Slow productivity growth hinders export growth

10 Jan 2019 – Analysis – Finnish economy

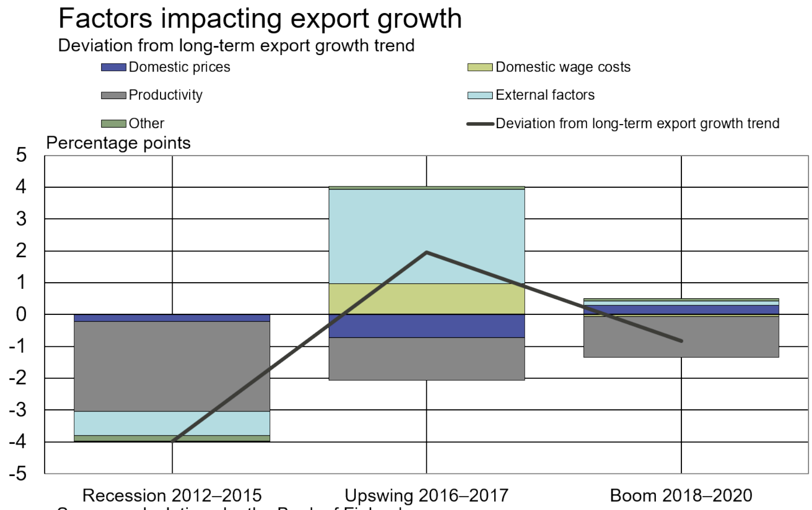
The Finnish economy started to grow at the end of 2015. This was preceded by an exceptionally long and deep recession, during which the economy contracted for several consecutive years and jobs were lost. Economic growth has continued for three years and the Finnish economy is currently booming. However, growth has passed its cyclical peak. The Bank of Finland's Aino forecasting model demonstrates that both external and domestic factors have influenced the cyclical upswing and, in particular, export growth of recent years. According to the forecast, exports are expected to lag behind trend, mainly due to weak productivity growth. Weak productivity growth is being underpinned both by structural changes in the economy — such as the decline and restructuring of manufacturing industries — and by diminishing productivity growth within industries themselves. Weak productivity growth raises domestic production costs in export industries and thus hampers competitiveness and growth.

As Finland is a small open economy, the performance of exports plays an important role in transmitting the effects of the business cycle to the aggregate economy. This Box examines the underlying factors impacting the development of Finnish exports from 2012 through 2020. The period is divided into three phases of the economic cycle: recession (2012–2015), recovery or upswing (2016–2017), and boom (2018–2020). The export figures for the last phase are based on the Bank of Finland December 2018 forecast (see Economic growth has passed its cyclical peak).

An interpretation based on the Bank of Finland's Aino[1] forecasting model shows that international factors, productivity development, domestic wage costs, and domestic prices have contributed to the deviation of export growth from its historical trend (Chart 1). The reference value for the historical growth trend is the average annualised growth rate during Finland's EU-membership (3.9%).[2]

The global financial crisis that originated outside of Finland hit the Finnish economy with force ten years ago. By the time Finland entered a period of recession from 2012 to 2015, the challenges faced by exports had changed from ones that were predominantly external to domestic. Overall, during the recession exports grew at a pace about 4 percentage points below trend, of which three quarters is explained by weak productivity and the rest mostly by external factors[3] (Chart 1). Looking at external factors, below-average export demand, for example, weighed on total exports somewhat (Chart 2).

Chart 1



Source: calculations by the Bank of Finland.
The historical average annualised growth rate for exports (3.9%) is calculated over 1995–2017 as the volume of exports per working-age person (15–74-year-old population).
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Productivity weakened for a number of reasons. Before the financial crisis began, labour productivity growth was very rapid (Chart 2). Since then, labour productivity has developed significantly slower. Weak productivity development is underpinned by structural factors — such as the decline of traditional industry — as well as by dwindling productivity growth within industries themselves. In recent years, productivity growth has weakened notably, especially in ICT manufacturing, which accounted for a large share of Finnish exports prior to the financial crisis. At the same time, industries in the ICT sector have seen their share of total output decline. Weak average productivity growth has raised production costs in manufacturing, also contributing to the rise of

1. The Bank of Finland's Aino model is a dynamic stochastic general equilibrium model that describes the business cycle. See Bank of Finland discussion paper 16/2016.
2. The average annualised growth rate for exports is calculated over 1995–2017 as the volume of exports per working-age person (15–74-year-old population).
3. In the calculation external factors comprise the price of oil, other commodity prices, external demand, competitors' export prices, the effective exchange rate, and the price mark-up of foreign export firms.

domestic production prices (Chart 2). This has reflected on export prices and, for its part, weakened the competiveness of Finnish export industries relative to Finland's competitors.

Labour productivity growth and the impact of the decline of ICT manufacturing on productivity growth is discussed in broader detail in the section Several reasons behind weak labour productivity. Furthermore, productivity growth on a corporate level is examined in the feature article Divergence of productivity growth in Finnish companies.

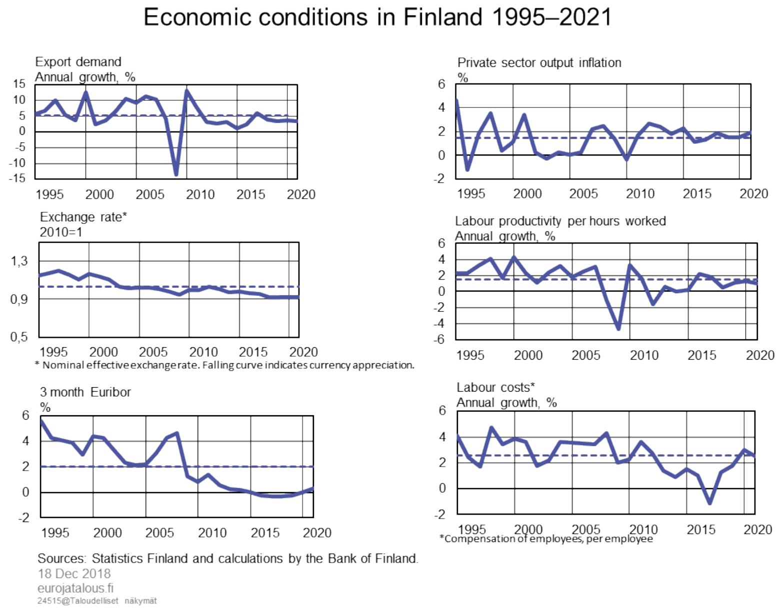
External factors, on the other hand, have played a major role in driving the upswing in exports. Inspecting the years 2016–2017, demand for Finnish exports has increased notably, while also being favourable for the structure of the export sector, which is weighted towards capital and intermediate goods. Moreover, financing conditions have been very easy due to an accommodative monetary policy, and e.g. the 3-month Euribor rate has been low for an extended period (Chart 2). The accommodative monetary policy has bolstered Finnish exports directly, and – through economic growth in the euro area – also indirectly.

During the economic upswing in 2016–2017, productivity improved considerably from what it was during the recession. Nevertheless, productivity growth has failed to recover to its previous levels on account of structural changes in the economy, among other factors. At the peak of the upswing, export growth surpassed its historical trend by some 2 percentage points. It would have reached almost 1.5 percentage points higher, had productivity growth followed its historical trend. At the same time, export price growth has surpassed its historical trend, partly due to domestic price factors, which has contributed to slowing export growth (Chart 1).

The economic policy measures which aimed at improving cost-competitiveness by lowering domestic wage costs have bolstered exports during the upswing. Here, domestic wage cost factors include average hourly earnings and employers' social security contributions, which the Competitiveness Pact aimed both to address. From the perspective of firms, labour costs lowered considerably in 2017 (Chart 2). The lowered wage costs strengthened export growth during the upswing (Chart 1).

The economy is currently booming, but growth has passed its cyclical peak. Export growth will remain almost one percentage point slower than its trend. The primary reason for this is sluggish productivity growth, which does not support exports the way it once did. The Finnish economy will not reach previously experienced levels of brisk productivity growth, as the economy has undergone structural changes. The combined effect of all other factors during the forecast period will remain moderate (Chart 1).

Chart 2



Tags

Aino model, economic cycles, exports