BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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Recession followed by slow recovery

19 OCT 2020 3:05 PM • ANALYSIS • ECONOMIC OUTLOOK

According to the Bank of Finland's assessment, Finnish GDP will contract by 4.7% in 2020 and grow at an annual rate of 2–3% in 2021–2022. Even though the recession appears to be shallower than feared in the spring, it is still deep, and recovery will be slow. Employment threatens to weaken for a protracted period, and the global recession is overshadowing the outlook for exports. Uncertainty stemming from the coronavirus pandemic will remain high, both in the global economy and in Finland. The risks of weaker-than-projected developments are still considerable and relate, in particular, to failure in preventing the spread of the virus.

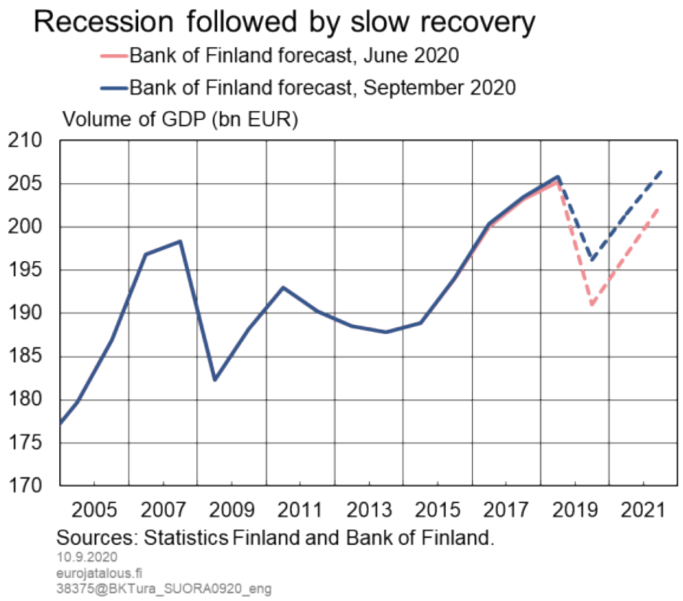
The Bank of Finland's interim forecast[1] is based on data available on 4 September 2020 and assumptions updated on 18 August 2020 concerning Finland's external environment and key financial market variables for the immediate years ahead.

1. The Bank of Finland publishes an interim forecast for the Finnish economy twice a year. The technical forecast updates published in March and September provide a revised outlook for GDP, employment and inflation. The Bank's more detailed forecasts for the Finnish economy are published in June and December.

The worst recession fears did not materialise, but recovery will be slow

The economic recession in Finland this year appears to be milder than feared based on the Bank of Finland's June forecast (Chart 1). The growth forecast for 2020 has improved due to a smaller-than-expected contraction in the Finnish economy in the second quarter of the year. However, the growth outlook for the next few years remains subdued. Economic recovery will also depend on the future evolution of the epidemic: the longer there will be concerns about the spread of the virus, the more fragile economic growth will be. Uncertainty will continue to weigh on the global economic recovery for a long time to come.

Chart 1.

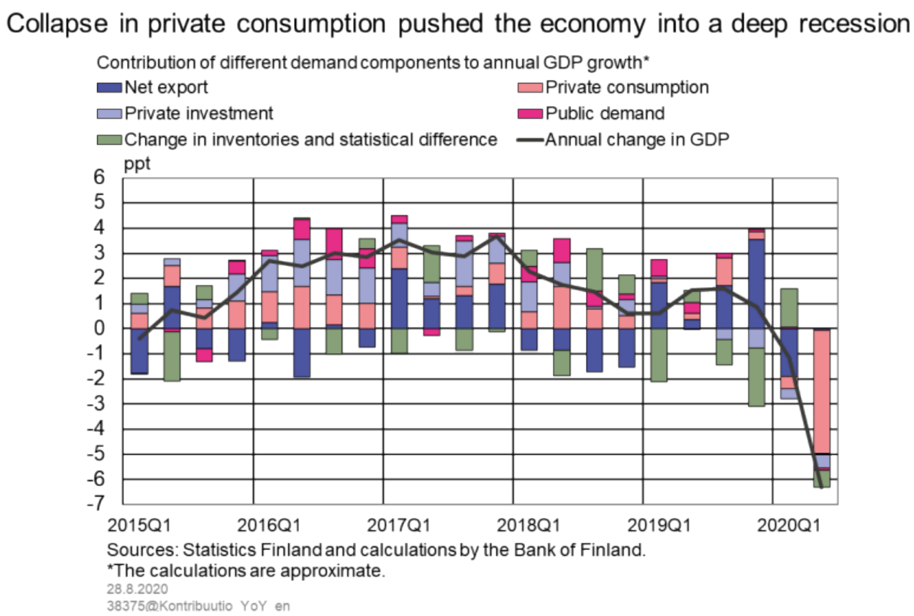


According to data published by Statistics Finland on 28 August 2020, Finland's real GDP contracted in the second quarter of 2020 by 4.5% quarter on quarter and by 6.4% year on year. Thus, according to current statistics, the Finnish economy has now contracted for three consecutive quarters.

The most prominent factor contributing to the sharp drop in GDP was the historic decline in private consumption in the second quarter of 2020 (Chart 2). The weakness of private consumption reflects fears of the spread of the virus as well as containment measures, both of which depressed services sector activity in the second quarter of the year. The substantial fall in exports was balanced by a marked drop in imports, so net exports made only a small negative contribution to GDP.

Overall, in light of current data, Finland's economic contraction in the second quarter of 2020 is among the smallest in Europe and also smaller than feared in the early summer. Although economic developments during the coronavirus pandemic have so far not been as disastrous in Finland as in many other countries, the recession is also deep in Finland.

Chart 2.



Finnish GDP will contract by 4.7% this year as a consequence of weak private consumption, fewer investments and declining exports (Table 1). In 2021, the economy will grow by 2.7% and in 2022, by 2.4%, once private consumption strengthens. However, a prerequisite for a pick-up in private consumption is that the epidemic stays under control.

Table 1.

Interim forecast summary

		2019	2020	2021	2022
GDP, annual growth (%)	Interim forecast, September 2020	1.1	-4.7	2.7	2.4
	Forecast, June 2020	1.1	-6.9	3.0	2.9
Employment rate (%)	Interim forecast, September 2020	72.6	70.8	70.6	71.0
	Forecast, June 2020	72.6	70.8	70.6	71.2
Inflation (%)	Interim forecast, September 2020	1.1	0.5	0.9	1.2
	Forecast, June 2020	1.1	0.2	0.7	1.3

Sources: Statistics Finland and Bank of Finland.

The mere dismantling of containment measures will not restore economic activity, as consumer behaviour will also be impacted by concerns about health and the spread of the virus. For this reason, the recovery of the economy requires that the epidemic be brought under control. In any case, recovery will be slow until a medical solution to the pandemic becomes available.

Since the recession caused by the pandemic is exceptionally global in nature, Finland's international operating environment will be very challenging in the coming years. The global recession and waning global investment will be reflected in Finnish exports for a long time to come. The prolonged uncertainty will also weigh on domestic investment. Given the global uncertainty and slow export market growth, the outlook for foreign trade will remain muted in the next few years.

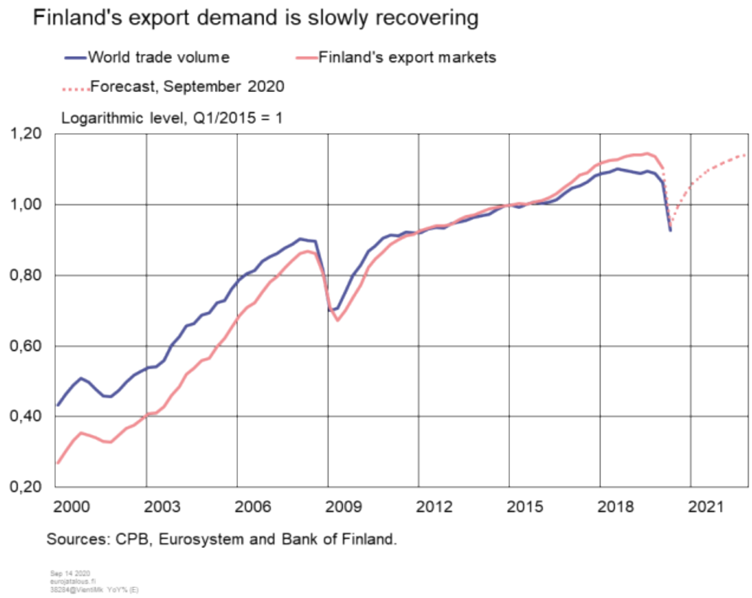
The employment rate will decline considerably due to the coronavirus pandemic, to 71% in 2022, i.e. a level significantly lower than prior to the pandemic (Table 1). Some of the coronavirus crisis-related job losses will become permanent, and an improvement in employment will also be restrained by the sluggishness of economic growth and the ongoing decline in the working-age population.

Consumer price inflation has slowed markedly during the year as a result of the coronavirus pandemic, and inflation as measured by the harmonised index of consumer prices (HICP inflation) will be 0.5% in 2020 (Table 1). Nevertheless, inflation will still be slightly faster this year and next than projected in June, as crude oil prices have risen and underlying inflation has not slowed as expected. Inflation will pick up slightly in the immediate years ahead, to 1.2% in 2022.

The corona pandemic perpetuates uncertainty in the global economy

The external environment of Finland's economy remains challenging. The global economy deteriorated exceptionally sharply in the spring as the coronavirus developed into a global pandemic. Fear of the spread of the virus, combined with strict restrictive measures in many countries, caused a sudden and clear weakening in growth prospects. World trade, along with Finland's export demand, collapsed in the second quarter (Chart 3). In 2020, the global economy will contract by around 4% and world trade by around 11% (Table 2). The outlook for the global economy remains highly uncertain, as there is great uncertainty about the strength and duration of the second wave of the virus. Key to a recovery in the global economy will be how successfully the virus can be brought under control around the world.

Chart 3.



World trade and manufacturing output have recovered slightly during the summer, but they are still well below pre-pandemic levels. Finland's foreign demand is expected to fall slightly less than projected in June and to gradually recover from the third quarter onwards. However, export demand will return to pre-pandemic levels only towards the end of the forecast horizon (Chart 3). From the perspective of Finland's economy and export prospects, the recovery of the euro area and the revival of investment therein are of paramount importance. Euro area GDP declined sharply in the second quarter, due to the decline in private consumption and investment. The euro area economy will contract by 8% in 2020 and return to growth in 2021 and 2022 (Table 2).[2] Private investment in the euro area is estimated to have collapsed in the first half of 2020 as a result of the restrictions introduced due to the corona pandemic, reduced demand and increased uncertainty. A slow recovery of investment is expected to begin in the second half of 2020. However, due to heightened uncertainty, investments may be postponed. As such, business investment for the euro area is expected to reach its pre-crisis level only towards the end of the projection horizon.

Finland's nominal effective exchange rate has appreciated and oil prices are expected to rise slightly faster than expected. However, oil prices remain at a low level in the forecast (Table 2). On the basis of market expectations, interest rates will remain at a lower level than previously assumed, preventing decline in total demand and thereby mitigating the economic impact of the pandemic.

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2. Read more about the projection for the euro area on ECB's website: https://www.ecb.europa.eu/pub/projections/html/index.en.html.

Table 2.

Forecast assumptions

	2018	2019	2020e	2021e	2022e
Volume change year-on-year, %					
Euro area GDP	1.8	1.3	-8.0	5.0	3.2
World GDP	3.6	2.8	-4.2	6.1	3.7
World trade*	4.1	0.6	-11.4	6.9	4.3
Finland’s export markets**, % change	4.0	1.4	-10.4	7.0	4.5
Oil price, USD/barrel	71.1	64.1	42.9	47.6	49.2
Export prices of Finland’s competitors, euro, % change	1.1	1.8	-4.5	-0.4	2.1
3 month Euribor, %	-0.3	-0.4	-0.4	-0.5	-0.5
Finland’s nominal effective exchange rate**	106.9	106.2	108.8	110.6	110.6
USD value of one euro	1.18	1.12	1.14	1.18	1.18

* Calculated as the weighted average of imports.

** 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.

*** Broad nominal effective exchange rate, 2015 = 100. The index rises as the exchange rate appreciates.

Sources: Eurosystem and Bank of Finland.

Short-term models anticipate growth towards the end of the year

On the basis of the short-term forecast models updated by the Bank of Finland on 4 September 2020, economic growth will recover in the third quarter after the collapse caused by the coronavirus in the second quarter (Table 3, Chart 4). The current economic outlook is summarised in the forecasts produced by nowcasting models, which have been used in the preparation of the interim forecast. However, the short-term models are based solely on published monthly statistics. For example, if the epidemic situation were to worsen or the economic situation continue to deteriorate, the forecasts based on short-term models would weaken and, of course, weigh on the economic growth for the rest of the year.

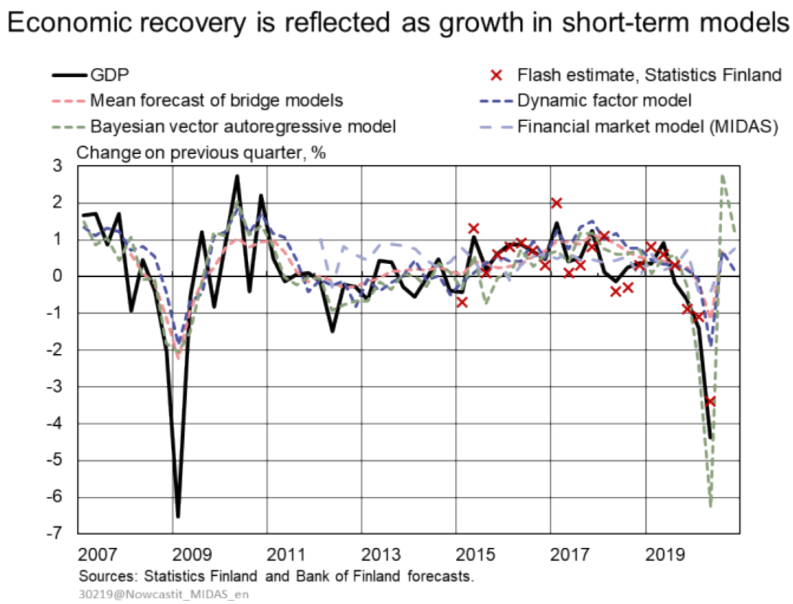
Table 3.

Third quarter will show cautious recovery

Quarterly GDP growth	2020Q1	2020Q2	2020Q3	2020Q4
BVAR	–2.4%	–6.4%	1.4%	1.0%
Factor model	–0.1%	–1.9%	0.6%	1.4%
Bridge model	–0.2%	–1.3%	0.5%	
Financial market model	–0.4%	–0.4%	0.3%	0.1%
Data	–1.9%*	–4.5%*		

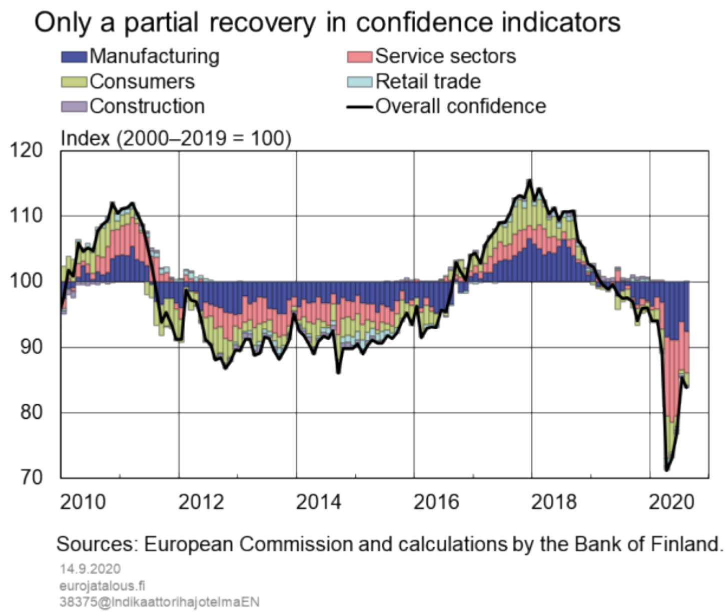
Updated on 4 September 2020.
** Updated in connection with the publication of Statistics Finland's national accounts on 28 August 2020.*

Chart 4.



The confidence of businesses and households in future economic development has recovered during summer, but the figures in August present a reminder of the fragility of the recovery (Chart 5). Consumer confidence declined again in August, as the outlook for the Finnish economy, in particular, deteriorated and consumers assessed that their own financial situation had deteriorated. Industrial confidence also decreased slightly in August, and confidence in the construction sector remained at the same low levels as in July. In services and retailing, confidence continued to recover, but remained low nonetheless, especially in the services sector. Overall, confidence figures indicate weak economic growth towards the end of the year.

Chart 5.



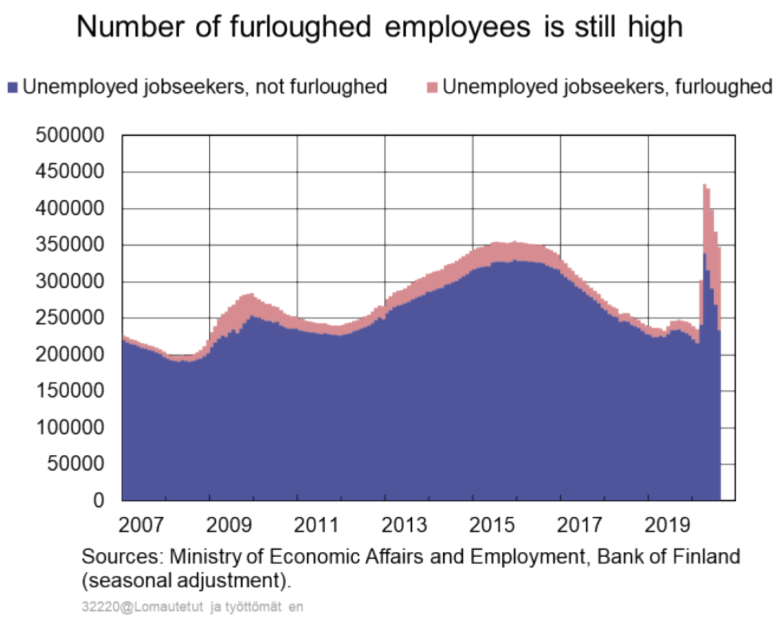
In Finland, the pandemic did not result in a widespread shutdown of factories, so the drop in manufacturing in the second quarter has naturally been smaller than in many other countries. Moderate order backlogs may also have softened the decline in output all the way into spring and summer. However, new orders in manufacturing have declined in Finland throughout the year, anticipating sluggish manufacturing output in the future. New orders do, however, vary significantly more than manufacturing output, and, for example, during the financial crisis, new orders fell more sharply than output. Exports have clearly deteriorated in the first half of the year. In June, exports fell in several main categories of goods, such as transport equipment, refined oil products and forest industry products. The global nature of the recession is also indicated by the fact that exports to several countries – such as Germany, Sweden and the United States – fell markedly in June. However, the outlook for the export industry had diminished even before the corona crisis, for example due to the trade war, Brexit and the general weakening of the global economy.

Retail trade has continued to grow, and also car sales seem to have recovered from the sudden halt in the spring. In the early stages, the downturn caused by the corona pandemic hit the service sector the hardest. The turnover of the service sector has suffered significantly from the coronavirus crisis, and while it improved slightly in the early summer, the sector still has a long way to go to pre-pandemic activity levels. The differences between the various service subsectors are large, and in particular sectors related to tourism, arts and entertainment have suffered considerably from the pandemic. The problems in the service sector are also reflected in services exports, which, on the basis of the balance of payments, have weakened more sharply and strongly than in the financial crisis. The plight of the service sector is also reflected on the labour market, which has deteriorated dramatically during the current crisis.

Employment threatens to weaken for a prolonged period

In response to the coronavirus pandemic, the labour market deteriorated in an exceptionally dramatic manner in the spring. The number of furloughed employees, in particular, rose more sharply and to higher levels than during the financial crisis (Chart 6). This was accompanied by an increase in the number of new spells of unemployment. During the summer, the rise in both the number of furloughed and the number of unemployed jobseekers came to a halt and started to reverse, as lockdown measures were lifted and the epidemic entered a calmer phase, but the numbers are still high. As the coronavirus situation begins to deteriorate again, the risk of weakening consumer confidence, new lockdown measures and the deepening of companies' distress are casting a shadow over the recovery of the labour market. An increase in bankruptcies would inevitably accelerate the rise in unemployment.

Chart 6.



Prolonged economic uncertainty also threatens to turn furloughs into unemployment. Even though the economy contracted less than feared, employment dropped sharply in the second quarter (Chart 7). The number of persons employed was in April–June on average nearly 80,000 lower than in the same period a year earlier.[3] The employment rate will weaken significantly in 2020 (Chart 7 and Table 1). The number of persons employed will also shrink drastically this year. The labour market will recover slowly in the coming years, while both the number of employed and the employment rate will remain significantly lower than before the pandemic.

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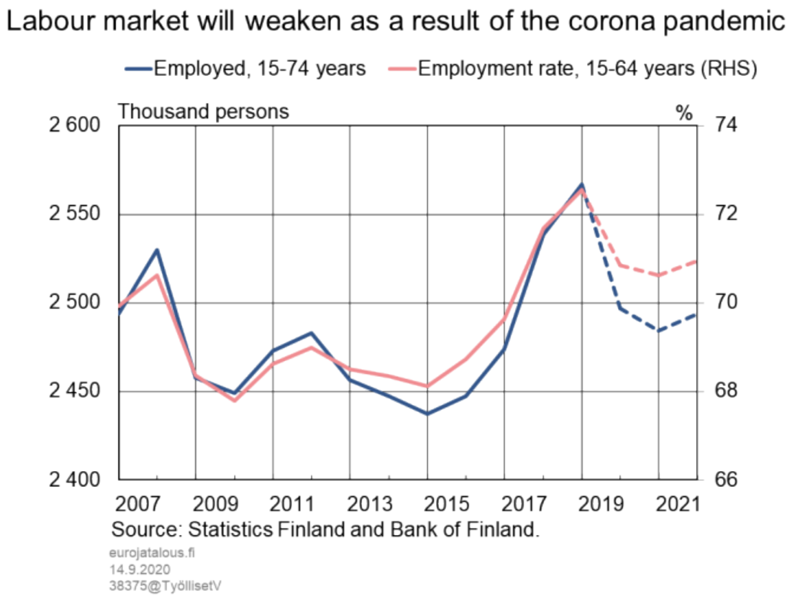
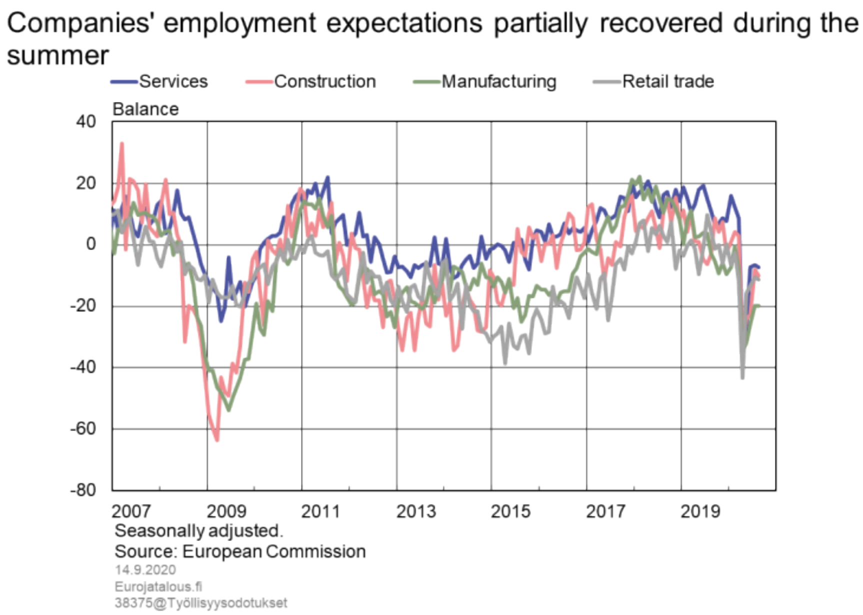
3. The labour market situation may be weaker than thought. The treatment of large and abrupt changes in the calculation of the trend in the series has a significant impact on our understanding of the current situation on the labour market and thus on the starting point of the forecast. In the Bank of Finland's interim forecast, the strong weakening in employment caused by the pandemic is treated as a level shift.

Chart 7.



Leading indicators of employment, for example the number of job vacancies and employment expectations in various industries, suggest a cautious recovery from the drastic collapse in the spring. In August, however, the recovery in companies' employment expectations came to a halt, reinforcing the picture that, for the labour market, autumn may be difficult (Chart 8). In consumer confidence surveys, too, unemployment expectations began to increase again in August.

Chart 8.



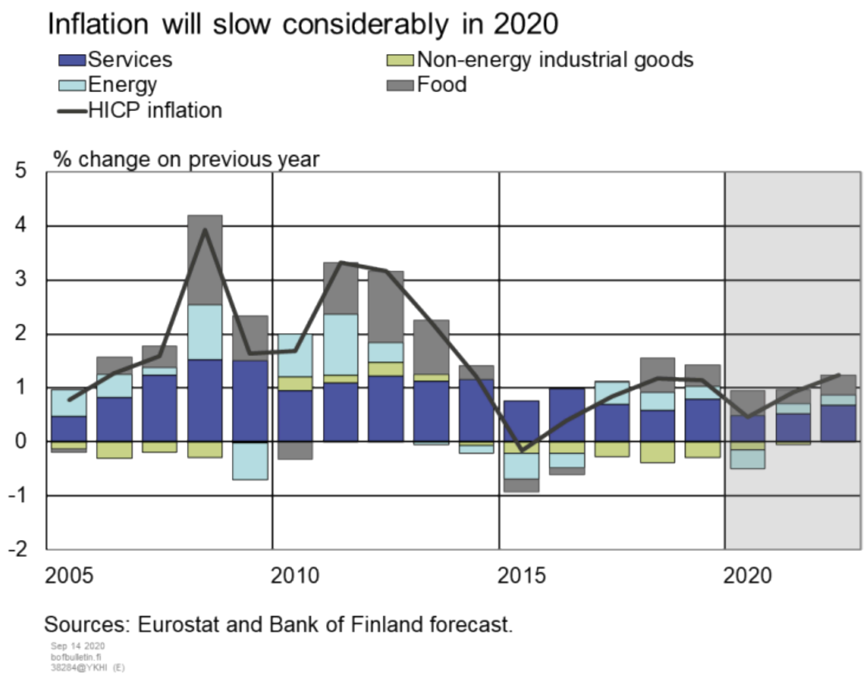
Price pressures will remain moderate in the coming years

Consumer price inflation has slowed considerably in 2020 as a result of the corona pandemic, and inflation as measured by the harmonised index of consumer prices (HICP inflation) will be 0.5% in 2020 (Table 1, Chart 9). The rise in services prices, in particular, has slowed significantly, and the subdued trend in prices is expected to continue until the effect of the pandemic on the consumption of services eases off.

The decline in the price of consumption goods came to a halt in summer 2020, but the price dispersion within product groups and monthly fluctuations have strengthened. The collapse in crude oil prices in the spring slowed inflation, but the impact has slowly decreased, in response to, for example, a subsequent rise in oil prices and higher taxes on fuels. Food prices have risen strongly in the euro area, as well as in Finland, as a result of the pandemic, but the sharpest upward trend is expected to level off towards the end of the year.

Inflation will also remain subdued in the immediate years ahead. Inflation will pick up only slightly in 2021, to 0.9%. Energy prices will rise and will reach levels slightly higher than in 2020. The rise in food prices will slow in 2021, following the rapid increase in 2020. Underlying inflation will pick up towards the end of the projection horizon, reflecting recovery in demand and a rise in input prices. Inflation in 2022 is expected to be 1.2%.

Chart 9.



Tags

corona, corona pandemic, economic forecast, Finnish economy, gross domestic product, labour markets