Editorial

Editorial: Monetary policy supports Finnish recovery

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The growth in private demand that has bolstered the economy has been accompanied by continued growth in the levels of household debt. Risks relating to this can be controlled centrally using macroprudential policy.



The euro area economy continued to grow in 2015, and forecasts for 2016 indicate a continuation of this positive trend. The unemployment rate has come down gradually from its previous high level. Notwithstanding the favourable general trend in the economy, euro area inflation has remained much slower than the target.

In order to meet the price stability objective, the ECB is pursuing an accommodative monetary policy, which also has effects on the Finnish economy. As economic growth in the euro area is broadly based, this will simultaneously reinforce Finland's exports to other members of the single

currency. In 2015, Finnish exports to the euro area continued to grow, whereas exports to other trading partners declined. Overall, Finland's export volumes were up somewhat, whilst the value of exports fell slightly.

As well as supporting Finnish exports, the ECB's accommodative monetary policy also supports domestic demand in Finland. The interest paid by households and non-financial corporations on new bank loans have continued to decline. This encourages both businesses and households to invest and consume.

The Finnish economy moved into gentle growth in 2015. With exports still sluggish, growth was bolstered by domestic demand, as private consumption increased. Moreover, towards the end of the year private investment began to grow, after previously contracting for a prolonged period. The second half of 2015 also saw a slight improvement in the employment situation. According to the Bank of Finland forecast, economic growth in the immediate years ahead will still be largely based on domestic demand, and the employment situation will improve only slowly.

One factor of uncertainty in the outlook for the Finnish economy in the coming years is the one-sided nature of developments. There is a limit to how strongly and for how long domestic demand based largely on growth in public and private debt can support economic growth if export earnings remain small. For growth to be sustainable, it is necessary to restore cost-competitiveness and continue structural reforms that can improve the outlook for growth.

Labour productivity growth has in recent years been sluggish in many advanced economies, despite the recovery in output. Underlying factors and the outlook for the future are now the subject of animated debate internationally. Some commentators perceive a threat of a prolonged period of slow growth, if, in addition to the effect of the changing population structure, growth is also slowed by sluggish productivity development. More optimistic assessments have also been put forward, based on the opportunities presented by digitalisation.

Finland is also affected by the threat of a sluggish long-term economic performance. This would mean a continuation of the recent economic headwinds. In Finland, labour productivity development has in recent years been much weaker than before. A major factor here has been the contraction of output in the electronics industry and certain other high-productivity sectors. In the immediate years ahead, at least, there is no prospect of a strong recovery of output in these sectors.

Even if the most pessimistic scenarios do not come to pass, for the next 15 years Finland nevertheless faces much slower economic growth than in recent decades. This poses a threat to the financing of the welfare state and highlights the need to implement measures to improve growth opportunities and the sustainability of the public finances. An improved outlook will

require better preconditions for employment, innovation and an improved business environment for both new and established businesses. The key is to undertake further structural reforms.

The current accommodative monetary policy means the situation is favourable for the taking of measures to improve the prospects of growth in the economy. The ability of companies to invest is highly significant in determining the practical impact of structural reforms and improved cost-competitiveness. As the prerequisites for growth improve, companies will have an opportunity to expand their output if they are able to invest, and the current relaxed financial conditions will support this.

The growth in household demand that has supported the economy in recent years has been accompanied by a continued accumulation of household debt. This raises the question of whether the level of debt is already too high. Does it pose risks to the stability of the financial system and future economic growth?

The level of debt relative to the average level of income of Finnish households is lower than in the other Nordic countries. On the other hand, it is high relative to many other countries in Europe. Moreover, the debt ratio has doubled in the past 20 years, and at the same time a larger proportion of the debt has accumulated in households with a very high level of debt relative to their income.

A justifiable cause for concern is rising debt ratios in a situation where the longer-term outlook for economic growth is weak relative to previous decades. There is a threat that servicing the accumulated debt in future will for many households turn out to be a heavier burden than expected.

As the wealth of indebted households often consists primarily of the homes they live in, housing price developments are highly significant for households' economic prospects. Research data indicates that besides pushing up the cost of accommodation, regulatory controls that significantly restrict housing construction also reinforce fluctuations in house prices. As housing demand varies with the level of interest rates and fluctuations in household incomes, house prices fluctuate all the more strongly, the weaker the reaction of housing construction to changes in demand. Therefore, improving the prospects for housing supply reduces the risks related to household indebtedness.

In managing the risks related to household indebtedness, there is also a key role for macroprudential policy. Its tools are used to steer the capital requirements on the banks and, among other things, practices pertaining to lending for house purchase. There is a need to broaden the toolbox of macroprudential policy in Finland to make it sufficiently well-equipped and on a similar level to many other European countries. The tools should be provided in good time before

there is a need to use them. Otherwise we could be hopelessly late, as demonstrated by Finland's experiences in the 1990s.

After a prolonged period of weak performance, the outlook for the Finnish economy has now taken a cautious turn for the better. The question of how solid the foundations of economic growth turn out to be will depend not only on developments in the global economy, but also above all by the solutions adopted in the domestic economy.

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