BANK OF FINLAND
BULLETIN
EUROJÄRJESTELMÄ
EUROSYSTEMET

5 · 2013

Economic outlook

Contents

The front cover depicts the national motif on the Spain 2 cent coin: the Cathedral of Santiago de Compostela, a pilgrimage destination.

Bank of Finland Bulletin 5 • 2013
Vol. 87
Published 9 January 2014
The Bank of Finland Bulletin is published five times a year.

Editor-in-Chief
Erkki Liikanen

The forecast was prepared by the Monetary Policy and Research Department under the direction of Anssi Rantala, Head of Forecasting.

Authors
Harri Hasko
Helvi Kinnunen
Jarkko Kivistö
Tuuli Koivu
Petri Mäki-Fränti
Seppo Orjasniemi
Jukka Railavo
Hannu Viertola

Assistants
Anna Marin
Reijo Siiskonen

The article 'Financial stability' was prepared by the Financial Markets and Statistics Department.

Authors
Jyrki Haajanen
Päivi Heikkinen
Kimmo Koskinen
Hanna Putkuri
Pertti Pylkkönen
Jukka Topi

Assistants
Nina Björklund

Translating and editing
Bank of Finland Language and Publication Services

Subscriptions
Email: BoFPublications@edita.fi

Printed
Edita Prima Oy, Helsinki 2014

ISSN 0784-6509 (print)
ISSN 1456-5870 (online)

Bank of Finland
PO Box 160
FI-00101 HELSINKI
Phone National 010 8311,
International +358 10 8311
Fax: +358 9 174 872
www.bof.fi

Preface

From the outbreak of the international financial crisis until spring 2013, economic debate in Finland was focused largely on economic developments abroad. Since summer 2013, the problems in the domestic economy, and particularly the major structural changes that have taken place, have taken centre stage. The Finnish economy is facing challenges that cannot be resolved simply by improvements in the international economy.

Economic growth in Finland has disappointed expectations on numerous occasions during the past 5 years. GDP is still approximately 5% smaller than prior to the outbreak of the financial crisis in 2008. Growth is now forecast to be gradually taking off. Even so, according to the Bank of Finland forecast, GDP in 2015 will still not reach the level of 2008.

Finnish GDP has since 2008 contracted more than the average for the euro area. Particularly weak has been the performance of exports. Over the past 5 years, the value of Finnish exports has declined more than in any other euro area country.

The problems of the Finnish economy relate in large measure to structural changes, including the contraction in electronics and the paper industry. In addition, the number of people of working age (15–64-year-olds) has been declining since 2010, as the post-war baby-boom generation has begun to reach retirement age. The prospects for growth have also been subdued by weaker cost-competitiveness, with unit labour costs rising approximately 10% since 1999 relative to the average among Finland's trading partners.

The contraction in GDP has weakened the funding base of the public finances. The disappointing figures for economic growth have led to a substantial deficit in central and local government finances. Although recent years have brought decisions on government consolidation, the central and local government deficits together with the lacklustre outlook for growth and an ageing population mean that the long-term sustainability of the public finances has not been secured.

The structural policy programme set out by the government will, once implemented, ease the long-term problems in the economy. If the programme is implemented with ambition, it will reinforce the foundations of growth and the long-term sustainability of the public finances.

One part of the programme concerns eradication of the structural deficit in local government. If this aspect of the programme's objectives is achieved as scheduled, according to calculations by the Bank of Finland, the upward course of the general government debt ratio should come to a halt at just above 60% before the end of the current decade. In the absence of further measures, however, the debt ratio will thereafter begin to rise at an accelerating pace. The measures for consolidating local government finances are therefore important to the general government balance as a whole in the immediate years ahead, although they cannot on their own bring the public finances onto a sustainable trajectory.

A rapid rise in the general government debt ratio in the 2020s can, according to what has been calculated, be largely prevented by implementing the government's structural policy programme in its entirety. Here, reform of the pension system is crucial. A pension reform that substantially alters the financial incentives to retirement is essential, if we wish to ensure the lengthening of working careers in the manner sought.

The decisions necessary to achieve the objectives of the structural policy programme will not be easy, and their preparation will require a great deal of work. However, the need to bring general government debt under control requires that decisions be taken soon, as many of the effects of the decisions taken will not be fully felt until several years later.

Alongside reforms to the structure of the economy, it is also important to support the favourable development of general government finances by further developing the fiscal policy steering system. The central government system of spending limits is part of this steering system. In recent years, the steering role of spending limits has been weakened by the failure of the general government funding base due to the structural problems in the economy. In order for the system of spending limits to work effectively even under such conditions, it may be worth using reviews of the spending limits to adapt the system to take account of a long-term, structural weakening of the funding base.

In addition to the government's structural policy programme, recent months have also seen the problems of the Finnish economy addressed with the help of a general agreement on pay between the social partners. This is important and will mean a slower rise in negotiated wages than in previous years. According to forecasts, it will end the rise in Finland's unit labour costs relative to its trading partners on average and will reduce unit labour costs relative to Germany and Sweden.

There is nevertheless cause to note that, based on these same forecasts, the immediate years ahead will not see Finland's unit labour costs coming down relative to the average for its trading partners. Thus, the agreement reached will not correct the weakening in cost-competitiveness that has followed the rapid rise in unit labour costs in previous years. Restoration of cost-competitiveness will require a slower rise in costs relative to Finland's trading partners for a period of several years after the recently concluded collective agreements have expired.

The major challenges to the Finnish economy have been responded to with important decisions in 2013. However, the problems have not yet been resolved. This will require determined, long-term decisions that implement structural reforms and boost cost-competitiveness both now and for many years to come.

9 December 2013

Erkki Liikanen

Bank of Finland forecasts

This issue of the Bank of Finland Bulletin presents the Bank's macroeconomic forecast, which is prepared by the Monetary Policy and Research Department. The forecast report examines recent developments in the economy and the outlook for the present calendar year and the next two years ahead. The focus is on the Finnish economy. The forecast itself describes the most probable developments in the economy, while the attached risk assessment discusses the uncertainties relating to the forecast.

The forecast is prepared as part of the Eurosystem staff projections for future macroeconomic developments in the euro area.[1] Accordingly, the underlying forecast assumptions and assessments of future developments in the international economy are the same as in the Eurosystem staff projections. The assumption is for interest rates to develop according to market expectations and for exchange rates to remain unchanged during the forecast period.

The forecast for the Finnish economy and the related risk assessment are prepared using a macroeconomic model developed at the Bank of Finland and a large body of other data and assessments of economic developments.[2]

The Bank of Finland macroeconomic forecast and the related separate articles are published in the June and December editions of the Bank of Finland Bulletin. The European Central Bank publishes summaries of the Eurosystem staff projections in the June and December editions of the ECB Monthly Bulletin.

[1] *The Eurosystem comprises the European Central Bank plus the national central banks of countries in the euro area, including the Bank of Finland.*

[2] *The forecast uses the latest version of the Bank of Finland's macroeconomic model, Aino. The basic features of the model are described in the article 'An estimated general equilibrium model for forecasting' by Elisa Newby, Jukka Railavo and Antti Ripatti, Bank of Finland Bulletin 3/2011: Economic outlook, p. 58–66.*

Executive summary

Finland's GDP began to contract in the second quarter of 2012, and the economic recession continued into the first quarter of 2013. Advance data indicate that during the course of 2013 the Finnish economy has recommenced gentle growth, but GDP for 2013 as a whole will still be less than the previous year.[1] According to the Bank of Finland's macroeconomic forecast, growth will continue to be sluggish in 2014. Finland's export markets will already see a recovery in growth in 2014, and export growth, too, will gradually gather pace as international investment strengthens.

A deteriorating employment situation and weaker consumer confidence have led to a decline in private consumption in 2013. A slight contraction in employment and real earnings will continue to restrict income development in 2014, and private consumption will not begin to grow again until 2015.

2013 has witnessed a decline in fixed investment, with the weak cyclical situation in the economy causing the postponement of investment projects. Investment will begin to grow in 2014 and this growth will gather pace in 2015 as the amount of unused capacity declines and resource constraints begin to appear. Housing construction will not grow until 2015, when the housing market will recover as the employment situation improves.

As exports, investment and domestic consumption have faded during the past year, declining imports have halted the weakening trend in the balance of foreign trade. In 2014, too, imports will grow more slowly than exports due to the continued downward trend in domestic consumption. The growth contribution of net exports will decline in 2015 as import growth gathers pace. During the forecast period, the current account will move from deficit to record a slight surplus, due to exports of goods and services growing more than imports.

The unemployment rate will remain slightly above 8% in 2014 as the decline in the labour force due to population ageing holds any rise in the unemployment rate in check. Moreover, many people of working age have recently left the labour force for a variety of reasons. Accelerating growth will boost employment and reduce unemployment only in 2015.

The general government deficit will deepen as GDP contracts in 2013, and economic recovery and a rising tax ratio will be insufficient to significantly reduce the deficit by 2015. This will mean a growth in the GDP ratio of general government debt to over 64% in 2015.

The general pay agreement negotiated in autumn 2013 will mean slower growth in wage and salary earnings than in previous years. The moderate growth in labour costs will also affect consumer price development, and there will be a marked deceleration in inflation during the forecast period. In 2013–2014 inflation will be driven by increases in indirect taxation, but in 2015 inflation according to the harmonised index of consumer prices (HICP inflation) will slow to 1.4%.

[1] The forecast is based on the statistical data available on 20 November 2013.

Table 1.

Forecast summary

Supply and demand

	2012	2011	2012	2013[f]	2014[f]	2015[f]
	At current prices EUR billion	Volume, % change on previous year				
Gross domestic product	192.5	2.7	–0.8	–1.0	0.6	1.7
Imports	79.8	6.2	–1.0	–7.3	0.9	4.2
Exports	78.1	2.7	–0.2	–1.7	1.7	4.7
Private consumption	108.5	2.6	0.2	–0.5	–0.2	1.0
Public consumption	48.3	0.5	0.6	1.3	0.7	0.6
Private fixed investment	32.7	6.2	–1.3	–1.8	0.3	4.3
Public investment	5.0	3.0	0.9	0.4	–0.4	0.0

Key economic indicators

	2011	2012	2013[f]	2014[f]	2015[f]
% change on previous year					
Harmonised index of consumer prices	3.3	3.2	2.2	1.6	1.4
Consumer price index	3.4	2.8	1.4	1.6	1.7
Wage and salary earnings	2.7	3.2	2.1	1.5	1.5
Labour compensation per employee	3.5	3.5	1.4	1.5	1.7
Productivity per person employed	1.7	–1.2	0.1	0.9	1.0
Unit labour costs	1.7	4.8	1.3	0.6	0.7
Number of employed	1.0	0.4	–1.1	–0.3	0.7
Employment rate, 15–64-year-olds, %	68.6	69.0	68.6	68.8	69.5
Unemployment rate, %	7.8	7.7	8.1	8.1	7.5
Export prices of goods and services	4.5	1.2	–0.2	0.8	1.3
Terms of trade (goods and services)	–1.8	–1.2	–0.2	0.1	–0.1
% of GDP, National Accounts					
Tax ratio	43.6	44.0	45.2	45.2	45.2
General government net lending	–1.0	–2.2	–2.4	–2.4	–2.1
General government debt (EDP)	49.2	53.6	59.0	62.4	64.2
Balance on goods and services	–0.7	–0.9	1.4	1.7	2.0
Current account balance	1.5	–1.7	–0.6	0.2	0.4

f = forecast
Sources: Statistics Finland and Bank of Finland.

The forecast is based on the assumption that the recovery in the global economy will gain strength and the economic situation in the stressed economies of the euro area will become more balanced. The trend in the international economy contains both upside and downside risks, for example in relation to growth and economic policy in the United States. In the euro area, general government consolidation will still require substantial structural measures. Postponement of reforms could cause a renewed aggravation of debt problems.

In Finland, both central and local government will probably be forced to reduce accumulation of further debt already during the forecast period, in order to avoid exceeding the debt criterion in the Stability and Growth Pact and the medium-term deficit criterion contained in national legislation based on the Treaty on Stability, Coordination and Governance. A strong contraction in the general government fiscal deficit would lead to slower-than-forecast growth in domestic demand.

Economic outlook

Recent developments

Finnish GDP was down by 0.8% in 2012, with the contraction extending into the first quarter of 2013 (Chart 1). In the second quarter, GDP grew by 0.2% on the previous quarter and, according to the first flash estimate by Statistics Finland, continued to record quarter-on-quarter growth of 0.4% in the third quarter.[1] Flash estimates point to incipient growth mainly in manufacturing and primary production, while services output will still be shrinking.

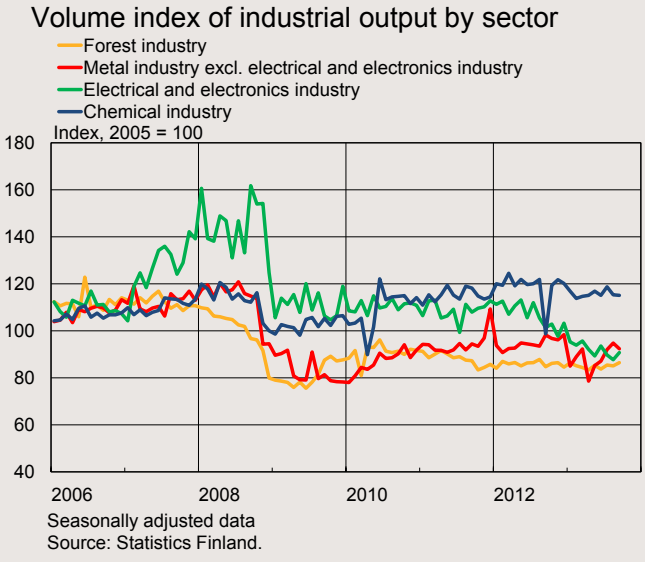
In 2013, industrial output was lower than the previous year, with the latest indicators not yet signalling a clear turnaround. The contraction in output has, as before, been strongest in electrical engineering and electronics (Chart 2). Output in the forest industry also falls behind the level attained in 2012. Moreover, chemical industry output, which increased most vigorously after the recession following the financial crisis, has declined in recent months.

The industrial outlook has remained fragile since the summer (Chart 3). The level of new industrial orders has been far lower than in 2012, and order books have become depleted. Goods exports in 2013 were down nearly 2% on 2012. Services exports were also down.

Goods and services imports have fallen more rapidly than exports, as demand for both intermediate goods used by companies and household consumer goods has receded. In the third quarter of the year, however, goods imports grew faster than exports, causing a widening in the trade deficit.

Chart 1.

Chart 2.



[1] Advance data on the third quarter of 2013 published on 5 December 2013 is discussed in Box 1.

Chart 3.

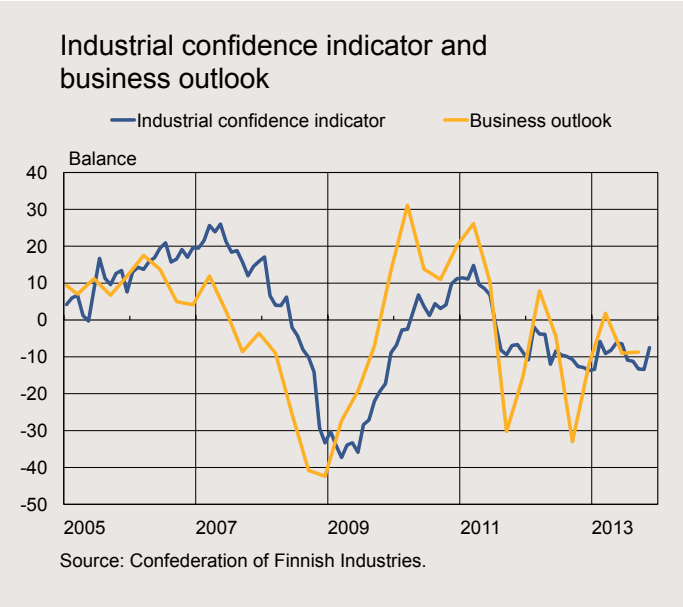
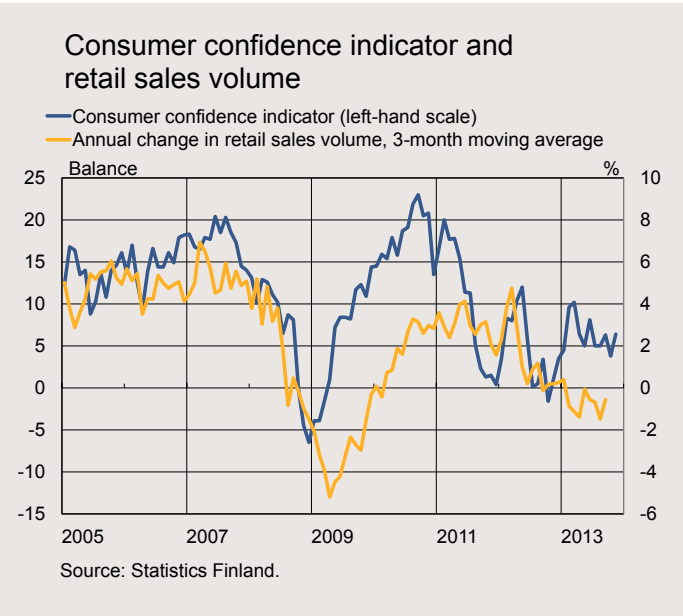


Chart 4.



With demand fading, firms have adjusted their operations by refraining from investment in expansion and reducing their work force. Construction investment has already been decreasing for more than a year, but even machinery and equipment investment that had been growing since 2011 contracted in the second quarter of 2013. A reduction in the number of building permits points to an ongoing decline in construction in the months ahead.

The employment situation deteriorated markedly in 2013. Some of the jobless have abandoned actively searching for work and are statistically recorded as inactive rather than unemployed, meaning that the unemployment rate has risen only very little from the previous year. In October 2013, the trend unemployment rate was 8.2%, ie only 0.3 of a percentage point higher than a year earlier. The number of employed has declined by 41,000, and the employment rate, previously 68.7%, decreased during the year by 0.6 of a percentage point.[2]

Consumer confidence declined in the course of 2013, as the threat of unemployment was perceived to have increased. Consumer caution has been reflected in car sales and retailing, where sales volumes have fallen during the year (Chart 4). The deteriorating situation has led to a reduction in retail trade employment in recent months.

The pace of increase in consumer prices slowed during 2013. In January, inflation was still 2.6%, but was only 1.7% in October, as measured by the harmonised index of consumer prices (HICP). The deceleration in inflation has been due, for the most part, to mildly falling energy prices and a slower pace of rise in food prices (Chart 5). The rise

[2] The employment effects of structural change in the industrial sector are examined in Box 2.

Box 1.

National accounts for the third quarter of 2013

On 5 December 2013, Statistics Finland published preliminary quarterly national accounts data containing the latest statistical data on Finnish economic developments in the third quarter of 2013.

The Bank of Finland's macroeconomic forecast presented in this publication is based on the quarterly national accounts published by Statistics Finland in September, a flash estimate for the third quarter released in November and extensive indicator data on economic developments.

According to the most recent quarterly national accounts, real GDP in the third quarter of 2013 contracted by 1% year on year, while staying at the same level as in the previous quarter. According to the flash estimate published in November, real GDP in the third quarter was the same in year-on-year terms and 0.4% higher quarter on quarter.

Growth in the second quarter of 2013 was 0.1 of a percentage point weaker than Statistics Finland's previous estimate. Hence, revised GDP growth in the second quarter of 2013 was 0.1% quarter on quarter.

The rate of private consumption growth in the first half of 2013 was slower than previously estimated. Private investment also grew more sluggishly than had been projected earlier. Export growth in the first quarter was higher, but in the second quarter lower than previously estimated.

Of demand components, only improving exports supported GDP growth in the third quarter. Exports were 1.5% up on the previous quarter. Goods exports fell back, but services exports increased. Private investment decreased by 2.9% quarter on quarter. Investment contraction was broadly based, with only investment in civil engineering projects posting quarter-on-quarter growth. For example, investment in machinery and equipment was 8.7% down and investment in housing construction 1.5% down on the previous quarter. Private consumption grew by only 0.1% quarter on quarter. Consumption of consumer durables increased, but other consumption components contracted from the previous quarter.

Value added at basic prices recorded quarter-on-quarter growth of 0.1% in the third quarter. Output contracted in service sectors and the forest industries. Chemical and metal industry output increased. Manufacture of electrical and electronic products also improved on the previous quarter. Imports in the third quarter grew strongly, by 5.1% quarter on quarter, with growth recorded in both goods and services imports. Rapid import expansion was counterbalanced by robust growth in the item containing inventory changes and statistical discrepancies.

Work input continued to contract. The number of people in employment declined by 0.4% and the number of hours worked by 0.8% quarter on quarter. Compensation per employee was 0.4% up on the previous quarter.

The most recent quarterly national accounts data signal similar economic developments for 2013 to the indicator data previously published. Economic growth has not returned to a clear upward trajectory during the year. Growth in domestic demand continues to be weak, and export performance has not improved as envisaged in the summer forecast.

Box 2.

Employment effects of structural change in manufacturing sector

The volume of Finnish manufacturing output in 2012 was nearly 15% down on 2008. During the same period, the number of persons employed in manufacturing declined by 52,000. However, falling manufacturing employment fails to provide a picture of the overall impact on employment of lower industrial output, as the production cutbacks have also been reflected in other sectors via reduced intermediate demand. This box reviews the aggregate effects on employment of diminishing demand for final manufactured products.

Finnish manufacturing industry employed 431,000 persons in 2008 (Table A). Against a backdrop of rapid structural change and the prevailing recession, more than 10% of jobs had been lost by 2012. Jobs were lost in all manufacturing sectors, with the exception of the food industry, but close to 4/5 of the job losses incurred in the metal industry, electrical engineering and electronics and the forest industries.

The employment effects of a sector's output embrace, in addition to people directly employed in the sector, persons needed to produce intermediate inputs. The total work force needed to produce a sector's final products can be assessed using input-output tables.

The number of persons employed in a sector may decrease without affecting the output volumes of final products, if operations are outsourced to other domestic sectors. In such a case, the volume of the sector's value added will decline, but the employment effect of the change on the economy as a whole will not be as great as examination of the sector's own employment data might suggest.

From 2008 to 2012, the output volume of the forest industries contracted by 12% and that of electrical engineering and electronics by 38%. Part of this contraction reflects production cutbacks in other sectors, as about a quarter of forest industry output and about 12% of electrical engineering and electronics output is used domestically as intermediate inputs for manufacturing in other industries. The employment

Table A.

Employment in manufacturing sectors

	Employment in the sector (thousand persons)		
	2008	*2012*	*Change*
Food industry etc.	*39*	*39*	*0*
Textile, clothing and leather industry	*13*	*12*	*–1*
Forest industries	*59*	*48*	*–11*
Printing	*13*	*11*	*–2*
Chemicals	*39*	*35*	*–4*
Non-metallic mineral manufactures	*18*	*17*	*–1*
Metal industry (excl. electrical engineering and electronics)	*170*	*152*	*–18*
Electrical engineering and electronics	*62*	*50*	*–12*
Other manufacturing (incl. furniture)	*18*	*15*	*–3*
Total	***431***	***379***	***–52***

Source: Statistics Finland.

effect of changes in demand for final electrical engineering and electronics and forest industry products can be assessed by excluding other industries' intermediate demand from the calculation.

In 2008, the employment effect of demand for final manufacturing products was about 600,000 persons, from which it fell to 525,000 in 2012 (Table B). Lower demand for final electrical engineering and electronics products has reduced labour demand by about 39,000 persons, of which an estimated 13,000 have exited directly from this sector. Similarly, lower demand for final products of other metal industries has led to a reduction in labour demand of about 21,000 persons, 9,000 of whom have exited from their own sector. Likewise, fading demand for final forest industry products has reduced labour demand by about 7,000 persons, but the cuts have only focused on the forest industries themselves. In the food industry, the use of intermediate goods produced by other sectors has declined, meaning that the employment effect of demand for final food industry products has increased in the sector itself, but decreased in other sectors.

Demand for final manufacturing products has been contracting rapidly since 2008, leading to a loss of about 74,000 jobs across the economy as a whole. At the same time, the number of people in employment in the economy as a whole has fallen by only 32,000 persons. Thus, the negative employment effects of lower demand for products manufactured in Finland have been compensated for by higher output and increased employment in other sectors, notably services. Since 2008, labour demand has been boosted, in particular, by growth in final demand for social and health care services, educational services and other private services.

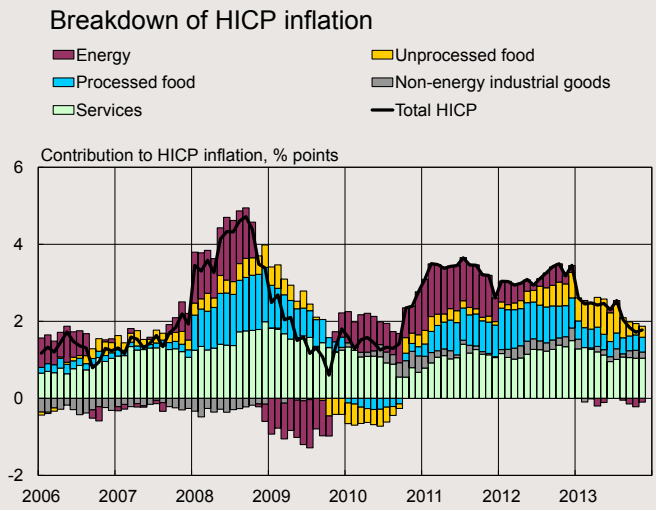
Table B.

Employment effect of demand for final manufacturing products

	Employment effect of final demand on own sector (thousand persons)			*Overall employment effect of final demand (thousand persons)*		
	2008	*2012*	*Change*	*2008*	*2012*	*Change*
Food industry etc.	*26*	*27*	*1*	*97*	*91*	*–6*
Textile, clothing and leather industry	*10*	*9*	*–1*	*13*	*11*	*–2*
Forest industry	*36*	*29*	*–7*	*98*	*91*	*–7*
Printing	*3*	*2*	*–1*	*4*	*3*	*–1*
Chemicals	*24*	*24*	*0*	*51*	*54*	*3*
Non-metallic mineral manufactures	*5*	*6*	*0*	*9*	*10*	*1*
Metal industry (excl. electrical engineering and electronics)	*101*	*92*	*–9*	*197*	*176*	*–21*
Electrical engineering and electronics	*54*	*41*	*–13*	*114*	*75*	*–39*
Other manufactures (incl. furniture)	*11*	*10*	*–1*	*16*	*14*	*–2*
Total	***270***	***240***	***–30***	***599***	***525***	***–74***

The calculations in the table are based on non-rounded figures.
Source: Statistics Finland and Bank of Finland calculations.

Chart 5.



HICP = Harmonised index of consumer prices.
Source: Statistics Finland.

in the national consumer price index (CPI) has eased off more strongly, due especially to the reduction in interest rates. The 1 percentage point increase in VAT rates in January triggered an imputed rise of about 0.7 of a percentage point in consumer price inflation during the year.

The ratio of household debt to disposable income increased no further in 2013. It has not been possible to remedy the general government fiscal deficit in the prevailing weakening business cycle. The corporate sector has remained in financial surplus despite deteriorating profitability, as investment has also been cut. The deficit in the Finnish economy is financed by borrowing from abroad, which is shown as a current account deficit persisting for the third year in succession.

Operating environment

International economy and Finland's export markets

Global growth continued to be slow through summer and autumn 2013. General government consolidation measures, the unravelling of private sector debt, widespread unemployment and sluggish wage developments have slowed growth in the advanced economies, which has also served to subdue the pace of growth in emerging economies too.

The global economy is currently marked by great uncertainty, for example in relation to budgetary policy in the United States, the progress of structural reforms in euro area countries, Japan's expansionary policies and the structure of growth in emerging economies. The level of investment relative to GDP remains small in many countries. Investment in machinery and equipment, in particular, has recovered only slowly since the crisis, putting a brake on world trade, a large share of which is accounted for by capital goods and consumer durables.

There has also been much debate over the general thrust of monetary policy. Expectations that the United States was about to start to reduce its use of quantitative monetary policy tools led in many countries during the summer to an upward shift in market interest rates and caused turbulence on the financial markets. Financial conditions tightened, particularly in a number of emerging economies, as capital flows were diverted elsewhere

and there was a sudden depreciation in their currencies.

Over the immediate years ahead, the global economy is expected to gradually pick up, but the pace of growth will still be notably slower than in the years before the crisis. The expectations of faster growth are supported by the fact that general government consolidation measures are in many places nearing completion. In addition, the cyclical situation will subdue inflation and enable continuation of an accommodative monetary policy. The end to unemployment growth coupled with rising asset prices are also expected to gradually restore confidence in the economy, thereby fuelling households' consumption demand and investment. Future developments are nevertheless subject to a great deal of uncertainty.

Economic outlook for the major economic regions

In the **euro area**, the economy began to grow in early summer. Although the motor of growth is still Germany, in many of the stressed economies, too, consumer and corporate confidence in the future has begun to improve. However, with the area labouring under high levels of unemployment, large debt burdens and the challenges in the banking sector, growth is expected to continue to be sluggish and both private consumption and private investment to pick up only slowly. A gradual strengthening in domestic demand will boost imports and the growth impact of net exports will be considerably reduced from the present level (Table 2).

In **the United States**, current-year growth has been hampered by general government consolidation, but growth is expected to pick up perceptibly in the immediate years ahead. It will be supported by private consumption, which, in addition to lower unemployment, will be fuelled by the improved asset position of households due to rising house prices. Brisk growth in construction is also expected, for the same reason. Uncertainty over federal budget policy will, however, temper the pace of growth, and in particular the channelling of corporate profits into new investments.

One year ago, **Japan** launched a new economic policy programme aimed at ending the country's deflationary spiral, primarily through a massive monetary policy stimulus. This has certainly strengthened inflation expectations in the country, but actual inflation so far has been due almost entirely to the depreciation in the value of the yen

Table 2.

Growth in GDP and world trade

% change on the previous year

GDP	*2012*	*2013^{f}*	*2014^{f}*	*2015^{f}*
United States	*2.8*	*1.7*	*2.6*	*3.2*
*Euro area**	*–0.6*	*–0.4*	*1.1*	*1.5*
Japan	*1.9*	*1.8*	*1.3*	*0.9*
Asia excl. Japan	*5.9*	*5.6*	*6.1*	*6.0*
World	*3.2*	*2.8*	*3.5*	*3.7*
World trade	*3.1*	*2.8*	*5.2*	*6.1*
*Finland's export markets***	*2.5*	*1.3*	*4.3*	*5.4*

** Eurosystem staff projections for macroeconomic developments in the euro area for the years 2013–2014.*
*** Crowth in Finland's export markets equals average growth in imports by countries to which Finland exports, weighted by their respective shares of Finnish exports.*
f = forecast
Source: Eurosystem.

pushing up import prices. Japanese leaders have not taken concrete steps for most of the structural reforms included in the stimulus package as announced, although in their absence economic growth in the immediate years ahead is expected to be slow.

In the **emerging economies**, growth has been weaker than forecast in 2013 and is expected in the immediate years ahead to remain slower than the pre-crisis years. The main cause of the weaker-than-expected trend has been the sluggish developments in exports. In a number of emerging economies, rapid growth in credit and consumption has caused inflated current account deficits, the funding of which will raise interest rates and subdue future growth. In addition, price developments in energy and other commodities are forecast to be lacklustre, and this will slow growth in many emerging economies. In recent years, **China** has sought to move towards a more consumption-driven economy, at the cost of slower growth. The structural change is progressing only slowly and investment is expected to continue to be the motor of growth in the future as well. In **Russia**, the pace of growth has slowed significantly in recent years. The contraction in investment has been particularly worrying, as in many sectors capacity is almost fully utilised. Unless there is a significant improvement in the investment climate, consumption-driven growth is expected to continue to be slow in the immediate years ahead.

World trade growth is expected to pick up as demand for capital goods and consumer durables gradually increases. The forecast has, however, been adjusted slightly downwards and, relative to GDP growth, world trade will in the immediate years ahead be less vigorous than before. This is partly because of the growing importance of the emerging economies in the global economy, as a large part of consumption in these economies is still domestically produced goods, such as food. In these countries, investment, too, is weighted more towards domestic output than in the advanced economies.

The forecast for international trade suggesting slower growth than previously forecast also means slower-than-previously forecast growth in Finland's export markets in the immediate years ahead. The country distribution of Finland's exports is weighted towards the slowly growing advanced economies, and growth in Finland's export markets will be more subdued than world trade as a whole during the forecast period.

Commodity and foreign trade prices

The slow pace of growth in the global economy has been reflected in the prices of energy and other commodities, which have come down. Price trends are also expected to be very moderate through the forecast period. The price forecast for Brent crude is based on the futures prices current on 14 November, according to which the dollar price of oil at the end of the forecast period will be around 8% lower than at present. Besides the slow pace of economic growth, increased output of oil in eg the United States will depress oil prices. On the other hand, based on the futures prices for food used

in the forecast, the world market prices of food are expected to remain more or less at current levels.

The expected moderate price trend in commodities will be reflected in the export prices of Finland's main export markets. In addition, the appreciation in the value of the euro that has already occurred and the forecast assumption of future stability in the external value of the euro will lower the export prices of Finland's export competitors in the current year. In the future, prices are expected to rise slowly.

Interest and exchange rates

According to a forecast assumption based on market expectations, the 3-month Euribor will slowly rise from its current level of 0.2% to gradually reach 0.6% in the final quarter of 2015 (Chart 6). The yield on 10-year Finnish government bonds should remain around the current level of 2% until the beginning of 2014 and thereafter rise to 2.7% by the end of the forecast period.

The interest rate assumptions in the forecast are derived from market expectations current on 14 November 2013. The assumptions on interest rates and exchange rates are purely technical and do not anticipate the monetary policy decisions of the Governing Council of the European Central Bank or estimates of equilibrium exchange rates (Table 3).

Chart 6.

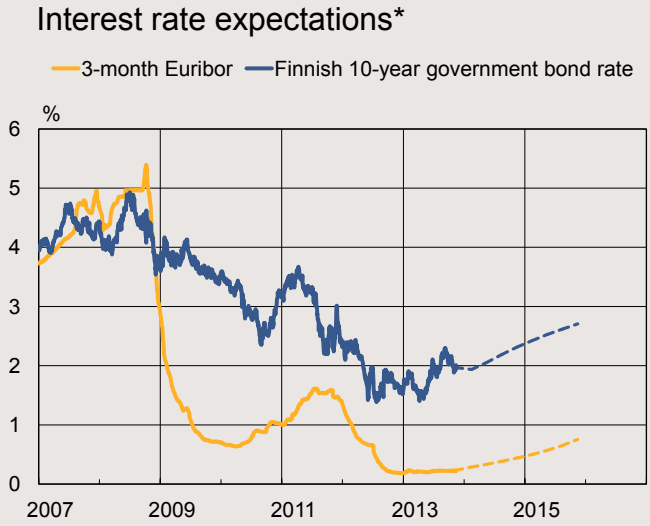


Table 3.

Forecast assumptions

	2011	*2012*	*2013f*	*2014f*	*2015f*
Finland's export markets[1], % change	*7.1*	*2.5*	*1.3*	*4.3*	*5.4*
Oil price, USD/barrel	*110.9*	*112.0*	*108.2*	*103.9*	*99.2*
Euro export prices of Finland's trading partners, % change	*4.5*	*3.1*	*–3.0*	*–0.3*	*1.3*
3-month Euribor, %	*1.4*	*0.6*	*0.2*	*0.3*	*0.5*
Yield on Finnish 10-year government bonds, %	*3.0*	*1.9*	*1.9*	*2.1*	*2.6*
Finland's nominal competitiveness indicator[2]	*103.0*	*100.1*	*102.3*	*103.3*	*103.3*
US dollar value of one euro	*1.39*	*1.28*	*1.33*	*1.34*	*1.34*

[1] Growth in Finland's export markets equals average growth in imports by countries to which Finland exports, weighted by their respective shares of Finnish exports.
[2] Narrow plus euro area, 1999Q1 = 100.
f = forecast
Sources: Eurosystem and Bank of Finland.

Financial markets

The financial market situation in the euro area has been relatively stable since autumn 2012. However, the tightening of capital requirements continues to restrict banks' ability to offer credit, which is reflected in the poor availability of corporate credit in the euro area. On the other hand, companies have increased their acquisition of funds directly from the bond markets and are hence less dependent than before on the banks.

The weakened state of the economy, low interest rates and impairment losses have eroded the profitability of euro area banks. Both impairment recognitions and the number of problem loans have continued to grow rapidly. In order to bolster economic growth, the European Central Bank in November lowered its key policy rate by 0.25 percentage points to 0.25%.

The balance sheets of euro area banks will be assessed under the leadership of the ECB in spring 2014, in order to preserve market confidence in the banks. With this in mind, banks operating in the EU have already been recapitalised with around EUR 700 billion.

The euro area debt crisis has so far had very little impact on access to finance for Finnish banks or non-financial corporations. According to stress tests conducted in cooperation between the Financial Supervisory Authority and the banks, the risk-bearing capacity of the Finnish financial system remains strong. Nevertheless, the continued sluggish performance of the economy both in the euro area and domestically still poses a risk to the stability of the Finnish financial markets.[3]

Due to the rapid accumulation of general government debt, the costs of financing central government debt could grow, which would also have knock-on effects for the funding costs of Finnish banks. The cyclical sensitivity of the Finnish economy is also increased by the substantial level of household debt. In the event of a decline in their financial position, indebted households will have to strongly adjust their consumption.

The availability of funding for Finnish banks has continued to be good, but banks' profitability has been weakened by the slow pace of economic growth and low interest rates. Banks have sought to improve their profitability by raising their customer fees and cutting costs. Loan losses have remained negligible relative to the stock of loans.

Financial conditions for the corporate sector in Finland are still better than the euro area average. The margins on new corporate loans have, however, been growing as banks have repriced their risks. The growth in loan margins has been most visible in loans for small enterprises. According to a survey by the European Central Bank, access to finance for SMEs in Finland has also become somewhat harder. The financing situation for large corporations has been eased by an

[3] The condition of the Finnish financial system is examined in detail in the feature article 'Financial stability', below p. 49–65.

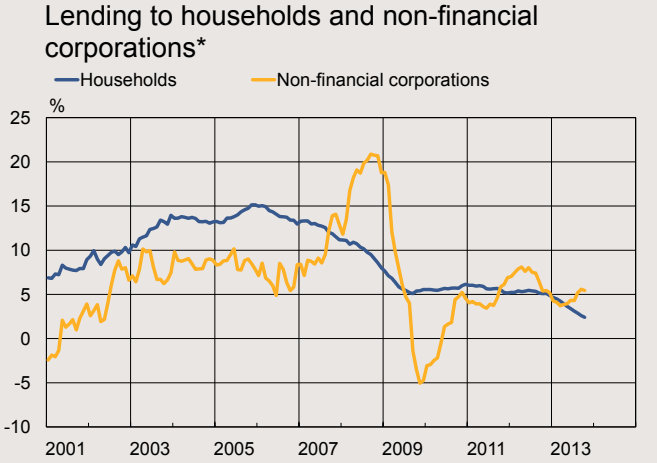
increased emphasis on the bond markets as a source of finance. Growth in banks' stock of corporate loans has also been limited by the weakness of corporate credit demand, due particularly to a scarcity of capital investment (Chart 7).

The availability of household credit remains good, but the sluggish housing market has meant a deceleration in the pace of growth in household credit demand. Annual growth in the stock of households' housing loans slowed in September to 2.9%, against 6.1% only a year earlier. Housing sales activity has been slowed by the uncertain economic outlook and weak earnings development. The fading activity on the housing market is also reflected in price trends. The rise in housing prices across the country as a whole has in recent years followed the pace of rise in consumer prices. However, in the third quarter of 2013 the price of old apartments across the country as a whole fell 0.2% on the previous quarter.

Fiscal policy assumptions

Finland's fiscal policy stance has been gradually tightening ever since 2010. The government discussion on spending limits in March 2013 reached agreement on several new consolidation measures for 2014 and 2015. However, the measures agreed to strengthen the general government finances were minor in net terms, as it was decided to improve the position of businesses by reducing corporation tax. The 2014 Budget is expected to follow the definition of policy set in the spending limits discussion.

Chart 7.



* Annual growth in Finnish monetary institutions' euro-denominated lending to households and non-financial corporations in the euro area.
Source: Bank of Finland.

The single most important decision taken in the spending limits discussion in spring 2013 related to the reduction of corporation tax from the beginning of 2014. This will cut the yield from direct taxation by approximately EUR 900 million, or over 0.4% of GDP. The lost tax revenue is, however, intended to be compensated by, for example, tightening the taxation of capital income. In spring 2013, the government also agreed increases to several indirect taxes. These include an increase in excise duties. Taxes relating to energy production and consumption are also to be raised.

The government has also agreed on expenditure savings affecting the various administrative branches. The most important of these relate to central government transfers to local government. The expenditure cuts will moderate growth in consumption expenditure and central government

transfers over the years 2013–2015. The trends in central and local government expenditure are also moderated in the forecast by the general incomes policy settlement agreed in autumn 2013 and a reduction in the number of people employed in the public sector. Public investment is assumed to follow growth in nominal GDP.

The municipalities are assumed to raise local income tax rates substantially in 2014. The average local income tax rate will rise in 2014–2015 by a total of 0.5 of a percentage point. The trend in interest rates payable on central and local government loans is assumed to more or less follow the trend in the yield on Finnish 10-year government bonds. Social security contributions are assumed to develop as agreed in connection with the general incomes policy settlement. Participation in the funding of crisis management will enlarge general government EDP debt in 2013 and 2014 by a total of 0.5% relative to GDP. To date, crisis management measures have increased Finland's general government debt ratio by a full 3 percentage points.

The forecast does not take into account the structural policy programme published by the government in August 2013 and the consequent savings or additional revenues, or the possible benefits from combating the grey economy. The forecast additionally assumes that neither central nor local government will privatise any of their assets.

Non-financial corporations

World trade is forecast to pick up in early 2014, fuelled by investment demand. Notably, the euro area will witness a strengthening of investment growth. Owing to the country breakdown of Finnish exports, and as Finland has been able to retain its export shares specifically in the euro area, growth in investment demand will help Finnish exports to recover from 2014 onwards.

The Finnish export industry has been struggling with weak export demand, price performance and competitiveness for a number of years. The volume of exports has barely increased for the past three years, and their value has also evolved poorly. The situation is not expected to improve significantly in the early months of 2014, when economic activity in many countries important for Finnish exports is projected to remain subdued. According to the forecast for the international economy, investment in these countries will pick up during 2014, with growth in euro area imports returning close to the normal annual rate of around 5%.

Higher industrial raw material prices will raise import prices. This will also increase the value of Finnish exports, as the bulk of these exports are raw materials and production commodities. Export prices for Finland's competitors will decline by more than Finland's in 2013. Towards the end of the forecast period, Finland's export prices will rise more slowly than those of its competitors. This is due, in part, to autumn's moderate pay

settlement. Finnish exports will, nevertheless, still be losing market share compared with growth in the export markets, although, relative to euro area demand, Finland will be able to retain its market shares (Chart 8).

The confidence of economic agents has continued to deteriorate in Finland, unlike elsewhere in Europe, where various confidence indicators already anticipate a slight improvement for 2013. In addition, the investment outlook in Finland is fragile. Private investment will still decline markedly at the beginning of the forecast period. Weak demand and a low capacity utilisation rate will continue to constrain willingness to invest, despite very low financing costs.

As the pull of international trade reaches Finland, the pent-up investment need will begin to be released in the form of brisk investment growth, particularly in 2015. The effects of the lowering of corporation tax, due for entry into force at the beginning of 2014, will not be seen until 2015. Despite the return to investment growth, the private sector's investment ratio will barely rise during the forecast period (Chart 9).

Investment in housing construction increased temporarily in the early months of 2013, but the halt to house price rises in the autumn turned housing investment downwards. The number of building permits and housing starts declined throughout the year. In 2014, real investment in housing construction will resume moderate growth, as house prices remain stable in real terms. Although real investment in housing construction will grow more slowly than other investment in 2015, its share of GDP will remain at the current high level.

Chart 8.

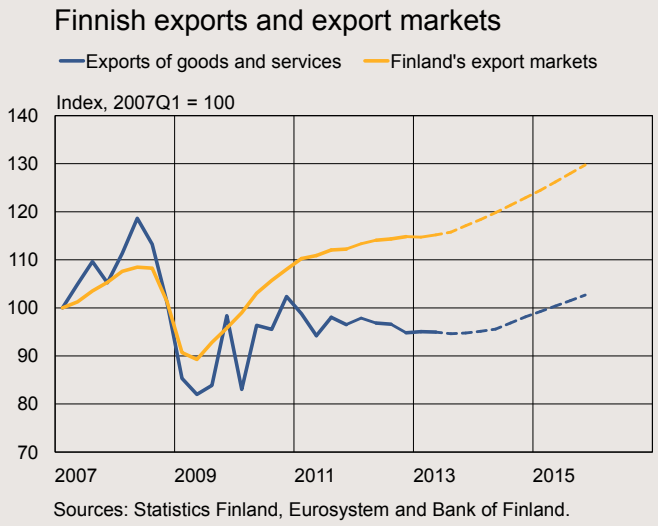
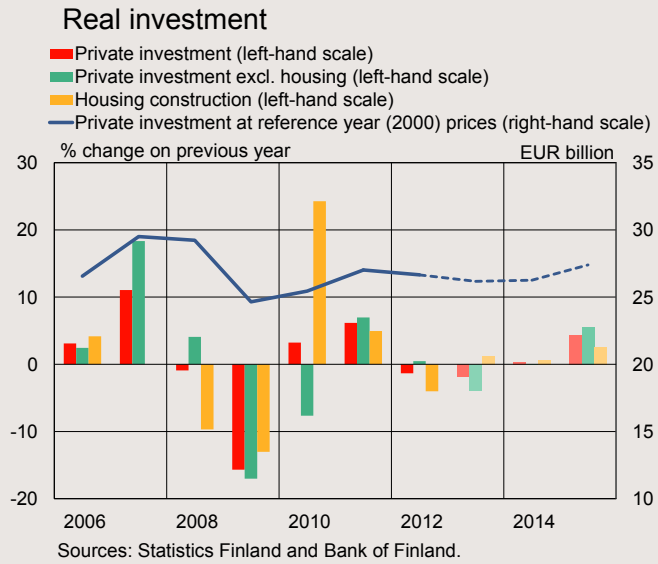


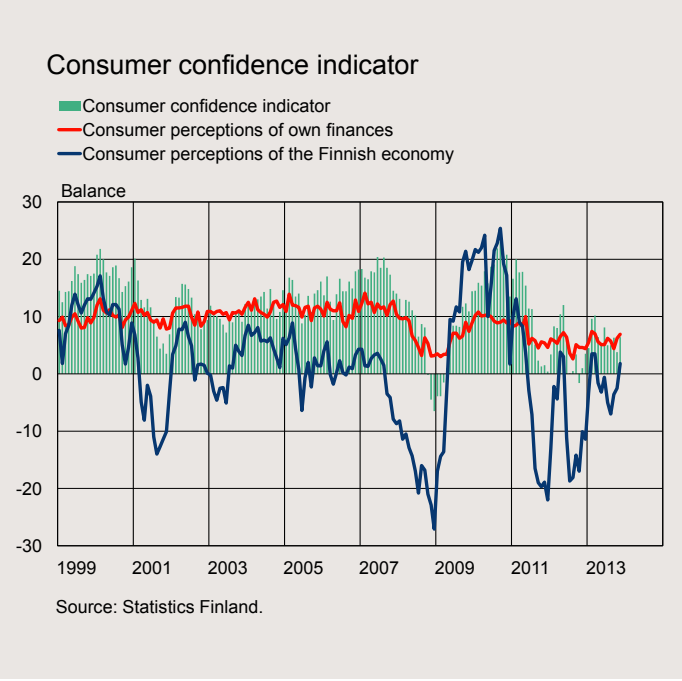
Chart 9.



Corporate profitability has deteriorated in recent years. During the forecast period, it will improve somewhat, amid moderate unit labour cost developments. Labour productivity will recover slowly, approaching its long-term average rate of growth, but not quite reaching it during the forecast period. Moderate increases in negotiated wages, as required by the agreement on employment and growth concluded by the social partners, will slow the rise in unit labour costs, thus supporting corporate profitability in the coming years.

Higher labour productivity in 2014 will reduce labour demand by non-financial corporations. Employment will still contract in 2014, despite resumption of growth in output. At the end of 2014, the number of hours worked will also begin to increase and the employment situation improve. In 2015, employment growth will already be fairly strong.

Chart 10.



Households

Consumer confidence in the economy continues to be weaker than the long-term average. However, consumers for the most part believe their own finances are in a better shape than the country as a whole. This has been a typical feature of consumer surveys in recent years (Chart 10), probably reflecting the uncertainty over the future that has been prevailing during the economic crisis. In recent months, consumers have expressed increased concern about their risk of becoming unemployed.

Private consumption, which had underpinned economic growth in Finland since 2010, began to recede in the first half of 2013. There are many factors underlying the lower household consumption: for example, increased risk of unemployment, a falling number of people actually employed, more sluggish earnings developments and tightening taxation.

Moderate earnings developments, accompanied by a reduction in the number of employed, has slowed growth in aggregate wages and salaries, which will grow by less than 1% in 2013 and by 1.2% in 2014. With consumer prices rising by around 1.5% in both years, aggregate real wages and salaries will decline slightly. Overall, households' disposable real earnings are predicted to contract by around ½% in

both 2013 and 2014 and to increase by around 1% in 2015.

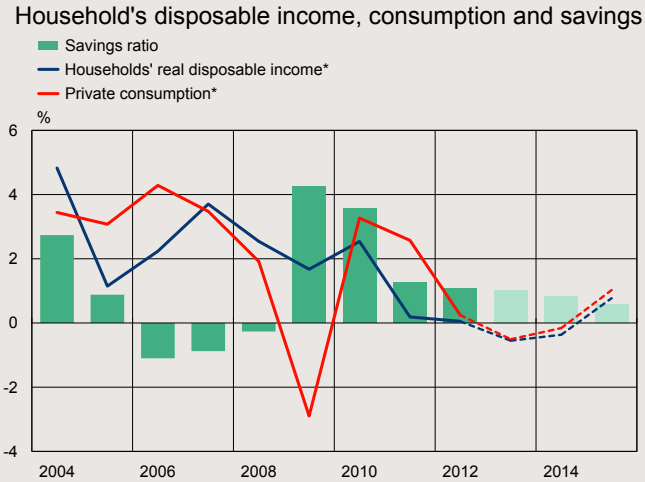
Lower household consumption has been reflected in retail trade, in particular, where sales for January–October 2013 were around 1% down on the same period a year earlier. Foreign travel has also declined. Moreover, according to consumer surveys, the time is not considered favourable for buying durable goods, nor for borrowing.

Accordingly, the household savings ratio will remain virtually unchanged in 2013 and 2014. Private consumption will decrease by ½% in 2013 and by 0.2% in 2014. With the economy gaining momentum in 2015, there will be around 1% growth in consumption and a decline in the savings ratio to around ½% (Chart 11).

Consumer caution has been reflected in a pronounced slowing of the growth rate for the household loan stock during 2013. By contrast, the growth rate for the stock of loans granted to housing corporations has picked up to some extent. Part of these loans are housing company loans, for which households are responsible. In fact, faster debt accumulation by housing companies may have contributed to the dampening of other household borrowing. The stock of household credit – including housing company loans – relative to disposable income has stabilised at around 117½%, ie growth in household indebtedness appears to have come to a halt.

The prices of old apartments and row houses continued to rise moderately in the greater Helsinki area in the third quarter of 2013. In the rest of Finland, housing prices have remained more or less unchanged compared with the same period in 2012. Housing prices are forecast to rise only mildly in the immediate years ahead, with real prices projected to remain broadly at current levels.

Chart 11.



GDP and employment

Economy begins to grow, pulled by export demand

Finland's economy contracted in 2013 for the second consecutive year. According to advance data from Statistics Finland, GDP in the third quarter of the year was roughly at the previous year's level, but the overall GDP contraction for 2013 is 1.0%. In 2014, the economy will gradually return to a growth trajectory, but, partly due to a weak carry-over effect, the pace of

growth will still remain modest, at 0.6% for the year. However, in 2015 GDP growth will accelerate to 1.7%, which is slightly above the Bank of Finland's estimate for long-term growth in the Finnish economy (Chart 12).

Chart 12.

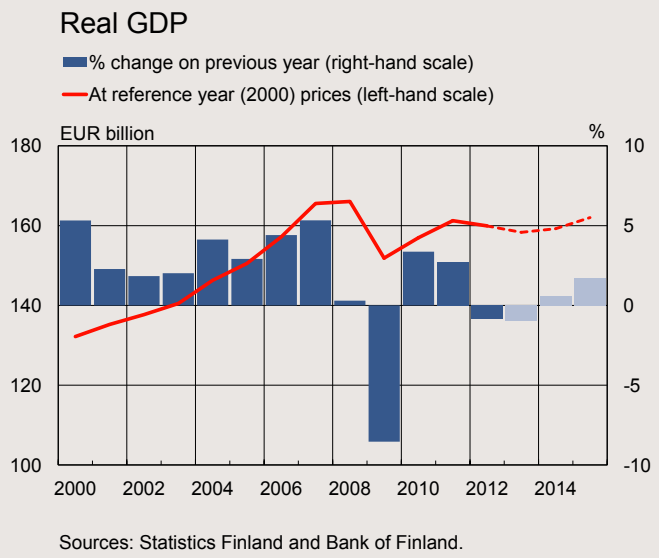
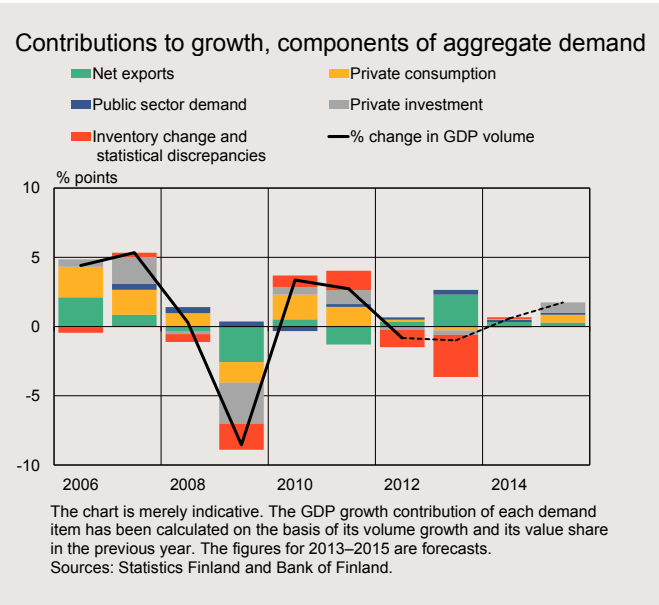


Chart 13.



Pulled by export demand, Finnish growth will begin to recover as growth in the euro area and in Finland's other major export markets picks up in the first half of 2014. The improvement in export competitiveness will partly be underpinned by the moderate pay settlement agreed between the social partners in autumn 2013. The higher contribution of net exports to GDP growth in 2013 was partly boosted by a significant contraction in imports in the first quarter of the year. By contrast, inventory changes and statistical discrepancies had a negative effect on output growth over the same period. In 2014, imports will still grow at a slower pace than exports, bolstering net exports. On the back of recovering export demand, Finnish companies' investment to expand production capacity will also begin to increase gradually during 2014. In 2015, private investment growth will strengthen to almost 4%, which is, however, still below the long-term average. Of all the component items of aggregate demand, private consumption will be the last to recover. It will turn gradually upwards in the second half of 2014 as the improving economic outlook begins to be reflected in employment and household incomes (Chart 13).

Slow upturn in employment

The pick-up in economic growth will be reflected in employment, but with a time lag. In addition, there may still be underutilisation of labour resources in the corporate sector due to the recession. Output growth can initially be met by increasing the number of

Box 3.

Weak economic trend reflected more in employment than unemployment

According to Statistics Finland's Labour Force Survey, the number of employed in Finland in the third quarter of 2013 averaged 2,490,000, or 39,000 less than in the corresponding period a year earlier. The employment rate – ie the number of employed as a proportion of the working-age population (15–74-year-olds) – contracted from a year earlier by 1.1 percentage points, to 60.9%.

The weakness of the business cycle has been reflected in unemployment less than in employment. In September 2013, the unemployment rate (7.6%) was 0.5 of a percentage point higher than a year earlier, but for the third quarter of 2013 the average unemployment rate (7.1%) was unchanged from a year earlier. At the same time, the number of unemployed averaged 191,000, which was actually slightly less than a year earlier.

The statistical data on the simultaneous contraction in the numbers of employed and unemployed may seem incompatible. However, changes in the employment and unemployment rates do not reflect only flows between employed and unemployed, but also flows of people to and from the labour market. Hence, although the modest response of the unemployment rate to the decline in the number of employed does reflect the contraction in the number of employed, it also reflects the fact that a larger number of persons who have lost their jobs have withdrawn fully from the labour force.

Statistics compiled by the Ministry of Employment and the Economy suggest that the labour market situation has, in reality, not improved. According to the Ministry, the number of unemployed totalled 285,000 in September, or 44,000 more than in 2012. The unemployment rate, in turn, was 11.6% (Chart A).

The Ministry of Employment and the Economy's definition of unemployment differs from that used in Statistics Finland's Labour Force Survey, as the Ministry categorises all unemployed jobseekers registered with employment offices as unemployed persons, regardless of their level of activity in seeking work.

The unemployment rate generated with Statistics Finland's Labour Force Survey is internationally comparable. The survey is a sample survey where the respondents determine their labour market status themselves. An unemployed person is out of work in the survey period, but is at the same time actively seeking employment.

It is likely that the statistics of the Ministry of Employment and the Economy include a growing number of persons who have registered as unemployed jobseekers only because it is a condition for receipt of unemployment benefits, but who in reality have given up actively searching for work.

Chart A.

Data seasonally adjusted
Sources: Statistics Finland, Ministry of Employment and the Economy and Bank of Finland.

The rapid rise in the Ministry's unemployment figures in recent months can also be partly explained by a change in the statistical criteria. At the turn of the year, the age limit and requirements concerning ability to work and labour market availability were excluded from the definition of 'unemployed jobseeker'.

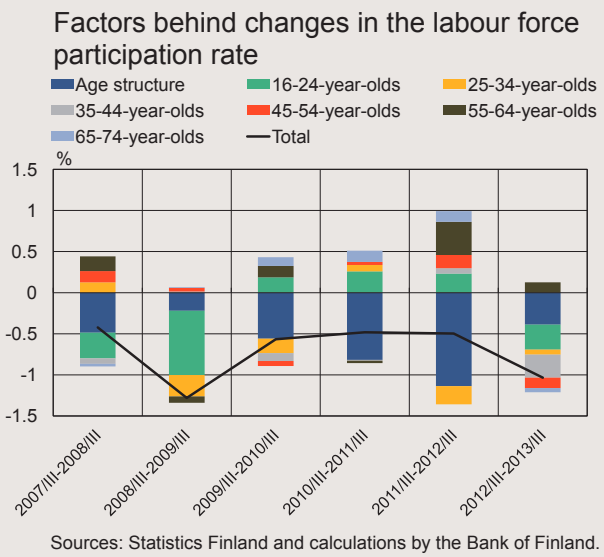
According to the Labour Force Survey, the number of persons outside the labour force increased in the third quarter of 2013 by 52,000 from the same period a year earlier. In terms of the number of persons, the increase was most prominent in the oldest age group (aged 65–74).

Chart B shows to what extent changes in the labour force participation of 10-year cohorts in 2008–2013 have been affected by the shrinking size of age groups and to what extent by a change in the labour force participation rate (LFPR). Population ageing is now clearly reflected in the size of the labour force. The number of men and women in prime working age has decreased noticeably, as the baby-boomers of the 1940s and 1950s have retired and been replaced by younger and smaller age groups.

All in all, the LFPR declined in the third quarter of 2013 by 1.2 percentage points from the previous year.

Withdrawal from the labour force is most likely at least partially cyclical in nature. In 2013, the age groups 16–24 and 25–34 were particularly prominent in withdrawing from the labour force. For the youngest age group, continuing studies is an alternative to unemployment in a weak labour market situation. The number of those receiving child home care allowance also increased during 2013, which explains withdrawal from the labour force by women aged 25–34. As the cyclical situation improves again, people will begin to return to the labour market and the LFPR could rise rapidly. However, for the long-term unemployed, there is a risk that an increasing number of people will drop permanently out of the labour market.

Chart B.



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

hours worked, so that in 2014 the employment rate may still actually weaken slightly and the unemployment rate will remain at around 8%. Improvement in employment will partly be restrained by employment developments in the public sector. The number of employees will decrease, particularly in local government, with the municipalities being forced to cut expenditure (Chart 14).

As economic growth gathers strength, companies will gradually begin to recruit additional labour. In 2015, the number of employed will already increase by about 20,000 and the unemployment rate decline to 7.5%. The fall in the unemployment rate will also stem partly from a shrinking labour force as a result of a continued decline in the number of people of working-age, due to population ageing.[4]

The weak employment situation has been reflected in an increasing number of long-term unemployed. If this development continues, high long-term unemployment may lead to some of the long-term unemployed withdrawing permanently from the labour market, further reducing the labour market participation rate.

Labour productivity growth has followed the business cycle during the financial crisis and the recession, as employment has fluctuated considerably less than output. Underpinned by economic growth, productivity growth will gradually begin to gather pace during the forecast period but will not yet reach the long-term average rate of 1.5%.

[4] Factors affecting employment and the unemployment rate are discussed in Box 3.

Chart 14.

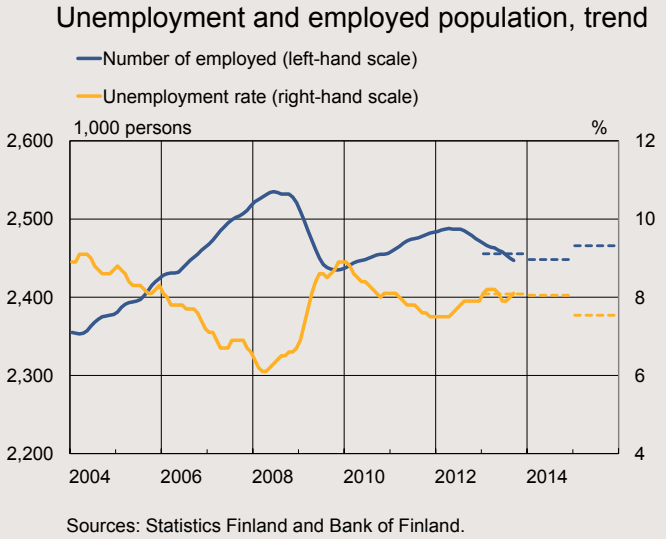
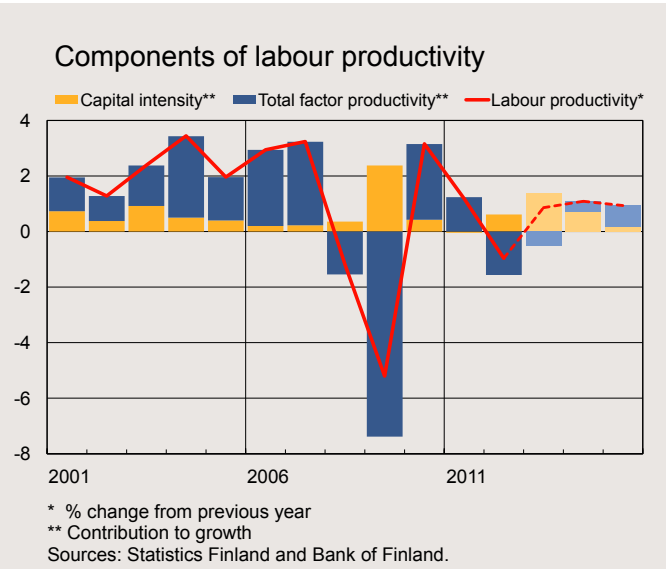


Chart 15.



Productivity growth will partly be constrained by the weak developments in capital intensity during the recession, since investment in productive capacity has remained modest (Chart 15).

Productivity developments in the past few years have been hampered by the strong structural change in the economy, as jobs have been lost in the manufacture of electrical and electronics products and in the forest industries, while new jobs have been generated in service sectors. With the ageing of the population, the structural change will continue in the years ahead.

Public finances

The contraction in the Finnish economy and slower growth in tax revenues considerably weakened general government finances in 2012. With total public expenditure also growing rapidly, the general government deficit deepened to 2.2% of GDP (Table 4).[5]

The central government deficit grew to around 4% of GDP, despite expenditure cuts and higher taxation. Local government finances also deteriorated markedly, the local government deficit growing to over 1% as revenue growth slowed due to central government consolidation measures being focused on transfers to local government. At the same time, local government expenditure continued to grow briskly. The surplus on the social security funds contracted slightly, influenced by a decrease in investment income relative to the previous year and continued strong growth in pension expenditure. Fuelled by rapidly increasing central and local government debt, general government EDP debt rose to 53.6% of GDP.

As a result of the contraction in GDP, the general government fiscal balance will deteriorate further in 2013. The central government balance will strengthen, but the contraction in the economy will considerably weaken the effect of consolidation measures. Despite substantial tightening of government taxation in 2013, central

[5] For an assessment of Finland's public finances, see Box 4.

Table 4.

General government financial balance and debt, % of GDP

% of GDP	*2011*	*2012*	*2013f*	*2014f*	*2015f*
General government net lending	***–1.0***	***–2.2***	***–2.4***	***–2.4***	***–2.1***
Central government	*–3.4*	*–3.8*	*–3.4*	*–3.3*	*–3.0*
Local government	*–0.6*	*–1.1*	*–1.1*	*–1.0*	*–0.9*
Social security funds	*2.9*	*2.7*	*2.1*	*2.0*	*1.9*
General government debt (EDP)	***49.2***	***53.6***	***59.0***	***62.4***	***64.2***
Central government	*42.2*	*43.6*	*48.0*	*50.6*	*52.0*
Total tax ratio	*43.6*	*44.0*	*45.2*	*45.2*	*45.2*
GDP, % change	*2.7*	*–0.8*	*–1.0*	*0.6*	*1.7*

f = forecast
Sources: Statistics Finland, State Treasury and Bank of Finland.

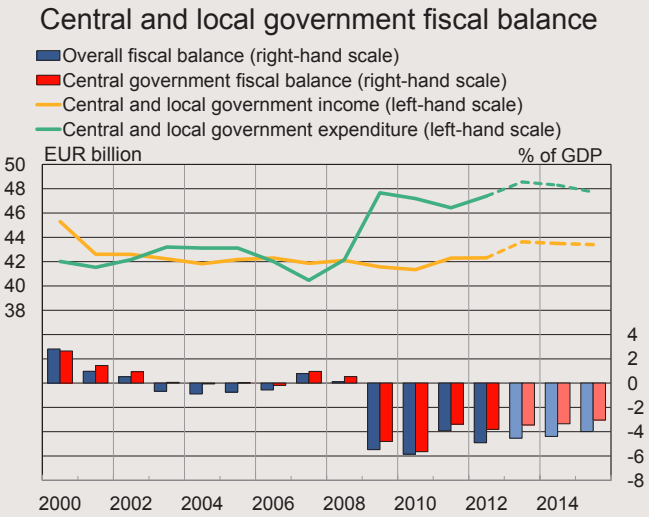
government will post a substantial deficit at the end of the forecast period, amounting to around 3% of GDP in 2015 (Chart 16).

Tax revenue growth has accelerated noticeably relative to the weak situation at the beginning of 2013. Direct and indirect tax receipts have both increased during the year. Corporation tax growth has picked up and the VAT increase at the beginning of the year has boosted indirect tax receipts. Tax revenues on earnings and capital income have also grown reasonably considering the economic situation.

Consolidation measures, together with slower growth in compensation of employees, will ease central government consumption expenditure in 2013–2015. On the back of the moderate settlement achieved in the general incomes policy agreement, negotiated wages will rise more slowly than before, thus improving the outlook for central and local government in the immediate years ahead. The number of public sector employees is also forecast to decline slowly over the next few years.

Despite the moderate pay settlement, the outlook for local government finances is still fairly bleak and the deficit will remain at around 1% of GDP until 2015. Since the government's expenditure savings have largely concentrated on central government transfers to local government, municipalities will be forced to raise their tax rates. However, the local government deficit will begin to contract gradually, as the moderate pay agreement will slow local government expenditure growth and municipal tax increases will compensate for the shortfall stemming from cuts in central government transfers. With growth in total local government expenditure also easing during the forecast period, the local government deficit will come down to 0.9% of GDP in 2015.

Chart 16.



The surplus on the social security funds will contract markedly in 2013, due to higher pension expenditure stemming from index increments and an increase in the number of pension recipients. Moreover, as earnings-related pension contributions remain roughly at the previous year's level and slowing growth in aggregate wages curtails growth in income from contributions, the surplus will contract to 2.1% of GDP in 2013.

At the end of the forecast period, the surplus on the social security funds will still be around 2% as a result of a substantial increase in social security

Box 4.

Finland's public finances

In recent years, Finland's economic growth has repeatedly been weaker than estimated. This has led to a deterioration in the funding base for successive Budgets. Due to weaker-than-expected developments in tax revenues, the impact of fiscal consolidation measures has been largely dissipated, and a considerable deficit has been accumulating in the public finances. In the immediate years ahead, the public finances will continue to post a deficit and the debt ratio will rise further.

The weaker-than-expected growth has also undermined the ability of the tools designed to steer fiscal policy in the longer term – such as the central government spending limits – to strengthen the public finances. With economic growth constantly weaker than projected, adherence to the spending limits is no longer enough to ensure sustainable expenditure policy.

As the general government balance has weakened, it has become evident that sustainable public finances cannot be achieved without substantial structural reforms. Hence, economic policy efforts in 2013 have focused on measures to strengthen the public finances in the long term. In autumn 2013, the government decided on a structural policy programme aimed at strengthening productivity growth in both private and public sectors, increasing labour supply and bridging the sustainability gap in the public finances. Stronger growth was the objective of a decision to lower corporate taxation, agreed in connection with the spring 2013 decision on central government spending limits. Besides long-term action, the structural policy programme also includes measures to bolster local government finances. These measures are meant to be carried out in the immediate years ahead.

With the economic situation deteriorating, it has been more or less impossible to comply with the national targets set for central government debt and the general government deficit. Furthermore, the Bank of Finland forecast indicates that, without additional measures, in the immediate years ahead Finland will no longer be able to fulfil the debt criterion under the excessive deficit procedure (EDP) or observe the reference value for the medium-term structural deficit, which were determined in the context of EU fiscal policy coordination.

Public finances in the medium term

According to the forecast, in the absence of new measures, the general government deficit will rise slightly in the years following the current forecast period extending to 2015, as age-related expenditure will deepen the structural deficit (Table A). The debt-to-GDP ratio will already exceed the 60% reference value in 2014. The financial assistance granted to stressed economies in the euro area will push the debt ratio up by slightly more than 3 percentage points.

Without new fiscal policy measures, the debt ratio will continue to rise in the next few years, even though the projected acceleration in economic growth will constrain debt accumulation. The national legislation required for ratification of the Fiscal Compact between the EU Member States (hereinafter the Fiscal Compact Act) sets the medium-term objective for Finland's structural deficit at ½% of GDP. The restrictions and rules set in the Fiscal Compact Act are binding and will therefore affect fiscal policy in the immediate years ahead. Therefore, exceeding the deficit threshold set in the Act and the EDP reference value means that public expenditure will need to be cut or taxes increased during the current decade.

As regards action extending to the immediate years ahead, the government has so far outlined measures targeted at local government finances. The objective set in the government's structural policy programme is

Table A.

Public finances in 2012–2019: baseline scenario and scenario incorporating local government consolidation

% of GDP	*2012*	*2013f*	*2014f*	*2015f*	*2016f*	*2017f*	*2018f*	*2019f*
Baseline								
General government net lending (EDP)	***–1.8***	***–2.4***	***–2.4***	***–2.1***	***–2.0***	***–2.2***	***–2.4***	***–2.5***
General government net lending (ESA95)	***–2.2***	***–2.4***	***–2.4***	***–2.1***	***–2.0***	***–2.2***	***–2.4***	***–2.5***
Central government	*–3.8*	*–3.4*	*–3.3*	*–3.0*	*–3.0*	*–2.9*	*–2.8*	*–2.7*
Local government	*–1.1*	*–1.1*	*–1.0*	*–0.9*	*–1.0*	*–1.0*	*–1.1*	*–1.1*
Social security funds	*2.7*	*2.1*	*2.0*	*1.9*	*1.9*	*1.7*	*1.5*	*1.3*
General government primary balance	*–0.7*	*–1.0*	*–0.9*	*–0.6*	*–0.5*	*–0.7*	*–0.8*	*–0.8*
General government debt (consolidated, EDP)	***53.6***	***59.0***	***62.4***	***64.2***	***65.9***	***67.5***	***68.8***	***69.9***
Total tax ratio	*44.0*	*45.2*	*45.3*	*45.3*	*45.2*	*45.3*	*45.3*	*45.4*
Change in GDP, %	*–0.8*	*–1.0*	*0.6*	*1.7*	*1.7*	*1.4*	*1.5*	*1.5*
Local government consolidation								
General government net lending (ESA95)	***–2.2***	***–2.4***	***–2.3***	***–1.6***	***–1.4***	***–1.2***	***–1.4***	***–1.5***
of which, Local government	*–1.1*	*–1.1*	*–0.9*	*–0.5*	*–0.3*	*–0.1*	*–0.1*	*0.0*
General government primary balance	*–0.7*	*–1.0*	*–0.8*	*–0.2*	*0.2*	*0.3*	*0.2*	*0.1*
General government debt (consolidated, EDP)	***53.6***	***59.0***	***62.3***	***63.6***	***64.5***	***65.0***	***65.4***	***65.6***
Total tax ratio	*44.0*	*45.2*	*45.2*	*45.4*	*45.4*	*45.6*	*45.6*	*45.8*

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

that local government obligations will be reduced by EUR 1 billion, and local government is additionally required to implement consolidation measures or increase taxes in the corresponding amount. The measures to consolidate local government finances are designed to take place in 2014–2017.

The strengthening of local government finances will affect medium-term economic growth and general government finances alike (Table A). The calculation is based on the assumption that the local government share of consolidation measures will be covered by tightening municipal taxation for the full EUR 1 billion. Higher taxation will reduce household purchasing power, which will lead to a slight reduction in central government tax revenue. In addition, weaker labour demand will result in slower GDP growth. All in all, due to the consolidation, GDP growth would decelerate by 0.4% in 2017. As a result of the consolidation measures, the local government deficit would melt away and the general government deficit would contract by around 1 percentage point.

Depending on the estimation method, the structural deficit will fluctuate between 1% and 1½% of GDP in 2013–2015. Estimated by the harmonised cyclical adjustment method used within the European System of Central Banks (ESCB), the deficit will be about 1½% of GDP.[1] The structural deficit estimation method used by the European

[1] *For a description of the common Eurosystem method, see Bouthevillain, C – Cour Thimann, P – Van den Dool, G – Hernández de Cos, P – Langenus, G – Mohr, M – Momigliano, S – Tujula, M (2001) Cyclically adjusted budget balances: an alternative approach. ECB Working Paper Series No. 77. September.*

Table B.

Cyclically adjusted general government financial balance

% of trend GDP	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*	*2019*
General government net lending (EDP), % of GDP	*–1.8*	*–2.4*	*–2.4*	*–2.1*	*–2.0*	*–2.2*	*–2.4*	*–2.5*
Cyclical factors (ESCB)	*0.0*	*–0.5*	*–0.8*	*–0.6*	*–0.2*	*0.0*	*0.0*	*0.0*
Structural balance (ESCB)	*–1.8*	*–1.9*	*–1.6*	*–1.5*	*–1.8*	*–2.2*	*–2.4*	*–2.5*
Structural balance (European Commission)	*–0.8*	*–1.0*	*–1.1*	*–1.2*				

Sources: Statistics Finland and Bank of Finland.

Commission has official status, since Member States' compliance with stability programmes and national legislation required by the Fiscal Compact is assessed on the basis of this approach. The Commission's method gives a lower deficit estimate than the ESCB method, as the former produces a higher negative output gap, particularly for 2013.[2]

However, according to both methodologies, the deficit in Finland's public finances will be deeper than ½% of GDP, ie the medium-term objective (MTO) for Finland's deficit specified in the national Fiscal Compact Act (Table B). If realised, a permanent EUR 2 billion consolidation of local government finances would reduce the general government deficit close to the MTO. However, adherence to the MTO will also require additional annual consolidation measures, since the structural deficit will increase at the end of the current decade by about 0.1 of a percentage point per annum due to population ageing.

[2] *For the European Commission's cyclical adjustment methodology, see https://circabc.europa.eu.*

In the absence of new measures, the general government debt-to-GDP ratio will rise to about 70% of GDP by the end of the decade (Table A). Debt will grow at a relatively slow pace, but nevertheless continuously. At the same time, the surplus on the employment pension funds will also decrease substantially. With economic growth remaining subdued, employment pension funds relative to GDP already begin to contract slightly by the end of the decade if earnings-related pension contributions are not increased more than has so far been agreed. The local government adjustment programme agreed in the government's structural policy programme would be adequate to reduce the general government debt ratio by about 4 percentage points by 2019. Even so, Finland would still record an excessive deficit in terms of the debt criterion.

Acquisition of funding

Even though central government debt has grown rapidly, Finland has maintained its good position on the sovereign bond markets. There have been no problems in the acquisition of funding, and the Finnish government has retained its AAA credit rating. The high credit rating and the generally low level of interest rates have curtailed growth in central government interest expenditure, which has eased the management of debt. The structural reform package presented by the government in autumn 2013 will slow debt accumulation, and, if executed in full, the package will strengthen confidence in the sustainability of Finland's public finances.

Central government's gross borrowing requirement in 2013 is estimated at around EUR 20 billion. Excluding loans maturing and needing rolled over, the net borrowing requirement is around EUR 9 billion. Almost 98% of central government debt consists of long-term debt with a maturity of over one year. However, most of the debt is foreign debt, which increases the associated refinancing risks.

Local government's net borrowing requirement in the forecast period will be around EUR 2 billion each year.

However, the pace of debt accumulation will ease slightly towards the end of the forecast period, as growth in municipal tax revenues picks up and expenditure growth eases, partly due to the effects of the municipal expenditure cuts in the government's structural policy package beginning to bite. The majority of local government funding needs are covered via loans by Municipality Finance Plc, which has also retained the highest possible credit rating.

Fiscal policy steering

The recurrent negative surprises in economic developments impose new requirements on national systems for fiscal policy steering. As the economic situation has deteriorated, the central government debt and deficit targets set in the Government Programme have inevitably become less important in practical policy choices. In the environment presented in the forecast, turning the central government debt ratio onto a downwards trajectory would require exceptionally extensive measures in 2015. Achievement of the central government deficit target set in the Government Programme would require even more ambitious consolidation measures.

Central government spending limits play a key role in the preparation of the annual Budget and the long-term expenditure framework. The four-year plans include operating guidelines and priorities for administrative branches and the key policy objectives. In setting the expenditure framework, account is taken of long-term expenditure pressures in the economy and the prospects for economic development. Hence, the spending limits have brought long-term commitment and also ownership of expenditure policy.

Due to the considerable deterioration of economic prospects in recent years, the central government spending limits are no longer constructed on a sufficiently realistic estimation of developments in the funding base. The spending limits decisions in both the previous and the current parliamentary term were based on the assumption that the funding base would grow at a significantly faster pace than has actually been the case, or is likely to be the case in the immediate years ahead considering the data presently available.[3] Central government expenditure has remained well within the spending limits, and, in real terms, on-budget expenditure will actually contract in the present parliamentary term. However, despite the tight spending limits, there has, in practice, still been relaxation in expenditure policy relative to the funding base.

If the developments in recent years were based merely on a cyclical contraction in tax revenue, the spending limits system would have been enough to stabilise the economic situation. However, due to the exceptionally strong structural change in the Finnish economy, long-term growth estimations have weakened. Higher economic growth will no longer improve the economic situation to the same extent as in the past. Rather, tax revenue losses will partly be permanent. In such a situation, the current spending limits system is not adequate to support the balancing of central government finances.

From the perspective of overall public expenditure, the steering of local government finances is more important than the steering of central government finances. Improving the steering framework is the objective of a project ongoing in the current parliamentary term to reform local government structures and social and health care services. In connection with the autumn 2013 structural policy reform, the government set a target of cutting local government expenditure but also improving the efficiency of the local government financial steering system. This project is pivotal for the controlling of public expenditure. How well the public sector can be adjusted to

[3] *In connection with the spending limits decision for the parliamentary term 2007–2011, GDP growth was estimated at 10% over the parliamentary term, whereas actual GDP growth was around 1½%. Correspondingly, when deciding on the spending limits for 2013–2016, GDP was estimated to grow by 21% by 2016, while the Bank of Finland's current forecast puts the likely actual growth at 13%. In euro terms, the difference in 2016 will be around EUR 20 billion.*

slower growth in the funding base depends largely on the success of the reform of this system.

Structural reforms and the sustainability gap

At the end of 2012, the Bank of Finland estimated that the fiscal sustainability gap was over 4%. Since then, the debt ratio has continued to grow, and the general government structural deficit has settled at a deeper level than projected at the time. According to the current projection, the general government deficit and primary deficit will be about 1 percentage point higher at the end of the current decade than estimated a year ago.[4]

However, the sustainability gap will contract due to slower-than-forecast growth in pension expenditure, on account of which the balance sheet of the earnings-related pension funds will be stronger than previously assessed. The previous calculations were based on the prediction for the pension replacement rate made by the Finnish Centre for Pensions (ETK) in 2011. In the ETK's new calculations, however, the pension replacement rate is smaller. Moreover, the number of pensioners has been revised down slightly from the sustainability projection of 2012. In addition, according to the most recent plans, earnings-related pension contributions will be raised faster than previously estimated.

The Bank of Finland's new forecast for the overall fiscal sustainability gap is roughly the same as at the end of 2012, ie 4½% of GDP.[5]

Economic recovery overshadowed by condition of the public finances

International comparisons show that Finland's public finances have emerged from the global recession and Finland's own structural crisis fairly well. Public debt and deficit have not been in breach of the rules and objectives set in the context of EU fiscal policy coordination, even though output losses have been more sizeable than in other countries.

Prior to the financial crisis, Finland's public finances were equipped with exceptionally strong buffers by international standards. Central and local government were roughly in balance, and, influenced by strong growth, the central government debt-to-GDP ratio had contracted to an exceptionally low level. The buffers have created room for manoeuvre in public finances during the recession.

However, the muted economic growth since the crisis, together with expenditure growth that has already commenced due to population ageing, has put the public finances on a much weaker footing. There is little room left for further debt accumulation, and the coming growth in age-related costs will weaken the situation further in the future. The fact that the debt and budgetary deficit thresholds will be exceeded requires the tightening of fiscal policy already in the immediate years ahead.

In terms of near-term economic developments, it is crucial how the government's structural policy programme progresses. If the reforms succeed in stabilising the long-term balance of the public finances, the need to tighten fiscal policy in the immediate years ahead will not be so pressing, and hence the output and employment losses due to this tightening will not threaten the longer-term economic outlook. This will be especially so if the local government finances are consolidated as extensively as envisaged in the reform programme.

Decisive implementation of the structural reform measures is imperative for the stabilisation of the public finances. Practical policy execution will also require more efficient instruments for the steering of fiscal policy. In particular, the spending limits for the long-term steering of expenditure policy should be based on a realistic picture of developments in the funding base.

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[4] *For more information on the calculation, see Kinnunen – Mäki-Fränti – Viertola (2012).*

[5] *On the sustainability assessment and structural reforms, see Kinnunen – Mäki-Fränti – Railavo, Structural reforms in the economy and fiscal sustainability', p. 67 below.*

contributions in 2014 and 2015. Influenced by slower inflation and earnings growth, index increments to pensions will be lower than before. Even though pension expenditure growth will slow down slightly next year, it will still average 4% per annum towards the end of the forecast period.

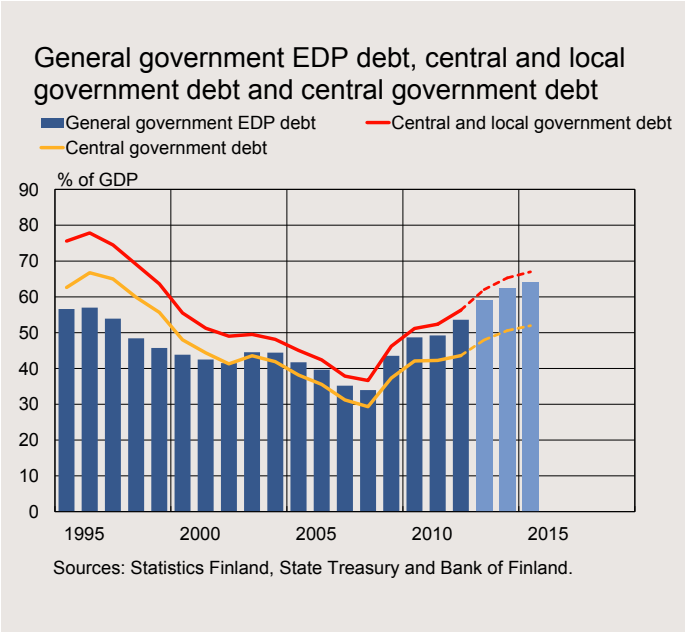
The tax ratio will rise in 2013, as central government taxation will tighten substantially. Central government taxation will be roughly neutral in 2014 and 2015, but increases in social security contributions and municipal taxes will keep the tax ratio roughly at the level of 2013 towards the end of the forecast period. The primary balance will continue to post a deficit throughout the forecast period, but the deficit will contract gradually towards the end of the forecast period.

The ratio of total general government revenue to GDP will remain roughly at the current level, standing at 55.8% in 2015. Total general government expenditure will grow at an average rate of just under 3% per annum in the forecast period, ie markedly slower than during the past 5 years. The ratio of expenditure to GDP – the expenditure ratio – will rise to 58.2% in 2013 and ease back in 2015, underpinned by slowing growth in general government expenditure and a gradual pick-up in economic growth.

Due to rapid accumulation of central and local government debt, consolidated general government EDP debt will grow substantially in 2013–2015. All in all, compared with 2012, general government debt will increase by over 10 percentage points relative to GDP during the forecast period. The general government debt-to-GDP ratio will in 2014 already exceed the 60% reference value specified in the Stability and Growth Pact. General government EDP debt will grow to 64% in 2015 (Chart 17). Local government EDP debt, in turn, will increase by about EUR 2 billion per annum, and is estimated to total over EUR 18 billion in 2015.

The most significant uncertainty surrounding the forecast for the public finances relates, above all, to new consolidation measures. In an environment of slow economic growth, a rapid rise in general government debt cannot be halted without new measures by the government. Therefore, the outlook for public finances may turn out to be more positive than forecast if the government's structural policy reform measures are implemented in

Chart 17.

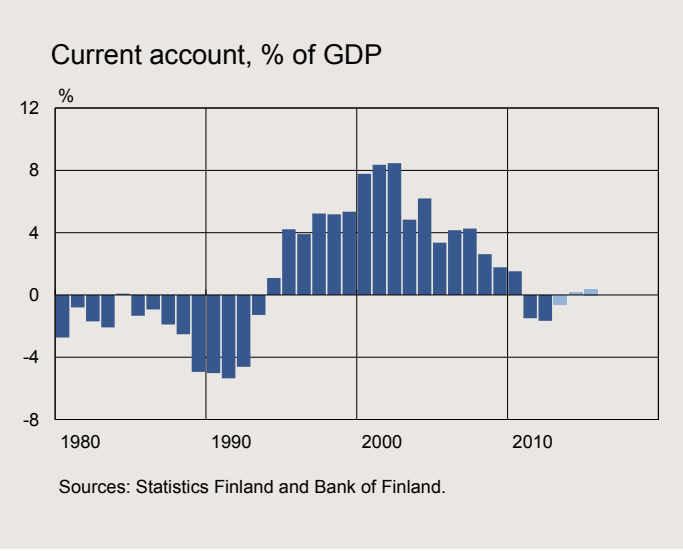


full and in a timely manner so they can curb the rise in general government expenditure and push up revenues already during the forecast period. Focusing the structural reforms especially on local government would restrain local government expenditure and thereby rein in the sector's rapid accumulation of further debt.

External balance

Finland's current account deficit has contracted relatively quickly during the past year. As recently as 2012, the deficit was EUR 3.3 billion, but in September 2013 the 12-month cumulative deficit had contracted to EUR 1.7 billion (Chart 18). The downward trajectory in the terms of trade (ratio of export prices to import prices) has already come to a halt and is no longer a significant factor in current account movements.

Chart 18.



The contraction in the current account deficit is due to the weakness of domestic demand, as a consequence of which import growth has been sluggish, and there has even been a momentary contraction in imports. In 2013, the net household savings ratio will remain around 1%, while the pace of debt accumulation has slowed as housing investment contracts. At the same time, corporate profitability has declined, although the corporate sector remains in surplus. In addition, the general government fiscal balance has weakened slightly.

During the forecast period, the current account will strengthen slightly, for largely the same reasons as in the past year. The household savings ratio will remain almost unchanged, and consumption growth will be sluggish. Investment growth will also be lacklustre, despite a small lift towards the end of the forecast period. The current account surplus will rest at EUR 0.8 billion at the end of the forecast period, or approximately 0.5% of GDP, as the recovery in domestic demand and exports will also boost imports.

The household savings ratio should remain around 1% in 2014, too. In 2015, savings will recede slightly as private consumption picks up due to a general improvement in the economy. Growth in the level of household debt will come to an end in the forecast period, but investment savings will show a deficit throughout the forecast period (Chart 19).

As corporate profitability declines, non-financial corporations will reduce their savings. Despite this, their

investment savings will remain positive, as they will also cut investment. During the forecast period, the financial position of non-financial corporations will improve slightly each year, due in part to moderate cost developments, but also to the very low level of investment activity. The general government financial balance will be boosted by both expenditure cuts and increases in taxes and social security contributions, but despite the consolidation measures will improve only slightly by 2015.

Wage and price trends

Negotiated wages to rise only slowly during forecast period

Growth in employee compensation will slow in 2013–2014 due to the weaker employment situation and the new general agreement concluded by the social partners. Although output and employment will begin to grow towards the end of the forecast period in 2015, the labour market will not tighten in such a way as to cause a significant rise in wages and salaries (Chart 20).

In view of the wide-ranging agreement on employment and growth reached by the social partners in autumn 2013, pay increases will be lower than in previous years. In 2014, the pace of growth in negotiated wages will be an estimated 0.6%, and in 2015 just 0.4%. Typically, in years when negotiated rises are smaller, wage drift has a tendency to grow. Therefore the forecast estimates that the total rise in nominal earnings will be 1.5% in both 2014 and 2015.

Chart 19.

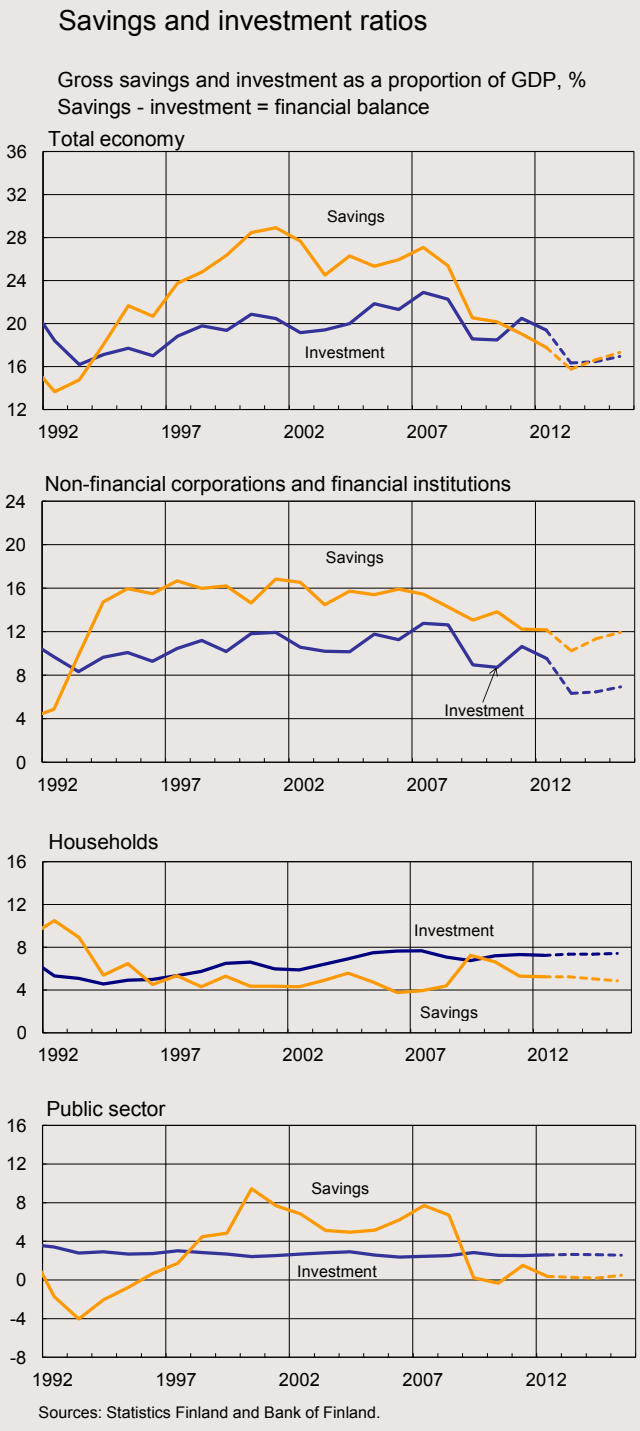
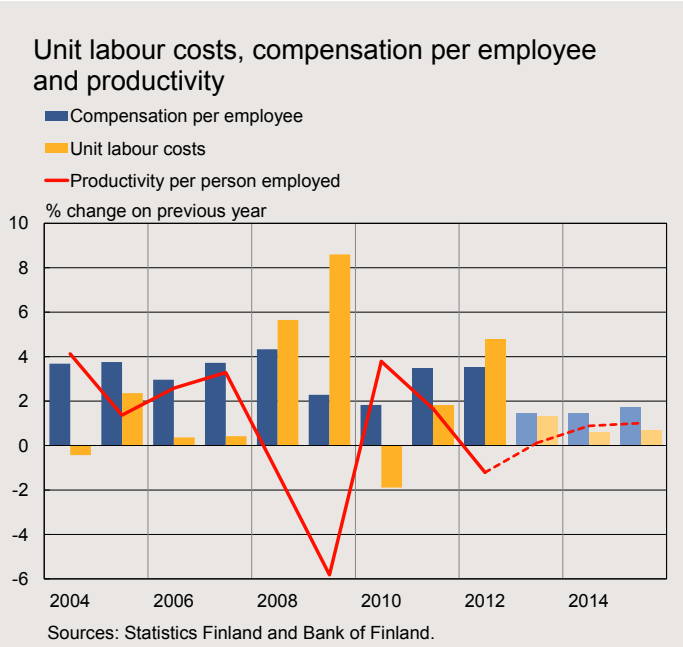


Chart 20.



Average wages will rise towards the end of the forecast period slightly faster than the index of wage and salary earnings, with the number of hours worked increasing as economic growth accelerates in 2015. Hence, in the forecast, compensation per employee grows by 1.5% in 2014 and 1.7% in 2015. The rise in average wages for 2013 is estimated at 1.4%. Despite slower inflation, real earnings will develop weakly in 2013–2015.

The pace of growth in unit labour costs has slowed in 2013 and will slow further during the forecast period. In 2012 unit labour costs grew by 4.8%, but in 2013 by only 1.3%. The rise was due to the twin causes of rising average wages and weakening productivity. Labour productivity growth will begin to gather pace again in 2014–2015. Viewed historically, however, the pace will be slow, at 1.0% in 2015.

Despite the moderate rise in negotiated wages, unit labour costs will rise 0.6–0.7% per annum in 2014–2015. Cost-competitiveness will improve relative to Sweden and Germany, but relative to the euro area the improvement in competitiveness will be modest (see Box 5). Restoration of Finland's relative cost-competitiveness will require a prolonged period of wage restraint.

Slower inflation

Inflation according to the harmonised index of consumer prices (HICP inflation) will slow during the forecast years from 2.2% in 2013 to 1.6% in 2014 and 1.4% in 2015 (Chart 21). Inflation according to the national consumer price index (CPI inflation) will, in contrast, accelerate to 1.7% in 2015. The slight difference in trend between the different measures of inflation is due primarily to the impact of housing prices and interest rates on the national index.

In addition to rising commodity prices and labour costs, inflation in 2011–2013 has also been driven upwards by higher indirect taxes. In 2013, VAT rates were increased by 1 percentage point, which translates as a 0.7 percentage point computational rise in inflation. In 2014, tax rises will continue with increases in the excise duties on alcohol and tobacco, non-alcoholic beverages and energy. Overall, the impact of tax increases on inflation in 2014 is estimated at 0.5 of a percentage point. In 2015, there will also be an increase in excise duty on sweets,

which will have an estimated 0.1 of a percentage point impact on inflation.

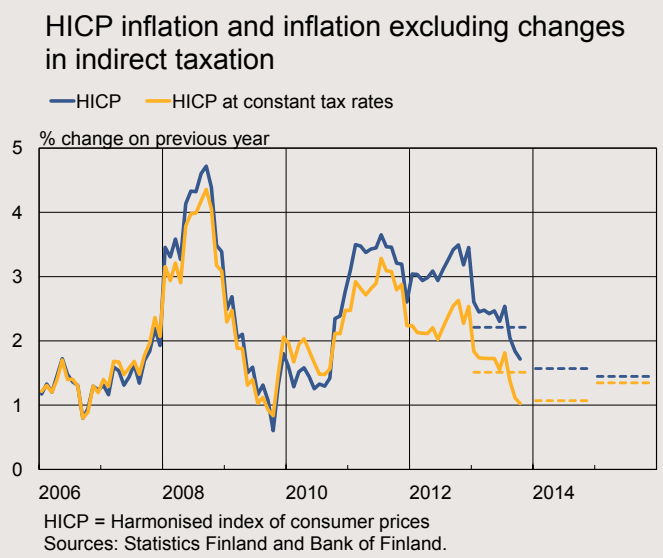
In 2013, prices of industrial goods and energy have risen more slowly than average inflation. Within non-energy industrial goods, prices of consumer durables have continued their downward trend. In contrast, nondurable goods have risen in price more quickly in 2013 than in 2012. This is in part due to the hike in VAT, but since July another factor pushing up prices in this category has been the rise in reference prices for prescription drugs. Of semi-durable goods, clothes prices have come down during the course of the year. All in all, the impact of the VAT hike on the prices of industrial goods has been less than expected. In 2014–2015, inflation in non-energy industrial goods will accelerate slightly, while remaining under 1% per annum.

The price of energy will fall slightly in 2013. This is due to a drop in the price of crude oil, which is feeding through into consumer prices for liquid fuels. According to market expectations, the price of crude oil will fall by approximately 8% in the forecast years, causing downward price pressures on liquid fuel prices as well. The market price of electrical energy is also expected to decline slightly, although transmission charges are facing upward pressures. An increase in energy taxes at the beginning of 2014 will affect both electricity and fuel prices, and the consumer price for energy will rise.

Service prices have risen 2.8% during the course of 2013. The rise has been driven by more expensive rents and restaurant and cafeteria services. Rents have continued to rise relatively rapidly in 2013, at an average 2.9%. With the rise in house prices assessed to have slowed slightly and the energy price trend flattened out, rents can also be expected to rise slightly more slowly during the forecast years. The prices of restaurant and cafeteria services will be affected in 2014 by the increase in alcohol taxation, but labour costs will rise much more slowly than in previous years. As a whole, the forecast expects service prices to rise around 2% in both 2014 and 2015.

The upward trend in food prices has slowed notably towards the end of 2013. Unprocessed food (fruits, vegetables, meat and fish) prices have risen exceptionally rapidly over the past year or more, but during the forecast years the pace of rise will slow substantially, unless weather conditions or other exceptional factors cause new production bottlenecks.

Chart 21.



Box 5.

Outlook for Finland's cost-competitiveness

Finland's cost-competitiveness relative to competitor countries has weakened in recent years. Unit labour costs across the Finnish economy as a whole have risen almost 22% between 2007 and 2012. Over the same period, unit labour costs have risen approximately 11% in the euro area, 8% in Sweden and 11% in Germany. In Finland, the social partners concluded in autumn 2013 a broad-ranging agreement on employment and growth, including very moderate wage rises for 2014–2015. Assessed against fresh forecasts by the Bank of Finland and the European Commission, this agreement alone will not suffice to restore Finland's cost-competitiveness relative to its key competitors to the position prevailing in 2007.

Due to the moderate pay settlement, the pace of rise in aggregate wages in Finland over the next 2 years will be slower than in Germany and Sweden. In the Bank of Finland's December 2013 forecast, the cumulative rise in average wages since 2012 is 4.7% (Commission forecast gives 5.7%). In the euro area as a whole, the rise in average wages between 2012 and 2015 is, according to the Commission forecast, 5%, against almost 8% in Germany and a good 9% in Sweden. However, in order to assess the burden of costs, the change in wages must be set against developments in productivity.

In Finland, the annual pace of growth in productivity during the forecast period will be only around 1%, meaning unit labour costs will rise by less than 1% in both 2014 and 2015. In its autumn forecast, the European Commission estimated the average rise in unit labour costs across the euro area to be equally slow (Table), but Finland's unit labour costs were still rising faster than the euro area average in 2013. Between 2012 and 2015, according to the forecasts, Finland will catch up on Germany and Sweden in cost-competitiveness. The pace of growth in unit labour costs in Finland will be 2.8 percentage points slower than in Germany, and 1.6 percentage points slower than in Sweden. Relative to the euro area as a whole, Finland's competitiveness will show no change.

From the point of view of Finland's cost-competitiveness, the agreement on employment and growth was a step in the right direction. However, due to the economic situation, the rise in wages has also been moderate in other European (competitor) countries. In light of the forecasts, it is clear that this autumn's pay settlement will not be enough to restore Finland's relative labour costs to the situation prevailing before the crisis (Chart). The third year

Table.

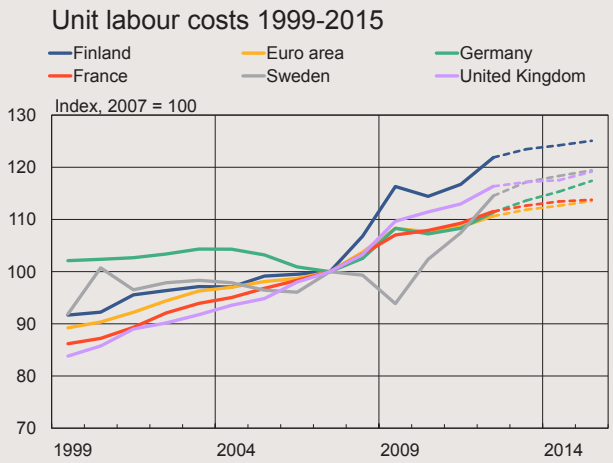
Annual change in unit labour costs, %

	2009	*2010*	*2011*	*2012*	*2013[f]*	*2014[f]*	*2015[f]*
Finland	*9.0*	*–1.6*	*2.0*	*4.4*	*1.3*	*0.6*	*0.7*
Euro area	*4.3*	*–0.6*	*0.8*	*1.9*	*1.1*	*0.7*	*0.8*
Germany	*5.6*	*–1.1*	*1.0*	*3.1*	*2.0*	*1.5*	*1.8*
Sweden	*4.4*	*–2.3*	*0.2*	*2.9*	*2.3*	*1.0*	*0.9*

f) For Finland, Bank of Finland forecast; otherwise, European Commission forecast.
Sources: European Commission and Bank of Finland.

included in the labour market agreement will facilitate the continuation of moderate wage developments, but improving Finland's relative position will also require measures to boost productivity.

Chart.



Sources: Macrobond, Bank of Finland and European Commission.

The pace of rise in the price of processed foods has slowed over the course of 2013. The rise in consumer prices for dairy and cereal products, in particular, has sustained inflation largely due to the price rises early in the year. The second half of the year saw only modest rises. Processed foods are not assessed to face significant upward price pressures for the next 2 years. Taxation changes will, however, push up the prices of processed foods in 2014. Increased duties on alcoholic and non-alcoholic beverages and tobacco will have an estimated 0.35 of a percentage point impact on overall inflation.

The course of inflation could turn out to be slower than forecast if private consumption were to weaken more than estimated. Corporate and household confidence in the economy could also remain weak for a longer period, hampering consumption and subduing the pace of price rises. Weaker-than-forecast economic growth internationally could lead to a stronger-than-estimated fall in commodity prices, which would also feed through into consumer prices. Inflation could also be faster than forecast if the economy were to begin growing more strongly than estimated.

Risk assessment

Risks relating to the international economy

According to the forecast, the global economy has been recovering since the latter part of 2013, and growth will strengthen further in the immediate years ahead. Particularly in the EU, the prospects for stable, self-reinforcing growth have improved. Forecast risks relating to the international economy are nevertheless still predominantly on the downside.

The growth outlook for the euro area rests on the stabilisation of public finances in the stressed economies and other deeply indebted countries. This will be dependent on the structural reforms needed to restore competitiveness and fiscal sustainability being carried through as planned. Implementation of the structural reforms has got off to a slow start. If the reforms are not implemented in the planned time, debt problems could become critical again. In addition, there would be a great deal of uncertainty in relation to economic policy, which would further weaken the financial markets and undermine the prospects for faster growth.

The response of the financial markets to changes in the United States' monetary policy stance poses another risk to developments in the euro area. In spring 2013, financial conditions tightened globally when the Federal Reserve announced the possibility it might slow the pace of monetary policy relaxation in the near future. If the US

economy continues to develop favourably and the uncertainty surrounding US economic policy is dispersed, it will be essential that other central banks are able through their communications and other actions to reassure the markets that a different pace of economic performance also requires a different pace in the development of interest rates. Unsuccessful communication could lead to an unnecessary growth in risk premia, which could in turn have widespread implications for the growth outlook globally.

The US economic recovery does, however, also pose an upside risk to the forecast for the international economy. In particular, there exists a possibility of stronger-than-estimated growth in consumption. Household confidence will be bolstered by the improved labour market situation and rising asset values. If, in addition, the uncertainty surrounding US economic policy is dispersed, global economic growth, and hence growth in Finland's export markets, could be faster than forecast.

Condition of public finances overshadows domestic growth prospects

Recovery from the deepest phase of the recession has, in Finland, been based primarily on domestic market growth and the continued accumulation of household debt. The risks related to this trend, which have been reported in connection with previous Bank of Finland forecasts,[6] have partially materialised in the past couple of years. Households have raised their savings ratio, which, together with the scarcity of corporate investment, has been reflected in a slower pace of growth in the economy.

During the forecast period, economic growth is more solidly based than before, as it will rely increasingly on external demand. Even so, the foundations of growth still remain somewhat unstable, as domestic demand is still based on the rapid accumulation of general government debt. Central and local government will both probably be forced to reduce accumulation of further debt already during the forecast period in order to avoid exceeding the debt criterion in the Stability and Growth Pact and the medium-term deficit criterion contained in national legislation based on the Treaty on Stability, Coordination and Governance. There is, in fact, a strong probability that growth in domestic demand will be somewhat slower than forecast. On the other hand, if the jointly agreed fiscal policy rules are followed, the risk of Finland losing its strong credit rating will be smaller. The low level of country risk will, for its part, support domestic investment by easing access to corporate finance.

In respect of the short-term trend in employment, the forecast still contains the risk that, despite increased output and a moderate pay agreement, demand for labour will not necessarily grow in the immediate years ahead in accordance with the forecast. This alternative is explored in the alternative scenario.

[6] See Bank of Finland Bulletin 3/2013: Economic outlook.

Box 6.

Alternative scenario: improved corporate profitability

According to the Bank of Finland forecast, total employment will decline less in 2013 and 2014 than could be assumed on average based on the estimated level of economic growth.[1] Due to the lower degree of employment adjustment, labour productivity growth is depicted in the forecast as continuing to be more sluggish than in the pre-crisis years and also as lagging behind the 1½% long-term annual growth forecast for the Finnish economy.[2]

The employment trend in the forecast is based on the idea that employers will retain their work force as they wait for an upswing in demand. On the other hand, external demand is expected to recover more slowly than previously estimated, and the outlook for domestic demand has also weakened somewhat. Employers' ability to sustain employment could thus turn out to be weaker than forecast.

Profitability among non-financial corporations in Finland has been much weaker than before in the wake of the financial crisis. It has been hit both by growth in costs and by stiffer competition due to weak demand. In recent years, labour costs have been pushed up particularly by a relatively rapid increase in pay levels, but also by the sluggish development of labour productivity. Improvements to corporate productivity will require either a reduction in production costs or enhanced corporate pricing power, or both at the same time.

This alternative scenario uses a general equilibrium model developed in the Bank of Finland to examine an alternative to the baseline forecast, in which output improves as described in the forecast, but the number of people employed is lower. This means that companies are able to boost their output by more efficient utilisation of their present labour resources than foreseen in the baseline forecast, which is reflected in a temporary acceleration in labour productivity growth relative to the baseline.

As the size of work force needed to service domestic output shrinks, companies' cost-competitiveness will improve and exports develop more favourably than in the baseline forecast. Companies will also seek to boost profitability by expanding their price margins, whereby the rise in the prices of goods will not slow at the same pace as the decelerating growth in production costs. As well as corporate demand for labour, investment growth, too, is slightly slower than in the baseline forecast, and imports less than forecast.

Technically, in the model, this change relative to the baseline is brought about by temporarily accelerating Finnish companies' labour-saving technological development and reducing price flexibilities in the demand for products during the forecast period.

The alternative scenario is formulated to bring labour productivity growth in line with the long-term forecast already from the beginning of 2014. Productivity growth per person employed will strengthen to an average 1½% per annum in the years 2014–2015 (Table). From the improvement in labour productivity it follows that employment during the forecast period is reduced by 17,000 persons relative to the baseline (Chart).

In the alternative scenario, the rise in negotiated wages remains in accordance with the social partners' agreement on employment and growth, but the weaker-than-forecast employment trend reduces wage drift. Slower development of

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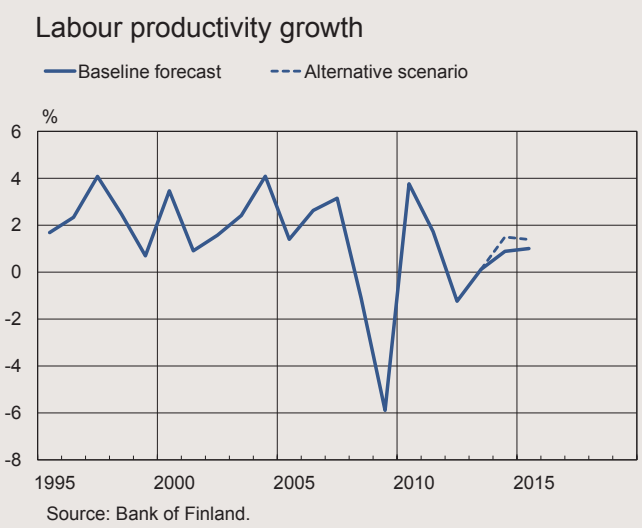
[1] *For a detailed discussion of the connections between economic growth and employment, see Bank of Finland Bulletin 5/2012: Economic outlook, Box 3 'The link between economic growth and the unemployment rate has changed', p. 30–32.*

[2] *See Kinnunen et al. (2012) 'Long-term growth forecast for the Finnish economy'. Bank of Finland Bulletin 3/2012: Economic outlook, p. 69–78.*

Chart.



wage and salary earnings reduces domestic demand, as a result of which the rise in prices slows, but not by as much as the rise in production costs. The rise in prices for private consumption during the forecast period is on average 0.4 of a percentage point slower than the baseline.

Lower production costs also decelerate the rise in export prices, which improves the cost-competitiveness of Finland's export sector compared with the baseline. In the alternative scenario, exports grow by an average 0.4 of a percentage point per annum above the baseline during the forecast period. Lower employment and slow growth in wages and salaries relative to productivity reduce the income share of labour by over 1 percentage point in the forecast period, thereby returning it closer to the level prevailing before the recession.

The alternative scenario provides good reasons why employment in the immediate years ahead could develop more weakly than forecast even if output develops according to the baseline. To date, relatively good employment figures have been sustained partly at the cost of corporate profitability.

Table.

Alternative secnario: Development of labour productivity

	2013	*2014*	*2015*	*2020 deviation, %*
GDP, % change				
Baseline forecast	*–1.0*	*0.6*	*1.7*	
Alternative scenario		*0.7*	*2.0*	
Difference		*0.1*	*0.2*	*–0.1*
Private consumption deflator, % change				
Baseline forecast	*1.6*	*1.5*	*1.5*	
Alternative scenario		*1.1*	*1.0*	
Difference		*–0.4*	*–0.4*	*0.0*
Exports, % change				
Baseline forecast	*–1.7*	*1.7*	*4.7*	
Alternative scenario		*2.1*	*5.1*	
Difference		*0.4*	*0.4*	*0.0*
Productivity per person employed, % change				
Baseline forecast	*0.1*	*0.9*	*1.0*	
Alternative scenario		*1.5*	*1.4*	
Difference		*0.6*	*0.4*	*0.0*
Employed (1,000 persons)				
Baseline forecast	*2,456*	*2,448*	*2,466*	
Alternative scenario		*2,436*	*2,449*	
Difference		*–12*	*–17*	*–0.1*
Average wages, % change				
Baseline forecast	*2.6*	*1.7*	*1.6*	
Alternative scenario		*1.3*	*1.1*	
Difference		*–0.4*	*–0.6*	*–0.4*
Unit labour costs, % change				
Baseline forecast	*2.2*	*0.7*	*0.7*	
Alternative scenario		*–0.4*	*–0.3*	
Difference		*–1.1*	*–1.0*	*–0.4*
Income share of labour, % change				
Baseline forecast	*51.8*	*51.3*	*50.8*	
Alternative scenario		*50.9*	*50.2*	
Difference		*–0.4*	*–0.7*	*–0.2*

Sources: Statistics Finland and calculations by the Bank of Finland.
The calculations are based on unrounded figures.

Changes from the previous forecast

The overall picture of developments in the Finnish economy over the immediate years ahead presented by the forecast has not changed significantly since the Bank of Finland's last forecast published in June 2013. However, the economy is now expected to recover from the recession slightly more slowly than previously forecast.

GDP is estimated to contract 1% in 2013, or 0.2 of a percentage point more than in the previous forecast. In 2014, GDP growth will be 0.1 of a percentage point slower, but in 2015, 0.3 of a percentage point faster than previously forecast.

The weakening of the forecast picture for 2013 is due primarily to the availability of more precise statistics for the reference year 2012. The contraction in the economy in 2012 was stronger than previously thought, but the recovery has also been faster than previously forecast. In 2013, domestic demand in particular has contracted less than previously estimated. Price developments have also been slightly less vigorous than previously forecast.

The changes in the economic operating environment in Finland's export markets will slow economic growth during the forecast period relative to the summer forecast. In the present forecast, growth in Finland's export markets is forecast to be 1 percentage point slower in 2013 and 0.6 of a percentage point slower in both 2014 and 2015. The more precise statistical picture has shown that already early in the year exports were growing more slowly than previously estimated, and for 2013 as a whole exports are expected to contract 1.7%, compared with the June forecast of 1.2% growth in exports. Moreover, export growth in 2014 is expected to be 1.8% weaker than previously forecast. The forecast for export growth in 2015 is unchanged at 4.7%. Exports are bolstered by the moderate pay settlement, which slightly improves the competitiveness of the Finnish export sector relative to the previous forecast.

Private consumption will contract in 2013 by 0.4 of a percentage point less than forecast in the summer, but the contraction is forecast to continue into 2014. The forecast for private consumption growth in 2014 and 2015 is on average 0.3 of a percentage point slower than forecast in the summer,

Table.

Current and June 2013 forecast

	2012	*2013*	*2014*	*2015*
GDP, % change	*–0.8*	*–1.0*	*0.6*	*1.7*
June 2013	*–0.2*	*–0.8*	*0.7*	*1.4*
Inflation (HICP), %	*3.2*	*2.2*	*1.6*	*1.4*
June 2013	*3.2*	*2.3*	*1.9*	*1.7*
Finland's export markets, % change	*2.5*	*1.3*	*4.3*	*5.4*
June 2013	*2.5*	*2.4*	*4.9*	*6.0*
Current account, % of GDP	*–1.7*	*–0.6*	*0.2*	*0.4*
June 2013	*–1.9*	*–1.5*	*–1.3*	*–1.2*
General government net lending, % of GDP	*–2.2*	*–2.4*	*–2.4*	*–2.1*
June 2013	*–2.3*	*–2.5*	*–2.5*	*–2.2*
General government dept, % of GDP	*53.6*	*59.0*	*62.4*	*64.2*
June 2013	*53.0*	*56.9*	*59.8*	*61.8*

as the growth in disposable household incomes in the forecast now published is substantially more subdued in the last two years of the forecast period.

As a result of weaker external demand, private investment growth in 2014 is expected to be 1.7 percentage points slower than envisaged in the previous forecast, and investment to boost production capacity in the export industries is expected to push up the pace of private investment only towards the end of the forecast period, when investment will grow 0.4 of a percentage point faster than estimated in the previous forecast. Market expectations of the level of interest rates in the euro area have remained more or less unchanged relative to the June forecast. Investment in housing construction is expected to grow an average of 1.5% per annum in 2013–2015, compared with the June estimate for average growth of –0.3%.

The weaker development of exports and domestic demand also means lower imports, which will grow in the forecast period considerably more slowly than estimated in the June forecast. The current account is forecast to enter surplus during the forecast period, whereas the previous forecast estimated it would remain in deficit. This change has been influenced by the weakness of imports in 2013, which bolsters the current account relative to the summer forecast.

The general government financial balance improves slightly compared with the June forecast. For each year of the forecast period, the deficit is forecast to be 0.1 of a percentage point smaller than in the June forecast. The local government deficit, in particular, is expected to be smaller than previously forecast. In contrast, the central government deficit will be deeper than estimated in the previous forecast. The weakness of the growth outlook for 2013 and 2014 means continuation of the general government deficit, and at the end of the forecast period general government debt relative to GDP will be approximately 64.2%, or 2.4 percentage points larger than estimated in the summer. The outlook for the public finances does, however, gain from the agreement on employment and growth concluded in the autumn. The slower rise in payroll costs in 2014–2015 relative to the previous forecast will mean slower growth in central and local government expenditure.

Financial stability

26 November 2013

The improved market situation has lowered euro area banks' funding costs and access to funding has improved on both the wholesale and the retail markets. The euro area banking sector's profitability is nevertheless still poor. In Finland, the risk-bearing capacity of the financial system has remained good. In the euro area, profitability is eroded by the state of the economy, higher impairment losses and low interest rates. At the same time, growth in the euro area loan stock remains subdued, and the volume of new bank loans is at a record low.

Economic developments and debt dynamics in Europe still constitute the largest external risk to the Finnish financial system. The most significant domestic risks in the near future relate to the conditions for economic growth and rising debt. The capital adequacy of the banking system has remained good relative to the assessed risks, but the profitability of deposit banking is strained by the low level of interest rates. The importance of long-term market funding has increased in Finland in the funding acquisition of both MFIs and non-financial corporations.

Banking union is progressing. A comprehensive assessment of banks' financial situation will be conducted before the European Central Bank assumes responsibility for supervision. The capital adequacy and viability of the banks that will be subject to single supervision will be ensured with corrective action, if necessary. The orderly wind-down of unviable banks requires a new resolution framework. In the new framework, the funding of resolution will be based on the principle of bail-in.

To prevent future financial crises, the European Union is introducing macroprudential tools that address systemic risks threatening financial stability. In Finland, the tools are regulated by the legislation on credit institutions, which is being revised. Due to the complexity of systemic risks, we need a variety of macroprudential tools to combat them.

Despite market stabilisation, euro area banks remain fragile

The functioning of the euro area financial markets has improved in the final quarter of 2013. This is reflected as an improvement in the market situation, increase in risk appetite and lower risk premia. Euro area banks' average funding costs have decreased further and access to funding has improved on both the wholesale and the retail markets. Particularly in the stressed economies of the euro area, deposits from the public have increased significantly over the past year. However, despite the improvement on the markets, the euro area economy remains fragile and a re-escalation of the sovereign debt crisis – as a result of, for example, weak economic growth, the slow pace of economic reforms, or political disagreements – could re-trigger the vicious circle between sovereign risk and the banking sector. Many banks are still dependent on the long-term refinancing operations of the Eurosystem, and the banking sector is still suffering from divergences in the

Many banks are still dependent on the long-term refinancing operations of the Eurosystem.

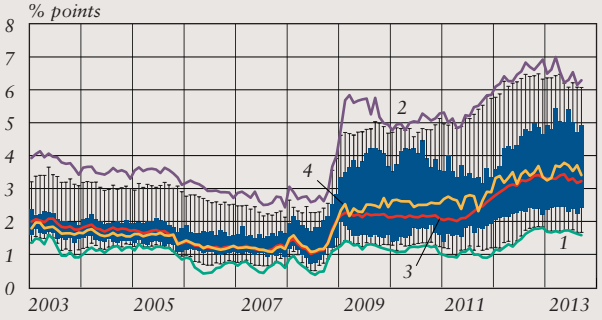
cost of funding, despite the fact that risk premia have come down. Access to market funding has been opened mainly for the large banks with the highest profitability and capital adequacy, and for many banks operating in the euro area's stressed economies market funding remains expensive.

Despite the partial recovery of the financial markets, there are still no signs of a pick-up in bank lending. Financing conditions have remained tight, particularly in the stressed economies, although, in recent months, the terms and conditions of bank loans have not been tightened any further. Growth in the euro area loan stock remains subdued, and the volume of new credit is at a record low. In a number of countries, the still high level of private sector debt and the protracted period of weak economic growth are limiting the investment appetite and loan-servicing capacity of non-financial corporations and households, thus dampening demand for credit. Regulatory requirements, market pressure and higher loan losses have forced banks to bolster their capital positions and decrease the amount of their risk-weighted assets.[1] This has resulted in tighter terms and conditions for high-risk loans, such as corporate loans to SMEs, in particular (Chart 1).

Chart 1.

Range between the imputed margins on small* corporate loans in the euro area

1. Country-specific margin, lowest
2. Country-specific margin, highest
3. Country-specific margin, average
4. Country-specific margin, median



** Up to EUR 1 million.*
The blue bars denote the range for 50% of the country-specific margins. The range illustrated by the black bars includes 95% of country-specific margins.
Sources: European Central Bank and calculations by the Bank of Finland.

The costs of corporate lending differ considerably between countries. The margins on corporate loans granted by banks in the stressed economies have remained high. Some of the large non-financial corporations, in particular, have replaced bank loans with market funding. Consequently, corporate bond issues have increased significantly in nearly all countries, while, at the same time, the yield required on bonds has decreased to record-low levels, due to high investor demand. The sustainability of the valuation of high-yield corporate bonds, in particular, has raised concern.

Euro area banks' profitability has remained weak (Chart 2). Profitability is eroded particularly by the poor economic situation, higher impairment losses and low interest rates. The low level of interest rates combined with weak demand for loans is weighing on banks' net interest income. Even though euro area banks have increased their

[1] In the second quarter of 2013, the average Tier 1 capital adequacy of large banks in the euro area was 12.1%, whereas at the end of 2011, it was still 9.8%.

margins on new loans, growth in the margins on the total loan stock remains slow. Small and medium-sized banks' own long-term funding costs have remained high, particularly in the stressed economies, which decreases their net interest income. The weakness of the economy is also eroding banks' fee income as economic activity declines. On the other hand, narrower interest rate spreads and favourable share price developments have boosted banks' profits from securities trading.

In an environment of low interest rates, there is a concern that the search for higher yields will turn capital flows excessively to higher-yield – but also high-risk – investments. The risks relating to the search for yield, the redirection of capital flows and asset values distorted by demand pressures have increased in both the banking and the insurance sector. Particularly in the stressed economies of the euro area, banks have taken significant amounts of government bonds onto their balance sheets. This exposes their investment portfolios to impairment losses in the event of a re-escalation of the euro area sovereign debt crisis.

Recognitions of impairment on loans and securities are the largest single reason for the weak performance of euro area banks. The higher level of unemployment and bankruptcies has significantly increased the amount of nonperforming assets and loan losses, particularly in the stressed economies. Due to the weak developments in their basic business, not all euro area banks are able to cover their growing loan losses by retaining earnings. Despite the increase in banks' impairment recognitions, growth in nonperforming loans has not come to a halt (Chart 3).

The rapid growth in nonperforming loans has increased the doubts about

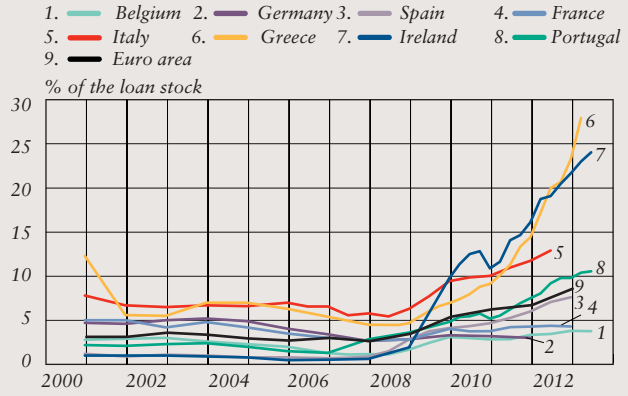
Chart 2.

Large European banks' return on equity (ROE), median

Source: Bloomberg.

Chart 3.

Share of nonperforming loans in the loan stock in selected euro area countries



Source: IMF.

The rapid growth in nonperforming loans has increased the doubts about banks' ability to withstand a possible increase in loan losses.

banks' ability to withstand a possible increase in loan losses, as well as doubts about their capital adequacy. The uncertainty is increased by the fact that the weak balance sheet items are spread unevenly between euro area countries and banks, and because there is scant information on banks' application of forbearance. Measures thus far to review and repair the quality of bank assets have not fully succeeded in removing the uncertainties surrounding the banks. To restore confidence, the balance sheets of large euro area banks will be subject to a comprehensive assessment, headed by the ECB, and the banks will be stress-tested to ensure uniform valuation of assets and assess the adequacy of their capital. An increase in confidence would decrease the fragmentation of the euro area financial markets and facilitate a more smooth transmission of the present accommodative monetary policy.

If the results of the comprehensive assessment show that banks' capital positions have to be strengthened, it is crucial that the groundwork for implementing corrective actions has been done in advance, so that the nascent confidence on the financial markets is not jeopardised.

Economic developments and debt dynamics in Europe constitute the largest external risk to the Finnish financial system

The threat of a slowdown in the European economy and a re-escalation of the euro area debt crisis is the largest external risk to the Finnish financial system. The Finnish economy and banks and insurance companies operating in Finland are in numerous ways dependent on developments in the international operating environment. A slowdown in economic growth and disruptions in financial intermediation in Europe would also quickly affect Finland, not only directly, but also through indirect channels.

A significant weakening in the economy would burden the Finnish banking sector, as it would increase impairment losses on corporate loans, in particular, and dampen demand for finance and other banking services. A strong decline in asset prices would weaken non-financial corporations' and households' creditworthiness and shrink banks' income from trading and investment activities. A sudden realisation of the risks in investment activities would also cause significant losses for insurance companies.

Financial market disruptions would rapidly affect banks and non-financial corporations operating in Finland. The Finnish banking sector is dependent on international market funding in its funding acquisition. A general tightening of financing conditions would increase funding costs and tighten the availability and terms of the finance intermediated by banks to the domestic market. Large companies would have to replace their market funding with bank loans, which would hamper the acquisition of funding by SMEs dependent on the banks.

In terms of the financial system, the most significant domestic risks in the near future relate to the conditions for economic growth and rising debt. The outlook for the Finnish economy

remains subdued.[2] The capacity of Finland's public finances and economy to withstand economic disruptions has weakened since the recession in 2009. The rise in household debt has also increased the entire economy's sensitivity to cyclical fluctuations. Confidence in the sovereign and bank solvency has remained good, but if this confidence were to falter it would significantly hamper domestic financial intermediation and weaken the conditions for economic growth.

The Finnish financial system's risk-bearing capacity remains good

The impact of possible severe disruptions in the real economy and financial markets on banks and insurance companies operating in Finland are assessed regularly with stress tests conducted jointly by the Finnish Financial Supervisory Authority (FIN-FSA) and its supervised entities. The outcome of these stress tests shows that the largest vulnerabilities in the Finnish financial system relate to credit and investment risks.

In the adverse scenario of the stress test conducted in 2013, the Finnish economy drifts into a deep recession, with output contracting and asset values declining markedly for three consecutive years. The stress test shows that the banking sector's total income would decline and impairment losses on loans would increase, but the operating profit of the banking sector as a whole would remain positive and capital adequacy would remain on average sound. Insurance companies' investment income would turn clearly negative, but solvency would remain at a satisfactory level.[3] Loss-absorbing capacity, however, varies significantly between individual banks and insurance companies, and, if the scenario was to materialise, some of them would have to make large adjustments to maintain adequate solvency.

The Finnish banking sector's capital adequacy has declined slightly and the notional loss-absorbing buffer has decreased in 2013. Capital adequacy and loss-absorbing buffers have, however, remained good relative to the assessed risks. At the end of June 2013, the banking sector's capital adequacy ratio stood at 15.6%, and the ratio calculated on the basis of the highest-quality capital, ie common equity Tier 1 (CET1) was 14.3% (Chart 4).[4] The rough indicator of banking sector leverage, ie the ratio of own funds and non-risk weighted assets, was 4.2% at the end of June.

The Finnish banking sector's capital adequacy and loss-absorbing buffers have remained good relative to the assessed risks.

The European Banking Authority (EBA) required in 2012 that large European banks reach a core Tier 1 capital ratio of a minimum of 9% and recommended subsequently that banks maintain an absolute amount of CET1 capital corresponding to this level. As the European Central Bank assumes

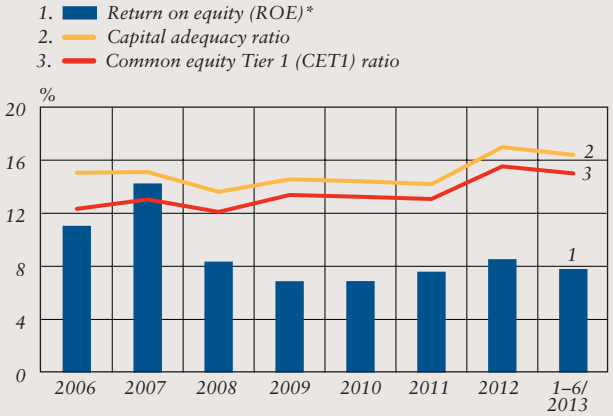
[2] For more information, see the section 'Economic outlook' in this Bulletin.

[3] The stress test was based on the 2012 outcome and a stress scenario for banks covering the years 2013–2015, and the stress test for insurance companies covered one instantaneous shock event. For more information, see FIN-FSA (2013) Financial sector stress test 2013.

[4] The core Tier 1 ratios of individual banking groups varied between some 10% and well over 18% (excl. some banks with a small balance sheet and considerably higher capital adequacy ratios). FIN-FSA (2013) Financial position and risks of supervised entities 2/2013.

Chart 4.

Profitability and capital adequacy of Finnish deposit banks



** Income in 2006–2007 reflects certain extraordinary income items due to restructuring in the banking sector.*
Source: Finnish Financial Supervisory Authority.

responsibility for the supervision of significant banks a comprehensive assessment will be conducted on their balance sheets and their resilience will be assessed with stress tests. The Finnish institutions to be included in the comprehensive assessment are OP-Pohjola Group, Nordea Bank Finland Abp and Danske Bank Oyj.

Banks' capital positions are also being strengthened through EU regulatory measures. The new Capital Requirements Directive and the associated Regulation will enter into force in 2014, and the new capital requirements introduced therein will be phased in gradually by the end of 2019. As a result of the tighter definition of own funds and risk weights of assets, Finnish banks' CET1 capital ratios will decrease if other factors remain unchanged. According to FIN-FSA, banks will be able to fulfil the new requirements without special measures to strengthen their capital adequacy.[5] The new regulations will ensure that Finnish banks' capital adequacy remains at a sound level in the future as well. This will bolster general confidence in the banking system and maintain banks' ability to ensure financial intermediation even in a challenging macroeconomic environment.

Profitability of deposit banking under strain

The Finnish banking sector's total pre-tax profits (EUR 1,182 million) for January–June 2013 were one fifth lower than a year earlier. Return on equity (ROE) declined to 8.1%, from 9.4% a year earlier (8.5% for the whole of 2012). There are, however, significant differences in profitability between banks, and banking groups' return on equity varied between some 4.5% and well over 13%.[6]

The accommodative euro area monetary policy has kept short-term market rates at a low level for a prolonged period. This has weakened banks' net interest income, and thereby particularly the profitability of deposit banking business.[7] The average differential between lending and deposit

[5] FIN-FSA (2013) Financial position and risks of supervised entities 2/2013.

[6] Excluding some banks with small balance sheets that were posting losses.

[7] Profitability has also been eroded by certain factors specific to individual banks. The most significant factor was the considerable increase in the commission expenses of Nordea Bank Finland Group due to a guarantee agreement with the Swedish parent.

rates, the overall margin, has narrowed in Finland and is now exceptionally small (Chart 5). This is due to the fact that the majority of loans are tied to Euribor rates. Moreover, before the financial crisis, when reference rates were higher, the average margin on bank loans was very small. The overall margin was at its lowest in summer 2013, after which it has started to gradually increase.

Banks have tried to improve profitability by, for example, increasing the margins on new loans. The largest increases have been witnessed in the margins on small corporate loans. This is an indication that, for example, credit risk and the amount of bank capital tied up in loans are better taken into account in pricing. The average interest rates on new corporate loans are, however, still at an historically low level and lower than the euro area average.

Banks have also increased the fees levied from customers and curbed the rise in staff and other administrative expenses. The bank tax, totalling EUR 133.4 million, pushed up the banking sector's other expenses. Finnish banks' low funding costs and their strong capital positions help to reduce the costs caused by regulation and the resulting pressure to raise prices.

The protracted uncertainty in the global economy and financial markets has also been reflected in many ways in the operations of insurance companies. Due to the low level of interest rates, the current risk-free nominal rates are not sufficient to cover the yield target of the technical provisions. Many insurance companies have started to favour higher-yield, but at the same time riskier investments. In fixed-income investment, corporate bond issues are attracting increasing interest. Many insurance companies have also increased the share of equity investments and equity-linked investments in their investment portfolios. The uncertainties on the equity markets pose the biggest threat to pension providers, but life and non-life insurers, too, have, on average, a larger share of equity-linked investments than most European insurance companies.

Chart 5.

Average interest rates on loans and deposits* in Finland, and the overall margin between them

** Loans to and deposits from the public.*
Source: Bank of Finland.

Finnish banking sector assets decline, loan losses remain small

The Finnish banking sector's total assets have declined significantly over the past year. This is mainly due to the decrease

in the balance sheet value of Nordea Bank Finland Group's derivative assets and liabilities due, for example, to increased use of central counterparty clearing. In addition, the assets of branches of foreign banks operating in Finland have shrunk by half compared with the situation a year earlier. This is mainly due to a decline in the deposits with the central bank and is an indication of the stabilisation of the international financial markets after the worst phase of the euro area debt crisis.

Finnish banks' nonperforming assets and net impairment losses on loans and other receivables have remained small.

Banks' nonperforming assets and net impairment losses on loans and other receivables have remained small relative to lending.[8] Based on current economic forecasts, credit risks are not expected to increase alarmingly, although their development is being monitored closely. Payment defaults and the number of bankruptcy petitions filed have increased.

In the comprehensive assessment of euro area banking sector balance sheets, particular attention will be paid to, for example, the classification of nonperforming assets, recognition of impairments, valuation of collateral and the risk weights used in capital adequacy calculation. This will improve the comparability of the balance sheets of European banks and is important for, for example, ensuring banks' market-based funding.

Increased importance of long-term bonds in funding

Banks' acquisition of funding has undergone changes in Europe since the crisis: in market funding, they have shifted to more stable sources by, for example, decreasing the share of short-term funding and increasing that of secured long-term funding. Changes in banking regulation are expected to strengthen this trend.

In Finland, deposits by the public, primarily Finnish residents, have traditionally been the single most important source of funding for deposit banks. Banks' good credit standing has also supported market-based funding, and the average maturities of funding have lengthened, as in other European countries. The stock of long-term debt securities issued by banks and other monetary financial institutions has increased considerably in recent years (Chart 6). Of this, a significant portion is accounted for by covered bonds, and the increasing use of these securities is a positive development in terms of funding. This does, however, increase banks' asset encumbrance, which may consequently hamper unsecured debt issues.

Loans granted by domestic MFIs are the most important source of debt financing for non-financial corporations and households in Finland. The lending capacity of MFIs has remained good overall, and the availability of funding sufficient. In 2013, the stock of loans granted to non-financial corporations and households has, however, grown at a very slow pace (Chart 7). This is due to both supply- and

[8] In January–June 2013, net impairment losses and nonperforming assets amounted to approximately 0.03% and 0.5%, respectively, of the stock of loans and guarantees.

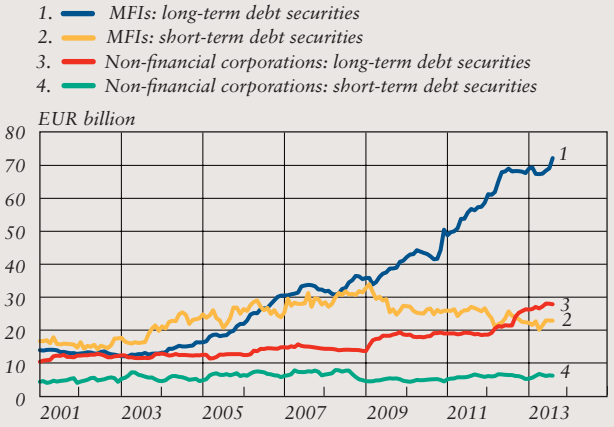
demand-driven factors. The terms and conditions and the availability of loans have tightened to some extent, but at the same time, non-financial corporations' need for external financing has been moderate and household demand for credit has faded. MFI loans to housing corporations continue to grow at a brisk pace compared with loans granted to the other sectors. Part of these loans are in practice the responsibility of households, via housing companies owned by households.

The importance of market funding has also increased in corporate finance, as large Finnish non-financial corporations have issued long-term bonds on both the domestic and international markets (Chart 6). The financing needs of SMEs are often smaller, and these companies are dependent on bank loans.

In 2013, concrete initiatives have been made to diversify the sources of corporate finance and to promote bond issuance. Nasdaq-OMX Helsinki published in October 2013 a draft rulebook on bond markets to be established in the multilateral trading facility First North. In addition, the Confederation of Finnish Industries and the Advisory Board of Finnish Listed Companies have drawn up model terms and conditions for corporate bonds. The aim is to lower the costs of bond issuance and thereby facilitate the use of bonds by smaller, non-listed companies. The model terms and conditions were published for comments in November 2013.

Chart 6.

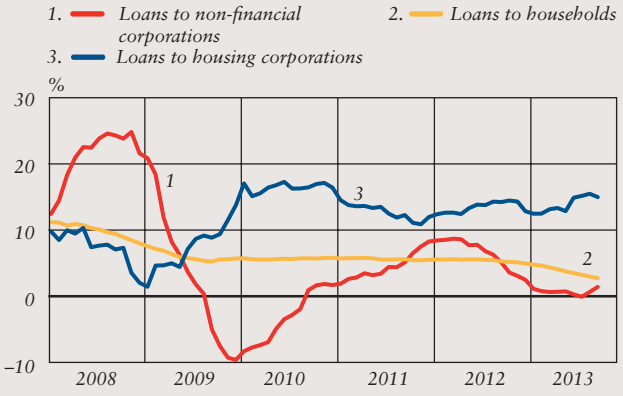
Stock of debt securities issued by Finnish MFIs and non-financial corporations



Source: Bank of Finland.

Chart 7.

Annual change in the stock of Finnish MFI loans to Finnish residents



Source: Bank of Finland.

Household debt shows signs of levelling off

The annual growth rate of the housing loan stock in September 2013 was 2.9%, compared with 6.1% a year earlier. At the same time, the protracted rise in household debt has slowed significantly. The debt ratio was in June 2013 approximately 117.3%, ie one percentage point higher than at the end of 2012 (Chart 8). The moderate developments are due, for example, to increased cautiousness on the part of households.

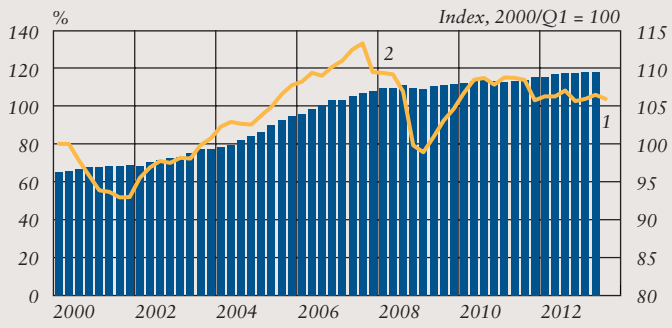
The prolonged upward trend in housing prices also shows signs of levelling off. Monthly price indices show that in the greater Helsinki area, the rise in the prices of dwellings in housing companies has come to a virtual halt, and elsewhere in Finland these prices have actually fallen slightly. Relative to wage and salary earnings, average house prices have declined since summer 2010.

The levelling off in house price trends can be considered positive in terms of financial stability, because in an environment of low interest rates there are often fears of potential excesses in asset markets. A rapid rise in housing prices, accompanied by excessive lending, has historically been one of the key sources of systemic risks. The Finnish financial system is particularly vulnerable to disruptions in the housing market because housing wealth accounts for the largest share of household assets and housing loans account for a large share of Finnish banks' lending. Moreover, household sector debt has increased for a prolonged period, the bulk of housing loans are tied to variable interest rates and new housing loans typically have a high loan-to-value (LTV) ratio.

Chart 8.

Household debt ratio and housing prices in Finland

1. *Household debt*, % of disposable income (left-hand scale)*
2. *Housing prices relative to wage and salary earnings (right-hand scale)*



** Incl. households' estimated share of the debt of housing companies owned by households.*
Sources: Statistics Finland and calculations by the Bank of Finland.

Banking union goes ahead

Banking union comprises the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM). At the same time, deposit guarantee schemes are to be improved by revision of the Directive on Deposit Guarantee Schemes.

Comprehensive assessment of risks before launch of the Single Supervisory Mechanism

The Single Supervisory Mechanism is due to be operational in November 2014. The Ecofin Council adopted the Regulation on the Single Supervisory Mechanism in October 2013, but before the European Central Bank

assumes responsibility for the supervisory tasks a comprehensive assessment will be conducted on the condition of banks, consisting of a risk assessment and the assessment of the quality of their balance sheets, as well as stress tests. The ECB and national supervisors will perform the balance sheet assessments based on detailed, jointly agreed assessment criteria. The stress tests will be conducted in cooperation with the European Banking Authority (EBA).

The balance sheet assessments and stress tests are important for restoring confidence, but they are not sufficient by themselves. The supervisory authorities must additionally agree on measures to correct identified problems. Weak but viable banks must be recapitalised and unviable banks wound down in an orderly manner. The purpose is to ensure the capital adequacy and viability of significant euro area banks before the ECB takes on the supervisory tasks. The orderly wind-down of a bank is possible only if there is a functioning resolution procedure. The resolution procedure is in practice similar to a bankruptcy procedure, but the bank is not officially declared bankrupt. The procedure enables the separation of the bank's sound activities from problematic ones, and continuation of the sound activities without excessive burden. The execution of the resolution process also requires funds for covering the bank's losses, maintaining critical functions and capitalising the new, viable bank that may emerge from the process.

Single Resolution Mechanism will reduce future banking crises

The European Union is currently preparing two significant initiatives to develop the resolution procedures for banks. The Commission proposal for a Directive establishing a framework for the recovery and resolution of credit institutions and investment firms, adopted in summer 2012, will harmonise and reform Member States' legislation on resolution. The Directive will allow in many of the Member States, for the first time, an orderly wind-down of even a large bank, without disruptions to the financial markets. The Directive represents a significant improvement on the practice whereby a bank's problems can be resolved only by declaring it bankrupt[9] or by saving it using public funds. The Directive will, however, be implemented as national legislation, and this is not sufficient in the case of banks with cross-border activities.

The Commission also adopted in summer 2013 a proposal for a Single Resolution Mechanism. This proposes that the banks participating in the banking union would be subject to a new single, centralised resolution procedure. A central body would take the key decisions on resolution and prepare a resolution programme for the distressed banks, identifying the necessary measures. The resolution programme would be implemented by national supervisors, but the Single Resolution Mechanism would monitor implementation, and it could, if

The resolution procedure enables continuation of the sound activities of a distressed bank.

[9] In accordance with standard bankruptcy legislation covering all companies.

necessary, take decisions that will be directly binding on individual banks.

The Single Resolution Mechanism addresses the deficiencies of national resolution procedures. Compared to current national resolution systems, the single centralised procedure allows for a significantly more effective wind-down of banks with cross-border operations. In addition, it ensures equal treatment of the banking business conducted in the various Member States, resulting in a uniform resolution procedure.

In the Commission's proposal for a resolution procedure, the funds needed for execution of the process will come primarily from the shareholders and creditors.

In the European Commission's proposal for a resolution procedure, the funds needed for execution of the process will come primarily from the shareholders and creditors, as in a standard bankruptcy procedure. The principle of bail-in will be realised by covering the bank's losses first with equity (and subordinated liabilities) and by converting an adequate amount of creditors' claims to (new) equity, to restore the solvency of the reorganised bank.

Resolution will also be financed by resolution funds financed by the banking sector, if necessary. According to the Commission proposal, the use of the funds would only be secondary, after the involvement of creditors. The Single Resolution Mechanism would also have a Single Bank Resolution Fund. The Commission proposes that the Fund's resources be built up over the next ten years and correspond to 1% of covered deposits in the banking system. (On the basis of the situation in 2011, this would amount to approximately EUR 55 billion.) The objective of the Single Bank Resolution Fund is to safeguard financial stability, not to support the activities of unviable banks. Under banking union, the Single Bank Resolution Fund would replace the national resolution funds.

In addition, deposit guarantee funds may have to contribute to the funding of the resolution process, in accordance with certain terms and conditions. The final burden-sharing between the various parties will, however, be clear only when all the details of the legislation on bank resolution have been finalised.

The objective is to have the Regulation on the Single Resolution Mechanism adopted before the European Parliament elections in spring 2014. The Mechanism could commence operations in January 2015, but the key provisions on the involvement of creditors would only become fully effective at a later date.

The Directive on the recovery and resolution of credit institutions and investment firms has a broadly similar timetable for implementation, and it too is expected to enter into force on 1 January 2015.

The short-term challenge is to agree the financial arrangements

Banking union addresses the deficiencies of euro area banking supervision and resolution in the medium term. In the short-term, however, temporary arrangements are needed that can operate until the key elements of banking union are in place. For the transition period, prior agreement has to be reached on the financial arrange-

ments. The launch of the Single Resolution Mechanism before the principle of bail-in is in force would also require prior agreement on temporary financial arrangements.

In principle, primary responsibility for a bank's legacy problems lies with the shareholders, and secondary responsibility with each Member State. The recapitalisation of banks in the current market situation can still be challenging, particularly if the need for capital is significant. If market funding is not available and the Member State cannot recapitalise a bank without jeopardising debt-sustainability, the alternatives are the orderly wind-down of the bank or recapitalisation with the help of Community-level support mechanisms. As a rule, unviable banks must be wound down.

The European Stability Mechanism (ESM) will in future be able to recapitalise banks directly, under certain conditions. Once the Single Supervisory Mechanism is operational, the establishment of a new support facility will be based on a unanimous decision of the Board of Governors of the ESM. Decisions on recapitalisation will also have to be unanimous. The details of the support facility will be finalised when the decisions on the Single Resolution Mechanism have been taken. The principle of bail-in will initially be applied by adhering to the EU rules on state aid and the requirements concerning financial assistance provided by the ESM. Participation of the ESM in the recapitalisation of a bank can, however, be arranged indirectly through a Member State before the Single Supervisory Mechanism becomes operational.

At the national level, a bank can, after implementation of the Recovery and Resolution Directive, be subjected to resolution proceedings,[10] which gives the authorities extensive powers to restructure its activities. Under banking union, the Single Resolution Mechanism, once realised, will be responsible for bank resolution.

Bank resolution should also in the transition period follow the same important basic principles on which banking union is built: public funds must not be used to rescue banks and the current problems of the banking sector must not be transferred through the new system to others for payment. The Single Resolution Mechanism must have sufficient funds for executing the resolution process. Both the Recovery and Resolution Directive and the Single Resolution Mechanism rest heavily on the realisation of bail-in. The objective can be achieved by ensuring that the entire resolution legislation becomes effective at the same time, in its full extent, and that introduction of any of its parts is not postponed. This applies in particular to the full application of bail-in. The use of the Single Resolution Fund must also be regulated so that no undefined liabilities and commitments are transferred through it to Member States.

[10] Another option is to issue national regulations on a temporary resolution procedure until the Directive can be applied.

Tools for macroprudential policy

In addition to banking union, the European Union will introduce special macroprudential policy measures to address the systemic risks underlying financial crises. Summer 2013 saw the entry into force of the revised Directive on credit institutions and the related EU Regulation[11], which implement the overall global reform of banking regulation (Basel III). The regulatory reform provides authorities responsible for macroprudential oversight the tools to improve the banking sector's resilience and to otherwise prevent the creation of systemic risks.

The new legislation on credit institutions will define the tools that can be used in Finland for the achievement of macroprudential policy objectives.

The European Systemic Risk Board (ESRB), which is responsible for macroprudential oversight of the EU financial system, has issued recommendations on intermediate objectives and instruments and on the implementation of macroprudential policy. The ESRB recommends that each Member State assign an authority responsible for macroprudential policy, and that the authority specify its intermediate objectives. The Board recommends that Member States ensure that the authorities have adequate policy instruments for achieving the intermediate objectives. The Board also recommends that the authorities define an overall strategy for the application of the macroprudential policy.

Finland is taking important steps to implement macroprudential policy by reforming the current legislation on credit institutions. The reform involves transposition of the new EU legislation on credit institutions and a revision of other regulation. In addition to macroprudential policy, the reform covers traditional regulation of individual banks. Legislation on macroprudential policy was discussed in depth by a working group set up by the Ministry of Finance and led by Minister Antti Tanskanen. The working group submitted a report in October 2012 on proposals for the arrangement of macroprudential policy and the necessary instruments.

It is important that Finnish legislation allow for an efficient macroprudential policy based on the overall assessment of systemic risks and financial system vulnerabilities and for which the authorities have adequate tools. Granting the decision-making powers concerning the use of macroprudential tools to the Board of the Financial Supervisory Authority, in accordance with the proposal of the Tanskanen working group, enables participation of the representatives of the key authorities in decision-making without the need to establish new institutions. Successful macroprudential policy requires smooth cooperation between the various authorities and ensuring all the various perspectives are taken into consideration when assessing the need to apply the instruments.

The legislation on credit institutions, which is being revised, will define the tools that can be used in Finland for the achievement of the macroprudential policy objectives. A key tool to be introduced for the authorities is the countercyclical capital buffer

[11] Directive 2013/36/EU of the European Parliament and of the Council and Regulation (EU) No 575/2013 of the European Parliament and of the Council.

requirement that will be imposed on banks, if necessary, and which is required in the EU Directive on credit institutions. The purpose of the countercyclical capital buffer requirement is to protect the banking sector with sufficient capital buffers against systemic risks caused by excessive lending and thereby to ensure that, when the financial system is under stress, banks do not need to cut lending due to capital restrictions.

Loan-to-value cap prevents housing market risks

Systemic risks and vulnerabilities that threaten the stability of the financial system are diverse and are created in a variety of ways. Averting these risks and vulnerabilities may thus require various tools best suited to preventing and containing the creation of problems. If banking sector lending growth is becoming excessive, it may be justifiable to address the growing risks by imposing on banks a supplementary capital buffer requirement based on their total assets. If it is, however, evident that severe systemic risks are developing specifically on the housing loan market, it may not be possible to prevent them by imposing a countercyclical capital buffer requirement, or imposing this requirement may unnecessarily restrict bank lending to, for example, non-financial corporations.

In Finland, the prevention of risks related to the housing market and lending for house purchase is particularly important for safeguarding financial stability, because housing assets account for the majority of Finnish households' assets, and housing loans account for the majority of household debt. Sharp fluctuations in lending for house purchase and housing prices have been the sources of several major banking and economic crises. Therefore, authorities must be given sufficiently effective specific tools for addressing, if necessary, excessive growth in lending for house purchase, rising household debt or a dangerously rapid rise in house prices. These tools can be particularly valuable for euro area countries, because regional overheating cannot be prevented with a single monetary policy adjusted for the needs of the entire euro area.

A possible macroprudential tool for containing systemic risks on the housing market is to restrict mortgage lending relative to the fair value of collateral, by imposing a maximum loan-to-value (LTV) ratio. Based on international experience, restrictions on the LTV ratio have helped to slow the pace of growth in lending and contain the rise in house prices and related expectations. In this way, imposing a binding loan-to-value cap or tightening the cap has had a positive impact on financial stability.

If the binding loan-to-value cap is to function as hoped, it should be imposed in such a way as to be countercyclical. Mortgage lending should be restricted with the LTV ratio only in special circumstances, ie when there is a danger of overheating in mortgage lending or on the housing market. The criteria for imposing a loan-to-value cap could be, for example, the pace of rise in house prices relative to develop-

In Finland, the prevention of risks related to the housing market and lending for house purchase is particularly important for safeguarding financial stability.

ments in aggregate wage and salary earnings.

Banking sector concentration must be taken into account

The Finnish banking system has a high degree of concentration (Chart 9), and its size relative to the economy has grown in recent years. Severe problems of the largest individual banks operating in Finland could, in an extreme situation, jeopardise the functioning of the entire financial system.

To safeguard macroprudential stability, particular attention must be paid to ensuring the loss-absorbing capacity of the large banks. It is therefore important that Finnish authorities can impose an additional loss absorbency requirement on global systemically important banks (G-SIBs) and other systemically important banks.[12] However, EU legislation allows only relatively small institution-specific additional capital requirements[13], and therefore the authorities have to consider alternative tools in preparing for such problems. In addition to the size of the banks, in defining the requirements, the authorities must consider, for example, the possibility of contagion between banks or between banks and other parts of the financial system.

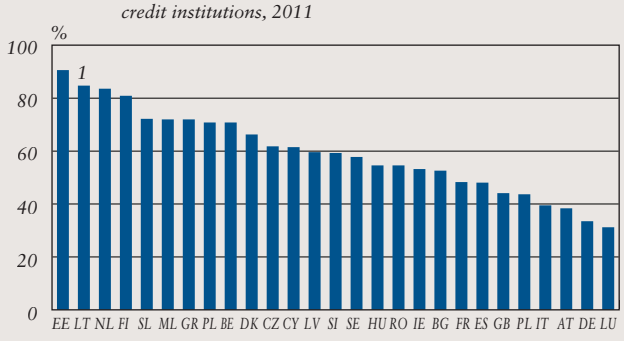
The Finnish banking sector is very closely interconnected with the other Nordic banking systems. To ensure the functioning of macroprudential policy and a level competitive environment, it is important that Finnish macroprudential policy tools and arrangements are sufficiently consistent with those in the other Nordic countries. According to an assessment[14] published by the IMF in September 2013, significant differences in financial system policies in the Nordic countries could lead to a concentration of risks and, ultimately, endanger financial stability across the region.

Several Nordic countries are planning to impose on banks capital

Chart 9.

Degree of banking sector concentration in selected European countries

1. *Share of the five largest credit institutions in the total assets of credit institutions, 2011*



The figures for EU countries include foreign subsidiaries and branches operating in the featured country.
Source: European Central Bank.

[12] For more information on the systemic additional capital requirements to be imposed on banks, see Vauhkonen – Westman (2013) 'Finland must be prepared to impose systemic capital requirements on banks'. Bank of Finland Bulletin 2/2013.

[13] The maximum additional capital requirement for global systemically important banks allowed by the Directive on credit institutions is 3.5% of risk-weighted assets and that for other systemically important banks is 2% of risk-weighted assets.

[14] International Monetary Fund (September 2013) Nordic Regional Report – Staff Report for the 2013 Cluster Consultation. IMF Country Report No. 13/274.

requirements tighter than the EU's minimum requirement, applying the requirements to be set for systemically important banks, but also a separate additional capital requirement provided by EU legislation, ie a systemic risk buffer. In order to adequately prepare for the risks enforced by the degree of concentration in the banking system, Finnish authorities should also have the possibility to use such a buffer as a macroprudential policy tool. The use of a systemic risk buffer would also harmonise the use of macroprudential tools in the Nordic countries.

In future, the prevention of systemic risks may require new macroprudential tools, depending initially on the effectiveness of the tools to be introduced and changes in risks. Finnish authorities must assess regularly the effectiveness of macroprudential policy and the adequacy of the tools, and introduce new tools, if necessary. In future, we must consider, in particular, how macroprudential policy should impact on the banking system's liquidity risks and on systemic risks created outside the banking system, as well as the interconnectedness of the banks and the other parts of the financial system.

From the assessment of systemic risks to policy action

Central banks and other authorities have already for a long time been analysing the stability of the financial systems as a whole and the related risks. A shift from the assessment of systemic risks, and communicating about them, to active risk prevention measures is a challenging step for the authorities, and it must be taken with care. The Bank of Finland and the Financial Supervisory Authority have begun practical preparations in close cooperation for assessment of the need to use macroprudential tools.

Adopting a macroprudential objective for the financial system has a profound impact on the objectives to be achieved with the requirements and restrictions imposed on banks or other financial system entities. Previously, the aim of banking supervision was to safeguard stability primarily by ensuring the capital adequacy and liquidity of individual institutions. In macroprudential policy, the objective is not the stability of individual institutions but the stability of the entire system. One of the objectives is that the financial market cycle would not accelerate or, on the other hand, hamper the provision of finance to households and non-financial corporations. For this purpose, capital requirements could be loosened in a downturn even if ensuring the capital adequacy of an individual bank required tightening of the requirements.

In addition to cooperation between national authorities, macroprudential policy also requires extensive cooperation in the European Union, and particularly within the banking union. With the introduction of the Single Supervisory Mechanism for banks, the ECB has the right, at its discretion, to tighten banks' countercyclical capital buffer requirements imposed by national authorities and other macroprudential policy tools

The Bank of Finland and the Financial Supervisory Authority have begun preparations in cooperation for the introduction of macroprudential tools.

applied under EU legislation. The aim is to prevent a situation where the authorities fail to address severe systemic risks that are developing.

Keywords: banks, banking union, financial markets, financial system, macroprudential policy, stability

Structural reforms in the economy and fiscal sustainability

25 November 2013

Helvi Kinnunen
Adviser
Monetary Policy and Research

Petri Mäki-Fränti
Economist
Monetary Policy and Research

Jukka Railavo
Economist
Monetary Policy and Research

In August 2013, the Finnish government published the general outlines of an extensive structural policy programme.[1] The programme sets out the objectives for bringing the public finances onto a sustainable footing. The aim is to strengthen local government finances by scaling down municipal obligations and to look for measures that will enable improvements to the productivity of public service provision, lengthen working lives, reduce structural unemployment and boost the economy's potential output via other means.

The structural reforms, if implemented as planned, would mean a considerable improvement in the state of the public finances. According to the Bank of Finland's calculations, the fiscal sustainability gap could be bridged if it were possible to implement the reforms in full and without delay. However, achievement of the targeted effects would require significant changes to the structures of the economy. The average employment rate would rise substantially. Employment structures would also change from what has been estimated previously, as the production of public services would require a much smaller work force than expected if the reduced level of local government services could be provided more efficiently.

The present article examines the structural reforms from the perspective of fiscal sustainability.[2] At the same time, we discuss the changes that the realisation of the objectives would necessitate in the labour market and other economic activity, among other factors. In addition, there is a projection of the position of the public finances a couple of decades ahead. The effects of the structural reforms will take several decades to feed through to the macroeconomy and the public finances. The key question is how high the general government debt ratio can rise before the structural reforms begin to exert an effect. The scenarios indicate that, even if local government consolidation measures materialise according to schedule and working lives lengthen as targeted, the debt ratio will rise to around 90% in the 2030s. If, in addition, public service productivity improves and potential output grows, the debt ratio will remain in the region of 70%.

The examination of the structural reforms is extended by an analysis taking account of economic agents' reactions to both the structural reforms and the resultant change in the required fiscal consolidation. In the Bank of Finland's macroeconomic model, the public finances are modelled in a way that enables assessment of the macroeconomic implications of a higher retirement age, increased potential output and local government savings.[3] Model simulations show that reforms enabling reductions in taxes and other charges on labour boost both growth and employment.

A projection of the fiscal sustainability gap in the absence of the measures envisaged in the structural policy programme

The fiscal sustainability gap indicates how much the general government

[1] Programme agreed on Thursday 29 August 2013, see Prime Minister's Office press release 351/2013.

[2] The sustainability scenarios are based on a projection that consistently takes labour market changes into account in the number of pensioners and the labour input of the economy as a whole. For more information on the sustainability scenario, see Kinnunen – Mäki-Fränti – Viertola (2012).

[3] For a more detailed description of the Bank of Finland's Aino model, see Kinnunen – Railavo (2011) or Kilponen – Kinnunen – Ripatti (2006).

financial balance would need to be improved immediately in order to ensure sufficient public revenue to cover future expenditure without causing the debt ratio to exceed 60%.[4] The sustainability scenario is based on economic developments in the immediate years ahead and over the medium term according to the Bank of Finland's forecast published in December 2013. Its key assumptions correspond to the sustainability gap projection made in connection with the December 2012 forecast.[5] However, the assumptions for the number of pensioners and the evolution of pension replacement rates have been updated to correspond to the latest long-term calculations by the Finnish Centre for Pensions.[6]

The fiscal adjustment need is 4.6%.

According to these assumptions, the fiscal consolidation requirement is 4.6%. The estimated sustainability gap in connection with the December 2012 forecast was 4.2%. The projected structural primary deficit has deepened by about 1 percentage point year on year.[7] In addition, the debt ratio is higher than foreseen a year ago. Even so, the gloomier picture of the deficit trend and debt accumulation is offset by a more favourable prediction by the Finnish Centre for Pensions of the development of the number of pensioners and the pension replacement rate after 2020. This improves the financial balance of the earnings-related pension funds, thus narrowing the projected sustainability gap.

Impact of the structural reforms on the sustainability gap

Consolidation of local government finances

To date, the most tangible proposals for measures under the structural policy programme relate to the consolidation of local government finances and the lengthening of working lives.[8] The effects of the structural reforms on the consolidation of local government finances will be felt in many ways.

The reforms will have the most obvious impact through local government expenditure cuts. A precise timetable has been set for these. The savings, supplemented by the municipalities' own measures to improve their financial balances, are designed to be carried through in 2014–2017. To reverse the trend in debt accumulation, local government is expected to cut expenditure, tighten taxation or increase productivity to a total value of EUR 2 billion during this period, either through cuts coupled with increased taxation or through efficiency savings. The present scenario assumes, as outlined in the structural programme, that EUR 1 billion will come from direct savings measures through the reduction of local government service obligations. The additional EUR 1 billion that the programme considers the responsibility of local government is here assumed to be accomplished entirely by raising municipal income tax rates.

[4] This corresponds to the European Commission's S2 indicator, most widely used to measure sustainability.

[5] See Kinnunen – Mäki-Fränti – Viertola (2012).

[6] See Risku et al. (2013).

[7] The deepening of the structural deficit is due, in particular, to increases in pension expenditure at the end of the current decade. In 2016–2019, they will increase the deficit by a total of 0.4 of a percentage point to GDP.

[8] For this issue, the cut-off date for information was 9 November 2013.

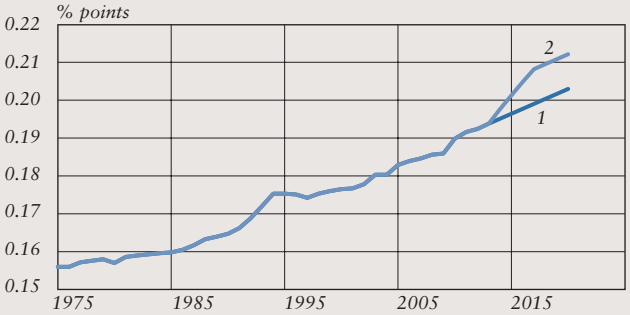
If implemented as envisaged, the expenditure cuts would reduce total local government expenditure by about 2% in 2017. Considering the level of local government expenditure, the savings target does not appear overwhelmingly ambitious. If, by contrast, the savings target of EUR 1 billion for which local government is responsible were focused entirely on local government income taxation, it would mean a substantial tightening, with municipal income tax rates rising by 2 percentage points on average (Chart 1). This would alter the structure of income taxation fairly strongly in the direction of a flat tax.

The local government deficit to GDP ratio in the baseline scenario is 1% in 2017. The savings, in combination with tightening taxation, would broadly balance the local government finances by that time. Hence, if local government finances were adjusted according to the proposed timetable and the changes to tax and expenditure bases were permanent, the sustainability gap would decline to 3.7%, ie by 0.9 of a percentage point (Chart 4). This projection is fairly close to the calculations by the Ministry of Finance.

Chart 1.

Average rate of municipal income tax

1. Baseline scenario
2. Increase in tax rate



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

Longer working lives

The single most important objective of the government's structural policy programme is to extend working lives by two years. The programme envisages a breakdown of the lengthening so that people would enter the labour market six months earlier and retire one and a half years later than now. The aim is that working lives would have lengthened by the mid-2020s.

Practical measures to attain this objective will become more specific only in the coming years as the content of the pension reform begins to take shape. These scenarios review the lengthening of working lives by assuming a growing probability that young people will enter working life earlier and older people continue longer. This probability is assessed by using coefficients measuring the impact of age and estimated from cohort data in the labour force survey.[9] The assumption for young cohorts, ie those aged 20–24, is that age will affect the probability of entering the labour market in the same way as in the case of five years' older cohorts. In older cohorts of 63–64-year-olds, in turn, the age effect is assumed to be the same as in the case of cohorts aged 55–59. According to the scenario, the effects of

[9] For more information on the methodology applied, see Kinnunen – Mäki-Fränti (2013).

the structural programme will begin to operate gradually from 2018 onwards, with the full impact of the reforms reflected in employment rates in 2030.

In a cohort-based analysis, for example in the cohort of those born in 1960 – whose average labour force participation rate (LFPR) when aged 63–64 would be 25% according to historically estimated interdependencies – the change in the age effect would mean that the reform would raise the LFPR to 40%. Similarly, those born in 2002 would participate in the labour market in 2020–2025 with a share about 5 percentage points larger than before the reform.

For the labour force participation rate, a lengthening of working lives would mean a significant change.

For the LFPR of the economy as a whole, a lengthening of working lives in the manner presented here would be a significant change. The structural policy programme also has the aim of reducing structural unemployment by 1 percentage point. If this could be achieved, the number of employed would increase further still. Lower structural unemployment is also assumed to reduce long-term unemployment, increasing labour force participation as the risk of being excluded from the labour market diminishes. If this effect is also taken into account, the LFPR will rise markedly.

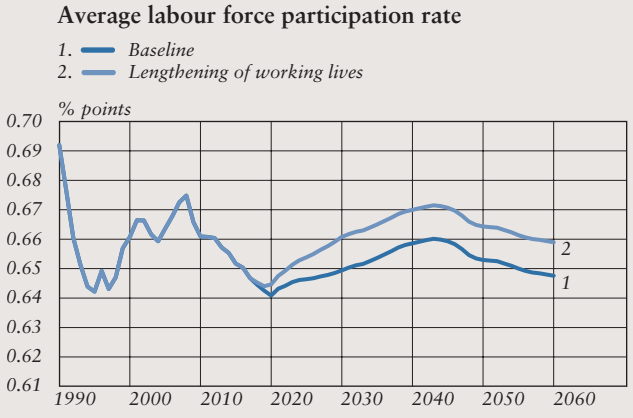
Compared with the baseline, working lives would become longer, particularly in the 2030s, with the average LFPR in 2040 being about 1 percentage point higher than in the baseline scenario. Labour force participation would rise to a level that has been reached only occasionally in the past two decades (Chart 2). Hence, longer working lives would in practice mean a big change in the amount and structure of labour resources in the economy.

Measures to promote longer working lives both at the beginning and at the end would, if implemented, be an effective means of improving fiscal sustainability. If LFPRs for both the youngest and the oldest working-age people increased as assumed, the sustainability gap would shrink by about 0.8 of a percentage point to 3.8% of GDP. A fall of 1 percentage point in structural unemployment would reduce the sustainability gap by another 0.6 of a percentage point.

The combined effect of longer working lives and lower long-term unemployment on the sustainability gap is in these scenarios somewhat smaller than the corresponding predictions by the Ministry of Finance.

Chart 2.

Average labour force participation rate



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

Increase in economy's potential output

In addition to lengthening working lives, the structural programme sets a separate

target for a one-off increase of 1.5% in the economy's potential output. In the short term, potential output will already be boosted by the moderate wage settlement agreement in autumn 2013. Measures taking effect over a longer period of time are improvements in access to finance by non-financial corporations, the promotion of competition and deregulation. But no such measures have been specified as yet.

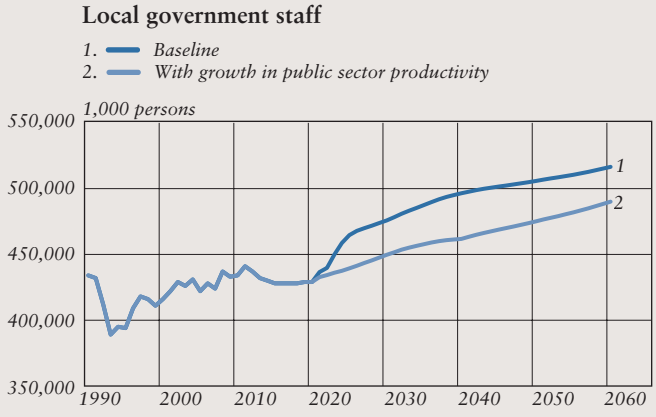
Measures increasing potential output are treated in this scenario as a temporary acceleration in the growth rates for the capital stock and total factor productivity. In 2014–2020, investment is predicted to grow by about 0.1 of a percentage point, and total factor productivity by about 0.2 of a percentage point faster than the baseline.[10] As the pick-up in investment and GDP growth is temporary, it will have some degree of permanent impact only on GDP levels, but not on long-term economic growth. A temporary acceleration in economic growth would reduce the sustainability gap by 0.2 of a percentage point, ie the effect would remain fairly limited.

Although the structural programme only targets a one-off increase in potential output, some of the proposed measures may permanently boost productivity and economic growth. According to Schumpeterian thinking, tightening competition in a sector may increase companies' willingness to innovate if, in doing so, they can avoid competition with technologically equal competitors and thus increase their profits. However, as it is hard to quantify such long-term effects of the structural programme on productivity growth, they were excluded from the present scenario. Consequently, the scenario may underestimate the effects of measures increasing potential output.

Productivity growth in public service provision

The structural programme seeks to accelerate the pace of growth in the productivity of public service provision to 0.5% annually. Faster productivity growth in the public sector would discernibly reduce the local government need for labour. If the objective were attained and adhered to until the end of the 2040s, the need to increase staff would be halved, from 100,000 to just under 50,000 (Chart 3). However, given the slow accumulation of the effects on personnel requirements, the impact

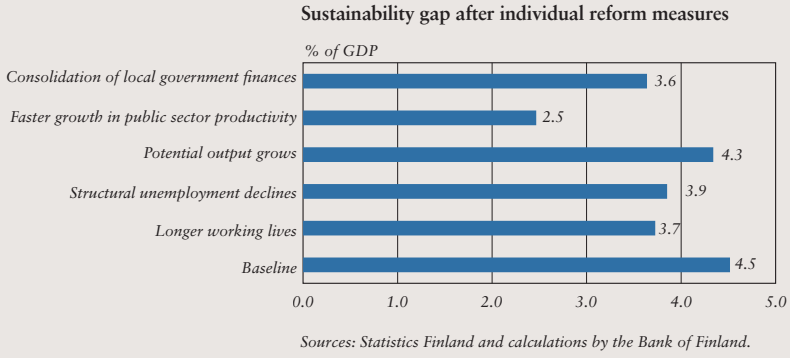
Chart 3.



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

[10] In assessing the acceleration of the growth rates for investment and GDP, use was made of the long-term growth forecast for the Finnish economy. See Kinnunen – Mäki-Fränti – Newby – Orjasniemi – Railavo (2012).

Chart 4.



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

would not be seen properly until far into the future.

Faster productivity growth in the public sector would also have spillover effects on the rest of the economy. More labour would be freed from local government to private service provision replacing public services and to other private production, where average productivity is better than in the public sector. However, as it is difficult to estimate the size of these indirect effects, they were excluded from the present scenario.

The scenario also assumes no response from public sector wages and salaries to higher productivity in public service provision. However, if higher productivity growth is reflected in pay demands, the effect on fiscal sustainability will weaken. Overall, the targeted productivity growth in public service provision would reduce the sustainability gap by 2 percentage points (Chart 4).

Consolidation paths

A long-term scenario for the public finances where tax rates and expenditure bases are kept unchanged would promptly lead to excessive deficits and unsustainable accumulation of debt. The central and local government primary balance would stay around –2% and the aggregate general government primary balance at almost –1% in the latter half of the current decade. Growth in age-related expenditure would increase the deficit, and the combined central and local government primary balance to GDP would be –4% as early as the beginning of the 2030s. The general government debt ratio would exceed nominal GDP at the end of the 2020s (Chart 5).

None of the proposed structural reforms will alone suffice to halt the pace of debt accumulation; fiscal sustainability will require the simultaneous attainment of several objectives.

To date, the most tangible proposals for the structural package are the consolidation of local government expenditures and revenues, the lengthening of working lives and the reduction of structural unemployment.

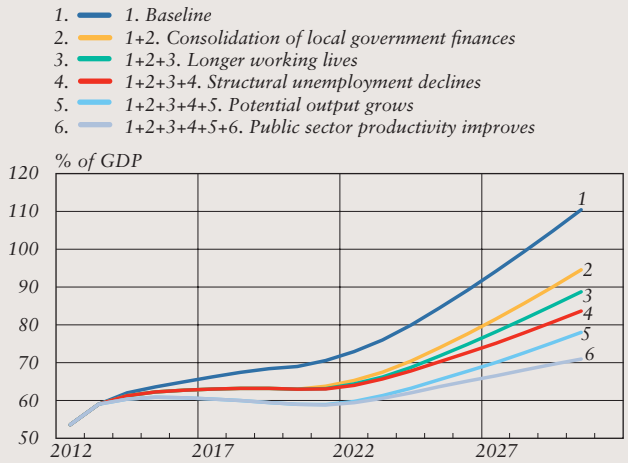
If all the objectives were achieved, they would together suffice to lower the debt ratio to about 80% at the end of the 2020s. If, on top of this, the private sector's potential output could be raised and productivity growth in public service provision accelerated, the debt ratio could decline to around 70% at that time (Chart 5).

The time paths of effects from higher potential output in the private sector and public sector productivity growth differ. Growth in potential output in the private sector would have a rapid consolidating effect on the public finances, as higher GDP would reduce the debt ratio and increase tax receipts. However, as faster productivity performance in the private sector also increases wages and salaries in the public sector, the long-term effect on the debt ratio would remain limited. By contrast, more rapid productivity growth in the public sector would impact on the debt over a longer period of time as savings in staff requirements begin to accumulate.

Instead of considering debt trajectories, the effects of the structural reforms can be examined from the perspective of the need for fiscal consolidation. This is measured here by the tax rate, taking as a base a medium-term forecast path extending until 2019. By that time, economic performance will have stabilised to a growth path determined by potential output and the general government deficit will be structural. In the baseline scenario, fiscal policy remains unchanged and the general government debt ratio rises close to 70%.

Chart 5.

General government debt ratio 2000–2030



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

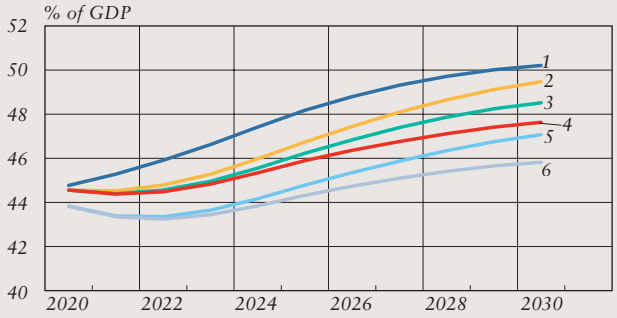
The scenario targets a stabilisation of the general government debt ratio to 60% of GDP over a longer period of time, ie by the beginning of the 2030s. It is also assumed that the GDP share of pension funds will remain unchanged. According to the baseline scenario, despite a long adjustment period, the total tax ratio will need to be increased strongly as early as the opening years of the 2020s. The tightening of taxation will concern both central and local government, as there is little upward pressure on pension contributions (Chart 6).

Consolidation of the local government finances would suffice to cause a reduction of about 0.7 of a percentage point in the need to tighten taxation by 2030. Measures impacting labour supply would have more substantial effects. Longer working lives, accompanied by lower structural unemployment, would mean a reduction of about 2 percentage points in the need to

The trend in the total tax ratio shows that it is more advantageous to carry out front-loaded structural reforms.

Chart 6.

Average tax ratio, cumulative effect of various measures



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

tighten taxation by 2030. Higher potential output and accelerating productivity growth in the public sector would reduce by a total of nearly 2 percentage points the need for further tax increases.

The trend in the total tax ratio shows that it is more advantageous to carry out front-loaded structural reforms, as this would mean a more even distribution over time of the burden from tightening taxation. The consolidation curves also suggest that attainment of a 60% debt ratio will require fiscal tightening well before the structural reforms begin to take effect.

Assessment of the effects of the measures using a general equilibrium model

Assessments of the effects of economic reforms based on sustainability scenarios fail to indicate the effects on the economy from price and wage changes that inevitably result from such reforms. Nor do mechanical sustainability scenarios enable assessments of how the economy is affected when, following structural reforms, economic agents need not take future fiscal adjustment needs into account to such an extent as previously in their own decisions regarding consumption and investment.

Increased labour supply caused by longer working lives may mean a lower wage level and, via this channel, growing demand for labour. In addition, public transfers and taxation have an impact on households' budget constraints, and thereby on incentives to work. If, for example, the need to tighten taxation diminishes, it typically increases labour supply. The incentives of working are also increased due to lower pension insurance contributions, as the number of pensioners relative to people in employment falls. On the other hand, if public consumption is divided into production in the public sector and purchased services, the effects of lower local government expenditure will depend on how the savings are channelled.

Using the Bank of Finland's general equilibrium model,[11] three structural policy reforms were analysed: local government savings, increased labour supply and growth in potential output. In the option involving local government savings, public consumption – following permanent savings of EUR 1 billion – was assumed to decline by an amount equivalent to about 1% of public

[11] For a description of the model, see Kilponen et al. (2006) and for a description of the effects of ageing, see Kinnunen and Railavo (2011).

consumption. In the labour supply option, in turn, the number of employed was assumed to grow by nearly 3% in such a way that both the working-age population and the labour supply of pensioners grow in the model. The growth of potential output by about 1½% again results from faster improvements in productivity than foreseen in the baseline. But key to the model projections is that, for example, labour supply was assumed to improve without making material changes to pension parameters. Previous model projections show that the weakening of pension benefits is a particularly effective tool in terms of labour supply.

In the model simulations, the public finances are balanced using taxation of labour, ie income taxes and social security contributions. The model includes separate balance sheet equations for the earnings-related pension funds and the rest of the public sector. Accordingly, the significance of various measures for the long-term need for consolidation is measured by changes in the tax rate.

The simulations raise some macroeconomic considerations. Firstly, in the model, a reduction in local government services leads to increased use of private services (Table 1). Following the reforms, employment and output will thus be better than envisaged in the baseline. Hence, the need for consolidation will diminish by slightly more than according to static projections.

The exogenous lengthening of working lives will reduce the need for tighter taxation by as much as earlier scenarios predicted. The results suggest

Table 1.

Effects of labour supply, local government expenditure restraint and potential output growth on the need for fiscal consolidation using a general equilibrium model

GDP, % points, %	*Local government expenditure cuts*	*Working lives and labour supply*	*Potential output growth*
Income tax rate, % points	***–1.0***	***–1.7***	***–1.6***
Pension insurance contributions	***–0.2***	***–1.8***	***–0.1***
Total tax ratio	***–0.7***	***–1.3***	***–0.2***
Public consumption / GDP, % points	*–0.5**	*–0.6*	*–0.1*
Pension expenditure / GDP, % points	*–0.1*	*–1.0*	*0.0*
Private consumption / GDP, % points	*0.3*	*–0.2*	*0.8*
Employment rate, % points	*0.1*	*1.5*	*0.1*
Employment, %	*0.2*	*2.9**	*0.1*
Share of public employment, % points	*–0.8*	*–0.7*	*0.0*
Real wages, %	*–0.1*	*–0.6*	*1.7*
General government debt / GDP, % points	*0.3*	*–0.1*	*0.0*
GDP, %	*0.5*	*2.8*	*1.5*
Labour productivity, %	*0.4*	*0.2*	*1.4**

% = % change in level
**= measure*
Source: Bank of Finland.

that increased labour supply also reduces real earnings. This is reflected in the smaller GDP share of private consumption. Higher labour force participation by pensioners will reduce by more than 1 percentage point the need to raise pension insurance contributions.

An increase of 1½% in potential output by speeding up productivity growth will improve income formation. Although this barely changes the GDP share of public consumption, the greater competitiveness will also be reflected in improved employment.

The outcomes of the model simulations are strongly conditional on the fiscal parameters with which the public finances are balanced. The outcomes presented here illustrate a situation where the adjustment is ensured by raising income taxes and social security contributions. Moreover, in the model, labour supply and thus wages and salaries respond fairly strongly to changes in expected wealth.

Structural reforms take time and are politically challenging

Making use of various scenario models, this article has assessed the effects of the government's structural package on the sustainability gap as well as on the time paths of the general government financial balance and debt ratio. If all measures can be implemented as planned according to a front-loaded approach and the effects are as expected, they will suffice to resolve the fiscal sustainability problem. However, as the debt is initially large, the economic outlook uncertain and the reforms will take time to be implemented, the risk of uncontrolled debt accumulation will be considerable, despite the agreement on major structural measures.

Implementation of the reforms means significant changes to the structures of the economy. Local government services would need to be provided with a substantially smaller staff than generally foreseen in projections of future service needs. Meanwhile, local government taxation would need to be tightened by as much as in the recession years of the 1990s, ie by about 2%. Furthermore, the economy's potential output would need to develop favourably. Fiscal consolidation will also require sufficiently rapid economic growth. It is particularly important that labour productivity also grow in the public services. The scope for accelerating overall productivity performance with economic policy measures is nevertheless limited.

Changes to taxation, social security and pension scheme parameters have effects on labour supply that are difficult to anticipate. Which parameter changes have a particular impact on labour supply is an area excluded from these projections. However, the scenarios made using the general equilibrium model do suggest that income taxes and social security contributions are of key importance for labour supply. If the reforms can prevent higher taxation of labour, they may prove more favourable for overall economic performance than predicted.

Keywords: structural reforms in the economy, fiscal sustainability, fiscal consolidation

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Articles and boxes from previous publications

Articles

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Boxes

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- Democraphic factors obscuring the picture of labour supply (p. 30–31).
- Composition of Finland's public debt (p. 36–38).
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Alternative scenarios

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- Alternative scenario: increased competition in labour and product markets. Bank of Finland Bulletin 5/2012, Economic outlook (p. 48–50).
- Alternative scenario: Households strengthen their financial position by adjusting demand. Bank of Finland Bulletin 3/2012, Economic outlook (p. 43–45).

Forecast tables

1. Balance of supply and demand, at reference year 2000 prices

% change on previous year

	2011	2012	2013f	2014f	2015f
GDP at market prices	2.7	–0.8	–1.0	0.6	1.7
Imports of goods and services	6.2	–1.0	–7.3	0.9	4.2
Exports of goods and services	2.7	–0.2	–1.7	1.7	4.7
Private consumption	2.6	0.2	–0.5	–0.2	1.0
Public consumption	0.5	0.6	1.3	0.7	0.6
Private fixed investment	6.2	–1.3	–1.8	0.3	4.3
Public fixed investment	3.0	0.9	0.4	–0.4	0.0

2. Contributions to growth[1]

	2011	2012	2013f	2014f	2015f
GDP, % change	2.7	–0.8	–1.0	0.6	1.7
Net exports	–1.3	0.3	2.3	0.3	0.3
Domestic demand excl. inventory change	2.6	0.1	–0.3	0.1	1.5
of which:					
– Consumption	1.6	0.3	0.0	0.1	0.8
– Investment	1.1	–0.2	–0.3	0.0	0.7
Inventory change + statistical discrepancy	1.4	–1.2	–3.0	0.1	0.0

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

3. Balance of supply and demand, price deflators

Index, 2000 = 100, and % change on previous year

	2011	2012	2013f	2014f	2015f
GDP at market prices	117.0	120.4	122.6	124.6	126.6
	2.8	2.9	1.8	1.6	1.6
Imports of goods and services	114.8	117.6	117.5	118.3	119.9
	6.3	2.4	–0.1	0.6	1.4
Exports of goods and services	100.4	101.6	101.3	102.1	103.4
	4.4	1.2	–0.2	0.8	1.3
Private consumption	120.7	124.3	126.3	128.2	130.1
	3.5	2.9	1.6	1.5	1.5
Public consumption	147.8	153.7	157.1	159.4	162.3
	3.9	4.0	2.2	1.5	1.8
Private fixed investment	118.0	122.8	125.4	127.4	129.5
	2.7	4.1	2.1	1.6	1.6
Public fixed investment	129.7	134.9	136.8	139.3	141.8
	3.5	4.0	1.4	1.8	1.8
Terms of trade (goods and services)	87.4	86.4	86.2	86.3	86.3
	–1.8	–1.2	–0.2	0.1	–0.1

4. Balance of supply and demand, at current prices

EUR million and % change on previous year

	2011	2012	2013f	2014f	2015f
GDP at market prices	188,679	192,541	194,143	198,438	205,096
	5.6	2.0	0.8	2.2	3.4
Imports of goods and services	78,671	79,762	73,891	75,003	79,183
	12.8	1.4	–7.4	1.5	5.6
Total supply	267,350	272,303	268,034	273,441	284,279
	7.6	1.9	–1.6	2.0	4.0
Exports of goods and services	77,313	78,118	76,576	78,456	83,186
	7.2	1.0	–2.0	2.5	6.0
Consumption	151,364	156,852	159,746	162,348	166,339
	5.6	3.6	1.8	1.6	2.5
Private	105,182	108,546	109,747	111,244	114,015
	6.2	3.2	1.1	1.4	2.5
Public	46,182	48,306	50,000	51,104	52,325
	4.4	4.6	3.5	2.2	2.4
Fixed investment	36,632	37,724	37,891	38,589	40,705
	8.7	3.0	0.4	1.8	5.5
Private	31,884	32,739	32,814	33,441	35,466
	9.0	2.7	0.2	1.9	6.1
Public	4,748	4,985	5,077	5,148	5,239
	6.5	5.0	1.9	1.4	1.8
Inventory change + statistical discrepancy	2,041	–391	–6,180	–5,951	–5,951
% of previous year's total demand	1.1	–0.9	–2.1	0.1	0.0
Total demand	267,350	272,303	268,034	273,441	284,279
	7.6	1.9	–1.6	2.0	4.0
Total domestic demand	190,037	194,185	191,457	194,985	201,093
	7.8	2.2	–1.4	1.8	3.1

5. Balance of supply and demand

% of GDP at current prices

	2011	2012	2013f	2014f	2015f
GDP at market prices	100.0	100.0	100.0	100.0	100.0
Imports of goods and services	41.7	41.4	38.1	37.8	38.6
Exports of goods and services	41.0	40.6	39.4	39.5	40.6
Consumption	80.2	81.5	82.3	81.8	81.1
Private	55.7	56.4	56.5	56.1	55.6
Public	24.5	25.1	25.8	25.8	25.5
Fixed investment	19.4	19.6	19.5	19.4	19.8
Private	16.9	17.0	16.9	16.9	17.3
Public	2.5	2.6	2.6	2.6	2.6
Inventory change + statistical discrepancy	1.1	–0.2	–3.2	–3.0	–2.9
Total demand	141.7	141.4	138.1	137.8	138.6
Total domestic demand	100.7	100.9	98.6	98.3	98.0

6. Prices

Index, 2000 = 100 and % change on previous year

	2011	2012	2013f	2014f	2015f
Harmonised index of consumer prices, 2005 = 100	114.2	117.8	120.4	122.3	124.0
	3.3	3.2	2.2	1.6	1.4
Consumer price index, 2005 = 100	113.4	116.6	118.3	120.2	122.2
	3.4	2.8	1.4	1.6	1.7
Private consumption deflator	120.7	124.3	126.3	128.2	130.1
	3.5	2.9	1.6	1.5	1.5
Private investment deflator	118.0	122.8	125.4	127.4	129.5
	2.7	4.1	2.1	1.6	1.6
Exports of goods and services deflator	100.4	101.6	101.3	102.1	103.4
	4.4	1.2	–0.2	0.8	1.3
Imports of goods and services deflator	114.8	117.6	117.5	118.3	119.9
	6.3	2.4	–0.1	0.6	1.4
Value-added deflators	118.0	121.3	123.1	125.0	126.9
Value added, gross at basic prices	2.4	2.8	1.4	1.6	1.5
Private sector	109.6	112.2	113.4	115.1	116.9
	2.0	2.4	1.1	1.5	1.5
Public sector	164.7	172.4	177.5	180.6	183.5
	4.2	4.7	3.0	1.7	1.6

7. Wages and productivity

% change on previous year

	2011	2012	2013f	2014f	2015f
Whole economy					
Index of wage and salary earnings	2.7	3.2	2.1	1.5	1.5
Compensation per employee	3.5	3.5	1.4	1.5	1.7
Unit labour costs	1.7	4.8	1.3	0.6	0.7
Labour productivity per employed person	1.7	–1.2	0.1	0.9	1.0

8. Labour market

1,000 persons and % change on previous year

	2011	2012	2013f	2014f	2015f
Labour force survey (15–74-year-olds)					
Employed persons	2,473	2,483	2,456	2,448	2,466
	1.0	0.4	–1.1	–0.3	0.7
Unemployed persons	208	207	216	214	201
	–7.0	–0.9	4.5	–0.8	–6.2
Labour force	2,681	2,690	2,672	2,663	2,667
	0.3	0.3	–0.7	–0.3	0.2
Working-age population (15–64-year-olds)	3,539	3,524	3,508	3,493	3,480
	–0.4	–0.4	–0.5	–0.4	–0.4
Labour force participation rate, %	66.1	66.0	65.4	65.0	64.9
Unemployment rate, %	7.8	7.7	8.1	8.1	7.5
Employment rate (15–64-year-olds), %	68.6	69.0	68.6	68.8	69.5

9. General government revenue, expenditure, balance and debt

% of GDP

	2011	2012	2013[f]	2014[f]	2015[f]
General government revenue	54.1	54.4	55.8	55.8	55.8
General government expenditure	55.2	56.6	58.2	58.2	57.8
General government primary expenditure	53.7	55.1	56.8	56.8	56.3
General government interest expenditure	1.4	1.4	1.4	1.5	1.5
General government net lending	–1.0	–2.2	–2.4	–2.4	–2.1
Central government	–3.4	–3.8	–3.4	–3.3	–3.0
Local government	–0.6	–1.1	–1.1	–1.0	–0.9
Social security funds	2.9	2.7	2.1	2.0	1.9
General government primary balance	0.4	–0.7	–1.0	–0.9	–0.6
General government debt (EDP)	49.2	53.6	59.0	62.4	64.2
Central government debt	42.2	43.6	48.0	50.6	52.0
Tax ratio	43.6	44.0	45.2	45.2	45.2

10. Balance of payments

EUR million

	2011	2012	2013[f]	2014[f]	2015[f]
Exports of goods and services (SNA)	77,313	78,118	76,576	78,456	83,186
Imports of goods and services (SNA)	78,671	79,762	73,891	75,003	79,183
Goods and services account (SNA)	–1,358	–1,644	2,685	3,453	4,003
% of GDP	–0.7	–0.9	1.4	1.7	2.0
Investment income and other items, net (+ statistical discrepancy)	122	–220	–2,376	–1,687	–1,730
Current transfers, net	–1,594	–1,335	–1,477	–1,432	–1,486
Current account, net	–2,831	–3,199	–1,168	333	787
Net lending, % of GDP					
Private sector	–0.5	0.5	1.8	2.6	2.4
Public sector	–1.0	–2.2	–2.4	–2.4	–2.1
Current account, % of GDP	–1.5	–1.7	–0.6	0.2	0.4

11. Interest rates

%

	2011	2012	2013[f]	2014[f]	2015[f]
3-month Euribor[1]	1.4	0.6	0.2	0.3	0.5
Average interest rate on new loans	3.2	2.3	1.6	2.0	2.2
Average rate of interest on deposits	1.0	0.8	0.4	0.4	0.5
Bank lending rate, average	2.6	2.3	1.8	1.8	2.0
Yield on Finnish 10-year government bonds[1]	3.0	1.9	1.9	2.1	2.6

[1] *Technical assumption derived from market expectations.*

12. International environment

Eurosystem staff projections

	2011	2012	2013[f]	2014[f]	2015[f]
GDP, % change on previous year					
World	3.9	3.2	2.8	3.5	3.7
USA	1.8	2.8	1.7	2.6	3.2
Euro area	1.6	–0.6	–0.4	1.1	1.5
Japan	–0.6	1.9	1.8	1.3	0.9
Imports, % change on previous year					
World	6.4	3.1	2.8	5.2	6.1
USA	4.9	2.2	1.5	5.1	6.7
Euro area	4.6	–0.8	–0.1	3.5	4.7
Japan	5.9	5.5	2.7	4.3	3.5
Index, 2000 = 100 and % change on previous year					
Import volume in Finnish export markets	175.2	179.6	182.1	189.8	200.0
	7.1	2.5	1.3	4.3	5.4
Export prices (excl. oil) of Finland's trading partners, national currencies	117.0	117.6	116.5	117.3	118.9
	2.6	0.5	–0.9	0.7	1.3
Export prices (excl. oil) of Finland's trading partners, in euro	102.1	105.3	102.1	101.9	103.2
	4.5	3.1	–3.0	–0.3	1.3
Industrial raw materials (excl. energy),	243.4	204.8	197.2	194.3	202.7
HWWA index, in US dollars	14.4	–15.8	–3.7	–1.5	4.3
Oil price, USD per barrel[1]	110.9	112.0	108.2	103.9	99.2
	39.3	0.9	–3.4	–3.9	–4.6
Finland's nominal competitiveness indicator[2]	103.0	100.1	102.3	103.3	103.3
	–0.5	–2.9	2.2	1.0	0.0
US dollar value of one euro[1]	1.39	1.28	1.33	1.34	1.34
	5.0	-7.7	3.2	1.5	0.0

[1] *Technical assumption derived from market expectations.*
[2] *Narrow plus euro area, 1999 Q1 = 100.*

Organisation of the Bank of Finland

1 January 2014

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