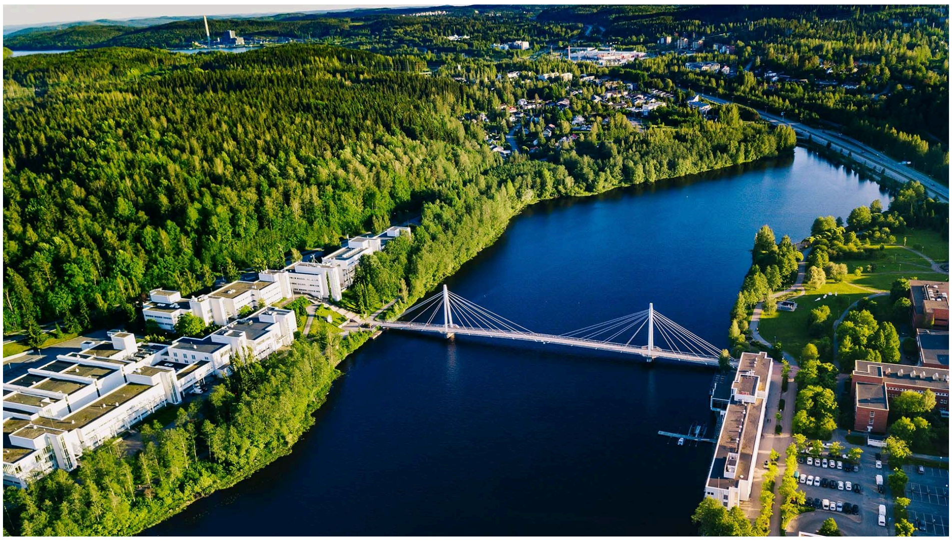
FORECAST FOR THE FINNISH ECONOMY

Finnish economy takes off as pandemic eases

24 Jun 2021 – Forecast – Finnish economy

Economic growth will gather pace across the board as the pandemic eases. Strong consumer confidence, together with the release of pent-up demand, will support household consumption. Finnish exports will rapidly rise back towards pre-pandemic levels as export markets revive, with investments also supporting economic growth. The Finnish economy will grow 2.9% in 2021 and 3.0% in 2022. This fast pace of growth will, however, be only temporary, and in 2023, GDP growth will slow to 1.3%, reflecting the lacklustre longer-term growth prospects of an ageing economy.



The international economic operating environment is again more favourable. The world economy has continued to recover, with global monetary and fiscal policy stimulus supporting growth prospects. Finnish exports are bouncing back to pre-pandemic levels on the back of a considerable strengthening of global demand. The European Central Bank (ECB) continues to pursue strong monetary accommodation, and the low level of funding costs will bolster household consumption and corporate investment over the forecast years. A rise in commodity prices and stronger consumer demand will, nevertheless, push up prices notably this year, threatening to curb growth worldwide.

However, the strong rise in prices is expected to be temporary.

The Finnish economy will begin to grow in response to a pick-up in private consumption. The robust increase in household consumption during the forecast years will be supported by an easing of the COVID-19 situation, recovery on the labour market and the release of pent-up household demand. In 2020, households put an exceptionally large share of their disposable income into savings, while the household loan stock continued to expand, and the debt-to-income ratio climbed to around 130%. During the past few years, growth in household financial assets has outpaced growth in financial liabilities, and this trend has been sustained during the COVID-19 pandemic (see Public purse carried households and businesses through the COVID crisis). The accumulation of household wealth will give private households more room for manoeuvre and may help buoy private consumption already in the forecast years. During the pandemic, households' room for manoeuvre has been sustained by the low level of interest rates, reflected in for example mortgage rates. Interest rates are expected to remain low in the immediate years ahead.

Corporate profitability has remained good on average during the pandemic, except in services, which have suffered directly from COVID-19. As uncertainty recedes, productive investments will begin a swift recovery. In particular, the brisk revival of export markets will improve the future outlook for business. In the immediate years ahead, profitability may, however, be restricted by a rise in commodity prices and difficulties in deliveries faced by world trade. Companies' investment opportunities will also be enhanced by their good financial position. Real interest rates have remained low and access to corporate loans has not been constrained to any significant degree. As profitability has remained good and investments have been modest, corporate sector indebtedness has even decreased during the pandemic. Over the longer term, however, the pace of investment will still be held back by unfavourable demographics and weak productivity growth.

The COVID-19 crisis will temporarily dampen the economic growth potential. After the crisis, potential growth will improve but remain modest because of structural factors in the economy. However, cyclical conditions will improve rapidly, with the output gap turning positive towards the end of the forecast horizon.

The labour market outlook is relatively bright. Strong economic growth will pave the way for employment growth and, as services recover, we can expect the growth to generate lots of jobs. However, in various surveys an increasing number of companies report they are already suffering from a shortage of suitable labour. In fact, the mismatch between jobs and unemployed jobseekers may hold back the recovery of the labour market. For a large number of people unemployment has become protracted, which makes finding employment more difficult. Moreover, the working-age population continues to shrink. Reflecting these factors, employment growth will moderate towards the end of the forecast horizon as both laid-off persons and more easily employed persons will have already landed a job. On the back of favourable cyclical developments, the unemployment rate will drop below the rate of structural unemployment at the end of the forecast period.

Inflation will pick up in 2021 amid rising commodity prices and growing consumer demand. Inflation expectations have remained moderate, and consumer price inflation will level off in 2022–2023 as the effect of temporary factors wanes. Growth in wages is expected to hold fairly stable at 2% per annum in the forecast years. Given this, forecast data point to a slight loss of cost-competitiveness relative to the euro area, whereas in 2020 Finland's cost-competitiveness seems to have strengthened somewhat.

The general government deficit will remain large. General government debt relative to GDP will continue to grow in 2021 despite the brisk pace of GDP growth and falling interest rate expenditure. In 2022, growth in the debt ratio will moderate temporarily, but the debt ratio will turn up again in 2023, reaching around 73%.

In the forecast, the greatest uncertainty still relates to the progress of the pandemic. As long as the pandemic is not brought under control everywhere in the world, it has the potential of disrupting production chains and holding back global economic growth. The most significant upward risk relates to household behaviour. If households start to deploy the savings accumulated during the pandemic, economic growth may even be stronger than projected, and the pace of inflation higher.

Table 1.

Key forecast outcomes

Percentage change on the previous year	2019	2020	2021^f	2022^f	2023^f
GDP	1.3	-2.8	2.9 (2.6)*	3.0 (2.7)*	1.3 (1.2)*
Private consumption	0.7	-4.9	3.3	4.6	1.3
Public consumption	2.0	2.3	2.4	-0.9	0.7
Private fixed investment	-1.6	-4.6	1.3	3.7	2.6
Public fixed investment	2.3	3.4	2.7	1.5	1.4
Exports	6.7	-6.6	5.9	5.5	3.0
Imports	2.2	-6.6	5.4	5.3	3.1
Effect of demand components on growth					
Domestic demand	0.6	-2.8	2.6	2.9	1.4
Net exports	1.7	0.0	0.2	0.1	-0.1
Changes in inventories and statistical error	-1.0	0.0	0.0	0.0	0.0
Savings rate, households, %	0.5	5.6	3.5	0.4	0.1
Current account, %, in proportion to GDP	-0.3	0.3	-0.1	-0.1	-0.2

* March 2021 forecast.

Sources: Statistics Finland and Bank of Finland.

Operating environment: assumptions and financial conditions

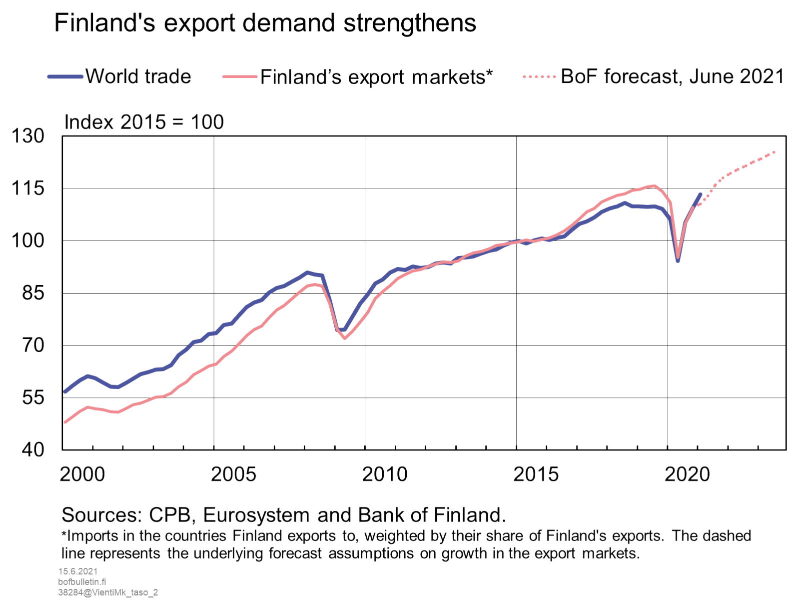
The growth outlook for 2021 and 2022 is strong both for the global economy and in the euro area. The rapid global economic growth will be a boon to Finnish exports. However, the COVID-19 pandemic continues to overshadow the outlook for both the Finnish and the global economy, even though the increasing vaccine coverage inspires hope that the pandemic is receding. The recovery of the global economy has got off to a good start but progress will be largely determined by the virus situation. The pandemic is not yet over, and will continue to impact the economy until the virus has been brought under control all over the world. The forecast is based on data available on 25 May 2021.

Global economy recovers in shadow of pandemic

The global economy has continued to pick up. The COVID-19 pandemic slowed the recovery in some of Finland's trading partners in early 2021, which slightly slowed growth in demand for Finnish exports (Chart 1). Nonetheless, global demand has increased and world trade has already passed its pre-pandemic peaks in terms of both value and volume. The global monetary and fiscal stimulus has also supported growth conditions. So, while there is still considerable uncertainty surrounding the pandemic, the overall sentiment in the global economy is positive.

The recovery of demand on the Finnish export market will increase from the second quarter onwards, thereby supporting Finland's exports and overall economic growth. The demand for Finnish exports will exceed its pre-pandemic peak already in 2021. On the other hand, the increase in raw material prices and increasing consumer demand will clearly raise world market prices in 2021 (Table 2), which threatens to weaken real growth. However, the strong rise in prices is expected to be only temporary.

Chart 1.



The global economy is bouncing back from last year's exceptionally deep recession to strong growth in 2021 (Table 2), as vaccinations gradually bring the COVID-19 pandemic under control. Additionally, in many countries economic activity has suffered less over the last few quarters than during the first wave in spring 2020. The cause for this could be, for example, the adoption of new practices and the support measures in force. In 2023, global growth will stabilise close to the long-term average of around 3.5%. Nevertheless, the future development of the global economy still hinges crucially on the coronavirus situation and how countries around the world manage to contain it.

The new wave of the COVID-19 pandemic slowed the recovery in the euro area early in the year. However, growth in the euro area will strengthen noticeably over the remainder of the year, as the pandemic is expected to recede more permanently with the increasing vaccine coverage.[1] Economic growth is driven by the strong recovery of private consumption and the easing of supply bottlenecks. According to the pandemic assumptions underlying the forecast, declining infection rates should allow a significant unwinding of the containment measures in the second half of 2021. The assumption is that the pandemic situation will allow a full relaxation of the containment measures in early 2022.

Euro area GDP will grow strongly in 2021–2022 as the epidemic recedes and pent-up demand is released. In addition to strong growth in household consumption, business investment and net exports will support growth, especially in the current year. Euro area GDP is projected to exceed its pre-pandemic level in the first quarter of 2022. Euro area inflation is expected to accelerate to 1.9% in 2021, driven by temporary upward factors, before returning to rates of around 1.5% in 2022 and 2023. At the moment, containment measures and fears of the spread of the virus continue to limit the conditions for economic growth. The fading of the pandemic also enables the normalisation of activities in the sectors most affected by it, consequently stimulating growth in many trading partners important to Finland.

Accommodative financial conditions support growth

The European Central Bank (ECB) has kept monetary policy highly supportive of growth in early 2021. Purchases under the pandemic emergency purchase programme (PEPP) will continue until at least the end of March 2022 and, in any case, until the ECB judges that the COVID crisis phase is over. Monthly net purchases under the asset purchase programme (APP) will also continue and the refinancing operations will continue to provide ample liquidity. Interest rates remain low. The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and –0.50% respectively. The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.

Financial conditions in Finland have remained accommodative and supportive of growth. The average interest rates for both new corporate loans and new housing loans remain moderate (Chart 2). The financial markets expect euro area short-term interest rates to remain low (Table 2). Continued low funding costs will support economic growth also through the forecast years. According to the Bank Lending Survey (BLS), credit standards have not changed significantly in early 2021. According to the Business Tendency Survey by the Confederation of Finnish Industries EK, financial difficulties have not become a particularly significant obstacle to output or sales over the last few quarters.

---

1. More detailed information on the euro area forecast is available at https://www.ecb.europa.eu/pub/projections/html/index.en.html

Chart 2.

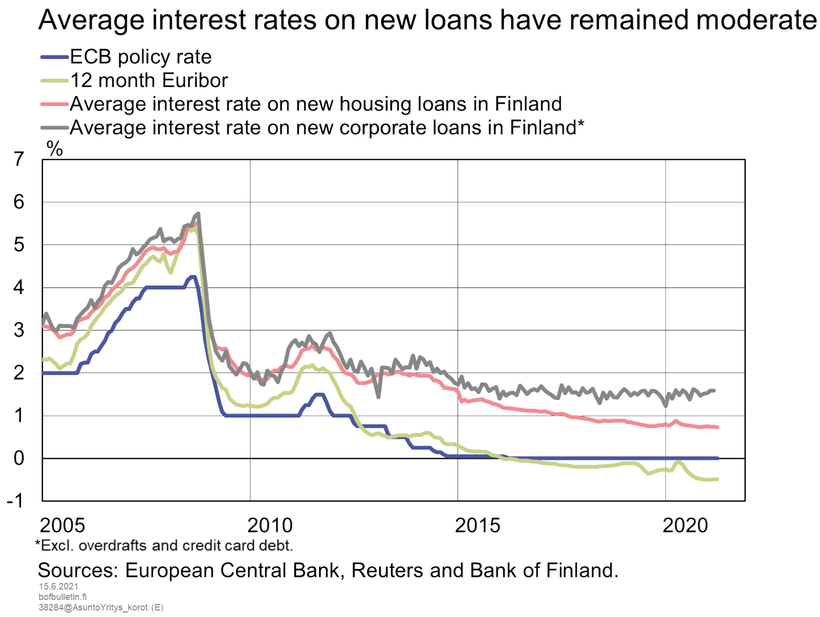


Table 2.

Forecast assumptions

Volume change year-on-year, %	2019	2020	2021[f]	2022[f]	2023[f]
Euro area GDP	1.3	-6.76	4.61	4.69	2.11
World GDP	2.7	-2.9	6.0	4.3	3.5
World trade*	0.8	-8.7	10.0	5.5	3.7
Finland's export markets, % change**	1.5	-8.6	8.7	5.8	3.5
Oil price, USD/barrel	64.0	42.3	65.8	64.6	61.9
Export prices of Finland's competitors, euro, % change	1.6	-4.0	4.1	1.3	1.0
3 month Euribor, %	-0.4	-0.4	-0.5	-0.5	-0.3
Finland's nominal effective exchange rate***	106.0	108.7	110.1	110.2	110.2
USD value of one euro	1.12	1.14	1.21	1.21	1.21

*Calculated as the weighted average of imports.
**The growth in Finland's export markets is the import growth in the countries Finland exports to, weighted by their average share of Finland's exports.
***Broad nominal effective exchange rate, 2015 = 100. The index rises as the exchange rate appreciates.

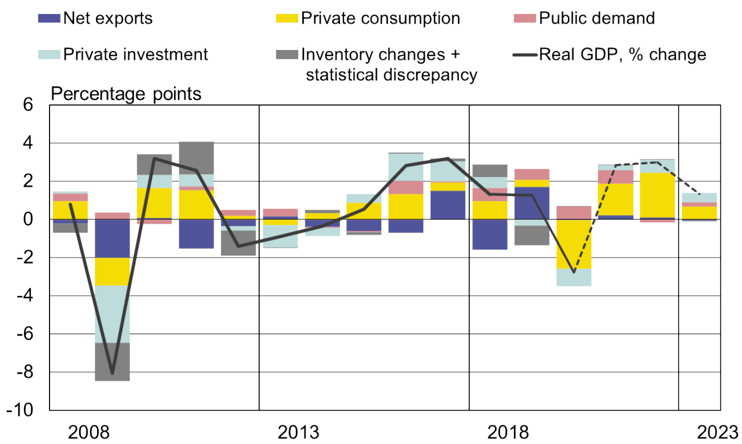
Sources: Eurosystem and Bank of Finland.

Demand and the public finances

The easing of the pandemic will boost economic growth across a broad front (Chart 3). Private consumption will be supported by returning consumer confidence and the release of pent-up demand. With the recovery of the export markets, Finnish exports will rapidly return towards pre-crisis levels. Economic growth will also be bolstered by fixed investments and construction.

Chart 3.

Economic recovery led by private consumption

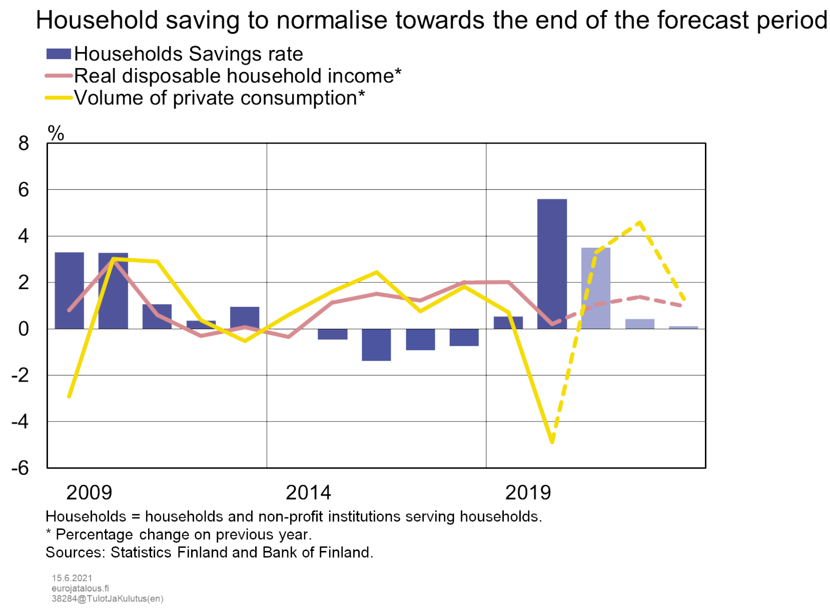


The GDP growth contribution of each demand component has been calculated on the basis of its volume growth and its value share in the previous year. The figures for 2021–2023 are forecasts.
Sources: Statistics Finland and Bank of Finland.
15.6.2021
bofbulletin.fi

The economy will recover, led by private consumption

Consumer confidence in both the Finnish economy and their own economic position has strengthened markedly in the early part of 2021, reflecting progress with the vaccination programmes and signs on the horizon that the pandemic could be receding. Private consumption will grow by 3.3% in 2021 and by 4.6% in 2022 (Chart 4). In 2023, the pace will slow to 1.3%. The strong growth in private consumption over the forecast horizon will be underpinned by the anticipated easing of the virus situation in Finland and the release of pent-up demand.

Chart 4.



Private consumption will also gain support from the recovery of the labour market once the pandemic is over. The employment rate will improve during the forecast period, pushing up household earnings. At the same time, average hourly earnings will grow at an average annual rate of slightly over 2%. On the other hand, growth in household purchasing power will be curbed by inflation, which will accelerate to 1.7% in 2021 and will stand at 1.6% at the end of the forecast period. Household purchasing power, i.e. real disposable income, will grow at an average annual rate of about 1% during the forecast period.

The net savings rate of households, i.e. the ratio of net savings to net disposable income, jumped exceptionally high in 2020. The COVID-19 pandemic has significantly curbed household consumption expenditure, but at the same time there has been a slight increase in households' disposable income. The savings rate will still be above average in 2021, at about 3.5%, but will fall substantially in 2022, once households' consumption expenditure grows with the receding of the pandemic. In spite of this, the savings rate will remain slightly positive until the end of the forecast period.

The household sector's financial assets have grown faster in recent years than financial liabilities and the trend has continued during the pandemic. As a result, the household sector's net financial assets, i.e. the difference between financial assets and liabilities, have increased, and, at the end of 2020, households' net financial assets relative to disposable income were in fact historically high (See Public purse carried households and businesses through the COVID crisis). Higher net assets will widen households' financial margin, with the potential of supporting private consumption over the forecast horizon. During the pandemic, households' financial margin has also widened on account of the low level of interest rates, which has been reflected, for example, in mortgage interest rates. Interest rates are expected to remain low during the forecast period.

Investment will resume growth

Corporate profitability during the pandemic has remained good, on average, with the exception of the services industries directly affected by the crisis. The capital-intensive forestry and metal industries have weathered the crisis particularly well. However, the uncertainty caused by the pandemic has led companies to postpone or cancel their investments. As uncertainty fades, fixed investment will begin to recover rapidly (Chart 5). The swift recovery of the export markets, in particular, will boost companies' future prospects.

Since companies are in a good financial position, this will also improve their investment opportunities. Real interest rates have remained low, and the ECB's Bank Lending Survey suggests that the availability of corporate loans has not deteriorated. On the back of good corporate profitability and low investments, the corporate sector's indebtedness has even decreased during the pandemic (See Public purse carried households and businesses through the COVID crisis).

Construction will begin to grow again in 2021. Construction investment will be supported by brisk housing market activity, especially in the greater Helsinki area and other growth centres. The number of new residential construction projects has been on the increase in recent months, and the number of building permits granted has also risen markedly in the early part of 2021.

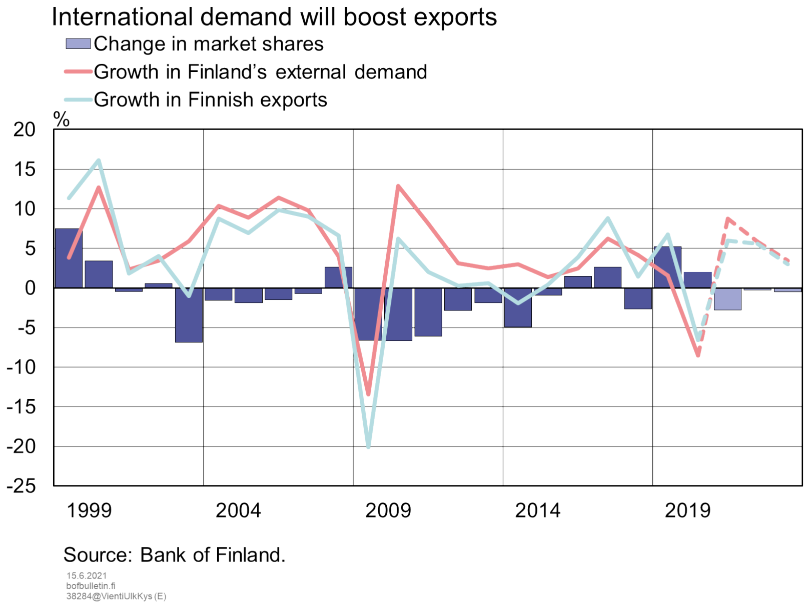
Private investment will resume growth of just under 1.5% in 2021. Investment growth will strengthen to almost 4% in 2022 and will only decelerate slightly in 2023. In the longer term, however, the pace of growth will be curbed by unfavourable demographic trends and weak productivity growth.

Chart 5.

International demand will boost exports

Finland's exports contracted significantly in 2020 on account of the pandemic-induced weakness of international demand. The overall contraction on the previous year was over EUR 6 billion, or 6.6%. Exports declined especially following the slump in services exports in spring 2020. Exports will begin to recover swiftly in 2021, however, and growth will also be brisk in the next few years, pulled by the export markets.

Chart 6.

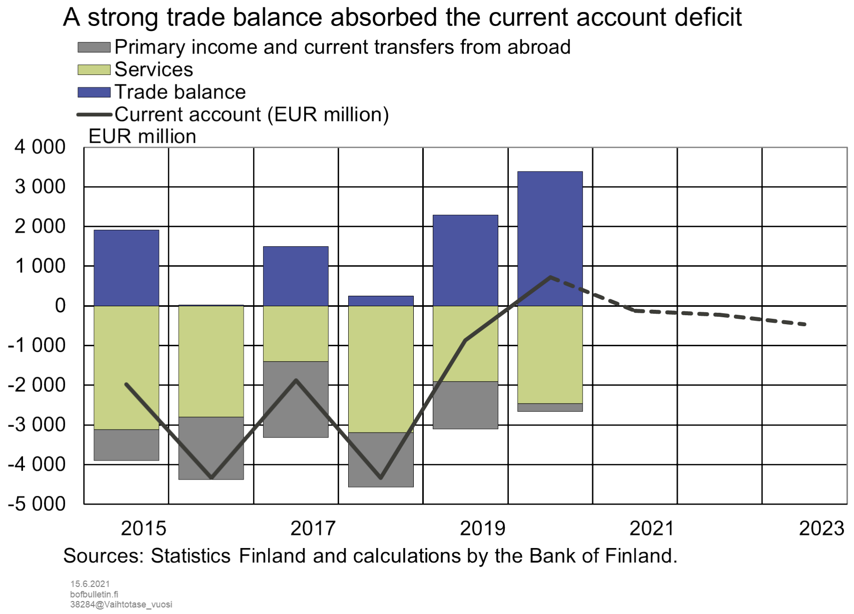


With the strengthening of international demand, Finnish exports are rapidly returning towards pre-crisis levels. Overall, Finnish exports will grow by almost 6% in 2021 (Chart 6). The favourable trend in demand for Finnish exports will also continue in 2022, when exports of goods and services will reach a growth of over 5% and surpass the pre-crisis level of 2019. After the fastest growth spurt in the export markets, export growth will slow to 3% towards the end of the forecast period.

The Finnish export industry uses imported inputs to a considerable degree, and hence imports play an important role in the production of export goods and services. In addition to exports, imports will be bolstered by higher investments and growing household consumption. In the forecast, imports will grow at almost the same rate as exports and will surpass the pre-crisis level in 2022. Net exports will support economic growth only marginally in 2021 and 2022.

The current account entered surplus in 2020 after a long period of deficit. The services balance exceptionally shifted to surplus at the end of the year, as the value of services exports increased more than the value of services imports (Chart 7). Despite this, the deficit on services deepened in 2020. On the other hand, primary income – e.g. asset income – outflows from Finland were lower than in previous years, and this strengthened the primary income balance. Due to a substantial surplus on trade balance in the last quarter of 2020, the current account recorded a surplus also in annual terms. However, the normalisation of the economic situation will mean that the current account will post a slight deficit during the forecast period.

Chart 7.

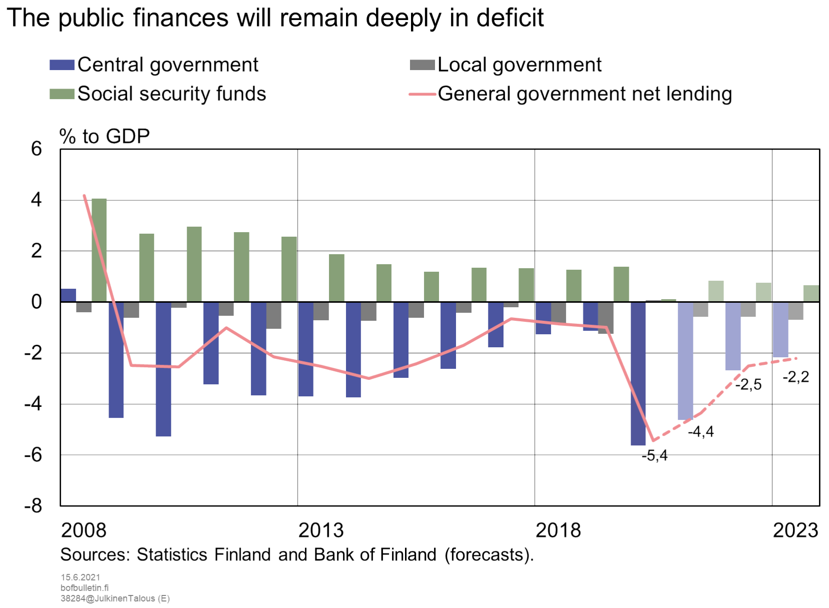


Public finances to remain deeply in deficit

General Government revenue from taxes and social security contributions will rebound in 2021 from the drop seen in the previous year once economic growth strengthens and the support measures to reduce social security contributions come to an end. However, due to the expenditure increases decided by the Government and expenditure on unemployment benefits, the general government finances will remain firmly in deficit in 2021 (Chart 8). In 2023, the deficit will be about 2% relative to GDP.[2]

2. The forecast takes into account the Government's first supplementary budget for 2021 and the second supplementary budget proposal.

Chart 8.



Revenues from value added tax and excise duties will grow swiftly during the forecast period, fuelled by the strong increase in private consumption. With the wage bill increasing and corporate income tax receipts returning to their pre-crisis level, income tax revenues will also grow sharply. Meanwhile, social security contributions collected will be boosted by the increase in unemployment insurance contributions and the end of the temporary reduction in the earnings-related pension contribution for private-sector employers.

The pandemic-related healthcare expenditures and other support measures already decided will push up the cost of public service provision. On the other hand, social and healthcare services customers have been cautious, which has resulted in a service and healthcare backlog. This will gradually begin to clear in the latter half of 2021, and especially in 2022. In response to the pandemic-related and stimulus measures, the volume of public consumption will continue to grow sharply in 2021, as in the previous year, and will then decrease momentarily in 2022. Growth in public investment will be sustained by the Government's discretionary measures and municipal construction investments. Subsidies received by companies and entities to compensate for the effects of the restriction measures will remain high in 2021. Support from the EU Recovery Package in 2021–2027 will be targeted at companies and households as investment subsidies and at public investments and other expenditures.

The heaviest burden of the pandemic-related health security and stimulus measures are borne by the State, which will be reflected as a deep deficit in central government finances. Local government finances will also shift back to deficit when transfers from central government return closer to pre-crisis levels.[3] The financial position of the earnings-related pension providers will be bolstered by higher pension contributions and

3. The forecast does not take account of the impact of the health and social services reform on central and local government obligations and revenue as the laws on the reform are still under preparation.

also by stronger growth of property income following the crisis. Other social security funds will return to a slight surplus once the number of persons furloughed falls back and the temporary extensions to unemployment benefits come to an end.

Because of the negative primary balance,[4] public debt relative to GDP will continue to grow in 2021, despite strong GDP growth and declining interest expenditure. In 2022, however, growth in the debt-to-GDP ratio will slow temporarily as the primary balance improves and GDP maintains its strong momentum. Growth in debt will be partly due to the pandemic-related financial transactions, such as capital injections and loans, and the acquisition of equipment by the Defence Forces. On the other hand, the need for borrowing will be reduced by, for example, the sale of state shareholdings related to future-oriented investments in 2021 and 2022. The debt ratio will grow further in 2023, to about 73%.

Supply and cyclical conditions

The COVID-19 crisis will dampen the economy's growth potential only temporarily. After the crisis, growth in potential output will strengthen, but will remain modest due to structural factors in the economy. The cyclical situation will improve rapidly, and the output gap will turn positive in the immediate years ahead. Employment will increase as demand recovers early in the forecast period. The Finnish economy will have some production bottlenecks and labour shortage problems during the forecast period.

Employment will recover as demand is restored

The labour market will recover as the COVID situation eases and demand is restored. During the forecast period, the employment rate will increase by some 2 percentage points from the level of 2020, i.e. to slightly under 73%. The number of employed will increase, and at the end of the forecast period, there will be some 63,000 more persons employed than in 2020. In 2021, the unemployment rate will decline only slightly below the level of the previous year, i.e. to 7.7%. On the back of favourable cyclical developments, the unemployment rate in 2022 and 2023 will be noticeably lower, at slightly below 7%.

The recovery in employment in the early part of the year has been slowed by the pandemic situation and the associated restrictive measures and health concerns, particularly in the labour-intensive service industries. Both the decrease in unemployment and the rapid decline in furloughs slowed down. The number of those on full-time furlough reached a peak in May 2020 and was approximately 170,000, and in April 2021 the number was still nearly 54,000.

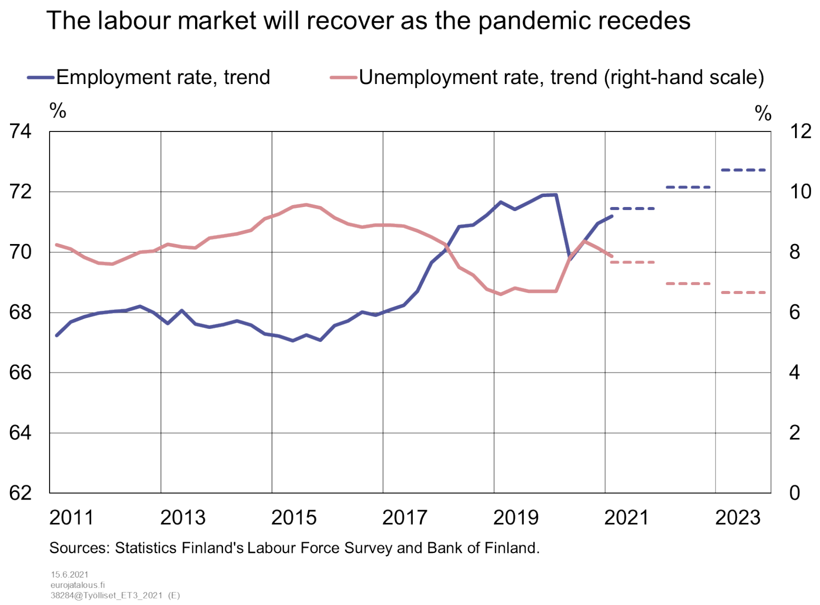
The outlook for the labour market is relatively bright. Employment growth will accelerate slightly in the early part of the forecast period, as workers furloughed in the service industries can return to work rapidly as demand grows. The number of job vacancies relative to the number of unemployed has risen, and an increasing number of companies are reporting a shortage of suitable labour. This data indicates a growth in labour

---

4. The difference between public revenue and expenditure excluding the impact of interest payments.

demand but also mismatch problems between vacant jobs and unemployed jobseekers. Long-term unemployment has increased by 40,000 persons during the year, and protracted spells of unemployment make it more difficult to find a job. The working-age population will continue to shrink in 2021 and in the coming years. Due to these factors, growth in employment will slow towards the end of the forecast period, as those furloughed and the unemployed persons more easily employed will have already found a job. On the back of favourable cyclical developments, the unemployment rate will fall below the level of structural unemployment at the end of the forecast period.

Chart 9.



Slow growth in potential output

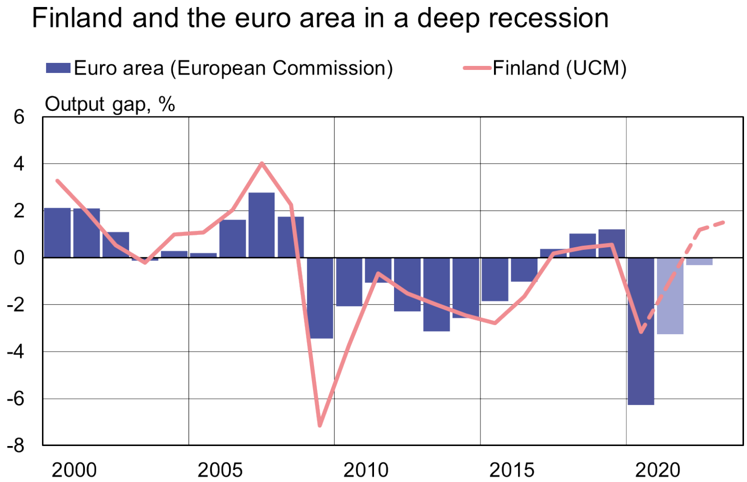
Due to the COVID-19 pandemic, the Finnish economy was suddenly pushed into a deep recession last year. As a result of the recession, the output gap turned some 3% negative.[5] The weakening of service sector activity had a considerable impact on the sudden deepening of the output gap. The economic[6] cycle is now rapidly turning more favourable, reflecting hopes for the ending of the pandemic and global economic recovery. The current crisis is expected to slow the economy's potential rate of growth only temporarily. Potential growth will recover from its dip during the crisis, reflecting the recovery of investment and the easing of the disruptions in supply chains.[7] GDP growth is estimated to be close to its long-term potential rate by the end of the forecast period.

---

5. The difference between GDP and potential output is referred to as the output gap, and it is usually expressed as a percentage of potential output. A positive output gap cannot be maintained without upward pressure on wages and prices
6. Poor performance in the service industries had a huge impact on the sudden widening of the output gap when COVID-19 made its presence felt in the spring. (Pönkä and Sariola (2020) The depths of the COVID-19 crisis, and the recovery, Bank of Finland Bulletin 6/2020).
7. Potential output is the volume of GDP when all the inputs in the economy are in normal use.

The COVID-19 pandemic pushed the euro area economy, too, into a deep recession in 2020. However, even at its worst, Finland's output gap remained markedly smaller than the euro area output gap and more moderate than during the financial crisis (Chart 10). Cyclical conditions will improve both in the euro area and in Finland during the forecast period. In 2022, Finland's output gap will turn positive. Reflecting improvements in the cyclical situation, the Finnish economy will have some production bottlenecks and labour availability problems during the forecast period.

Chart 10.

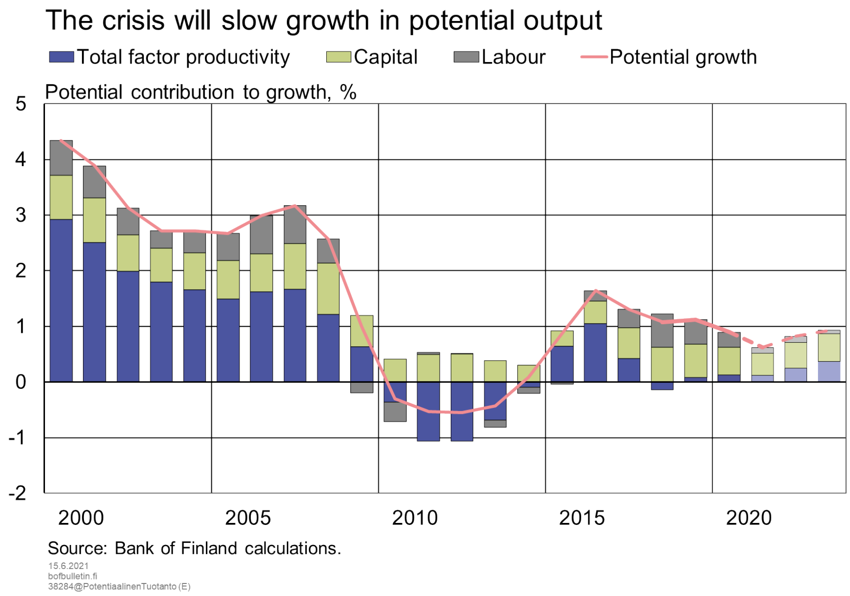


Finland's output gap assessed with the aid of an Unobserved Components Model (UCM).
Sources: European Commission and calculations by the Bank of Finland.

15.6.2021
bofbulletin.fi
38284@OutputGap_EN_2

The crisis will slow growth in potential output temporarily (Chart 11). Even though economic growth will return to pre-crisis rates in the medium term, the level of potential output will remain slightly lower than forecast before the pandemic. Growth in the capital stock has been slow during the pandemic, due to the weakness of investment, which will erode potential output. The capital-intensive manufacturing sector has, however, coped with the crisis better then feared, and, going forward, the pick-up in capital investment will bolster the capital stock and potential output. The increase in long-term unemployment and the slight rise in structural unemployment caused by the pandemic will reduce the importance of labour as a source of potential output during the forecast period. Labour supply will be constrained also by the decrease in the working age population (15–74-year-olds). Growth in total factor productivity will remain subdued temporarily, due to disruptions in supply chains and lags in the reallocation of resources. In addition to an immediate shortage of components, the pandemic may for example force companies to find new subcontractors and employees to move from withering companies to successful ones. Structural rigidities and frictions in the economy will play an important role in how effectively economic resources are reallocated and how quickly potential output improves.

Chart 11.



Prices, wages and costs

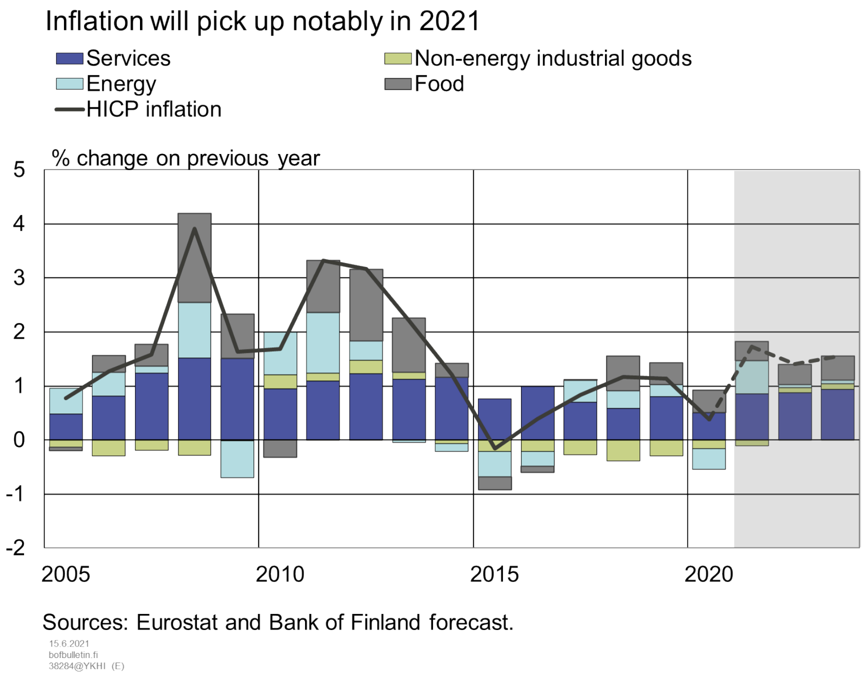
Inflation will pick up in 2021, reflecting higher commodity prices and growth in consumer demand. The rise in consumer prices will, however, level off in 2022–2023, as the impacts of temporary factors fade. Growth in nominal earnings will be 2.3% in 2021 and will remain at over 2% during the forecast period. Compensation per employee, i.e. the price of labour, will increase over 4% in 2021, following the slight contraction in 2020, but the rate of increase will slow, to some 2% in 2023. Finland's cost-competitiveness improved relative to the euro area in 2020, but based on the forecast figures, the achieved advantage will be lost in 2021–2023.

Consumer price inflation will pick up temporarily

Inflation has been rising since the early months of 2021. The annual rate of change in the harmonised index of consumer prices (HICP inflation) was in April over 2%, compared with only 0.2% in December 2020. The higher rate reflects in particular the rise in energy prices in response to the return of the price of crude oil to the pre-pandemic level. Services inflation, too, rose in April, to over 2%. This was partly due to the exceptionally low level of prices in April last year, as a result of which the rise in the prices of transportation services and package holidays, in particular, was strong in April. Services inflation is, however, expected to remain strong also in the coming months, due to growth in services consumption as the pandemic recedes and the related containment measures are eased.

Inflation is projected to pick up to 1.7% in 2021 (Chart 12). Energy prices are expected to rise by nearly 7% per annum, as fuel prices are much higher than last year. Higher commodity prices and freight costs will partly spill over to the prices of consumer goods and food, but, on the other hand, the moderate price expectations for commodities do not indicate a persistent rise in inflation. In the baseline forecast, inflation will level off as the impacts of temporary factors fade, but the outlook is subject to significant risks that are related to developments in the pandemic as well as commodity and import prices, bottlenecks in supply chains and the unwinding of accrued savings (see Alternative scenario: Households use their savings more quickly than anticipated).

Chart 12.

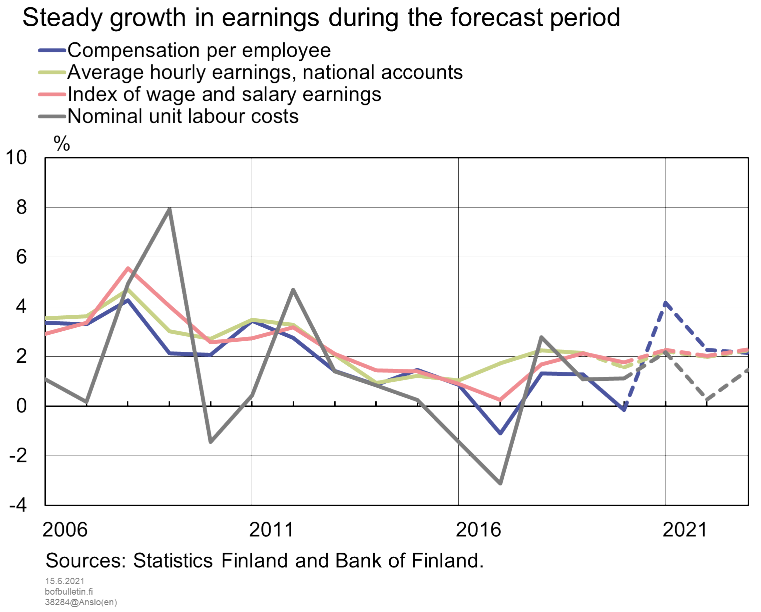


In 2022, inflation will slow to 1.4%. The upward trend in energy prices, in particular, will slow compared with 2021, as the rise in crude oil prices will no longer fuel inflation in the same manner as in the current year. Reflecting growth in consumption and improvements in the cyclical situation, price pressures will, however, increase, as a result of which underlying inflation will pick up to 1.6%, driven by higher services prices. The inflation forecast for 2023 is 1.6%. Due to the slowdown in economic growth, the rise in consumer prices will not accelerate significantly from the previous year.

Steady growth in earnings during the forecast period

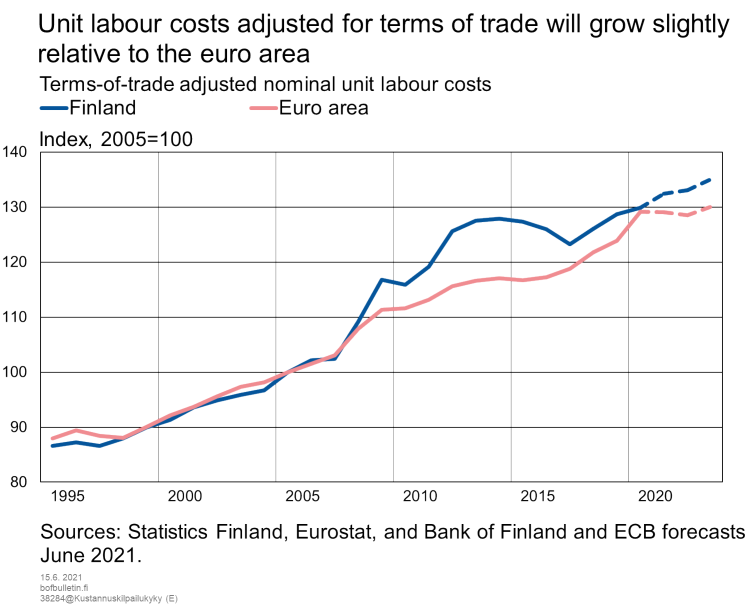
Growth in nominal earnings will accelerate slightly in 2021, to an estimated 2.3% (Chart 13). The rate of growth is also expected to remain at over 2% in 2022–2023. The forecast is based on the technical assumption that the pace of growth in real wages in 2020–2023 will be broadly the same as the growth in productivity. Growth in real earnings will slow to below 1% in the current year as inflation picks up. The price of labour, measured in terms of compensation per employee, will rise by over 4% in 2021, following the slight decline in 2020. The fluctuation is due to pandemic-related factors, in particular the ending of the temporary reductions in private sector employer pension contributions. In the following years of the forecast period, the rate of increase in the price of labour will slow to some 2%.

Chart 13.



Nominal unit labour costs will increase by some 2% in 2021. The rise in compensation per employee will accelerate the increase in unit labour costs, which, on the other hand, will be dampened by the improvement in labour productivity. The levelling off in the upward trend of the price of labour will, however, also slow the increase in unit labour costs towards the end of the forecast period. Due to the impacts of the COVID pandemic, estimates of developments in cost-competitiveness are still subject to significant uncertainty. Forecasts for unit labour costs for the economy as a whole indicate a slight weakening of Finland's cost-competitiveness relative to the euro area in the forecast period 2021–2023, whereas, based on the same indicator, cost-competitiveness improved slightly in 2020 (Chart 14).

Chart 14.



Risk assessment: Pandemic still poses a threat to economic recovery

Overall, the risks in the forecast are close to balanced. The greatest uncertainty in the forecast period still relates to developments in the pandemic. Global infection rates are still high, and a too fast re-opening of the economy may lead to a rapid deterioration in the situation and another tightening of the containment measures. Over the next few years, new variants of the virus may lead to new infection waves even after the vaccinations have been completed. The greatest upside risk in the forecast relates to the behaviour of households. The economy could actually grow faster than forecast if in the years ahead households begin to spend the savings they have accumulated during the crisis.

Despite progress in the vaccination programme, we have not yet fully defeated the pandemic. The effectiveness of vaccines against new, possibly yet unknown variants of the virus may prove to be lower than hoped, and total vaccination coverage may also remain too low to completely eradicate the disease. Until the COVID situation is controlled globally, the pandemic may slow down global economic growth and disturb production chains.

The greatest upside risk in the forecast relates to the consumption behaviour of households over the next few years. During the crisis, Finnish households have accumulated around EUR 9 billion in savings due to reduced opportunities to consume. According to the baseline forecast, the household savings rate will return to normal, but the accumulated savings are not expected to be released in the immediate years ahead. If households begin to spend their accumulated savings, for example on private consumption or the housing market, the economy could grow faster than expected over the forecast horizon (Alternative scenario: Households spend their savings faster than expected).

On the other hand, households may be more cautious than usual even after the containment measures are lifted, especially in the consumption of services. The economic impact of the pandemic has also been spread very unevenly between households. Some households have suffered major income losses while most have accumulated savings. Large differences between households and unevenly accumulated savings increase uncertainty and make it more difficult to estimate the recovery rate of consumption. If most of the savings have been accumulated by wealthier households, there is no reason to expect a large-scale channelling of savings into consumption, even after the pandemic fades.

Economic recovery combined with strong growth in demand threaten to accelerate inflation globally. The upward pressure on prices is increased by rapidly rising commodity prices and bottlenecks in supply chains. The semiconductor shortage has already caused issues in the supply of electronic devices. Inflation in Finland and the euro area has accelerated during spring 2021, but more moderately than in the United States. In addition, euro area inflation expectations have risen slightly in recent months, although they remain notably lower than in the United States.

The acceleration of inflation and shortage of skilled labour may increase the pressure to increase wages in the next round of collective bargaining negotiations in autumn 2021. A significant wage hike combined with prolonged strong demand could lead to a more substantial increase in inflation expectations, which in turn would serve to drive faster inflation. Another contributing factor could be fiscal policy, which remains very accommodative relative to the economic cycle. In addition to inflationary pressures from abroad, the rise in consumer prices may be accelerated by the release of Finnish households' savings into domestic consumption, which could speed up services inflation, in particular.

So far, there are no signs of a longer-term acceleration of inflation, and, if the price increases driven by international demand and bottlenecks in supply chains are only temporary, the risk of them being reflected in other cost factors, such as wage demands, will diminish. As temporary factors fade and long-term growth prospects remain subdued, there is even a risk that price inflation will be slower than forecast.

Stimulus measures have offered significant support to the economy through the crisis, but, as the measures are wound down, their impact on economic growth will inevitably be only temporary. At the same time, general government indebtedness has grown strongly both in Finland and in other countries, increasing the vulnerability of the economy and reducing the room for manoeuvre in fiscal policy. Additionally, the longer-term structural challenges of the Finnish economy – such as the sustainability gap in the public finances and the ageing of the population combined with weak productivity – remain unresolved.

Tags

uncertainty, COVID-19, COVID-19 pandemic, forecast, economic growth, households, economic forecast