# BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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# Slowing growth in the shadow of global uncertainties

3 JUL 2019 1:00 PM • BANK OF FINLAND BULLETIN 3/2019 • ECONOMIC OUTLOOK

Finland's economic growth will slow in the forecast period to close to its potential rate. GDP will grow 1.6% in 2019 and 1.5% in 2020. Thereafter, the pace of growth will ease to 1.3% in 2021.

Economic growth has slowed both in the euro area and globally. Risks to the global economy remain elevated and weak foreign demand is overshadowing the growth outlook for exports. However, Finnish goods and services are positioned to compete more favourably against other countries' products. Monetary policy is still accommodative in the euro area and the low level of interest rates creates good conditions for consumer spending and corporate investment also in Finland. Therefore, Finland's overall economic environment still supports the conditions for continued growth, despite the global uncertainties

The uncertainty in the global economy is particularly reflected in slower growth of corporate investment, which has a significant impact on Finland's exports. However, the dip in export growth witnessed in 2018 will remain a temporary phenomenon. The euro area economy, which is important for Finnish exports, will continue to grow at a passable pace, and recent years' improvements in cost-competitiveness will underpin Finnish companies' export efforts. Net exports, i.e. the difference between imports and exports, will remain modest, however, since imports, too, will continue to grow. Hence, economic growth during the forecast period will rest mainly on domestic demand.

Pay rises and improving employment figures will bolster household purchasing power. In addition, households' financial room for manoeuvre will benefit from the low level of interest rates. However, the increased uncertainty seems to have made households more cautious and fed their appetite for saving. Private consumption growth will no longer exceed the growth rate of disposable household income. Nevertheless, household consumption will still support economic growth during the forecast period.

Economic growth will also be sustained by private investment, growth in which will, however, be slower. Private investment has long been bolstered by brisk activity in the housing construction sector. However, this activity is now moderating. The cyclical downturn on the housing market has already been reflected as an increase in the number of unsold new homes. The contraction in housing construction will be compensated to some extent by a continued growth in private fixed investment.

Recent years' cyclical upswing has been accompanied by an increase in constraints on economic growth. The capacity (e.g. machinery and equipment) utilisation rate has risen, and labour shortages have impeded the expansion of production in some sectors. These capacity constraints will ease in the forecast period to some extent as economic growth slows. Labour demand will decrease, easing the shortage of labour. Labour market mismatches between job vacancies and unemployed jobseekers will continue, however. In addition, population ageing will continue to constrain employment growth because there will be less and less people of working age relative to the population as a whole. Employment will continue to grow during the forecast period, but at a notably slower pace than in a few recent years. The decline in the unemployment rate will stabilise to slightly over 6% at the end of the forecast horizon.

Economic growth ultimately depends most on labour productivity, which is measured by the added value produced by an employee during one working hour. Labour productivity growth is set to be much slower than prior to the financial crisis, i.e. at less than 1% on average per annum. The lower growth figures reflect both an increasing dominance of services in the economy and the weakness of productivity growth within economic sectors. In addition, growth in private fixed investment relative to GDP will still remain close to the lowest levels recorded since the turn of the millennium, even though it will still grow at a passable rate.

Wages will rise at an average annual rate of 2.5% during the forecast years. Inflation will be 1.3% in 2019 and will pick up to 1.6% in 2021. Wage growth will gradually push up services prices and thus contribute to boosting inflation in the forecast period.

Finland's public finances have improved in recent years. Faster economic growth and higher employment have increased tax revenues, while fiscal consolidation measures have pushed down expenditure. Despite these favourable factors, public expenditure has exceeded income, and Finland will not be able to attain a balanced budget position in the forecast period. General government debt fell to just below 60% relative to GDP in 2018, and the downward trend will continue throughout the forecast period. The forecast does not take into account the fiscal policy plans of the new Government.

The forecast is based on Statistics Finland's flash estimate of GDP for the first quarter of 2019 and other data available on 22 May 2019.

Table 1.

## Forecast summary

| Percentage change on the previous year | | | | |
|---|---|---|---|---|
| | 2018 | 2019f | 2020f | 2021f |
| **GDP** | 2.3 | 1.6 | 1.5 | 1.3 |
| Private consumption | 1.4 | 1.3 | 1.4 | 1.4 |
| Public consumption | 1.4 | 0.4 | 0.6 | 0.1 |
| Fixed investment | 3.2 | 1.8 | 1.6 | 1.9 |
| Private fixed investment | 3.3 | 2.2 | 2.0 | 2.0 |
| Public fixed investment | 3.0 | 0.3 | 0.1 | 1.5 |
| Exports | 1.5 | 2.8 | 2.1 | 2.8 |
| Imports | 4.2 | 1.9 | 1.8 | 2.6 |

| **Effect of demand components on growth** | | | | |
|---|---|---|---|---|
| Domestic demand | 1.8 | 1.2 | 1.2 | 1.2 |
| Net exports | –1.0 | 0.3 | 0.1 | 0.1 |
| Changes in inventories and statistical error | 1.6 | 0.0 | 0.1 | 0.1 |

| | | | | |
|---|---|---|---|---|
| **Savings rate, households, %** | 0.1 | 0.2 | 0.2 | 0.1 |

| | | | | |
|---|---|---|---|---|
| **Current account, % of GDP** | –1.9 | –0.7 | –0.7 | –0.6 |

| **Labour market** | | | | |
|---|---|---|---|---|
| Number of hours worked | 2.6 | 0.7 | 0.4 | 0.4 |
| Number of employed | 2.6 | 0.8 | 0.4 | 0.4 |

| Forecast summary | | | | |
|---|---|---|---|---|
| Unemployment rate, % | 7.4 | 6.5 | 6.4 | 6.3 |
| **Unit labour costs** | 1.8 | 0.7 | 1.8 | 1.4 |
| Labour compensation per employee | 1.5 | 1.5 | 2.9 | 2.3 |
| Productivity | –0.3 | 0.7 | 1.1 | 0.9 |
| | | | | |
| **GDP, price index** | 1.9 | 1.8 | 1.8 | 2.1 |
| Private consumption, price index | 1.3 | 1.2 | 1.3 | 1.6 |
| | | | | |
| **Harmonised index of consumer prices** | 1.2 | 1.3 | 1.4 | 1.6 |
| Excl. energy | 0.9 | 1.1 | 1.4 | 1.6 |
| Energy | 4.6 | 3.7 | 0.8 | 0.5 |
| f = forecast | | | | |
| **Sources: Statistics Finland and Bank of Finland.** | | | | |

## Forecast assumptions regarding the external environment

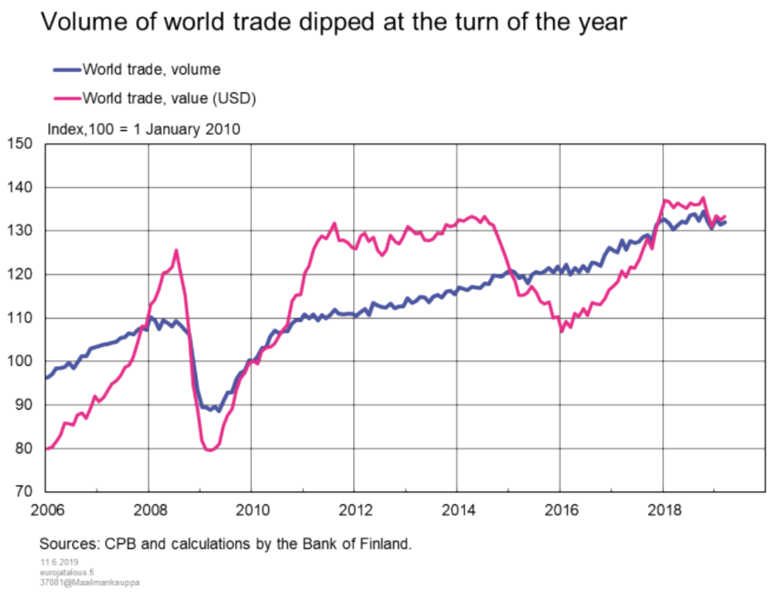
In 2018, economic growth slowed both in the euro area and around the world. Risks to the international economy remain larger than usual due to the escalation of trade disputes, and weak foreign demand overshadows the growth prospects for Finland's export sector. The competitiveness of Finnish exports has, however, strengthened and exchange rate developments support exports. Inflation in the euro area has remained moderate in early 2019. Monetary policy is still conducive to growth in the euro area and domestic financial conditions will remain relaxed. Therefore, Finland's overall economic environment still shows the preconditions for continued growth, despite the uncertainties in the global economy. The cut-off date for the forecast is 22 May 2019.

### Global economic growth has slowed

The growth rate for the global economy began to slow during 2018, and growth forecasts for the immediate years ahead were revised downward during autumn 2018 and early

2019. The volume of international goods trade dipped noticeably at the turn of the year (Chart 1), and the growth rate of Finland’s foreign demand has slowed markedly. Escalating problems in the Chinese economy overshadow the outlook for Finnish foreign trade, as China's slowing economic growth affects Finnish export demand both directly and indirectly, through Finland’s other trading partners. China’s economic issues have affected, for example, the outlook for German industry. Despite the deterioration in the international economic situation, the US economy, for example, has continued to grow at a steady pace.

Chart 1.




In autumn 2018, economic growth in the euro area slowed markedly, only to pick up again in the first quarter of 2019. This year, growth is projected to recover further. Economic growth in the euro area will continue throughout the forecast period, albeit at a slower pace than previously anticipated. During the forecast years, euro area growth will continue to be supported by favourable financing conditions, a mildly expansionary fiscal stance, further employment gains and rising wages, as well as the ongoing – albeit somewhat slower – expansion in global activity.

Imports and investment in the euro area continued to grow in 2018 and the first quarter of 2019. This growth supports Finland’s foreign demand, as Finnish export goods consist largely of intermediate and capital goods, and around 30% of Finnish exports go to the euro area. As a whole, Finland’s export markets will grow further during the forecast period, especially from 2020 onwards (Table 2).

From 2015 to 2018 there was a prolonged, unbroken period of appreciation in Finland’s nominal effective exchange rate. This is the trade-weighted average of nominal bilateral rates between the euro and the currencies of Finland’s most important trading partners. However, in the second half of 2018 and early 2019, the exchange rate has slightly weakened, supporting the competitiveness of Finnish exports. The effective exchange rate will remain stable throughout the forecast period (Table 2).

Annual consumer price inflation in the euro area edged up to over 2% during 2018, but fell back to 1.5% at the turn of the year. Euro area core inflation, i.e. consumer price inflation excluding energy and unprocessed food, continued to grow at a rather slow pace in spring 2019. However, growth in labour costs accelerated in the euro area during autumn 2018, as tightness in the labour market has increased. This would suggest an increase in services prices, in particular, and an acceleration in underlying inflation. Consumer price inflation in the euro area will pick up moderately over the forecast period.

The slowing of the inflation rate at the end of 2018 was caused mainly by a decline in the price of oil. The price of crude oil declined sharply in autumn 2018, plummeting from a peak near USD 90 to USD 50 a barrel. In spring 2019, the price of oil has gone back up to around USD 70 a barrel. The price of oil is expected to decline moderately over the forecast period, standing at around USD 63 a barrel in 2021 (Table 2). Prices of other industrial commodities will rise a little over the forecast period. For this reason, energy and commodity prices will not cause substantial short-term consumer price inflation pressures.

## Monetary policy remains accommodative

The ECB has long anticipated that interest rates will remain at their present level an extended period of time, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term. In March, the ECB also announced a new series of quarterly targeted longer-term refinancing operations (TLTRO-III) starting in September 2019 and ending in March 2021. The new series of operations will support banks' funding and help preserve the smooth transmission of monetary policy and low funding costs.

The ECB has also announced that it intends to continue reinvestment of principal payments from maturing securities acquired under the programme for an extended period of time, well past the date when the Governing Council starts raising the policy rate, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. All in all, monetary policy will remain accommodative for an extended period of time.

## Funding costs remain low

As market expectations regarding the key ECB interest rates have moved further into the future, the financing conditions of both the private and public sector are expected to remain accommodative for the time being in Finland, too. This will support investment and consumption, thus strengthening the growth prospects of the economy (Table 2).

Households' housing-loan interest payments are lower than in the euro area on average (Chart 2). The average interest rate on new housing loans has continued to decline slightly. The total costs of housing loans have also declined as a result of narrowing interest margins, whereas the annual percentage rate of consumer credit has risen slightly in 2019.

Business financing costs, in turn, are slightly higher than in the euro area, but still remain moderate (Chart 3). According to the Business Tendency Survey by the Confederation of Finnish Industries EK, financing conditions for Finnish businesses still remain favourable and access to finance is not constraining production. Financing issues have not increased in manufacturing or in service companies and remain modest. In the first months of the year, the share of construction companies with financial issues was unchanged from the end of last year, even though it increased from a year earlier.

Chart 2.

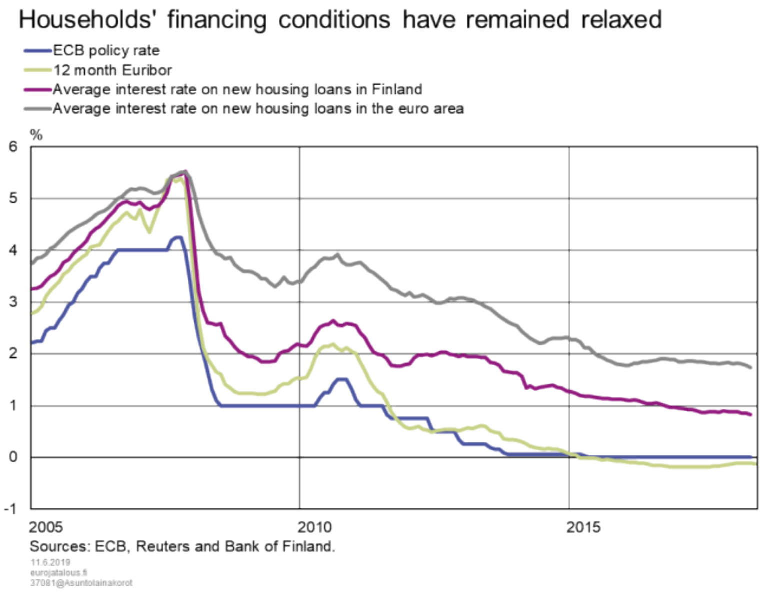



Chart 3.

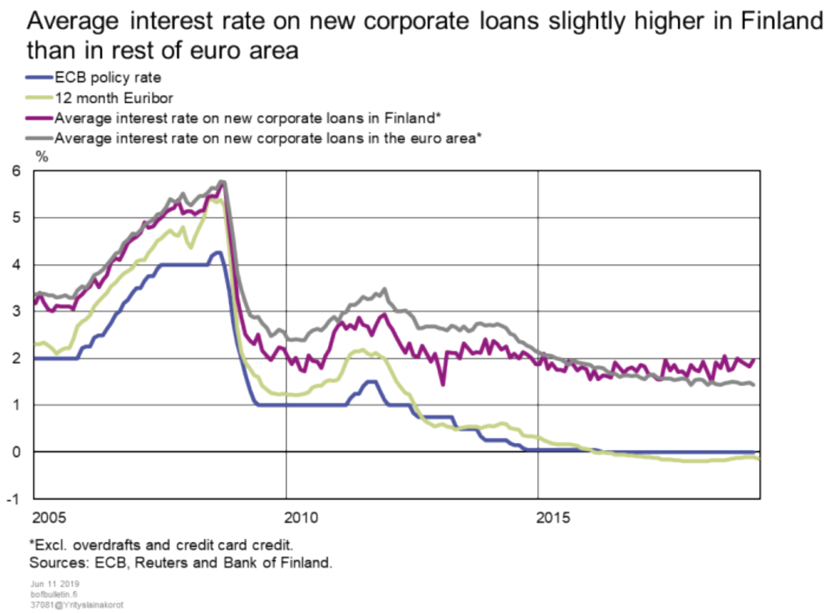



Table 2.

## Key forecast assumptions

| | 2017 | 2018 | 2019f | 2020f | 2021f |
|---|---|---|---|---|---|
| Growth in Finland's export markets[1], % | 5.9 | 3.5 | 1.9 | 2.8 | 3.2 |
| Oil price, USD/barrel | 54.4 | 71.1 | 68.1 | 65.8 | 62.7 |
| Export prices of Finland's competitors, euro, % change | 2.9 | 1.4 | 3.5 | 2.6 | 2.4 |
| 3 month Euribor, % | -0.3 | -0.3 | -0.3 | -0.3 | -0.2 |
| Finland's 10-year government bond yield, % | 0.5 | 0.7 | 0.3 | 0.4 | 0.5 |
| Finland's nominal competitiveness indicator[2] | 104.6 | 108.5 | 108.2 | 108.3 | 108.3 |
| US dollar value of one euro | 1.13 | 1.18 | 1.12 | 1.12 | 1.12 |

[1] The growth in Finland's export markets is the import growth in the countries Finland exports to, weighted by their average share of Finland's exports.

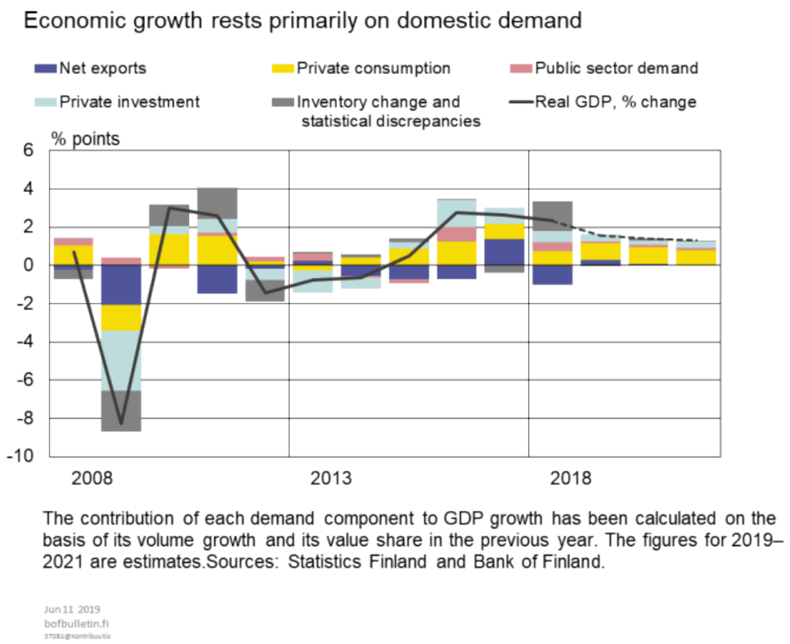
[2] Broad nominal effective exchange rate.

**Sources: European System of Central Banks and Bank of Finland.**

## Demand

Heightened uncertainty surrounding the global economy will weigh on growth in Finland's export markets. Thus, Finland's economic growth during the forecast period will rest primarily on domestic demand (Chart 4). Growth in earnings and employment will support household income development, but the heightened uncertainty has made consumers more cautious. Towards the end of the forecast horizon, private consumption will grow roughly in step with income, and the household savings rate will remain slightly positive throughout the forecast period. Investment will also continue to lend support to demand but its pace of growth will slow on the back of weaker residential construction activity.

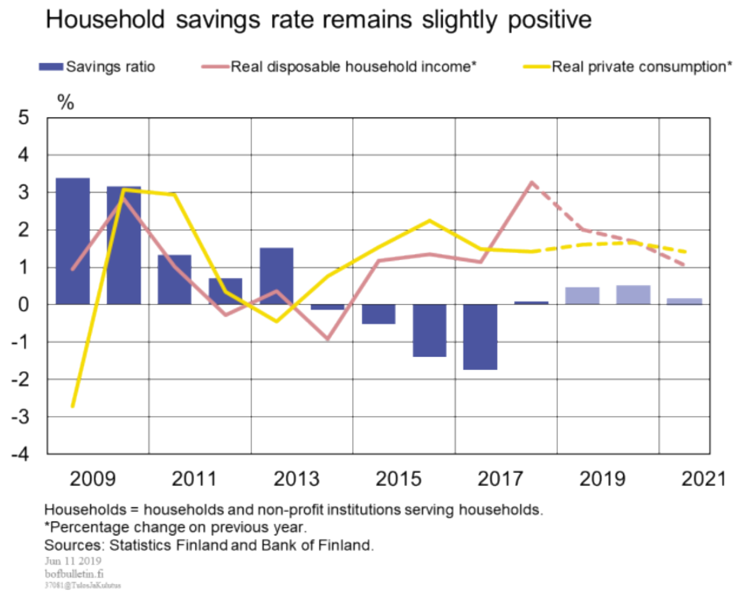
Chart 4.




## Consumers increasingly cautious

Households' purchasing power will continue to grow steadily during the forecast period and consumer confidence in their own financial position has remained relatively buoyant. Private consumption growth will track growth in real disposable income, despite heightened uncertainty about the direction of the economy (Chart 5).

Chart 5.




Households' purchasing power will continue to benefit from wage increases and employment growth. Towards the end of the forecast horizon, however, purchasing power growth will abate noticeably. Earnings will rise by an average annual rate of about 2.5% in the forecast years. Other household income, which primarily consists of capital income and current transfers, will rise by almost 2% in 2019. Thereafter, income growth will pick up to about 3% in 2020 and 2021. Pension and benefits income will rise particularly after 2019, when the freezing of indexed increments comes to an end.

Taxation of earned income will be eased in 2019, but excise duties and employees' pension contributions will rise at the same time. Overall, however, the tax changes will only have a marginal effect on purchasing power in 2019. The new Government's plans related to taxation and income transfers were still unknown at the cut-off date of this publication.

Inflation will pick up slightly during the forecast period. It will still remain at around 1.3% in 2019, but in 2021 consumer prices will already rise by over 1.5%. Inflation will be fuelled by services prices, in particular, which will rise in response to wage increases. Households' real earnings will grow in the forecast period at an average annual rate of slightly over 1%.

In addition to higher earnings, disposable household income will be boosted by improved employment. In 2019, the number of persons employed will increase by about 0.8% from the previous year but, influenced by slower economic growth, the annual growth rate will abate to about 0.5% in 2020 and 2021. Considering the rise in earnings and transfers, higher employment and the inflation rate, households' purchasing power will grow by an annual rate of about 1.4% during the forecast period.

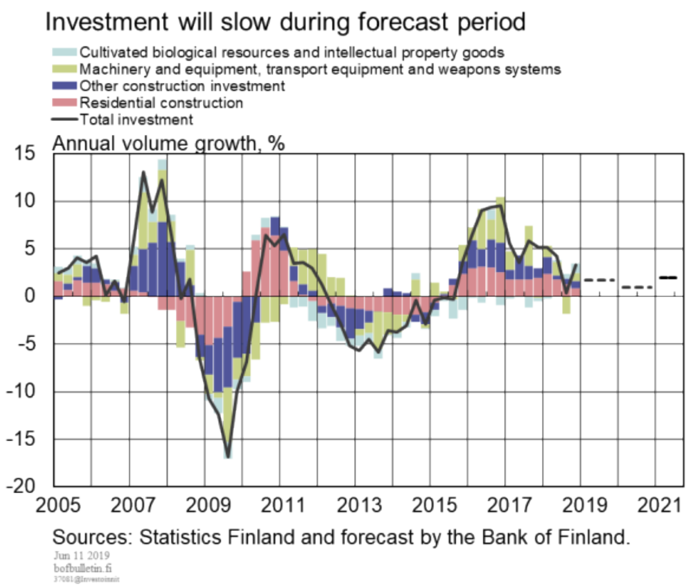
Uncertainty about the direction of overall economic developments has increased and made consumers more cautious, which has already led to slower growth in private investment. At the beginning of 2019, retail trade grew sluggishly compared with household incomes. Car sales were also modest in early 2019, which can partly reflect uncertainty about future developments in car taxes. All in all, however, private consumption in the forecast years will grow roughly at the same pace as real disposable income, i.e. at an average annual rate of 1.4%.

Households' caution is also reflected in higher savings. The household savings rate turned slightly positive in 2018. Before that, households had run down their savings for many years. The savings rate will remain slightly positive in the forecast period, but household gross debt relative to disposable income will continue to grow at a moderate pace. Interest rates will remain low, supporting households in repaying their debts. However, average household indebtedness is not such a high risk as growth in the number of heavily-indebted households. The number of these households has risen further in recent years.

## Investment growth abates from previous year

Private investment growth will moderate in the forecast period in response to a moderation in residential construction activity. Non-residential investment will continue to grow during the forecast period, albeit at a slower pace than in previous years. Private investment will increase by 2.2% in 2019, and by 2.0% in 2020 and 2021 (Chart 6). However, in an environment of strong corporate profitability, favourable financing conditions and moderate rises in labour costs, there is potential for private investment growth in the forecast period, although the uncertainties surrounding the economy may discourage corporate investment.

Chart 6.

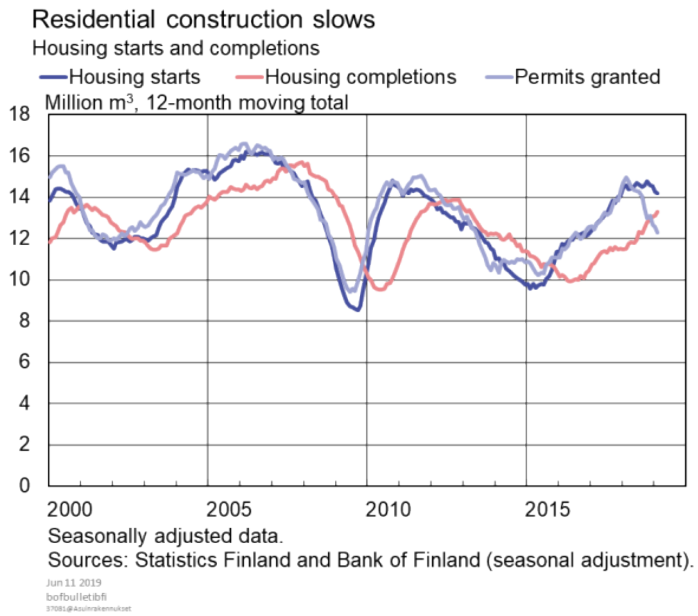



In 2018, investment growth abated already noticeably from the two previous years. Growth in non-residential investment in the corporate sector alone fell from 2.8% in 2017 to 2.1% in 2018. Total investment across the economy increased by 3.2%.

Non-residential investment will continue to grow during the forecast years but the pace of growth will abate further. The moderation in investment partly reflects the weaker cyclical outlook and higher uncertainty, but is also explained by the completion of certain major industrial investment projects. The increasing dominance of services in the economy may also have dampened investment. A further possible factor is the decline in the price of labour input relative to the price of investment. This change in relative prices has contributed to supporting the strong growth in employment. At the same time, however, it may also explain the sluggish investment dynamics in recent years. As investment has begun to lag behind employment growth, the volume of capital per employee has decreased, i.e. the capital intensity of the economy has declined. However, the volume of capital per employee will begin to rise during the forecast period, as investment continues and employment growth moderates.

Residential construction, which has supported investment for a long time, will moderate in the forecast period (see also the article 'What factors influence house prices and residential construction?'). Residential construction growth will be dampened by the sluggishness of new-build construction. Renovation work, in turn, is still estimated to continue its steady growth. The number of building permits peaked already a year ago, since when it has declined steeply (Chart 7). Housing starts will decrease especially in 2019 and 2020. Gradually, the number of housing completions will also begin to decline. Investment into civil engineering works contracted in 2018, but infrastructure construction will be supported in 2019 by e.g. major infrastructure projects in Helsinki.

Chart 7.




Non-financial corporations' financing conditions will remain favourable. The interest rates on new corporate loans have remained low in 2019 and, influenced by the accommodative monetary policy, the trend will continue throughout the forecast period. Growth in domestic corporate loans has levelled off but is still brisker than in recent years. Access to finance is not a dominant bottleneck for companies. Instead, insufficient demand has become the dominant factor preventing growth for some companies in the manufacturing and services sectors, while some companies report that the availability of labour is their most dominant concern.

Corporate sector profitability improved further in 2018. In the National Accounts, operating surplus is the counterpart of operating profits recorded in non-financial corporations' financial statements. In 2018, the operating surplus from ordinary activities rose by almost 6%. Even though corporate profitability has improved uninterruptedly already since 2013, relative to value added it has not reached the pre-financial crisis level.

## Public finances will remain in deficit without further measures

Higher economic and employment growth, lower unemployment and the previous Government's consolidation measures have strengthened Finland's public finances in recent years. Despite these favourable developments, Finland's general government will not attain a balanced budgetary position in the forecast period. Instead, the general government deficit will stabilise to –0.3% relative to GDP in 2021 (Chart 8). In the absence of further measures by the new Government, the central and local government primary balance (budget balance net of interest payments) will remain negative throughout the forecast period. Measured by the structural budget balance, however, the fiscal stance will turn countercyclical, i.e. contradictory, in 2020, after having been almost neutral in 2018–2019. The forecast does not take into account the fiscal policy plans of the new Government.[1]

The general government debt-to-GDP ratio fell to just below 60% in 2018 for the first time since 2013. If there are no further discretionary increases in government expenditure, the debt-to-GDP ratio will decline further throughout the forecast period, to slightly over 57% in 2021.[2] In that case, Finland will continue to fulfil the requirements for the general government deficit and debt stipulated in the EU Treaty. The public debt in millions of euros will, however, continue to grow further also in 2021. The total tax ratio will decline to around 42%, after having been 44% in 2016.

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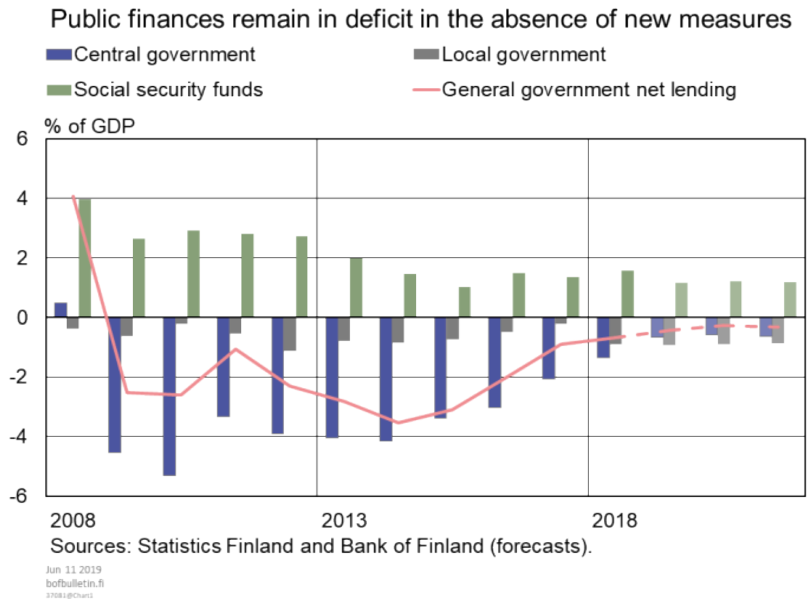
1. The forecast for the public finances for 2019–2021 is based on the no-policy-change assumption, except for the discretionary changes already known. The fiscal policy plans of the Government to be formed after the spring 2019 parliamentary elections will be taken into account in forthcoming forecasts.
2. According to the Technical General Government Fiscal Plan published by the Ministry of Finance, the Government has allocated an annual appropriation of EUR 1.5 billion for fighter aircraft procurement for 2021–2023. However, the timing of the procurement may change as the related details are finalised. The fighter aircraft procurement has not been taken into account in this forecast. It will be taken into account once there is a final decision on the matter and the procurement schedule is known. If the portion of the procurement for 2021, EUR 1.5 billion, is covered by additional debt, the debt-to-GDP ratio for 2021, i.e. 57.2%, would be 0.6 of a percentage point higher.

Chart 8.




Public final consumption expenditure will grow in 2019, fuelled by contractual pay increases and age-related expenditure. However, real growth in public consumption of final products is expected to remain moderate in 2019–2021 on the back of the previous Government's consolidation measures and conclusion of key general government projects. Under a no-policy-change assumption, public investment will grow modestly and this, too, reflects the conclusion of the key projects.

Tax revenue will grow at an annual rate of about 3% in 2019–2021 due to higher revenues from direct and indirect taxes alike. Increases in excise duties will continue in 2019, and so will the reduction of the deductibility of mortgage interest expenditure. Vehicle taxes, in turn, will be lowered. Taxation of earned income will be eased to compensate for the effects of the Competitiveness Pact and the rise in the level of earnings.

The central government deficit will decline to –0.6% relative to GDP by 2021. Despite positive revenue developments, the central government primary balance will remain negative throughout the forecast period, since expenditure other than interest payments will be slightly higher than revenue. The local government deficit was –0.8% relative to GDP in 2018 and is expected to remain roughly unchanged until 2021. Of the social security funds, the surplus on the earnings-related pension funds will continue to trend downward in the forecast period. Other social security funds will also continue to post a slight surplus.

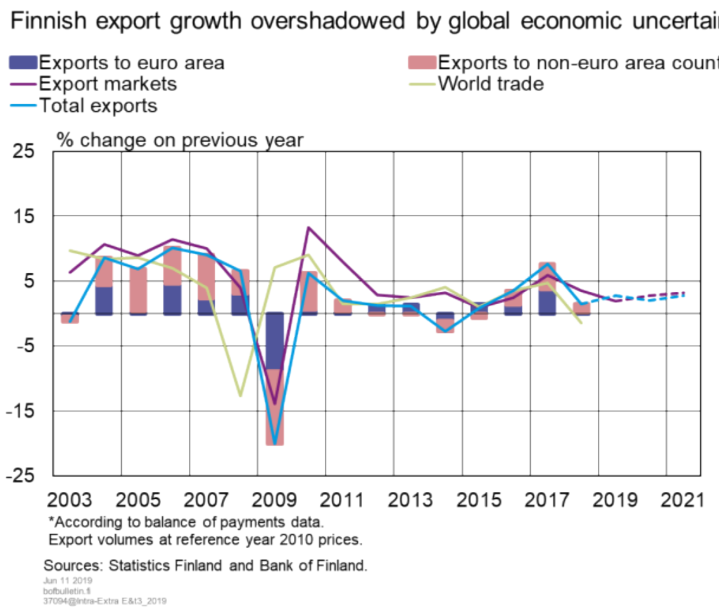
## Exports grow, but Finland accumulates foreign debt

Finland's foreign trade is overshadowed by increasing protectionism and the related direct and indirect effects on Finland's main trading markets. However, the euro area economy, which is important for Finnish exports, will continue to grow at a moderate pace. Export growth will also be supported by better cost-competitiveness and accommodative financing conditions. Nevertheless, net exports will grow sluggishly in the forecast years, since domestic consumption demand and the high share of import inputs in the export industry will boost imports.

In recent years, Finland has managed to increase market shares in exports to both the euro area and elsewhere. In 2018, however, Finland's export growth deteriorated markedly, to 1.5%, falling notably behind growth in the export markets (Chart 9). Higher global uncertainty and slower growth in the euro area easily depress investment growth, which in turn is reflected in Finnish exports. The deterioration of Finland's exports in 2018 was particularly due to a moderation of exports to the euro area. Net export growth abated also because of an increase in imports. Services imports in particular increased markedly. Imports were boosted by domestic consumption demand. The export industry uses a lot of imported goods and services in the manufacturing of export products, which usually also raises imports.

Trade policy uncertainty has increased and global economic sentiment has weakened. The conditions for continued favourable export developments remain in place, however, and the slowdown in Finnish exports is forecast to remain temporary. The euro area accounts for about one-third of Finland's goods and services exports, and economic performance in the euro area will remain fair. Finnish exports to the euro area focus on goods, while services play a greater role in exports to non-euro area countries.[3] The accommodative monetary policy in the euro area together with Finnish companies' low funding costs and better competitiveness also create potential for growth in Finnish exports.

Chart 9.




Finland's exports will be sustained by growth in its export markets. However, Finland will lose some market share in the forecast period, albeit notably less than in 2018.

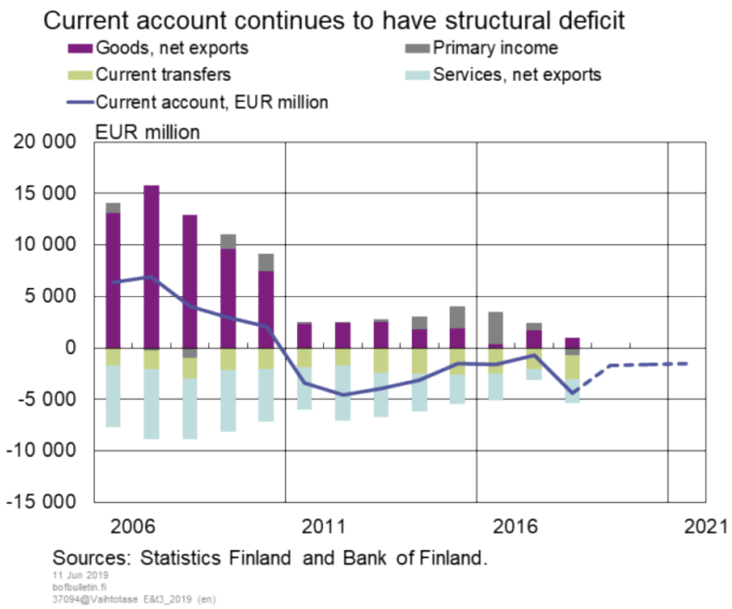
3. According to balance of payments statistics.

Finland's export growth is also affected by annual fluctuations in exports of cruise ships. In 2019, cruise ship deliveries will strengthen export growth, which will rise to 2.8% and temporarily exceed export market growth. In 2020 and 2021, exports will grow at an average rate of 2.4%.

Net exports will remain weak throughout the forecast period, as domestic demand and high import inputs in the export industry boost imports. Imports will grow at a notably slower pace than exports only in 2019, when exports will be strengthened mainly due to temporary factors.

The current account deficit deepened in 2018 to almost EUR 4.4 billion, equal to over 2% relative to GDP (Chart 10). The goods and services accounts both deteriorated markedly. In addition, primary income and current transfers paid abroad increased from the previous years and were significantly higher than the corresponding items received. Measured by the current account deficit, Finland has accumulated foreign debt since 2011, in a total amount of over EUR 23 billion.

Chart 10.




In the forecast period, the current account will remain in a deficit of slightly below 1% relative to GDP. The deficit is permanently sustained particularly by primary income and current transfers payable abroad. The modest improvement in the goods and services account will not suffice to diminish the structural deficit in the current account during the forecast period. Balancing the current account and halting foreign debt accumulation would necessitate a permanent surplus in the goods and services account and a significantly higher value of exports relative to the value of imports.

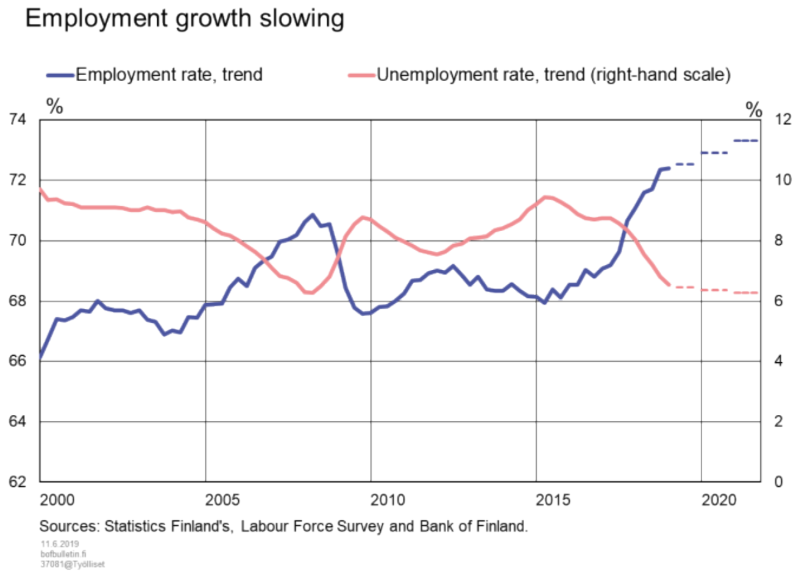
## Supply

Due to the favourable cyclical conditions of recent years, the capacity utilisation rate rose and a shortage of labour became a constraint on growth in some sectors. These capacity constraints will not be further tightened in the forecast years, as economic growth will slow. However, the moderation in growth and declining demand for labour notwithstanding, the availability of labour continues to act as a constraint on output growth. Towards the end of the forecast horizon, economic growth will broadly mirror the pace of potential output growth. Productivity growth will remain subdued.

## Employment growth slows

The exceptionally rapid growth in employment seen in the past faded in early 2019. The employment rate has risen above 72%, while the unemployment rate has fallen to around 6.5%. Slow employment growth will continue over the forecast horizon. In 2019–2021, the number of persons employed will increase by around 40,000 and the employment rate climb to a little over 73%. The decline in the unemployment rate will flatten out to stand slightly above 6% at the end of the forecast period.

Chart 11.

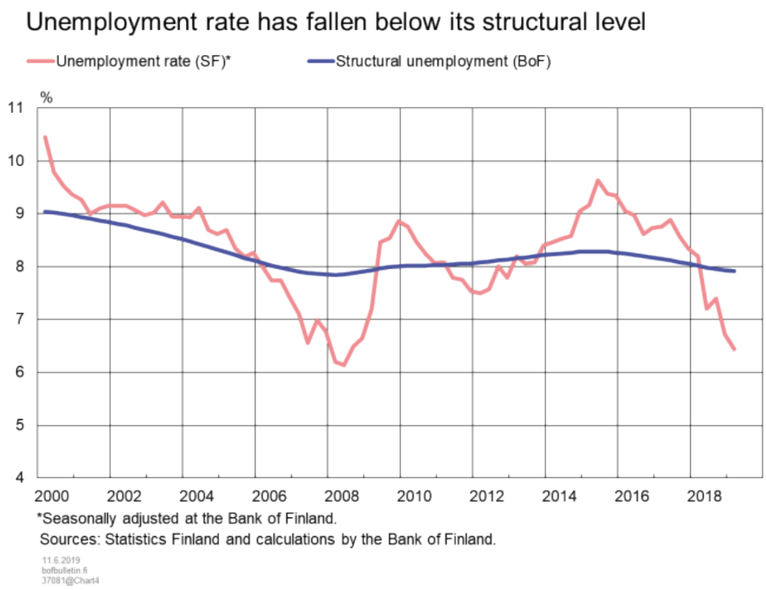



A moderation in the pace of employment growth is discernible in many sectors. After experiencing a surge in employment, the construction sector has now passed its cyclical peak, reflected in a downward trend in the sector's employment. Manufacturing saw an increase in employment until the end of 2018, but the rise has tailed off, in response to a deterioration in global cyclical conditions and slackening exports. The most rapid phase of employment growth appears to be over also in trade, accommodation and food services, social welfare and health services, education and public administration, whereas employment continues to grow in other sectors. Similarly, the downturn in employment expectations in the main sectors at the end of last year also points to slowing employment growth, despite a further increase in vacancies.

The exceptionally rapid employment growth in 2018 will remain a temporary phenomenon. During the past 18 months, economic growth has been reflected in the labour markets above all as an improvement in employment, while growth in labour productivity has remained very modest. The situation is expected to normalise during the forecast period, in that growth will become more evenly distributed between employment and productivity.

The unemployment rate has dropped one percentage point since the year before. The recent decline in the unemployment rate has largely been of a cyclical nature, indicated by the fact that the unemployment rate fell below the estimated rate of structural unemployment already in early 2018 (Chart 12). This implies that the decline in the unemployment rate is sensitive to changes in cyclical conditions. Part of the decline is, nevertheless, attributable to structural factors, such as slower growth in labour costs and recent labour market reforms.

Chart 12.

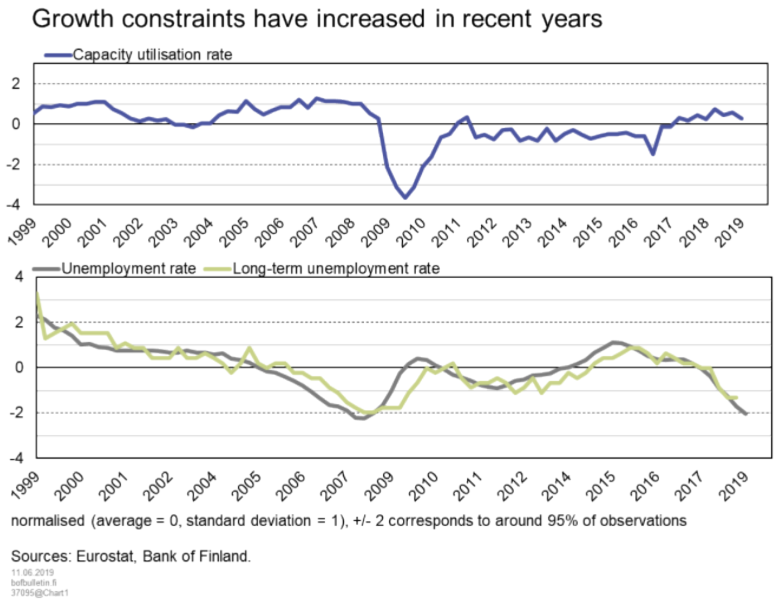



Despite the slowing of employment growth, availability of labour acts as a constraint on employment growth in some sectors. Labour mismatch problems are holding back job creation and maintaining structural unemployment. The decline in the working-age population will also constrain employment growth in the forecast years, as will the fading of the effects of the structural reforms undertaken during the past few years.

## Capacity constraints no longer increasing

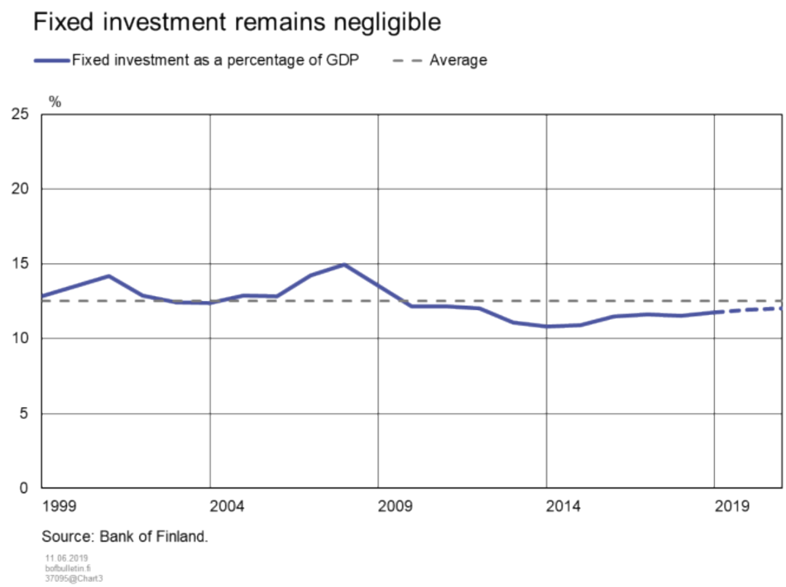
Constraints on growth have increased as a result of the upswing in recent years. As employment has rapidly improved during the past year, the capital stock has not kept up with the growth in labour. The capacity utilisation rate has increased slightly above average, while companies report problems of labour availability. In response to the weakening of the global economy and the fixed investments made, capacity utilisation rates have not been increasing anymore just lately (Chart 13).

Chart 13.



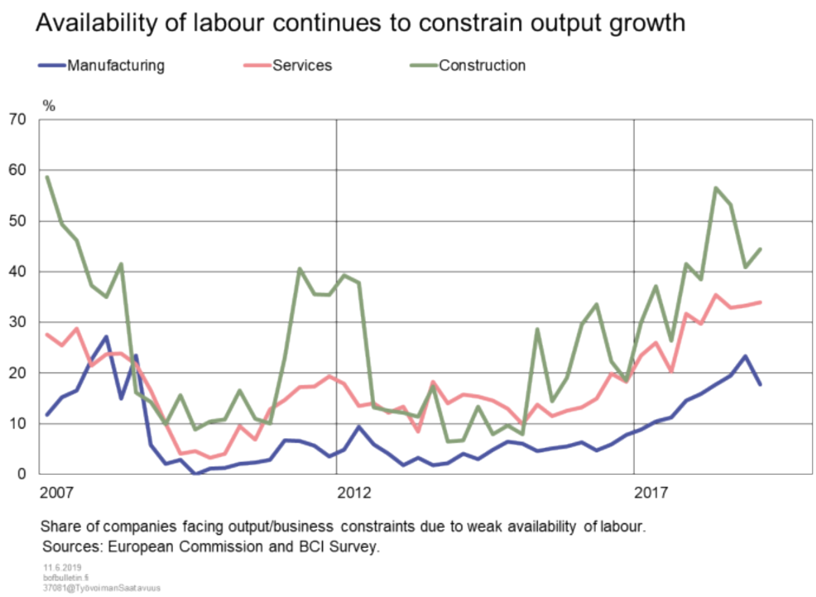

With economic growth losing momentum, capacity constraints will no longer be tightened towards the end of the forecast period. Fixed investment will expand, contributing to this development. The growth in fixed investment notwithstanding, the investment rate will remain well below the rate before the financial crisis (Chart 14). The low level of fixed investment may, in part, reflect a shift in the structure of the economy towards an increasing dominance of services.

Kuvio 14.




Weak labour availability remains a problem. Companies continue to report difficulties in recruiting skilled labour in all the main sectors, although the problems have not been further aggravated (Chart 15). Both the unemployment rate and the long-term unemployment rate have dropped well below the average recorded for Finland during the euro era (Chart 13). The construction sector is assessed as facing the largest difficulties in finding skilled labour, but the labour situation will improve with the slowdown in new-build construction. In services, the shortage of labour has stabilised but is still larger than during the previous cyclical peak, while industrial employers also report problems of labour availability. While demand for labour is weakening, many service sectors may still continue to experience a shortage of labour, as labour supply is concurrently restrained by a reduction in the working-age population.

Chart 15.




## Economic growth falling back to its long-term potential rate

GDP growth has passed its cyclical peak. GDP has increased briskly over the past few years, with output growth exceeding its potential rate[4] and the output gap closing. Towards the end of the forecast period, GDP growth will broadly mirror potential output growth.

The output gap remained negative both in Finland and in the euro area for an exceptionally long period during the double-dip recession that followed the financial crisis, meaning that economic resources were being underutilised. As economic conditions have improved, the capacity utilisation rate and employment have also strengthened. As it stands, less economic slack is available for raising production than before. Yet, although positive, the output gap will remain moderate, as economic growth will slow (Chart 16).[5]

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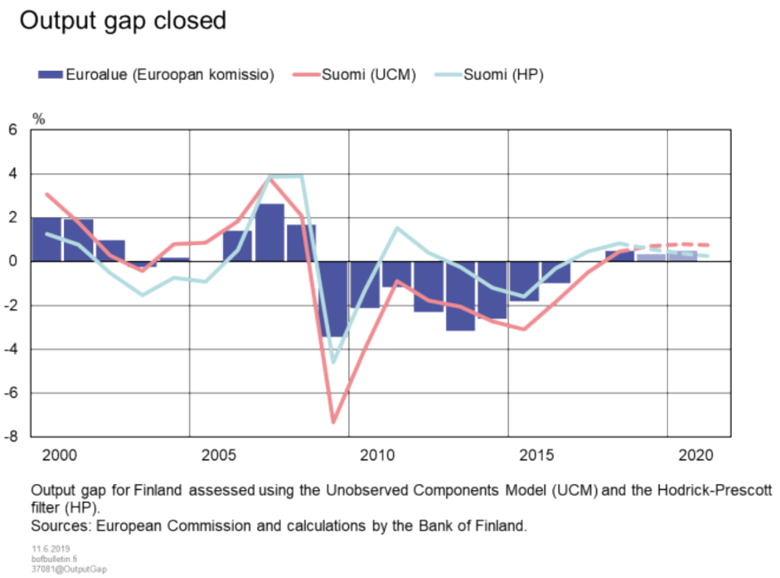
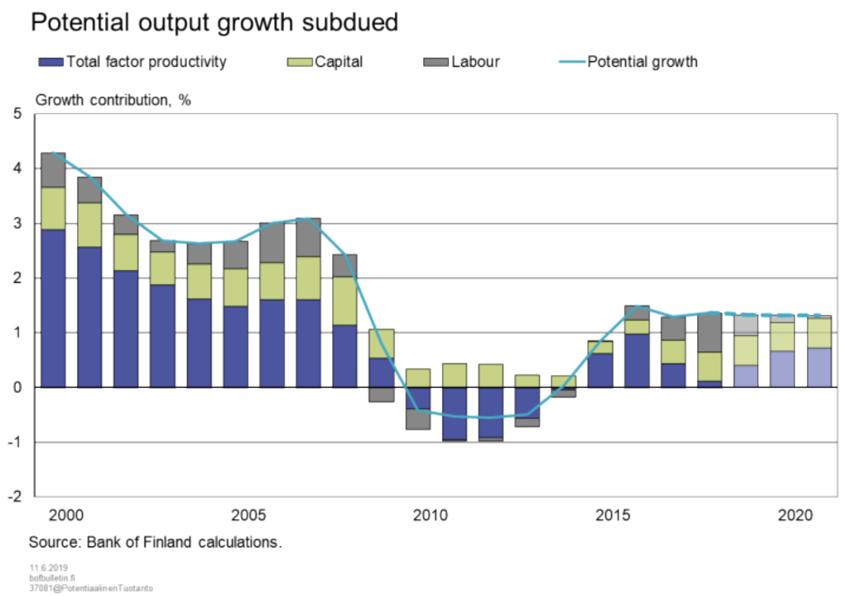
4. Potential output is the level of real GDP when all the economy's factors of production are fully utilised.
5. The output gap assessment is based on e.g. the unobserved components model (An unobserved components model for Finland: Estimates of potential output and NAWRU)

Chart 16.



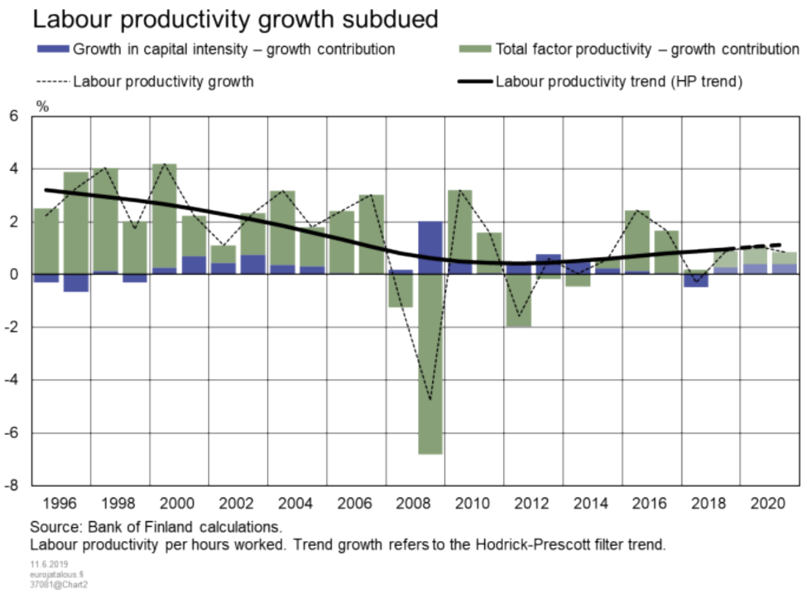

The growth in potential output is significantly slower than before the financial crisis (Chart 17). Total factor productivity has strengthened since the protracted downturn, but it is nevertheless far below record years. In 2019–2021, an increase in investment will boost the capital stock and strengthen potential output. Towards the end of the forecast period, the importance of labour as a source of potential output may fade. The supply of labour will wither despite the projected improvement in the employment rate. Labour supply is restrained as the 15–74-year-old population begins to decrease, while the rate of structural employment remains high, despite a slight dip.

Kuvio 17.




Following a protracted downturn, labour productivity increased at an annual rate of around 2% over the years 2016–2017. While the economy was expanding at a rate of over 2% in 2018, there was no increase in productivity, due to exceptionally strong employment growth. Going forward, employment and productivity are expected to provide more balanced support to economic growth. In 2019–2021, the pace of labour productivity growth will be slow, on average 2%. The higher capital intensity of the economy will, however, improve labour productivity slightly, reflecting the larger amount of capital available per hours worked (Chart 18).

Chart 18.




Labour productivity growth is set to remain considerably slower than in the first post-millennium years, when the annual growth rate averaged 2.5%. The slowdown in productivity growth can be explained by e.g. the smaller weight of high-productivity industries and increased dominance of services in the economy, a shift in investment from machinery and equipment to housing as well as a contraction in the share of R&D investment. (Several reasons behind weak labour productivity). For example, despite passable growth in machinery and equipment, the growth rate will remain close to the lowest figures recorded in the new millennium relative to GDP. Slower productivity growth has also been witnessed in many other advanced economies (see e.g. OECD Economic outlook May 2019 chapter 2).

## Costs and prices

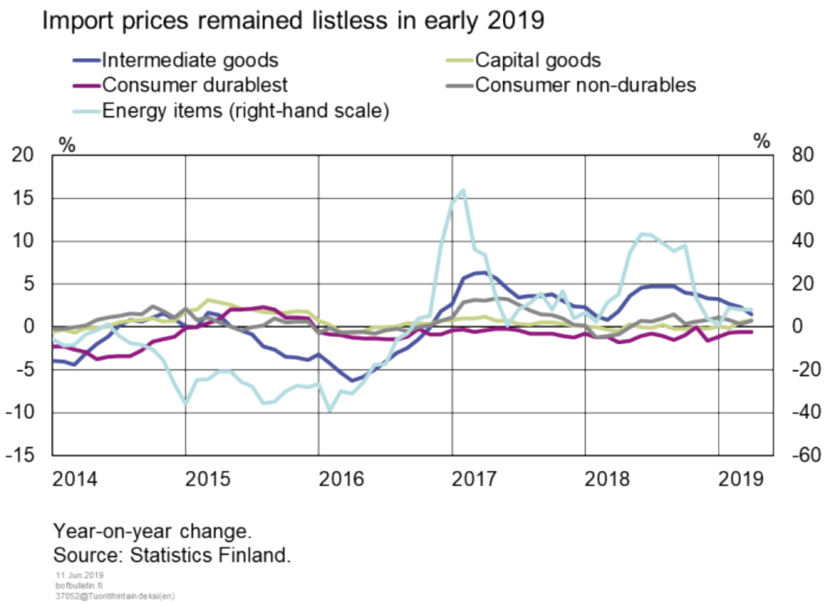
Inflation will continue to pick up moderately over the forecast period. Faster nominal wage growth than in recent years will contribute to rising consumer prices. Growth in the nominal earnings of wage and salary earners will exceed 2% in 2019. The temporary reduction in public sector holiday bonuses is set to expire in 2020 and will accelerate wage growth even further.

## External price pressures will remain subdued

Annual growth in the import prices for industrial goods has slowed in the first half of 2019 relative to previous years (Chart 19). In particular, growth in the import prices for energy items has declined significantly. Oil futures anticipate a gradual decline in the price of crude oil to approximately USD 63 a barrel during the forecast period. Fears of further trade war escalation are expected to weigh on oil demand. Price expectations for electrical energy during the forecast period have recovered from a sustained decline but nevertheless remain weaker than at the turn of the year. Import prices on consumer and capital goods have continued to develop sluggishly in the early part of 2019.

Annual growth in producer prices for agricultural products and industrial goods manufactured and sold in Finland has been slightly slower in early 2019 than in 2018. Meanwhile, producer prices in the service sector have picked up somewhat in Q1 2019, covering services sold to households and firms as well as to general government.

Chart 19.




## Wages and labour costs continue to rise

Nominal wage growth strengthened markedly in 2018 (Chart 20). Average labour costs (i.e. labour compensation per employee) increased by about 1.5%, and average productivity declined. As a result, unit labour costs expanded again last year.

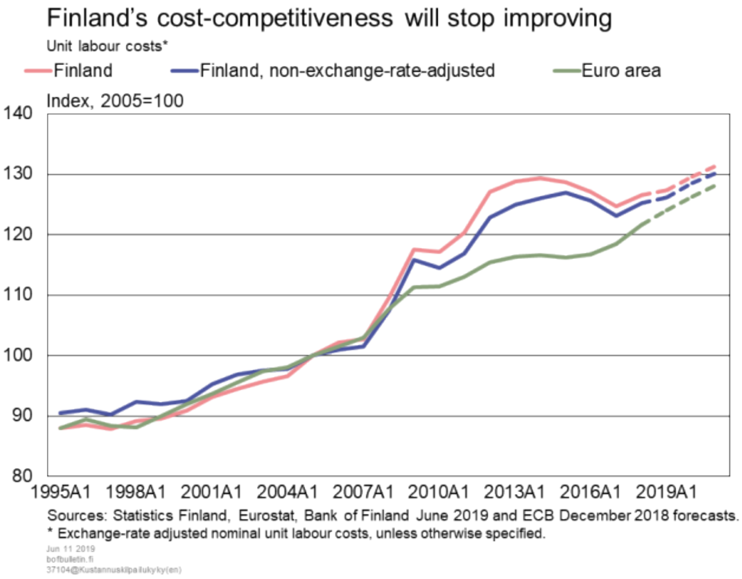
Chart 20.


At the start of the forecast period, wage growth will still largely be determined by the collective wage agreements negotiated for 2018–2019, still currently in effect. Accordingly, negotiated wages will rise by 1.6% in the private sector and about 2% in the public sector in 2019. In the economy-wide aggregate, nominal wages will increase by about 2.4% in 2019 as measured by the index of wage and salary earnings. In 2019, average labour costs will grow at a considerably more moderate pace than average earnings, owing to cuts in employers' social security contributions. The temporary reduction in public sector holiday bonuses, as outlined in the Competitiveness Pact, will end in 2020 and boost wage growth to almost 2.8%. In 2020 and 2021, labour costs will increase at a similar pace as average earnings. Nominal earnings, taken as average hourly earnings based on the wage bill, will rise at an average annual pace of 2.6% during the forecast period.

Per-employee productivity contracted slightly in 2018 but will grow at an average annual rate of just under 1% over the forecast horizon. Unit labour costs will increase at a moderate pace of below 1% in 2019, slower than the euro area average (Chart 21). Finnish cost-competiveness will thus continue to improve relative to the euro area, based on this measure. Unit labour cost growth is projected to accelerate to an average rate of just over 1.5% in 2020 and 2021, which is largely in line with developments in the euro area.

Finland is due to hold comprehensive collective bargaining negotiations in 2019 and 2020. The forecast is based on the technical assumption that real wages will increase at a pace similar to the rate of productivity growth in 2020 and 2021. Following this assumption, Finland will retain its improvements in cost-competitiveness relative to the euro area, if developments in the euro area correspond with the forecast. Higher pay rises, in contrast, would weaken Finland's cost-competitiveness.

Chart 21.



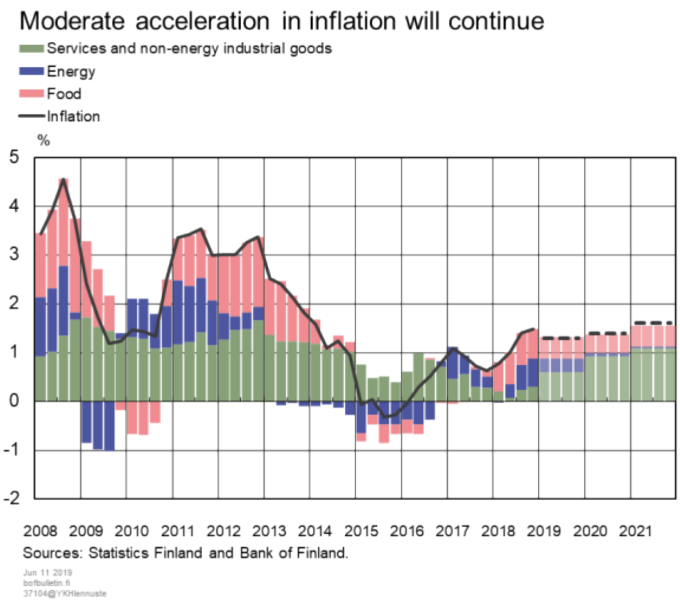

## Moderate acceleration of inflation will continue

Inflation as measured by the harmonised index of consumer prices (HICP inflation) will come in slightly below 1.5% in 2019 and 2020, and 1.6% in 2021 (Chart 22). Consequently, consumer price growth will remain on a relatively subdued path, having even contracted slightly in 2015.

During the forecast period, consumer price growth will be supported by wage rises, which will gradually feed through into services prices, in particular. In addition, inflation will receive a slight momentum in 2019 from the tax hikes introduced at the turn of the year on tobacco products, alcoholic and non-alcoholic beverages, and heating fuels. The new government's policy proposals regarding indirect taxation and other administered prices will be taken into account in the Bank of Finland's December 2019 inflation forecast.

Because headline inflation is currently above measures of core inflation (see 'Measures of core inflation filter out temporary price changes'), it is likely that the former will see more moderate developments in the coming months. Nevertheless, measures of core inflation have picked up. Firmer underlying price pressures will help ensure that the moderate acceleration in inflation is sustained. In the forecast period, consumer price inflation will be bolstered primarily by rising prices in services and, to a degree, food. Non-energy industrial goods will contribute slightly negatively to inflation for most of the forecast period.

Chart 22.




## Risk assessment and alternative scenario

The risks of the forecast clearly indicate that the economy is weakening. The threat of an escalation of the trade war overshadows stable economic growth and is causing uncertainty for the Finnish economy. A particular concern for Finnish exports is the dwindling outlook for the main export markets in Europe, especially in Germany. Even domestic risks point to weaker-than-expected growth.

### Shadows continue to loom over the global economy

The growth outlook for the global economy and the euro area has diminished since the start of the year, and uncertainty about stable economic developments has increased. Rising protectionism poses a threat to the Finnish economy. An escalation of the trade war would further erode confidence in the global economy and impact investment growth. This, in turn, could have very negative effects on Finnish exports.

It is difficult to estimate the magnitude of the negative effects of a trade war. An increase in protectionist measures may alter trade flows and production chains to the detriment of Finnish exports (Table 3). While the direct effects of a trade war would have only little impact on Finnish exports, the indirect adverse effects would be markedly greater.

China's slowing economic growth and the trade war with the United States may have unpredictable effects due to the complexity of global value and production chains. China's importance for Finnish exports has grown in the past few years. China’s slowing growth and growing indebtedness is cutting into the country’s imports and investment. The trade war with the United States, in particular, may escalate the issues in the Chinese economy. A significant weakening of Chinese growth would dampen Finnish exports to China.

The outlook for Finland's main export markets in Europe, and especially in Germany, weakened substantially during the spring, even though growth had picked up at the beginning of the year. This is of particular concern for Finnish exports. Most recent statistical data, for example consumer confidence in Europe, indicate that the decline is levelling out, but it is not yet certain how temporary the economic weakness of Europe and the euro area will be. Prolonged weak economic growth in the euro area would inevitably be reflected in Finland's export demand and exports.

In recent years, the car industry has experienced a record number of major problems and the challenges are far from over. The latest of the threats have been external, caused by the slowing growth in China, the escalating trade war and the uncontrolled Brexit-situation. The car industry is also struggling with some hard-to-measure variables, such as shifts in consumer attitudes. The realisation of these risks would be a threat to the economy of the entire euro area.

Uncertainty regarding the United Kingdom's withdrawal from the EU continues, effectively weakening overall confidence. The prevailing uncertainty about an agreement has negative impacts on companies engaging in foreign trade between Finland and the UK. The UK is an important export market for Finland. And while the direct effects of trade barriers between Finland and the UK may be small, it could result in far greater indirect effects. Protracted uncertainty potentially leading to a 'no deal Brexit' would have adverse effects on the development of Finland's export markets, as it would become increasingly difficult for Finnish companies to export anything to the UK.

The risks to the international economy as a whole are clearly on the downside. Slowing investment growth in important export markets could dampen Finnish exports significantly.

Table 3.

Trade war poses significant threat to global economy

| **Foreign risks** | |
| --- | --- |
| (--) | Protectionism and a spreading trade war and its impact on Finnish export markets |
| (--) | China's growing issues may hamper Finnish exports |
| (-) | Brexit |
| (-) | Prolonged slowing of economic growth in the euro area |

## Domestic risks also on the downside

The downside risks to the forecast for the Finnish economy have recently increased significantly. The Finnish economy may grow more slowly than projected, especially in 2019. The upside risks to the forecast are mostly related to non-residential investments.

Labour costs have increased moderately for several consecutive years, contributing to the competitiveness of Finnish export companies. However, cost-competitiveness may deteriorate rapidly if Finnish wages begin to rise faster than in Finland's competitors. If unit labour costs start rising faster than in competing countries, this would weaken the relative competitiveness of companies operating in Finland (Table 4).

The baseline forecast does not take into account the investment plans of individual companies. Non-residential investment growth may pick up quicker than forecast in the years ahead, if the significant investments in the forest and energy industries proceed as planned. Should these investments materialise, manufacturing investment will grow faster than the forecast baseline. In an environment of favourable conditions and small financing costs, there is good potential for new investment projects. In the longer term, larger investment projects increase productivity and strengthen exports.

In the last few years, household indebtedness has grown significantly. High household indebtedness poses a risk that could materialise if the economy were to deteriorate significantly. In such a situation, the housing market could also slow down quickly, as unemployment begins to rise and employment to decline. A worsening of the economic cycle combined with the high debt burden would slow private consumption growth faster than projected.

Table 4.

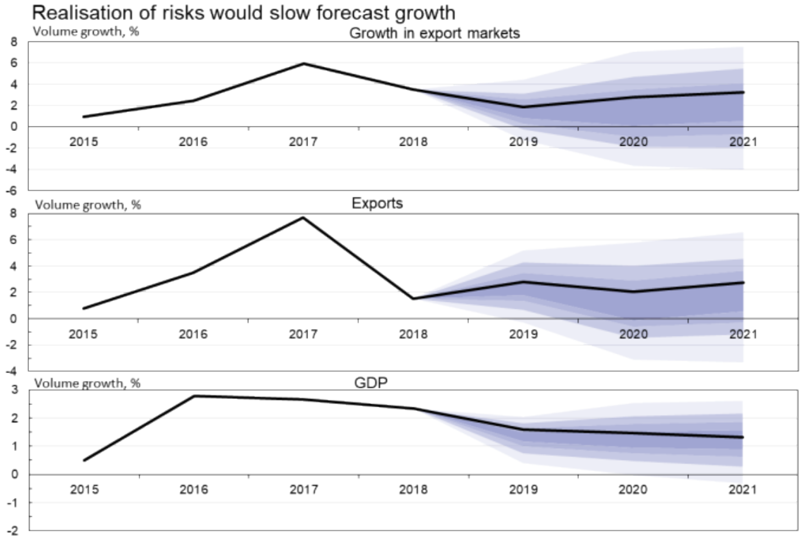
Domestic downside risks have also increased

| **Domestic risks** | |
|---|---|
| (--) | Downside risks to the Finnish economy have increased, and economic growth may remain slower than anticipated in the short term |
| (+) | Fixed investments may grow faster than anticipated |
| | • A favourable environment for companies and relaxed financing costs |
| (-) | Rapid cooling of the housing market |
| (-) | Growing household indebtedness amidst a significantly weakening economy |
| (-) | Wage increases exceed productivity |

## Risks to the international economy threaten to slow growth

The most significant downside risk to Finland's growth forecast stems from the uncertainties in the global economy. Realisation of global economic risks and weaker growth in the export markets would weigh on Finnish exports, in particular. Weaker exports, in turn, would be reflected in economic growth, which would underperform the baseline forecast.[6] Forecast uncertainty related to risks to the export markets is best illustrated by fan charts (Chart 23). The asymmetry of the distribution is indicative that the risks to the export markets fluctuate unevenly around the baseline forecast. The fan charts illustrate the forecast uncertainty related to external factors and provide an assessment of asymmetrical risk factors. The GDP growth forecast for 2019 is also lowered by the downward revision of GDP statistics at the end of 2018 in the latest statistical release (see Recent statistics suggest a faster-than-expected slowing of the economy) which could not be taken into account in the baseline forecast.

Chart 23.




Sources: European Central Bank and calculations by the Bank of Finland. The black line represents the baseline forecast. The different shades of colours represent 90%, 70%, 50% and 30% probability intervals.
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Risks to the export markets are tilted on the downside compared with the baseline. As a result, the uncertainty around the baseline is asymmetrical with regard to growth in the export markets (Chart 23). With this level of uncertainty included, annual export market growth displays a spread of about -4% to 7% during the forecast years 2020–2021.

To assess how sensitive the Finnish economy is to uncertainties stemming from the external environment, the forecast can be conditioned on the uncertainty surrounding the export markets. Uncertainty surrounding export market growth is directly reflected in Finnish export demand, which is why the alternative forecast paths for exports are tilted on the downside compared with the baseline. Using the standard forecast assumption as baseline, export growth displays a spread of -3% to 6% over the forecast years 2019–2021.

Weak exports, in turn, are reflected in GDP growth, whereby the risks to GDP are also predominantly on the downside compared with the baseline, especially in the short term. The GDP forecast fluctuates both above and below baseline, from 0% to 2.5% and is strongly skewed on the downside. Yet, in light of the alternative scenario, the probability of economic growth coming to a halt in the forecast period is very small.

The materialisation of risks to the global economy would dampen Finnish export demand significantly and potentially lead to a slight contraction of exports, even in the immediate years ahead. However, a complete cessation of GPD growth would require either longer-than-expected deterioration of the export markets or a simultaneous triggering of risks to the domestic economy, for example as a result of an escalation of a trade war.

### Tags

international trade, public finances, gross domestic product, inflation, forecast, Finland, employment, economic growth, economic forecast