BANK OF FINLAND
BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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BANK OF FINLAND FORECAST

Finland has left recession behind

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The Finnish economy has returned to growth. During 2016, growth has strengthened particularly on the back of private consumption and investment recovery. GDP will continue to grow in 2017–2019, driven by domestic demand, but will remain subdued, at a good 1% per annum, relative to previous cyclical upswings. The risks to the baseline forecast are tilted on the downside.

The Competitiveness Pact will curb increases in average earnings and unit labour costs in 2017. This will boost growth in investment, exports and GDP. Meanwhile, the outlook for the international economy is weaker than in summer 2016, and demand for Finnish exports will be weaker. However, improved competitiveness will see Finnish exports return to an upward trajectory, thereby supporting favourable GDP performance towards the end of the forecast horizon.

Private consumption will be the main driver of growth, especially in the early part of the forecast period. Growth in real disposable household income will be bolstered by the gradual improvement of the employment situation and low inflation. Growth in disposable income will decelerate only slightly in 2017 because of lower labour taxation.

Investment growth since 2015 has been markedly faster than previously envisaged. On top of very brisk growth in construction investment, corporate fixed investment has moved into growth, which also bodes well for future output potential. Despite this turnaround, the level of corporate fixed investment is only modest. The prolonged weak condition of Finnish manufacturing is taking a turn for the better. Industrial output in 2016 has recorded year-on-year growth for the first time in four years.

Consumer price increases are set to remain exceptionally subdued during the forecast period, despite a gradual increase in the price of oil. Inflation will not pick up until the end of the forecast horizon, achieving 1%. The Competitiveness Pact will contribute to the sluggish price developments, as the particularly muted trend in labour costs will, in part, be reflected in end-product prices.

Employment has also resumed growth, which is predicted to remain fairly strong in the forecast years, relative to GDP performance. New jobs will be created by more than the employment growth figures on their own would suggest, as the working-age population continues to contract. Increasing employment will be underpinned by higher labour demand against the backdrop of the Competitiveness Pact and by the fact that economic growth will predominantly rest on domestic demand, notably labour-intensive service sectors and construction. On the other hand, obvious mismatch problems and a huge number of long-term unemployed will cause concern on the labour market. Going forward, high long-term unemployment will also begin to hamper the recovery of the economy.

Even modest economic growth will strengthen the general government fiscal position, as will measures to restrict increases in public expenditure. At the same time, growth in pension expenditure will remain rapid. The Competitiveness Pact will make a negative contribution to the public finances over the short-term, meaning that the general government structural budget balance will weaken in 2017. Growth in general government debt will continue towards 70% of GDP. Although halting the rise of the debt ratio over the medium term appears feasible, the long-term sustainability problem in the public finances remains unresolved.

GDP: Domestic demand the engine of growth

According to the Bank of Finland forecast, Finnish GDP will grow by 1.3% in 2017. Domestic demand is functioning as the engine of growth. The economy will continue to grow by 1.2% in 2018 and 2019. In spite of the recovery, growth will, nevertheless, remain slower in Finland than elsewhere in the euro area during the whole period. Finland’s GDP will grow by roughly 3½%, overall, over the years 2017–2019, against close to 5% over the same period in the euro area as a whole (Chart 1).

Table 1.

Forecast summary

% change on previous year

	2016[f]	2017[f]	2018[f]	2019[f]
Gross domestic product	1.0	1.3	1.2	1.2
Private consumption	1.9	1.4	1.0	0.9
Public consumption	0.3	0.3	0.3	–0.3
Private fixed investment	5.8	3.4	2.5	2.7
Public fixed investment	3.1	0.6	–0.2	–0.1
Exports	0.7	2.1	2.5	2.6
Imports	1.2	2.0	2.1	1.9
Contributions to growth				
Domestic demand	2.2	1.5	1.1	0.9
Net exports	–0.2	0.0	0.1	0.3
Inventory change + statistical discrepancy	–1.1	–0.2	0.0	0.0
Savings ratio, households, %	–1.0	–1.0	–0.9	–0.3
Current account balance, % of GDP	–0.8	–0.9	–1.0	–0.9
Labour market				
Hours worked	0.9	0.8	0.8	0.7
Number of employed	0.4	0.6	0.6	0.7
Unemployment rate, %	8.8	8.5	8.3	8.2
Unit labour costs	0.5	–1.2	0.0	0.4
Labour compensation per employee	1.1	–0.5	0.6	1.0
Productivity	0.6	0.7	0.7	0.5
GDP, price index	1.2	–0.1	0.3	0.7
Private consumption, price index	0.5	0.6	0.7	0.8

f = forecast

Sources: Statistics Finland and Bank of Finland.

Forecast summary				
Harmonised index of consumer prices	0.4	0.8	0.8	1.0
Excl. energy	0.7	0.6	0.7	0.8
Energy	–3.8	3.0	2.5	3.3
f = forecast				
Sources: Statistics Finland and Bank of Finland.				

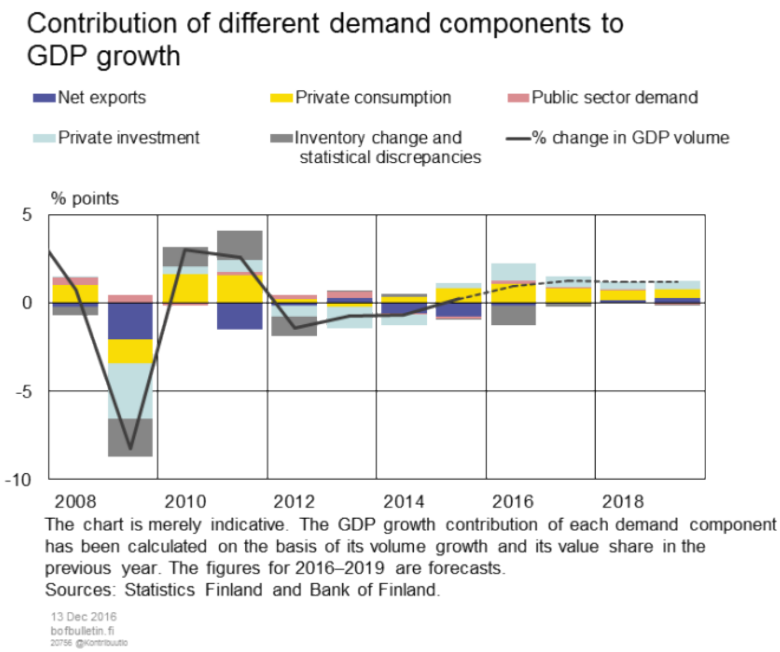
Throughout the forecast period, economic growth will be mainly dependent on private consumption and investment (Chart 2). Private consumption will be buoyed by a gradual improvement in employment, growth in purchasing power and accumulation of debt. An exceptionally accommodative monetary policy will keep interest rates low on retail and corporate loans, also supporting consumption and spurring investment. Investment growth will be strongest early in the forecast period, reflecting the revival of new-build construction.

Export growth will finally pick up slightly. The Competitiveness Pact provides for lower unit labour costs, thus underpinning the prospects for export growth. However, due to the weaker-than-expected global outlook, demand for Finnish exports will not be as strong as foreseen. The loss of export markets will continue, but moderately, in response to stronger competitiveness.

The external indebtedness of the Finnish economy continues to grow. Over the years 2010–2015, the current account deficit already climbed to just over EUR 11 billion. The ratio of the current account deficit to GDP will remain in the region of 1% in the forecast period, reflecting deterioration in the terms of trade, as the Competitiveness Pact will keep domestic price developments moderate, while domestic demand will grow.

Chart 1.

Chart 2.



The forecast takes account of statistical data and other information available on 23 November 2016. On 2 December 2016, Statistics Finland released the latest data on the quarterly national accounts, and these have been discussed in more detail in a separate article (National Accounts for the third quarter of 2016).

Households: Consumers sustain economic growth

The continued accommodative stance of monetary policy and strong consumer confidence will boost private consumption, particularly early in the forecast period.

Indeed, private consumption will remain the major factor contributing to economic growth in Finland. The increase in households' real income will be driven by gradual improvements in employment and low inflation, while growth in nominal earnings will be lacklustre. In the forecast period, consumption growth will mirror developments in households' disposable income, and households will no longer take on debt at the rate they have done in recent years.

Consumption will increase by nearly 2% in 2016 and this growth will slow only slightly in 2017, to around 1½%. With the conclusion of the Competitiveness Pact, the rise in average earnings will moderate, but the stronger employment outlook, together with the continued very low rate of consumer price inflation, will boost the purchasing power of wage earners. The easing of taxes on labour will offset the shift of social security contributions from employers to employees.

The increase in public transfers to households has sustained the purchasing power of households in recent years despite the recession. Notwithstanding the fall in unemployment, public transfers will continue to grow by a full 2% in 2017–2019, as the number of pensioners increases further.

In 2018 and 2019, consumption will grow at around 1% per annum, against a backdrop of continued improvements in employment and sustained low inflation. In 2019, consumer price inflation will pick up to 1%.

Growth in household debt accumulation will moderate over the forecast horizon, reflecting the expected more cautious behaviour of households in the wake of the rapid surge in debt levels witnessed in recent years. The Act on housing loan caps introduced in July 2016, together with lower tax deductibility for housing loans, will also serve to rein in debt accumulation. Under the new Act, housing loans are limited to 90% of collateral value, 95% for first time buyers.

The most highly-indebted households typically represent the highest income brackets, which are better equipped to bear the risks of debt. Their purchasing power is strongly supported by the low level of interest rates. In fact, low-income households in rented accommodation, who are not in a position to benefit from the fall in interest rates but have to pay increasingly higher rents, are a more vulnerable group than mortgage holders.

The pick-up in housing sales will fuel demand for new housing loans, while the growth rate of the housing loan stock will remain moderate. Considering that annuity loans make up a significant proportion of housing loans, amortisations will account for a higher share of loan servicing expenditure in a low interest rate environment, thus holding back growth in the loan stock.[1] As well as growth in the housing loan stock, the continued brisk pace of renovation work will, however, also add to the household debt burden. In fact, the debt burden of households increasingly consists of debt to housing corporations.

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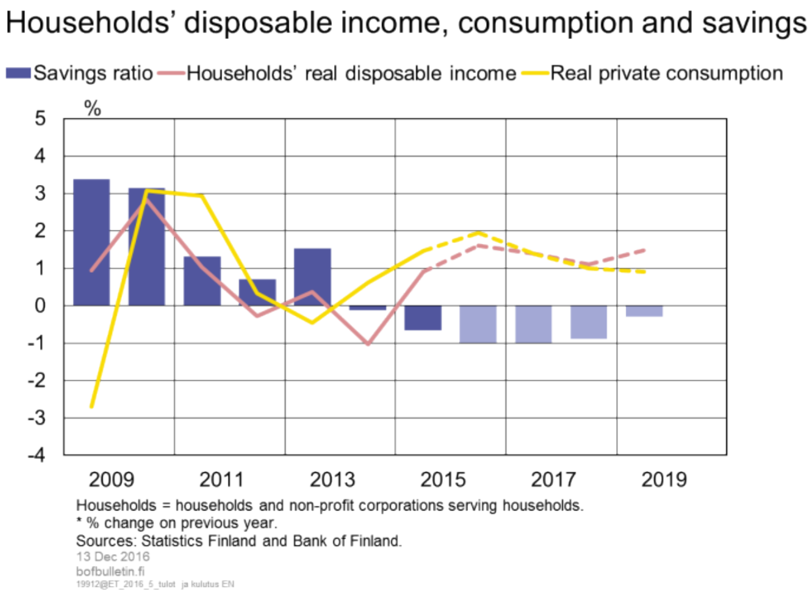
1. According to a sample survey conducted by the FIN-FSA, annuity loans accounted for 46% of new housing loans in 2012, against 40% in 2010. The data of the sample survey comprised housing loan awards made in the course of three days.

Internal migration will continue in the forecast years, and regional differences in house prices will increase further in response. House price rises will also be constrained by slower growth in household income and an increased supply of housing.

Chart 3.

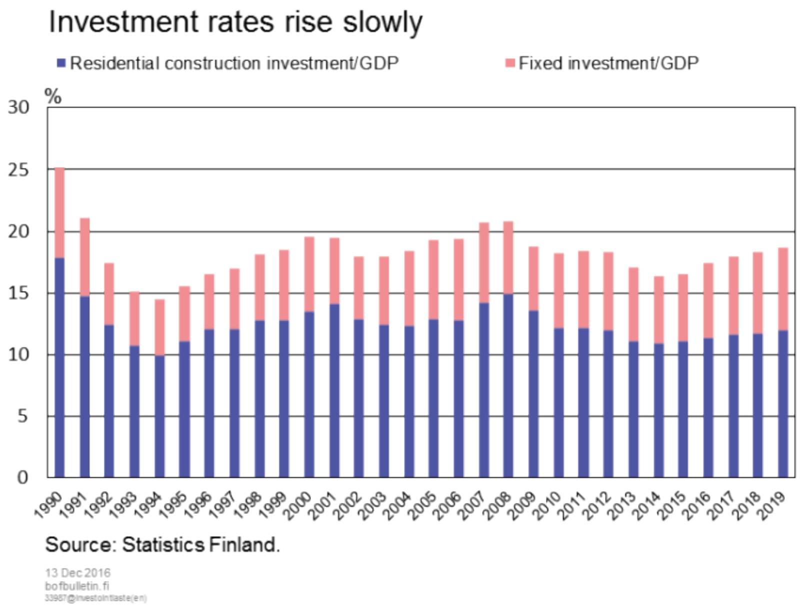


Non-financial corporations: Investments recovering and construction rising from the ashes

A severe contraction in private investment lasting several years ended in 2015, and an upturn in investment began to show. The 2016 growth in private investment has been driven particularly by a recovery in construction. The period of highest investment growth will occur in 2016–2017. In the second half of the forecast period, the growth rate will level out. The GDP share of productive investment will remain lower than usual.

Despite the recent upturn, private investment remains very modest. As a result of several years of investment recession, investments are nearly 6% lower than in 2011. In addition, private investment has declined much more than GDP, which has led to a drop in the total investment ratio (Chart 4). Private investment can be divided into residential construction investment and productive investment. Productive investment's share of GDP has decreased particularly significantly. The growth in total private capital stock will remain subdued in the forecast period.

Chart 4.

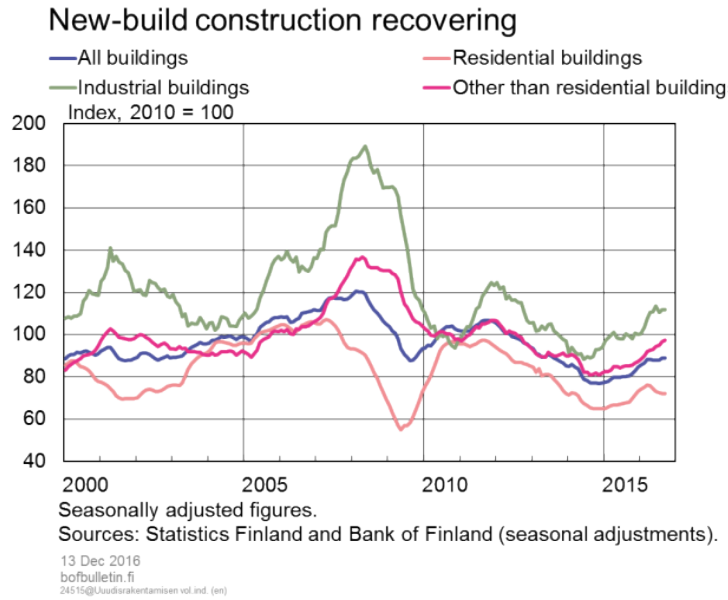


New-build construction has returned to rapid growth after a long period of decline (Chart 5). The number of residential building permits granted started to grow already towards the end of 2015, which shows in the increased residential construction in 2016.

Several factors have favoured the recovery in construction. Labour market recovery and migration to growth centres have supported residential construction. Low interest rates and availability of funding have strengthened the investment environment, and household confidence has also improved. Moreover, the extensive programme for renovation of old residential buildings will sustain investment in the future, too.

The growth in residential construction investment will peter out towards the end of the forecast period. The fastest growth will be at the beginning of the forecast period as investment growth takes off from a low level. Despite slowing growth, residential investment relative to GDP is considerable (Chart 4). There is a risk that the willingness to invest in new housing will cool faster than expected. New-build production may fade rapidly if sales of completed housing do not develop as expected.

Chart 5.



Productive investment, such as industrial investment in machinery and equipment and investment in infrastructure, began to grow in 2015 after several years of contraction.

The growth in productive investment will continue in 2017–2019. Productive investment is supported by, among other things, increased industrial capacity utilisation, low interest rates and good availability of funding. Corporate investment is also favoured by the Competitiveness Pact agreed by the social partners and the resulting improved competitiveness. The recovery in exports will raise investment needs. In addition, there are still several significant major individual investment projects currently underway.

In general, confidence has improved slightly in the corporate sector, and in some areas expectations have risen at a rate a little above average. However, expectations of industrial production are still modest in spite of a small improvement. In a questionnaire addressed to non-financial corporations, funding was not seen as a general obstacle to growth.

The profitability of non-financial corporations measured against operating surplus has been weak since the financial crisis (see also 'Winners and losers in industrial profitability'). Corporate profits' share of national income has decreased. In general, economic growth and cuts in employers' social security contributions will improve non-financial corporations' operating surplus.

Foreign trade: Improved competitiveness will strengthen exports

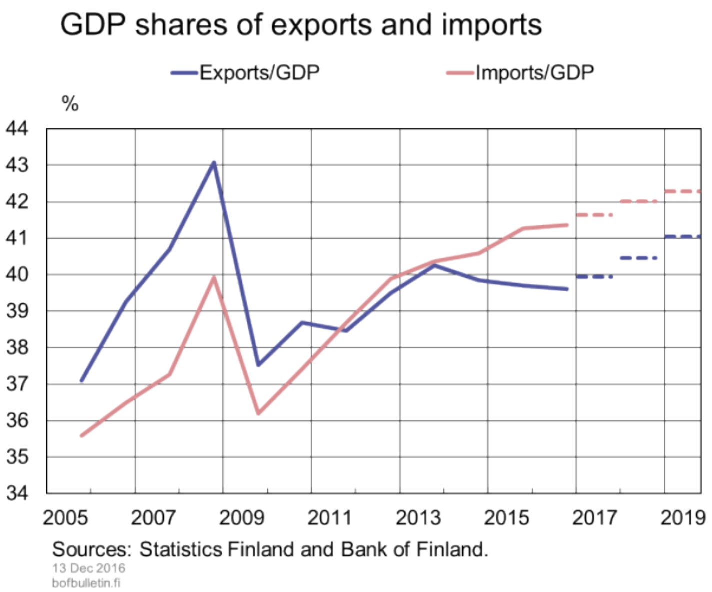
Finnish exports are expected to return to gentle growth after several weak years. In 2016, exports will grow at a rate below 1%, but in 2017–2019 they will notably pick up in line with improved competitiveness and strengthened foreign demand.

In recent years, total Finnish exports have not grown as expected, lagging behind the trend in the export markets. Reduced industrial capacity combined with problems caused by deteriorated cost-competitiveness have kept export growth extremely modest. At the same time, low global investment and uncertainties in the international economy have eroded the export prospects.

Despite lagging total exports, many industries and companies have been able to increase their own exports. Exports of transport equipment, among other things, have picked up in recent years. The downward trend in electrical engineering and electronics seems to be levelling out, but a clear growth is so far hard to distinguish. Although services exports have been growing in the past few years, they are still at the level of 2010 and have not been able to turn around the fragile export performance of recent years. SMEs have lately succeeded better than large companies in increasing their exports, but their share of total exports is much smaller.

Foreign trade still accounts for a very significant share of total output, even if exports have clearly decreased from the peak years. The GDP share of exports increased through the 2000s up to 2008, when it peaked at around 45%. Industrial restructuring, weak global demand for capital goods and competitiveness problems thereafter lowered the share below 40%, after which it has been stable around 40% since 2013. In contrast, the GDP share of imports has continued to grow steadily since 2013, as domestic demand has boosted imports and domestic production has increasingly been replaced by imports (Chart 6).

Chart 6.

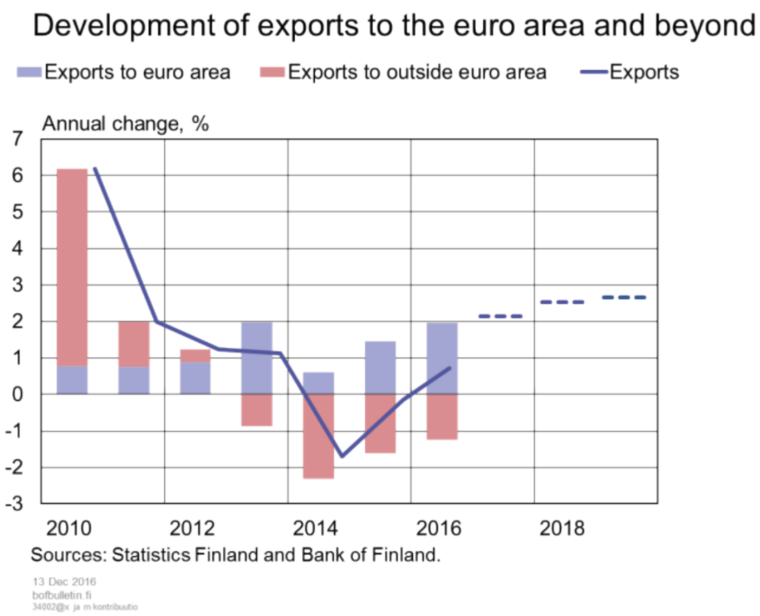


However, the contraction of exports in recent years is expected to end in 2016 and turn into growth over the next few years. The growth in exports will be spurred by the improved cost-competitiveness brought by the Competitiveness Pact, while global investment is also expected to keep growing. The accommodative monetary policy will sustain increased euro area investments and strengthen Finnish exports. In the next few years, domestic investment will increase export capacity and the preconditions for export growth. In line with the hike in the price of crude oil, a gradual improvement in the Russian economy is also expected.

In Finland, the significance of foreign trade will grow in the next few years. At the same time, the euro area has become an increasingly important export market. Exports' share of total output will gradually increase in the next few years as exports grow faster than GDP.

In 2016, export growth will be below 1% due to the weak early part of the year, but in 2017 it will to accelerate to more than 2%. Export growth will continue to rise in 2018, and at the end of the forecast period will be nearly 3% (Chart 7). However, Finland's most important export markets and global trade will still grow faster than Finnish exports.

Chart 7.

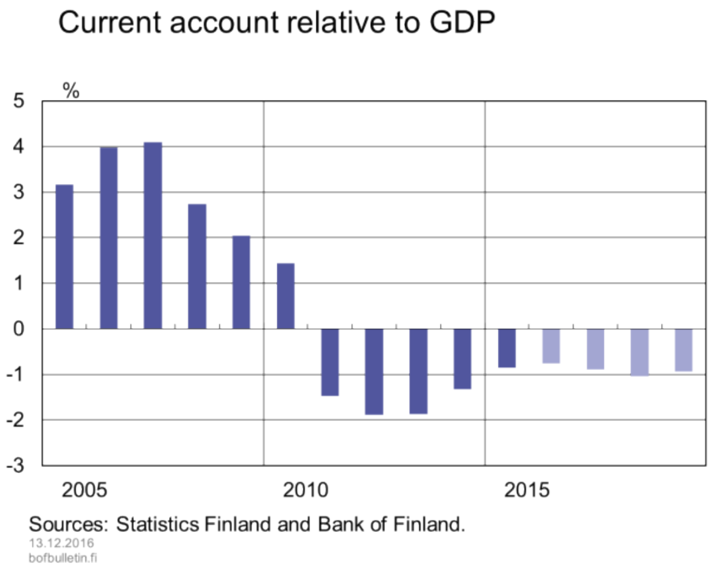


Given the significant import content of exports, the growth of imports will also pick up and their GDP share will keep growing in the forecast period (Chart 6). Import growth will, however, be lower than export growth, as contracted growth in real household incomes will dampen growth in private consumption. There will also be a slowdown in investment growth, which will reduce imports. In addition, imports will be dampened by a higher rise in import prices than in domestic prices. Imports will become increasingly expensive in relative terms, and therefore replaced by domestic production. Net exports will strengthen, but in 2019 will still be substantially negative.

The current account will remain in deficit throughout the forecast period 2016–2019. The steeper rise in import prices than in exports will weigh on the current account in the near future. As the Competitiveness Pact depresses the pace of domestic price rises, the rise in export prices will also be more modest. The current account has been showing a deficit since 2011, and in 2015 the deficit was below, but close to, EUR 1 billion (Chart 8).

In 2017–2018, the current account deficit will deepen, but the increased value of exports will gradually reduce the deficit. However, it will still be more than EUR 2 billion in 2019.

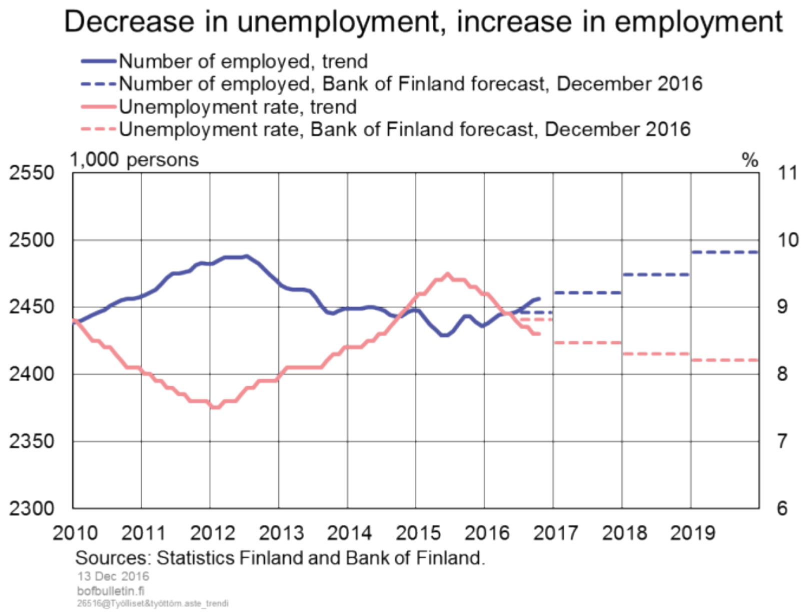
Chart 8.



Labour market: Long-term unemployment slowing general recovery in employment

The improvement in the labour market situation in Finland has been reflected in a rapid decline in unemployment, but the labour market recovery is slowed by structural problems. The unemployment rate has dropped in the past year or so by nearly one percentage point, to around 8.7%, but the improvement in employment has been more difficult. According to the forecast, the number of employed will increase by some 2.2% in 2016-2019 and the employment rate will rise to 70.2%. The unemployment rate will remain close to 8.2% in 2019. The labour force (15–74-year-olds) will grow slightly in the forecast period (Chart 9).

Chart 9.



Domestic demand has supported employment significantly. New jobs have been created in the rapidly-growing construction sector, but also in services and trade. The continued weakness of exports has been reflected in the low level of employment in manufacturing.

As a result of population ageing, the number of employed among 15–64-year olds has not increased as much as suggested by the decline in unemployment. By the third quarter of 2016, the number of unemployed had decreased by 20,000 persons, following the peak in the second quarter of 2015, but the number of people employed had only increased by 15,000 persons. On the other hand, during the same period, 12,000 persons exited the working-age population, and therefore the number of new employed has increased more than suggested based merely on net growth in employment. This trend will continue in the forecast period and shows that employment growth is challenging in a situation in which labour supply is constrained by population ageing.

The decrease in the unemployment rate is, however, partly illusory, and the structure of unemployment has weakened. Unemployment, as measured by the Ministry of Economic Affairs and Employment and including all unemployed persons who receive unemployment benefits, has increased more strongly since 2012 and has not decreased at the same pace as unemployment as measured by the Labour Force Survey of Statistics Finland and including only those unemployed persons who are actively seeking work. This reflects an increase in the number of unemployed who have given up job seeking (Chart 10). The number of long-term unemployed and persons in hidden unemployment is therefore already very high (Chart 11).

Chart 10.

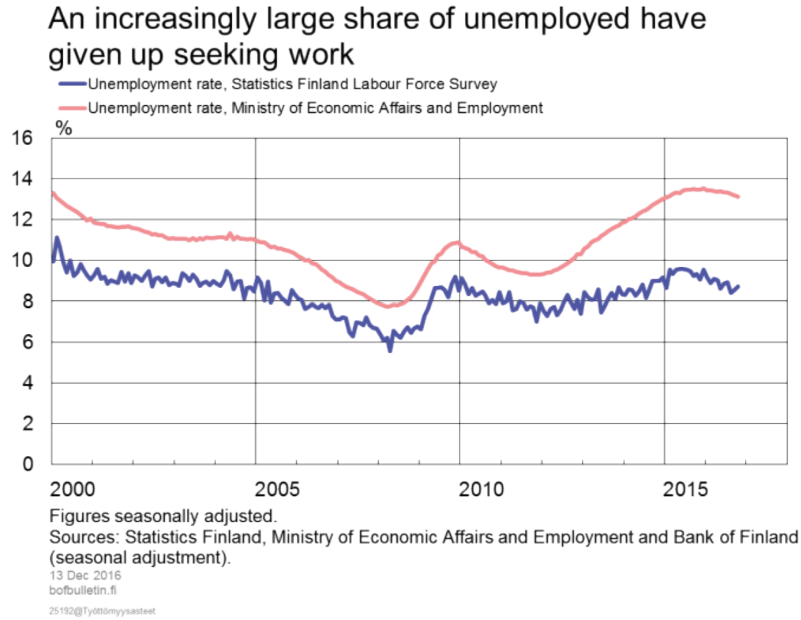
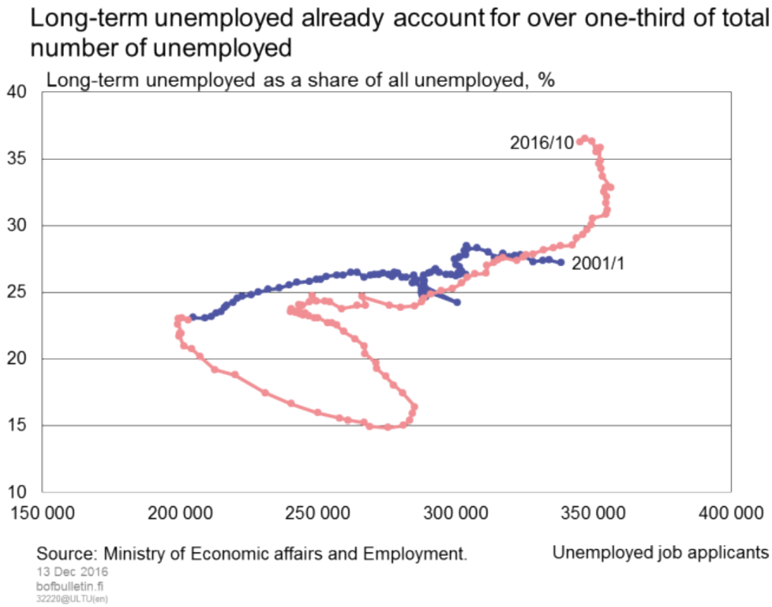


Chart 11.



During the forecast period, improvements in the labour market situation will be subject to both favourable and unfavourable influences. Developments in labour-intensive industries will have a positive impact on the trend in employment, as economic growth will be based on improvements in private consumption as well as dynamic developments in private investment, particularly construction, early in the forecast period.

The Competitiveness Pact concluded by the social partners is expected to have a positive impact on employment during the forecast period. Lower labour costs will strengthen demand for labour, and a decrease in unit labour costs will boost growth in investment, exports and GDP. Tax cuts on earned income will have a positive impact on labour supply. For employment dynamics, the other positive signs are the strengthening of employment expectations in the corporate sector and a significant increase in job vacancies.

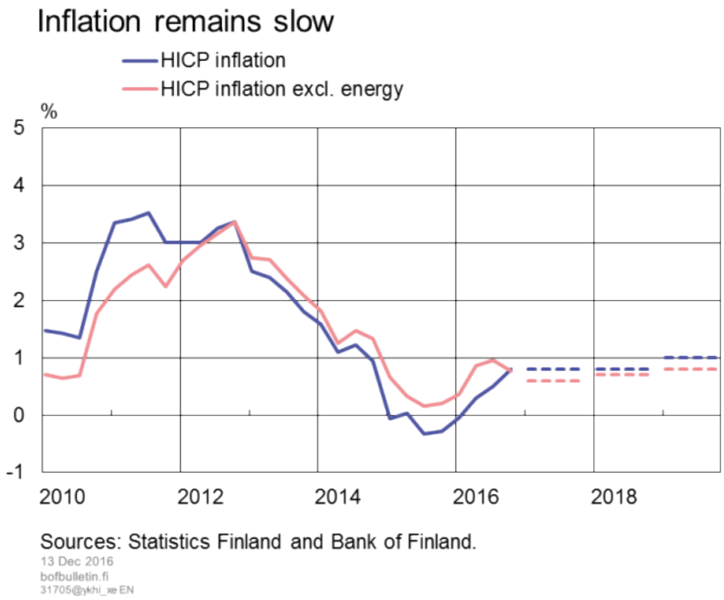
Already over one third of unemployed people have been out of work for more than 12 months. Based on the definition by the Ministry of Economic Affairs and Employment, nearly two thirds of unemployed jobseekers are hard to employ. Particularly for young adults, labour market developments have been weak, and the number of young persons at risk of social exclusion has grown. There is a risk that the Finnish labour market will be characterised by a permanently higher level of unemployment and that the number of persons exiting the labour market will increase.

The high level of long-term unemployment reflects the mismatch and incentive problems on the labour market. In addition to problems of occupational mismatch, the process of reducing unemployment is also slowed by problems of regional mismatch that are affected by e.g. the functioning of the housing market. Employment growth will be constrained by the continued contraction in the working-age population. The high level of long-term unemployment and contraction in the working-age population may in future form a significant bottleneck for economic recovery (see also 'Long-term growth from a productivity and employment perspective').

Wages and prices: Wages and prices will rise slowly

Inflation will remain exceptionally slow in 2017–2019, due to moderate developments in costs. Inflation according to the harmonised index of consumer prices (HICP inflation) will be just 0.4% in 2016, but will rise to 0.8% in 2017, as the impact of the decline in crude oil prices fades (Chart 12). According to Bank of Finland estimates, inflation developments in 2016 would have been significantly weaker still without the impact of non-standard monetary policy measures (ECB's extended asset purchase programme has significantly bolstered Finnish growth). Labour costs will decline, dampening inflationary pressures particularly towards the end of the forecast period. Inflation will be 0.8% in 2018, rising to 1.0% in 2019.

Chart 12.



The fading of the base effect from the decline in crude oil and other commodity prices will fuel inflation in early 2017, but inflation (excl. energy prices) will still be slower than normal in the forecast period. It will be dampened by the Competitiveness Pact, which will reduce wage cost pressures. The net impact on the HICP of changes in indirect taxes will be close to zero, as the removal of excise duties on sweets at the start of 2017 will slow the rise in food prices at the same time as taxes on tobacco products and energy are tightened. The pace of increase in rents will slow further during the forecast period, but the rise in the prices of housing-related services will continue to fuel inflation in the future. The hikes in customer fees on social and welfare services will drive inflation, depending on how extensively the municipalities use the possibility to increase their maximum fees.

Consumer prices will rise in Finland at a slower pace than in the euro area in the forecast period, as economic growth, too, will be more subdued than in the other countries and competitiveness measures will curb price rises. This will shrink the difference in price levels relative to the euro area. In 2014, Finland was still the most expensive country in the euro area, but was in 2015 overtaken by Ireland. In recent years, domestic prices have risen relative to the other euro area countries, due to higher rents and tighter indirect taxes as well as administrative fees. Prices set directly by the authorities, as well as prices on which the government has a significant impact, have risen at a higher pace than other consumer prices (Chart 13).

Chart 13.

Inflation will also be exceptionally slow in 2019, as the decline in labour costs will be reflected in consumer prices with a lag. Due to sluggish economic growth, the output gap will close slowly, but despite its downward trend, unemployment will still be notably high at the end of the forecast period, which will dampen upward pressures on wages, as well as inflation expectations.

Earnings growth will be sluggish in the immediate years ahead. In 2016, nominal earnings will grow by just over 1%. Growth in earnings is determined by the Pact for Employment and Growth concluded earlier by the social partners and based on which the pay rise is some ½%. Growth in earnings will slow temporarily in 2017, because, in accordance with the Competitiveness Pact, the social partners will refrain from negotiated pay rises in 2017. Growth in average hourly wages based on the wage bill will slow in 2017 close to zero, as the rise in hourly wages will be curbed by zero level pay rises as well as longer working hours.

Despite the moderate negotiated pay rises, earnings will improve in real terms in 2016, because the rate of increase in prices will remain lower than normal. In 2017, average hourly earnings will decrease slightly in real terms. For 2018 and 2019, nominal earnings are expected to grow in line with the combined effect of higher productivity and increasing output prices. This assumption is in line with balanced developments on the labour market, where real wages follow productivity growth across the economy as a whole.

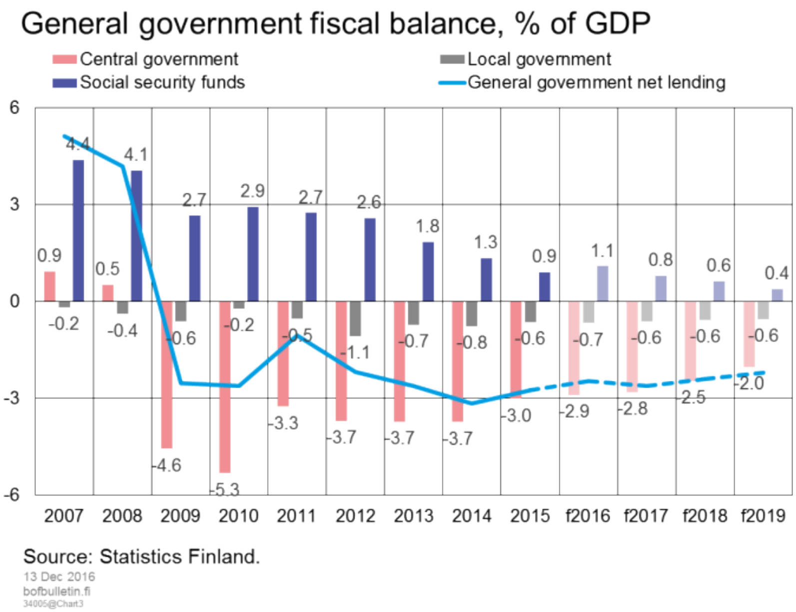
Cost-competitiveness, as measured by nominal unit labour costs, will improve during the forecast years relative to the euro area, as a result of a significantly slower rate of increase in compensation per employee in Finland compared with other euro area countries. In addition to the moderate increase in the wage bill, growth in labour costs will be dampened by significant cuts in employers' social security contributions, in accordance with the Competitiveness Pact. Nominal unit labour costs will decrease in Finland by a full 1% in 2017, whereas in the euro area as a whole they will increase by 1% per annum over the same period, according to the European Central Bank's December 2016 forecast. Productivity will grow at a very subdued pace both in Finland and in the other euro area countries. Annual productivity growth will remain close to ½% throughout the forecast period. Due to structural changes in the economy, the improvements in productivity will be modest in historical terms.

Public finances: Fiscal policy supports growth

The outlook for the public finances for 2016–2019 is particularly affected by adjustments in government expenditure and the Competitiveness Pact. As a counterbalance to savings, the Government will allocate an additional EUR 1.6 billion to key government projects in 2016–2018. In addition, immigration-related expenditure will grow markedly in 2016, as expenditure relating to asylum seekers is expected to increase to 0.3% of GDP. Therefore, fiscal policy is almost neutral in 2016, in contrast to the notable tightening in 2015. Fiscal policy will ease in 2017, with the implementation of the cuts in taxes and social security contributions decided in connection with the Competitiveness Pact. As a result of these measures, the total tax ratio will decline to 43.7% in 2017.

The Competitiveness Pact's temporary 30% reduction in public sector holiday bonuses and 24-hour extension in annual working time will generate savings that will partly finance the gap in general government revenues. The Competitiveness Pact will strain public finances in the short term by an estimated EUR 1.2 billion in net terms. In the longer term, the impact of the Competitiveness Pact on public finances may be neutral, should it increase employment as envisaged. In 2019, fiscal policy will, for its part, tighten somewhat as the financing of key government projects comes to an end. As a result, the central government deficit will decline to 2% of GDP (Chart 14).

Chart 14.



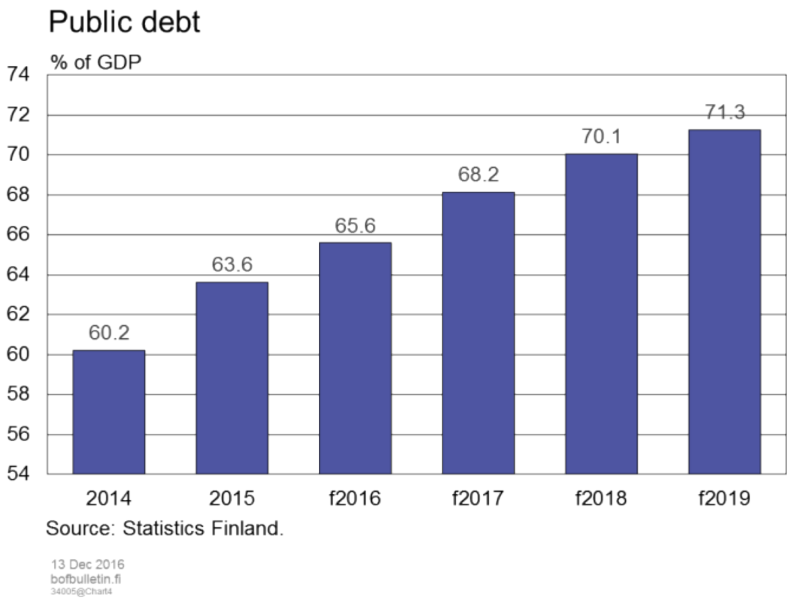
The local government deficit will remain almost unchanged at around 0.6% during the forecast years 2016–2019. Growth in local government expenditure has slowed over the past two years, and the subdued trend is projected to continue. Local government finances will gain from the Competitiveness Pact's cuts in public sector holiday bonuses and the working-time extension, but the tax reductions included in the Pact will reduce local government revenues. Central government will take account of these effects in deciding on local government transfers, and so the impact of the Competitiveness Pact on local government finances will be relatively neutral. A considerable change for local government will be the social and health service (SOTE) reform to be launched towards the end of the forecast period, which will transfer these services away from municipalities and cut municipal tax rates by 12.3 percentage points. Local government social and health care investments have been limited by law already since summer 2016, and after the SOTE reform increases in municipal taxes will be temporarily restricted to 0.5 of a percentage point per annum. This forecast does not include an assessment of the direct effects of the SOTE reform.

The surplus on the earnings-related pension funds will decrease in the years ahead on the back of a continued rapid growth in pension expenditure. This will grow from 2015 to 2019 by about EUR 4 billion, which is roughly equal in size to the fiscal adjustment measures planned by the Government. This shows how difficult it is to take measures to improve the budget balance at the level of general government as a whole in an environment of rapid population ageing. Pension insurance contributions will be increased in 2017 in accordance with the pension reform agreement, while the financial burden will increasingly be shifted from employers to employees in 2017–2020.

The budgets of other social security funds will move closer to balance. The national pension index fell in 2016, and this was allowed to affect index-linked benefits. In 2017, the index will be cut by 0.85%, because the freezing of index increases decided on earlier is not expected to bring about the targeted savings in an environment of subdued inflation. The index cut will impact on e.g. national pensions, guarantee pensions, labour market subsidies and child allowances. The increase in unemployment insurance contributions in 2016 will strengthen the unemployment insurance fund's budgetary balance. The burden of unemployment insurance contributions will also shift towards employees in 2017–2018. Without government compensation, lowering the employers' health insurance contribution in accordance with the Competitiveness Pact in 2017–2019 would create a gap in the health insurance fund's income. Health insurance expenditure will also contract, due to the savings measures that entered into force at the beginning of 2016, such as patients' increased personal responsibility for the costs of medicines.

Finland's general government debt grew to 63.6% of GDP in 2015 (Chart 15). The consolidated general government debt, calculated by deducting liabilities between general government sub-sectors from the gross debt, was higher than previously estimated, since the earnings-related pension funds reduced their investments in government bonds. The improved coverage of debt statistics also contributed slightly to the rise in the consolidated gross debt. The debt will continue to grow at a rapid pace in 2016–2019, and in 2019 the debt ratio will already exceed 71%, reaching the peak levels of the 1940s and the 1990s. The level of public debt is affected by sales of central government assets, which are planned to be increased in 2017. The proceeds from these sales have not been taken into account in the forecast.

Chart 15.



Risk assessment: Uncertainty over global economy also affects Finland

The Finnish economy has returned to growth. For the immediate years ahead, however, there is a considerable risk that developments will be more unfavourable than expected. Uncertainty surrounding the global economy has grown exceptionally high, and economic growth in Finland will continue to rest mainly on domestic demand.

The United Kingdom's Brexit decision is reflected in the forecast as weakening growth prospects in both the United Kingdom and other EU countries. However, estimates of the effects of Brexit are still subject to a high degree of uncertainty, particularly in the medium term. If the exit negotiations turn out to be longer and more difficult than anticipated, the impacts on trade, investments and corporate confidence in EU countries may be more negative than expected.

Growth in the euro area may also be dampened by internal problems, especially in the event of an exacerbation of banking sector difficulties. The concentration of the Nordic banking sector and its large size relative to the Nordic economies amplifies the risks of the banks operating in Finland. In particular, overheating on the Swedish housing market also amplifies the macroeconomic risks for Finland. These risks are discussed in more detail in the financial stability assessment (Financial stability assessment: Finland alerted to household debt).

Political uncertainties have also increased outside Europe. The outcome of the US presidential election increases the probability of a rise in protectionism and a moderation of world trade growth over the medium term. Unexpected changes in the direction of US fiscal policy may be quickly reflected on the foreign exchange and sovereign bond markets. In particular, faster-than-expected debt accumulation and higher inflation in the United States may push up interest rates on sovereign bonds further, also outside the United States.

Geopolitical uncertainty increases the risks of oil supply shortages which, if realised, could lead to a considerable rise in oil prices. On the other hand, markedly higher oil prices would boost recovery in the Russian economy and stimulate Finnish exports to Russia.

The risk of slower economic growth in China has increased further. Private real investment has continued to grow at a subdued pace, and investment growth hinges increasingly on the Chinese government. At the same time, high corporate indebtedness has increased the vulnerability of the Chinese financial sector.

The alternative scenario estimates the effects of the realisation of these global economic risks on the Finnish economy. According to our calculation, halving the growth rate of Finnish export markets from the assumed 4% to 2% would cut GDP by about 1.2% in cumulative terms during the forecast period. This means that government revenue and expenditure would require a total adjustment of around EUR 1.5 billion in 2018 and 2019 for growth in the government debt-to-GDP ratio to remain at the same level as in the baseline scenario.

Order books and investments have developed more favourably than expected in recent months in certain export industries, such as the car, shipbuilding and forest industries. Despite these individual positive signs, Finnish economic growth will continue to rest mainly on domestic demand during the forecast period.

The effects of the Competitiveness Pact may turn out to be temporary and smaller than expected. Inflation expectations in the euro area will remain low, which may lead to moderate wage increase demands in other euro area countries, too. In addition, it is possible that, after the current wage settlement period ending in 2018, wage and salary earners in Finland will require compensation for previous years' low pay rises.

On the other hand, the effects of the Competitiveness Pact may turn out to be more positive than expected. Low wage increases may pass through to product prices more strongly than expected and, in addition, export demand may respond to improved competitiveness more quickly than expected. The effects of the Competitiveness Pact may be greater than expected in the domestic market, too. This would rapidly improve employment, particularly in labour-intensive service sectors.

As for domestic demand, housing construction is fairly cyclical by nature, and new housing starts can decline rapidly if the demand for new housing does not meet the increased supply. At present, the demand for new housing is mainly concentrated on the Helsinki area and other growth centres, and the majority of the demand is investor demand focused on new rental housing.

If the pick-up in economic growth remains temporary or weaker than expected, this would also be quickly reflected in central and local government finances. In such a case, stabilisation of the public finances may be significantly delayed without additional adjustment measures.

The household savings ratio will remain slightly negative through the forecast years 2017–2019. Even if further household debt accumulation relative to disposable income moderates, the level of debt will remain at a record high. Backed by the low level of interest rates, the price of owner occupation relative to rented occupation has declined, the housing market has picked up and the number of new housing loans has increased.

Some new housing loans, particularly loans for first-time buyers, have been quite large relative to housing values. Large housing loans relative to housing values (i.e. a small self-financing share) increases the risks relating to falling house prices. At the same time, house price developments have begun to diverge regionally, and housing in declining regions, in particular, has lost value. A fall in house prices could particularly reduce consumption by heavily indebted households with a weak net financial position.

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