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BANK OF FINLAND ARTICLES ON THE ECONOMY

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ALTERNATIVE SCENARIO

Weaker global economic activity one of the key risks

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Exports will finally begin to grow in response to export demand, with net exports gradually beginning to support growth alongside domestic demand. However, one of the key risks to the forecast is a weaker-than-forecast performance in the international economy. Global trade growth is muted relative to global GDP growth, and economic growth in the emerging economies may sag by more than anticipated. Hence developments in the global economy are exceptionally uncertain.

In this alternative scenario to the forecast, growth in Finland's export markets remains much slower than predicted. In 2008–2015, the export markets grew by an average of 2% annually. The scenario assumes growth in the export markets to remain at only 2% in 2018 and 2019, instead of the envisaged level of just under 4% in the baseline forecast.

In addition, the scenario includes the following assumptions:

- Given that increases in nominal wages and prices are very muted even in the baseline forecast, the alternative scenario assumes no additional adjustment from this source. Consequently, wages and prices will not fall further if a new shock were to hit the Finnish economy, and thus Finland would not benefit from a decline in relative prices compared with the prices of competitor countries.

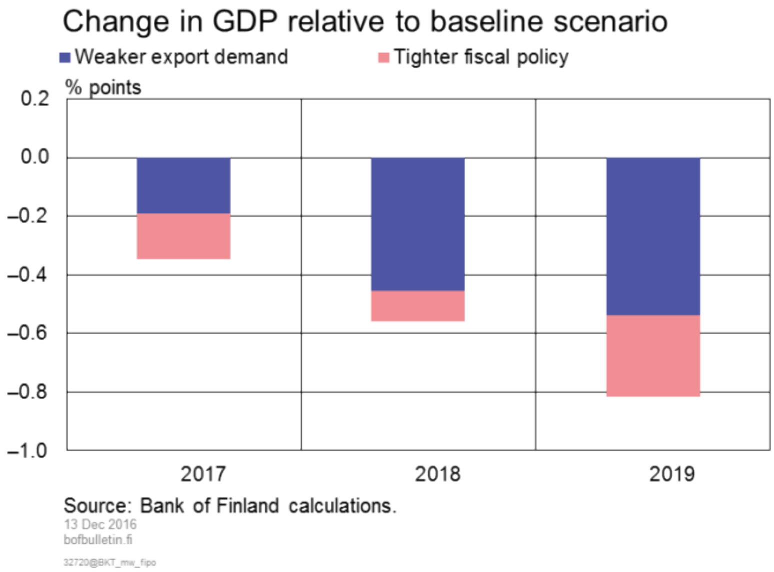
- The scenario also assumes policy rates remaining in line with the baseline. In the baseline forecast, interest rates are already at their lower bound and the scope for conventional monetary policy to provide further accommodation via interest rates is very limited.
- Another assumption is that fiscal space has already been exhausted. Despite the Government's consolidation measures, the ratio of public debt to GDP has been growing at an alarming pace, and the European Commission ranks Finland among the group of countries that are risking a breach of the provisions of the Stability and Growth Pact. Moreover, the alternative scenario assumes that, in order to attain its objectives for the public finances, the Government is able to carry out further consolidation, despite the weak performance of the export markets. On account of the consolidation measures, the debt ratio in 2019 remains broadly the same in size as in the baseline forecast.

If export market growth falls below the predicted path, demand for Finnish exports weakens, thus directly cutting aggregate demand. The resultant over-supply is balanced in a normal situation, at least in part, via reductions in wages and prices. As the scenario assumes no adjustment in wages and prices, output volumes need to adapt to the prevailing situation.

Lower demand for end products leads to a contraction in demand for domestic intermediate goods and factors of production used in their manufacture. Working hours diminish and investment is scaled down. However, Finnish export prices do not decline relative to the prices of competing countries. Exports contract sharply, as export prices are rigid and therefore do not cushion the impact of lower export demand. In 2019, real GDP is a good 1% below the baseline figure. In the absence of new fiscal measures, general government debt to GDP rises to a level around ½ a percentage point higher than in the baseline (Table).

If the general government debt ratio is to be brought back onto the baseline path, additional consolidation of well over EUR 1.5 billion is required. Such additional adjustment further slows growth in the real economy over the short term. Chart 1 shows the effects of a combination of export demand and fiscal tightening on the growth rate of GDP.

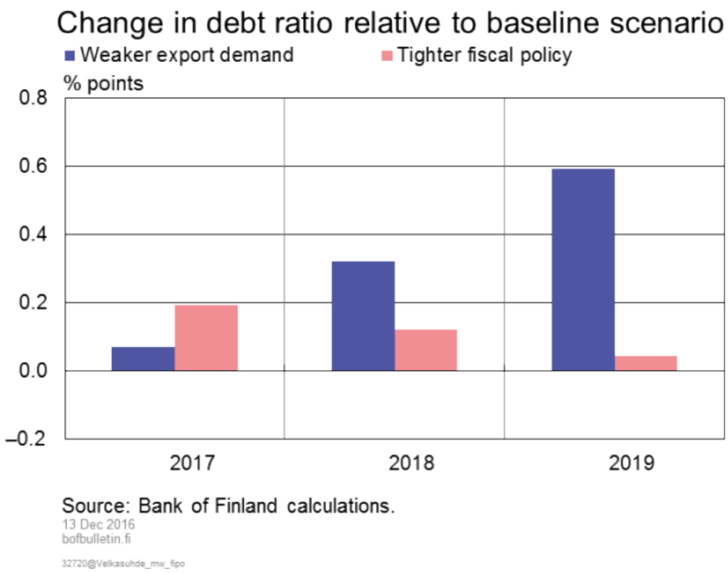
Chart 1.



In order for the general government debt ratio to return close to the baseline path, the scenario assumes the following breakdown for the Government's adjustment measures of well over EUR 1.5 billion, implemented mainly in 2018 and 2019: an increase of EUR 500 million in value added tax revenue, cuts of EUR 500 million in central government expenditure, cuts of EUR 500 million in benefits and subsidies and cuts of EUR 200 million in government transfers. Cutting public expenditure further reduces aggregate demand and – with prices remaining unchanged – output volumes.

Chart 2 indicates the general government debt ratio, impaired by export demand, as a deviation from the baseline, without fiscal tightening. The chart also presents how fiscal policy responds, with additional adjustments, in order to bring the public finances back close to the baseline path by 2019.

Chart 2.



The alternative scenario shows how much global economic activity affects a small and open economy such as Finland's. The results also indicate how difficult it is to adjust the public finances if there are stronger headwinds blowing in the international economy. On the other hand, preventing a rise in the debt ratio reduces future public expenditure. From this it follows that it is advisable to create sufficient fiscal space in the public finances even in a slightly more favourable economic environment, so as to ensure that such space will be available in more adverse circumstances. This enables avoidance of procyclical economic policies.

Supply and demand in 2016-2019 at 2010 prices

		2016	2017	2018	2019	2019 deviation, %
% change on previous year						
GDP	Baseline forecast	1.0	1.3	1.2	1.2	195,637
	Alternative scenario	1.0	1.1	0.8	0.6	193,352
	Difference	**0.0**	**-0.2**	**-0.5**	**-0.5**	**-1.2**
Imports	Baseline forecast	1.2	2.0	2.1	1.9	82,729
	Alternative scenario	1.2	1.5	1.1	0.7	80,619
	Difference	**0.0**	**-0.5**	**-1.0**	**-1.1**	**-2.6**
Exports	Baseline forecast	0.7	2.1	2.5	2.6	80,289
	Alternative scenario	0.7	1.4	1.0	1.0	77,253
	Difference	**0.0**	**-0.8**	**-1.5**	**-1.6**	**-3.8**
Private consumption	Baseline forecast	1.9	1.4	1.0	0.9	110,033
	Alternative scenario	1.9	1.3	0.8	0.7	109,480
	Difference	**0.0**	**-0.1**	**-0.2**	**-0.2**	**-0.5**
Private investment	Baseline forecast	5.8	3.4	2.5	2.7	36,360
	Alternative scenario	5.8	3.2	1.6	1.3	35,483
	Difference	**0.0**	**-0.2**	**-0.9**	**-1.3**	**-2.4**
Export markets	Baseline forecast	1.8	2.8	3.6	3.7	127.2

Source: Bank of Finland calculations.

Supply and demand in 2016-2019 at 2010 prices

	Alternative scenario	1.8	2.0	2.0	2.0	122.3
	Difference	**0.0**	**-0.8**	**-1.6**	**-1.6**	**-3.8**
Hours worked	Baseline forecast	0.9	0.8	0.8	0.7	4,232
	Alternative scenario	0.9	0.5	0.0	-0.2	4,148
	Difference	**0.0**	**-0.3**	**-0.8**	**-0.9**	**-2.0**
Current account	Baseline forecast	-0.8	-0.9	-1.0	-0.9	-2,100
	Alternative scenario	-0.8	-1.0	-1.8	-1.8	-3,905
	Difference	**0.0**	**-0.1**	**-0.7**	**-0.8**	
General government debt	Baseline forecast	65.6	68.2	70.1	71.3	71.3
	Alternative scenario	65.6	68.3	70.4	71.9	71.9
	Difference	**0.0**	**0.1**	**0.3**	**0.6**	**0.6**
Household savings ratio	Baseline forecast	-1.0	-1.0	-0.9	-0.3	-0.3
	Alternative scenario	-1.0	-1.2	-1.6	-1.5	-1.5
	Difference	**0.0**	**-0.2**	**-0.7**	**-1.2**	**-1.2**

Source: Bank of Finland calculations.

Tags

- public finances
- gross domestic product
- alternative scenario