SUOMEN PANKKI FINLANDS BANK

EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland Bulletin 1-2014

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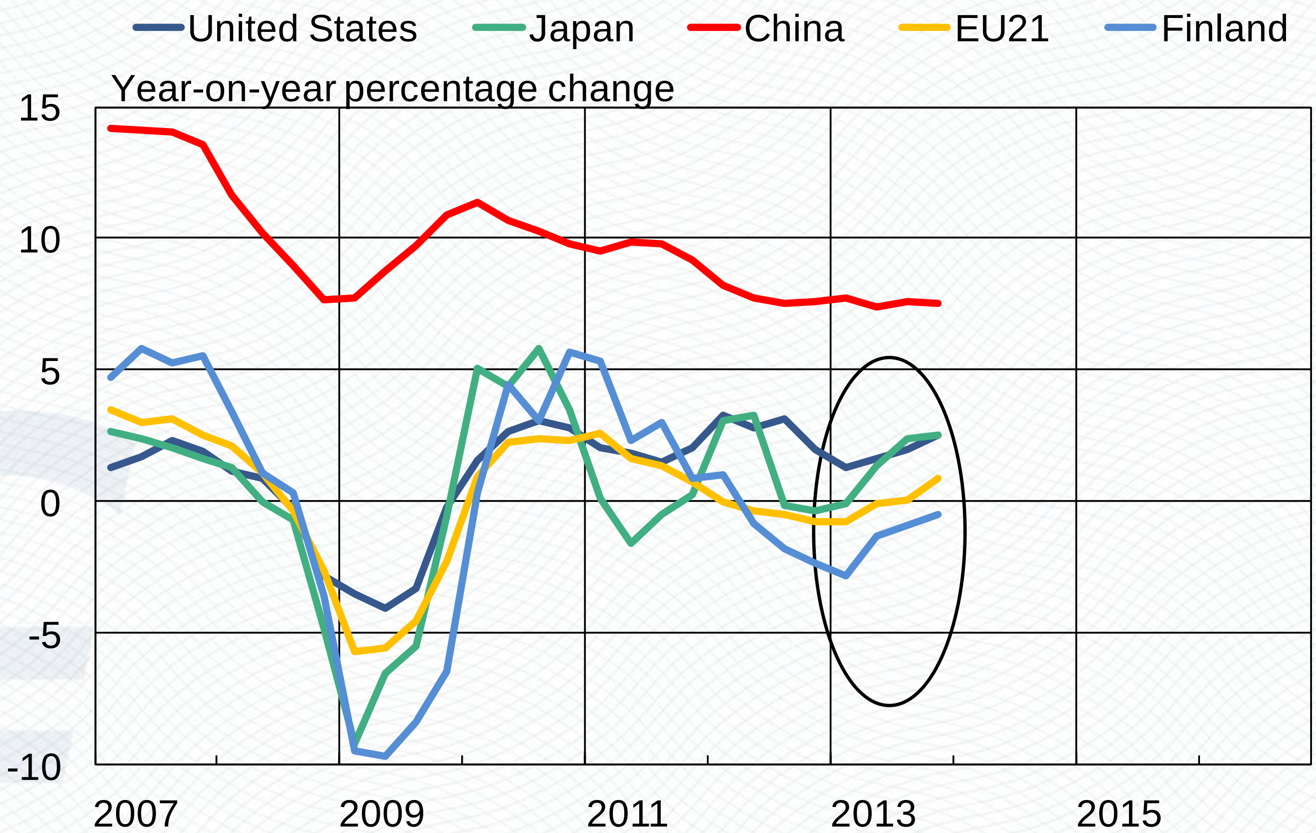
Themes

- ***From crisis prevention to strengthening the foundations of growth***
  – Progress with consolidation, but financial crisis casts a long shadow
  – Structural change weighs ability to adapt
- ***Bank of Finland forecast for the international economy***
  – Growth will continue, albeit at a subdued pace; a period of low inflation
- ***Bank of Finland 2013***
  – Profit of EUR 239 million, of which EUR 180 million to the State
- ***Three challenges for the Finnish economy***

From crisis prevention to strengthening the foundations of growth

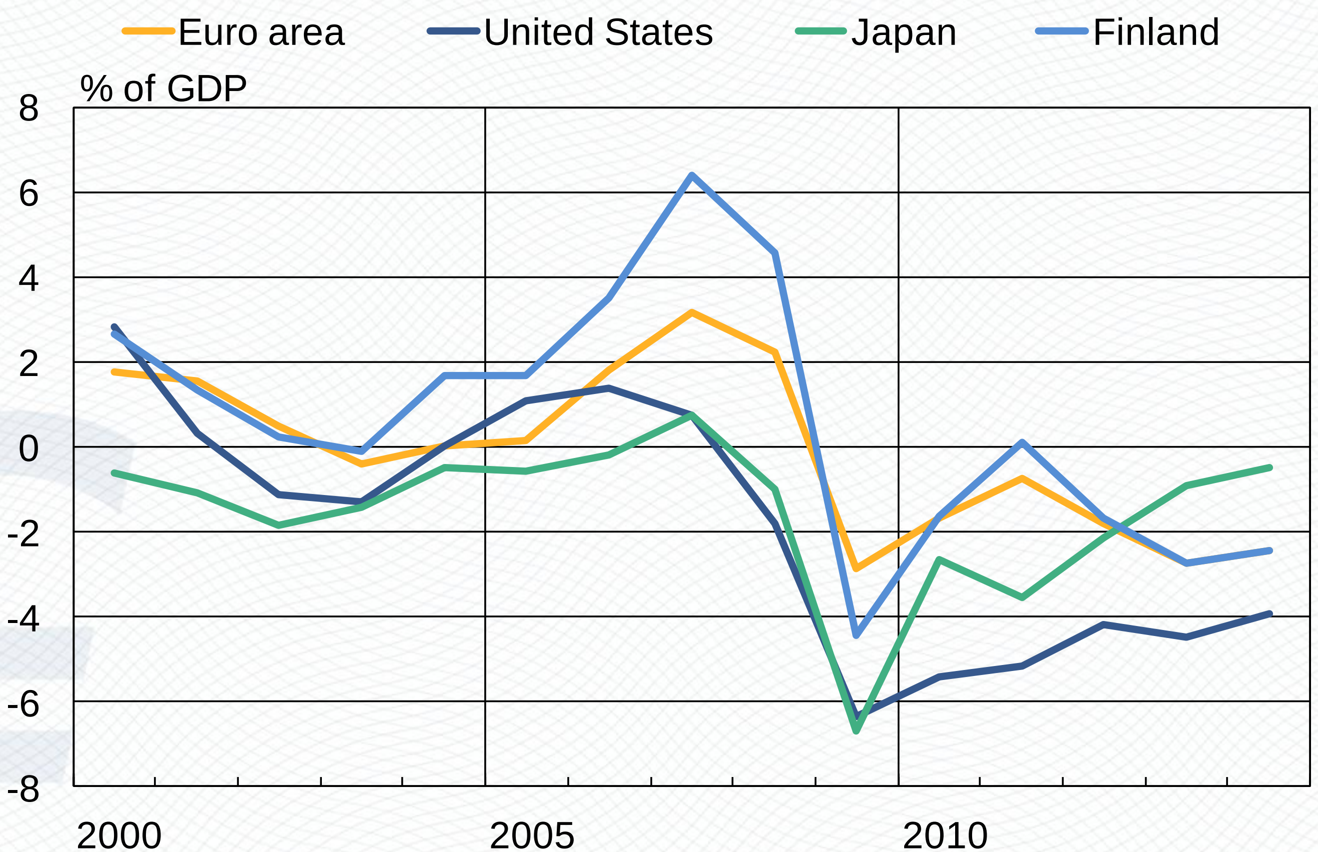
GDP growth in advanced economies picked up in the latter half of 2013



EU21 = euro area, Sweden, Denmark and United Kingdom.
Dash lines: Bank of Finland's latest forecast.

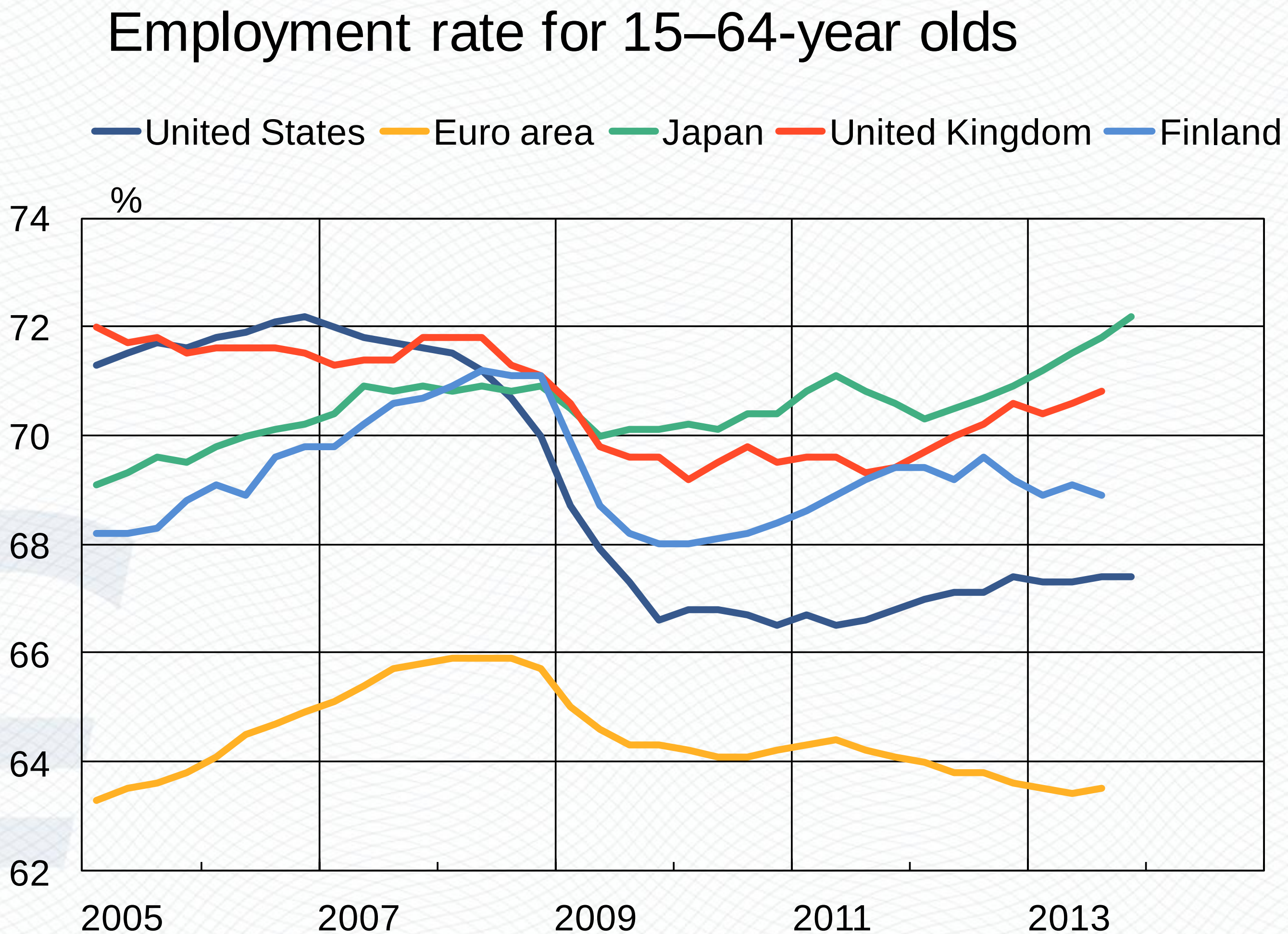
Sources: BEA, ESRI, National Bureau of Statistics of China, Eurostat and Bank of Finland.

GDP still performing below potential output …



Data for 2013–14 are WEO (World Economic Outlook) forecasts from October 2013.
Source: IMF.

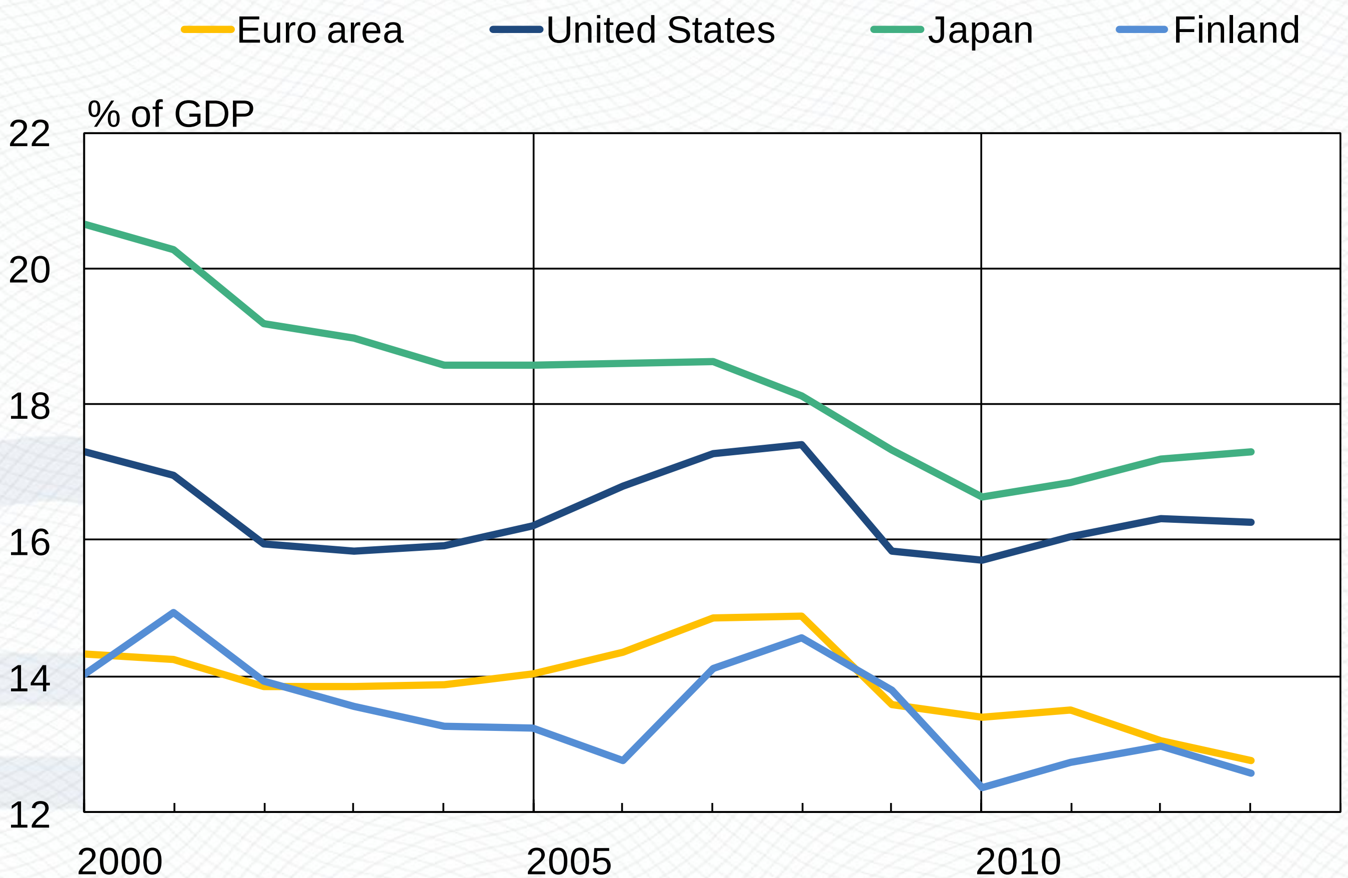
… as employment rates are low …



Source: OECD.

… and investment low

Fixed investment in productive capacity excl. housing investment



Source: European Commission.

From crisis prevention to damage repair

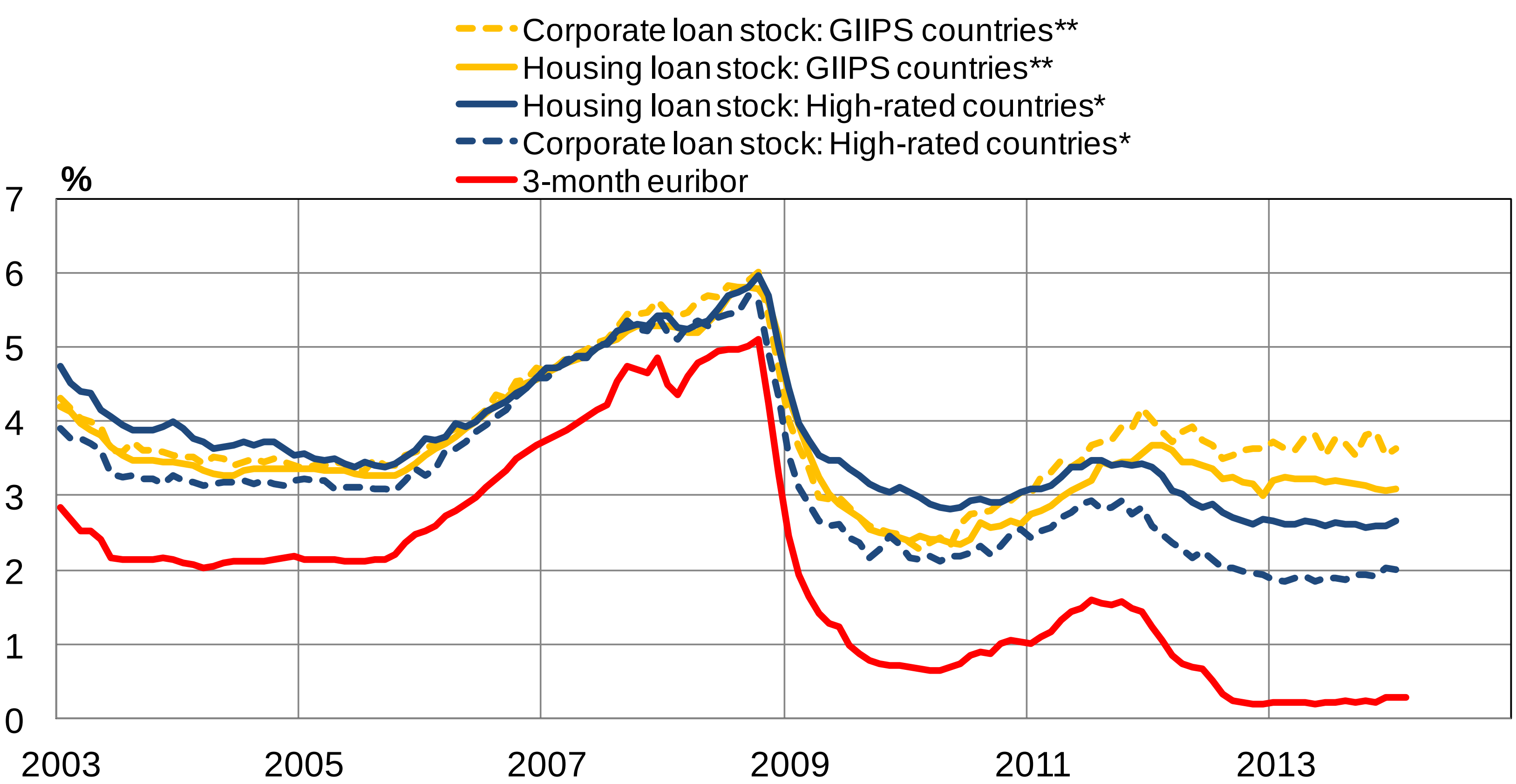
- ***Adjustment has made headway***
  - Deficits, indebtedness, competitiveness
  - Absorbing sizeable imbalances takes time

- ***Focus of economic policy on building the foundations of growth***
  - Production resources need reallocated
  - Concerns both labour and capital

- ***Structural change requires ability to adapt***
  - Places big demands on economic policy

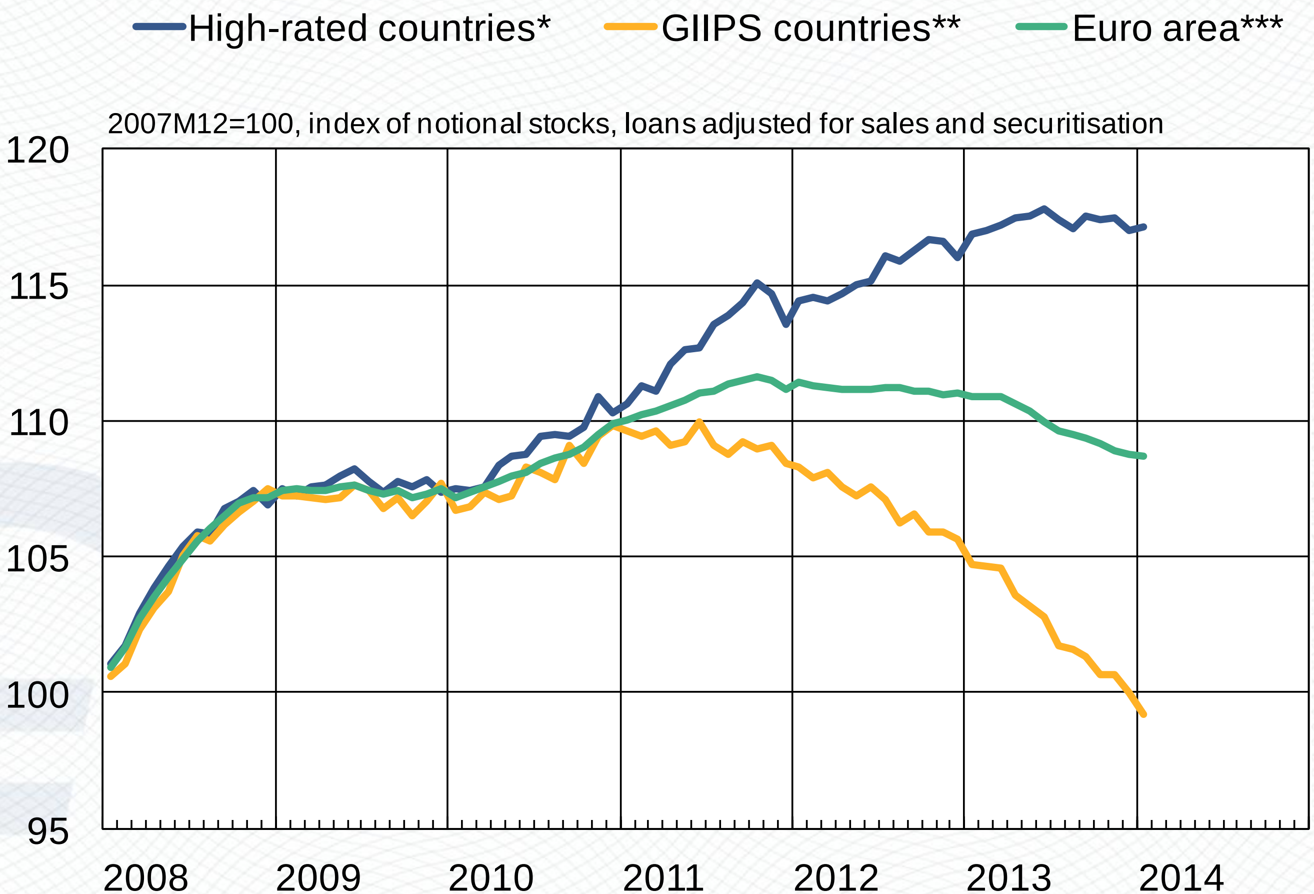
Financial intermediation Comprehensive assessment of the condition of banks

Major cross-country differences remain in interest rates paid by households and businesses



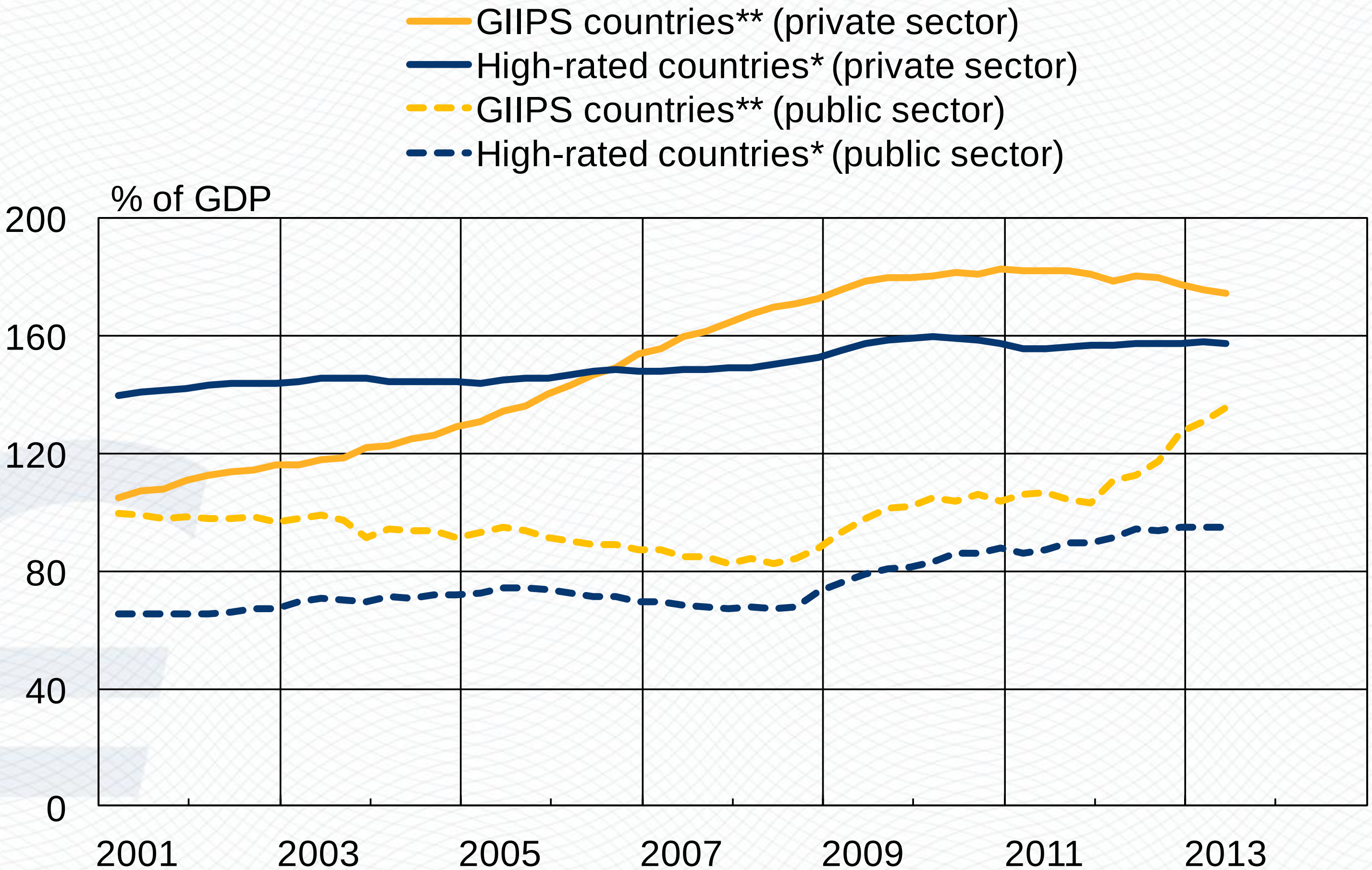
* Germany, France, Netherlands, Belgium, Austria and Finland.
** Greece, Italy, Ireland, Portugal and Spain.
New corporate and housing loan agreements, initial rate fixation period of up to 1 year.
Sources: European Central Bank and calculations by the Bank of Finland.

Divergence also in loan stock performance



* Germany, France, Netherlands, Belgium, Austria and Finland.
** Greece, Italy, Ireland, Portugal and Spain.
*** excl. resale agreements with central counterparties.
Sources: ECB and calculations by the Bank of Finland.

Debt ratio adjustment made only little progress



* Germany, France, Netherlands, Belgium, Austria and Finland.

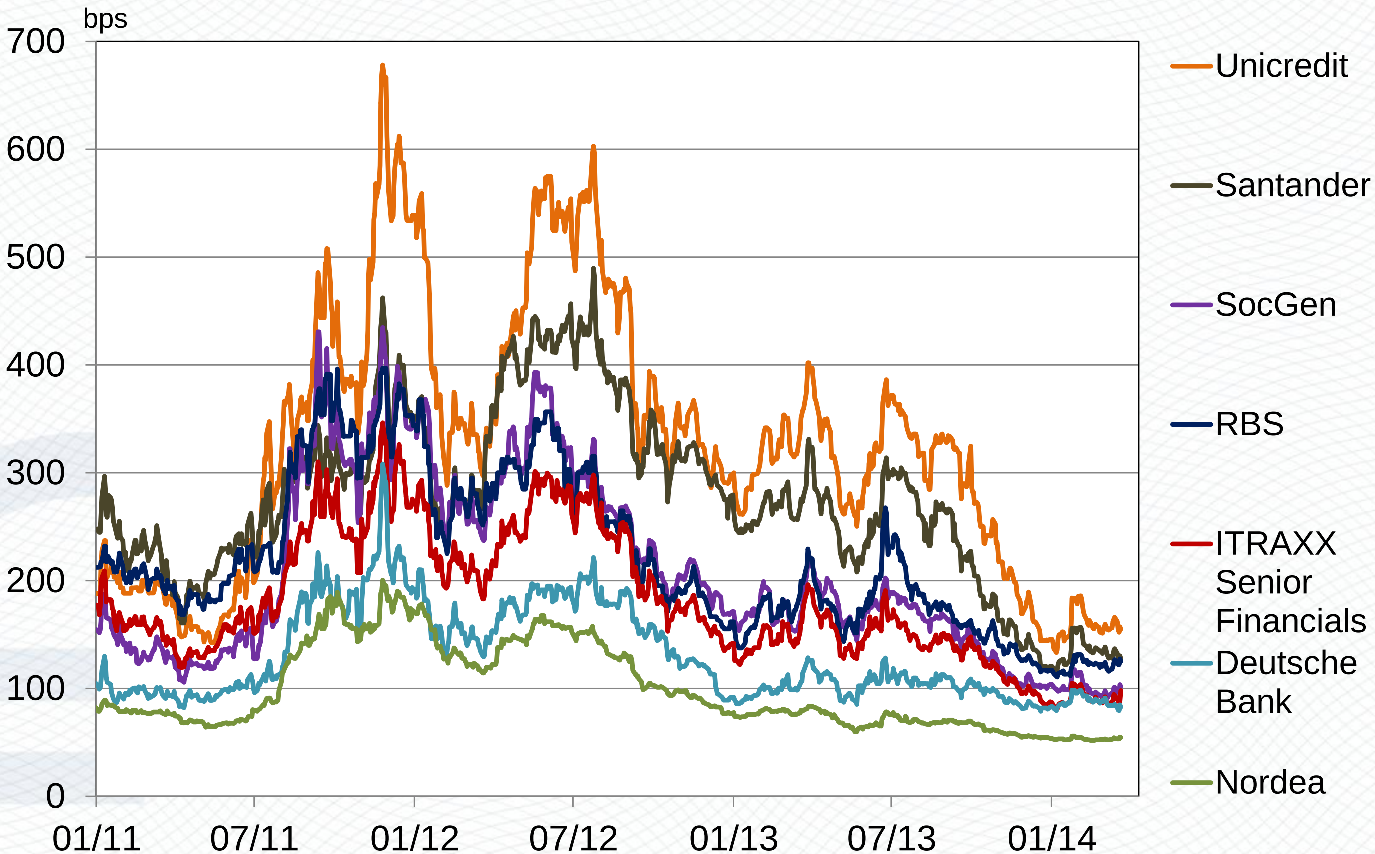
** Greece, Ireland, Italy, Portugal and Spain.

Source: European Central Bank.

Banking union and comprehensive assessment of banks

- ***Lack of confidence in balance sheets still looms large***
  - Households, non-financial corporations, banks
  - Building and reinforcing confidence
- ***Comprehensive assessment of banks helps meet challenge***
  - Increases confidence in banks
  - Strengthens banks' ability to finance lending
- ***Agreement on Single Resolution Mechanism on 20 March 2014***
  - Solution very close to December ECOFIN Council outcome
  - Faster accumulation of resolution fund

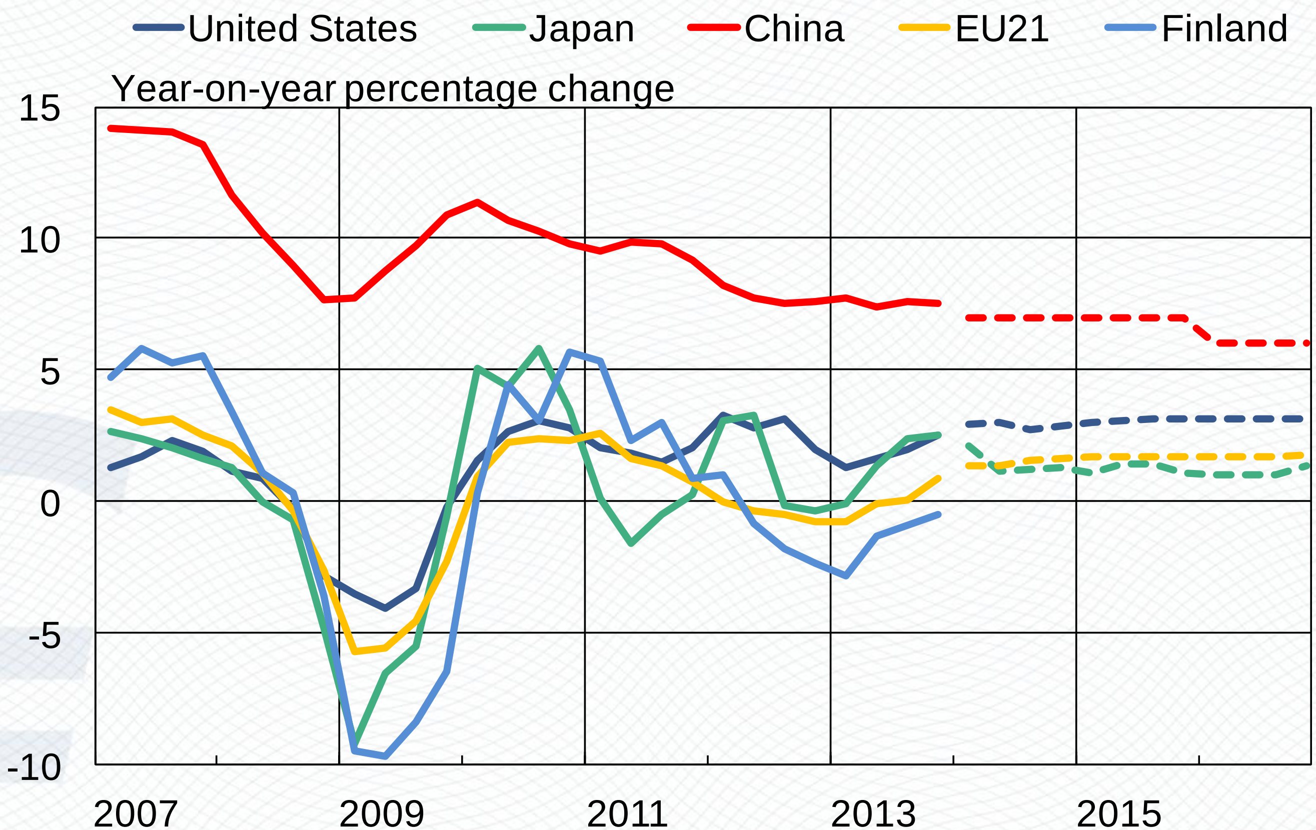
Comprehensive assessment of banks
CDS prices for European banks



Source: Reuters
5yr CDS prices

Bank of Finland forecast for global economy: key conclusions

Bank of Finland forecast
Growth picking up but will remain moderate



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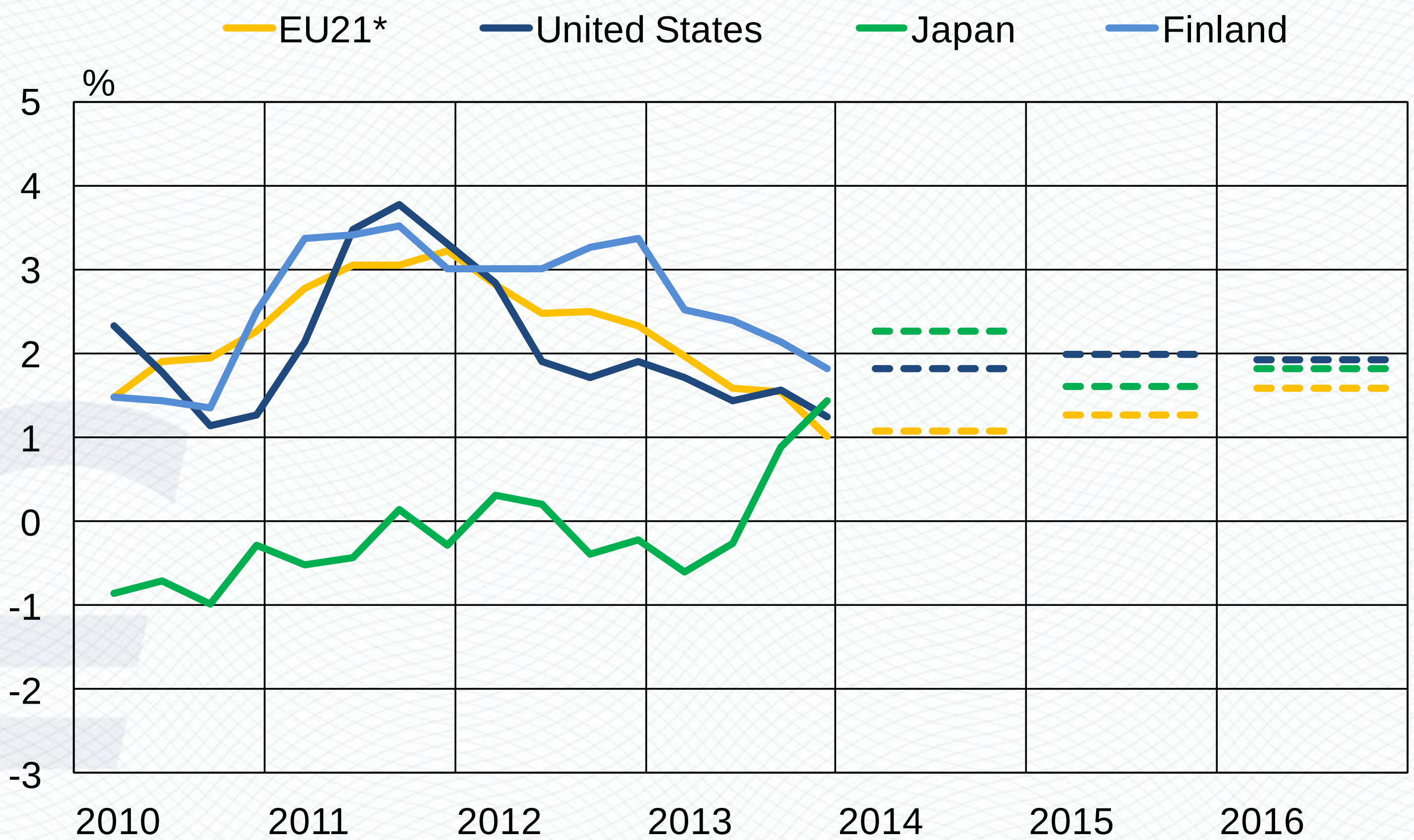
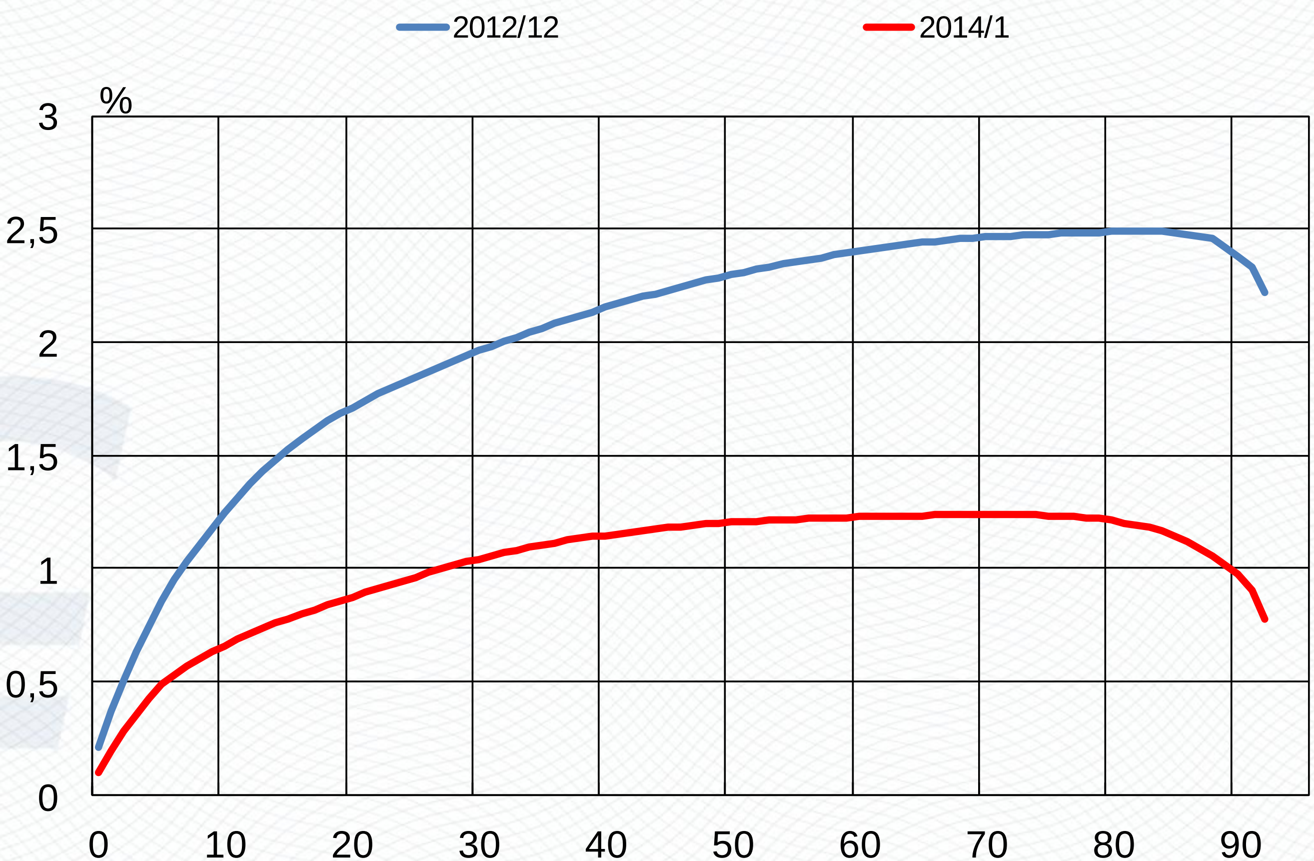
Sources: BEA, ESRI, National Bureau of Statistics of China, Eurostat and Bank of Finland.

Bank of Finland forecast
Subdued outlook reflected in inflation



* Euro area, Sweden, Denmark and United Kingdom.
Sources: National statistical authorities and calculations by the Bank of Finland.

Inflation in the euro area
Pace of change in relative prices has slowed



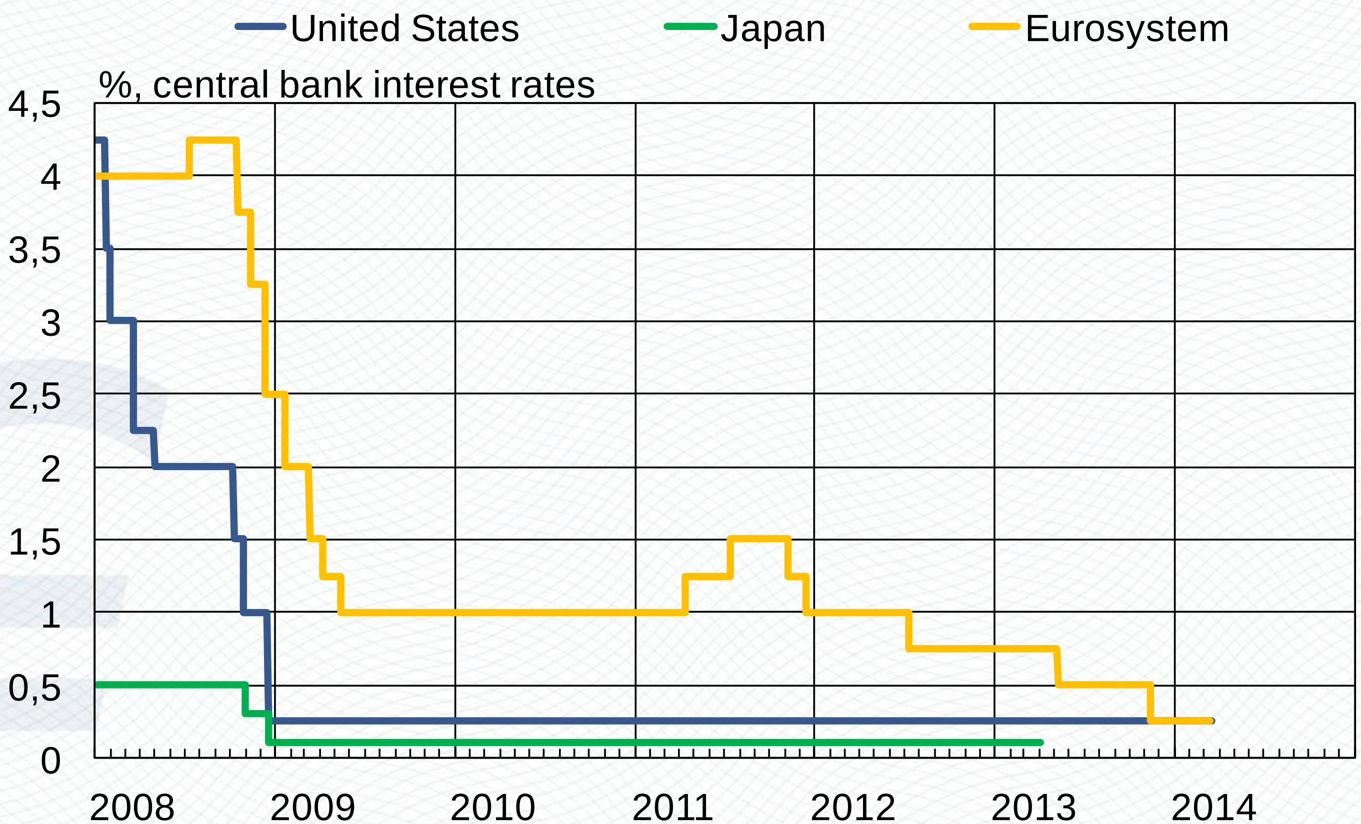
Sources: Eurostat and Bank of Finland.

Bank of Finland forecast
Global forecast exposed to downside risks

- ***The period of low inflation may***
  - ***be more protracted than previously forecast***
  - ***impede economic adjustment more than estimated***
- ***Impact of the crisis in Ukraine***
  - ***Russia; EU (Finland); United States; global economy***
  - ***Short-term outlook, longer-term impact***
- ***Emerging economies: current state and outlook***
  - ***Tightening financial conditions in some emerging economies***
  - ***Structural change in Chinese economy, sustainability of financial sector***

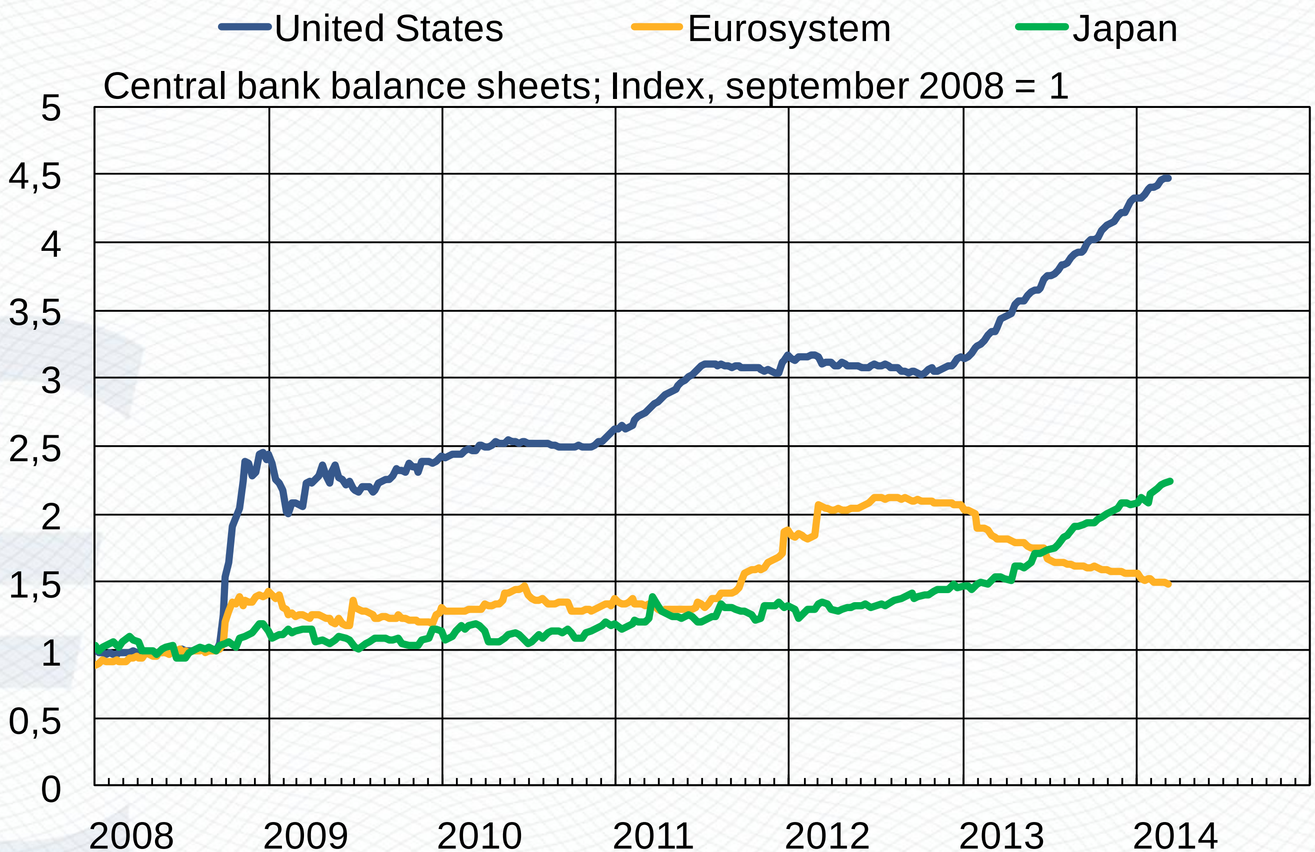
Monetary policy in the euro area

Euro area monetary policy stance to remain accommodative as long as necessary



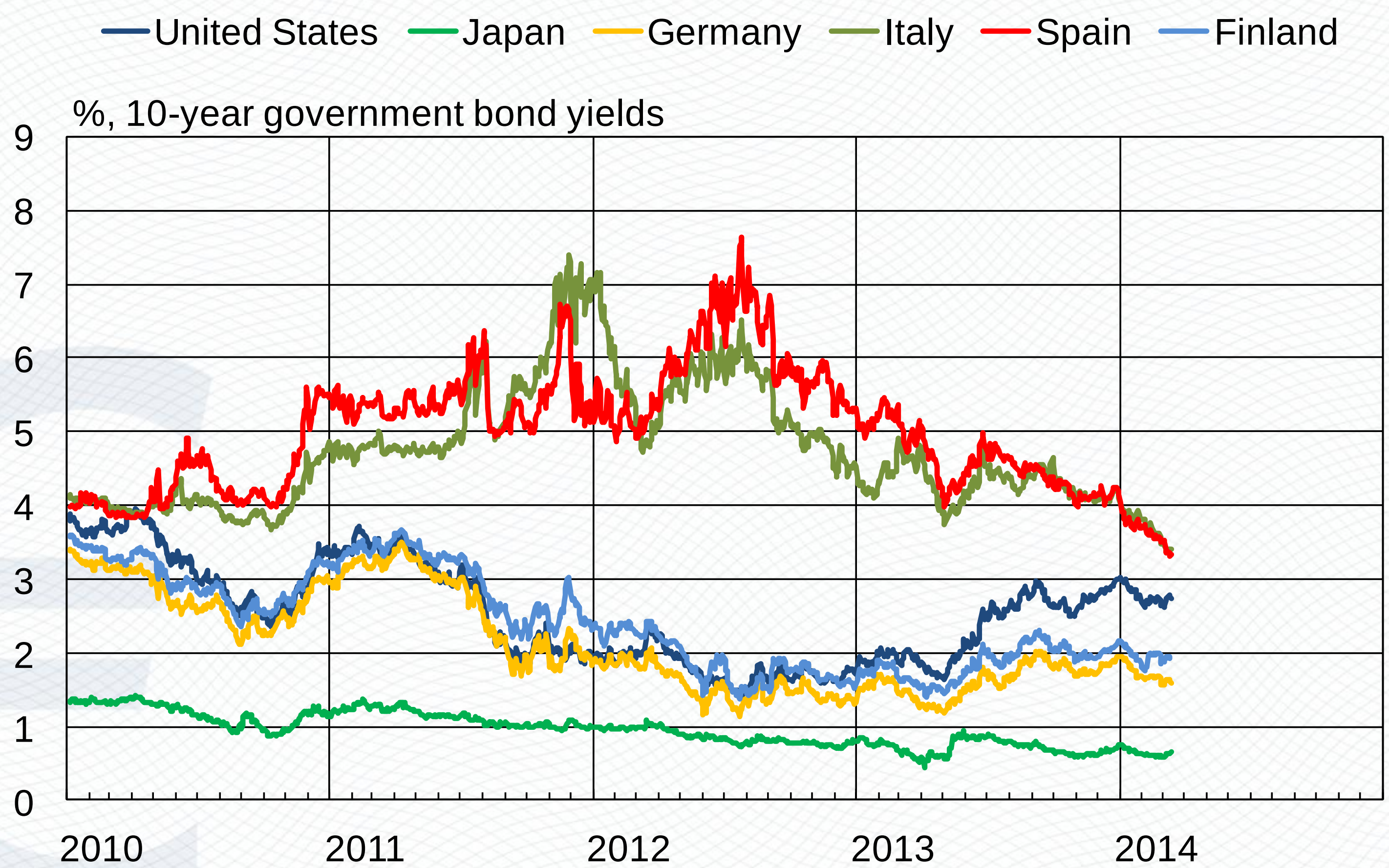
Source: Bloomberg.

Asset purchase programmes led to an increase in Federal Reserve and Bank of Japan balance sheets



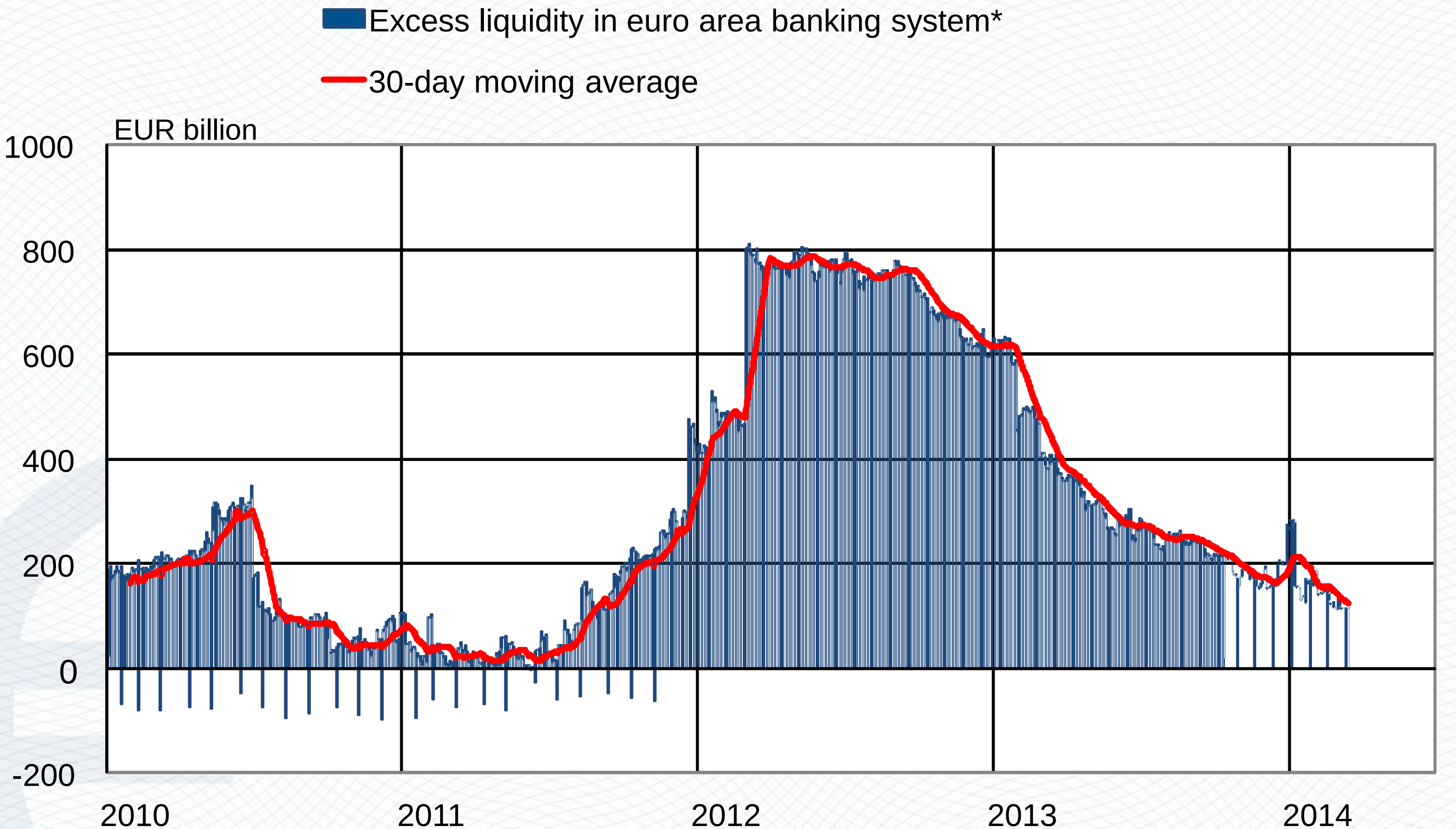
Sources: Central banks.

Developments in long-term interest rates reflect differences in growth outlook and monetary policy



Source: Reuters.

Euro area balance sheet shrunk as banks repay credit



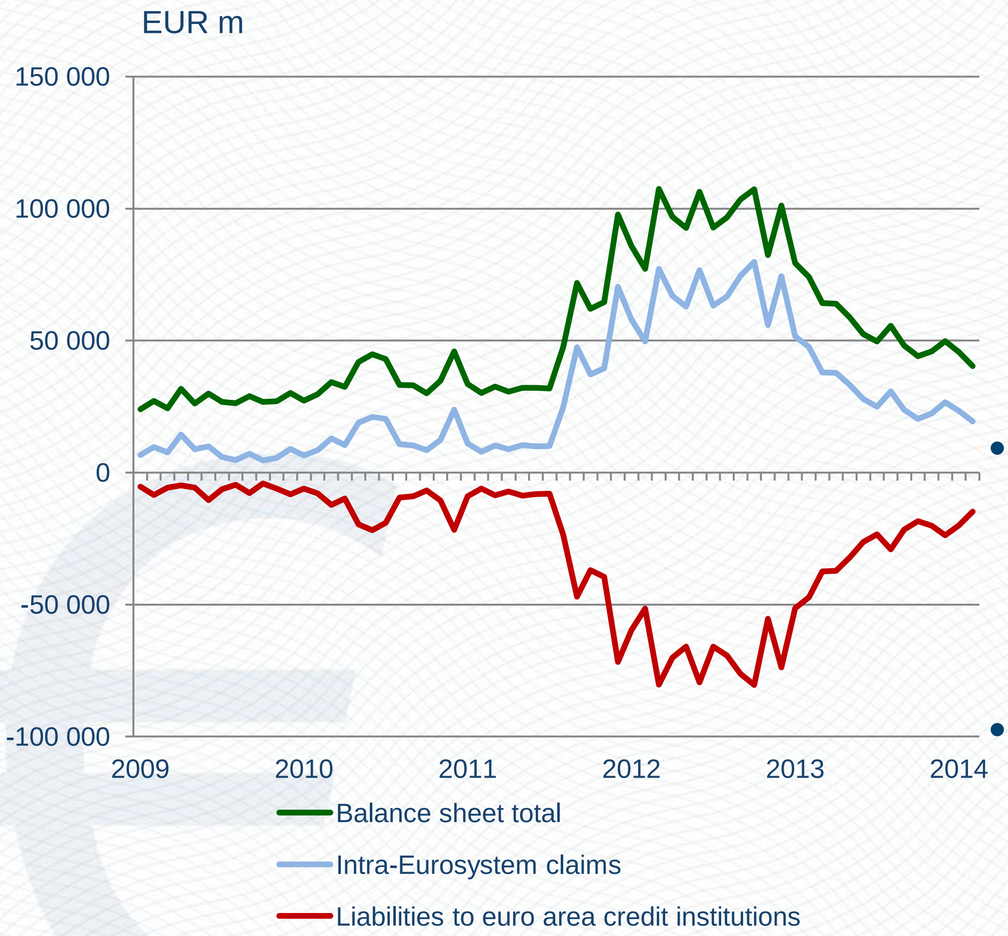
Source: Bank of Finland.
* Reserve deposits – minimum reserve requirements + overnight deposits – use of marginal lending facility.

Monetary policy stance

- ***Current monetary policy stance is accommodative***
  - Policy rates and expectations regarding their future development have pushed shortest market rates down close to zero.
- ***Monetary policy stance to remain accommodative***
  - Outlook for inflation is subdued extending into the medium term.
  - There is ample unused capacity in the economy.
  - The credit stock has declined.
- ***Governing Council ready to adopt new measures, if necessary***

Bank of Finland’s financial result 2013

Bank of Finland's financial result 2013: Balance sheet contracted but still large



- The volumes of monetary policy operations and extension of non-standard measures have significantly affected the financial result via net interest income.
- Financial result also weakened due to lower level of interest rates.
- Bank deposits (and correspondingly TARGET claims) down to one third.

Bank of Finland's financial result 2013: Result for the financial year and profit distribution

EUR m	2012	2013
OPERATING PROFIT	**754**	**411**
TRANSFERS TO PROVISIONS		
General provision	–300	–50
Provision for real value loss	–117	–122
PROFIT FOR THE FINANCIAL YEAR	**337**	**239**
OF WHICH DISTRIBUTED TO THE STATE	**227**	**180**

Provision against additional Eurosystem risks EUR 100 m (2012: EUR 200 m)

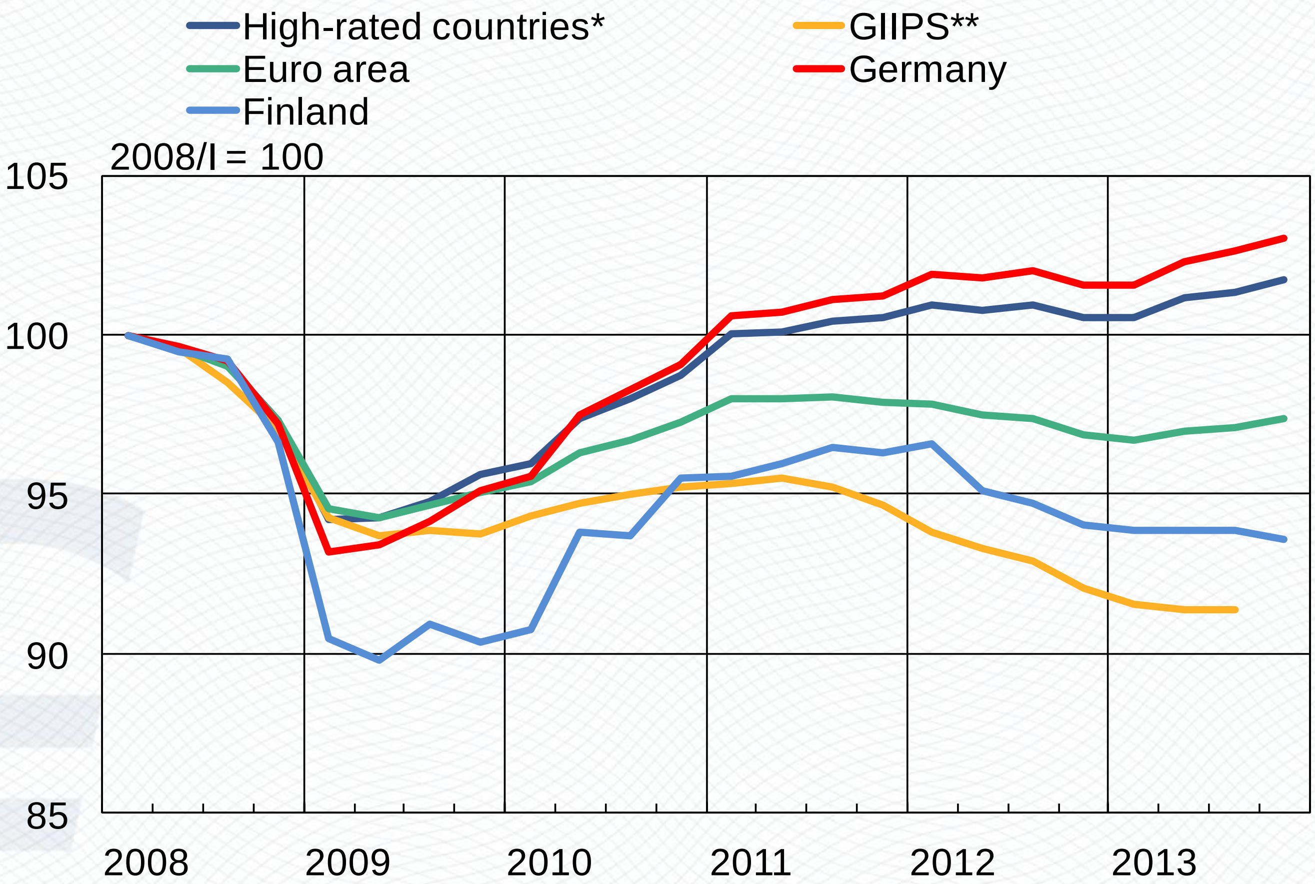
In 2012, EUR 100 m on unredeemed markka banknotes was spread over forthcoming years' profit distribution. In 2013, EUR 50 million of this item was carried over to the financial result.

Bank of Finland's financial result 2013: Summary

- ***Profit EUR 239 million, of which EUR 180 million to the State (in 2012: EUR 227 million)***
- ***Provisions used for strengthening the balance sheet; central banks' exposures and risks still high***
  - Provisions in respect of unreturned markka banknotes being reduced gradually
- ***Operating expenses held in check***
  - Continued efforts to prioritise and increase the efficiency of activities

Challenges facing the Finnish economy

Post-crisis economic developments in Finland worrying



* Germany, France, the Netherlands, Belgium, Finland and Austria.
** Greece (2011–2013 arvio), Ireland, Italy, Portugal and Spain.
Sources: National statistical authorities and Eurostat.

Three major challenges for the Finnish economy

- ***Structural change in Finnish industry***
- ***Population ageing***
- ***Global economic developments***
  - Risks associated with the situation in Ukraine

“Finland has not recovered from the industrial collapse which began in 2008 and resulted in the loss of a significant part of Finland’s economic base.”

Bengt Holmström, Sixten Korkman and Matti Pohjola, 21 February 2014

How to respond to the challenges

- ***Ambitious and frontloaded implementation of the Government's <u>structural policy programme</u>***
- ***Immediate <u>fiscal consolidation</u> also needed***
- ***The <u>Ukraine crisis</u> may lead to an even bigger structural change and larger adjustment needs in the economy***
  - Regeneration capacity: labour mobility across sectors and regions, housing supply etc.

Confidence is key

- ***Current economic shocks and turmoil are exceptionally strong. They <u>can undermine confidence in the Finnish economy.</u>***
- ***Solutions improving long-term outlook – even if difficult in the short term – are <u>crucial to bolstering confidence.</u>***
- ***Difficult decisions on structural reforms can improve <u>corporate and household confidence in the future so that positive results can be seen immediately.</u>***

The economic situation in Finland has changed fundamentally. Looking forward, it is vital that institutions (government and social partners) are able to take corrective action.

In conclusion

Summary

- ***From crisis prevention to repairing the damage***
  - Will weigh capacity of economies to adjust
  - Economic policy must support change
- ***Continued low inflation, monetary policy remains accommodative***
  - Low inflation may impede adjustment
  - ECB Governing Council stands ready to act if
    - deflationary developments pose a risk to the euro area or
    - monetary policy is not transmitted in the desired manner
- ***All economic policy segments needed***
  - Monetary policy, banking sector consolidation, growth-supportive structural reforms, fiscal consolidation

Bank of Finland Bulletin 1/2014 Contents

- ***Monetary policy and the global economy***
  - ***Boxes***
    - Inflation and relative prices in the euro area
    - Crimea crisis increases risks to the Russian economy
    - Uncertainties over quotations increased need for reference rate updates
  - ***Niko Herrala and Seija Parviainen***
    - Japan’s inflation expectations as a measure of the success of Abenomics
  - ***Tuomas Välimäki***
    - Dual use of Eurosystem credit operations: steering interest rates and preserving financial stability
  - ***Juhana Hukkinen***
    - Economic policy options in conditions of weak growth and low inflation

Thank you!