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ECB monetary policy, European Economic and Monetary Union and the Finnish economy

Bank of Finland Bulletin 4/2017

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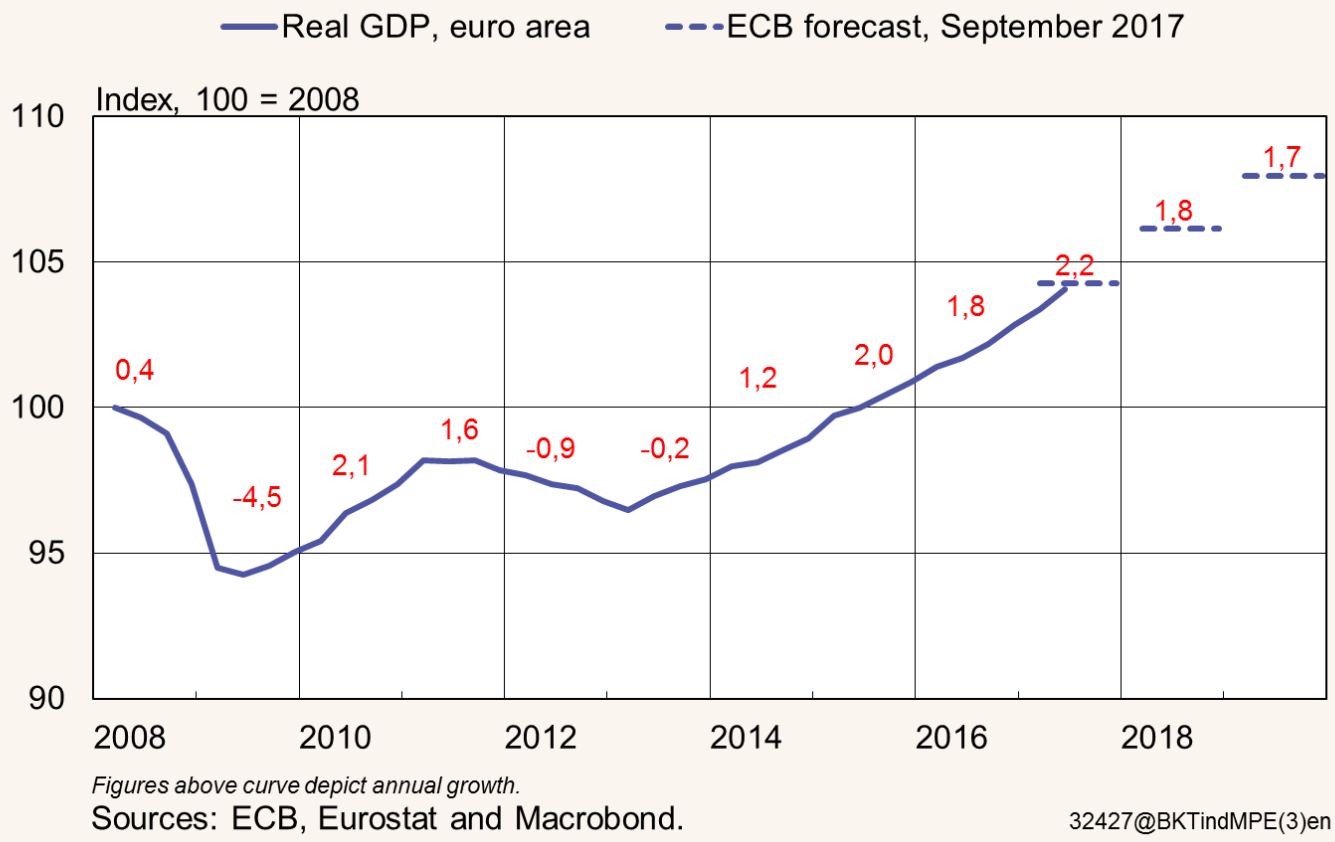
Euro area economic and inflation outlook

Broadly based growth in the euro area...



Figures above curve depict annual growth.

Sources: ECB, Eurostat and Macrobond.

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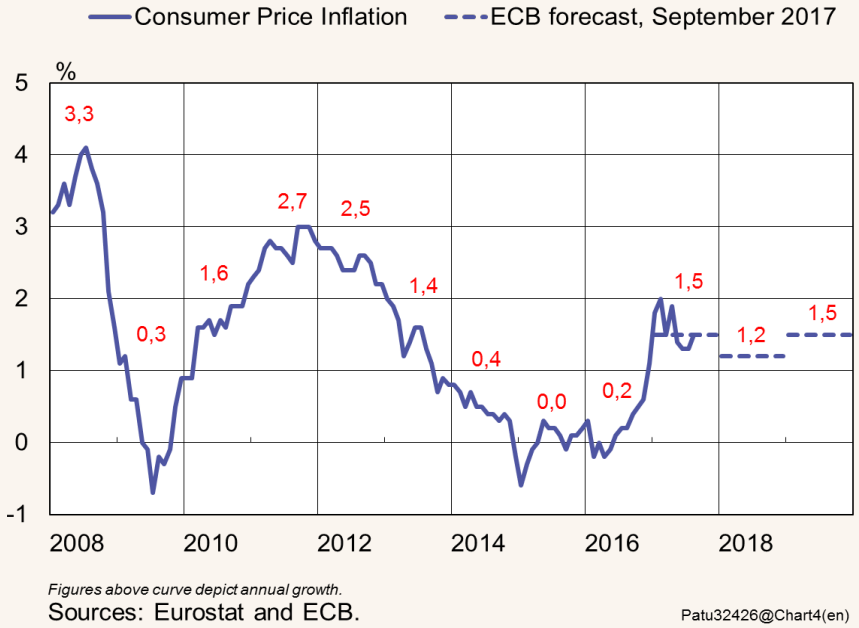
…but path of inflation sluggish



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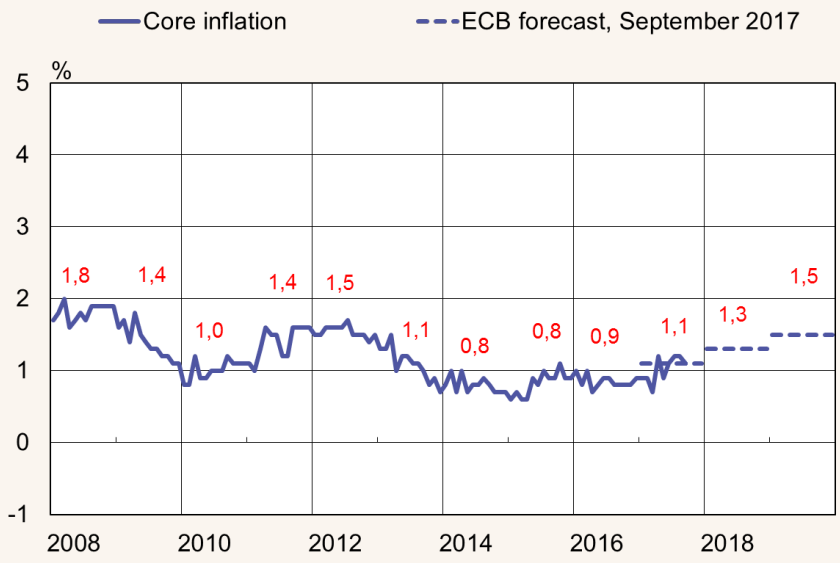

Figures above curve depict annual growth.
Sources: Eurostat and ECB.

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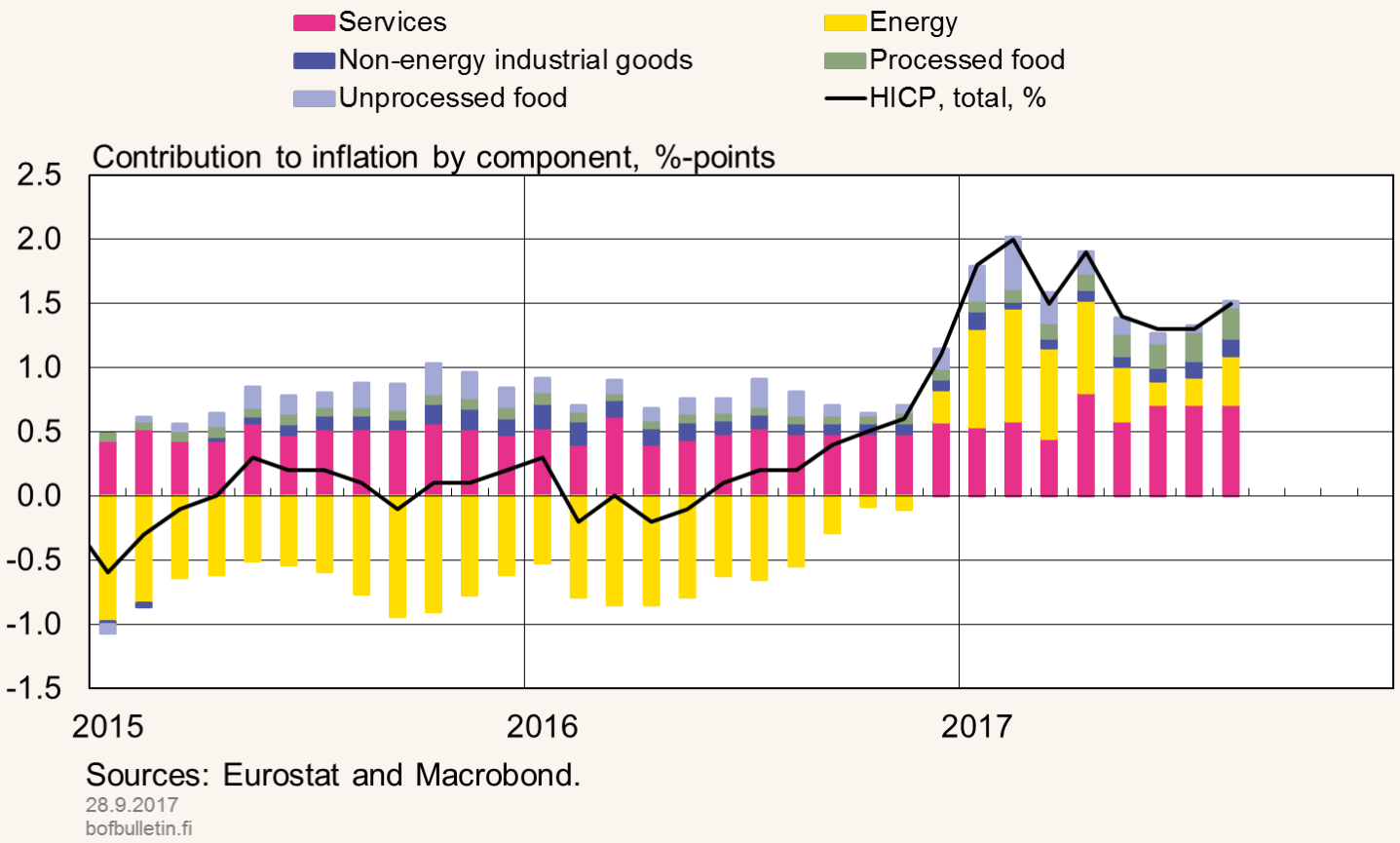
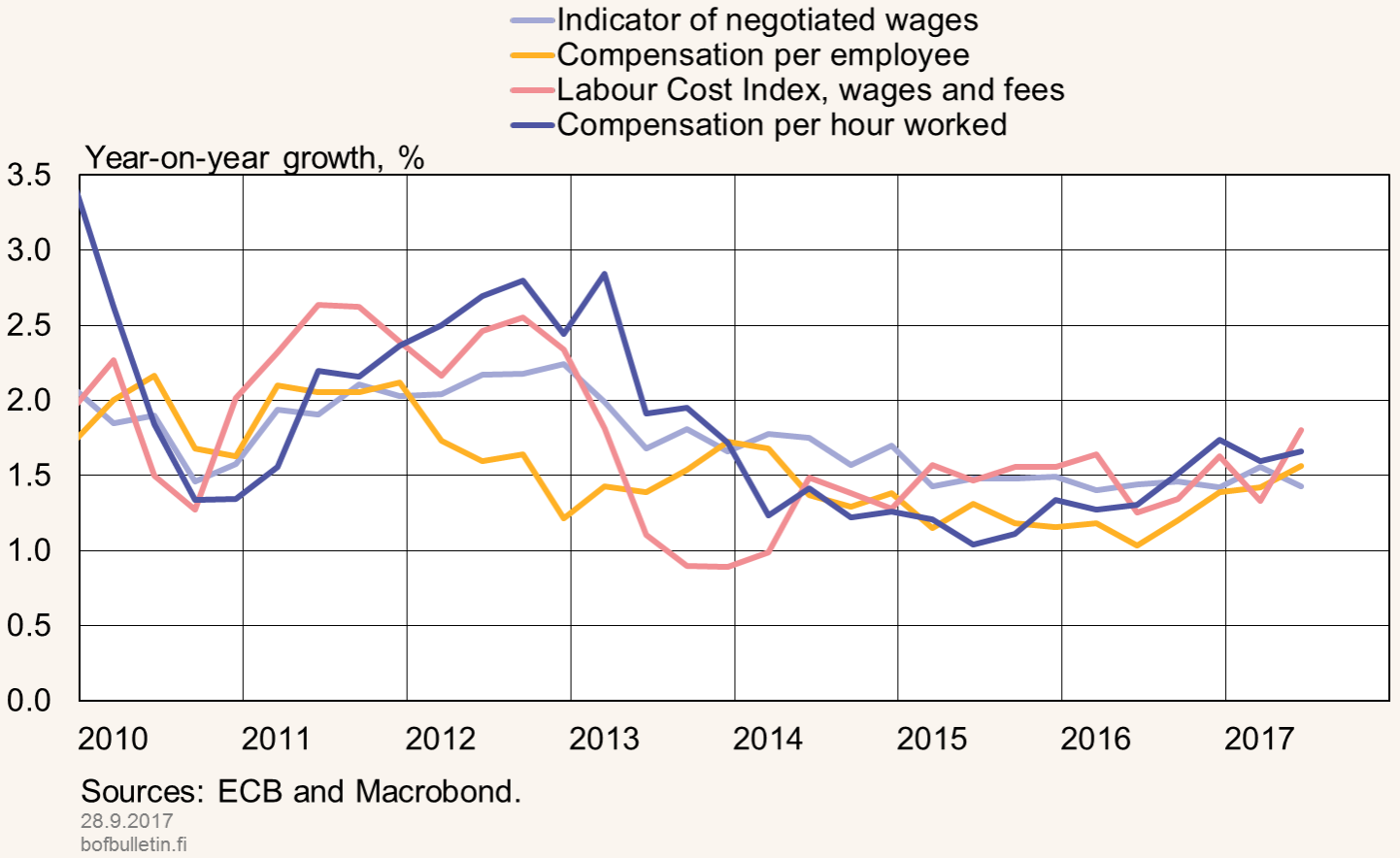
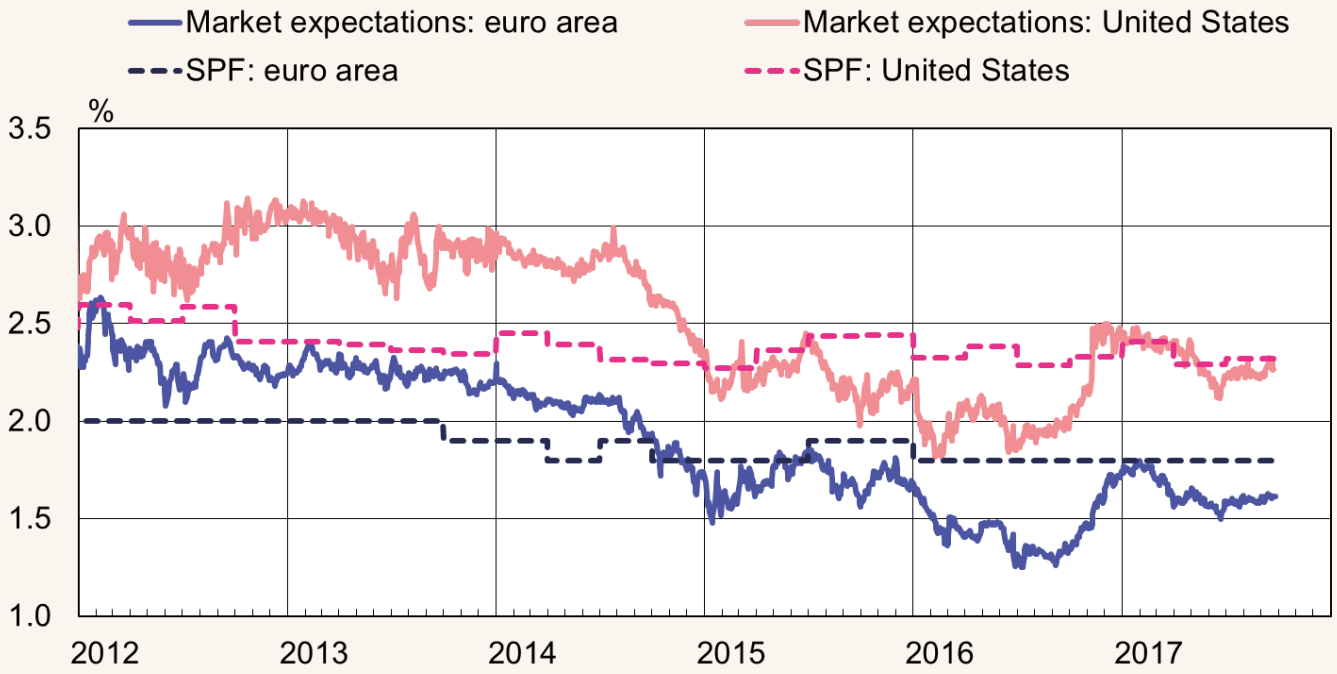
Price of energy driving inflation
Euro area HICP, and its components' contribution to inflation



Euro area wage pressures remain moderate



Euro area's non-standard monetary policy halted decline in inflation expectations



Market expectations are derived from 5-year and 10-year inflation swaps.
SPF: 5-year inflation expectation 5 years ahead.
Sources: Bloomberg, ECB, Fed of Philadelphia and Macrobond.
28.9.2017
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Euro area growth and price outlook

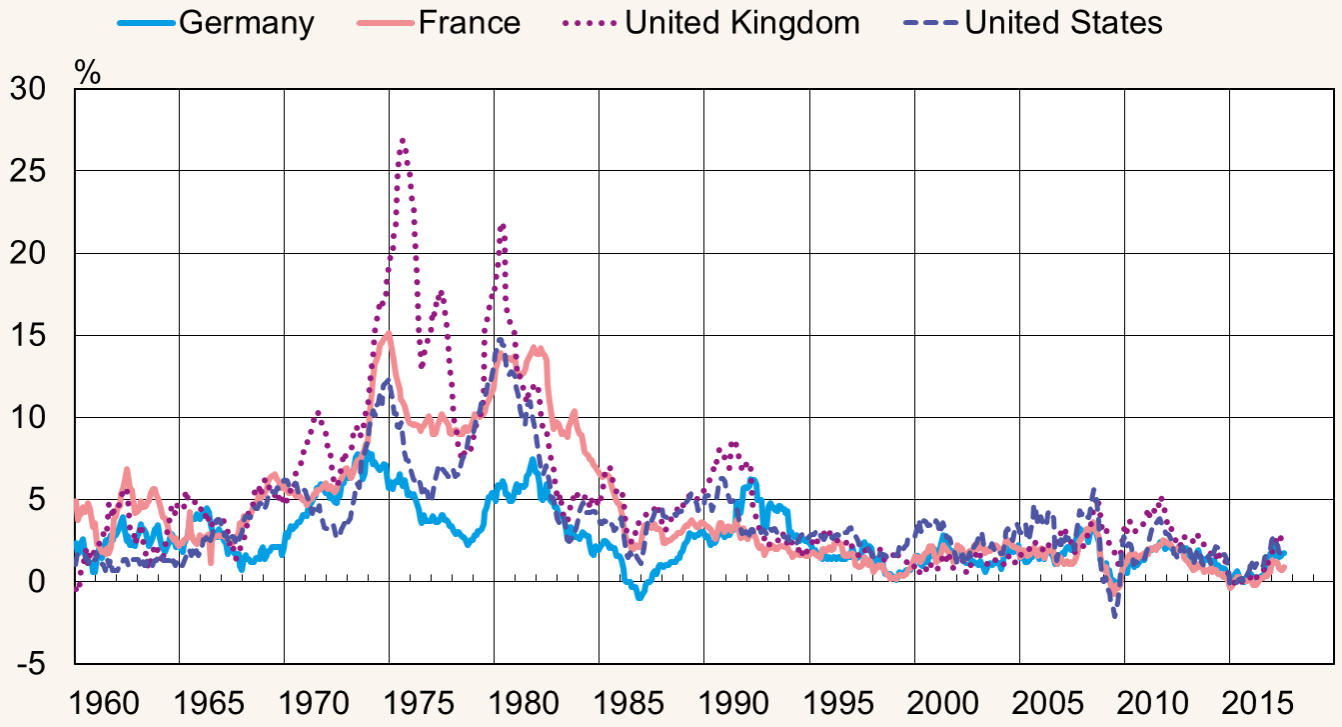
ECB's September projection (cf. Eurosystem staff macroeconomic projection June 2017)

- **GDP**
  - **2017: 2.2 % (+0,3)**
  - **2018: 1.8 % (unchanged)**
  - **2019: 1.7 % (unchanged)**

- **Inflation**
  - **2017: 1.5 % (unchanged)**
  - **2018: 1.2 % (-0.1)**
  - **2019: 1.5 % (-0.1)**

Why does the price stability objective lie below but to close 2%?

Inflation levelled out in large economies



Change in consumer prices, % per annum.
Sources: Macrobond and OECD.

Price stability the primary objective of euro area monetary policy

- ***The primary objective of monetary policy is to maintain price stability.***
- ***A quantifiable price stability objective anchors inflation expectations and increases the transparency of monetary policy.***
- ***Price stability is an important primary objective of monetary policy, because it supports economic growth over the medium term.***
  - In the long term, inflation and employment are not connected.
  - The ECB may also support other objectives, as long as the integrity of the price stability objective is not compromised.

Why price stability?

- ***When inflation is too high:***
  - ***Inflation results in a random redistribution of income and wealth.***
  - ***Inflation uncertainty adds a risk premium to interest rates and costs.***
  - ***Discrepancies in inflation rates lead to disturbances on financial and currency markets.***
- ***When inflation is too slow:***

'Inflation helps grease the wheels of the economy' (James Tobin, 1972)

  - ***Deflation raises real interest rates, if nominal rates are close to zero.***
  - ***Deflation pushes consumption and investment into the future, deepening recessions.***

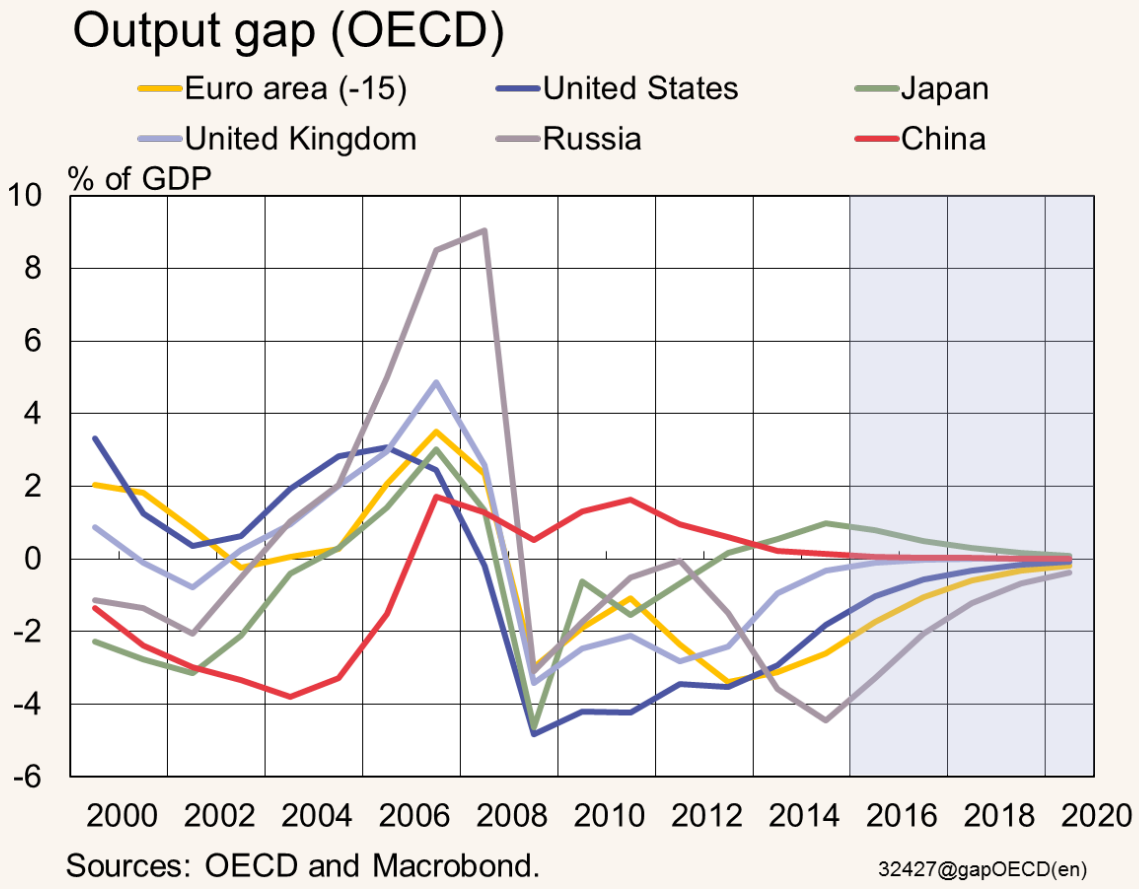
Why is the target around 2%?

- ***The inflation target must not be too high***
  - ***Volatility in inflation increases as the average rate becomes higher.***
- ***The inflation target must not be too low***
  - ***Measuring change in price levels is subject to a margin of error and can be prone towards overestimation.***
  - ***An effort is made to avoid running into the Zero Lower Bound where real interest rates can no longer be lowered.***

Price stability in the euro area – below 2%, but close to it

- ***Continued economic growth reaffirms expectations that***
  - ***the inflation rate is slowly returning to its target but has not yet led to a desired acceleration in the path of inflation.***
- ***The development of core inflation has remained modest in the euro area;***
  - ***therefore, a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and boost the trend in total inflation in the medium term.***

Output gaps closing slowly due to sluggish growth

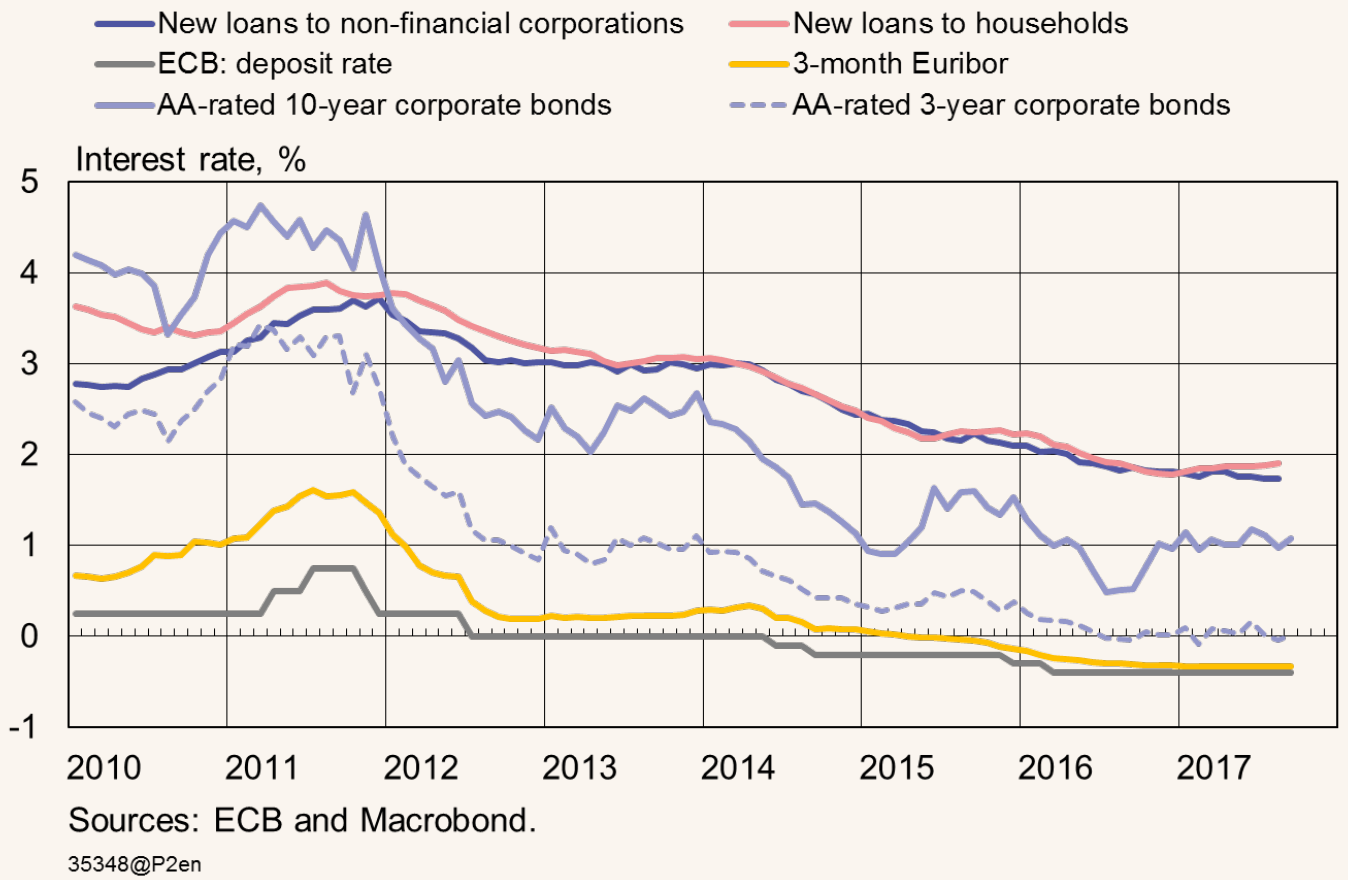


The monetary policy of the ECB is accommodative

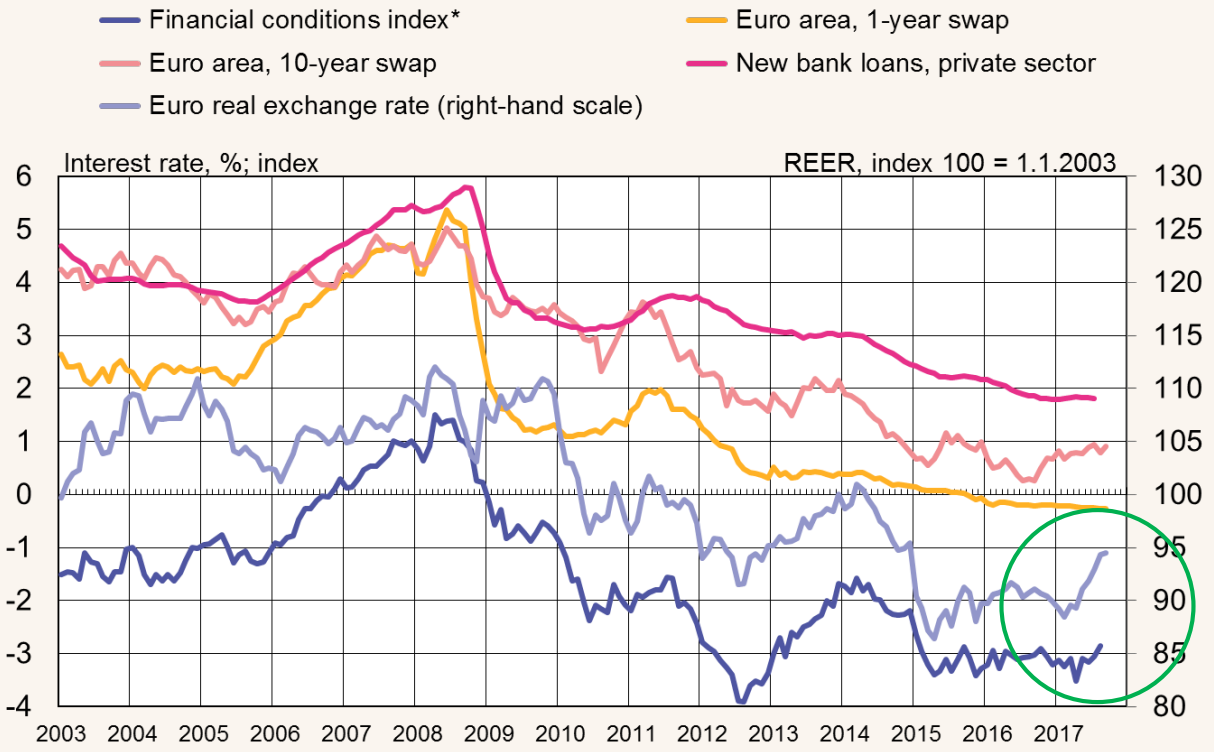
Monetary policy has been accommodative for a long time

- **Central bank policy rates close to zero for several years**
  - Deposit rate negative since June 2014
- **Banks given access to longer-term funding**
  - volume of credit allocated to the funding of the real economy exceeds EUR 760 billion
- **Extensive securities purchases launched in January 2015**
  - **Eurosystem balance sheet total has expanded from EUR 1,000 billion to around EUR 4,200 billion in 10 years.**

Key policy rates have kept interest rates low overall



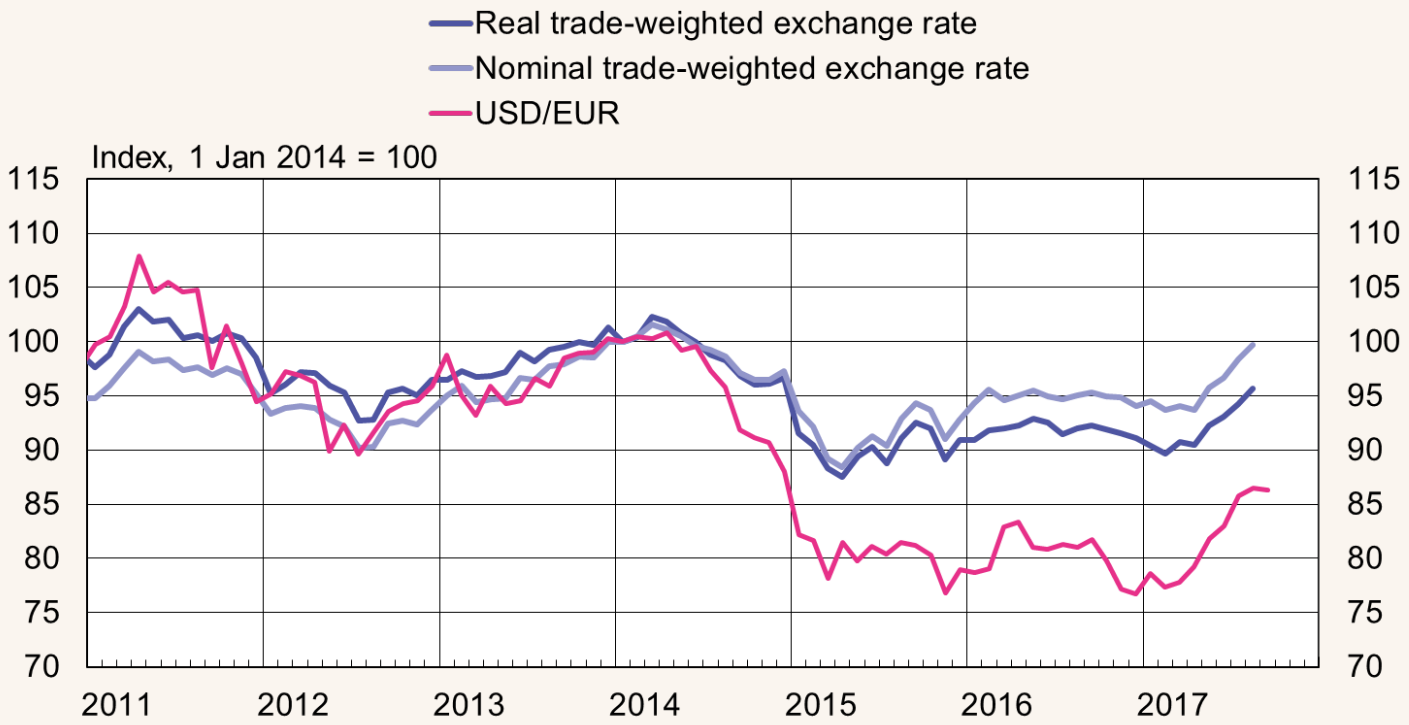
Financial conditions accommodative according to all indicators



Sources: European Commission, ECB, Macrobond and Bank of Finland calculations. 34131@rahoitusolot(en)

* The financial conditions index computed by the European Commission captures short-term interest rates and the exchange rate. A fall (rise) in the index denotes an easing (tightening) of financial conditions.

Trade-weighted exchange rate of euro rises to level of 2014



A rise in the index denotes euro appreciation.
Sources: JP Morgan and Macrobond.
28.9.2017
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Monetary policy will continue to be accommodative…

- ***Net asset purchases, at a monthly pace of EUR 60 billion, will run until the end of 2017, as previously decided.***
  - **Principal payments from maturing securities purchased under the EAPP will be reinvested, past the horizon of the net asset purchases.**
  - **The ECB Governing Council will this autumn decide on the calibration of its policy instruments beyond the end of the year.**

- ***Forward guidance on interest rates***
  - **The ECB Governing Council expects key interest rates to remain at their present low levels for an extended period of time, and well past the horizon of the net asset purchases**.

…until there is a sustained adjustment in the pace of inflation consistent with the price stability objective

- ***Price stability has been defined for the <u>medium-term horizon</u>***
  - ***the inflation outlook for 2019–2020 is now the focus of attention***
- ***The adjustment of inflation in line with the price stability objective must be <u>sustained</u>***
  - ***a transitory increase in prices is not enough***
- ***Price stability must be <u>self-sustaining</u>***
  - ***the inflation aim should be achieved even without a highly accommodative monetary policy stance.***

European Economic and Monetary Union needs strengthening

Banking Union

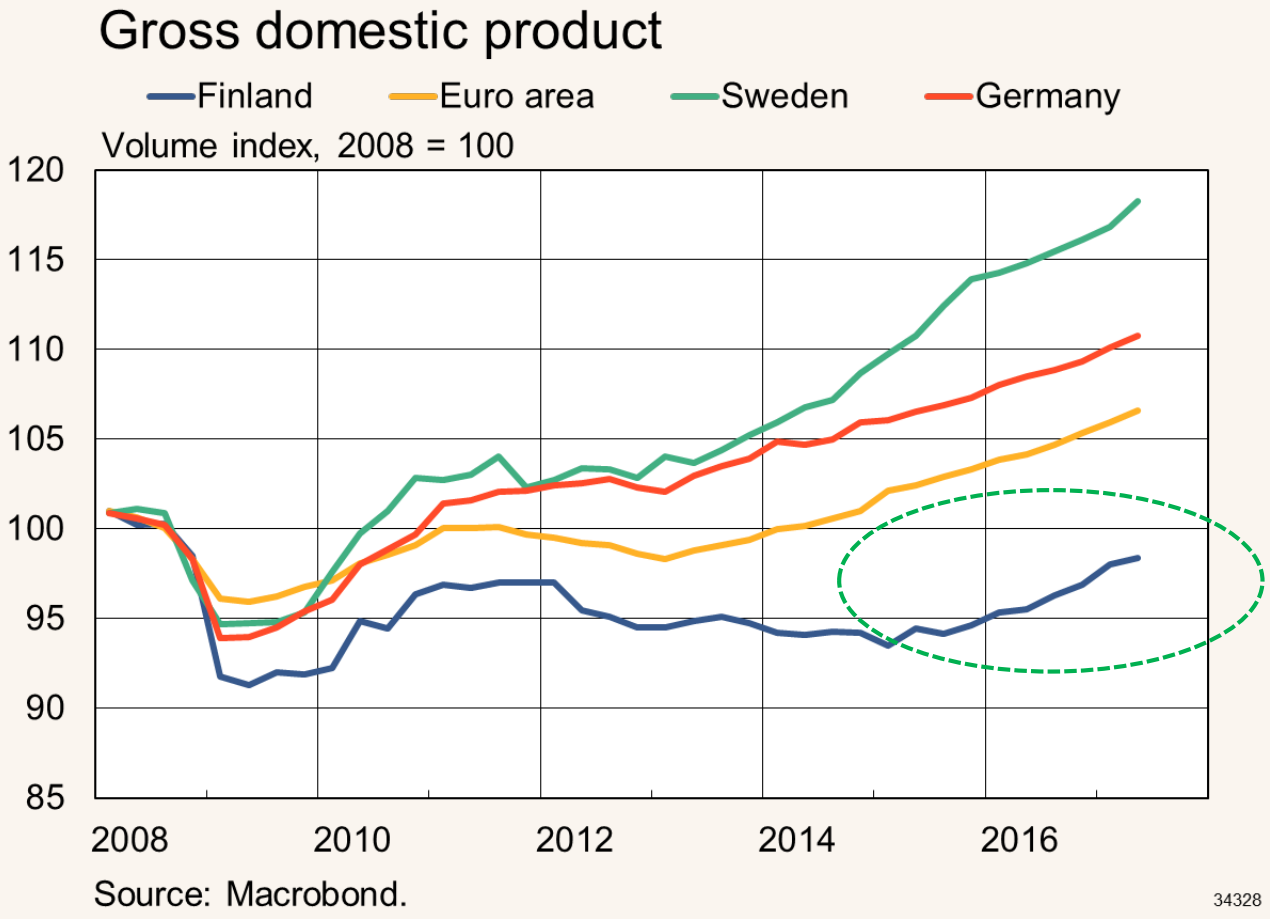
- ***Completion of Banking Union necessary***
  - ***Single Supervisory and Resolution Mechanisms already in place, but common deposit insurance scheme missing***
  - ***First priorities***
    - ***Phased solution to the problem of non-performing loans***
    - ***Consistency of banks' risk position and assessment***
    - ***Harmonised level of resolution preparedness***
- ***A common insurance-type deposit guarantee is in the interests of both individual countries and EMU***
- *'Improving the resilience of Europe's Economic and Monetary Union', working group appointed by the Ministry of Finance and chaired by Antti Suvanto*
- *http://vm.fi/en/publication?pubid=7801*

Single capital market

- ***Implementation of Capital Markets Union must be stepped up***
  - ***Further progress needed in order to diversify funding sources and improve the functioning of the financial system***
  - ***Essential for ensuring more effective risk sharing on the financial markets***
  - ***Priority must be given to the objectives of the broad action plan***
  - ***Initiative on the part of Member States also important***

Brighter outlook for the Finnish economy; this progress must be sustained

Annual growth rate for Finland has now overtaken that for the euro area, but the gap to be closed is wide



Exports growing: 20% year on year

Figures seasonally adjusted.
Sources: National Board of Customs and Bank of Finland (seasonal adjustment).

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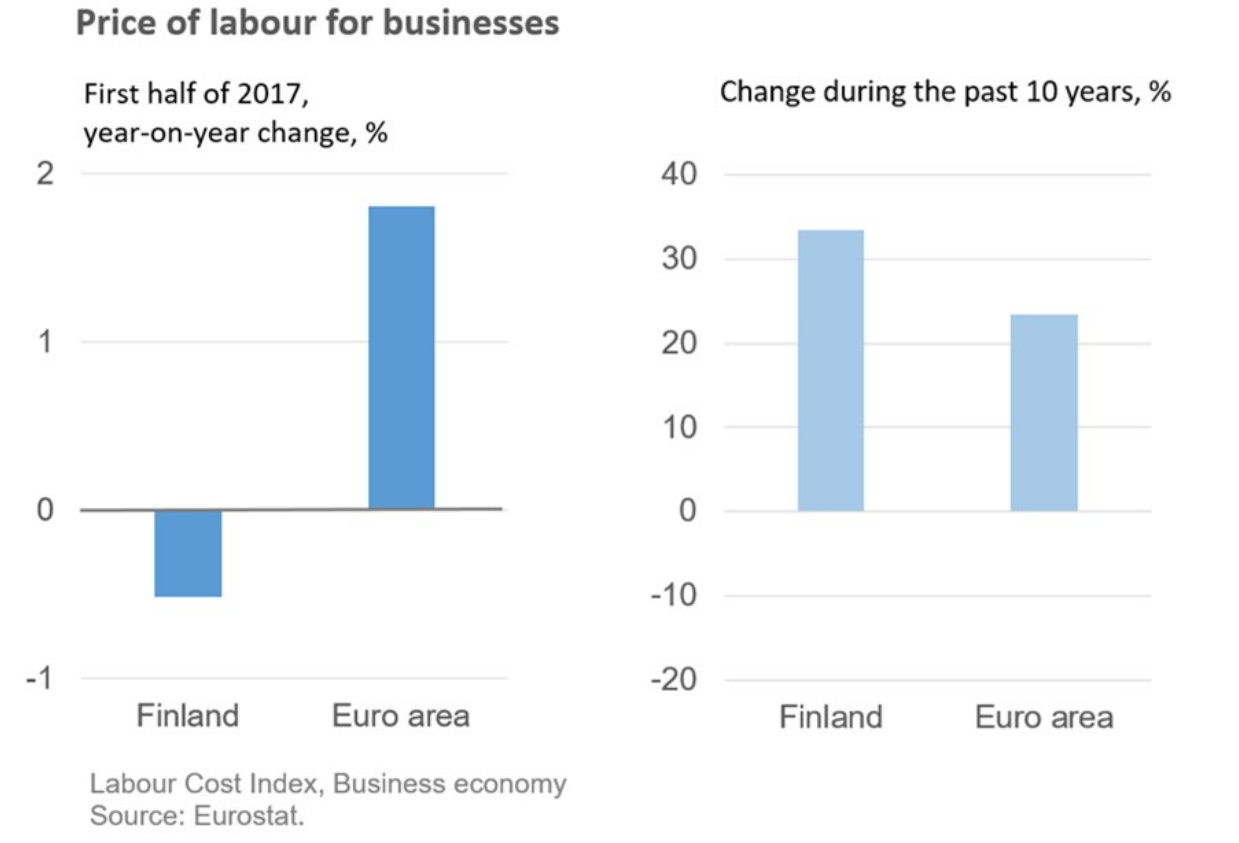
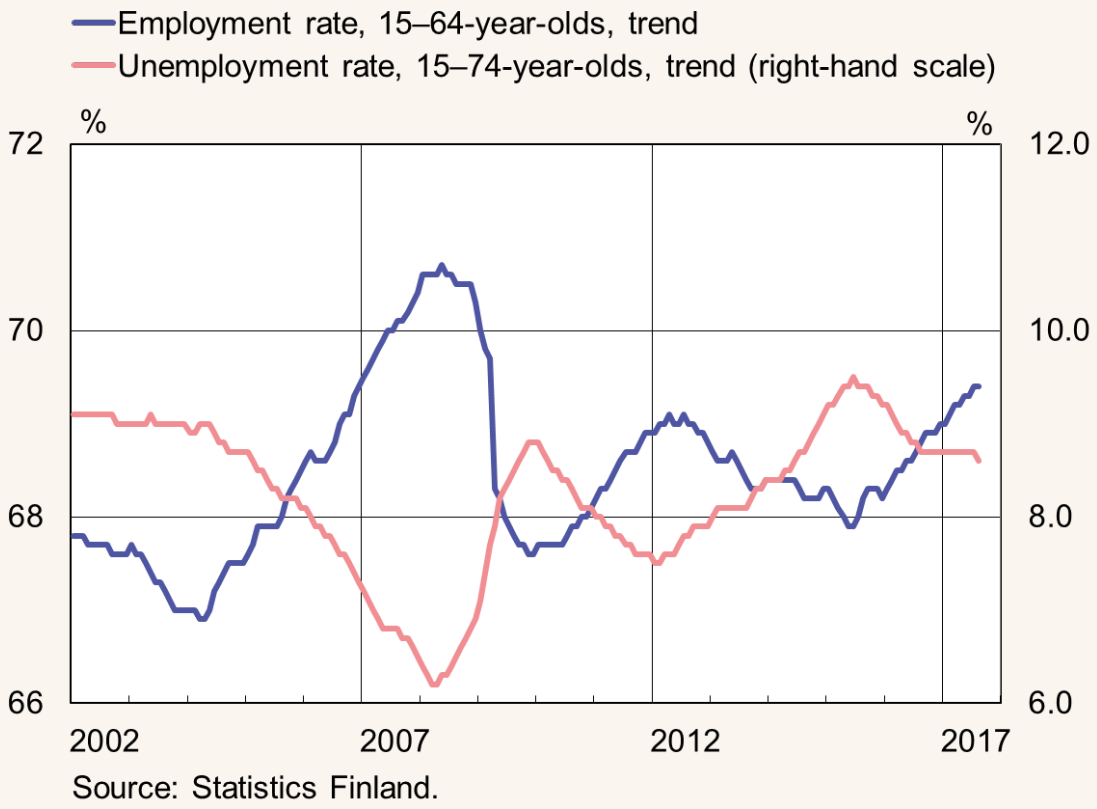
Cost-competitiveness improved, but work not yet complete



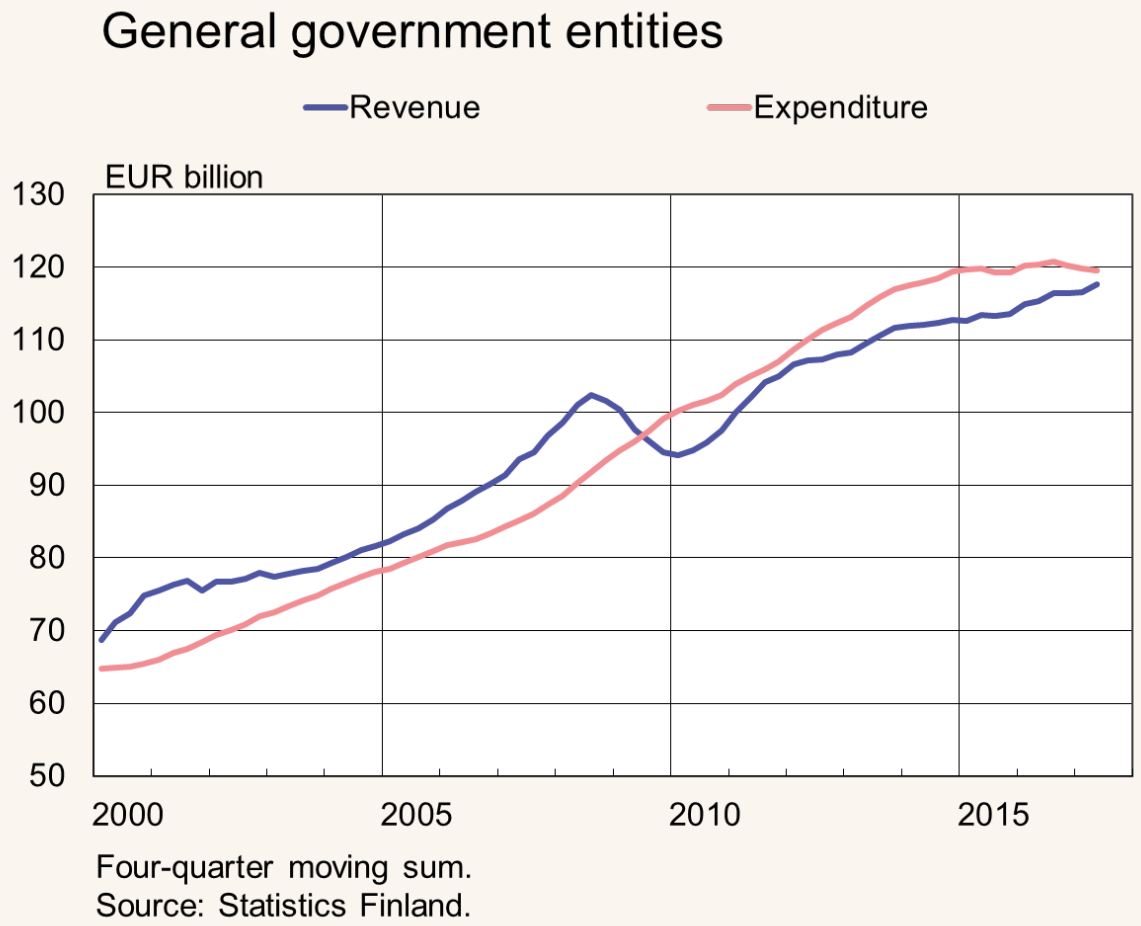
Employment up



Source: Statistics Finland.

- ***Number of people outside the labour market has declined***
- ***Unemployment is slowly falling***
- ***Number of long-term unemployed has decreased, but remains high***

Economic growth has improved public sector figures – *but structural imbalance between revenue and expenditure remains*



Important that consolidation measures designed to strengthen Finland's economy continue to be implemented

- ***The decline in cost-competitiveness has been turned around. It is essential to sustain this progress and recover the losses of the past decade.***
- ***Fostering employment and productivity, with a special focus on reducing youth unemployment, and education, innovation and competition***
- ***Public finances must be further strengthened; important to ensure long-term fiscal sustainability***

Thank you !