

Pentti Hakkarainen: Bank of Finland and its activities and the Finnish economic outlook

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Honorary Consulars meeting, Helsinki, 9 June 2011.

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Dear Honorary Consulars,

Welcome to the Bank of Finland. I appreciate the opportunity to give a presentation to you. Let me first tell you about the Bank of Finland and its activities. Then I will move on to the Finnish economic outlook.

Bank of Finland and the Eurosystem

The Bank of Finland has an interesting history. We got a central bank already before our country's independence. The Bank of Finland is the fourth oldest central bank in the world.

In 1811 Tsar Alexander I of Russia establishes the Bank of Finland under the name of "Office of Exchange, Lending and Deposits in the Grand Duchy of Finland" (**Slide 3**). In 1865 Finnish markka is tied to the silver standard, and, in practice, Finland exits from the Russian monetary system. In 1999 the euro area is born. The euro becomes the official currency of the euro area. The Bank of Finland becomes a part of the Eurosystem

The Bank of Finland acts as Finland's central bank, national monetary authority and member of the European System of central banks and the Eurosystem (**Slide 4**).

The Eurosystem covers the European Central Bank and the euro area central banks. It administers the world's second largest currency, the euro. There are over 300 million people living in the euro area and from the beginning of 2011 the area covers 17 countries. Therefore, the Bank of Finland's strategies are related to both domestic and Eurosystem objectives.

The main objective of the Eurosystem and Bank of Finland alike is price stability, which means maintaining a moderate rise in consumer prices. Price stability creates the prerequisites for a sound economy. In order to meet this objective, the Bank of Finland participates in the preparation and decision-making process of the Eurosystem's monetary policy as well as implementing the policy in Finland. A broad research base provides a solid background to the Bank's expertise in these tasks.

In addition to monetary policy and research, the Bank of Finland has three other core functions: financial markets and statistics, banking operations and the maintenance of currency supply. There are approximately 460 persons working at the Bank of Finland and an additional 210 in association with it at the Financial Supervisory Authority (FIN-FSA).

The Bank of Finland's scope of activities cover four, clearly-defined core tasks: monetary policy and research, financial supervision, banking operations as well as the maintenance of currency supply (**Slides 5, 6 and 7**).

Monetary policy and research

The key objective of the Eurosystem's monetary policy is the maintenance of price stability throughout the euro area (**Slide 8**). The decisions relating to the policy are centralised, being taken by the Governing Council of the European Central Bank (ECB) and implemented at member country level by the individual national central banks.

As a member of the ECB's Governing Council, the Governor of the Bank of Finland is therefore one of those deciding on the interest levels set for the euro area and at the same time for Finland, too.

The Bank of Finland assesses the impact of the single monetary policy on the Finnish economy and takes it into account in the setting of domestic economic policy. The Bank publishes a macroeconomic forecast twice a year.

The Bank's influence in the Eurosystem is based on internationally recognised high-quality research (**Slide 9**). The three main approaches taken by the Bank's research activities are the modelling of monetary policy, the future of the financial services sector and analyses of economies in transition (primarily China and Russia).

Financial supervision

The Bank of Finland promotes financial sector stability and efficiency using thorough macroprudential analyses and through the maintenance of contingency management procedures (**Slide 10**). The Bank's crisis management preparedness is based on up-to-date information on the condition of the banking system and financial markets and the functioning of their respective infrastructure. When needed, the Bank of Finland acts as a lender of last resort to the banks.

The Bank of Finland bears responsibility for oversight of the financial system and macroeconomic supervision. The Finnish Financial Supervision Authority (FIN-FSA), on the other hand, is the main authority responsible for supervision of banks, insurance and pension insurance companies as well as other insurance sector companies, investment firms, management companies and the stock exchange. The operations of the FIN-FSA are 95% financed by the supervised entities, while the remaining 5% is financed by the Bank of Finland. Administratively the FIN-FSA cooperates with the Bank of Finland and otherwise operates entirely independently.

The Bank produces a range of statistics, analyses and risk assessments to serve decision makers. Compilation of statistics is a function that supports the central bank in the preparation of monetary policy and analysis of the stability of the financial market.

Banking operations

The Bank of Finland is the banks' bank (**Slide 11**). It implements the Eurosystem's monetary policy in Finland through its own monetary policy operations in cooperation with its Finnish counterparties, generally banks.

The Bank of Finland safeguards the domestic financial system's liquidity management and handles payment transfers between banks. Banking operations also covers the management of the Bank's own financial reserves (such as currency reserves) and the prudent and lucrative investment of the Bank's share of ECB capital.

Maintenance of currency supply

The Bank of Finland is responsible for currency supply management in Finland and works to improve the quality, efficiency and security of the currency supply system (slide 12). The Bank issues new euro bank notes and coins in Finland. It is also responsible for ensuring the authenticity and quality of the money in use in the country by removing counterfeit and damaged notes from circulation.

The Bank of Finland has ongoing cooperation with companies specialized in banking and cash distribution services.

The Bank of Finland and the Eurosystem

Finland's monetary unit is the euro. All EU countries that have adopted the euro belong to the euro area (17 countries, 1 January 2011). The central banks of these countries, together with the European Central Bank (ECB), form the Eurosystem (**Slide 13**).

The Bank of Finland is Finland's national central bank and a member of the Eurosystem. It participates in the preparation and decision-making of the ECB's monetary policy and is responsible for monetary policy implementation in Finland (**Slide 14**).

The Eurosystem operates under the leadership of the European Central Bank. The highest decision-making body of the Eurosystem is the Governing Council of the ECB. The Governor of the Bank of Finland participates in monetary policy decision-making as a member of the ECB Governing Council (**Slide 15**). Each of members is in the meetings as a person, not advocating any issues for his or her institution or country.

The Eurosystem's objectives are price stability and support for general economic policy. Its main principles are independence, accountability and transparency (**Slide 16**). The monetary policy stance is set for the euro area as a whole, not for any single country.

Dear Guests,

Let me now move to the economic outlook of Finland. We are in the midst of preparing our next economic forecast next week, but before that comes out, let us see the general outlook without foretelling any of the content of the forecast. The Bank of Finland's forecast will be available on 15 June 2011.

Economic outlook of Finland

The Finnish economy will grow relatively briskly in the immediate years ahead. In 2011 the pace of growth will rise to almost 4%, but in 2012–2013 it will be much slower. The pre-recession level of output will be regained during the course of 2012, somewhat earlier than estimated half a year ago. Export growth will be bolstered by stronger global demand for capital goods towards the end of the forecast period.

Industrial and construction confidence indicators (**Figure 17**) suggest that companies have positive expectations of the future. Especially the construction sector has recovered strongly from the recession.

Consumer confidence levels recorded in Finland in 2010 reached a record high, even though the euro area debt crisis did at times cause uncertainty among Finnish consumers. Consumer purchasing power was bolstered in by an increase in household incomes, cuts in income tax, the improved employment situation and low interest rates. The stronger confidence and continuation of low interest rates continued to encourage the taking out of new housing loans.

The Finnish economy is recovering quite strongly. In 2010 the growth boosted by both domestic demand and exports (**Figure 18**). The robust economic growth of GDP seems to continue in 2011. In the first quarter of 2011 GDP growth was about 5.5%.

Private consumption has grown steadily since the second quarter of 2009, but slowed down in the first quarter of 2011. Housing construction growth was exceptionally brisk in 2010, and growth is expected to moderate in 2011. Construction of other buildings picked up towards the end of the year 2010 but remains still weak at the beginning of 2011 (**Figure 19**).

During the course of 2010, Finnish exports of goods began to benefit from growth in export markets (**Figure 20**). In 2011, the structure of growth is expected to still be unfavorable for Finland's capital-goods-weighted export structure. In 2012–2013, global demand for capital goods will begin to accelerate, and boost Finnish exports. The recovery of industrial output has progressed at a very different pace in different industries. The chemical industry started

to recover early from the recession, and metal industry output began to grow during the course of 2010. Forest industry output is not expected to return to pre-recession levels due to cuts in production capacity. Electronics industry output is still almost 20% below the level of 2008.

The operating environment for businesses in Finland improved significantly in 2010 due to a considerable strengthening of demand in Finland's export markets. Strengthening demand for the products of export companies and increasing output volumes will gradually raise the level of corporate fixed investment.

Now, let me take up some major factors affecting our economy's outlook.

The financial crisis hit Finland, even though it took place outside our country, and we lost a lot of our total production (**Figure 21**). GDP fell by about 8 % in 2009. According to the March 2011 Bank of Finland forecast, the pre-recession level of output will be regained during the course of 2012. The recession has caused a contraction in the GDP share of industry, and conversely an increase in the share of services sectors, which are characterised by slower productivity growth. Over the longer term, this shift will weaken the growth potential of the economy.

As regards the structure of growth in Finland, in 2010, the strengthening of export demand boosted the growth impact of net exports (**Figure 22**). It will remain strong, but in 2012–2013, the significance of net exports will decline as import growth picks up. Private consumption supported growth in 2010 and will continue to do so throughout the forecast period 2011–2013. Despite strong growth in housing investment in 2011, the growth impact of private investment was zero. Private investment is expected to pick up and support growth throughout the forecast period. The annual GDP growth will slow down to 2,7 % in 2012 and to 2,5 % in 2013 (**Figure 23**).

The unemployment rate will continue to be fairly high, averaging 7% in 2013 (**Figure 24**). Employment did not decline very much during the recession considering the depth of the collapse of output. The explanation is the use of temporary layoffs and employers' willingness to retain skilled work force. Similarly, the post-recession growth in output has generated relatively few new jobs.

Inflation measured by HICP (harmonised index of consumer prices) has risen to above 3% in the first 4 months of 2011 (**Figure 25**). The acceleration in inflation is mainly due to rise in the world market prices of energy and food. In Finland there is an additional impact from the hike in energy taxes as of the beginning of 2011. According to market expectations, oil price will decline. Average wage growth in Finland is expected to remain at around 3 %.

Last, but not the least important topic; public finances. We have had fairly good balance in our government finances, and compared with the other European countries in general, our public debt has been kept at a fairly low level. However, due to the economic recession we saw somewhat concerning development starting. Looking into the coming years we have to curb the current pace of incurring of the public debt.

In the absence of new fiscal policy measures during the forecast period, the general government deficit will contract only slightly and the general government debt will continue to grow during the forecast period (**Figure 26**).

Let me conclude by saying that, in general, the recent developments in the Finnish economy have been mixed. On one hand, economic growth has strengthened and surveys indicate strongly improved confidence in the future. On the other hand, the rapid growth has touched only some sectors of the economy, and new areas of concern have emerged both internationally and domestically. The key challenge for economic policy is to restore the sustainability of the public finances in Finland.

Thank you very much for your attention and successful meetings in Helsinki during the following days.

Heading for stable monetary conditions

1865



MARKKA joins silver standard

1999



EURO taken into use

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Two roles of the Bank of Finland

- Finland's monetary authority
- Member of the Eurosystem

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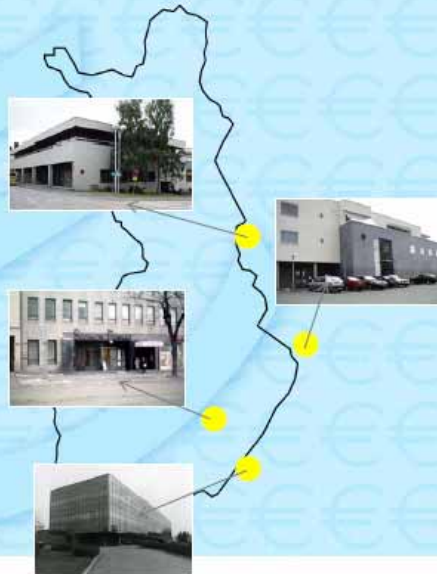
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Organisation



Bank of Finland

- ◆ Fourth oldest central bank in the world
 - Established in Turku in 1811, moved to Helsinki in 1819
- ◆ The Bank of Finland employs about 450 staff; the Financial Supervisory Authority about 210
- ◆ Regional offices in Tampere, Kuopio, Oulu and Vantaa



Bank of Finland's four core functions

Monetary policy
and research

Financial system
oversight

Banking
operations

Cash supply

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Monetary policy

◆ Monetary policy objective: price stability



◆ The Bank of Finland participates in the preparation, decision-making and implementation of Eurosystem monetary policy

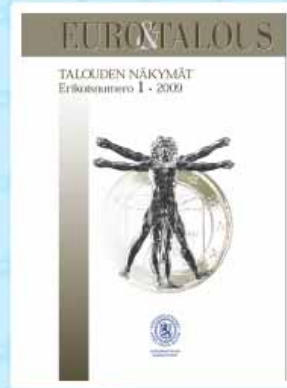
◆ The Governor of the Bank of Finland, as a member of the ECB's Governing Council, is one of those deciding on euro area monetary policy

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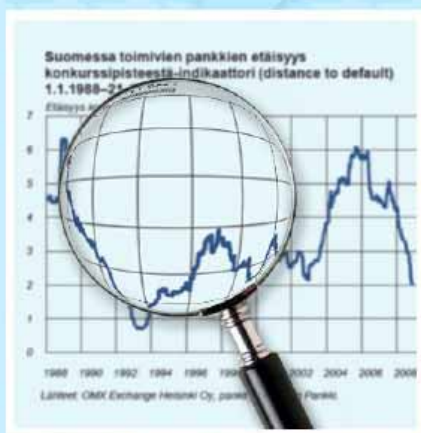
Monetary policy

- ◆ In addition to monetary policy decision-making, the Bank of Finland takes part in domestic debate on economic policy
- ◆ Underlying the Bank of Finland's expert role is internationally-recognised high-level research
- ◆ Priorities of research:
 - 1) Monetary policy modelling
 - 2) The outlook for the financial services sector
 - 3) Russian and Chinese economies



The Bank's macroeconomic forecast is published twice a year

Financial supervision



- ◆ The Bank of Finland **monitors the financial system as a whole**
- ◆ The objective is to maintain stable, reliable and effective financial and payment systems in Finland
- ◆ **The Financial Supervisory Authority (FIN-FSA)**, operating in connection with the Bank of Finland, supervises individual banks and insurance companies
- ◆ The financial crisis has prompted development of common euro area and EU supervisory frameworks

Banking operations



- ◆ The Bank of Finland is the bank of banks
- ◆ With responsibility for
 - **Implementing Eurosystem monetary policy** in Finland
 - Securing the banking system's liquidity
 - Transmitting large-value payments between banks

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Cash supply

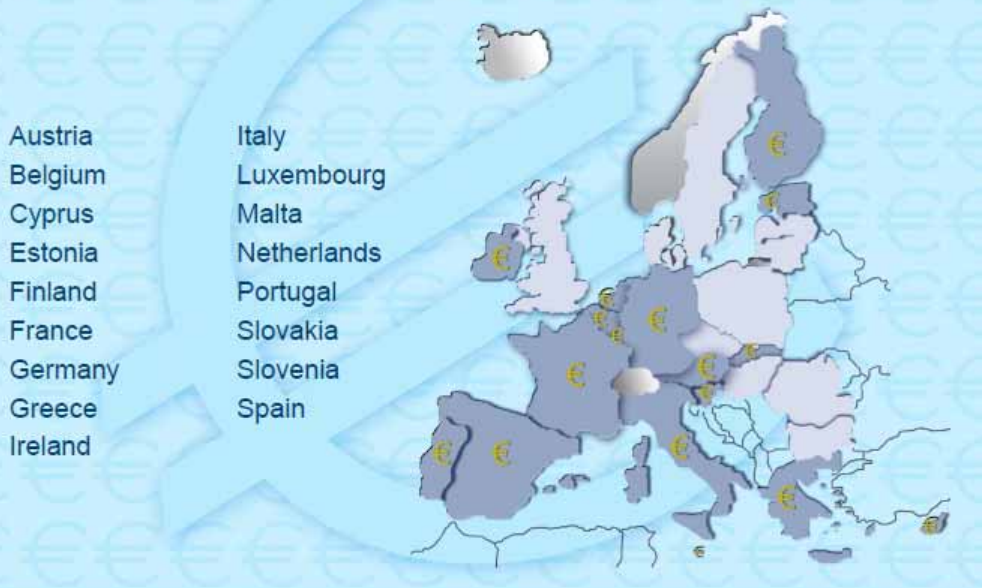
- ◆ Exclusive right to issue cash in Finland
- ◆ Responsibility for ensuring the fitness and authenticity of cash in circulation



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From 1 Jan 2011 the euro area will cover 17 countries



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Decision-making



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ECB Governing Council



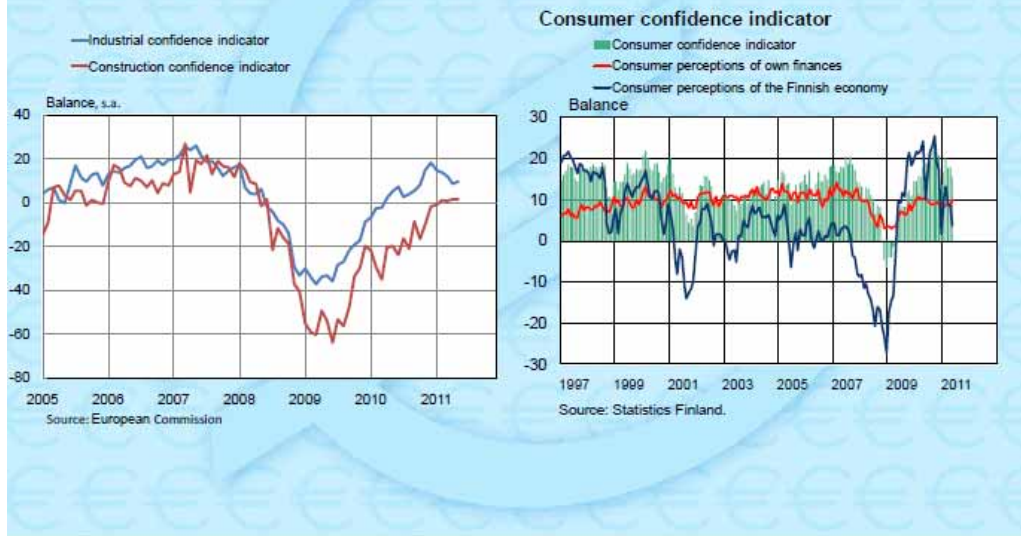
The ECB Governing Council members are listed as follows:

- President:** Jean-Claude Trichet
- Vice-President:** Vitor Manuel Ribeiro Constâncio
- Secretary:** Lorenzo Bini Smaghi
- Members:** Michael C. Bonello, Luc Coene, Carlos Costa, Mario Draghi, Miguel Fernández Ordóñez, José Manuel González-Páramo, Patrick Honohan, Marko Kranjec, Erkki Liikanen, Andros Lipstok, Jozef Makuch, Yves Mersch, Ewald Nowotny, Christian Noyer, Athanasios Orphanides, Peter Praet, Georgios Provopoulos, Jürgen Stark, Jens Weidmann, and Nout Wellink.

Eurosystem objectives and principles

- ◆ **Price stability** is the primary objective of the monetary policy
 - The aim is to keep annual euro area inflation at rates of below, but close to, 2% over the medium term
- ◆ **Support for general economic policy**
 - Support is lent to stable and sustainable growth and employment, without prejudice to the objective of price stability
- ◆ The principles of the Eurosystem are **independence, accountability and transparency**

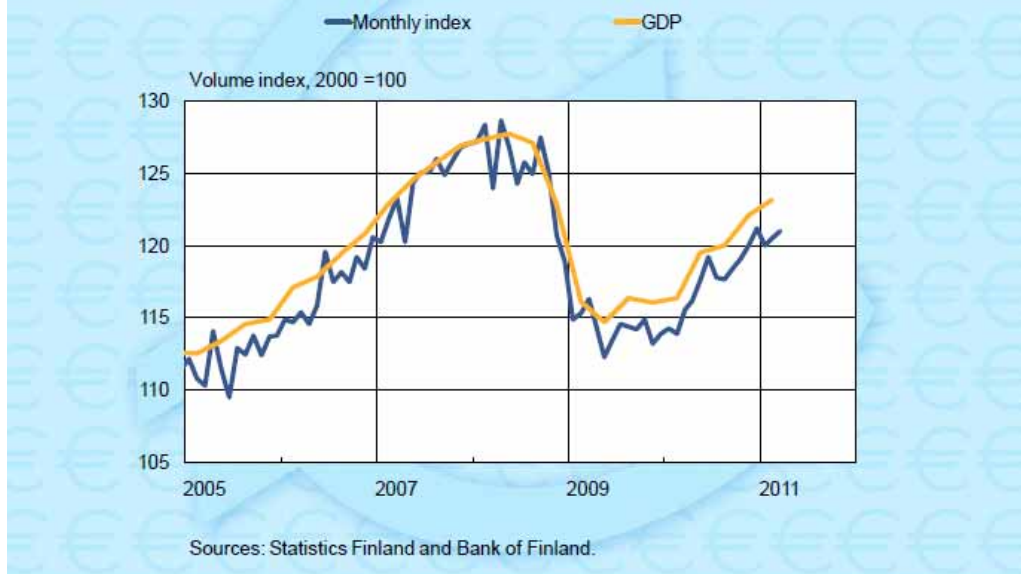
Both business and consumer confidence at fairly high levels



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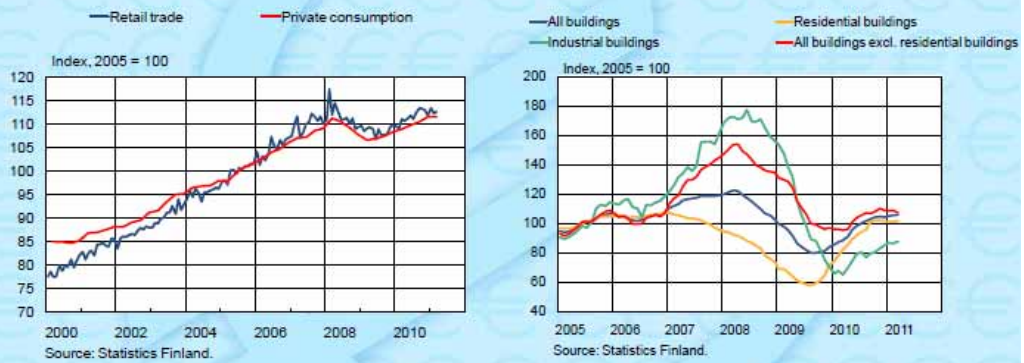
Robust GDP growth in 2010



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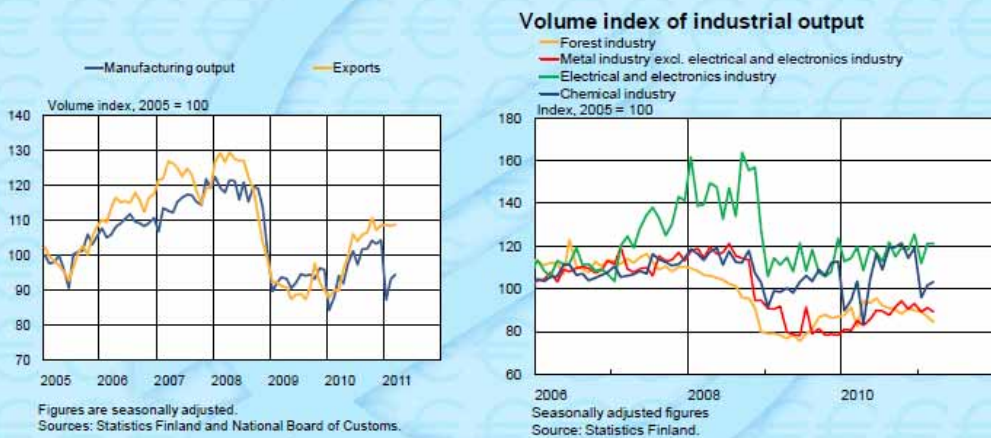
Growth moderating in domestic markets



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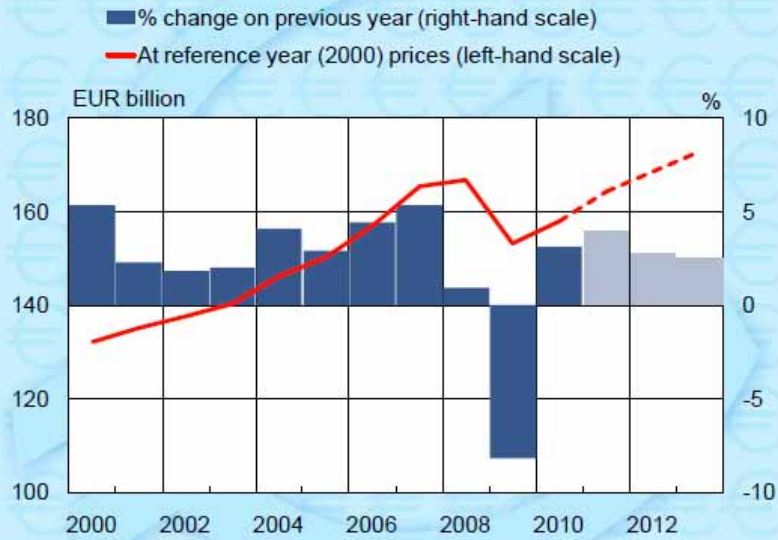
World demand supports exports



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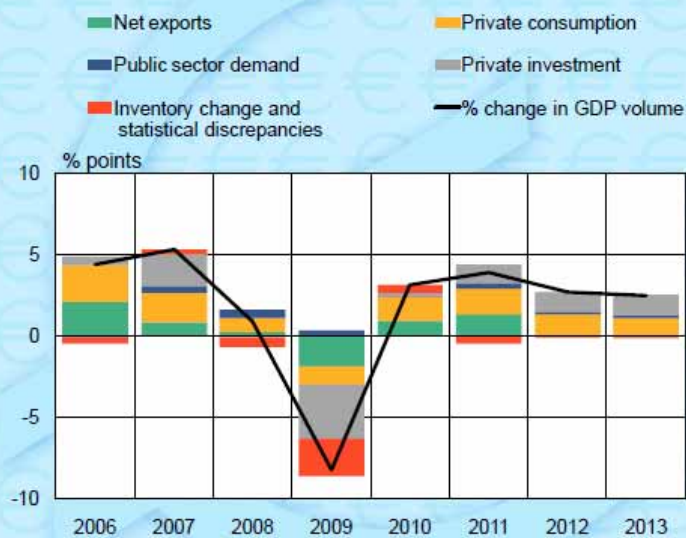
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Finnish economy recovers strongly



Sources: Statistics Finland and Bank of Finland.

Domestic demand supporting growth



The chart is merely indicative. The GDP growth contribution of each demand item has been calculated on the basis of its volume growth and its value share in the previous year. The figures for 2011–2013 are forecasts.
 Sources: Statistics Finland and Bank of Finland.

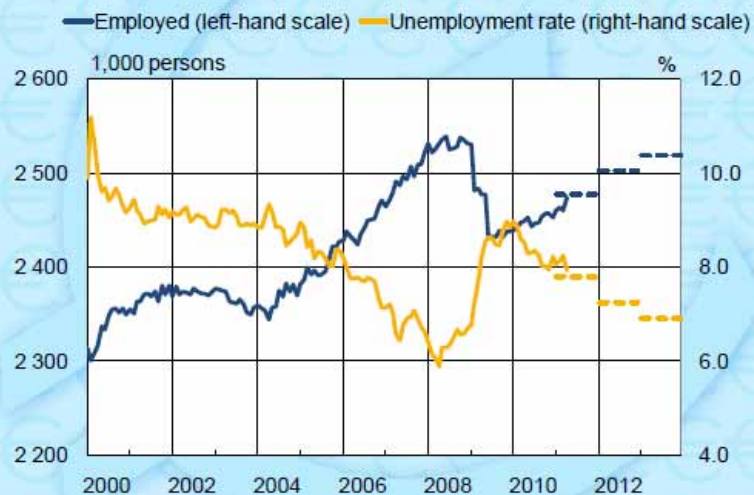
Supply and demand

	2010	2009	2010	2011f	2012f	2013f
	At current prices EUR billion		Volume, % change on previous year			
Gross domestic product	180.3	-8.2	3.1	3.9	2.7	2.5
Imports	65.2	-17.6	2.6	4.2	6.1	7.0
Exports	70.2	-20.1	5.1	7.4	5.9	6.5
Private consumption	97.3	-2.1	2.6	2.9	2.4	2.0
Public consumption	44.2	1.0	0.4	1.2	0.5	0.8
Private fixed investment	28.5	-17.4	0.9	7.1	7.4	7.3
Public investment	4.9	6.2	0.1	1.0	0.7	-0.2

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Unemployment falling, but slowly

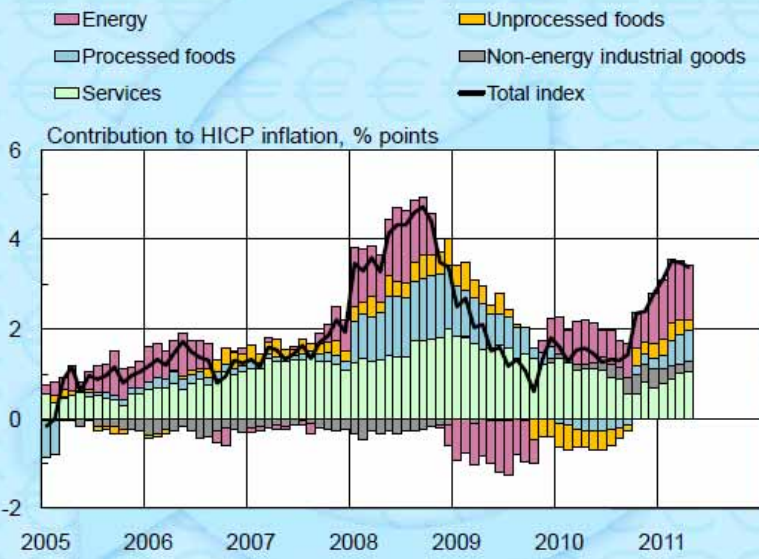


Bank of Finland's seasonally adjusted figures
Sources: Statistic Finland and Bank of Finland

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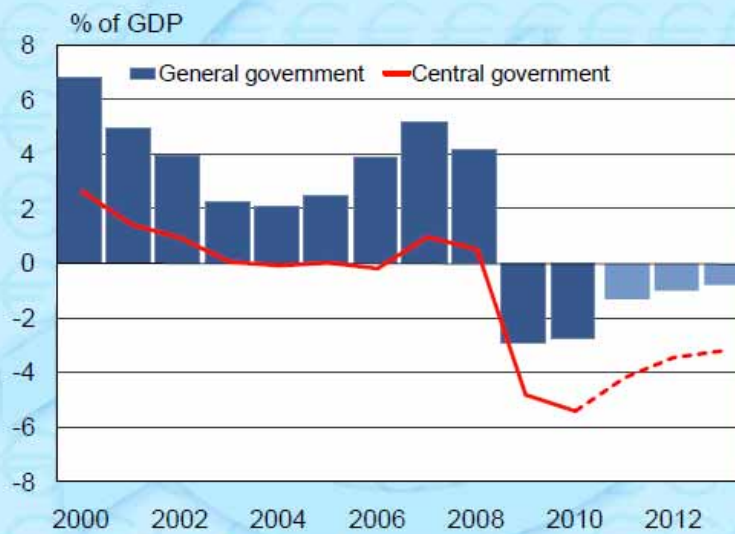
Energy and food prices driving inflation



HICP = Harmonised index of consumer prices
Source: Statistic Finland and Bank of Finland.

Public finances remain in deficit

General government balance



Sources: Statistics Finland and Bank of Finland.