Analysis

Information key on tumultuous markets

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The monitoring of financial markets is an important part of the preparation of monetary policy decisions and the monitoring of their implementation, as information from the financial markets provides clues on the state of the economy and financial conditions. Crises emphasise the importance of financial market surveillance, as emerging problems in the economy and the financial system are usually first reflected in the financial markets.



Financial market monitoring supports monetary policy decision-making

The financial markets do not always represent the economy reliably, as the functioning of the

financial markets and market prices also involve a lot of technical and psychological elements. But they do offer important tips on the current state of and outlook for the economy.

The prices and volumes of instruments quoted on the financial markets are an important factor in the central bank's assessment of financing conditions. Financing conditions broadly describe the conditions and extent to which companies, households, banks and general government can access funding.

Financing conditions are a key driver of economic activity and, ultimately, of inflation, which the ECB seeks to control in pursuit of its price stability objective. Under normal conditions, the Governing Council uses its main policy rate to guide financing conditions. The Governing Council may also utilise securities purchases, credit operations and forward guidance if needed.

Financial market tensions may hinder the transmission of the monetary policy pursued by the Governing Council. For example, a rise in risk premia could lead to an excessive rise in market rates and a tightening of financing conditions. In such an event, it may be necessary to alleviate financial market tensions through non-standard monetary policy measures, such as targeted securities purchases or longer-term and low-cost credit operations.

The financial markets are thus an important channel for the transmission of monetary policy. Monetary policy has a direct and indirect impact on all aspects of the financial markets. Therefore, mapping and analysing the conditions, outlook and expectations of the financial markets is an important part of the preparation and follow-up of monetary policy decisions.

In addition to the preparation and monitoring of monetary policy, market surveillance is also utilised by the Bank of Finland in its financial stability tasks and by the Financial Supervisory Authority.

Change is constant on the financial markets

The financial markets never sleep. Global financial markets keep turning around the clock, and there is a continuous inflow of news that moves the markets.

The Bank of Finland works in close cooperation with market participants. Market surveillance is carried out with the help of various news and market information systems and by engaging in dialogue with Finnish and international financial market participants. The key objective is to filter and digest the information into clear messages of chief importance to the ECB's monetary policy.

One particular challenge for market surveillance is the scope of the monitoring field, as financial instruments and phenomena relevant to the ECB's monetary policy are found in bond and

currency markets as well as in equity and commodity markets. Moreover, surveillance is not limited regionally to the euro area, but extends to other developed markets such as the United States, the United Kingdom and Japan, as well as to the largest emerging markets, such as China, India, Russia and Brazil.

In addition to financial market variables, the surveillance encompasses monetary and economic policies, international politics, economic data and potential risks in countries of key importance to the euro area. In addition to describing the condition of the financial markets, the purpose of surveillance and analysis is also to assess future developments on the markets and identify potential transmission channels for such changes. There are several instruments on the market for anticipating market participants' expectations.

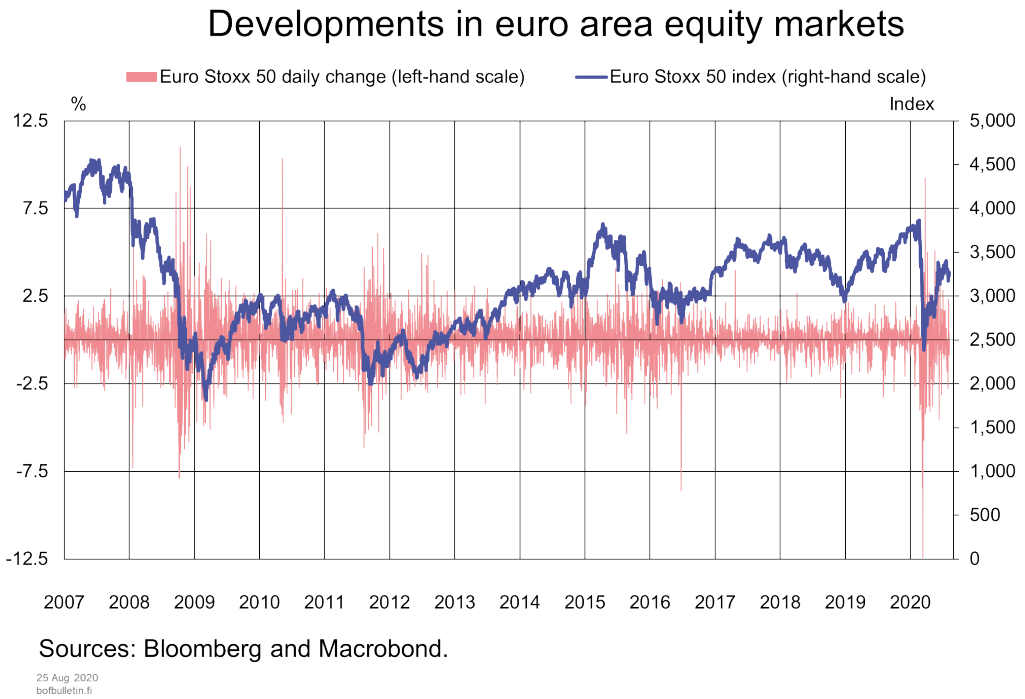
A key aspect of market surveillance is the monitoring of market expectations regarding the ECB's monetary policy. Although monetary policy is not guided by market expectations, it is important to be aware of market participants' expectations when making monetary policy decisions, as the current state of the financial markets at any given moment is a key reflection of expectations for the future. Once a monetary policy decision has been made, the impact of the decision and its implementation on the financial markets is closely monitored.

Financial markets are monitored both in real time and by addressing topical phenomena and themes. Daily reviews and ad hoc news flashes maintain awareness of the current situation, while more in-depth analysis serves to give background and illuminate phenomena and themes relevant to the ECB's monetary policy. The status, outlook and expectations of the financial markets are carefully reviewed before the Governing Council's meetings.

Crises highlight the need for monitoring the financial markets

During the coronavirus crisis, movements on the financial markets were exceptionally tumultuous, and the ECB had to react quickly in its monetary policy stance to increase accommodation and ensure the transmission of monetary policy. As an example of market movements, Chart 1 shows a sharp increase in the day-to-day fluctuations in euro area share prices. On the weakest days, share prices fell by more than 12%, while on the strongest days they increased by more than 9%. In terms of markets fluctuation and quickly plunging stocks, this exceeded even the financial crisis.

Chart 1.



Maintaining an up-to-date picture of the situation and the identification of financial market tensions played an important role in the preparation and implementation of the ECB's monetary policy decisions. The financial markets were closely monitored from morning to evening. Since then, the situation on the financial markets has calmed down, and the focus of market surveillance has shifted to monitoring the effects of monetary policy decisions on the financial markets. However, close monitoring of the situation continues, as the uncertainty in the economy and on the financial markets is exceptionally high.

Keywords

COVID-19, financial markets, monetary policy