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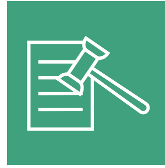


EDITORIAL

Conditions for sustainable economic growth must be ensured

16 Dec 2022 – Editorial – Finnish economy

Economic policy in the past few years has responded to the COVID-19 pandemic and then Russia's war in Ukraine. These crisis years have demonstrated the importance of maintaining sufficient fiscal space. The swift and robust monetary and fiscal policy measures taken helped avoid a wave of bankruptcies while also supporting the favourable trend in employment and preventing a substantial contraction in household incomes.

The downside is that Finland's general government debt ratio has grown significantly. The Bank of Finland estimates that the country's public debt this year amounts to about 72% of gross domestic product (GDP), and that the debt ratio will continue to grow in the coming years unless corrective measures are taken.

Even before the pandemic, there was a significant structural problem in Finland's public finances. The Bank of Finland's latest estimate of the sustainability gap is approximately EUR 13 billion, or 4% of GDP. The effects of the sustainability gap are already visible as a

deterioration in key public services.

During the pandemic, Finland's general government debt ratio grew significantly more than that of Sweden or Denmark. Finland's debt ratio is considerably above the level in other Nordic countries, but the difference is not explained solely by the pandemic. Unlike the other Nordic countries, the general government debt ratio in Finland has grown for nearly 15 years.

In Finland, economic policy now has to focus simultaneously on resolving both short and longer range problems of major significance. The most important short-term goal is to bring down the exceptionally high level of inflation. Higher energy prices are the main factor behind the surge in inflation, but the rise in prices has broadened out to almost all goods and services.

The European Central Bank's monetary policy is aimed at efficiently reducing inflationary pressures and keeping inflation expectations anchored. By tightening monetary policy, the ECB aims to avoid the emergence of a detrimental upward spiral in consumer prices and wages.

The Governing Council of the ECB has raised key interest rates to stabilise inflation at its 2% target over the medium term. The key interest rates were raised by half a percentage point in July, by a 0.75 percentage points in September and October and by a further half percentage point in December. Interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to our two per cent medium-term target.

Fiscal policy can support the achievement of the inflation target if it refrains from fiscal measures that would boost aggregate demand. The near term is shrouded in uncertainty, but when supply factors constrain the economy, expansionary fiscal policy does not support economic growth or employment but, rather, will lead to a rise in prices and costs.

The scale of support measures taken in Finland to tackle the energy crisis has been moderate by international comparison. The risk, however, is that these measures will raise the wholesale price of electricity and prove costly to the public finances, and without a respective benefit to households. If the support measures will need to be continued, they should be targeted more precisely at the most vulnerable households, while also ensuring that incentives for saving energy are retained.

After the crises it will be important to build confidence in fiscal sustainability and to strengthen the conditions for sustainable economic growth. The public finances must be strengthened to ensure the financing of increasing levels of age-related expenditure. Safeguarding key services will require prioritizing needs and goals and ensuring a comprehensive knowledge base to support the decision-making on these matters.

The aim should be longer term debt sustainability, and to achieve this a coherent economic adjustment programme should be drawn up stretching over several government terms. This will allow to avoid sudden tightening later on, and economic policy will help support a stable and predictable operating environment.

It is vital to build a strong political commitment to fiscal sustainability and to the resolute implementation of the measures this calls for. The spending limits procedure or other fiscal rules are not intended to take away from democratically elected decision-makers any power to determine fiscal policy, but instead to support the ability of the political system to function and to increase transparency.

Besides debt sustainability, we must also ensure the conditions are in place for sustainable economic growth. The development of Finland's economy has historically been based largely on the expansion of its education system and the general increase in the level of education.

It is therefore concerning that the rise in young age cohorts' education levels has halted, and those born in the late 1970s remain for the time being the most highly educated generation. The emphasis in investment has been on the building stock rather than on investing in areas that enhance productivity. Population ageing is also weighing on the longer term growth outlook for the Finnish economy. If current trends continue, there is a risk than the stock of human capital in Finland will begin to decline in the 2040s.

However, this development can be influenced by investing in education and training and in research and innovation activities. Recruitment of more international experts through an increase in work-based immigration of skilled workers would also help boost human capital. Particular attention should be given to improving the opportunities for those foreign students who are taking higher education degrees in Finland to stay on and use their expertise to the benefit of Finnish society.

***

As a consequence of Russia's brutal war in Ukraine and the energy crisis created along with it, the security policy environment and economic environment of Europe and Finland are currently going through a very tough transition. The rise in energy prices has dramatically reduced living standards. Inflation has become more broad-based and next year's economic outlook is marked by uncertainty. In Finland, the working-age population is shrinking and the outlook for labour productivity is dampened by the fact that the rise in the average educational attainment of the population has levelled off.

In Europe and Finland, economic policy must now seek to resolutely and simultaneously resolve both the short-range inflation problem and longer range structural problems. By tightening monetary policy, the risk of a detrimental wage-price spiral will be reduced and inflation will be stabilised at its target of 2% over the medium term. Long-term growth prospects must be supported by investing in education, by supporting the creation, adaptation and diffusion of innovations, and by improving the scope for work-based and education-based immigration.

Helsinki, 15 December 2022

Olli Rehn
Governor of the Bank of Finland

Tags

economic policy, Ukraine, public finances, energy crisis, inflation, public debt, monetary policy

SIMPLY SHORT

Finnish economy set to slide briefly into recession

16 Dec 2022 – Simply Short – Finnish economy

Rising electricity and fuel prices have accelerated the increase in other prices. The resulting high level of inflation is weakening consumers' purchasing power and general confidence in the economy. The energy crisis will push the Finnish economy into a mild recession in 2023, but this will be short-lived. Energy prices will gradually fall, and in 2024 the economy will return to growth. In the country's public finances, spending will continue to exceed revenues.

Growth will stall temporarily due to Ukraine war and energy crisis Households will be under pressure as inflation broadens out
Public finances will remain in deficit

Economic growth picked up globally in the early part of 2022, when COVID-19 restrictions were removed and the pandemic began to fade from the spotlight. Finland's economy, too, grew briskly throughout the first half of the year. Growth then stalled again due to Russia's invasion of Ukraine. Consumers and businesses are now behaving cautiously.

The war in Ukraine has led to reduced availability of energy, and this has driven up electricity and fuel prices considerably. Businesses have responded to rising costs by raising their own prices, but consumers' incomes have not kept pace with this. The purchasing power of their incomes has weakened, despite income growth in a still favourable employment situation. A lot of new staff have been hired in the service sectors in particular. Businesses in many industries are experiencing a shortage of skilled staff, and many employers are therefore particularly keen to retain employees.

In the Bank of Finland forecast, the output of the Finnish economy in 2023 will fall below the figure for 2022, and the general rise in prices, or inflation, will remain high. Employment will no longer be growing, and consumption of goods and services in the economy will be held back by inflation. The elevated cost of living will be felt most by households that have few savings to rely on. Businesses will be cautious in their investment decisions due to the substantial uncertainty about the economic outlook. House building will also see a decline in the immediate years ahead.

Chart 1.

The forecast indicates that the recession will, however, be milder than during the pandemic in 2020, when Finland's economy came to a sudden standstill. The rise in energy prices will be halted in 2023 as energy imports from Russia are replaced with energy from other sources. Raw material and component shortages will subside further, and disruptions in the international transport of goods will continue to ease. In 2024, the Finnish economy will return to growth.

The European Central Bank has raised interest rates during the autumn. Interest on loan repayments is therefore taking a larger slice of family income for those households with outstanding loans. Higher interest rates will nevertheless help in tackling inflation, and in 2024–2025 inflation is expected to have been brought down to around 2%. This will

be accompanied by an increase in consumers' purchasing power and a decrease in economic uncertainty, giving a boost to consumption and economic recovery.

Central and local government expenditure will exceed revenues in all years of the forecast, and this deficit in the public finances will be met by borrowing. Over the next few years there will be additional central government expenditure arising from the need to strengthen the country's security of supply and national security, and the Defence Forces' purchase of new fighter aircraft. Population ageing will mean that health and social services expenditure will continue to rise for many years to come.

The pandemic and the war in Ukraine have demonstrated that the emergence of a crisis brings additional government expenditure needs. There has to be room for manoeuvre in the economy to allow for such contingencies. But this will not be possible unless public spending is brought into line with revenues in normal times. Central and local government revenue and expenditure must once again be extensively reviewed.

READ FULL ARTICLE

FORECAST FOR THE FINNISH ECONOMY

Finnish economy set to slide into recession

Today – Forecast – Finnish economy

Growth in the Finnish economy for the full year 2022 will amount to 1.9%, following strong activity in the early part of the year. The high level of inflation has, however, eroded households' purchasing power, and consumer confidence has slumped to a very low level. In 2023, the economy will slide into a mild recession and real GDP will contract by 0.5% in response to the energy crisis exacerbated by Russia's war in Ukraine and the surge in the cost of living. The recession will, however, be fairly short-lived. Growth will rebound to 1.1% in 2024 as the headwinds to the economy subside. In 2025, Finnish real GDP will grow by 1.5%.

Russia's war in Ukraine, the energy crisis, the surge in inflation and rise in interest rates as a consequence are weakening the global economy, with the war and the energy crisis weighing on growth in Europe, in particular. Finnish export growth is hampered by the marked decline in economic growth in Finland's major export markets.

The stalling of Finland's economic growth and the decline in companies' employment expectations will also reverse the favourable situation on the labour market. Employment

growth will slow, causing a temporary rise in the unemployment rate. At the same time, the labour shortages will ease somewhat in cyclically sensitive industries. Employment will nonetheless remain good, given the brief duration of the recession and the structural nature of the labour shortage in many sectors.

Inflation has increased further in 2022. Higher energy and raw material prices and protracted supply chain disruptions have led to a widespread rise in consumer prices. The rise in the inflation rate will be slowed by a decline in the prices of crude oil and raw materials, but high electricity costs will keep price pressures high especially during the coming winter months. Some of the price pressures will spill over to food, consumer goods and services prices after a time lag. Inflation will slow to 5% in 2023, following the easing of supply chain bottlenecks, the feed-through of monetary policy tightening to the economy and the weakening of domestic demand.

Private consumption will decrease in 2023 in response to the weak development of purchasing power. Nominal earnings growth has clearly fallen below the rate of inflation, and there is consequently an exceptional decline in real earnings this year. Due to the high level of inflation, the European Central Bank has raised its policy rates, which is depressing private consumption. However, some households are able to resort to savings accumulated during the COVID-19 pandemic. Disposable nominal income will improve because employment remains stable and earnings growth is positive. Purchasing power – and by extension private consumption – will gradually start to revive from next year onwards, as inflation slows down.

Deteriorating cyclical conditions, uncertainty about the economic outlook and higher financing costs will also start to show in private investment, which will contract in 2023. Housing construction will decline markedly. Households and residential property investors have little appetite to borrow. The launch of construction projects will also be slowed by the rapid rise in construction costs.

The public finances will remain in deficit. While the general government deficit-to-GDP ratio will still improve in 2022, from 2023 onwards public spending will grow faster than revenues, and the ratio will start to rise again. The public debt-to-GDP ratio will decline slightly in both 2022 and 2023 as, due to the general increase in prices, nominal GDP growth will be faster than growth in public spending. The debt ratio will begin rising again considerably from 2024 onwards and will reach almost 75% by the end of 2025.

The risks surrounding the forecast are on the downside. The outlook in Finland’s export markets continues to be uncertain due to the war in Ukraine. In Finland, if the period of high inflation is more protracted than foreseen, this may cut consumers' purchasing power and private consumption by more – and for longer – than projected, driving the economy into a deeper recession than expected.

Table 1. Key forecast outcomes (1/2)

Percentage change on the previous year						
	2020	2021	2022f	2023f	2024f	2025f
GDP	-2.2	3.0	1.9	-0.5	1.1	1.5
Private consumption	-4.0	3.7	2.4	-1.3	0.4	1.1
Public consumption	0.3	2.9	2.7	0.7	0.6	0.5
Fixed investment	-0.9	1.5	5.1	-1.2	0.4	4.2
Private fixed investment	-3.2	4.7	4.7	-2.0	-0.1	1.7
Public fixed investment	9.5	-11.5	7.2	2.4	2.5	14.7
Exports	-7.8	5.4	1.7	1.8	2.8	3.1
Imports	-6.2	6.0	8.6	-1.0	1.3	3.8
Effect of demand components on growth						
Domestic demand	-2.3	2.9	3.1	-0.8	0.4	1.6
Net exports	-0.7	-0.2	-2.7	1.3	0.7	-0.3
Changes in inventories and statistical error	0.7	0.3	1.5	-1.0	0.0	0.1

Savings rate, households, %	4.7	2.0	-1.2	0.3	0.4	0.3
Current account, % of GDP	0.7	0.6	-3.7	-0.8	0.4	-0.2

Key forecast outcomes (2/2)

	2020	2021	2022[f]	2023[f]	2024[f]	2025[f]
Labour market						
Number of hours worked	-2.5	3.2	1.0	-0.5	0.7	0.6
Number of employed	-2.0	2.6	2.6	-0.2	0.3	0.3
Unemployment rate, %	7.8	7.6	6.9	7.4	7.2	7.1
Unit labour costs	0.7	2.5	4.4	5.8	2.9	2.0
Labour compensation per employee	0.4	2.9	3.7	5.5	3.8	3.2
Productivity	-0.2	0.4	-0.7	-0.3	0.9	1.1
GDP, price index	1.5	2.5	5.8	4.8	2.4	1.8
Private consumption, price index	0.5	1.7	5.5	5.1	1.8	1.9
Harmonised index of consumer prices	0.4	2.1	7.2	5.0	1.6	1.7
Excl. Energy	0.8	1.3	4.7	4.4	2.3	2.1
Energy	-5.0	9.7	31.6	9.6	-3.9	-2.2

General government, % of GDP						
General government balance	-5.5	-2.7	-0.9	-1.8	-2.0	-2.6
General government gross debt (EDP)	74.8	72.4	72.2	71.9	73.2	74.9

[f] = forecast.

Sources: Bank of Finland and Statistics Finland.

Operating environment: Assumptions and financial markets

Russia's war in Ukraine, the energy crisis, the surge in inflation and rising interest rates

are weakening the global economy. Growth in the global economy will continue, however, and even strengthen in the longer term. There is still great uncertainty about the future outlook, particularly as the war in Europe and the uncertain path of the energy crisis are clouding the economic outlook. This economic forecast by the Bank of Finland is based on data available on 30 November 2022.

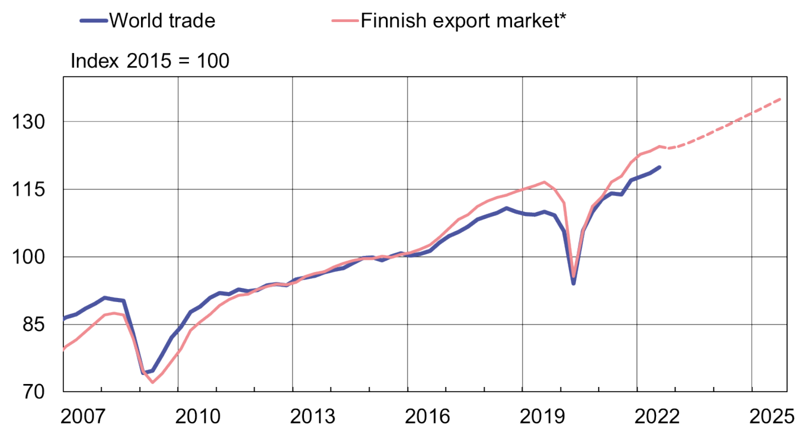
Global economic growth will slacken

The global economy is losing momentum as the end of 2022 approaches, with growth abating especially in the advanced economies in response to heightened uncertainty, the energy crisis, the surge in inflation and rising market rates. Russia's war in Ukraine is weighing on growth in the European economy, in particular.

World trade growth will slow markedly in 2023 (Table 2). At the same time, however, the supply chain disruptions in world trade will ease further, partly due to the decline in global demand. After the weak performance in the early part of the year, global trade is expected to pick up towards the end of 2023, and demand in Finland's export markets is likely to rebound in 2024 and 2025 (Chart 1, Table 2). Although the global economy will strengthen as 2024 nears, considerable downside risks remain.

Chart 1.

Demand for Finland's exports will increase after subdued start to 2023



Sources: CPB, Eurosystem and Bank of Finland.
*Imports in the countries Finland exports to, weighted by their share of Finland's exports. The dashed line represents the underlying forecast assumptions on growth in the export markets.

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Higher energy prices will push up production and import prices worldwide, driving up inflation. In addition, the depreciation of the euro against the US dollar will raise the euro-denominated prices of imported goods. Energy prices are assumed to gradually fall, in line with market expectations (Table 2), while the prices of other raw materials will remain close to their current levels. The forecast is based on the assumption that oil imports from Russia will end but gas imports continue, and some of the lost Russian gas will be replaced from other sources.[1]

1. The alternative scenario 'Household consumption could be hard hit in the energy crisis' examines a situation

Economic growth will decline substantially in Finland's main export markets, which will dampen the level of growth in Finnish exports and GDP. The growth outlook for both the euro area and the United States is weaker than earlier projected, while the Chinese economy is strained by problems in the real-estate markets and the continuation of the COVID-19 pandemic. The demand for Finland's exports is also adversely affected by the decline in trade with Russia.

Euro area growth will fall back due to the energy crisis exacerbated by the war, and the euro area economy will slide into a mild recession around the turn of the year.[2] Growth is being undermined not only by the energy crisis and high inflation but also by, for example, heightened uncertainty, tighter financing conditions and the cooling of the global economy. Furthermore, the favourable conditions for services sectors as a result of the fading concerns about the pandemic are starting to subside. In the longer term, economic growth will pick up as uncertainty dissipates, real wages improve and supply chain disruptions are eliminated.

Euro area inflation has broadened out and is projected to gradually moderate from 2023 onwards, coming down to a little over 2% in 2025. Inflation will slow in response to a fall in energy prices consistent with market expectations, the normalisation of ECB monetary policy and the easing of global bottlenecks. Euro area underlying inflation (excl. energy and food prices) is also projected to slow, but strong wage growth, among other things, will keep it a little above 2% still in 2025.

Rising interest rates are tightening financing conditions

In December 2022, the Governing Council of the European Central Bank (ECB) decided to raise interest rates by 50 basis points.[3] The interest rate on the main refinancing operations will now be 2.50%, the rate on the marginal lending facility 2.75% and the rate on the deposit facility 2.00%. Interest rates will still have to rise significantly to reach levels that are sufficiently restrictive to ensure a timely return of inflation to the 2% medium-term target. The ECB Governing Council also decided that from March 2023 onwards the principal payments from maturing securities under the asset purchase programme (APP) will no longer be reinvested in full, i.e. the portfolio will be allowed to decline gradually.

Interest rates have risen rapidly in the second half of 2022. Following the increase in market rates, average interest rates on new mortgages and new corporate loans have also begun to rise sharply in Finland (Chart 2). Financial markets expect euro area short-term interest rates to climb to around 3% in 2023 (Table 2), and to fall slightly by 2024 as inflationary pressures moderate.

The findings of the euro area bank lending survey show that the credit standards and terms and conditions of respondent banks have not been widely tightened in Finland in 2022. The Business Tendency Survey released by the Confederation of Finnish Industries in October found that while the financial difficulties of companies have slightly increased

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where the energy crisis escalates and winters are colder than normal in the immediate years ahead.

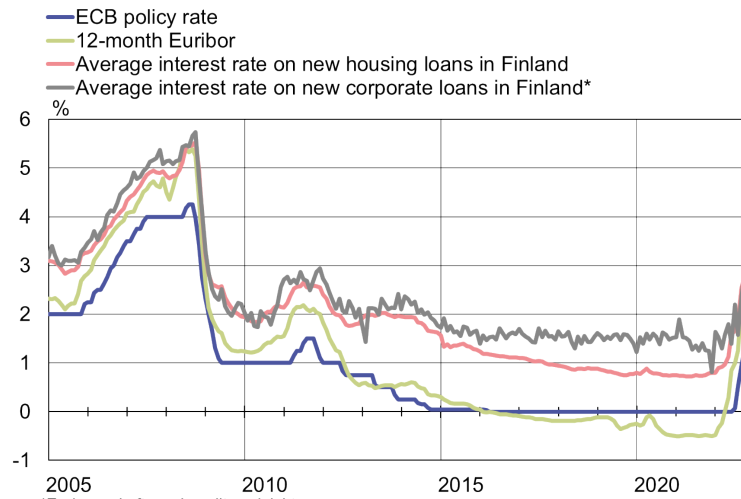
2. More detailed information on the euro area forecast is available on the ECB website.

3. More detailed information on the ECB's monetary policy decisions is available on the ECB website.

in many industries, it is the insufficient level of demand, the shortage of skilled labour and material and capacity constraints that continue to pose a more significant obstacle to production or sales.

Chart 2.

Average interest rates on new loans are rising steeply



*Excl. overdrafts and credit card debt.

Sources: European Central Bank, Reuters and Bank of Finland.

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Table 2. Forecast assumptions

Volume change year-on-year, %	2021	2022^f	2023^f	2024^f	2025^f
Euro area GDP	5.2	3.4	0.5	1.9	1.8
World GDP (excl. euro area)	6.4	3.3	2.6	3.1	3.3
World trade (excl. euro area)*	12.6	5.6	1.9	3.3	3.3
	2021	2022^f	2023^f	2024^f	2025^f
Finland's export markets, % change**	10.4	5.6	1.7	3.1	3.3
Oil price, USD/barrel	71.1	104.6	86.4	79.7	76.0
Export prices of Finland's competitors, EUR, % change	9.9	16.9	2.9	0.8	0.9
3-month Euribor, %	-0.5	0.4	2.9	2.7	2.5
Finland's nominal effective exchange rate***	109.4	106.5	106.8	106.8	106.8
USD value of one euro	1.18	1.05	1.03	1.03	1.03

** Calculated as the weighted average of imports.*

*** The growth in Finland's export markets is the average of the import growth of the countries Finland exports to, weighted by their respective shares of Finland's exports.*

**** Broad nominal effective exchange rate, 2015 = 100. The index rises as the exchange rate appreciates.*

^{f} = forecast.

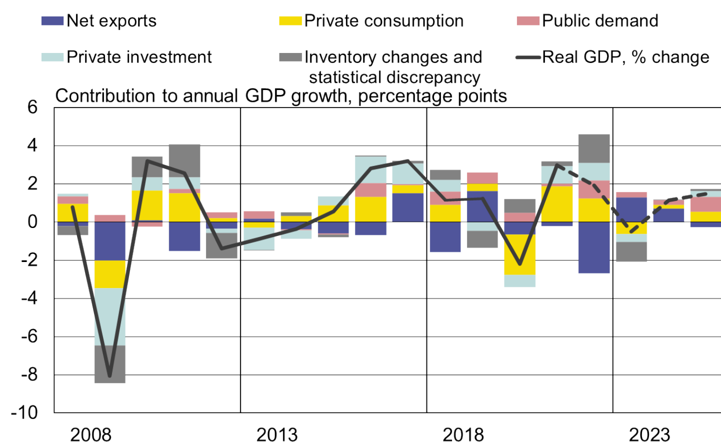
Sources: Bank of Finland and Statistics Finland.

Demand and the public finances

The Finnish economy is set to slide into recession in 2023 as a consequence of the energy crisis, which is exacerbated by the war in Ukraine, and the fast rise in living costs (Chart 3). A loss of momentum in economic growth is widespread across the economy. High inflation has eroded purchasing power, and consumer confidence has slumped to a very low level. Uncertainty is impacting private consumption and investment demand. Growth will nevertheless be underpinned by net exports, despite the weak trend in

Finland's export markets. The recession will be short-lived, however, and the economy will slowly start to grow again in 2024 as the energy crisis eases and uncertainty recedes. Finland's public finances will show a deficit throughout the entire forecast period.

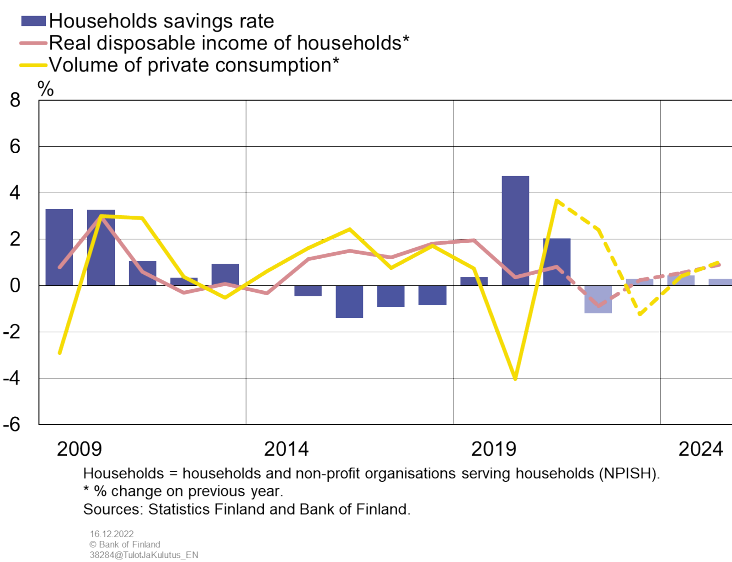
Chart 3.



Weaker purchasing power will slow consumption growth

The improved employment rate and earnings growth have meant that household incomes have increased in 2022, but high inflation is eroding the growth in purchasing power (Chart 4). At the same time, consumer confidence has plummeted to a very low level. Private consumption is nevertheless being underpinned by services demand, which has picked up following the fading of pandemic concerns and lifting of restrictions.

Chart 4.



Earnings levels will increase faster in 2023 than this year, but inflation will continue to consume most of the rise in household income.

Purchasing power will no longer be boosted by employment levels, as the slowdown in economic growth will bring the favourable employment trend to a halt. Private consumption will remain under pressure from both weak income growth and general uncertainty in the economy until the economic outlook starts to brighten towards the end of the forecast period.

Owing to the weak trend in purchasing power, private consumption will begin to decline in 2023 (Chart 4). High inflation has resulted in the European Central Bank raising interest rates, which will slow down the private consumption even more. Many households will see more of their income being swallowed up by mortgage costs.[4]

The household savings rate began to increase during the pandemic, and more than EUR 6 billion was accumulated in additional savings in 2020 and 2021. The weak trend in purchasing power, however, has meant that in 2022 households have had to resort to their savings, and so the savings rate is negative. At the same time, inflation and a fall in asset values have eaten away at household wealth. Households nevertheless still have financial assets to serve as buffers against recession and inflation. From 2023, the savings rate will again be slightly positive, with nominal disposable income rising as a result of stability in the employment rate and a healthy trend in earnings.

In 2024 and 2025 the inflation rate will be considerably lower than now. As inflation slows, consumers' purchasing power will start to improve and confidence will be restored. Private consumption will once again start to rise in the period 2024–2025 at around the same rate as the growth in purchasing power.

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4. The impact of interest rate rises on private consumption is dealt with in more detail in the alternative scenario.

Waning investment

Good economic growth at the start of the year has boosted private investment for 2022 as a whole, although uncertainty has been created by the war in Ukraine and the deepening energy crisis as a consequence of it (Chart 5). Both non-residential investment and housing construction this year have continued to be buoyant.

The weakening economy and the general uncertainty are slowing non-residential investment, and in 2023 the level of this investment will fall to some extent compared to the current year. Investment will be affected not only by the economic situation, but also by the rise in interest rates for corporate loans.

The fall in investment will nevertheless be temporary. As the economic situation brightens and companies gradually start to become less uncertain about the future, non-residential investment will begin to recover in 2024 and pick up further in 2025. Over the next few years, business investment will be boosted by the green transition, which is gaining renewed impetus because of the energy crisis.

Chart 5.

Housing construction has been exceptionally brisk and the demand for housing has been high for several years now. In 2021 there was a record number of new housing starts and this continued into 2022, which will mean a substantial increase in investment in housing construction for the year as a whole.

High inflation, the tightening of monetary policy that has ensued, and the decline in purchasing power have all meant that consumers and residential property investors are less interested in acquiring property. The demand for housing is expected to decrease markedly, as mortgage interest rates have risen and households have been less willing to take out a mortgage. The rate of new project starts in the immediate years ahead will also be slowed as a result of the exceptionally rapid rise in construction costs and in the financing costs faced by builders. The number of building permits issued for new homes

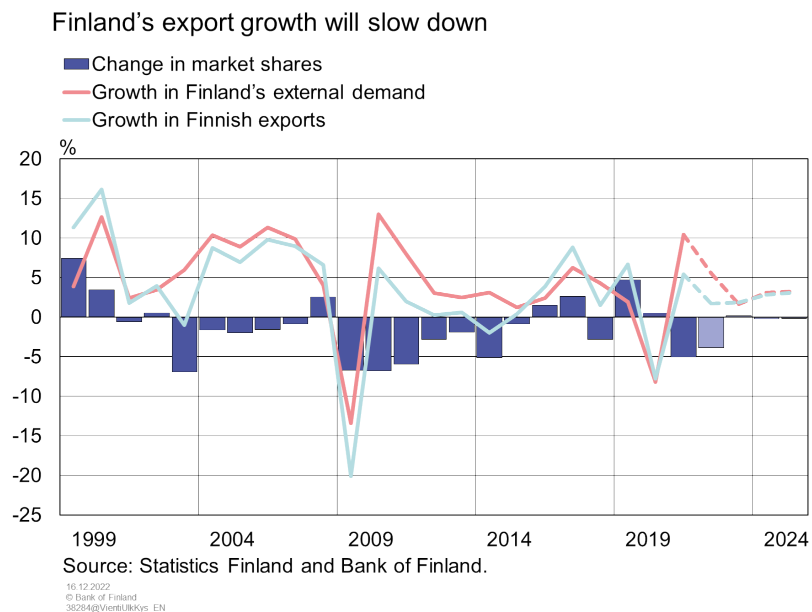
has decreased considerably, which will be reflected as a decline in residential investment in 2023 and 2024. The amount of housing construction has been exceptionally high, but is now starting to return to its normal, long-term level.

Investment in housing construction will start to pick up again in 2025. Lower inflation, a good level of employment and an increase in disposable income will push up the demand for housing. The uncertainty surrounding the economy will also gradually dissipate. However, housing construction will not reach the volume seen in recent years.

Short-lived slowdown in export growth

Slower growth or even the threat of recession in Finland's main export markets has caused a deceleration in Finnish export growth in 2022. A further factor has been the collapse in exports to Russia. Finland's export growth will clearly fall below the growth in external demand this year (Chart 6). It will take time before exports to Russia can be replaced with exports to other markets, because companies are unable to replace their lost market shares immediately.

Chart 6.



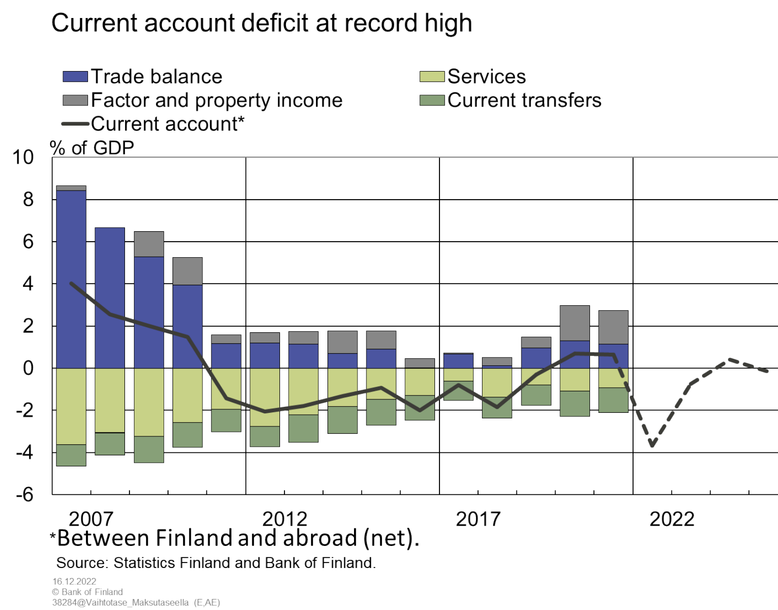
The growth in exports will improve only slightly in 2023, increasing more or less in line with Finland's external demand. The growth in exports over the next few years will be spurred on particularly by the gradual fading of uncertainty in the euro area and in Finland's other main export markets and by the easing of the energy crisis. Exports will continue to grow at roughly the same rate as in Finland's main export markets in 2024 and 2025. The drop in Finnish exports due to the collapse of exports to Russia will be temporary, as exporting companies will discover new markets. Other factors supporting export growth in the forecast period include major deliveries of seagoing vessels.

Imports have grown exceptionally quickly in 2022, easily surpassing the growth in exports. This has reduced the figure for net exports. However, imports will decrease in 2023, as private investment and private consumption, in particular, fall. Imports will go

up again in the latter part of the forecast period. Imports will increase more slowly, on average, than exports in the period 2023–2025, and so net exports will help drive economic growth. The increase in imports in 2025 will be due to greater private demand and the public investment in military equipment.

The current account deficit has grown to almost record levels in 2022, reaching around 3.5% of GDP (Chart 7). That is the largest deficit since the start of the millennium. There are several concurrent factors that explain this. The increase in imports of services has been faster than the growth in exported services for various reasons, such as the lifting of restrictions on travel, and this has caused the travel accounts in the balance of payments to weaken. Imports of goods have also been substantial, and this has weakened the trade balance. Companies have paid an unusually high amount of investment income abroad, which is clearly apparent from the weakened primary income balance. Additionally, more current transfers have been paid abroad than received from abroad.

Chart 7.

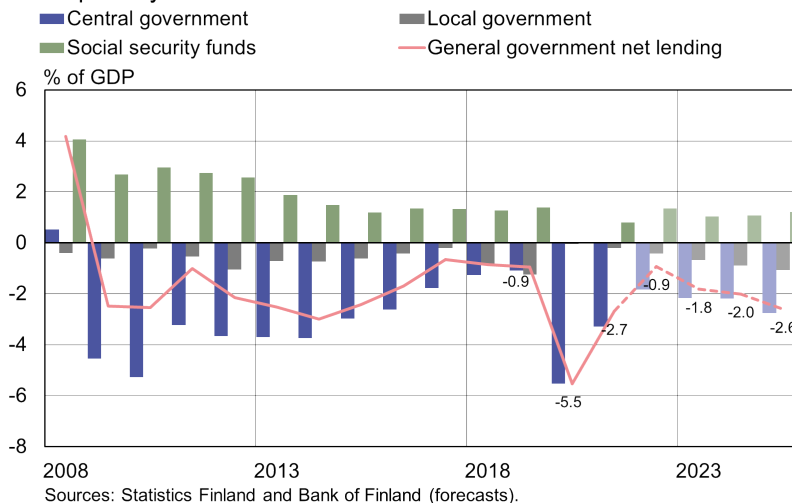


However, the current account deficit will gradually disappear, when net exports increase and strengthen the trade balance. In 2024 the current account will show a slight surplus as exports strengthen. It will, furthermore, remain virtually in balance at the end of the forecast period, although net exports will fall a little because of the rise in imports.

Short-lived improvement in public finances

Discretionary additional expenditure, surging inflation and increased interest expenditure will deepen the deficit in the public finances following a brief period of improvement. The deficit relative to GDP will narrow to almost 1% in 2022 (Chart 8). The increase in public expenditure will exceed the growth in revenues as from 2023, and the deficit relative to GDP will deepen to around 2% in the period 2023–2024. From 2025, public investment will see an increase with the procurement of fighter aircraft by the Finnish Defence Forces, and this will serve to deepen the deficit further.

Chart 8.



General government revenues have continued to increase rapidly in 2022. Payroll growth and the rise in private consumption have increased tax revenues and the revenue from social security contributions. The increase in public revenues will slow down as from 2023, but this will not be dramatic, as the employment rate and earnings growth will remain fairly stable.

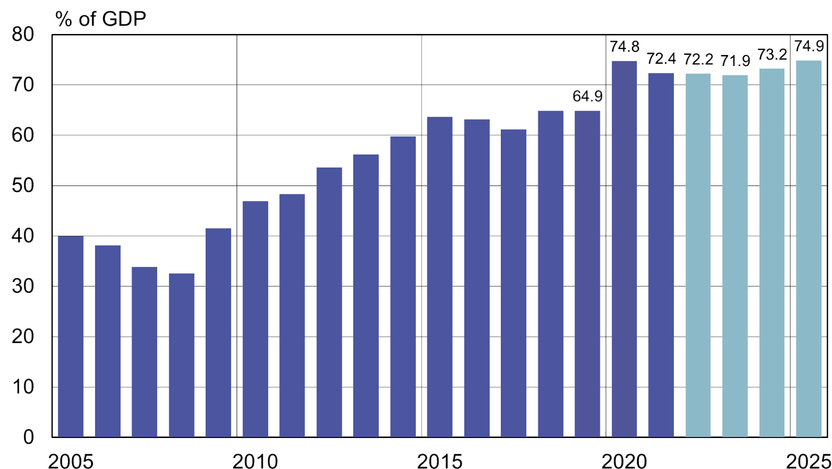
The central government expenditure associated with the COVID-19 pandemic has decreased, but new, additional expenditures connected with preparedness and security of supply have taken its place. The interest expenditure on central government debt had been decreasing since 2013, but has begun to rise in 2022. This will place an ever heavier burden on central government finances in the years covered by the forecast.

The cost of the wellbeing services provided by local government will be pushed up by rising prices for intermediate goods and the significant pay increases awarded in this sector. Public investment will recover as the wellbeing services counties start to function, although heavily increased construction costs will curb the start-up of new projects.

There will be a huge increase in the payment of index-linked social benefits especially in 2023, due to the sharp rise in consumer price inflation. The earnings-related pension funds' surplus in 2022 has been strengthened by an increase in property income, but the rise in benefit expenditure will temporarily weaken the pension funds' financial position from 2023.

The government debt-to-GDP ratio will narrow slightly over the period 2022–2023, as the nominal growth in GDP will be more rapid than the increase in the public deficit (Chart 9). The debt ratio will increase once more from 2024, ending up at almost 75% at the end of 2025. The amount of debt will rise because of defence procurement, government capital injections and other additional expenditure.

Chart 9.



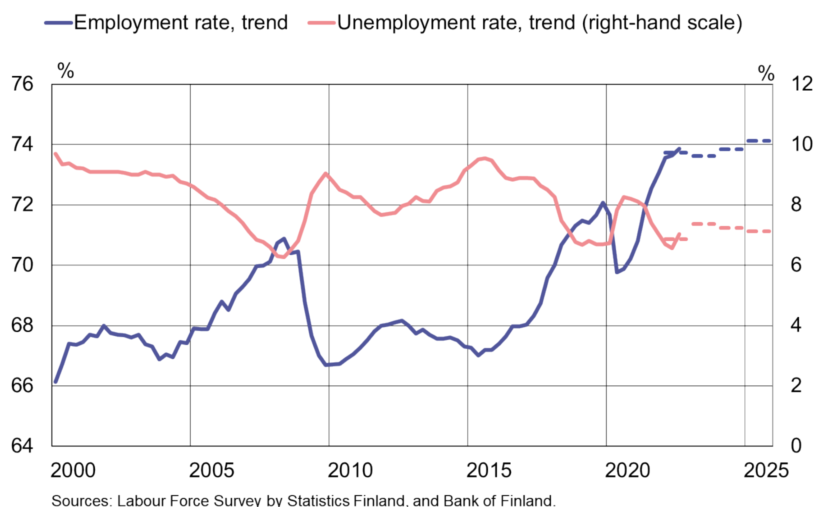
Supply and cyclical conditions

The boom in the Finnish economy is fading and will give way to a mild recession in 2023. Growth will slow to less than its potential rate, and productive resources will be somewhat underutilised. In 2025 the economy will be in a more balanced position. The peak in the labour market has now passed, as the economic effects of the war and rising prices are transmitted to the job market. Employment will remain high throughout the forecast period, but the growth in employment will slow and the unemployment rate will increase temporarily. At the same time, labour shortages will ease somewhat in cyclical industries.

Employment rate to dip temporarily

The positive trend in the labour market that has continued up till now is levelling out. The employment rate will nevertheless remain high. As with GDP, the employment rate will drop temporarily in 2023, but it will then begin to rise and will reach 74.1% in 2025. In 2025 there will be approximately 13,000 more people in work than in 2022, on average. The unemployment rate in 2023 will rise by slightly more than half a percentage point compared to 2022, but will fall again in the coming years (Chart 10).

Chart 10.



The post-pandemic labour market continued to be strong in the first half of 2022, which was due to the rebound in demand for labour-intensive services following the lifting of restrictions. The employment rate has risen to a record high, while the level of unemployment has fallen to just below the structural unemployment rate. At the same time, however, employers have had difficulties finding skilled workers and the number of job vacancies relative to the number of unemployed jobseekers has increased (Chart 11). Despite the tightness of the labour market, employment continued to rise during the first half of 2022. Unemployment has fallen, although by less than the rate at which employment has improved. The labour force participation rate has risen to a remarkably high level.

The peak in the labour market has nevertheless now passed. The rise in the rate of employment will halt temporarily, with the unemployment rate increasing to some extent in the early part of the forecast period. The weakened expectations for employment in all the main industries point to a cooling labour market. This has not so far led to an increase in temporary lay-offs, unlike during the pandemic; instead, the level of unemployment has risen. In 2023 employment growth will slow as private consumption falls, triggered by a decrease in the demand for services and weak purchasing power. At the same time, the number of lay-offs may increase.

Chart 11.

The labour shortages and tight labour market are the result of both cyclical and structural factors. The tightness of the labour market will ease slightly as the economy cools, which will mitigate the labour shortages in cyclical industries. However, the labour shortages will also remain a longer term structural problem in Finland. The structural labour shortage in many non-cyclical industries – for example, healthcare and care for older people – is partly due to Finland's ageing population, and so this can be expected to impede employment growth across business cycles. The rapid rise in the labour force participation rate has eased the labour shortages to some extent. Since the participation rate is already at a record high, and its rise is to slacken off over the forecast period, it cannot be expected in the future to ease the tightness of the labour market or promote any substantial increase in employment unless there are new structural measures in place.

Finnish economy to enter a mild recession

Finland's economy, with the exception of the public finances, had largely recovered from the deep recession caused by the COVID-19 pandemic when the next crisis hit. Thanks to a good start to the year, there has been rapid growth in 2022 and the output gap has remained positive.[5] But due to the crisis caused by the war in Ukraine and the subsequent further rise in energy prices, the assessment of cyclical conditions for the coming years has been adjusted downwards. According to current estimates, the Finnish economy will slide into recession in 2023, and GDP growth will slow to less than the growth potential. The output gap will therefore be negative (Chart 12). In 2025 the economy will be in a more balanced position, with an output gap that is more or less neutral and growth close to its potential rate.[6]

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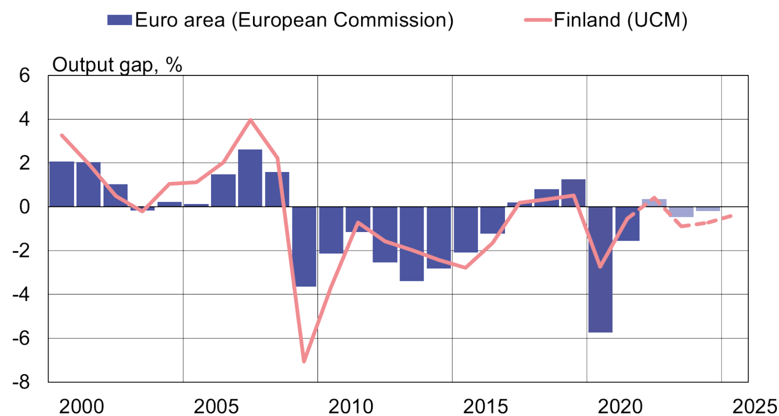
5. The difference between GDP and potential output is referred to as the output gap and is usually expressed as a percentage of potential output. According to economic theory, a positive output gap cannot be maintained without upward pressure on wages and prices.

The war is undermining growth in the economy via its impact on both demand and supply. The uncertainty caused by the war is weakening domestic demand and causing a contraction in Finland's export markets, and the war is also worsening global supply disruptions and pushing up the prices for energy and other raw materials. Nevertheless, the supply disruptions and general uncertainty are expected to ease gradually.

Chart 12.



Finland's potential output growth was already recovering from the setback experienced during the COVID-19 crisis when Russia attacked Ukraine (Chart 13). The growth in potential output will remain slow over the forecast period, partly due to weaker-than-projected growth in investment and therefore also in the stock of capital. The war and continuing high prices for energy are expected to reduce the economic growth potential during the next few years. GDP growth is projected to be close to its long-term potential rate at the end of the forecast period.

High levels of structural unemployment will make labour a less significant factor in output in the forecast period.[7] The labour supply will also be constrained by the fact that the working age population (aged 15–74) has already started to shrink. On the other hand, and despite headwinds in the economy, a continued high participation rate will support labour input and potential output.

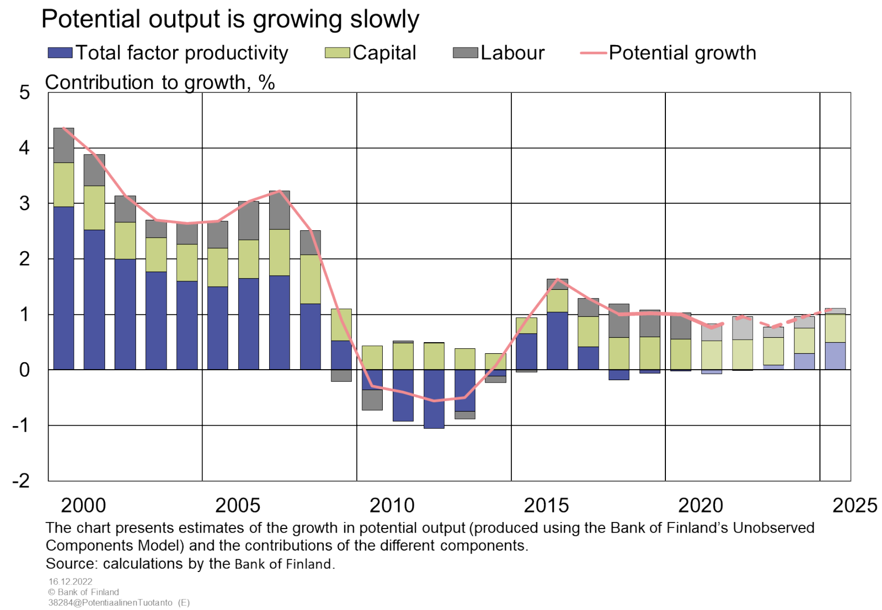
Capital stock is slowly growing, contributing to growth in potential output. Growth in total factor productivity will remain subdued temporarily, due to supply disruptions and a reallocation of resources. Global tensions and supply disruptions are prompting some companies to look for new subcontractors, reorganise production chains and ensure uninterrupted availability of energy. It is especially during crises that structural rigidities and frictions in the economy play an important role in how effectively economic

6. Potential output is the volume of GDP when all the inputs in the economy are in normal use.

7. The NAIRU (non-accelerating inflation rate of unemployment) is estimated to be around 7.5% during the forecast period.

resources are reallocated and how quickly potential output improves.

Chart 13.



The chart presents estimates of the growth in potential output (produced using the Bank of Finland's Unobserved Components Model) and the contributions of the different components.
Source: calculations by the Bank of Finland.

The war in Ukraine may affect potential output in many ways, which is why the projection is subject to more uncertainty than usual. The war may have a prolonged or even a permanent negative impact on the economy's growth potential if it leads to permanently reduced international trade and a less effective global division of labour. This in turn would slow down productivity growth. On the other hand, diversifying critical production chains and moving production closer to the domestic market may reduce the risk of supply disruptions and improve economic resilience going forward.

Growth in the stock of capital will be affected by two opposing forces. On the one hand, the reorganisation of production and a massive investment in the green transition will increase the capital stock, but, on the other hand, possible cancellations of investment due to the war will have an adverse impact on capital stock growth.[8] Part of the capital stock may become obsolete if there are major disruptions in the availability of oil and gas or if prices stay high permanently. A permanent increase in the cost of energy could well weaken potential output via a number of impact channels (e.g. *ECB: How higher oil prices could affect euro area potential output*[9]). The war is not expected to have any major impact on the overall trend in the labour supply in the forecast period, partly because migrants generally only find work in Finland after a relatively long time lag.

Prices and costs

Inflation has continued to accelerate in 2022 due to the effects of the war in Ukraine and the pandemic. Higher prices for energy and raw materials and protracted supply chain disruptions have led to a widespread rise in consumer prices. Nominal earnings have

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8. Greater uncertainty and the high cost of energy, for example, will discourage investors.

9. ECB Bulletin 5/2022, Box 4.

increased substantially less than inflation, and so real earnings have actually fallen this year. However, the inflation rate will come down in the immediate years ahead, and nominal earnings are projected to rise by more than prices in the period 2024–2025. Finland's cost competitiveness relative to the euro area as a whole is expected to remain almost unchanged in the forecast period 2022–2025.

Inflation will fall in the forecast period

Inflation has increased rapidly towards the end of 2022. The provisional figure for inflation in November, measured by the Harmonised Index of Consumer Prices (HICP), was 9.1%. The sharp rise was still due in large part to increased energy prices, although inflation has broadened out across the economy during the year. Despite the accelerating inflation, however, there are also signs that the pressure on prices is easing. For example, recent months have seen a slowdown in the rising prices of consumer durables.

Inflation will fall to 5% in 2023, as the inflation-fuelling effects of supply factors grow weaker (Chart 14).[10] International freight costs have decreased, and the bottlenecks in production have eased in many places. The fall in crude oil and raw material prices will curb the increase in consumer prices, although, on the other hand, dearer electricity will prolong price pressures, especially in the coming winter months. Some of the accumulated cost pressures will eventually transfer to the prices of food, consumer goods and services.

The low level of consumer confidence and the fall in demand for consumer goods will start to bring inflation down in 2023. In a survey of consumer confidence, respondents felt that these are especially bad times for making purchases, and purchase intent regarding consumer durables in particular was very low. The tightening of monetary policy will also slow the rise in consumer prices during the course of 2023. Nevertheless, the expected rise in earnings will push up prices of services, meaning that underlying inflation will be slightly higher than in 2022.

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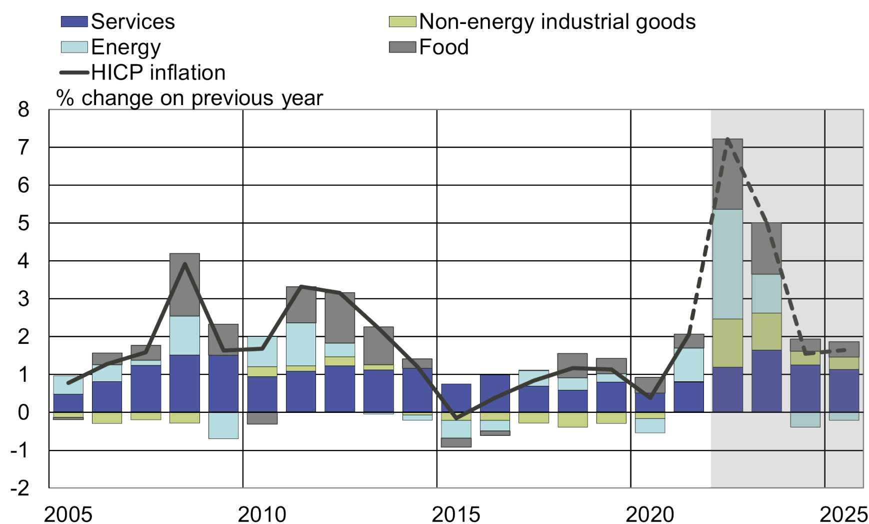
10. Inflation in 2023 is forecast to be 5.0%, measured by the euro area's Harmonised Index of Consumer Prices (HICP). However, using the national Consumer Price Index (CPI), inflation is projected to be 5.5%. The CPI figure is higher mainly on account of the rise in average mortgage interest rates.

Chart 14.

Inflation still high in 2023



Sources: Eurostat and Bank of Finland forecast.

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In 2024 inflation will slow to less than 2%. Current market expectations indicate that the wholesale prices for crude oil, electricity and gas will decrease, and so consumer prices for energy will begin to fall. The rise in food and consumer goods prices will be much slower than in the two previous years. Services inflation will also fall compared to the year before, but will remain above the long-term average as real earnings start to climb once again. In 2025 inflation will rise slightly as energy prices decline less steeply and consumer demand picks up due to a rise in purchasing power. The underlying inflation rate will slow towards the end of the forecast period, but will remain at just over 2%.

Real earnings will start to rise again

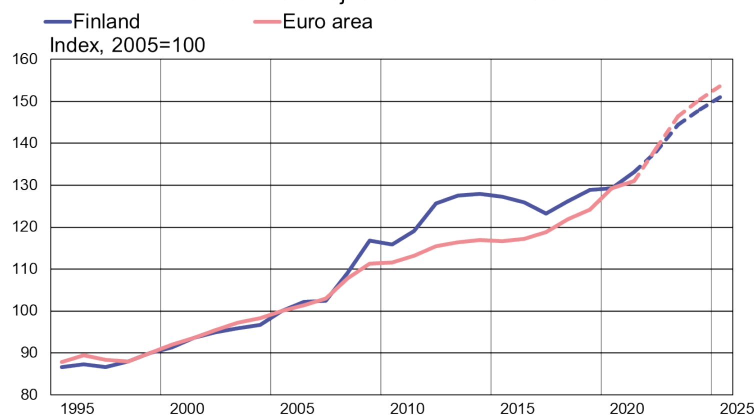
The growth in nominal earnings this year is expected to be 2.6%, measured by the index of wage and salary earnings (Chart 15). Nominal earnings growth in 2023 will rise to above 4%. In the later years of the forecast period the increase in earnings will slow down again. The earnings forecast assumes that real wages will increase at approximately the same rate as productivity – this assumption is based on a long-term link observed between these two variables. Real earnings will fall in 2022 and 2023 on account of high inflation, but will rise in the latter part of the forecast period as inflation slows.

Chart 15.

The cost of labour, or compensation per employee, has increased by 3.7% in 2022 from the previous year, supported by the increase in the employment rate. The cost of labour will continue to increase in 2023, after which it will gradually decrease again. The higher cost of labour and weak growth in labour productivity will push up nominal unit labour costs significantly in 2023. In 2024 and 2025 the cost of labour will rise less markedly and labour productivity will return to growth, causing nominal unit labour costs to increase more modestly towards the end of the forecast period.

Projections of aggregate unit labour costs adjusted for the terms of trade suggest that Finland's cost competitiveness relative to the euro area as a whole will remain almost unchanged in the period 2023–2025 (Chart 16). However, there is considerable uncertainty surrounding projections of cost competitiveness because of the impacts of the war in Ukraine and the energy crisis, and the change in labour costs.

Chart 16.



Risk assessment

The risks surrounding the forecast are predominantly on the downside. Finland's external environment is becoming more volatile due to the war in Ukraine. A more prolonged period of high inflation in Finland than forecast could cut consumers' purchasing power and private consumption by more – and for longer – than was projected, and this would make an economic recession deeper than expected.

Housing construction is expected to slow down gradually. If the economy performs less well than forecast and the rise in interest rates is faster than predicted, this could cause the housing market to cool down more than expected, which would be reflected quickly in the supply of new housing.

It is still difficult to assess all the economic consequences of Russia's war in Ukraine. In the Bank of Finland's December 2022 forecast the assumption is made that the prices for electricity and crude oil will gradually start to fall next year, although the energy crisis may also deepen further. The worsening problems of energy availability across Europe could weaken demand in Finland's export markets and so slow down the growth in exports. Furthermore, a cold winter with many windless days may push up the price of electricity and compel regulation of its distribution in Finland.

In addition, the COVID-19 pandemic is not yet over in global terms. Although the global supply chain disruptions that emerged during the pandemic began to ease in early 2022, the number of COVID-19 cases, for example in China, has started to rise again fast. If the disease cannot be contained, this could lead to production and logistics bottlenecks.

According to the forecast, inflation will start to slow down in 2023. There is much uncertainty in the forecast, however, as price rises in 2022 have now spread from energy commodities to other sectors of the economy. Moreover, the energy crisis could continue,

and energy prices increase, for longer than expected.

Despite rising costs, corporate profitability has remained good, though this will increase wage pressures in pay negotiations in the winter. The pressure on wages will also be intensified if there are higher than usual pay rises in competitor countries. There are nevertheless large differences in profitability between different industries and among companies, and the slowdown in the economy will become visible in company results only after a time lag. If wage rises cannot be funded without price increases, there is an increased risk that consumer prices will rise faster than anticipated.

Besides any negative developments, Finland's economic growth in the next few years could also include positive surprises. The reduction in aggregate demand and the tightening of monetary policy may slow down inflation faster than anticipated, which would increase the purchasing power of households more than forecast. Furthermore, the exporting companies that have pulled out of the Russian market may succeed in discovering new markets more quickly than expected. The green transition has been gathering pace as a consequence of the energy crisis, and this could increase investment and provide companies with new export opportunities.

Tags

euro area, Ukraine, Finnish economy, forecast, public finances, Russia, supply disruption, employment, potential output, competitiveness, energy crisis, inflation, wages

ASSESSMENT OF PUBLIC FINANCES 2022

Finland's crisis-hit public finances need strengthening

Today – Assessment of Public Finances – Finnish economy

In recent years, Finland's public finances have drifted from one crisis to the next. The pandemic, Russia's war in Ukraine, the energy crisis and high inflation, along with continued low economic growth, have caused radical changes in the economic environment. What stands out in particular is the change in Finland's debt trajectory since before the outbreak of the pandemic. In 2023, Finland's public finances will be running a deficit for the fifteenth consecutive year. The debt-to-GDP ratio does not yet differ from that of other euro area countries with lower-than-average public debt, but projections point towards a concerning trend. The debt trend is similar to that seen in the most indebted countries of the euro area, where the scars of the global financial crisis and the European sovereign debt crisis run deep. The pandemic persists while Russia's war in Ukraine and the energy crisis sow uncertainty in the economy and in fiscal policy as the parliamentary term draws to an end. The crises have demonstrated the continued need of sufficient fiscal space in the public finances.

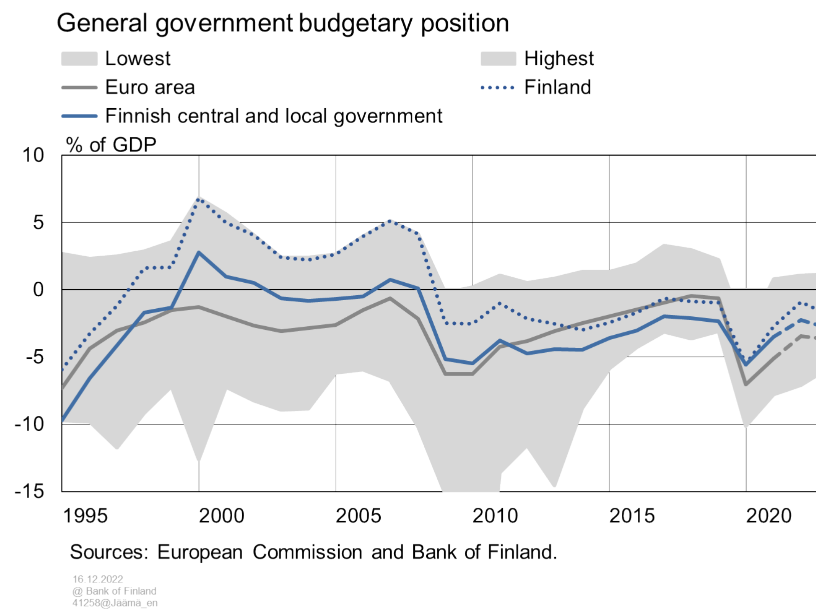
General government finances – Finnish public debt

is growing

Finland's general government finances deteriorated rapidly in 2009 and balance has not been re-established since. Economic growth has been low for a long time and Finland has been unable to rebalance public expenditure and revenues. The ratio of public debt to GDP has doubled during this period and the debt will continue to grow unless the direction of fiscal policy is corrected. In terms of general government deficit and public debt, Finland is still doing better than the euro area average, as the general government budgetary position is enhanced by the earnings-related pension funds' surplus and the fact that the level of public debt was initially low.

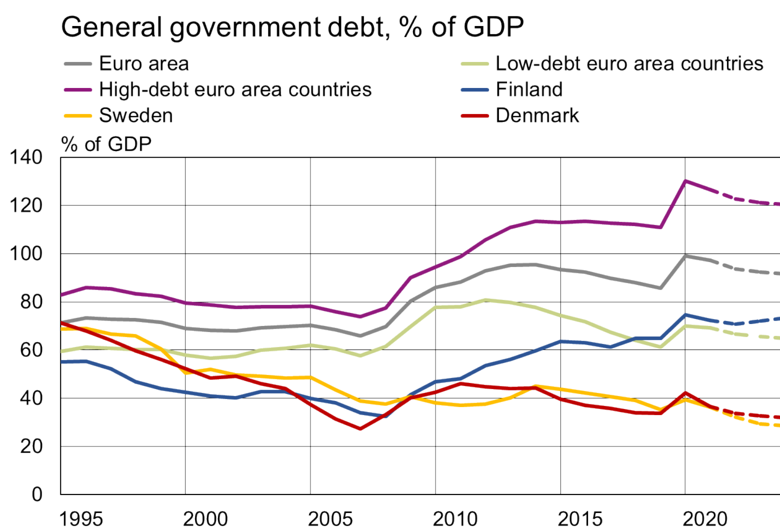
If the earnings-related pensions funds are excluded, Finland's general government deficit was weaker than the euro area average almost throughout the 2010s. During the pandemic, however, the combined deficit of central government, local government and other social security funds has been smaller than the euro area average (Chart 1). Thus, when measured by economic indicators, Finland has come through the pandemic relatively well so far.

Chart 1.



During the two pandemic years 2020–2021, Finland's debt-to-GDP ratio grew by a total of 7.5 percentage points, whereas the average increase in the euro area was a little over 11 percentage points (Chart 2). However, a look at Finland's closest peer countries reveals a less flattering difference. The debt-to-GDP ratio grew just fractionally less in Finland than in other euro area countries with lower-than-average public debt. Moreover, Finland's debt ratio grew by more than that of Sweden or Denmark. In Sweden, the debt ratio increased by only just over 1 percentage point and in Denmark by around 3 percentage points between 2019 and 2021.

Chart 2.



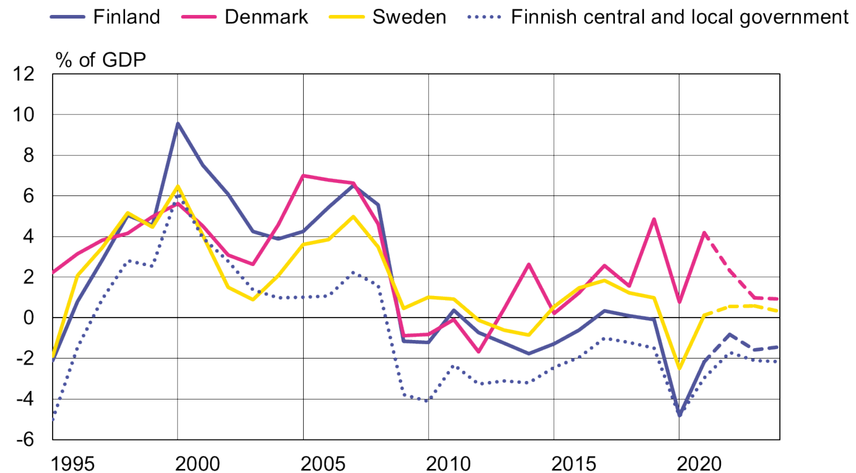
What is particularly striking is Finland's pre-pandemic debt trajectory. Since the global financial crisis, Finland's debt-to-GDP ratio has grown almost continuously. This is hardly in line with Finland's reference group of euro area countries with below average public debt, but is instead similar to the trend in the euro area's most indebted countries, where the scars of the financial crisis and the European sovereign debt crisis run deep. Although Finland's debt ratio does not yet differ from its euro area peer countries, the ratio's trajectory is divergent and concerning.

Chronic imbalance between revenues and expenditure

When compared against other Nordic countries, Finland's public finances have deteriorated over the last ten-plus years. In the 2010s and since, the general government primary budget balance (net lending excluding interest expenditure) has been clearly stronger in Sweden and Denmark (Chart 3). The difference is particularly evident in the growth of the debt ratio. While Finland's debt ratio has doubled since 2009, in Sweden and Denmark the debt-to-GDP ratio has varied between 30% and 40%.

Chart 3.

General government primary budget balance



Sources: European Commission and Bank of Finland.

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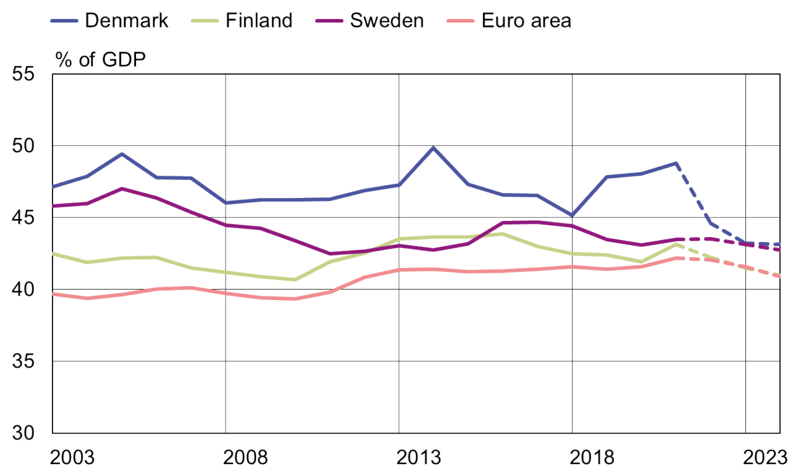
Sweden and Denmark have managed to balance public revenues and expenditure better than Finland. Both Sweden and Denmark have had a higher tax-to-GDP ratio than Finland, although the difference between Finland and Sweden is not large (Chart 4). By contrast, other public revenue, such as property income (especially income from earnings-related pension funds), has been somewhat higher in Finland. Then again, the ratio of public expenditure to GDP is 3–4 percentage points higher in Finland than in Sweden and Denmark.

Chart 4.

Tax-to-GDP ratio in Finland, Sweden, Denmark and the euro area



Source: European Commission.

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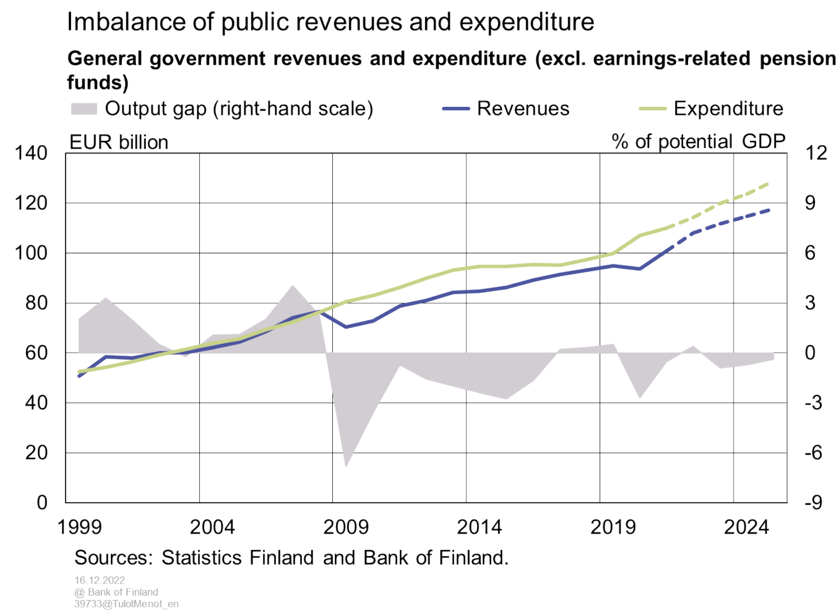
Finland has not managed to balance public revenues and expenditure since the financial crisis, and instead central and local government deficits have turned chronic and even

the earnings-related pension funds' surplus has diminished as pension expenditure has increased. In Finland, the ratio of public revenue (excluding earnings-related pension providers) to GDP has averaged around 40% since 2009, while the average expenditure-to-GDP ratio has been close to 44%. The imbalance between revenues and expenditure is structural, i.e. the public finances have not been balanced since 2008 (Chart 5), even in normal economic conditions. In the pre-pandemic period 2010–2019, Finland's structural deficit averaged 1.0% of GDP, as estimated by the European Commission. Over the same period, Sweden had a structural surplus averaging 0.2% of GDP and Denmark a structural surplus averaging 0.5%.

Chart 5.



In the early 2010s, public expenditure continued to grow, despite the crumbling revenue base. Of all the general government consumption expenditure items, which currently amount to just over 24% of GDP, expenditure on social protection has increased the most[1]. Finland's average social protection expenditure in 2010–2019 as a percentage of GDP was 1.3 percentage points higher than the corresponding figure for 1999–2008. The same comparison for expenditure on healthcare provision reveals an increase of 0.8 percentage points.

Employment in health and social services has been growing rapidly for a long time. Over the past two decades, this growth has increased further, especially in the private sector (Chart 6). From 2010 to 2021, the number of persons employed in health and social services increased by around 40,000 in the public sector and by over 57,000 in the private sector. This means that the public and private health and social services sectors

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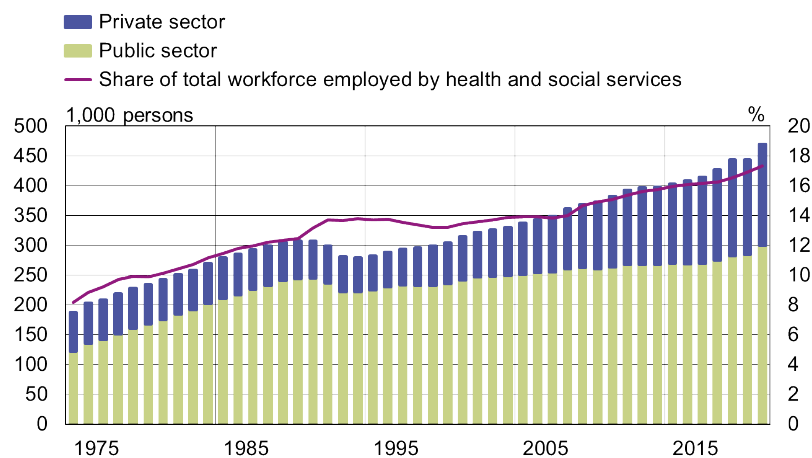
1. General government expenditure by function, Statistics Finland. Consumption expenditure is calculated by adding together output (including public sector labour compensation costs, intermediate consumption and consumption of fixed capital) and social transfers in kind through market producers, and by deducting the sales of goods and services. Social protection refers to all publicly funded measures provided by public or private organisations to ensure basic services and livelihoods for households and individuals when faced with risks (including services for older people).

accounted for nearly half (45%) of the overall growth of 216,000 in persons employed in Finland over the same period. The demand for health and social services provided by the private sector has been bolstered by publicly funded use of purchased services. The item in the national accounts comprising services purchased by general government[2] grew by just over 0.5 percentage points relative to GDP between 2010 and 2020. Correspondingly, the provision of services by the public sector also increased.

The employment needs in health and social services pose a major challenge for the Finnish economy. As Finland's working-age population is declining, a growing share of the labour force will be working in health and social services in the future. It is difficult to increase labour productivity in practical care work. While digitalisation can offer partial solutions, the quality of care work is still strongly linked to labour input. When a sector with low productivity growth expands in relation to other sectors, it weakens productivity growth in the economy as a whole and, consequently, the overall potential for growth.

Chart 6.

Growing share of Finnish workforce employed by health and social services



Source: Statistics Finland.

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Health and social service expenditure will continue to grow in the future as the number of older people increases. Responsibility for organising health and social services will be transferred to the wellbeing services counties at the beginning of 2023. Cost-effectiveness in service production will be an important part of curbing expenditure growth in the wellbeing services counties in the future. Unfortunately, the financial incentives for the counties to operate more effectively are weak, while other incentive mechanisms, such as the threat of being merged with other counties, do not, in practice, apply to a significant number of the welfare services counties. A further concern is the so-called soft budget constraint, meaning that it is difficult for the State not to provide additional funding to counties if they are otherwise unable to provide public services to which people have a right. Giving the wellbeing services counties moderate rights to levy

2. Social transfers in kind provided by general government via market producers refers to expenditure arising from the public funding of goods and services provided to households by the private sector.

taxes would, on the one hand, likely increase their incentives to improve the cost-effectiveness of their service provision[3]. On the other hand, having an additional tier of government with tax-levying rights could potentially lead to higher taxes. However, the tax-to-GDP ratio will ultimately depend on the direction of public expenditure. To avoid a higher tax-to-GDP ratio, public sector resources must be used efficiently.

Public current transfers relative to GDP have increased by around 3 percentage points between the periods 1999–2008 and 2010–2019, to just over 18% of GDP as a result of increased pension expenditure. In other respects, the growth of monetary social benefits has been moderate, and in 2019 social benefits other than those paid by earnings-related pension funds were in fact about 1 percentage point of GDP lower than in 2010. In 2020, the pandemic caused a strong increase in social benefit expenditure (by 0.8% of GDP).

General government interest payments have been falling for a long time. In 1999, central and local government interest payments[4] amounted to 3.9% of GDP, but in 2021 to just 0.5% of GDP. Since 2010, interest payments relative to GDP have decreased by 0.8 percentage points. Now that interest rates have begun to increase significantly, general government interest payments will increase to an estimated 1% of GDP by 2025. Interest payments are now increasing in tandem with many other costs, and are at the same time limiting fiscal space.

Fiscal stance during high inflation

In the early stages of the COVID-19 pandemic in 2020, the economic recession weakened general government revenues while public support to households and companies increased public expenditure. The general government deficit increased by more than 4 percentage points. In 2021, the economy recovered and tax revenue grew strongly in relation to the cyclical circumstances.

Economic growth strengthened further and continued to support the public finances during the first half of 2022 (Chart 7), but as growth is projected to slow, it will no longer underpin the public finances. Over the forecast years 2022–2025, the fiscal balance will only improve in 2022. A mild recession will weaken the balance in 2023. The rising interest rates will also increase general government interest payments in the forecast years. High inflation will affect both public revenues and expenditure. Whether tax revenues increase depends on the growth of private consumption in the current conditions of high inflation and on how inflation passes through to wages. Tax revenue growth will be constrained both by measures aimed at mitigating the effects of rising energy prices and by index adjustments to the tax brackets for earned income tax. Public expenditure will increase due to the index increases made to social security benefits and social allowances and the increased costs of public sector wages, purchases and investments.

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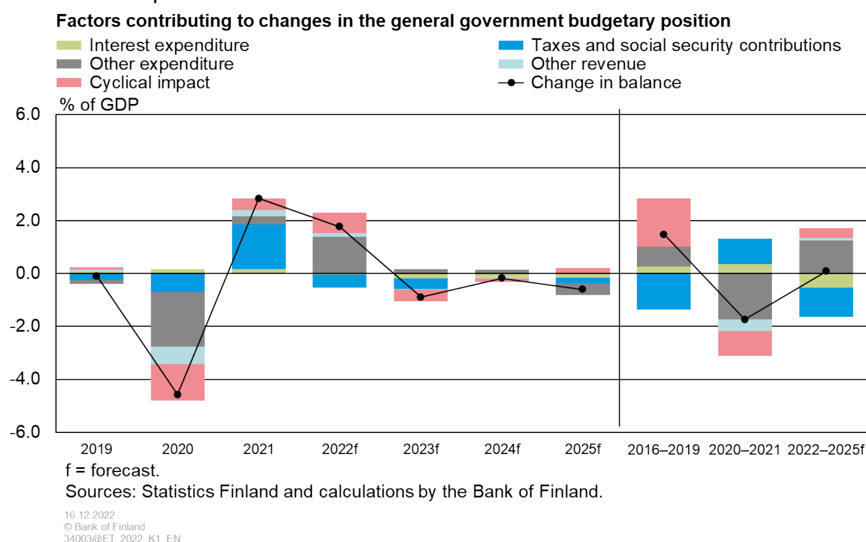
3. Mika Kortelainen, Kaisa Kotakorpi and Teemu Lyytikäinen (2021) 'Incentive effects of the wellbeing services counties' financing model' (in Finnish), Kansantaloudellinen aikakauskirja/The Finnish Economic Journal (pp. 203–211).
4. Unconsolidated interest payments by central and local government.

Chart 7.

2022 budgetary position improved due to economic situation and winding down of pandemic-related measures



f = forecast.
Sources: Statistics Finland and calculations by the Bank of Finland.

As inflation has increased well beyond the European Central Bank's inflation target and there is a risk that above-target inflation may take root in the longer term, fiscal policy measures that boost aggregate demand and accelerate inflation should be avoided. As energy prices have risen exceptionally high, it is understandable that there is pressure to mitigate its impact on households and businesses. Both the European Commission[5] and the IMF[6] have recommended such measures, as long as they are temporary and carefully targeted at the most vulnerable. A neutral fiscal stance or one that curbs aggregate demand would support efforts to quickly tame inflation.

The measures to strengthen security and mitigate the effects of the energy crisis are mainly temporary. So far, the measures decided in Finland for compensating for the rise in energy prices have been relatively moderate (0.6% of GDP in 2022–2023) by European comparison[7]. The impact of tax subsidies and direct aid on the fiscal balance would be mitigated by revenue from a possible windfall tax, although no decision has been taken on this so far. However, support to compensate for high energy prices has not been targeted only at those most in need; for example, the reduced VAT on electricity applies to all households, regardless of the price agreed upon in the electricity contract. Moreover, the tax reduction may lead to increased demand for electricity and push up wholesale prices. This measure offers limited benefits to households and comes with a high cost for the public sector.

Different indicators paint slightly different pictures of the fiscal stance in 2022 and 2023. One way to examine the impact of fiscal policy on the economy is to look at the structural primary balance, i.e. the cyclically adjusted general government budget balance net of interest payments. The general government structural primary balance is estimated to be

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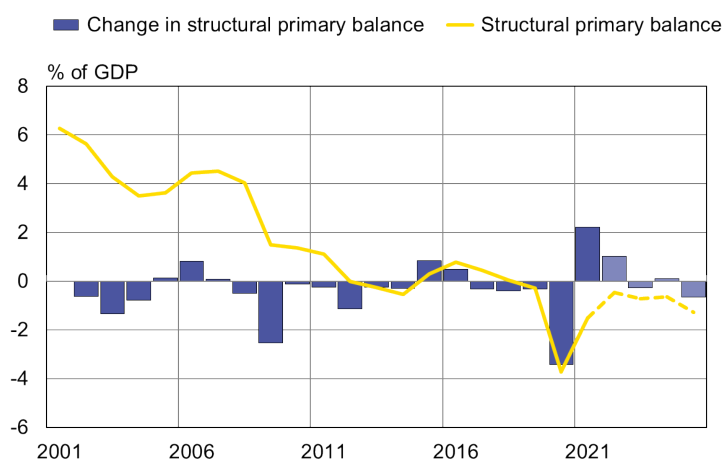
5. Recommendation for a Council Recommendation on the economic policy of the euro area 2023.
6. IMF: Staff Concluding Statement of the 2022 Article IV Mission.
7. See National fiscal policy responses to the energy crisis (bruegel.org), 21 October 2022.

-0.5% in 2022 and -0.7% in 2023, so in light of this indicator, the fiscal stance is slightly expansionary (Chart 8).

Another way to examine the effects of fiscal policy decisions is to observe the change in the structural primary balance, i.e. the fiscal impulse. According to this indicator, the fiscal policy tightened in 2022, mainly due to reduced investments in managing the COVID-19 pandemic. In 2023, the fiscal stance will be eased slightly due to investments in national security and energy subsidies.

Chart 8.

Fiscal stance remains relatively accommodative



Source: Bank of Finland.

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NB: Deliveries under the HX Fighter Programme will begin in 2025, increasing public investment by around 0.5% of GDP.

Based on the growth rate of public expenditure, the European Commission assessed Finland's fiscal stance to be broadly neutral[8] in both 2022 and 2023. The European Union's Recovery and Resilience Facility instrument will have a small supportive impact on economic growth, but since the expenditure increase is funded by non-repayable grants from the EU, the investments made through these instruments are not reflected in the fiscal stance.

In its statement on 17 November 2022, the IMF recommended that Finland should aim for a slightly tighter-than-planned fiscal stance in 2023. The IMF estimates that the measures to compensate for higher energy prices could be targeted better and without impeding the impact of price signals on energy demand. Over the medium term, the IMF recommends fiscal consolidation in order to reduce the debt ratio and make room for age-related spending.

Public debt ratio set to rise again

Finland's general government debt-to-GDP ratio for 2022 will show a further decrease,

8. Commission Opinion of 22.11.2022 on the Draft Budgetary Plan of Finland, C(2022) 9508 final, European Commission 22 November 2022.

due to unusually fast growth in nominal GDP, the denominator of the ratio. The level of nominal public debt, however, continues to rise. During 2023–2025, borrowing will be driven by the budget deficits of central and local government (Chart 9). The period of favourable interest rates appears to have ended and interest expenditure will start to rise going forward, but nominal GDP growth will continue to have an offsetting effect on the debt ratio. The public debt will also be swelled by the procurement of defence equipment, such as fighter aircraft, with payment instalments beginning before delivery. Finland's public debt ratio will reach 75% in 2025 and is on course to rise further.

The general government debt position rose by about 6 percentage points because of a statistical revision made in June 2022[9]. The revision raised general government assets and liabilities by equal amounts, resulting in a revised gross debt stock of 72.4% of GDP in 2021. The statistical revision is a good reminder that in addition to the gross public debt it is worth paying attention to general government financial assets. On the other hand, some caution is needed when examining the latter. For instance, the investment portfolios of earnings-related pension funds are recorded as general government financial assets, and even though they are intended for financing future pension liabilities, they are not recorded as part of general government financial liabilities. Second, company shares make up a high proportion of the government's financial assets and their values can fluctuate sharply, as seen once again in 2022: the share value of state-owned listed companies at the end of November 2022 stood at about EUR 25.5 billion, a 27% decline compared with a year earlier. Such government shareholdings are often for strategic purposes, such as security of supply, which limits the extent to which these holdings can be sold. General government financial assets also generate property income for central government and municipalities, totalling about 1.3% of GDP per annum.

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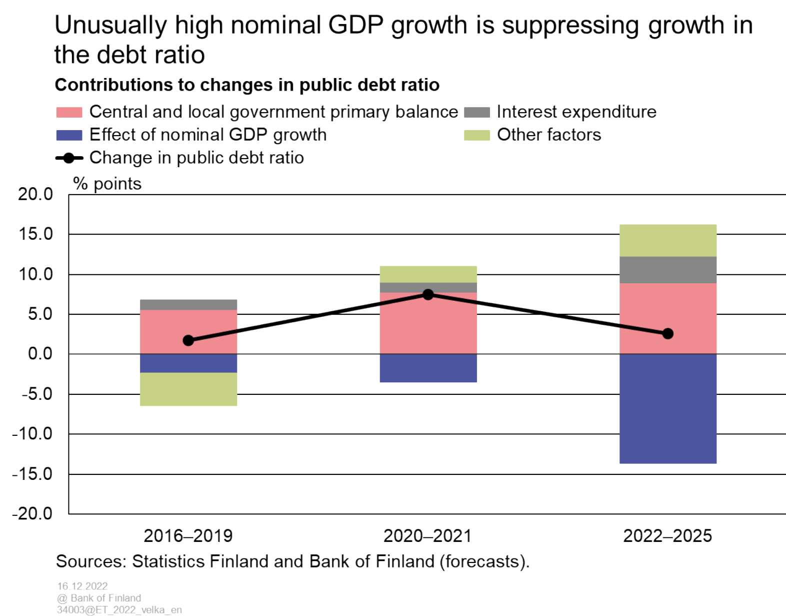
9. In June 2022 Statistics Finland revised the method by which interest subsidy loans for rental housing and right-of-occupancy housing are treated in the national and financial accounts. In the financial accounts, ARA interest subsidy loans will in future be presented in general government financial assets and liabilities. The revision significantly altered the general government consolidated EDP (excessive deficit procedure) debt and raised the public debt ratio by 5.9 percentage points in 2021. The revision was applied retroactively to the financial accounts data going back to the year 2000.

Chart 9.



Sustainability of public debt

Finland's public debt-to-GDP ratio has doubled over the past 14 years, and the level of debt will continue growing in the coming years according to the Bank of Finland's latest forecast with the assumption of unchanged fiscal policy. Finland's population is ageing, which means spending on health and social care can be expected to rise further in the coming years. Meanwhile, the working-age population is contracting, and a smaller labour force is weakening the revenue base for public expenditure. The population dependency ratio[10] will rise from 62.4% to 67.3% between 2019 and 2035, and further to 80.4% in 2070. With the public finances in deficit to begin with and the level of public debt markedly higher than before, the future burden of age-related expenditure relative to the revenue base risks swelling the public debt even further and widening the sustainability gap.

The long-term growth potential of the Finnish economy is weaker than before, because the working-age population is continuing to shrink and productivity growth has slowed. Productivity growth is being constrained by the availability of skilled labour, but also by the employment growth in health and social services, where raising labour productivity is difficult. In the services sector especially, it is likely that productivity gains will stem from improved management systems and organisational structures, and from the adoption of new technologies. Key to all these is an educated and skilled labour force. However, there is concern over the growth of human capital, as the average level of educational attainment in Finland has stopped rising, at least for the time being.

The long-term sustainability gap in Finland's public finances is estimated to be about 4% of GDP at the 2027 level (See Finland's public debt sustainability and fiscal consolidation

10. The number of people younger than 15 or older than 64 relative to the working-age (15–64) population. In 2009, the dependency ratio stood at 50.6%.

needs). This Bank of Finland estimate is about 0.5 percentage points higher than the estimate it made in 2021, as the forecast of the structural deficit in 2027 is slightly weaker than before, which means that future deficits are higher. In addition, the higher public debt and interest expenditure also affect the estimate. The estimate is based on the long-term forecast for the Finnish economy and a determination of the public finances in which fiscal policy is assumed to remain unchanged. The estimate is thus not a forecast but instead a stress projection of the pressures on the public finances. In spite of the calculation's inherent uncertainty, it illustrates the scale of the imbalance in the public finances over the long term.

Addressing the long-term challenges to the public finances should be done one step at a time. The sustainability gap indicator consists of three parts: future interest payments on the current debt stock, the general government structural balance in the base year of the calculation, and the present value of future primary balances. If our aim is to reduce the sustainability gap, then progress on this can best be made by focusing on the structural balance in the immediate years ahead. In addition, keeping the public debt stock at a moderate level would boost confidence in the management of the economy and help keep the risk premia associated with the debt interest rates in check. The long-term sustainability of the public finances can be improved by rebalancing them in the immediate years ahead and carrying out structural reforms that would strengthen the functioning of the economy in the future.

The general government (excluding earnings-related pension providers) structural deficit is estimated to come to just under EUR 6 billion in 2024. The deficit will further widen as interest payments and age-related expenditure increase on the back of a rising debt stock and growing share of older people in the population. Rebalancing the public finances will thus require a long period of fiscal consolidation that even upon completion will require an ongoing readiness to adjust spending in order to maintain the fiscal balance. Rebalancing the public finances over the coming parliamentary terms would entail a fiscal adjustment of about EUR 13 billion. Halting the rise in the public debt ratio would require an estimated adjustment of EUR 7 billion over the next eight years (See Finland's public debt sustainability and fiscal consolidation needs).

National fiscal framework put to the test

During the current parliamentary term, the Finnish and global economies have been buffeted by a major pandemic, Russia's invasion of Ukraine and an energy crisis. Fiscal rules and established practices have been set aside in favour of using the public finances to support the safety and wellbeing of society and to strengthen security in these exceptional circumstances. Nevertheless, the Government has made progress with implementing its Government Programme drawn up before the pandemic, adjusting the measures very little to the changed circumstances. It is repeatedly stated in the Programme and in the General Government Fiscal Plan that the Government is committed to reviewing its plans if their implementation should jeopardise achievement of the objectives set out for the public finances. However, such a review has not been carried out, and fiscal policy objectives have been pushed back.

In 2023, Finland's public finances will be running a deficit for the fifteenth consecutive

year. Structural changes occurring in the economy following the 2008 financial crisis – changes in the production structure and the retirement of baby boomers – have created a gap between public expenditure and revenues, which threatens to widen in the near future. Governments have aimed to close the gap by boosting economic growth especially with structural policies, such as raising the employment rate, but also in part by implementing moderate spending cuts. The strategy does not appear to have been an unmitigated success, as the public debt in 2023 will be over 36 percentage points higher than in 2008, when the general government sector was last running a surplus.

With age-related expenditure rising each year, fiscal adjustments will have to be made to contain the expansion of total public expenditure. Put differently, it is likely that any resources freed by making spending cuts will in large part have to be put towards rising health and long-term care costs. The soundness of the Finnish spending limits system is of primary importance in controlling public spending. Exceptional circumstances cannot always be managed by exceeding the central government spending limits at will. Successfully controlling public expenditure and abiding by fiscal rules will foster trust in Finland's ability to service its public debt in the future.

EU fiscal rules at a turning point: Commission proposal to relax rules

The European Commission issued a Communication on 9 November 2022 outlining plans to reform the EU economic governance framework. The Commission's proposal would leave unchanged the Treaty reference values – a budget deficit threshold of 3% of GDP and a 60% debt-to-GDP ratio – but would nevertheless mark a significant departure from the existing framework. The framework would be based on a medium-term (10-year) debt sustainability analysis conducted by the Commission and would assume an unchanged fiscal policy. The Commission would set a reference fiscal adjustment path for net primary expenditure[11] where the public debt ratio would begin to shrink or remain at prudent levels. The fiscal adjustment path would be more stringent for countries with a substantial (> 90%) debt challenge. Countries moderately in excess of the 60% reference value would be granted more time to turn around their debt ratio. Each Member State breaching the debt limit would draft a four-year fiscal-structural plan compatible with the long-term sustainability of their debt and submit it to the Council for endorsement.

A Member State would be allowed to propose a longer adjustment period, extending the fiscal adjustment path by up to three years, if it commits to structural reforms and investments that support economic growth, debt sustainability and common EU priorities and targets. At the same time, the debt reduction targets could be relaxed as long the Member State's debt ratio is assessed to be on a sustainable path.

The advantage of the Commission's proposal is that, compared with structural budgetary

11. Given that the fiscal adjustment path would be based on growth forecasts and associated projections of public revenues, a Member State would be able to deviate from its designated adjustment path by simultaneously implementing measures that raise public revenues, such as tax increases. That is why the reformed framework would focus on net primary expenditure, where the effects of automatic stabilisers and discretionary measures on the revenue side are removed from changes in public expenditure.

positions and their relative changes, regulating the growth rate of primary expenditure is a much more feasible operational indicator. At the same time, it would, at least in principle, be more readily adoptable by local government and other general government subsectors outside central government. Monitoring the path of net primary expenditure without cyclical unemployment expenditure would allow automatic stabilisers to operate freely. In addition, limiting the growth of net expenditure would cause the public finances to strengthen during periods of economic expansion, as it would not be possible to offset higher revenue growth by immediately raising expenditure.

There have been weaknesses in the enforcement of the current EU fiscal rules. Because calculating the structural balance requires an estimate of potential output, a variable which cannot be directly measured, it is subject to uncertainty. This means that changes in the structural balance have been estimated conservatively, and failure to comply with the preventive arm of the Stability and Growth Pact (SGP) has not led to activation of the significant deviation procedure (SDP) for countries in the euro area. This procedure, along with structural balance monitoring and the associated medium-term objective (MTO), would now be discontinued. The Commission's proposal does not comment on the future of the Fiscal Compact between Member States. The Fiscal Compact prescribes a more stringent MTO for participants (applies to the euro area) and requires that the MTO be brought into national legislation.

In its Communication on reforming the economic governance framework, the Commission considers that enforcement would be improved by reducing the financial sanctions that constitute part of the enforcement mechanism. The Commission also proposes that a 'debt-based EDP' be activated by default when a Member State with substantial debt challenges deviates from its agreed fiscal adjustment path. For breaches of the 3% of GDP deficit reference value ('deficit-based EDP'), on the other hand, the (potential) activation of the EDP would remain unchanged. The Commission also proposes stronger accountability for Member States who fall short of meeting EDP objectives: they would be required to report to the European Parliament on corrective actions taken. In addition, macroeconomic conditionality could also be applied to other EU financing, meaning that funding could be suspended if a Member State neglected the effective action required by the EDP. The proposals for strengthening the enforcement mechanism seem useful, but their effectiveness in practice would depend on the specifics of their implementation, for example the amount of discretion available to the Commission and the Council of the European Union.

National ownership of the fiscal framework would also be strengthened by stepping up the role of national independent fiscal institutions in the assessment and monitoring of fiscal plans. The surveillance of macroeconomic imbalances in Member States would also focus on a more preventive approach, and greater attention would be paid to imbalances affecting the EU and the euro area.

New rules for the new parliamentary term: Ministry of Finance calls for more rigorous governance of the public finances

A Ministry of Finance working group tasked with developing the governance of the public

finances proposed in its November 2022 report[12] that the central government spending limits system, tax policy, and the target levels for the general government budgetary position should all be coordinated so as to bring the public debt ratio onto a downward trajectory. First, the targets for the general government budgetary position would be derived from the targeted debt-to-GDP ratio, and then the extent of the necessary fiscal adjustments would be determined. The central government spending limits for the parliamentary term and the overall tax policy stance would then be established in the Government Programme in line with the budgetary position target. The fiscal adjustment target would be maintained irrespective of the economic situation, but an escape clause would exist for exceptional conditions.

The proposed model is a welcome and more ambitious step in the right direction compared with current practices. It also makes more concrete the fiscal adjustments needed to meet the budgetary objectives by expressing them in euro terms. Tax policy would still not be explicitly tied to central government spending limits, which means that, for example, preventing circumvention of the spending limits by increasing tax subsidies would have to be stated in the Government Programme, as is currently the case. However, tax policy could still play a substantial role together with expenditure policy in achieving the aim of rebalancing the public finances if the Government so desired.

The working group report compares the fiscal policy governance systems of Finland, Sweden, Denmark and the Netherlands. What all these have in common is an expenditure ceiling, although in contrast to the other countries, Finland's ceiling is not statutory. The expenditure ceiling in the other countries also covers a larger share of public expenditure: 55% in Sweden, 75% in Denmark and 80% in the Netherlands, compared with 45% in Finland. All of the countries have set a medium-term objective for their structural deficit. The only country with a debt ratio target more stringent than the EU's 60% reference value is Sweden, where deviating from 35% of GDP requires the government to issue a report to parliament outlining corrective measures.

When the financing of the wellbeing services counties is brought directly under central government control at the start of 2023, a higher proportion of public expenditure could fall within the scope of the spending limits. The funding for the counties should indeed be included under the spending limits, although it might be justified to create a separate supplementary budget provision for the funding that would not be available for other expenditure. At the same time, it is worth thinking about how the commitment of future governments to achieving the targets could be made more effective.

The Ministry of Finance working group did not directly take a view on which elements of Finnish law regarding fiscal rules should be reformed. The current statutory framework for fiscal policy governance is mostly related to EU regulation while the most effective governance instrument – the spending limits system – is based on established practices. It is conceivable that having a broader statutory base for the governance of the public finances might be more effective in influencing such matters. The downside would be some loss of flexibility. On the other hand, flexibility is also lost when fiscal space is

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12. Developing the steering of general government finances (English summary). Publications of the Ministry of Finance 2022:71.

reduced by rising debt.

Working towards resilient public finances

Ensuring the sustainability of public finances even during future crises requires an active policy of creating fiscal space. Rebalancing the public finances not only requires direct adjustments to public revenues and expenditure in the near term but also structural reforms that will strengthen the public finances over the medium term. These measures can be taken by prioritising expenditures – cutting spending where it is less important and reallocating resources. Spending reviews which evaluate the effectiveness of different expenditure items can be used as an aid to this. In general, keeping the growth rate of total public expenditure below the long-term growth rate of nominal GDP can also be an effective way of balancing revenues and expenditure.

Public revenues can be strengthened by improving the efficiency of the tax system, for example by reducing tax subsidies and other exceptional measures. The Ministry of Finance has already announced that it will conduct a tax review with the aim of assembling information on potential tax changes that would improve the neutrality and efficiency of taxation and on how this might affect GDP growth and employment.

In the coming parliamentary terms, the boundaries set for the public finances must be seen as more binding if we wish to avoid accumulating a legacy of debt that would limit future choices. The domestic governance of fiscal policy must be enhanced. The targets for the general government budgetary position need to be consistently set with a long-term view spanning beyond parliamentary terms, and achieving the targets has to be supported with fiscal policy rules. The legislation on fiscal policy could be expanded to include the setting of public finance objectives and central government spending limits. Concrete targets as well as means for fiscal adjustment derived from rebalancing objectives would be found in Government Programmes.

The economy's growth potential could be strengthened by investing in education and research and development. Efforts such as these would also support the green transition and its necessary investments. When the public finances are built on a solid foundation, they will also be able to withstand future crises.

Tags

economic policy, public finances, sustainability of public finances, public debt

Finland's public debt sustainability and fiscal consolidation needs

Today – Analysis – Finnish economy

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Finland's public finances have long been in structural deficit, irrespective of the cyclical situation. The continued deficits have led to an increase in the amount of public debt relative to gross domestic product (GDP). As interest rates have now risen significantly, interest payments on public debt are growing as the stock of debt is rolled over and expands further. At the same time, population ageing is adding to the need for health and social services and the related spending. Halting the accumulation of further debt in the immediate years ahead would aim to give sufficient room for manoeuvre in future crises and for coming generations. A fiscal correction will require significant spending cuts and tax increases in future parliamentary terms.

Public debt continues to grow

According to the Bank of Finland's December 2022 forecast, Finland's general

government deficit relative to GDP will grow to over 2.5% by 2025 (see Finnish economy set to slide into recession). In addition to the permanent expenditure increases already decided, the public finances will be weakened by age-related expenditure, and by higher debt servicing costs stemming from higher interest rates. At the same time, public debt relative to GDP will be approaching 75% by the end of 2025. The debt ratio will continue to grow in the long term, too, unless the trajectory of the public finances is corrected.

The Bank of Finland's forecast for the public finances is based on a no-policy-change assumption that only takes into account already-known policy decisions concerning the future, available statistical data, and macroeconomic forecasts and assumptions (Table 1). With the end of the parliamentary term approaching, even the fiscal stance for the immediate years ahead is surrounded by high uncertainty.

Table 1.

Assumptions about the Finnish economy in the medium term

	2010–2019	2020–2025	2026–2035
General government (excl. employment pension schemes) net lending, % of GDP	−3.5	−3.5	-4.3
Nominal (implicit) interest rate on public debt, %	1.9	1.0	2.2
Consolidated general government debt, % of GDP	61.7	73.2	83.1
GDP volume growth, %	1.2	0.8	1.3
Consumer price inflation (HICP), %	1.5	3.0	2.0
Number of persons employed (aged 15–74), 1,000 persons	2,444	2,583	2,599
Unemployment rate, %	8.3	7.3	7.6

Sources: Statistics Finland and calculations by the Bank of Finland.

Recent years have once again demonstrated that gaining fiscal space through increased borrowing may become necessary in the future, too. The higher the level of public debt in relation to the size of the economy, the more likely it is that higher interest payments will be paid on the debt. To prevent debt servicing costs from overly limiting fiscal policy in normal times, the amount of debt should be maintained at a reasonable level.

In the Finnish national accounts, the general government sector also includes private earnings-related pension funds, i.e. employment pension schemes. This has served to strengthen the general government budgetary position. However, the surplus of the employment pension schemes does not directly reduce the borrowing needs of other general government subsectors, nor can it be used to service public debt. Hence, public debt accumulation is particularly affected by the combined net lending of central

government, local government and social security funds other than employment pension schemes. According to the Bank of Finland's forecast, the structural primary balance [1] of the general government sector (excl. employment pension schemes) is estimated at -1.0% relative to GDP in 2024, or approximately EUR 3 billion. Rebalancing central and local government finances in structural terms, including interest payments, would require EUR 5.7 billion in 2024.

Although the long-term fiscal sustainability challenges associated with Finland's age demographics have long been known, the country's public debt ratio has doubled over the past 14 years. The fiscal issues that previously appeared as long-term challenges have in many respects already turned into today's problems. Efforts must be made to improve the balance of the public finances to ensure that there will also be funds to tackle the ecological problems affecting our future generations. Even though Finland's public debt ratio has already reached the level of the crisis years of the early 1990s, the current situation is markedly different. Fiscal correction is not yet a matter of compulsion; there is still time if action is taken soon and is continued on a long-term basis.

Calculating fiscal consolidation needs

Bringing the public finances onto a sustainable path will take time. In the calculations presented here, we estimate the fiscal consolidation required over the next two parliamentary terms. We analyse the impact of the consolidation on the deficit and on the level of debt for the period up to 2035. The aim here is to halt or reverse the upward trend in the debt-to-GDP ratio by 2035. The debt ratio may also be affected by EU Treaty and economic governance framework requirements. At its simplest, the accumulation of debt is halted by balancing general government (excl. employment pension schemes) revenues and expenditures. If there is no need to take on new debt, the debt-to-GDP ratio will decline as the economy grows, i.e. as GDP (the denominator of the debt ratio) increases.

The need for age-related services will increase each year, so the related higher spending must be counteracted in some way to keep the accumulation of debt in check. However, with both debt and interest rates rising, the higher price of new debt will gradually drive up interest payments on the total stock of debt, thus also automatically fuelling public spending. These dynamics hamper the management of the public finances.

The levels of general government deficit and debt can be reduced both by consolidation measures targeted at public revenues and expenditure and by structural reforms. For the sake of simplicity in the calculations presented here, the fiscal consolidation is split evenly between spending cuts and tax increases. The spending cuts are assumed to be targeted at transfers, monetary social benefits and subsidies paid by general government to other sectors. Thus, it is assumed no cuts are made to public service provision or public investment.[2] As for the tax increases, the assumption is that half will concern direct taxes (largely income tax receipts) and half indirect taxes (value added tax being

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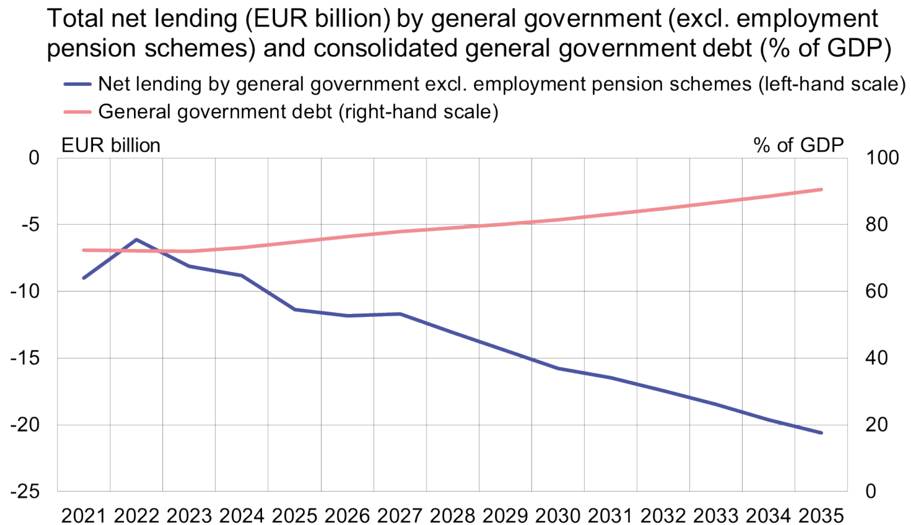
1. Budget balance adjusted for cyclical effects, one-off factors and interest payments.
2. The potential areas of public spending cuts and the extent of these have been analysed in the article Assessment of public finances 2019 by Arto Kokkinen (Forecast for the Finnish economy, December 2019).

the most important individual tax class). The fiscal consolidation scenarios are based on the Bank of Finland's December 2022 economic forecast, the long-term forecast and a fiscal sustainability calculation. The sustainability calculation is presented later in this article. The aim is also to ensure the calculations take into account the impact on economic growth.

Chart 1.



In the absence of any new decisions on fiscal consolidation, the general government (excl. employment pension schemes) deficit will increase to almost EUR -21 billion, or 4.9% of GDP, by 2035 (Chart 1). Under this no-policy-change scenario, the rising deficit will be fuelled by growth in age-related spending and public debt servicing costs. Age-related spending (excl. earnings-related pension expenditure) will grow by 0.8 percentage points relative to GDP in the period 2022–2035. Over the same period, interest payments relative to GDP will grow by 1.8 percentage points.[3]

First, we estimate the size of the fiscal consolidation required to halt or reverse further growth in the amount of public debt. Annual general government (excl. employment pension schemes) expenditures and revenues are adjusted in the scenario over the period 2024–2031, covering two parliamentary terms. The calculation assumes that this consolidation is distributed evenly, i.e. the same levels of permanent expenditure cuts and tax increases are made each year, cumulatively on top of the adjustments of each previous year. Rebalancing the general government finances, and therefore halting the accumulation of further debt, would require an evenly distributed fiscal consolidation totalling EUR 13 billion, starting in 2024 (Chart 2).

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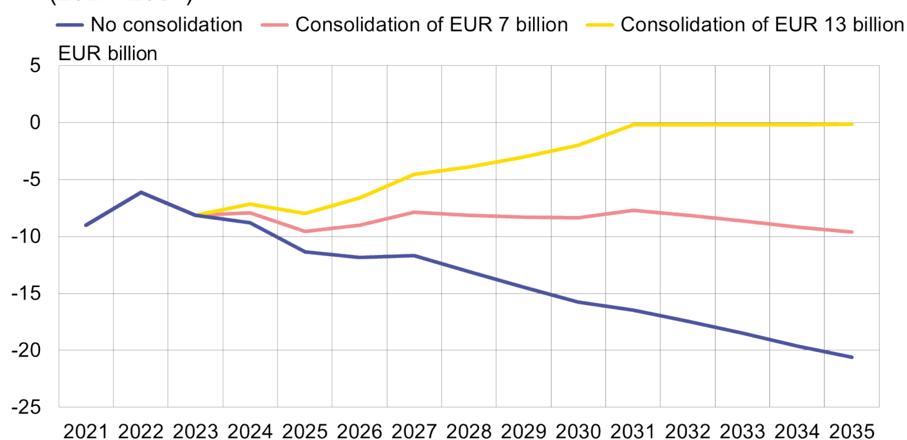
3. The assumption concerning the interest rate on public debt is the same as that of the European Commission's Ageing Working Group, i.e. the nominal interest rate will rise to 4% in 2050.

Chart 2.



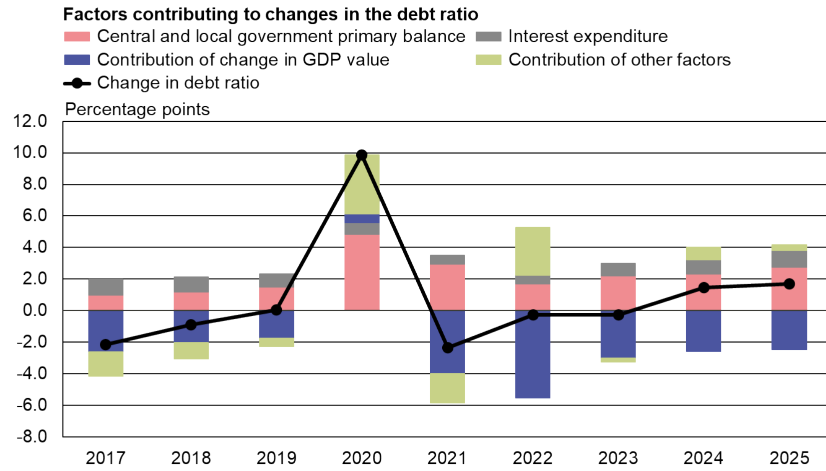
Bringing the debt ratio down to 60% would require rebalancing the public finances

The ratio of public debt to GDP does not necessarily grow if the amount of debt increases. If the general government primary budget position [4] is sufficiently close to balance, the rise in the debt-to-GDP ratio will depend on the difference between the interest rate paid on public debt and the economy's growth rate, i.e. the so-called interest rate-growth differential. If the GDP growth rate exceeds the average interest rate on the stock of debt, the debt ratio will decrease, and vice versa. The debt ratio is also affected by various timing factors and periodic financial transactions, such as revenue on asset sales or the use of liquid cash reserves (Chart 3).

4. The difference between public revenue and expenditure other than interest payments.

Chart 3.

Primary balance and interest payments will raise the debt ratio again from 2024 onwards



Sources: Statistics Finland and calculations by the Bank of Finland.

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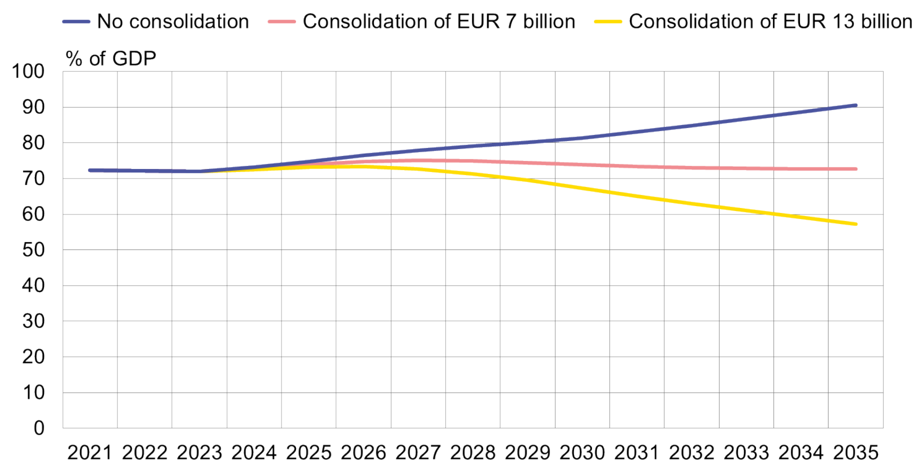
Without fiscal consolidation, public debt relative to GDP will grow to around 91% by 2035 (Chart 4). Stabilising the debt ratio would require an evenly distributed consolidation totalling EUR 7 billion over 8 years, i.e. over the next two parliamentary terms. With a consolidation of EUR 13 billion, Finland would be in compliance with the EU Treaty reference value of 60% for the debt-to-GDP ratio in 2035, and the amount of debt would not grow further.

Chart 4.

Consolidated general government debt (% of GDP) with fiscal consolidation distributed evenly over 8 years (2024–2031)



Sources: Statistics Finland and calculations by the Bank of Finland.

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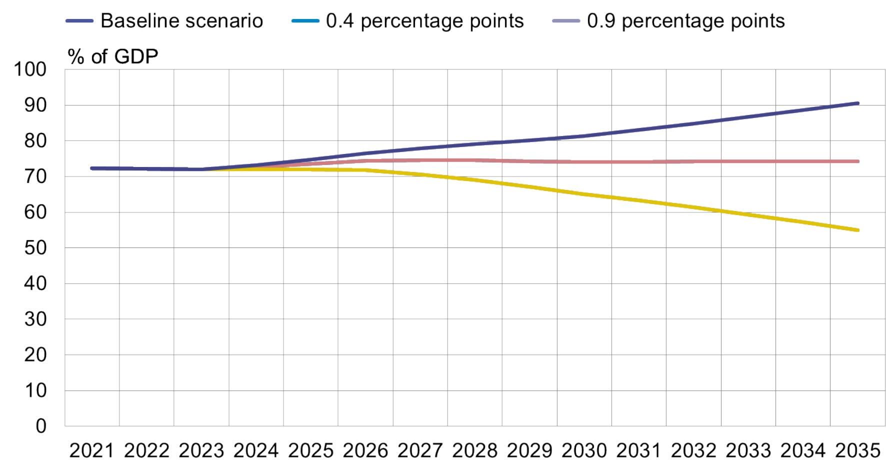
Since the global financial crisis, the contractionary effect that the interest rate-growth differential has had on the debt ratio in Finland has been surpassed by the expansionary effect of the negative primary balance. As a result, the debt ratio has increased

substantially. At the same time, the surplus of the employment pension schemes has kept the total general government net lending within the framework of the 3% of GDP deficit reference value. With public debt remaining below the reference value of 60% of GDP, general government borrowing has continued. Even a breach of the debt-to-GDP reference value has not been sufficient as such to launch an excessive deficit procedure against Finland.

As described above, strong economic growth is a highly effective remedy against growing debt ratios. If GDP volume growth were to permanently accelerate by 0.4 percentage points above the assumed baseline scenario (Table 1) starting from 2024 [5], the debt ratio would not rise in the period 2026–2035 (Chart 5). Should GDP growth accelerate by 0.9 percentage points above the baseline scenario, further growth in the amount of debt would also come to a halt by 2035.

Chart 5.

Consolidated general government debt (% of GDP) when GDP volume growth is assumed to increase permanently



Sources: Statistics Finland and calculations by the Bank of Finland.

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@ Bank of Finland
41307@Chart5

By supporting economic growth, structural reforms can, in the best case, reduce the upward pressures on public spending or broaden the tax base. If it is assumed that healthcare and long-term care expenditure relative to GDP remain at the level of 2027 in real terms, then stabilising the debt ratio and rebalancing the general government (excl. employment pension schemes) budget position by 2035 would each necessitate a fiscal consolidation that is EUR 2 billion smaller than if the projected growth of age-related spending is taken into account.

Based on these scenarios, it is evident that the most effective way to balance the public finances would be a combination of fiscal consolidation and structural reforms that support economic growth and employment. Growth-fuelling reforms and their implementation are essential in the immediate years ahead, but it is only fiscal consolidation that can be attained with certainty through policy decisions.

5. Such acceleration of growth is assumed to stem from labour productivity growth.

Interest payments on public debt are growing as the amount of debt increases and interest rates rise. It might, therefore, be more efficient to front-load fiscal consolidation, because this would more rapidly curb debt accumulation. Using a front-loaded approach, stabilising the debt ratio or balancing general government (excl. employment pension schemes) net lending by 2035 would require a consolidation that is, in rough terms, almost equal to that required in the evenly distributed approach. However, in the case of a front-loaded consolidation of EUR 7 billion [6], net lending would improve faster and the debt ratio for 2035 would decrease to just below 70%, which is more than 2.5 percentage points less than with the evenly distributed consolidation. If the consolidation is EUR 6 billion in the next parliamentary term and EUR 3 billion in the subsequent one, distributed evenly each year [7], the debt ratio would fall to around 65% and the general government (excl. employment pension schemes) deficit would shrink to EUR 6 billion by 2035.

If the public finances are consolidated only by raising taxes, then stabilising the debt ratio by 2035 would require the tax-to-GDP ratio (aggregate taxes and tax-like payments relative to GDP) to be tightened annually by almost 0.3 percentage points in the period 2024–2031. In such a case, the consolidation would lead to a tightening of the tax-to-GDP ratio by a total of over 2 percentage points. Halting further growth in the amount of debt by 2035 would require the tax-to-GDP ratio to be tightened annually by slightly over half a percentage point, resulting in the ratio tightening overall by over 4 percentage points.

Long-term sustainability gap

Finland's long-term debt sustainability is assessed by gauging changes in public revenue and expenditure up to the year 2070.[8] This technical quantification of the pressure on the public finances assumes that age-related expenditure grows as demographic changes occur. In addition, the calculation of property income and expenditure, which is based on interest rate assumptions, has an impact on age-related expenditure. Long-term debt sustainability is measured by the 'S2' indicator, which summarises in a single figure the extent to which the general government budgetary position should be permanently adjusted for public debt not to increase in an uncontrollable manner in the future. According to the Bank of Finland's estimate, Finland's sustainability gap will be about 4% of GDP in 2027.

The Bank of Finland's current estimate for the sustainability gap is higher than the one produced in 2021 (3.5%). The increase is largely attributable to future interest expenditure on gross debt for the calculation's base year, and the base year's structural deficit. Both of these are now slightly higher. In the calculation, both age-related spending and interest payments will cause changes in public spending relative to GDP

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6. The annual adjustment would be EUR 0.9 billion in the forthcoming parliamentary term and EUR 0.3 billion in the subsequent one.
7. In this case, the annual adjustment is EUR 1.5 billion in the forthcoming parliamentary term and EUR 0.75 billion in the subsequent one.
8. For more details on the principles guiding the calculation of the sustainability gap, see the Bank of Finland Bulletin article by Jarkko Kivistö and Pirkka Jalasjoki, published as part of the December 2021 forecast for the Finnish economy.

after 2027, the calculation's base year. Age-related spending takes account of the Finnish Centre for Pensions' new long-term projections [9] and estimates of the number of pension recipients and the pension replacement ratio. Changes in expenditure on healthcare, long-term care and education and training are also affected by the age structure of the population (Table 2). The level of public spending is estimated based on data for 2020, with the exception of healthcare expenditure, as the 2020 data includes additional pandemic-related spending. Growth in healthcare spending is therefore assessed on the basis of 2019 data. The level of public revenues is primarily based on economic growth – the growth rate of labour productivity and employment. The assumption concerning the interest rate on public debt is the same as that of the European Commission's Ageing Working Group, i.e. the nominal interest rate will rise to 4% in 2050.

Table 2.

Age-related expenditure relative to GDP

	2019	2020	2035	2070	Change 2019–2035	Change 2019–2070
Pensions	13.3	13.9	13.4	14.0	0.0	0.7
Healthcare	6.8	7.3	7.5	8.0	0.7	1.2
Long-term care	2.0	2.0	2.9	4.8	0.9	2.8
Education and training	5.6	5.8	5.2	5.5	-0.4	-0.1
Unemployment	1.7	2.0	2.0	1.9	0.2	0.2
Total age-related expenditure	**29.5**	**31.1**	**30.9**	**34.3**	**1.4**	**4.7**
Age-related expenditure excl. pensions	**16.2**	**17.2**	**17.6**	**20.3**	**1.4**	**4.1**

Sources: Statistics Finland, Finnish Centre for Pensions and calculations by the Bank of Finland.

Conclusion

The upward pressures on Finland's public debt stem from the imbalance between public revenue and expenditure. This imbalance will become more marked in the coming years due to growth in health and social services spending and public debt service payments. Stabilising the debt ratio by 2035 would require a combined expenditure and revenue adjustment of EUR 7 billion over the next two parliamentary terms if the consolidation is distributed evenly over 2024–2031. If the consolidation is based on tax increases alone,

9. Tikanmäki et al. (2022) Lakisääteiset eläkkeet – pitkän aikavälin laskelmat 2022. Finnish Centre for Pensions, Reports 05/2022 (in Finnish with an English summary 'Statutory pensions – long-term projections 2022').

the tax-to-GDP ratio should be raised over the same period by almost 0.3 percentage points annually, i.e. by a total of more than 2 percentage points.

Halting the accumulation of further debt by 2035 would require a combined expenditure and revenue adjustment of EUR 13 billion. In this case, the debt ratio would also fall below the EU Treaty reference value of 60% of GDP. As the calculations concerning the future presented in this article build on various assumptions, the results are naturally subject to uncertainty. Nevertheless, medium-term and long-term calculations provide a picture of the scale of the challenges in public finances that decision-makers are likely to face in the coming years. Halting the accumulation of further debt in the immediate years ahead would aim to give sufficient room for manoeuvre in future crises and for coming generations. Fiscal correction is not yet a matter of compulsion; there is still time if action is taken soon and is continued on a long-term basis.

Tags

sustainability gap, fiscal sustainability, public finances, public debt

ALTERNATIVE SCENARIO

Household consumption could be hard hit in the energy crisis

Today – Forecast – Finnish economy

The alternative scenario in the Bank of Finland's forecast for the Finnish economy examines risks surrounding the Bank's December 2022 baseline forecast which, should they materialise, could lead economic growth to be weaker than projected. The scenario estimates the possible impacts on the Finnish economy if Russia's war in Ukraine drags on and if the availability of energy weakens further and economic uncertainty increases. Compared to the baseline forecast, a further deepening of the crisis would prolong the economic recession in Finland and maintain price pressures in 2023 at a higher level than projected. With higher inflation and a higher increase in interest rates than in the baseline forecast, private consumption would be notably weakened. The high level of household indebtedness may deepen the recession, particularly if the financial margin of indebted households is small.

Ukraine war and energy crisis could prolong the recession

The alternative scenario describes a situation where growth is weaker than in the baseline forecast.[1] It assumes that the war in Ukraine drags on and maintains uncertainty in the economy. In addition to the continuation of the war, geopolitical tensions remain high and disruptions in the international value chain continue. The assumption is made that banks' funding costs will grow as a result of the heightened uncertainty and weaker economic situation (Table 1).

The scenario assumes that there will be a shortfall in energy availability in the euro area as gas imports from Russia dry up completely. This will lead not only to high energy prices but also to cuts in industrial production in the euro area this winter and next winter, as the scenario assumes that winters will be cold. The weakness of the euro area economy, caused by the production problems, will erode Finland's export demand. It is also assumed in the scenario that due to the cold weather, there will be electricity shortages this winter in Finland, too, which will cause disruptions in production. The scenario assumes that Russia's extra-EU oil exports will also decrease in the short term. The world market price of crude oil will rise to a clearly higher level than in the baseline forecast (Table 1).

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1. The alternative scenario does not necessarily reflect the views of the European System of Central Banks. The scenario utilises the European Central Bank's December 2022 downside scenario assumptions regarding developments in the external economic environment.

Table 1. Alternative scenario's assumptions

		2022^f	2023^f	2024^f	2025^f
Export markets (annual growth, %)	Baseline forecast	5.6	1.7	3.1	3.3
	Alternative scenario	5.6	-0.3	0.7	4.0
Competitors' export prices (annual growth, %)	Baseline forecast	16.9	3.7	2.1	2.0
	Alternative scenario	16.9	7.5	1.2	0.7
Crude oil (USD/barrel)	Baseline forecast	104.6	86.4	79.7	76.0
	Alternative scenario	104.6	122.5	92.0	76.8
Interest rate on corporate loans (%)	Baseline forecast	1.6	3.4	3.9	4.0
	Alternative scenario	1.6	3.7	4.6	4.7

Baseline forecast: Bank of Finland December 2022 forecast trajectory.

^{f} = forecast.

Sources: ECB and Bank of Finland.

The alternative scenario is performed in two stages. In the first stage, we use the Bank of Finland's Aino 2.0 model – also used for preparing the baseline forecast – to estimate the impact of the weaker scenario, described above, on economic growth, private consumption, the employment rate and inflation (phase 1).

In the second stage of the alternative scenario, the Aino 3.0 model is used to estimate the impacts of lower-than-expected economic growth on the situation of households in particular (phase 2). This model calculation enables assessment of the impacts of indebtedness on the ability of households to adjust to the decline in purchasing power and to rising interest rates prompted by high inflation, and the magnitude of the possible macroeconomic second-round effects. The Aino 2.0 model cannot be used for estimating these impacts, due to the structure of the model.[2]

2. In Aino 3.0, the household sector is modelled in more detail than in the Aino 2.0 model used in the production

In the first phase of the alternative scenario, the slowdown in economic growth is larger and more prolonged than in the baseline forecast (Chart 1, Table 2), and GDP in 2025 is still significantly lower than in the baseline scenario. Uncertainty is exacerbated by the continuation of the war and the deepening of the energy crisis, and this will weaken private consumption and investment compared to the baseline forecast. Economic growth will slow in 2023, and this will also be due to muted export demand, rising interest rates and higher prices.

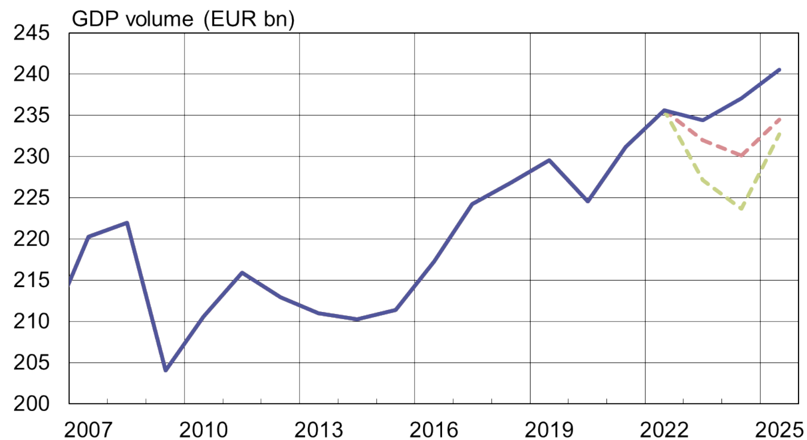
Employment will weaken in the wake of the economic situation, and the labour market in 2025 will still be less strong than in the baseline forecast. The employment rate will, however, remain at over 70% in the first phase of the scenario, and will reach 71.4% in 2025 (Table 2).

As a result of the higher energy prices and production problems, price pressures will ease in the alternative scenario at a slower pace than in the baseline forecast, and inflation will be higher particularly in 2023 (Table 2). Towards the end of the forecast period, the decline in energy prices and demand will slow the rise in prices.

Chart 1.

GDP will suffer long-term from prolongation of the Ukraine war and escalation of the energy crisis

Scenario, phase 1 (Aino 2.0)
Scenario, phase 2 (Aino 3.0)
Bank of Finland forecast, December 2022



Sources: Statistics Finland and Bank of Finland.

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of the baseline forecast. By contrast, in the Aino 3.0 model, a proportion of households are assumed to be mortgage-indebted and their borrowing is constrained by the binding maximum loan-to-value ratio. The model can therefore be used for estimating the macroeconomic effects of household borrowing.

Table 2. Alternative scenario results

		2022^f	2023^f	2024^f	2025^f
Gross domestic product, annual growth (%)	Baseline forecast	1.9	-0.5	1.1	1.5
	Scenario, phase 1 (Aino 2.0)	1.9	-1.6	-0.8	1.9
	Scenario, phase 2 (Aino 3.0)	1.9	-3.6	-1.5	4.1
Private consumption, annual growth (%)	Baseline forecast	2.4	-1.3	0.4	1.1
	Scenario, phase 1 (Aino 2.0)	2.4	-3.2	-1.6	3.3
	Scenario, phase 2 (Aino 3.0)	2.4	-4.2	-2.0	6.6
Unemployment rate (%)	Baseline forecast	73.7	73.6	73.8	74.1
	Scenario, phase 1 (Aino 2.0)	73.7	72.7	70.8	71.4
	Scenario, phase 2 (Aino 3.0)	73.7	70.5	64.6	66.1
Inflation* (%)	Baseline forecast	7.2	5.0	1.6	1.7
	Scenario, phase 1 (Aino 2.0)	7.2	6.0	1.6	1.9
	Scenario, phase 2 (Aino 3.0)	7.2	9.4	1.5	1.6

Baseline forecast: Bank of Finland December 2022 forecast trajectory.

** = Harmonised Index of Consumer Prices.*

^{f} = forecast.

Sources: Statistics Finland and Bank of Finland.

Household sector indebtedness may deepen the recession

In the first phase scenario calculation presented above, one of the underlying assumptions is that households are able to smooth their consumption over time by saving or by tapping into their savings if there is a change in their disposable income. They can also adjust their borrowing to finance their consumption. In reality, households may, however, have credit or liquidity constraints that prevent them from taking out a loan if their income suddenly decreases.[3]

The higher inflation, larger contraction in purchasing power and stronger rise in interest rates in the first phase of the alternative scenario will weaken the position of indebted, credit-constrained and liquidity-constrained households, in particular. These households will not necessarily be able to compensate for the rising cost of living by tapping into their savings or by borrowing as their real income shrinks and purchasing power diminishes as a result of the recession and high inflation.

Under the scenario assumptions, risk premia on loans will increase and financing conditions tighten because of the economic uncertainty. As a result, interest rates on housing loans, too, will rise, which will increase the loan-servicing costs of mortgage-indebted households and decrease the amount of income available for other consumption. At the same time, an economic recession and rise in interest rates will typically lower housing prices and thus the loan collateral values, which will further weaken households' ability to borrow.

If, in a situation like this, a large amount of households have to decrease their consumption substantially due to liquidity and credit constraints, it could have significant macroeconomic second-round effects. The recession will be deeper and the recovery slower.

Next, we examine how the first phase calculations presented above change when we take into consideration that some households are indebted and will be subject to credit constraints. In the second phase of the scenario, we use the same assumptions as above about the greater-than-expected deterioration in Finland's external environment (Table 1). In the model, 12% of all households are mortgage-indebted and their ability to borrow depends on the collateral value of the housing.[4] Due to the credit constraints, they will have to cut their consumption drastically if their income decreases.

In this phase two scenario, private consumption will shrink by 2.9 percentage points more in 2023 and 2.4 percentage points more in 2024 than in the baseline forecast

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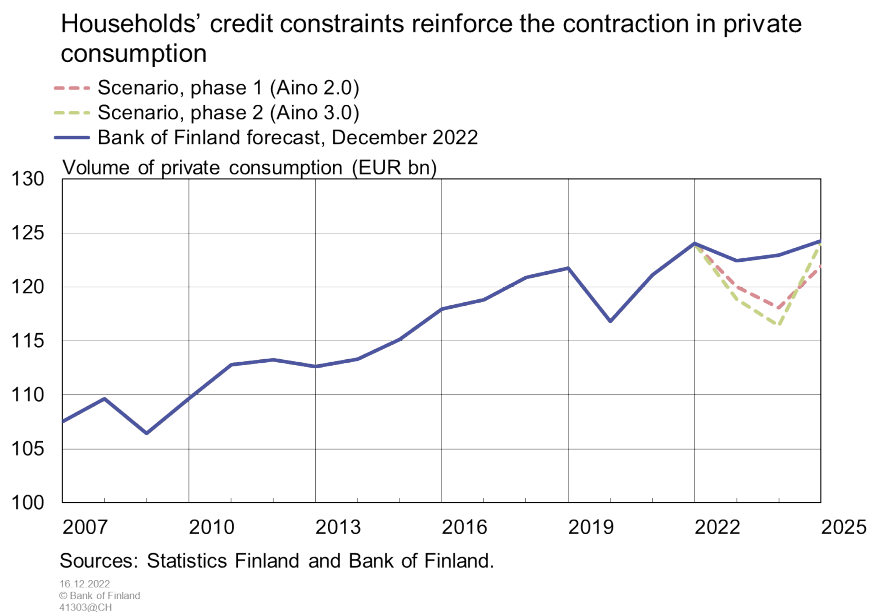
3. Credit constraint refers to a situation in which a household is not granted the loan it has applied for, or is granted a smaller loan. Liquidity constraint, in turn, refers to a situation in which a household has only a small amount of liquid assets – for example cash or bank deposits in transaction accounts – that could provide a financial buffer for a rainy day.
4. The proportion of credit-constrained households was estimated using the household-level data from Statistics Finland's 2019 Household Finance and Consumption Survey and by applying the definition described by Kaplan et al. (2014). See Kaplan, G., Violante, G. L. and Weidner, J., 'The Wealthy Hand-to-Mouth', NBER Working Paper 20073, 4/2014.

(Table 2, Chart 2). Compared to the first phase of the scenario, private consumption will shrink 1 percentage point more in 2023 and 0.4 percentage points more in 2024. This difference indicates the macroeconomic second-round effects resulting from household indebtedness and credit constraints. Following the rise in interest rates, households' nominal housing loan-servicing costs will, in 2023, be some 7% higher than in the baseline forecast. In 2024, the growth in loan-servicing costs will turn onto a downward trend. They will, however, be nearly 9% larger towards the end of the forecast period than they were still in 2022, as interest rates will remain at a higher level.

Chart 2.



The demand for new housing loans will decrease as real incomes shrink and interest rates rise. At the same time, high inflation will erode the real value of the existing loan stock. The real stock of housing loans, adjusted for the rise in prices, will shrink in the immediate years ahead, and in 2025 will be 1.6% smaller than in the baseline forecast. The household sector's housing debt relative to income will nevertheless increase during the forecast period compared to the situation in 2022, as disposable income will shrink more than the stock of housing loans. High inflation will not, therefore, ease the situation of mortgage-indebted households.

The strong decrease in households' consumption demand will also weaken growth in GDP and in labour demand and wages. This will exacerbate the recession further (Chart 1). As a result of a deep recession, the employment rate will also decrease substantially. Economic growth in this scenario will, in 2023, be more than 3 percentage points lower than in the baseline forecast (Table 2). Growth in 2024 will be 2.6 percentage points lower than in the baseline forecast. Compared to the first phase of the alternative scenario, the economy will shrink 2 percentages more in 2023 and 0.7 percentage points more in 2024. This difference indicates again the amplifying effects of households' credit constraints.

In 2025, the economy will start to recover as Finland's external demand strengthens, inflation slows significantly and the rise in interest rates subsides. Private consumption and at the same time the entire economy will recover rapidly as the situation of indebted households, in particular, eases and their income improves. GDP growth will be 2.6 percentage points higher than in the baseline forecast.

The second phase of the alternative scenario outlined here describes a severe shock to the economy and a situation where indebted households face binding credit constraints. The strong contraction in private consumption demand produced by the model is due especially to indebted households having to adjust their consumption very markedly as a result of credit constraints, when their disposable income changes.

Based on data for Finland and earlier analysis, the financial margin of indebted households is, however, typically reasonable, and in reality a high proportion of households that are heavily indebted relative to income are able to dampen the impact of financial shocks on their own situation with the help of various buffers.[5] The results of the second phase model scenario can thus be considered to represent the maximum extent of the macroeconomic second-round effects that could be caused by household sector indebtedness, whereas in the first phase scenario, these effects are fully disregarded.

Tags

Bank of Finland, economy, Finland

5. The financial situation and margin of heavily indebted households are analysed in more detail using data from the 2019 Household Finance and Consumption Survey in Mäki-Fränti, P. (2021), 'The financial situation of the highly indebted varies in Finland', Bank of Finland Bulletin, 25 November 2021 (in Finnish only). The analysis finds that large debts are held particularly by high-income and wealthy households that are well able to meet the loan-servicing costs. It also found that the financial margin of indebted households is good, on average, despite the high level of debt.

Forecast tables for 2022–2025 (December 2022)

16 Dec 2022 – Forecast – Finnish economy

The energy crisis will push the Finnish economy into a mild recession in 2023, but this will be short-lived. Energy prices will gradually fall, and in 2024 the economy will return to growth. In the country's public finances, spending will continue to exceed revenues.

1.BALANCE OF SUPPLY AND DEMAND AT REFERENCE YEAR 2015 PRICES

% change on previous year

	2021	2022[f]	2023[f]	2024[f]	2025[f]
GDP at market prices	3.0	1.9	-0.5	1.1	1.5
Imports of goods and services	6.0	8.6	-1.0	1.3	3.8
Exports of goods and services	5.4	1.7	1.8	2.8	3.1
Private consumption	3.7	2.4	-1.3	0.4	1.1
Public consumption	2.9	2.7	0.7	0.6	0.5
Private fixed investment	4.7	4.7	-2.0	-0.1	1.7
Public fixed investment	-11.5	7.2	2.4	2.5	14.7

[F]=forecast.

Sources: Bank of Finland and Statistics Finland.

2. CONTRIBUTIONS TO GROWTH[1]

	2021	2022f	2023f	2024f	2025f
GDP, % change	3.0	1.9	-0.5	1.1	1.5
Net exports	-0.2	-2.7	1.3	0.7	-0.3
Domestic demand excl. inventory change	2.9	3.1	-0.8	0.4	1.6
of which Consumption	2.6	1.9	-0.5	0.4	0.7
Investment	0.4	1.2	-0.3	0.1	1.0
Inventory change + statistical discrepancy	0.3	1.5	-1.0	0.0	0.1

[1] Bank of Finland calculations. Annual growth rates using the previous year's GDP shares at current prices as weights.

F=forecast.

Sources: Bank of Finland and Statistics Finland.

3. BALANCE OF SUPPLY AND DEMAND, PRICE DEFLATORS

Index 2015 = 100, and % change on previous year

	2021	2022[f]	2023[f]	2024[f]	2025[f]
GDP at market prices	108.7	115.0	120.5	123.3	125.6
	2.5	5.8	4.8	2.4	1.8
Imports of goods and services	108.9	130.7	133.4	130.9	133.0
	9.4	20.0	2.0	-1.8	1.6
Exports of goods and services	110.0	134.4	138.1	137.2	138.7
	9.9	22.2	2.8	-0.7	1.1
Private consumption	105.8	111.6	117.3	119.4	121.7
	1.7	5.5	5.1	1.8	1.9
Public consumption	109.7	112.2	116.9	120.2	123.1
	3.3	2.3	4.2	2.8	2.5
Private fixed investment	113.5	119.2	123.2	124.8	127.5
	2.2	5.0	3.4	1.3	2.1
Public fixed investment	110.9	116.5	119.1	120.7	122.8
	3.1	5.1	2.2	1.4	1.8
Terms of trade (goods and services)	101.0	102.8	103.6	104.8	104.3
	0.5	1.8	0.8	1.1	-0.5

F=forecast.

Sources: Bank of Finland and Statistics Finland.

4. BALANCE OF SUPPLY AND DEMAND, AT CURRENT PRICES

EUR million and % change on previous year					
	2021	2022[f]	2023[f]	2024[f]	2025[f]
GDP at market prices	251,367	270,933	282,437	292,448	302,209
	5.6	7.8	4.2	3.5	3.3
Imports of goods and services	98,505	128,348	129,686	128,945	135,927
	15.9	30.3	1.0	-0.6	5.4
Total supply	349,872	399,281	412,123	421,393	438,136
	8.3	14.1	3.2	2.2	4.0
Exports of goods and services	99,081	123,132	128,934	131,653	137,239
	15.9	24.3	4.7	2.1	4.2
Consumption	189,543	202,904	211,333	216,784	223,345
	5.7	7.0	4.2	2.6	3.0
Private	128,190	138,438	143,690	146,811	151,257
	5.4	8.0	3.8	2.2	3.0
Public	61,353	64,466	67,643	69,973	72,088
	6.3	5.1	4.9	3.4	3.0
Fixed investment	59,450	65,624	66,889	68,004	72,310
	3.8	10.4	1.9	1.7	6.3
Private	48,924	53,769	54,479	55,116	57,261
	7.0	9.9	1.3	1.2	3.9
Public	10,526	11,855	12,409	12,888	15,049
	-8.7	12.6	4.7	3.9	16.8
Inventory change + statistical discrepancy	1,798	7,621	4,967	4,953	5,242
% of previous year's total	0.2	1.7	-0.7	-0.0	0.1

EUR million and % change on previous year					
	2021	2022^f	2023^f	2024^f	2025^f
demand					
Total demand	349,872	399,281	412,123	421,393	438,136
	8.3	14.1	3.2	2.2	4.0
Total domestic demand	250,791	276,149	283,189	289,740	300,897
	5.6	10.1	2.5	2.3	3.9

F=forecast.

Sources: Bank of Finland and Statistics Finland.

5. BALANCE OF SUPPLY AND DEMAND

% in proportion to GDP at current prices					
	2021	2022f	2023f	2024f	2025f
GDP at market prices	100.0	100.0	100.0	100.0	100.0
Imports of goods and services	39.2	47.4	45.9	44.1	45.0
Exports of goods and services	39.4	45.4	45.7	45.0	45.4
Consumption	75.4	74.9	74.8	74.1	73.9
Private	51.0	51.1	50.9	50.2	50.1
Public	24.4	23.8	23.9	23.9	23.9
Fixed investment	23.7	24.2	23.7	23.3	23.9
Private	19.5	19.8	19.3	18.8	18.9
Public	4.2	4.4	4.4	4.4	5.0
Inventory change + statistical discrepancy,	0.7	2.8	1.8	1.7	1.7
Total demand	139.2	147.4	145.9	144.1	145.0
Total domestic demand	99.8	101.9	100.3	99.1	99.6

F=forecast.

Sources: Bank of Finland and Statistics Finland.

6. PRICES

Index 2015 = 100, and % change on previous year					
	2021	**2022f**	**2023f**	**2024f**	**2025f**
Harmonised index of consumer prices, 2005=100	106.1	113.8	119.5	121.3	123.3
	2.1	7.2	5.0	1.6	1.7
Consumer price index, 2005=100	105.8	113.4	119.6	121.6	123.5
	2.2	7.1	5.5	1.7	1.6
Private consumption deflator	105.8	111.6	117.3	119.4	121.7
	1.7	5.5	5.1	1.8	1.9
Private investment deflator	113.5	119.2	123.2	124.8	127.5
	2.2	5.0	3.4	1.3	2.1
Exports of goods and services deflator	110.0	134.4	138.1	137.2	138.7
	9.9	22.2	2.8	-0.7	1.1
Imports of goods and services deflator	108.9	130.7	133.4	130.9	133.0
	9.4	20.0	2.0	-1.8	1.6
Value-added deflators					
Value-added, gross at basic prices	108.9	115.5	121.2	124.0	126.3
	2.4	6.1	4.9	2.4	1.8

F=forecast.

Sources: Bank of Finland and Statistics Finland.

7. WAGES AND PRODUCTIVITY

% change on previous year					
	2021	2022[f]	2023[f]	2024[f]	2025[f]
Whole economy					
Index of wage and salary earnings	2.4	2.6	4.3	3.5	3.0
Compensation per employee	2.9	3.7	5.5	3.8	3.2
Unit labour costs	2.5	4.4	5.8	2.9	2.0
Labour productivity per employed person	0.4	-0.7	-0.3	0.9	1.1

F=forecast.

Sources: Bank of Finland and Statistics Finland.

8. LABOUR MARKET

1,000 persons and % change on previous year					
	2021	2022[f]	2023[f]	2024[f]	2025[f]
Labour force survey (15–74-year-olds)					
Employed persons	2,548	2,614	2,609	2,616	2,625
	2.6	2.6	-0.2	0.3	0.3
Unemployed persons	210	193	208	204	201
	1.9	-9.0	7.8	-1.7	-1.5
Labour force	2,759	2,807	2,817	2,820	2,826
	2.5	1.7	0.3	0.1	0.2
Working-age population (15–64-year-olds)	3,417	3,420	3,420	3,419	3,418
	-0.1	0.1	0.0	-0.0	-0.0
Labour force participation rate, %	67	68	69	69	69
Unemployment rate, %	7.6	6.9	7.4	7.2	7.1
Employment rate (15–64-year-olds), %	72.1	73.7	73.6	73.8	74.1

F=forecast.

Sources: Bank of Finland and Statistics Finland.

9. GENERAL GOVERNMENT REVENUE, EXPENDITURE, BALANCE AND DEBT

	2021	2022f	2023f	2024f	2025f
% relative to GDP					
General government revenue	52.7	52.5	52.4	52.2	51.9
General government expenditure	55.4	53.4	54.2	54.2	54.5
General government primary expenditure	54.9	52.8	53.4	53.3	53.5
General government interest expenditure	0.5	0.6	0.8	0.9	1.1
General government net lending	-2.7	-0.9	-1.8	-2.0	-2.6
Central government	-3.3	-1.8	-2.2	-2.2	-2.8
Local government	-0.2	-0.4	-0.7	-0.9	-1.1
Social security funds	0.8	1.3	1.0	1.1	1.2
General government primary balance	-2.2	-0.4	-1.1	-1.1	-1.6
General government structural balance[1]	-2.0	-1.0	-1.5	-1.5	-2.3
General government debt (EDP)	72.4	72.2	71.9	73.2	74.9
Central government debt	51.2	52.2	52.3	53.4	54.7
Tax ratio	43.0	42.7	42.4	42.3	42.1
Current prices, EUR billion					
General government net lending	-6.8	-2.5	-5.1	-5.9	-7.9
Central government	-8.2	-5.0	-6.1	-6.4	-8.3
Local government	-0.5	-1.2	-1.9	-2.6	-3.2
Social security funds	2.0	3.6	2.9	3.1	3.7
General government debt (EDP)	181.9	195.7	203.1	214.0	226.2

[1]Based on the cyclical adjustment method used by the European System of Central Banks.

F=forecast.

Sources: Bank of Finland and Statistics Finland.

10. BALANCE OF PAYMENTS

EUR billion					
	2021	2022[f]	2023[f]	2024[f]	2025[f]
Exports of goods and services (SNA)	99.1	123.1	128.9	131.7	137.2
Imports of goods and services (SNA)	98.5	128.3	129.7	128.9	135.9
Goods and services account (SNA)	0.6	-5.2	-0.8	2.7	1.3
% to GDP	0.2	-1.9	-0.3	0.9	0.4
Investment income and other items, net (+ statistical discrepancy)	4.0	-2.3	0.9	0.9	0.9
Current transfers, net	-3.0	-2.5	-2.3	-2.4	-2.7
Current account, net	1.6	-10.0	-2.1	1.1	-0.5
Net lending, % to GDP					
Private sector	3.3	-2.8	1.2	2.6	2.5
Public sector	-2.7	-0.9	-2.0	-2.2	-2.7
Current account, % to GDP	0.6	-3.7	-0.8	0.4	-0.2

F=forecast.

Sources: Bank of Finland and Statistics Finland.

11. INTEREST RATES

%	2021	2022[f]	2023[f]	2024[f]	2025[f]
3-month Euribor[1]	-0.5	0.4	2.9	2.7	2.5
Yield on Finnish 10-year government bonds[1]	-0.1	1.2	1.7	1.8	1.9

[1]Technical assumption derived from market expectations.

F=forecast.

Sources: Bank of Finland and Statistics Finland.

12. INTERNATIONAL ENVIRONMENT

The Eurosystem staff projections					
	2021	2022[f]	2023[f]	2024[f]	2025[f]
GDP, % change on previous year					
World (excl. euro area)	6.4	3.3	2.6	3.1	3.3
USA	5.9	1.9	0.6	0.9	1.8
Euro area	5.2	3.4	0.5	1.9	1.8
Japan	1.7	1.5	1.4	1.3	1.3
Imports, % change on previous year					
World (excl. euro area)	12.6	5.6	1.9	3.3	3.3
USA	14.1	8.2	-1.1	2.4	2.9
Euro area	8.2	7.9	3.1	3.3	3.4
Japan	5.1	7.6	3.3	2.4	2.4
Index, 2015 = 100, and % change on previous year					
Import volume in Finnish export markets	117.2	123.7	125.8	129.7	133.9
	10.4	5.6	1.7	3.1	3.3
Export prices of Finland's trading partners, national currencies	116.6	136.3	141.3	144.3	147.2
	10.6	16.9	3.7	2.1	2.0
Export prices of Finland's trading partners, in euro	106.6	128.0	132.4	135.1	137.8
	9.9	20.0	3.4	2.1	2.0
Industrial raw materials (excl. energy), HWWA index, in US dollars	152.9	162.7	145.2	146.1	148.2
	42.1	6.4	-10.8	0.7	1.4
Oil price, USD per barrel[1]	71.1	104.6	86.4	79.7	76.0
	71.3	47.1	-17.4	-7.7	-4.7

The Eurosystem staff projections					
	2021	2022^f	2023^f	2024^f	2025^f
Finland's nominal exchange rate [2]	91.4	93.9	93.6	93.6	93.6
	-0.7	2.7	-0.3	-0.0	-0.0
US dollar value of one euro[3]	0.8	1.0	1.0	1.0	1.0
	-3.5	12.6	2.1	0.0	0.0

[1]Technical assumption derived from market expectations.

[2] Broad nominal effective exchange rate, January – March 2015 = 100. The index rises as the currency depreciates. Assuming no changes in the exchange rate.

[3] Assuming no changes in the exchange rate.

F=forecast.

Sources: Bank of Finland and Statistics Finland.

13. Current and June 2022 forecast

	2021	2022^f	2023^f	2024^f	2025^f
GDP, % change	3.0	1.9	-0.5	1.1	1.5
June 2022	3.5	1.7	0.5	1.5	
Inflation (HICP), %	2.1	7.2	5.0	1.6	1.7
June 2022	2.1	5.6	2.4	1.8	
Employment rate, %	72.1	73.7	73.6	73.8	74.1
June 2022	72.2	73.7	73.8	74.3	
Unemployment rate, %	7.7	6.9	7.4	7.2	7.1
June 2022	7.6	6.5	6.5	6.4	
Current account, % to GDP	0.6	-3.7	-0.8	0.4	-0.2
June 2022	0.7	-1.0	-0.6	0.1	
General government net lending, % to GDP	-2.7	-0.9	-1.8	-2.0	-2.6
June 2022	-2.6	-1.9	-1.8	-1.6	
General government debt (EDP), % to GDP	72.4	72.2	71.9	73.2	74.9
June 2022	65.8	64.4	65.4	66.1	

F=forecast.

Sources: Bank of Finland and Statistics Finland.

Tags

economic outlook, forecast, indicators, economic situation, economic forecast, Finland