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BANK OF FINLAND ARTICLES ON THE ECONOMY

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INTERIM FORECAST MARCH 2023

Finnish economy in hibernation

4 Apr 2023 – Forecast – Finnish economy

The Finnish economy slipped into recession last autumn as a result of the energy crisis brought on by Russia's war in Ukraine. The economy's weak performance will continue this year, as it takes time for the effects of high inflation and the rise in interest rates to be felt in full. However, the recession is likely to be short-lived and the employment rate will remain high throughout the downturn. Energy prices have fallen sharply in recent months and the immediate threat posed by the energy crisis has abated. The upward pressure on consumer prices will gradually subside and inflation will slow down substantially by next year. However, there is still high uncertainty about the path the global economy will take and the impact of this on Finland.

The Bank of Finland's interim forecast[1] is based on data available on 15 March 2023, and assumptions updated on 16 February 2023, regarding Finland's external operating

1. The Bank of Finland publishes interim forecasts for the Finnish economy twice a year, in March and September. These are technical updates of the forecast, in which the outlook for GDP, employment and inflation is updated. The interim forecast does not necessarily reflect the views of the Eurosystem. The Bank's more extensive forecasts for the Finnish economy are published in June and December each year.

environment and key financial market variables in the immediate years ahead.[2]

Economic growth will stall this year

According to the Bank of Finland's March 2023 interim forecast, GDP will contract by 0.2% this year (Chart 1, Table 1). Growth will be held back by economic uncertainty, which increased last year due to the war and the energy crisis, and by the surge in inflation and the consequent rapid rise in interest rates. Consumers' weakened purchasing power and higher interest rates will have an adverse impact on economic growth in the immediate years ahead. Despite the challenges, the Finnish economy will hold out, and the recession is currently expected to be short-lived and shallow.

Euro area inflation will slow this year and, based on the market expectations underlying the forecast, the rise in interest rates will start to tail off in the second half of the year. It will still take some time before all household and corporate loans are repriced. In January, the annual interest rate on the stock of household loans issued by Finnish banks was 2.7%, which is 1.4 percentage points more than in April 2022, when market rates started to rise. In the same period, the 3-month Euribor rose by 2.8 percentage points, while the 12-month Euribor gained 3.3 percentage points.[3] The increasing level of interest expenditure is stifling consumption opportunities particularly for those households with outstanding housing loans.

As a result, the rise in interest rates will still be adversely affecting private consumption and investments in 2024 as well. The purchasing power lost in 2022 due to rapid inflation will not be recovered either, although purchasing power is not likely to weaken further this year in view of slower inflation, continued strong employment and the wage settlements reached during the spring.

Global trade and Finland's export markets will gradually rebound from the downswing caused by the energy crisis, inflation and interest rate increases, and this will support the recovery of economic growth in Finland. Growth will nevertheless be at a fairly weak level, as interest rates will remain elevated and no quick recovery is expected in the demand for Finnish exports: Finnish GDP will grow by 0.9% in 2024 and by 1.5% in 2025 (Table 1).

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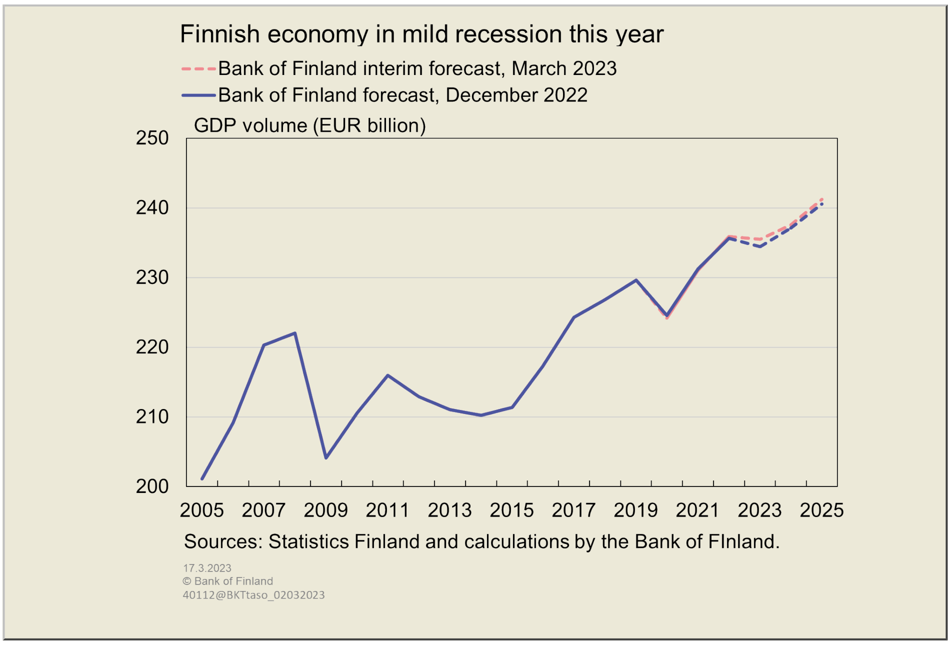
2. The forecast's underlying assumptions about the development of Finland's external environment and of financial market variables are based on the assumptions of the European Central Bank's March 2023 forecast.
3. The difficulties in the US banking sector that were revealed in the second week of March and the resulting turbulence in the financial markets substantially reduced market interest rates in the euro area as well, at the time of preparing this forecast. Major fluctuations in interest rate markets indicate significant uncertainty over the outlook for the economy.

Chart 1.



1. INTERIM FORECAST SUMMARY

	2021	2022	2023f	2024f	2025f
Annual GDP growth (%)					
Interim forecast, March 2023	3.0	2.1	-0.2	0.9	1.5
Forecast, December 2022	3.0	1.9	-0.5	1.1	1.5
Employment rate (%)					
Interim forecast, March 2023, 20–64-year-olds	76.4	78.1	78.1	78.0	78.3
Interim forecast, March 2023, 15–64-year-olds	72.0	73.8	73.9	73.7	74.0
Forecast, December 2022	72.1	73.7	73.6	73.8	74.1
Inflation (%)					
Interim forecast, March 2023	2.1	7.2	4.6	1.6	1.7
Forecast, December 2022	2.1	7.2	5.0	1.6	1.7

f = forecast.

Sources: Bank of Finland and Statistics Finland.

The key risks surrounding the forecast concern financing conditions and the energy markets, and if these risks materialise, the economy could perform below the levels projected in the forecast. The rise in interest rates already seen could lead to weaker economic growth than projected if monetary policy tightening were to cause a deeper-than-expected recession in Finland's main export markets. In mid-March, the failure of certain US banks, partly as a result of rapidly rising interest rates, substantially fuelled uncertainty in the international financial markets. This heightened degree of uncertainty could weaken growth in the euro area and Finland. If economic performance is below the projected level, this would also lead to lower employment rates.

Although the European and Nordic energy markets have coped with the past winter better than expected, uncertainty remains regarding the availability of energy next winter, and energy prices could rise again. Inflation could also persist at a higher level than anticipated if the transfer of companies' accumulated cost pressures to consumer prices takes longer than expected.

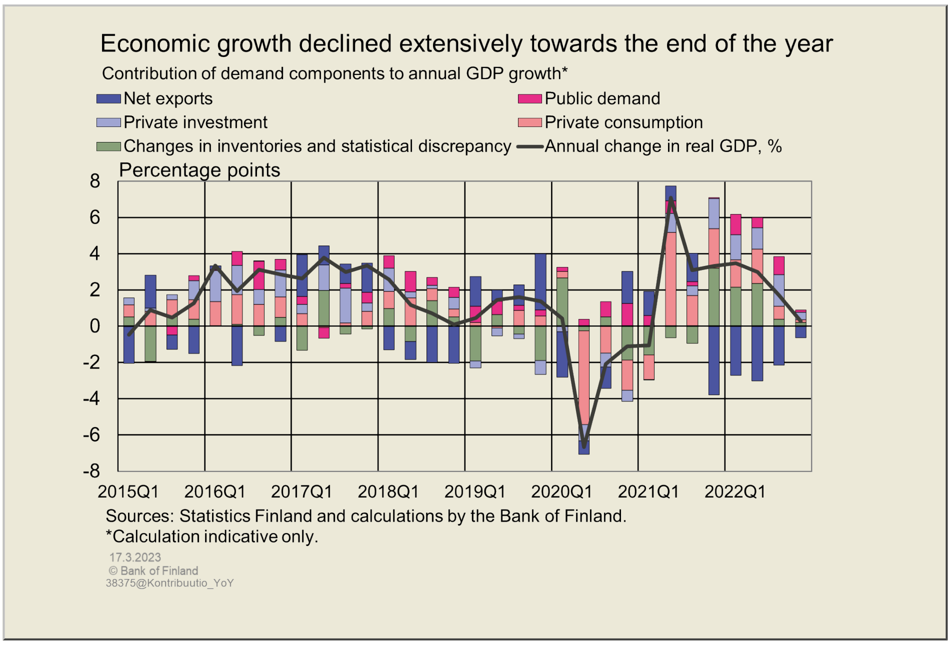
On the other hand, growth in the Finnish economy may also turn out to be higher than forecast. This would be the case especially if employment remains at a good level and consumer confidence improves further, which would be a boon for private consumption. If at least some of the investments planned for the green transition and energy independence were to take place, this could boost economic growth more than forecast. In the global economy, the reopening of China after the easing of its strict COVID-19 policy could spur growth in international trade more than expected, which would also underpin growth in the Finnish economy.

Finland slipped into recession in autumn 2022

Growth in the Finnish economy was already slowing significantly towards the end of 2022. During the last quarter of the year, GDP volume contracted by 0.4% from the previous quarter. According to revised data, GDP in the third quarter of 2022 contracted by 0.2% from the previous quarter. Finland's economy was therefore in a technical recession in the second half of 2022. However, economic growth was still strong in the first half of the year, and thus in 2022 as a whole, GDP rose by 2.1% on the previous year.

The deterioration in growth was evident broadly across the economy in the fourth quarter, and annual GDP growth slowed significantly (Chart 2). In the early part of 2022, annual GDP growth relied largely on private consumption and investment, but both of these performed considerably less well towards the end of the year. The widespread slowdown in economic growth is explained by the uncertainty caused by the energy crisis, high inflation and the strong rise in interest rates that started in spring 2022.

Chart 2.



The weak trend in private consumption at the end of 2022 was due to slower growth in the consumption of services. Consumption of services, in particular accommodation and food services, supported the growth of private consumption as a whole last year. On the other hand, the consumption of convenience goods and consumer durables contracted throughout the year.

Private investment continued to grow in the last quarter of 2022 compared with the previous year. Investment in housing fell back significantly as the housing market quickly cooled. However, other private investments continued to show year-on-year growth.

The weak trend in net exports eroded economic growth throughout 2022. In the last quarter of the year, both exports and imports were down from the previous year, although exports weakened more than imports.

The balance of trade in both goods and services was substantially negative last year. The value of goods imports grew more quickly than that of goods exports, especially due to the rapidly rising prices of energy products. On the other hand, the value of exported services grew more slowly than the value of imported services, for instance because travel abroad from Finland increased substantially after pandemic concerns faded and travel restrictions were eased, while travel from other countries to Finland did not return to pre-pandemic levels. All in all, Finland’s current account showed a record EUR 10 billion deficit in 2022 following two years of surplus. An equivalent deficit in proportion to GDP was last seen at the time of the 1990s recession.

Weak economic growth to continue in early part of 2023

The Bank of Finland employs several short-term forecasting models, or nowcasting models, which condense mainly monthly economic indicator data into GDP growth forecasts for the current and forthcoming quarter (Table 2). These short-term forecasts are taken into account in the preparation of the interim forecast.

These models predict that economic growth will strengthen slightly during the first quarter of 2023, but will again weaken during the second quarter (Table 2) However, the GDP growth figures predicted by the models contain a high degree of variation, which indicates that the growth outlook for the upcoming months is subject to quite a high degree of uncertainty and that the signals from different indicators are partially conflicting. With respect to the second quarter of 2023, the uncertainty of the forecasts is compounded by the small amount of data available so far.

2. Nowcasting model results

GDP, quarterly growth

	2022Q3	2022Q4	2023Q1	2023Q2
BVAR	-0.7%	0.2%	0.6%	-0.3%
Factor model	-0.3%	0.1%	0.1%	0.1%
Bridge model	-0.3%	-0.1%	0.2%	
Financial market model	0.3%	1.3%	1.2%	-0.3%
Model average**	-0.4%	0.1%	0.3%	-0.1%
Actual growth	-0.2%*	-0.4%*		

Nowcasting models updated 15 March 2023.

**Updated after release of National Accounts 15 March 2023.*

***Average excludes financial market model.*

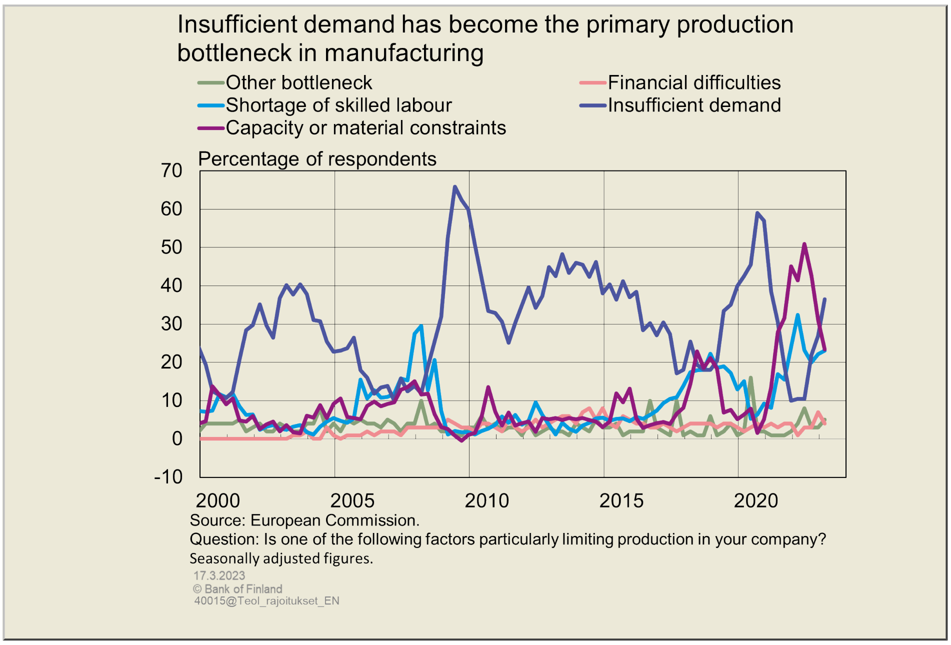
Source: Statistics Finland, calculations by Bank of Finland.

Although the latest economic indicators suggest that the Finnish economy lost momentum during the winter, growth has picked up slightly in the early part of 2023. In January, both the output of the Finnish economy and manufacturing output were higher than a year earlier. The value of new orders in manufacturing was roughly at the same level as a year earlier. The volume index of sales in the wholesale and retail trade and in construction was weak in January. The growth in the output of service companies continued, on the other hand. However, on the basis of income statements published by listed companies in the early part of the year, listed companies' sales weakened during the last quarter of 2022 compared with the previous quarter, and the deterioration in profitability which started in the autumn grew worse.

Expectations about Finland's economic outlook are tinged with a slight optimism among both companies and consumers. Although consumer confidence remains weak, confidence in consumers' own finances and in the Finnish economy increased somewhat in January and February following the historically bleak atmosphere of the autumn. Faltering consumer confidence was evident as a clear weakening of private consumption growth in the latter part of 2022. The slight improvement in confidence could be a sign of the passing of the initial shock caused by Russia's invasion of Ukraine, and of consumers expecting the economy to pick up and inflation to gradually slow this year.

The Confederation of Finnish Industries' Business Confidence Indicator has remained almost unchanged since last autumn. According to the Confederation's Business Tendency Survey[4], companies' business outlooks have improved slightly from last autumn. However, insufficient demand has become the primary production-limiting factor for businesses as the shortages of skilled labour, capacity and raw materials have quickly eased (Chart 3). This points to a turnaround in the economy at the end of the year.

Chart 3.



Uncertainty about outlook for global economy remains high

According to the underlying assumptions of the interim forecast, the situation regarding the global economy and the euro area has improved slightly compared with assessments made at the end of 2022. Nevertheless, there is still great uncertainty regarding the direction in which the economy is headed. The worst scenarios of the energy crisis have not materialised and the past winter has been mild in Finland and Central Europe, which has contributed to people's confidence that the economy will perform somewhat better than had been previously forecast. The decrease in global supply disruptions and the

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4. Confederation of Finnish Industries' Business Tendency Survey.

strengthening of the Chinese economy are also positively contributing to the mood in the global economy. Euro area GDP is projected to grow by 1.0% in 2023 (Table 3).[5] This will stimulate growth in the demand for Finland's exports.

Although euro area inflation will remain high for some time, it will slow down during the course of this year. Energy prices, which climbed rapidly last year, and companies' higher production costs are still being transferred to the prices of end products. The price of crude oil tumbled at the end of the year, and the interim forecast assumes that oil prices will decline slightly further in the immediate years ahead, to below USD 80 per barrel. The significant decline in energy prices following last year's price peaks will reduce future cost and price pressures. The euro is expected to appreciate somewhat this year, which could weaken Finland's external competitiveness (Table 3).

The underlying assumptions of the forecast indicate a further tightening of financing conditions due to persistent inflation. On the basis of market expectations, the 3-month Euribor rate will average 3.3% this year (Table 3). However, there is currently considerable uncertainty surrounding interest rate expectations, due to the turbulence that erupted in the global financial market in mid-March.

3. FORECAST ASSUMPTIONS

	2021	2022	2023^{f}	2024^{f}	2025^{f}
Volume percentage change on previous year					
Euro area GDP	5.3	3.6	1.0	1.6	1.6
World GDP (excl. euro area)	6.6	3.3	3.0	3.2	3.3
World trade (excl. euro area)*	13.0	5.6	2.5	3.4	3.4

5. More detailed information on the most recent euro area forecast and the risk scenario is available on the ECB website.

	2021	2022	2023f	2024f	2025f
Finland's export markets**, % change	10.6	5.8	2.1	3.0	3.3
Oil price, USD/barrel	71.1	103.7	82.6	77.8	73.9
Export prices of Finland's competitors, EUR, % change	10.0	19.8	1.4	2.0	2.0
3-month Euribor, %	-0.5	0.3	3.3	3.3	2.8
Finland's nominal effective exchange rate***	109.4	106.6	108.7	108.7	108.7
Value of EUR in USD	1.18	1.05	1.08	1.08	1.08

**Calculated as a 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. A rise in the index indicates an appreciation in the exchange rate.*

f = forecast.

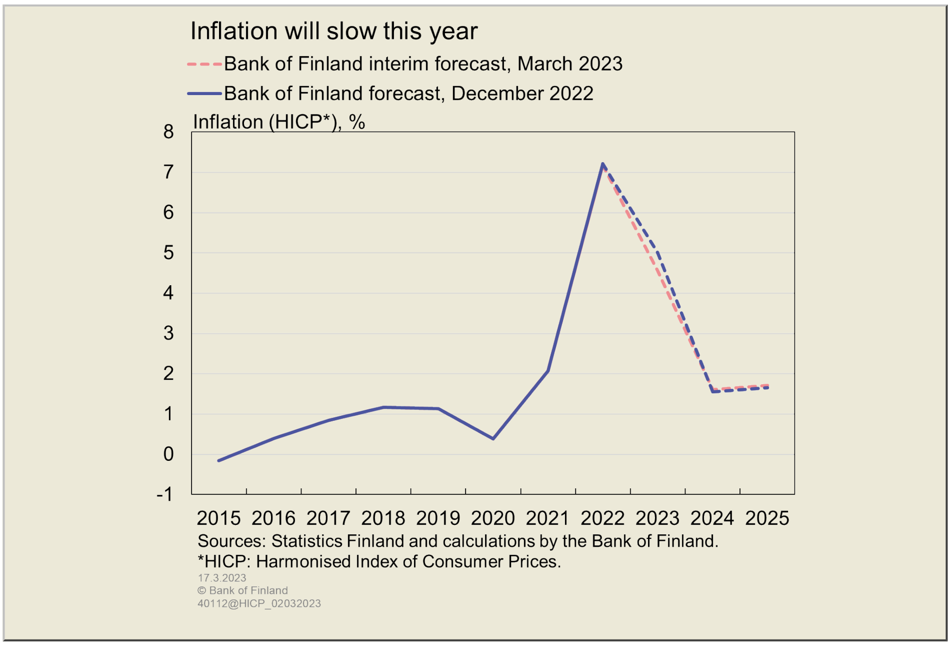
Sources: Eurosystem and Bank of Finland.

Inflation will slow

Peak consumer price inflation was reached in Finland in November 2022, when the Harmonised Index of Consumer Prices recorded a rate of 9.1%. In February, the inflation rate was 7.9%. However, underlying inflation, which excludes energy and food prices, increased further to 5.0% in February. This suggests that, although the energy and raw materials price peak has already passed, companies are still transferring their increased costs to consumer prices. As a result, a levelling off of inflation will still require more time.

Nevertheless, the rapid decline in energy prices at the end of 2022 and in early 2023 is moderating the headline inflation rate. At the same time, the considerable tightening of monetary policy and the increase in market interest rates will curb price increases during 2023. This year, the inflation rate is projected to be 4.6%. The rise in the prices of services and consumer goods will also gradually slow and inflation will return to below 2% next year. Consumer prices will rise by 1.6% in 2024 and by 1.7% in 2025 (Chart 4).

Chart 4.



Employment rate will decline temporarily

The employment rate strengthened in autumn 2022 and also remained high in the early part of this year. The trend employment rate for people aged 15 to 64 was 74.2% in January, while for those aged 20 to 64 it was 78.4%.[6] For the whole of 2022, the average employment rate for the latter age group was 78.1%. The improvement in the employment rate was due especially to an increase in the labour force participation rate: the number of economically inactive people declined last year while the number of unemployed people remained virtually the same. The trend unemployment rate has remained nearly unchanged for a year already. The trend unemployment rate for people aged 15 to 74 was 7.0% in January.

The rapid rise in the employment rate will pass because growth in the economy is stalling. However, the recession will be so shallow and short-lived that the labour market will remain strong throughout the forecast period, and the employment rate of people aged 20 to 64 will remain near 78% in 2023 and 2024. Corporate balance sheets remain comparatively strong, and companies will not need to resort to widespread dismissals. In 2025, the employment rate will improve again once the economy picks up (Chart 5). If economic growth is weaker than anticipated, the employment situation could deteriorate.

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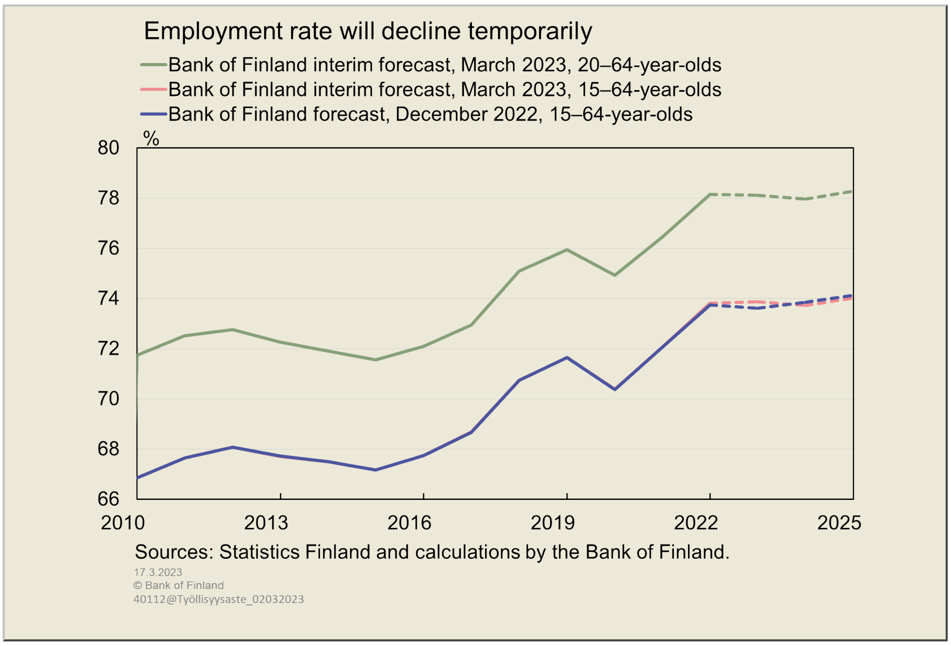
6. In February 2022, Statistics Finland started reporting the employment rate primarily for the 20 to 64 age group, whereas it was previously calculated for the 15 to 64 age group. To facilitate comparison, in this interim forecast the employment rate projection has been prepared for both age groups; previously the projection was prepared for the 15 to 64 age group.

Chart 5.



Tags

uncertainty, forecast, economic growth, recession, employment, inflation