Euro area set to recover

2 Oct 2015 – Monetary Policy Review – Monetary policy

Monetary policy in the euro area has been highly accommodative in recent years. The accommodative stance has also been reflected in banks' lending rates. The transmission of monetary policy has become more effective, following the strengthening of the euro area banking system and the improvement in banks' capital adequacy from previous years.

The euro area economy is getting back on track. In 2014, private consumption was the component of overall demand that made the strongest contribution to GDP growth. A pick-up in investment is hampered by weak profitability, an abundance of spare production capacity and, partly, by bottlenecks in lending. Euro area fiscal policy will be relatively growth neutral in the immediate years ahead.

Euro area inflation remains very low and well below the ECB's price stability objective. The sliding price of oil has been the major single factor underlying the sudden deceleration in inflation. However, the rate of inflation has already been well below its long-term average for a prolonged period.

Growth and inflation risks in the euro area can be divided into external, internal and longer-term risks. The key external risk relates to a deterioration in the growth outlook for emerging economies, while the major internal risk relates to a permanent or even aggravated segregation of euro area countries. Longer-term risks include population ageing, lacklustre growth in output potential and weaker risk resilience in the public finances of several euro area countries. The recent surge in refugee flows has created a new challenge for Europe that could also be an opportunity for the ageing continent.

ECB committed to accommodative monetary policy

In 2014, economic developments in the euro area deteriorated, inflation edged down and inflation expectations dampened. In response, the ECB's Governing Council took a decision in January 2015 to introduce further accommodation of monetary policy by expanding the asset purchase programme to also include public sector securities. The ECB and euro area national central banks are to purchase public sector debt securities, covered bank obligations and private asset-backed securities to a total monthly value of EUR 60 billion. Purchases are to be carried out until the end of September 2016 and will in any case be conducted until the Governing Council sees a sustained adjustment in the path of inflation consistent with the aim of achieving inflation rates below, but close to, 2% over the medium term.

The Governing Council has emphasised its commitment to the full-scale implementation of the asset purchase programme. The carrying through of the decisions taken has been seen as a condition for the return of inflation to a path consistent with the target, in the years ahead. To ensure smooth progress of the asset purchase programme, the Governing Council took a decision in September to increase the share issue limit from the initial limit of 25% to 33%.[1]

The pick-up in inflation expectations in the first half of the year is consistent with desired developments, but actual inflation is only barely positive and the rate of inflation has not yet been brought back onto a sustainable path towards the target. The oil price decline since June has put downward pressure on inflation, thereby lowering market-based inflation expectations. (Chart 1).

Chart 1

1. This is subject to a case-by-case verification that this would not create a situation whereby the Eurosystem would have blocking minority power.

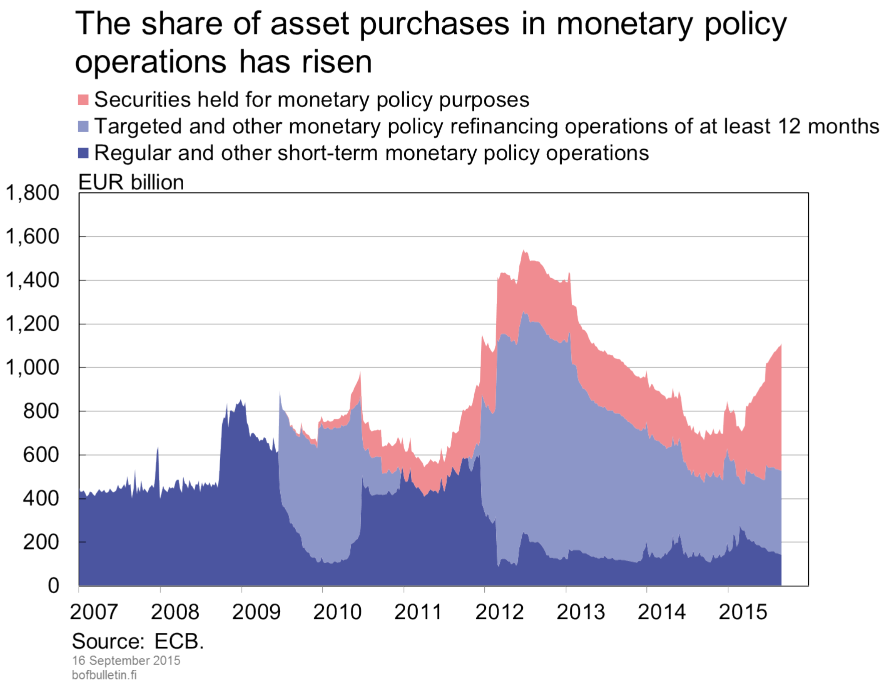
In late summer, short-term inflation expectations fell markedly, as did longer-term expectations. While the oil price slide alone has a temporary dampening effect on inflation, there is a danger of a more persistent deceleration in inflation if inflation expectations are formed in a context of slow inflation. Against the backdrop of recent developments in inflation and inflation expectations, there is no reason to question the necessity of full-scale implementation of the asset purchase programme.

The Governing Council will closely monitor all relevant incoming information and emphasises its willingness and ability to use all the instruments available within its mandate. If warranted, the current expanded asset purchase programme (EAPP) provides sufficient flexibility for further monetary accommodation by adjustment of the size, composition or duration of the programme.

A highly accommodative monetary policy

By the end of August, securities worth around EUR 360 billion had been purchased within the framework of EAPP. The programme provides for an expansion of the Eurosystem balance sheet and an increase in the share of securities in monetary policy operations. (Chart 2).

Chart 2



The EAPP is a non-standard monetary policy measure. Such measures can be adopted for two reasons: to support the transmission of monetary policy using the key policy interest rate and to ease financial conditions especially where the key policy rate has hit the zero lower bound in nominal terms, thus preventing its further use in implementing monetary policy.

In the early days of the financial crisis, the former reason prevailed, reflected in an increase in credit from monetary policy operations. In autumn 2008, the monetary policy stance was relaxed by reducing key interest rates, while, at the same time, the transmission of monetary policy was enhanced by lifting the quantitative restrictions on the provision of liquidity to the banking system. The Governing Council strengthened the transmission of monetary policy to longer-term interest rates notably by lengthening the maturities of central bank credit. In summer 2009, the Eurosystem conducted the first longer-term refinancing operation with a maturity of 12 months, and in the two longer-term refinancing operations undertaken at the turn of 2011/2012 central bank credit was provided with maturities as long as three years. Beginning in 2009, the effectiveness of monetary policy transmission has since been further increased through asset purchases (Securities Markets Programme (SMP) and Covered Bond Purchase Programmes (CBPP)), but these programmes accounted for only 20% of the securities held for monetary policy purposes shown on the Eurosystem balance sheet. (Chart 2).

Following the lowering of the ECB's key interest rates to the lower technical bound in 2014, asset purchases have been resorted to for further monetary accommodation. These measures are generally referred to as quantitative easing (QE). The asset purchase programme has been reflected in an expansion of securities holdings on the Eurosystem balance sheet. At the end of August 2015, over 50% of the monetary policy operations on the Eurosystem balance sheet comprised securities purchases.[2]

In the context of non-standard monetary policy instruments, an unambiguous representation of the monetary policy stance – i.e. the degree of accommodation afforded to economic growth – cannot be provided. When applying standard monetary policy tools, the stance of monetary policy can be examined against the movements in key policy rates or short-term (risk-free) market rates.

The monetary policy stance at the zero lower bound of nominal interest rates can be analysed using what is referred to as a 'shadow policy rate'. The shadow policy rate provides a gauge of the hypothetical policy rate in the absence of a zero lower bound on nominal interest rates. The non-standard measures of monetary accommodation adopted at the zero lower bound of nominal interest rates are, hence, reflected as negative values of the shadow policy rate.

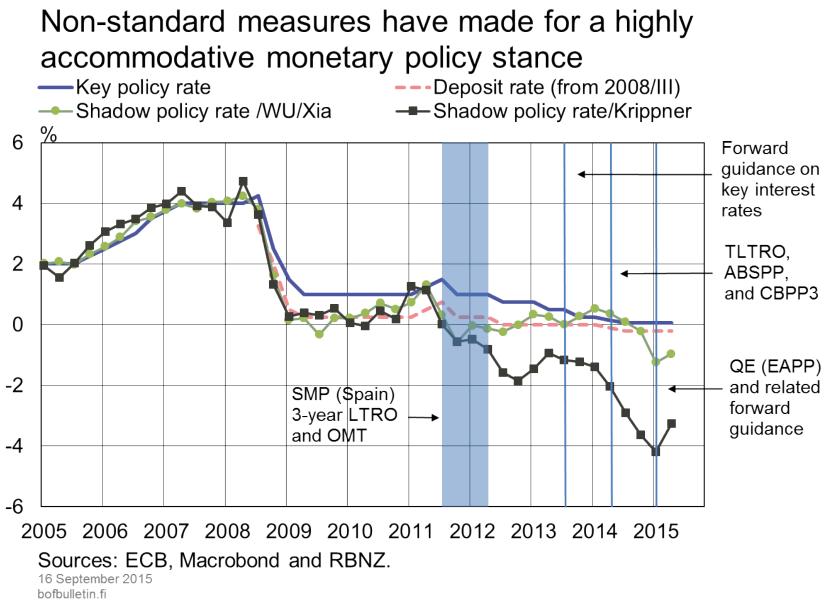
The shadow policy rate can be conceived as providing an answer to the question what policy rate would produce the perceived level of interest rates if there are no bounds on how deep the policy rate can be driven into negative territory. The idea is that non-standard policy measures are adopted to reduce the level of interest rates in the economy, while the shadow policy rate is used to assess how large a reduction in the key policy rate would have produced a decline of the same magnitude.

The shadow policy rate is a latent variable and calculation of the rate must therefore be based on a model. There are two publicly available estimates of the shadow interest rate for the euro area: one is based on a model developed by the Federal Reserve Bank of New Zealand economist Leo Krippner and another is based on the model of University of

2. The significance of monetary policy measures is, however, not directly quantifiable from the Eurosystem balance sheet. For example, the Outright Monetary Transactions (OMT) scheme was a highly effective measure of monetary policy despite the total absence of asset purchases. Forward guidance is another significant monetary policy instrument that is not directly reflected on the Eurosystem balance sheet.

Chicago researchers Wu and Xia (Chart 3).

Chart 3



Shadow interest rates indicate that the variety of non-standard policy measures adopted in the euro area have provided a higher degree of monetary accommodation than suggested by developments in key interest rates alone: both shadow interest rates are well below key ECB interest rates. The level of the shadow rate is, however, surrounded by considerable uncertainty, with different models producing highly divergent outcomes of the stance of monetary policy. In any case, shadow interest rates demonstrate that the non-standard measures already adopted have eased monetary policy, while the EAPP has heralded a highly accommodative monetary policy stance. The non-standard measures help maintain an active monetary policy in the absence of the interest rate tool.

Financial conditions eased in euro area

The interest rates prevailing in the economy are the product of yields on debt securities of varying maturities, with yield also being one determinant of banks' lending rates. Monetary policy purchases reduce market rates and, by extension, banks' lending rates. This, in turn, boosts investment and consumption.

The yield on debt securities of varying maturities can be expressed as the sum of two factors. The first factor represents risk-free yield, defined as the average of expected short-term interest rates over the maturity of the instrument. The second factor is the risk premium, i.e. the yield (compensation) required by investors, for example in return for not investing in low-risk debt securities of short maturities.

The transmission mechanisms of the asset purchases undertaken as a measure of monetary accommodation can be divided into two main categories: 1) the signalling channel and 2) the portfolio rebalance channel.[3] The signalling channel influences yields by lowering risk-free yield, while the portfolio rebalance channel works to reduce risk premia.

Through the signalling channel for asset purchases the central bank conveys signals that it is committed to an accommodative monetary policy in the future. Consequently, financial markets expect short-term rates to remain low for a prolonged period, which is reflected in lower yields on all debt instruments.

The portfolio effect may arise in a number of ways, but the key feature of all mechanisms is that the amount (or maturity) of debt instruments held by the public is reduced by the asset purchases and the balance sheets of market participants are adjusted to reduce risks. In response, the supply of long-term assets will decline, cutting the compensation received for holding them.[4] In addition, market participants may attempt to compensate for balance sheet adjustments by purchasing higher-risk securities, pushing up their prices.

Market expectations of the launch of quantitative easing reduced government bond yields already before a decision on the asset purchase programme had been taken. Once the purchases began, yields fell further, but in late April 2015 yields at longer maturities, in particular, began to rise (Chart 4). This trend was reversed at the end of June, when longer-maturity yields turned down again. At the same time, however, yields at short maturities have remained more or less unchanged. This speaks of market confidence in the Governing Council's commitment to the asset purchase programme, and yields on short-term assets therefore reflect a stance of monetary policy consistent with forward guidance.

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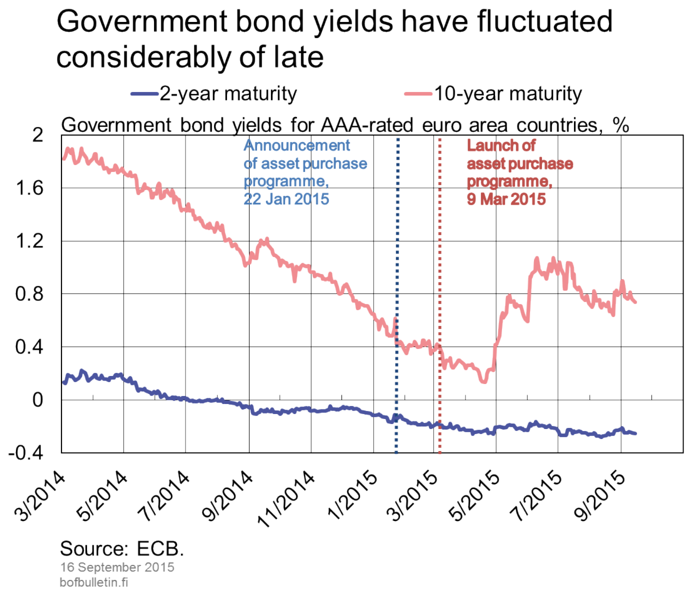
3. This is not a clear-cut division, as both channels are present in some mechanisms. In addition there is a third transmission channel related to asset purchases, namely that of inflation expectations, where inflation expectations in the economy arise under the combined influence of monetary and fiscal policy.
4. For the supply of debt securities of a certain maturity to have an impact on yields, there must be rigidities and incompleteness on the bond markets. Asset valuation models typically do not capture the portfolio effect, as the models do not feature the necessary rigidities, which means that yields are unaffected by the supply of assets. This may have prompted Ben Bernanke to say that 'quantitative easing works in practice, not in theory'. See 'Central banking after the great recession: lessons learned and challenges ahead' (16 Jan 2014). The Brookings Institution.

Chart 4



Various potential reasons have been cited for the increase in yields on long-maturity bonds in spring and summer 2015. Firstly, expectations of economic growth and inflation gathered strength, raising the prospects of a future tightening of the monetary policy stance. Secondly, many euro area countries have stepped up their bond issuance, thus adding to the supply of bonds. This reduces the portfolio balance effect of the asset purchases. Thirdly, long-term interest rates fell markedly before the launch of the Eurosystem government bond purchases and in the first few weeks after the launch. The market may have overestimated the impact of the asset purchases on the bond market, especially as regards availability, in which case the increase in yield levels since late April may represent a correction of excessive expectations. Fourthly, there is a host of market-technical and seasonal reasons.

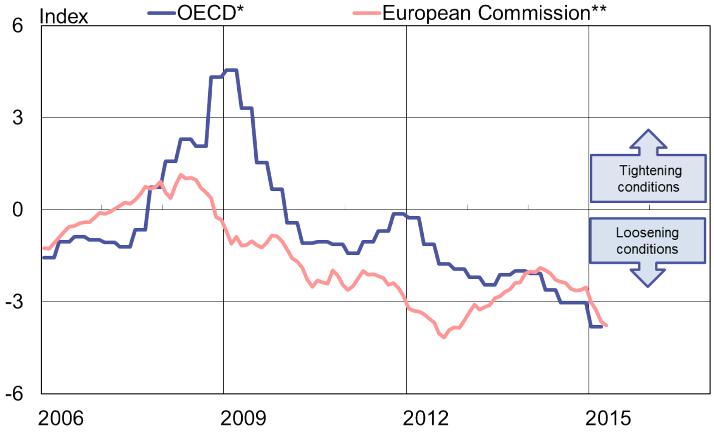
Conversely, trends moving in the opposite direction to those mentioned above are reflected in lower bond yields. The fluctuation in yields witnessed since the end of June may at least be found to be consistent with inflation expectations.

Overall, in the longer-term perspective, it can be established that the Eurosystem purchases of government bonds and related forward guidance have reduced government bond yields. In other words, the EAPP and the related forward guidance have, as expected, pushed down longer-term interest rates in the euro area. However, considering that there are other determinants of government bond yields besides monetary policy, influencing yields by means of monetary policy is more difficult than, for example, influencing short-term market rates by the key policy rate.

To ensure appropriate transmission of the asset purchases undertaken as a measure of monetary accommodation it is important that the decline in bond yields feeds through to the broader economy in the form of lower financing costs. The indices computed by the OECD and the European Commission both point to a significant easing of monetary conditions in the euro area since the beginning of 2015 (Chart 5).

Chart 5

Euro area indices point to a relaxation in financial conditions



Sources: OECD and European Commission.
* Financial Conditions Index (FCI) includes short-term and long-term interest rates, corporate loan spread, credit availability, household wealth position. Reverse index.
** Monetary Conditions Index (MCI) includes short-term interest rates and the exchange rate.
16 September 2015
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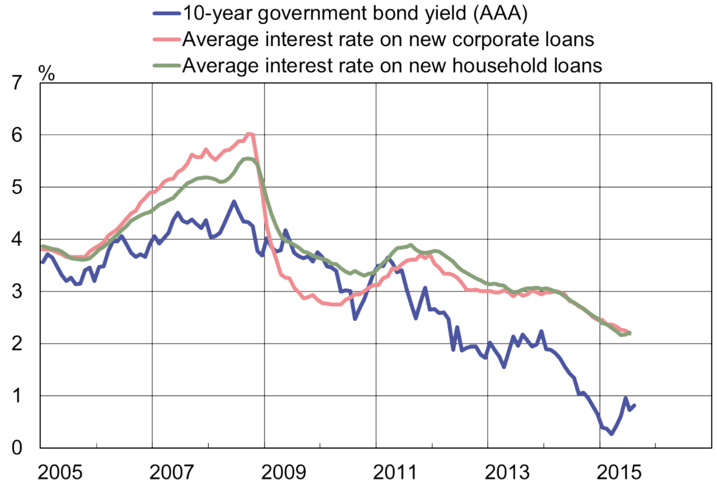
The accommodative stance is also reflected in banks' lending rates. Given the bank-centred structure of the euro area financial system, monetary policy measures should also be reflected in an expansion of bank lending volumes and a reduction in the average lending rate. Notwithstanding the fluctuation in government bond yields, banks' lending rates for both non-financial corporations and households continued their downward trend in the summer (Chart 6).

Chart 6

Lower lending rates also contributed to easing of euro area financial conditions



Sources: ECB and Macrobond.
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In the early part of 2015, the yield spread of bank loans versus government bonds surged close to the record level witnessed in 2008, i.e. 2 percentage points. Before the crisis, the interest rate spread was only half as big. In a context of favourable economic developments there may be further room for lowering lending rates, even if market rates remain higher.

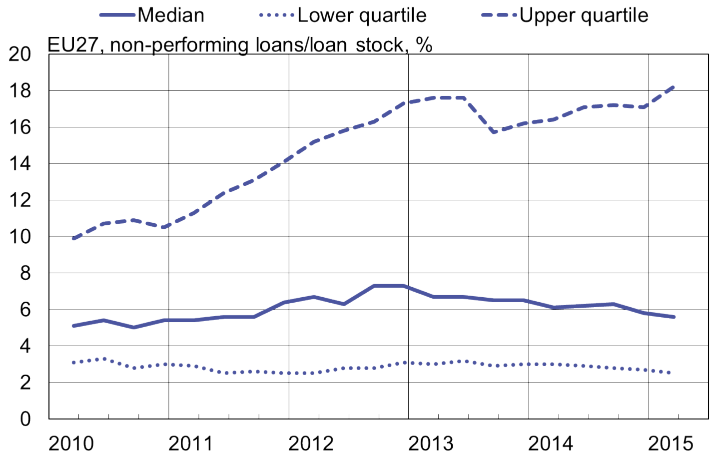
Banks now focusing on traditional banking

The euro area banking system has become stronger and banks' capital adequacy improved from previous years. Stronger capital adequacy is of vital importance for banks to be able to increase lending and, thereby, support recovery in the real economy and the transmission of monetary policy.

After two years' of contraction, banks' balance sheets began to expand towards the end of 2014. Banks have disposed of risk-weighted assets, increased lending and built up equity. Owing to the poor profitability of recent years, the build-up of equity using retained earnings has proved challenging in the euro area overall. Banks have therefore resorted to share issues as a source of market funding. The relatively large number of bank share issues seen over the past few years is illustrated by the fact that banks' net share issues over the past three years accounted for more than half of total net share issues in the euro area, although the market value of banks represents a mere tenth of the entire stock market.

Chart 7

Non-performing loans as a proportion of the loan stock have declined, but large differences between countries remain



Source: EBA.
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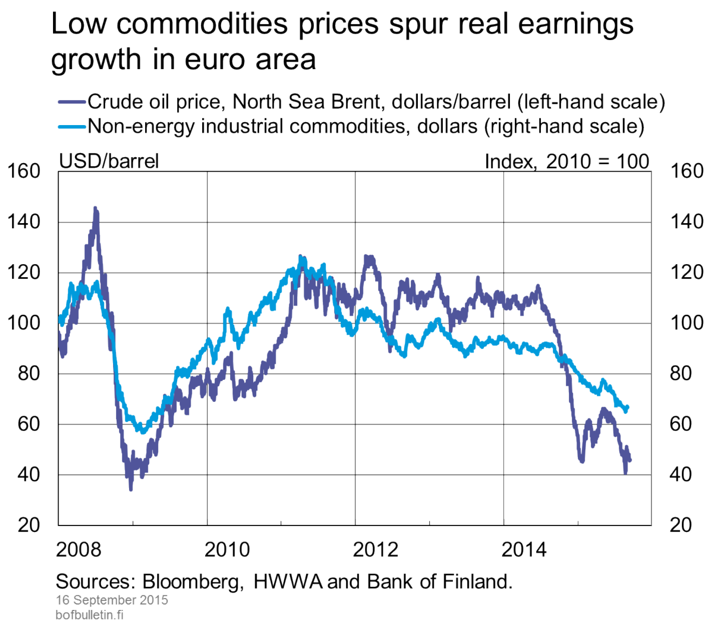
The banking sector is burdened by non-performing loans, remnants of pre-crisis excessive debt accumulation by the private sector and the poor economic situation in the aftermath of the crisis (Chart 7). The large amount of non-performing loans weighs on the profitability of banks, as it implies lower interest yields and higher loan loss provisions. In addition, non-performing loans consume more of banks' limited equity, in relative terms, thereby reducing the assets available for lending. In step with the recovery of the economy, the proportion of non-performing assets in the lending stock has gradually begun to shrink, although differences across countries remain large. Looking at the financially stressed countries, proportions of non-performing loans have been gradually declining, especially in Spain and Ireland, whereas the proportions of non-performing loans in the existing loan stock in Greece, Cyprus and Italy have recently increased further.

The general decline in loan losses boosts the profitability of banks. Profitability has also been improved by a shift in banks' business focus. They have increased the share of low-risk corporate and housing loans on their balance sheets, and, correspondingly, reduced investment banking activities. As lending is increasingly financed with deposits (in addition to which banks have access to central bank money at low cost), developments in net interest income have been favourable given the circumstances. However, despite the gradual improvement underway in the profitability of euro area banks, average profitability still remains well below pre-crisis levels.

Euro area economy getting back on track

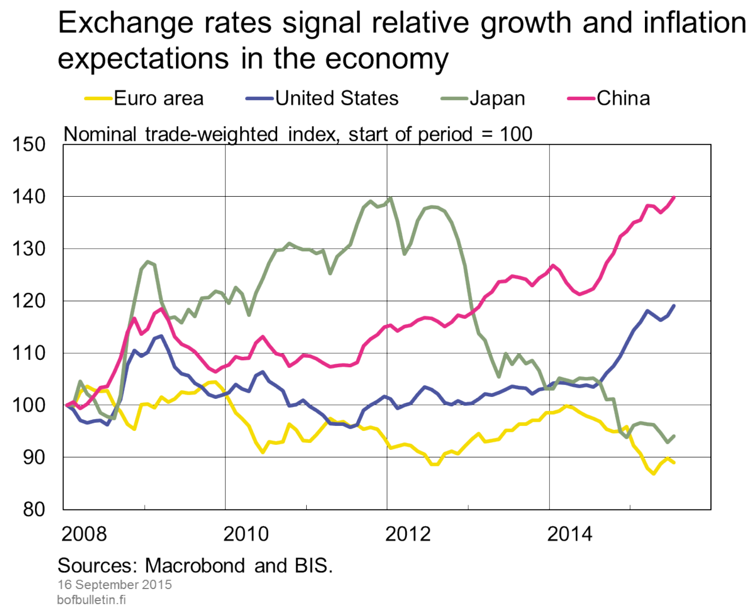
Of the factors external to the euro area, the world market price of crude oil has fallen back during the summer months, close to the level witnessed at the beginning of the year. This has coincided with a drop in crude oil futures prices, broadly to the level prevailing at the beginning of the year. The oil price decline is related to both supply and demand factors. The decline in the level of oil prices over the past 12 months has not been accompanied by a noticeable fall in production: there is an oversupply of oil. Demand expectations have fallen above all in response to market assessments of a deterioration in the growth outlook for China in July and August. From the euro area perspective, the oil price decline mainly represents a positive supply factor that will support euro area growth but also bring down the rate of inflation in the immediate year ahead.

Chart 8



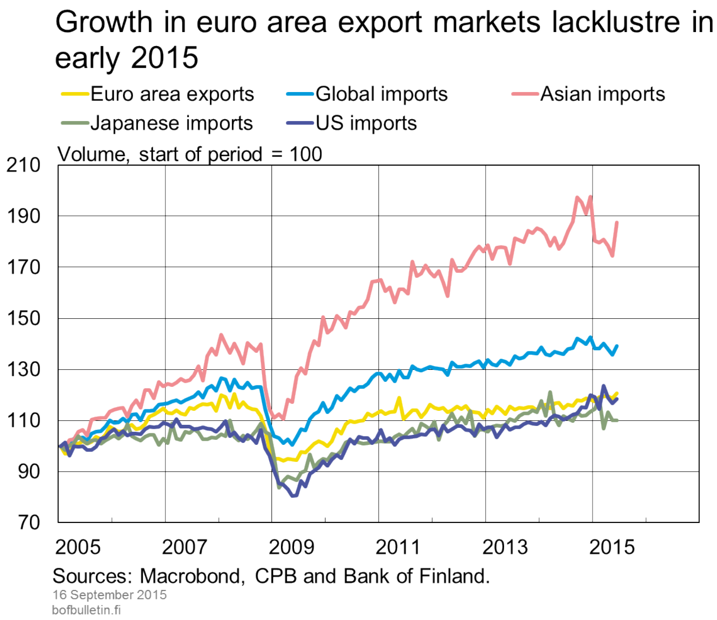
The price decline on non-energy commodities is largely weighted towards supply factors. The rate of growth in commodities demand is slowing in response to changes in the structure of Chinese growth. The weight of investment in total demand leaves more room for private consumption, while on the demand side the share of the service sector has grown rapidly close to 50% of total output. In the face of slowing economic growth in China, falling share prices and poor export performance, unrest emerged on the financial markets in late summer. In early August 2015 the unrest was heightened by the Bank of China's reform of the exchange rate mechanism. In the latter half of August, there was an outright collapse of share prices in China, with widespread spillover of the unrest to the advanced and emerging economies. During September, the market has zigzagged around new, lower share prices.

Chart 9



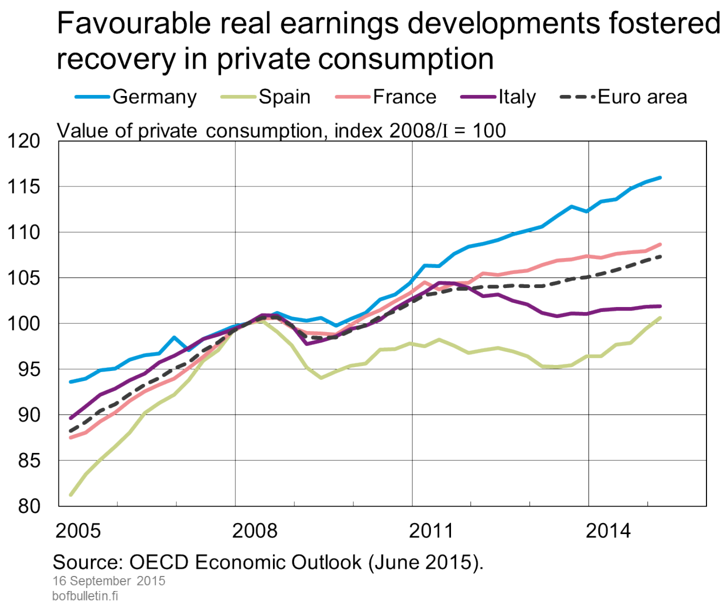
The growth outlook for the euro area export market has deteriorated somewhat. The global trade volume shrank in the early part of the year, mainly in the wake of the contraction in Asian imports. The Bank of Finland forecast projects that world trade growth will remain permanently slower than foreseen earlier. Overall, the contribution of net exports to euro area growth will continue to be very modest in the forecast period.

Chart 10



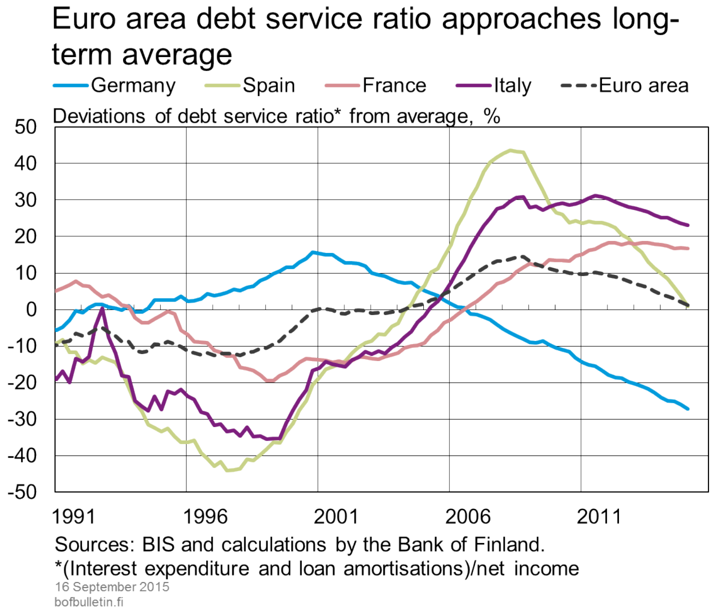
The value of private consumption in the euro area has increased steadily since the beginning of 2014 and is currently 8% higher than in the first quarter of 2008 (Chart 11). In fact, private consumption was the component of overall demand that made the strongest contribution to GDP growth in 2014. It was driven by real earnings growth related to improvements in employment and falling energy prices.

Chart 11



The recovery of private consumption will continue, in a context of improvements in the employment outlook and a sustained very low level of interest rates. With interest rate expenditure remaining moderate, there will be better scope for faster repayment of debt and an improvement of the economic risk resilience of households. Household indebtedness may be analysed by examining household interest expenditure and loan amortisations as a percentage of net income (Graph 12). Deviation of this debt service ratio from its long-term trend impacts inversely on private consumption growth.

Chart 12



The higher the proportion of household income used for servicing debt, the lower the share available for consumption. While variations between countries remain large, the average debt service ratio for the euro area has dropped back close to its long-term average and continues on a downward trend. In addition, average net assets of euro area households have grown in 2014, although remaining below their long-term average.

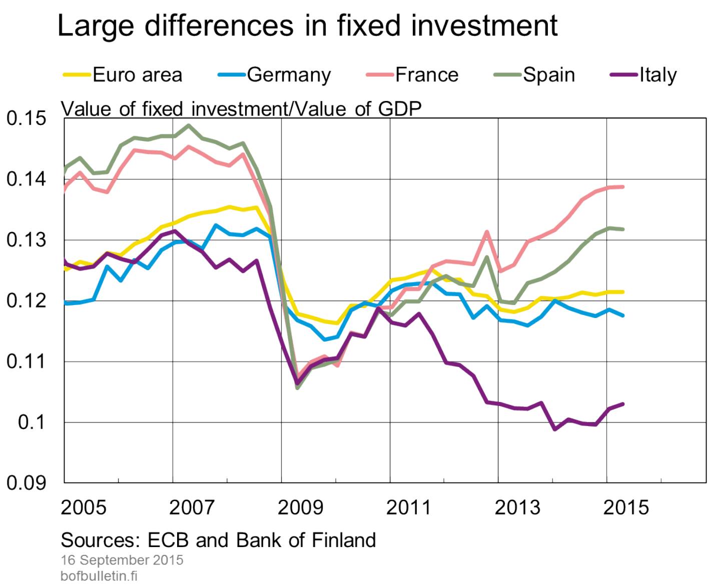
In many euro area countries, housing market recovery is only just getting underway. Consequently, the average housing price index for the euro area is still 5%, in nominal terms, and nearly 15%, in real terms, below the reading at the beginning of 2008. By contrast, housing prices in e.g. Austria and Ireland have recently been rising relatively rapidly, especially in the big cities.

The average growth rate of the euro area household loan stock has picked up during 2015, but there are large differences across countries. Of the large euro area countries, the growth rate shows a clear upward trend in France and Germany, whereas in Spain the contraction in the household loan stock has not yet bottomed out. In the euro area, the average interest rate on new housing loans has fallen rapidly since the beginning of 2014.

The findings of the Bank Lending Survey show that banks relaxed housing loan terms and conditions in the second quarter of 2015. Terms and conditions were eased more than the banks were expecting as late as April. Of the large euro area countries, a significant easing was seen notably in France and Italy. Mirroring the first quarter, demand for housing loans remained strong. The increase in household demand for housing loans was related both to the low level of interest rates and the favourable outlook for the housing market.

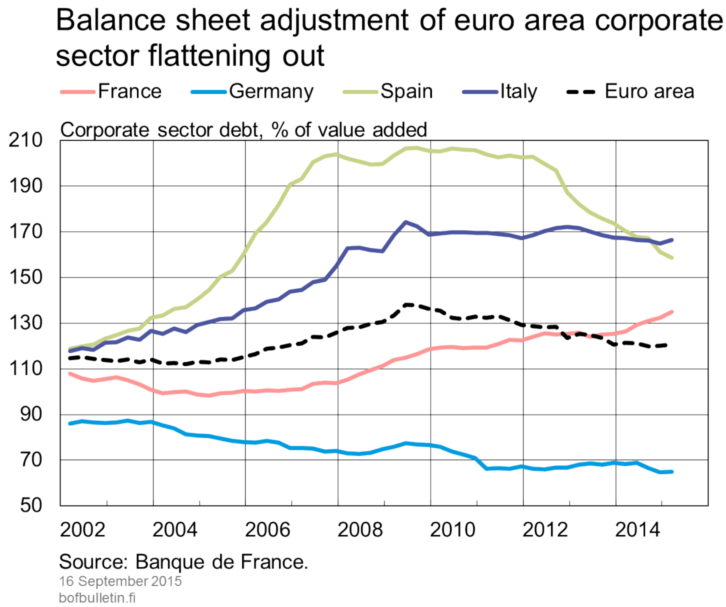
The value of private fixed investment has increased since the beginning of 2014, but remains around 5% below the level witnessed in the first quarter of 2008. A pick-up in investment is hampered by weak profitability, an abundance of spare production capacity and, partly, bottlenecks in lending. Because of the uncertainty clouding future economic developments, investors continue to demand high risk premia, and so developments in average capital costs have not kept pace with the fall in the costs of bank and government bonds. However, recent developments in fixed investment in Spain and Germany, in particular, have been encouraging. The European Strategic Investment Fund that will become fully operational this autumn will bring some alleviation to the slump in investment. The Fund aims to channel over EUR 300 billion to non-financial corporations to foster the launch of productive investment and job creation.

Chart 13



Corporate indebtedness in the euro area has continued to decline slightly, on average, and is already lower than at the onset of the crisis (Chart 14). It is important that non-financial corporations that were left indebted by the crisis undertake balance sheet adjustments and that funding is channelled to cater for the investment needs of healthy and productive enterprises.

Chart 14

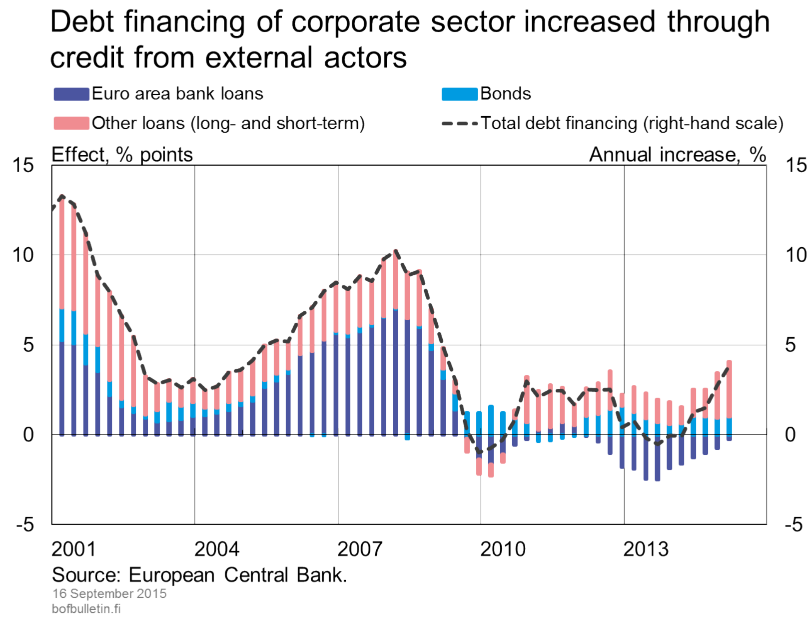


Corporate debt ratios in the euro area have posted highly divergent developments across countries since 2008. The upside is that the countries where debt levels surged prior to the crisis (Ireland, Spain, Portugal) have paid off their debt, pushing debt ratios back very close to pre-crisis levels. However, in countries where debt ratios have posted a moderate development in both historical terms and relative to the euro area average, a rise in the debt ratio cannot be regarded as an entirely undesirable development.

The contraction in the euro area corporate loan stock has generally already bottomed out, although a major revival is not yet discernible in the big euro area countries, save for France. Similarly, developments in corporate loan demand were favourable, although falling short of banks' expectations. The explanation offered by the banks was the increasing use of alternative sources of finance in corporate fund raising.

According to the findings of the ECB's Survey on the Access to Finance by Enterprises (SAFE), in the six-month period up to March 2015, access to funding had been dismissed as the smallest problem facing the companies, whereas shortage of demand was still reported to be the biggest problem. In step with the mounting need for bank loans and improvements in non-financial corporations' own situation, banks' willingness to grant loans increased and the loan application rejection rate fell. According to the Bank Lending Survey, in the second quarter of 2015 banks continued on the path of relaxation of lending terms that they embarked on in the early part of the year, which is above all reflected in narrower margins. In nearly all the euro area countries, the margins on higher-risk corporate loans were also reduced in the second quarter.

Chart 15



Although the annual growth rate of corporate loans extended by euro area banks remains negative, total corporate debt financing has shown an upward trend since the end of 2013. Market-based debt financing, loans from non-euro area banks and non-bank financial institutions make a stronger contribution to the external financing of non-financial corporations (Graph 15). The ECB's asset purchase programme contributes to supporting the corporate bond market as investors dispose of government bond holdings in favour of higher-risk securities.

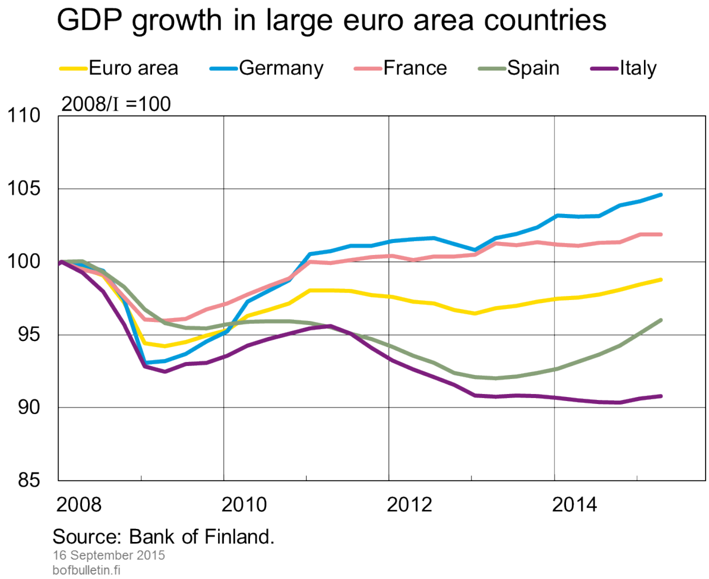
Outlook for large euro area countries more positive

Economic fundamentals in **Germany** are sound. Competitiveness is very high, household indebtedness is moderate and unemployment is amongst the lowest in the euro area. As a result of balanced public finances and the lowest debt ratio of the largest euro area countries, there is no need for fiscal consolidation in the immediate years ahead.

In **France**, economic growth is projected to improve in the forecast period, after weak dynamics in 2014. Growth will be fuelled by a pick-up in private consumption. Tax cuts and lower energy costs will increase corporate profits which, together with low interest rates, will strengthen French companies' investment opportunities. Fiscal consolidation will continue, albeit at a more moderate pace.

The **Spanish** economy grew very robustly in the first half of 2015. However, output has currently only reached the level of 2009. The unemployment rate has declined from the peak of 27% in early 2013 to around 22%. Economic growth is supported by the success of the EU-IMF banking sector adjustment programme agreed in 2012 and structural reforms that have enhanced e.g. labour market flexibility. Financing conditions have continued to ease and Spain is benefiting from the accommodative monetary policy. The general government deficit is still large, however, and public debt will rise to around 100% in 2015.

Chart 16



In **Italy**, the recent faster-than-expected economic growth, strong investment dynamics, improved financing conditions and an upward trend in confidence indicators indicate that the economy may have started to recover in a sustainable manner. Bank lending rates have declined further and the availability of funding has improved, which has turned household borrowing upward and slowed the decline in the corporate loan stock. In particular, the brisk growth in investment after a prolonged period of contraction, and the very robust outlook for industry, are signals of positive economic developments in the forecast period.

The United Kingdom's economic outlook remains favourable in the immediate years ahead. Positive labour market dynamics, low oil prices, a pick-up in real wage developments and growth in confidence in the private sector are bolstering private consumption and strengthening growth prospects for the corporate sector. Even though housing prices have continued to rise, households have reduced their debt levels further. In the general elections in May 2015, the Conservatives won a majority in the House of Commons and will, as promised, hold a referendum on the UK's membership of the EU by the end of 2017.

Economic growth in **Sweden** will remain stable during the forecast period. At present, growth is strongly based on domestic demand, but exports will also improve, supported by the euro area recovery. Labour markets have evolved favourably, the labour force will grow at a faster rate in the forecast period and unit labour costs have risen more moderately than in many other countries. The greatest downward risk to the forecast is associated with growth in house prices and hence also continued growth in household indebtedness.

The economic outlook for **Denmark** has strengthened in the course of 2015. Economic growth has stemmed largely from an improvement in both private and public demand, but the export sector has also rebounded. Construction growth has picked up and investments will recover at a brisk pace during the forecast period. Denmark is currently enjoying almost full employment. In this respect, tightness on the labour market is the greatest risk for weaker-than-anticipated developments, should labour demand exceed labour supply in the near future.

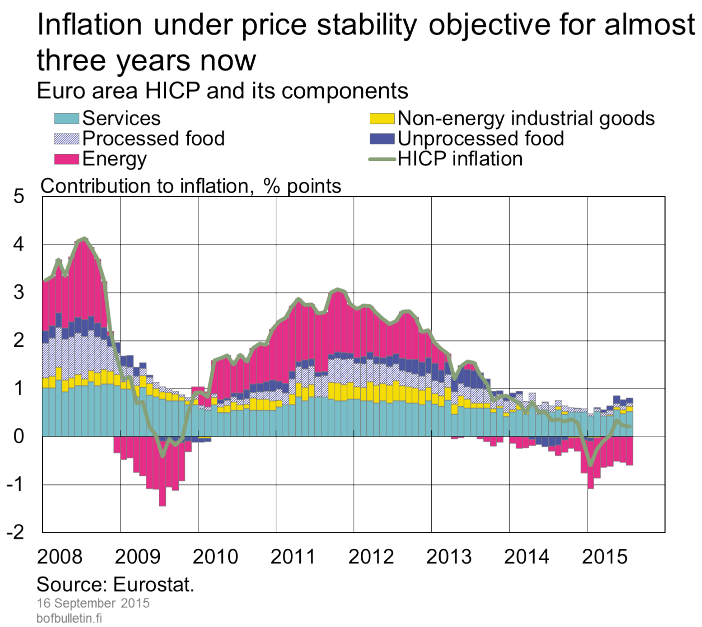
The Bank of Finland's forecast for global economic growth in the next few years is presented in more detail in the article 'Increased uncertainty in the global economy'.

Inflation to remain lower than targeted

Euro area inflation slowed markedly in autumn 2014 (Chart 17). The rate of change in prices reached a trough of -0.6% at the beginning of 2015, but has subsequently gathered pace and been positive since April. Inflation is still very sluggish, however, and far from the ECB's objective for price stability.

The most significant individual factor underlying the steep fall in inflation in the latter part of 2014 was the price of oil. The other components of consumer price inflation have changed only marginally. Services price inflation, which is the largest subcomponent of consumer price inflation, has risen at a very low rate, at around 1%, for a prolonged period. Industrial goods prices and the prices of processed food, and of unprocessed food in particular, have turned upward, but have a relatively small impact on consumer price inflation. Nevertheless, price developments in all the subcomponents of the index have persistently been below their long-term average, which has led to a protracted trend of slowing inflation.

Chart 17

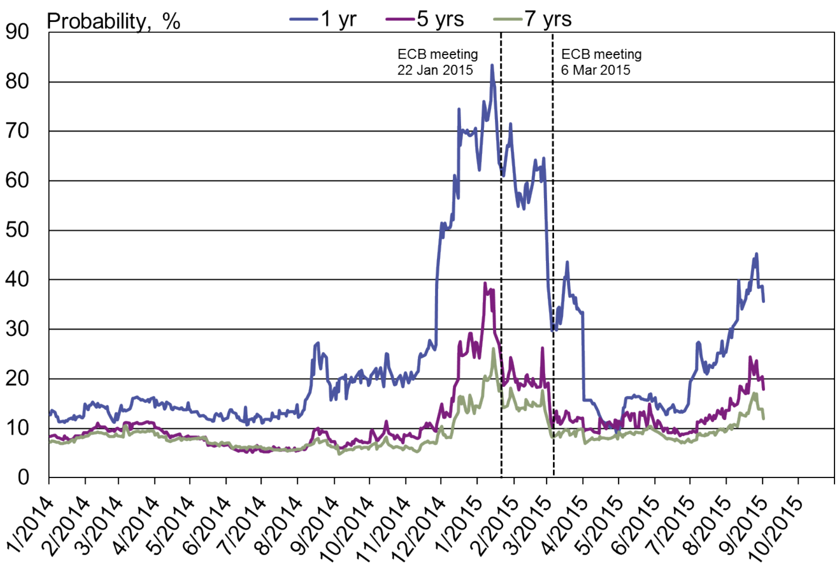


The effects of oil price fluctuations on inflation can be either direct or indirect. The direct effects of oil price fluctuations are, as a rule, one-off in nature and do not therefore have a permanent impact on inflation. The potential indirect effects of oil price fluctuations are reflected via inflation expectations and wage developments. Unlike the direct effects, the indirect effects may be reflected in the economy more widely. Therefore, even a temporary shock in oil prices can have longer-term effects on inflation. If the direct effects of a fall in oil prices slow inflation, this will depress inflation expectations which, in turn, is reflected in wages by easing wage pressures. In such a case, there is a risk that the economy falls in a spiral of ever falling wages and inflation.

The probability of negative inflation – i.e. deflation – can be measured by inflation options (Chart 18). The probabilities of negative average inflation are 'risk-neutral' probabilities, meaning they reflect not only the probability of an outcome but also the riskiness of different states for market participants.

Chart 18

Increased probability of negative inflation



Probability of negative average inflation for different time horizons. Moving average of three observations.
Sources: Bloomberg and calculations by the Bank of Finland.
16 September 2015
bofbulletin.fi

According to other market-based inflation expectations, the probability of negative inflation has increased considerably in the short term on account of falling oil prices. The probability of negative average inflation over the longer term has also increased, albeit more moderately than short-term inflation expectations. However, the probability of negative inflation for all time horizons is still lower than at the beginning of January 2015.

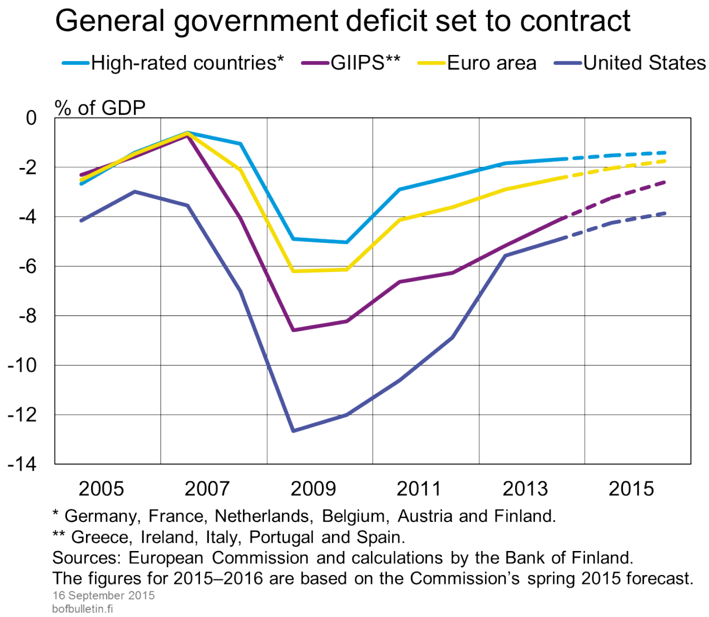
In addition to oil prices, exchange rate changes and their transmission are another external factor that affects domestic inflation. Exchange rate changes have only a limited overall impact on consumer prices, however, since even import goods prices are affected, in addition to import prices, by several domestic cost factors, such as transportation, storage and processing costs. Moreover, exports from extra-euro area countries account for just around 25% of the euro area consumption basket. According to estimates, a depreciation of the euro by 10% pushes up inflation by about 0.4%.

Domestic price pressures in the euro area are moderate. In an environment of subdued growth, a negative output gap and high unemployment, wage developments have been weak. Growth in the wage bill per employee has been easing for a couple years, and there are practically no signs of a pick-up in the current year, either. Average wage developments in the euro area have been subdued. This has been primarily due to the high unemployment rate, but is also a consequence of the weak outlook for energy and commodity prices, which has increased real wages and thereby eased pressures for nominal wage rises.

Fiscal policy no longer restraining growth

In 2015, the euro area general government deficit is expected to contract to approximately 2% of GDP. Moreover, the fiscal balance will continue to improve in the immediate years ahead, and in 2017 the deficit is forecast to decline closer to 1% of GDP. The decline in the deficit stems mainly from cyclical improvement. From the perspective of growth, the fiscal stance is relatively neutral. Of the largest euro area countries, the public finances will remain in surplus over the forecast period in Germany. In France, Italy and Spain, the general government deficit will contract and fiscal consolidation will also continue during the forecast period.

Chart 19



The euro area general government debt-to-GDP ratio reached a peak in 2014, at over 94% of GDP. From 2015 onwards, the debt ratio will start to decline gradually. At the country level, however, the debt ratios will fall at different paces. Of the largest euro area countries, the debt ratio will continue to grow in 2015 in France, Italy and Spain and will decline only in Germany.

The downturn in the euro area general government debt ratio is based on improvements in three fundamental factors that influence public debt dynamics. These factors are economic growth, interest expenses paid by general government to its creditors and the general government primary balance.

The improvement in euro area economic growth in the next few years is mainly cyclical in nature. In order to boost growth over the longer term, the European Commission has, in its growth strategy,[5] emphasised a fiscal policy supportive of long-term growth, investment and structural reforms that promote growth potential and employment.

As for the second factor, general government interest expenditure has declined. The interest rates on government debt securities have fallen on the markets from the previous year following commencement of the Eurosystem's expanded asset purchase programme.

As for the third factor, the improvement in the euro area general government primary balance has helped turn the general government debt-to-GDP ratio onto a downward path. The primary balance has improved in response to the consolidation of public finances with tax increases and expenditure cuts. However, substantial efforts are still needed in several countries to put the debt ratio below the threshold of 60% of GDP specified in the Stability and Growth Pact. For example, the country-specific recommendations published by the Commission in late spring call for new reform measures from France, Italy and Spain. However, fiscal policy in the euro area in the early part of the forecast period is notably more relaxed than in previous years.

In the long term, euro area public finances will also face the challenge of age-related expenditure. According to the European Commission's latest Ageing Report,[6] age-related expenditure will increase in the euro area by about 1.5% by 2060. However, the projection has improved markedly from the 2012 Ageing Report, in which age-related spending was projected to grow over twice as fast over the same period. The improvement is due particularly to an easing of the projection for pension expenditure growth e.g. as a result of pension reforms in several euro area countries.

Gridlock in the Chinese economy the key external risk for the euro area

Risks to the euro area can be divided into three categories: external, internal and longer-term risks. At present, the major external risk relates to the possibility of gridlock in the Chinese economy, to which a slowdown in debt-driven economic growth could in the worst case lead. A decline in Chinese demand would particularly affect commodity-producing countries, but the repercussions of sudden gridlock would spread widely to the global economy. Commodity prices would drop even further, which would also lower inflation in the euro area.

China surprised everyone in August with a shift towards a market-based determination of the exchange rate for the yuan. This gave the currency room to depreciate against the US dollar by approximately 3%. The appreciation of the dollar and weaker economic outlook for the United States as a result of the sharp slowdown in Chinese economic growth could postpone the interest rate rise expected in the United States for end-2015 and the start of normalisation of US monetary policy.

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5. See http://ec.europa.eu/europe2020/pdf/2015/ags2015_en.pdf.
6. See http://ec.europa.eu/economy_finance/publications/european_economy/2015/pdf/ee3_en.pdf.

Even though a normalisation of US monetary policy as such is welcome, it could include a risk of too strong reactions on the financial markets. One of the factors that causes concern at present is the high US dollar-denominated debt of emerging economies' private sectors. The more the dollar appreciates, the higher the debt of these countries' private sectors grows in local currency terms. For example, the Bank for International Settlements (BIS)[7] has assessed that monetary system mechanisms and the ever-tightening dollar linkages may intensify the effects of dollar fluctuations. For these reasons, the impact of the Fed's interest rate rise may turn out to be greater than normal and may spread more widely to the global economy, which will also increase the risks to stability on the financial markets.

Internal diversity in the euro area increases uncertainty

The major internal risk relates to a permanent or even aggravated divergence of euro area countries. If economic developments of individual countries in a monetary union diverge sharply, this will increase difficulties in the different sectors of common monetary policy and national economic policies alike. In the euro area, the Member States are primary responsible for their own economic developments. Factors that increase economic flexibility help the countries adjust to shocks and maintain sustainable and balanced economies. The risk is that the flexibility is insufficient and policy measures are inappropriate or inadequate to the situation. In such cases, economic developments in an individual country may diverge further from the euro area average, which could lead either to a prolonged period of very sluggish growth, or to overheating and, eventually, to collapse.

In the worst case, a very strong divergence of a single euro area country could lead to a substantial increase in fears that the country will exit the euro area. The past few months' developments in Greece can be seen as a worrisome example of the potential for such an event. When the negotiations on the finalisation of the second EU-IMF support package for Greece broke down in the summer, Greece's temporary exit of the euro area was also raised in the aftermath of the referendum on the terms of the support package.

Such an alternative comes with a risk of nonlinear developments. The situation of a country that has substantially diverged from average euro area developments may be aggravated abruptly. The repercussions of increased uncertainty may be very protracted: uncertainty can affect e.g. companies' decisions on where to set up their business.

Changes in the future outlook may lead to policy errors

The euro area is also subject to risks associated with longer-term trends. The situation in the euro area is currently very different from that which prevailed prior to the financial and debt crises. The long shadow of the financial crisis intertwines with population ageing and low potential output in the euro area. Changes in future prospects may lead to a false assessment of the situation and errors in setting the stance of monetary policy.

The surge of refugees that has recently increased markedly brings a new element to the

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7. Shin (2015), Global liquidity and monetary policy transmission. Representation at conference 'Liquidity and Market Efficiency – Alive and Well?' organised by SUERF and the Bank of Finland in Helsinki, 3 July 2015.

longer-term outlook for the euro area. The factors underlying this phenomenon – such as Syria's war and the difficulties in North African countries – cause huge human distress. In the short term, such an influx of refugees may cause various difficulties within the euro area. From the perspective of the economy, however, one positive longer-term effect could be a growth in the working-age population and younger age structures in many euro area countries. Yet, this would require successful measures for the smooth reception and integration of refugees.

Another major long-term risk relates to a protracted period of weak risk resilience in the public finances of several euro area countries. In such a situation, there is almost no fiscal leeway, meaning the emergence of a new crisis would require possibly very large cuts in public expenditure, which is known to aggravate crises. As the global financial crisis emerged in 2008, there was much more room for manoeuvre in public finances. At present, fiscal leeway has contracted generally, and in a few euro area countries, even a relatively small shock could jeopardise the sustainability of the public finances. Since it is a very slow process to reduce debt levels, several euro area countries will have no fiscal leeway for a prolonged period, and therefore the public finances will also be subject to risks for a prolonged period.

Tags

euro area, ECB, global economy, EU, inflation, economic situation, monetary policy