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The Euro area economy: outlook and challenges

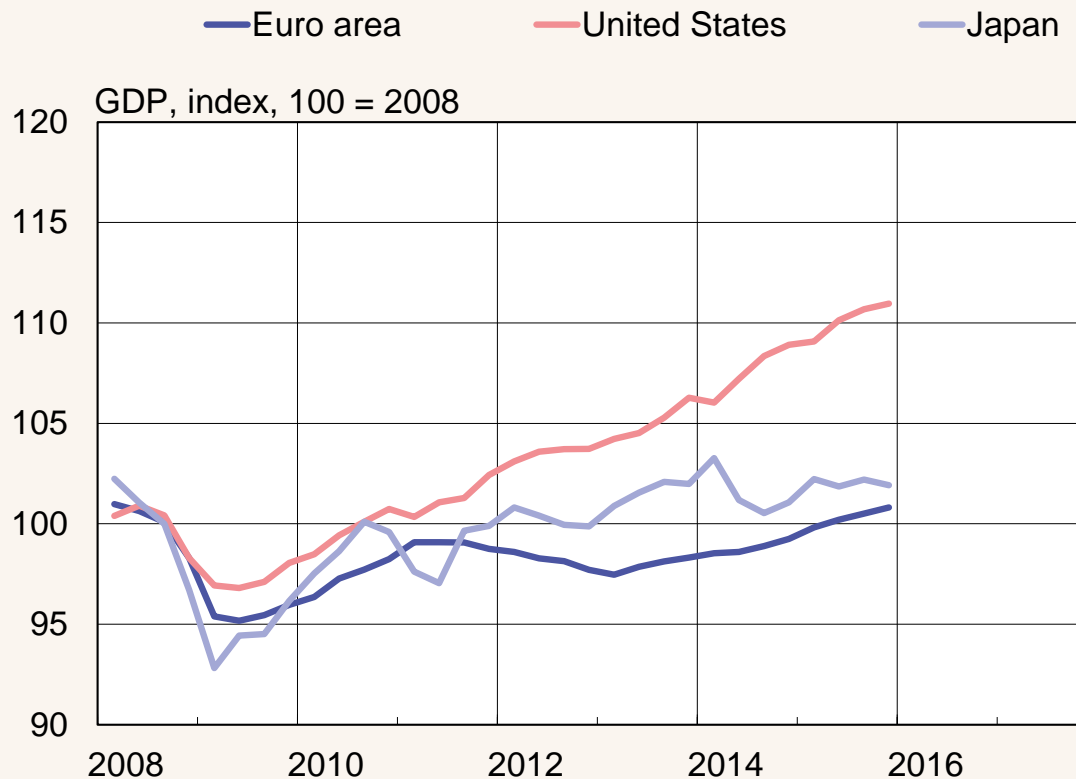
HKMA seminar, Hong Kong

Friday, April 22, 2016





Advanced main economic regions: Recovery divergent and laborious



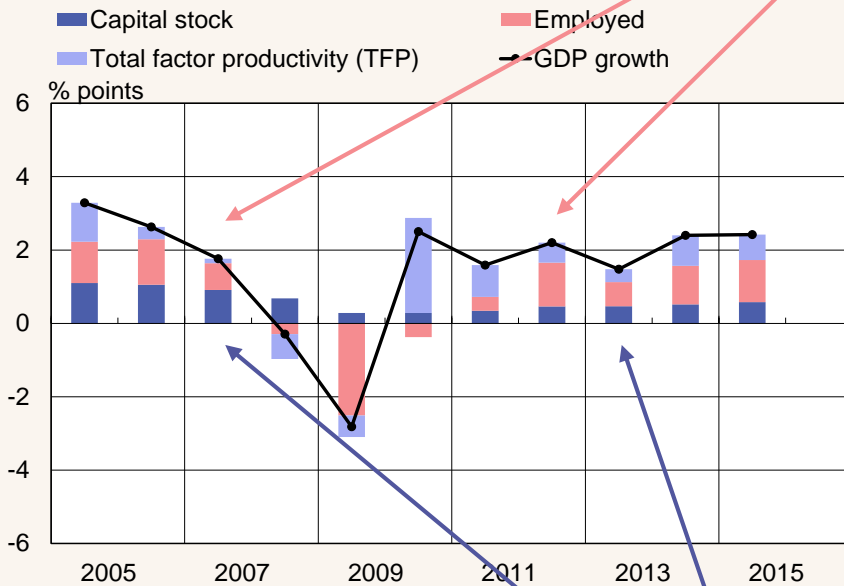
Sources: National statistical authorities and Macrobond.



United States and euro area: Growth structure pre- and post-crisis

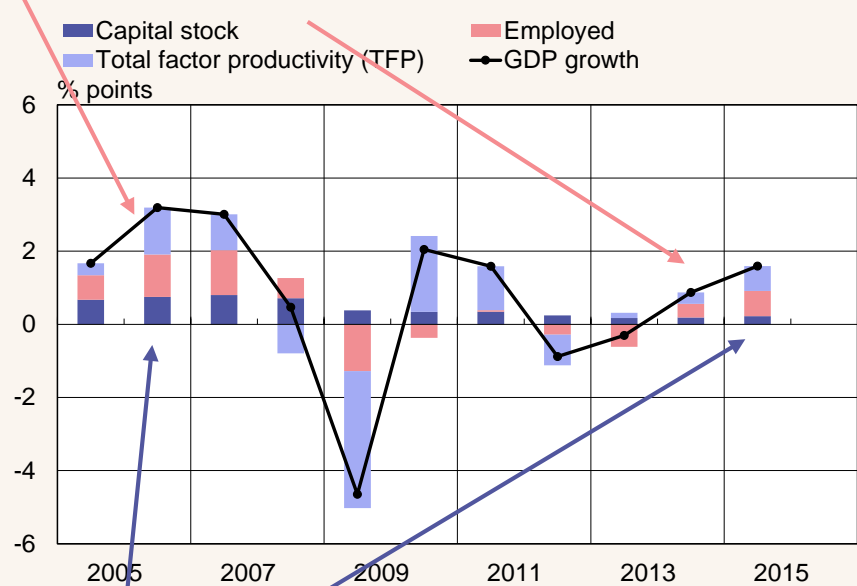
Employment

Contributors to US GDP growth



Sources: European Commission and Bank of Finland calculations.

Contributors to euro area GDP growth



Sources: European Commission and Bank of Finland calculations.

Capital stock

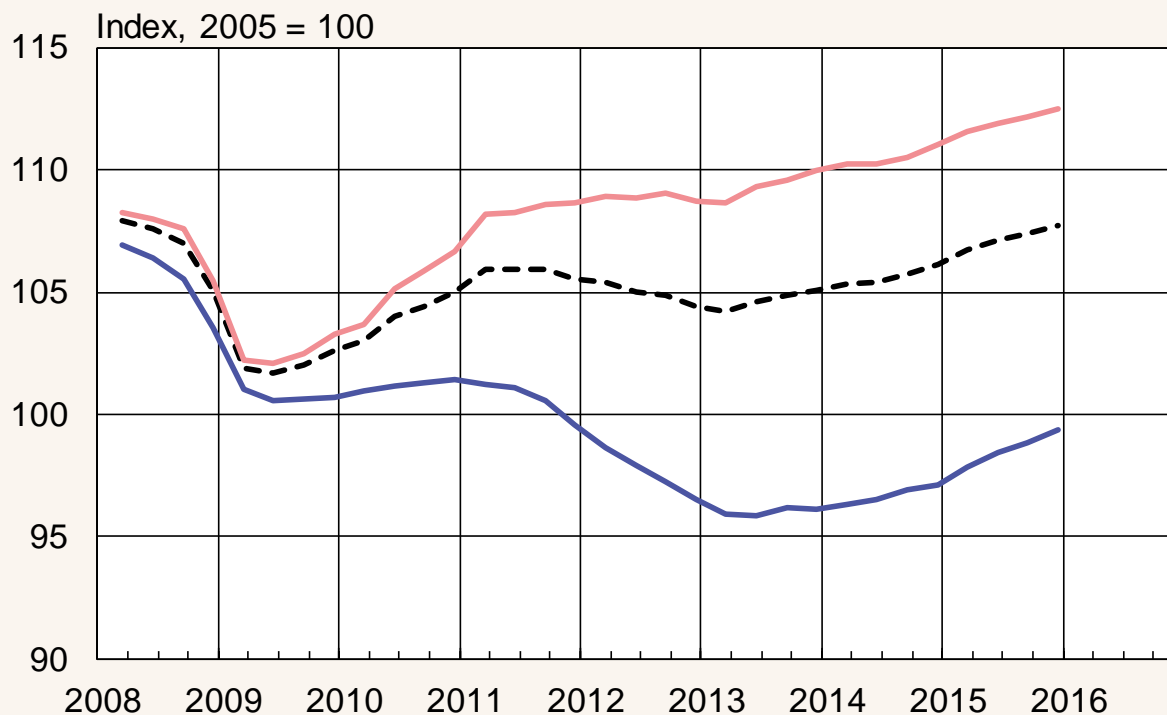
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GDP growing again in the euro area

GDP

--- Euro area — High-rated countries** — GIIPS*



Sources: Eurostat, Macrobond and Bank of Finland calculations.

*Greece, Ireland, Italy, Portugal and Spain.

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

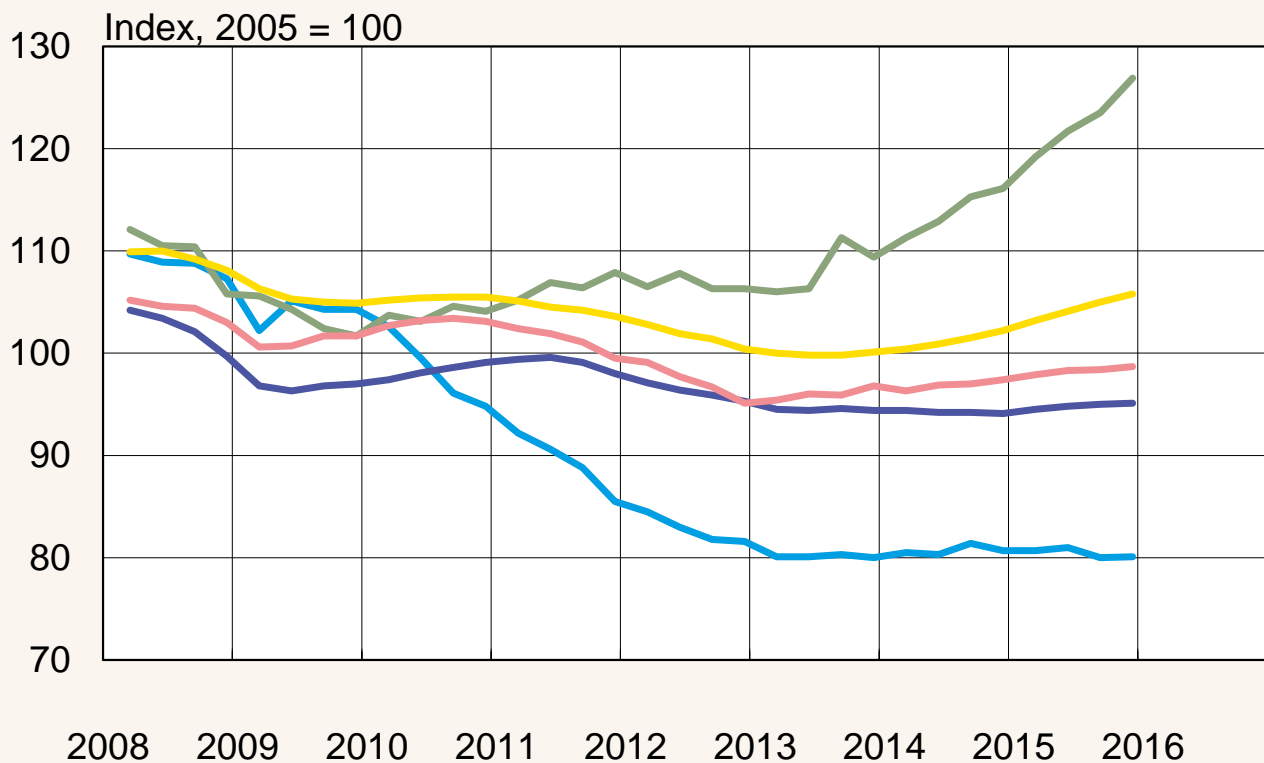
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Still considerable differences among GIIPS countries

GDP GIIPS

— Greece — Ireland — Italy — Portugal — Spain

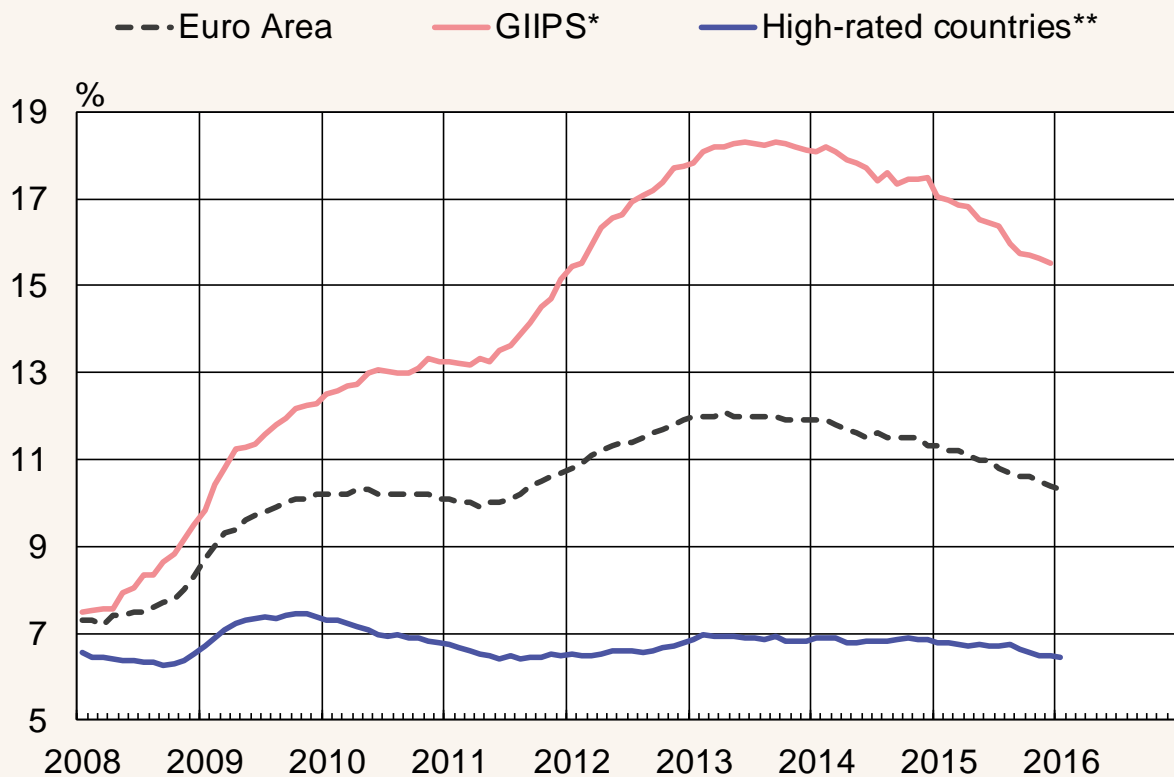


Sources: Eurostat and Macrobond.



Unemployment declining but still very high in GIIPS countries

Unemployment rates



*Greece, Ireland, Italy, Portugal and Spain.

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

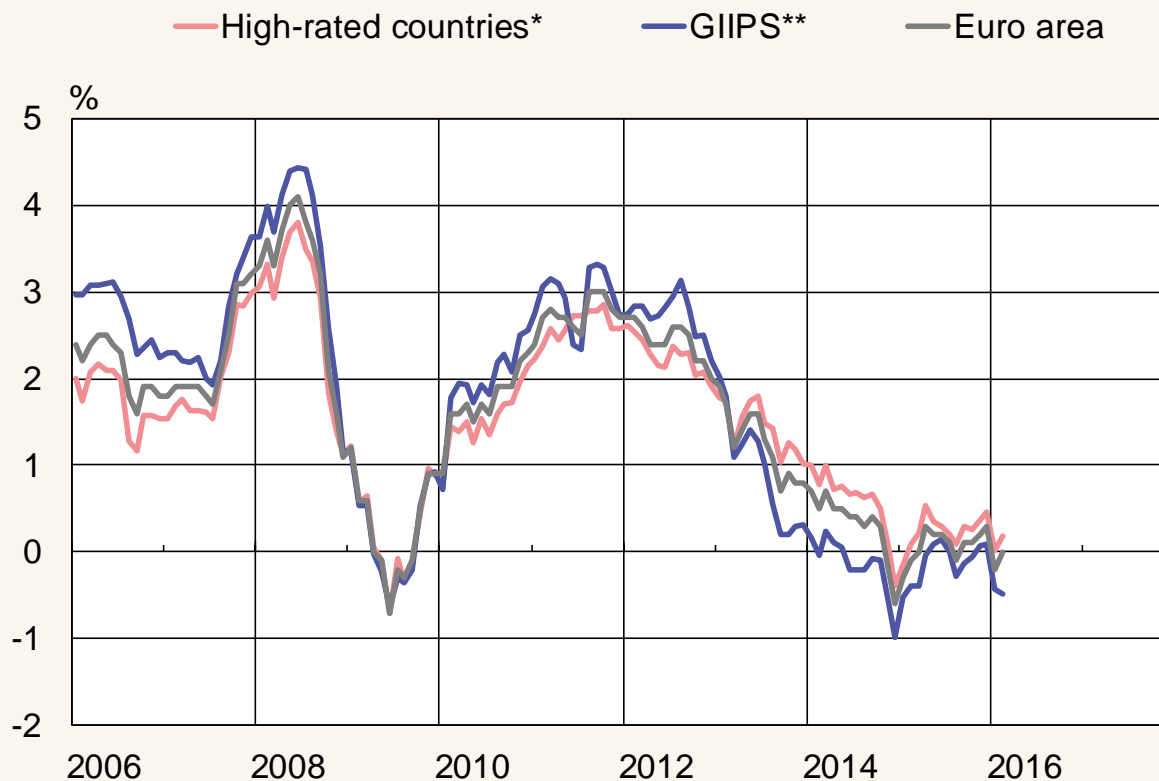
Sources: OECD, Macrobond and Bank of Finland calculations.

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Inflation very low in the euro area

Harmonised Consumer Price Index



Sources: Eurostat, Macrobond and Bank of Finland calculations.

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

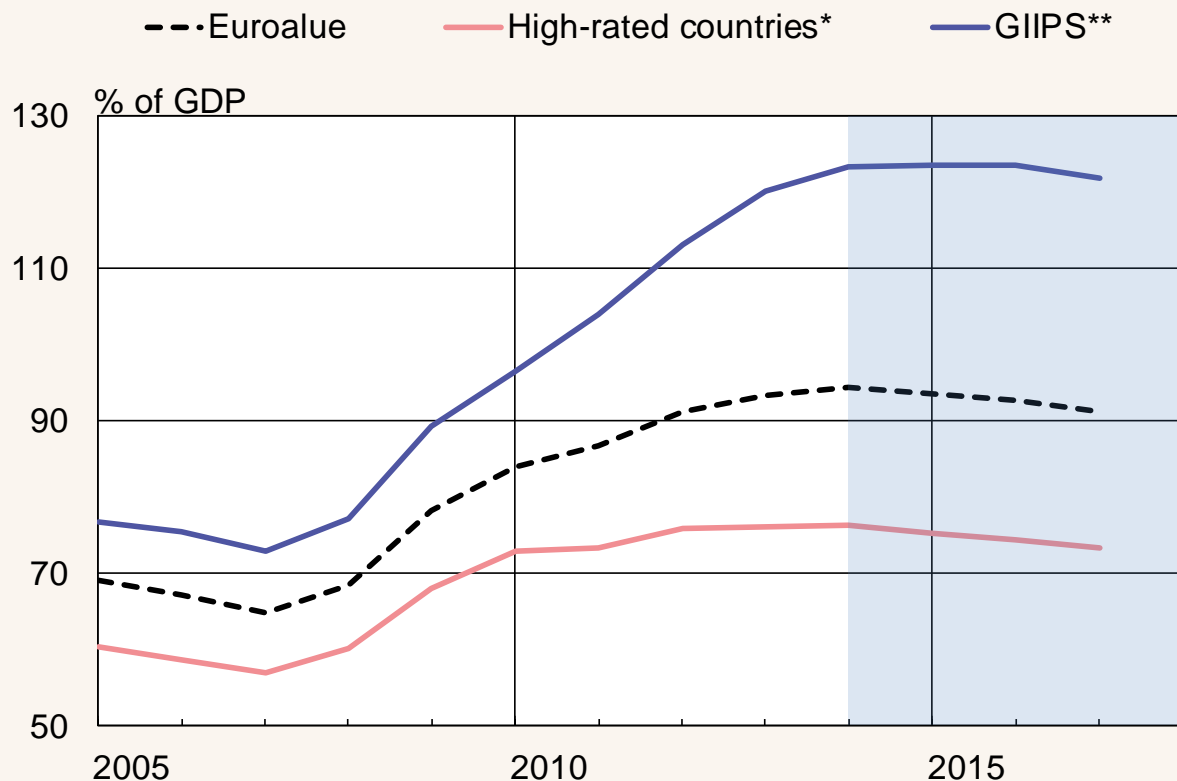
** Greece, Ireland, Italy, Portugal and Spain.

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Government debt projected to decrease in 2015 for the first time since 2007

Public Debt



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

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

The figures for 2015-2017 are based on the European Commission's forecast.

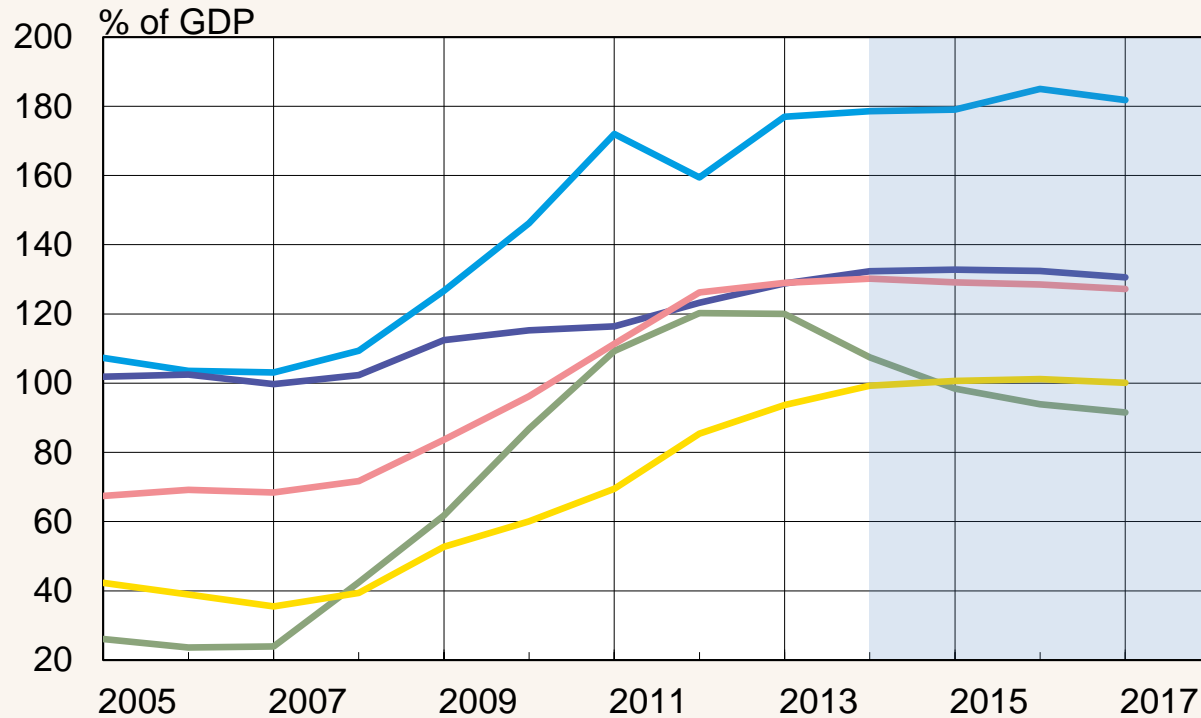
Sources: European Commission, Macrobond and Bank of Finland calculations.



Government debt stabilizing even in GIIPS countries

Public Debt

— Greece — Ireland — Italy — Portugal — Spain

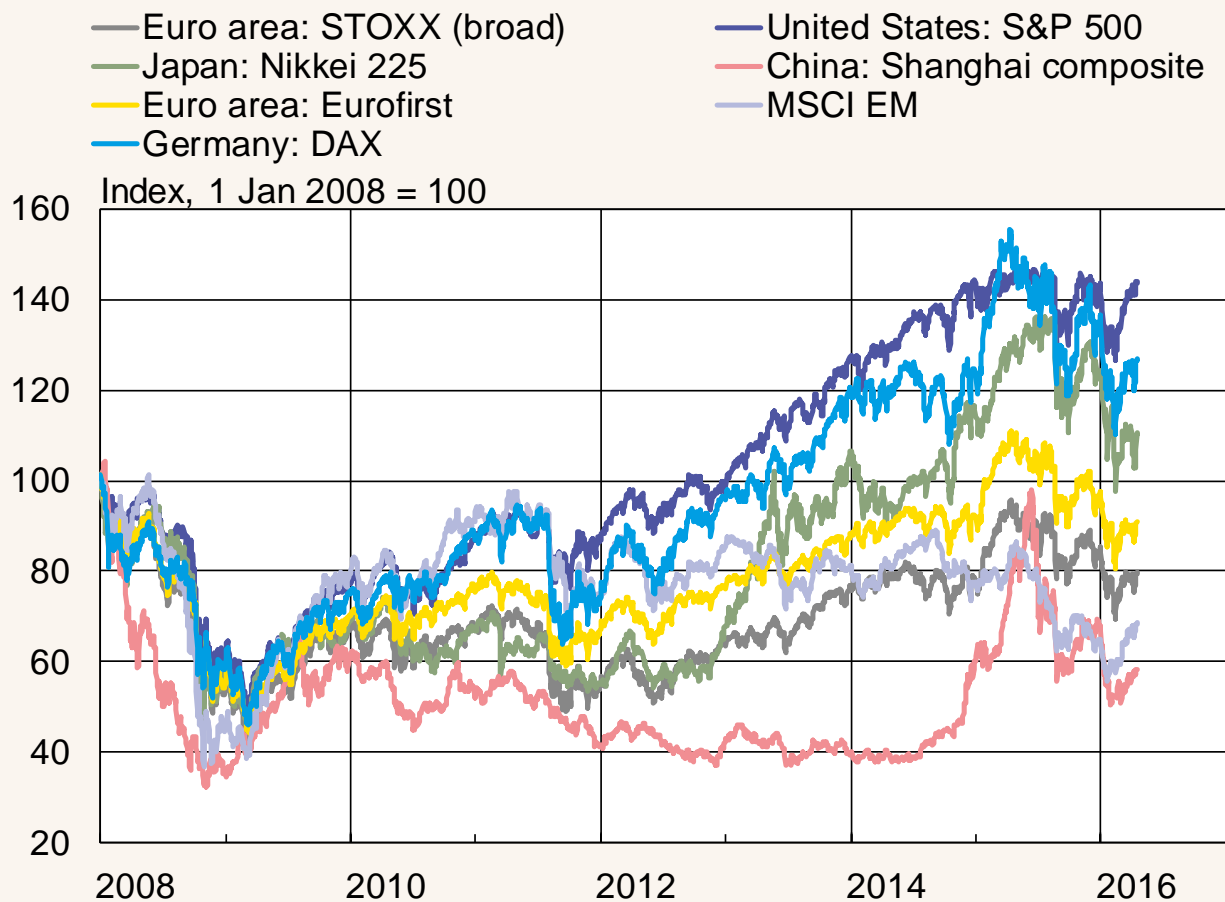


The figures for 2015-2017 are based on the European Commission's forecast.
Sources: European Commission and Macrobond.

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Stock markets have been very volatile

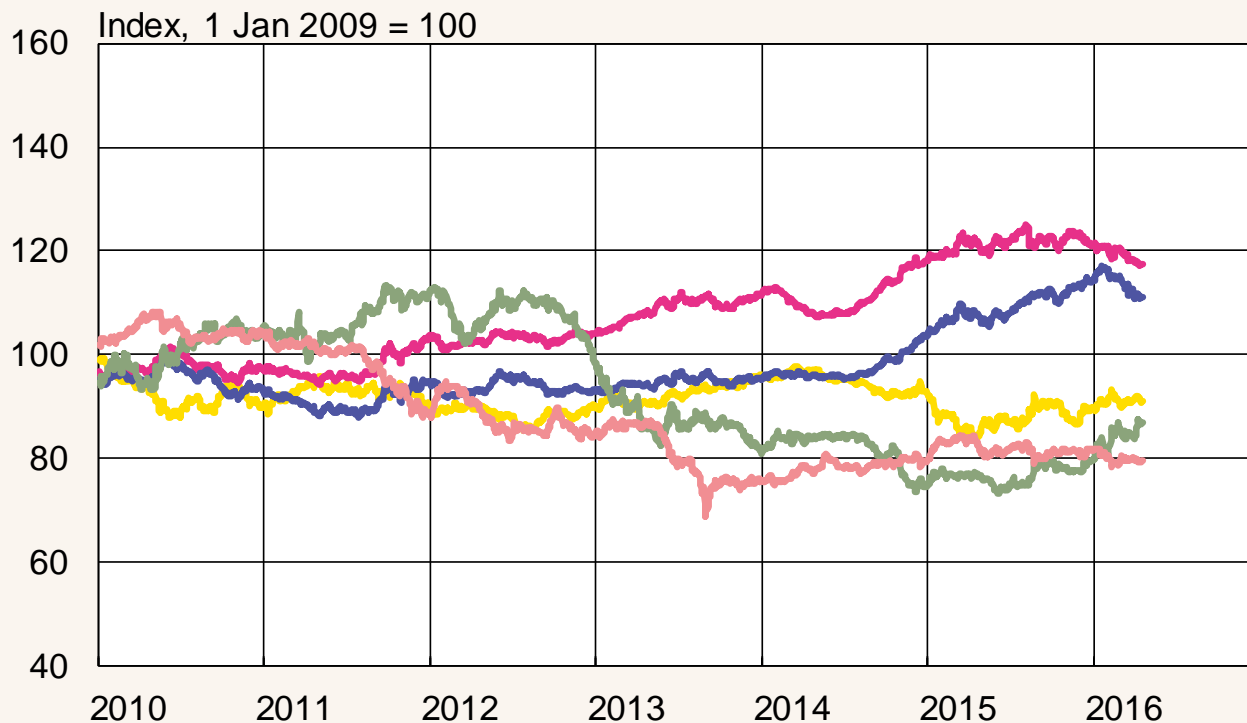


Lähde: Macrobond.
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Euro and yen have been appreciating this year

— Euro — Chinese renminbi — US dollar
— Japanese yen — Indian rupee



Nominal Effective Exchange Rate
Sources: JP Morgan and Macrobond.
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Euro area and world growth

**%change on previous year
(previous forecast)**

GDP	2015	2016f	2017f	2018f
EU22	1,5 (1,7)	1,4 (1,8)	1,7 (1,9)	1,7 (-)
United States	2,4 (2,6)	2,2 (3,0)	2,3 (2,8)	2,2 (-)
Japan	0,5 (0,6)	0,4 (1,1)	0,7 (1,0)	1,2 (-)
China	7 (7)	6 (6)	6 (6)	5 (-)
Russia	-4 (-4)	-3 (-2)	0 (1)	1 (-)
World	2,8 (3,0)	2,8 (3,2)	3,2 (3,5)	3,2 (-)
World trade	1,4 (1,8)	2,7 (3,7)	3,8 (4,5)	4,0 (-)

f = forecast

E22 = euro area, United Kingdom, Sweden and Denmark.



Inflation outlook

**%change on previous year
(previous forecast)**

Inflation	2015	2016f	2017f	2018f
EU22	0 (0)	0,2 (1,1)	1,2 (1,7)	1,6 (-)
United States	0,1 (0,2)	1 (1,6)	2,3 (2,0)	2,2 (-)
Japan	0,8 (0,4)	0,2 (1,1)	1,5 (1,6)	1,4 (-)

f = forecast
E22 = euro area, United Kingdom, Sweden and Denmark.



Forecast risks

- ***The euro area, external risks***
 - *A broad-based and strong slowdown in the global economy*
 - *E.g. a sudden halt in Chinese growth and decline in oil prices*
 - *Direct effects on demand*
 - *Balance sheet effects, dollar-denominated debt and exchange rates*

- ***Risks internal to the euro area***
 - *Euro area recovery still fragile*
 - *Long-term effects from the financial crisis*
 - *on individual euro area countries and banks*
 - *Political uncertainties*
 - *Brexit referendum on 23 June 2016*
 - *Handling of the refugee crisis*



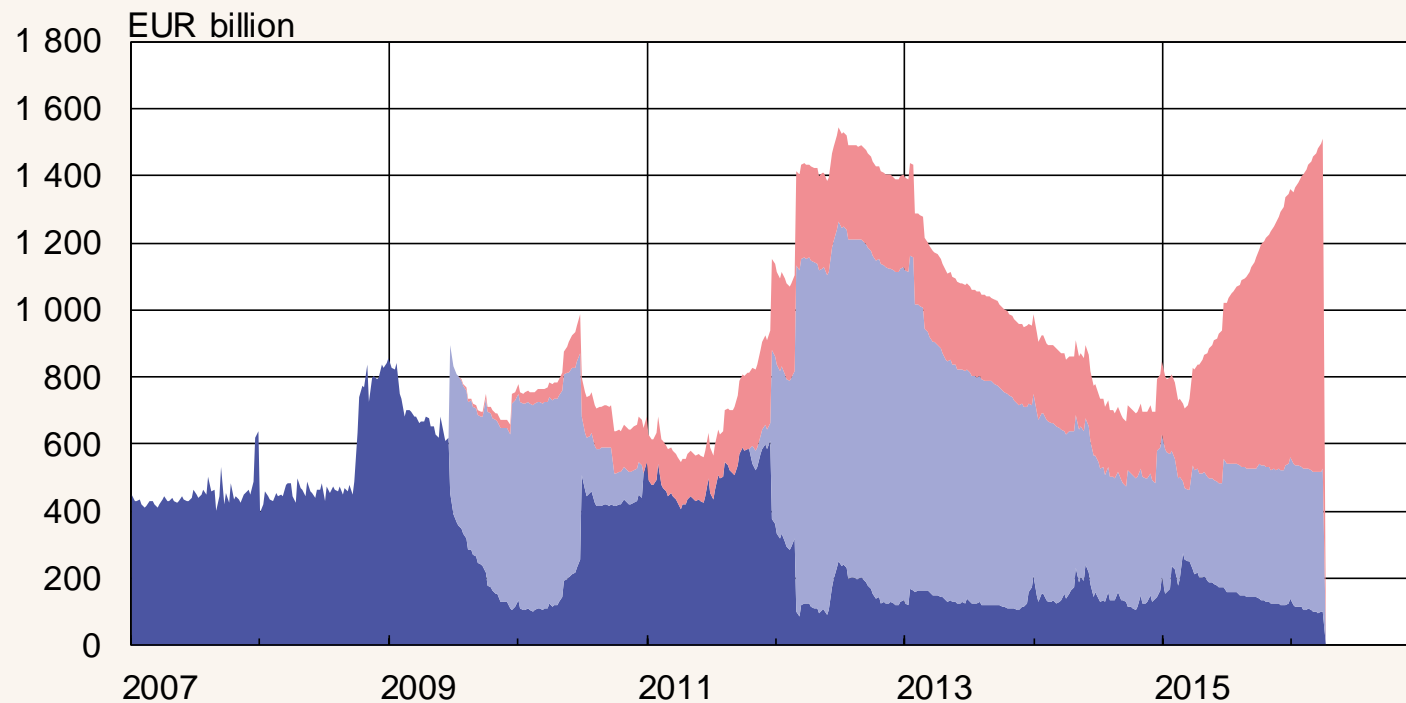
Monetary policy was eased on 10 March 2016 with the adoption of a comprehensive monetary policy package.



Refinancing operations and asset purchases

Credit operations and asset purchases

- Securities held for monetary policy purposes
- Targeted and other monetary policy refinancing operations of at least 12 months
- Regular and other short-term monetary policy operations



Sources: ECB and Macrobond.

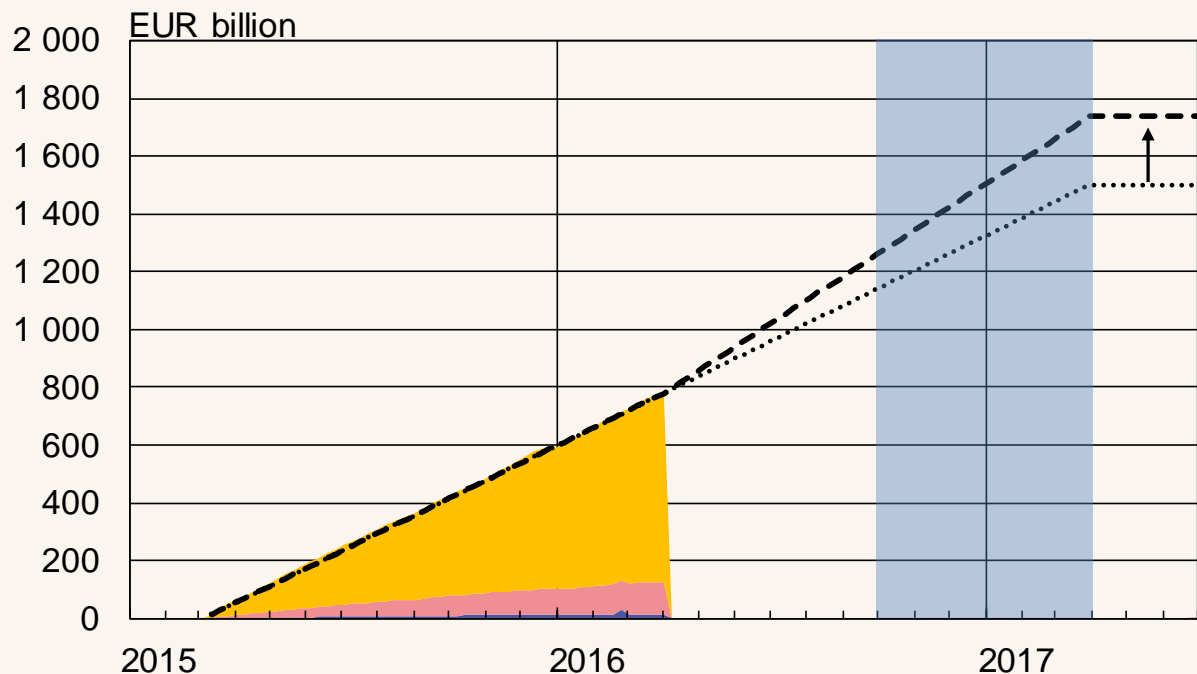
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Expanded asset purchase programme (EAPP)

Monthly purchase volumes increased from EUR 60 billion to EUR 80 billion

- Asset-backed securities
- Covered bonds
- Public sector debt securities



Sources: ECB and Macrobond.

The dashed line illustrates the target level announced in March, while the dotted line marks the previous target level as announced in December 2015.

18 March 2016
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Objectives of the March monetary policy decisions:

- *To further ease financing conditions in euro area countries*
- *To foster increased lending*

BACKGROUND:

- *Weakened outlook for global economy*
- *Tightening of financing conditions in early year*
- *Subdued inflation outlook*

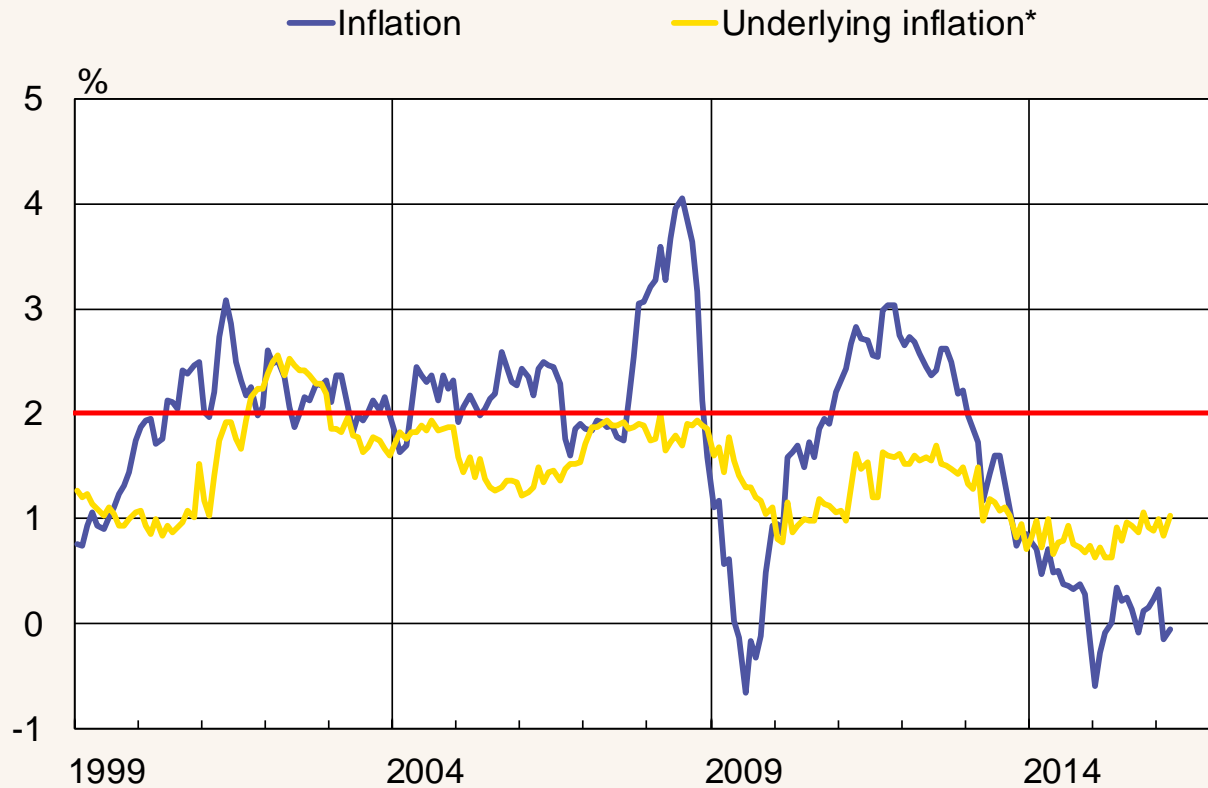


Inflation outlook weakened and expectations subdued



Still weak consumer price inflation

Euro area consumer price inflation (HICP)



* Underlying inflation = inflation excluding energy, food, alcohol and tobacco.

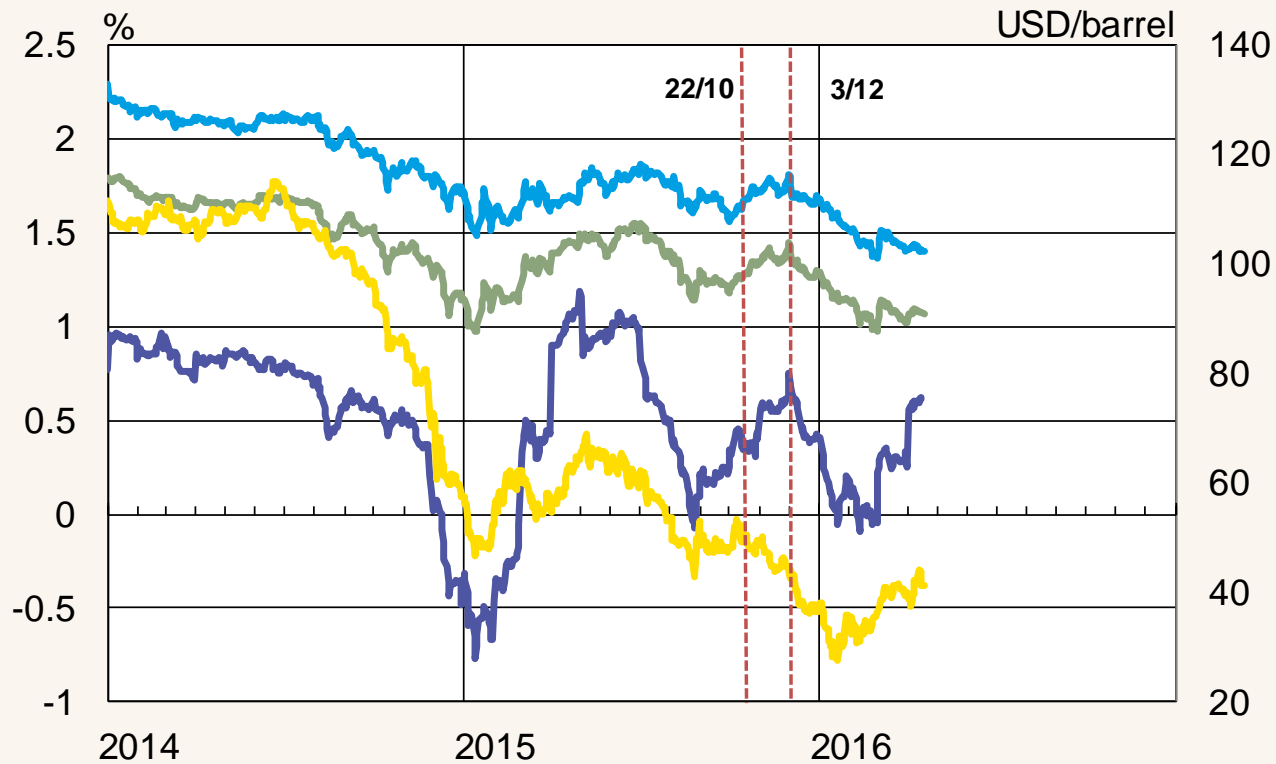
Sources: ECB and Bank of Finland.

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Oil price strongly depressing short-term inflation expectations

- 1-year inflation-linked swap rate
- 5-year inflation rate 5 years ahead
- 10-year inflation-linked swap rate
- Oil price (Brent) (right-hand scale)

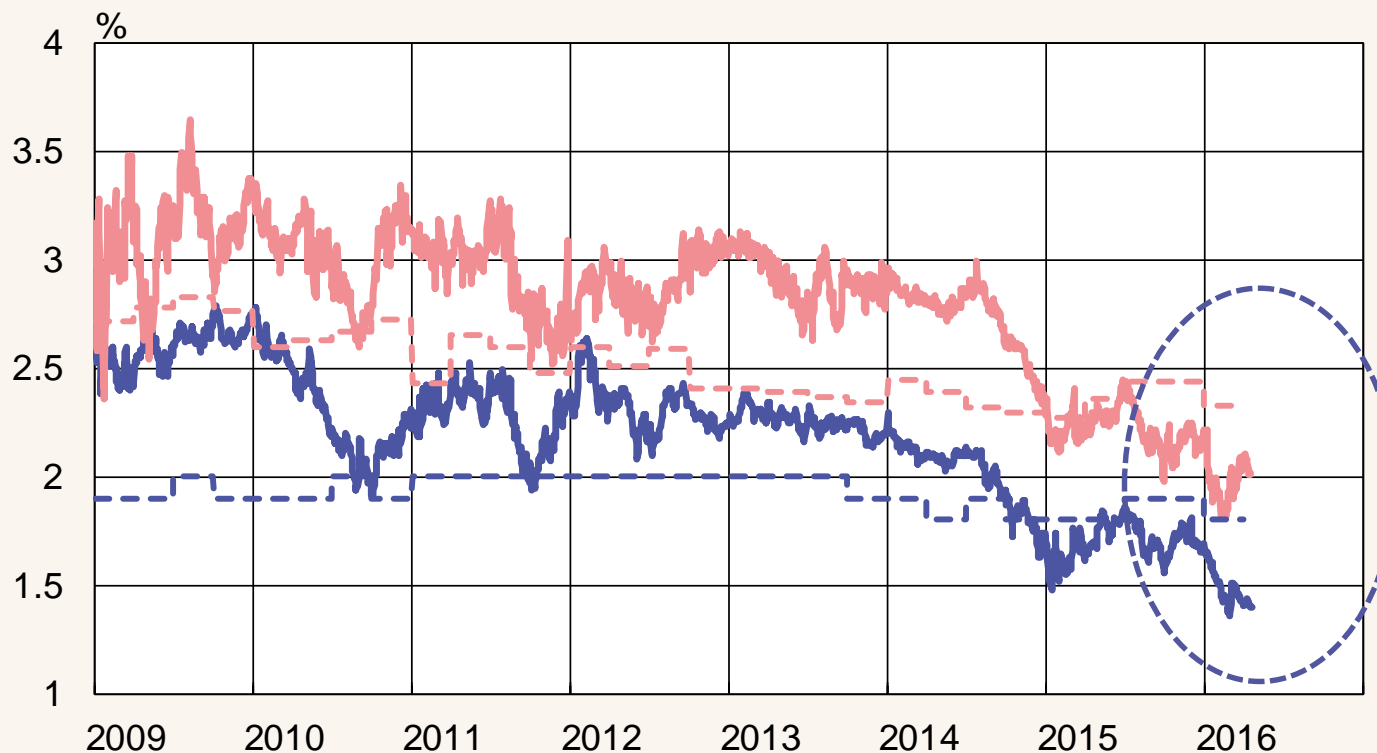


Sources: Bloomberg, Macrobond and calculations by the Bank of Finland.



Long-term inflation expectations have weakened again in euro area and USA

- Market expectations, euro area
- Market expectations, USA
- - - SPF survey, euro area
- - - SPF survey, USA



Sources: Bloomberg, ECB, Fed of Philadelphia and Macrobond.
Market expectations are based on 5-year and 10-year inflation-linked swap rates. The SPF survey horizon extends five years ahead.

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What monetary policy decisions were taken on 10 March?



Governing Council decisions in March 2016

- ***Monetary policy rates were lowered***
 - Key interest rate (MRO) to **0.0%** (change -5 bp)
 - Deposit facility rate to **-0.40%** (-10 bp)
- ***Monthly purchase volumes in the expanded asset purchase programme (EAPP) were expanded (by €20 bn) to €80 bn as of 1 April 2016***
 - Investment-grade bonds issued by non-banking-sector corporations were included on list of assets eligible for purchase
- ***A second series of targeted longer-term refinancing operations (TLTRO 2) will be launched in June 2016.***
 - These will enhance the transmission of monetary policy measures to the economy by encouraging banks to increase lending to the real economy.
 - Each operation will have a 4-year maturity, and the interest rate can be as low as the rate on the deposit facility.



Forward guidance on monetary policy

- ***Purchases are intended to run until at least the end of March 2017, or beyond, if necessary, until inflation is on a sustained path towards a level below, but close to, 2%.***
- ***In view of the current outlook for price stability, the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time, and well beyond the horizon of the asset purchases.***

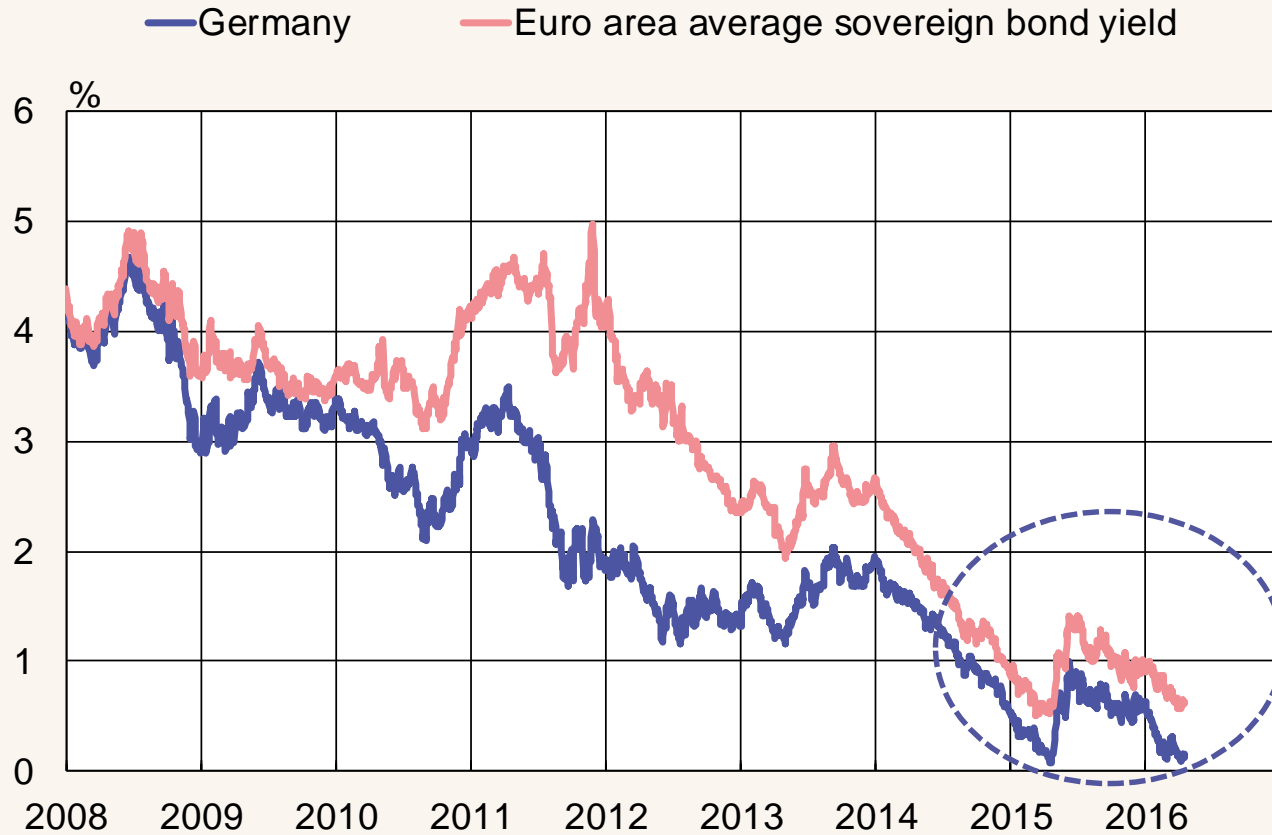


Transmission of monetary policy:

The historically accommodative stance of monetary policy supports economic recovery and price stability through several transmission channels.



Euro area sovereign bond yields at low levels



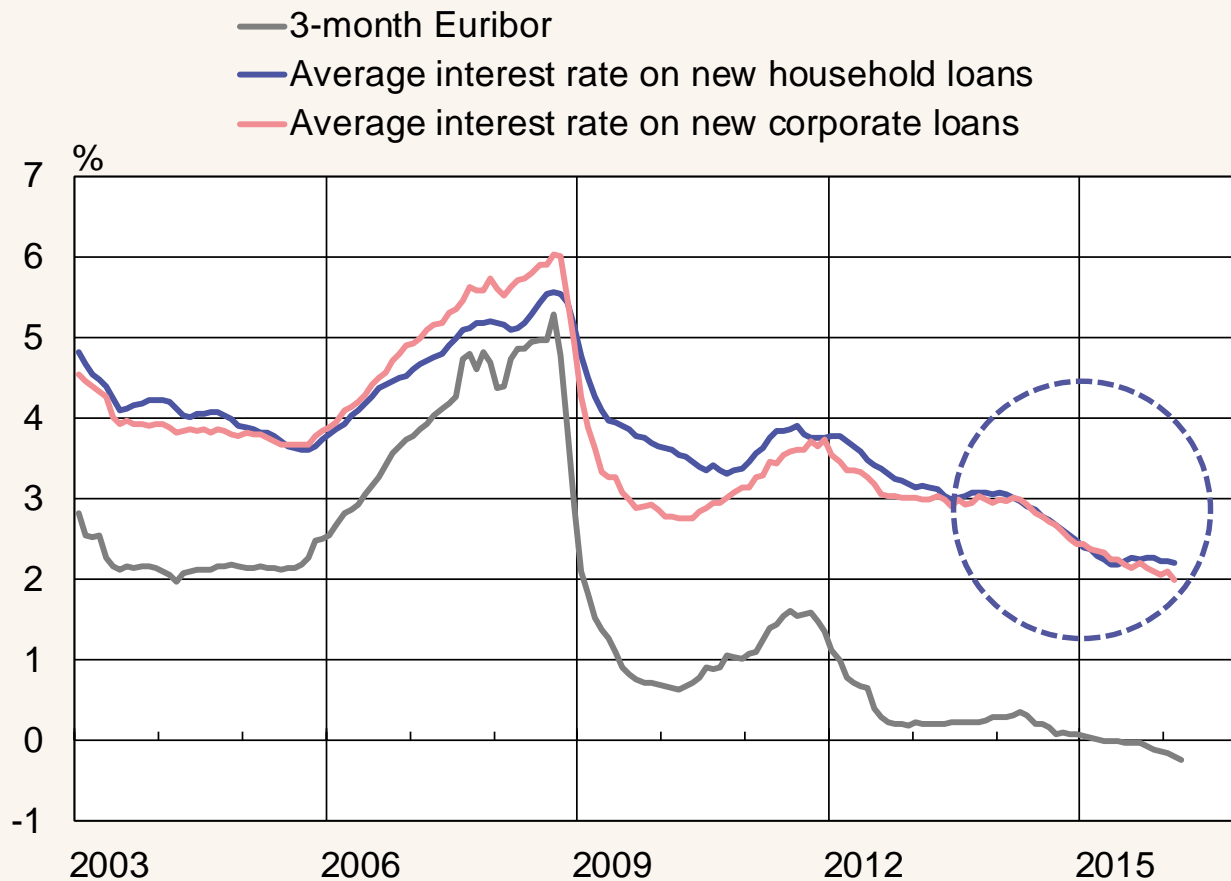
10-year sovereign bond yield.

Source: Macrobond.

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Bank lending rates on household and corporate loans have decreased



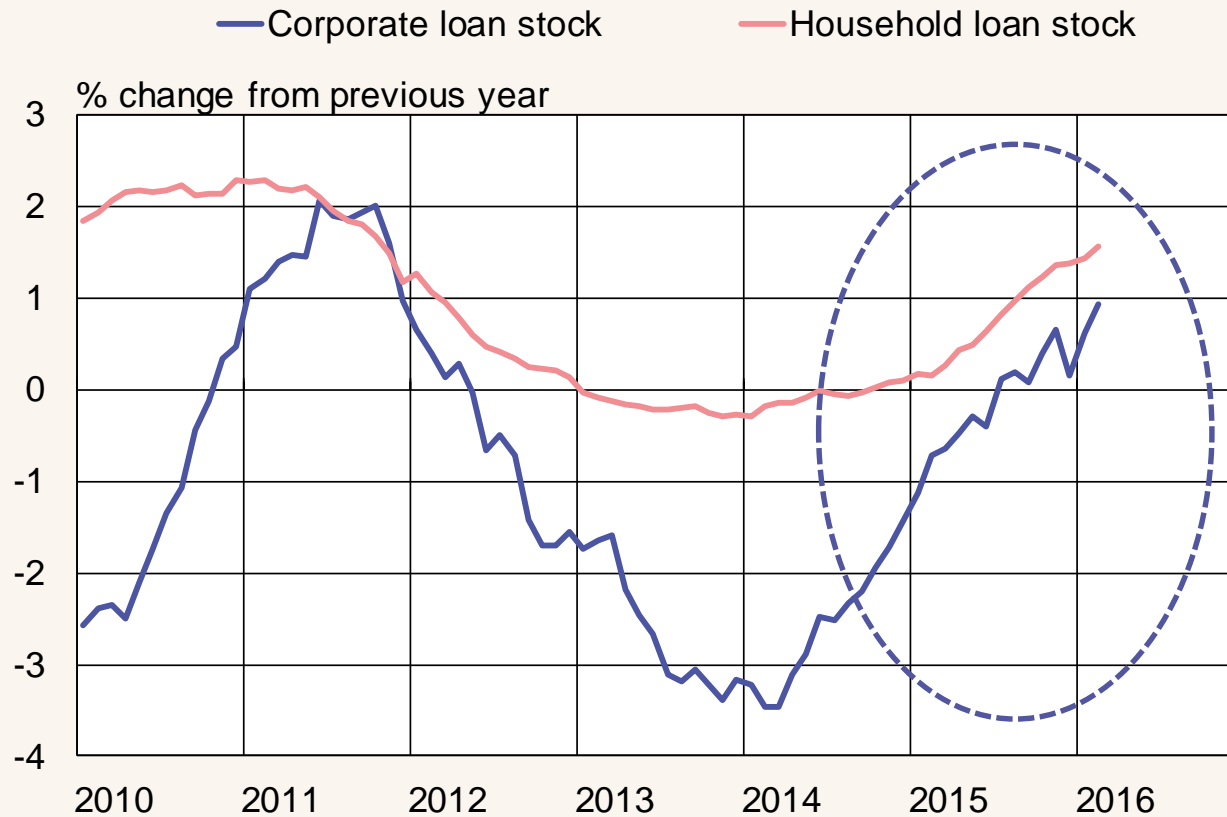
Sources: ECB and Macrobond.

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Growth in bank loans has accelerated

Annual growth in loan stocks



Loan stocks adjusted for balance sheet transfers and securitisation.
Sources: ECB and Macrobond.

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Condition of European banks



Banking Union: main elements

Banking Union: Euro area & opt-ins

Single Supervisory Mechanism (SSM)

- Efficient, effective supra-national supervision with the ECB at the centre
- Clear separation of monetary policy and supervision

Single Resolution Mechanism (SRM)

- Harmonised tools
- Investor/debtor responsibility (bail-in)
- Industry responsibility (resolution fund)
- No bail-out

European Deposit Insurance Scheme (EDIS)

- Commission proposal
- Three sequential stages
- National schemes would co-exist alongside EDIS

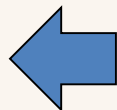
Single Rulebook (all EU)

Bail-out of banks

- Expensive, politically loaded
- Case-by-case decisions (ESM)



When this is properly done ...



...the likelihood of this is significantly reduced.



European Deposit Insurance Scheme (EDIS), proposal

- At present there is some harmonization but not yet a common framework.
- Member states differ in their position towards EDIS.
- According to the Commission proposal, EDIS would be developed over time in three stages:
- **PHASE 1: RE-INSURANCE (2017 - 2019)**
 - National Deposit Guarantee Schemes (DGS) could access EDIS funds only after exhausting its own resources.
 - EDIS funds will provide extra funds only up to a certain level.
- **PHASE 2: CO-INSURANCE (2020 - 2023)**
 - EDIS contributes from first euro of loss. The share contributed by EDIS would start at a low level and progressively increase.
- **PHASE 3: FULL INSURANCE National DGS (2024>)**
 - By gradually stepping up the share of risk that EDIS covers to 100%, EDIS will fully insure national DGS as of 2024.



Evolution of large banks' share prices at the beginning of the year

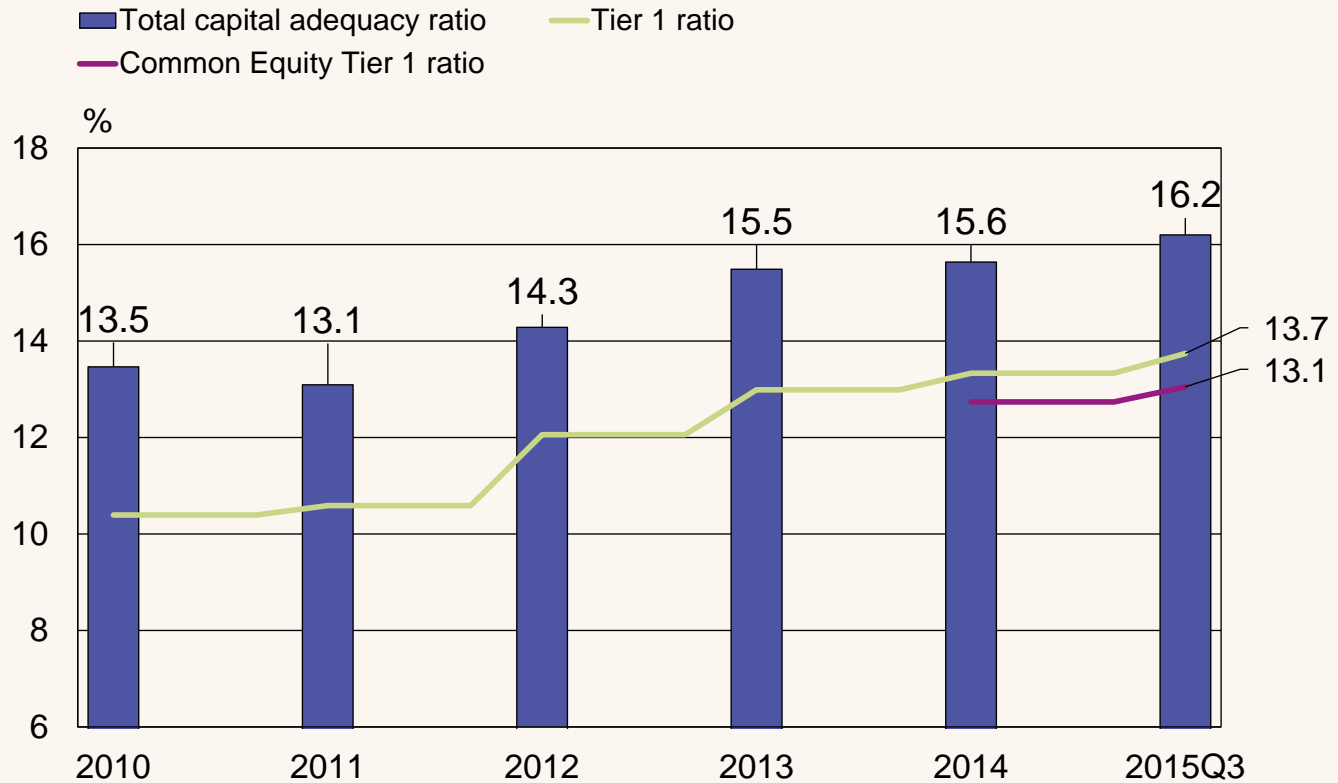
— Japan — United States — Europe — Nordic countries



Source: Bloomberg.



Euro area banks increased their capital



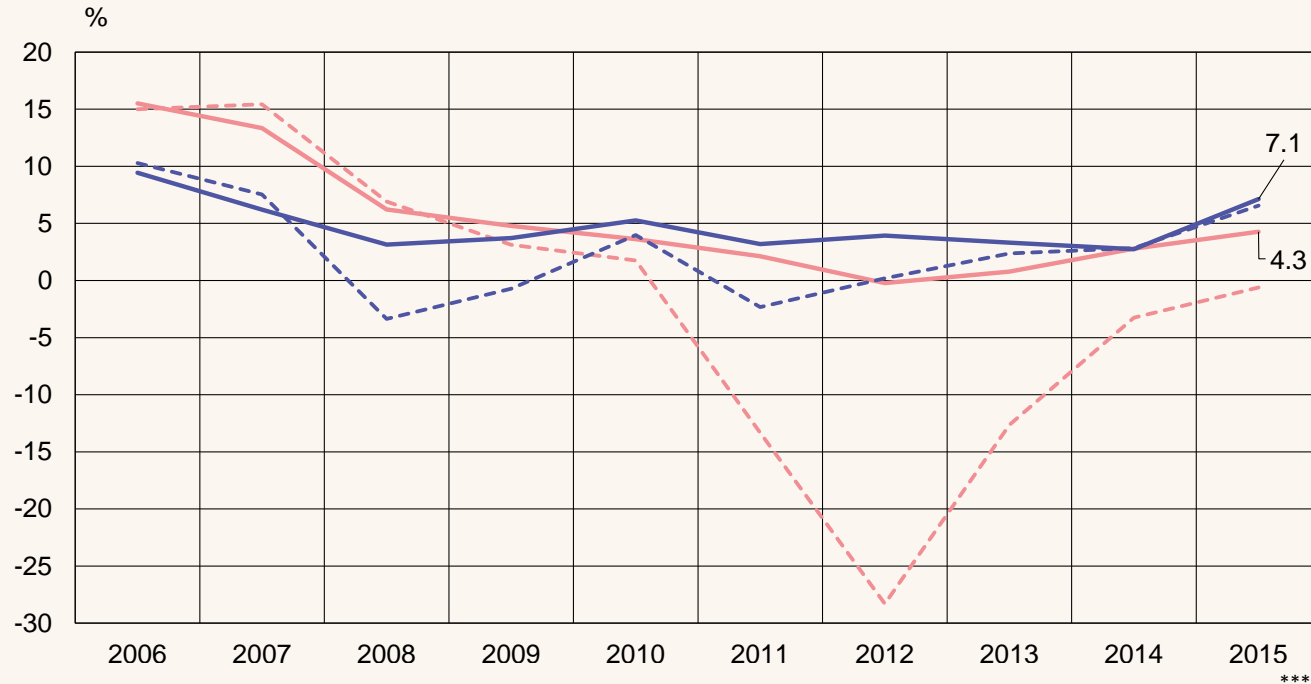
Source: European Central Bank.



Banks' financial results improved since the crisis

(Return on equity, ROE)

- Non-core countries, median *
- - - Non-core countries, unweighted average *
- Core-countries, median**
- - - Core-countries, unweighted average **



*Non-core countries = CY, ES, GR, IE, IT and SI.

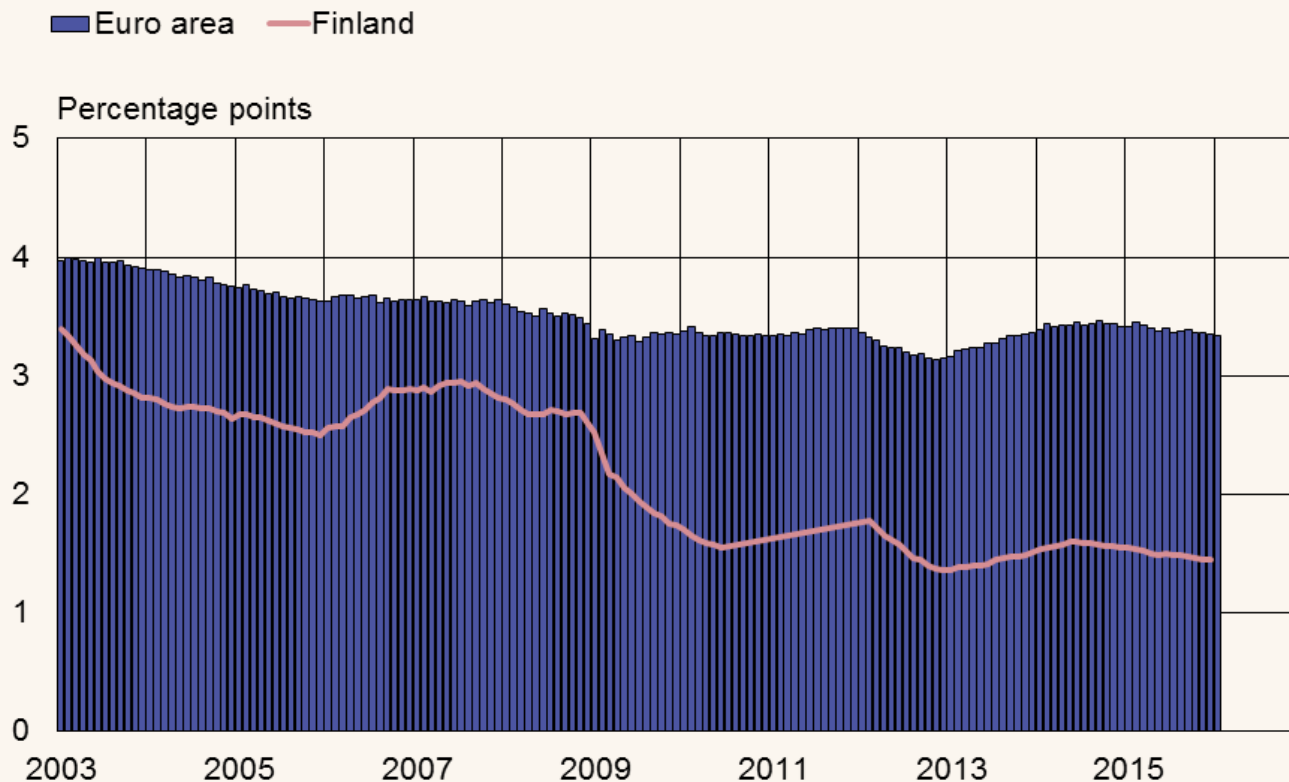
**Core-countries = AT, BE, DE, FI, FR and NL.

*** 2015 covers all banks that have reported year-end financial statement by 16 March 2016

Source: SnI.



The differential between bank lending and deposit rates has decreased



Source: European Central Bank.



Non-performing loans weigh on banks

- *The problem of non-performing loans particularly affects mid-sized banks in countries hit by the crisis.*
- *The amount of non-performing loans has decreased in some countries, but progress is uneven and takes time.*
- *A swift reduction in non-performing loans is essential for banks' ability to grant new loans.*



Tax-payers' or creditors' responsibility?

- ***The crisis resolution framework that entered into force at the beginning of the year emphasises creditor involvement in situations where a bank runs into trouble.***
- ***Functions critical to society can be preserved and problems dealt with in an orderly manner.***
- ***The transition to the new resolution framework will not be easy, but it is important to complete it.***



Banks' position in a nutshell

- ***Banks are already in better shape, but challenges remain.***
- ***Strong economic growth will improve profitability and help reduce the amount of non-performing loans.***
- ***Reducing the amount of non-performing loans is a precondition for improving banks' ability to function.***
- ***Well capitalised banks are key to an effective transmission of monetary policy.***



Thank you!