Monetary Policy Review

Growth continues, outlook more moderate

International economy, Monetary policy | 18 October 2018

The outlook for global economic growth has moderated from the spring. Growth in international trade has decelerated. Confidence in the economic outlook remains fairly strong, but trade tensions, in particular, are a downside risk to growth. Global economic growth will slow if protectionist measures expand and uncertainty leads to postponement of investment. In the worst case, increased import tariffs will cause global growth to dampen considerably. Due to the complex nature of global supply chains, protectionist measures may have unexpected and long-lasting consequences.

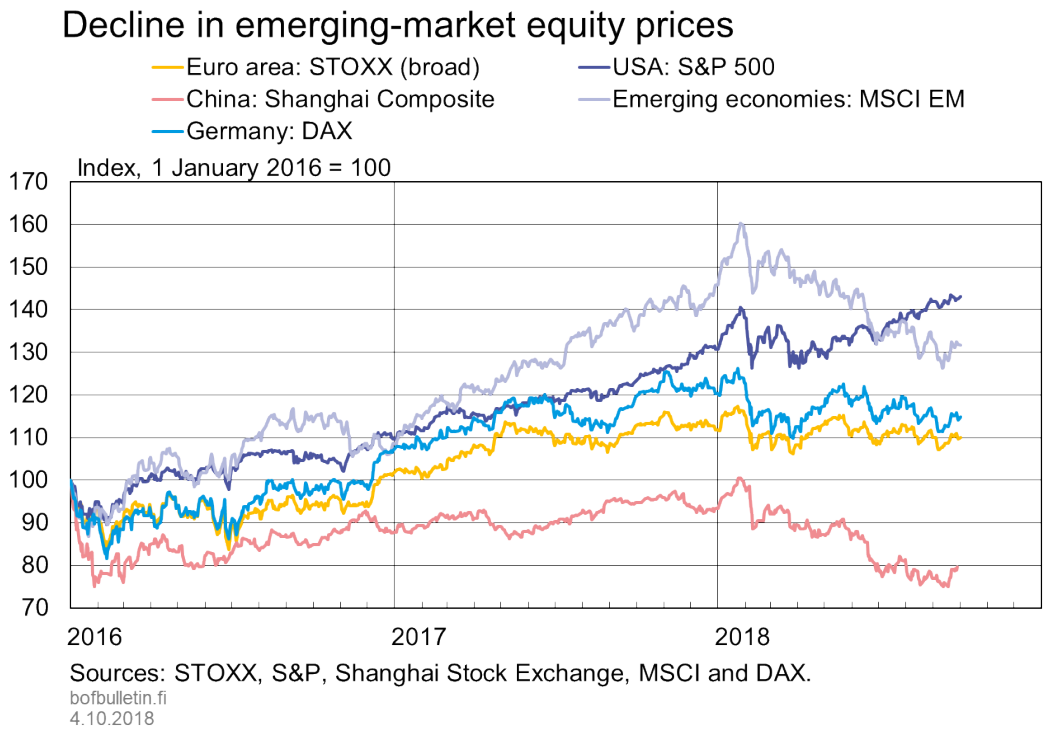


International financial markets change course

Growth in the world economy is forecast to remain strong, but the growth outlook is slightly moderated from last spring, and differences between countries have grown. The fastest stage of growth has already passed in the major economies, except for the United States.[1] Although industrial purchasing managers' indices have weakened further, the confidence climate has remained good. However, the growth rate of international trade slowed down in the first half of the year.

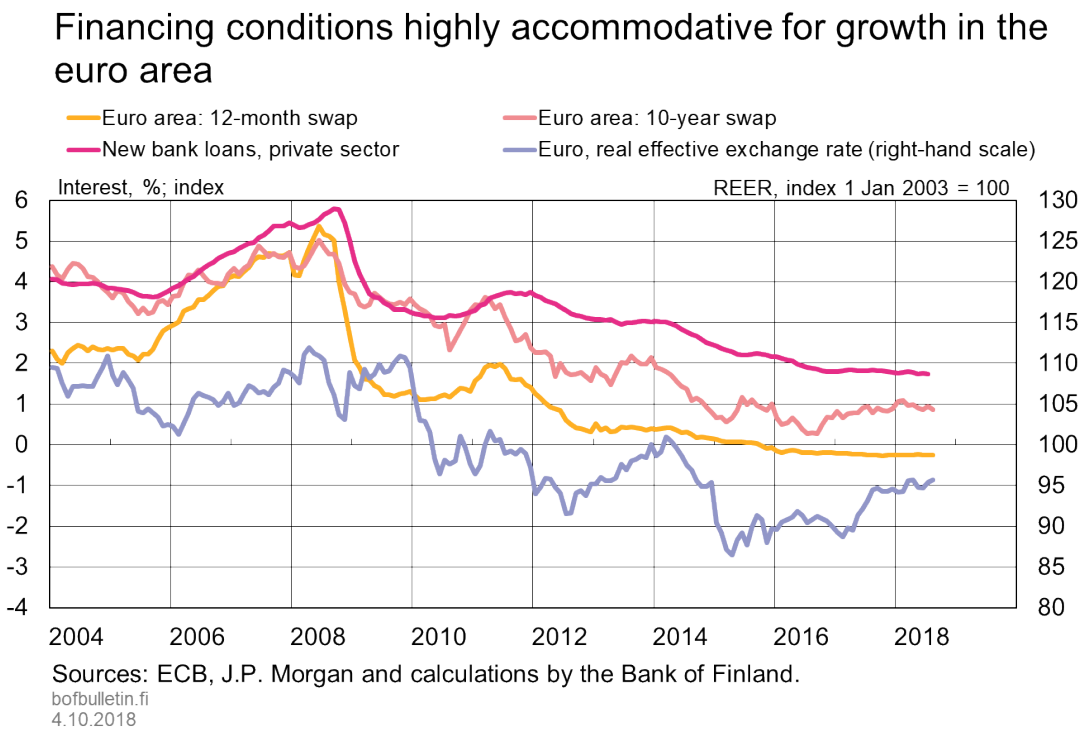
Inflation has increased globally, and inflation in the OECD countries increased in the summer to 3% (underlying inflation being about 2%). Globally speaking, exceptionally accommodative monetary policy measures are being withdrawn, with the United States in the forefront (Chart 1). The gap in interest rates between the United States and the other advanced economies has grown. This again makes investing in the United States attractive. Indeed, the US dollar has become stronger against other major currencies, and the exchange rates of emerging economies in particular have weakened.

Chart 1.



Many emerging economies rely on dollar-denominated financing, meaning that higher interest rates in the United States and weaker exchange rates increase debt-servicing costs in such economies. This is why the economic outlook of many emerging economies has weakened. The steep decline of especially the Turkish and Argentinian currencies is primarily the result of domestic economic policies, with contagion to other emerging economies remaining limited thus far.

Chart 2.



Higher interest rates in the United States, flow of capital from emerging countries and concerns of trade war have reflected on global financing markets during the last six months. Due to a weaker economic outlook, share prices have declined significantly in emerging economies in 2018 (Chart 2). On the other hand, the S&P 500 Index, tracking the US stock market, is close to record figures.

Within the euro area, yields on Italian sovereign bonds increased in late May as political uncertainty grew in Italy. The yield rise reflects on, for example, the markets' concerns about the sustainability of Italian general government debt if the new government's original financial policy plans are implemented.

Durable convergence of inflation towards the policy objective still requires monetary accommodation

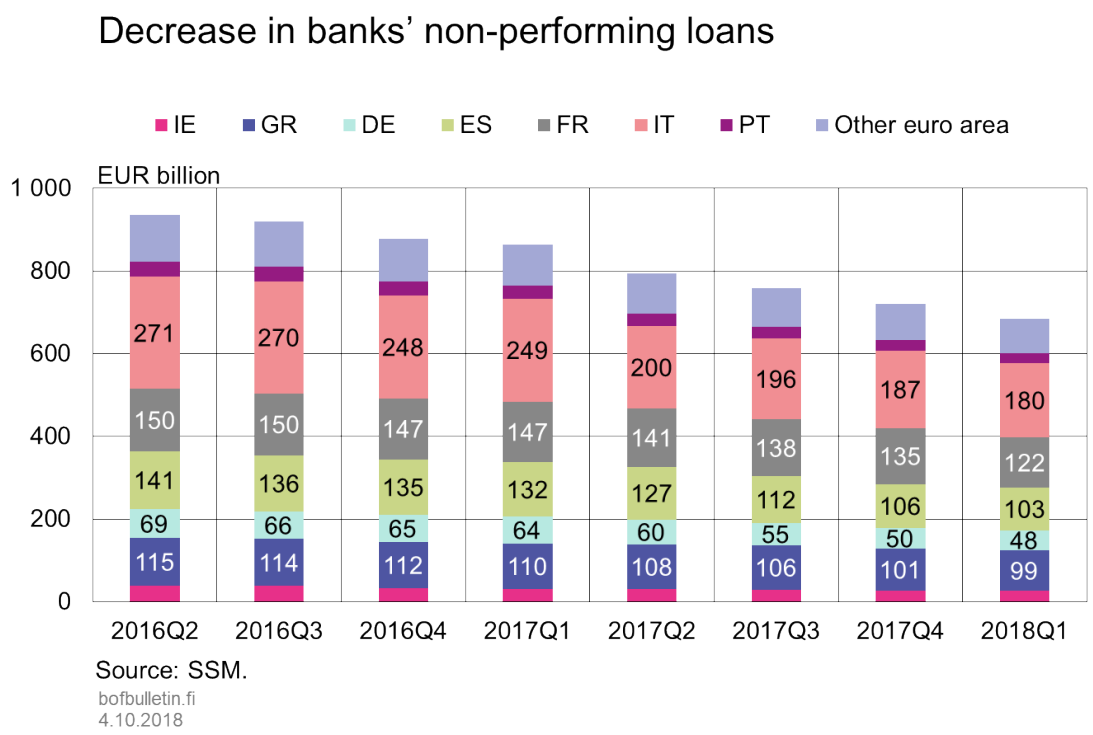
In the euro area, economic growth is returning to a normal pace of about 2% in 2018. Lower unemployment will fuel wage pressures and support inflation's sustained convergence towards the policy objective of just under 2%. In June the ECB's Governing Council stated that the inflation dynamics had progressed well towards to target. The Governing Council decided in September, as expected, that it would reduce net purchases of assets after September from EUR 30 billion to EUR 15 billion per month. The Governing Council confirmed a decision it had made already in June

of ending net purchases at the end of 2018 if interim information will correspond to its medium-term inflation outlook. If the net purchase of assets ends at the turn of the year, the purchase programme will encompass some EUR 2,600 billion, that is, slightly over 20% of the euro area's GDP (see article about Target2 balances).

However, in order for inflation to remain on track to the target, a very accommodative monetary policy must be pursued. The ECB's Governing Council changed its forward guidance concerning interest rates in June, saying it expected monetary policy interest rates to remain at their present levels through the summer of 2019 and if necessary, even beyond. Financial markets' expectations about the timing of the first interest rate rise are consistent with this communication (see article about monetary policy normalisation).

Reducing and possibly ending net asset purchases is not at this stage significant in terms of the prevailing monetary policy stance, because securities already purchased and the re-investment of principal payments on maturing assets will restrict the supply of bonds on the market. Indeed, the Governing Council has announced that it will continue to re-invest all principal payments on maturing securities for a long period even after the end of net purchases. The volume of maturing securities and therefore also the re-investments will be significant after the New Year (Chart 3).[2] The Eurosystem balance, which will remain substantial, and the re-investment of maturing securities will depress long-term interest rates, thereby supporting economic growth and inflation.

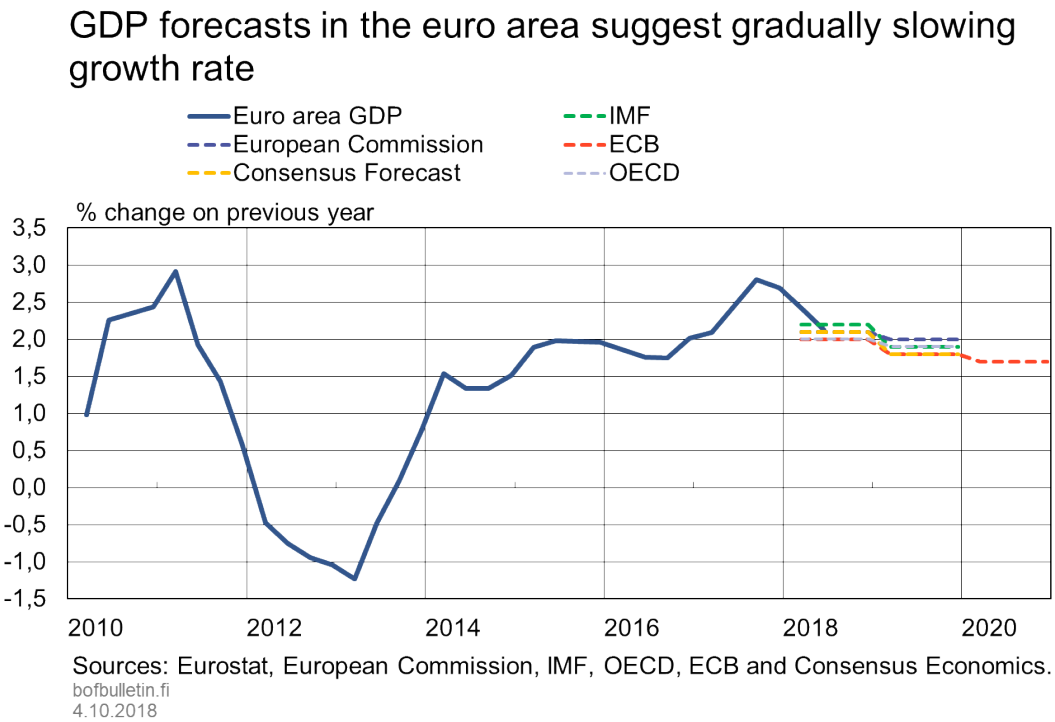
Chart 3.



Accommodative financing conditions have increased corporate lending

The ECB's accommodative monetary policy has been transmitted through the banking sector to the loan interest rates of households and businesses. Loan interest rates seemed to have reached their lowest point, being slightly under 2% in the euro area. The interest rate differences between the four large euro area countries[3] and between businesses and households have grown narrower. The average interest rates on new corporate loans are still above the average in Ireland, Portugal and Greece. The interest rates of corporate bonds involving higher risk have been rising since the beginning of 2018, while yields on low-risk corporate bonds have remained almost unchanged. Historically speaking, the interest rates are nevertheless still low.

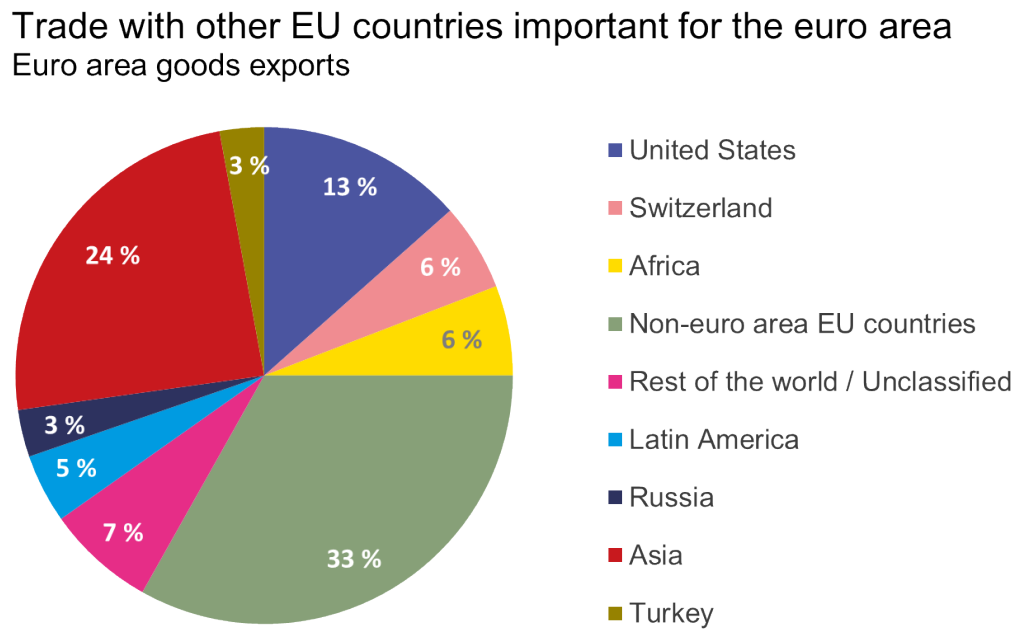
Chart 4.



The low interest rate level has accelerated loan stock growth in the euro area. The growth of the corporate loan stock has accelerated especially in Germany and Spain. Currently corporate loan stocks are growing at about the nominal GDP growth rate, so their growth rate can still be considered moderate, historically speaking.

Moderate growth of loan stock in relation to GDP and a low investment rate also result in a contraction in private-sector indebtedness. Corporate debt relative to value added decreased further in early 2018, whereas households' debt ratios have been falling steadily already since 2010 (Chart 5). In Spain in particular, the private sector has been consolidating its balance sheet intensively. Of the large countries, only the French debt ratios have risen in recent years, but even there, the private sector's indebtedness has since the end of 2017 showed signs of levelling. On the whole, euro area growth would still seem sustainable, because private-sector indebtedness has not increased.

Chart 5.



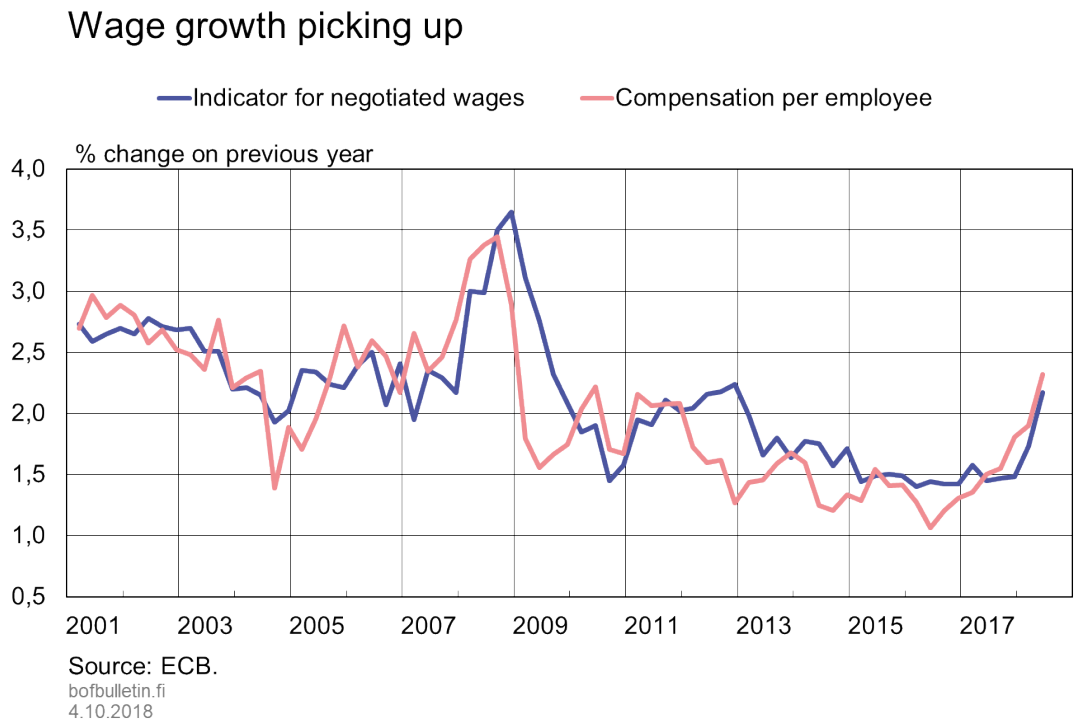
Source: Eurostat.
bofbulletin.fi
4.10.2018

Banking sector profitability recovering, albeit slowly

The profitability of banks in the euro area has improved in recent years. The return on equity (ROE) of banks in the euro area was 6.6% in the first quarter of 2018. ROE increased somewhat compared to the end of the last quarter of 2017, but fell behind slightly year on year. In fact, the improved profitability of banks in the euro area can during the past few years be attributed to lower credit losses, in particular. Lower credit losses and credit risks have contributed significantly to the profitability of banks in countries bearing the brunt of the sovereign debt crisis in particular, and to a gradual recovery of lending.

During the first quarter of 2018, the euro area banks had non-performing loans totalling some EUR 688 billion in their balance sheets, which is almost 20% less than a year ago (Chart 6). In proportion to the entire loan stock, non-performing loans accounted for 4.8% in the first quarter. This positive development has been affected by, among other factors, secondary market activity and various national measures to improve the integrity of the banking sector. Despite the relatively far-reaching positive development, the situation with non-performing loans in some euro area countries is still challenging.

Chart 6.



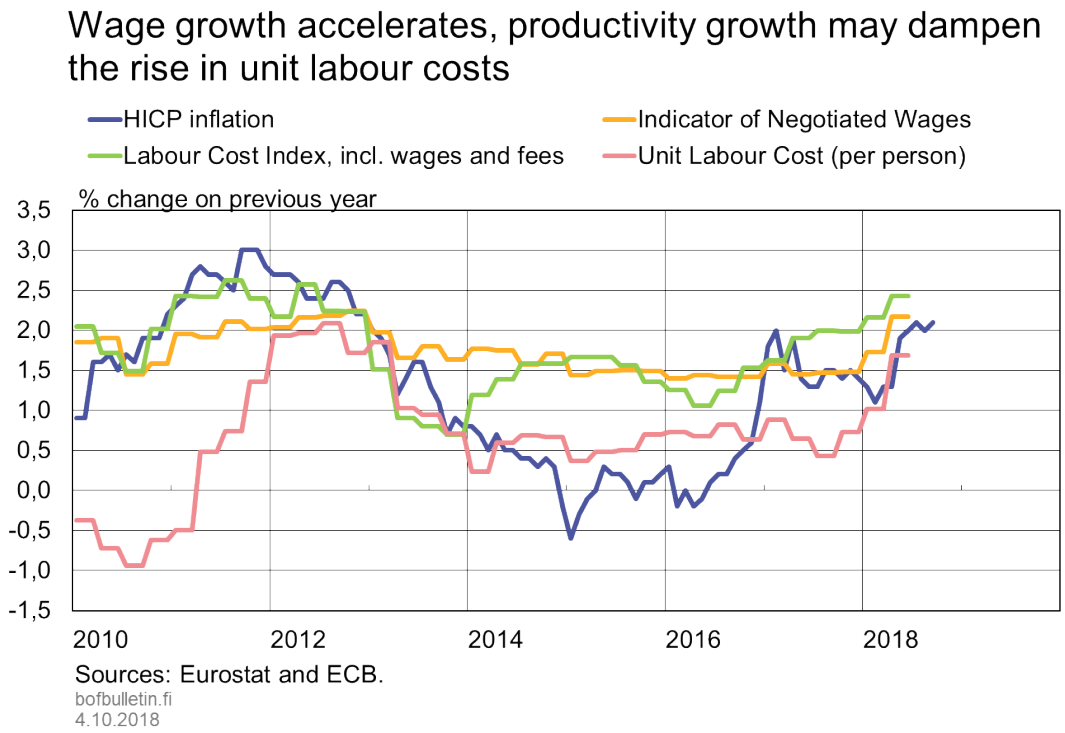
The profitability of banks' basic business is still weak. In terms of the banks' profits, the crucial net interest income has been suffering for a long time from low interest rates and a flat yield curve. As a rule, banks see their profitability increase when the yield curve becomes steeper. But the effect of higher interest rates depends to a large extent on how quickly interest rates go up, how steep the yield curve is, what the structure of banks' receivables and liabilities is, and how banks are able to re-price their receivables. If the loan stock growth remains weak and loan interest rates remain low for a long time, a simultaneous rise in funding costs could also have negative effects on banks' net interest income, at least in the short term. This risk exists especially in countries where the majority of the loan stock has a fixed rate.

In future, there will be pressure to increase the price of funding by banks. As a result of changes effected after the financial crisis, banks' equity ratios are higher, deposits account for more of their funding, market financing is more long-term, and banks have bigger liquidity buffers. These factors protect banks in case of higher interest rates and higher funding costs. Progress in monetary policy normalisation and, for example, an increase in the issue of covered bonds fulfilling MREL requirements[4] will increase funding costs.

Euro area growth slowing down

Momentum in the world economy and accommodative financing conditions boosted euro area growth in 2017. GDP grew exceptionally quickly, by about 2.5%. In the early part of 2018, GDP growth slowed down due to subdued development of net exports in particular. As a result of a more subdued half of 2018, GDP forecasts for the full year in the euro area have been reduced from more than 2% to about 2%.

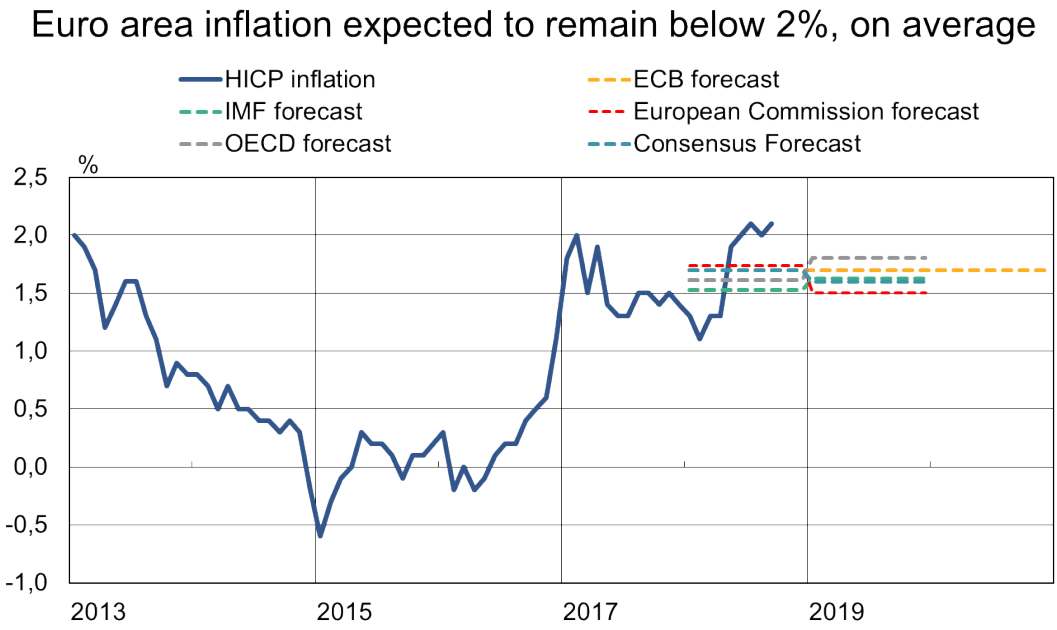
Chart 7.



The fact that growth has slowed down is mainly due to the strong period of growth in late 2017 and the subsequent period of normalised growth rate. Confidence indicators have correspondingly decreased, but they too began to fall from the high figures of late 2017 (Chart 7). In early autumn 2018, the confidence indicators were still high enough to suggest that GDP growth would continue at a somewhat higher rate than potential output during the next few quarters (Chart 8).

According to the ECB's latest forecast, GDP in the euro area will increase in 2018 by an average of 2.0% (June forecast 2.1%), 1.8% (1.9%) in 2019, and 1.7% (1.7%) in 2020.

Chart 8.



An increase in households' disposable income will boost private consumption as the employment situation improves and labour income increases further. Another indicator of steady growth of private consumption is that the confidence climate among consumers and in retail trade has remained good. During the second quarter of 2018, private consumption nevertheless grew exceptionally sluggishly.

The growth of investments in the euro area has been broad since 2014. Productive investments and housing investments have increased in almost all euro area countries. Investment growth in the next few years will be buttressed by the low interest rate environment, the need to renew the capital base and the lower level of the capital ratio for corporate sector debt. Another factor pointing at a need for investment and growth is the euro area's capacity utilisation in manufacturing, which in the summer of 2018 was close to the highest figure since 1980 when this was first recorded. However, investments are partly affected by businesses' uncertainty about the future, possibly reflecting trade policy tension, among other factors. If the growth of investments were to slow down, it would be detrimental to the euro area's future growth and growth potential.

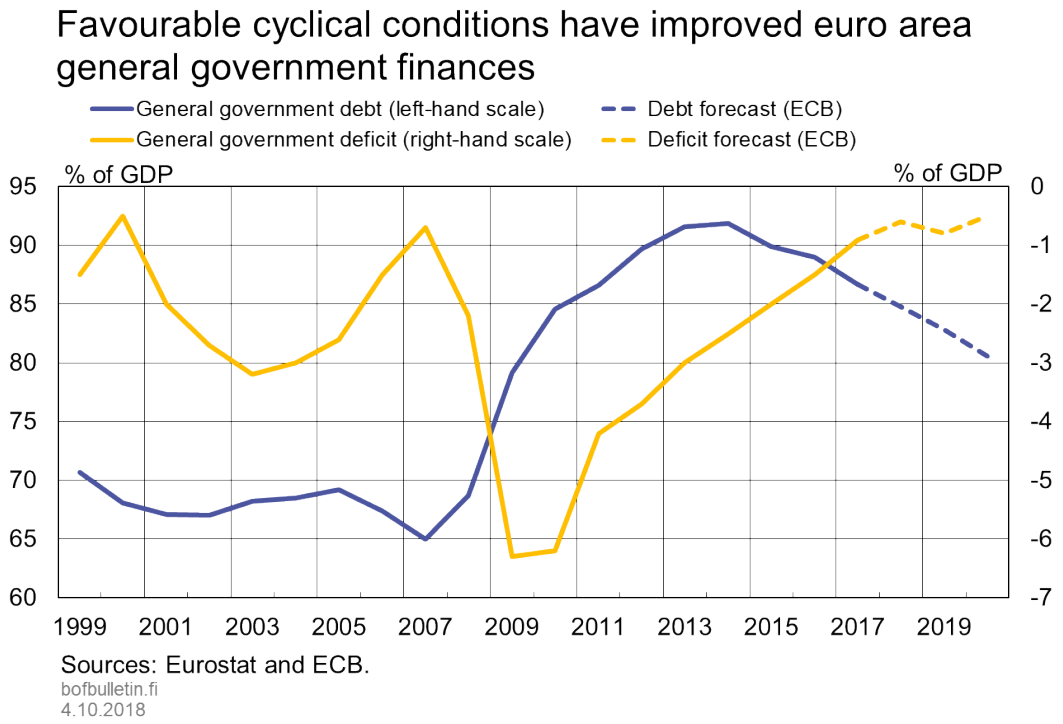
The euro area's net exports increased significantly in the latter half of 2017, but turned negative in early 2018. The development of net exports is affected by slower export growth in the wake of slower world trade growth. The current account surplus in the euro area in the early part of 2018 was about 4% in relation to GDP. The current account surplus was about 8% in Germany, about 3%

in Italy and about 1.5% in Spain. In France, the current account was less than one per cent in the deficit. The current accounts of countries worst affected by the crisis had a surplus of about 3%. Current account surplus stabilises economic development in case unfavourable shocks are realised. The sizeable current account surplus in the euro area nevertheless means that savings exceed investments; in other words, investments in the euro area are still relatively low.

EU internal market important for euro area trade

The euro area is a relatively open market in comparison to other major economies. The GDP share of goods and services exports was around 28% in the euro area in 2017, compared with much lower ratios in China (20%), Japan (18%) and the United States (12%) (Chart 9). In recent years, the euro area has developed into an increasingly open market, whereas the GDP shares of other major markets have remained virtually unchanged or even declined.

Chart 9.



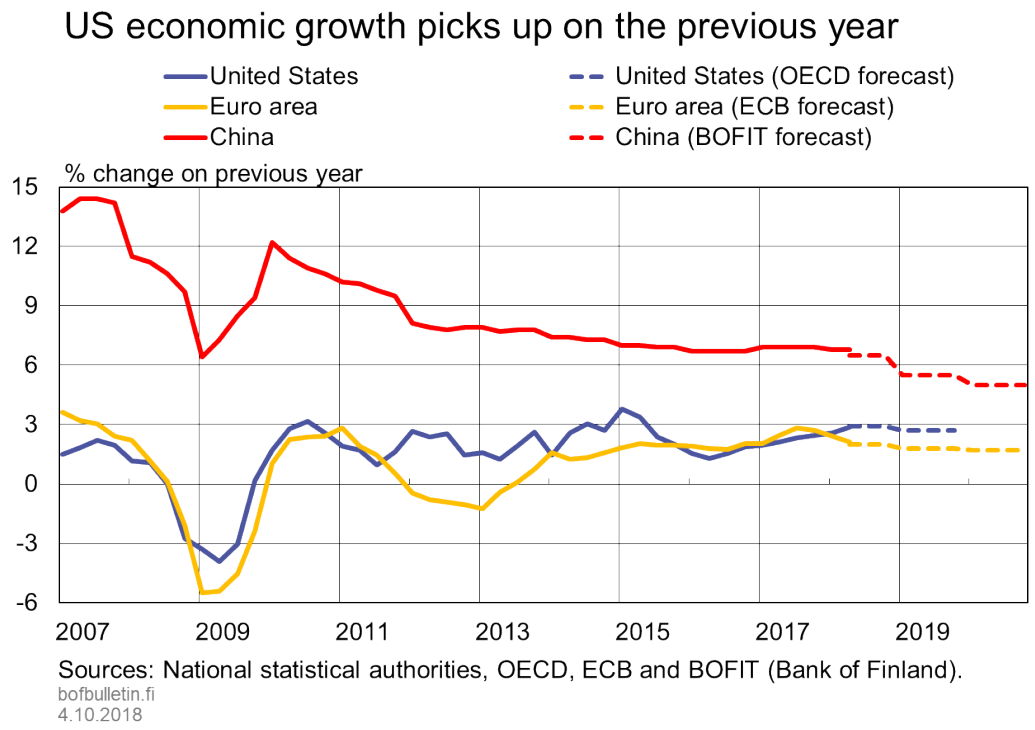
Euro area exports have grown briskly during the past few years, which has bolstered the area's economic recovery. Exports have been directed notably to the United States and Asia. Global economic growth has supported the export of machinery and equipment which are important for euro area exports.

Non-euro area EU countries are the euro area's major trading partners, accounting for roughly

30% of euro area goods imports and exports (Chart 10). The free-trade area allows for close integration of supply chains across the Union, which also protects the EU from any protectionist measures introduced by non-EU Member States. The United Kingdom's withdrawal from the EU in 2019 and the final outcome of the Brexit negotiations will, nevertheless, have a bearing on trade relations.

Trade policy tensions between China and the United States are also reflected in euro area foreign trade, as the two countries are the area's second most important trading partners, with around 13% of euro area goods exports bound for the United States and around 24% for Asia. Although the direct economic effects of the trade measures appear limited, the uncertainty that they create is detrimental to global investment and, by extension, to euro area exports growth (see Trade policy tensions casting shadow on economic horizon). In the longer term, rising protectionism may have unforeseen effects not least because of the complexity of international supply chains.

Chart 10.



Growth settling around its potential rate

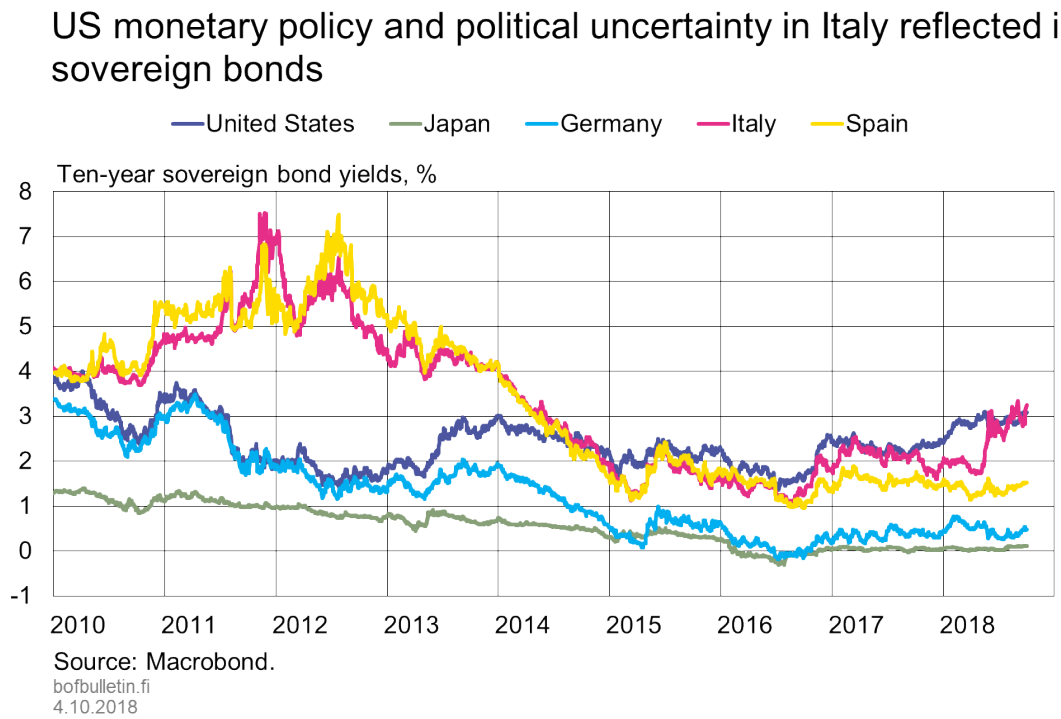
The cyclical growth peak is expected to have passed in the euro area, with the pace of growth gradually moderating towards its potential rate, which describes the long-term equilibrium of the economy. Key estimates of the rate of potential output growth in the euro area have remained close to 1.5% per annum, since spring. Estimates of potential growth rates are, however, always

subject to a considerable degree of uncertainty.

Estimates of potential growth rates have increased slightly since the early 2010s. The rise in potential output growth has been supported especially by the revival in total factor productivity from the very slow phase witnessed during the financial crisis. In fact, labour productivity per employee continued to grow at a rate of around 1% in the early part of the year, which is in line with pre-crisis average growth rates. The pick-up from 0.4% in 2016 reflects both a cyclical change and higher potential growth in response to the structural reforms adopted.

The higher labour force participation rate in the euro area has increased the supply of labour and boosted potential output growth. However, the participation rate has already reached the US level, and its positive contribution to growth is expected to fade over the immediate years ahead (see Labour-force participation on the rise in euro area – United States trending in opposite direction). The participation rate of the young (15–24-year-olds) has, nevertheless, still remained below the pre-crisis level. Furthermore, the contraction in the participation rate of the working-age population (15–64-year-olds) has already began in the euro area and will be steepest around the mid-2020s (Chart 11). The projected steeper contraction in the working-age population will, then, also be reflected in potential growth.

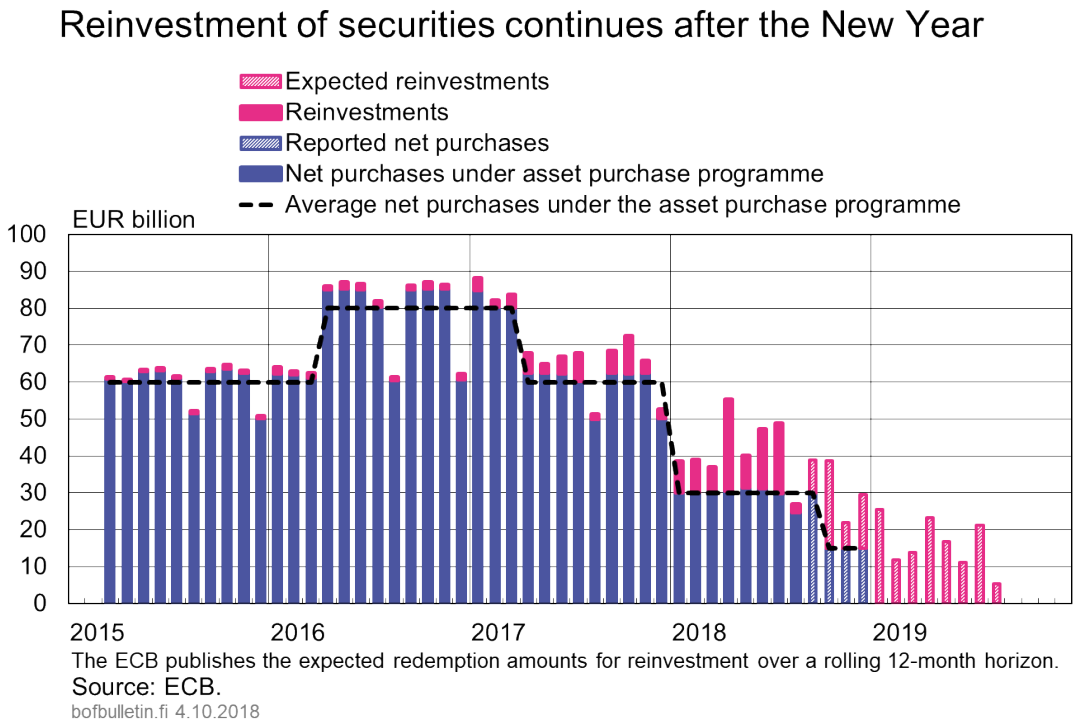
Chart 11.



Signs of wage pressures building up in the labour market

The brisk pace of economic growth has been reflected in a steady decline in the euro area unemployment rate, to close to 8%. This is roughly the same as the estimates of several international institutions, such as the European Commission or the OECD, of the NAIRU (around 8.3% for 2018), which measures equilibrium unemployment. The NAIRU refers to an inflation-neutral unemployment rate; hence, a tightening in labour market conditions is expected to put upward pressure on wages (Chart 12). Several institutions estimate that unemployment will fall below the estimated NAIRU. Of the large euro area countries, the rate of unemployment is still well above pre-crisis levels in Spain and Italy. Since the outbreak of the financial crisis, these two countries have undertaken a number of labour market reforms that may have reduced the level of equilibrium unemployment. In other words, there is still room for unemployment to fall further in these two countries before substantial wage pressures will start to build up. Signs of labour market tightening have started to emerge notably in Germany, but also in France. As well as German companies, especially businesses based in France and the Netherlands increasingly report the shortage of skilled labour. The employment rate of 15–64-year-olds has climbed to around 67% in the euro area, focusing on Germany and France, in particular.

Chart 12.

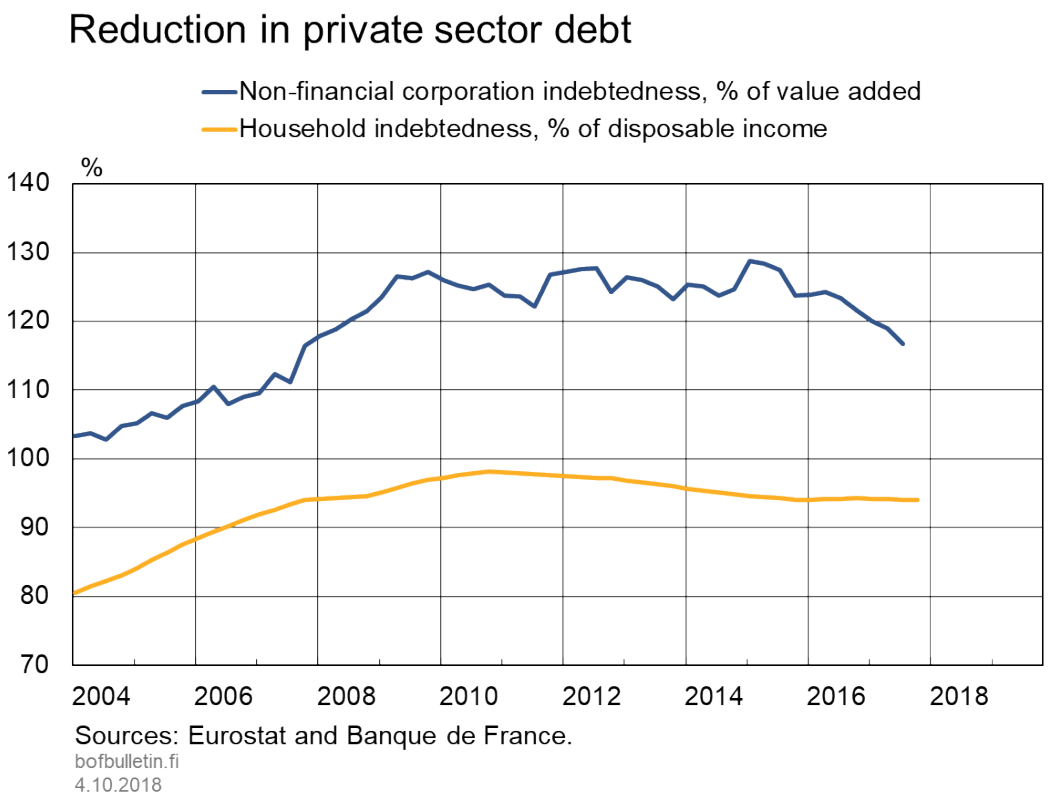


Euro area inflation expected to remain slightly below 2%

Euro area consumer price inflation accelerated during the summer, to levels around 2% (Chart 13). The pick-up in inflation is, however, largely the effect of a rise in energy prices. In summer 2018, the price of oil was some 50% higher than in the year-earlier period. This factor alone has fuelled consumer price inflation by nearly one percentage point. At the same time, the prices of unprocessed food also rose year-on-year, which contributed somewhat to consumer price inflation.

Underlying inflation (HICP excl. energy and food), which is measure of domestic cost pressures in the euro area, has since 2014 persistently remained close to 1%. A key driver of underlying inflation is the pace of growth in wages.

Chart 13.

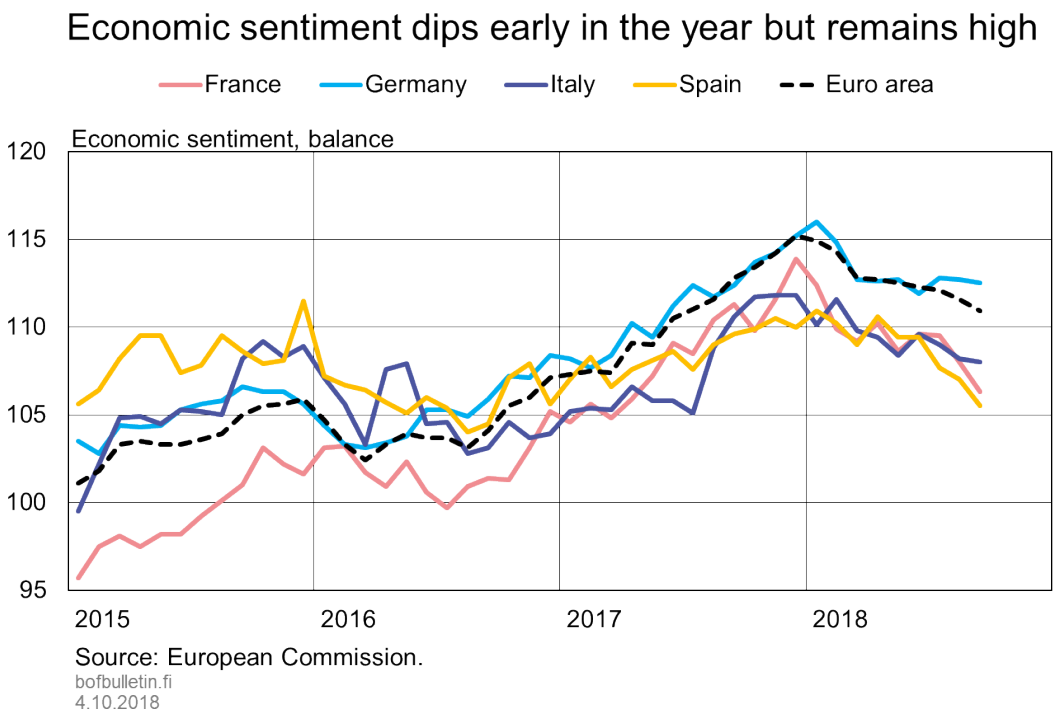


Wage inflation in the euro area remained considerably below its long-term average for an extended period; however, labour markets are beginning to tighten, and euro area wage inflation picked up in the first half of the year, as measured by a number of wage indicators.

Yet the effects of wage growth on consumer price inflation are diminished if productivity increases at the same time. In such a scenario, the cost impact per unit of output might remain

unchanged — or even decrease — thus mitigating the effects of increased labour costs on sales prices. Unit labour cost, i.e. the cost of labour per unit of output, is a measure of wage inflation which takes changes in productivity into account. Since 2014, the annual growth rate of unit labour costs in the euro area has averaged 0.7%, compared to an average of 1.4% for the period since the introduction of the euro (Chart 14). However, the most recent data indicate that growth in unit labour costs has also accelerated slightly.

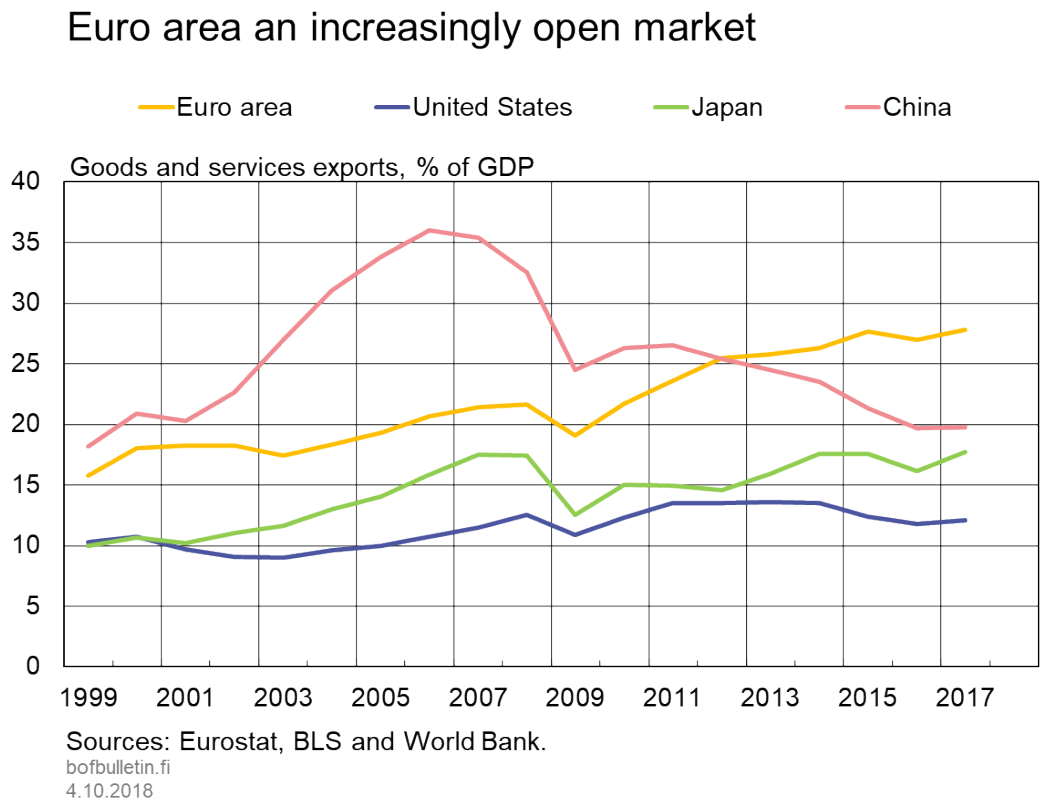
Chart 14.



Economic agents' perception of future inflation forms a basis for wage agreements and thereby plays a key role in wage formation. Monitoring and influencing inflation expectations is therefore important for the realisation and maintenance of price stability.

Short-term inflation expectations have risen steadily from the year earlier, but the upward trend has halted, at close to 1.5%. The ECB survey of professional forecasters (SPF) shows that longer-term expectations, which reflect perceptions of inflation over the current economic cycle, have remained well anchored close to the objective of price stability. By contrast, the rise in longer-term inflation expectations derived from market prices has come to a halt and levelled off to around 1.7%, following developments in the early part of the year (Chart 15).

Chart 15.

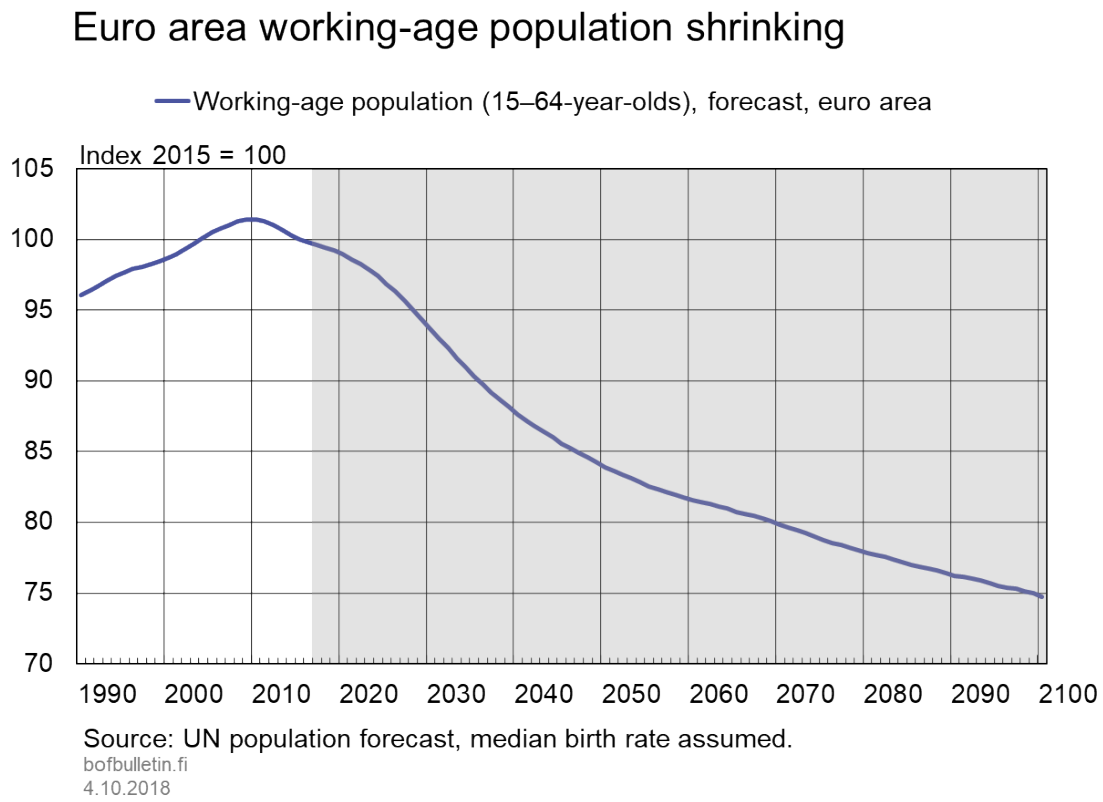


According to the ECB's projections, euro area inflation will accelerate to 1.7% in 2018, from 1.5% the year earlier. The main factor behind the pick-up in inflation is the price of oil, but its contribution is expected to gradually fade. Oil futures display a downward trend, and if realised, will exert downward pressures on inflation.

As the impact of the oil price dissipates, inflation is expected to gradually decelerate to about 1.5% by mid-2019. Past this, inflation is expected to remain largely stable, before displaying torpid acceleration towards the end of the forecast horizon. The ECB's September projections foresee inflation to average 1.7% in 2019–2020.

In spite of the upswing, growth has filtered through to inflation relatively slowly due to persistently muted inflation expectations. The sustained momentum of strong growth, the closing of the output gap, and shrinking unemployment should, however, gradually strengthen inflation expectations and accelerate wage growth, thus fuelling inflation in a sustainable manner. Nevertheless, key forecasters expect inflation to remain below 2% in the immediate years ahead (Chart 16).

Chart 16.



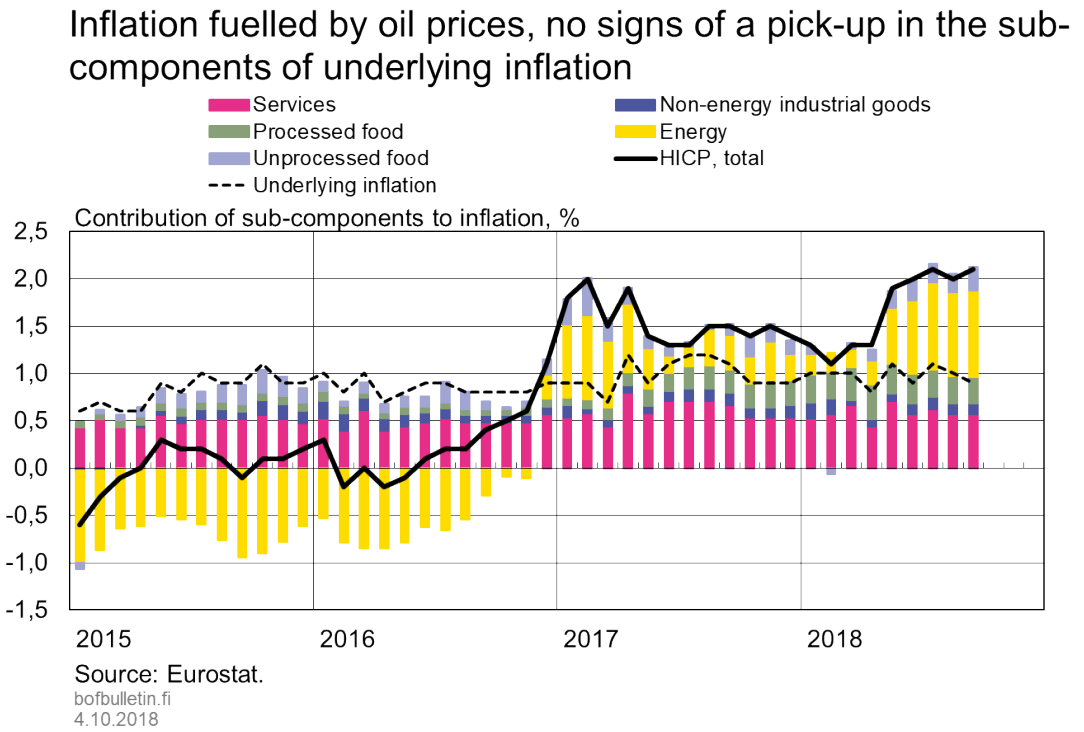
Italy's outlook dampened by political uncertainty

Of the four largest euro area countries, the outlook for the Italian economy has seen the most change from last spring. Italy has already recorded the weakest growth figures among the largest euro area economies for a number of years (Chart 17). Estimates of the rate of potential growth are low, clearly below 1% for 2018–2020. This is due to for example, the low rate of investment, weak productivity and unfavourable demographics. Italy's volume of general government debt is at approximately 130% of GDP. Appointed in May, the new Italian government's proposals of basic income, flat tax, a lower age of retirement, and increased fiscal stimulus, have all raised concerns on the financial markets, and Italian sovereign bond yields have been at high levels since the end of August. Political uncertainty and tighter financing conditions, if protracted, will dampen the economy. Substantial public debt and subdued potential output growth mean that budget discussions in Italy will be followed closely.

Germany's economic growth remains broadly based, despite a slowing in the early part of the year. Germany is already suffering from a shortage of labour, as the unemployment rate is clearly below 4% and employment has risen to 76%. The tightening of the labour market is already reflected in wage pressures. Both the IMF and the European Commission have urged Germany to enhance the

growth potential of the economy by using its budget surplus for investments that support physical and human capital and boost productivity, which would also slightly reduce the exceptionally large current account surplus. Germany will thus increase public spending in 2018–2019 by increasing investment in, for example, infrastructure, education, research, digitalisation and housing, in addition to boosting military spending and increasing child benefits. These stimulus measures are expected to bolster Germany's GDP growth by a couple of tenths of a percentage point in 2018–2019.

Chart 17.



France's GDP is expected to grow in 2018–2020 by just under 2%. The key challenges to the economy are the fiscal deficit and the current account deficit. The French government is seeking to solve these problems by introducing reforms that cut public expenditure and improve competitiveness. The Macron administration has already implemented labour market reforms, which will be followed by employment security and pension reforms.

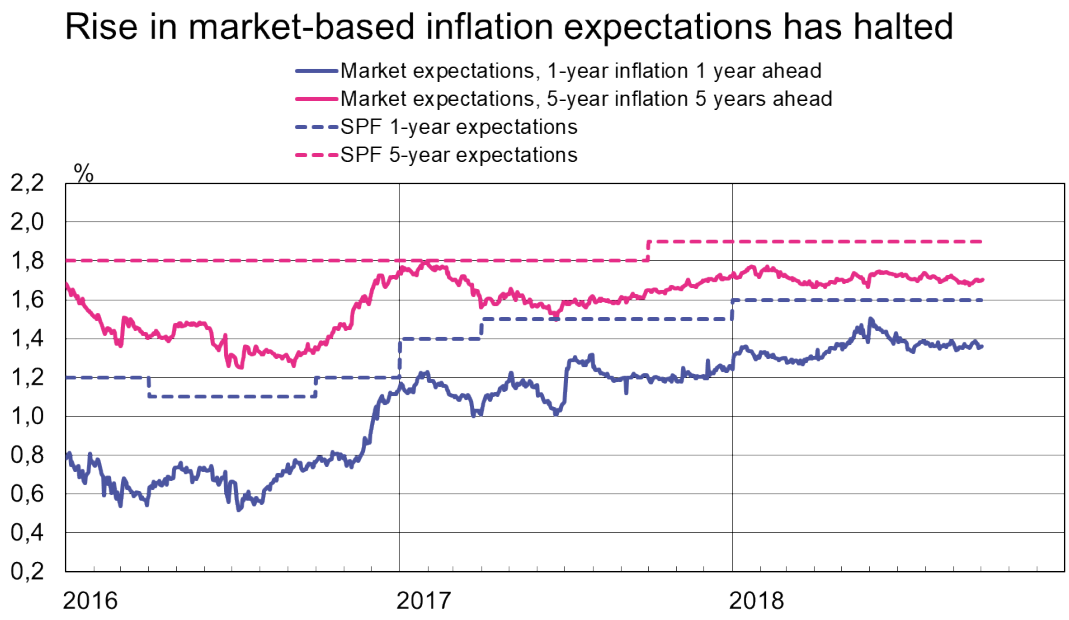
The Spanish economy grew by 3% in 2017, but the growth rate is expected to slow and approach 2%. The unemployment rate has declined, to around 15%. New jobs have been added especially to tourism and hospitality and also, more recently, to the recovering construction sector.

Euro area fiscal policy stance slightly accommodative

The euro area general government debt-to-GDP ratio is expected to shrink to levels close to 85% in 2018 and is expected to continue to decline gradually (Chart 18). The pre-financial crisis debt ratio (below 70% of GDP) is still a long way off and differences between countries are large. Of the large euro area countries, Germany has already reached its pre-crisis level, but in France and Italy, general government debt-to-GDP is some 30% higher than prior to the crisis, and in the case of Spain, some 60% higher. The euro area's overall fiscal deficit is expected to shrink to below 1% of GDP in 2018, i.e. to a level preceding the financial crisis.

The improvements in the public finances of the euro area are the result of strong cyclical conditions and reduced interest expenditure. The fiscal policy stance is expected to be slightly expansionary in 2018–2019 but will tighten slightly thereafter. The expansionary fiscal stance is partly due to reductions in income tax rates or social security contributions in certain euro area countries, for example in Germany and in the Netherlands. Such measures are aimed at improving long-term potential output but constitute fiscal stimulus in the short term. The new Italian government has also planned stimulus measures. Gradual consolidation of public finances should be continued in euro area countries in which the general government-to-debt ratio is expected to remain high. This would bolster market confidence and provide governments with more fiscal room-for-manoeuvre.

Chart 18.



Market expectations derived from inflation swaps.
Sources: ECB, Bloomberg and calulations by the Bank of Finland.
bofbulletin.fi
4.10.2018

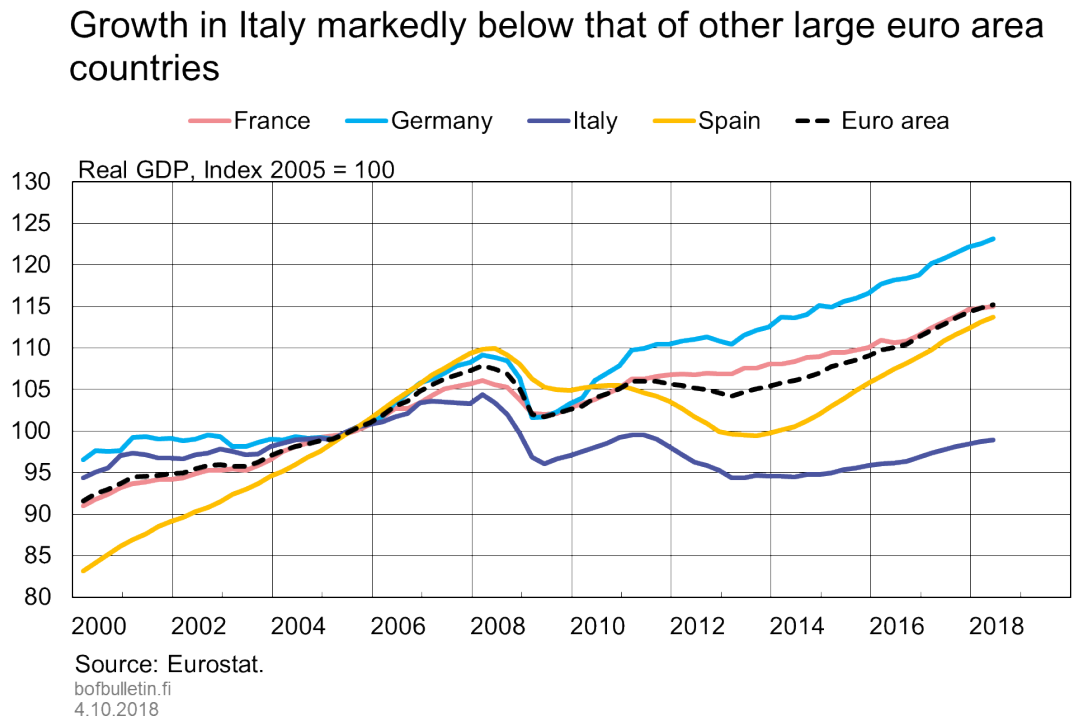
Global economic upswing has passed its peak

The outlook for global economic growth has moderated slightly from the spring. Differences between countries have increased. Growth in the United States will accelerate from 2017 on the back of fiscal stimulus, but other major economies already appear to have passed the most rapid phase of growth. In addition, the outlook for emerging economies has weakened. On balance, however, confidence indicators suggest that economic momentum will remain strong. Growth is still widely supported by expansionary economic policies – especially those in the United States and China. However, world trade has widely performed modestly since the beginning of 2018 (Chart 19), and trade war-related concerns are a significant downward risk to global growth.

Oil prices have risen since summer 2017 by almost USD 30 per barrel, to around USD 80 per barrel. The rise stems from higher oil demand and supply-side constraints particularly due to the OPEC agreement to restrict oil output. In the near future, supply-side factors may still push up oil prices to some extent. In the longer term, however, the supply cap can be compensated via other sources.

Inflation in OECD countries has picked up from the early months of spring, to close to 3%, largely as a result of higher oil prices. Of the major economies, underlying inflation, which measures inflationary pressures over the medium term, has accelerated mainly in the United States. The fact that economies are expanding at a pace above potential output, however, is expected to increase inflationary pressures elsewhere, too.

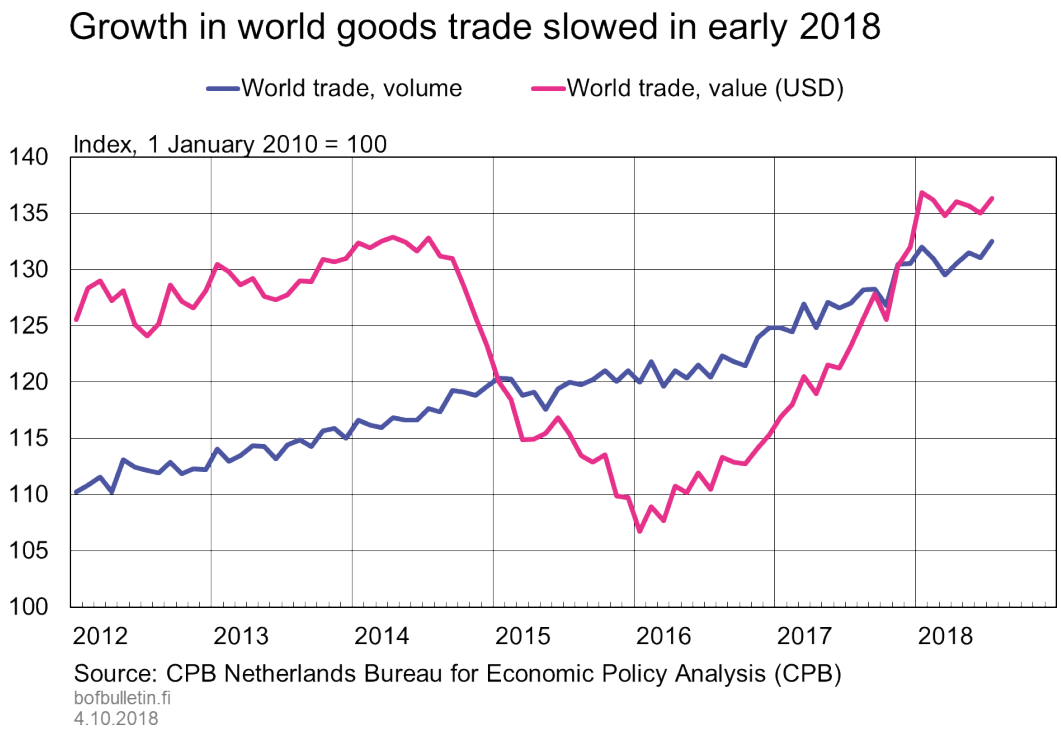
Chart 19.



US economy growing at a rapid pace

The US economy grew at a rapid pace in the first half of 2018. Strong consumer and industrial confidence suggest that solid growth is set to continue. Private consumption – the traditional motor of US economic growth – will be supported by expansionary fiscal policy. The recent development of investment has also proved favourable. The US tax reform will underpin the growth prospects of investments. One of the factors bolstering investments is the higher price of crude oil, which will boost investment in the oil and gas industries. These investments, in turn, will have multiplier effects on the other segments of the economy.

Chart 20.



The outlook for US growth has remained roughly unchanged from the spring. Influenced by fiscal stimulus measures, the US economy is expected to grow rapidly, at a pace of almost 3% in 2018–2019 (Chart 20). Fiscal policy is expected to tighten in 2020, and growth will moderate towards the rate of potential output. Fiscal tightening may depress growth more than expected, but on the other hand the tax reform may stimulate potential output slightly more than anticipated.

Despite solid economic growth, the US general government deficit and debt are expected to grow due to fiscal stimulus and rising interest expenditure. The overall stimulus is about 2% of GDP in 2018–2019. According to most recent forecasts, the general government deficit is expected to grow to about 6% of GDP in 2019, while the general government debt is expected to climb to over 110% of GDP in 2020. The US current account deficit has remained near 2.5% of GDP for several years. The trade and current account deficits are expected to persist and even grow despite protectionist measures, since fiscal policy will increase import demand.

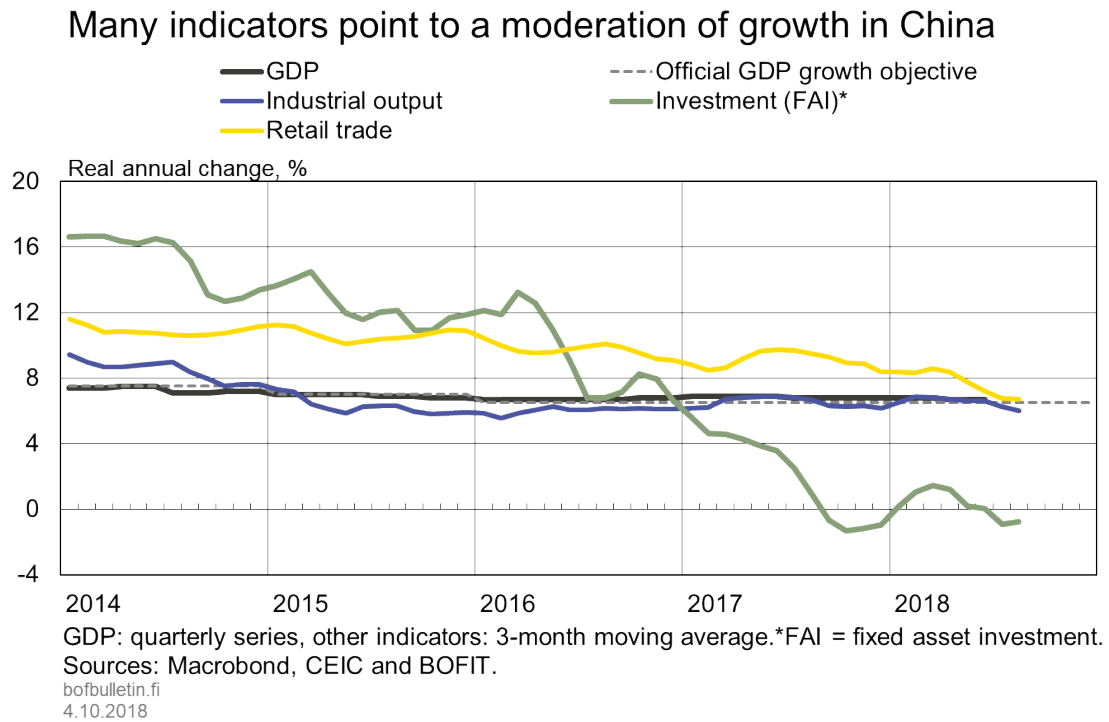
US inflation picked up to just under 3% and underlying inflation to well above 2% during the summer. The average inflation rate is expected to be about 2.5% in 2018 and above 2% in the immediate years ahead. Inflation has been fuelled by both higher crude oil prices and a reduction in economic slack. The unemployment rate has declined to below 4% and annual wage growth, as measured by average hourly compensation, is showing signs of acceleration. In an environment of

full employment and rapid growth, fiscal stimulus will add to inflationary pressures. Against this backdrop, the Federal Reserve is expected to continue the gradual normalisation of its monetary policy. That is, the interest rate hikes commenced in December 2015 and the gradual reduction of the Federal Reserve balance sheet commenced in October 2017 are both set to continue.

Moderation of Chinese growth to increase market shocks

The outlook for the Chinese economy has deteriorated during 2018, as the trade war with the United States has led to heightened uncertainty. These tensions have been reflected in both lower share prices and a weaker yuan against the US dollar, deepened by the Federal Reserve's interest rate rises and the narrowing of interest rates between the US and China. However, the underlying reason for the strong market reactions lies in China's domestic economic situation – in particular the moderation of its growth rate and its rising debt levels. According to the Chinese government's official estimates, annual GDP growth in the first half of 2018 slowed only marginally, to 6.8%, after having been 6.9% throughout the previous year. However, the picture of unwavering growth from year to year projected by the official Chinese GDP data is hardly credible, given the major changes ongoing in China. In fact, many other indicators point to a moderation of growth (Chart 21).

Chart 21.



The fact that China has substantially increased fiscal and monetary policy stimulus is also a

reflection of more moderate growth. The impetus for the stimulus is the target of doubling real GDP by 2020 from its 2010 level, which has long dominated economic policy in China. To keep to the target, GDP growth must be sustained between 6% and 6.5% over 2018–2020. In practice, the growth target and the related stimulus measures have superseded views emphasising risks in the financial markets and sustainable growth, and are increasing the already alarming debt burden and maintaining the old structures of the economy. At the same time, the necessary market-oriented structural reforms have been postponed, which is one of the reasons for China's current trade policy problems. The growth target also exposes statistical data to manipulation, of which there are several examples.

In spite of the many problems experienced in the financial sector this year too, China still has the resources to address various shocks: the country's debt is largely domestic, the current accounts is still in surplus despite the discernible downward trend, and China's currency reserves amount to USD 3,200 billion owing to tight restrictions on capital flows. Buffers are indeed needed since China's growth will moderate regardless of the party's growth targets due to both internal factors (debt, transition towards a service economy, demography, environmental problems) and external factors (trade tensions, US interest rate rises), and lower growth increases problems and impedes their management. As before, the Bank of Finland forecasts relatively strong growth for China, albeit the pace of growth will moderate to about 5% in 2020.

Japan has reached the peak of the cycle – inflation refuses to accelerate

The Japanese economy's brisk growth is starting to reach its peak, and in the years ahead, growth is expected to stabilise at about 1%, in line with potential output. Unemployment is extremely low and the labour force participation rate relatively high, since Japan has successfully increased the participation of women and the elderly in the work force. Many parts of Japan are already facing labour shortage, and efforts to facilitate employment-based immigration have not yet been enough to alleviate this development.

The competition for labour resources has accelerated the pace of wage growth, but underlying inflation, which measures domestic price pressures, still remains near zero. The Bank of Japan has announced that it will continue its prevailing light monetary policy stance. Japan also intends to continue its fiscal expansion in order to, among other factors, help offset the contraction in domestic demand following from the planned increase of consumption taxes at the end of 2019. Increased general government spending in conjunction with slow economic growth will, however, delay the government's ambitions of balancing the public finances and reducing the country's record-high debt burden.

United Kingdom suffering over Brexit anxieties

The United Kingdom will leave the European Union at the end of March 2019, and its economic outlook is currently dominated by the uncertain outcome of the Brexit negotiations. The country's GDP growth has slowed from 1.8% in 2017 and will likely settle to about 1.3% in 2018. According to recent forecasts, growth in 2019 is predicted at 1.5%, but this estimate is subject to considerable uncertainty. The Bank of England has raised its key rate twice within the past twelve months, because inflation has remained above the target level of 2% since the beginning of 2017.

Sweden's strong economic growth continues

Sweden's GDP grew at an annual rate of over 3% in the first half of the year, driven by domestic demand. In 2018, average consumer price inflation has been 1.8%. Swedish labour markets are in rude health: employment and labour productivity have continued to reach record levels and unemployment is below 6.5%. Despite this, wage pressures are still very moderate. Confidence in the economy has dipped slightly due to uncertainties associated with the export and housing markets. After falling last winter, home prices have proved largely stable over the spring and summer.

Economic growth in Russia remains slow

The recovery of the Russian economy that began in autumn 2016 has continued rather sluggishly (see BOFIT forecast for Russia). The price of oil has gone up significantly, but the federal budget rule requires that excess oil tax revenues are set aside. The VAT increase on 1 January 2019 will erode the growth in private consumption but will also, in part, allow for higher government spending. Revival of investment is hampered by growing uncertainty in the operating environment for business. GDP growth is expected to decelerate, as there are still no signs of meaningful market-friendly structural reforms (See BOFIT Forecasts for Russia and China).

Emerging economies have suffered from slower Chinese growth and US monetary tightening

Trade tensions, concerns about slowed growth in China, falling commodity prices (excl. energy) and uncertainties relating to economic policy have eroded confidence in the economy especially in Asia and in Latin America. A decline in Chinese growth also impacts emerging economies, as many of them rely on the export of intermediate goods and commodities to China.

Many of the emerging economies have experienced significant capital outflows during the spring;

their currencies have depreciated; and share prices in these countries have declined. These developments are likely the effect of the Federal Reserve's tightening of monetary policy as well as repercussions of trade tensions and concerns related to China. The currency crises in Argentina and Turkey have served to increase worries about a widespread currency crisis in emerging economies, but so far there has been relatively little contagion in other countries.

Global growth risks tilted towards the downside

In the near-future, global economic growth is forecast to continue at slightly under 4%, but the outlook is clouded by downside risk. The growth of the world economy may turn out more subdued than expected, if the United States continues to adopt protectionist measures. The current tariffs will have a relatively small direct impact on the economy (see Trade policy functions casting shadow on economic horizon). Tariffs imposed by the United States may, however, have serious repercussions on individual sectors or small economies. Building barriers to international trade — and even expounding rhetoric to this effect — increases uncertainty. Heightened uncertainty is reflected in the financial markets, causing the postponement of investment, in particular. From a longer-term perspective, new bilateral trade agreements negotiated by the United States may shift international trade away from the multilateral system. This would frustrate international trade, which in turn would dampen economic growth in all regions, especially in the long term. Should all economic areas impose tariffs on one another, this could have significant immediate repercussions on the world economy, yet this scenario is unlikely. Another major question for international trade is Brexit. If the European Union and the United Kingdom fail to reach an agreement that supports bilateral trade, growth will weaken in both economic areas. The brunt of the effects, however, would be felt in the UK economy.

Concerns remain with regard to the sustainability of China's stimulus-based economic growth. Contradictory goals for domestic economic policy has led to a stop-and-go economic policy, which combined with slower growth and a worsening debt problem might increase market disturbances, in which case all market agents ought to prepare for a considerably sharper decline in growth. Should China's growth rate drop substantially, it would have significant and unexpected consequences for the world economy due to declined confidence, falling commodity prices and the disruption of international supply chains. The outlook would also be weakened, if currency crises, such as those in Turkey and Argentina, were to proliferate. Because the Turkish and Argentinian crises mainly stem from domestic economic policies, contagion to other emerging economies has so far remained limited. A full-scale debt crisis in Turkey would impact the euro area through exports and links to the banking sector.

The single most important internal risk to the euro area is the uncertainty related to Italy's

economic policy. The new government's fiscal policy plans have raised longstanding concerns about the future of the Italian public finances, which is reflected in higher yields on the country's sovereign bonds. In the current situation where the Italian general government sector is heavily indebted and the country's economic growth modest, rising interest rates on sovereign bonds may set the debt on a path that is no longer sustainable. Italy is the world's third biggest issuer of sovereign bonds, and should concerns relating to the country's debt sustainability get out of hand, this would have widespread and serious repercussions. Because Italy is one of the euro area's major economies (at 15% of euro area GDP), a sharp weakening of Italy's economic growth can in any case be considered a risk to the euro area.

Notes

1. According to the latest forecasts by the ECB (excl. the euro area), IMF and OECD, world trade will continue to increase in the coming years by just a little under 4%. ↑
2. The ECB will announce the expected volume of maturing securities for the next six-month period. ↑
3. Germany, France, Italy and Spain. ↑
4. Minimum Requirement for Own Funds and Eligible Liabilities. The idea is to ensure that banks have enough of their own funds and debt instruments that can be used in case of crisis to cover banks' losses and help in their recapitalisation. ↑

Keywords

euro area, inflation, monetary policy