BANK OF FINLAND
BULLETIN

ARTICLES ON ECONOMY BY BANK OF FINLAND

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Falling oil prices translate into an income transfer from producers to consumers

18 MAY 2015 1:00 PM • BANK OF FINLAND BULLETIN 1/2015 • ECONOMIC OUTLOOK

The fall in the oil price is broadly reflected across the current situation in the global economy and the outlook for the future. According to most assessments, the oil price drop is for the most part a positive supply shock that in the short term will support growth and slow inflation in net oil-importing countries. In addition to the oil price, long-term interest rates have also declined substantially in the euro area. As a whole, the outlook for the advanced economies has strengthened on average, while the outlook for many emerging economies has weakened. There are, however, major differences within the country groups, a fact also reflected in exchange rates. A particular case in point is the appreciation of the US dollar.

According to the Bank of Finland forecast, global growth will gradually accelerate from the 3.1% seen in 2014 to 3.7% in 2017. US growth will continue at a brisk pace, while in the EU22, growth will also accelerate in 2015. Slower growth in China is both expected and primarily positive. The Russian economy will contract in the immediate years ahead. According to the Bank of Finland forecast, the EU22 will experience zero inflation in the current year. In 2016, inflation will average 1.1%, accelerating slowly to 1.7% in 2017.

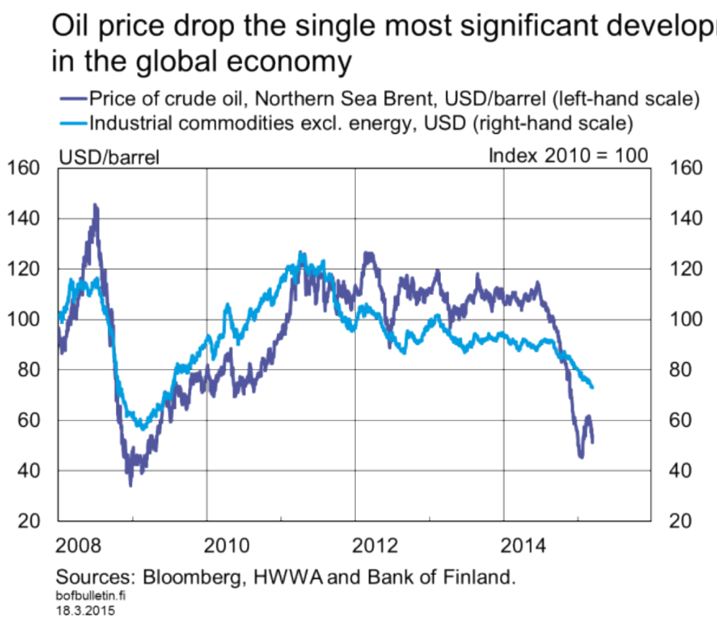
The uncertainty surrounding the growth and inflation forecasts is greater than before, but now also includes upside risks. The low oil price and long-term interest rates could stimulate global growth more than previously estimated. Moreover, depreciating exchange rates in the EU22 and Japan could also drive faster-than-forecast growth and inflation. On the other hand, prolonged slow inflation could interfere with growth, particularly in the EU22. Geopolitical risks continue to overshadow the outlook.

The decision by the Governing Council of the ECB to relax monetary policy through an expanded asset purchase programme will boost demand and accelerate inflation via a number of channels. Completion of the comprehensive assessment of bank balance sheets and the steps taken by the ECB will enhance monetary policy transmission via bank lending. The relaxation in corporate financing conditions and the moderate scale of debt in the euro area corporate sector create the conditions for a recovery in investment. In many euro area countries, households' high debt-servicing expenses and low net assets will maintain pressures to reduce the level of debt while also weakening household demand. Although the accommodative monetary policy stance is justified in order to ensure price stability, negative side-effects cannot be entirely ruled out. It should be possible to apply macroprudential policy to support the focusing of the relaxed monetary policy stance on fixed investment rather than on the housing market.

Falling oil prices translate into an income transfer from producers to consumers

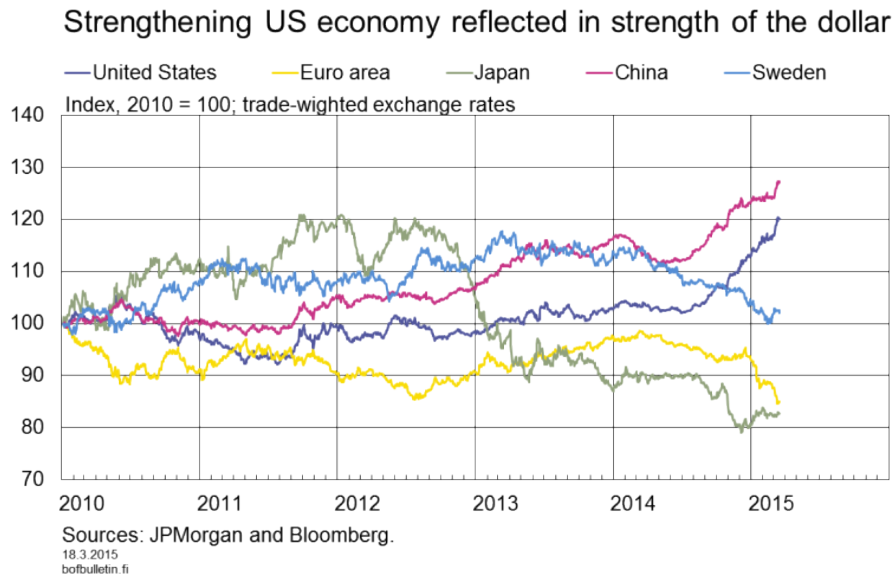
The recent decline in oil prices has been the single most significant change in the global economy over the past six months and as such is reflected broadly in assessments of global economic developments and outlook. Most estimates see the fall in oil prices mainly as a positive supply-side shock that supports growth and curbs inflation over the short term in net oil-importing countries. At the same time, however, the situation in oil-exporting countries has weakened and uncertainty has increased on both financial and commodity markets.

Chart 1.



For a long time, the financial crisis that escalated in 2008 manifested itself mainly as an economic and debt crisis in advanced economies with only a minor impact on emerging economies. By 2013 this situation had changed among increasing signs of economic recovery in the United States. The resulting expectations of a gradual normalisation of the Federal Reserve's monetary policy added to uncertainty on the financial markets, causing difficulties particularly for advanced economies with weaker fundamentals. Over the past few months, the outlook for the advanced economies improved on average, whereas the outlook for most emerging economies continued to weaken. Large country differences within the groups have been reflected in exchange rate movements, with the US dollar, in particular, appreciating (Chart 2).

Chart 2.



Falling oil prices have meant weaker income prospects for oil-producing countries and non-financial corporations in the energy sector, and their borrowing costs on the financial markets have increased accordingly. At the same time, long-term government bond yields have fallen sharply in the United States, the euro area and Japan.

The market yield of long-term government bonds can be broken down into three components: expected inflation, real interest rate and liquidity premium. Long-term real interest rates can similarly be broken down into short-term interest rates and a so-called time premium. In 2014, medium and long-term inflation expectations fell considerably in the euro area and in the United States. For the most part, changes in e.g. five-year government bond yields in the euro area and the United States can be explained by the decline in inflation expectations. In the United States, real yields on five-year government bonds increased slightly in 2014, while in the euro area they fell slightly. According to a Federal Reserve estimate,[1] however, time premia on e.g. 5–10-year government bonds diminished significantly in the United States.

The diminishing time premia are most likely explained by growing demand for government bonds. Demand growth has been supported by central bank purchasing programmes, safe haven demand from market participants and a partially regulation-driven need for market participants to hold government bonds.

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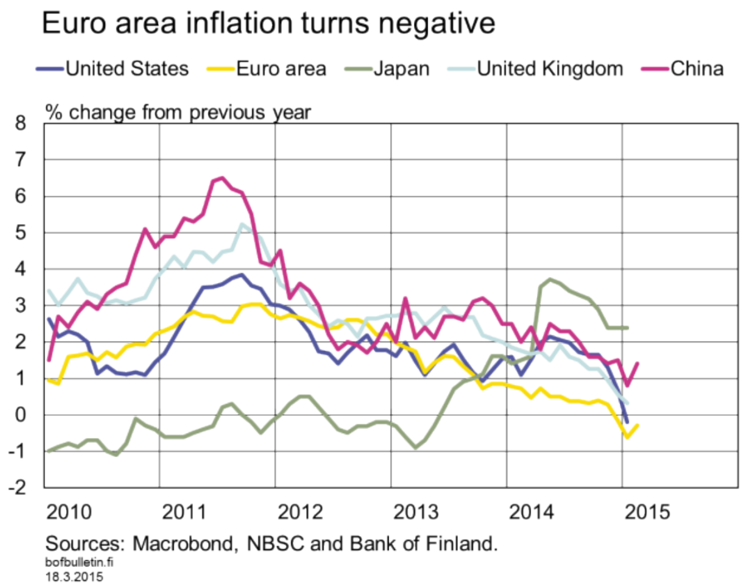
1. D´Ámico, S. – Kim, D. – Wei, M. (2010) Tips from TIPS: the information content of Treasury Inflation-Protected Security prices. FED DP 19/2010. See also FED New York Database 2015. No similar analysis was available for the euro area.

Low inflation causes concern

In most major economies, inflation has fallen considerably since end-2014. The euro area has the lowest inflation of all economic regions, with the annual rate of change in consumer prices at -0.3% in February. In the United States, too, inflation rates fell below zero in January. In Japan, inflation was still approximately 2.5%, partly on account of the rise in consumption taxes in April 2014. In China, consumer prices have been falling for a number of years now.

Chart 3.

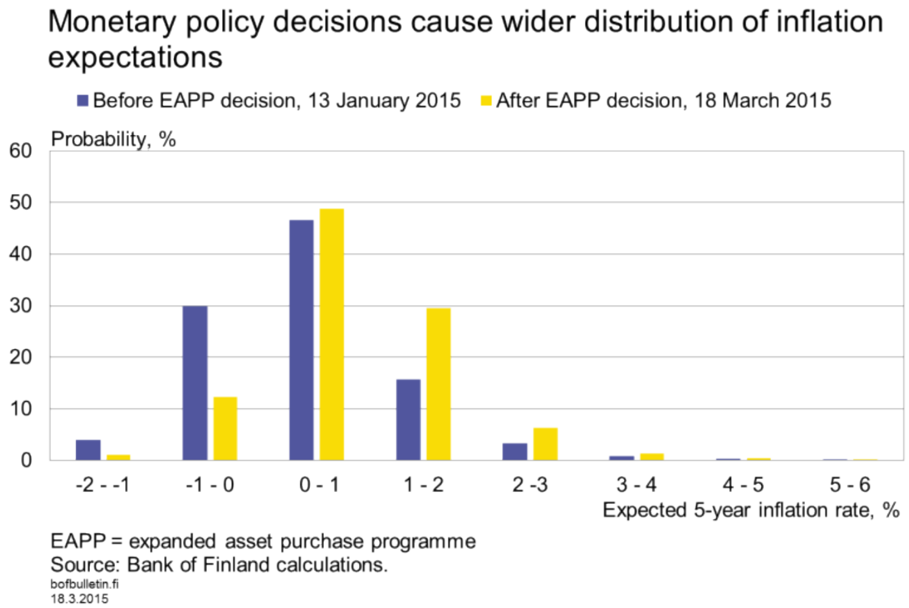


The recent decline in inflation is mainly due to the fall in world market prices of crude oil. Other commodity prices have also contributed to lower inflation. In January, world food prices were 5% lower than a year earlier and approximately 16% lower than in June 2014.

Core inflation (excluding food and energy prices) has declined less than consumer price inflation but is similarly historically low. The subdued price developments reflect supply side factors but also continued cyclical weakness. Output gap estimates and e.g. the low employment rate support the view that there is still unused capacity in the major economic regions.

Alongside actual inflation, expected inflation has also declined. The Governing Council of the ECB decided in its January monetary policy meeting on an expanded asset purchase programme (EAPP) aimed at fulfilling the ECB's price stability mandate. The purchase programme and the accompanying inflation-based forward guidance produced a marked change in inflation expectations. The pronounced fall in longer-term inflation expectations stalled and inflation expectations stabilised. Monetary policy in the euro area is covered in more detail in the section 'Euro area monetary policy'.

Chart 4.



Market expectations about future inflation can be gauged from swap rates and options which reflect, respectively, average expectations and dispersion. Inflation options can be used to estimate a (risk-neutral) probability distribution for expected inflation. Looking at average 5-year inflation probability distributions before and after the January decisions of the Governing Council, Chart 4 shows a considerable change in the distribution of expected inflation. The probability of negative inflation, in particular in the range of -1–0%, has fallen markedly and the probability of higher inflation has grown. Risk-neutral probability distributions show that the monetary policy decisions have had a larger impact on market expectations about future inflation than can be seen when looking at average expectations alone.

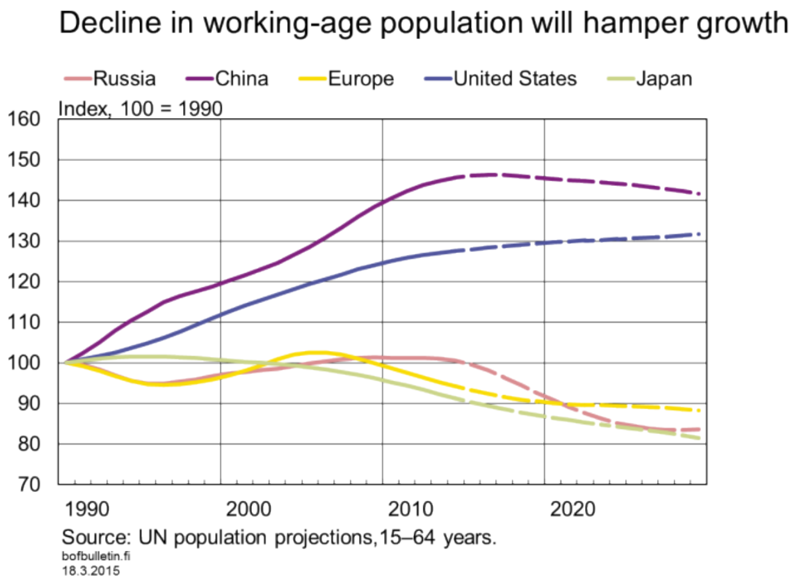
Global growth to pick up over forecast horizon

The point of departure for the Bank of Finland's March 2015 forecast for the international economy is slightly more positive than at the time of the September forecast. Net oil-importing countries are benefiting from the fall in oil prices. In e.g. the euro area and Japan, the growth and inflation outlook is supported by already occurred exchange rate developments, while the recovery in the United States is in harmony with the strong dollar.

Forecast assumptions about commodity prices, interest rates and exchange rates are based on market expectations. Fiscal policy assumptions are based on structural reform estimates by national and international institutions, EU fiscal policy rules and forecast cyclical developments. The forecast also assumes that the situation in Greece will be resolved without aggravating the crisis.

In the Bank of Finland forecast, global economic growth will increase gradually from 3.1% in 2014 to 3.7% in 2017. The global real GDP growth forecast for 2015–16 has been revised downwards. The situation in several emerging economies (excl. China) has deteriorated and their economic outlook has moderated. Forecasts for the United States and the euro area remain broadly unchanged. Differences in economic growth across the major advanced economies reflect imbalances both from before the financial crisis and arising from the subsequent economic crisis. In addition, the dwindling working-age population and differences in fixed investment since 2008 are reflected in estimates of potential output.

Chart 5.



The weaker economic outlook in the emerging economies also has an impact on the forecast for world trade growth. Over the forecast horizon, world trade should accelerate as consumption and investment growth improves in the advanced economies. In 2017, world trade growth is forecast to reach around 5½%.

Table 1.

Growth in GDP and world trade

BKT	2014	2015f	2016f	2017f
United States	2.4	3.1	3.0	2.8
	2.1	*3.1*	*3.1*	
EU22	1.2	1.6	1.9	1.8
	1.1	*1.6*	*1.9*	
Japan	-0.1	0.6	1.4	1.0
	1.1	*1.2*	*1.2*	
China	7.4	7.0	6.0	6.0
	7.0	*7.0*	*6.0*	
Russia	0.6	-4.4	-1.8	0.5
	0.0	*0.5*	*1.5*	
World	*3.1*	*3.3*	*3.5*	*3.7*
	3.2	*3.7*	*3.7*	
Worldtrade	3.5	4.2	5.0	5.4
	3.9	*5.1*	*5.4*	

f = forecast.

EU22 = euroarea, Sweden, Denmark and United Kingdom.

% change from previous year (lower line from previous forecast).

Source: Bank of Finland.

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Growth gathers pace in Europe

The Bank of Finland March forecast for the international economy foresees accelerating economic growth in the EU22 (euro area, United Kingdom, Sweden and Denmark) in 2015. Exports, private consumption and later also investments are expected to grow slightly faster than previously forecast. Compared with the December 2014 forecast of 1.3%, GDP growth for 2015 has been revised upwards by nearly 0.3 of a percentage point. The annualised quarter-on-quarter real GDP growth rate is anticipated to reach 1.7–1.8% in the second half of 2015 and to remain at these levels also in 2016–17.

According to the forecast, GDP in the EU22 will surpass its 2008 level during 2016, although sizable country differences will remain.

As regards fiscal policy, the overall fiscal deficit in the euro area shrank to 2.6% of GDP in 2014. The deficit is still shrinking, but fiscal policy is forecast to remain broadly neutral to growth. The shrinkage of the deficit can be mainly attributed to improving cyclical conditions. The envisaged growth would reduce the overall fiscal deficit in the euro area well below 2% of GDP in 2017.

According to the Bank of Finland forecast, EU22 inflation in 2015 will be zero. This is due to the much lower price oil compared with a year ago. The dampening impact of oil prices on inflation will fade by the end of the year and inflation return to positive territory.

Table 2.

Inflation returning towards price stability objectives

% change from previous year (lower line from previous forecast).

	2014	2015	2016	2017
EU22*	0.6	0.0	1.1	1.7
	0.8	1.2	1.5	
United States	1.6	0.2	1.6	2.0
	1.8	1.9	2.1	
Japan	2.7	0.4	1.1	1.6
	2.9	2.0	1.8	

* Euroarea, Sweden, Denmark and United Kingdom

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

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Inflation is forecast to average 1.1% in 2016 and to accelerate to 1.7% in 2017. In the United Kingdom, a favourable outlook for growth should boost wage increases, thus contributing to price pressures. In the euro area, the ECB's highly accommodative monetary policy will improve economic activity and support the anchoring of inflation expectations. The recovery will also gain from stronger domestic demand, while economic growth should allow wages to start rising moderately. The depreciation of the euro will also contribute to higher inflation via import prices. According to the forecast assumptions, oil and other commodity prices will start to grow moderately over the projection horizon. Nevertheless, inflation will rise only slowly in view of the abundant unused capacity in the economy. The unemployment rate will remain high and the output gap is not expected to close until the end of the decade.

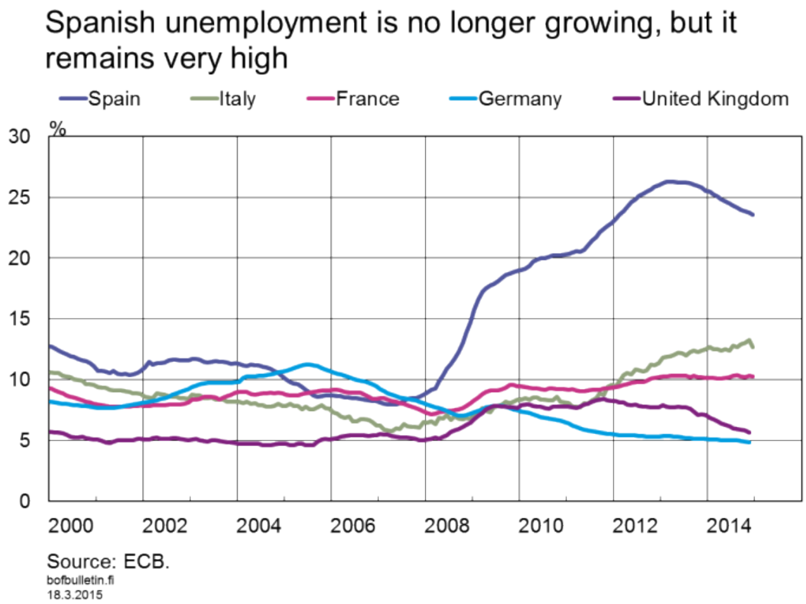
Large differences between EU countries

The economic situation in Germany shows promise for 2015. The carry-over growth effect should be in the order of around ½ a percentage point, and the economic fundamentals are sound. The German economy is competitive, household indebtedness is at a moderate level and the unemployment rate ranks among the lowest in the euro area. On the back of a balanced budget and the lowest debt ratio among the large euro area countries there is no further need for fiscal consolidation over the forecast horizon.

The French economy grew 0.4% in 2014, as in 2013. The drop in the price of oil and a more moderate pace of fiscal consolidation should support private consumption over the forecast horizon. Tax cuts, lower energy costs and the weaker euro should improve the competitiveness of French non-financial corporations, thus enhancing their investment prospects. Structural reforms pave the way for higher employment. Nevertheless, the unemployment rate is forecast to fall only gradually over the forecast horizon.

In Italy, GDP growth has been weak since the onset of the financial crisis in 2008. The Bank of Finland is forecasting sluggish growth for the coming years, too, although Italy stands to benefit from the accommodative monetary policy stance more than average on account of its high debt ratio. Italy has sought to implement reforms to its political system, labour market and banking sector in order to reduce public sector indebtedness and improve growth prospects over the long term. Implementing these and other structural reforms will be key to stabilising the Italian economy.

Chart 6.



Spanish GDP began to growth again in mid-2013 after almost five years of contraction. Growth is expected to remain brisk, and the still high unemployment rate of 23% is expected to moderate over the next few years. Growth will be bolstered by the successful consolidation of the banking sector and structural reforms that have made the labour market more flexible. Inflation fell to around zero in Spain as early as autumn 2013 and clearly entered negative territory around the turn of the year 2014–15. The public finances still substantially in deficit and public debt will slightly exceed 100% of GDP in 2015.

Economic growth in the United Kingdom remained robust in 2014 notwithstanding a slight faltering in pace in the second half of the year. Growth is strongly supported by private consumption, which in turn has been boosted by further improvements in the condition of the labour market, a reduction in household indebtedness and rebounding confidence levels. The output gap is forecast to turn positive towards the end of the forecast horizon and to gradually slow economic growth. Inflation is forecast to remain slow in 2015 but to return rather briskly to a growth path in the latter part of the year as wages growth gathers pace.

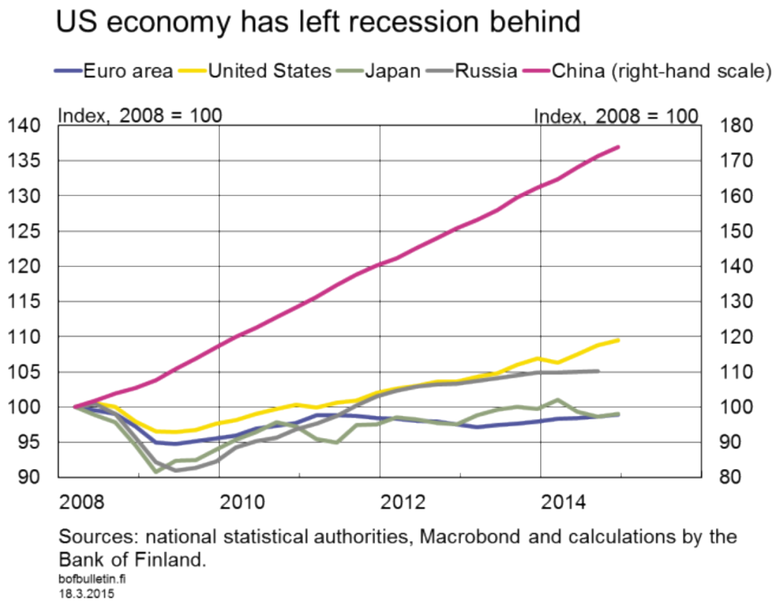
The growth prospects for the Swedish economy remain fairly good, although ongoing household debt accumulation overshadows the medium-term outlook. Despite problems with private sector indebtedness, the Swedish economy has experienced relatively strong growth. Consumer and business confidence indicators indicate solid faith in the future. Inflation has been low and declining continuously. The Riksbank accordingly decided in February to lower its key interest rate to -0.1% and to launch a SEK 10 million government bond purchase programme. In view of this decision, private sector debt accumulation is likely to continue over the forecast horizon.

Denmark is recovering from a long recession. In Denmark, the financial crisis was preceded by a housing market financing bubble that led to significant over-indebtedness among households. With the financial crisis, the Danish banking system ran into difficulties and the private sector was plunged into a balance sheet recession. The outlook for non-financial corporations has for some time been markedly better than the outlook for households. Danmarks Nationalbank has already had to lower its deposit rate to –0.75%.

Strong growth in the United States

The US economy grew by 2.4% in 2014. Of all the advanced economies, its outlook is the most solid, as the balance sheet adjustment of recent years has considerably reduced private sector indebtedness. Lower oil prices also have a positive impact on the US economy as a whole, although shale oil production is suffering. Economic growth is forecast to remain above its potential over the entire forecast horizon, supported by strong private consumption and investment, and GDP is forecast to grow at an annual rate of around 3%.

Chart 7.



Although US general government finances have undergone significant consolidation, the overall fiscal deficit was approximately 5% of GDP in 2014. According to the Congressional Budget Office (CBO), the federal deficit should diminish over the forecast horizon on the back of cyclical developments. In recent years the deficit has been reduced by significant spending cuts and tax hikes.

Inflation has been on a declining path since May 2014, and in January 2015 it became negative. The main factors behind the recent fall in the inflation rate are the lower price of oil and the appreciation of the dollar since summer 2014. In addition, price pressures have been dampened by still modest wage developments. Over the forecast horizon, inflation will pick up as the dampening effect of the oil price fades and the improved economic growth narrows the output gap and tightens the labour market.

Japanese structural reforms progressing slowly

In Japan, the economy reacted strongly to the raising of consumption taxes in 2014. In the final quarter of the year, however, the economy rebounded, and the outlook for economic growth in Japan over the next few years is moderately positive. In the Bank of Finland forecast, GDP growth in Japan averages approximately 1% in the coming years.

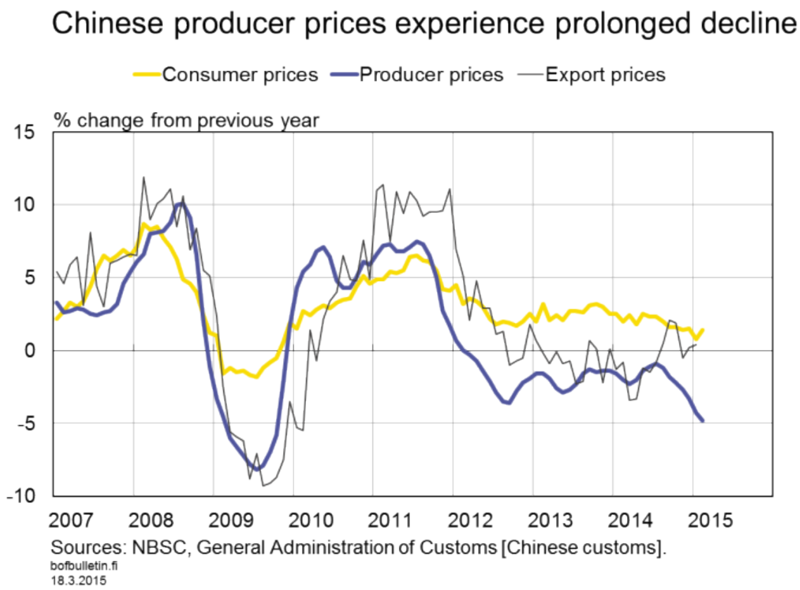
In recent years, Japan has sought to boost economic growth through monetary and fiscal policy. However, the structural reforms that constitute the third pillar of the government's growth strategy have made only slow progress. Successful structural reforms are essential to the success of Japan's long-term growth strategy and consolidation of the public finances.

Inflation increased in Japan in 2014 with the raising of consumption taxes and depreciation of the yen. The inflation rate will slow with lower oil prices and the fading of the impact of the consumption tax hike. In the Bank of Finland forecast, Japan's inflation rate for 2015 is 0.4%, rising to 1.6% by 2017.

Controlled slowdown in growth cannot be guaranteed in China

Economic growth in China slowed in 2014 as expected, with GDP growing 7.4%. In 2015, growth is still expected to reach 7%, but to decline thereafter to 6% in 2016–17. This decline is expected and largely positive. Over the forecast horizon, however, determined implementation of structural reforms will gain in importance. The financial markets expect a deposit protection scheme to be launched in 2015, which would enable the country to remove interest rate restrictions. China also intends to expand the floating range of the renminbi by the end of 2015. Capital markets have gradually opened, but trading is still restricted through various programmes and quotas. A true opening of the capital markets could have a positive impact on economic growth over the forecast horizon.

Chart 8.



In 2014, the GDP share of private and public consumption for the first time surpassed the share of investments. Over the forecast horizon, imports are expected to grow slightly faster than exports and the current account deficit is expected to stay at just below 2% of GDP. These dynamics are driven, on one hand, by higher growth in China than in the rest of the world and by growing consumption and, on the other hand, by the appreciation of the Chinese currency and by low-value-added production moving out of China as labour costs increase.

In 2015, consumer price inflation fell to 0.8%, mainly on account of food and energy prices. Inflation excluding food and energy prices was 1.2%. The protracted fall in producer prices is due particularly to unused capacity in several industries as a result of mainly investment-based stimuli in earlier years.

Russian economy to contract markedly in 2015

Economic growth in Russia has now contracted significantly for three consecutive years. In 2014, GDP grew by just 0.6%, stagnating for part of the year. With the drop in oil prices, the economy is contracting and there are plans to cut public expenditure. GDP is forecast to contract by over 4% in the current year. Once oil prices start to rise at a moderate pace, GDP should stabilise. With the ongoing tensions in eastern Ukraine and a lack of clarity about sanctions and Russian counter-measures, however, exceptional uncertainty prevails in non-financial corporations as regards investment. Hence, recovery will be slow and the economy will continue to contract in 2016.

Russian imports have dwindled in the past 18 months, and in 2015 the economic contraction will further reduce imports. The real exchange rate of the rouble is 25% below its central rate of 2014, which indicates a considerable drop in imports. Russia's fiscal deficit could nevertheless reach 3–4% of GDP in 2015. With impaired access to market sources, this deficit is already being financed – through the banks – by the central bank. The government also has a Reserve Fund it intends to draw on. The size of the Reserve Fund corresponds to approximately 7.5% of Russian GDP. The central bank has also been used – again through the banks – to finance the external debt servicing of the state oil corporation.

Tags

- forecast
- inflation
- economic situation