BANK OF FINLAND FORECAST

Finland’s economic situation remains difficult

18 Dec 2015 – Forecast – Finnish economy

The Finnish economy is still in a difficult situation. During the forecast period, the return to growth will be very sluggish and much slower than in the rest of the euro area. Developments in Finland’s export markets now look weaker than previously forecast, and as a result foreign trade will give little stimulus to the economy in the immediate years ahead. During the forecast period, growth will depend on domestic demand. In 2016, the Finnish economy will grow 0.7%, followed by 1.0% in 2017. Risks to the forecast are predominantly on the downside and productivity development will be weak.

World trade growth, and hence Finland’s export demand, was much more sluggish in 2015 than expected in the Bank of Finland’s June 2015 forecast. Chinese growth has slowed, and the Russian economy will continue to contract during the forecast period 2015–2017. On the other hand, growth is fairly brisk in important Finnish export markets in Europe and the United States, and euro depreciation will help facilitate exports outside the euro area. The continued accommodative monetary policy stance will boost euro area growth, thereby improving the outlook for Finnish exports.

Increasing investment in the euro area will support export growth in 2016. The weakening trend in Finland's cost-competitiveness will, however, not be turned around during the forecast period, and Finnish exports will not reach the pace of growth in the export markets. At the present moment, factors that have usually facilitated a speedy recovery in exports (such as rapid growth in world trade or especially competitive, new export products) are lacking. The alternative scenario explores a situation in which exports do not begin to grow at all during the forecast period and the gap between exports and the export markets deepens.

Consumer price inflation will continue to be exceptionally slow in the forecast years, reflecting the sluggish trend in crude oil prices. In April 2015, Finnish inflation dipped below the euro area average, and the difference in price levels relative to the rest of the euro area has slowly begun to narrow. Inflation according to the harmonised index of consumer prices (HICP inflation) will average -0.1% in 2015, picking up to 0.3% in 2016 and 1% in 2017.

Nominal earnings will rise moderately in the forecast period in accordance with the current labour market agreement, and the slow inflation will support growth in real earnings, particularly in the early part of the forecast period. Despite the wage restraint, the growing trend in unit labour costs would appear set to continue at a faster pace than in the rest of the euro area, as productivity growth will continue to be very slow.

Private consumption will increase only moderately in the forecast years, but even weak growth will help sustain private demand. Household incomes have developed in a relatively stable manner during the recession years. This is partly due to the increased significance of current transfers as a source of income, particularly on account of the increase in the retired population. In fact, the growing share of households' income formation taken by pensions has reduced the sensitivity of private consumption to the business cycle.

During 2015, there were at last some signs of a recovery in investment activity and rising investment expectations. Investment is forecast to enter a period of gentle growth in 2016 and 2017, as gradually strengthening external demand and the projects already underway support an increase in corporate fixed investment.

The steep labour market decline that continued until June 2015 has now bottomed out. Due to the weak first half of the year, however, the number of employed will remain more or less the same as in 2014, while the unemployment rate will rise to 9.4%. The labour market situation will improve only slowly in the forecast period on account of the sluggish growth in the economy and an increase in structural unemployment.

The rapid growth in the number of asylum seekers has also raised questions over the economic impacts of immigration. Over the longer term, the key factor here is how successful immigrants are in finding employment. Most immigrants are of working age, hence immigration could potentially ease the problems related to a contracting labour force. Effective integration can help immigrants find employment.

Finland's general government fiscal position has been in deficit for 6 years already, causing a substantial increase in the public debt. During the forecast period, general government debt will exceed 68% of GDP, and in 2017 it will be twice the level of 2008. The pace of debt accumulation is a matter for concern, as Finland's longer-term growth outlook is weak, on account of the prolonged recession, contraction in the working-age population and the ongoing restructuring of Finnish industry. Despite the Government's consolidation measures, the general government structural deficit will show scarcely any improvement in the forecast period, as the surplus on the earnings-related pension funds is continuing to erode due to the rapid increase in pensions expenditure.

A review of Finland's external balance in light of the financial balance of the various sectors reveals a major change since the global financial crisis, but one that has attracted too little attention. In contrast to previous years, both households and the public finances have since 2009 been simultaneously in deficit. The external balance of the economy has, in contrast, long been bolstered by the financial surplus in the corporate sector. This trend is a cause for concern, as the corporate sector's financial surplus is sustained by the low level of corporate investment. The Finnish economy is currently running on debt at the same time as the potential output of the economy continues to decline. This trend is unsustainable.

Finnish growth to remain among the weakest in the euro area

According to the Bank of Finland forecast, GDP will contract by 0.1% in 2015. Domestic demand will pull GDP growth into positive territory in 2016, but it will remain very muted. Growth will reach 0.7% and 1.0% in 2016 and 2017, respectively. In the forecast years, GDP in Finland will improve only by a total of 1.6%, while growing in the euro area by 5.1% over the same period. Risks to the forecast will continue to lie on the downside, and productivity performance will be weak.

Table 1.

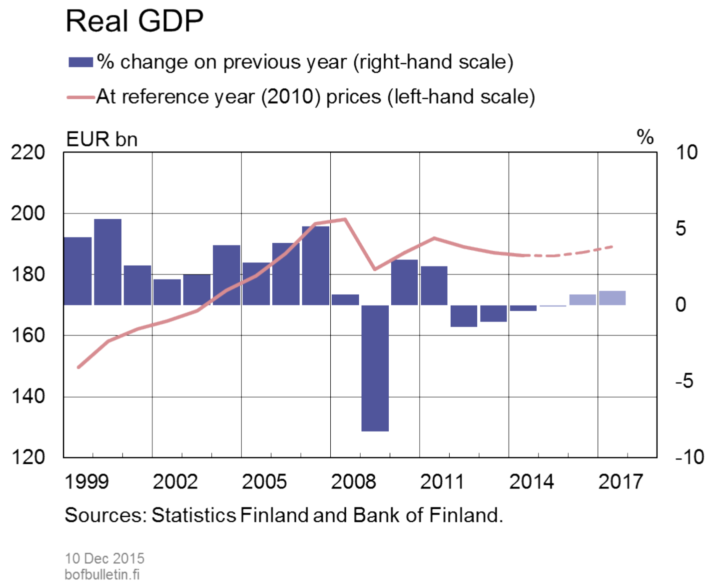
Forecast summary

Change on previous edellisestä year	2014	2015f	2016f	2017f
Gross domestic product	–0.4	–0.1	0.7	1.0
Private consumption	0.5	0.5	0.6	0.6
Public consumption	–0.2	-0.1	0.6	0.6
Private fixed investment	–3.9	–1.1	3.3	2.8
Public fixed investment	–0.9	-2.3	1.3	1.4
Exports	–0.7	0.1	2.1	2.7
Imports	0.0	–2.8	3.2	2.8
Contributions to growth from components of demand				
Domestic demand	–0.5	0.0	1.1	1.0
Net exports	–0.3	1.1	–0.4	0.0
Inventory change and statistical discrepancies	0.4	–1.2	0.1	0.0
Savings ratio, households	–0.3	0.1	0.6	0.7
Current account, % of GDP	–0.9	–0.1	–0.2	–0.3
Labour market				
Hours worded	–0.7	0.1	0.5	0.5
Number of employed	–0.4	–0.3	0.4	0.4
Unemployment rate, %	8.7	9.4	9.2	9.1
Unit labour costs	1.4	1.7	1.1	1.0
Compensation per employee	1.4	1.8	1.4	1.5
Productivity	0.0	0.2	0.3	0.5
Gross domestic product, price index	1.6	0.5	1.0	1.0
Private consumption, price index	1.6	0.2	0.4	1.0
Harmonised index of consumer prices	1.2	-0.1	0.3	1.0
Excl. energy	1.5	0.3	0.5	0.8
Energy	–1.7	–5.8	–1.8	3.6

f = forecast

Sources: Statistics Finland and Bank of Finland.

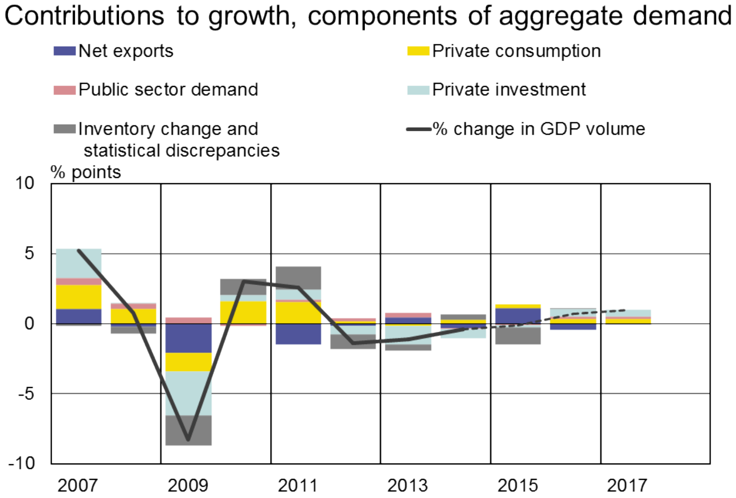
Chart 1



Economic growth in the forecast period will hinge on private consumption and investment. The exceptionally accommodative monetary policy will maintain a low level of lending rates for households and non-financial companies, support consumption and enable a pick-up in investment following a period of contraction lasting several years. The contribution of net exports to economic growth will remain limited during the forecast period, as the usual pull is not coming from Finland's export markets and competitiveness has not improved.

The cut-off date for the statistical data and other information included in the forecast was 19 November 2015. On 4 December 2015, Statistics Finland released the latest quarterly national accounts data, which are discussed more closely in a separate article.

Chart 2



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 2015–2017 are forecasts.
Sources: Statistics Finland and Bank of Finland.

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Households: Slow inflation supports growth in purchasing power

Current growth in private consumption, though subdued, has helped sustain domestic demand. Private consumption will continue to rise at a moderate rate over the forecast years, with the rate of growth remaining practically unchanged from 2015, at around 0.5%, in 2016 and picking up slightly in 2017.

The prolonged recession is reflected in consumer confidence, which has weakened almost continuously since May 2015. In autumn, consumers' expectations of both Finnish economic developments and of their own prospects have declined. However, even large fluctuations in the consumer confidence indicator are known to occur without being instantly reflected in household consumption behaviour.

Real household income is expected to increase by 0.8% in 2015. This means a turn for the better in household income development, after three years of stagnation or contraction in real household income. While earnings growth will be sluggish in 2015, growth in real household income will be buoyed by falling consumer prices. Nominal wages will continue to increase only slowly in 2016 and 2017, but real earnings will rise, supported by subdued inflation, especially in 2016. A slight improvement in employment will also begin to drive up real household earnings, which will continue to increase at an average rate of just under 1% over the forecast years.

Changes in the taxation structure, together with higher social security contributions, will lower households' disposable income by around EUR 500 million in 2015 and by roughly the same amount in 2016–2017. The major loss of purchasing power in 2015 is related to the increase in indirect taxes, whereas in 2016 it will derive from an increase in the unemployment insurance contribution, and in 2017 from an increase in pension contributions.

In 2015, the availability of instalment-free periods on housing loans has bolstered growth in households' purchasing power. The total value of housing loan contracts renegotiated by autumn 2015 amounted to around EUR 13 billion. This is estimated to increase the amount of household assets available for other consumption and savings by a little over EUR 500 million in 2015 and a little under EUR 200 million in 2016.

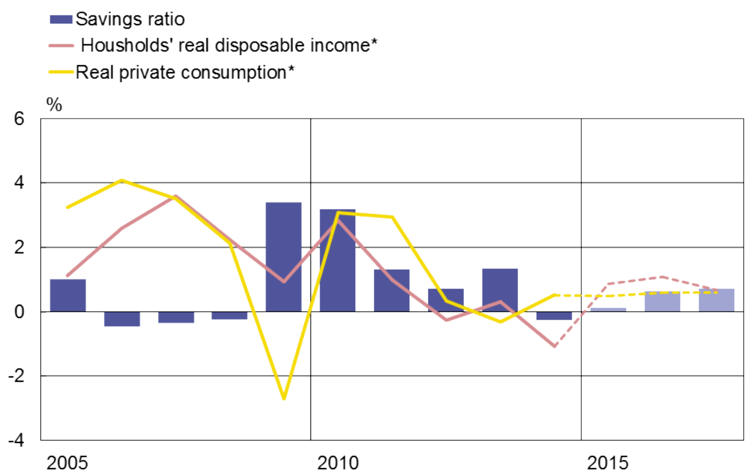
Income transfers have gained in importance as a source of income, in part due to rising unemployment, but above all to growth in the retired population. In 2015, the retired population in Finland already reached over 1.5 million people. Similarly, newly awarded pensions have grown in amount, reflecting the longer working careers of new retirees. Pension income is, at least in the short term, independent of economic cycles, and, hence, a higher share of pension income in household income formation will help reduce the sensitivity of private consumption to cyclical fluctuations.

The sluggish income development witnessed in recent years has had a surprisingly small impact on private consumption, as the household savings ratio has fallen during the recession. The savings ratio will pick up slightly in the forecast years, but will remain historically low.

In step with house purchases and rising nominal house prices, the stock of outstanding housing loans has expanded, while the low level of interest rates has supported households' debt servicing capacity. The availability of instalment-free periods on housing loans has also contributed to the expansion of the housing loan stock. In the second quarter of 2015, households' debt-to-income ratio had already surged to 123%, and debt accumulation is expected to continue also in the forecast years.

Chart 3

Slow inflation supports growth in real income



Households = households and non-profit corporations serving households.
* % change from previous year.
Sources: Statistics Finland and Bank of Finland.

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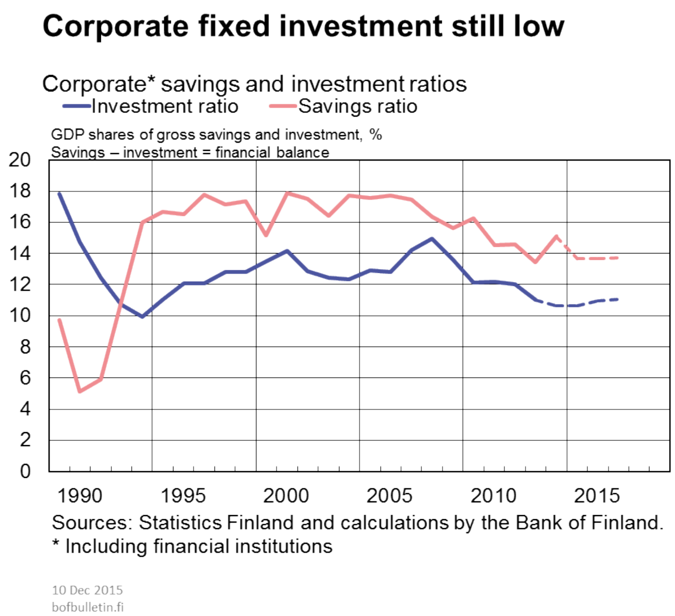
Investment ratio still low

Investment in Finland has been contracting for several years. Developments have been much weaker than in competing countries and the euro area as a whole. In 2015, we have finally seen some signs of investment recovery and expectations have risen, with a slight upturn in investment forecast for 2016–2017.

Private investment has declined considerably in recent years. Investment is more than 15% below the 2011 level and, at the same time, corporate profitability – operating surplus in relation to value added – has deteriorated. Private investment has declined much more than total output, which has led to a drop in the total investment ratio. Both fixed and residential construction investment have contracted considerably since 2011. The GDP share of corporate fixed investment has not been so low since the mid-1990s (Chart 4).

Chart 4

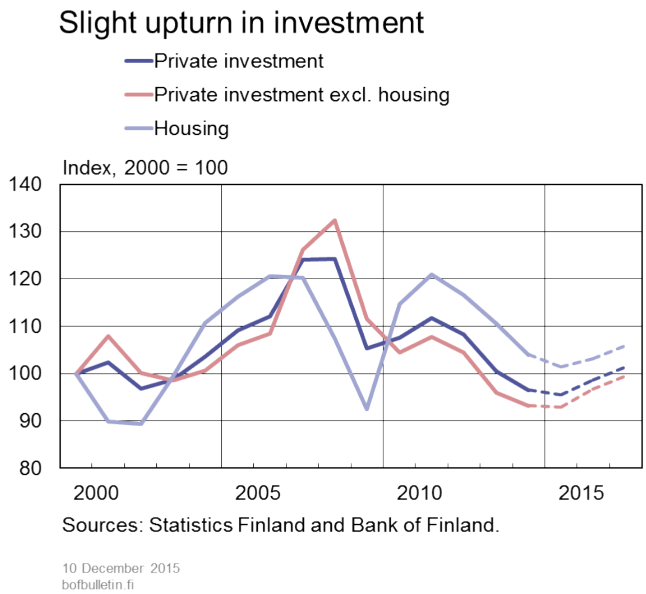


Changes in Finland's industrial structure, weak demand and growth prospects, excessive surplus capacity, uncertainty over the future and an ageing population have all contributed to the subdued level of investment. Both surveys and the recent growth in corporate loans indicate that financial factors pose no obstacle to growth.

In 2015, investment is still decreasing. However, during the course of the year there have been some signs of a recovery in fixed investment. A number of individual, large investment projects are underway, turnover in construction has begun to grow and an industrial investment survey reveals that corporations estimate they will be increasing their investment. In 2015, residential construction has declined due to subdued new-build construction. On the other hand, the brisk pace of renovation work is expected to continue.

During the forecast period 2016–2017 private investment will begin to grow, particularly as corporate fixed investment increases (Chart 5). Growth in corporate fixed investment will be bolstered both by gradually strengthening external demand and by projects already underway. In 2016, housing investment will increase as new-build construction picks up. The growth in investment will be sufficient to put the investment ratio of the economy on a slightly strengthening trajectory. However, despite the forecast recovery in investment, the investment ratio in the forecast period will remain well below the long-term average.

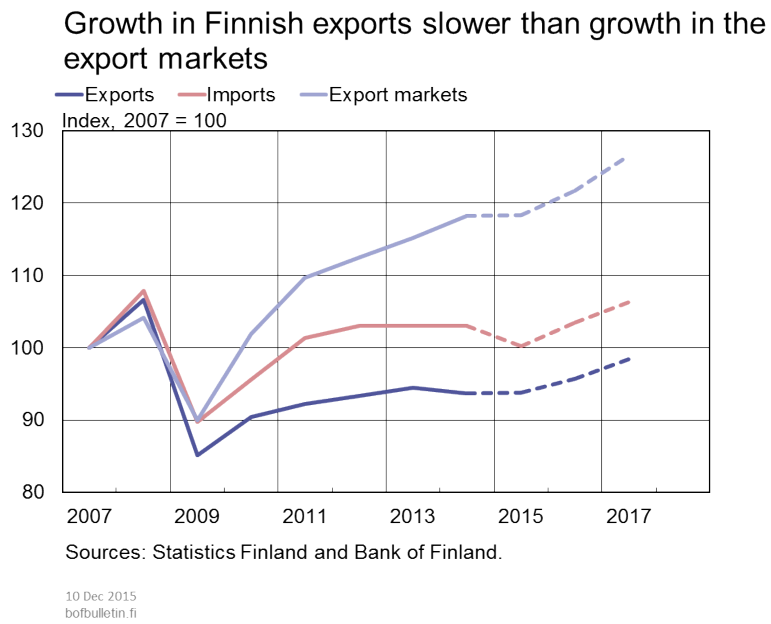
Chart 5



Foreign trade: Euro area investment will support export growth

The recovery in Finnish exports has been delayed and is lagging behind the progress of exports in competing countries, although increased investment in the euro area will support export growth. (Chart 1). Global growth prospects have deteriorated, particularly in the emerging economies, bringing uncertainty to the budding growth. The depreciation of the euro will facilitate exports to countries outside the euro area.

Chart 6



Finnish exports largely comprise capital goods and services, so increased investment in the euro area will generate an upturn in Finnish exports in 2016. The large proportion of capital goods explains the delay in export growth compared with other euro area countries, and export growth will remain slower than the pace previously witnessed.

The growth impact of net exports (the difference between exports and imports) will in 2015 remain positive due to the contraction in imports of goods and services. Increased investment and exports will also lead to increased imports, so the positive impact of net exports will fade towards the end of the forecast period.

The export markets will continue to grow, with support from the US and European economies, but growth will be slower than previously expected. The slowdown of the Chinese economy and the increasingly weak prospects for other emerging economies have added uncertainty to the outlook for Finnish exports.

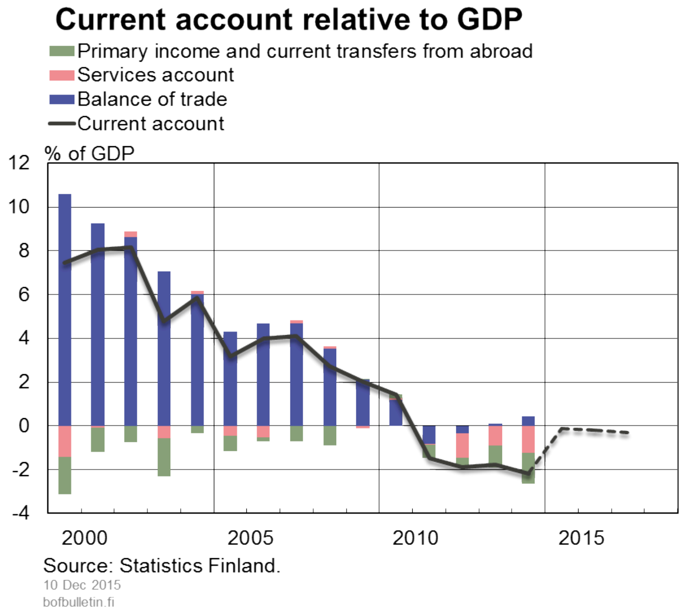
Export growth will continue to be slower than the progress in the export markets. Since the turn of the millennium, Finland's share of world trade has contracted sharply, particularly compared with the growing share of the emerging economies. Over the forecast horizon, export growth will remain slower than in competing countries, so market shares will also contract relative to other advanced economies.

The euro's depreciation against the dollar supports Finnish exports. On the other hand, the prospects of exports to Sweden and Russia are subdued after the depreciation of the krona and the collapse of the rouble.

In 2015, the value of foreign trade suffered from the drop in the price of crude oil, which particularly reduced imports. In addition, the recession in the Russian economy cut exports. By contrast, increased exports of vehicles to Germany expanded exports.

The goods and services account turned positive in 2015 as a result of improved terms of trade, and the account will remain positive throughout the forecast period. (Chart 2). The terms of trade improved primarily in response to the drop in the price of crude oil, so the impact will be temporary. The current account will be close to balance due to negative net current transfers.

Chart 7



Developments in the exports and imports of goods over the past 25 years has been analysed in a separate article.

Labour market: Weakening labour market trend bottomed out

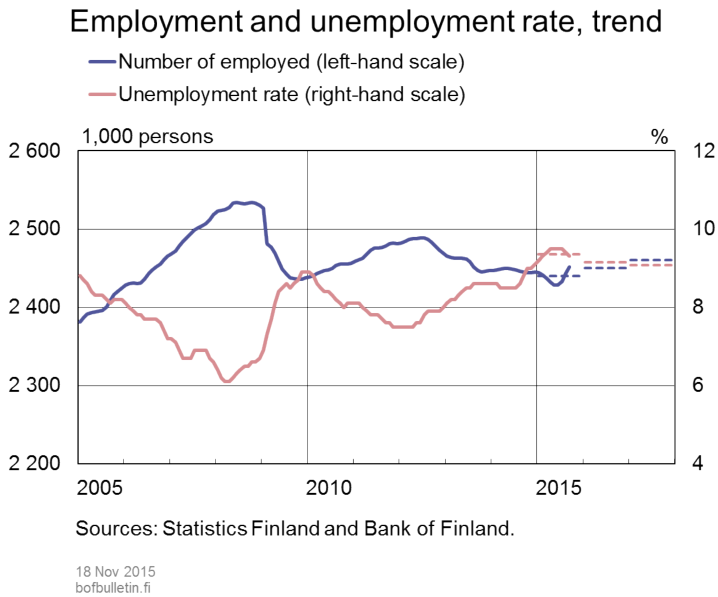
The decline in employment and increase in unemployment appear to have flattened out, but labour market conditions will improve only slowly in the forecast period. Subdued economic growth and high structural unemployment will slow the improvement in employment, and unemployment will remain high.

The steep deterioration in labour market conditions since summer 2014 has eased. The rise in the trend unemployment rate has come to a halt and, in recent months, the rate has fallen to 9.3%. The number of people employed has increased and the trend employment rate has improved significantly.

In recent years, the number of people employed has decreased particularly in manufacturing. The recent improvement in labour market conditions is partly due to the fact that manufacturing employment has finally recovered. The number of people employed has grown in 2015 also in social and health care services, and to a slight degree in construction. In the trade sector, in contrast, employment developments have been weak.

Due to the weakness of the labour market in the first part of the year, the number of people employed in 2015 will remain unchanged from the previous year but will post an increase of 0.2% in 2016 and 0.4% in 2017. The unemployment rate will climb to 9.4% this year, falling back slowly to 9.1% in 2017 (Chart 8).

Chart 8



Due to the subdued economic growth, labour market conditions will improve only slowly in the forecast period. The prolonged weakness of the economy has been reflected in an increase in long-term and structural unemployment in recent years. The average duration of unemployment continues to lengthen, and the vacancy filling rate is still slow. In recent years, flows between employment and unemployment have slowed and job creation is lethargic. Overall, labour market dynamics continue to be sluggish and the unemployment rate will remain persistently at over 9% throughout the forecast period.

The arrival of asylum seekers in Finland during the autumn will have only a minor impact on the labour market in the forecast period. Due to the asylum seekers, the unemployment rate is expected to climb by a few tenths of a percent towards the end of the forecast horizon. The effect of immigration on the labour market and the public finances is examined in more detail elsewhere.

Costs and prices: Inflation exceptionally slow

Developments in consumer prices remain exceptionally subdued. Inflation according to the harmonised index of consumer prices (HICP inflation) will average –0.1% in 2015, but will rise to 0.3% in 2016 and 1.0% in 2017. Increases in indirect taxation will push up inflation by 0.3 of a percentage point in the forecast period.

The largest individual factor that has affected consumer prices in 2015 is the drastic dip in the world market price of crude oil since summer 2014. The price of crude oil has been reflected directly in fuel prices, and indirectly in the prices of other goods in the production of which energy is used as an intermediate good. Developments in the price of crude oil are expected to remain subdued in the forecast period. In the early part of 2016, there will be a temporary inflationary peak as the impact of the dip in the price of crude oil fades. In addition to energy prices, many other commodity prices have also declined in recent years.

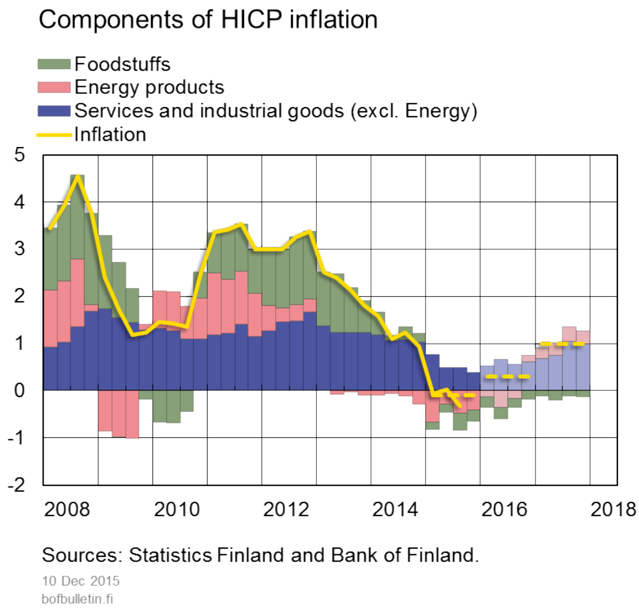
The prices of manufactured consumer goods are expected to continue their downward trend. The fall in world market prices of commodities and slowdown in the emerging economies will push down the prices of industrial goods. On the other hand, the depreciation of the euro will push up the consumer prices of imported goods, which will become manifest towards the end of the forecast period.

Food prices started to decline in 2015. Price competition in the daily consumer goods trade, low prices of crude oil and the fall in world market prices of food commodities will sustain the subdued developments in consumer prices throughout the forecast period.

Services prices are the only items fuelling inflation in 2015. Rents, which are included under services prices, and the prices of other housing services have risen in recent years at a rapid pace. In early 2015, there was a broadly based slowdown in services inflation, suggesting that the impact of a weak economy and moderate wage developments have passed through to consumer prices.

Domestic inflation slowed in April 2015 to a level below the euro area, and thus the difference in price levels relative to the euro area, which had been expanding since the financial crisis, has begun to slowly contract. Price developments in Finland and the euro area are examined in more detail elsewhere in this publication.

Chart 9



Nominal earnings will grow by some 1% per annum in the forecast period. The Pact for Employment and Growth concluded by the social partners in 2013 defines the pay rises for 2015 and 2016. Earnings will grow in real terms, too, due to the very slow rise in prices.

Growth in unit labour costs will slow in 2016–2017 to some 1%. Competitiveness, as measured by unit labour costs, will not improve relative to the euro area (European Commission's Autumn 2015 Economic Forecast). Even though earnings growth is moderate relative to past experience, this does not improve cost-competitiveness, because, at the same time, non-wage labour costs are rising and improvements in labour productivity are sluggish. Labour productivity has declined in recent years, due partly to structural changes in the economy. Productivity growth will remain exceptionally modest throughout the forecast period.

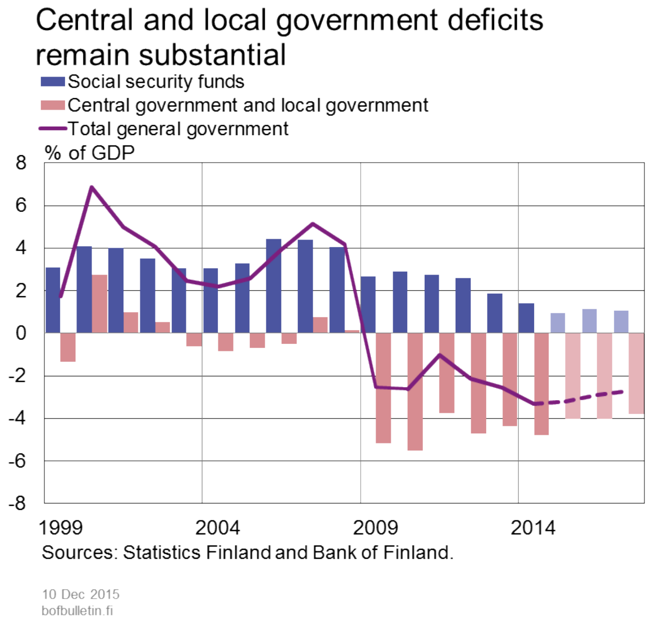
Chart 10

Public finances: Debt will continue to grow at a rapid pace

Finland's public finances will continue to post a deficit of close to 3% during the forecast period, and the public debt will increase further to 68% of GDP in 2017. The forecast takes account of the new Government's budget proposal for 2016 and measures envisaged for 2017. The Government's objective is to halt the growth in the debt ratio during the government term, but it is uncertain whether the objective will be achieved.

The general government deficit exceeded the 3% threshold set in the EU's Stability and Growth Pact already in 2014. The deficit was lower than expected, and the previous Government did not decide on any new measures in the early part of 2015 beyond earlier savings measures. Thus, the deficit will exceed the threshold in 2015, too, amounting to 3.2% of GDP. Weak economic growth will drag down fiscal consolidation in the next few years, too. In response to consolidation measures, the general government deficit will contract to 2.9% in 2016, and further to 2.7% in 2017 (Chart 11). Fiscal policy was accommodative in 2014, but will tighten in 2015 and 2016. The general government structural deficit will barely change, since pension expenditure will continue to grow at a brisk pace despite the cyclical situation (Chart 1 in Pace of debt growth disquieting).

Chart 11



Central government finances will improve slightly in 2015 and through the forecast period, but will still remain substantially in deficit. The new Government already outlined targeted savings measures in its Government Programme. The measures amount to around EUR 4 billion at the overall general government level during the government term. The savings measures comprehensively cover the central government expenditure items, but the largest cuts will be made in the largest expenditure items, i.e. social benefits and education. Expenditure on development aid will also be markedly decreased. The Government will ease earnings-related taxation and tighten indirect taxes so that, overall, taxation will ease slightly. At the same time, there will be a one-off investment of EUR 1.6 billion in 2016–2018 to support key government projects and reduce the infrastructure maintenance backlog. The forecast also takes account of the addition of EUR 450 million to the 2016 Budget due to the refugee situation. On-budget debt will rise to 53.5% of GDP in 2017.

Local government finances will also remain in deficit in the forecast period. The rate of increase in municipal taxes will moderate overall in 2016, and the focus of local government finances will shift in the forecast years towards adjustment of expenditure. Measures available for attaining more balanced local government finances include savings achieved via reductions in municipal responsibilities and commitments, and increased revenue from higher service charges and real-estate taxes.[1] Growth centres, in particular, are facing increasing service needs and investment due to expansion. The challenge for regions suffering net migration loss is to reconcile population ageing and a weakening funding base. Local government debt will continue to grow rapidly, exceeding 10% of GDP in 2017.

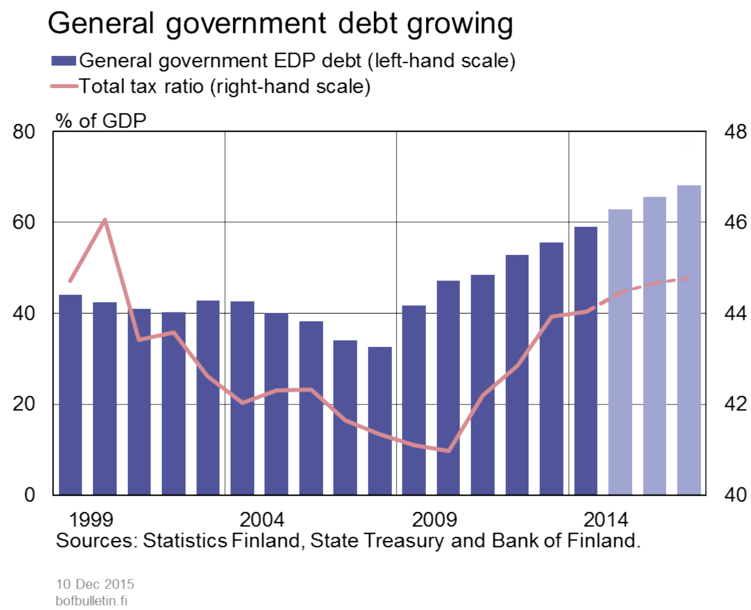
The surplus on the earnings-related pension funds will remain at 1.3% in the forecast period. Earnings will be fuelled by an increase in pension premiums in 2017 in

1. These measures have not been taken into account in the forecast.

accordance with the pension reform. Pension expenditure growth will moderate slightly, as index increments to pensions will remain low due to slow inflation and the slow rise in the level of earnings. The number of pension recipients will continue to grow at a brisk pace. The financial position of other social security funds will be eroded by the deficit on the unemployment insurance fund, in particular. In the context of the agreement to continue the Pact for Employment and Growth, it was also agreed to increase unemployment insurance contributions by 1 percentage point in 2016. The downturn in the number of unemployed in 2016 will also gradually ease the position of the social security funds, as expenditure on unemployment and social assistance will begin to contract.

Influenced by increases in social security contributions, the tax ratio will rise slightly in 2016–2017, to 44.8%. The Government's objective is to halt the growth in the debt ratio by the end of the government term. Growth in public debt will moderate in the forecast period, but the debt ratio will rise to over 68% in 2017.

Chart 12



External balance: Current account bolstered by corporate sector

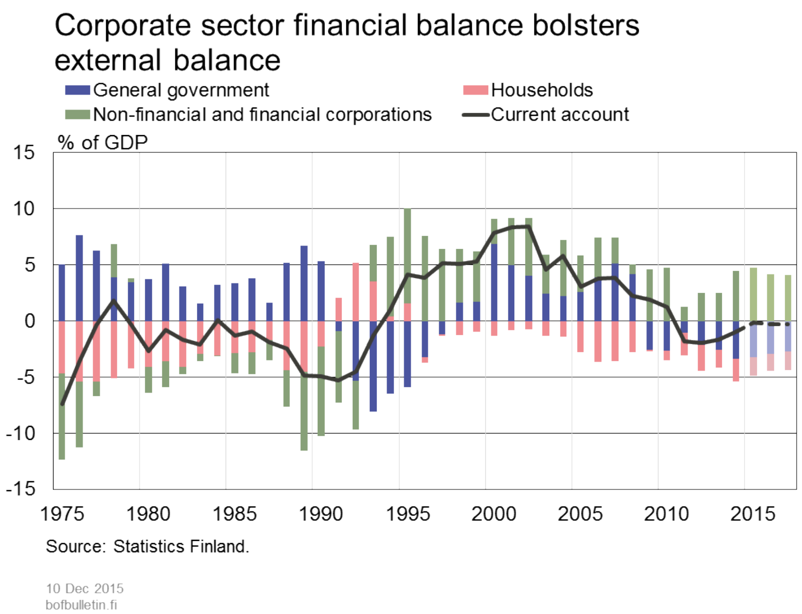
An examination of the external balance of the Finnish economy in the light of different sectors' financial balances reveals the big change the Finnish economy has undergone in the recession years. Unlike before, both households and the public sector have simultaneously been incurring debt since 2009. In contrast, the economy's external balance has long been supported by financial surpluses in the corporate sector.

Households and the public sector alternately showed deficits and surpluses from the 1970s until the recession years. One sector's surplus financed the other's deficit. For example, in the depression years of the 1990s, an increase in the household savings ratio and a contraction in housing investment slowed external imbalance growth amid the accumulation of public debt. In the years preceding the current recession (i.e. in 2009 and 2010) the household savings ratio was also high (cf. Chart), but it has subsequently decreased strongly. Instead, in recent years, household debt accumulation has increased and is expected to do so in the forecast period, too, in parallel with public sector debt.

The Finnish corporate sector has shown financial surpluses since the beginning of the 1990s. During the recession, the sector has remained in surplus, but the surplus is now explained by factors other than those in past decades. At the beginning of the 1990s, the corporate sector's financial balance was an indication of improving capital positions. Finnish companies were digesting large investments made in the 1980s in their efforts to rapidly internationalise. The financial balance reflected good corporate profitability since the latter part of the '80s. In particular, the large operating surplus of the electronics industry boosted the entire corporate sector's financial surplus. Corporate profitability has weakened since the financial crisis, with the sector's surplus now being mainly accounted for by its historically low investment ratio. Notably, corporate fixed investment in manufacturing has declined sharply.

In the recession years, domestic demand has been sustained by household and public consumption rather than investment. Towards the end of the forecast horizon, the household savings ratio will turn positive and the general government deficit will contract to some extent. The economy's external balance will improve, as the corporate sector's surplus is sufficient to cover other sectors' deficits. This is causing concern, however, as the corporate sector's financial surplus is maintained by the paucity of its investment. Such a trend is unsustainable in the long term.

Chart 13



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