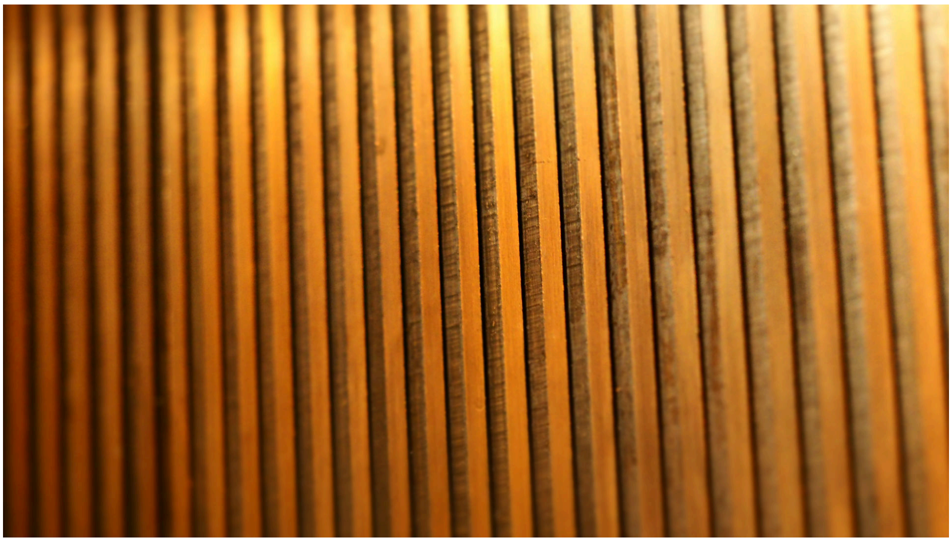
BANK OF FINLAND FORECAST

The Finnish economy is returning to growth

23 Jun 2016 – Forecast – Finnish economy

The Finnish economy is returning to growth. Economic data have strengthened, and leading indicators suggest growth continuing through the forecast years. However, this growth is entirely dependent on domestic demand, and net exports remain weak. The Finnish economy is still lagging behind activity in the rest of the euro area, and real GDP will not recover its pre-financial crisis level even by the end of the forecast period. Meanwhile, the increasing role of the service sector in the economy slows productivity growth and the decline in the working-age population also dampens longer-term prospects. The Bank of Finland forecast foresees 1.1% GDP growth in 2016. The economy will continue to grow by 1.1% in 2017 and 1.0% in 2018.



Private consumption has developed better than predicted. In particular, there has been a strong boost in consumer durables. Household consumption has increased faster than real disposable income, pushing the savings ratio deeper into negative territory. In 2016–2018, consumption will grow at almost the same pace as disposable income. The household savings ratio will thus remain negative throughout the forecast horizon. This very unusual trend is accounted for by households' strong incentives to consume, as interest rates are expected to remain at exceptionally low levels. Household debt relative to disposable income will, therefore, continue to grow. Even if the debt is not very high, particularly relative to the other Nordic countries, continued debt accumulation poses a risk for the financial system in a situation where both current and future income generation is subdued.

Private sector investment began to grow at the end of 2015. Preliminary data and indicators for developments in the early months of 2016 suggest a continued pick-up in investment. In addition to construction investment, growth in corporate fixed investment will strengthen, underpinned by accommodative financing conditions and an increase in the capacity utilisation rate. Investment growth will be most rapid in the current year.

Finnish exports are predicted to finally resume growth, driven by the export markets, but the strength of domestic demand will increase imports, causing foreign trade, on balance, to remain in deficit. Finnish exports have barely grown since 2011 and, in recent years, the strong contraction of exports to Russia in particular has depressed total exports, and extra-euro area exports as a whole have declined. By contrast, exports to the euro area have grown substantially since 2013, notably due to increasing exports to Germany.

Finnish export prices in the immediate years ahead are envisaged to rise more slowly than those of competitor countries, and growth in unit labour costs will also remain slightly slower than in other euro area countries. However, marginal improvements in competitiveness will not suffice to pull the market shares of Finnish foreign trade onto a growth path.

Growth in nominal earnings will be subdued, around 1% annually during the forecast period. It will be slowest in 2017, when contractual wage increases are assumed to be zero. Possible agreement on a competitiveness pact is not included in the baseline forecast.

Inflation will be sluggish throughout the forecast horizon. Consumer price increases in 2016–2018 will remain below the euro area inflation rate, having been faster almost without a break since 2008.

The labour market has already witnessed a turn for the better. Employment has increased and unemployment decreased since the end of 2015. The employment situation is expected to improve further still during the forecast period. Contrary to earlier cyclical turning points, growth will be supported by labour-intensive service sectors and construction rather than exports and industry. As in other euro area countries, employment developments in Finland can be expected to be slightly better relative to the growth rate of the economy in the forecast years than typically seen in previous years. On the other hand, employment growth will be constrained by the persistent contraction of the working-age population and labour market mismatch problems, among other factors.

The general government deficit will decline to 2.3% as the business climate improves, but general government debt will rise to 70% of GPD in 2018. The central government financial position will strengthen markedly, while the local government deficit and the surplus on the social security funds will remain broadly unchanged during the forecast period. The structural budget balance will not improve, as age-related expenditure will continue to grow rapidly.

Finland is returning to growth supported by domestic demand

According to the Bank of Finland forecast, Finnish GDP will grow by 1.1% in 2016. Domestic demand is functioning as the engine of growth. The economy will continue to grow by 1.1% in 2017, and by 1.0% in 2018. However, growth will remain slower than elsewhere in the euro area during the whole period. In Finland, the volume of total output will grow by 3.2% over the forecast horizon, whereas it will grow by 5.0% in the euro area over the same period.

Table 1.

Forecast summary

% change on previous year				
	2015	2016f	2017f	2018f
Gross domestic product	0.5	1.1	1.1	1.0
Private consumption	1.4	1.6	0.6	0.7
Public consumption	–0.9	0.6	0.3	0.2
Private fixed investment	–1.0	4.7	3.6	2.6
Public fixed investment	–1.2	2.3	1.6	–0.5
Exports	0.6	0.7	2.4	2.5
Imports	–0.4	2.7	2.5	2.0

	2015	2016f	2017f	2018f
Labour market				
Hours worked	–0.1	0.6	0.8	0.5
Number of employed	–0.4	0.4	0.7	0.6
Unemployment rate, %	9.4	9.2	9.0	8.9
Unit labour costs	0.7	0.5	0.6	0.8
Labour compensation per employee	1.6	1.2	0.9	1.3
Productivity	1.0	0.7	0.4	0.5

	2015	2016f	2017f	2018f
Contributions to growth				
Domestic demand	0.4	1.9	1.1	0.9
Net exports	0.4	–0.7	–0.1	0.2
Inventory change + statistical discrepancy	–0.2	0.0	0.0	0.0

Savings ratio, households, %	–0.6	–0.8	–0.7	–0.3

Sources: Statistics Finland and Bank of Finland.

Forecast summary

Current account balance, % of GDP	0.1	–0.6	–0.8	–0.7
GDP, price index	0.4	0.1	0.7	1.0
Private consumption, price index	0.2	0.4	0.6	0.8
Harmonised index of consumer prices	–0.2	0.2	0.8	1.0
Excl. energy	0.3	0.6	0.6	0.9
Energy	–6.0	–4.4	3.2	2.8

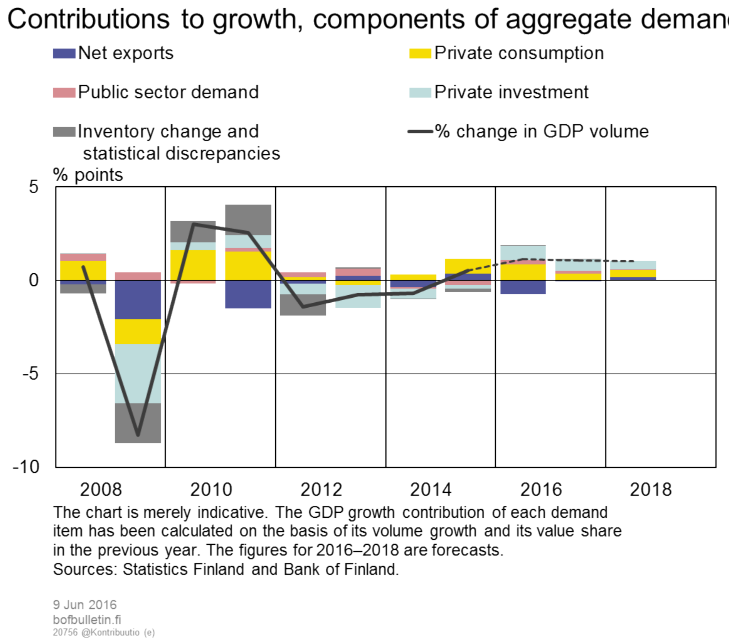
Sources: Statistics Finland and Bank of Finland.

Chart 1

Throughout the forecast period, economic growth will be dependent on consumption and investment (Chart 2). An exceptionally accommodative monetary policy will keep interest rates low on retail and corporate loans, supporting consumption and spurring investment after several years of contraction. Over the forecast horizon, exports will finally return to growth, due particularly to stimulus from the euro area, although the growth in exports will lag well behind the growth in foreign demand. The rise in export prices will be slower in Finland than in competing countries, slightly aiding the recovery of exports. However, the strength of imports means that net exports will not support growth. Growth based on domestic demand relies heavily on household and public sector debt accumulation, reflected in a weakening of the external balance of the economy.

The forecast takes account of statistical data and other information available on 18 May 2016. On 3 June 2016, Statistics Finland released the latest data on the quarterly national accounts, and these have been discussed in more detail in a separate article.

Chart 2



Households: consumption remains debt-driven

Private consumption continues to support domestic demand in Finland, although the rate of growth will moderate towards the end of the forecast horizon. Consumption growth will mirror developments in households' disposable income, but household saving will, nevertheless, remain negative. The continued accommodative stance of monetary policy will bolster private consumption throughout the forecast period. Consumption will continue to grow at the same rate in 2016 as in 2015, i.e. by a little over 1.5%, but the rate of consumption growth will ease to just over 0.5% in 2017, picking up only slightly towards the end of the forecast horizon.

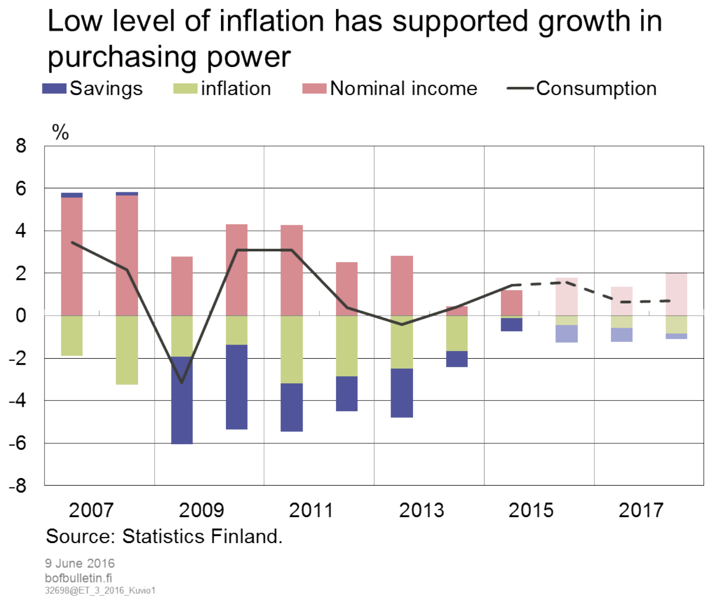
Consumer confidence has strengthened since the beginning of 2016. Consumers' expectations of their own economy are now broadly in line with the long-term average, while confidence in the national economy is actually above its long-term level. Consumer confidence indicators, however, are known to have fluctuated widely over the past few years, without the fluctuations having been clearly reflected in consumer demand.

Disposable household income will continue to increase by just under 1.5% this year, but the rise in purchasing power will moderate markedly in 2017, as negotiated wage increases remain close to zero and inflation picks up slightly. In fact, earnings growth will mainly hinge on wage drifts in 2017 and 2018. Unemployment will ease slowly during the forecast years, but the increase in the number of employed by nearly 1% per annum will bolster households' purchasing power.

Real household income continued to increase in 2015. The wage bill expanded slowly, but purchasing power was buoyed by subdued inflation (Chart 3). The increase in public transfers has also sustained the purchasing power of households despite the recession. Consumer price inflation in Finland will continue to hover around zero in 2016, but is projected to accelerate to around 1% in 2017 and 2018. Households have financed part of their consumption by taking on debt, and the savings ratio has long remained negative. During the forecast years, the savings ratio will improve somewhat but not yet turn positive.

Taxes on earned income are not expected to tighten in the forecast years, as the income tax scales are fully adjusted for inflation and earnings growth. The deduction on earned income allowed to households will be raised, increasing the disposable income of low-income households by EUR 450 million in 2016. At the same time, however, the rate of the employees' unemployment insurance contribution will rise by 0.5 of a percentage point, while the validity of the so-called solidarity tax for high-income earners will be extended. Taken together, these measures will reduce wage and salary earners' income by the same sum, EUR 450 million. In addition, hikes in indirect taxes will erode consumers' purchasing power by around EUR 120 million. A rise in the pension contribution rate will also curtail households' disposable income in 2017.

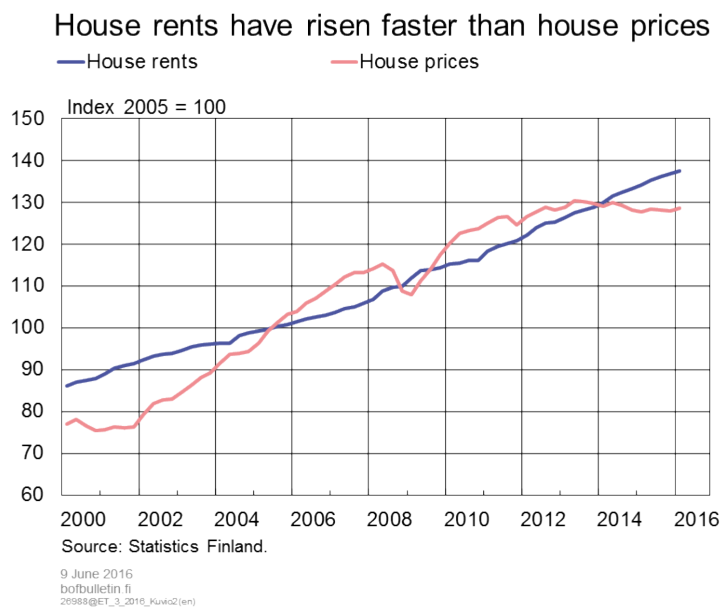
Chart 3



Household debt accumulation has continued, with households' debt-to-income ratio already standing at around 123% at the beginning of 2016. The availability of instalment-free periods on housing loans bolstered debt-financed consumption and growth in the household loan stock notably in 2015, but instalment-free periods will no longer be available after the first months of 2016.

The rise in household debt accumulation has been mainly related to an expansion in the housing loan stock. The housing market currently shows substantial regional variation, however. Whereas housing sales are picking up in growth centres, with nominal house prices trending up, smaller municipalities and migration loss areas, in particular, are experiencing a fall in house prices and a lengthening of selling periods. The regional divergence in house prices has been related to the low level of interest rates, which has underpinned demand for housing in growth centres, in particular, where housing production has failed to keep pace with growing demand.[1]

Chart 4



Household debt has increasingly become concentrated in households whose debts are at least four times their disposable income. However, the highly-indebted households typically represent the highest income brackets, which are better equipped to bear the risks of indebtedness. The record low level of interest rates has also markedly supported mortgage holders' debt servicing capacity. At the same time, rents have increased faster than prices for houses also in the Helsinki Metropolitan Area, making owner occupation more favourable than rented occupation (Chart 4). In fact, an increasing number of low-income earners living in rented housing are suffering under the burden of rising housing expenditure.

Non-financial corporations: investment recovering at last

In 2016, investment is starting to show sturdy growth, driven by both construction and fixed investment. The growth rate will be highest in 2016, reaching 4.4%. In 2017 and

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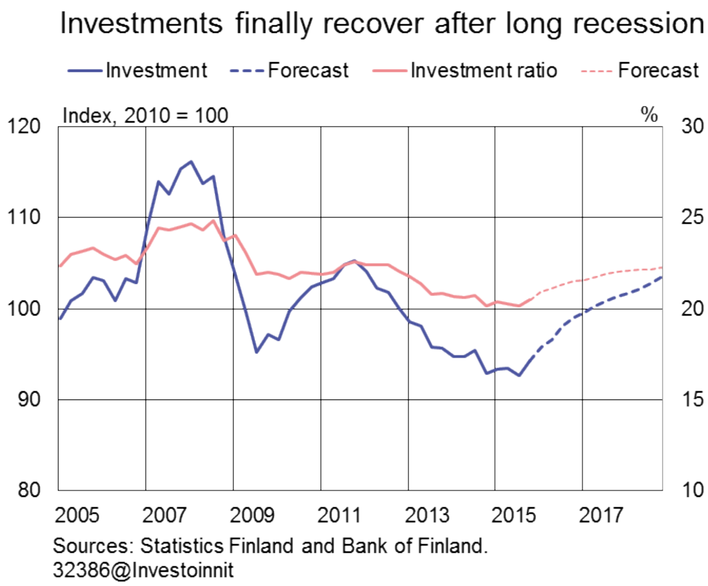
1. For a more detailed discussion on the regional divergence of the housing market see the article 'Low level of interest rates reflected in house prices' by Essi Eerola.

2018, investment will grow by an average of slightly more than 3% (Chart 5).

Chart 5



Residential construction and excavation work, in particular, have clearly started to grow. It should be noted, however, that the starting point is modest after four years of continuous contraction. A strong increase in the number of building permits granted and new construction projects predicts continued growth in construction investment after 2016 (Chart 6).

In line with the brisk increase in investment, the investment rate – gross fixed capital formation relative to GDP – will start to increase and will rise to 22% towards the end of the forecast period. In 2015, the investment rate was only 20%, after having dropped 4 percentage points since 2008. Low interest rates and good financing conditions support corporate growth prospects as export demand recovers.

Overall, the outlook for companies is still subdued. Based on the business and consumer survey by the European Commission, corporate confidence in economic developments still lags behind the long-term average, except for the construction industry. However, compared with a year ago, confidence has improved somewhat in all sectors with the exception of manufacturing. Investment in manufacturing does actually show some signs of recovery. According to an investment survey by the Confederation of Finnish Industries, the share attributable to productive investment, in particular, is expected to grow.

Corporate profitability has been modest in the years since the financial crisis.[2] The contracted operating surplus of companies has been reflected particularly in decreased retained profits. Moderate growth in operating surplus can, however, be expected over the forecast horizon due to the slow increase in employee compensation.

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2. Corporate profitability can in the National Accounts be measured as operating surplus relative to output, which is comparable to operating profit in corporate financial statements.

Chart 6

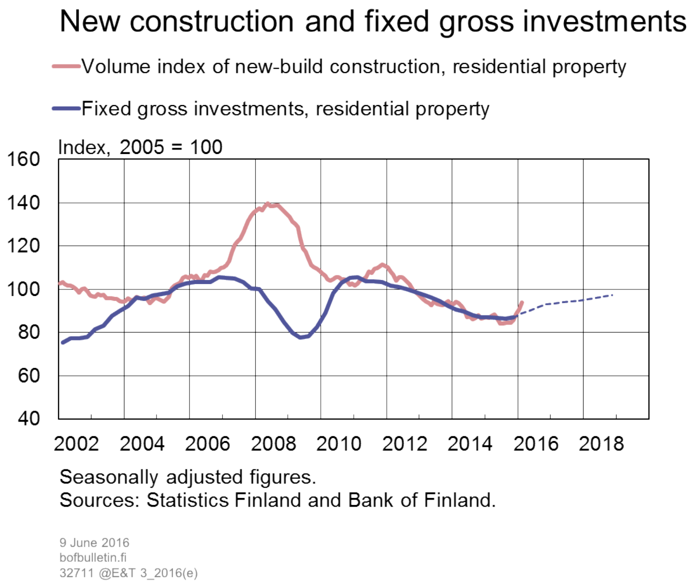
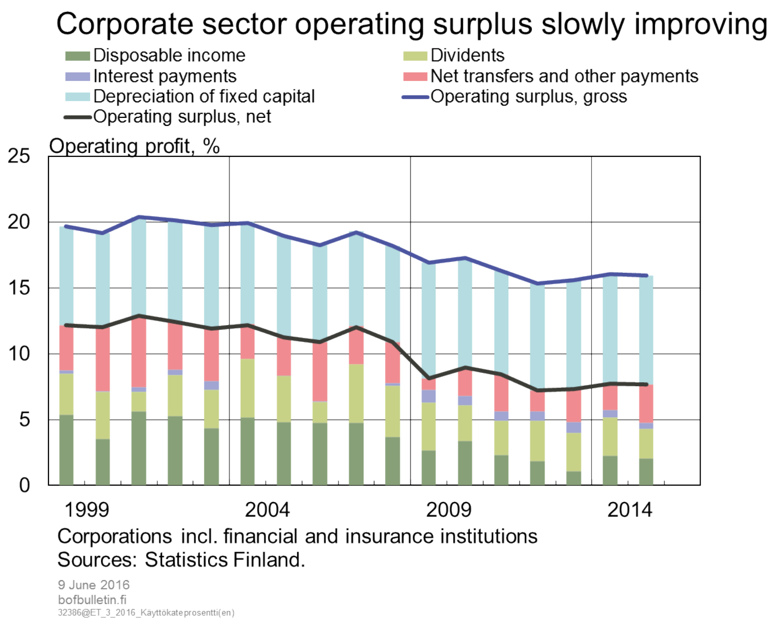


Chart 7



Foreign trade: current account returns to deficit

The Finnish export sector has been in difficulty for a prolonged period and the loss of export markets has been considerable. Exports to Russia have been cut by half in just a short time. Exports will grow only moderately in 2016–2018. They will be supported by a pick-up in the export markets, and particularly by an increase in investment in the euro area.

The volume of Finnish exports grew in 2015 by only ½%. Export growth was sustained by services exports, as goods exports declined. Subdued developments in 2015 are partly explained by the decrease in demand in the export markets. Russian export demand, in particular, continued to weaken considerably.

Finnish exports have been encountering difficulties for a prolonged period and the loss of export markets has been considerable. Since 2008, Finnish export markets have grown by 12%, but the volume of Finnish exports is still 12% smaller than in 2008.

The structure of exports has changed. The share of high-technology exports has decreased significantly. In 2008, as much as 18% of Finnish goods exports were high-tech products, whereas in 2015, the portion of these products had shrunk to 7%.[3] The structure of Finnish exports has also changed in terms of country of destination. In the past couple of years, Russia's ranking has dropped, and it is now only the fifth largest export destination for Finland. A few years ago, Russia was Finland's main trading partner, but in a short period of time exports to Russia have been cut by half. In 2015 alone, goods exports to Russia declined by about one third. Export volumes to the United States have exceeded the volume of exports to Russia, and the United States has become the third most important export partner for Finland. Finnish exports to the most important export destination, Germany, have increased, and Germany's share of total Finnish exports has strengthened.

Export growth in 2016 will remain below 1%. In 2017 and 2018, export growth will accelerate slightly, to some 2½%. Exports will be supported by a pick-up in the export markets and changes in the structure of export demand that are more favourable for Finnish exports, particularly in the euro area. Capacity utilisation rate in the euro area has risen steadily and is approaching normal levels, and investment growth is expected to pick up towards the end of the forecast period. Finnish exports will also be facilitated by the fact that Finnish export prices are rising at a more moderate pace than in competing countries. Despite the pick-up in exports, Finland will continue to lose export market share in the forecast period.

Net exports will not yet support economic growth in the current year. Economic growth based on domestic demand will boost imports, and, as a result, import growth will in 2016 exceed export growth. Towards the end of the forecast period, export growth will slow, due to the dampening of investment and consumption demand. The decline in import growth will be reflected in net exports, which will start to make a positive contribution to economic growth.

The current account reported a slight surplus in 2015, for the first time since 2010. The surplus of some EUR 300 million consisted of the balance of trade, as primary income and current transfers from abroad as well as the services account were in deficit. The balance of trade surplus was due to the improvement in the terms of trade, in response to the strong decline in world market prices of oil and other commodities.

The current account surplus in 2015 will be temporary. In the forecast period 2016–2018, the current account deficit will be just under 1% of GDP. Import and export prices will continue to decline throughout the current year. In subsequent years, foreign trade prices will turn upwards, in response to developments in world market prices of oil

3. Customs duty-based goods exports at current prices.

and other commodities. Reflecting the moderate developments in costs, export prices will rise at a slightly slower pace than in Finland's competitors. As a result, import prices will rise more rapidly than export prices, and the terms of trade will deteriorate slightly.

Chart 8

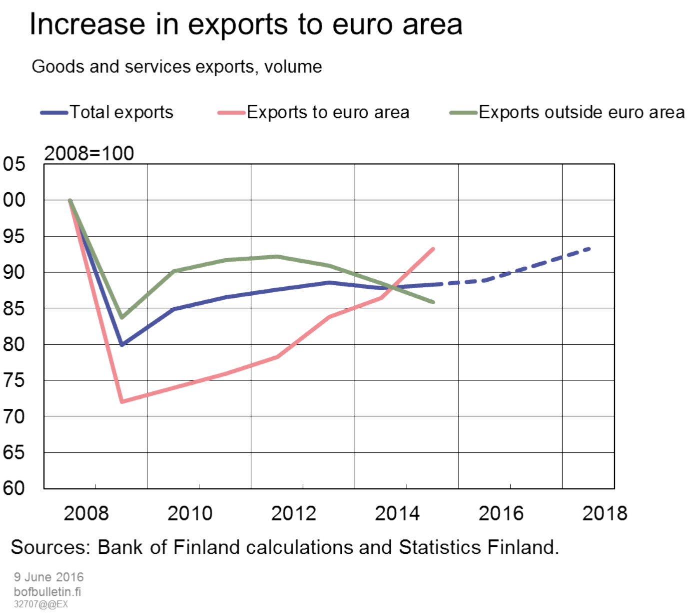
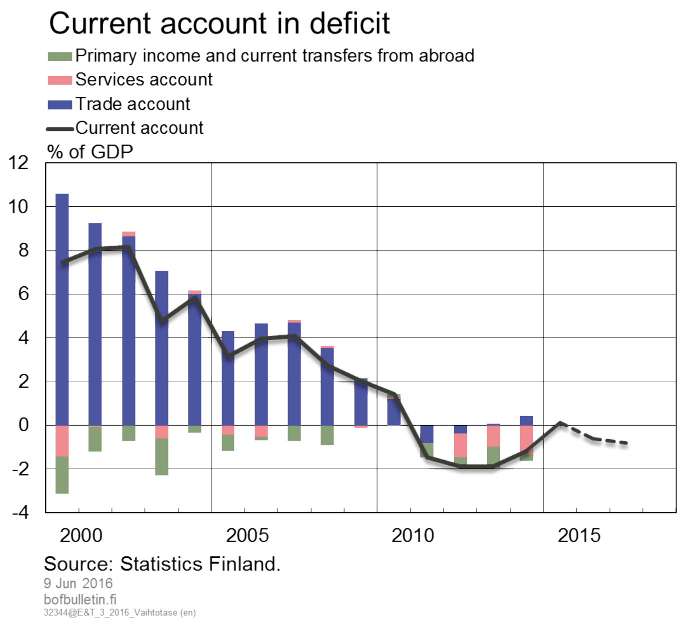


Chart 9



Labour market: a turn for the better

The Finnish labour market has already witnessed a turn for the better. Employment has increased and unemployment has declined since the latter part of 2015. The employment situation is expected to improve further still during the forecast period.

Labour market developments reflect the sluggishness of exports and the fact that the strongest contribution to growth comes from domestic demand. In many services sectors, employment has continued to increase and, since 2015, employment has also improved in construction. In manufacturing, the long-term trend decline in employment has levelled off, but thus far there are no signs of a turn for the better.

Both new spells of unemployment and terminated spells of unemployment have decreased in the past year or so. Consequently, fewer workers are becoming unemployed but, on the other hand, the probability of finding employment is lower and the average duration of unemployment longer. This has been reflected in an increase in long-term unemployment, despite the decline in unemployment. Long-term unemployment is typically slower to decline in an economic upswing than general unemployment.

The decrease in new spells of unemployment and the levelling off in the decline in the number of jobs in manufacturing indicate that the strongest phase of the restructuring of Finnish industry is coming to an end.

The number of job vacancies has grown moderately, but they are still being filled at a slow rate. Labour market mismatches are already evident in some professions, e.g. in construction, despite the fact that unemployment is still relatively high. According to construction sector surveys, the number of companies suffering from a shortage of labour is growing. In addition to skill mismatches, the decline in unemployment is slowed by regional mismatches that are affected by, e.g. the functioning of the housing market. For example, in the Greater Helsinki Area, the filling of vacancies is hampered by excess demand for housing, despite the exceptionally high level of construction activity in the area. This may slow the recovery of the economy.

The number of people employed has increased faster than the number of unemployed has declined. This reflects growth in the labour force, as unemployed people who had given up job seeking have returned to the labour market in recent months or fewer employees have left the labour market.

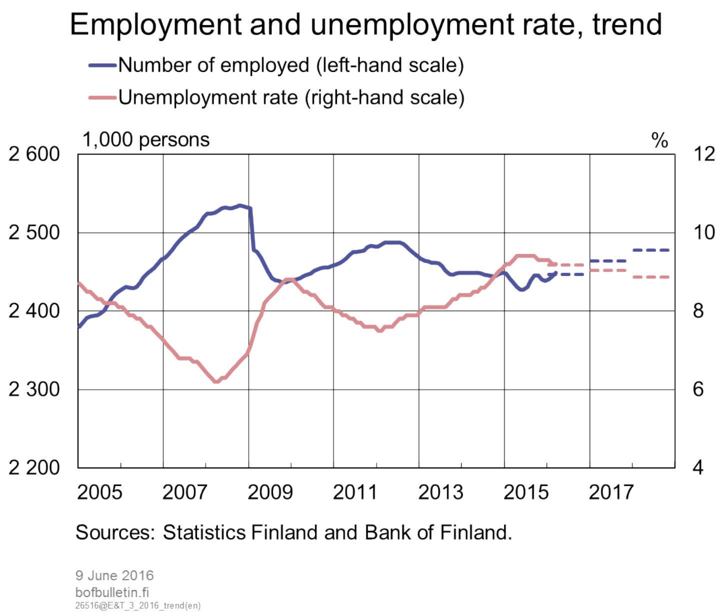
In recent years, labour market dynamics have been characterised by changes in the labour force participation rate and employment rate of the various age cohorts. Particularly in the cohort of 55–64-year-olds, both the labour force participation rate and the employment rate have improved in recent years, despite the weakness of the economy. In contrast, the labour force participation and employment rates of young adults have dropped particularly sharply. The impact of demographic change on the labour market is discussed in more detail in the article 'Demographic change reduces the labour force and the number of employed'.

The improvement of the labour market situation is subject to both favourable and unfavourable factors. In other euro area countries where the economy has already been growing for a longer period, employment dynamics have been more positive than expected because, contrary to earlier cyclical turning points, growth has been supported by labour-intensive services sectors and construction rather than exports and industry. As the composition of economic growth in Finland is similar to that in the other euro area countries, employment developments in Finland can be expected to be slightly better relative to the growth rate of the economy in the forecast years than typically seen in previous years.

On the other hand, employment growth will be constrained by the persistent contraction of the working-age population, labour market mismatches, a high level of long-term unemployment, and companies' need to improve competitiveness after a number of weak years.

According to the forecast, the number of employed will increase by 1.6% in 2016–2018 and the employment rate will rise to 69%. A large portion of the unemployed has already been unemployed for a long time, which can be expected to slow the decline in unemployment. At the end of the forecast period, the unemployment rate will remain close to 9%. The labour force will grow slightly in the forecast period.

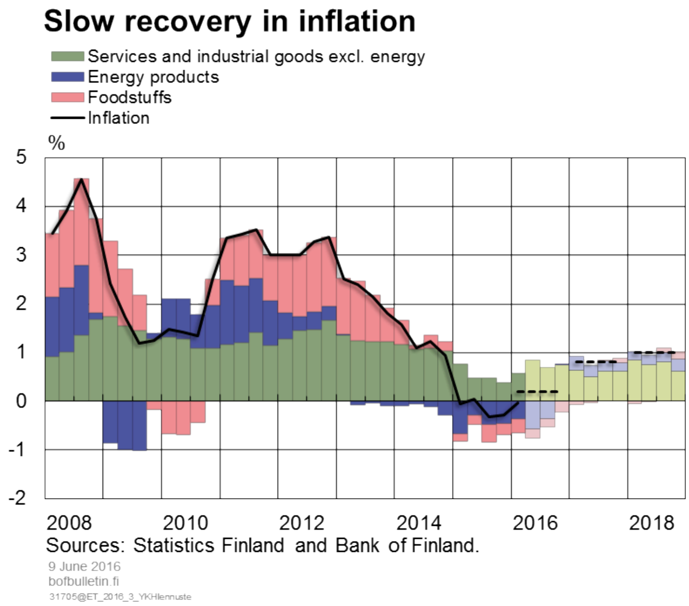
Chart 10



Prices and wages: inflation slow for an extended period of time

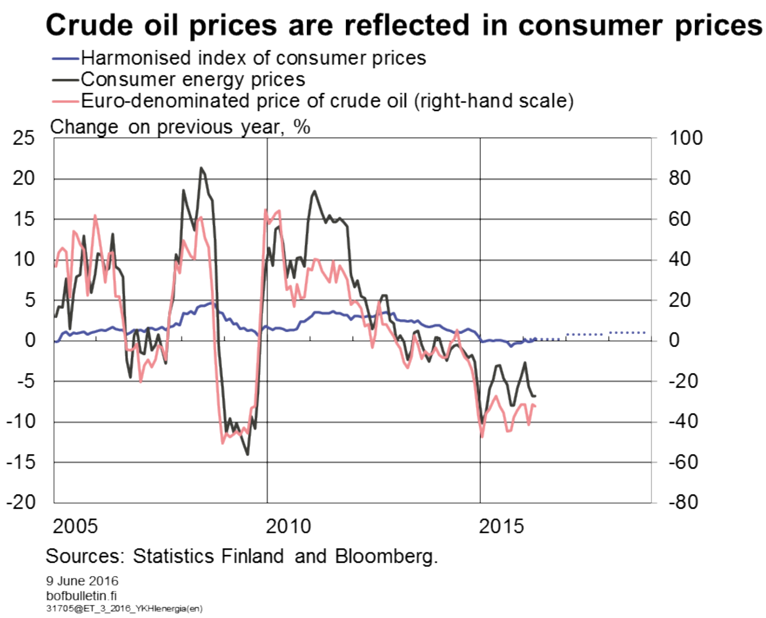
Mainly due to a decline in crude oil prices, consumer prices will rise at a slow pace in Finland in 2016 and inflation will remain at 0.2%. Moreover, towards the end of the forecast period, inflation will be slower than expected, due to subdued economic growth, a slow increase in wages and low import prices. The direct impact of the decline in oil prices will fade at the end of 2016 and inflation will rise in response to higher prices for services, to 0.8% in 2017 and 1.0% in 2018 (Chart 11). Inflation in Finland will fall behind euro area inflation in the forecast period, which is only natural as Finnish economic growth is also slower.

Chart 11



The sharp decline in the world market price for crude oil since 2014 and the subsequent strong volatility are still the most significant factors determining the pace of inflation (Chart 12). Developments in the price of crude oil also continue to be surrounded by uncertainty in the forecast period, but the impact of previous shocks will fade in late 2016.

Chart 12



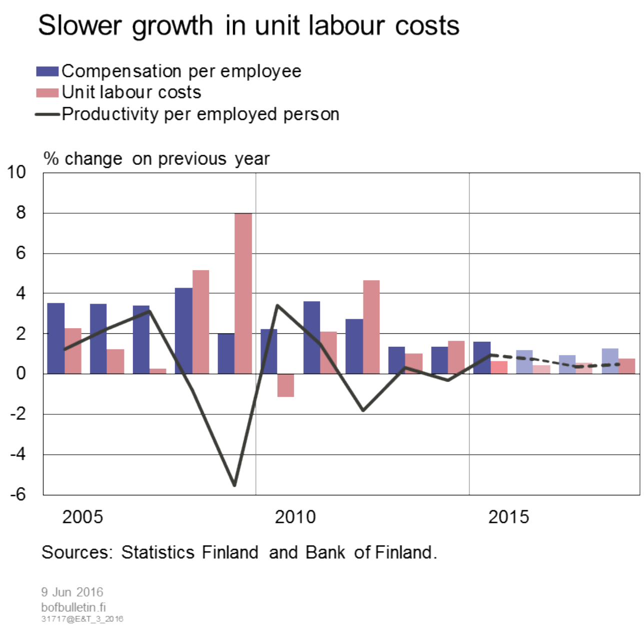
The indirect impact of the low level of energy prices will continue to be reflected in the prices of food and transport services in 2016. Food prices have also been pushed down by increased price competition in retail trade. Increases in indirect taxes have been reflected mainly in the prices of tobacco products, but overall the upward impact of taxation on prices has weakened slightly.

The upward trend in services prices has sustained inflation, and this impact increased as a result of the rise in the prices of social and welfare services at the beginning of 2016. Rents have also continued to rise rapidly, albeit at a slightly slower rate in recent months. Moderate developments in wages will dampen the upward pressure on services prices in the forecast period.

Earnings growth will be sluggish in the immediate years ahead. Earnings will improve in real terms, despite the moderate negotiated pay rises, as the rate of increase in prices will remain lower than normal. In 2016, nominal earnings will grow by just over 1%. Growth in earnings will be determined by the Pact for Employment and Growth, concluded earlier by the social partners, and based on which the pay rise will be approximately ½%. Growth in earnings will slow temporarily in 2017, because the forecast assumes that the social partners will refrain from negotiated pay rises in 2017. In 2018, earnings will grow again, by just over 1%.

Competitiveness, as measured by nominal unit labour costs, is improving slightly relative to the euro area. Unit labour costs in nominal terms will grow in Finland by some ½% in 2016 and 2017, whereas in the euro area they will grow by 1% per annum according to the European Commission's Spring 2016 Economic Forecast. The moderate growth in earnings will support the improvement of cost competitiveness. Cost competitiveness will, however, improve only slightly, as non-wage labour costs are rising and improvements in productivity are sluggish. Annual productivity growth will remain close to ½% throughout the forecast period. Due to structural changes in the economy, productivity growth will remain modest relative to its historical trend.

Chart 13



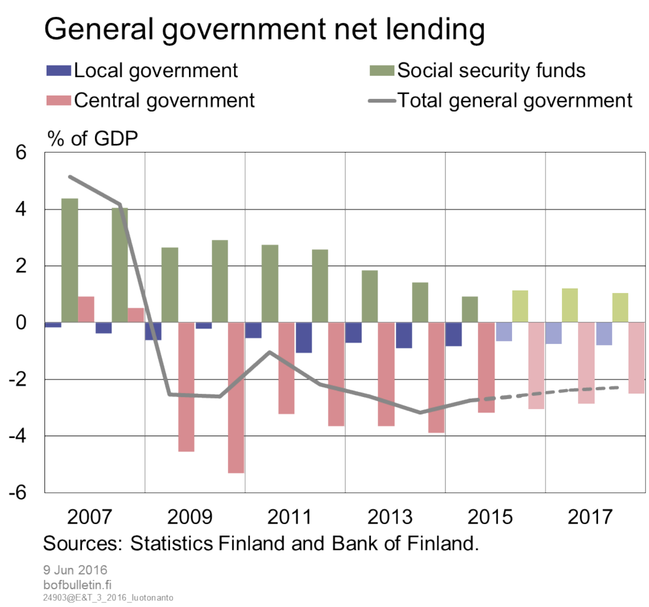
Public finances: no improvement in structural deficit

The general government deficit will decrease over the forecast horizon in response to an improvement in central government finances, but public debt will continue to increase. The deficit will shrink to 2.3% and public debt will grow to 70% of GDP in 2018.

Finland's fiscal deficit fell below 3% of GDP in 2015, reflecting an improvement in central government finances, in particular, due to higher-than-expected tax revenues and fiscal consolidation. Notwithstanding this, general government consolidated debt climbed to 63.1% of GDP. The increase in debt was driven slightly by a contraction in the consolidated debt of general government entities, as earnings-related pension funds reduced their holdings of government bonds.

Central government consolidation measures will slow down growth in expenditure over the forecast years 2016–2018. Government Programme measures will reduce public expenditure by EUR 4 billion over this parliamentary term. For central government finances, the savings mean a reduction in budgeted expenditure for 2016 by around EUR 700 million. Investments in the Government's key projects as well as expenditures allocated to handling the refugee situation will, however, dampen the effect of expenditure cuts. Interest expenditure on central government debt will decline further, to stand at around 1% of GDP in 2018, while the rise in central government tax revenue will be slightly below GDP growth. The forecast assumes that earned income taxation will not be tightened and that the envisaged changes in indirect taxes will be implemented as outlined in the Government Programme. The central government deficit will shrink to 2.5% of GDP in 2018 (Chart 14).

Chart 14



The local government financial balance will remain unchanged, at around 0.8% of GDP, over the forecast horizon. Local government revenue will grow more slowly than nominal GDP. Government grants will remain roughly stable, while the rise in municipal taxes was exceptionally modest in 2016. In addition, the increased apportionment of corporate tax revenues will be restored back to the normal level in 2016, thus eroding local government tax revenue. It is assumed that the municipalities will raise tax rates in 2017–2018, and increases in real estate taxes will also tighten taxation further. Slow income growth will increase pressure to adopt measures to rein in expenditure growth. The rise in consumption expenditure will be curbed by a decline in the number of local government employees, in response to retirement and other saving measures adopted by the municipalities. The investment needs of municipalities will remain unchanged.

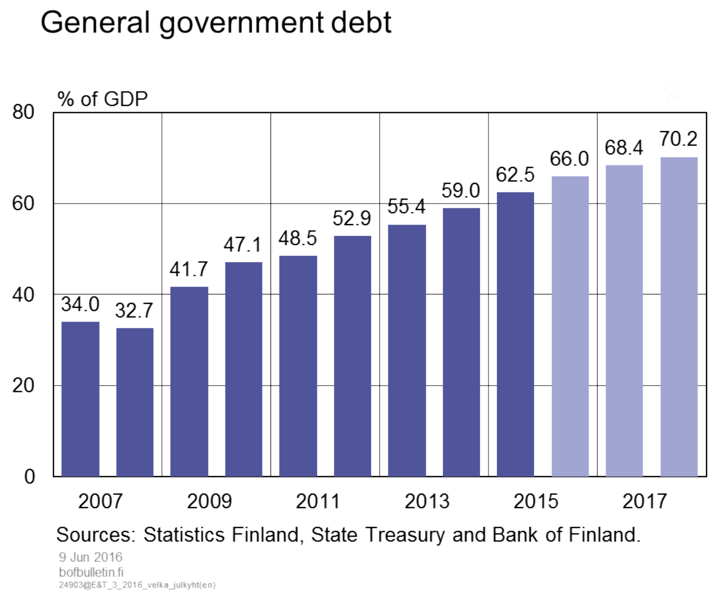
The surplus on social security funds will erode slightly during the forecast years, with the surplus on earnings-related pension funds gradually shrinking from 1.3% in 2016 to below 1% in 2018. The increase in the asset income of pension funds will be dampened by the low level of interest rates, but the higher rate of pension contributions to be introduced in 2017 will bolster the economy of the funds. Pension expenditure will continue to grow, albeit at a slower rate than before, as index increments to pensions will remain modest due to subdued inflation and earnings growth.

The financial balance of other social security funds will improve somewhat in response to an increase in unemployment insurance contributions, which will help bring the finances of the Unemployment Insurance Fund into balance. The rise in unemployment expenditure will come to a halt and expenditure will begin to decline as the employment situation improves. Growth in other social benefits will slow in response to the Government's saving measures. However, following the transfer of the payment of income support benefits from the municipalities to the Social Insurance Institution expenditure may increase as underutilisation of the benefit declines.

Public debt will continue to grow in the forecast years, with the debt-to-GDP ratio reaching 70% of GDP in 2018. The central and local government deficits will result in a further accumulation of debt, by a total of just over EUR 22 billion in the period 2016–2018. Compared with other euro area countries, the public debt-to-GDP ratio will increase most in Finland, outstripping the debt rates of Germany and the Netherlands, for example. The debt ratio shows a downtrend in most euro area countries.[4] In the current environment of slow growth and low inflation it will be difficult to halt growth in the debt ratio, as the increase in nominal GDP will not be sufficient to offset the impact of interest rates on the growth in debt before 2018.

4. European Commission spring 2016 forecast

Chart 15



The general government structural deficit will remain in the region of 1.8% in the forecast years. Most of the contraction in the nominal deficit is, hence, related to cyclical factors of the economy. Finland's medium-term objective is to achieve a structural balance in general government finances of –0.5%. Given that the structural balance is not approaching its objective and the public debt-to-GDP ratio is climbing towards 70%, Finland's public finances will continue to be subject to close scrutiny in the assessment of compliance with the EU fiscal policy framework.

Risk assessment: risks to the forecast more balanced than before

Risks to the forecast are more balanced than before. The international environment is still subject to downside risks related to the emerging economies, in particular. If economic growth in China or other emerging economies slows more strongly than expected, demand for euro area and Finnish export goods will remain more subdued than in the baseline forecast, which will depress the prospects for growth. The recovery of the Russian economy is of major importance to the Finland. Even though growth is already well under way in many export markets important to Finland, it also involves risks. The US presidential elections and the United Kingdom's EU referendum may increase uncertainties over economic developments. The growth outlook for the Swedish economy is also subject to downside risks, if, for example, the overheated housing market were to start cooling down. The Finnish economy is interconnected with the Nordic countries via both international trade and the Nordic financial markets (see 'Nordic financial sector vulnerable to housing market risks'). Based on international experience, a rapid correction in the overheated housing market could have a significant impact on the Finnish economy.

Finnish growth in the forecast period will hinge on private demand, while exports are expected to lag even further behind growth in the export markets. If Finland were to finally stop losing market shares as a result of a slight improvement in competitiveness and market shares were instead to start increasing, the conditions would be in place for the Finnish economy to grow at an even more rapid pace. It is also possible that the forecast underestimates the impact of quantitative easing on economic growth. Due to the low level of interest rates, construction activity may be stronger than forecast and further increase the contribution of domestic demand to GDP growth. Faster-than-forecast recovery in the euro area, supported by monetary policy, would also have a positive impact on Finnish exports.

Finland's economic activity in the immediate years ahead will be strongly affected both by the progress made with the Government's policy measures and structural projects to consolidate public finances and by developments on the labour market. The uncertainty surrounding domestic economic policy decreased slightly when the Government confirmed its commitment to cutting the growing public debt with its decision on spending limits, taken in March. On the other hand, the achievement of cost savings related to the social and health care reform involves risks, which could have a significant impact on public finances. Overall, as a result of the decrease in fiscal policy leeway, even small negative surprises will require a reassessment of fiscal policy.

During the forecast period, growth in the domestic markets will still be strongly predicated on both public and household borrowing. Growth in export earnings will remain slow and, with ongoing population ageing, an increasingly large part of the population will be outside the labour market permanently (see 'Is Finland following the same path as Japan?'). As a consequence, the forecast foresees an ever greater part of domestic demand still being based on income from the public sector, financed through taxes, pension contributions and borrowing. This will be reflected in growth in external debt. Clearly, domestic demand growth cannot rest indefinitely on a weakening external balance.

Household debt relative to disposable income will continue to grow in the forecast years. Albeit the debt is not very high, particularly relative to other Nordic countries, continued debt accumulation poses a risk for the financial system in a situation where both current and future income generation is subdued.

In the baseline forecast, negotiated wage increases are assumed to be zero in 2017, which will boost the demand for labour as well as economic activity. The other aspects of a possibly agreed competitiveness pact between the labour market organisations is not included in the baseline forecast. When a competitiveness pact is concluded as a result of sector-specific negotiations, growth in labour costs will be more moderate, and this will be reflected in somewhat faster economic growth. On the other hand, if competitiveness problems still cannot be resolved, the pick-up in investment may be jeopardised due to increased uncertainty, and economic activity in the immediate future may be weaker than forecast.

Productivity improvements during the forecast period may be stronger than forecast and boost economic growth if the changes in Finland's industrial structure experienced in recent years begin to generate new production to make up for the lost output. This would imply downside risks to inflation, because the larger than expected volume of unused capacity in the economy would push down prices.

Tags

private consumption , labour markets, companies/firms, forecast, economic growth, public finances, inflation, foreign trade, households, investment, Finland