European economy and monetary policy in the shadow of the war and energy crisis

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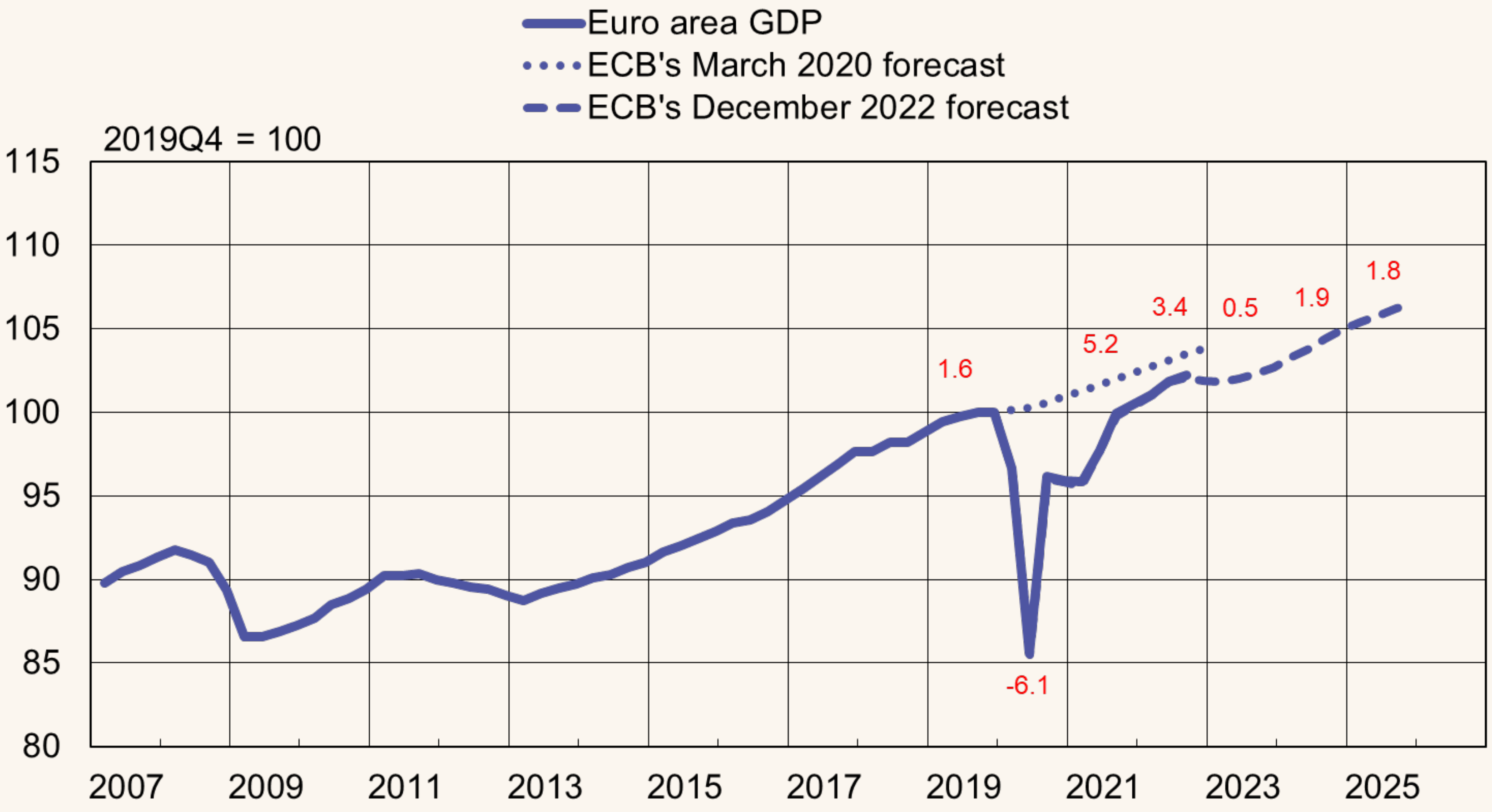
Energy crisis is weakening the growth outlook for the euro area



Figures next to the curve are annual growth rates, %.
Sources: Eurostat and ECB.
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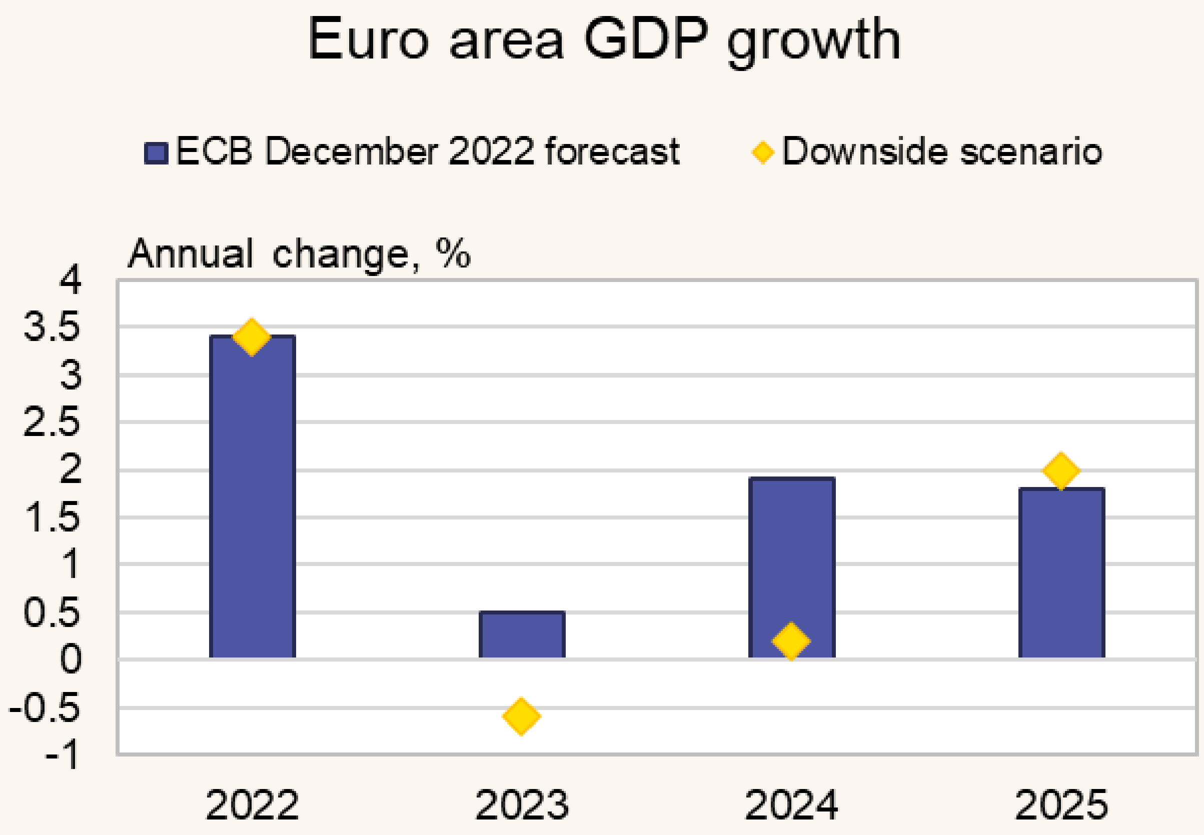
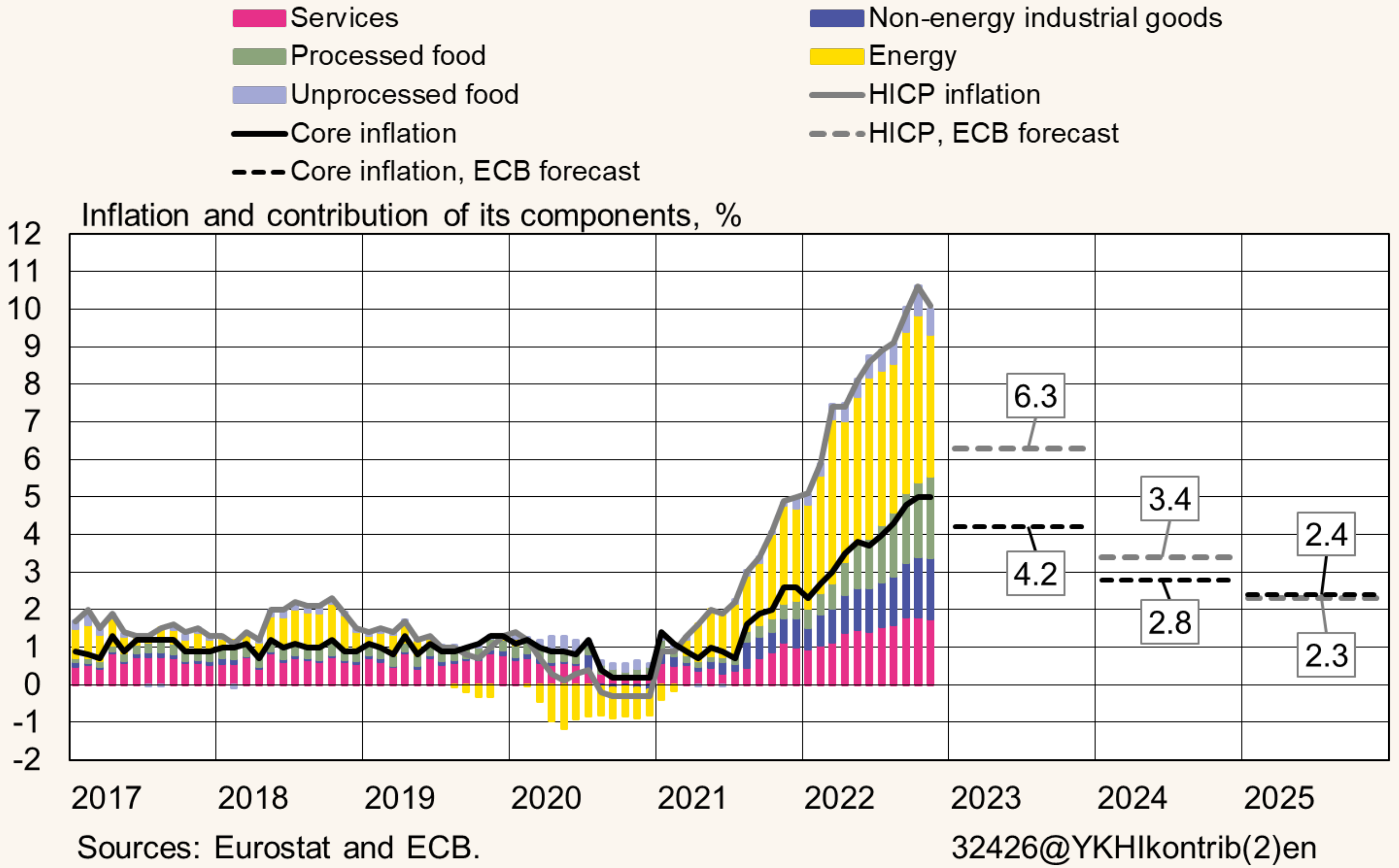
In the ECB's downside scenario, the euro area will slide into recession



Source: ECB calculations. 35781 Skenaariot

- In the ECB's downside scenario, euro area GDP growth in 2023 will be -0.6%.
- Underlying assumptions:
  - Supply disruptions persist and uncertainty remains elevated.
  - There is a shortage of energy and energy prices will remain high.
  - Global economic growth will be slower than projected.

Energy inflation explains 40% of the rise in prices – but inflation has broadened out to the entire economy



Surge in energy prices is most important factor driving up inflation

- Higher energy prices are the main factor behind inflation, but the rise in prices has broadened out to almost all goods and services.
- The ability of monetary policy to directly influence energy prices is very limited.
- Monetary policy must nevertheless respond to the steepening rise in the general price level to avoid the risk of a wage-price spiral and to keep inflation expectations anchored.
- To curb the rise in energy prices, it is important to maintain incentives to save energy. Support measures should be targeted at households that are suffering most from the rise in energy prices.

ECB Governing Council has raised key interest rates in order to stabilise inflation at its 2% target over the medium term

1. On 15 December, the ECB Governing Council decided to increase key ECB interest rates by 0.5 percentage points. The ECB will continue to raise its key rates due to the significant weakening of the projected outlook for inflation.

2. Interest rates will still have to rise significantly to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. Raising interest rates to restrictive levels will over time reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift in inflation expectations.

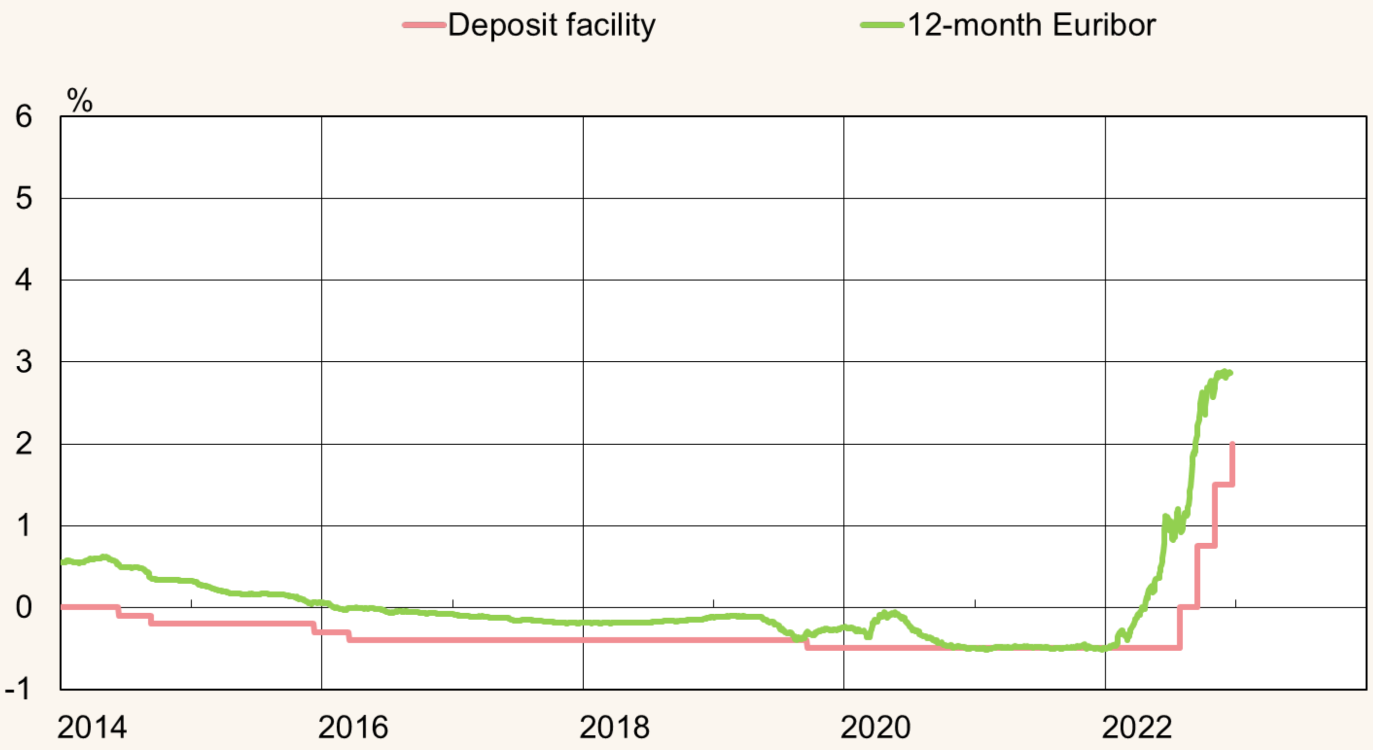
3. Future policy rate decisions will continue to be data-dependent and determined meeting by meeting.

Principal payments from maturing securities under the expanded asset purchase programme (APP) will no longer be reinvested in full

- The ECB Governing Council will continue to reinvest in full the principal payments from maturing securities under the asset purchase programme (APP) until the end of February 2023.
- From the beginning of March 2023 onwards, the APP portfolio will decline at a measured and predictable pace, as not all of the principal payments from maturing securities will be reinvested.
- The decline will amount to EUR 15 billion per month on average until the end of the second quarter of 2023 and its subsequent pace will be determined over time.

Monetary policy tightening is reflected as a rise in market interest rates

- The ECB's Governing Council has raised its key interest rates on four occasions in 2022, by a total of 2.5 percentage points, as a result of which, the deposit facility rate will increase to 2.00%.
- The most common reference rate on housing loans in Finland, the 12-month Euribor, has risen rapidly as a result of and also in anticipation of the ECB's interest rate hikes.



Source: ECB.
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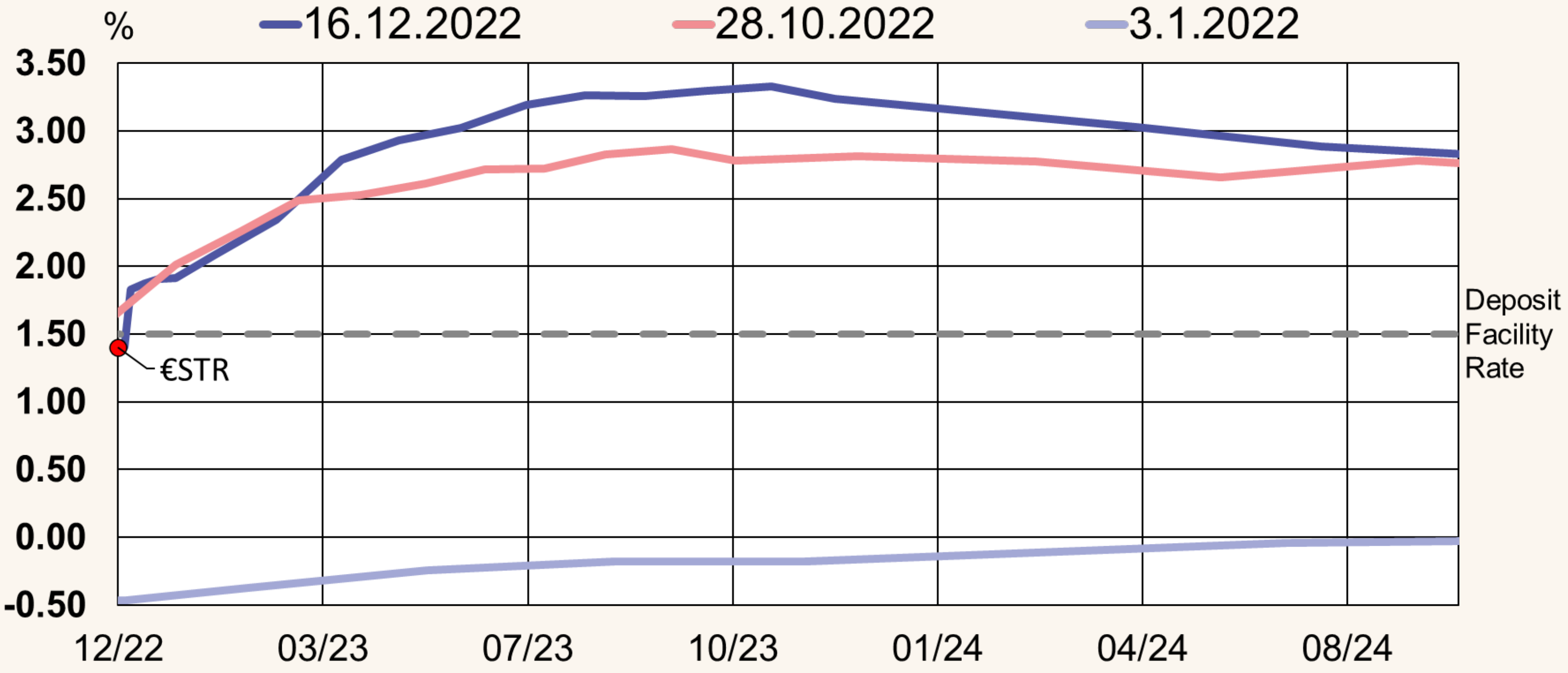
Market interest rates have risen

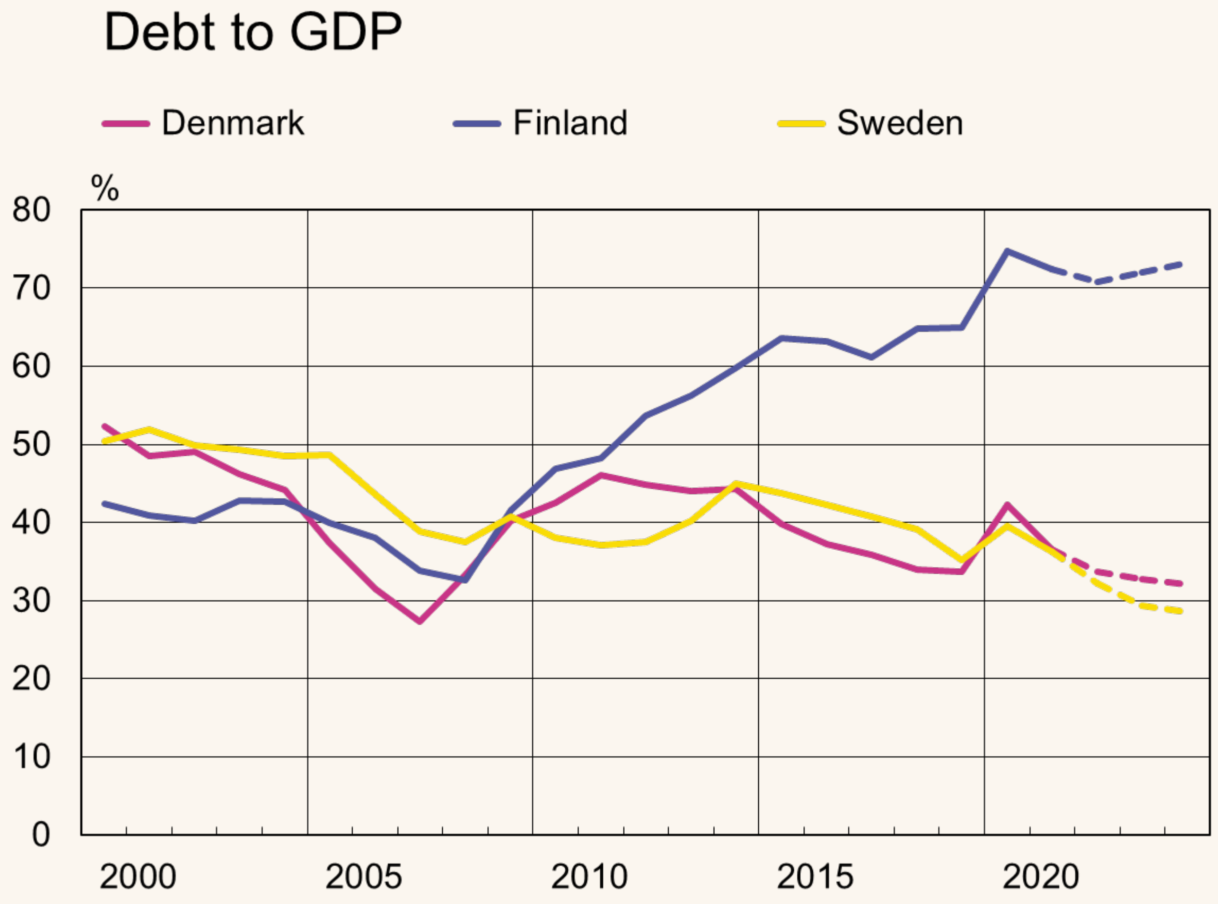
(NB: the change in the interest rate on the deposit facility will take effect on 21 December 2022)



Forward €STR rates based on euro area OIS rates.
Source: Bloomberg and Bank of Finland’s calculations.

Finland's public debt ratio has grown almost continuously since the global financial crisis

- Finland's public finances have weakened compared to the other Nordic countries in the past ten years or more.
- Finland's public debt ratio has doubled, while that of Sweden and Denmark has remained close to 40%.
- The debt ratio is still below the euro area average, but its growth trend is divergent and alarming.



Source: European Commission, Autumn 2022 Economic Forecast.

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Public finances must be strengthened

- The public finances must be strengthened to ensure the financing of increasing levels of age-related expenditure.
- Strengthening requires active measures affecting both revenues and expenditures.
- Safeguarding key services will require prioritising needs and goals and ensuring a comprehensive knowledge base to support the decision-making on these matters.
- It is vital to build a strong political commitment to fiscal sustainability and to the resolute implementation of the measures this calls for.
- These goals would be facilitated by a reform of the EU’s economic governance framework, which should be decided on without undue delay.

Sustainable economic growth must be supported

- Human capital has been an important factor for Finland's economic growth.
- The positive trend is coming to an end, as the level of educational attainment among the young age cohorts has come to a halt.
- Population ageing and weak productivity growth dampen the outlook for growth.
- There is a risk that the stock of human capital in Finland will begin to decline in the 2040s.
- We need investment in:
  - education and research and innovation and
  - efforts to increase work-based immigration and the recruitment of skilled labour.
- We also need cooperation between companies and educational establishments to ensure employment of international students.

Short-term and long-term challenges must be resolved

- A recession is likely both in the euro area and in Finland, and inflation is still too high.
- Interest rates will still have to rise significantly to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target.
- Raising interest rates to restrictive levels will over time reduce inflation by dampening demand and will also guard against the risk of a persistent upward shift in inflation expectations.
- The shrinking of the working-age population and weak productivity growth in Finland weaken the long-term potential for growth.
- Finland is nevertheless very well placed not only to cope but to thrive – the withering can be stopped.

Thank you!

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