

Erkki Liikanen  
Bank of Finland

# Finnish economy, monetary policy and financial stability

10 December 2015





**Economy generating less income, spending increasingly financed by borrowing**

**Five important changes:**



# 1. Decrease in income generation



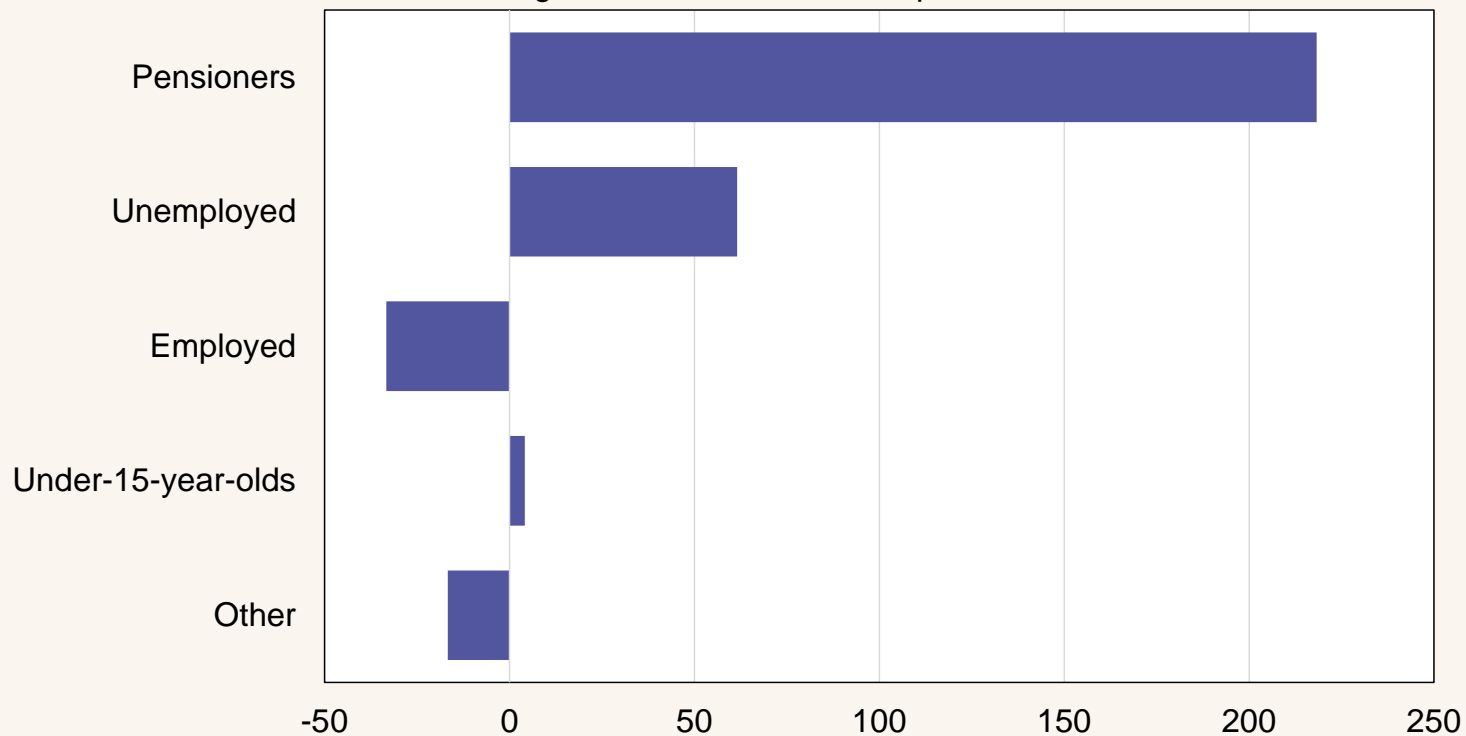
Sources: Statistics Finland and Bank of Finland.

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## 2. Economic dependency ratio weakened

Forecast change, 2007–2017, thousand persons

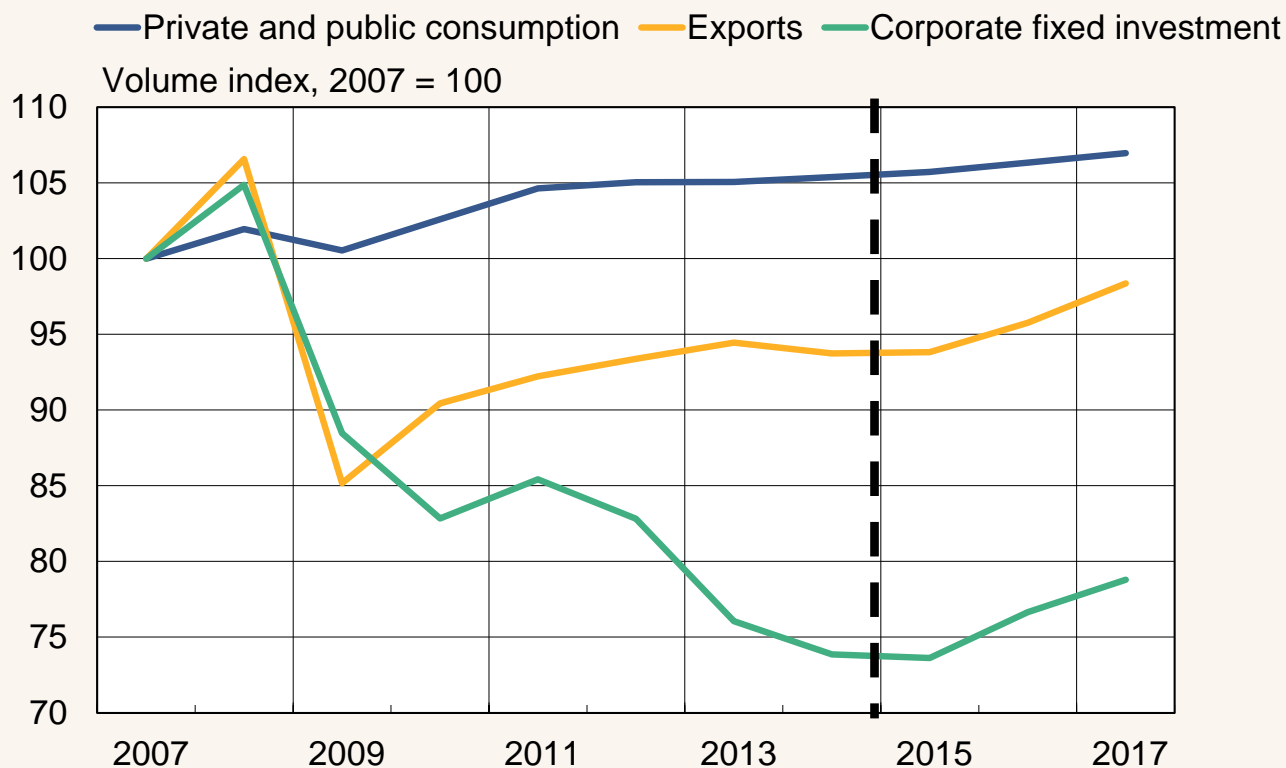


Sources: Finnish Centre for Pensions, Statistics Finland and Bank of Finland.

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### 3. Notable decline in exports and investment, increase in consumption

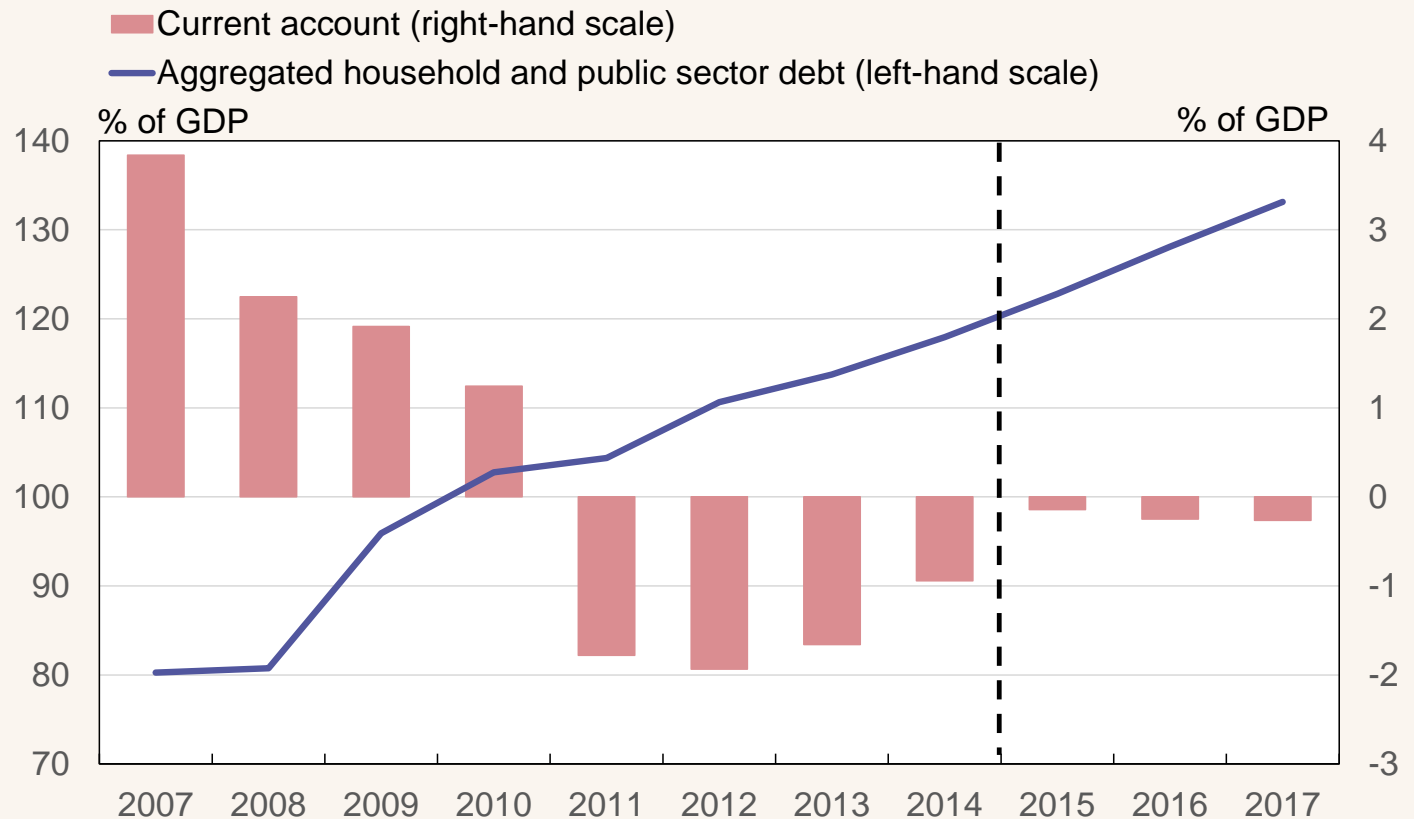


Sources: Statistics Finland and Bank of Finland.

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## 4. Standard of living maintained by continued debt accumulation

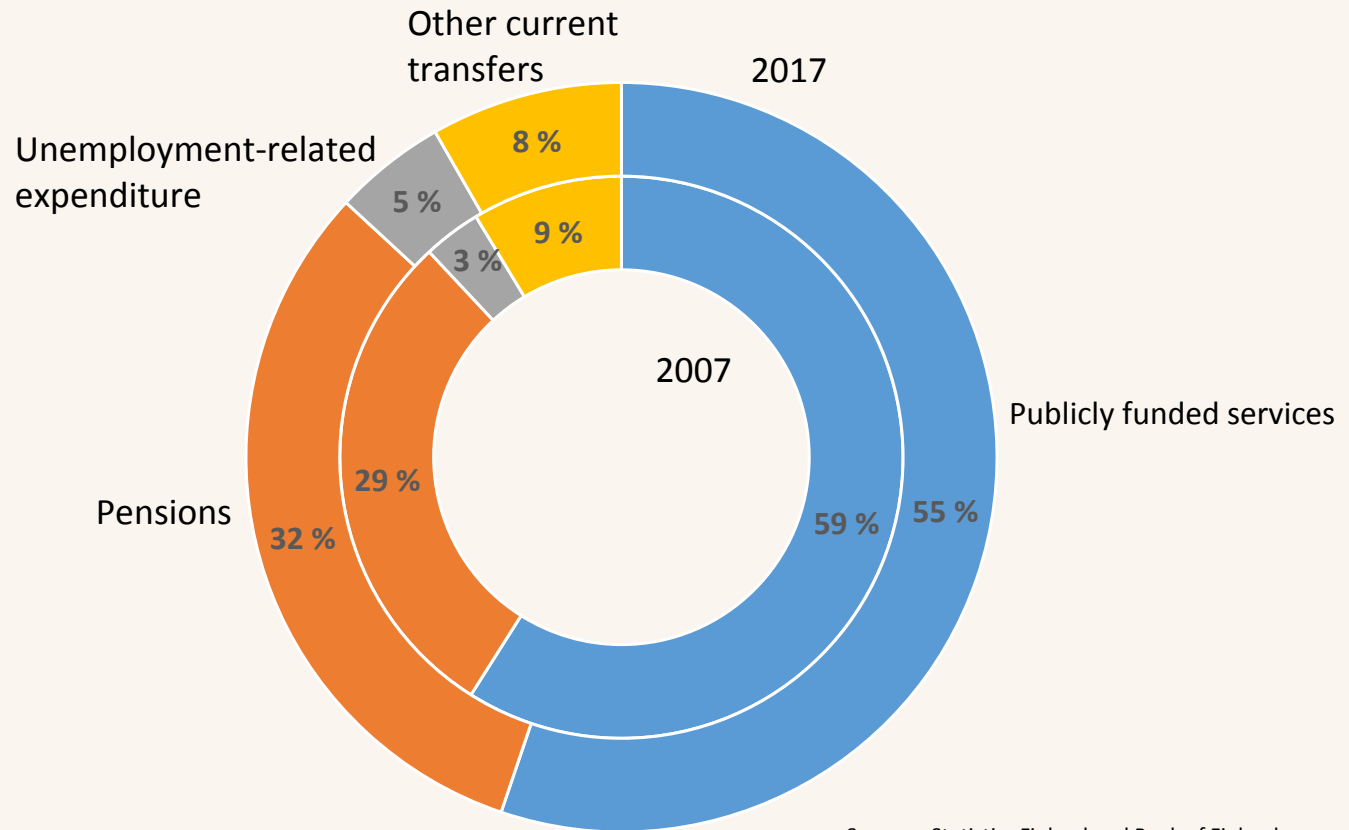


Sources: Statistics Finland and Bank of Finland.

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## 5. Pensions and unemployment benefits erode public services funding



Sources: Statistics Finland and Bank of Finland.  
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# What corrective measures are needed? Will they restore confidence?





## We have to take determined, corrective economic policy measures

- ***Restoration of cost-competitiveness***
- ***Structural reforms***
- ***Halt upward trend in public debt***
- ***Economic recovery also supported by monetary policy***
- ***At the same time, macroprudential policy must mitigate risks arising from protracted period of low interest rates***



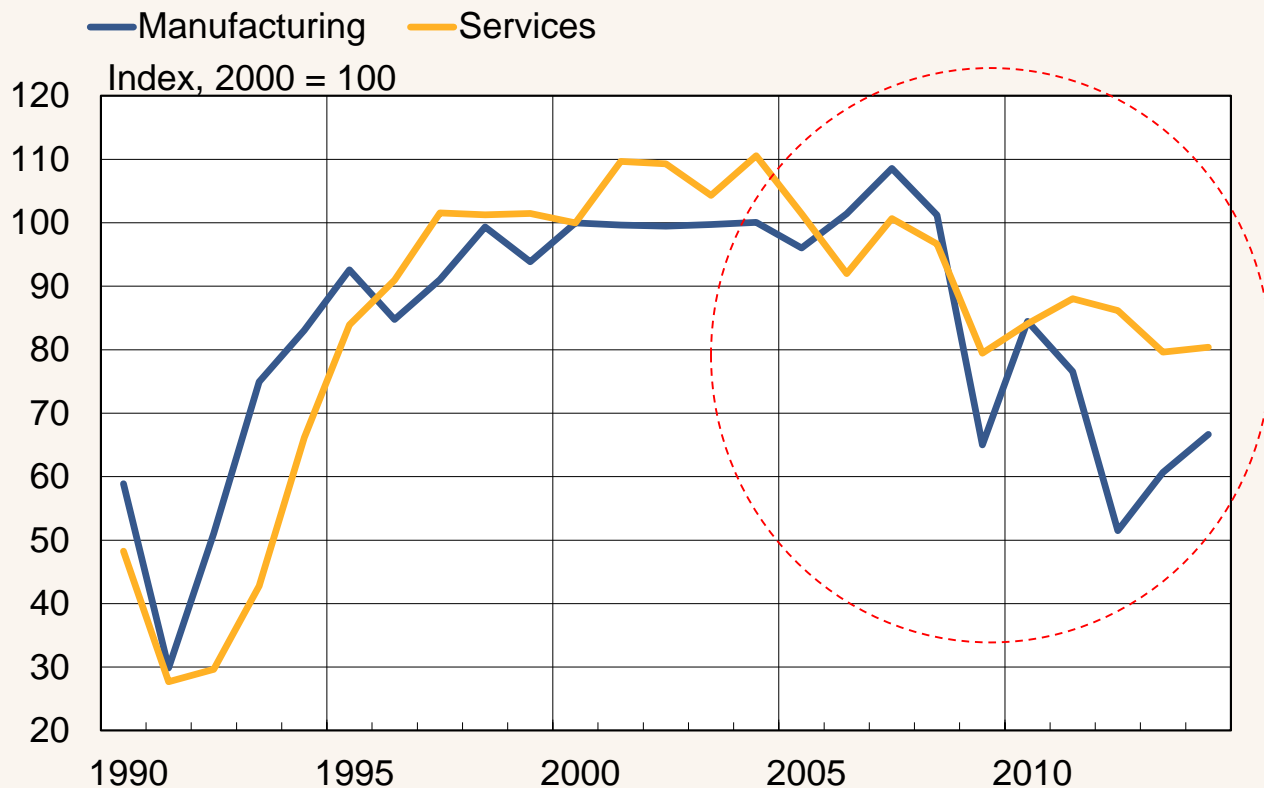
# 1. Improvement in cost-competitiveness supports exports and employment

## When cost-competitiveness improves,

- *export businesses with production in Finland can make profitable offers at a price that translate into contracts;*
- *it pays to invest in production that takes place in Finland;*
- *production and employment grow in export industries;*
- *income generation in the economy as a whole increases, which supports demand and employment in a sustainable manner also in production for the domestic market.*



## Profitability of production taking place in Finland has weakened, particularly in manufacturing



Non-financial corporations' net operating surplus divided by net value added

Source: Statistics Finland.

31563



## 2. Structural reforms

- ***Structural reforms needed to improve growth potential and ensure fiscal sustainability***
  - Pension reform is an important step, but further efforts are needed
  - New assessment of the long-term sustainability gap in public finances is 3½%
  
- ***Lengthening of working careers***
  - From the beginning, middle and end
  
- ***Conditions for supply of housing***
  
- ***Social and health care reform that improves productivity and curbs expenditure growth***



## Structural reforms: Increased competition

- ***Improves productivity and constrains the rise in prices***
  - Advantages to consumers: lower prices, better products
  - Advantages to the economy: higher productivity, more innovation
- ***Regulatory reforms are key***
- ***Removal of barriers to competition often resisted by groups enjoying special benefits***
  - Changes therefore require determination and long-term commitment from decision-makers.



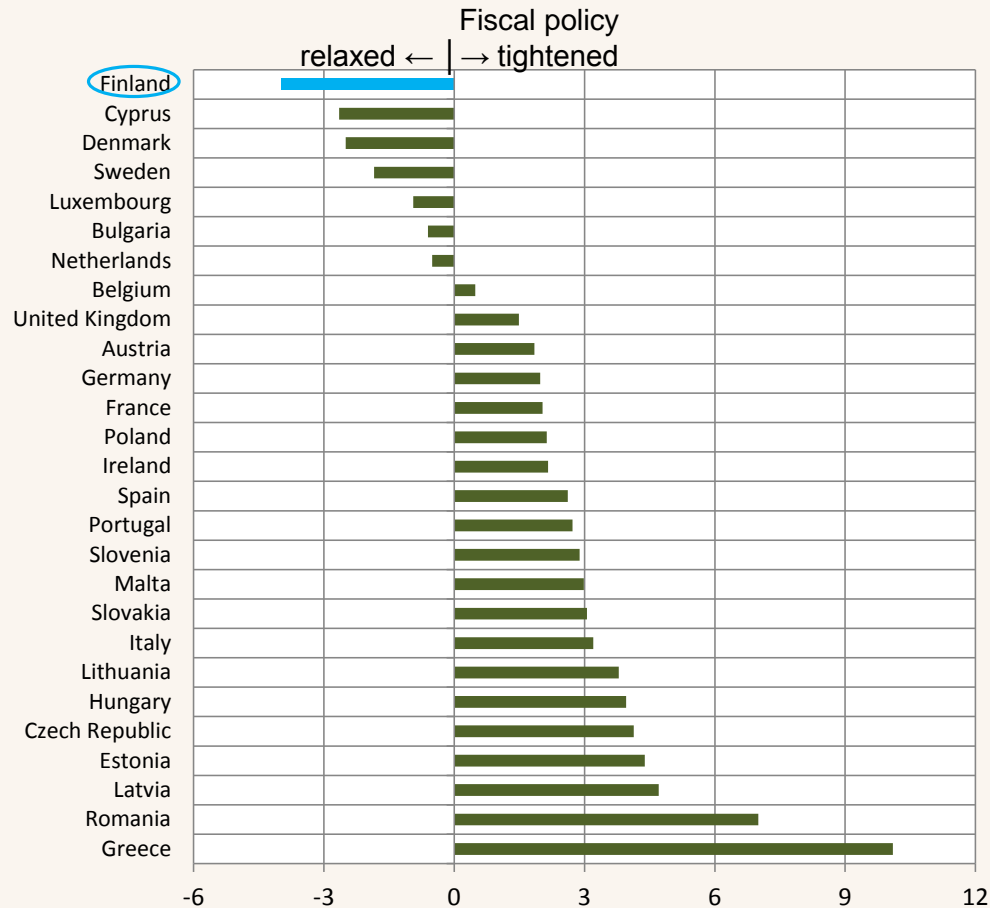
### 3. Fiscal stimulus cannot resolve problems in the export industry

- ***Particularly weak dynamics in exports and export industry investments***
- ***Decline in the number of persons employed has affected mainly manufacturing***
  - In the service sector, the number of persons employed has increased since 2008.
- ***Export production cannot be supported by stimulus measures that sustain domestic demand and fuel public debt***
  - Nevertheless, selected public investments that support private investment can be beneficial.



# Exceptionally large support from fiscal policy to the general economy in Finland

**Structural balance of public finances / GDP, change in 2008–2014, % points**



Source: European Commission.

27795



## Why does the public deficit need to be reduced now?

- ***Accumulation of public debt would be a smaller problem if we could expect a prolonged period of strong economic growth.***
- ***Additional debt taken by Finland now must be serviced in future in a situation in which a smaller portion of the population is of working age***
  - and in which a larger portion of the population needs social and health care services.
- ***Age structure weighs on the outlook for the public finances, aggravated by continued debt accumulation.***





## What if public consolidation is postponed far into the future?

- **If consolidation measures are not fully implemented, the youth of today will have to not only**
  - ***pay the majority of the pensions as well as social and health care services for the baby-boomers, but also***
  - ***service the debt of the previous generation***
  - ***and seek work in a situation in which the problems in the economy are still unresolved.***



# How does monetary policy support economic recovery?



## Euro area monetary policy very accomodative

- ***The ECB's monetary policy measures have already had significant positive effects on financial conditions, credit and the real economy.***
- ***Decisions of 3 December 2015 strengthen forward guidance and the asset purchase programme.***
  - ***Full implementation of all monetary policy measures secures a sustained adjustment in the path of inflation consistent with price stability***
- ***The ECB is willing and able to act, if warranted, by using all the instruments available within its mandate.***

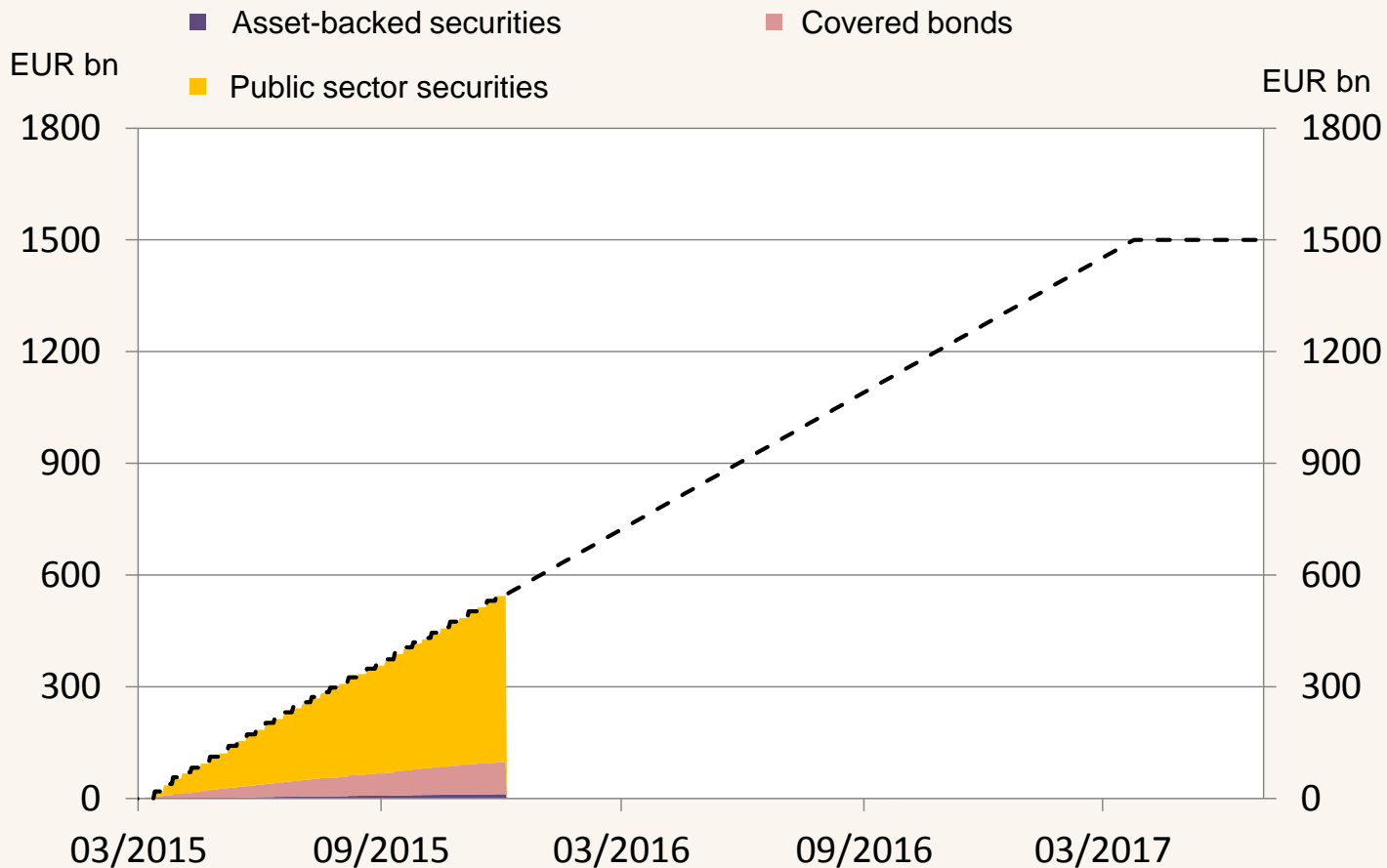


# Monetary policy measures and forward guidance

- ***Monetary policy measures and the Governing Council's commitment to introduce additional measures, if necessary, keep inflation expectations anchored.***
  
- ***Key decisions of 3 December 2015:***
  - ***The asset purchase programme was extended until March 2017, and it was announced that the principal payments on the securities purchased under the programme will be reinvested as they mature.***
  
  - ***The interest rate on the deposit facility was lowered to -0.3%.***
  
  - ***Fixed rate tender procedures with full allotment will be continued until at least the end of 2017.***



# Purchases under the expanded asset purchase programme



Source: Bloomberg.



## ECB monetary policy and Finland

- ***Accommodative monetary policy also supports the Finnish economy.***
  - ***The low level of interest rates has been transmitted to loan interest rates paid by households and non-financial corporations.***
  - ***Improved potential for exports to euro area***
  
- ***In the years to come, monetary policy will provide an effective stimulus to the economy, if***
  1. ***measures are implemented to correct current domestic economic trends***
  2. ***and the stability of the banking system is safeguarded.***
  - ***In this event, accommodative monetary policy will boost investment.***



## 5. Can low interest rates pose a risk to financial stability?



## Finland must prepare in good time for risks to financial stability

- *Experiences in many other countries are a warning sign of the risks related to higher house prices and household debt.*
- *Current macroprudential instruments available in Finland are limited.*
- *Risk weights on housing loans should also cover systemic risks related to lending for house purchase.*





## Finnish financial system stable, but vulnerabilities remain

- ***Banks have maintained a good level of capital adequacy and profitability in an otherwise weak operating environment.***
- ***Finnish financial system and economy vulnerable to housing market shocks***
  - Higher household debt
  - Low risk weights on housing loans
  - Importance of housing loans as collateral for covered bonds
- ***The Finnish banking system is among the most concentrated in the euro area, with a significant level of cross-border interconnectedness.***



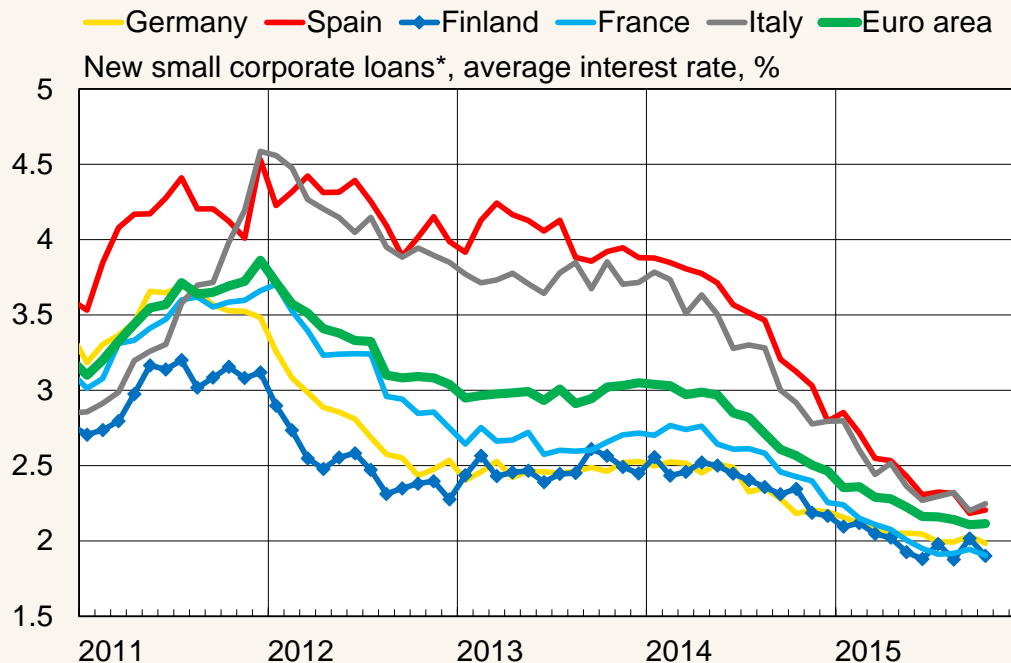
## Short-term risks to financial stability have decreased in the euro area

- ***An expected gradual recovery in the real economy supports financial institutions and markets.***
- ***Banking Union and other policy measures have decreased the negative feedback loop between banks and sovereigns.***
- ***Banks have strengthened their capital adequacy and profitability.***
- ***A high level of nonperforming loans and low level of interest rates burden banks' balance sheets and profitability.***



# Have financing conditions for SMEs tightened in Finland?

- ***Low risk weights on housing loans steer bank lending towards housing loans instead of corporate loans.***
- ***In recent years some signs of a slight deterioration in access to finance by SMEs, but financing conditions are still less tight than in many other countries.***





# Single deposit guarantee scheme planned

- ***Missing part of Banking Union***
  - Already in place: single rulebook, supervision and crisis resolution
- ***If implemented correctly, would increase resilience to crises***
  - Would weaken the negative feedback loop between banks and sovereigns
- ***Would limit risks to public finances, particularly in countries with banking sector concentration similar to Finland***
- ***Essential to examine if Finland's priorities can be achieved in context of gradual introduction of the scheme, as proposed by the Commission***
  - If conditions imposed on countries are tight enough and their compliance is monitored



**Thank you!**