BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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BANK OF FINLAND FORECAST

Upswing more broadly based – Improved chances for balanced growth in Finland

11 JAN 2018 1:00 PM • BANK OF FINLAND BULLETIN 5/2017 • ECONOMIC OUTLOOK

Finland's economic growth is broadly based, exports are fuelling growth and at the same time domestic demand continues to be strong. According to the Bank of Finland forecast, Finland's GDP will grow 3.1% in 2017 and 2.5% in 2018. Over the years 2019–2020 the economy will grow approximately 1.5% per annum. Inflation will gather pace but throughout the forecast period will be slower than elsewhere in the euro area.

The key factors behind the upswing have been external factors such as the buoyant growth in Finland's trading partners and the accommodative monetary policy in the euro area. Although the upswing now seems much stronger and more broadly based than before, the current year's growth will be the most rapid in the forecast period 2017–2020. The pull from the international economy and the growth impact of monetary policy will ease somewhat and Finland's subdued long-term potential growth will slow actual growth towards the end of the forecast period. In the immediate years ahead, the forecast risks are, however, on the upside.

Finland's exports in the years 2017–2020 will gain from continued strong growth in the export markets and improvements in Finnish cost-competitiveness. The Finnish export sector stands to gain particularly from investment growth in the euro area. Excluding 2017, however, net exports' contribution to growth will be fairly marginal, as the Finnish export sector imports a lot of intermediate goods and strong domestic demand will also boost imports. Export growth will nevertheless bolster the current account, which will be almost in balance throughout the forecast period. This will help lay a foundation for sustainable growth.

Private consumption will grow on the back of the improved employment situation and consumers' enhanced purchasing power. Moreover, continued negative real interest rates and strong consumer confidence will encourage households to consume. The exceptionally accommodative monetary policy will hold interest rates low on corporate loans and hence support investment. Investment will grow strongly in the immediate years ahead, but this growth will slow as we approach 2020.

Finland's more export-driven growth will over the short term change the structure of growth. Productivity growth has clearly accelerated in 2016–2017 and will be supported in the immediate years ahead by growth in capital investment, which will improve output capacity and hence potential growth. Finland's economic growth in the forecast years will rely largely on productivity growth.

For its part, employment growth has so far been rather sluggish relative to the acceleration in economic activity. In 2017 and 2018 employment growth will accelerate as demand for labour increases, but mismatch problems, the change in population structure and other constraints on labour supply will slow employment growth towards the end of the forecast period.

The improved economic conditions have also brought an improvement in the public finances. The general government deficit will shrink to 1.1% of GDP in 2017 and 0.7% by 2020. The economy's overall tax burden will be reduced by 2.4 percentage points during the forecast period. The better economic situation will not, however, resolve the longer-term problems with the public finances. The fiscal policy stance during the forecast period is light relative to the economic situation. The sustainability gap in public finances will remain around 3%.

GDP: Exports boost Finnish economic growth

According to the Bank of Finland forecast, Finland's GDP will grow 3.1% in 2017. Exports are fuelling growth, while domestic demand also continues to be high, particularly investment demand. Growth will continue to be broadly based during the forecast period 2017–2020, but will gradually slow. The economy will grow 2.5% in 2018 and will continue to grow at a rate of about 1.5% in 2019 and 2020. GDP will not exceed the level of 2008 until 2018. GDP growth in the forecast period as a whole will total 8.6% in Finland, against 8.3% for the euro area.

Table 1.

Forecast summary				
Percentage change on the previous year				
	2017f	2018f	2019f	2020f
GDP	3.1	2.5	1.6	1.4
Private consumption	1.9	1.8	1.3	1.2
Public consumption	0.5	0.7	0.1	0.4
Private fixed investment	11.2	5.8	3.2	2.5
Public fixed investment	–1.1	3.3	–0.5	1.2
Exports	8.4	3.8	3.5	3.0
Imports	2.2	3.4	2.9	2.7
Effect of demand components on growth				
Domestic demand	3.1	2.4	1.3	1.3
Net exports	2.2	0.2	0.2	0.1
Changes in inventories and statistical error	–2.2	0.0	0.0	0.0
Savings rate. households, %	–1.5	–1.6	–1.7	–1.7
Current account, % of GDP	0.0	0.0	0.0	0.2
Labour market				
Number of hours worked	0.5	1.1	0.7	0.5
Number of employed	0.8	0.8	0.5	0.4
Unemployment rate, %	8.6	8.2	7.9	7.6
Unit labour costs	–2.8	–0.4	1.0	1.7
Labour compensation per employee	–0.6	1.3	2.0	2.8
Productivity	2.3	1.8	1.1	1.1
GDP, price index	1.3	1.8	1.4	1.9
Private consumption, price index	0.8	1.2	1.5	1.5

f = forecast

Sources: Statistics Finland and Bank of Finland.

Forecast summary				
Harmonised index of consumer prices	0.8	1.1	1.4	1.5
Excl. energy	0.5	0.9	1.4	1.6
Energy	5.9	3.0	1.0	0.2
f = forecast				
Sources: Statistics Finland and Bank of Finland.				

Exports will speed up growth especially in 2017. The better-than-expected outlook for the global economy will boost Finnish exports, especially as a result of brisker investment in the euro area. The Competitiveness Pact will improve Finnish competitiveness, and higher capital investment will improve the growth outlook for exports even further. As imports are also increasing, however, the growth contribution of net exports will be relatively moderate after 2017.

At the same time, domestic demand will remain high (Chart 2). Private investment will grow steeply in 2017, but at a slower rate towards the end of the forecast period. Private consumption growth will also be brisk in 2017, but slower in 2018.

Chart 1.

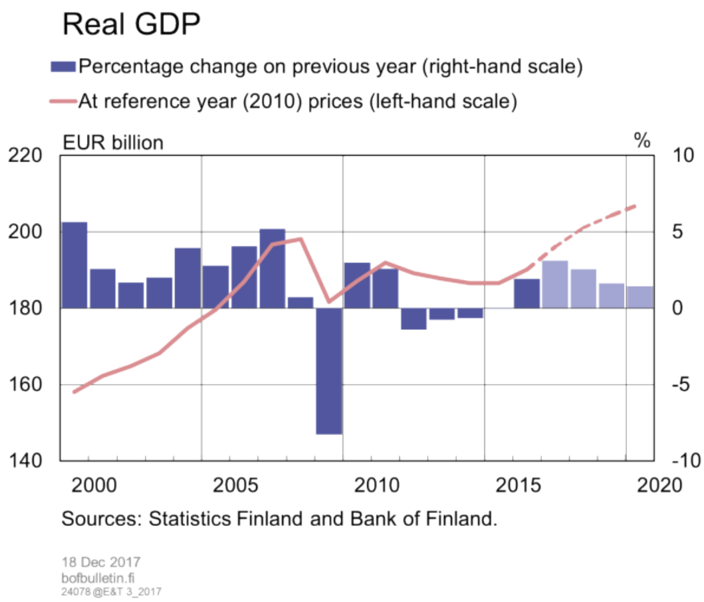
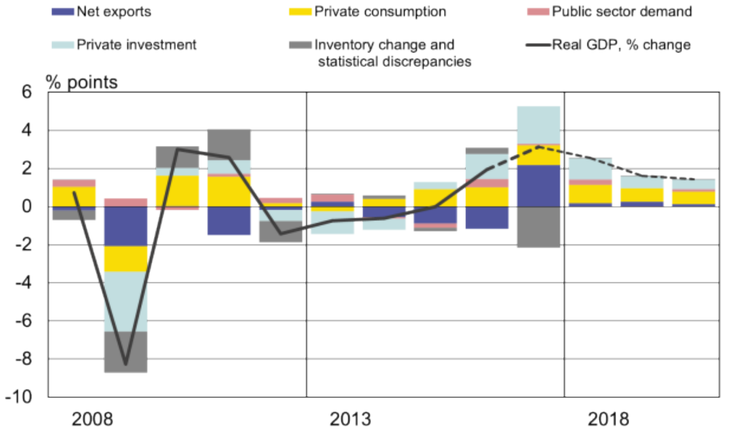


Chart 2.

Economic growth becomes more broadly based



The chart is merely indicative. The effect of each demand component on GDP growth has been calculated on the basis of its volume growth and its value share in the previous year. Figures for 2017–2020 are estimates.
Sources: Statistics Finland and Bank of Finland.
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The current account will be close to balance in the forecast period, which means that at the national level income covers expenses. The balance on goods and services is positive in the forecast period, and the current account will also benefit from the growth of capital income on Finnish companies' foreign investments as well as lower interest expenses.

Economic growth will arise in the forecast period more through growth in labour productivity than in labour input, reflected in relatively moderate growth in labour input. The improved economic situation has been reflected in a steep rise in investment. Along with investment, an increase in the capital base will improve the output potential of the economy in the long run.

The current forecast is based on Statistics Finland's quarterly national accounts (third quarter) published on 1 December 2017 and other available information.

Households: Growing indebtedness despite economic upswing

Private consumption will continue to contribute to economic growth, although the pace of growth in consumption is showing signs of abating. Positive developments in earnings growth and employment will boost households' purchasing power and sustain consumer confidence. Yet, despite improvements in purchasing power, household expenditure will continue to exceed disposable income. Therefore, the savings rate will remain negative and household indebtedness will continue to deepen.

The cyclical upswing in the economy will particularly strengthen households' purchasing power in 2018. Wage drift accounted for most of the pay increases seen in 2016 and 2017, but accelerating productivity and profitability growth have begun to increase corporate margins and room for wage growth. To this end, earnings growth will increase by 2.3% in 2018 and should remain at a similar level over the course of 2019 and 2020.

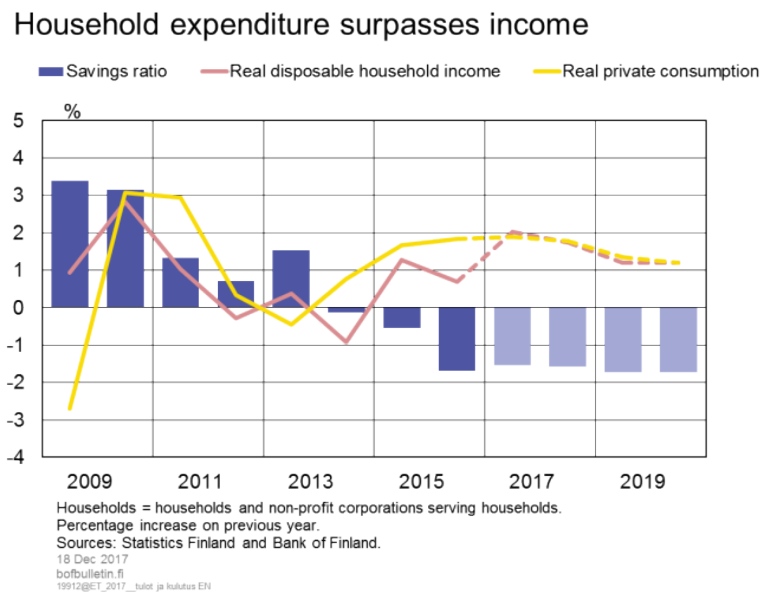
In addition to earnings growth, households' purchasing power will be bolstered by improvements in employment. In 2018, the number of employed persons will increase by approximately 1%, but the pace of increase will slow to around 0.5% in 2019 and 2020. Overall, real disposable income is set to grow by a full 2% in 2018 and a full 1% in both 2019 and 2020.

Consumption will not only be supported by increased purchasing power but also by strong consumer confidence. As economic growth picked up in early 2017 consumer sentiment reached its highest level since 2010.

Taxation of earned income will be eased by approximately EUR 300 million in 2018 to compensate for the Competitiveness Pact's changes to social security contributions. In addition, income taxation will be subject to normal adjustments for inflation in 2018 and 2019. The proposed tax cuts will only be enough to offset the effects of rising social security contributions and increased indirect taxation, as earnings-related pension contributions are set to grow by 0.2 percentage points and unemployment insurance contributions by 0.4 percentage points in 2018. Excise duties on tobacco and alcohol will also be increased.

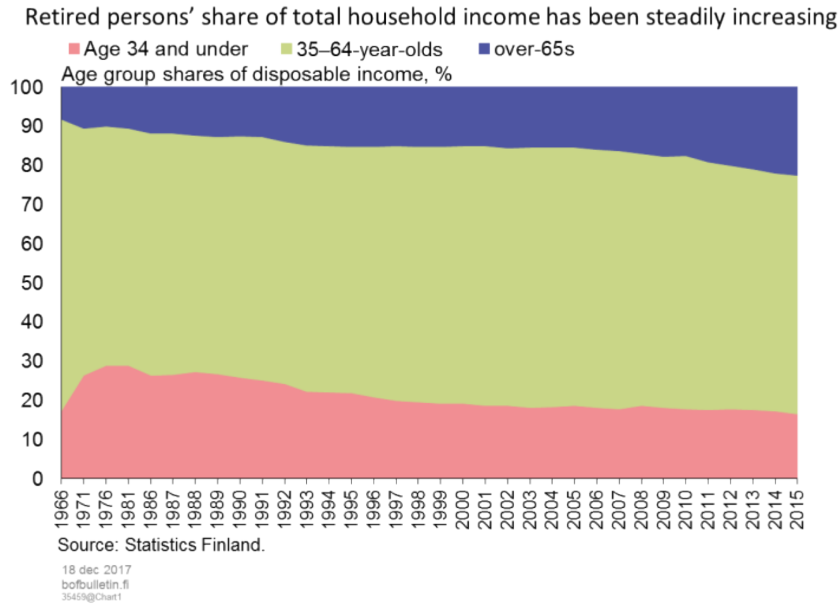
Private consumption will grow by almost 1.9 % in 2017, but the pace will slow to around 1.5% over the course of the forecast period as economic growth gradually fades. Despite improvements in real household incomes, the savings ratio will remain negative and households will continue to accumulate new debt (Chart 1). In mid-2017, household debt stood at almost 128% of income, and this is forecast to reach 129% in 2020.

Chart 3.



Population ageing offers a partial explanation for the low savings ratio. The share of retirement-age persons' income out of all disposable household income and households' financial assets has long been on the rise (Chart 4). Consequently, an increasingly large share of household income consists of pensions and other social benefits. Because pension payments are not directly impacted by cyclical changes to the economy, older people have less of an incentive for precautionary savings than younger people. At the same time, younger people face an increasingly large debt burden, and therefore their only really effective means of saving is through mortgage amortisation.

Kuvio 4.



The accommodative financing conditions have contributed to household indebtedness. The imputed margin on housing loans has narrowed and the most commonly used reference rate has continued to fall during 2017. In new housing loan agreements, the average interest rate currently stands at approximately 1.1%. Interest rates on household credit will remain low over the forecast period. This will be compounded by a gradual pickup in inflation, resulting in even lower real interest rates.

However; despite low interest rates and the economic recovery, the increase in demand for new housing loans will be relatively modest compared with the period leading up to the recession. Moreover, the growth rate of Finland's housing loan stock is quite restrained compared with the rest of the euro area. In early 2017, the housing loan stock increased by approximately 2% in Finland, whereas Sweden and Germany saw figures of well over 7% and just below 4%, respectively. An increase in demand for non-mortgage-related loans also helps explain the mounting household debt. Consumer credit has increased, while the stock of student loans has risen in response to the higher ceiling on government guaranteed loans. Nevertheless, these forms of credit still account for a relatively small share of household debt.

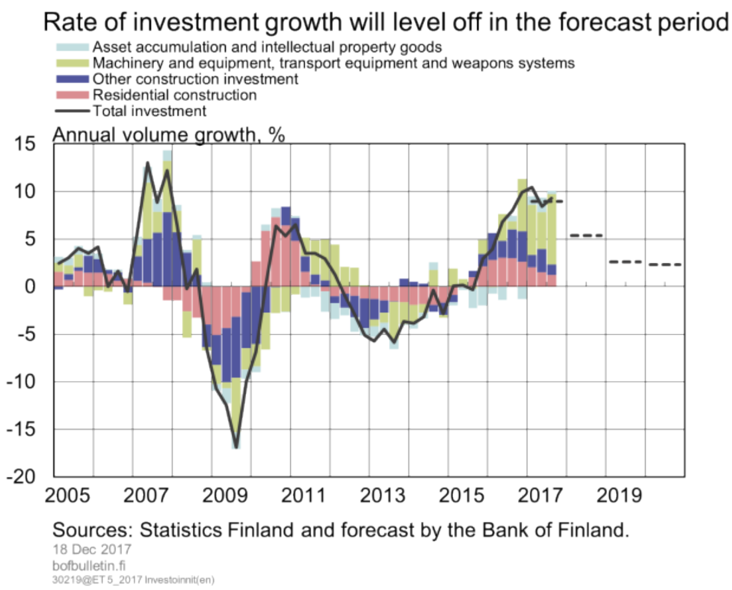
Despite their growing debt burden, households still hold considerable wealth. The most recent data on household wealth were collected in 2013, when the median household in Finland enjoyed a net worth of EUR 110,000 – a 5% increase from 2009. It is important to remember, however, that approximately 70% of household wealth is owned in the property market, and most of this wealth is owned by households who are relatively debt-free and advanced in age. As a result, financial assets only provide households with a limited buffer against economic shocks.

Non-financial corporations: Business confidence remains strong

Favourable cyclical conditions have boosted industrial capacity utilisation rates and spurred corporations to invest. The profitability of non-financial corporations has improved. Among the sectors, industrial production, in particular, has enjoyed rapid growth during the course of 2017. The effects of the cyclical upswing have already for some time been evident in the services and construction sectors.

Investment across the economy as a whole increased by 7% in 2016 and maintained robust growth well into 2017 (Chart 5). In 2017, the average quarterly growth rate for investment has been almost 2%, and annual growth is projected to reach 9%. Corporate sector fixed investment has increased strongly. By sector, services saw the greatest increase in 2016, at 8%. Investment growth in industry was comparatively modest at 5%, but the sector's internal investment questionnaire suggests that the figure for 2017 should reach 12%.

Chart 5.



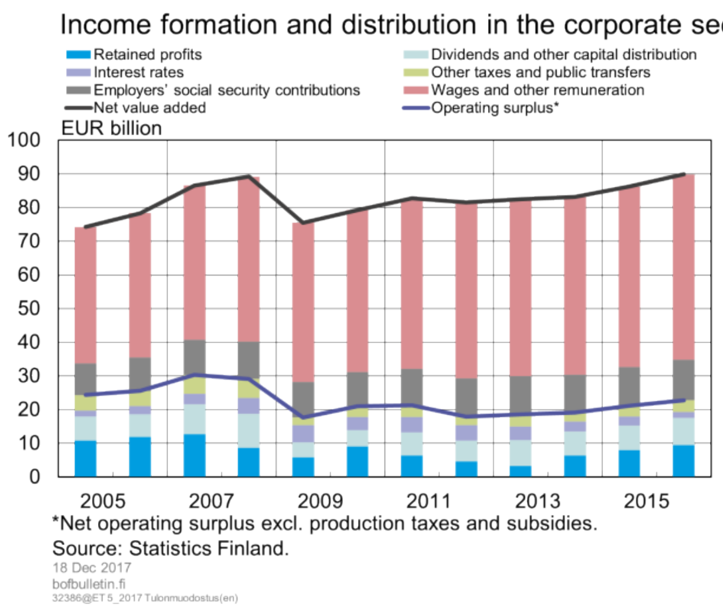
The number of building permits issued and construction projects commenced have increased strongly since 2015. This trend continued into early 2017 and will be reflected in the amount of new-build construction completed during the year. Annual average growth in completed construction, measured in metric cubes, trended at 13% over January –September. The growth in issued building permits is, however, beginning to flatten out, suggesting that the cyclical tailwinds driving construction are slowing. This is despite the fact that construction activity has not returned to the heights seen on average in 2000–2008.

Corporate confidence in the economy remains strong. In services and trade, confidence has continued to rise since early 2016 and has in 2017 reached the height not seen since before the recession. Industrial confidence and output expectations have substantially improved in 2017.

Corporate sector profitability, measured in operating surplus, has also increased (Chart 6). In the national accounts, operating surplus is equivalent to the operating profits reported in a firm's financial statements. Operating surpluses have grown by 5% per annum on average in 2013–2016. When viewed against other areas of the economy, the corporate sector has remained a net creditor ever since the turn of the millennium and has continued to strengthen this position in 2017. Over 2017–2020, corporate sector profitability will remain good on the back of rapid productivity growth.

Corporate sector financing conditions have remained favourable and have helped spur investment. The average rate of interest on the corporate loan stock currently stands at 1.4%, below the euro area average. Lending margins are contracting slightly. In 2017, the corporate sector loan stock has grown at an annual average rate of 3.5%.

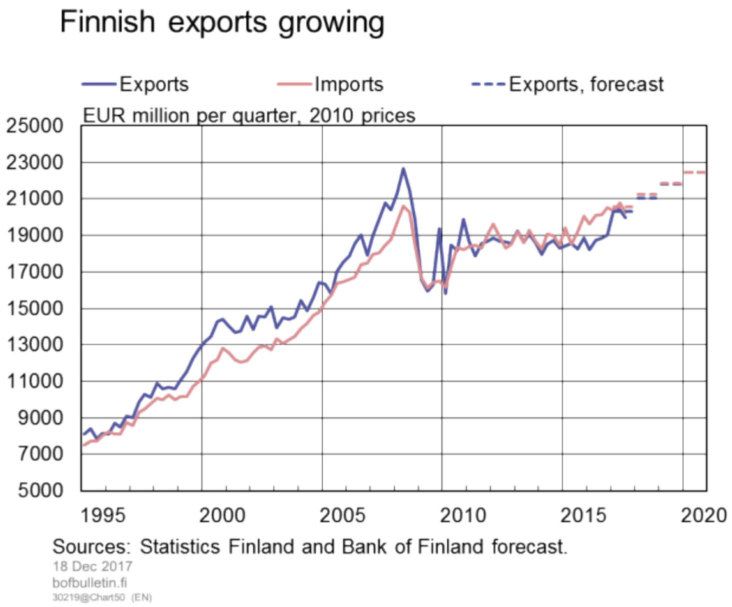
Chart 6.



Foreign trade: Finland's current account to enter balance

Finland has been able to partake in the strong growth of global export markets with a marked turnaround in the performance of exports. In 2017, the volume of exports will increase by up to 8.4%, on the back of global economic growth and improved cost-competitiveness. Growth will peak towards the beginning of the forecast period, but is projected to slow to 3.0% in 2020. (Chart 7)

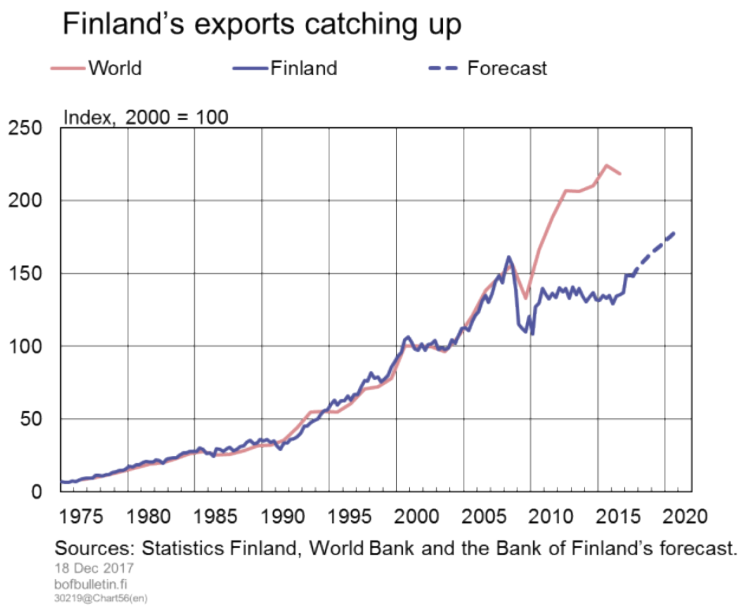
Chart 7.



Exports have increased to almost all of Finland’s key trading partners, and the volume of goods exported to the fifteen largest of these increased in 2017. The growth of goods exports was fastest within the euro area, but exports to China and Russia have also grown briskly (see article ‘Finland's cyclical expansion bolstered by investment and export growth’). Increased capacity utilisation in the euro area has driven demand for capital goods exports. Eastern trade will pick up in response to the recovery in the Russian economy, but will not reach the peak levels of previous years. Of the industrial sectors, export growth has been the most rapid in vehicle manufacturing but has also been strong in the forest and metal industries.

Finland's export values will catch up with developments in the rest of the world during the forecast period. In the decades prior to the financial crisis, Finland's export growth closely followed that of the sum total of other countries. After the financial crisis, Finland began to significantly underperform relative to the overall development of export markets. This trend will reverse during the forecast period. (Chart 8)

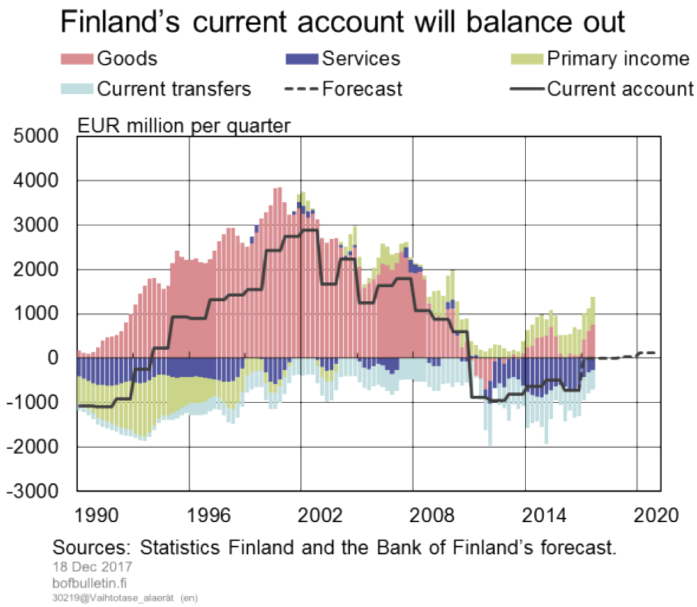
Chart 8.



Imports will be driven by private consumption as well as increased demand for commodities and capital goods. Export growth will slow down somewhat in the forecast period as cyclical conditions mature and investment growth slows. In 2017, import growth will only reach 2.2% but is expected to pick as export growth also accelerates. Import growth will fall beneath export growth during the forecast period. The contribution to economic growth from net exports will peak in 2017–2018.

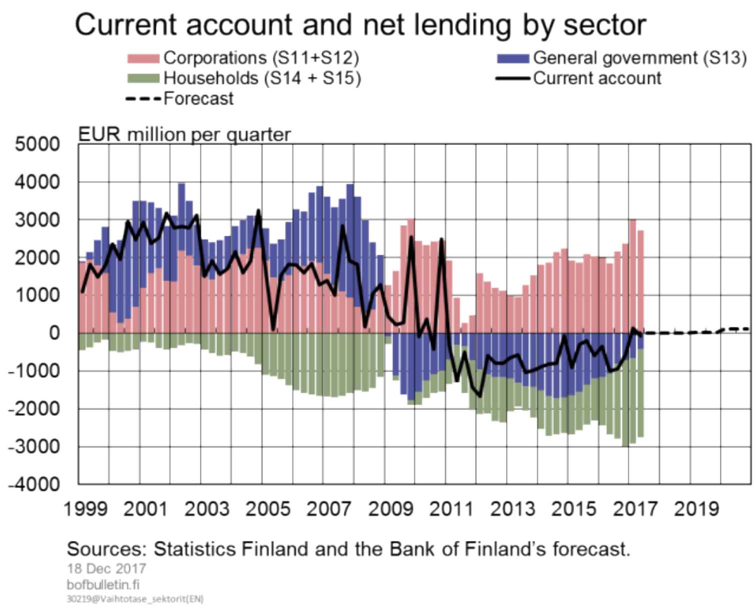
The current account will balance out in 2017 when the trade surplus on goods increases and the services deficit contracts. The current account will improve, although the terms of trade are expected to deteriorate slightly in 2017, as the Competiveness Pact will restrain growth in export prices. Imports and exports will see similar price developments towards the end of the forecast period. The current account will also be boosted by growing capital gains on foreign assets and a reduction in interest payments on government debt. A balanced current account means that the national economy's income covers its expenses. (Chart 9)

Chart 9.



As the current account reaches equilibrium, the amount of external sovereign net debt decreases. Finland has been a net borrower during early 2011–2017. Despite the improved external balance, Finland's domestic sectors are still imbalanced regarding borrowing and lending. The amount of net lending in the non-financial corporate and financial sectors has increased while the public sector's net borrowing has been reduced, but the household sector's deficit has grown. (Chart 10)

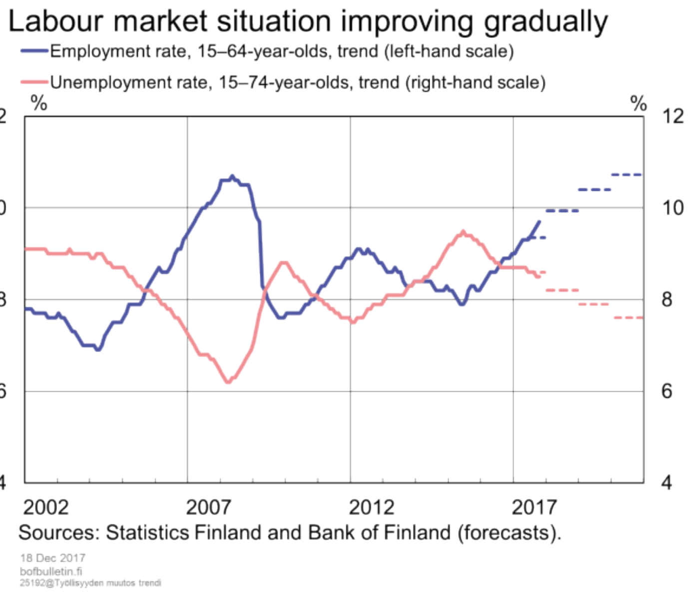
Chart 10.



Labour market: Labour market recovering slowly

The upswing in the Finnish economy has so far only manifested as a relatively moderate improvement in employment and reduction in unemployment. An acceleration of growth in 2017 and 2018 will also improve the employment situation, but towards the end of the forecast period the employment growth rate will slow again. Labour demand is high thanks to the cyclical conditions, but employment growth is impeded by recruiting frictions and labour supply restrictions. The number of persons employed is forecast to increase by a total of about 2.4% in 2017–2020, with the employment rate rising to 70.7%. The unemployment rate will be about 7.6% in 2020. The labour force (people aged 15–74) will increase somewhat.

Chart 11.



The employment rate has so far improved only moderately considering the cyclical conditions. Part of the reason for this may be that the employment rate never weakened that much in proportion to the sharp fall in GDP during the recession following the financial crisis. In the years since the crisis, downward nominal wage rigidity – and in low-inflation conditions especially downward real wage rigidity –during weak cyclical conditions undermined Finnish companies' profitability and competitiveness and hence also the creation of new jobs.[1] The profitability and competitiveness gap that opened up during the early years of the recession is only just beginning to close during the forecast period as a result of the Competitiveness Pact that entered into force in 2017.

The better economic situation in recent months has improved corporate profitability and strongly boosted investment, while employment growth has so far been more moderate. However, employment growth typically follows higher economic activity with a lag, so a

1. See, for example, Obstbaum, M. and Vanhala, J. (2016) *Paikallinen sopiminen, Kansantaloudellinen aikakauskirja 2016; (2): 129–153 (Available only in Finnish.),* and Nurmi, S, Vanhala, J. and Virén, M. (2017) *Profitable firms generate employment and pay higher wages, Bank of Finland Bulletin 3/2017: Economic Outlook, 29.6.2017.*

higher rate of growth in 2017 and 2018 will improve the employment figures. In addition, investment will also increase companies' production potential, creating better conditions for more job creation in the future. The trend in wages and total factor productivity in the coming years will play an important role in the number of new jobs that will be generated in the future.

On the other hand, the moderate developments may also reflect the ongoing restructuring of the economy, with production requiring a smaller labour input than previously. Faster growth in the coming years indicates the end of the prolonged poor spell, particularly in industry. Yet industrial jobs have barely increased despite the economic upswing (Chart 12). The structural changes in the economy are also having an effect on the wholesale and retail trade sector, where the employment trend has been weak in recent years.

Thanks to the current cyclical situation, labour demand is very high, but several indicators suggest that labour market mismatch problems are set to increase (Chart 13). It is more and more difficult for companies to find people who have the right competence and are perhaps prepared to relocate, meaning that positions take longer to fill and people take longer to find a job. On the other hand, problems with labour supply and with incentives may lie behind what appear to be mismatch problems and the slow rise in the employment rate, for example high reservation wages. Incentives and labour market structures significantly influence the decisions of especially young people, women in childbearing age and older workers to participate in the labour market. (See the article 'The influence of age, gender and education on labour supply in Finland'.) According to many estimates, the Finnish labour market is already approaching the level of structural unemployment (see 'A new method to measure structural unemployment via labour market flows'), meaning that cyclical conditions cannot be expected to reduce the unemployment rate very quickly.

The reason why the unemployment rate has so far improved only slightly can be attributed to the only moderate improvement in the employment rate and a higher participation rate. As employment prospects improve, less people are leaving the labour market, while the number of people entering it has increased. The structure of unemployment has also changed slightly for the better, as the percentage of long-term unemployed has fallen somewhat.

Chart 12.

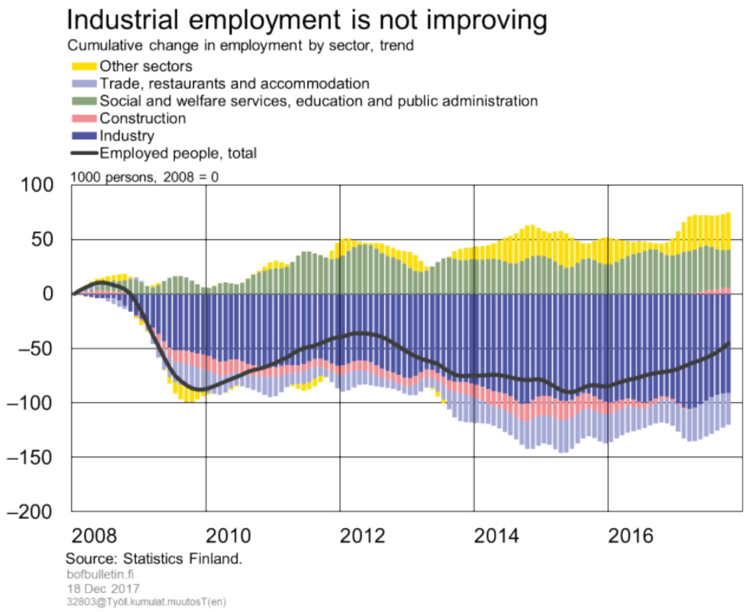
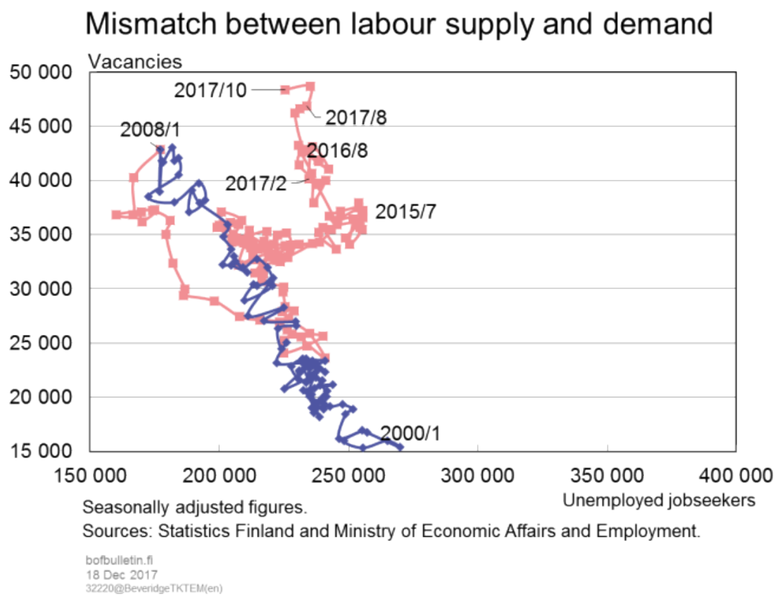


Chart 13.



Wages and prices: Prices rises still moderate

Inflation will accelerate slowly in 2017–2020 as economic growth picks up. Inflation according to the harmonised index of consumer prices (HICP inflation) will be 0.8% in 2017 and 1.1% in 2018. Towards the end of the forecast period, in 2020, consumer price inflation in Finland will still remain slower than in the euro area, reflecting moderate developments in costs in Finland. Inflation will still be sustained mainly by increases in services prices, and particularly by higher rents. Towards the end of the forecast period, growth in labour costs will exert an upward pressure on services prices. In addition, rises in the price of oil and other commodities will fuel the pace of increase in energy and food prices (Chart 14). Prices will also be pushed up somewhat by increases in indirect taxation. On the other hand, the strengthening of the euro will dampen the upward trend in the prices of imported goods.

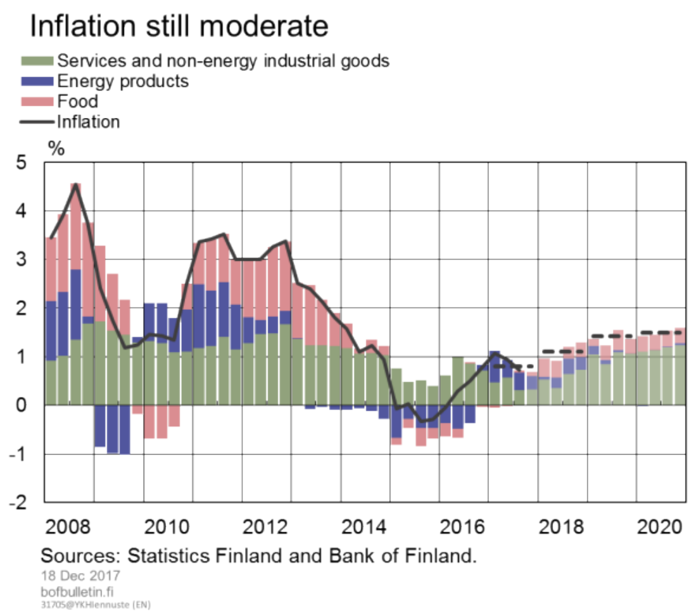
The upward trend in services prices will still be the most significant factor affecting consumer prices. The pace of increase in rents according to the consumer price index has moderated to 2%, which is slow by historical standards. However, the contribution to inflation of rents and housing services is only 0.2 percentage points. The upward trend in services prices will be fuelled also by increases in the prices of social and welfare services and prices charged by restaurants and cafes.

The prices of oil and other commodities have risen in the wake of the global economic upswing. The price of crude oil in US dollars has risen, but its impact on domestic prices has been dampened somewhat by the appreciation of the euro exchange rate. The price of crude oil per barrel has risen since summer 2017, from EUR 40 to EUR 55. The higher prices of crude oil will be reflected in the consumer prices of energy and food in the early part of the forecast period. Based on world market futures prices, the price of crude oil is expected to remain at its present level or even decrease slightly.

Food prices have decreased in recent years, as a result of price competition in retail trade. The upward trend in energy and commodity prices will be reflected in the producer prices of food and food prices will start rising. The increase in excise duties on alcohol will push up the consumer price index by some 0.1 of a percentage point.

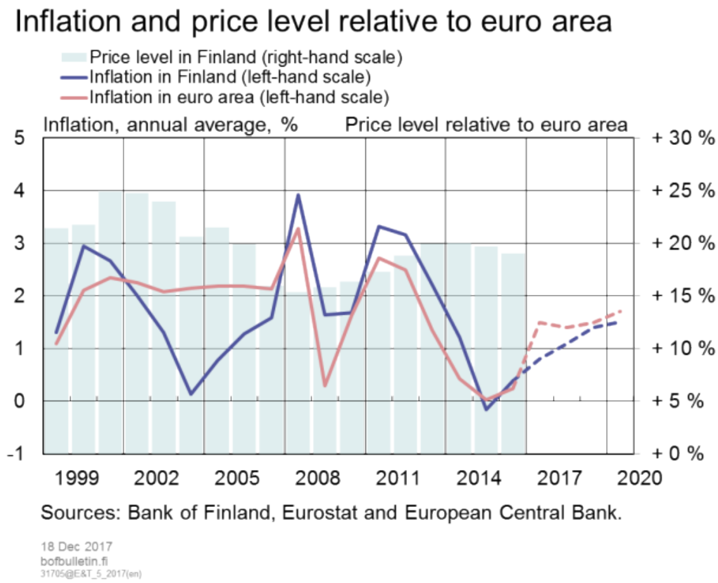
The prices of goods have declined for four consecutive years, and this trend will continue until 2020. Prices have been depressed particularly by the lower prices of household equipment and electronics, as well as cars.

Chart 14.



Overall, consumer price inflation in Finland will remain slower than the euro area average in the forecast period (Chart 15). Finland is thus narrowing the gap in price level with the rest of the euro area. In 2016, Finland was the third most expensive country in the euro area. Food, alcohol and clothing are relatively expensive in Finland. In contrast, prices of furniture, household equipment and electronics are fairly close to the euro area average. Below the euro area average are the prices of energy (approximately –24%) and communications services (–27%).

Chart 15.



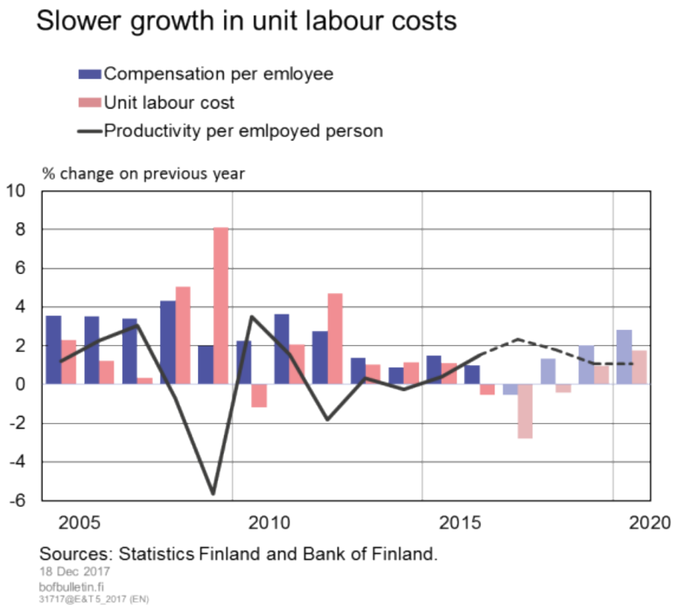
In 2017, earnings growth in Finland will depend largely on the Competitiveness Pact. However, the statistics provide a mixed picture of earnings growth. Growth in nominal earnings according to the index of wage and salary earnings will remain only slightly above zero, reflecting the zero-level rises in negotiated wages, and the cut in holiday bonuses in the public sector, which will reduce earnings by public sector employees. Growth in average earnings according to national accounts data is in 2017 significantly higher than growth in average earnings according to the index of wage and salary earnings. This is due to the fact that, according to national accounts statistics, the number of hours worked has increased very little relative to the strengthening of economic growth (Chart 16).

Statistical data on labour cost developments in the first half of 2017 also provide a partly mixed picture. Compensation per hours worked according to national accounts statistics has not decreased despite cuts in employers' social security contributions, reflecting the fairly rapid growth in average hourly earnings. In contrast, according to the labour cost index, average hourly earnings have decreased significantly in the first half of 2017. The forecast for the change in labour costs per employee in 2017 is –0.6%, based on national accounts data.

In the ongoing negotiations between the social partners, the first sectors have reached agreement on pay rises for the next two years. In these agreements, negotiated wages will rise by 1.6% per year. The forecast is based on the assumption that this will be the general size of pay rises and that negotiated wages will rise by 1.6% on average, in 2018 and 2019 across the economy as a whole. The other factors affecting earnings growth are expected to remain virtually unchanged, as a result of which wage drift would be approximately 0.7% per annum.

In the economy as a whole, average earnings will rise by 2.3% in 2018 and 2.2% in 2019. In 2020, the rise in average earnings will accelerate slightly, due to the ending of the temporary cut in holiday bonuses. The pace of growth in real wages in 2017–2020 will be slightly slower than productivity growth and unit labour costs will fall.

Chart 16.

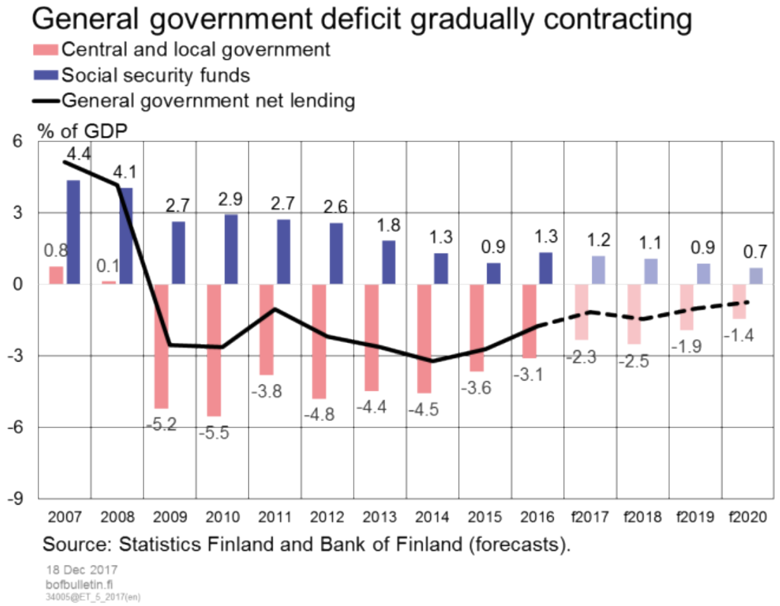


Public finances: General government deficit contracts amid improving cyclical conditions

Public consumption will grow slowly in 2017 as the Competitiveness Pact's reductions in public sector holiday bonuses, working-time extension and cuts in employers' social contributions depress public sector labour costs. At the same time, expenditure adjustments will restrain public consumption growth in the coming years, too, and especially in 2019. Public investment will increase in 2018 when the appropriations for key government projects grow around EUR 250 million from the previous year. Fiscal policy has been eased in 2017 by implementing the Competitiveness Pact's cuts in taxes and social security contributions. The total tax-to-GDP ratio will decline by over 1 percentage point, to 42.9% in 2017, and again, to 41.7% in 2018.

In 2017, the general government deficit will contract to 1.1% and further to 0.7% by 2020 (Chart 17). The central government deficit has contracted for three consecutive years since 2015. In 2017, it stands at 2.1% of GDP, after which it will contract to below 1% by the end of the forecast period. At its highest level in the 2000s, the central government deficit-to-GDP ratio was over 5% in 2010.

Chart 17.



The consolidation measures in the Government Programme and lower expenditure on unemployment benefits and immigration will push down government expenditure. On the other hand, key government projects, the net increase in appropriations due to the Competitiveness Pact and higher pension expenditure will all push up government expenditure. At the same time, the easing of income taxation has reduced tax receipts. However, tax receipts for 2017 have been boosted by an individual supplementary prepayment of EUR 700 million relating to corporation tax. In addition, receipts from inheritance and gift tax have temporarily increased in 2017 as the Tax Administration has cleared its backlog work. Certain excise and vehicle duties will be increased in 2017–2018, while the car tax will be reduced.

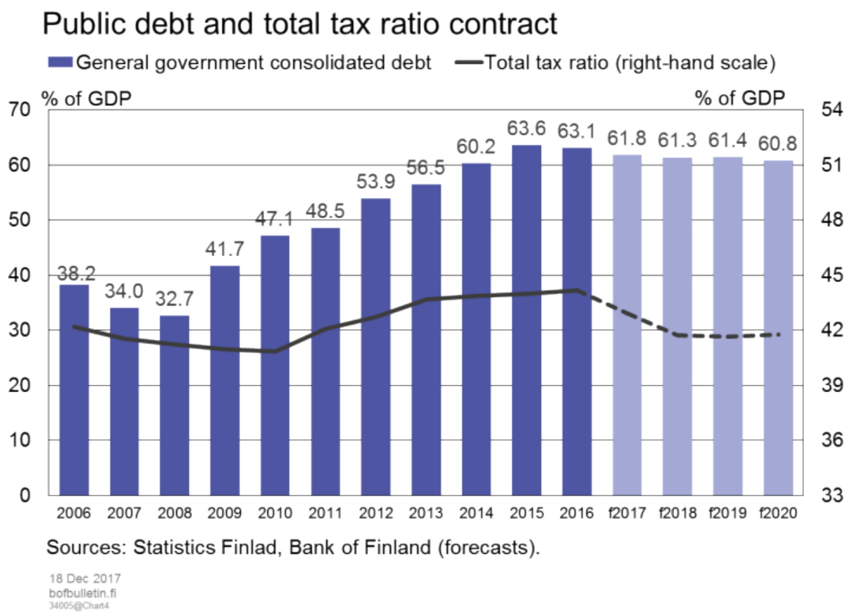
The contraction in the local government deficit will come to a halt in 2018, and the local government budget balance will weaken each year in 2018–2020. The local government deficit-to-GDP ratio will rise from 0.2% in 2017 to 0.6% by 2020. Annual central government transfers to local government will decrease by about 4% from the level of 2016, since the transfers take account of a contraction in labour costs due, in part, to the Competitiveness Pact. On the other hand, local government finances will be supported by lower compensation of employees paid by municipal employers on account of the Competitiveness Pact and the pension reform. This forecast does not include an assessment of the effects of the regional government reform on the central and local government budget balances.

The surplus on the earnings-related pension funds will contract in the forecast period, continuing the trend witnessed for ten years already. Net lending relative to GDP will decrease from 1% in 2017 to 0.6% by 2020. Pension benefits paid by earnings-related pension providers will increase in the forecast period by just under 4% on average per annum. At the same time, pension contributions received by earnings-related pension providers as well as current transfers from central government and other social security funds will grow at a slower pace. Growth in earnings-related pension assets is explained by investment returns, since earnings-related pension providers' pension expenditure has been higher than the pension contributions received by them since 2014.

Other social security funds are forecast to post a slight surplus in 2017–2019. Expenditure on unemployment benefits will decrease on the back of lower number of unemployed and the cuts in the maximum duration of earnings-related unemployment allowances. On the other hand, the negative cyclical buffer of the unemployment insurance scheme will need to be strengthened in the coming years. Central government transfers to other social security funds will grow in 2017 from the previous year by about EUR 1.4 billion, as government will compensate revenue losses arising e.g. from the Competitiveness Pact's cuts in social security contributions.

Growth in the consolidated general government debt moderated in 2016 and will continue at somewhat slower rates than in previous years throughout the forecast period. The debt-to-GDP ratio turned onto a downward trend already in 2016 and will fall to around 61.5% in 2017–2019 (Chart 18). The positive developments in the debt ratio during the forecast period are primarily the result of GDP growth.

Chart 18.



Risk assessment: Risks facing global economic growth lessened

Finland's economic growth is set to become increasingly broadly based in the near term on the back of export growth as well as investment and private consumption. Concerns about the performance of the global economy are easing, possibly leading to an even stronger increase in export demand than forecast. There are, however, downside risks associated with Finland's domestic economy.

Growth risks to the global economy have eased on the back of diminished political uncertainty worldwide. The cyclical upswing driving the global economy has now been ongoing for some time, however, so growth risks in the medium term are predominantly on the downside. A greater share of Finnish export growth now stems from China and the United States rather than Europe, so the risks associated with economic developments in these countries are becoming increasingly significant for Finland's economy.

In the United States, the Trump administration is about to implement a large tax reform bill, of which one goal is to significantly reduce corporate taxation. While these tax cuts might produce a temporary boost in economic growth, they will also upset the balance of an already strained public sector. Moreover, the long term effects on the country's economic performance are still unclear. The US economy poses risks for the Finnish export sector in the form of potential tariffs and deteriorating terms of trade. Global financial stability may also become more susceptible to risk if the deregulation of US financial markets goes ahead.

China's economic growth has largely been based on debt, increasing the vulnerabilities of the country's financial sector. A crisis in the Chinese financial sector would quickly erode confidence on financial markets worldwide. This, in turn, would quickly impact growth in the real economy.

Although growth remains strong in the euro area, the region's banking sector is still relatively vulnerable. One particularly thorny issue is the large amount of non-performing assets held by many European banks. Uncertainties shadowing the outcome of Brexit have lifted, as meaningful steps have been taken in the negotiations. So far, settlements have been reached on Northern Ireland, Britain's payments to the EU, and the rights of EU citizens residing in Britain. The next phase of the negotiations will outline the terms of free trade between the EU and Britain.

The Nordic banking system's large size, concentration and interconnectedness all add to the risks faced by the Finnish banking sector. Over the forecast period, the largest risks to financial stability lie in the Swedish housing market, which is showing signs of overheating. A rapid and deep decline in house prices would increase the risk weights on mortgage loans on banks' balance sheets. Because of the banking system's interconnectedness, banks who also operate in Finland might find it more expensive to raise funding on international capital markets. A decline in housing prices would also halt Swedish new-build construction, which would impact Finland's exports to Sweden.

Negotiated pay increases outlined in the autumn 2017 round of collective wage negotiations were set at approximately 1.5%, which should increase Finland's cost-competitiveness over the forecast period. Yet, as growth continues at a relatively brisk pace, the limits of the economy's output draw closer, especially with regard to labour requirements. At the end of the forecast period, there is a risk of wage acceleration, which would spur inflation and erode the export sectors' competitiveness. On the other hand, increased adoption of industry-specific bargaining could improve labour market efficiency and lead to lower wage drift.

Household consumption continues to surpass disposable income and the savings rate will remain negative while indebtedness continues to grow. Insolvency amongst households with outstanding housing loans has increased somewhat, but the overall risk to financial stability caused by household indebtedness remains low in Finland. A rise in the number of heavily indebted households can still create macroeconomic instability in the long run, as indebted households' propensity to consume is sensitive to unemployment and mortgage rate hikes. These households' precautionary savings may also rapidly increase if cyclical conditions worsen.

New-build housing accounts for a significant proportion of investment growth, and housing construction activity is historically sensitive to changes in the business cycle. The majority of construction is in the form of flats built in the Helsinki metropolitan area that have been directly sold to real estate investors. Especially in 2018 a lot of apartments will come on the market, which might cause a temporary oversupply. If the rent level of new leases falls as the market seeks equilibrium, investors' demand for new rental units could be quickly eroded.

Tags

economic development, economic forecast, Finland, general government deficit, households, inflation, public finances