BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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BANK OF FINLAND FORECAST

Finland falling further behind euro area growth

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Economic growth in Finland has been slow for a prolonged period, both historically and by international comparison. In recent years, growth has been depressed not only by the weak international economy, but also by sectoral and structural problems, such as an ageing population and lacklustre productivity development. In the forecast years 2015–2017, the economy will start to grow sluggishly as the export markets revive. The continued accommodative stance of monetary policy will also help support growth.

Finland will not catch up with the pace of recovery in the other euro area countries. Due to weak cyclical conditions and the structural problems in the economy, the stagnation of economic growth in Finland will have prevailed for close to 10 years by the end of the forecast period. In the absence of a quick remedy for the structural problems, there is a risk that growth will continue to lag behind the pace of growth witnessed in the 1990s and early 2000s even after the forecast period.

Finnish exports have suffered a considerable loss of market share since 2009, the most severe year of the recession. Competitiveness has been eroded, while the forest industries and electrical engineering and electronics, in particular, have experienced serious difficulties. During the years 2008–2012, only a few sectors report improvements in employment due to exports. Exports will rebound in the forecast period, with net exports supporting growth, but the current account will nevertheless remain in deficit.

It will take time for new export sectors and companies to emerge and make up for the loss of production. Although they will contain the weakening of price competitiveness, moderate pay rises will be slow to actually improve price competitiveness. Productivity growth will remain sluggish throughout the forecast period.

In the years following the financial crisis, consumer price inflation was higher in Finland than in other euro area countries. Due to the poor performance of the economy, the rate of inflation in Finland will, over the forecast period, remain below that of the other euro area countries, thus slightly narrowing the price difference built up in past years. At the same time, real earnings growth will be buoyed by the slow price developments.

During the recession, the economy was supported by private consumption. Consumer confidence has improved and households have been willing to finance part of their consumption by taking on debt. Finnish household debt as a percentage of income (120%) is still relatively moderate in comparison with the other Nordic countries. The pace of debt accumulation has, however, been rapid; in a context of slow economic growth, this increases households' risks.

Household income developments have been influenced by the rapid increase in retirement income. In step with the ageing of the population, the retired population has grown in size, and has also enjoyed stronger income growth than the wage-earning population. Towards the end of the forecast horizon, wages will also begin to rise, thus bolstering private consumption growth. However, both earnings and employment growth will remain sluggish. The increase in purchasing power is largely explained by the low rate of inflation prevailing at the beginning of the forecast period.

Companies have reduced their output capacity in response to low demand, and the volume of fixed investment has been modest despite the low level of interest rates. Housing construction activity has largely been reliant on renovation work and the production of housing for rent, and housing construction is not expected to pick up until towards the end of the forecast period. Fixed investment growth will also remain relatively sluggish despite some large individual projects. R&D expenditure has fallen and no longer supports productivity growth as it did in the past.

On the labour market, the moderate cyclical upswing currently underway is reflected in longer working days /increased working hours. The employment situation will scarcely improve during the forecast period. Long-term unemployment surged during the recession, and prolonged unemployment is threatening to further aggravate the problems of regional and sectoral mismatch on the labour market and to increase structural unemployment. Export-driven growth is feeding more slowly through to labour demand, as the share of the labour force employed in the export sector is shrinking.

The consequences of the sluggish economic growth in Finland have been most dramatic for the public finances. In 2014, the fiscal deficit already rose above the 3% threshold defined in the Stability and Growth Pact, and this will not be reduced without further consolidation measures. In 2017, general government debt will climb as high as 67% of GDP, which corresponds roughly to a doubling of the debt-to-GDP ratio since 2007. Debt accumulation will continue to accelerate in the environment of a large fiscal deficit, sluggish economic developments and a marked increase in age-related spending. In the alternative scenario, the consolidation measures agreed in the new Government

Programme will reverse the trend in the debt-to-GDP ratio by the end of the Government's term in office.

Growth will begin slowly

Finland's GDP will continue to be lacklustre in the forecast years 2015–2017. The prolonged period of contraction in the economy will, nevertheless, come to an end. In 2015, the economy will grow slowly, at a rate of 0.2%. A pick-up in external demand, together with the depreciation of the euro, will boost exports, and domestic demand will also recover gradually. Real GDP growth will accelerate to 1.2% in 2016 and to 1.3% in 2017.

Chart 1.

Growth estimates have been revised slightly upwards relative to the Bank of Finland's December 2014 forecast, which envisaged a mild contraction in GDP in 2015 and projected GDP growth of 1% in 2016 (Table 1). Compared with the previous forecast, the economic outlook for the international economy and the euro area, in particular, has improved.

The extensive Asset Purchase Programme initiated by the European Central Bank in the early part of 2015 contributes to a pick-up in demand.[1] In response to the highly accommodative monetary policy, interest rate expectations for the years ahead have moderated and the external value of the euro has depreciated, spurring economic activity in the euro area and enhancing the area's external price-competitiveness. Finnish export growth is, however, subdued, partially by the weak performance of the Russian economy. This will weigh on GDP growth especially in 2015.

1. The Asset Purchase Programme is discussed in broader detail in the feature article.

Comparison: current and December 2014 forecasts

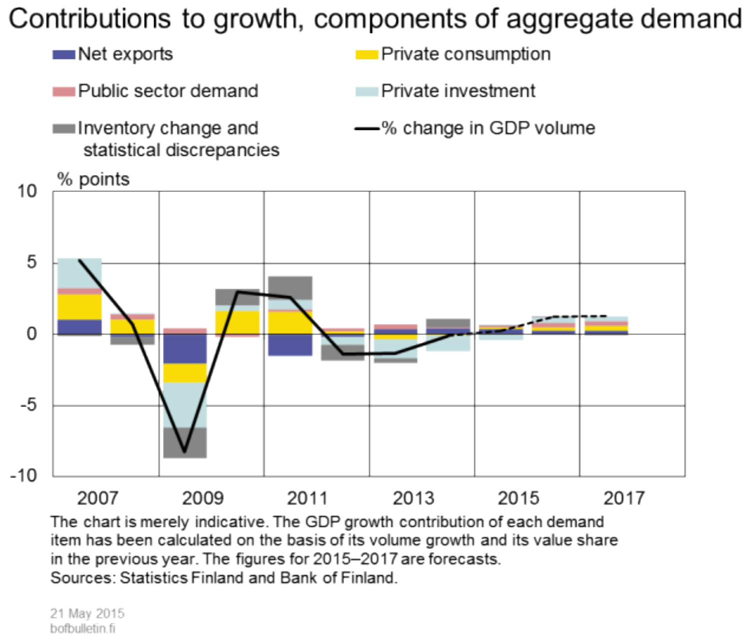
	2014	2015	2016	2017
GDP, % change	–0.1	0.2	1.2	1.3
December 2014	–0.2	–0.1	1.0	
Inflation (HICP), %	1.2	0.2	1.0	1.5
December 2014	1.3	1.0	1.4	
Current account, % of GDP	–1.1	–1.1	–0.8	–0.6
December 2014	–1.5	–1.7	–1.7	
General government net lending, % of GDP	–3.2	–3.1	–3.1	–3.0
December 2014	–2.6	–2.2	–2.2	
General government debt (EDP), % of GDP	59.3	62.5	65.1	67.3
December 2014	59.3	61.7	63.8	
Unemployment rate	8.7	9.1	8.9	8.6
December 2014	8.5	8.5	8.2	

Sources: Statistics Finland and Bank of Finland.

View forecast summary in table form.

The structure of growth will initially be weighted towards net exports (Chart 2). Foreign trade will make a net contribution to growth especially in 2015, as import growth is depressed by weak domestic demand. Later, investment growth will gather strength and private consumption begin to grow. Public sector demand will, in turn, support growth throughout the forecast period.

Chart 2.



Households: consumption to recover gradually

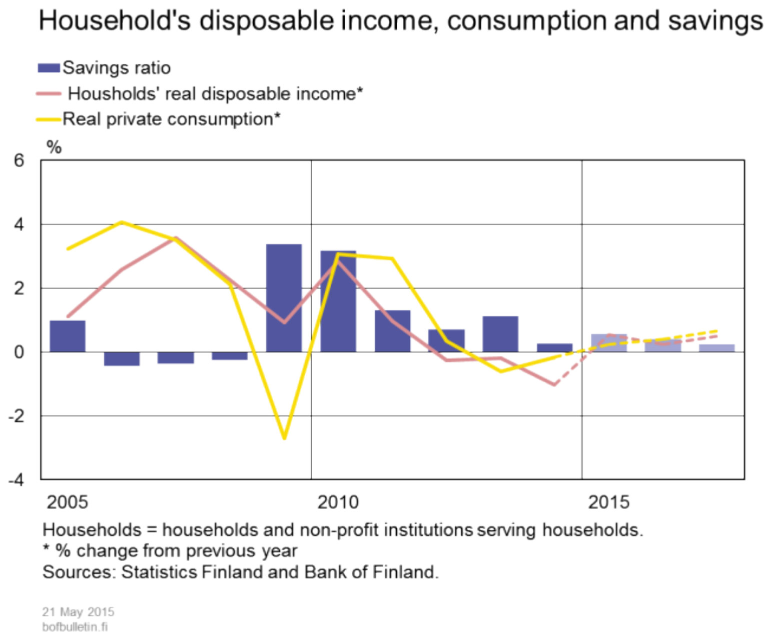
After two years of contraction, household consumption will return to slow growth, driven by rising purchasing power, but private consumption growth will, nevertheless, remain slow compared to past experience (Chart 3). Growth in disposable real income will be driven by higher wages but also by the exceptionally low level of inflation. Growth in nominal earnings will be slower than we have been accustomed to in the past.

Household consumption growth will, in part, be supported by the availability of instalment-free periods on housing loans, which attracted considerable interest in the early part of 2015. Consumer confidence in both their own finances and in the national economy has improved during the past few months. Another indication of consumption growth gathering pace is the increase in retail sales in the early part of the year compared with the previous quarter. However, sales were still down on the corresponding period a year earlier.

Any increase in purchasing power will be subdued in the forecast period, reflecting moderate earnings growth, accelerating inflation and only a slow improvement in the employment situation. Similarly, growth in current transfers to households will moderate, although a substantial proportion of overall household income will still be derived from current transfers (see ‘Households increasingly dependent on current transfers’). In the baseline forecast, taxes paid by households will increase only slightly in the immediate years ahead. Annual growth in private consumption will average ½% throughout the forecast period.

The household savings ratio fell by about 1 percentage point to 0.3% in 2014 and is projected to remain in the region of ½% throughout the forecast period. The persistent exceptionally low level of interest rates reduces the appetite for saving and fosters borrowing. In addition to income growth, rising house prices and the availability of funding, the low level of interest rates has fuelled household borrowing during the major part of the 2000s. However, with the recession, the pace of household debt accumulation has moderated from the peak during the past few years and will continue to moderate during the forecast period.

Chart 3.

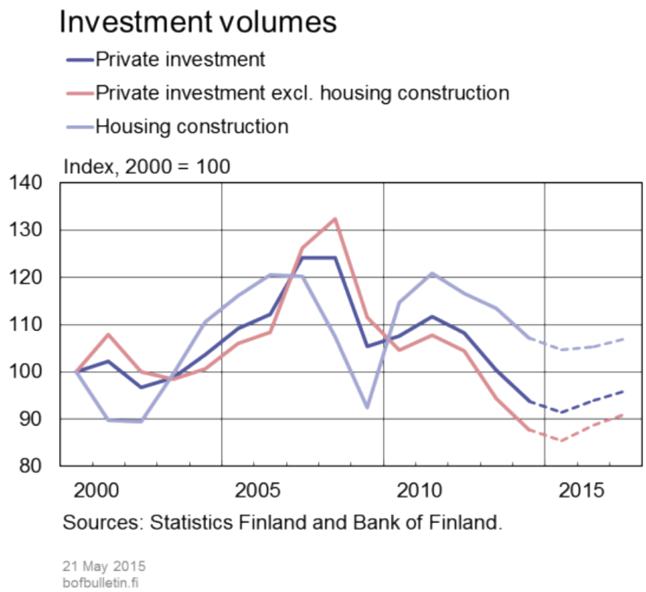


Non-financial corporations: individual projects to boost investment

Corporate investment continues to be dampened by weak overall demand and under-utilisation of capacity. However, some large investment projects to be launched in 2015 will turn capital investment upwards. Early in the forecast period, the depressed demand outlook will reduce construction of new housing, but the continued brisk pace of renovation work will contribute to investment growth.

During the forecast period, investment growth will be slower than previously witnessed and will remain far behind the situation prevailing before the onset of the financial crisis (Chart 4). Annual investment growth will be only 2% in 2016 and 2017. The demand outlook will continue to be subdued, and profitability in the corporate sector will remain low. A positive feature in investments is that the focus is shifting towards productive investments. The increase in investment is not, however, projected to make up for capital depreciation in industry, and consequently the productive capital stock will contract further, eroding the output potential of the economy.

Chart 4.



Foreign trade: exports to pick up

Finnish exports and export markets are expected to revive, driven by global and euro area growth. Exports will return to growth in 2015 as investment starts to grow, notably in the euro area. Higher investment growth will bolster Finnish exports, of which capital goods form a large part. The recent depreciation of the euro supports growth in exports to non-euro area countries. In addition, export demand will be underpinned by easier access to funding and the low interest rate environment of the euro area.

Chart 5.

The problems encountered by Finnish exports over the past few years will slowly begin to fade in the immediate years ahead as investment activity in Finland's export markets picks up. Finnish export growth will also gather strength. The price-competitiveness of exports will strengthen, reflecting the slower rise in export prices compared with competing countries.

Export growth will, however, remain sluggish in 2015 and lag well behind growth in the export markets (Chart 5). The sharp contraction in the Russian economy will continue to substantially dampen export growth in 2015. Export growth will accelerate above 3% in 2016, and to 4% in 2017, in step with the gradual waning of the effect from the contraction in exports to Russia and the ongoing revival in the export markets.

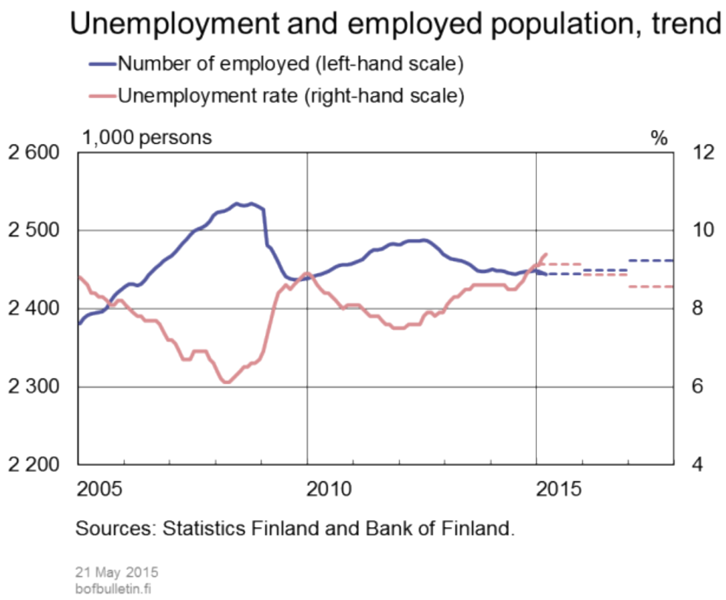
Given the high import content of exports, imports will also grow, as many foreign intermediate goods and commodities are used in the manufacture of export products. For this reason, the contribution of net exports will remain relatively modest, although making a contribution to growth throughout the forecast period. Finland has suffered substantial losses of market share since the recession year 2009. Finland's export growth will continue to be slower than growth in the export markets. The loss of market share will, however, slow in the forecast period.

The current account deficit will shrink in the forecast period, but the current account will remain in deficit at the end of the forecast horizon. The balance on goods and services will strengthen annually and will post a surplus of about EUR 0.5 billion in 2017. The positive developments reflect an increase in export volumes, as the terms of trade will make a negligible contribution to the goods and services account throughout the forecast period. The terms of trade will deteriorate further in 2015.

Labour market: employment to improve only slightly

The number of people employed in 2015 will remain unchanged from the previous year and thereafter will increase only slowly due to sluggish economic growth, posting an increase of 0.2% in 2016 and 0.5% in 2017. No significant revival in manufacturing employment is in view in 2015. In the recession years, it has become harder for unemployed people to find work. Job vacancies are slow to be filled and periods of unemployment have grown longer. Employers' ability to adjust work input by increasing working hours is further contributing to the slow employment growth.

Chart 6.



The unemployment rate will climb to 9.1% this year, falling back to 8.6% in 2017 (Chart 6). The prolonged weakness of the economy has been reflected on the labour market more than before, not only as growing unemployment per se but also in the structure of unemployment. The proportion of long-term unemployed out of all the unemployed has increased to one third, with a surge in recent years in the number of long-term unemployed aged 25–54, in particular. Long-term unemployment is typically slow to decline, and its growth therefore presages the persistence of high unemployment over the forecast period. Long-term unemployment also heightens the risk of structural unemployment and labour market exit in the future, especially considering the growing prevalence of long-term unemployment among young cohorts.

The labour force will grow slightly in the course of 2015 and thereafter remain fairly stable. The labour market outflow caused by the sustained poor performance of the economy has been reversed, and the labour force has begun to expand. However, this has been reflected in an increase in unemployment rather than in employment. Consequently, labour force growth cannot be construed as representing a clear sign of improvement in labour market conditions.

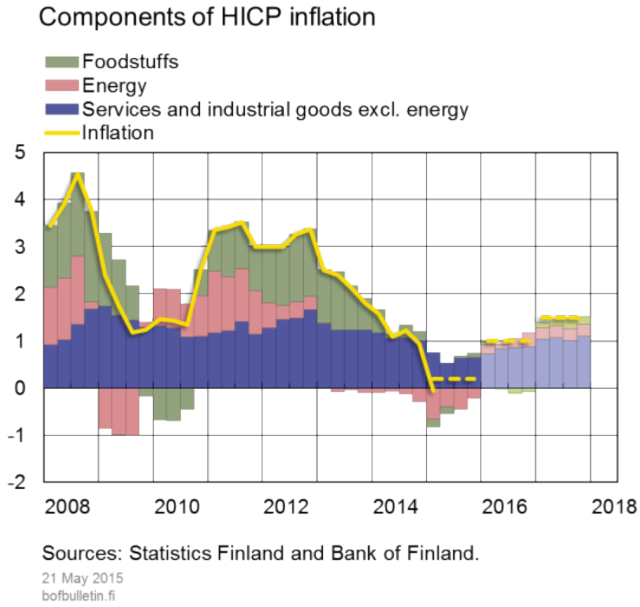
Costs and prices: sluggish growth

The steep decline in the price of crude oil fed into consumer prices and pushed inflation below zero in early 2015. In the years ahead, inflation will, correspondingly, be fuelled by price increases on oil and imported products. Although services prices will sustain a positive rate of inflation in the future, inflation in Finland will fall behind the euro area average due to weak demand. This will slightly reduce the average difference in the level of prices between Finland and the euro area that was built up in the wake of the financial crisis. Upward pressure on wages will remain subdued on account of the weak economic and employment trend, but real earnings growth will be supported by the low level of inflation.

Inflation according to the harmonised index of consumer prices (HICP inflation) will average 0.2% in 2015, but will rise to 1.0% in 2016 and 1.5% in 2017.

In 2015, inflation was dampened by falling energy and food prices and slower growth in services prices (Chart 7). Towards the end of the forecast period, fuel inflation will be boosted by a rise in the world market price of crude oil. The dip in the oil price witnessed in the early part of 2015 will be reflected in a mild inflationary peak in the price of oil in the corresponding period in 2016.

Chart 7.

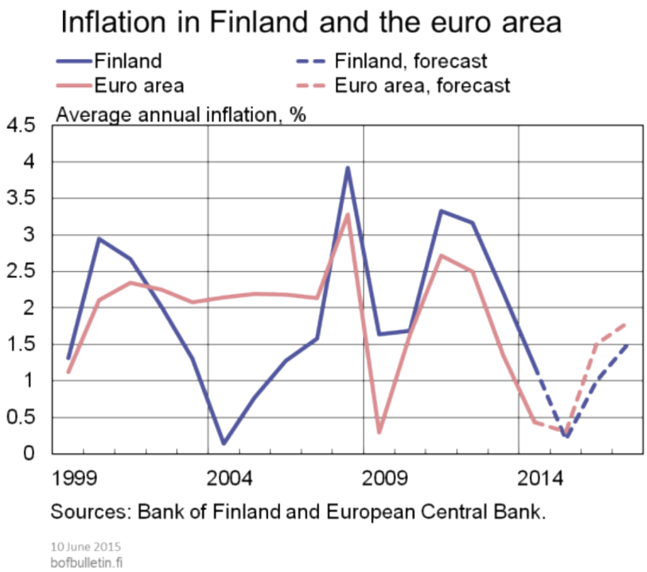


During the forecast years, inflation will be sustained especially by increases in services prices (see article on services prices). In early 2015, there was a broadly based moderation in the prices of many services, and price pressures will remain contained until the end of the forecast period. The weak economic outlook and wage developments will be reflected in the prices of services.

Prices of manufactured consumer products are declining in 2015, but this trend will be cut at the end of the forecast period. Individual food producer prices show mixed trends, whereas developments in food consumer prices will be subdued over the forecast horizon. The end of the downward trend in the prices of industrial commodities, the revival of global growth and the monetary policy stimulus measures in the euro area will exert some upward pressure on consumer prices.

Inflation will drop below the euro area average (Chart 8). In the years since the financial crisis, Finnish consumer prices have grown faster than elsewhere in the euro area, but in response to the country's relatively weak economic situation price pressures will remain contained during the forecast period. According to the Eurosystem macroeconomic projections, the rate of inflation for the euro area as a whole will be 0.3% in 2015, 1.5% in 2016 and 1.8% in 2017.

Chart 8.

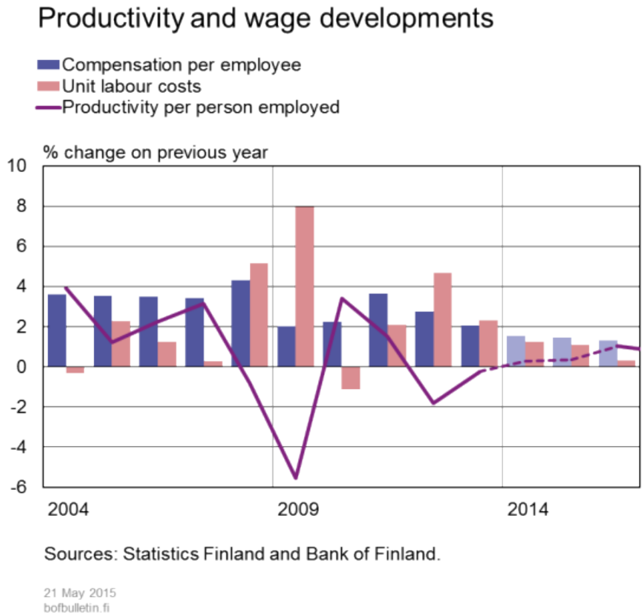


In 2015, nominal earnings will grow by 1.1%, with pay rises being subdued in the forecast period. Growth in nominal earnings will be 1.2% in 2016 and 1.5% in 2017, indicating pay rises will remain well below their long-term average. The weak economic and employment trend will subdue earnings growth in the forecast period. In response to slowing inflation, real earnings will improve in 2015 despite the exercise of wage restraint.

Labour productivity will grow slowly compared with past performance, at an average of less than 1% per annum (Chart 9). Output growth will continue to be concentrated on services, which are characterized by lower-than-average productivity. Growth in unit labour costs will be contained by moderate pay rises. In 2015, unit labour costs will, however, still continue to rise by 1.1%, although towards the end of the forecast period the rate will fall below 1%, reflecting a slight improvement in productivity growth.

Since 2007, Finland has suffered a substantial loss of cost-competitiveness, but during the forecast period the fall in cost-competitiveness will stop relative to key competitors. Competitiveness, as measured by unit labour costs, will, however, improve only slowly.

Chart 9.



Public finances: rapid growth in debt

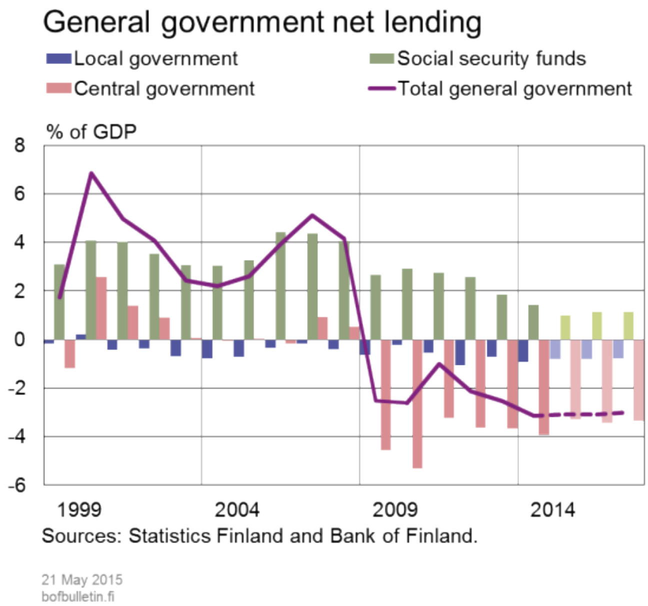
There was a marked deterioration in the general government financial balance in 2014, with Finland's fiscal deficit crossing the threshold set in the EU's Stability and Growth Pact. In the absence of further consolidation measures, the fiscal deficit will scarcely improve and public debt will continue to surge.

Finland's general government deficit proved deeper in 2014 than estimated in the forecasts, as revenue growth was again slower than expected. The increase in unemployment expenditure, in particular, was more rapid than previously projected. The deficit exceeded the 3% threshold set in the EU's Stability and Growth Pact, to stand at 3.2%. The ratio of public debt to GDP increased to 59.3%.

The forecast does not assume implementation of the fiscal consolidation measures proposed by the new Government. A separate analysis of their impact is provided in the alternative scenario.

Despite the tightening of fiscal policy in 2015, central government saving measures will fall short of achieving a significant improvement in the public finances given the weak economic conditions. Hence, the fiscal deficit will remain at 3% of GDP in the forecast years (Chart 10). Public debt will continue to grow, with the debt-to-GDP ratio standing at 67% in 2017. The tax ratio will stabilise at 44.4% in the forecast years.

Chart 10.



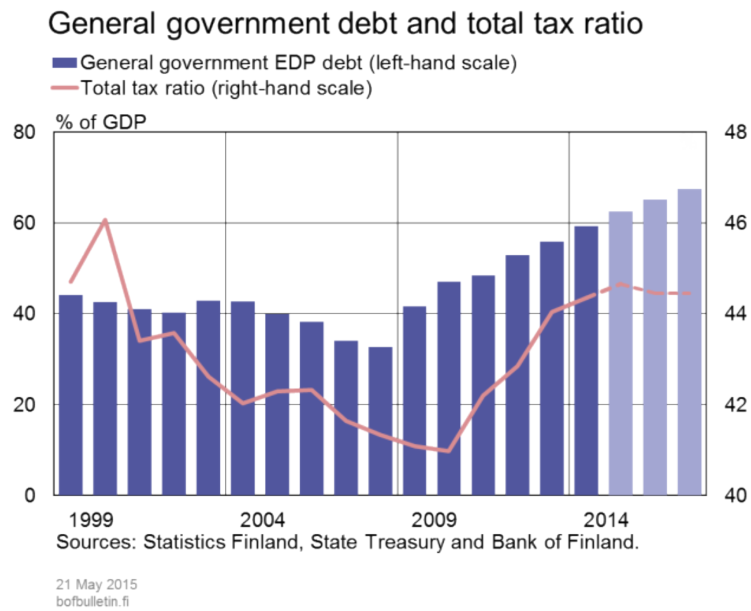
Central government finances will improve in 2015 in response to the expenditure cuts and tax increases already planned by the previous government. The rise in tax revenue will be supported by tax-increasing measures, but in a context of slow economic growth the increase in central government revenue, taken as a whole, will remain subdued. The expansion of central government expenditure will be restricted by the spending cuts put in place in 2015, and the central government deficit will shrink. However, central government spending will grow faster than revenue again in 2016. Although revenue growth will gain momentum in 2017, driven by economic growth, the central government financial balance will improve only slightly, to -3.3%.

The local government financial balance will remain unchanged, at around -0.8%, throughout the forecast period. Growth in local government revenue has been slowed by cuts in current transfers from central government, which prompted an increase in local taxes for 2015 by an average of 0.1 of a percentage point. The forecast assumes continued increases of the same magnitude in the years ahead. Local government expenditure relative to GDP will not fall, as the expansion of social and health care services will continue in response to the ageing of the population and there has been no change in the investment needs of the municipalities.

The surplus on the social security funds will erode further in 2015, to 1%. Despite a rise in pension contributions, growth in pension expenditure will be faster than the increase in premiums written and the asset income of the earnings-related pension funds. The rise in social security contributions will be dampened by lacklustre employment and earnings growth. The 0.4% ceiling on index increments to social benefits imposed in 2015 will rein in the increase in these benefits, with index increments also being modest in 2016 due to the low level of inflation. Expenditure on unemployment and income support will, however, continue to surge in 2015 but start to decline again in 2016–2017 in step with an improvement in the unemployment situation. The cyclical buffer of the Unemployment Insurance Fund has been exhausted and, in spite of an increase in unemployment insurance contributions, the Fund will have to resort to borrowing in 2015.

In the forecast years, the ratio of public debt to GDP will rise above 67% (Chart 11). After deducting Finland's contribution to safeguarding European financial stability, the debt in 2016 will already exceed the 60% threshold set in the Stability and Growth Pact.

Chart 11.



Forecast summary

Supply and demand	*2014*	*2013*	*2014*	*2015*[f]	*2016*[f]	*2017*[f]
	At current prices, EUR billion	Volume, % change on previous year				
Gross domestic product	204.0	–1.3	–0.1	0.2	1.2	1.3
Imports	76.9	–1.6	–1.4	–0.4	2.5	3.4
Exports	76.0	–0.7	-0.4	0.6	3.3	4.0
Private consumption	112.7	–0.6	-0.2	0.2	0.4	0.7
Public consumption	51.0	0.6	0.2	0.0	1.0	1.1
Private fixed investment	32.3	–7.3	-6.5	-2.5	2.7	2.2
Public fixed invesment	8.5	4.0	0.6	2.6	1.0	1.2

Key economic indicators *% change on previous year*	*2013*	*2014*	*2015f*	*2016f*	*2017f*
Harmonised index of consumer prices	2.2	1.2	0.2	1.0	1.5
Consumer price index	1.5	1.0	0.1	1.1	1.4
Aggregate wage and salary earnings	2.1	1.4	1.1	1.2	1.5
Labour compensation per employee	2.1	1.5	1.5	1.3	1.6
Productivity per person employed	–0.2	0.3	0.4	1.0	0.7
Unit labour costs	2.3	1.3	1.1	0.3	0.8
Number of employed	–1.1	–0.4	–0.1	0.2	0.5
Employment rate, 15–64-year-olds, %	68.5	68.3	68.2	68.6	69.2
Unemployment rate, %	8.2	8.7	9.1	8.9	8.6
Export prices of goods and services	–0.8	–1.7	0.9	2.3	2.5
Terms of trade (goods and services)	0.5	0.0	–0.4	0.1	–0.1
% of GDP, National Accounts					
Tax ratio	44.0	44.4	44.7	44.4	44.4
General government net lending	–2.5	–3.2	–3.1	–3.1	–3.0
General government debt (EDP)	55.8	59.3	62.5	65.1	67.3
Balance on goods and services	–0.9	–0.4	–0.2	0.1	0.3
Current account balance	–1.4	–1.1	–1.1	–0.8	–0.6
f = forecast.					
Sources: Statistics Finland and Bank of Finland.					

See other forecast tables.

Tags

- inflation
- GDP
- economic situation
- forecast