



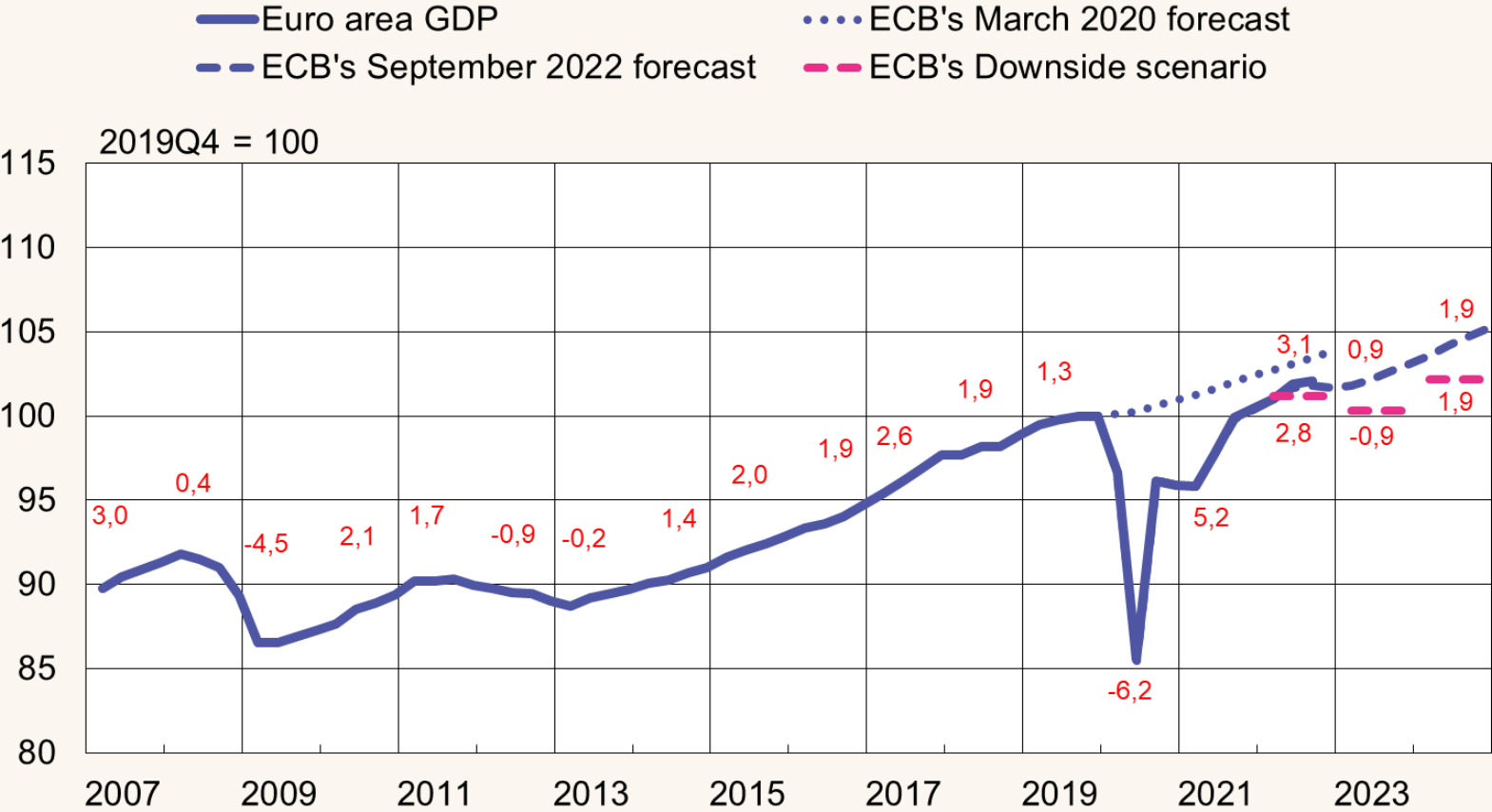
# The European and Finnish economies in the shadow of the war and energy crisis

The Committee of Economic Affairs of the Parliament of Finland

Public hearing on 22 November 2022

Governor Olli Rehn  
Bank of Finland

# Probability of recession has increased in the euro area

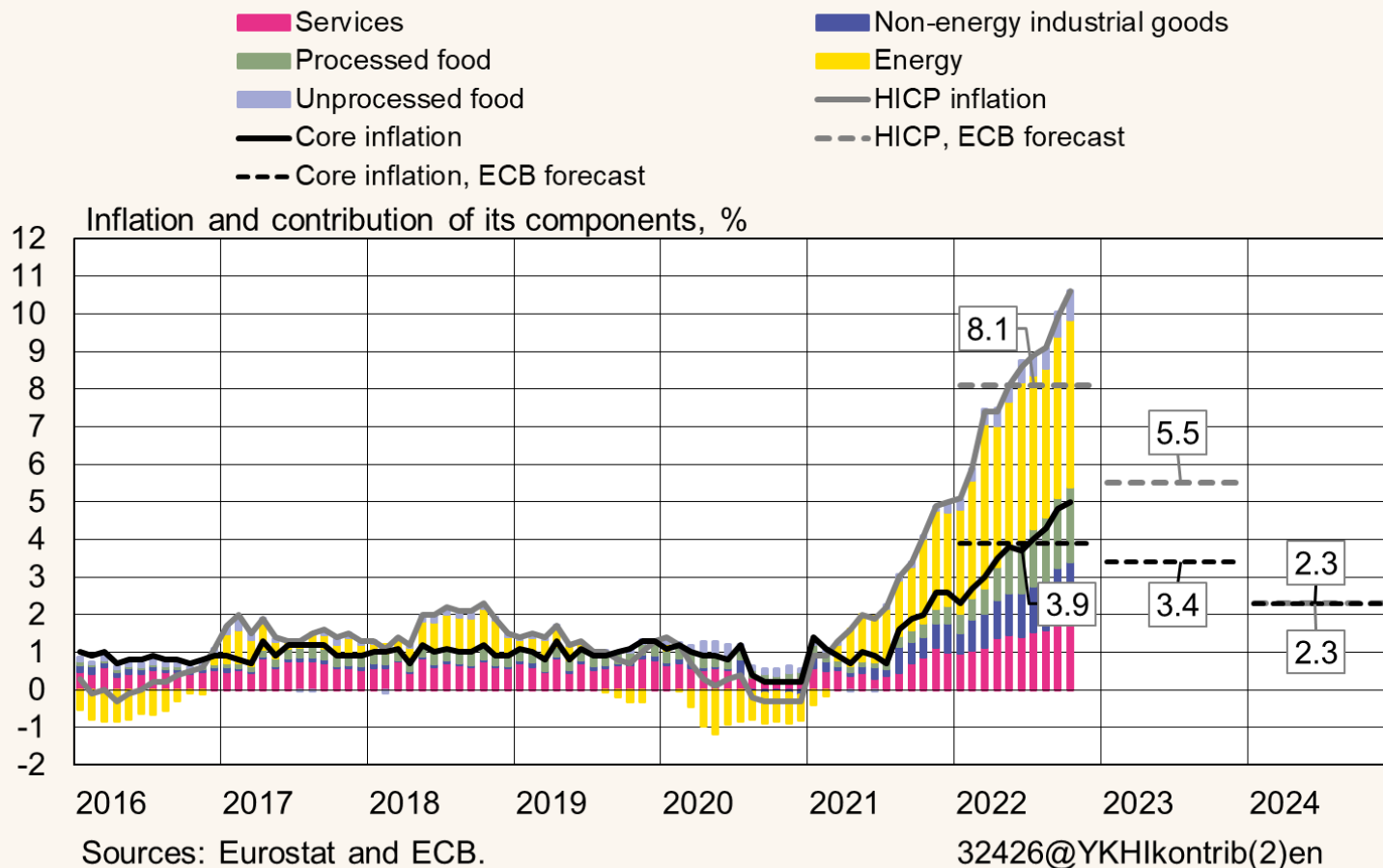


Figures next to the curve are annual growth rates, %

Sources: ECB calculations and Bank of Finland.

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# Euro area inflation has risen further: 10.6% in October, with underlying inflation at 5.0%

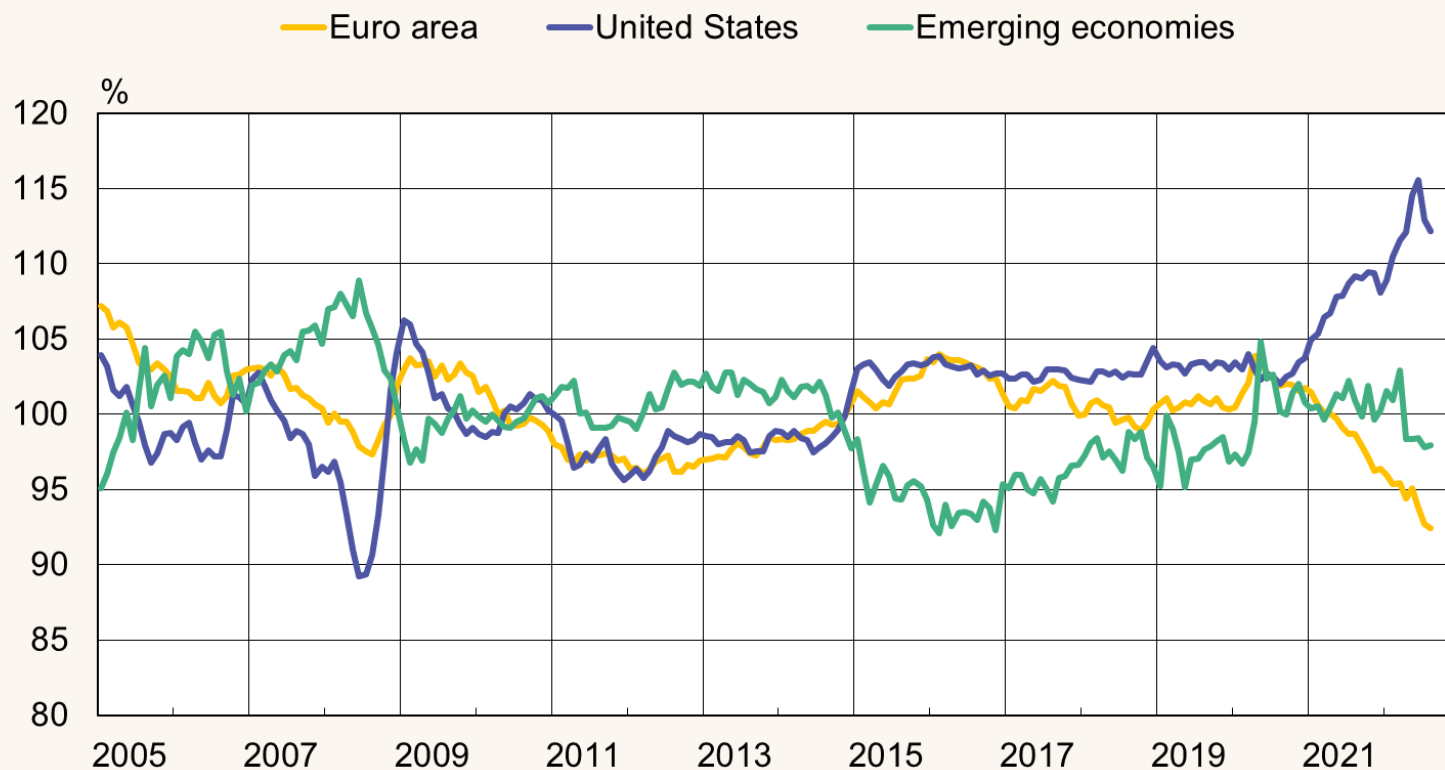


# Inflation driver and anchor in the euro area

- Driver: rapid energy inflation
- Anchor: still-moderate wage inflation – but more rapid in recent months
- Monetary policy not very effective in containing energy prices
- Inflation expectations and the psychology of inflation → Will the anchor hold going forward?

# Euro area terms of trade fallen to historic low due to the war and energy crisis – cost of living risen by 7%

## Terms of trade



Terms of trade are defined as the ratio between the index of export prices and the index of import prices, multiplied by 100.

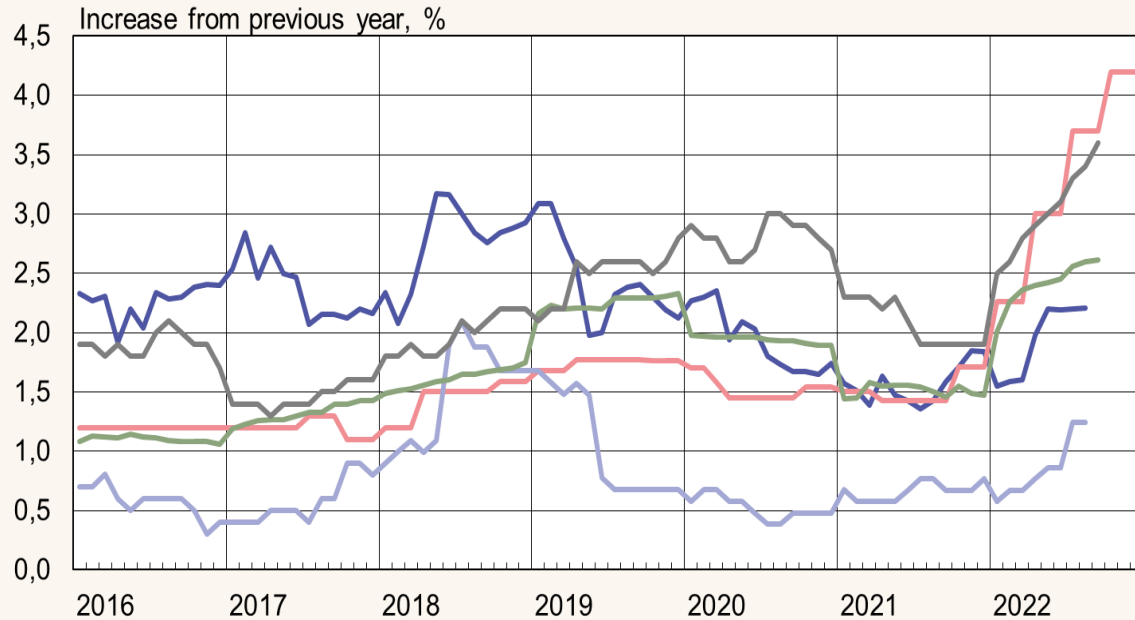
Source: CPB Netherlands Bureau for Economic Policy Analysis.

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# Wage inflation has long been moderate but has risen in 2022

## Wage indicators

— Germany (excl. one-offs & bonuses) — France — Italy — Spain — Netherlands

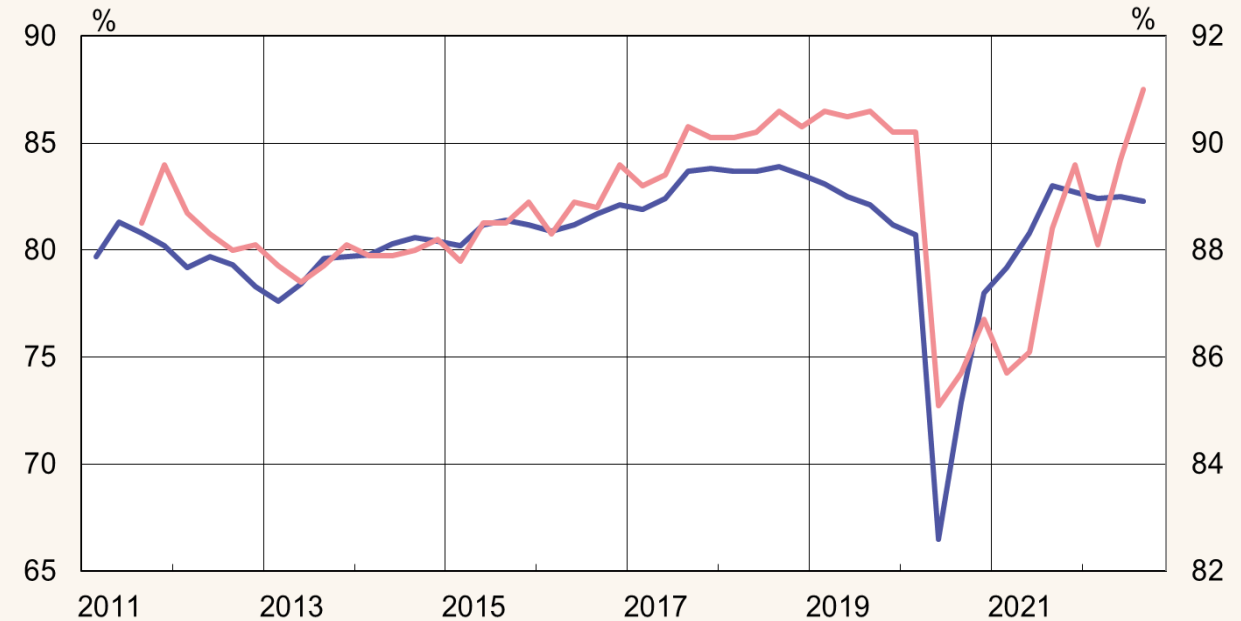


Sources: Bundesbank, INSEE, ISTAT, Spanish Ministry of Economy and Business, CBS.

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## Euro area capacity utilisation

— Manufacturing — Services (right-hand scale)



Sources: Eurostat and DG ECFIN.

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# What is essential for price stability in the current situation?

- The ability of monetary policy to influence energy prices directly is very limited. Monetary policy must nevertheless respond to the steepening rise in the general level of prices (for both goods and services).
- The tightening of monetary policy essentially reduces the risk of a detrimental wage-price spiral. Such a wage-price spiral would be a sign that inflation expectations have become de-anchored.
- If expectations are no longer anchored, then achievement of the inflation target over the medium term will be at greater cost to the real economy, because it would lead to tighter monetary policy and slower growth in the economy.

# Confidence in monetary policy retained – inflation expectations still at around 2%



Sources: ECB and Bloomberg.  
\* Forward rates based on inflation swaps.

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# ECB's Governing Council has raised key interest rates to stabilise inflation at 2% over the medium term

1. Key ECB interest rates have now been raised three times in July–October meetings: by 0.5 percentage points in July and by 0.75 percentage points both in September and October.
2. Inflation remains far too high and will stay above the target for an extended period. The Governing Council expects to raise key ECB interest rates further to ensure the return of inflation to the 2% medium-term target.
3. The future policy rate path will continue to be based on the evolving outlook for inflation and the economy, following a meeting-by-meeting approach.

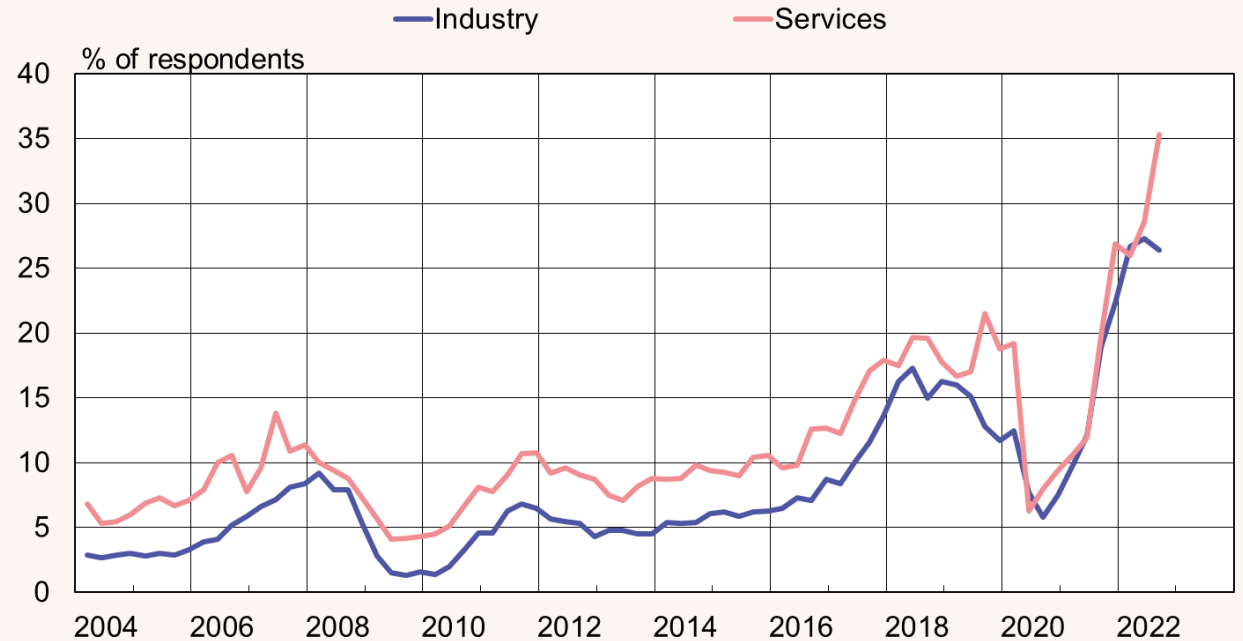
# Warding off stagflation: very low unemployment rate in euro area – businesses concerned about availability of labour



Sources: Eurostat and ECB.

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## Labour shortage in the euro area

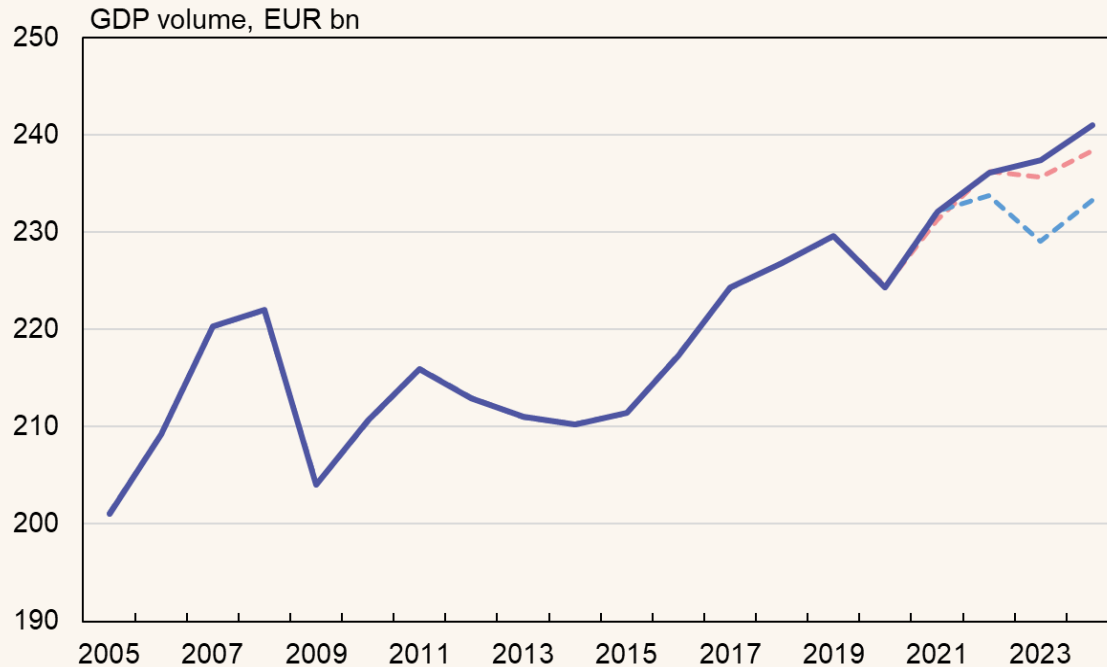


Source: European Commission DG ECFIN, business and consumer surveys.

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# Bank of Finland's September forecast: Finland's GDP growth headed for mild recession in 2023

- Bank of Finland interim forecast, September 2022
- Risk scenario
- Bank of Finland forecast, June 2022

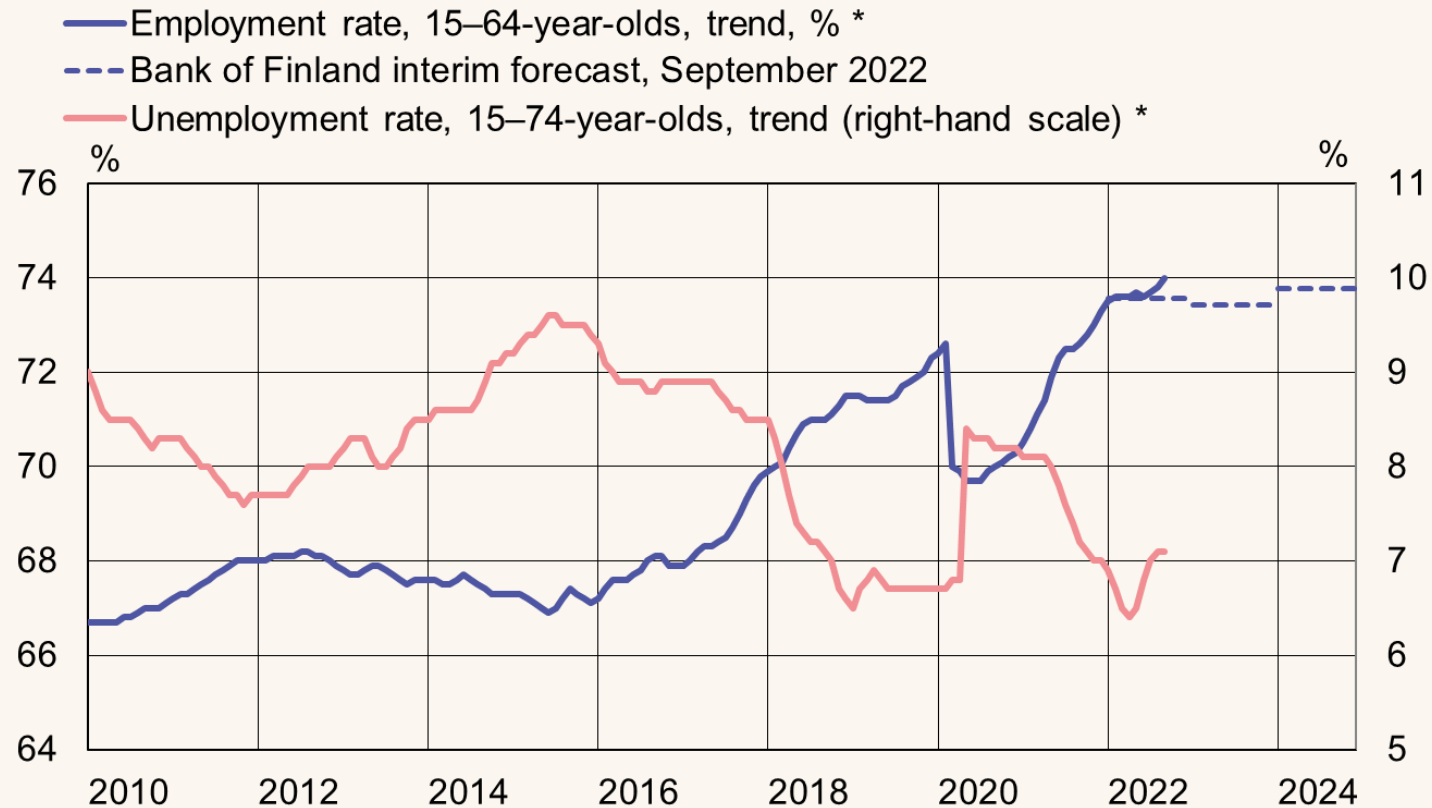


Sources: Statistics Finland and calculations by the Bank of Finland.

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	September 2022	June 2022	December 2021
<b>2021</b>		3.5%	3.5%
<b>2022</b>	2.2% ↑	1.7% ↓	2.6%
<b>2023</b>	-0.3% ↓	0.5% ↓	1.5%
<b>2024</b>	1.1%	1.5%	1.3%

# Employment has developed favourably in Finland 2016–2022



Sources: Statistics Finland and calculations by Bank of Finland.

\*Seasonally adjusted figures by Statistics Finland.

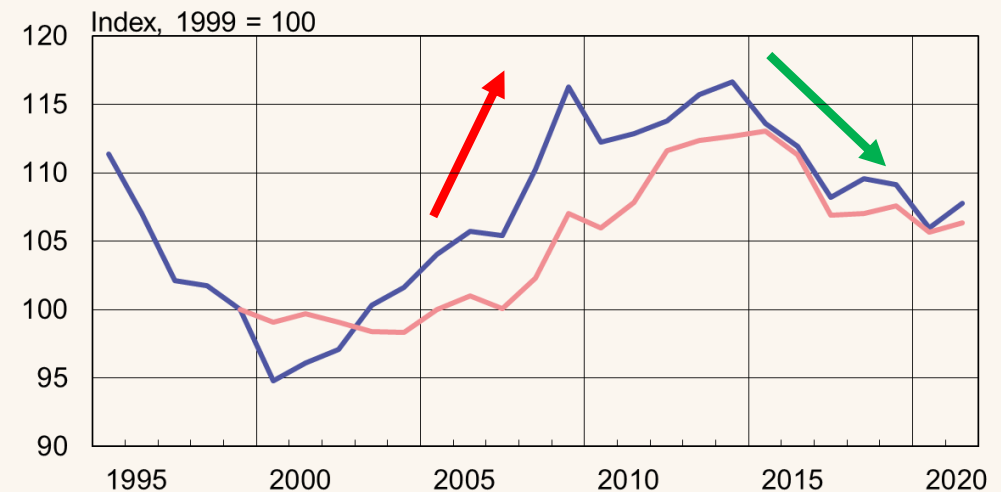
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# Competitiveness of Finnish labour and businesses improved in past decade

- Competitiveness of Finnish labour and businesses deteriorated following the financial crisis
- A decade of slow growth and low employment followed
- Measures to improve competitiveness since 2016 – subsequently the employment rate has risen from 67% to 74%
- Competitiveness did not weaken during the COVID-19 crisis
- Forthcoming wage agreements here and elsewhere will determine the way forward for competitiveness

Unit labour costs adjusted for the terms of trade, total economy\*\*\*

- Relative to advanced-economy trading partners\*
- Relative to average for the first 12 euro area countries \*\*



\* 14 traditional industrial economies weighted by their share of Finnish foreign trade, in the same currency.  
\*\* The first 12 members of the euro area.

\*\*\* Labour costs divided by national income, total economy.

Forecasts: European Commission

Sources: European Commission, OECD, Macrobond and calculations by the Bank of Finland.

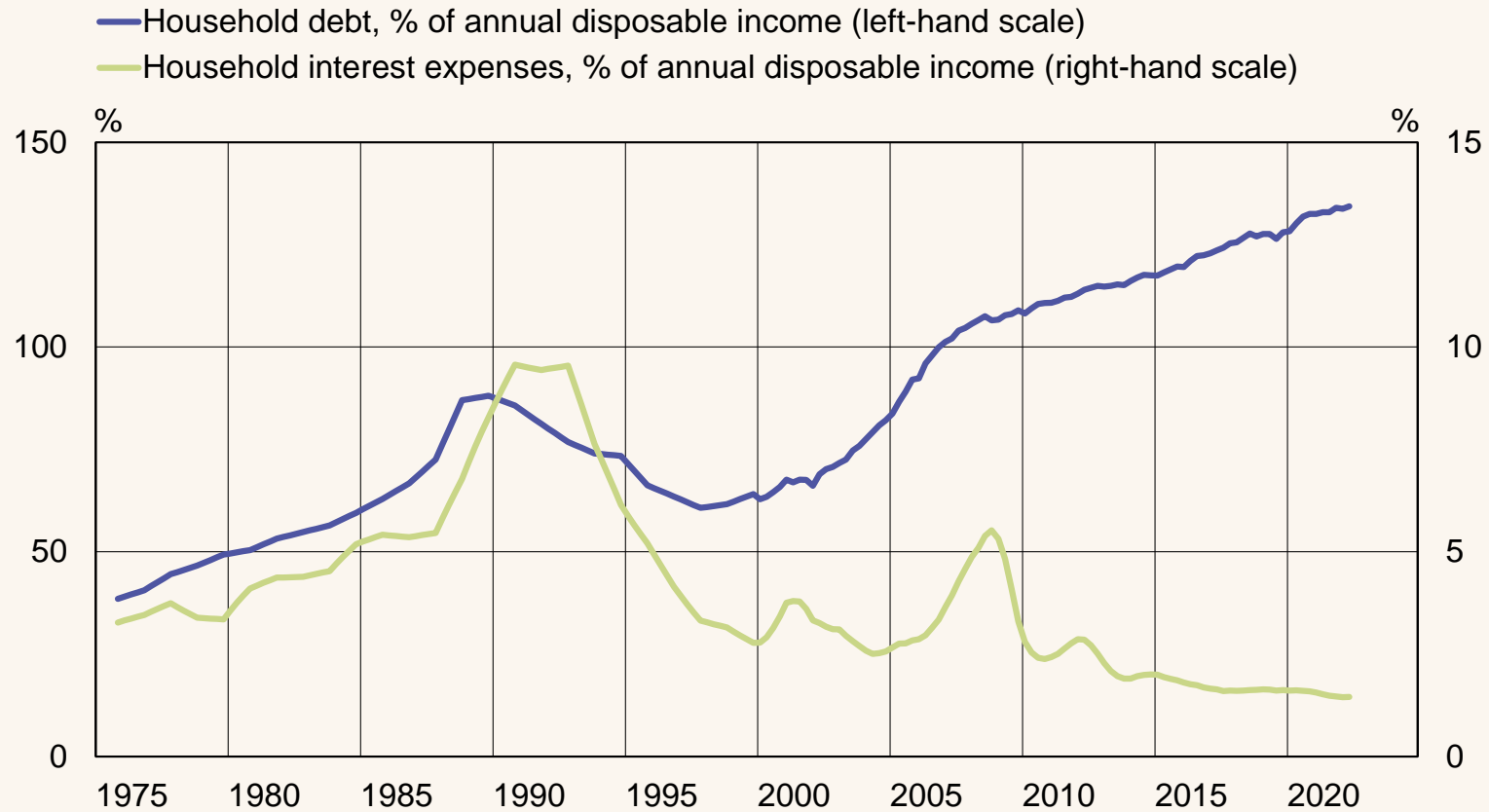
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# Green transition in energy now moving forward, though not in a planned manner

- Energy prices already began to rise last year with the recovery of the global economy from the pandemic
- This winter characterised by major imbalance between demand and supply
  - Efforts should be made to get the most out of all demand flexibilities and energy saving opportunities; support measures should be carefully targeted
- Besides the coming winter, immediate years ahead also challenging
- Euro area too dependent on fossil energy imports; long-term direction of Europe's energy policy is unresolved
- Situation in Finland not as difficult as in major euro area economies

# More household debt than ever before

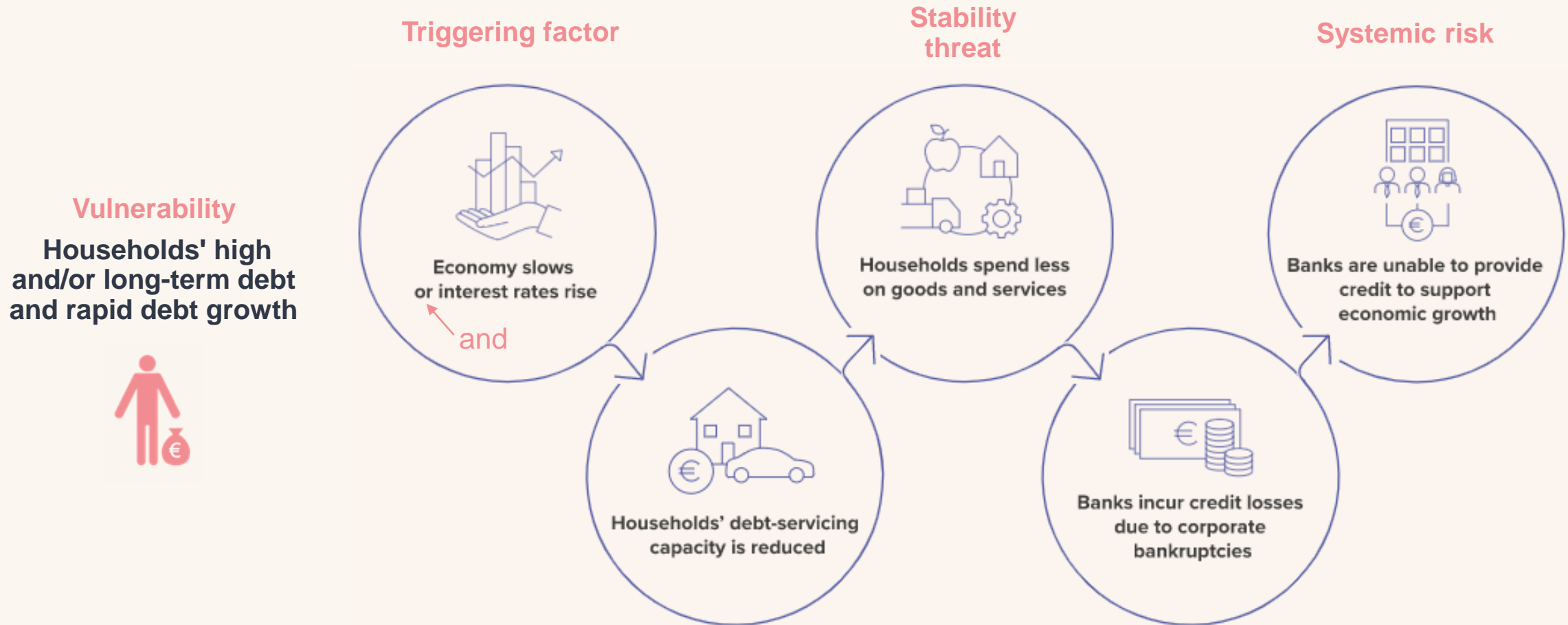
## Finnish households' indebtedness and interest burden



Sources: Statistics Finland and calculations by the Bank of Finland.

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# Indirect risks to the economy may be greater than banks' direct credit risks from housing loans



Source: Bank of Finland.



# Financial stability risks increasing – Finland's crisis resilience at a fairly good level

- In September, the European Systemic Risk Board urged preparedness for a rise in risks relating to financial stability
- Finland began to increase structural macroprudential buffers in June 2022
  - Due to the uncertainty of the economic outlook, the requirements need to be tightened cautiously and gradually to avoid procyclical effects
- Legislative amendments currently considered by Parliament are expected to improve the crisis resilience of new borrowers

# Enhanced certainty of being able to make everyday payments

- The threat of cyber and hybrid attacks has increased in the financial sector as well.
- Critical systems and services relating to daily payments are mainly located abroad.
- Last summer, Finnish authorities set up backup arrangements to protect the ability to make daily payments in the event of serious disruptions.
- If a bank were to suffer a serious long-term disruption in its operations, its customers' account and card services could be handled in the new National Emergency Account System.

# Responsibilities under the everyday payments backup system

## Finnish Financial Stability Authority (FFSA)

- Maintains the new National Emergency Account System to ensure functioning account and card payment services in the event of serious disruptions.
- The Government decides on the introduction of the system.

## Bank of Finland

- Maintains interbank transactions in serious disruptions and exceptional circumstances.
- Maintaining the National Emergency Interbank Payment Scheme is a new task, but comparable to tasks under normal circumstances.
- When necessary, the backup system will be activated at the discretion of the Bank of Finland.

## Banks

- Regular reporting of information needed to operate the backup system to the FFSA (new task).
- Maintain the ability to use the Bank of Finland's backup system for interbank payments.
- The National Emergency Account System provides services on behalf of the bank affected by the serious disruption. The customer relationship in the original bank will remain unchanged.

# Even amid a crisis it is important to focus on resolving long-term challenges

- The effects of changing population's age structure and climate change are already visible
- Balancing the public finances will require active measures on both revenue side and expenditure side
  - Finding balance becomes even more challenging in an environment of rising interest rates
  - We need fiscal rules and prioritisation in public expenditure: **a comprehensive spending review in connection with the formation of the next government**
    - Structural reforms are needed to bolster sustainable economic growth on a long-term basis
      - Investment in skills, incentives for employment
      - Promotion of research and development
      - Competitive markets, sensible regulation and a stable operating environment



# Conclusion

- The escalation of the energy crisis has increased the risk of recession both in Finland and in the euro area, and inflation has remained higher than forecast
- While the ability of monetary policy to influence energy prices is limited, measures are needed to respond to the surge in the general price level
  - These measures aim to reduce the risk of a wage-price spiral and to stabilise inflation at its 2% target over the medium term
- Finland's long-term growth challenges have not gone away
  - A shrinking working-age population and low growth of labour productivity weaken long-term growth prospects
- That being said, Finland is still well placed not only to overcome the challenges but to thrive – gradual decline can be stopped



Thank you!

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