EDITORIAL

Finnish households’ purchasing power is improving – The economy’s long-term challenges are acute

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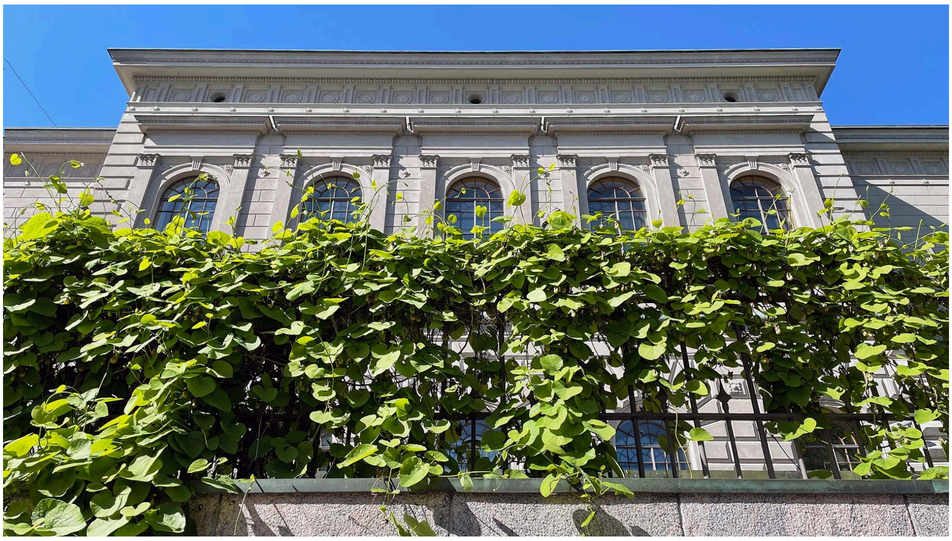
The Bank of Finland’s June forecast shows that the Finnish economy will shrink this year. Growth is being restrained across a broad front by the combination of inflation, which is slowing but still too high, tighter monetary policy and weak export demand. The recession nevertheless looks like being short-lived, and lower inflation will gradually create more favourable conditions for growth in the economy.



The surge in consumer prices in 2022 weakened purchasing power across the board, affecting all households. It did not affect every household in the same way, however. The rapid and extensive rise in consumer prices affected low and middle-income households slightly more than high-income households, as food prices and housing costs increased the most.

The strongest impact of the rapid rise in interest payments, on the other hand, is being felt by middle and high-income households with debts that are large in absolute terms and relative to income. However, they also have the means to smooth consumption over time. This will lessen the impact on private consumption from the loss of purchasing power and the rise in interest rates.

The strong labour market has also improved the prospects for households to cope with rising prices and interest rates. This favourable situation is continuing to support the economy both in Finland and elsewhere in Europe. The labour market has remained tight despite weak growth in the economy, and businesses in many sectors are experiencing problems in recruiting sufficient skilled workers.

Growth in nominal earnings has already been rising and will be relatively brisk in the immediate years ahead. Growth is also being restored in the real purchasing power of households during the current year, due to lower inflation, the negotiated wage increases and index adjustments to social benefits. This will mean that the significant decline seen in the real purchasing power of Finnish households in 2022 will be corrected reasonably quickly.

The decline in energy prices has slowed inflation significantly in the early part of this year already. However, underlying inflation, which measures price movements in consumer goods and services, will fall only after some delay, as wage increases and rent rises will maintain inflation in service prices.

In the euro area, headline inflation was 6.1% in May, while underlying inflation, which excludes energy and food prices and is especially important for monetary policy, has slowed moderately but was still significantly above the 5% mark in May, at 5.3%.

In Finland, both headline inflation and underlying inflation have been somewhat below the average for the euro area throughout the period of elevated inflation rates, which began towards the end of 2021. In May this year, Finland's headline inflation was at 5.0% and its underlying inflation at 4.4%.

Inflation is also projected to fall more quickly in Finland than the euro area average. In both 2024 and 2025, it could even be below 2%, according to the Bank of Finland's forecast.

Nevertheless, the period of elevated inflation rates has persisted, and this has prompted discussion of what other background factors might be at play. One hypothesis that has received attention is that businesses might be trying to exploit high inflation by raising their prices to expand their profits, in turn fuelling inflation. However, analysis of the Finnish economy using preliminary data from 2022 does not indicate that there were any significant changes in corporate pricing strategies last year.

If inflation is too high and is difficult to predict, this will hamper decision-making by businesses and by households, which would be detrimental to growth in the economy. Raising interest rates will ensure price stability, which is also essential for sustainable economic growth and high employment.

The key policy rate is now at 3.5%. The Governing Council of the European Central Bank has raised interest rates to prevent inflation from getting out of control and to restore households' real purchasing power. This will ensure economic stability, which is essential for sustainable growth and high employment.

The decisions on interest rates are based especially on an assessment of how underlying inflation (excludes energy and food prices) is likely to develop and an assessment of the strength of monetary policy transmission. Underlying inflation must be clearly and durably on a downward path before we bring the monetary policy tightening cycle to a close. We will bring interest rates to levels sufficiently restrictive to achieve a timely return of inflation to the 2% medium-term target and keep them there as long as necessary.

Throughout Europe, the employment situation is now better than it has been for decades, which is good news for the economy in Finland, too. If we continue with a consistent stance in monetary policy for as long as is necessary, we can stabilise inflation at its target without severe costs to the economy or to employment.

Sustainable public finances represent a further important pillar of a stable economy, in addition to price stability. Finland's public finances have been almost continuously in deficit since the global financial crisis of more than 15 years ago. The Bank of Finland's latest forecast for the public finances coincides with the transition between two government terms. The projection is based on an assumption of unchanged fiscal policy and sees the general government deficit deepening to 3.6% and the general government debt-to-GDP ratio rising to 78.3% in 2025.

The challenges of Finland's public finances are largely structural and cannot be resolved with short-term measures devised on a one-time basis. The Government Programme seeks to respond to these challenges with substantial fiscal adjustments and structural measures to strengthen employment and growth.

Sustainable economic growth is based on improvements in labour productivity. Although public sector measures can only influence private sector productivity indirectly, and with a time lag, the public sector does have a key role in supporting productivity growth.

Research evidence indicates that in innovation policy, the public sector should focus not on individual projects but on expanding human capital and on comprehensive packages for improving the operating environment of the private sector.

One obvious example is higher education and basic research. This is because, on the one hand, the private sector's incentives for investing in these are weak, and, on the other, their benefits are broad-based and are for the good of society as a whole – also for businesses and sectors that do not yet even exist.

This is a very topical subject in Finland. The Government Programme commits to the target specified in the R&D funding legislation, of raising R&D expenditure to 4% of GDP by 2030. The challenge during the new and subsequent government terms is to be able to allocate central government R&D funding in such a way that it supports productivity improvements and sustainable economic growth. Success in this will determine whether private sector R&D expenditure will increase to meet the goal set in the R&D funding legislation.

Based on the Bank of Finland's long-term scenarios, the availability of skilled labour will be adversely affected by population ageing and by the standstill in the previously rising educational level of young adults, and this will also diminish the economy's growth potential, due to a decrease in human capital.

An increase in the labour force participation rate has, for the time being, still been supporting the level of employment, even though the size of the working-age population has started to decline. The demographic change in Finland is so significant that it will be very difficult to secure the prerequisites for growth without an increase in work-based immigration.

The amount of work-based immigration to Finland has actually been growing significantly during the post-pandemic recovery in the economy. However, it should not be taken for granted that internationally mobile skilled labour can be attracted to Finland. If the favourable trend of recent years is to continue, it will be necessary to increase the resources for ensuring smooth immigration and for developing international recruitment.

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The new government term will begin in circumstances that are difficult in many ways. In recent years, public sector decision-making has had to focus on responding to various challenges of a new and different kind. At the same time, Finland's long-term challenges – strengthening the public finances and securing the conditions for sustainable economic growth – have now become acute.

Meeting these challenges calls for major changes, though the challenges are also very much interrelated. The Government Programme establishes a foundation for strengthening the public finances and the prerequisites for sustainable growth. But unless the means for achieving growth – human capital and entrepreneurial dynamism – are expanded, even a balance in the public finances will be impossible to maintain. And without sustainable public finances, the operating conditions for households and businesses will deteriorate during the ongoing transition.

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Tags

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