BANK OF FINLAND
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BANK OF FINLAND ARTICLES ON THE ECONOMY

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Finland grows, and gathers more debt

YESTERDAY 3:00 PM • BANK OF FINLAND BULLETIN 3/2017 • ECONOMIC OUTLOOK

The economic upswing in Finland has strengthened, and growth particularly in the first part of 2017 has been strong in the light of the statistical data. Economic growth in recent years has rested exclusively on domestic demand, but the base of growth is now broadening towards exports. The Bank of Finland forecasts GDP growth of 2.1%, 1.7% and 1.4% in 2017, 2018 and 2019, respectively.

Economic growth will, however, slow towards the end of the forecast horizon 2017–2019. This reflects weak structural factors present in the Finnish economy that weigh on potential growth. Inflation will gather pace, but will be slower than the rest of the euro area throughout the forecast horizon.

Despite the firming of exports, economic growth in the forecast period will mainly depend on private consumption and investment. Private consumption growth will be bolstered, in particular, by an improvement in the employment situation and rising purchasing power, but also by household debt accumulation. Saving by Finnish households has, in fact, already been at very low levels for an historically prolonged period. Looking to the immediate years ahead, the savings ratio will also remain exceptionally modest as the low level of interest rates and strong consumer confidence encourage households to consume.

The very accommodative stance of monetary policy will continue to keep loan interest rates low, not only for households but also for non-financial corporations, and support investment. Investments will still boost economic growth in the forecast period, although their rate of growth will decelerate slightly towards the end of the forecast horizon, with the bottoming out of the upward trend in construction.

Finnish exports will benefit from the strengthening of the export markets and from the composition of growth generally turning more favourable for Finland's exports, especially in the euro area. Finnish export prices will rise more slowly than those of competitor countries, and the economic situation in Russia will improve, with these factors, too, making a positive contribution to exports.

Despite economic growth, Finland's external indebtedness will continue to grow. The accumulated current account deficit in 2010–2016 already stands at more than EUR 14 billion, as both general government and household debt levels have been rising rapidly. The current account will remain in deficit in the forecast period against the backdrop of strong demand for imports and a weakening in the terms of trade, with the Competitiveness Pact keeping domestic price developments moderate.

The improved cyclical situation will not be sufficient to remedy the general government fiscal balance. Fiscal policy will be eased in 2017, on account of lower taxes and reductions in social insurance contributions relating to the Competitiveness Pact. In the later forecast years 2018–2019, fiscal policy will be tightened, but this will not suffice to repair the general government structural deficit. General government debt in the forecast years will grow to 66.8% relative to GDP.

Inflation will gather pace slightly in 2017, but will be slower than the euro area as a whole throughout the forecast horizon. Although moderate growth in labour costs as a consequence of the Competitiveness Pact will rein in upward pressures on consumer prices, the positive cyclical environment, greater aggregate demand and higher import prices will boost inflation to some extent.

The employment situation is expected to ameliorate further in the forecast period, driven by the cyclical trend, but employment growth will be restricted by labour market mismatch problems and constraints in labour supply. Demographic change will slow expansion of both the labour force and the number of employed in the forecast years. The emphasis of economic growth will also be shifting to less labour-intensive sectors as exports assume a greater role as the engine of growth. At the same time, however, productivity growth and corporate profitability will improve.

GDP: GDP finally larger than in 2008

The Bank of Finland forecasts GDP growth of 2.1% in 2017. Finland has regained the growth rates of the rest of the euro area, and the recovery in the economy is strengthening. Growth in recent years has rested exclusively on domestic demand, but in the forecast period exports will also increase and support growth. Economic growth will slow towards its longer-term trend at the end of the forecast horizon. The economy will grow 1.7% in 2018 and 1.4% in 2019. In 2019, GDP will be larger than in 2008.

Table 1.

Forecast summary

% change on previous year			
	2017[f]	2018[f]	2019[f]
Gross domestic product	2.1	1.7	1.4
Private consumption	1.3	1.3	1.2
Public consumption	–0.2	0.1	–0.2
Private fixed investment	5.2	3.0	2.8
Public fixed investment	2.4	0.2	–0.1
Exports	3.9	3.4	2.9
Imports	2.7	2.3	2.1

	2017[f]	2018[f]	2019[f]
Labour market			
Hours worked	1.0	0.9	0.4
Number of employed	0.5	0.7	0.5
Eunemployment rate, %	8.6	8.2	8.1
Unit labour costs	–1.8	0.2	0.5
Labour compensation per employee	–0.3	1.1	1.4
Productivity	1.5	1.0	1.0

	2017[f]	2018[f]	2019[f]
Contributions to growth			
Domestic demand	1.7	1.3	1.3
Net exports	0.4	0.4	0.4
Inventory change + statistical discrepancy	0.0	0.0	0.0

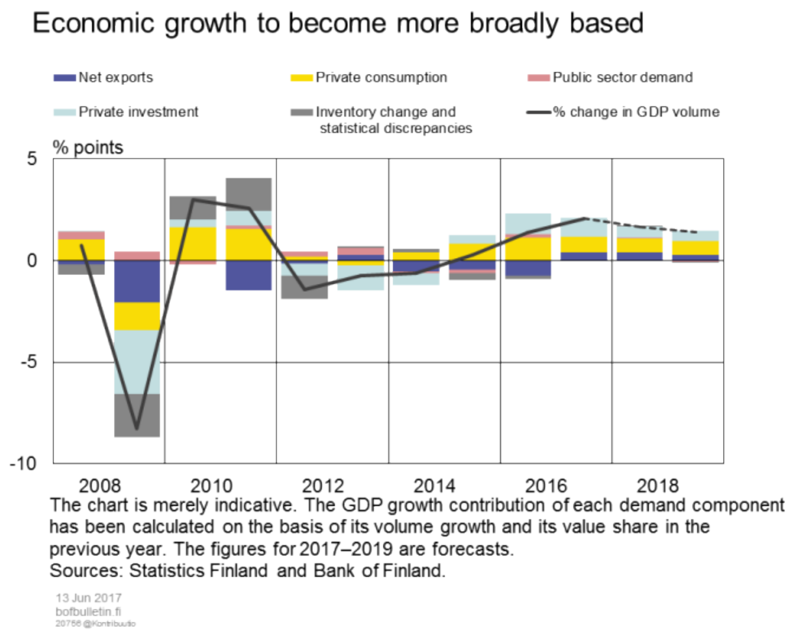
Forecast summary

Savings ratio. households, %	–1.2	–1.4	–1.5
Current account balance, % of GDP	–1.2	–0.9	–0.8
GDP. price index	0.6	1.2	1.4
Private consumption. price index	0.8	1.3	1.5
Harmonised index of consumer prices	0.8	1.0	1.3
Excl. Energy	0.4	0.9	1.2
Energy	5.9	1.1	2.5
f = forecast			
Sources: Statistics Finland and Bank of Finland.			

Despite the firming up of exports, economic growth in Finland in the forecast period will mainly depend on private consumption and investment (Chart 2). Private consumption will be bolstered by an improvement in the employment situation, rising purchasing power, stronger confidence and household debt accumulation. (See article ‘Household saving at an historic low’). The very accommodative stance of monetary policy will continue to keep interest rates on household and corporate loans low, which will sustain consumption and spur investment. The fastest phase of investment growth will occur at the beginning of the forecast period, with ongoing strong new-build construction.

Chart 1.

Chart 2.



Export growth will finally gain momentum. The Competitiveness Pact will improve cost competitiveness, and higher corporate fixed investment will boost the growth prospects for exports. The outlook for the global economy is also better than previously projected, and demand for Finnish exports will increase. The ongoing accommodative stance of monetary policy will strengthen euro area investment, thereby also structurally supporting Finnish exports. Even if picking up, export growth will remain lower than that of the export markets. (See article 'Finland struggling to defend its market share in rapidly expanding markets').

Despite economic growth, the external indebtedness of the Finnish economy will continue to grow. The cumulative current account deficit in 2010–2016 already stands at more than EUR 14 billion. In 2017–2019, the current account deficit relative to GDP will stay around 1%, with well over EUR 6 billion in additional deficit accumulation. General government and household debt levels are rising rapidly (Chart 3). The widening of the current account deficit is also due to higher investment appetite among non-financial corporations.

Chart 3.

The forecast takes account of statistical data and other information available on 23 May 2017. On 1 June 2017, Statistics Finland released the latest data on the quarterly national accounts, and these have been discussed in more detail in a separate article (See article 'National Accounts for the first quarter of 2017').

Households: Employment gains bolster private spending

Employment growth and a pick-up in earnings towards the end of the forecast horizon 2017–2019 will underpin consumers' purchasing power. While growth in private consumption will moderate from the level of 2016, consumption will still remain higher than disposable income. Consequently, the household saving ratio will remain negative and debt will continue to accumulate.

Consumer confidence strengthened further in the first half of 2017, with the value of the consumer confidence indicator in May recording the highest reading throughout its history. That said, consumers' expectations for their own finances clearly fall short of their expectations for the Finnish economy. Of the components of the confidence indicator, the threat of unemployment is assessed to be lower than before, on the back of improvements in the labour market situation. Furthermore, conditions are also assessed to be more conducive to borrowing now than in the long term, on average.

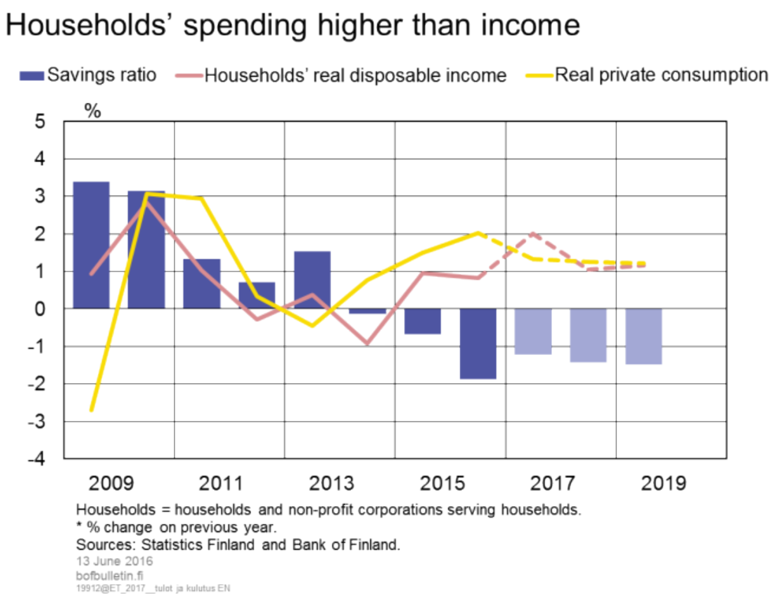
The pick-up in economic growth notwithstanding, the increase in households' disposable income remains slow. In keeping with the Competitiveness Pact, the social partners will refrain from negotiated wage increases in 2017, while the upward impact of wage drift on earnings will be broadly the same as in 2016. Nominal wage earnings will rise 0.7% overall in 2017. With the pace of economic and productivity growth gaining momentum, demands for higher wages will grow stronger, pushing up the rate of increase in nominal wages to 1.8% by 2019. Capital income and public transfers will also add to households' aggregate income in the forecast period. An increase in public transfers may boost spending even more than an equivalent rise in earnings, reflecting the higher-than-average propensity of low-income earners to consume.

Higher social security contributions, together with the cut in public-sector holiday bonuses agreed as part of the Competitiveness Pact, will curtail households' purchasing power, but the effects of these measures on disposable income will be almost fully offset by the income tax cuts introduced in 2017. The Competitiveness Pact will, however, have consequences for income distribution between the private and public sectors. Disposable income will increase in the private sector as holiday bonuses remain intact and income taxation is eased.

In 2016, growth in households' purchasing power largely hinged on employment growth and most payroll growth will over the forecast years, too, be derived from gains in employment.

The purchasing power of households has, in recent years, been bolstered by low consumer price inflation, but, over the forecast years, the rate of inflation will gradually lift. In 2017, consumers' real purchasing power will increase by roughly 2%, overall, and then fall back to a full 1% per annum in 2018–2019 (Chart 4).

Chart 4.



Over the forecast years 2017–2019, the rate of consumption growth will moderate from 2016, settling close to 1.3%. In response to subdued income growth and the low level of interest rates, households have in recent years financed consumption by realising their assets or taking on more debt. The household savings ratio will remain negative in the forecast years, too, declining to around -1.5% of disposable net income. (See article 'Household saving at an historic low').

Accommodative financing conditions have also helped sustain households' purchasing power during the past few years. The reference rates for residential mortgages (home loans) have remained low, while interest margins on home loans narrowed further in the early part of 2017. Nominal interest rates are not expected to rise much over the forecast years, in addition to which accelerating inflation will push down real interest rates.

The low level of interest rates has provided more scope for consumption, notably for mortgage-indebted households, and speeded up repayment of mortgages, insofar as they are annuity loans. That said, the low interest rates have also encouraged households to take on more debt. At the end of 2016, the household debt-to-income ratio was 126.9%, or 2.5 percentage points higher than a year earlier. New drawdowns of home loans have increased slightly in the early part of the year, but growth in the stock of home loans has remained moderate compared with pre-2010 levels.

Growth in demand has, in fact, been stronger for consumer credit than for home loans. In March 2017, the volume of consumer credit increased by 13.7%, nearly twice as much as a year earlier. However, consumer credit accounts for just a small share of household borrowing. In addition to loans taken out in their own names, households are also burdened by loans taken out via housing companies, which are growing rapidly, not least because of the continued brisk pace of renovation work.

Non-financial corporations: Improvements in growth prospects and profitability support investment

Investment will continue to fuel economic growth, although the rate of increase in investment will moderate slightly over the forecast horizon. Investment picked up 5.2% in 2016, driven by private investment. Behind the growth in investment lay better growth prospects and higher profitability, underpinned by an accommodative monetary policy. The favourable performance is reflected especially in residential and other construction investment, but a revival has also been seen in investment in machinery and equipment.

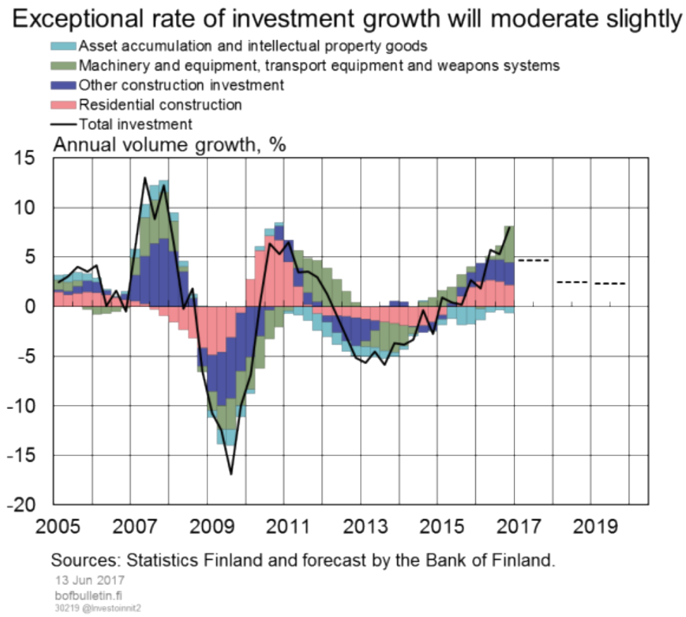
In the years since the financial crisis, the private sector investment rate – gross fixed capital formation relative to GDP – dropped by more than 4 percentage points, to around 16% in 2015. The strong rebound in investment will push up the private sector investment rate to 19% in the forecast period.

The current exceptionally fast growth in investment will moderate as the construction boom gradually matures. Private fixed investment will increase 5.2% in 2017 and then ease off to roughly 3% per annum towards the end of the forecast period 2017–2019, when growth will be derived mainly from investment in productive capacity (Chart 5).

In 2016, investment in residential construction was up 9.1%, and productive investment by 4.6%. In fact, most of the revival in investment was due to an exceptional surge in residential construction. The forecast, however, projects growth in residential investment to moderate to 2% in 2019. However, the annual growth rate of productive investment will still be above 3% at the end of the forecast period, offsetting the moderation in residential construction growth.

Approvals of construction permits and newly launched construction projects increased substantially in the early part of 2017, portending that construction activity will still remain brisk this year and in 2018. The exceptional surge in new-build construction is, however, mainly related to the protracted downturn in the construction sector and the unravelling, since 2016, of accumulated demand for housing construction, and growth is not expected to remain as brisk in the immediate years ahead. By contrast, demand for renovation work will remain unchanged in the face of the ageing of the housing stock.

Chart 5.



Corporate confidence in the economy has improved broadly across different sectors. Growth prospects for non-financial corporations notably in the services sector and manufacturing are now much brighter than a year earlier. In manufacturing, output and employment expectations have improved, with an increase in new orders recorded particularly in the metal industry. Business confidence also strengthened in other advanced economies over the course of 2016.

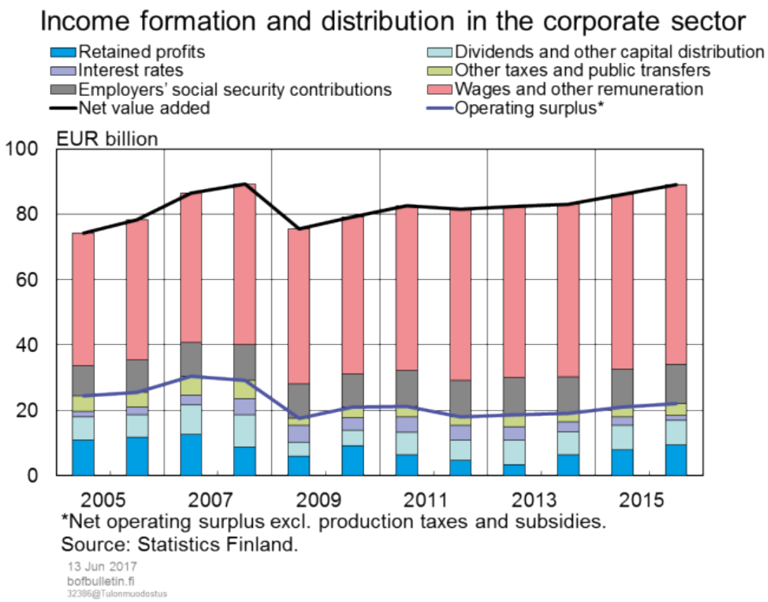
Financing conditions for non-financial corporations will remain highly favourable, with exceptional monetary accommodation keeping lending rates down. The low rate of investment growth witnessed in recent years has, in fact, been due to lacklustre export demand and slow productivity growth, rather than poor access to funding. Better prospects for global and euro area growth and stronger business confidence, together with the Competitiveness Pact, bolster corporate appetite for investment, notably in the export sectors and manufacturing. Buttressing exports, the rebound in productive investment will support economic growth in the years ahead.

Profitability in the corporate sector has remained modest in the years since the financial crisis, despite an upturn in operating surplus over the past few years. In the National

Accounts, operating surplus equals operating profits in the financial statements of non-financial corporations. In 2016, however, a tangible reduction in interest payments boosted average return on equity in the corporate sector. In response to lower interest payments, both retained corporate profits and dividends and other capital distribution to other sectors increased (Chart 6).

Over the forecast period, corporate sector profitability will improve, as output growth continues and the share of value added taken by the operating surplus rises on the back of the Competitiveness Pact. The improvement in profitability also enables corporate growth and, hence, fosters employment (See 'Profitable companies generate employment and pay higher wages').

Chart 6.



Foreign trade: Exports firming up, current account remains in deficit

Finnish exports are projected to return to a pronounced growth path, after several years of weak performance. Over the years 2017–2019, exports will increase at an average rate of a full 3%, with strengthening external demand and improvements in cost-competitiveness. Finnish exports will be underpinned by the growth in the export markets and the pick-up in euro area investment.

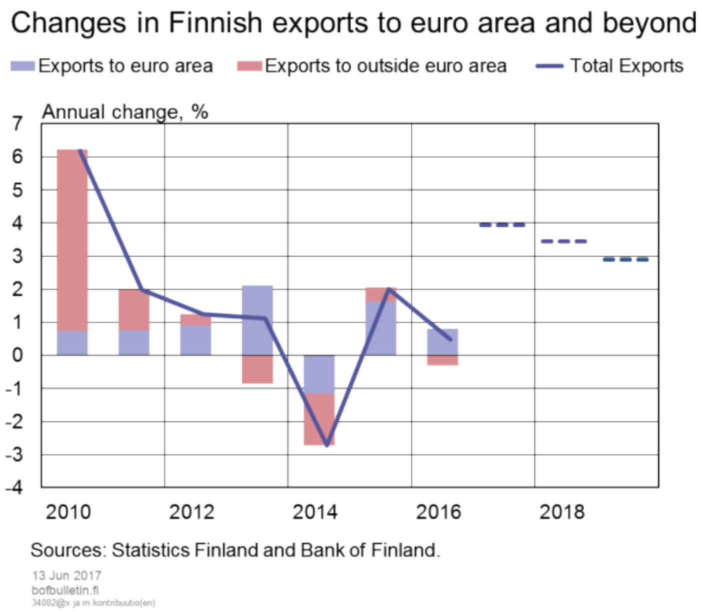
Finnish exports have long been struggling. Export growth has been modest, and loss of export markets considerable. While the export markets have expanded by 17% since 2008, Finnish exports still remain 12% below 2008 levels (Chart 7). The volume of Finnish exports grew in 2016 by only ½%. Goods exports increased slightly, while services exports remained practically unchanged from the year before. Especially non-euro area exports – including to Russia – remained subdued. By contrast, exports to the euro area have grown, with the euro area having gained in importance for Finnish exports in recent years (Chart 8).

Chart 7.

There is a notable turnaround in export performance currently underway. The rate of export growth will climb close to 4% in 2017, falling back to around 3% in 2018 and 2019. In 2019, export volume will amount to EUR 8 million, up by around 10% from 2016. Exports are underpinned by stronger export market performance and a shift in the structure of export demand favourable to Finnish exports. Finnish exports are also currently driven by a slower rise in export prices compared with competitor countries. Moreover, Russia's economic situation is expected to gradually improve.

The accommodative monetary policy will sustain a rebound in investment in the euro area, thereby buttressing Finnish exports. In the euro area, the capacity utilisation rate has already risen steadily above its long-term average and investment growth is expected to continue. Domestic investment, in turn, will stimulate export capacity and export growth prospects in the immediate years ahead.

Chart 8.



The contribution of net exports to economic growth will strengthen over the forecast horizon 2017–2019. Rising domestic demand will sustain imports, but due to moderate domestic cost developments, a proportion of imports will be replaced by domestic production.

The revival in exports notwithstanding, export growth will be more sluggish than normal in the forecast period (Chart 9). In 1996–2014, the rate of export growth averaged 4.7%. The slower-than-average increase in exports still reflects domestic cost and structural factors, such as weak productivity and a low level of competition on the domestic market. Finland continues to lose export market shares.[1]

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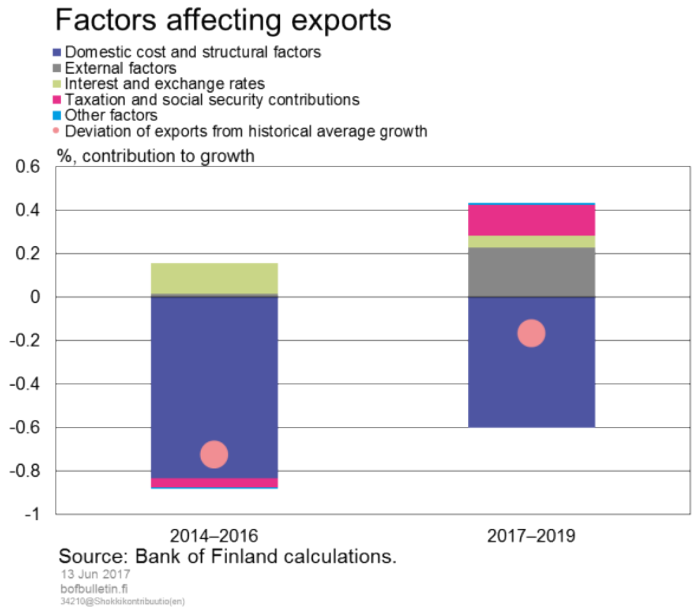
1. For a more detailed examination of changes in export market shares, see 'Finland struggling to defend its market share on rapidly expanding markets'. Bank of Finland Bulletin 3/2017.

Chart 9.

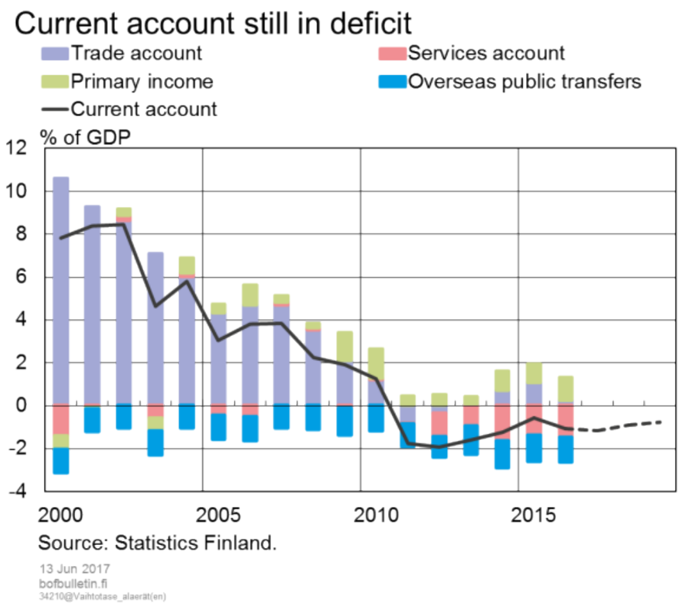


In 2016, the current account deficit deepened further, to 1.1% of GDP. The deficit of a little over EUR 2 billion accrued from trade in services and public transfers paid abroad. The balance on goods and services posted a deficit of nearly EUR 2.7 billion, with domestic demand sustaining imports and the terms of trade deteriorating upon a reversal of the decline in oil and other commodity prices. The primary income account, which includes earnings and capital income from abroad, posted a surplus, as in previous years.

Export and, notably, import prices are posting brisk growth in 2017. Towards the end of the forecast horizon, the rate of increase in foreign trade prices will taper off, mirroring developments in oil prices and other world market prices.

The terms of trade will deteriorate as the Competitiveness Pact subdues the increase in export prices. This will erode part of the increase in the value of exports. At the same time, domestic demand will improve, fuelling rapid import growth. On the back of these factors, the current account will remain in deficit also in 2017–2019 (Chart 10). The current account deficit relative to GDP will continue to hover around 1%.

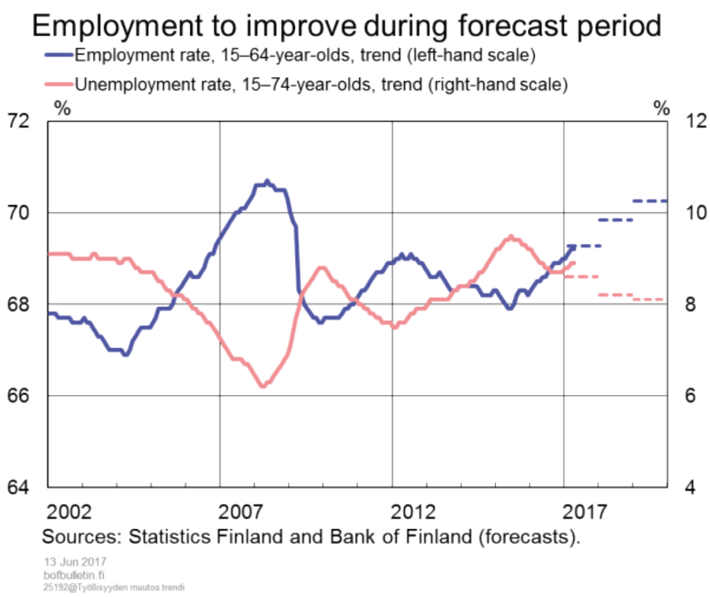
Chart 10.



Labour market: Improvements in employment slowed by mismatch problems

The strengthening of the Finnish economy has been reflected as improvements in employment. The employment situation is expected to improve further, driven by the cyclical trend, but employment growth will be restricted by frictions associated with recruitment and constraints on labour supply. According to the forecast, the number of employed will increase by some 1.7% in 2017–2019, while the employment rate will rise to 70.3%. The unemployment rate will remain close to 8.1% in 2019. The labour force (15–74-year-olds) will grow slightly in the forecast period (Chart 11).

Chart 11.

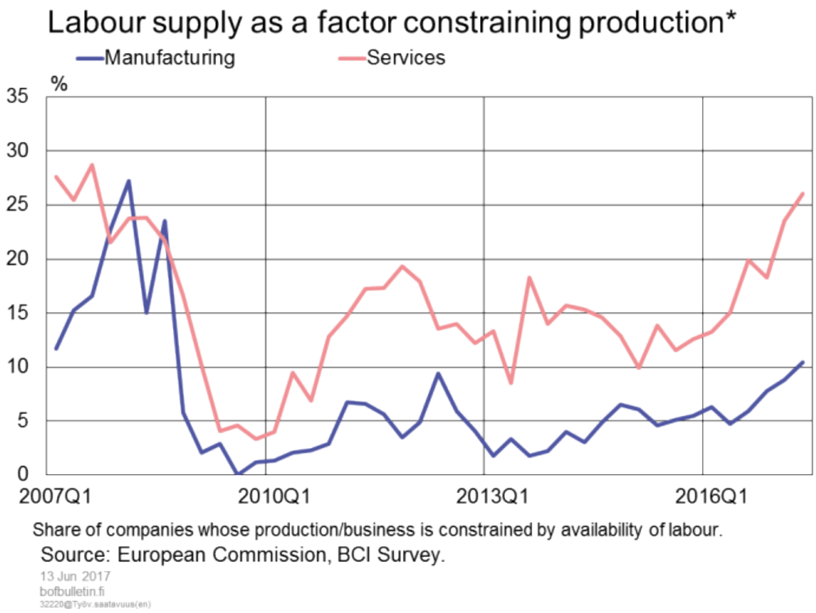


Positive developments in employment have thus far been based on growth in labour-intensive industries, such as construction and services. During the forecast period 2017–2019, the composition of economic growth will change. The emphasis will shift to less labour-intensive sectors, as the share of exports in aggregate demand increases. Economic resources are increasingly being allocated to manufacturing and the private sector, where productivity growth is higher than in services and the public sector. The higher productivity will generate additional revenue in the economy and also gradually boost employment.

Improvements in employment are being slowed by mismatch problems on the labour market. The shortage of suitable employees will become an increasingly significant challenge for companies, as the more easily employed persons have already landed a job (Chart 12). In addition to mismatch problems between professions, the decline in unemployment is slowed by low regional mobility and weak incentives to accept work.

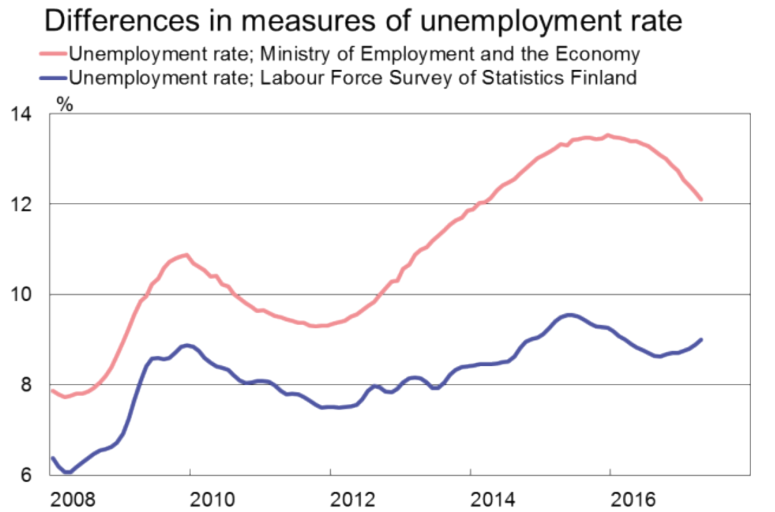
For many, very long spells of unemployment have an effect on their likelihood of finding employment. Active job-seeking may decrease as unemployment becomes protracted, and skills may erode. In addition, employers may be reluctant to employ applicants who have been unemployed for a long time, even when their characteristics are not actually different from persons with shorter spells of unemployment (See article 'Estimation of structural unemployment important, but complicated').

Chart 12.



In recent months, improvements in employment have been reflected as a rapid decrease in unemployment as measured by the Ministry of Employment and the Economy and including all unemployed persons who receive unemployment benefits. In addition, the recent rapid decline in unemployment according to this measure is due to the introduction of interviews conducted at fixed intervals, as a result of which some of the persons who have actually already found work have been sifted out of the unemployment statistics. In contrast, unemployment as measured by the Labour Force Survey of Statistics Finland and including only those unemployed persons who are actively seeking work has increased slightly. This may be an indication of an increase in the number of unemployed who had given up job-seeking but have now returned to the labour market (Chart 13). The number of hidden unemployed outside the labour force has, in fact, decreased in recent months.

Chart 13.



Seasonally adjusted figures.
Sources: Statistics Finland, Ministry of Employment and the Economy, Bank of Finland (seasonal adjustment).
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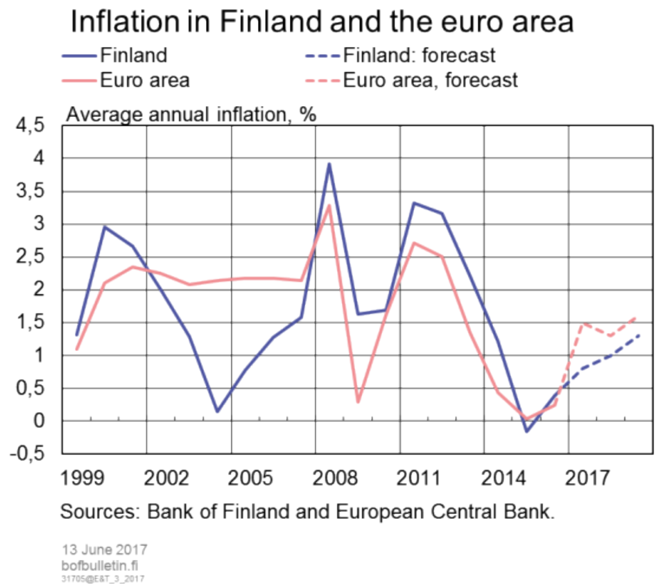
Population ageing will constrain labour supply, which will increase the challenges related to employment growth. Demographic change will weigh on the participation rate and slow expansion of both the labour force and the number of employed in the forecast years. Improvements in the participation rate by age cohorts will, however, continue and will compensate the decrease in the working-age population; accordingly, the labour force will not contract.

Wages and prices: Moderate rise in wages and prices

Inflation will pick up slightly in 2017, but will remain slow until the end of the forecast horizon 2017–2019. Inflation according to the harmonised index of consumer prices (HICP inflation) will accelerate to 0.8%, driven by energy prices. Inflation will rise to 1% in 2018 and 1.3% in 2019.

Chart 14.

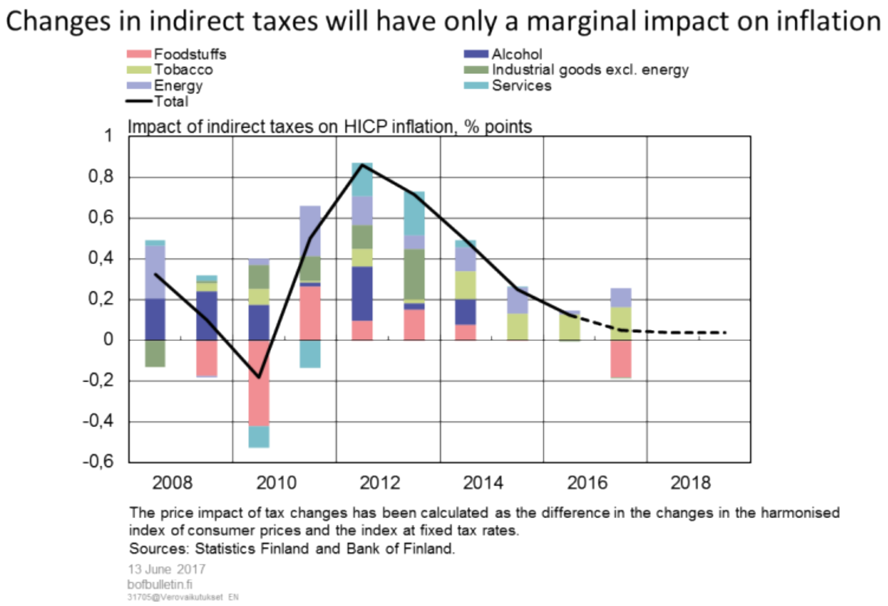


The recovery in the prices of crude oil and other commodities has fuelled inflation in early 2017. The effect of these components will, however, be temporary. The upward trend in services prices slowed in early 2017 and will remain more subdued during the forecast period. The impact of the hikes in customer fees on social and welfare services will be smaller in 2017 than in the previous year. Moderate pay agreements and the Competitiveness Pact will also slow the upward trend in services prices.

Although the moderate growth in labour costs will rein in upward pressures on consumer prices, greater aggregate demand and higher import prices will boost inflation slightly. Towards the end of the forecast period, inflation will accelerate slightly, due to a gradual rise in import prices and wages. Inflation in Finland is slower than in the other euro area countries, and thus the high level of prices in Finland will just slowly approach the average level in the euro area.

The impact on the HICP of changes in indirect taxes will be close to zero in 2017. The effects of the increase in excise duties on tobacco products and fuel and of the removal of taxes on sweets will more or less offset each other (Chart 15).

Chart 15.

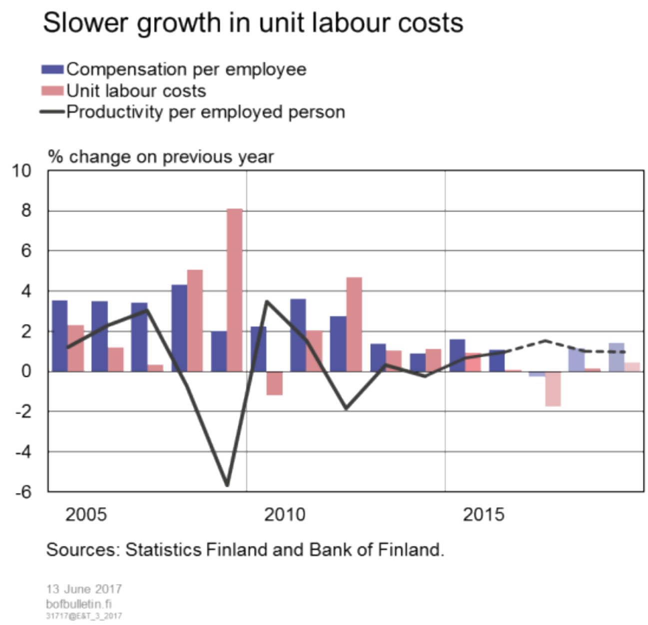


The Competitiveness Pact will slow the rise in wage and salary earnings in 2017. Nominal earnings according to the index of wage and salary earnings will grow by 0.7% in 2017, which is almost entirely due to wage drift as negotiated pay rises will remain at zero. Growth in real earnings will also remain close to zero, due to the pick-up in consumer price inflation. In the forecast period, earnings growth is expected to be slightly higher than envisaged in the Bank of Finland forecast in March, as both economic growth and productivity growth will pick up. In 2018 earnings will grow by 1.5%, and in 2019 by 1.8%, according to the index of wage and salary earnings. Negotiated wage increases will be on average 1% in both 2018 and 2019, and the extent of wage drift will remain unchanged from previous years.

Improvements in employment will support the growth in the wage bill during the forecast period. Wage bill-based average earnings will rise at a slightly higher pace than the index of wage and salary earnings, because in a cyclical upswing that has gained momentum total hours worked increase more rapidly than the number of employed. The increase in hours worked is only partly reflected in the wage bill, as part of it is the result of unpaid longer working hours in accordance with the Competitiveness Pact.

Compensation per employee will decrease in 2017, due to significant cuts in employers' social security contributions. The lower cost of labour will support Finland's cost-competitiveness. Unit labour costs will decrease significantly in 2017, reflecting lower labour costs and higher productivity growth. Productivity growth will remain close to 1% in 2018–2019, and at the same time, labour costs will begin to grow again. Unit labour costs will thus begin to increase moderately in 2018–2019 (Chart 16).

Chart 16.



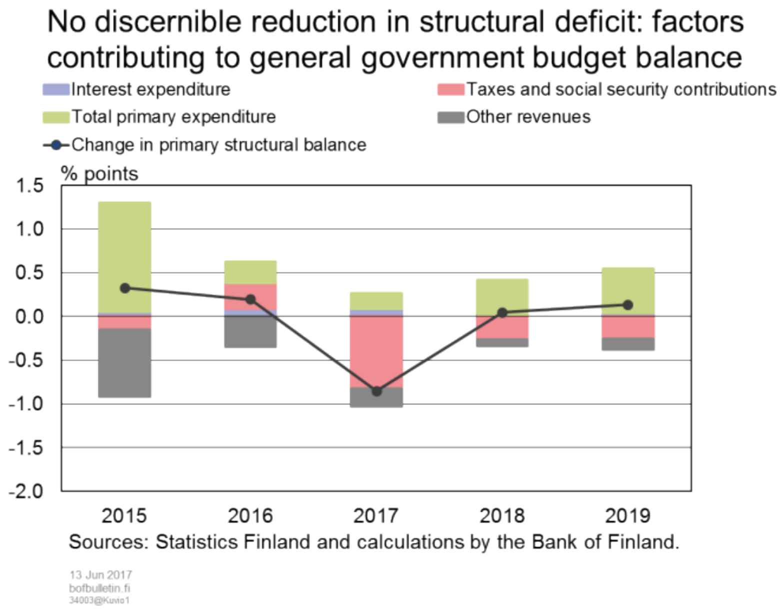
Public finances: Public finances in structural deficit

The improvement in cyclical conditions will not be sufficient to bring about a material correction in the general government financial balance. Fiscal policy will ease in 2017 as a result of the cuts in taxes and social security contributions decided in connection with the Competitiveness Pact. In the latter forecast years 2018–2019, fiscal policy will tighten again, but this will not be sufficient to correct the structural deficit in the public finances.

Public expenditure relative to GDP will decrease during the forecast years 2017–2019. The volume of public consumption will contract slightly in the forecast period, on the back of the Government's savings measures and lower labour costs, the latter stemming from the Competitiveness Pact and the contraction in public sector employment. A decline in the number of asylum seekers coming to Finland will also reduce public expenditure. On the other hand, temporary key government projects will still fuel public consumption in 2017–2018. The action plan to reduce the maintenance backlog of transport infrastructure will continue to fuel public investment both this year and next.

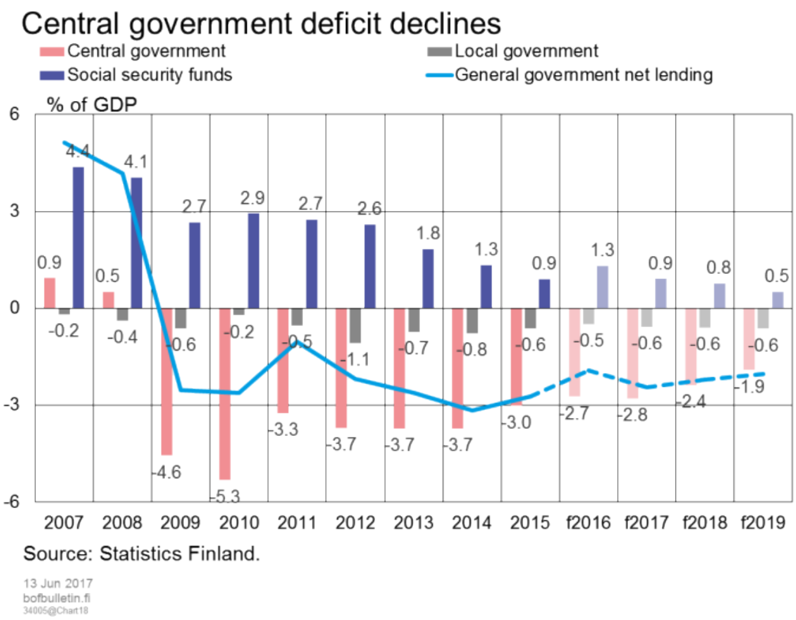
The total tax ratio will fall by almost 1 percentage point, to stand at 43.2% in 2017. The decline will continue in 2018–2019, but at a slower pace. The cuts in taxes and employers' social security contributions agreed in the Competitiveness Pact will directly weaken the general government budget balance. This is due to the fact that the savings generated by lower employers' contributions and the temporary reduction in public sector holiday bonuses fall short of funding the gap from cuts in taxes and social security contributions. Therefore, measured in terms of the structural primary balance, fiscal policy will ease in 2017 (Chart 17). In 2018, fiscal policy will be neutral, but in 2019 it will tighten noticeably, when the funding for key government projects runs out.

Chart 17.



Growth in central government tax revenues will remain slow in 2017 on account of the reduction in income tax. However, higher private consumption will support growth in indirect taxes. Central government consumption expenditure will fall in 2017, due to e.g. lower compensation for employees and immigration-related costs. The central government deficit as recorded in the National Accounts will grow to 2.8% in 2017, but will decline in the next few years, to below 2% in 2019 (Chart 18).

Chart 18.



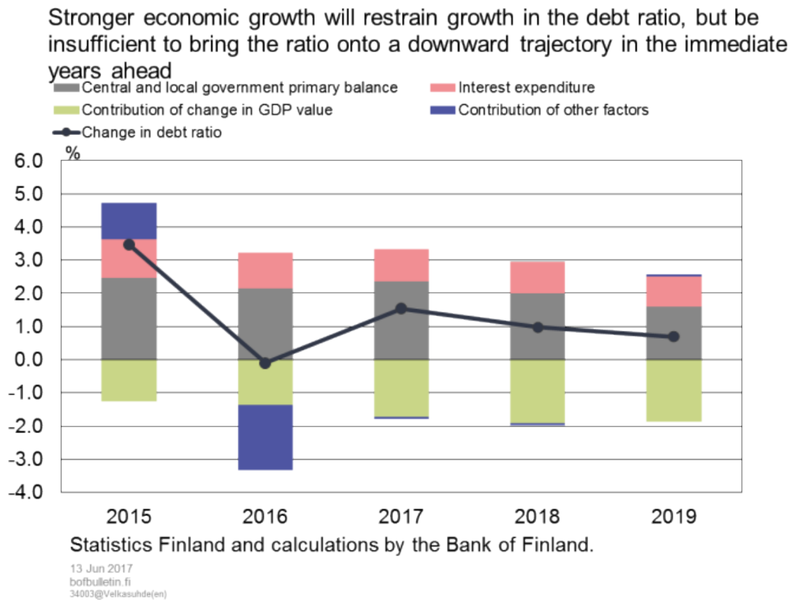
The local government deficit will remain unchanged at around 0.6% of GDP. The Competitiveness Pact and public sector savings will rein in spending by municipalities and joint municipal authorities, but at the same time municipal tax revenues will also decline. The changes in revenues and expenditure will be largely compensated by central government transfers to local government. These transfers will fall overall in 2017. The social and health care reform to be launched towards the end of the forecast period will transfer responsibility for the organisation of these services away from municipalities. At present, the organisation of these services accounts roughly for about half of municipal expenditure. This forecast does not yet include an assessment of the effects of the regional government reform on the local government financial balance, nor does it take into account any related short-term costs that are yet to be specified.

Pension expenditure will continue to grow during the forecast period in step with a further increase in the number of pension recipients. Pension insurance contributions will be raised in 2017 in accordance with the agreed pension reform, while the financial burden will increasingly be shifted towards the insured. However, low interest rates will push down growth in the asset income of earnings-related pension funds, and the surplus on the funds relative to GDP will erode.

The budget balance of other social security funds will remain slightly positive in 2017–2019. Benefits paid by the Social Insurance Institution will decline in 2017, since the national pension index will be cut by 0.85% from the level of 2016. The level of the index has been frozen for 2018–2019. Expenditure on unemployment benefits begun to shrink in 2016, and the trend will continue also during the forecast years. The social security funds will also be strengthened by, for example, the cuts in the maximum duration and the supplementary parts of paid unemployment allowances as well as the extension of waiting periods.

Public debt will continue to grow. Even though interest expenditure on public debt will decrease relative to GDP, the continued central and local government deficits will fuel growth in the debt-to-GDP ratio throughout the forecast period. Consequently, the debt ratio will grow to 66.8% of GDP in 2019 (Chart 19). The strengthening of economic growth will restrain growth in the debt ratio, but will not be sufficient to bring the debt ratio onto a downward trajectory in the forecast years.

Chart 19.



Risk assessment: Risks to economic developments balanced

Through the forecast years 2017–2019, Finnish economic growth will be more broadly based than heretofore. As growth will no longer hinge solely on domestic demand, and global cyclical conditions have improved, the risks to economic developments are balanced overall. In the short term, risks to the economy are on the upside, because both export demand and investment growth may turn out to be stronger than expected. Towards the end of the forecast period, however, there is an increasing risk that the export market cycle will mature.

Political uncertainty will continue, perpetuating the risks to global economic developments. The impact of Brexit on economic growth in the United Kingdom and the euro area have so far remained modest. However, if the exit negotiations turn out to be longer and more difficult than anticipated, the impacts on trade, investments and corporate confidence in EU countries may be more negative than expected.

Economic growth in the euro area has got off to a good start, but the banking sector is still vulnerable in some respects. In particular, the large volume of banks' nonperforming loans in many euro area countries poses a significant problem.

The aspirations of the new US administration related to infrastructure investments, tax reforms and deregulation may fuel the country's economic growth more than expected in the short term. At the same time, however, developments in the USA have increased the probability of protectionist measures, and such a move would slow global economic growth.

Economic growth in China is expected to slow in a controlled manner, to about 5% per annum during the forecast years. Nevertheless, the risks to the Chinese economy continue to be tilted on the downside. In particular, the Chinese economy is increasingly exposed to financial market disruptions, as the protracted debt accumulation has increased the vulnerability of the Chinese financial sector.

Global economic developments are also subject to upside risks. Growth in the global economy and world trade may turn out to be stronger and more protracted than anticipated, which would push up Finnish exports. Since the Finnish export structure is focused on capital and intermediate goods, it would be particularly advantageous for Finnish export developments if investments in the advanced economies continue to recover. In fact, there is increasing upwards pressure on investment because investment rates in the advanced economies have long been low. This has eroded the capital stock in these countries.

The cost-competitiveness of Finnish exports is expected to improve further during the forecast period, with the level of earnings growing faster in the competitor countries than in Finland. The improvement in competitiveness in 2017 is explained by the Competitiveness Pact signed in 2016 and the fact that, in the competitor countries, the economic upturn occurred at an earlier phase than in Finland. After the current wage settlement period extending from 2017 to early 2018, wage and salary earners may require higher-than-anticipated wage increases as compensation for previous years' low pay rises. This has happened before. The risk is even greater, the looser the coordination of future wage negotiations turns out to be.

The Finnish financial system is stable. The capital adequacy and profitability of banks operating in Finland is good, but the concentration of the Nordic banking sector, its large size and strong interlinkages between banks amplify the risks of the Finnish banking sector, too.

Housing construction, which is highly cyclical in nature, will grow strongly, especially at the beginning of the forecast period. New housing starts typically decline rapidly if the demand for housing does not meet expectations. On the other hand, the demand for new housing is now more broadly based than before. In recent years, new housing demand has been mostly supported by strong investor demand, but with the economic recovery, new home sales to households have also picked up from the beginning of the year. The housing construction boom may turn out to be even stronger than expected.

The household savings ratio will remain negative through the forecast years 2017–2019. The level of household debt relative to disposable income is at a record high, and debt continues to accumulate. The number of heavily indebted households, in particular, has increased.

The risks to financial market stability stemming from household indebtedness are still small. However, high debt levels may intensify cyclical fluctuations, since heavily indebted households are prone to reduce consumption in the event of e.g. a higher unemployment risk or rapid rises in interest rates. These risks are discussed in more detail in the financial stability assessment (see Nordic interconnectedness and indebted households pose a risk to financial stability).