Monetary Policy Review

Expansionary economic policy boosts growth

International economy, Monetary policy | 27 April 2018

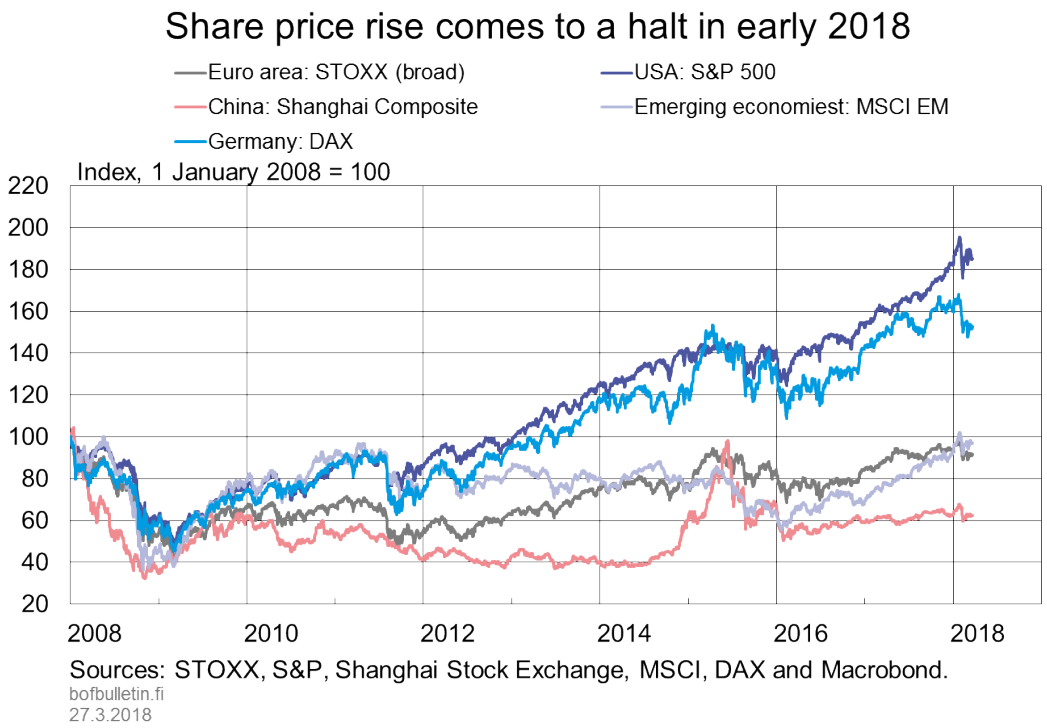
The growth outlook for the global economy is strong. Growth is supported by a synchronized expansion in several key economic regions, accommodative monetary policy, and fiscal stimulus in the United States. China continues to pursue rapid growth, while the accumulation of debt continues. Growth is reducing economic slack in several countries simultaneously, leading to a gradual increase in inflationary pressures. If favourable developments continue, monetary policy in key countries is expected to tighten gradually.



Global economy growing strongly, financial markets volatile

The global economy and world trade grew across a broad front and at a good pace in 2017. Confidence in economic growth is strong, although early in the year purchasing managers' indices, in particular, dipped in certain countries. Global growth is expected to reach about 4% this year.[1] Growth is supported by approximately similar rates of recovery in many key economic regions, by accommodative monetary policy and by fiscal stimulation in the United States.

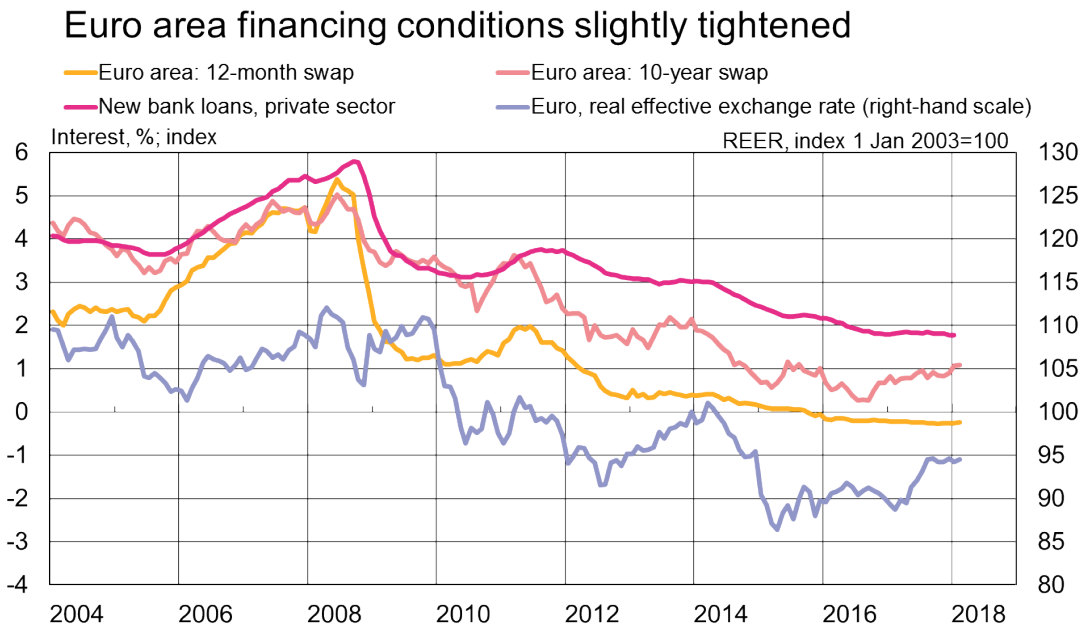
Chart 1.



Despite solid economic growth, inflation has grown only slightly on a global scale. Inflation in OECD countries was a little over 2% in 2017. The good growth has nevertheless strengthened expectations of higher inflation and an interest rate hike especially in the United States, where the fiscal stimulus is expected to increase inflationary pressures (see Chart 1). Expectations of tighter monetary policy and uncertainty about US economic policy and developments have nevertheless been reflected on the share markets.

An abrupt turn took place in share prices in early February, when the upswing that had been ongoing for over a year came to an end (see Chart 2) and at the same time the VIX index measuring share market volatility increased significantly. Interest rates are still rising, dampening share market developments, and the financial markets may become even more volatile than they are at present.

Chart 2.



ECB monetary policy still supportive of growth

The ECB's policy rates have been exceptionally low for a long time. The interest rate is 0% for main refinancing operations, 0.25% for the marginal lending facility, and -0.4% for the deposit facility. The Governing Council announced in October 2017 that it will continue the net purchase of securities until at least September 2018, but reduced the monthly net purchases from EUR 60 billion to EUR 30 billion. Net purchases can be continued if the Governing Council does not consider the rate of inflation is returning sustainably in line with the objective. The Governing Council also expects policy rates to remain at their current level for a prolonged period, and in any case beyond the end of the net asset purchases under the programme.

The Eurosystem will continue to reinvest any capital maturing from previously purchased securities well after the net purchases have ended. A monthly average of EUR 10 billion will mature of securities purchased between January and September 2018 (see Reinvestment of securities in ECB's expanded asset purchase programme), meaning that monthly gross purchases will average EUR 40 billion.

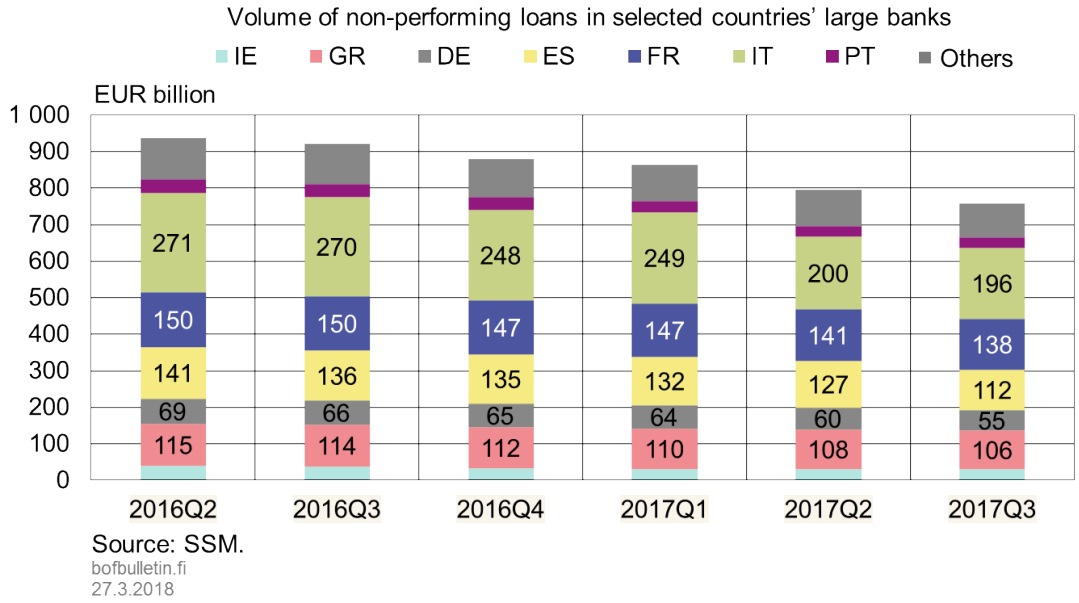
The ECB's monetary policy stance currently consists of net purchase of securities, a large balance sheet and reinvestment of maturing securities coupled with low key policy rates and forward guidance on these. Forward guidance regarding the policy rates enables the ECB to influence long-

term interest rates and expectations regarding the timing of any eventual rate hike.

The effect based on the purchase programme's size derives from the fact that securities held by the Eurosystem reduce their availability to investors. Low availability with respect to demand increases the price of securities, which in turn results in lower interest rates on the bond markets. In particular, the compensation demanded by investors for holding on to bonds with a long rather than a short maturity will decrease as demand for bonds with a long maturity recedes. This will bring long-term interest rates down. Even after net purchases have ended, earlier purchases by the ECB will substantially slow down the rise of long-term interest rates.

Chart 3.

Volume of non-performing loans of large euro area banks well down on previous year



Source: SSM.
bofbulletin.fi
27.3.2018

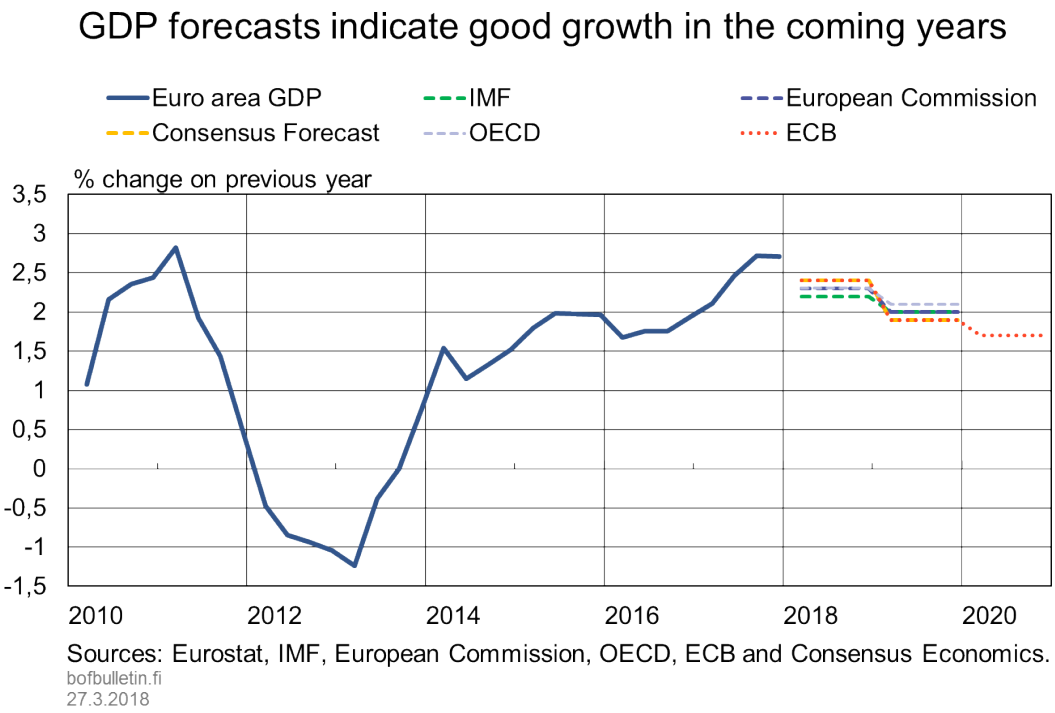
Euro area financing conditions favourable despite slight pinch

The Governing Council's aim is to keep euro area financing conditions relaxed until the price stability objective has been sustainably achieved. Financing conditions are affected, among other factors, by market interest rates, access to finance, asset price development and exchange rates.

Rising long-term interest rates and appreciation of the euro have tightened financial conditions somewhat (see Chart 4). Long-term interest rates have risen since summer 2016. This growth has continued in early 2018 thanks to the positive outlook in the euro area and the global economy.

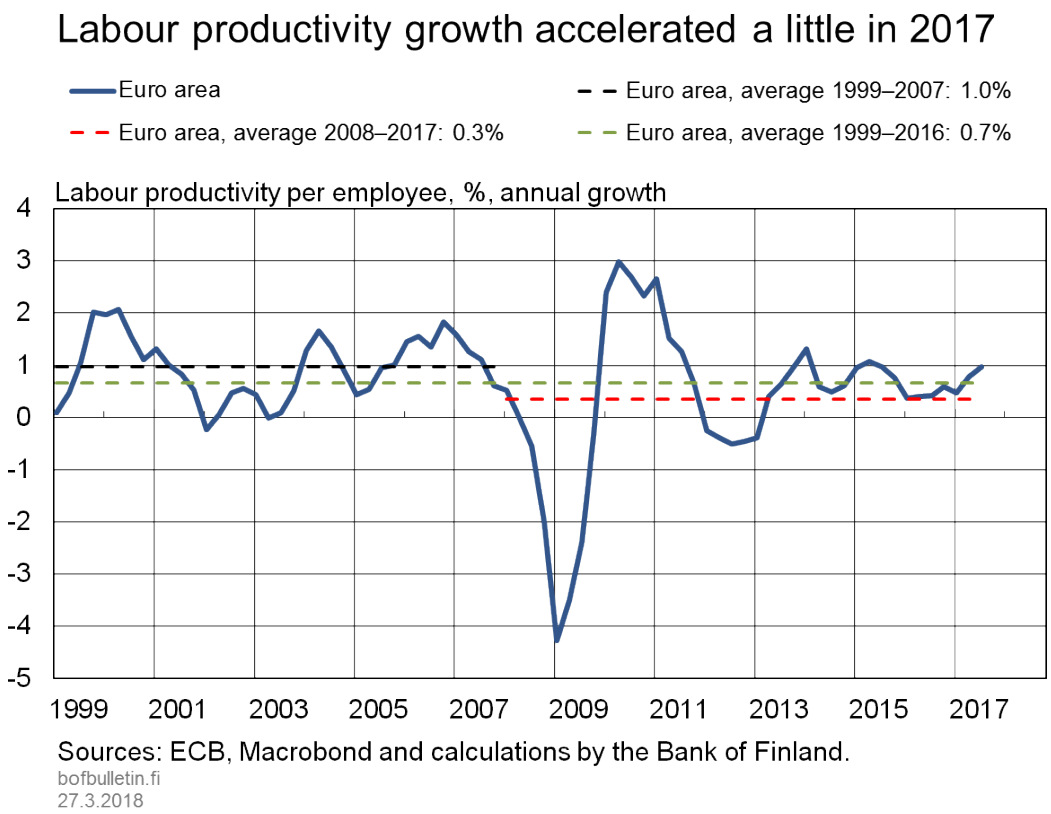
A good growth outlook and current account surplus will strengthen the euro despite the accommodative monetary policy. The euro became significantly stronger during 2017 against the dollar and also in terms of the nominal trade-weighted index. However, the real exchange rate is still not historically high (see Chart 4).

Chart 4.



An accommodative monetary policy has kept short-term interest rates and interest rates paid by the private sector for their bank loans exceptionally low (see Chart 5). The interest rates on new bank loans to non-financial corporations and households in the euro area have remained below 2% since mid-2016. Although interest rates are low and the private sector's balance sheet adjustment has for the large part already been applied, lending has not accelerated significantly in the euro area. The loan stock has, nevertheless, grown significantly in countries with a high credit rating, while growth has been moderate in countries that were hardest hit by the crisis (see Chart 5). The rise in house prices in the euro area has accelerated to around 4%.

Chart 5.



Euro area banking sector slowly recovering

The profitability of banks in the euro area continued to recover in 2017. According to the single supervisory mechanism (SSM), the return on equity of euro area banks in the third quarter of 2017 was 7.0%, as against 5.4% year on year. Banks' operating profit increased by about 30% year on year. Banks' profitability has been maintained especially by lower recognition of credit losses or impairments, and a good increase in trading profits.

Core banking operations in the euro area, on the other hand, have remained weak. The low interest rate environment weakens especially net interest income. This is very important to banks, and net interest income contracted in the third quarter of 2017 by 2% year on year. At the same time, balance sheet adjustment by banks, changes in business models and increasing investments in digitalisation have kept costs high.

Investors' confidence in the banking sector has nevertheless been improved by a moderate rise in inflation expectations and a steeper interest curve. Combined with the good economic outlook and increasing lending, these factors foreshadow a better outlook also for banks in the medium term. In addition, the ECB's accommodative monetary policy has kept banks' funding costs

historically low.

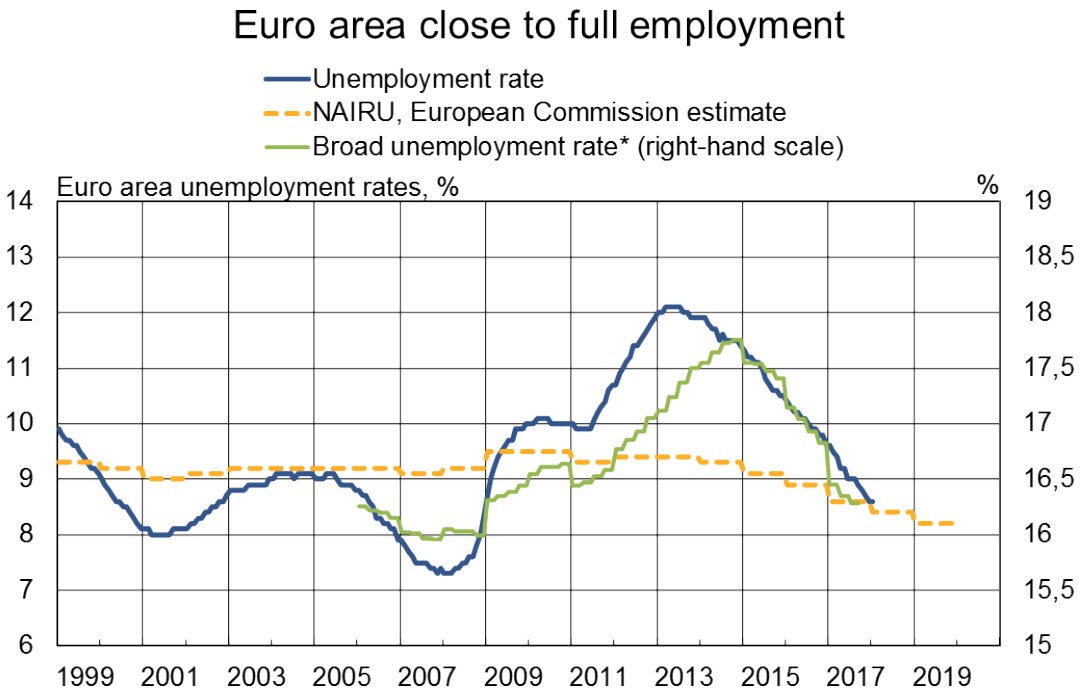
Investor confidence in euro area banks has also been improved by the banks' lower balance sheet risk and higher capital adequacy. According to the single supervisory mechanism (SSM), euro area banks' Tier 1 capital adequacy ratio in the third quarter of 2017 was 15.3% (14.6% a year earlier). Banks' non-performing loans have also shrunk (see Chart 6). Large banks in the euro area had EUR 759 billion of non-performing loans in the third quarter of 2017, which is almost 18% less than a year earlier. The non-performing loan total has been reduced to about 5.2% of all loans by banks.

Despite the positive developments, the large volume of non-performing loans is still weakening the profitability of some banks and contributing to lending differentials across euro area countries. Measures taken to reduce balance sheet risks should therefore be continued.[2] The reduction of balance sheet risks is also important as we move towards the European Deposit Insurance Scheme (see 'Construction of a risk-based European Deposit Insurance Scheme'). The absence of a common deposit protection scheme intertwines the fates of banks and their home sovereigns. Banking Union aims to loosen the bank-sovereign feedback loop in the euro area (see 'How has the feedback loop between banks and sovereigns changed since the crisis years?').

Banks' risk-bearing capacity will be tested again this year. The European Banking Authority carries out EU-wide stress tests every other year with the ECB, the European Systemic Risk Board and national regulators.

A total of 48 banks will take part in the 2018 stress tests, covering about 70% of the banking sector in the euro area, other EU countries and Norway. The purpose of the stress tests is to evaluate banks' loss absorbing capacity in some hypothetical situation in which the condition of the banks' operating environment weakens significantly as a result of extensive real economy and financial market disturbance. The stress test results will be published in early November 2018.

Chart 6.

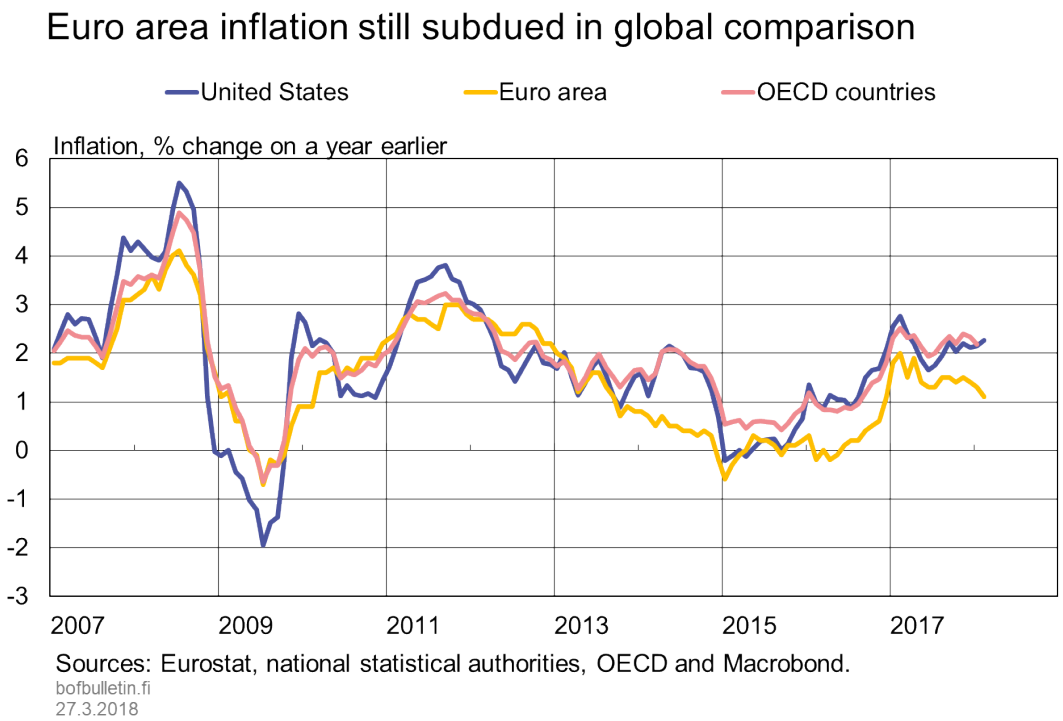


Strong economic upturn in the euro area

Euro area GDP has finally recovered from the financial crisis, and production figures exceed the level before the crisis by 5%. Real economy growth in the euro area has been good in recent years. GDP grew by about 2.5% in 2017. Confidence indicators forecast GDP growth to continue well during the next few quarters (Chart 7). As confidence is growing and growth has been better than expected, growth forecasts for 2018 have been rising for almost the whole past year. The strong economic growth in the euro area is also reflected in the exchange rate.

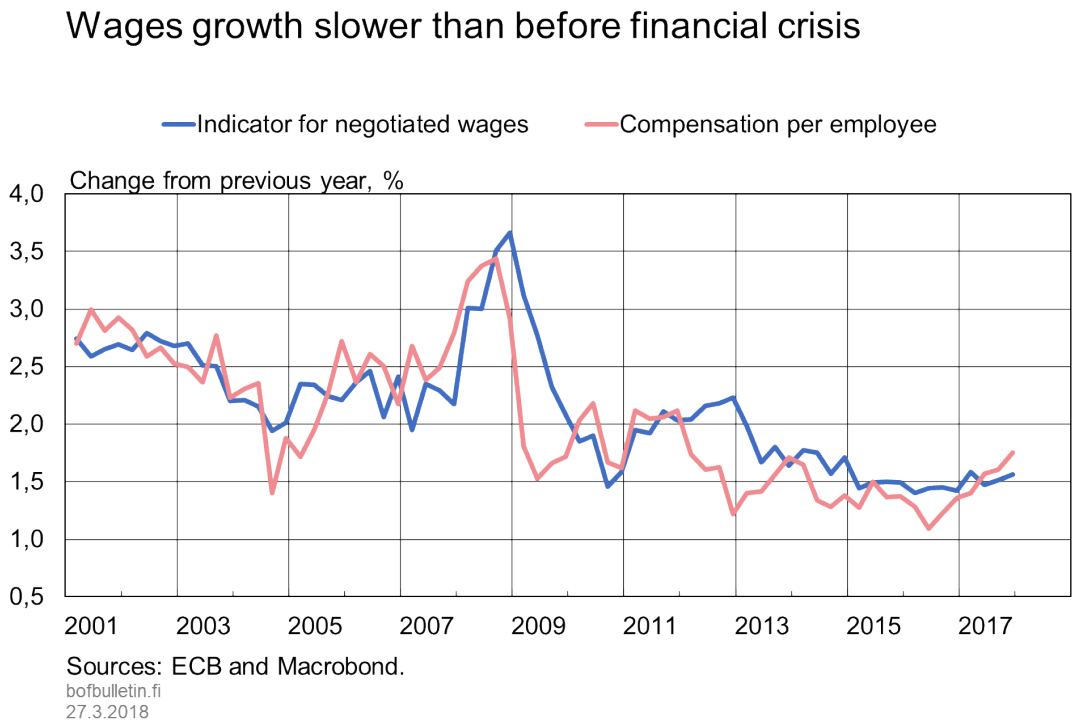
Economic forecasts could become even more optimistic despite the higher exchange rate, especially if the change in the rate continues to be caused by internal economic factors. During the past year, the role of internal factors is estimated to have been significant. If the stronger exchange rate was not in any way connected with the euro area's own development (that is, if it were exogenous), this would slow economic growth. It is clear that the stronger euro is affected by factors both within the euro area and outside.

Chart 7.



Economic growth in the euro area accelerated to 2.7% in the latter half of 2017. In 2018, growth will probably still be a good 2%, but the economic upswing is expected to flatten out, with growth gradually dipping below 2%, i.e. closer to the rate of potential growth (Chart 8). According to the ECB forecast, the euro area economy will grow by 2.4% in 2018, 1.9% in 2019 and 1.7% in 2020. Of the components of aggregate demand, private consumption and private investment are the factors that have had the greatest influence on boosting economic growth in the euro area between 2014 and 2017. Net exports and public consumption have also supported growth, but their effect on GDP growth has been considerably lower than that of private consumption and investment. Private consumption will continue to grow well in the next few years. Investment and exports are also expected to support growth somewhat better than in recent years.

Chart 8.



Private consumption will be bolstered in the next few years by an increase in households' disposable income amid a steadily improving employment situation and higher labour income. On the other hand, the slightly accelerating inflation will also dampen growth real disposable income, and the financing conditions are forecast to gradually tighten just a little.

The growth of investment in the euro area has been broadly based since 2015. Private productive investment and residential investments have increased both in all the big countries within the euro area and in euro area countries outside this group.[3] Investment growth in the next few years will be buttressed by the very low interest rate environment, the need to renew the capital base and the lower level of the capital ratio for corporate sector debt.

Exports from the euro area have grown in recent years at a higher rate than the export markets have. According to the OECD, the order books of export companies in the euro area at the beginning of 2018 were fuller than at almost any time between 1985 and 2017. Exports are forecast to grow steadily in the next few years, maintaining the high current account surplus in the euro area.

The euro area current account surplus grew in the third quarter of 2017 to 4.4% of GDP. The surplus is partly the result of high export volumes. Germany's current account surplus is as high as 8%, and even the countries that were worst hit by the crisis have a current account surplus of

about 2.8%.

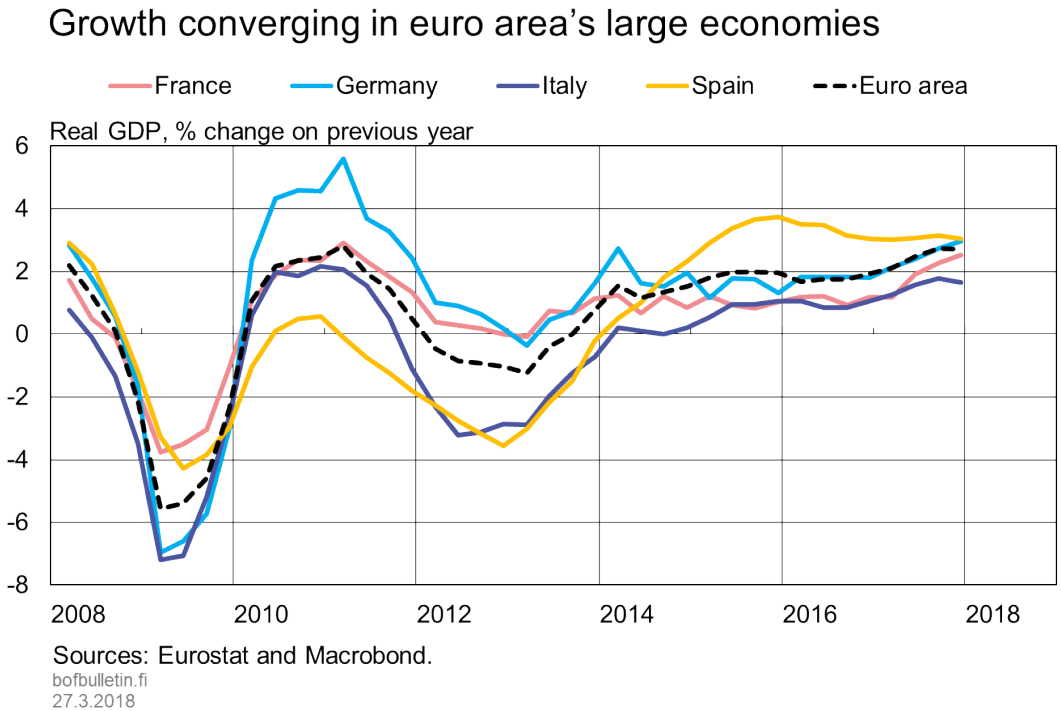
A current account surplus stabilises the economy in the event of unfavourable shocks. The major current account surplus in the euro area nevertheless means that savings exceed investment; in other words, investment in the euro area is still relatively low.

What is the euro area's long-term growth outlook?

The improved cyclical condition has raised the question whether the higher rate of growth in the euro area is really cyclical and short-term or structural and long-term. The euro area economy is forecast to grow in the next few years faster than its potential growth rate. At the same time, however, estimates of the rate of potential growth have increased.

Potential output, which depicts long-term growth prospects in the euro area, developed weakly after the financial crisis peaked. Its growth rate slowed then to as low as under 1%, against almost 2% before the financial crisis (Chart 9). The slow development of potential output is a global phenomenon, the prime reason being the extended trend of relatively sluggish productivity development. The reasons for this have been proposed as, among other things, lower benefits from ICT investments, less input in research and product development and the long shadow of the financial crisis.[4]

Chart 9.

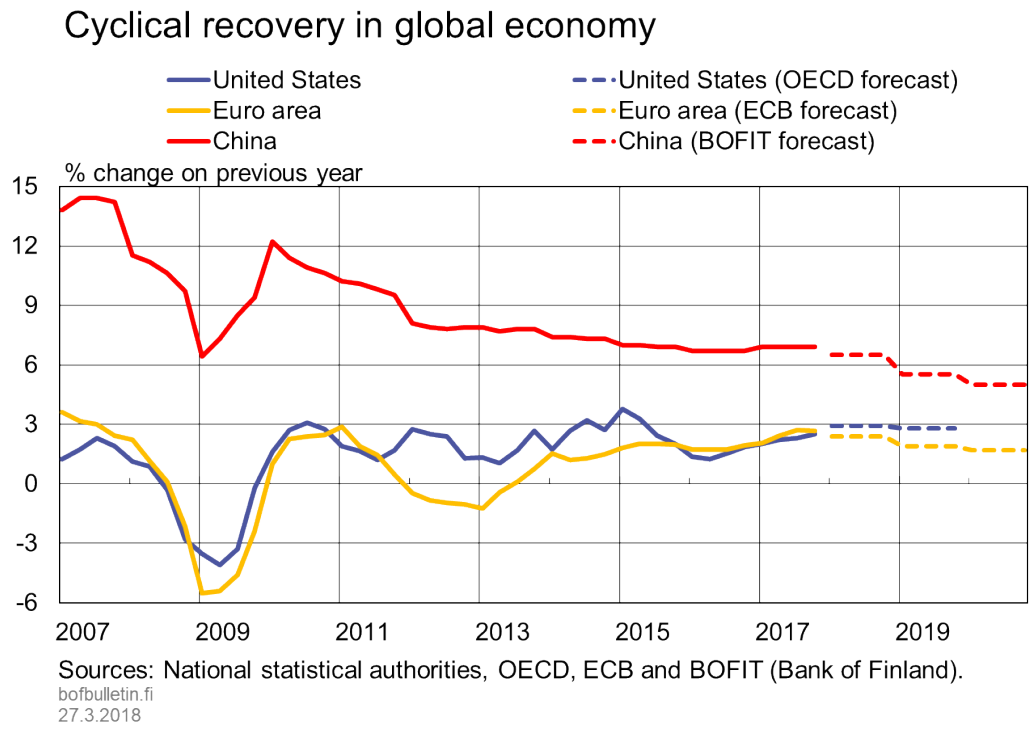


In recent years, the growth rate of potential output has been estimated to have increased, although it is still slower than before the crisis. The European Commission estimated in autumn 2017 that potential growth in 2018 would be 1.5%, while the spring 2017 estimate was for 1.2%. Any estimate on the potential growth rate comes with considerable uncertainty attached.

Growth potential is affected by labour input and productivity development. Productivity in the euro area per employee grew in the third quarter of 2017 by 1% year on year, which is roughly the equivalent to the average before the financial crisis (Chart 10).

The higher rate of productivity growth from 0.4% in 2016 is probably to a large extent cyclical. At times it may, however, reflect the positive effects of the structural changes that took place in many households after the crisis. Several reforms were carried out on both the product and labour markets in 2010–2015, especially in countries that were hardest hit by the crisis. These reforms are often reflected in stronger indicators measuring the financial structures of these countries.[5]

Chart 10.



Regardless of any reforms, cross-country differences within the euro area's economic structures are still considerable (see 'Euro countries recovered from crisis at different paces'). In addition to this, the rate of reforms in euro area countries has slowed, with a few exceptions. This is also shown in indices measuring structural reforms.[6] Indeed, all euro-area countries have some catching up to do in terms of indicators measuring economic structures, compared with the

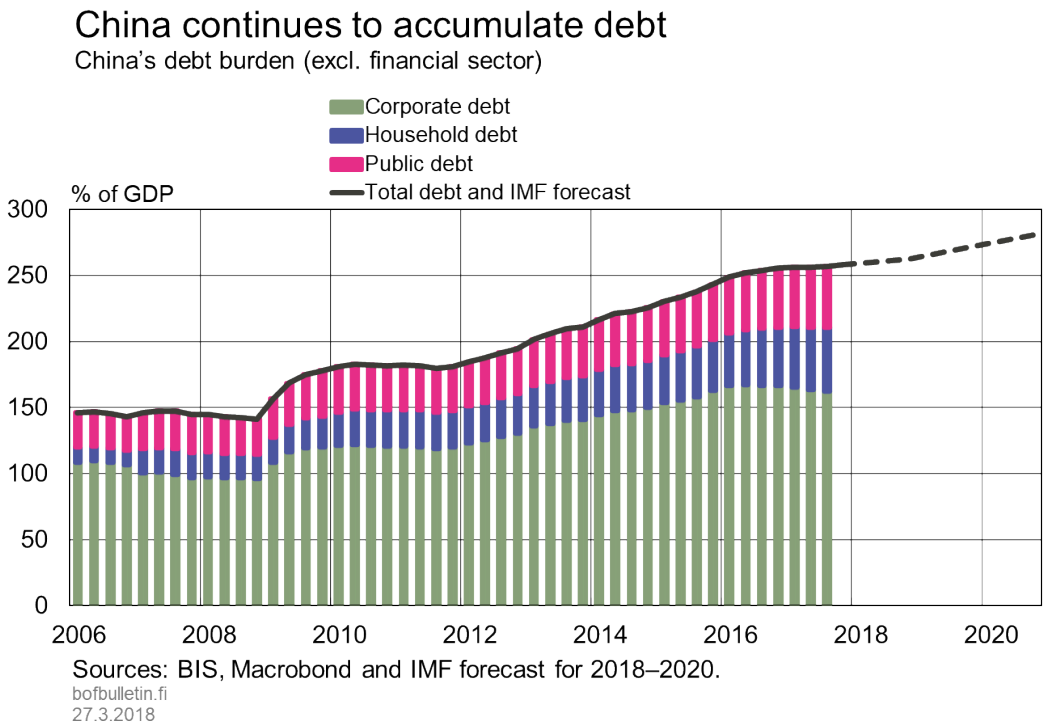
strongest economies. In the USA and Singapore, for example, economic structures, measured both with the Doing Business and the Word Economic Forum indicators, function better than in any euro area country. However, France especially is in the process of implementing numerous economic reforms. Changes affecting the labour market are already in the implementation phase, and both tax and pension reforms are being prepared. If successful, they can balance the country's public economy, reduce unemployment and give a boost to potential growth.

Growth potential is not affected only by labour productivity, but also by the size of the labour force available. Percentage growth in the working-age population (aged 15–64) in the euro area has almost stopped in recent years, while early in the new millennium it was about 0.5%.

In the current decade the effects of slow population development have been alleviated by a higher participation rate. As the population as a whole ages, the working-age population is forecast to contract in the next decade, especially in many of the newer euro area countries, and among the larger countries, in Germany and Spain. In order for the working age population to continue to grow, the participation rate would also have to keep growing. However, the participation rate in the euro area is already level with that of the United States (Chart 11). In order to raise the participation rate even further, major labour market structural changes would be required, and without these, the growth of potential output relies more and more on higher productivity.

Long-term growth in the euro area economy is forecast to be low, because the population is not really growing and the growth of potential output relies on higher productivity. Potential output growth in the United States is forecast to be faster than in the euro area, as population development is more favourable there than in the euro area, and labour productivity growth is faster.

Chart 11.



Do we have full employment in the euro area?

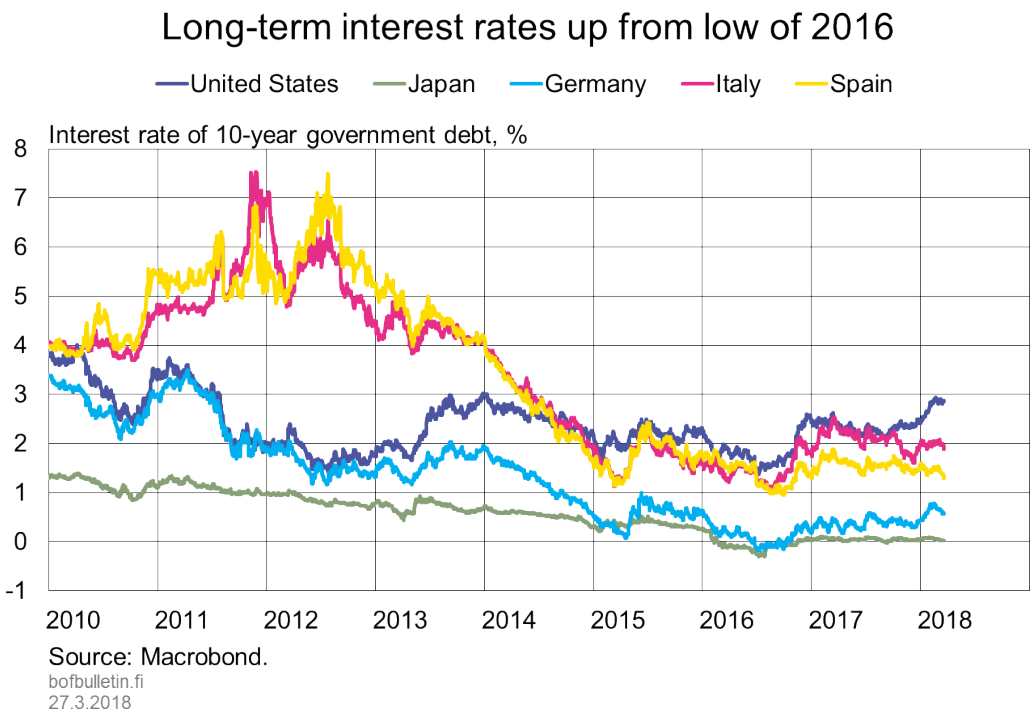
As a result of recent economic growth – which has been much faster than the potential growth – there is less unutilised economic capacity. According to the latest estimates by the IMF, European Commission and the OECD, the euro area's output gap is about to close up.

However, real-time assessment of the output gap comes with a considerable amount of uncertainty. According to many estimates, production was lower than the potential output in 2009–2017, that is, for about 9 years. This shows that the financial crisis and sovereign debt crisis have exceptionally long-term after-effects. Now, however, we have caught up with the effects of the crisis on production, and production is forecast to exceed potential output in a few years. Once production exceeds the level of estimated potential output (that is, making the output gap positive), the economy will begin to boom.

The higher rate of economic growth in the euro area has brought unemployment down. At the beginning of 2018, the unemployment rate was about 8.5%. This is close to the European Commission's autumn forecast (8.4%) about non-accelerating-inflation rate of unemployment, or NAIRU,[7] which describes the level of full employment in 2018 (Chart 12). Although the upswing may still bring the unemployment rate down, current NAIRU estimates indicate that reducing

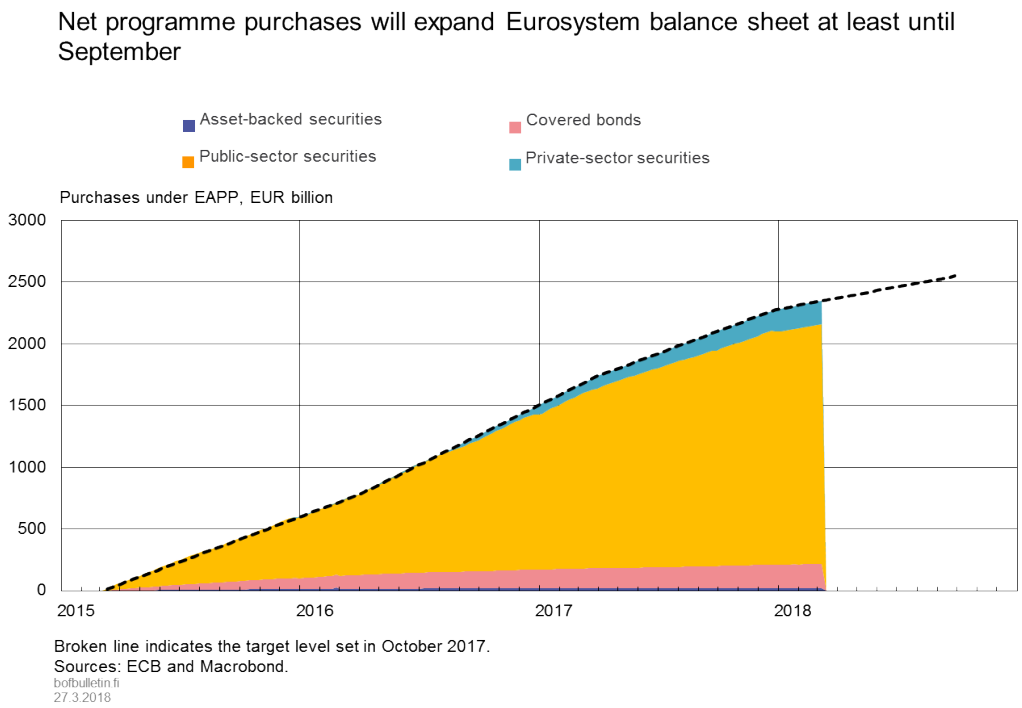
unemployment in the future would require labour market reform. On the other hand, NAIRU levels are difficult to estimate. The free available labour force may be greater than if it is calculated using the traditional unemployment rate, because working hours have increased less after the crisis than the employment rate has, and some fall under the heading of marginally attached or underemployed workers and are not included in ordinary unemployment rate figures.

Chart 12.



Employment rates in the euro area have risen as the economic situation has improved, and the number of people employed has reached the level of before the financial crisis. Cross-country differences in employment rates are, however, still significant. Germany's employment rate is in a league of its own, at about 75%, while in Italy it is only 58%. The number of hours worked has nevertheless increased more slowly than the employment rate has, meaning that the number of hours worked per person has fallen (Chart 13). The fact that the number of hours worked has remained lower than in 2000–2010 may indicate that there is more available labour force in the euro area than can be deduced on the basis of the employment rate. On the other hand, a lower number of working hours may also be a permanent phenomenon. This reduction has been going on since the 1990s and may reflect a growing appreciation of leisure time, for example. Moreover, the recent increase in the participation and employment rates can be mostly contributed to the older generation's (aged 55–64) more active participation in the labour market. These age groups may well want to work shorter hours than younger people.

Chart 13.

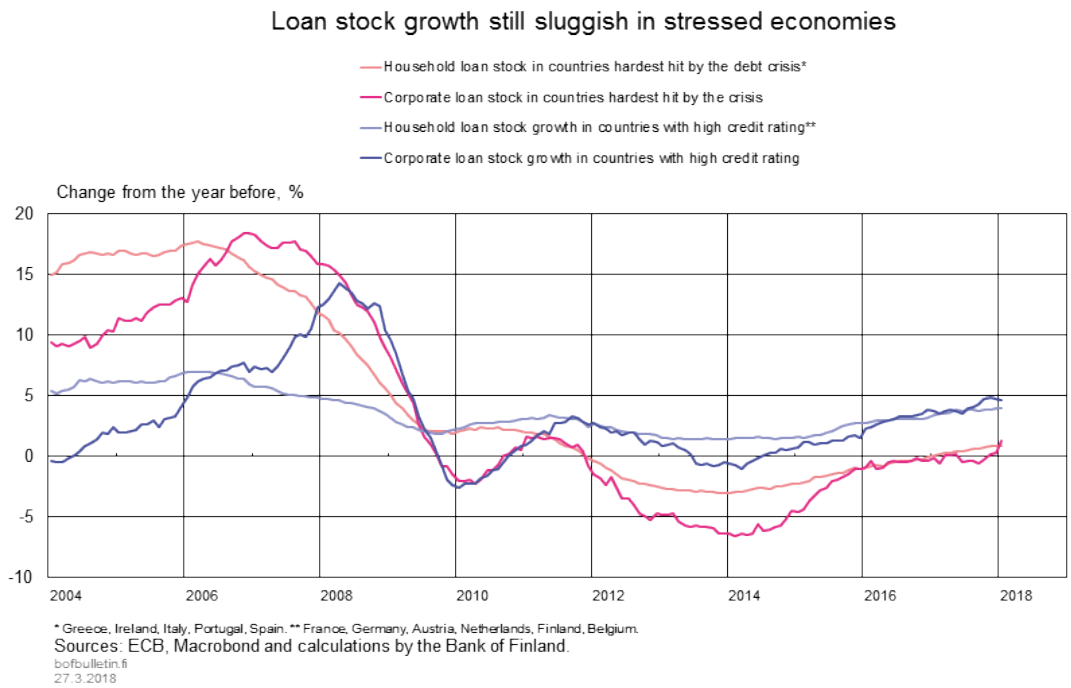


During the recession, people working part-time in the euro area against their will increased, as did the number of people not actually looking for work but nevertheless prepared to work. the broader measure of labour underutilisation, which takes into account marginally attached and underemployed workers, was a little over 16% in the third quarter of 2017 (Chart 12).[8] All marginally attached and underemployed workers accounted for an average of 7.7% of the labour force in 2017, which is almost one percentage point more than at the height of the economic upswing before the financial crisis. Taking them into account will somewhat increase the estimate of the free labour force, but does not seem to significantly change the picture about the development of available economic capacity.

Euro area inflation gradually gathering pace

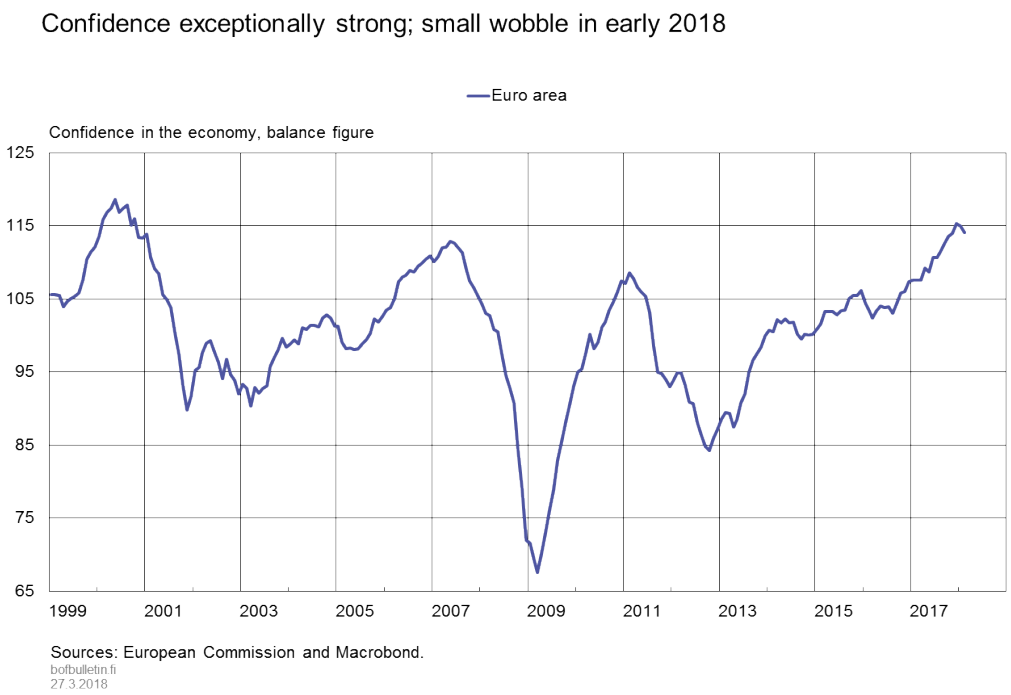
Growth in inflation last year, both globally and within the euro area, can largely be attributed to the recovery in the price of oil. Inflation has remained consistently near 2% across the OECD area and the United States for over a year now; however, in spite of modest improvement, the pace of inflation in the euro area continues to underperform the OECD average, and has done so for several years (Chart 14). Consumer price inflation rose by 1.5% in the euro area last year, representing a marked increase over the 2014–2016 average of 0.2%.

Chart 14.



Underlying inflation, which omits the more volatile categories of food and energy prices and serves as a better measure of the euro area's internal price pressures and longer term inflationary outlook, remains rather low, at approximately 1%, where it has largely remained since 2014 (Chart 15). Nevertheless, underlying inflation is expected to gather strength in the forthcoming years, as the cyclical upswing eventually results in real GDP surpassing the economy's level of potential output. The cyclical upswing and a recovery in inflation expectations should together create the conditions for euro area inflation to gradually accelerate.

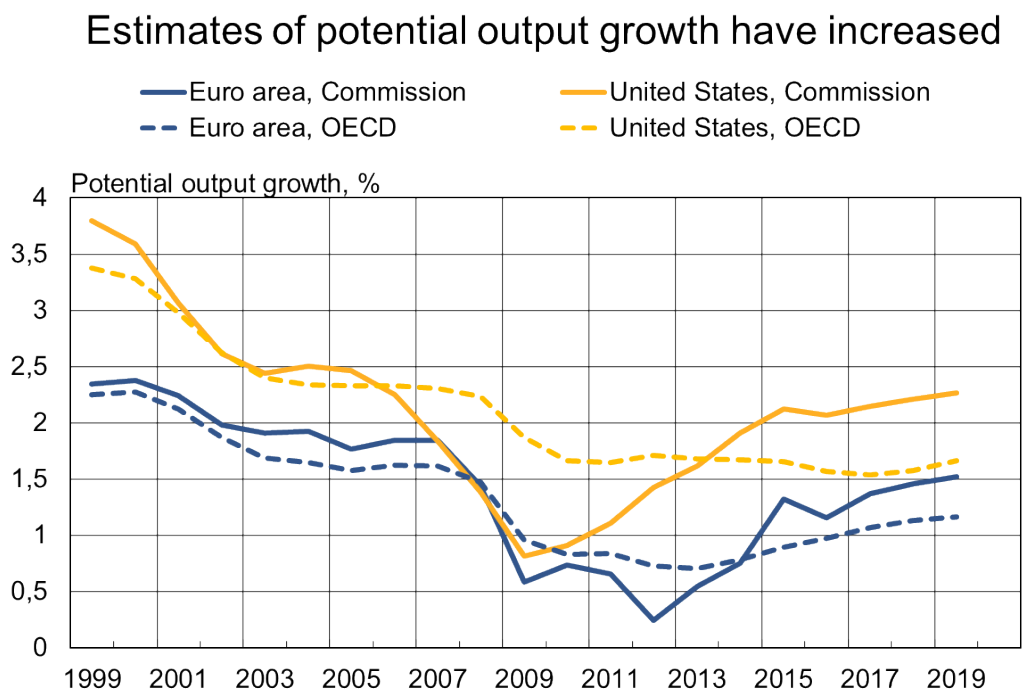
Chart 15.



Wages growth is expected to pick up on the back of increased labour demand, as the cyclical upswing spurs output and reduces the amount of slack in the economy. Wages growth has remained as of yet comparatively modest, despite reductions in unemployment across the euro area.

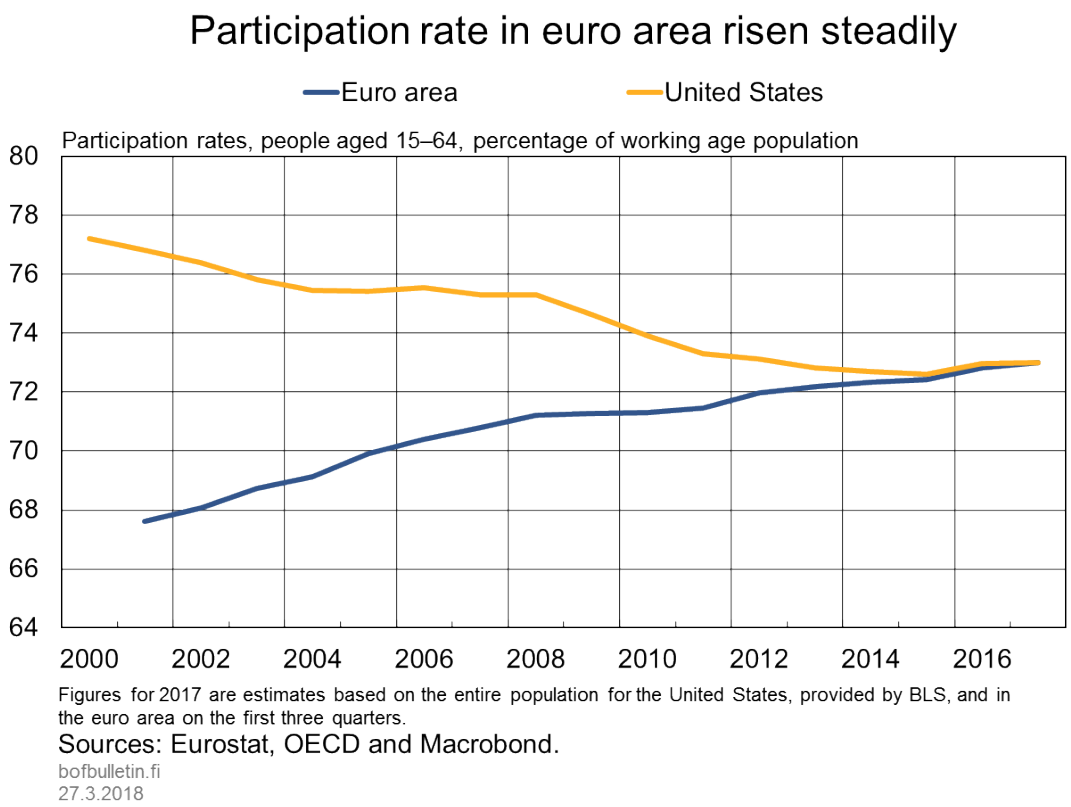
Growth in compensation per employee currently stands at 1.8%, slightly up from the low of 2016, but remains significantly lower than its rate of around 2.5% before the onset of the crisis (Chart 16). Lacklustre wage inflation might be explained by a variety of causes, including low productivity growth, subdued inflation expectations and a reduction in workers' leverage in wage negotiations caused by factors such as globalisation. It is worth bearing in mind, however, that wages are often slow to respond to improvements in economic conditions.

Chart 16.



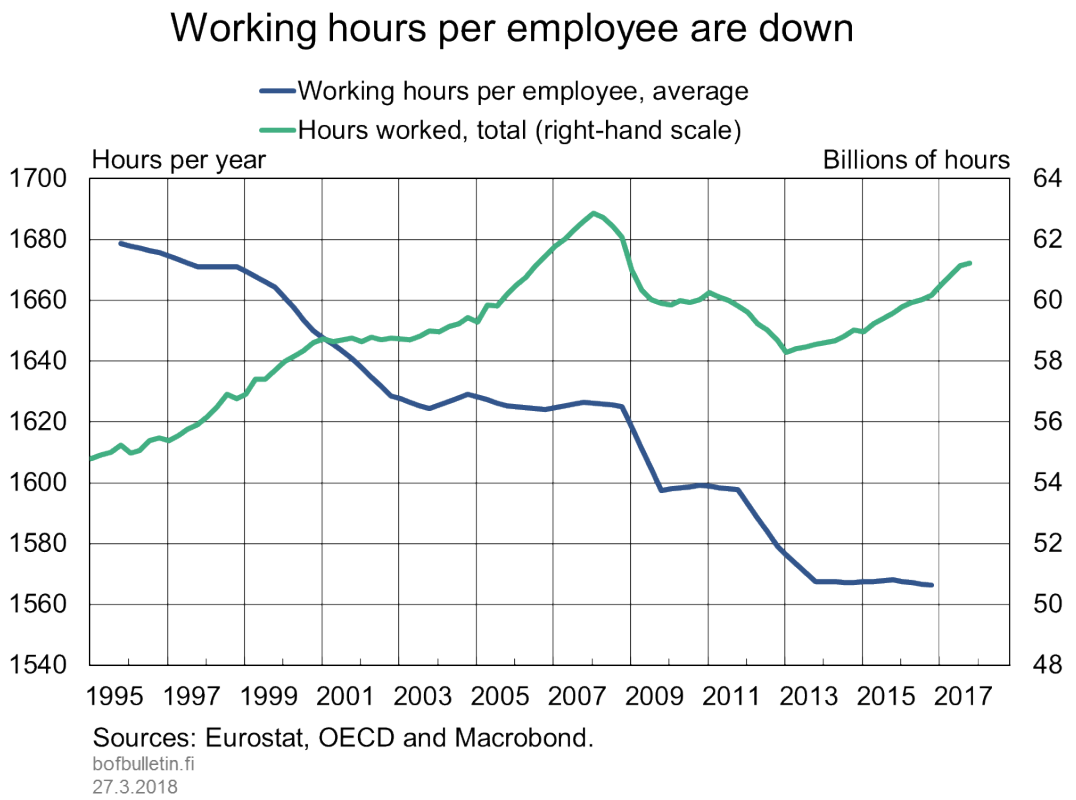
Inflation expectations have broadly firmed up since last summer, whether measured by survey or obtained from market data. Short-term inflation expectations have largely increased on the back of the cyclical upswing, but other factors, such as the recovery in the price of oil, have also bolstered sentiment. However, short-term expectations are secondary to the performance of long-term inflation expectations from the perspective of the monetary policy objective. As such, the euro area's long-term inflation expectations are just under 2%, which is still considerably lower than during the onset of the financial crisis (Chart 17). Although the immediate risk of negative inflation has all but disappeared, the probability, derived from financial market information, of inflation reaching the monetary policy objective has increased only little. The likelihood of inflation reaching a level clearly surpassing the policy objective still remain slim.

Chart 17.



In the current year, inflation will be supported by a slightly higher oil price as compared with the reference period in 2017, but these effects will be somewhat offset by the recent appreciation of the euro. Euro area inflation is expected to gradually accelerate towards the policy objective in the coming years (Chart 18). Although robust economic growth is foreseen to continue, all major forecasts predict that inflation will remain shy of 2% in the immediate years ahead. According to the ECB's forecast, euro area inflation will reach 1.4% in 2018 and remain at that level in 2019, before accelerating to 1.7% in 2020. It is certainly possible that the strong cyclical upswing and a sudden rise in inflation expectations might spur inflation to accelerate beyond these figures. Overall, the euro area's inflation outlook is characterised by a measure of uncertainty, as underlying inflation has shown little sign of growth despite improvements in unemployment and the expected closure of the output gap. Finally, inflation expectations have remained relatively subdued in spite of favourable economic conditions.

Chart 18.



Euro area's large economies growing, but regional unemployment imbalances remain

German economic growth accelerated to 2.9% towards the end of 2017, on the back of strong domestic demand and export growth. Germany's strong growth is widely expected to continue. The country's public finances are in surplus and the debt-to-GDP ratio has shrunk to approximately 65%. A new government was formed in March, which announced plans to spend its accumulated surplus on a variety of programmes, but especially on social welfare. Consequently, increased government spending will slightly boost growth in the years ahead. Germany's unemployment rate of 3.8% (youth unemployment at 6.6%) has sunk below the natural rate of unemployment and is beginning to be reflected in wages growth. Early signs of this were visible in February, when Germany's largest labour union, IG Metall negotiated a deal with the metals industry's employer representatives in the south-western state of Baden-Württemberg. Accordingly, employees affected by the deal will see their wages increase by 3.5% over the course of 12 months, and this is widely believed to serve as a weather vane for the rest of the German economy. German labour costs have grown at an annual average rate of around 2.5% in recent years.

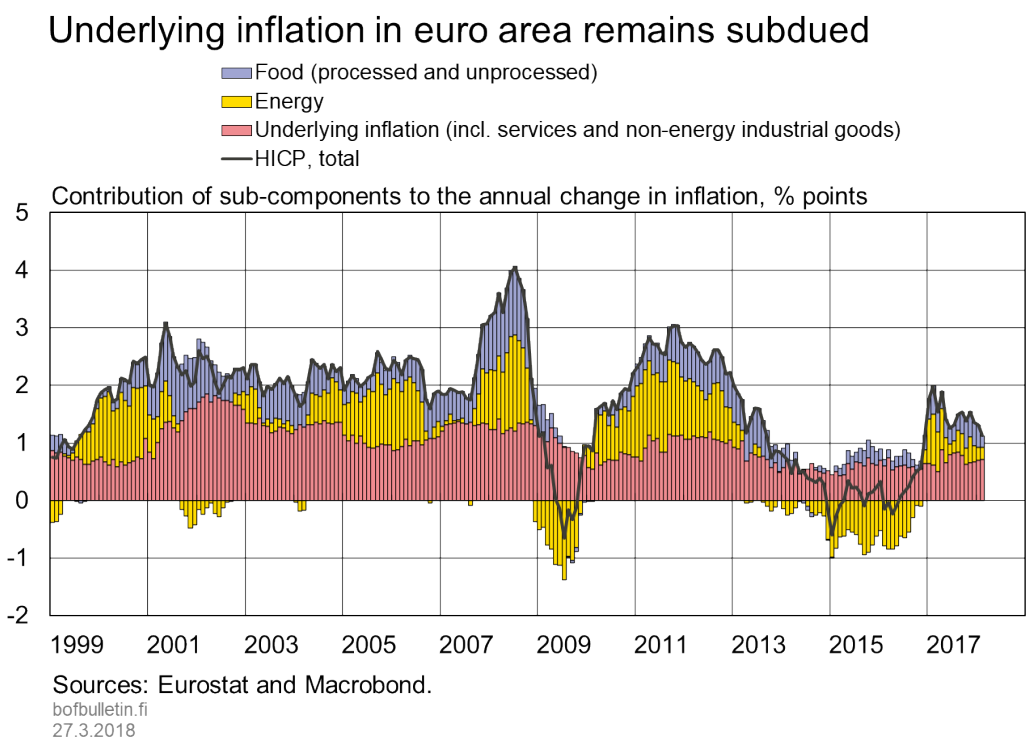
In France, economic growth picked up last year and is expected to continue at just below 2% in the current year and in 2019. Growth is mainly being driven by domestic demand. The French economy has not benefited from the global economic upswing to the degree that Germany has. A series of economic reforms proposed by President Macron are aimed at improving competitiveness. At the same time, measures will also be taken to address labour market efficiency, in an attempt to tackle unemployment as well as youth unemployment, currently close to 10% and 25%, respectively. The reforms will also seek to balance the public finances and reduce the country's debt-to-GDP ratio, which has reached almost 100%.

In Italy, GDP increased by approximately 1.5% last year, largely on the back of private consumption and investment; however; growth is expected to gradually slow. The contribution of net exports to GDP growth will remain slight, as both imports as well as exports have seen brisk growth. Italy's labour force participation rate has firmed up, leading to an increase in employment; however, labour participation is still low compared with the euro area's other large economies. Unemployment remains high at over 10%, with youth unemployment exceeding 35%. This, together with a large estimated level of hidden unemployment, has resulted in weak wages growth. This is only compounded by a labour productivity rate that is significantly below the euro area average. The implementation of much-needed structural reforms is being frustrated by shortcomings in the country's political system. As such, Italy's potential growth is forecast to remain low. Overall, the subdued growth outlook and high public debt-to-GDP ratio (over 130%) increase the Italian economy's exposure to risk.

Spain has been able to maintain growth above the euro area average for several years now in its efforts to make up for time lost during the crises. In 2017, the Spanish economy grew by 3.1%. The prevailing economic upswing has increased demand for Spanish exports, both within the euro area and globally, and the economy has benefited accordingly. Unemployment has improved rapidly but is still over 16% (youth unemployment over 40%). A large share of Spanish unemployment is structural by nature, meaning that it will be more resistant to the effects of the cyclical recovery.

Nevertheless, the country's labour force participation rate is fairly strong, and employment has grown steadily since 2013. The Spanish economy continues to benefit from the familiar elements of structural reforms, improvements in cost-competitiveness, slowly recovering house prices and accommodative financing conditions. Yet, despite its brisk growth, the country's public finances remain in deficit and the debt-to-GDP ratio has only decreased marginally. Overall, Spain's growth conditions have firmed up and potential growth has steadily improved, almost matching that of France.

Chart 19.



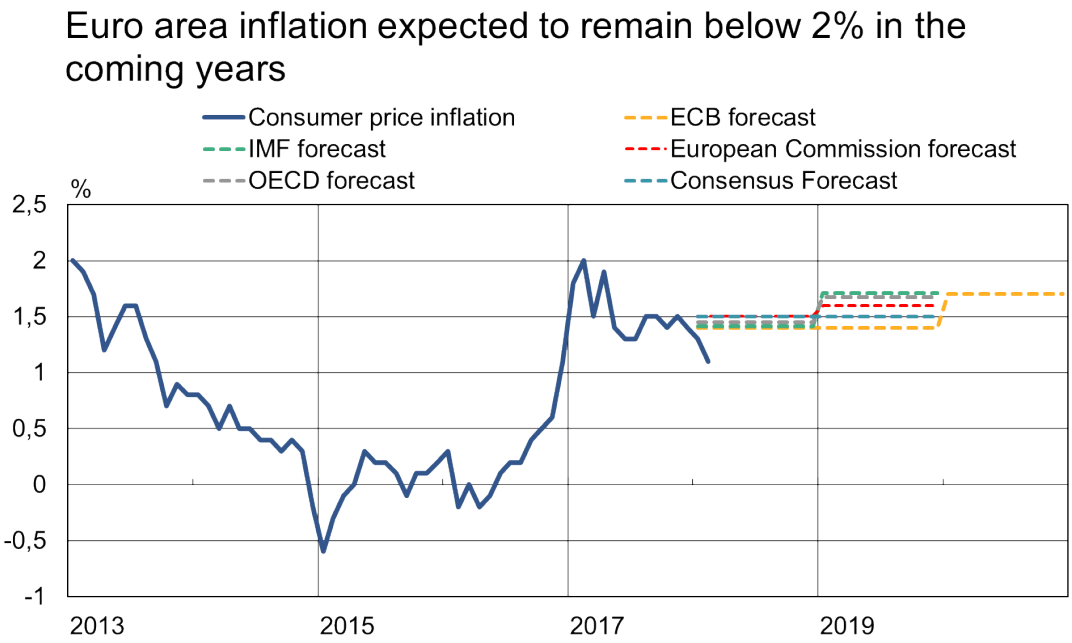
Cyclical upswing would be an opportune time to rebalance public finances

The euro area's debt-to-GDP ratio shrunk to somewhat under 90% in 2017, and the debt ratio is expected to continue its gradual improvement (Chart 20). At its peak, debt-to-GDP reached 92% in 2014. But while the euro area aggregate has improved, wide regional imbalances remain. Of the large economies, France, Italy and Spain are expected to maintain large debt-to-GDP ratios in the near future. The euro area's overall fiscal deficit contracted to approximately 1% of GDP in 2017. Historically, this figure is small.

Recently, the euro area's public finances have mainly improved on the back of the strong cyclical recovery. Not only does brisk growth bring additional tax revenue; it also reduces pressure on a variety of public expenditures, such as unemployment benefits. This in turn reduces the deficit. The debt ratio also sees additional improvement from the simple fact that when the ratio's denominator, or GDP, grows, the overall figure of debt-to-GDP becomes smaller. Additionally, reduced interest expenditure firms up the public finances. The overall impact of fiscal policy on the euro area's public finances has remained slight in recent years, and the conduct of fiscal policy is likewise expected to remain neutral in the immediate years ahead.

Although the euro area's public finances will be backed by strong cyclical conditions and low interest rates in the upcoming years, many countries will continue to grapple with high debt-to-GDP ratios. The current growth cycle would be an opportune time to make adjustments to the public finances, especially in countries burdened by excessive debt. According to countercyclical fiscal policy, public spending should be limited during cyclical upswings. This would provide governments with additional headroom for the conduct of fiscal policy and bolster market confidence, even in the midst of less favourable cyclical or financing conditions.

Chart 20.

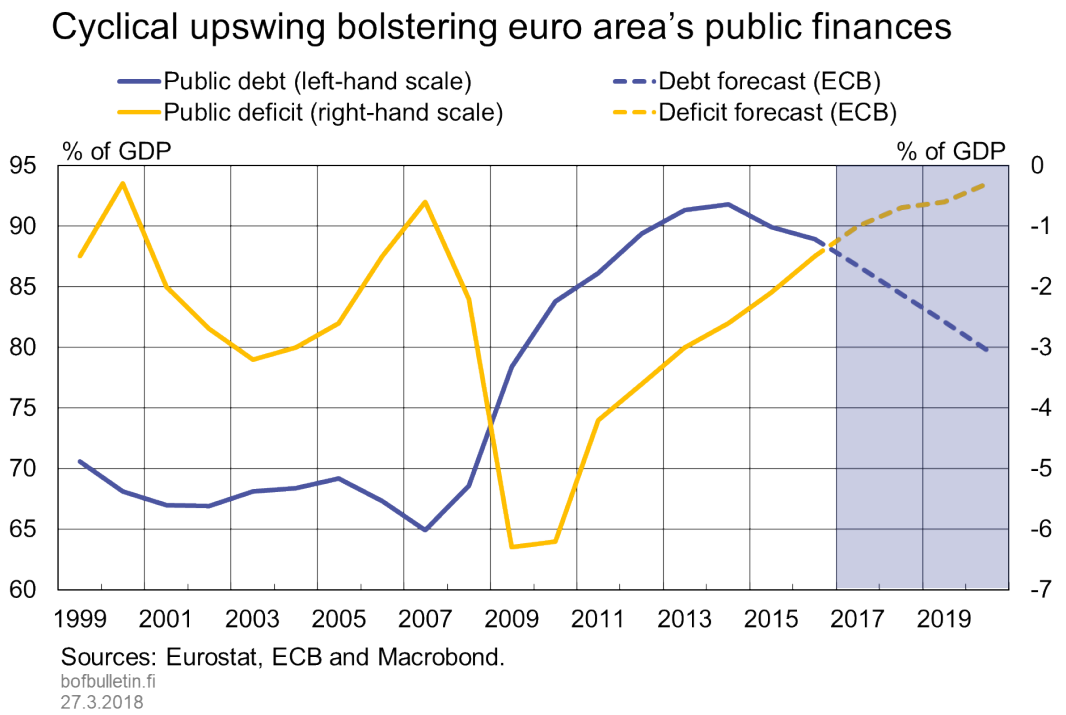


Global economic growth broadly based

The outlook for the global economy remains strong, but growth risks are tilted on the downside. The US economy grew by 2.3% in 2017, while the Chinese economy's growth rate accelerated to 6.9%, according to the country's official data. In the same period, the euro area grew by 2.5%, with the growth rate reaching approximately 2.7% in the latter half of the year. Widespread accommodative economic policy will continue to support growth in the upcoming years. In the United States, fiscal policy will remain exceptionally light in spite of the strong cyclical conditions. The Chinese government remains committed to its target of doubling 2010's real GDP by 2020; to accomplish this it will need to continue its economic stimulus. In the euro area, growth is still being supported by the ECB's non-standard monetary policy measures.

The global economy is gaining from a period of simultaneous upturn among many major economies. Should growth exceed its potential level, the remaining slack in the global economy will diminish and result in increased inflationary pressures. Barring any significant changes in prevailing conditions, monetary policy is expected to be tightened at a gradual pace while the ratios of debt-to-GDP remain largely unchanged. Similarly, growth is expected to gradually return to its potential rate, following the cyclical upswing's peak phase.

Chart 21.



Revival of US oil production to balance oil supply

The price of oil recovered sharply towards of the end of last year, on the back of increased demand as well as supply-side factors. OPEC's agreement to curb oil production, signed in December 2016, was extended a year later and is poised to last until the end of 2018; however, the subsequent increase in the oil price has prompted US shale producers to increase their output. In addition, Iran's return to the oil market, following the lifting of sanctions, has helped balance the supply of oil. Turning to the demand side, favourable cyclical conditions have reinvigorated the global economy's appetite for oil and other commodities. Indeed, many commodities saw even larger price hikes than oil, largely driven by strong demand in China. Oil approached USD 70 a barrel at the beginning of the current year, but oil futures predict this to drop to under USD 60 by 2020.

US short-term outlook bolstered by expansionary fiscal policy

The US economy grew by 2.3% in 2017, and strong consumer and industrial confidence suggest that brisk growth is set to continue. Fiscal stimulus has played a major role in boosting the country's short-term growth outlook. US legislators passed a tax reform bill towards the end of last year, and its effects will already start to be felt in the economy this year. The bill introduces reductions to corporate and personal tax rates and adjusts the taxation of multinational corporations. The corporate tax rate will be slashed from 35% to 21%, but at the same time tax deductibles will be reined in. The average and marginal tax rates on wage income will drop by around 1 percentage point and 2.5 percentage points, respectively. In addition, public spending will be increased over the next two years.

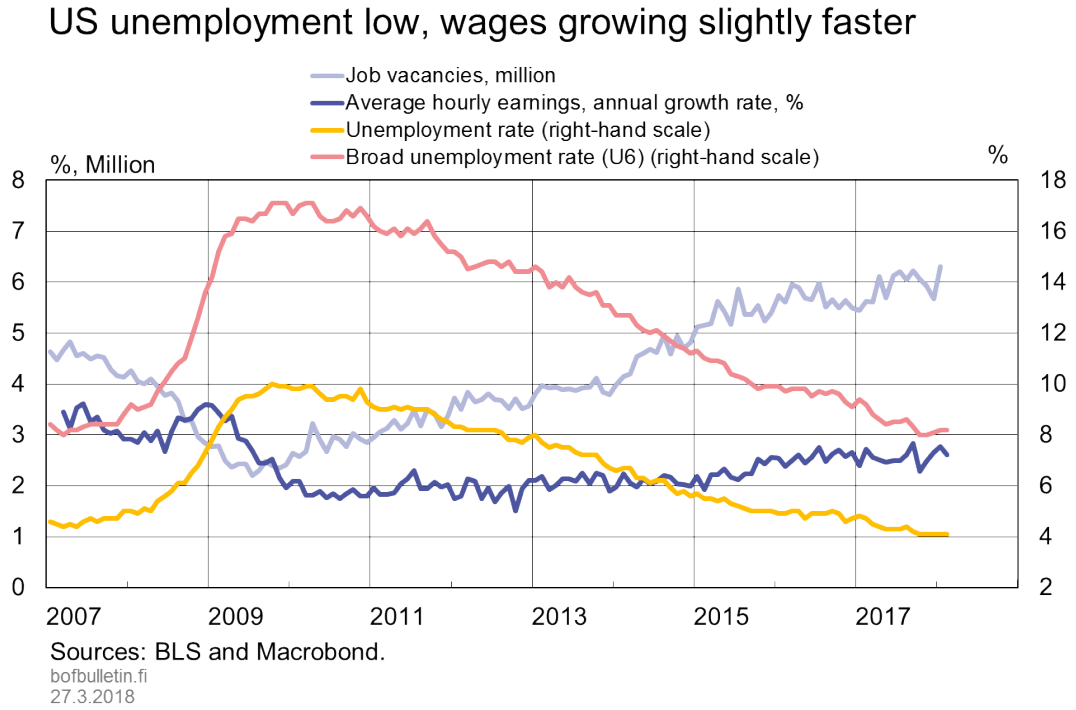
The tax reform bill and increase in public spending will encourage growth in private sector consumption and investment and stimulate the economy, especially in 2018–2019. According to the OECD's forecast, annual growth will improve by 0.5–0.75 percentage points over 2018–2019.[9] More specifically, the forecast puts growth at 2.9% this year and 2.8% in 2019 (Chart 21).

The country's overall general government deficit remained near 4.5% in 2017, and the debt-to-GDP ratio reached approximately 108%, a slight increase over the year before. The fiscal stimulus is expected to contribute significantly to the deficit and debt ratio in the near future, despite strong GDP growth. In 2020, the deficit and public debt are expected to be approximately 1.5 and 3 percentage points higher than they would have been without the additional fiscal stimulus.[10]

If full employment has been reached and the economy is already experiencing brisk growth, a fiscal stimulus will add to inflationary pressures. US unemployment currently stands at around 4% (Chart 22). The gap between unemployment aggregates (i.e. those that are narrower and broader in scope) has decreased, especially in 2017, which would indicate that less workers are forced to settle for part-time positions against their will. Annual wage growth, as measured by average hourly compensation, has picked up and is expected to accelerate due to the labour market conditions. The inflation rate has remained just over 2% since late 2017 and is expected to exceed 2 % in the immediate years ahead. Underlying inflation, which excludes the more volatile price categories of energy and food, has accelerated, although it is still slower than headline inflation. The reduction in economic slack will inevitably lead to increased inflationary pressures. In consequence, the Federal Reserve is expected to continue its gradual normalisation of monetary policy, implying further interest rate hikes and balance sheet adjustments, measures which it began in December 2015 and October 2017, respectively.

Fiscal policy will sustain the growth rate well above potential in the immediate years ahead, but growth will eventually adjust towards its potential. It has been suggested that the tax bill might increase the level of potential output, but this proposition is still uncertain. The US current account deficit stands at approximately 2.5% of GDP and is expected to remain large. The government's proposed tariffs on steel and aluminium are not expected to decrease the trade deficit, nor will other similar restrictions on trade. The announced fiscal stimulus will also contribute to the trade deficit. Increased protectionism in the United States will only add to the country's downside risks to growth.

Chart 22.



China committed to policy of high growth

According to the country's official statistics, growth in China accelerated slightly last year, reaching 6.9%. While it is difficult to evaluate cyclical conditions from GDP data, the economic situation is estimated to have improved from 2015–2016, as external demand has recovered and domestic consumption remains strong. Consumption accounted for 60% of growth last year; however, additional headroom remains, as private consumption only accounted for 40% of GDP, while public consumption stood at 15%. Investment growth has slowed, but its share of GDP remains significant, at 44%.

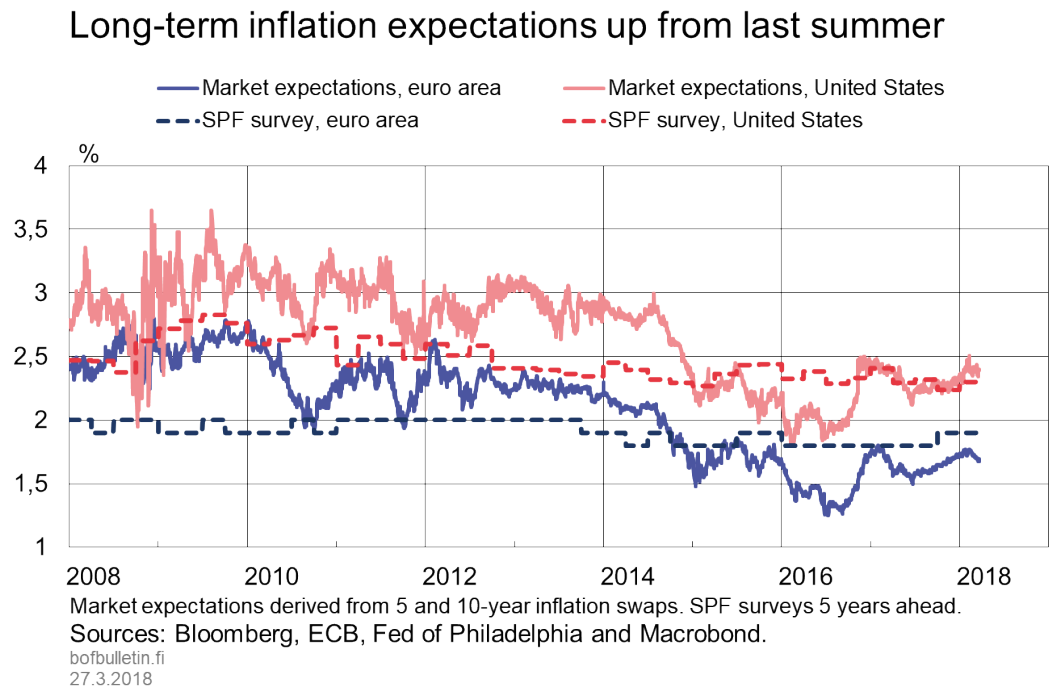
The current account surplus has shrunk to just over 1% of GDP. China has maintained its

restrictions on capital outflow, which has raised the country's currency reserves and supported its exchange rate. Last year, the yuan appreciated 7% against the USD and depreciated 6% against the euro, but the trade-weighted exchange rate remained relatively stable.

The Chinese government's expansionary fiscal policy (e.g. public investment and support of state-controlled enterprises) has also contributed to the brisk pace of growth. China's economic policy stance is seen to have changed. In a departure from a market-based policy, it has recently emphasised the role of the Party, illustrated by a decision at March's National People's Congress, where legislators lifted constitutional restrictions on presidential term limits. The pace of reforms has also slowed. Instead, all efforts will be placed on meeting the government's target of doubling 2010's real GDP by 2020 – a target which cannot be met without additional deficit spending. To this end, the government set its GDP growth target at 6.5% for the current year, a figure which China is expected to reach. In the near future, however, China will be forced to address risks associated with its financial markets as well as tackle its considerable environmental problems.

These issues, along with structural factors, will see the growth rate decline to approximately 5% by 2020, according to calculations by the Bank of Finland (see BOFIT Forecast for China). The official growth statistics should be viewed as approximations, as China feels a need to meet its growth targets and has certain difficulties in statistical reporting.

Chart 23.



Japanese growth burdened by population ageing and debt

Japan's economy has enjoyed sustained growth during the past eight quarters, and growth in 2017 amounted to 1.7%. This growth is mainly backed by an increase in exports, as domestic demand has been modest. Corporate investment has recovered slightly, but Japanese businesses are reluctant to invest domestically due to an ageing and contracting population.

Household consumption has suffered from relatively subdued wages growth. Businesses are beginning to face labour shortages, however, and will soon be forced to compete for workers by increasing wages. Measures aimed at increasing the labour supply, such as encouraging women into the workforce or raising the retirement age, will have little effect at this point.

Negligible wage inflation has a direct impact on the prices faced by consumers. As such, the meagre gains in consumer price inflation have primarily been the result of increased costs in importing energy. Underlying inflation remains near zero, and the central bank has signalled that its accommodative monetary policy is set to continue.

In the longer term, Japanese growth will slow to approximately 1%. However, because the population is contracting, slower growth does not mean that living conditions will deteriorate. Indeed, GDP per capita has actually increased in recent years. The main issue posed by slower growth lies in Japan's ability to remain solvent amid its massive sovereign debt, where the country has struggled to reduce its considerable debt-to-GDP ratio.

UK economy preparing for life after Brexit

The United Kingdom's economy grew by 1.8% last year, but growth is expected to slow in the immediate years ahead due to uncertainties related to Brexit. Private consumption is growth being subdued by the effects of faster inflation on real income. Inflation accelerated to approximately 3% towards the end of 2017. Although the UK's growth rate is expected to slow, unemployment has remained under 4.5%. The outcome of the Brexit negotiations continue to remain important for the UK's economic outlook.

Price correction in Sweden's housing market

In Sweden, GDP grew by 2.7% and HICP inflation stood at approximately 1.9% in 2017. Confidence in the economy has remained strong amid low unemployment (approximately 6.5%) and a high employment rate (approximately 78%). The country has a strong current account surplus and its volume of public debt remains small. These favourable conditions were also backed by a sustained boom in the housing market, which seems to have ended in a minor correction (see

'The impact of the housing market on the Swedish economy').

Continued slow growth outlook for Russian economy

Russia's economy showed signs of recovery last year with GDP growth at 1.5% (see BOFIT forecast for Russia). Imports began to pick up after a deep recession and grew by 17%, as the rouble's real exchange rate strengthened and domestic demand increased. In 2018, growth will be backed by the recovery in the oil price. GDP growth is expected to accelerate to just under 2%, resulting in a slightly larger GDP than in 2014. If the price of oil does not firm up and if, following March's presidential election, no efforts are made to diversify the economy, then Russia's growth rate is expected to slow to its potential of 1.5% in the immediate years ahead.

Global growth risks tilted on the downside

The global economic outlook is weighed down by growing protectionist sentiment in the United States, as exemplified by the country's planned imposition of tariffs on steel and aluminium and its new-found ambitions of negotiating better terms of trade for itself. Potential tit-for-tat retaliation and similar restrictions would have a negative impact on global trade. Even the risk of heightened protectionism may reduce confidence and weaken the global economy's growth outlook significantly. The effects of global protectionism would be both profound and long-lasting.

There are growing fears that China is pursuing its growth targets at the expense of implementing important structural reforms. Moreover, the apparent shift towards the Party's and state's role in managing the economy (e.g. the removal of presidential term limits) has created cause for concern. Indebtedness has also continued to grow, albeit at a slighter slower rate. China's total debt (excluding the financial sector) already stands at approximately 260% of GDP, and the lack of reforms means that the marginal productivity of new debt will only decrease. As the country continues to accumulate more debt, it faces growing risks to its financial markets and growth rate.

Political uncertainty currently abounds, relating to e.g. Russia, the United States and North Korea. These geopolitical tensions and political uncertainties could lead to severe and unpredictable consequences.

Fiscal stimulus amidst full employment will add to inflationary pressures in the United States. This might force the country's central bank to normalise its monetary policy at a faster pace than currently predicted. Rapid successive interest rate hikes as well as other uncertainties related to the US economy could create volatility on global financial markets and increase the risk of an asset price correction, which could even surpass the worst estimates.

The United Kingdom's EU membership will expire in March 2019, and an agreement is finally being reached on the 'transition period' which will last until the end of 2020. Outlining transitional arrangements will help ease the uncertainty overshadowing the United Kingdom's economic outlook, but it will not shed light on the country's long-term trade relationship with the European Union. The Treasury estimates that a Brexit resulting in a free-trade deal with the EU will lead to a 4.6–7.8% contraction in output over 15 years, as compared with remaining within the EU. In the worst-case scenario, where no deal is reached and trade is based on WTO rules, the reduction in output would be 5.4–9.5%.[11] The effects of Brexit on other EU members and the euro area's growth outlook are expected to be significantly smaller, but its unprecedented nature might lead to unforeseen consequences.

The euro area's growth risks are predominantly on the upside in the short term, but remain tilted on the downside in the long term. The strength and duration of the euro area's cyclical upswing may still be underestimated, and so growth could still exceed short-term forecasts. External downside risks stem from the growth risks related to the global economy. Internal risks, on the other hand, relate to uncertainties surrounding the implementation of structural reforms in the euro area as well as risks to the public finances and banking sectors in certain countries. Despite recent improvements, non-performing loans continue to strain the balance sheets of several banks and play a part in creating yield spreads across the euro area. In recent years, the pace of reform has slowed in the majority of euro area countries. The continued implementation of structural reforms remains crucial for increasing growth potential and the ability to withstand crises. Raising the growth potential also improves a national economy's ability to service its sovereign debt. In particular, deepening the integration of European Monetary Union by completing Banking Union would substantially improve the euro area's crisis resilience and thereby reduce the threats posed by downside risks.

Notes

1. This corresponds to estimates by the IMF, OECD and the ECB (excluding the euro area). The global economy grew by 3.7% in 2017. ↑
2. At the moment the Single Supervisory Mechanism is drawing up instructions for a new practice for the reservation of non-performing loans in order to increase banks' loan loss reserves and crisis resilience. What is more, the new accounting standard IFRS 9 entered into force at the beginning of 2018, according to which anticipated impairments are recorded already when granting loans. ↑
3. Euro area excl. Germany, France, Spain and Italy. ↑
4. See 'Weak productivity a drag on global economy', Bank of Finland Bulletin 4/2017. ↑
5. For example, the World Bank's Doing Business index improved significantly after 2010 in Spain, Italy, Greece and Portugal. ↑

6. For example, the World Economic Forum's Global Competitiveness Report 2018 does not indicate any considerable improvement on 2017 in the euro area countries. ↑
7. NAIRU refers to an unemployment rate that has a neutral effect on inflation. Any unemployment rate lower than this will accelerate inflation. If the unemployment rate is the same as NAIRU, it is a common interpretation that the economy has full employment. ↑
8. See ECB (2017), 'Assessing labour market slack', ECB Economic Bulletin 3/2017, Box 3. ↑
9. OECD (2018), Interim Economic Outlook, March. ↑
10. See CBO (2017), An Analysis of the President's 2018 Budget, July and CRFB (2018), Updating the U.S. Budget Outlook, March. ↑
11. HM Treasury analysis: the long-term economic impact of EU membership and the alternatives. Presented to Parliament by the Chancellor of the Exchequer by Command of Her Majesty. April 2016. ↑

Keywords

ECB, employment, euro area, global economy, growth, inflation, monetary policy, risks to growth