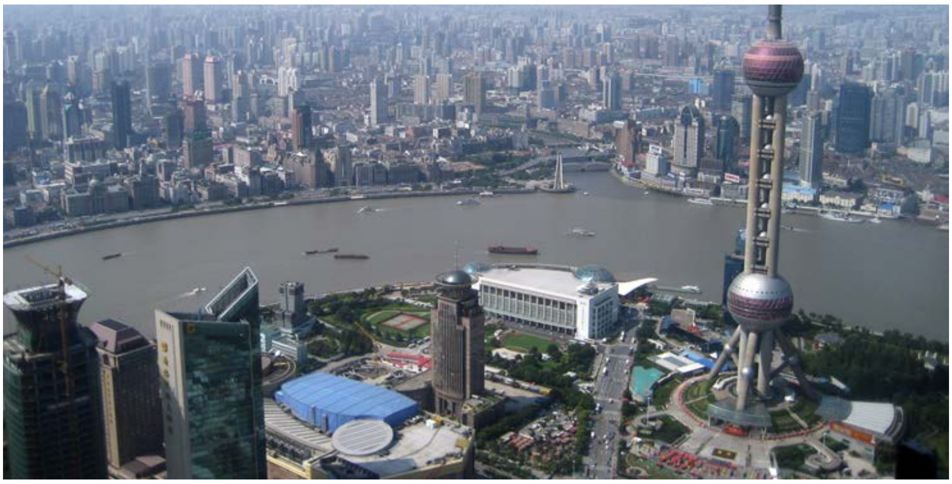
Tags

- forecast
- Russia
- BOFIT

Are Chinese GDP statistics reliable?

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

Despite increased economic and market uncertainty, China's GDP statistics still point to almost 7% growth, which is in line with official growth targets. According to the statistics, the deceleration of growth has been very smooth. This has once again raised suspicions over the reliability of Chinese GDP data. However, although there is much room for improvement in the coverage and transparency of the Chinese statistics, recent studies do not generally find evidence of significant or systematic falsification of GDP figures.

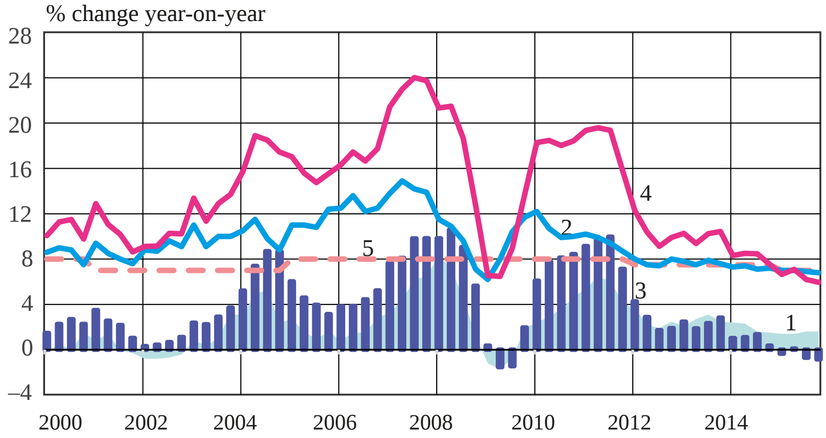


Debate on the accuracy of Chinese GDP figures has once again heated up. The slowing of nominal GDP growth below real growth has been seen as one indication of GDP performance in reality falling below the reported figure of around 7%. In recent years, nominal GDP growth has been much more volatile than real growth and has slowed much faster (Chart 1). The implicit GDP deflator turned negative in 2015, due mainly to increasingly sharp price declines in industry and construction (Chart 2).

Chart 1.

Chinese GDP growth has slowed

1. Consumer price inflation
2. Real growth
3. GDP deflator
4. Nominal growth
5. GDP growth target



Sources: National Bureau of Statistics of China and Bank of Finland.

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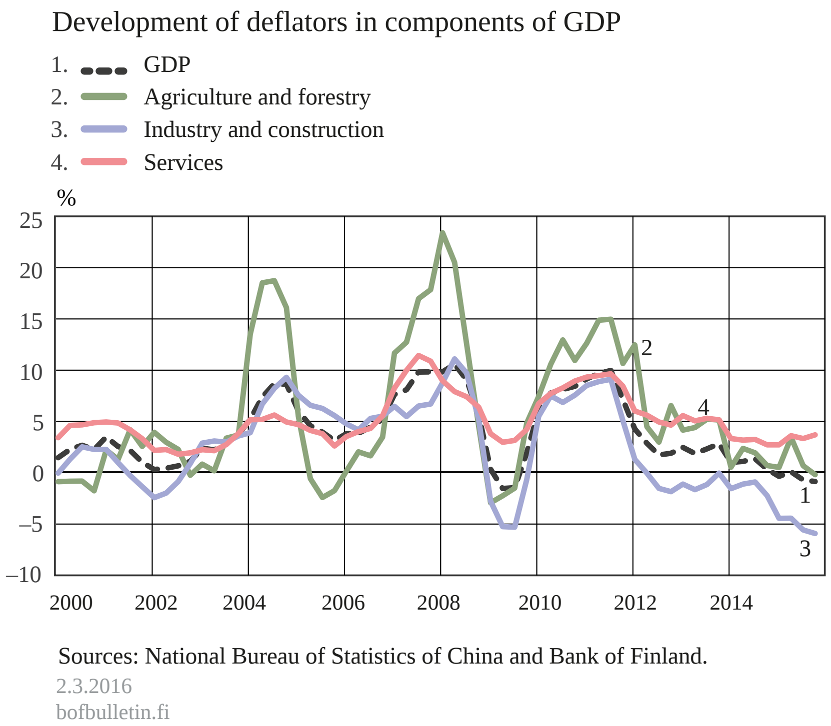
Chart 2.

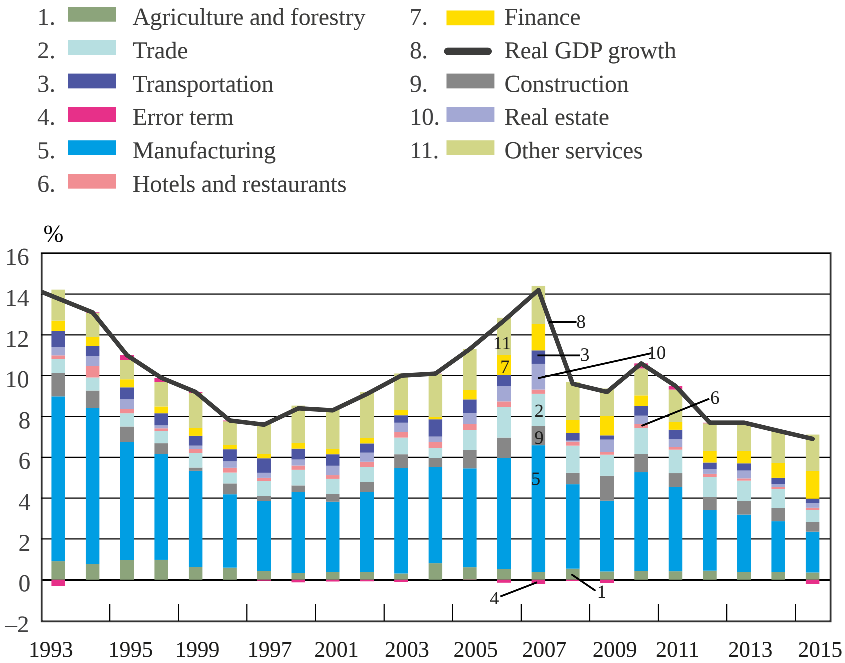


There are several widely known shortcomings in Chinese GDP statistics. Overall, it is very difficult to reliably measure the size of an economy like China undergoing swift structural change. Revisions by the National Bureau of Statistics (NBS) to the composition of Chinese GDP have systematically adjusted the service sector upwards, but the statistics are still likely to understate the size of the service sector. According to one estimate, the service sector could be about 20% and total GDP 10% larger than shown by current statistics.[1] At present, service sectors in particular are sustaining China's brisk growth (Chart 3). In 2015, the financial sector made particularly rapid progress.[2]

1. Rosen – Bao (2015). China uses the SNA 1993 statistical standard, which has a more limited coverage of, for example, the financial and real estate sector and R&D expenditure than the reformed standard. The statistical authorities have indicated their intention to adopt the more recent SNA 2008 standard, whereby the share of the service sector in the economy would expand and slower growth in industry would contribute less to overall GDP growth.
2. In 2015, the financial sector grew by 16%. The financial sector's rapid enlargement is due, in part, to the stock market boom seen in 2015. With the normalisation of the financial sector's growth rate to a good 9% (the average of 2010–2014), the growth rate of headline GDP would decline by about 0.5 percentage point.

Chart 3.

Service sector contributing more than before to Chinese growth



Sources: National Bureau of Statistics of China and Bank of Finland.
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The GDP growth target is an important guideline in Chinese economic policy, and policy success is measured in terms of achieving the target. This erodes the credibility of the GDP statistics released by the National Bureau of Statistics. The Bureau does not publish any official GDP deflator. In applying slightly different weightings to price changes, the authorities can, at least in theory, influence the published real growth figure and make it better correspond to the growth target. A rather widely held view is that the official Chinese figures present a slightly smoothed version of reality.[3] On balance, however, recent studies do not provide evidence of systematic errors in official GDP figures compared with other macroeconomic indicators.[4] In the longer term, GDP is considered as representing a relatively reliable measure of economic activity in China.

Given that Chinese GDP statistics give rise to suspicions, several research institutes also use alternative indicators for monitoring China's economy.[5] These offer additional viewpoints for discussion but, considering their current scope of coverage, they do not

3. See e.g. Nakamura – Steinsson – Liu (2014).
4. See, among others, Holz (2014) and Mehrotra – Pääkkönen (2011). Angus Maddison and Harry Wu are perhaps the most well-known critics of China's official statistics. They have calculated an alternative GDP time series for China, in which average annual growth in 1992–2003 was 8.7% instead of the official 9.9% reported by NBS. See Maddison – Wu (2008). According to Fernald et al. (2015), Chinese GDP figures have become more reliable since 2008, compared with other indicators.
5. The most well-known of the alternative indicators is perhaps the index named after the present prime minister, Li Keqiang, composed of electricity consumption, the railway cargo volume and bank lending.

suffice to replace GDP as a comprehensive indicator of macroeconomic activity. The biggest problem with regard to alternative indicators is that they are unable to account for the structural change in the Chinese economy. They mainly illustrate the evolution of heavy industry, construction and foreign trade, failing to adequately capture the growth of the service sector and private consumption.

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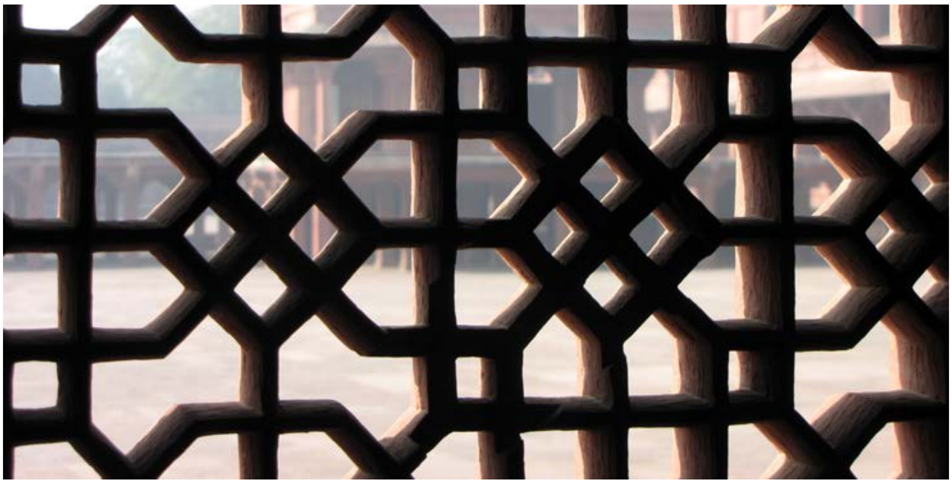
Tags

- China
- statistics
- BOFIT
- gross domestic product

India stands out

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

Global economic growth has been resting on the performance of the BRICS countries (Brazil, Russia, India, China and South Africa), but now these countries are facing headwinds. China's economic growth is slowing down, Brazil's and Russia's economies are contracting, and growth in South Africa is sluggish. Within this group, India's economy of 1.3 billion people stands out to its advantage. India's economic growth is strengthening and, according to forecasts by the International Monetary Fund (IMF), stood at 7.3% in 2015. IMF projects India's growth rate to accelerate further and to reach levels close to 8% by the end of the decade, which underpins India's position as the world's fastest-growing large economy.



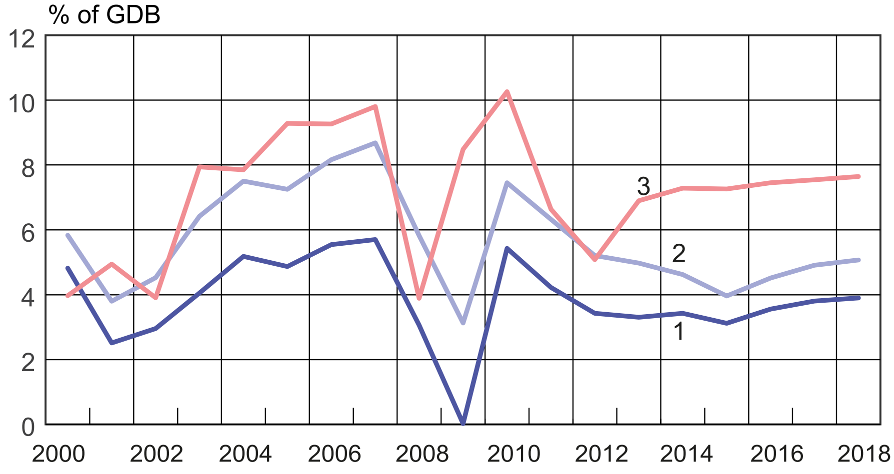
India is the world's seventh largest economy in terms of GDP at market prices, and the third largest economy in terms of GDP adjusted for purchasing power. However, the standard of living in India is far lower than, say, in China, where purchasing power-adjusted GDP per capita is nearly four times as high as in India. [1]

1. According to IMF estimates, in 2015, purchasing power-adjusted GDP per capita was approximately USD 6,200 in India and USD 24,000 in China. The figures for India's economy have been calculated on the basis of financial years that run from the beginning of April until the end of March of the subsequent year.

Chart 1.

Indian growth has diverged from growth path emerging economies

1. World*
2. Emerging and developing countries*
3. India*



* Figures for 2015 forward are based on IMF forecasts.
Source: IMF.

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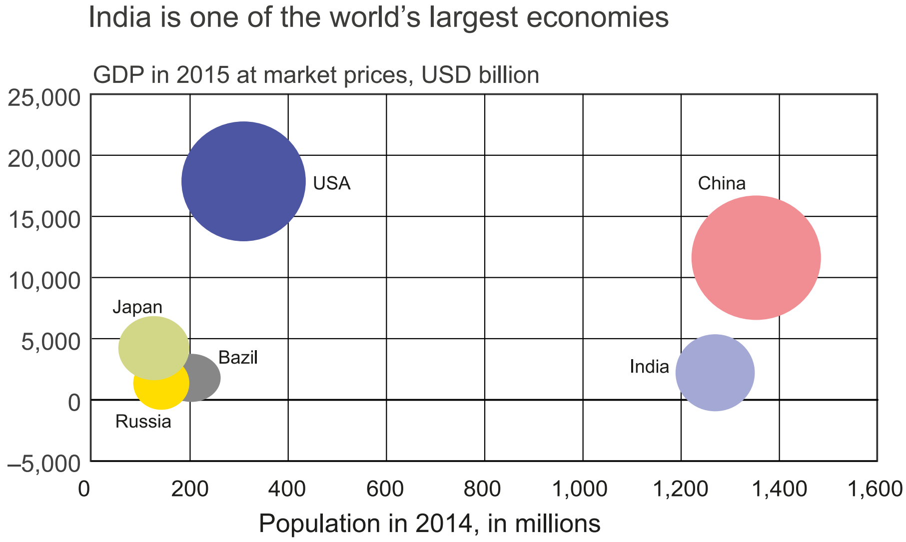
India has benefited significantly from the decline in oil prices, which has strengthened its current account balance and fiscal balance and moderated the increase in inflation. Moreover, economic policy measures, including those aimed at removing obstacles to competition and increasing the credibility of monetary policy, have strengthened confidence in India's prospects. Investment and domestic demand are expected to boost economic growth.

The turbulence on Chinese markets has only had a moderate impact on India. India displays net imports in commodities, and it is relatively independent of Chinese imports. In addition, the strengthening of India's macroeconomic situation has protected the country against the increase in global financial market volatility.

Chart 2.



The size of the circle illustrates purchasing power-adjusted GDP in 2015.
Source: IMF.
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Faster growth would require structural reforms

India remains a poor economy where the agricultural sector still plays a significant role. Some 21% of India's population, or 275 million people, subsist on an income below the poverty line.[2] The agricultural sector accounts for some 20% of India's GDP and employs half of the country's labour force.

An increase in agricultural productivity and a shift of labour force towards industrial and construction sectors with better productivity would allow for an acceleration in India's economic growth.

Such a structural change in the economy would, however, necessitate significant reforms. Key preconditions include reducing poverty and improving education and healthcare services. Growth is constrained by, for instance, bottlenecks in infrastructure, challenges in land management, rigidities on the labour and goods markets as well as the weakness of the business environment.

Prime Minister Modi, who entered office in May 2014, has embarked on a significant reform programme. Its implementation has, however, been slow in many respects.

2. World Bank data from 2011: the poverty line is taken to be USD 1.90 per day.

Risks overshadow growth outlook

Despite strong growth forecasts for India's economy, the downside risks to the projected outlook remain significant. In particular, a weakening of the global economic environment, a slowdown in export growth and a reversal of capital inflows would constrain the financing of investment in India and complicate the current account and budgetary situation.

Internally, the main risks relate to the financial sector and the implementation of economic reforms. India's corporate sector is highly indebted and, in particular, the balance sheets of government-owned banks (accounting for 76% of India's banking sector) have weakened. To safeguard banks' ability to finance investments critical to growth, it is important to recognise the risks threatening the banking sector, recapitalise banks and implement governance reforms.

Another internal risk relates to the governing party's ability to advance the reform programme and dismantle growth-restricting economic structures.

Despite reasonably stable growth prospects, India's development remains far behind China's success story.

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Tags

- India
- economic development
- structure of economy

Significance of the car industry in EU countries

TODAY 1:00 PM • BANK OF FINLAND BULLETIN 1/2016 • ECONOMIC OUTLOOK

In the EU countries, the car industry is of greatest significance to GDP and employment in Germany and some countries in East-Central Europe. In these countries a shock to the car industry could have a heavy impact on the national economy. The industry accounts for some 10% of the EU's goods exports.

In autumn 2015, the emission scandal surrounding the German car manufacturer Volkswagen immediately raised questions and concerns about the state of and outlook for car production in the EU. Possible macroeconomic effects can be assessed by studying the significance of the car industry[1] in the EU countries on the basis of national accounts and foreign trade statistics.

Car industry most important to Germany and economies of East-Central Europe

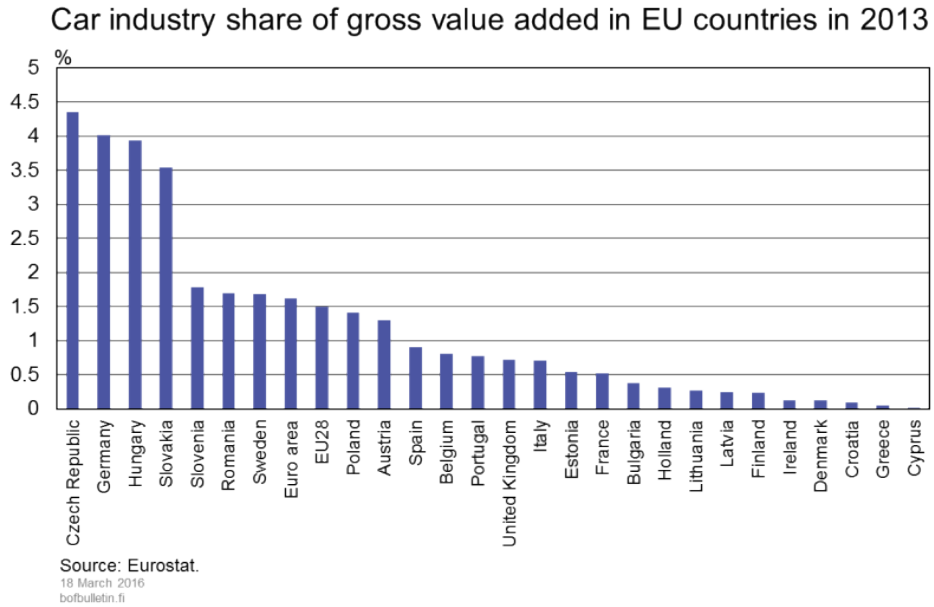
The car industry's share of gross value added in EU countries in 2013[2] was largest in the Czech Republic, Germany, Hungary and Slovakia, where it varies around 4% (Chart 1). This proportion is more than double the average (about 1.5%) in EU countries and the euro area.

Although the car industry in, for example, the Czech Republic has long traditions, the car industry's present significance in the countries of East-Central Europe is due to investments by foreign – particularly German – car manufacturers. On the other hand,

1. Here, production of motor vehicles and trailers as well as related parts and accessories are included under the car industry.
2. Most recent comprehensive industry-level information.

the car industry’s share of gross value added in the traditional car manufacturing countries of France and Italy is relatively small: in France only about 0.5% and in Italy about 0.7%. In Spain, the share is nearly 1%, which as in the countries of East-Central Europe is substantially due to German investments.

Chart 1.



The presented information (Chart 1) probably somewhat underestimates the car industry’s share of gross value added, because it does not cover all inputs of the industry, for example tyres. In addition, the car industry's overall effect on GDP is larger than its share of gross value added, due to multiplier effects. The wage and capital income of car industry employees and owners create new demand for domestic goods and services, and the income from supplying them creates further new demand etc. These effects have not been assessed here.

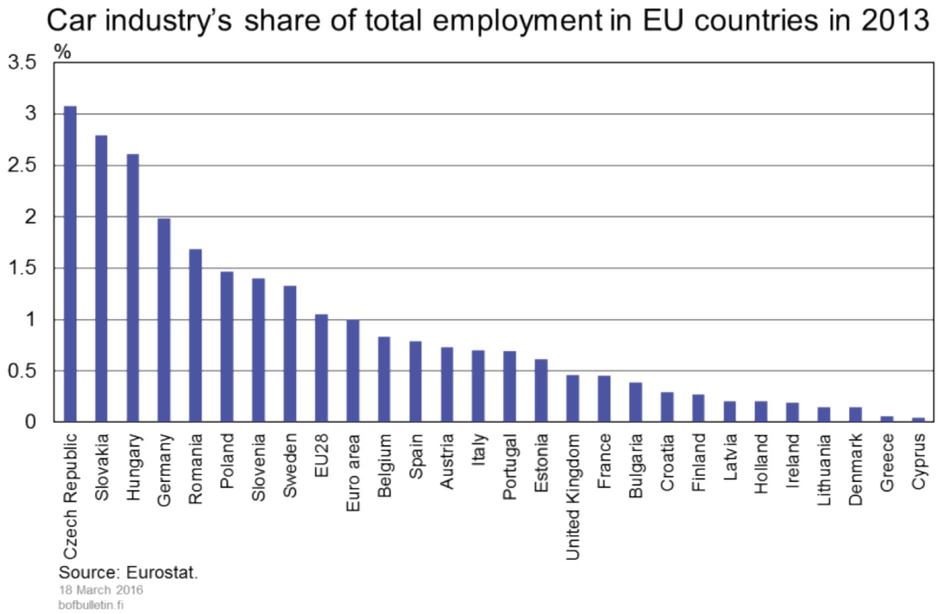
Car industry as employer in EU countries

A study of the car industry’s share of total employment in EU countries in 2013 also shows the significance of the industry as an employer (Chart 2). The industry’s share of total EU employment is slightly more than 1%, which amounts to a little less than 2.4 million people. Their share of total employment in the euro area is more or less the same as in the EU as a whole.

The car industry’s share of total employment is largest in the Czech Republic (more than 3%), followed by Slovakia, Hungary and Germany. The industry’s share of total employment is smaller than its share of gross value added, because it is so highly automated that in relative terms the necessary workforce is smaller than in many other industries.

Increased productivity requires investment in research and development. In 2014, the car industry's R&D expenses were about EUR 40 billion, which matches about a quarter of all R&D expenses of industrial corporations in the EU.[3]

Chart 2.



Car industry share about 10% of EU goods exports

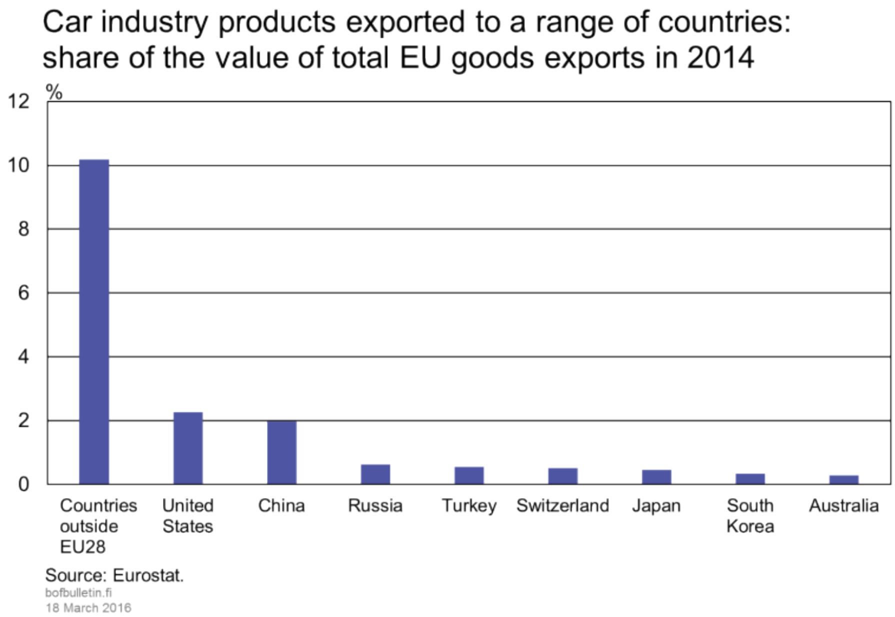
In 2014, about 30% of EU car industry production was exported.[4] A study of car industry products exported to different countries and their share of the value of total EU goods exports shows that the car industry's share of exports to regions outside the EU is slightly over 10% (Chart 3). The USA is the single most important export market for the EU car industry. About 22% of car industry exports to regions outside the EU go to the USA. The second most important market is China, whose share is a little less than one fifth. Since the US and Chinese shares are so considerable, the EU car industry represents one channel along which demand shocks originating in these countries are transmitted to the EU area. Other important export markets are Russia, Turkey, Switzerland and Japan.

In addition to their exports, European car manufacturers also have significant production outside the EU. Correspondingly, there are foreign – particularly Japanese – car manufacturers in Europe.

3. European Commission (2015): The 2015 EU Industrial R&D Investment Scoreboard. JRC/DG RTD.

4. Eurostat Europroms.

Chart 3.



Overall, the car industry is significant in EU countries. Since this industry is most important to Germany and some countries of East-Central Europe, a shock to the car industry could have a heavy impact on their national economies. Of these countries, the effects on Germany would be most significant to the EU as a whole. Still, the car industry's share of gross value added in Germany is much smaller than, for example, the share of financial services in the United Kingdom (a little less than 7% in 2013).[5]

Tags

- car industry
- employment
- exports
- gross value added

5. ONS (2014) An International Perspective on the UK - Gross Domestic Product. The figure presented by the ONS is based on data from the OECD.