BANK OF FINLAND BULLETIN

ARTICLES ON ECONOMY BY BANK OF FINLAND

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Forecast risks

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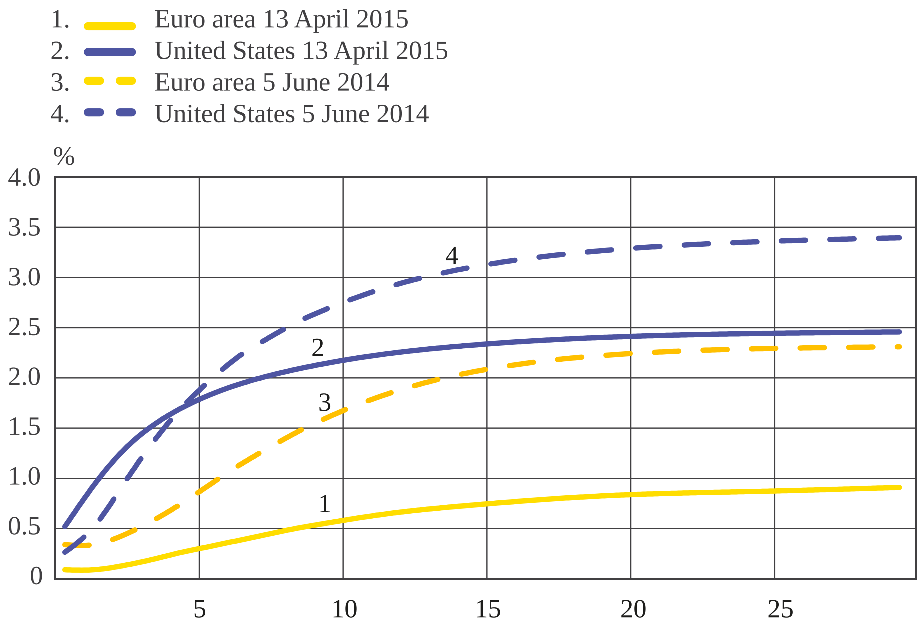
There is increased uncertainty surrounding the growth and inflation forecasts, yet this time upside risks are also present. On one hand, low oil prices and long-term interest rates could boost global economic growth more than estimated. In addition, currency depreciation in the EU22 and Japan could result in higher-than-forecast growth and inflation. On the other hand, protracted low inflation together with downward wage and price rigidities could be a drag on growth, especially in the EU22. Geopolitical risks continue to weigh on the outlook.

In the Bank of Finland's March forecast for the international economy, assumptions about commodity prices, interest rates and exchange rates are based on market expectations. Risks relate to both the assumptions used and their estimated impact. In particular oil prices could deviate significantly from their current futures prices. Even with stable demand, unforeseeable supply side fluctuations could have an impact on oil prices. Expected long-term interest rates are also exceptionally low. The United States 30-year swap rate has declined approximately 0.9 of a percentage point since June 2014. In the euro area, the corresponding decline has been even greater, at 1.4 percentage points. In mid-March, the euro area 30-year swap rate was just 0.9%.

Chart.

Substantial decline in long-term interest rates



Swap rates.
Sources: Macrobond and Bank of Finland.

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The risks related to growth and inflation have grown more varied. This time, they include upside risks to the growth forecast. On one hand, low oil prices and long-term interest rates could boost economic growth in the advanced economies more than estimated. Low long-term interest rates could also have a greater positive impact on credit growth than incorporated in the current forecast, and the resulting growth in investment and consumption would also likely produce higher inflation rates. On the other hand, geopolitical risks continue to weigh on the outlook.

In the EU22 and Japan, the upside risks to the growth and inflation forecasts are amplified by the possible stronger-than-estimated impacts of the depreciation of the yen and the euro. A stronger-than-forecast pick-up in exports would boost both investment and growth, while higher-than-estimated import price inflation could lead to higher-than-forecast inflation.

Protracted low inflation together with downward wage and price rigidities could, however, drag on growth, especially in the EU22. When inflation is low, elasticity in relative prices sometimes gives way to real elasticities. Any delay in structural reforms to enhance the elasticity of relative prices could therefore result in even greater real adjustment needs for the EU22 in a low-inflation environment.

It is assumed that the situation in Greece will be resolved in a positive manner and that there will be no contagion like in 2010 or 2011–12. Euro area economies are stronger than in the earlier phase of the crisis, and the European Stability Mechanism and the ECB's Outright Monetary Transactions have contributed to a more robust firewall to keep the crisis from spreading. It is, however, difficult to assess the impacts of a possible renewed crisis situation.

Overall, the risks to the forecasts for growth and inflation are broadly balanced for the global economy, while for the EU22 upside risks prevail. The positive impact on growth and inflation in the EU22 from low oil prices and long-term interest rates and from the depreciation of the euro could potentially outweigh the downside risks from low inflation, wage and price rigidities and the geopolitical situation.

Tags

- forecast
- inflation
- risks