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China develops, growth slows*
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EDITORIAL

Monetary policy exceptionally accommodative for a prolonged period

24 SEP 2015 11:00 AM • BANK OF FINLAND BULLETIN 4/2015 • EDITORIAL



The outlook for the global economy weakened during summer 2015. The sudden slowdown in economic growth in China was reflected in a considerable weakening of global stock markets and rising long-term interest rates. The situation in China is dichotomous. On one hand, lower imports are dampening world trade, while, on the other hand, the focus of domestic demand on consumption at the expense of investment would serve to rebalance the Chinese economy. The global economy has also been affected by uncertainty about the timing of the US Federal Reserve's monetary policy tightening. Capital inflows shifting into capital outflows from emerging economies has impaired their prospects. In the euro area, growth has been held back by the weakness of the Greek economy.

Euro area monetary policy is exceptionally accommodative: policy rates are at the zero lower bound, forward guidance and asset purchases have together brought long-term interest rates down, credit operations have lowered the costs of bank funding and eased securities-based borrowing. Clear signs of an improvement in the situation are visible on the financial markets, for instance the private credit markets.

The fading outlook for the global economy and, as a partial consequence, the decline in the price of oil have led to downward revisions in growth and inflation forecasts. Owing to increased uncertainty, the risks to both growth and inflation are also on the downside.

However, the September ECB staff projections expect euro area growth to increase to 1.8% in 2017.

Monetary policy is responsible for achieving the price stability objective. In January 2015, euro area HICP inflation was still -0.6% compared with a year earlier. Through its actions, the Eurosystem has succeeded in breaking the harmful deflationary spiral, and the most recent inflation outcome from August pointed to an increase of 0.1% in prices. Underlying inflation is advancing even faster, having recorded 0.9% in August. According to the September ECB staff projections, euro area inflation is expected to pick up so as to reach 1.7% on average in 2017.

Despite the expected acceleration in inflation, inflation expectations have again weakened slightly and the likelihood of deflation derived from market prices has increased. At the beginning of September, the Governing Council of the ECB judged it 'premature to conclude on whether these developments could have a lasting impact on the outlook for prices and on the achievement of a sustainable path of inflation towards our medium-term aim, or whether they should be considered to be mainly transitory.'

Given that overall euro area recovery has been slow, the resultant situation, if continuing, will pose new challenges to euro area monetary policy. The European Central Bank has access to monetary policy instruments for continuing the accommodative stance of monetary policy over a longer period of time than announced thus far and also stands ready to deploy additional measures, if necessary. For example, the expanded asset purchase programme provides sufficient flexibility in terms of adjusting the size, composition and duration of the programme.

The key role of inflation expectations in monetary policy underlines the importance of a firm policy commitment, particularly in a prolonged period of low interest rates. An increase in average inflation to a level below, but close to, 2% means having to accept that inflation will occasionally exceed 2%.

Helsinki, 23 September 2015

Erkki Liikanen

Governor

Bank of Finland

Tags

- [inflation](#)
- [monetary policy](#)
- [economic situation](#)
- [global economy](#)
- [EU](#)
- [ECB](#)

Euro area set to recover

TODAY 2:00 PM • BANK OF FINLAND BULLETIN 4/2015 • MONETARY POLICY

Monetary policy in the euro area has been highly accommodative in recent years. The accommodative stance has also been reflected in banks' lending rates. The transmission of monetary policy has become more effective, following the strengthening of the euro area banking system and the improvement in banks' capital adequacy from previous years.



The euro area economy is getting back on track. In 2014, private consumption was the component of overall demand that made the strongest contribution to GDP growth. A pick-up in investment is hampered by weak profitability, an abundance of spare production capacity and, partly, by bottlenecks in lending. Euro area fiscal policy will be relatively growth neutral in the immediate years ahead.

Euro area inflation remains very low and well below the ECB's price stability objective. The sliding price of oil has been the major single factor underlying the sudden deceleration in inflation. However, the rate of inflation has already been well below its long-term average for a prolonged period.

Growth and inflation risks in the euro area can be divided into external, internal and longer-term risks. The key external risk relates to a deterioration in the growth outlook for emerging economies, while the major internal risk relates to a permanent or even aggravated segregation of euro area countries. Longer-term risks include population ageing, lacklustre growth in output potential and weaker risk resilience in the public finances of several euro area countries. The recent surge in refugee flows has created a new challenge for Europe that could also be an opportunity for the ageing continent.

ECB committed to accommodative monetary policy

In 2014, economic developments in the euro area deteriorated, inflation edged down and inflation expectations dampened. In response, the ECB's Governing Council took a decision in January 2015 to introduce further accommodation of monetary policy by expanding the asset purchase programme to also include public sector securities. The ECB and euro area national central banks are to purchase public sector debt securities, covered bank obligations and private asset-backed securities to a total monthly value of EUR 60 billion. Purchases are to be carried out until the end of September 2016 and will in any case be conducted until the Governing Council sees a sustained adjustment in the path of inflation consistent with the aim of achieving inflation rates below, but close to, 2% over the medium term.

The Governing Council has emphasised its commitment to the full-scale implementation of the asset purchase programme. The carrying through of the decisions taken has been seen as a condition for the return of inflation to a path consistent with the target, in the years ahead. To ensure smooth progress of the asset purchase programme, the Governing Council took a decision in September to increase the share issue limit from the initial limit of 25% to 33%.^[1]

The pick-up in inflation expectations in the first half of the year is consistent with desired developments, but actual inflation is only barely positive and the rate of inflation has not yet been brought back onto a sustainable path towards the target. The oil price decline since June has put downward pressure on inflation, thereby lowering market-based inflation expectations. (Graph 1).

1. This is subject to a case-by-case verification that this would not create a situation whereby the Eurosystem would have blocking minority power.

Graph 1.

Inflation expectations have dampened again since the end of June



Source: Bloomberg.
16 September 2015
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In late summer, short-term inflation expectations fell markedly, as did longer-term expectations. While the oil price slide alone has a temporary dampening effect on inflation, there is a danger of a more persistent deceleration in inflation if inflation expectations are formed in a context of slow inflation. Against the backdrop of recent developments in inflation and inflation expectations, there is no reason to question the necessity of full-scale implementation of the asset purchase programme.

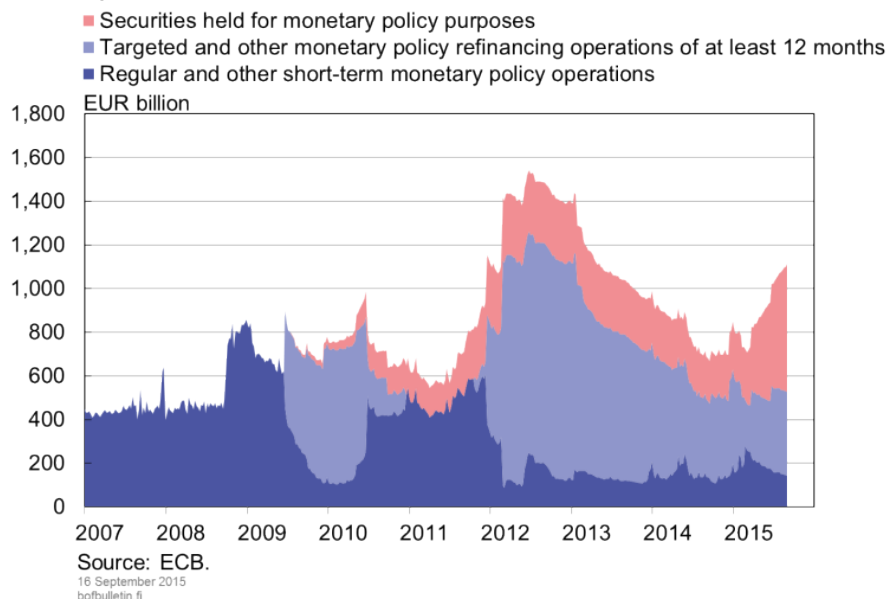
The Governing Council will closely monitor all relevant incoming information and emphasises its willingness and ability to use all the instruments available within its mandate. If warranted, the current expanded asset purchase programme (EAPP) provides sufficient flexibility for further monetary accommodation by adjustment of the size, composition or duration of the programme.

A highly accommodative monetary policy

By the end of August, securities worth around EUR 360 billion had been purchased within the framework of EAPP. The programme provides for an expansion of the Eurosystem balance sheet and an increase in the share of securities in monetary policy operations. (Graph 2).

Graph 2.

The share of asset purchases in monetary policy operations has risen



The EAPP is a non-standard monetary policy measure. Such measures can be adopted for two reasons: to support the transmission of monetary policy using the key policy interest rate and to ease financial conditions especially where the key policy rate has hit the zero lower bound in nominal terms, thus preventing its further use in implementing monetary policy.

In the early days of the financial crisis, the former reason prevailed, reflected in an increase in credit from monetary policy operations. In autumn 2008, the monetary policy stance was relaxed by reducing key interest rates, while, at the same time, the transmission of monetary policy was enhanced by lifting the quantitative restrictions on the provision of liquidity to the banking system. The Governing Council strengthened the transmission of monetary policy to longer-term interest rates notably by lengthening the maturities of central bank credit. In summer 2009, the Eurosystem conducted the first longer-term refinancing operation with a maturity of 12 months, and in the two longer-term refinancing operations undertaken at the turn of 2011/2012 central bank credit was provided with maturities as long as three years. Beginning in 2009, the effectiveness of monetary policy transmission has since been further increased through asset purchases (Securities Markets Programme (SMP) and Covered Bond Purchase Programmes (CBPP)), but these programmes accounted for only 20% of the securities held for monetary policy purposes shown on the Eurosystem balance sheet. (Graph 2).

Following the lowering of the ECB's key interest rates to the lower technical bound in 2014, asset purchases have been resorted to for further monetary accommodation. These measures are generally referred to as quantitative easing (QE). The asset purchase programme has been reflected in an expansion of securities holdings on the Eurosystem balance sheet. At the end of August 2015, over 50% of the monetary policy operations on the Eurosystem balance sheet comprised securities purchases.^[2]

In the context of non-standard monetary policy instruments, an unambiguous representation of the monetary policy stance – i.e. the degree of accommodation afforded to economic growth – cannot be provided. When applying standard monetary policy tools, the stance of monetary policy can be examined against the movements in key policy rates or short-term (risk-free) market rates.

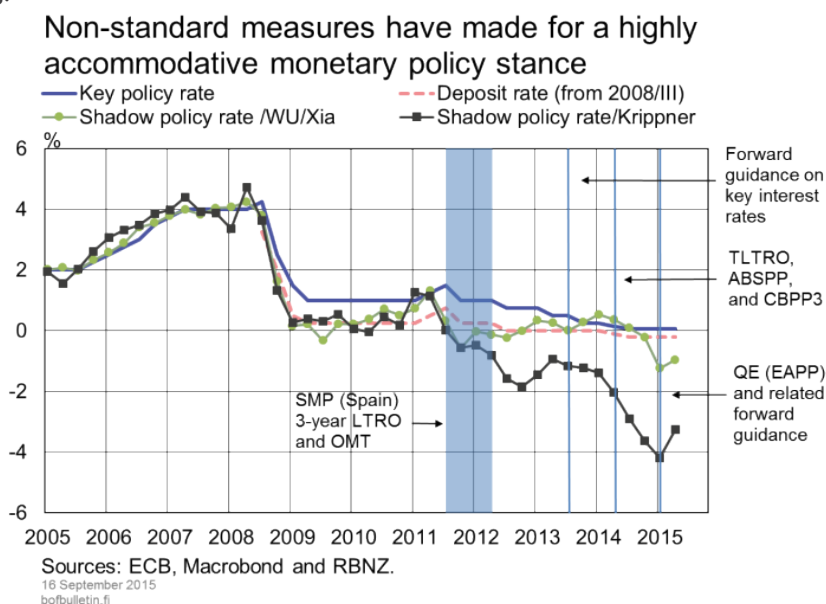
The monetary policy stance at the zero lower bound of nominal interest rates can be analysed using what is referred to as a ‘shadow policy rate’. The shadow policy rate provides a gauge of the hypothetical policy rate in the absence of a zero lower bound on nominal interest rates. The non-standard measures of monetary accommodation adopted at the zero lower bound of nominal interest rates are, hence, reflected as negative values of the shadow policy rate.

The shadow policy rate can be conceived as providing an answer to the question what policy rate would produce the perceived level of interest rates if there are no bounds on how deep the policy rate can be driven into negative territory. The idea is that non-standard policy measures are adopted to reduce the level of interest rates in the economy, while the shadow policy rate is used to assess how large a reduction in the key policy rate would have produced a decline of the same magnitude.

The shadow policy rate is a latent variable and calculation of the rate must therefore be based on a model. There are two publicly available estimates of the shadow interest rate for the euro area: one is based on a model developed by the Federal Reserve Bank of New Zealand economist Leo Krippner and another is based on the model of University of Chicago researchers Wu and Xia (Graph 3).

2. The significance of monetary policy measures is, however, not directly quantifiable from the Eurosystem balance sheet. For example, the Outright Monetary Transactions (OMT) scheme was a highly effective measure of monetary policy despite the total absence of asset purchases. Forward guidance is another significant monetary policy instrument that is not directly reflected on the Eurosystem balance sheet.

Graph 3.



Shadow interest rates indicate that the variety of non-standard policy measures adopted in the euro area have provided a higher degree of monetary accommodation than suggested by developments in key interest rates alone: both shadow interest rates are well below key ECB interest rates. The level of the shadow rate is, however, surrounded by considerable uncertainty, with different models producing highly divergent outcomes of the stance of monetary policy. In any case, shadow interest rates demonstrate that the non-standard measures already adopted have eased monetary policy, while the EAPP has heralded a highly accommodative monetary policy stance. The non-standard measures help maintain an active monetary policy in the absence of the interest rate tool.

Financial conditions eased in euro area

The interest rates prevailing in the economy are the product of yields on debt securities of varying maturities, with yield also being one determinant of banks' lending rates. Monetary policy purchases reduce market rates and, by extension, banks' lending rates. This, in turn, boosts investment and consumption.

The yield on debt securities of varying maturities can be expressed as the sum of two factors. The first factor represents risk-free yield, defined as the average of expected short-term interest rates over the maturity of the instrument. The second factor is the risk premium, i.e. the yield (compensation) required by investors, for example in return for not investing in low-risk debt securities of short maturities.

The transmission mechanisms of the asset purchases undertaken as a measure of monetary accommodation can be divided into two main categories: 1) the signalling channel and 2) the portfolio rebalance channel.^[3] The signalling channel influences yields by lowering risk-free yield, while the portfolio rebalance channel works to reduce risk premia.

Through the signalling channel for asset purchases the central bank conveys signals that it is committed to an accommodative monetary policy in the future. Consequently, financial markets expect short-term rates to remain low for a prolonged period, which is reflected in lower yields on all debt instruments.

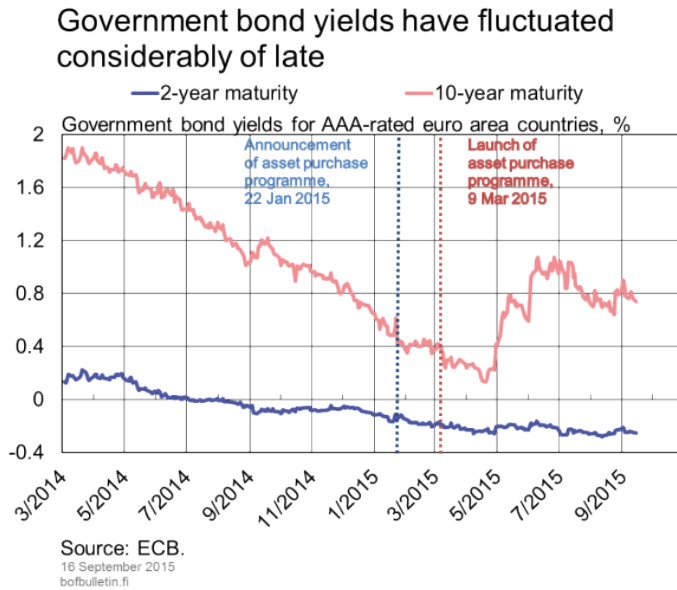
The portfolio effect may arise in a number of ways, but the key feature of all mechanisms is that the amount (or maturity) of debt instruments held by the public is reduced by the asset purchases and the balance sheets of market participants are adjusted to reduce risks. In response, the supply of long-term assets will decline, cutting the compensation received for holding them.^[4] In addition, market participants may attempt to compensate for balance sheet adjustments by purchasing higher-risk securities, pushing up their prices.

Market expectations of the launch of quantitative easing reduced government bond yields already before a decision on the asset purchase programme had been taken. Once the purchases began, yields fell further, but in late April 2015 yields at longer maturities, in particular, began to rise (Graph 4). This trend was reversed at the end of June, when longer-maturity yields turned down again. At the same time, however, yields at short maturities have remained more or less unchanged. This speaks of market confidence in the Governing Council's commitment to the asset purchase programme, and yields on short-term assets therefore reflect a stance of monetary policy consistent with forward guidance.

3. This is not a clear-cut division, as both channels are present in some mechanisms. In addition there is a third transmission channel related to asset purchases, namely that of inflation expectations, where inflation expectations in the economy arise under the combined influence of monetary and fiscal policy.

4. For the supply of debt securities of a certain maturity to have an impact on yields, there must be rigidities and incompleteness on the bond markets. Asset valuation models typically do not capture the portfolio effect, as the models do not feature the necessary rigidities, which means that yields are unaffected by the supply of assets. This may have prompted Ben Bernanke to say that 'quantitative easing works in practice, not in theory'. See 'Central banking after the great recession: lessons learned and challenges ahead' (16 Jan 2014). The Brookings Institution.

Graph 4.



Various potential reasons have been cited for the increase in yields on long-maturity bonds in spring and summer 2015. Firstly, expectations of economic growth and inflation gathered strength, raising the prospects of a future tightening of the monetary policy stance. Secondly, many euro area countries have stepped up their bond issuance, thus adding to the supply of bonds. This reduces the portfolio balance effect of the asset purchases. Thirdly, long-term interest rates fell markedly before the launch of the Eurosystem government bond purchases and in the first few weeks after the launch. The market may have overestimated the impact of the asset purchases on the bond market, especially as regards availability, in which case the increase in yield levels since late April may represent a correction of excessive expectations. Fourthly, there is a host of market-technical and seasonal reasons.

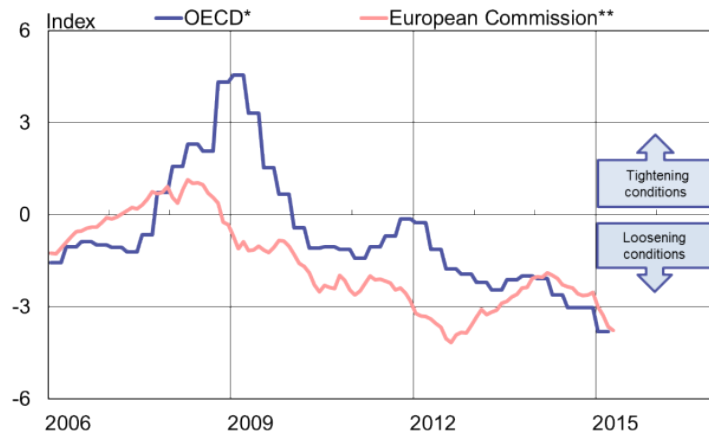
Conversely, trends moving in the opposite direction to those mentioned above are reflected in lower bond yields. The fluctuation in yields witnessed since the end of June may at least be found to be consistent with inflation expectations.

Overall, in the longer-term perspective, it can be established that the Eurosystem purchases of government bonds and related forward guidance have reduced government bond yields. In other words, the EAPP and the related forward guidance have, as expected, pushed down longer-term interest rates in the euro area. However, considering that there are other determinants of government bond yields besides monetary policy, influencing yields by means of monetary policy is more difficult than, for example, influencing short-term market rates by the key policy rate.

To ensure appropriate transmission of the asset purchases undertaken as a measure of monetary accommodation it is important that the decline in bond yields feeds through to the broader economy in the form of lower financing costs. The indices computed by the OECD and the European Commission both point to a significant easing of monetary conditions in the euro area since the beginning of 2015 (Graph 5).

Graph 5.

Euro area indices point to a relaxation in financial conditions

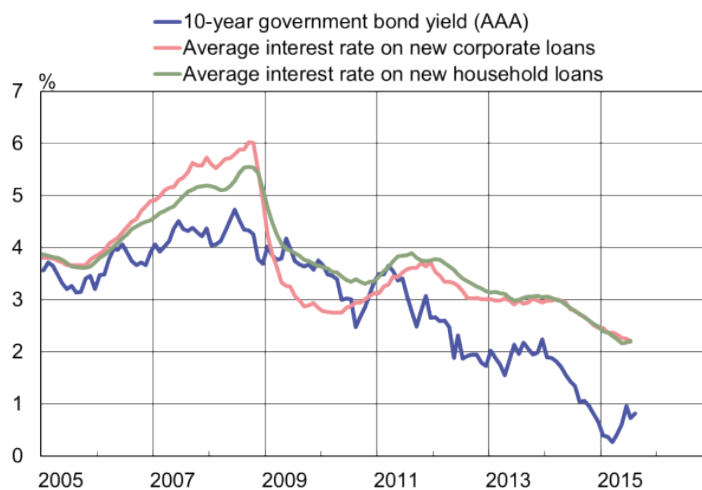


Sources: OECD and European Commission.
 * Financial Conditions Index (FCI) includes short-term and long-term interest rates, corporate loan spread, credit availability, household wealth position. Reverse index.
 ** Monetary Conditions Index (MCI) includes short-term interest rates and the exchange rate.
 16 September 2015
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The accommodative stance is also reflected in banks' lending rates. Given the bank-centred structure of the euro area financial system, monetary policy measures should also be reflected in an expansion of bank lending volumes and a reduction in the average lending rate. Notwithstanding the fluctuation in government bond yields, banks' lending rates for both non-financial corporations and households continued their downward trend in the summer (Graph 6).

Graph 6.

Lower lending rates also contributed to easing of euro area financial conditions



Sources: ECB and Macrobond.
 16 September 2015
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In the early part of 2015, the yield spread of bank loans versus government bonds surged close to the record level witnessed in 2008, i.e. 2 percentage points. Before the crisis, the interest rate spread was only half as big. In a context of favourable economic

developments there may be further room for lowering lending rates, even if market rates remain higher.

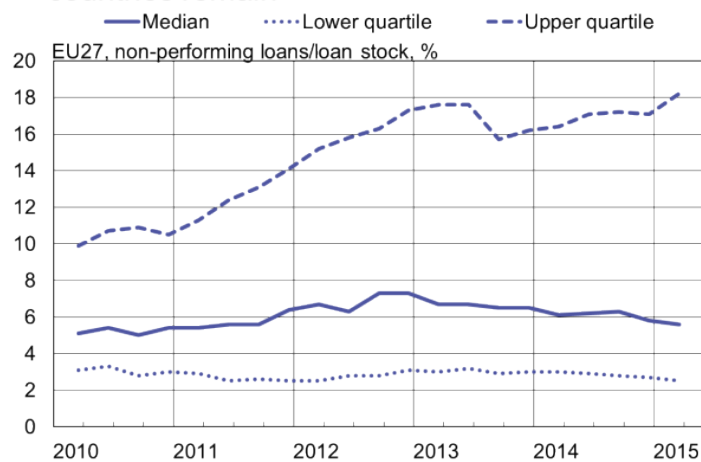
Banks now focusing on traditional banking

The euro area banking system has become stronger and banks' capital adequacy improved from previous years. Stronger capital adequacy is of vital importance for banks to be able to increase lending and, thereby, support recovery in the real economy and the transmission of monetary policy.

After two years' of contraction, banks' balance sheets began to expand towards the end of 2014. Banks have disposed of risk-weighted assets, increased lending and built up equity. Owing to the poor profitability of recent years, the build-up of equity using retained earnings has proved challenging in the euro area overall. Banks have therefore resorted to share issues as a source of market funding. The relatively large number of bank share issues seen over the past few years is illustrated by the fact that banks' net share issues over the past three years accounted for more than half of total net share issues in the euro area, although the market value of banks represents a mere tenth of the entire stock market.

Graph 7.

Non-performing loans as a proportion of the loan stock have declined, but large differences between countries remain



Source: EBA.
16 September 2015
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The banking sector is burdened by non-performing loans, remnants of pre-crisis excessive debt accumulation by the private sector and the poor economic situation in the aftermath of the crisis (Graph 7). The large amount of non-performing loans weighs on the profitability of banks, as it implies lower interest yields and higher loan loss provisions. In addition, non-performing loans consume more of banks' limited equity, in relative terms, thereby reducing the assets available for lending. In step with the recovery of the economy, the proportion of non-performing assets in the lending stock has gradually begun to shrink, although differences across countries remain large. Looking at the financially stressed countries, proportions of non-performing loans have been

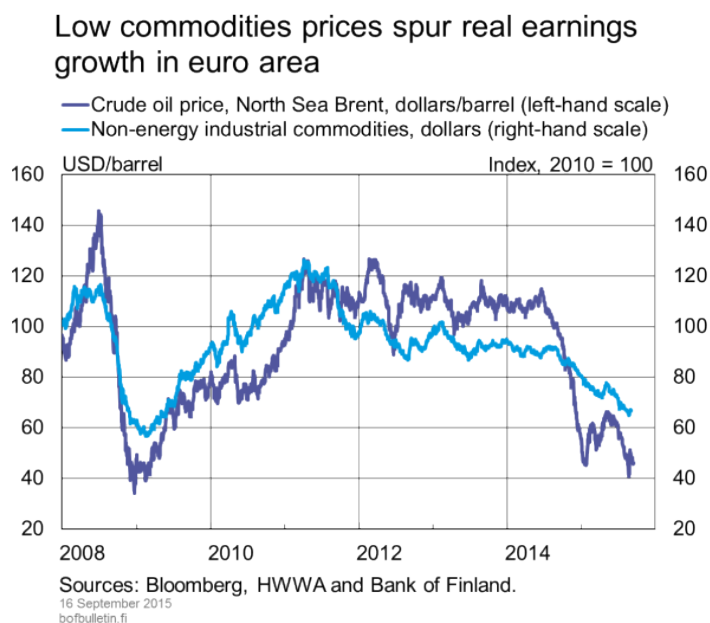
gradually declining, especially in Spain and Ireland, whereas the proportions of non-performing loans in the existing loan stock in Greece, Cyprus and Italy have recently increased further.

The general decline in loan losses boosts the profitability of banks. Profitability has also been improved by a shift in banks' business focus. They have increased the share of low-risk corporate and housing loans on their balance sheets, and, correspondingly, reduced investment banking activities. As lending is increasingly financed with deposits (in addition to which banks have access to central bank money at low cost), developments in net interest income have been favourable given the circumstances. However, despite the gradual improvement underway in the profitability of euro area banks, average profitability still remains well below pre-crisis levels.

Euro area economy getting back on track

Of the factors external to the euro area, the world market price of crude oil has fallen back during the summer months, close to the level witnessed at the beginning of the year. This has coincided with a drop in crude oil futures prices, broadly to the level prevailing at the beginning of the year. The oil price decline is related to both supply and demand factors. The decline in the level of oil prices over the past 12 months has not been accompanied by a noticeable fall in production: there is an oversupply of oil. Demand expectations have fallen above all in response to market assessments of a deterioration in the growth outlook for China in July and August. From the euro area perspective, the oil price decline mainly represents a positive supply factor that will support euro area growth but also bring down the rate of inflation in the immediate year ahead.

Graph 8.

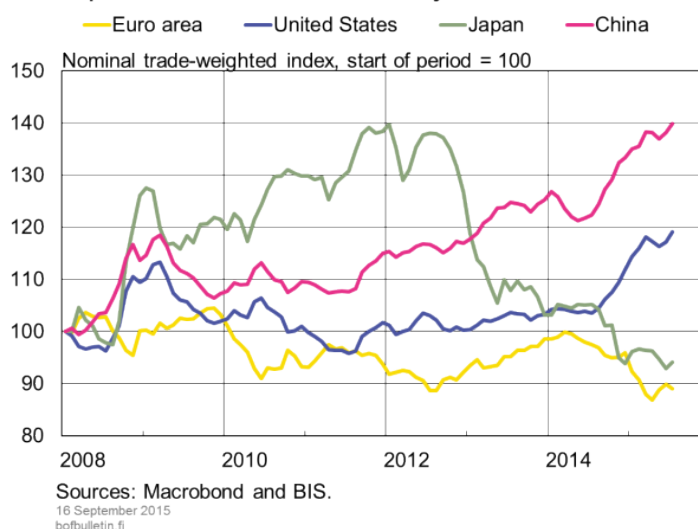


The price decline on non-energy commodities is largely weighted towards supply factors. The rate of growth in commodities demand is slowing in response to changes in the structure of Chinese growth. The weight of investment in total demand leaves more room

for private consumption, while on the demand side the share of the service sector has grown rapidly close to 50% of total output. In the face of slowing economic growth in China, falling share prices and poor export performance, unrest emerged on the financial markets in late summer. In early August 2015 the unrest was heightened by the Bank of China's reform of the exchange rate mechanism. In the latter half of August, there was an outright collapse of share prices in China, with widespread spillover of the unrest to the advanced and emerging economies. During September, the market has zigzagged around new, lower share prices.

Graph 9.

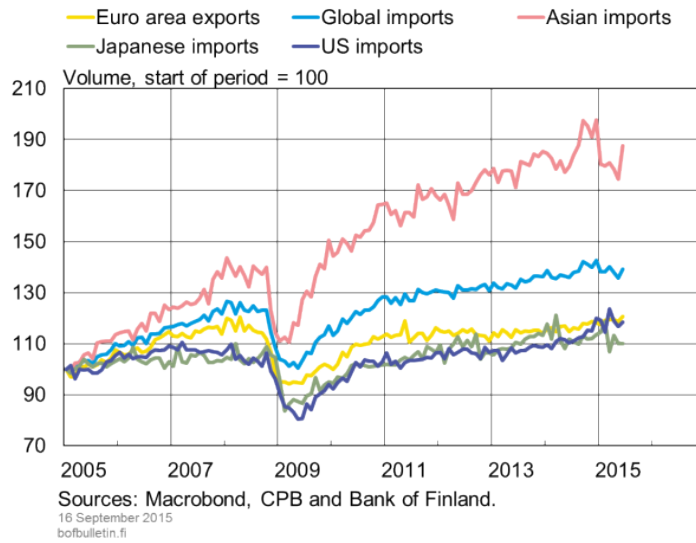
Exchange rates signal relative growth and inflation expectations in the economy



The growth outlook for the euro area export market has deteriorated somewhat. The global trade volume shrank in the early part of the year, mainly in the wake of the contraction in Asian imports. The Bank of Finland forecast projects that world trade growth will remain permanently slower than foreseen earlier. Overall, the contribution of net exports to euro area growth will continue to be very modest in the forecast period.

Graph 10.

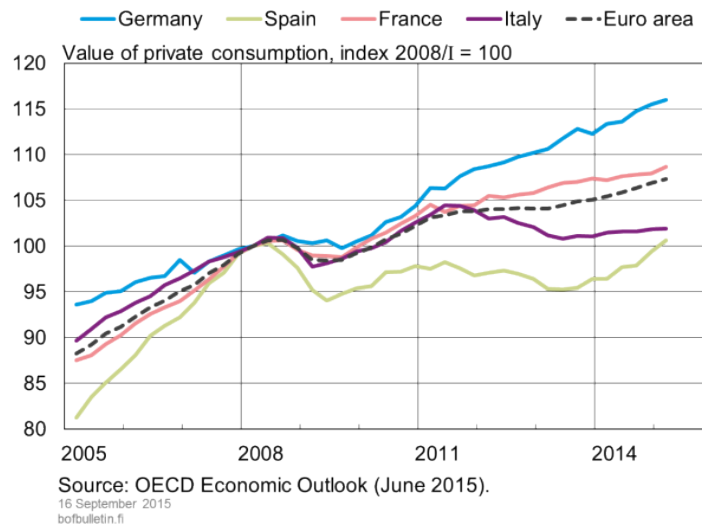
Growth in euro area export markets lacklustre in early 2015



The value of private consumption in the euro area has increased steadily since the beginning of 2014 and is currently 8% higher than in the first quarter of 2008 (Graph 11). In fact, private consumption was the component of overall demand that made the strongest contribution to GDP growth in 2014. It was driven by real earnings growth related to improvements in employment and falling energy prices.

Graph 11.

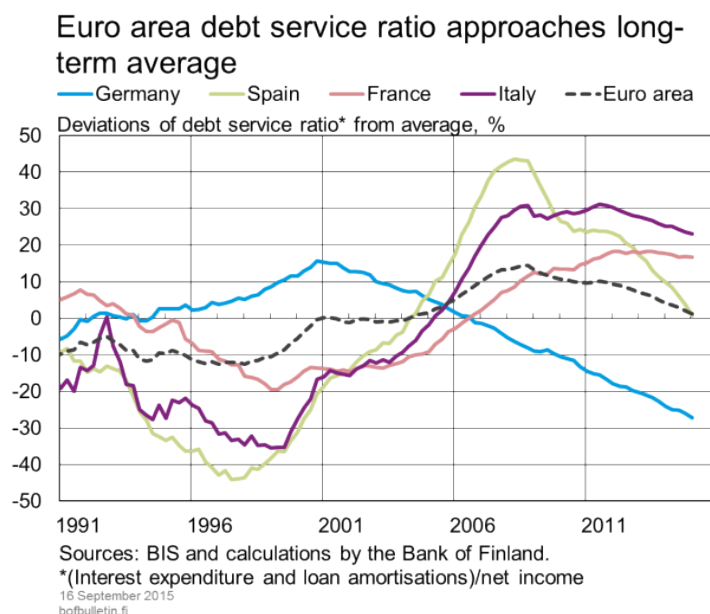
Favourable real earnings developments fostered recovery in private consumption



The recovery of private consumption will continue, in a context of improvements in the employment outlook and a sustained very low level of interest rates. With interest rate expenditure remaining moderate, there will be better scope for faster repayment of debt and an improvement of the economic risk resilience of households. Household

indebtedness may be analysed by examining household interest expenditure and loan amortisations as a percentage of net income (Graph 12). Deviation of this debt service ratio from its long-term trend impacts inversely on private consumption growth.

Graph 12.



The higher the proportion of household income used for servicing debt, the lower the share available for consumption. While variations between countries remain large, the average debt service ratio for the euro area has dropped back close to its long-term average and continues on a downward trend. In addition, average net assets of euro area households have grown in 2014, although remaining below their long-term average.

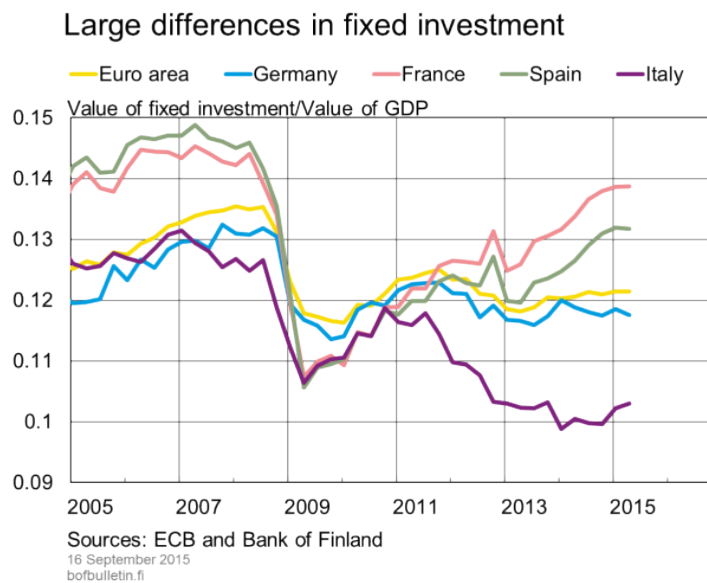
In many euro area countries, housing market recovery is only just getting underway. Consequently, the average housing price index for the euro area is still 5%, in nominal terms, and nearly 15%, in real terms, below the reading at the beginning of 2008. By contrast, housing prices in e.g. Austria and Ireland have recently been rising relatively rapidly, especially in the big cities.

The average growth rate of the euro area household loan stock has picked up during 2015, but there are large differences across countries. Of the large euro area countries, the growth rate shows a clear upward trend in France and Germany, whereas in Spain the contraction in the household loan stock has not yet bottomed out. In the euro area, the average interest rate on new housing loans has fallen rapidly since the beginning of 2014.

The findings of the Bank Lending Survey show that banks relaxed housing loan terms and conditions in the second quarter of 2015. Terms and conditions were eased more than the banks were expecting as late as April. Of the large euro area countries, a significant easing was seen notably in France and Italy. Mirroring the first quarter, demand for housing loans remained strong. The increase in household demand for housing loans was related both to the low level of interest rates and the favourable outlook for the housing market.

The value of private fixed investment has increased since the beginning of 2014, but remains around 5% below the level witnessed in the first quarter of 2008. A pick-up in investment is hampered by weak profitability, an abundance of spare production capacity and, partly, bottlenecks in lending. Because of the uncertainty clouding future economic developments, investors continue to demand high risk premia, and so developments in average capital costs have not kept pace with the fall in the costs of bank and government bonds. However, recent developments in fixed investment in Spain and Germany, in particular, have been encouraging. The European Strategic Investment Fund that will become fully operational this autumn will bring some alleviation to the slump in investment. The Fund aims to channel over EUR 300 billion to non-financial corporations to foster the launch of productive investment and job creation.

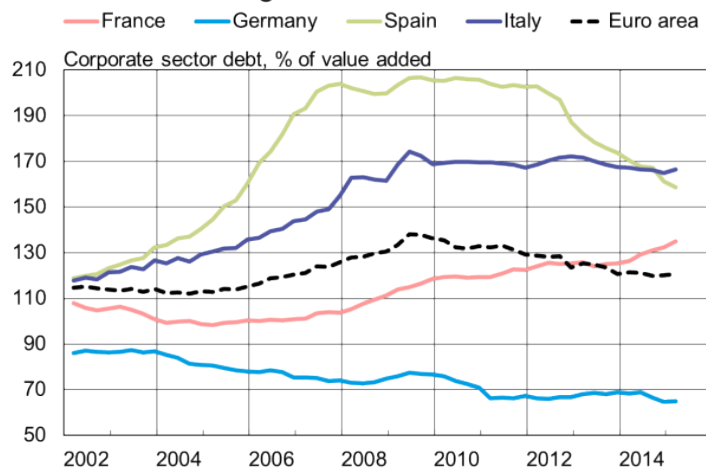
Graph 13.



Corporate indebtedness in the euro area has continued to decline slightly, on average, and is already lower than at the onset of the crisis (Graph 14). It is important that non-financial corporations that were left indebted by the crisis undertake balance sheet adjustments and that funding is channelled to cater for the investment needs of healthy and productive enterprises.

Graph 14.

Balance sheet adjustment of euro area corporate sector flattening out



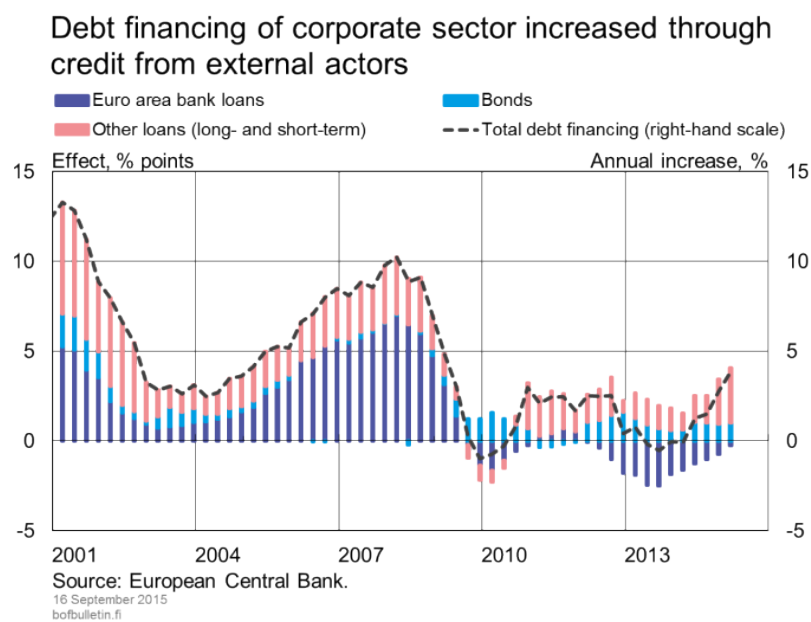
Source: Banque de France.
16 September 2015
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Corporate debt ratios in the euro area have posted highly divergent developments across countries since 2008. The upside is that the countries where debt levels surged prior to the crisis (Ireland, Spain, Portugal) have paid off their debt, pushing debt ratios back very close to pre-crisis levels. However, in countries where debt ratios have posted a moderate development in both historical terms and relative to the euro area average, a rise in the debt ratio cannot be regarded as an entirely undesirable development.

The contraction in the euro area corporate loan stock has generally already bottomed out, although a major revival is not yet discernible in the big euro area countries, save for France. Similarly, developments in corporate loan demand were favourable, although falling short of banks' expectations. The explanation offered by the banks was the increasing use of alternative sources of finance in corporate fund raising.

According to the findings of the ECB's Survey on the Access to Finance by Enterprises (SAFE), in the six-month period up to March 2015, access to funding had been dismissed as the smallest problem facing the companies, whereas shortage of demand was still reported to be the biggest problem. In step with the mounting need for bank loans and improvements in non-financial corporations' own situation, banks' willingness to grant loans increased and the loan application rejection rate fell. According to the Bank Lending Survey, in the second quarter of 2015 banks continued on the path of relaxation of lending terms that they embarked on in the early part of the year, which is above all reflected in narrower margins. In nearly all the euro area countries, the margins on higher-risk corporate loans were also reduced in the second quarter.

Graph 15.



Although the annual growth rate of corporate loans extended by euro area banks remains negative, total corporate debt financing has shown an upward trend since the end of 2013. Market-based debt financing, loans from non-euro area banks and non-bank financial institutions make a stronger contribution to the external financing of non-financial corporations (Graph 15). The ECB's asset purchase programme contributes to supporting the corporate bond market as investors dispose of government bond holdings in favour of higher-risk securities.

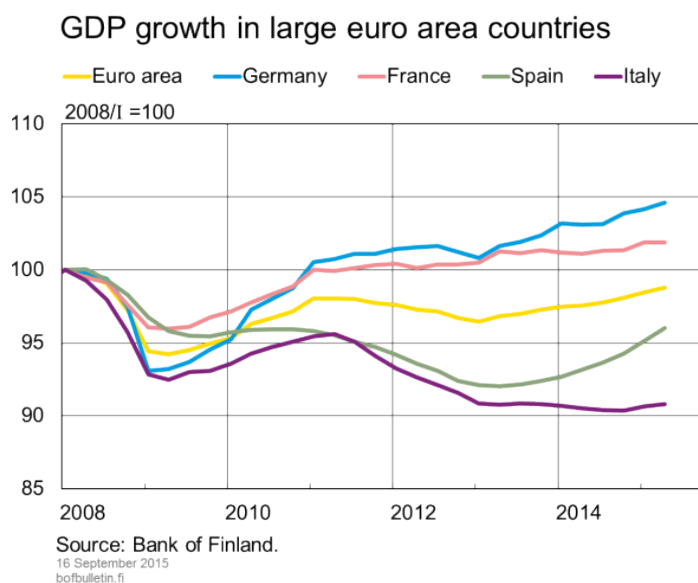
Outlook for large euro area countries more positive

Economic fundamentals in **Germany** are sound. Competitiveness is very high, household indebtedness is moderate and unemployment is amongst the lowest in the euro area. As a result of balanced public finances and the lowest debt ratio of the largest euro area countries, there is no need for fiscal consolidation in the immediate years ahead.

In **France**, economic growth is projected to improve in the forecast period, after weak dynamics in 2014. Growth will be fuelled by a pick-up in private consumption. Tax cuts and lower energy costs will increase corporate profits which, together with low interest rates, will strengthen French companies' investment opportunities. Fiscal consolidation will continue, albeit at a more moderate pace.

The **Spanish** economy grew very robustly in the first half of 2015. However, output has currently only reached the level of 2009. The unemployment rate has declined from the peak of 27% in early 2013 to around 22%. Economic growth is supported by the success of the EU-IMF banking sector adjustment programme agreed in 2012 and structural reforms that have enhanced e.g. labour market flexibility. Financing conditions have continued to ease and Spain is benefiting from the accommodative monetary policy. The general government deficit is still large, however, and public debt will rise to around 100% in 2015.

Graph 16.



In **Italy**, the recent faster-than-expected economic growth, strong investment dynamics, improved financing conditions and an upward trend in confidence indicators indicate that the economy may have started to recover in a sustainable manner. Bank lending rates have declined further and the availability of funding has improved, which has turned household borrowing upward and slowed the decline in the corporate loan stock. In particular, the brisk growth in investment after a prolonged period of contraction, and the very robust outlook for industry, are signals of positive economic developments in the forecast period.

The United Kingdom's economic outlook remains favourable in the immediate years ahead. Positive labour market dynamics, low oil prices, a pick-up in real wage developments and growth in confidence in the private sector are bolstering private consumption and strengthening growth prospects for the corporate sector. Even though housing prices have continued to rise, households have reduced their debt levels further. In the general elections in May 2015, the Conservatives won a majority in the House of Commons and will, as promised, hold a referendum on the UK's membership of the EU by the end of 2017.

Economic growth in **Sweden** will remain stable during the forecast period. At present, growth is strongly based on domestic demand, but exports will also improve, supported by the euro area recovery. Labour markets have evolved favourably, the labour force will grow at a faster rate in the forecast period and unit labour costs have risen more moderately than in many other countries. The greatest downward risk to the forecast is associated with growth in house prices and hence also continued growth in household indebtedness.

The economic outlook for **Denmark** has strengthened in the course of 2015. Economic growth has stemmed largely from an improvement in both private and public demand, but the export sector has also rebounded. Construction growth has picked up and investments will recover at a brisk pace during the forecast period. Denmark is currently

enjoying almost full employment. In this respect, tightness on the labour market is the greatest risk for weaker-than-anticipated developments, should labour demand exceed labour supply in the near future.

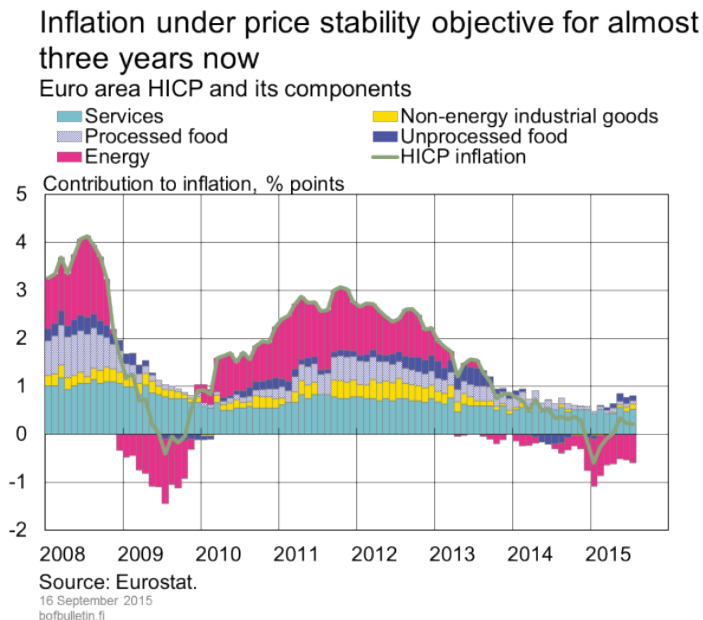
The Bank of Finland's forecast for global economic growth in the next few years is presented in more detail in the article '[Increased uncertainty in the global economy](#)'.

Inflation to remain lower than targeted

Euro area inflation slowed markedly in autumn 2014 (Graph 17). The rate of change in prices reached a trough of -0.6% at the beginning of 2015, but has subsequently gathered pace and been positive since April. Inflation is still very sluggish, however, and far from the ECB's objective for price stability.

The most significant individual factor underlying the steep fall in inflation in the latter part of 2014 was the price of oil. The other components of consumer price inflation have changed only marginally. Services price inflation, which is the largest subcomponent of consumer price inflation, has risen at a very low rate, at around 1%, for a prolonged period. Industrial goods prices and the prices of processed food, and of unprocessed food in particular, have turned upward, but have a relatively small impact on consumer price inflation. Nevertheless, price developments in all the subcomponents of the index have persistently been below their long-term average, which has led to a protracted trend of slowing inflation.

Graph 17.

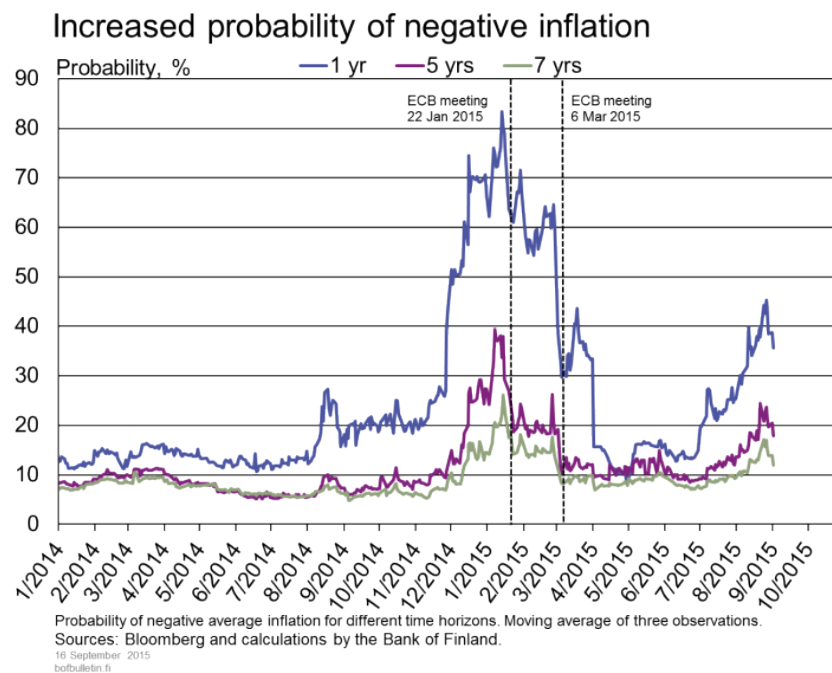


The effects of oil price fluctuations on inflation can be either direct or indirect. The direct effects of oil price fluctuations are, as a rule, one-off in nature and do not therefore have a permanent impact on inflation. The potential indirect effects of oil price fluctuations are reflected via inflation expectations and wage developments. Unlike the direct effects, the indirect effects may be reflected in the economy more widely. Therefore, even a

temporary shock in oil prices can have longer-term effects on inflation. If the direct effects of a fall in oil prices slow inflation, this will depress inflation expectations which, in turn, is reflected in wages by easing wage pressures. In such a case, there is a risk that the economy falls in a spiral of ever falling wages and inflation.

The probability of negative inflation – i.e. deflation – can be measured by inflation options (Graph 18). The probabilities of negative average inflation are ‘risk-neutral’ probabilities, meaning they reflect not only the probability of an outcome but also the riskiness of different states for market participants.

Graph 18.



According to other market-based inflation expectations, the probability of negative inflation has increased considerably in the short term on account of falling oil prices. The probability of negative average inflation over the longer term has also increased, albeit more moderately than short-term inflation expectations. However, the probability of negative inflation for all time horizons is still lower than at the beginning of January 2015.

In addition to oil prices, exchange rate changes and their transmission are another external factor that affects domestic inflation. Exchange rate changes have only a limited overall impact on consumer prices, however, since even import goods prices are affected, in addition to import prices, by several domestic cost factors, such as transportation, storage and processing costs. Moreover, exports from extra-euro area countries account for just around 25% of the euro area consumption basket. According to estimates, a depreciation of the euro by 10% pushes up inflation by about 0.4%.

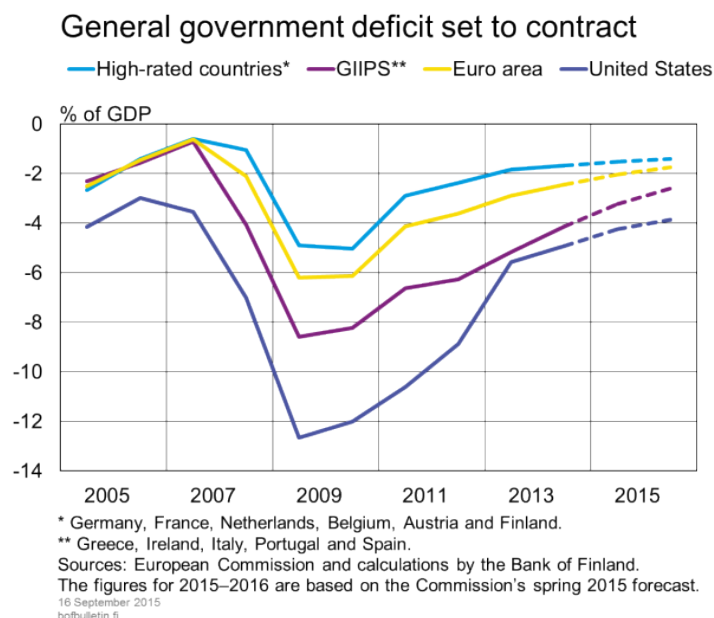
Domestic price pressures in the euro area are moderate. In an environment of subdued growth, a negative output gap and high unemployment, wage developments have been weak. Growth in the wage bill per employee has been easing for a couple years, and there

are practically no signs of a pick-up in the current year, either. Average wage developments in the euro area have been subdued. This has been primarily due to the high unemployment rate, but is also a consequence of the weak outlook for energy and commodity prices, which has increased real wages and thereby eased pressures for nominal wage rises.

Fiscal policy no longer restraining growth

In 2015, the euro area general government deficit is expected to contract to approximately 2% of GDP. Moreover, the fiscal balance will continue to improve in the immediate years ahead, and in 2017 the deficit is forecast to decline closer to 1% of GDP. The decline in the deficit stems mainly from cyclical improvement. From the perspective of growth, the fiscal stance is relatively neutral. Of the largest euro area countries, the public finances will remain in surplus over the forecast period in Germany. In France, Italy and Spain, the general government deficit will contract and fiscal consolidation will also continue during the forecast period.

Graph 19.



The euro area general government debt-to-GDP ratio reached a peak in 2014, at over 94% of GDP. From 2015 onwards, the debt ratio will start to decline gradually. At the country level, however, the debt ratios will fall at different paces. Of the largest euro area countries, the debt ratio will continue to grow in 2015 in France, Italy and Spain and will decline only in Germany.

The downturn in the euro area general government debt ratio is based on improvements in three fundamental factors that influence public debt dynamics. These factors are economic growth, interest expenses paid by general government to its creditors and the general government primary balance.

The improvement in euro area economic growth in the next few years is mainly cyclical in nature. In order to boost growth over the longer term, the European Commission has, in its growth strategy,^[5] emphasised a fiscal policy supportive of long-term growth, investment and structural reforms that promote growth potential and employment.

As for the second factor, general government interest expenditure has declined. The interest rates on government debt securities have fallen on the markets from the previous year following commencement of the Eurosystem's expanded asset purchase programme.

As for the third factor, the improvement in the euro area general government primary balance has helped turn the general government debt-to-GDP ratio onto a downward path. The primary balance has improved in response to the consolidation of public finances with tax increases and expenditure cuts. However, substantial efforts are still needed in several countries to put the debt ratio below the threshold of 60% of GDP specified in the Stability and Growth Pact. For example, the country-specific recommendations published by the Commission in late spring call for new reform measures from France, Italy and Spain. However, fiscal policy in the euro area in the early part of the forecast period is notably more relaxed than in previous years.

In the long term, euro area public finances will also face the challenge of age-related expenditure. According to the European Commission's latest Ageing Report,^[6] age-related expenditure will increase in the euro area by about 1.5% by 2060. However, the projection has improved markedly from the 2012 Ageing Report, in which age-related spending was projected to grow over twice as fast over the same period. The improvement is due particularly to an easing of the projection for pension expenditure growth e.g. as a result of pension reforms in several euro area countries.

Gridlock in the Chinese economy the key external risk for the euro area

Risks to the euro area can be divided into three categories: external, internal and longer-term risks. At present, the major external risk relates to the possibility of gridlock in the Chinese economy, to which a slowdown in debt-driven economic growth could in the worst case lead. A decline in Chinese demand would particularly affect commodity-producing countries, but the repercussions of sudden gridlock would spread widely to the global economy. Commodity prices would drop even further, which would also lower inflation in the euro area.

China surprised everyone in August with a shift towards a market-based determination of the exchange rate for the yuan. This gave the currency room to depreciate against the US dollar by approximately 3%. The appreciation of the dollar and weaker economic outlook for the United States as a result of the sharp slowdown in Chinese economic growth could postpone the interest rate rise expected in the United States for end-2015 and the start of normalisation of US monetary policy.

5. See http://ec.europa.eu/europe2020/pdf/2015/ags2015_en.pdf.

6. See http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee3_en.pdf.

Even though a normalisation of US monetary policy as such is welcome, it could include a risk of too strong reactions on the financial markets. One of the factors that causes concern at present is the high US dollar-denominated debt of emerging economies' private sectors. The more the dollar appreciates, the higher the debt of these countries' private sectors grows in local currency terms. For example, the Bank for International Settlements (BIS)^[7] has assessed that monetary system mechanisms and the ever-tightening dollar linkages may intensify the effects of dollar fluctuations. For these reasons, the impact of the Fed's interest rate rise may turn out to be greater than normal and may spread more widely to the global economy, which will also increase the risks to stability on the financial markets.

Internal diversity in the euro area increases uncertainty

The major internal risk relates to a permanent or even aggravated divergence of euro area countries. If economic developments of individual countries in a monetary union diverge sharply, this will increase difficulties in the different sectors of common monetary policy and national economic policies alike. In the euro area, the Member States are primary responsible for their own economic developments. Factors that increase economic flexibility help the countries adjust to shocks and maintain sustainable and balanced economies. The risk is that the flexibility is insufficient and policy measures are inappropriate or inadequate to the situation. In such cases, economic developments in an individual country may diverge further from the euro area average, which could lead either to a prolonged period of very sluggish growth, or to overheating and, eventually, to collapse.

In the worst case, a very strong divergence of a single euro area country could lead to a substantial increase in fears that the country will exit the euro area. The past few months' developments in Greece can be seen as a worrisome example of the potential for such an event. When the negotiations on the finalisation of the second EU-IMF support package for Greece broke down in the summer, Greece's temporary exit of the euro area was also raised in the aftermath of the referendum on the terms of the support package.

Such an alternative comes with a risk of nonlinear developments. The situation of a country that has substantially diverged from average euro area developments may be aggravated abruptly. The repercussions of increased uncertainty may be very protracted: uncertainty can affect e.g. companies' decisions on where to set up their business.

Changes in the future outlook may lead to policy errors

The euro area is also subject to risks associated with longer-term trends. The situation in the euro area is currently very different from that which prevailed prior to the financial and debt crises. The long shadow of the financial crisis intertwines with population ageing and low potential output in the euro area. Changes in future prospects may lead to a false assessment of the situation and errors in setting the stance of monetary policy.

7. Shin (2015), Global liquidity and monetary policy transmission. Representation at conference 'Liquidity and Market Efficiency – Alive and Well?' organised by SUERF and the Bank of Finland in Helsinki, 3 July 2015.

The surge of refugees that has recently increased markedly brings a new element to the longer-term outlook for the euro area. The factors underlying this phenomenon – such as Syria’s war and the difficulties in North African countries – cause huge human distress. In the short term, such an influx of refugees may cause various difficulties within the euro area. From the perspective of the economy, however, one positive longer-term effect could be a growth in the working-age population and younger age structures in many euro area countries. Yet, this would require successful measures for the smooth reception and integration of refugees.

Another major long-term risk relates to a protracted period of weak risk resilience in the public finances of several euro area countries. In such a situation, there is almost no fiscal leeway, meaning the emergence of a new crisis would require possibly very large cuts in public expenditure, which is known to aggravate crises. As the global financial crisis emerged in 2008, there was much more room for manoeuvre in public finances. At present, fiscal leeway has contracted generally, and in a few euro area countries, even a relatively small shock could jeopardise the sustainability of the public finances. Since it is a very slow process to reduce debt levels, several euro area countries will have no fiscal leeway for a prolonged period, and therefore the public finances will also be subject to risks for a prolonged period.

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FORECAST FOR THE GLOBAL ECONOMY

Uncertainty in global economy has increased

TODAY 2:00 PM • BANK OF FINLAND BULLETIN 4/2015 • ECONOMIC OUTLOOK

Uncertainty about the condition of the global economy increased in August–September. Concerns relate particularly to China, whose decelerating growth has unnerved the markets. In the Bank of Finland forecast, global growth will be 3.0%, 3.2% and 3.5% in 2015, 2016 and 2017, respectively. In addition to developments in China, the fact that world trade growth is past its peak weakens the outlook for the global economy compared with earlier predictions. There are downside risks to the forecast for the global economy.



World trade to grow more slowly than previously forecast

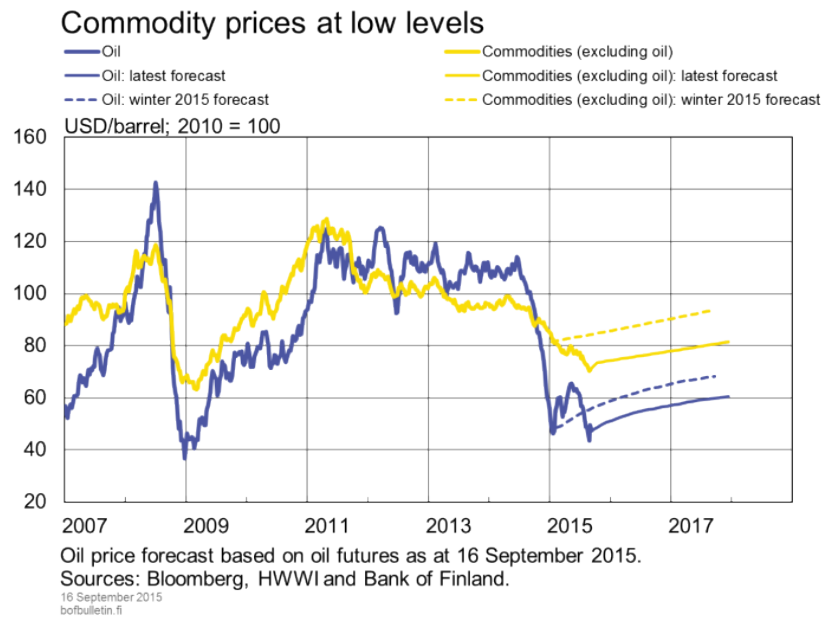
Global growth in the first half of 2015 remained slightly lower than previously anticipated. Growth slowed particularly in the emerging economies, but the United States also witnessed a bumpy first half. The volume of world trade declined in the early part of the year, which is very exceptional. This volume reduction was due, mainly, to a contraction in Asian imports.

The Bank of Finland predicts higher growth in the global economy and trade during the course of 2015–2017. However, growth will lag behind earlier projections, with a weaker growth outlook for international trade, in particular. The modest trade performance impairs the export prospects for the advanced economies (incl. the euro area).

Near-term cyclical developments will be affected by four key factors: falling oil and other commodity prices, accommodative monetary conditions, exchange rate changes and the winding down of debt.

The oil price slide is due to an oversupply of crude oil: output has not responded to the lower oil price. But reductions in oil and particularly other commodity prices also reflect more subdued growth in their demand. In China, oil demand is held in check by changes in the structure of growth: the significance of commodity-intensive investments for growth is decreasing, while the role of private consumption is increasing. The low level of oil and commodity prices supports growth in the advanced economies but erodes the outlook for commodity-producing emerging economies.

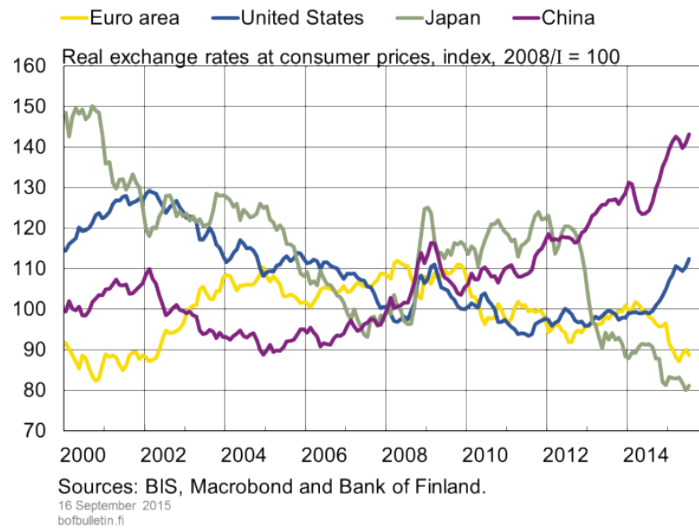
Graph 1.



The markets expect the US Federal Reserve to raise its policy rate later in the year. However, the changes will be moderate and, overall, monetary conditions will still remain accommodative for a prolonged period. This will boost global growth and inflation throughout the Bank of Finland’s forecast horizon. Viewed over the longer term, exchange rate movements have mirrored changes in countries’ relative growth and inflation outlooks. The devaluation of the Chinese renminbi in early August 2015 has, in fact, been moderate relative to the renminbi being at end-July about 14% stronger than a year earlier.

Graph 2.

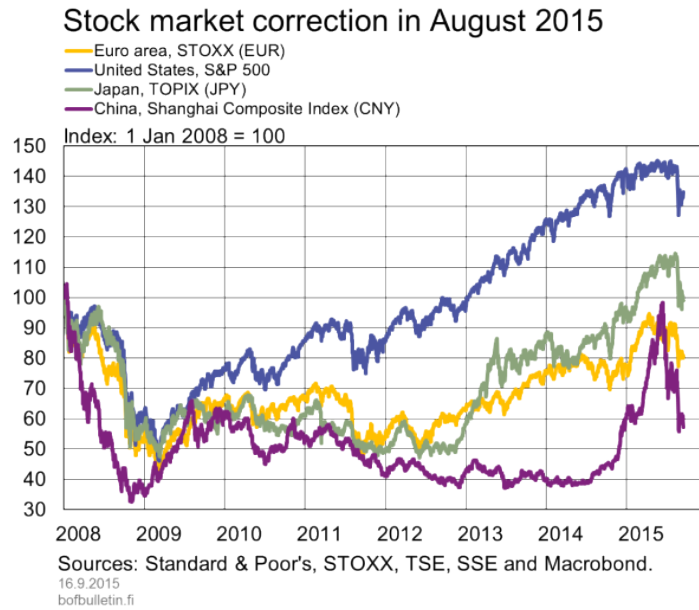
Longer-term exchange rates



Private sector deleveraging (which previously put an overall drag on growth, particularly in the advanced economies), fiscal tightening and weak labour market developments are gradually easing. On the other hand, in many emerging economies, weak commodity price performance, the appreciation of the US dollar and the acceleration of capital outflows have sapped growth and growth prospects. Moreover, in some advanced economies debt levels have assumed considerable proportions.

On the whole, weaker growth prospects for the advanced economies and the fact that world trade growth has passed its peak have changed the outlook for the global economy in the Bank of Finland forecast. It is as yet difficult to assess the overall impact of such changes on the prospects for the advanced economies. The uncertainty is illustrated by market reactions in August–September to the situation in China. To what extent do they reflect local stock price corrections and to what extent changed estimates of the outlook for the global economy as a whole? The growth forecast is subject to downside risks.

Graph 3.



Growth to remain at 3%

In the Bank of Finland forecast,^[1] global growth will pick up gradually from about 3% in 2015 to 3½% in 2017. World GDP growth in the forecast period will remain slightly lower than earlier projected, due, among other factors, to the more muted growth outlook for net exporters of oil, Latin America and other emerging economies. In contrast, the forecast for the EU22 remains broadly unchanged. The pace of world trade growth in 2015 will be around 3%. Even if trade growth were to accelerate, it would lag clearly behind the levels foreseen in the previous Bank of Finland forecast.

Table 1.

1. Forecast assumptions about commodity prices, interest rates and exchange rates are based on market expectations current on 16 September 2015. 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.

GDP and world trade

% change on previous year (previous forecast)

GDP	2014	2015f	2016f	2017f
United States	2.4	2.6	3.0	2.8
	(2.4)	(3.1)	(3.0)	(2.8)
EU22	1.3	1.7	1.8	1.9
	(1.2)	(1.6)	(1.9)	(1.8)
Japan	-0.1	0.6	1.1	1.0
	(-0.1)	(0.6)	(1.4)	(1.0)
China	7.4	7	6	6
	(7.4)	(7)	(6)	(6)
Russia	0.6	-4	-2	1
	(0.6)	(-4.4)	(-1.8)	(0.5)
World	3.1	3.0	3.2	3.5
	(3.1)	(3.3)	(3.5)	(3.7)
World trade	3.4	1.8	3.7	4.5
	(3.5)	(4.2)	(5.0)	(5.4)

f = forecast.

EU22 = euro area, Sweden, Denmark and United Kingdom.

Source: Bank of Finland.

In the euro area, growth is based on domestic demand

The low level of oil and other commodity prices, active and exceptionally accommodative monetary policy and the depreciation of the euro's external value in the past twelve months will underpin the euro area's cyclical outlook in the forecast period. The growth prospects for euro area export markets are, however, weaker than previously anticipated. The private sector's debt-servicing burden (which has long been a barrier to growth in euro area domestic demand), fiscal tightening and weak labour market developments are

slowly easing. Euro area growth in the forecast period will largely depend on domestic demand. Inflation will pick up from around zero to close to the ECB's price stability objective during the course of 2017.

The growth prospects for euro area export markets are slightly weaker than previously thought. On balance, the contribution of net exports to euro area growth will remain very limited during the forecast period.

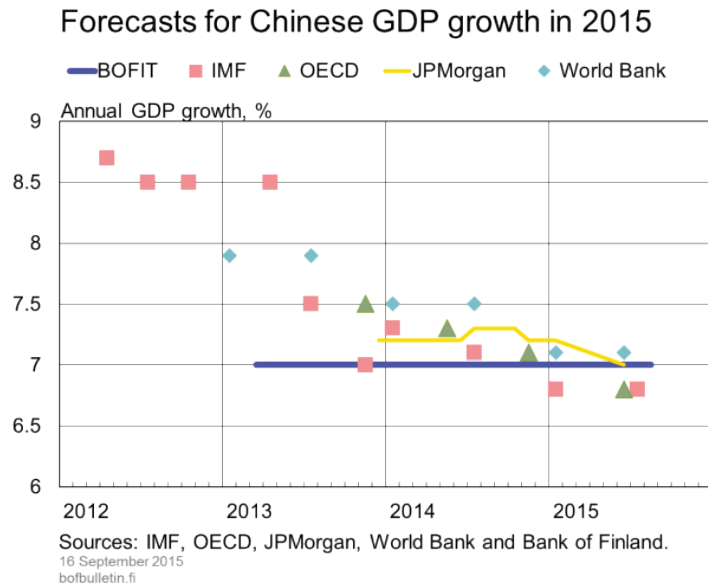
The aggregate demand component that contributed most to euro area GDP growth in 2014 was private consumption. Its value has risen steadily since the beginning of 2014, driven by real income growth amid an improved employment situation and falling energy product prices. Private consumption is expected to continue to recover as the employment outlook improves and the exceptionally low interest rate environment continues. With interest expenditures remaining moderate, repayments of loan principal will gather momentum and households will thus stand a good chance of improving their financial risk resilience.

The value of private fixed investment has grown in the euro area since the beginning of 2014, and the impact on growth in 2014 was mildly positive. Investment recovery has been held back by weak profitability, an abundance of free production capacity and, on occasion, lending bottlenecks. These factors will play a minor role going forward. Moreover, at the level of the euro area as a whole, an easing of debt-servicing pressures in the corporate sector will bolster investment growth. Partial relief will be provided by the European Fund for Strategic Investments (EFSI), scheduled to launch full-scale operations in mid-September with the aim of channelling a total of more than EUR 300 billion to non-financial corporations for the mobilisation of productive investments and the creation of jobs.

Market disruptions shaking China

Indicators for China over the summer corroborate a picture of slowing growth. GDP growth in January–June was 7%, and data for July–August point to growth continuing broadly as earlier in the year, especially if the ongoing stimulus measures give traction for the rest of the year. China's reforms have also progressed roughly as expected, which is important for both the emergence of new drivers of growth and the solution of existing problems. The Bank of Finland still sees growth reaching nearly 7% this year and slowing to around 6% in 2016–2017. Consumer price increases in China have already been moderate for several years, and the Bank of Finland forecast estimates no material change in the situation in 2016–2017.

Graph 4.



Although market disruptions constitute a natural component of China’s development phase, there is no reason to downplay the presence of problems and risks. The mere lack of statistics, the opacity of the system and big differences across the country’s regions result in nobody having an accurate picture of the real economic situation in China. Worthy of note is that debt levels in the country are on the increase, meaning that this already key economic policy problem is worsening and risks in this respect are growing. For the situation in China, see the article ‘Lower growth an inevitable feature of Chinese progress’.

Steady growth in the United States

The US economy continues to rest on solid ground, as private consumption, which accounts for a large share of the country’s GDP, is growing at a pace of around 3%. The economy has recovered well from the problems early in the year but, owing to the weak first quarter, forecasts for 2015 have been subject to slight downward revisions. Growth over the next couple of years is envisaged to accelerate to approximately 3%.

Stable employment growth and stronger household balance sheets have bolstered consumption. Likewise, the low price of oil has supported purchasing power. Consequently, consumer confidence is high. The unemployment rate has edged down to just over 5%. However, the employment rate is still low, despite cautious signs of improvement.

US exports have been hampered by the strong dollar and declining Chinese growth, and export growth is thus projected to remain sluggish in 2015. The significance of exports for the country’s economy is, however, fairly limited. The US oil industry has been affected by the low price of oil. Even so, US investment is predicted to grow at a reasonable pace of around 5% in the forecast period.

The Bank of Finland foresees annual US inflation (consumer price inflation) remaining close to zero in 2015 but increasing thereafter so as to exceed 2% in 2017. This higher inflation can be mainly attributed to oil price changes dropping out of the calculation of the annual inflation rate and the tightening of the labour market, with consequent wage increases.

Japanese inflation still slow

Japan continues to face difficulties in returning to growth. The near-term outlook is, nevertheless, cautiously optimistic. The low price of oil and subdued inflation will raise consumers' real incomes, thereby increasing private consumption. In addition, the government is seeking to boost the investment appetite of non-financial corporations by reducing the corporate tax rate.

Japan's prospects are overshadowed by the slowing of the Chinese economy. This impairs Japan's export outlook, despite competitive advantages brought about by the yen's weakness and increasing US import demand. Net exports will gain strength in the immediate future as the gradual restarting of nuclear reactors reduces the need for imported energy. The Bank of Finland forecasts approximately 1% growth in Japanese GDP in 2016–2017.

Japanese inflation plunged back close to zero as the impact of the consumption tax hike in April 2014 dropped out of annual price changes. Inflation has been further depressed by the falling price of oil, but underlying inflation is also slow. However, the labour market is tight and there are upward pressures on wages. The Bank of Finland forecast for Japan's inflation rate in 2015–2016 is around 1%. The consumption tax hike will cause inflation to rise to around 2% in 2017.

Japan's biggest medium-term problem is weakening potential output due to population ageing (See the article 'Structural reforms to provide boost during lean years in the global economy'), which poses challenges for efforts to wind down the considerable levels of debt and for rebalancing the economy.

Russian economy to recover only gradually

The Russian economic outlook for the current year and the immediate years ahead remains unchanged. The economy is weighed down particularly by the low price of oil. According to the Bank of Finland forecast, Russian GDP will contract by around 4% in 2015. In 2016–2017, the assumed fall in the price of oil will subdue domestic demand in Russia by slightly more than previously foreseen. Government expenditure is predicted to continue showing a slight contraction in real terms. A modest further reduction in investment is also expected, as the recession has freed up capacity. The Bank of Finland foresees a decline of around 2% in Russian GDP in 2016. There may also be some further decline in imports. The low level of imports will also be sustained, in part, by the likelihood of continuing external trade sanctions and Russian counter-sanctions.

The impact of the oil price collapse will fade in 2017, and growth in consumption, investment, exports, GDP and imports will rebound gradually. Slowing inflation will

underpin consumption. Even so, economic growth will remain very modest, as the paucity of investment and the protracted structural problems in the Russian economy have weakened the economy's trend growth, bringing it down close to 1% in annual terms.

Tags

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Structural reforms can provide an answer to lean years in global economy

TODAY 2:00 PM • BANK OF FINLAND BULLETIN 4/2015 • MONETARY POLICY

Structural reforms are playing an increasingly important role in the recovery of long-term outlook for growth. Globally, growth has been slow since the Great Recession. Reasons for this have been sought from both supply- and demand-side factors. At least some of the problems are structural and cannot be addressed with counter-cyclical stimulus policies.



The Great Recession has already lasted seven years

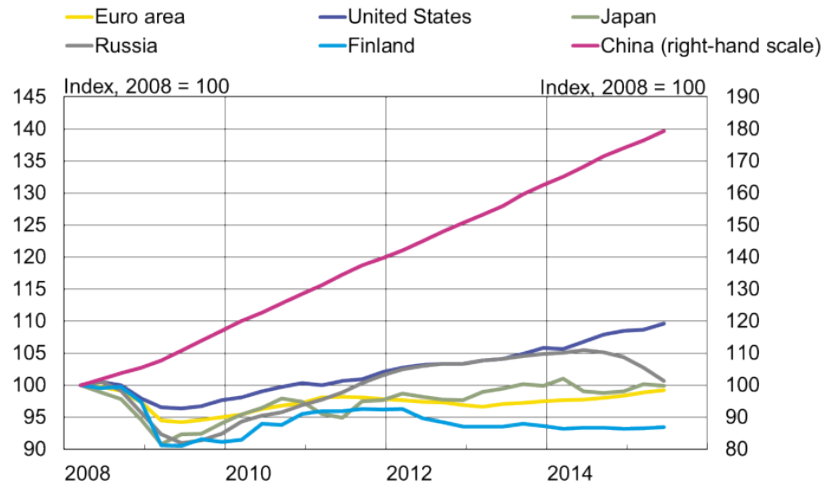
The global financial crisis which escalated at the end of 2008, and the Great Recession that followed have already caused seven lean years for the global economy. The real impact of the financial crisis has hit the advanced economies hardest of all. The direct effects of the crisis spread rapidly throughout the world, and world trade declined swiftly, leading in turn to the postponement of investment plans by non-financial corporations. Despite monetary and fiscal stimulus, the decline in demand eventually resulted in lower demand for labour.

During the Great Recession, output collapsed to a level below potential output.^[1] In addition, potential output decreased, i.e. the prospects for economic growth weakened, due to slower investment growth, reflected as a decline in growth of the capital stock and the exclusion of parts of the labour force from the labour market, as well as a lower labour participation rate. The decrease in potential output is a long-term phenomenon, and its restoration to a stronger level requires structural reforms.

1. Potential output is often defined as the level of GDP that the economy can attain without inflationary pressures.

Graph 1.

The recession's effects on output

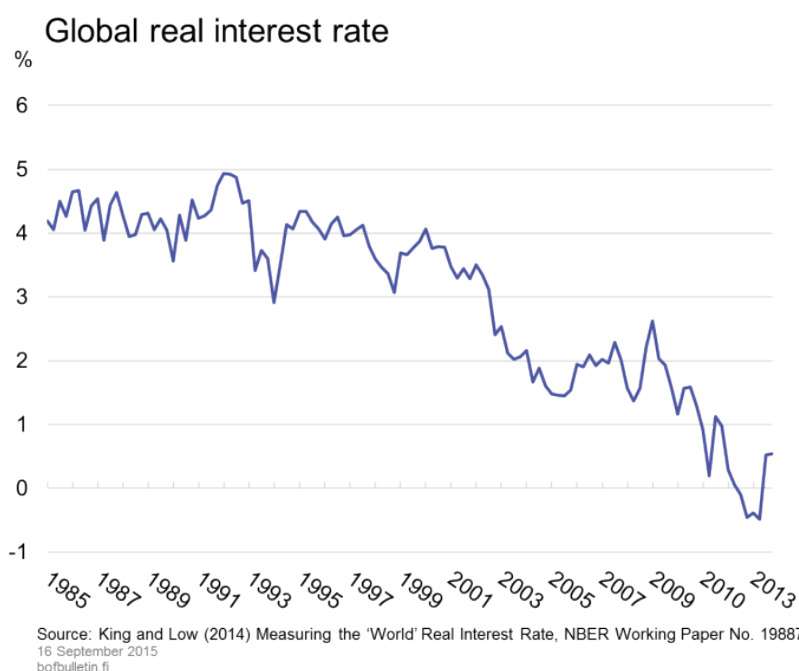


Sources: National statistical authorities, Macrobond and calculations by the Bank of Finland.
16 September 2015
bofbulletin.fi

The real interest rate also declined sharply. This decline is, however, a longer-term phenomenon. The real interest rate, defined on the financial markets (credit markets), may in the short term deviate from the long-term equilibrium real interest rate of supply and demand. The equilibrium real interest rate harmonises the marginal return and compensation that savers require to postpone consumption. The output achieved with this equilibrium real interest rate is at the level of potential output and the economy exhibits equilibrium employment.

In the short term, monetary policy can also be used to influence the real interest rate when the central bank changes the nominal interest rate with the aim of maintaining price stability and bringing output close to potential. The level of real interest rates, which is defined on the markets, depends not only on savings and investment but also on the risks attaching to financial assets. A long-term decline in the real interest rate can be an indication that the economy has entered a period of slower growth.

Graph 2.



Growth has weakened permanently

Lawrence Summers^[2] has proposed that the growth prospects of the global economy have probably weakened permanently. This view is based on the impact of the disruptions caused by the Great Recession and on estimates on the long-term factors of economic growth. One possible interpretation^[3] of this hypothesis of secular stagnation is that investment growth will slow if companies see that slow future population growth and subdued innovation will diminish the return on investment. The real interest rate – that normally balances investment and savings – cannot decline sufficiently in this situation. The zero bound on the nominal interest rate, in particular, constrains the decline of real interest rates into negative territory, especially if this is coupled with very slow inflation rates in nearly all the advanced economies. Summers notes that, in future, the zero bound on the nominal interest rate and a permanent weakening of growth prospects will create a pressure to maintain the real interest rate at a very low level so that emerging economies can reach full employment. This may cause instability on the financial markets.

According to Summers, a collapse in demand alone does not explain the more permanent decline in potential output. As an explanation, he provides the hysteresis effect in which

2. IMF Fourteenth Annual Research Conference in Honor of Stanley Fisher (2013) and VoxEU eBook (2014) Secular Stagnation: Facts, Causes and Cures, see <http://www.voxeu.org/content/secular-stagnation-facts-causes-and-cures>.

3. See <http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/31-why-interest-rates-low-secular-stagnation>.

a decline in current output levels will also weaken future output. Even though the hysteresis effect may be a good explanation of a collapse in potential output, the detailed channels of this effect remain unclear.

According to Robert Gordon ^[4], the weaker growth prospects of the global economy, and particularly the US economy, do not reflect only inadequate demand. Gordon states that the slow pace of GDP growth is mainly due to supply-side factors. For example, technological change has slowed to a trajectory of weaker long-term growth. The other headwinds of the economy are unfavourable demographics (slow population growth and population ageing), the decrease in the benefits achieved from education (the general level of education is already high), the increase in inequality and high government debt. Gordon estimates that longer-term productivity growth adjusted for technological slowdown and educational stagnation will be around a good ½ a percentage point per annum in the United States. He also estimates that supply-side factors will reduce average growth in real US GDP to 0.9% per annum over the period 2007–2032.

In the other advanced economies, these factors will have a similar effect as in the United States, although the differences across countries will be substantial.

Regional differences in the sources of growth

The sources of economic growth can be classified roughly as employment growth, increase in capital intensity and higher productivity.

According to population prospects by the United Nations (Table 1), the population of the United States will grow by approximately 0.5 percentage points per annum in the next 50 years. In Europe, there are considerable differences across countries: population will increase in some countries and decrease in others. For Europe as a whole, population growth is estimated to stagnate for the next 50 years, and therefore population developments will not have a significant impact on growth. In Asian countries, too, developments will be mixed. Of the high-population countries, China's population growth is slowing. In India, population will continue to grow at a rapid pace, pushing total population growth in Asia and increasing the supply of labour. The high rate of population growth in Africa is projected to maintain the rapid pace of increase in world population.

Table 1.

4. See <http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/31-why-interest-rates-low-secular-stagnation>.

Average population growth 2015–2065, %

United States	0.5
Germany	-0.3
United Kingdom	0.4
France	0.2
Italy	-0.2
China	-0.2
India	0.6
Africa	1.9
World	0.7

Source: United Nations (2015). World Population Prospects.

Of supply-side factors, in addition to population growth, employment dynamics also reflect developments in the labour force participation rate. The OECD's long-term projections on the evolution of the labour force participation rate are moderate, and therefore population growth can be considered a rough estimate of labour input in the long term. The potential labour force relative to population will decrease in the United States, the euro area and China in 2014–2030.

Even though China will probably rebalance the structure of its economy towards domestic consumption, the investment ratio will long remain much higher than in the advanced economies. This will increase the amount of capital in the economy more in emerging economies than in advanced economies. Capital intensity can be assumed to continue to rise in the emerging economies of Asia, despite the abundant supply of labour. In the OECD long-term projections, capital stock relative to output will increase in Asia particularly in 2014–2030.

Assessments of productivity are considerably hampered by the uncertainty surrounding future technical innovations. In emerging economies, general productivity growth is expected to follow at the maximum the trend productivity growth of past decades. The US economy has at least in the past been more dynamic than European economies. The largest benefits from the expansion of cutting-edge technology may in the future, too, be found in the United States. Emerging economies – including China and particularly India – are, however, approaching the technological frontline, which will enable the utilisation of existing technical advances. This catch-up in technology will in the future, too, generate rapid growth in the emerging economies of Asia. In the OECD's long-term projections, improvements in labour productivity in the euro area slightly exceed the rate

of productivity growth in the United States, but both economies lag behind labour productivity growth in the high-population countries of Asia.

Structural reforms will boost the economy

From the perspective of economic policy, it is essential to know to what extent the weaker growth prospects are due to problems on the demand side and to what extent they are the result of supply-side problems. The Great Recession has been alleviated by relaxing monetary and fiscal policy stances. The protracted recession has, however, shaped our understanding of the nature of the problems that the economy is facing. It is increasingly clear that some of the problems are of a permanent nature and cannot be affected by monetary or fiscal policies that are aimed at stimulating demand; they will instead have to be solved by structural reforms.

According to Summers, in an environment of zero interest rates, the real interest rate can be reduced by changing the inflation rate target. This does, however, involve risks and may weaken the credibility of monetary policy. In addition, the experiences of Japan are not encouraging: setting an inflation target and the subsequent raising of this target have thus far not resulted in a significant decline in the real interest rate in Japan. The real interest rate can also be reduced by conducting a policy of quantitative easing, in which the central bank aims to reduce long-term bond yields. The latter method has been used extensively in the advanced economies.

Table 2.

Breakdown of potential GDP for 2014–2030 (2031–2060)

	Potential GDP	Potential GDP per capita	Trend productivity excl. capital	Capital/output	Potential employment ratio
USA	2.4 (1.7)	1.6 (1.2)	1.7 (1.2)	0.2 (0)	−0.3 (0.1)
Euro area	1.7 (1.5)	1.5 (1.5)	1.5 (1.7)	0 (−0.1)	−0.1 (0)
China	5.0 (2.4)	4.7 (2.8)	4.4 (3.2)	0.7 (0)	−0.4 (−0.5)
India	5.8 (4.3)	4.8 (3.9)	3.4 (3.8)	0.5 (0)	0.8 (0.1)

Source: OECD Economic Outlook (May 2014).

In the advanced economies, fiscal policies have rapidly faced problems concerning the sustainability of government debt, leading to a need for fiscal tightening.

In advanced economies, fiscal and monetary policy measures are currently considered as having limited possibilities of providing an additional stimulus to aggregate demand.

Therefore, the only viable economic policy tools available are structural reforms. Structural reforms are considered beneficial irrespective of whether the recession is due to supply or demand factors. Implementation of the reforms is, however, hampered by a number of factors. The appropriate structural reforms differ across countries. Moreover, their implementation is often painful, particularly during a downturn, when old structures have to be broken down and new ones created. On the other hand, if structural reforms are implemented worldwide, everyone benefits more, i.e. the reforms generate synergies.

Structural reforms may, in the longer term, significantly accelerate the pace of economic growth. Structural reforms can be divided roughly into labour and product market reforms. Among other approaches, the operation and incentives of markets can be improved by changes in taxation, e.g. by shifting the focus from input taxes to consumption taxes.

The European Commission has assessed the impact of EU-wide structural reforms in selected EU countries (Table 3). The assessments are based on a wide range of structural reforms that differ across countries. The structural reforms are implemented immediately, and possible institutional delays have not been taken into consideration. The calculations can therefore be said to represent the upper limit of the possible benefits of structural reforms.

Table 3.

The GDP effects of structural reforms, %				
	5 years	10 years	20 years	50 years
Germany	3.2	5.5	8.7	12.1
France	4.2	7.7	13.3	17.8
Italy	3.9	8.5	16.1	23.4
Finland	5.2	9.6	15.8	19.4
United Kingdom	2.1	4.3	7	10.7

Source: Varga and in't Veld (2014), The potential growth impact of structural reforms in the EU: A benchmarking exercise, European Commission, Economic Papers, 541.

The figures presented (Table 3) are slightly smaller than in the OECD assessment^[5] in which the full implementation of extensive reform packages can in the period of ten years

5. Bouis and Duval (2011) Raising potential growth after the crises: A quantitative assessment of the potential gains from various structural reforms in the OECD area and beyond. OECD Economics Department Working Papers, No. 835.

add up to 10% to the GDP of an average OECD country. The various empirical and imputed estimates on the effects of structural reforms are naturally very uncertain, but they are nevertheless believed to be capable of providing a significant boost to annual economic growth.

Tags

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China develops, growth slows

24 SEP 2015 11:00 AM • BANK OF FINLAND BULLETIN 4/2015 • ECONOMIC OUTLOOK

As projected in earlier forecasts, Chinese economic growth continues to slow. 2015 GDP growth overall should average around 7 % p.a., and then the growth is expected to fall to around 6 % p.a. in 2016 and 2017. China faces the challenge of creating new engines of growth and managing its existing problems. This calls for determined reforms that inevitably will also bring about various kind of disturbances in the economy. Given decelerating growth and rising indebtedness, the risk that the Chinese economy underperforms this forecast is rising.



Slower growth pace in coming years

China's GDP growth slowed to 7.3 % in 2014. GDP growth this year was 7 % in January-June, and the July-August figures indicate growth will continue roughly at that level particularly if already-implemented stimulus measures produce their intended effect in the second half. Despite exceptionally weak performances in both exports and imports, the slowdown in GDP growth closely matches our forecast of late last winter.

China has proceeded with wide-ranging financial market reforms. Sticking to implementation of reforms is critical in order to create new engines for growth and to resolve existing problems. In line with the Bank of Finland's earlier forecasts, our new forecast sees China's GDP growth averaging around 7 % this year and slowing to the 6 % range in 2016–2017.

Changing structures

The slowdown is a natural consequence of economic development and rising living standards in China. In terms of nominal GDP, China is already the world's second largest economy after the United States. Using GDP measured in terms of purchasing power parity (PPP), which captures better the actual use of resources, China's economy is already as large as the US economy. Given the huge size of the economy and the sheer amount of resource inputs needed to sustain current growth rates, a slower pace of

growth is inevitable. Moreover, many of the factors that once drove high growth have vanished. The working-age population is shrinking, the available workforce in rural areas is diminishing and China has reached the point where it can no longer ignore environmental degradation.

The slowdown in growth reflects the transition from a growth paradigm driven by fixed-asset investment and goods manufacturing to a growth paradigm crowned by robust consumer demand and a large service sector. Evidence of this shift has been visible for some time now and can be seen in every part of the economy. One obvious area affected by the new growth model is the structure of Chinese imports. Import volumes of numerous commodities used in construction have already fallen. Similarly, low value-added component assembly work ineluctably continues to trickle away from China to countries with lower labour costs.

For the first time since 2006, private and public consumption last year accounted for more than half of GDP. Fixed investment in excess of 40 % of GDP is still phenomenally high, suggesting China has plenty of room for further structural realignment for many years to come. On the supply side, service sector output has increased rapidly and now generates nearly 50 % of GDP. Moreover, services now play the lead role in supporting job creation. Based on available information, it appears that China's labour markets withstand an economic slowdown. China's poor labour market statistics, however, makes accurate assessment of this situation difficult.

Current account surplus and stimulus bolster short-term growth

Due to the tightening labour supply and the sky-high investment ratio, growth in China must increasingly be based on productivity gains. Both China's urbanisation process and technological advancement strongly support this trend. Development in the technical sphere is already apparent in that China has been the world's top purchaser of industrial robots for some years now, even if there are still few robots relative to the number of workers.

Growth over the short run is supported by two factors: fiscal and monetary policy stimulus measures and the positive terms-of-trade effect stemming from the drop in global prices for oil and other commodities. Despite a remarkable boom in Chinese international tourism that moderates China's current account surplus, it could still reach 3 % of GDP this year.

In the years ahead, current account surplus will begin to shrink. Chinese incomes and consumption will continue to rise significantly faster than the global average and, consequently, import growth is expected to outstrip export growth. China's foreign currency reserves, while prodigious, have shrunk to less than \$3.6 trillion reflecting e.g. the recent surge in capital outflows. These factors in combination suggest that China's trade and capital flows are no longer feeding the global imbalances seen in the last decade.

With modestly rising consumer prices at the moment, policymakers do not seem overly concerned with threats of higher inflation or deflationary risks. Producer prices, in contrast, have entered their fourth consecutive year of decline. This reflects both the slide in world commodity prices and overcapacity problems that continue to plague many sectors.

Yuan spearheads reform policy

Measures to open financial markets provide the clearest examples of progress in policy reforms. Reform policy pursues the strategic goals of promoting international use of the yuan and strengthening China's presence in the global economy. At a practical level, this can be seen in China's efforts to have the yuan included in the IMF's SDR basket of the key currencies. China has recently moved ahead with the dismantling of capital controls, revised its mechanism for setting exchange rates to a more market-driven approach, continued with deregulation of deposit rates and launched a deposit insurance scheme. All these measures increase competition on the domestic market and support international acceptance of the yuan.

In many other sectors of the economy, the progress in reforms has been slower than hoped. State-owned enterprises still enjoy an array of competitive advantages denied their private counterparts, and reform of the service sector would be important to pull structural reforms ahead. Foreign firms operating in China have expressed concern over the worsening business environment due to slow progress in reforms.

Nevertheless, reforms have already altered the business environment considerably but policymaking and related communication have not kept up with changes. For example, inconsistent and confused policy by authorities this summer with regard to stock markets and foreign currency markets implied significant costs for the government and added to market uncertainty. While visible inconsistencies in policymaking could indicate differences among decision-makers over reform policy, they also demonstrate the fact that China's decision-makers find themselves operating in unfamiliar territory. This is part of a natural learning process. What counts is that China has stuck with its financial market reforms in spite of market turbulence.

Market uncertainty should not be downplayed

Slower growth of China's economy, falling share prices and weak export/import trends have made markets increasingly jittery in recent months. It now seems apparent that markets have clung too long to overly optimistic views about China's economic growth and that disturbances in the financial markets have been interpreted too literally as a sign of dramatic weakening in the real economy. Given the scale of systemic and structural changes in China, it is clear that the process involves adjustments that bring about disturbances of varying degrees in the economy. In fact, such disruptions are at least partly a sign that things are developing in the desired direction.

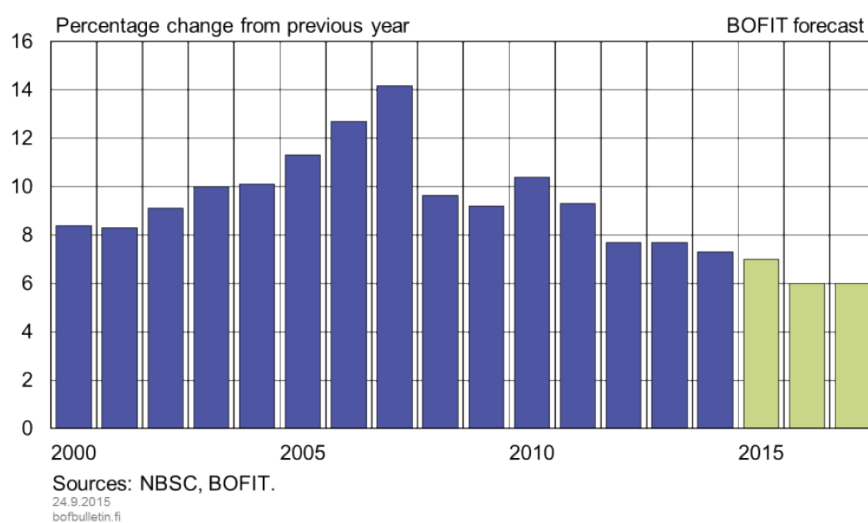
Although shocks are natural at this phase of China's development, problems and the seriousness of the risks they entail cannot be treated lightly. In themselves, the poor statistical data, the lack of transparency in the system, and the huge differences among

China's regions already create the situation where nobody has a clear picture of the economy. Debt levels in the country are rising, which means that this major sore point of economic policy continues to fester and related risks increase.

At their worst, severe market disturbances could trigger a situation where economic reforms come to a halt. Signs of impeded reform processes have already been seen following the recent turmoil in the stock markets and foreign exchange markets. If policymakers give in to pressures to suspend reforms and Chinese policy becomes inward looking, a reassessment of China's development trajectory and growth outlook would definitely be in order.

Chart 1.

China's GDP growth and BOFIT forecast for 2015–2017



Tags

- [China](#)
- [gross domestic product](#)
- [forecast](#)
- [BOFIT](#)

How can we simultaneously maintain both price stability and financial stability in the euro area?

10 SEP 2015 1:00 PM • BANK OF FINLAND BULLETIN 4/2015 • MONETARY POLICY •
HANNA FREYSTÄTTER

The operating environment for monetary policy has changed: the euro area macroprudential system – or macroprudential framework – for dampening country and sector-specific overheating is now stronger than before the financial crisis. The new system is, however, not yet complete, which increases the need to contribute to the maintenance of financial stability also via monetary policy measures. Even if the macroprudential system were stronger than it currently is, it is very difficult to fully prevent the possibly unfavourable side-effects of an exceptionally accommodative monetary policy. In the current situation, however, the strengthening of economic growth via monetary policy measures does also support financial stability.



In the current situation, an accommodative monetary policy maintains both price and financial stability

The aim of the euro area's exceptionally accommodative monetary policy is to keep inflation expectations anchored and ensure that the period of low inflation does not continue for too long. A protracted period of low policy rates and the ongoing expanded purchase programme will serve to depress long-term interest rates, ease financial conditions for non-financial corporations and households and boost asset prices in the euro area. Expectations that monetary policy will remain more accommodative than in other key economic regions weaken the euro exchange rate against other currencies. Overall, the accommodative monetary policy boosts demand and pushes up inflation in the euro area.

In the euro area, monetary policy is transmitted particularly via bank lending. The completion of the comprehensive assessment of banks' balance sheets and the launch of

single banking supervision in autumn 2014 are improving the functioning of the bank lending channel. These measures are accompanied by the ongoing gradual tightening of banks' fixed capital requirements to safeguard financial stability. The combined effect of the various components of the new regulatory framework is difficult to assess, and in the transitional period the effects may be different from the longer term. In the transitional period, these tighter requirements may e.g. dampen the monetary policy stimulus effect, but in future the banking sector will be more resilient to adverse shocks in the economy. A sound banking sector will also be able to increase lending as growth in the euro area picks up.

One of the concerns that has been raised is that under the new regulatory regime banks may avoid high-risk corporate lending because this would require them to have a higher level of additional capital than previously.^[1] At the same time, the smaller risk weights of lending for house purchase may attract banks to increase mortgage lending. Most badly hit would be SMEs and new companies, as they are dependent on banks, whereas larger companies are increasingly acquiring finance on the capital markets. In the worst case, in the new regulatory environment monetary stimulus could, via the banks, be channelled too strongly onto the housing markets instead of into corporate sector fixed investment.

A sustainable normalisation of inflation requires that monetary policy impacts extend to the broader real economy. It would therefore be hoped that accommodative monetary policy would ease non-financial corporations' funding conditions and stimulate fixed investment in the euro area. The Eurosystem's monetary policy measures aimed at improving lending are designed to encourage banks to increase lending particularly to non-financial corporations. In the euro area, the problem has been that the exceptionally low policy interest rate has not been fully transmitted into bank lending rates in all euro area countries, and bank lending has been subdued, particularly lending to non-financial corporations. For example, in the targeted longer-term refinancing operations (TLTRO) begun in September 2014, banks are required to increase lending to the euro area non-financial private sector in order to be entitled to low-cost and long-term central bank refinancing (that will mature at the end of 2018).

There is, however, a risk that the significant increase in liquidity brought by the expanded asset purchase programme, combined with tighter regulation, may result in a situation in which the monetary policy stimulus is channelled excessively onto the housing markets or into the shadow banking sector. An overheating of the housing market would be particularly dangerous, as the bursting of a leveraged housing bubble usually results in a deep and protracted recession. Even though the creation of a stock market bubble is similarly not welcome, the impact on the real economy and price stability have usually been smaller than the consequences of the bursting of a housing market bubble. If the monetary policy stimulus focuses strongly on the shadow banking sector and is transmitted via this sector, this contains risks, as the resulting threats to financial stability are not necessarily fully understood yet, let alone managed.

A rise in asset prices is, however, a key channel through which the effects of an accommodative monetary policy are transmitted, as it supports the balance sheets of the

1. See e.g. Fontaine Vive (2015) and Barut et al. (2015).

household and corporate sectors. A rise in asset prices and growth in lending are not automatically an indication of an emerging bubble. The improvement of the euro area economy via accommodative monetary policy measures is also beneficial for financial stability,^[2] as it boosts employment and facilitates the servicing of debt and the reduction of the considerable leverage ratios, both of which will also have a positive effect on the banking sector.

A strong macroprudential system minimises unfavourable side effects of accommodative monetary policy

Compared with before the financial crisis, the euro area is considerably better equipped, with the help of macroprudential policy, to manage risks to the financial system. The countercyclical (dynamic) macroprudential policy framework being launched extensively in the euro area in 2014–2016 is targeted at curbing excessive credit and leverage growth in a cyclical upswing, thus dampening the procyclicality^[3] of the financial system, i.e. tendencies that amplify business cycles. Countercyclical macroprudential policy can be used to support the favourable allocation of accommodative monetary policy measures in the euro area in a way that prevents excess and ensures the effects reach evenly all sectors of the economy.^[4]

In the new macroprudential system^[5] of the euro area, the risks to financial stability arising from the exceptionally accommodative monetary policy are tackled on two levels: primarily with measures taken by national macroprudential authorities (first line of defence) and secondarily, if necessary, with more stringent requirements imposed by the ECB (second line of defence). Even if lessons have been learned from the crisis, the euro area macroprudential system is not yet fully operational, and several deficiencies have already been pointed out.

Key in the new system is that national macroprudential authorities, e.g. in Finland the Financial Supervisory Authority, bear primary responsibility for the macroprudential policy of their country.^[6] The majority of the macroprudential policy toolkit is defined by EU legislation as common to all Member States. Member States may also issue national regulations on additional tools. As yet, however, not all Member States have yet used this opportunity very extensively.

2. See e.g. ECB (2015).

3. See e.g. Freystätter et al. (2013).

4. Macroprudential policy in the euro area has also been strengthened by introducing macroprudential tools that are not primarily intended for countercyclical use but strengthen the resilience of the financial system.

5. The term 'macroprudential system' refers to a wider concept than the available macroprudential tools (e.g. the countercyclical capital buffer or loan cap), because it also includes issues relating to e.g. competence and decision-making.

6. In Finland, macroprudential supervision is based on cooperation between several authorities. The national macroprudential authority is the Financial Supervisory Authority (FIN-FSA), and the FIN-FSA Board takes the decisions on the use of macroprudential tools. The decisions are based on a macroprudential analysis, made in close cooperation by the Bank of Finland, the Financial Supervisory Authority and the Ministry of Finance.

The work of national macroprudential authorities in different countries is thus restricted by the toolkits included in their national legislation. If, for example, a national macroprudential authority notices that an exceptionally accommodative monetary policy is strongly reflected on the housing market, it cannot act effectively if the macroprudential tools that are best suited to preventing the overheating of the housing market have not been provided for in national legislation. Legislators thus play a key role in the construction of an efficient national macroprudential system.

When, in November 2014, the ECB assumed responsibility for the supervision of the largest banks it also assumed macroprudential policy powers. In the new institutional structure of the euro area, macroprudential policy powers are divided between national authorities and the ECB.^[7] The ECB can impose more stringent requirements on the macroprudential tools under its power than national supervisors. At the ECB, significant responsibility for euro area macroprudential policy lies with the Governing Council, which is ultimately responsible for ensuring that macroprudential policy is tight enough.

The role of the ECB in the macroprudential policy of the euro area is still taking shape. Members of the ECB's Executive Board have in their speeches discussed their new role by e.g. underlining the protection of financial stability as part of their role, as well as the significant role of the ECB's Governing Council in macroprudential policy decision-making.^[8] The macroprudential powers of the ECB are, however, limited. They extend only to certain macroprudential tools available to national authorities, the powers are asymmetric (no power to impose less stringent requirements) and responsibility is shared with the national authority.^[9]

For macroprudential policy to have an effect, the tools available should be effective enough.^[10] From the perspective of the ECB, the achievement of this goal is restricted by the fact that the additional tools adopted by national authorities are not within the reach of the ECB. For example, the loan-to-value ratio is not part of the tools regulated by the ECB, and each national authority can decide on the use of this instrument.

The ECB does, however, have at its disposal the macroprudential tools included in the EU's Capital Requirements Directive and Regulation (CRD IV/CRR). In practice, these include two countercyclical macroprudential tools: a countercyclical capital buffer imposed on banks and higher capital requirements (higher risk-weights) vis-à-vis real estate exposures. The ECB does not necessarily have the possibility to impose effectively more stringent macroprudential measures on each problem at hand. On the other hand, if the national macroprudential policy is effective and appropriate, the fact that the set of tools available to the ECB is limited does not necessarily create problems.

The asymmetry of powers can also be considered a limitation. The ECB's powers to impose only more stringent measures has, however, been carefully considered. The purpose is to prevent passiveness in situations in which national authorities should

7. Currently, the banking union consists of only euro area countries, and therefore both the single monetary policy of the Eurosystem and the ECB's macroprudential powers apply to euro area countries.

8. See e.g. Draghi (2014) and Lauterschläger (2014).

9. Grande (2014).

10. See e.g. Schoenmaker (ed.) (2014).

implement macroprudential measures that are unpopular with the general public. In contrast, it may be easier for the national authorities to take less stringent macroprudential decisions without the help of the ECB.

The shared responsibility of the ECB and national authorities may also, in a worst case, lead to a situation in which neither party acts according to their responsibilities. The ECB's (and particularly the Governing Council's) powers can be justified by the fact that the ECB has the best overall picture of the euro area and an ability to understand the interdependencies of the various policy areas.

Doubts^[11] about the effectiveness of the available common countercyclical macroprudential tools (e.g. the countercyclical capital buffer) apply to both the ECB and the national macroprudential supervisors. Criticism can also be presented on the limited scope of the macroprudential tools: the instruments currently available in the euro area apply almost entirely to banks and their financial intermediation activities, i.e. they do not cover non-bank financial intermediation or e.g. stock market bubbles.

One perspective, however, is that a macroprudential policy that addresses bank credit can be effective in the euro area because the bulk of financial intermediation takes place via banks and the current macroprudential tools focus on this type of financial intermediation.^[12] The euro area is also a special case because there is still some fragmentation on the financial markets. Country-specific macroprudential measures directed at the banking sector are thus more effective than they would be if the importance of the capital markets was high and the degree of financial fragmentation was low.

It is, however, worth considering whether individual banks are already currently able to carry the responsibility for their own macroprudential stability and whether the ECB is able to carry its responsibilities as the last line of defence for euro area financial stability. For example, housing market overheating can be a difficult situation if national authorities are restricted by the lack of adequate macroprudential tools in national legislation and/or measures by the ECB's Governing Council are restricted by the fact that it cannot use in its decision-making the macroprudential tools designed particularly for dampening the overheating of the housing markets. A rapid broadening of the available macroprudential toolkit is to be hoped for.^[13] We also have to prepare for the active use of countercyclical macroprudential tools, as policy interest rates are likely to remain at a low level for a protracted period and the expanded purchase programme will be continued until inflation is on a sustainable path towards price stability.

11. See e.g. Cecchetti (2015).

12. Panetta (2014).

13. See e.g. Constâncio (2015).

Should monetary policy contribute to maintaining financial stability in the euro area?

The primary objective of the ECB is to maintain price stability. When the objective of price stability is not endangered, monetary policy can also be used to support other economic objectives of the EU, such as balanced economic growth. Financial stability contributes to the achievement of price stability and thus the fulfilment of the ECB's mandate. Financial stability is necessary for the operation of the financial system and the efficient transmission of monetary policy, which in turn enable the central bank to maintain price stability. An environment of financial stability reduces the probability of reaching the zero-bound interest rate and having to resort to non-standard monetary policy measures.

The euro area's single monetary policy is currently conducted in an operating environment where the effectiveness of the macroprudential system of the euro area is uncertain. Due to this uncertainty, it is unclear whether current monetary policy is conducted in an environment of a weak or strong macroprudential system. To put it simply, we can estimate that if the current macroprudential system of the euro area is strong, the unfavourable side effects of an exceptionally accommodative monetary policy will remain minor. If, on the other hand, the current system is still too weak, monetary policy can be used for actively and fully leaning against the wind,^[14] financial stability issues can be left unattended in monetary policy decisions, or the measures can be something in between the two aforementioned.

The new institutional architecture of macroprudential policy in the euro area means that the current situation would not be a standard case of leaning against the wind. Primary responsibility for financial stability lies within national macroprudential policies, which are expected to dampen financial cycles and reduce the need to lean against the wind with the help of monetary policy.

The possible complementary role of monetary policy in the maintenance of financial stability has, however, been reintroduced in recent years.^[15] It has been proposed that monetary policy should contribute to the maintenance of financial stability if the macroprudential system is not very strong.^[16] In addition, even if macroprudential policy targeted at lending were successful, tighter regulation may push financial stability risks to the shadow banking sector. As long as the euro area lacks macroprudential tools that cover the shadow banking sector, monetary policy may have to take responsibility because its effects extend to the shadow banking sector, too, via general financing conditions.

In a weak macroprudential system, monetary policy decision-making would therefore give a larger-than-zero weight to the maintenance of financial stability (third line of

14. See e.g. IMF (2014). Leaning against the wind refers to a monetary policy stance that is tighter than necessary in terms of only the price stability target but seeks to dampen the rise in asset prices and prevent an increase in financial imbalances.

15. See e.g. Bernanke (2011) and King (2012).

16. Smets (2014).

defence). If monetary policy contributes to the maintenance of financial stability, it may have to be tightened so that inflation and output remain for a longer period lower than their target and potential to prevent the creation of a financial bubble. Such a situation does, however, pose the risk that the central bank's credibility as the guardian of price stability could suffer.^[17] In such a situation, measures should be taken to strengthen the credibility of the primary objective. One proposal is that the central bank should commit to a price-level target.^[18] In this case, the protracted low level of inflation is compensated at some point so that the price level remains on its target path.

In an environment of a strong macroprudential system, monetary policy decision-making would be easier, as it could focus fully on its primary objective, the maintenance of price stability. However, in the case of a strong macroprudential system, the use of countercyclical macroprudential tools would (via lending and asset prices) also have an impact on the economic cycle, and hence on inflation. In the euro area, this would mean changes to the operating environment of monetary policy that are not yet fully understood. If, for example, a strong monetary policy and strong macroprudential policy work in the same direction, the tightening impact on financing conditions and the dampening impact on credit growth of countercyclical macroprudential policy should be included in the total impact assessment so that the monetary policy stance is not scaled in an inappropriate manner. In such a situation, the macroprudential policy stance in the various euro area countries should be an important component of the assessment of economic developments in the euro area.

In the short term, the other policy areas, e.g. monetary policy, have to take the euro area's current macroprudential system as a given. Over a slightly longer period, the current system could be changed if it turns out that it is not yet effective enough or its coverage is inadequate (e.g. does not reach the shadow banking sector). Various parties have, however, warned about having too high expectations for macroprudential policy: it may not be possible to build even in the longer term a macroprudential system that is so strong that the countercyclical macroprudential policy would be effective enough in the euro area to compensate for the unfavourable effects of a monetary policy that is exceptionally accommodative from time to time. It has also been proposed that macroprudential policy and monetary policy should be thought of as complements.^[19] Macroprudential policy cannot be expected to be fully effective if the objective is to offset a monetary policy stance.^[20]

Monetary policy must take into consideration that the effectiveness of the euro area's current macroprudential system can be either under or overestimated. If the effectiveness is overestimated, the unwanted side effects of monetary policy may be assigned for management by macroprudential policy, even although it is at least thus far not equipped to do this. If, however the effectiveness is underestimated, the monetary policy stance may be formulated in an inappropriate manner. The euro area may also find itself in a situation in which the macroprudential system is strong in some countries

17. Smets (2014).

18. Woodford (2012).

19. E.g. Hannoun (2015) and Bruno et al. (2015).

20. See also IMF (2013).

and weak in others. The ECB Governing Council's strong commitment to the objective of price stability is nevertheless essential, and the improvement of the euro area economy will also support financial stability.

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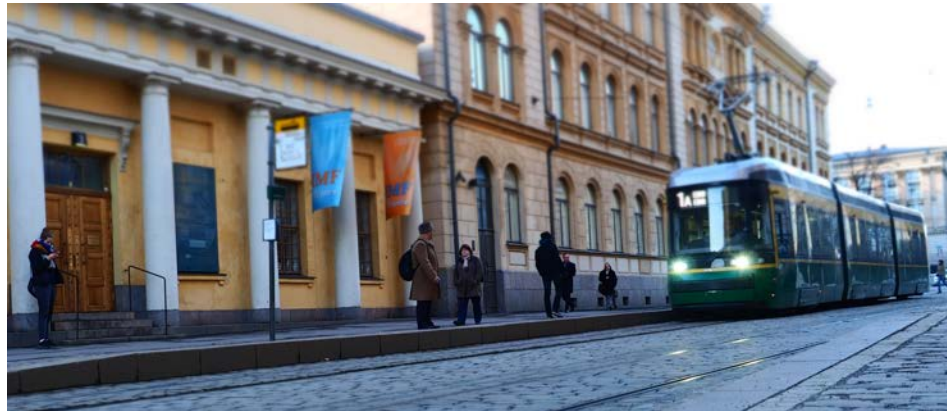
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Macroprudential supervision racing to keep pace with market developments

TODAY 2:00 PM • BANK OF FINLAND BULLETIN 4/2015 • FINANCIAL STABILITY •
KATJA TAIPALUS, JOUNI TIMONEN

In a prolonged environment of exceptionally low interest rates, the authorities are responsible for ensuring the adequate monitoring of potential vulnerabilities due to low interest rates. Before measures to manage risks can be implemented, the risks must first be identified. Owing to continuous market developments, there is a strong need to update the analysis conducted by the authorities.



Low interest rates may pose a challenge to stability

Macroprudential supervision is conducted by the authorities for the purpose of preventing threats to the financial system as a whole. Macroprudential supervision seeks to safeguard the smooth functioning of financial intermediation.

Economic activity in the euro area has been subdued, despite a long period of accommodative monetary policy. The European Central Bank (ECB) has signalled its commitment to accommodative monetary policy over an extended period of time, until achievement of the inflation target (inflation rates below, but close to, 2% over the medium term). The ECB's exceptionally accommodative monetary policy and non-standard monetary policy measures, such as asset purchases, are indispensable for the euro area economy.

Improved access to finance, via both bank and market lending, supports economic recovery. A rebound in economic growth will also promote the stability of the financial system. Consequently, monetary policy measures are not in conflict with the objectives of macroprudential policy. However, a policy of maintaining a long period of low interest rates – particularly in combination with ample global liquidity – may also have negative

side-effects for the financial markets. The build-up of systemic risks related to such factors needs to be monitored closely.

The way the ECB support measures are allocated is vital for euro area economic recovery. In order for the measures to foster economic growth, they should be focused on underpinning healthy risk-taking and the financing of investments. The vulnerability of the economy will grow if the support measures mainly boost risk-taking on financial markets rather than investments in the real economy, postpone the implementation of necessary reforms and increase moral hazard.

In a protracted period of low interest rates, there is an obvious cause for increased risk-taking on the financial markets: a search for yield. In an environment of ample liquidity, investors look for better returns on their investment assets. Generally, this means investment in riskier investment products offering higher yields than offered by products with lower risk.

There is a danger that, in their investment assessments, investors fail to pay adequate attention to economic fundamentals, while mainly concentrating on yield expectations based on continued price increases, which contributes to an ineffective allocation of capital in the economy. The situation may result in strong increases in asset prices across several different sectors. Clear signs of the search for yield are already visible, as just such demand pressures have e.g. affected yields on lower-quality corporate bonds, causing them to fall to record lows on the market.

Lower bond yields improve e.g. the debt sustainability of non-financial corporations and governments, as funding costs decrease. However, incentives to carry through the necessary structural reforms may diminish in response to lower debt-servicing costs and significantly easier access to finance.

The consequences of such a scenario are negative for a country's long-term growth prospects: if old problems remain unresolved, the foundations of the economy will not strengthen to support sustainable growth. Despite institutional reforms during the crisis, it has not yet been possible to sever the negative feedback loop between banks and governments. The stability of the financial system is not only tied to economic growth, but also to sovereign debt sustainability.

During a period of low interest rates, many financially weak firms and households are able to service their loans. As soon as interest rates begin to rise, these borrowers may rapidly exceed the limit where they are no longer capable of meeting their obligations. In such a situation, banks' poor-quality balance sheet items increase, acting as a constraint on their operating capacity amid lower profitability and weaker capital adequacy.

Therefore, in a low interest rate environment, it would be advisable to wind down debt levels, which are still considerable in many places, as a legacy from the financial crisis. Unfortunately, however, we have seen only marginal adjustment of leverage ratios, with a partial resumption of growth in leverage. This type of development may strengthen further still: sharp increases in asset prices and particularly potential excess growth in valuations have a strong negative impact on stability, as the elevation of asset prices enables an increase in leverage via higher collateral values.^[1]

Growth in leveraged investment activity boosts demand and puts pressure on asset valuations to climb even more strongly.

Similar trends were seen in the global financial crisis. In fact, collateral values play an important role in amplifying credit cycles. There is a higher risk of disturbance if the correlations between the price developments of different assets increases, as observed recently. If leverage grows very fast in a low interest rate environment or maintains its already inflated level, an increase in interest rates will very quickly affect debtors via higher debt-servicing costs. Economic recovery could then remain more subdued or more quickly reach its limits.

In the economy, moral hazard refers to risk-taking at the expense of others in such a way that the risk-taking party gets the benefit from successful risk-taking while the others pay most of the costs for unsuccessful risk-taking. In the banking sector, moral hazard may mean greater risk-taking than is beneficial for society. It may be a consequence of expectations regarding public sector bail-outs.

Debt developments need to be monitored closely for the identification of systemic risks, as the worst economic recessions have typically occurred in the wake of strong debt accumulation.^[2]

Smooth functioning of financial intermediation as a goal

Well-functioning market funding and low costs support banks' own funding activity, thereby strengthening their lending capacity. Particularly in Europe, the banking sector's good capital adequacy and frictionless credit supply are important, as the area's banks are still key players in the channelling of finance.

Even so, a protracted period of low interest rates also poses challenges to banks. Banks' net interest income has remained low, and bank profitability is weak in many countries. However, low interest rates and, on the other hand, small differentials between short- and long-term interest rates (a flat yield curve) affect very differently banks with different approaches to interest rate linkage in their lending.

Given that average profitability in banking is still weak in Europe,^[3] banks are seeking new sources of income or changing their business activities. Changes in business also reflect increased regulation. In addition, the traditional banking business is challenged by increasing market funding: advantageous funding on the debt market offers some non-financial corporations seeking finance a highly important alternative to bank funding.^[4] Market funding is not accessible to all non-financial corporations, however.

1. Schoenmaker, D. – Wierds, P. (2015) Regulating the Financial Cycle: An Integrated Approach with a Leverage Ratio. Duisenberg School of Finance – Tinbergen Institute Discussion Papers No. TI 15-057 / DSF 93.

2. Among others, Mian, A. – Sufi, A. (2014) House of Debt. University of Chicago Press.

3. The profitability of the Finnish banking sector is good

4. Alternative providers of finance and banking sector competition are discussed in greater detail in, among others, the Bank of Finland Bulletin (2/2015) articles [Structural changes in banking have paved the way for shadow banks](#) and [Major changes underway in European banking sector](#).

Along with the traditional banking sector, we are witnessing a very rapid emergence of a number of totally new market participants as providers of finance. Their ability and readiness to deal with risks may, however, be weaker than those of traditional providers.

With a widespread search for yield on the markets and an increasing share of new market participants (such as the shadow banking sector) as lenders, the capacity to assess risks related to loan applicants may deteriorate compared with traditional banking, where customers are often known over a long period of time. Nevertheless, the activity of alternative providers of finance has grown very fast, as the new market participants are able to make use of the benefits of digitalisation, among other things. Admittedly, alternative channels of financing diversify, and bring greater efficiency to, the supply of finance, while also increasing competition. On top of the entry of totally new market participants, the traditional operating environment of banks has been subject to sectoral shifts, with representatives from other sectors, such as insurance companies, offering services traditionally perceived as belonging to the banking sector.

The smooth functioning of financial intermediation is a precondition for the transmission of monetary policy. This is conditional on financial intermediaries maintaining their operational capacity and financial health over the business cycle. In respect of the banking sector, both microprudential supervision (banking supervision) and macroprudential supervision, covering the financial system as a whole, are aimed at achieving this goal.

The financial system is, however, undergoing a major transition, with financing channels offering alternatives to the banking sector growing strongly. This makes it necessary to ensure that the means are in place to strengthen the resilience of alternative providers of finance. Similarly, we must secure the availability of tools that enable containment of credit cycles deriving from the alternative system, whenever necessary.

Risks must be identified in advance

A protracted period of low interest rates may create threats to the stability of the financial system via many channels of influence. Given the abundance of potential channels of influence, the first priority for the authorities is to ensure an adequate monitoring of vulnerabilities caused by low interest rates.

Macroprudential policy, examining the operation of the financial system as a whole, needs to be supported by constantly evolving analysis. Conducting the analysis is not unproblematic, as the monitoring of developments in risk-enhancing vulnerabilities is based on information on previous crises and their causes. Even so, the analysis is of great importance for the planning of policy measures: there must be an ability to foresee new vulnerabilities and related risks, which continue to build up and change in response to the evolution of the financial markets. Policy measures can only be directed at already identified systemic risks.

With a protracted period of low interest rates and an accommodative monetary policy, the possibility of undesirable side effects on financial stability increases. Authorities should be prepared to forestall the related systemic risks. The starting point is to set realistic objectives. Current tools make it most realistic to aim primarily at improvement

of the banking sector's risk resilience.^[5] Another important aim is to seek to soften the steepness and depth of credit cycles. Prevention of systemic risks and banking and other financial crises caused by such risks is the primary objective of macroprudential policy, aimed at safeguarding the stability of the financial system as a whole.

Macroprudential supervision should be extended to cover non-banks. However, the EU legislation providing for macroprudential policy is primarily banking regulation, meaning that the development work seen so far has mainly focused on actions concerning the banking sector. The current toolkit is only able to impact on credit cycles emerging within the banking sector. The authorities have no established methods in place for containing credit cycles outside the banking sector. This enables regulatory arbitrage,^[6] benefiting non-bank financing. Another factor is the strongly procyclical nature of market funding: funding is available considerably more abundantly and on easier terms and conditions in an economic upswing than in a downswing. Excessive reliance on frictionless access to market funding may thus expose the system to a liquidity crunch, i.e. a tightening in the availability of finance.

For this reason, efforts are under way to broaden the scope of macroprudential supervision and its toolkit so as to include the non-bank financial system. At EU level, the European Systemic Risk Board is currently working on the development of legislation supporting this aim. With regard to the extension of regulation and the policy toolkit, however, we must accept the fact that not everything can, or should, be controlled by more regulation. The broadening should be prioritised with care. Rather than increasing regulation, more attention should be devoted to creating incentives conducive to stability.

Macroprudential stability requires a national, but also a euro area perspective. Macroprudential policy mainly consists of activity by national authorities, which is warranted considering the structure of the banking system, in particular. However, potential threats that the authorities want to address may also be of a cross-border nature, and especially so when actualised. This is particularly striking in the shadow banking sector.^[7]

Along with single banking supervision within the banking union, the European Central Bank was also given a mandate in macroprudential policy. The ECB can impose more – but not less – stringent requirements than the actions taken at national level on the basis of EU legislation. The purpose of these asymmetric powers is to prevent passiveness (inaction bias) in the pursuit of macroprudential policy by national policy-makers, as the

5. According to Thakor (2014), a healthier bank pre-crisis can better provide credit during a crisis than a capital-constrained bank. This is also the premise on which the objective of countercyclical macroprudential policy is based. The banking sector's capital adequacy is strengthened during an economic upswing in order to ensure less restrictive lending in a recession. This smooths out the booms and busts of the financial cycle. See Thakor, Anjan V. (2014) Bank capital and financial stability: An economic tradeoff or Faustian bargain. *Annual Review of Financial Economics*, vol. 6.

6. Regulatory arbitrage is reflected in the banking system particularly as circumvention of capital adequacy regulation by making use of artificial arrangements and gaps in the regulatory framework. Regulatory arbitrage is here understood to mean the transfer of a regulated institution's operations beyond the reach of regulation.

7. The frequently cited term 'shadow banking sector' is not particularly well-chosen. It means financial intermediation outside the banking sector. Shadow banks are not necessarily shadier than banks.

deployment of macroprudential instruments is unpopular and tends to meet with opposition. In the euro area, the ultimate responsibility for macroprudential policy is thus conferred on the Governing Council of the ECB. This has the advantage of national analysis being complemented with independent ECB analysis and the euro area as a whole being reflected in policy actions.

However, legislators in various countries have adopted partially different tools for implementing their respective macroprudential policies. Common EU legislation has been interpreted and implemented in part differently across Member States. Additional EU legislation would be required to ensure consistency in the implementation of macroprudential policy across the euro area.

The primary macroprudential tools available to the authorities are either those enshrined in EU^[8] legislation or separately defined in national laws for macroprudential policy. Instruments strengthening banks' risk resilience mainly comprise capital buffers, which have a broad-based impact but include delays in implementation.^[9] Sectoral capital requirements (for example higher risk weights), which also improve banks' resilience, are more precise tools, especially if targeted at housing loans or other mortgage-backed lending.^[10] Instruments impacting directly on loan demand can be effective quickly if included in national legislation, but are typically targeted at new loans rather than the loan stock. In addition, authorities have the option of setting liquidity requirements for banks.

As a secondary option, softer actions may be taken, such as issuance of recommendations, influencing via communication or using institution-specific supervisory tools, especially Pillar 2 measures.^[11] These actions enable the strengthening of banks' risk resilience, thus supporting macroprudential policy, but they are institution-specific and not generally made public. (For these reasons, such measures should not be applied as a first option.) Stress tests – in this connection particularly regarding interest rate risk (vis-à-vis either borrowers or lenders) – are macroprudential tools if they include requirements to remedy the shortcomings detected in the tests.

8. See EU Capital Requirements Regulation and Directive.

9. These additional capital requirements include the capital conservation buffer requirement, the countercyclical capital buffer requirement, the requirements set on the basis of global and national systemic importance (G-SII and O-SII) and the systemic risk buffer requirement. Each additional capital requirement strengthens banks' risk resilience, but the justifications for their activation differ.

10. Risk weights help to establish each bank's minimum own funds relative to lending, ensuring a bank's ability to cover the related credit risk. For example, some Nordic countries have set higher risk weights on mortgage-backed lending (see the article '[Housing loan risk weights affect banks' capital adequacy](#)', Bank of Finland Bulletin 2/2015).

11. Pillar 2 is an annual supervisory review process in which the supervisor may impose discretionary bank-specific additional capital requirements. It is incorporated into the global regulatory framework (Basel 3) established by the Basel Committee on Banking Supervision. Pillar 1 of the framework includes minimum capital requirements and Pillar 3 disclosure requirements.

Macroprudential policy does not operate in a vacuum

Macroprudential policy is a complement to monetary policy and operates together with other economic policy segments. The operating environment of macroprudential policy is better when the actions run parallel with those of the other economic policy segments. For example, in the case of a systemic crisis, an easing of both monetary policy and macroprudential policy – or similarly, in the case of an accelerating credit cycle, a tightening of both policies – is mutually supportive.

An easing of monetary policy and a tightening of macroprudential policy at the same time is not unproblematic. Financial regulation is exposed to regulatory circumvention. Financial markets are dynamic and their institutions are innovative in developing new products and making use of regulatory arbitrage. It may well be that the stronger the macroprudential measures, the greater the incentives to circumvent them. The costs may rise so high that they lead to new problems difficult to foresee in advance. For example, the financial sector can move operations to the shadow banking sector, outside the regulatory perimeter.

It is harder to circumvent and bypass monetary policy measures. Monetary policy is a blunt tool, it hits all, but is thus also omnipresent. In contrast, macroprudential measures can have a more specific focus. As the relevant analysis becomes more sophisticated, macroprudential measures can be targeted at those segments of the financial system where the analysis finds a build-up of systemic risks. With an accumulation of experience and research literature, macroprudential policy is expected to reduce the need for monetary policy to concentrate on financial stability during normal times. If banks are required to proactively hold additional levels of capital and prepare for liquidity problems, the need to use monetary policy for dealing with post-crisis management will diminish. In the case of systemic crises, however, it is likely for monetary policy to be required to take account of financial stability for the purpose of maintaining the monetary policy transmission mechanism and mitigating liquidity problems. Monetary policy and macroprudential policy will then run parallel with each other.^[12]

If monetary policy is unable to temper national credit cycles, for example, in a monetary union where monetary policy designed for the area as a whole may be non-optimal – too relaxed or too tight – for an individual country, macroprudential policy needs to take this limitation of monetary policy into account. For this reason, the development of macroprudential policy is seen as being of particular importance for the euro area.^[13]

Tags

- [financial stability](#)
- [macroprudential stability](#)

12. Hellwig, Martin (2015) Financial stability and monetary policy. Preprints of the Max Planck Institute for Research on Collective Goods. Bonn 2015/10.

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- macroprudential policy
- systemic risks
- shadow banks
- stability threats
- leverage

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