Overheating of global financial market could also have a destabilising impact on Finland

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An overheating of the international financial markets would spread to Finland, too, pushing up asset prices and possibly boosting the supply of loans. From a macroprudential perspective, strong growth in both these indicators would increase domestic vulnerabilities. The financial crisis has increased the understanding of cross-border stability risks, but the tools for mitigating these risks remain insufficient.

Finland's domestic financial market is tightly interconnected with the European financial markets. Stress on the latter would, via a number of different channels, have a strong impact also on the former. As overheating and the resulting correction in prices is currently considered one of the most significant risks on the global financial markets, from the perspective of financial stability it is of key importance to examine the possible impacts of such a scenario on Finland.

The scenario examined in this article covers the period between April 2015 and the end of 2017. The impact study utilises the structural VAR model presented by Gulan, Haavio & Kilponen (2014).[1]

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1. Gulan, Adam – Haavio, Markus – Kilponen, Juha (2014) From Finnish Great Depression to Great Recession. Bank of Finland Bulletin 3/2014. Bank of Finland.

The adverse scenario assumes that the exceptionally strong positive trend in the global financial markets will continue for a further 18 months. During this period, share prices would rise in Finland by 27.5% and the interest rate margins on bank loans remain at the current narrow levels. In the scenario, the indicator of contemporaneous systemic stress[2] and disruptions in financial intermediation on the euro area financial markets remain at a very low level for the entire period of 18 months.

The scenario examined is largely in line with developments that preceded the global financial crisis. It is a composite of conditions prevailing in 2006–2009 in various financial market segments, a combination of the prevailing environment of low interest rates, easy access to finance, moderate loan margins and a strong rise in share prices.

In the scenario, an 18-month period of robust growth on the financial markets is followed by a strong negative correction that extensively paralyses the international financial markets in the subsequent 18 months. During this period, the contemporaneous stress on the financial markets grows and financial intermediation through the markets decreases, while share prices on the domestic market follow global developments and collapse by 50%. In addition, the interest rate margins on bank loans widen by approximately one percentage point by 2017, reflecting risk re-pricing and banks' higher funding costs.

The results of the adverse scenario described here are contrasted with a baseline scenario that, in terms of GDP and inflation developments, corresponds to the Bank of Finland's latest macroeconomic forecast. Differences between the adverse scenario and the baseline scenario are due to disruptions on the international financial markets, asset prices, domestic loan supply and domestic supply and demand.

Compared with the baseline scenario, a positive outcome of the adverse scenario and the related strong growth in international financial market activity would boost asset prices by 30% and increase domestic lending by 18% (Chart 1). GDP growth would improve by 1.2 percentage points compared with the baseline scenario, and, at the same time, inflation would accelerate by approximately one percentage point. The model would forecast a sudden end to the current period of slow inflation.

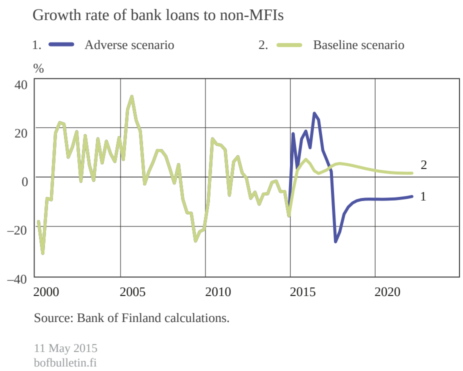

Chart 1

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2. Holló, Dániel – Kremer, Manfred – Lo Duca, Marco (2012) CISS – a composite indicator of systemic stress in the financial system. ECB working paper No 1426.

In the adverse scenario, the strong negative correction on the international financial markets would start 18 months after a period of exceptionally positive developments. A negative correction on the financial markets would hamper the acquisition of market funding and increase its cost, while also resulting in a strong downward correction in asset prices. Compared with the baseline scenario, asset prices would decline in Finland by 36%, the volume of new loans would decrease by 7%, and quarterly loan losses would reach EUR 350 million by the end of 2017 (Chart 2). GDP growth would collapse in 2017 by 2.7 percentage points compared with the baseline.

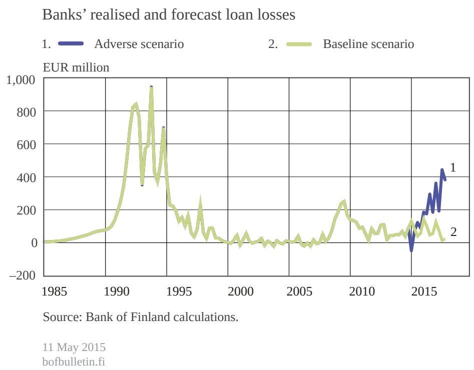

Chart 2

As the simulation shows, developments on global financial markets have a significant impact on the domestic financial system and macroeconomic developments in Finland. The possibility of cross-border risks to financial stability are now better recognised than before the financial crisis, and this helps us prepare for the risks. Tools must be developed to prevent disruptions generated on the international financial markets and to mitigate their adverse impacts.

Tags

financial markets, overheating, macroprudential stability