Forecast

Forecast: Finland's economy booming

Finnish economy | 06 July 2018

Finland's economic growth will continue and remain broadly based. Strong global demand, improved cost-competitiveness, growth in household income and favourable financing conditions will all support growth over the forecast period. GDP growth forecasts for 2018–2020 stand at 2.9%, 2.2% and 1.7%. The declining growth rate in the immediate years ahead reflects the moderate long-term outlook for growth. Inflation will remain close to 1% over the years 2018–2019 before gathering pace and reaching 1.5% in 2020.



GDP: Improvement of productivity supports growth

The Finnish economy has been growing for three consecutive years. In 2018, Finland will move from an upswing to a boom, with economic resources in more intensive use than is normally the case. Output is growing faster than its potential, and the output gap has closed (see "The output gap has closed; Finland's economy at cyclical peak").

Output has grown in recent years mainly due to the favourable development of labour productivity. Employment has grown at a slower rate than productivity, except for a period of rapid growth in the second half of 2017. In 2018, GDP will finally reach its level of 2008, immediately preceding the financial crisis.

Rapid capital investment growth has increased the capital stock and boosted labour productivity, thus strengthening the economic conditions for growth in the coming years. Growth potential over the coming years will be largely dependent on productivity growth. Employment will also increase in the forecast period, but more slowly than productivity. Population ageing and problems with labour supply will slow employment growth. At the same time, the labour supply issues and high capacity utilisation within industry will limit output growth.

According to the Bank of Finland forecast, GDP growth will accelerate to 2.9% in 2018. Both domestic demand and exports will boost overall demand. Net exports will support economic growth throughout the forecast period, as lower domestic demand will slow import growth.

In the immediate years ahead, growth will continue to be broadly based, but slowing towards the end of the forecast period. In 2019, growth will reach 2.2% and will then slow to 1.7% in 2020.

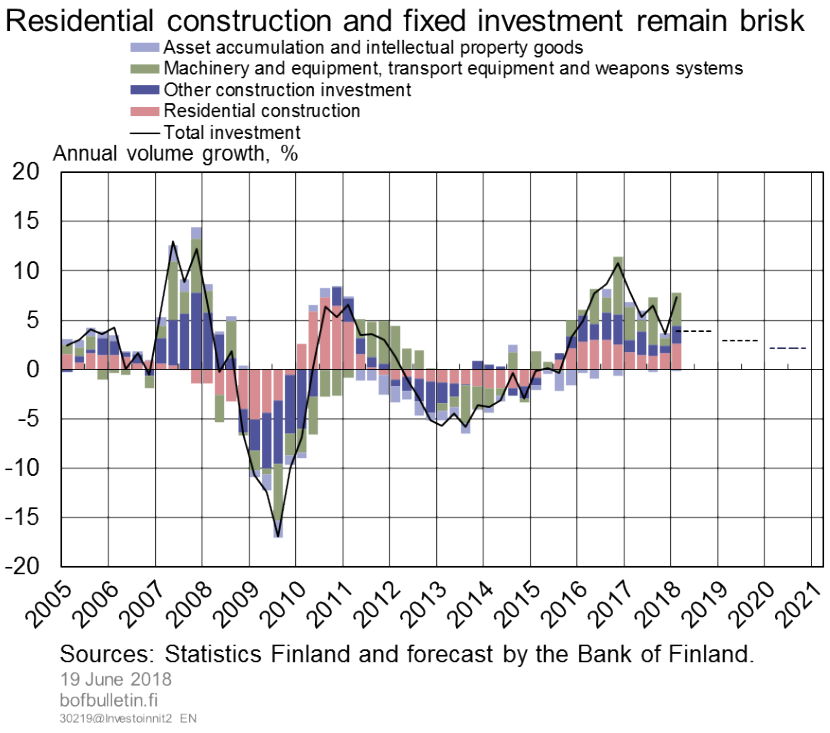
Table 1.

Forecast summary				
Percentage change on the previous year				
	2017	2018[f]	2019[f]	2020[f]
GDP	2.6	2.9	2.2	1.7
Private consumption	1.6	2.3	1.9	1.6
Public consumption	1.3	0.6	0.1	0.7
Fixed investment	6.3	3.9	2.9	2.1
Private fixed investment	8.4	4.2	3.3	2.5
Public fixed investment	−2.9	2.2	0.5	0.4

Forecast summary				
Exports	7.8	5.1	3.9	3.1
Imports	3.5	3.1	2.8	2.6
Effect of demand components on growth				
Domestic demand	2.6	2.2	1.7	1.5
Net exports	1.5	0.8	0.5	0.2
Changes in inventories and statistical error	−1.4	−0.1	0.0	0.0
Savings rate, households, %	−1.5	−1.9	−1.8	−1.9
Current account, % of GDP	0.7	0.9	0.7	0.9
Labour market				
Number of hours worked	0.7	1.3	0.7	0.4
Number of employed	1.1	1.4	0.8	0.4
Unemployment rate, %	8.6	8.0	7.7	7.5
Unit labour costs	−2.7	−0.6	0.6	1.9
Labour compensation per employee	−1.2	1.0	2.0	3.2
Productivity	1.5	1.6	1.4	1.3
GDP, price index	0.9	1.1	1.6	2.0

Forecast summary				
Private consumption, price index	0.9	1.0	1.3	1.7
Harmonised index of consumer prices	0.8	0.9	1.0	1.5
Excl. energy	0.5	0.8	0.9	1.7
Energy	5.7	3.0	2.4	–0.6
f = forecast				
Sources: Statistics Finland and Bank of Finland.				

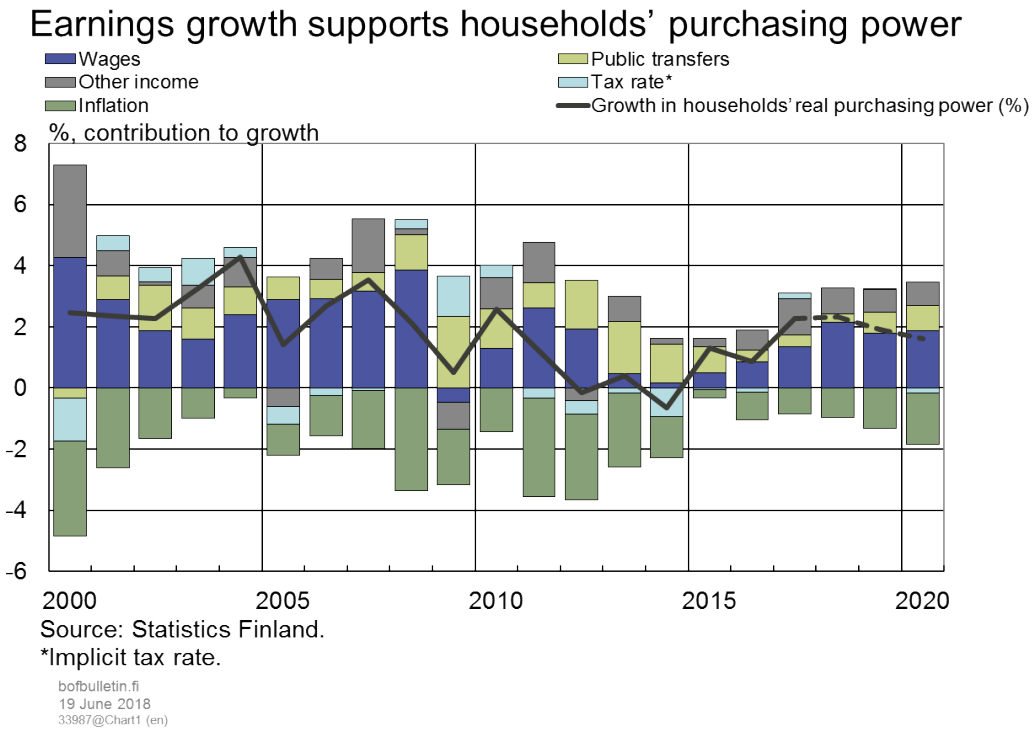
Chart 1.



Higher net exports during the forecast period will further improve the current account, and the persistent current account deficit is melting away. The current account surplus is largely a consequence of improvement in the public finances, reducing government borrowing from abroad. Furthermore, the current account has been strengthened by export income and the increase in

profits and capital gains received by non-financial corporations on their foreign investments. Meanwhile, the household borrowing will continue to increase.

Chart 2.



The forecast is based on Statistics Finland's Quarterly National Accounts (last quarter of 2017) published on 16 March 2018, and other available information. The Quarterly National Accounts published by Statistics Finland on 31 May 2018 are discussed in "First quarter of 2018 sees a surge in investments".

Households: growth in purchasing power supports consumption

The boom will strengthen households' purchasing power on the back of both earnings and employment growth. Private consumption will still grow at a rate of around 2% in 2018, falling below 1½% towards the end of the forecast horizon. Yet, private consumption will exceed disposable household income throughout the forecast period, and households will continue to accumulate further debt.

The negotiated wage increases agreed upon in the course of the winter and spring were reflected in higher earnings growth compared with previous years. Another factor behind the growth in earnings is the notably higher wage drift compared with previous years. Overall, earnings growth

will average around 2½% per annum in the forecast years, but real earnings growth will be subdued by the pick-up in inflation towards the end of the forecast period.

In the current year, the rise in households' purchasing power will be driven more by strong employment growth than by pay rises. In 2018, the number of employed will increase by around 1½% on 2017. In 2019 and 2020, economic growth will fade, with the annual rate of employment growth falling to ½%.

The tax amendments announced will not have a major impact on households' aggregate disposable income. The easing of taxes in 2018 will be almost outweighed by the simultaneous increase in social security contributions.

Growth in households' purchasing power will peak in 2018, when real disposable income will increase by roughly 2%, falling back below a 1½% per annum increase in 2019 and 2020.

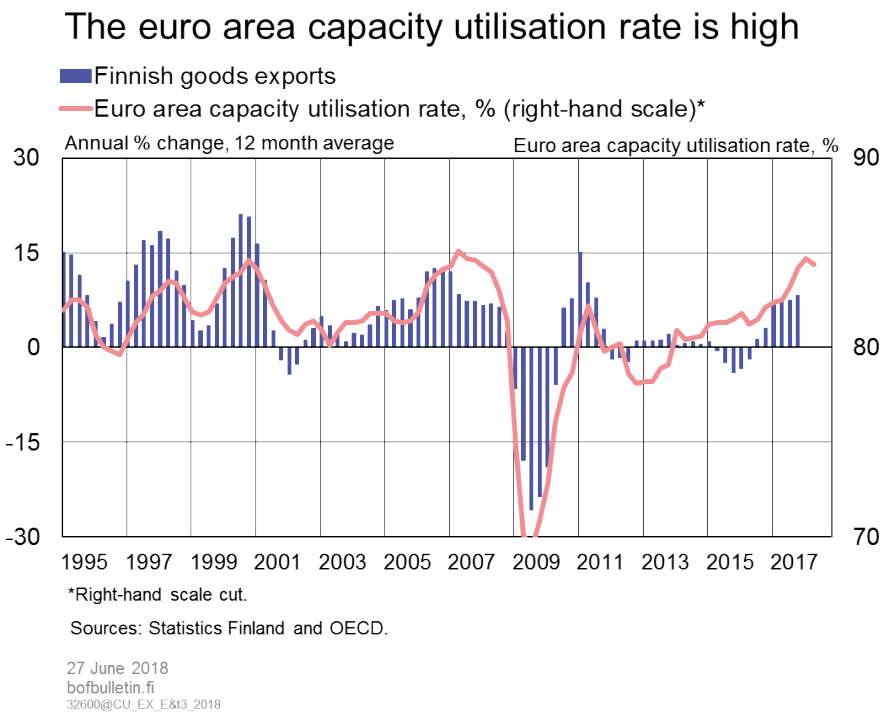
As well as growth in purchasing power, private consumption will also be sustained by consumers' strong confidence in both their own finances and in the Finnish economy. According to Statistics Finland's 'Consumer Survey', consumer confidence in the continuation of positive growth is above all sustained by the favourable employment situation.

Private consumption will continue to underpin economic growth, but the pace of growth in consumption will slowly abate. While private consumption will still grow at an annual rate of close to 2% in 2018, this will slow to 1.2% in 2020.

The share of households' consumer spending accounted for by services has been increasing during the last years. However, in the current cyclical upswing, semi-durables, such as clothing, have recorded the most rapid increase, up by around 5% in 2017 from the year before.

Although growth in purchasing power is currently much faster than in the recession years, the household savings rate will remain negative, with household indebtedness deepening further. Given that the public sector continued to be in deficit last year, the national economy has been reliant on the corporate sector for savings (Chart 3).

Chart 3.



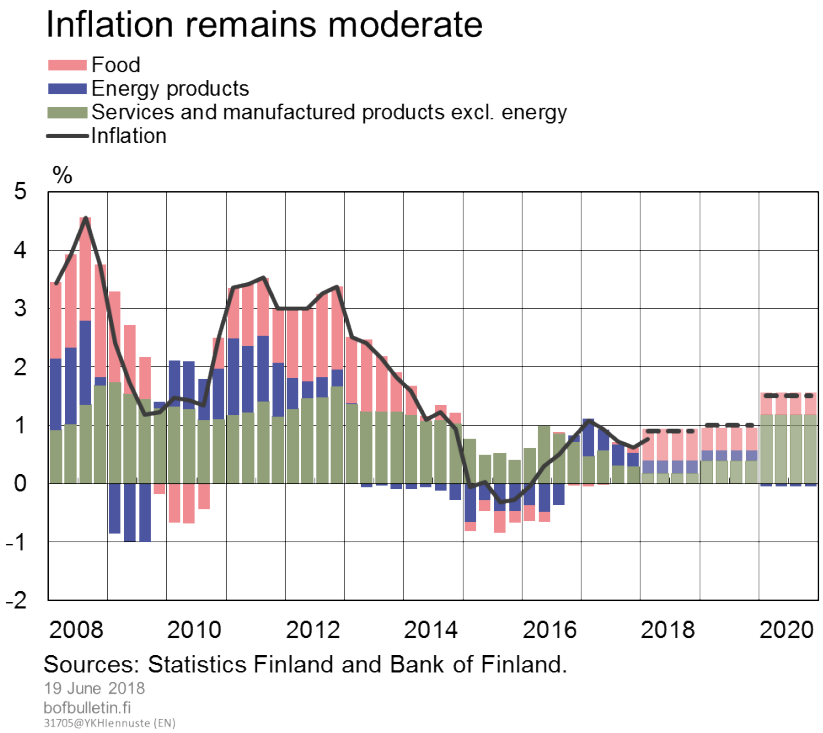
In the last quarter of 2017, the ratio of household debt to disposable income was just over 128%, and households will continue to accumulate further debt in the forecast years. The favourable economic cycle, together with low real interest rates, will bolster demand for new housing loans, especially in the Greater Helsinki area and other growth centres where housing sales are brisk. The household loan stock will expand faster than disposable income, with the growth rate expected to pick up slightly in the forecast years (Chart 4). In the early part of the year, households' housing loan stock increased at an annual rate of roughly 2%, against 6–7% at the turn of the previous decade. The stock of consumer credit has posted steady growth of 3–4% per annum in recent years and is expected to continue to expand in the future.

The growth rate of the housing loan stock underestimates the rate of debt accumulation for mortgage-holding households, as it does not include the household debt held by housing corporations. According to an estimate by Statistics Finland, households held housing company loans worth around EUR 18 billion at the end of 2017.[1]

Nationwide, growth in the housing loan stock is reined in by regional differences within the housing market. While in growth centres households are ready to take on increasingly large loans to facilitate their entry to the housing market, sales of old flats outside the growth centres have been sluggish. However, in response to the steep increase in the prices of flats and the large share of housing sales accounted for by new-build construction, the number of heavily indebted

households has increased in growth centres, where first time buyers must take on increasing amounts of debt to be able to enter the housing market.

Chart 4.

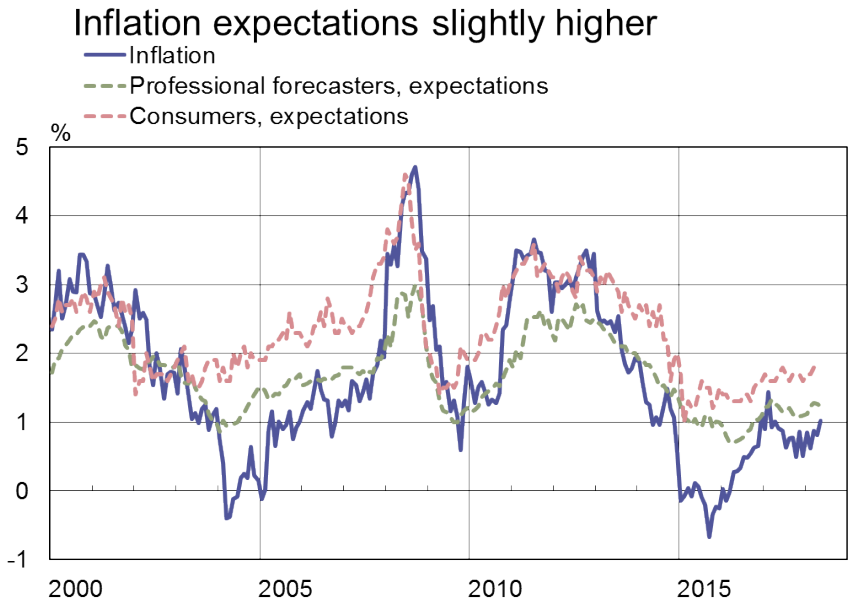


Non-financial corporations: investment spurs growth

Private investment has spurred growth, with both residential construction and fixed investment remaining brisk. The positive trend in investment reflects a favourable growth outlook, good corporate profitability and higher profits, supported by an accommodative monetary policy and the Competitiveness Pact. In the forecast period, investment growth will peak in 2018, climbing to 4.2%. Growth in private fixed investment will moderate over the forecast horizon in response to fixed investment dwindling and investment concentrating towards construction. Investments are surrounded by an upside risk, provided that the planned industrial investments are realised on a broad scale.

In 2017, total investment was up by 6.3%, and private investment by 8.4%. This strong upswing was sustained in the early part of 2018, despite the completion of certain large investment projects in 2017. Investment in machinery, equipment and transport equipment, in particular, expanded considerably. Fixed investment currently serves to enhance the output potential of the economy, making up for the depreciation of productive capital witnessed in the recession years.

Chart 5.



Expectations one year ahead.
Sources: Statistics Finland and Consensus Economics.
19 June 2018
bofbulletin.fi
31705@Chart34 (en)

The rebound in investment has pushed up the investment rate – gross fixed capital formation relative to GDP – to around 23% (and the private sector investment rate to 19%). The current very strong growth in investment will gradually ease off with a moderation in construction growth. Private fixed investment will increase 4.2% in 2018, with the pace of growth moderating to 3.2% and 2.4%, respectively, in 2019 and 2020.

Construction activity remained buoyant in the early part of 2018, and notably the pace of residential construction was brisk. However, growth in construction investment is levelling off and will decline towards the end of the forecast horizon. Residential construction will remain brisk in 2018 and, judging from the increase in construction permits, large numbers of new flats will be completed this year. Renovation work will also continue to grow, with commercial construction driving growth in construction as a whole. By contrast, other construction activity will slow. Industrial construction has shown a downtrend for several years already, while commercial construction has been sustained by warehouse construction. Civil engineering construction will also fade, despite the major infrastructure projects underway in the forecast period. The capacity utilisation rate is high in the growth centres, with building production constrained by a shortage of skilled labour.

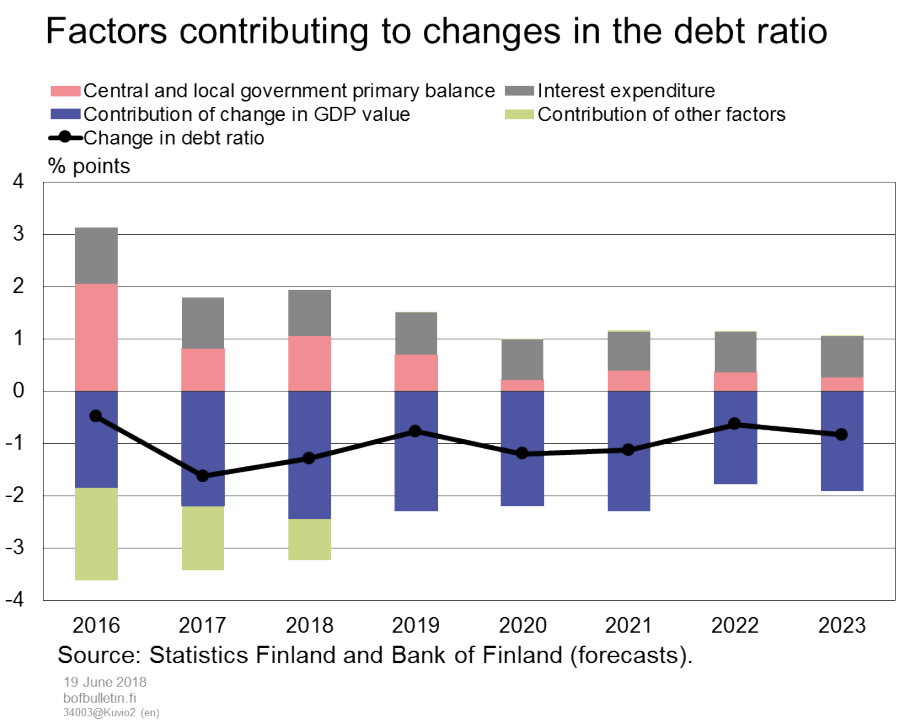
Corporate confidence remained strong in the early part of 2018, and cyclical conditions across all main sectors of industry are assessed to be better than average. In manufacturing, output and new

orders increased in the early part of the year, output expectations are high and the order stock is expected to remain robust. The capacity utilisation rate has almost returned to pre-crisis levels. Confidence also continues to be strong in the services and retail sectors. The conditions for business activity and entrepreneurship have also improved across every region of Finland relative to 2017.

Financing conditions for non-financial corporations will remain favourable, with good access to funding supporting growth in investment. The accommodative stance of monetary policy will keep lending rates down. The average rate of interest on the corporate loan stock was 1.4% in the early part of 2018, i.e. around 0.7 percentage points below the euro area average, and loan margins have remained stable for the past year. The corporate loan stock expanded in 2017 and 2018, although the growth rate for new corporate loan drawdowns has slowed for several consecutive months. Small and medium-sized enterprises (SMEs), who have faced funding bottlenecks, have also slightly increased their use of external funding sources. Having been negative for three consecutive years, net issues of Finnish corporate bonds turned positive in the amount of EUR 1.8 billion in 2017. Overall, access to funding does not appear to be impairing growth for non-financial corporations; rather, there are some bottlenecks due to the shortage of suitable labour.

Corporate sector profits have grown (see also the article 'Are weekly performing firms suppressing economic growth?'). In the National Accounts, operating surplus equals operating profits in the financial statements of non-financial corporations. In 2017, the operating surplus from ordinary activities rose by as much as 17.5%, against 5% on average in 2013–2016. However, aggregate entrepreneurial income for non-financial corporations (which roughly corresponds to profits before taxes and dividend payments) was up by only 10%, due to a decline in the capital income counting towards entrepreneurial income.

Chart 6.



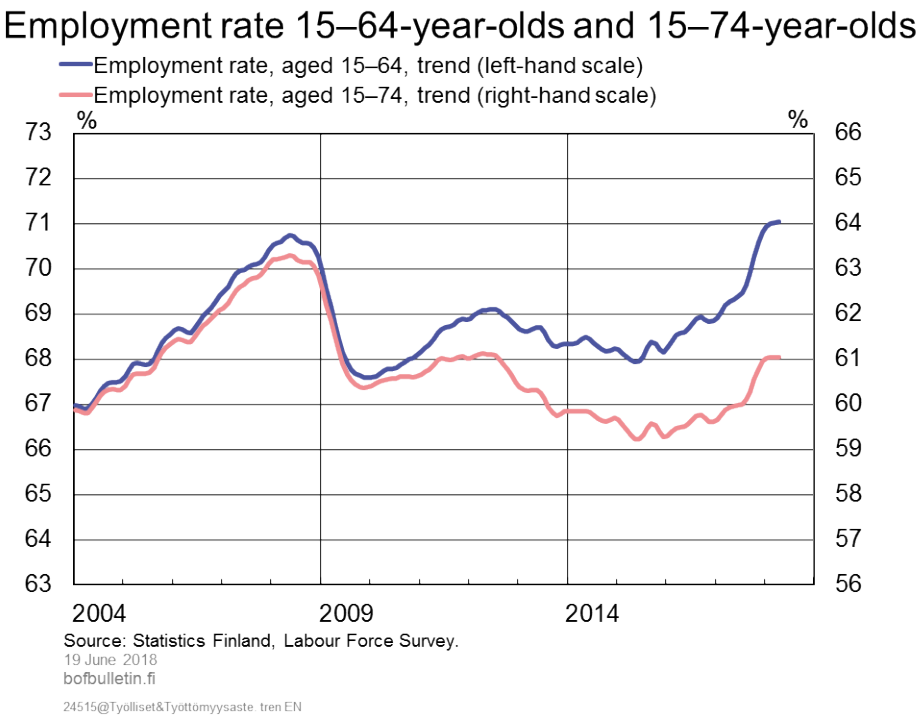
The corporate sector's financial position showed a surplus of EUR 8.4 billion in 2017, and the status as net lender enjoyed by the corporate sector throughout the 2000s continued to strengthen. In the years 2018–2020, corporate sector profitability will remain strong on the back of output growth and rapid productivity growth. This creates scope for corporate investment and growth, and further improvements in employment.

Foreign trade: exports boosted by strength of global economy

Finland’s export growth accelerated markedly last year. Exports will remain on a firm growth path, supported by external factors, but the pace of growth will abate somewhat after the spurt seen last year.

In 2017, Finnish exports increased by 8% (Chart 7), growing faster than the export markets, meaning Finland actually gained market share. Both goods and services exports increased at a rapid pace. Growth has been broadly based both geographically and by commodity structure. The brisk growth in exports notwithstanding, export volumes were still 3% below 2008 levels, although the export markets have expanded by 25% over the same period.

Chart 7.

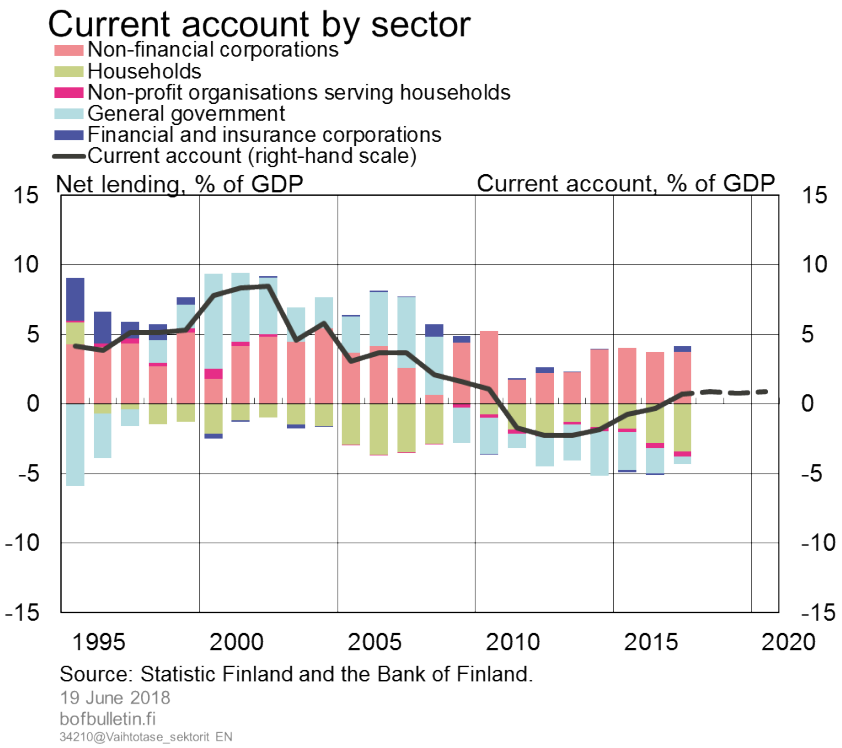


In the forecast period, exports will remain on a strong growth path, posting faster growth than the average since the turn of the millennium. The conditions for export growth are in place, and the favourable export outlook is underpinned by several factors. During the forecast period export volumes will finally rise above the levels of 2008.

Finnish exports will be substantially bolstered by external factors, with the export markets driven by the strong global cycle. The prolonged expansion of export markets is conducive to Finland's investment-driven export structure. The fixed investment undertaken domestically in the past few years will also broaden export opportunities. Moderate wage increases and productivity gains have also contributed to the improvement in the cost-competitiveness of exports. By contrast, the appreciation of the exchange rate will somewhat rein in growth in exports to countries outside the euro area.

Accommodative monetary policy has sustained a rebound in investment, thereby supporting Finnish exports. The capacity utilisation rate in the euro area is very high, and growth in investment is expected to continue. The euro area is Finland's key export market, and cyclical fluctuations in the area are quickly reflected in export developments (Chart 8). Weaker-than-expected performance in the euro area economy would entail slower-than-expected export growth for Finland.

Chart 8.

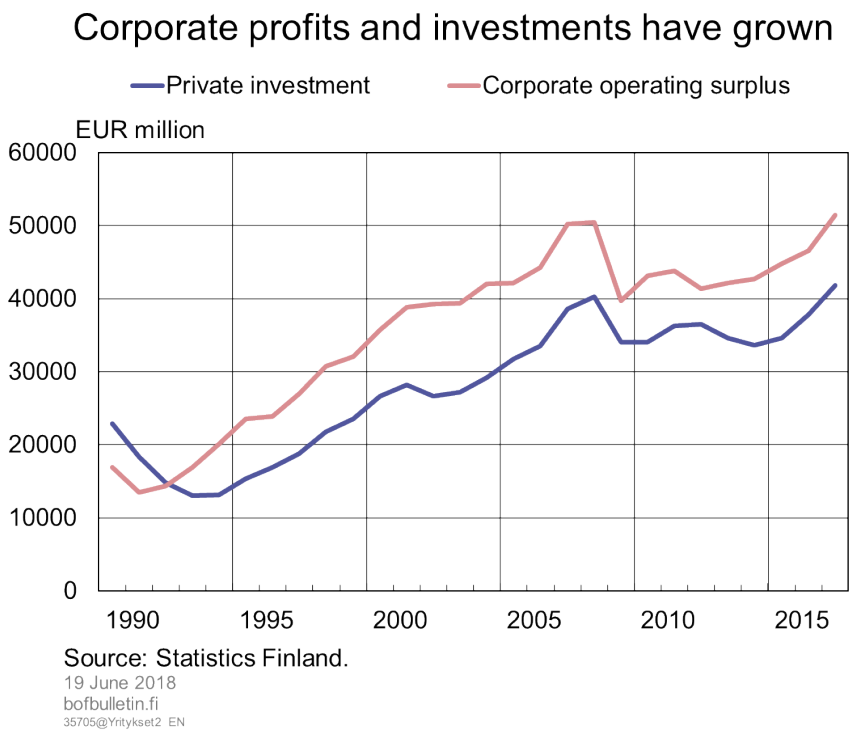


In 2017, the current account was slightly in surplus for the first time in many years (Chart 9). During the past six years, Finland had run up a large current account deficit of more than EUR 18 billion.

The current account surplus of around EUR 1½ billion (0.6% of GDP) in 2017 was generated by the surplus in export of goods, and by factor income. Both the services account and the international transfers account posted a deficit (Chart 9).

The current account will remain slightly in surplus also in 2018–2020. Strengthened by exports, the surplus will stand at 1% of GDP. The terms of trade will not improve, as the increase in export prices will be contained by domestic cost developments. An improvement in the terms of trade is also held back by Finland's economic recovery lagging behind the global upswing.

Chart 9.

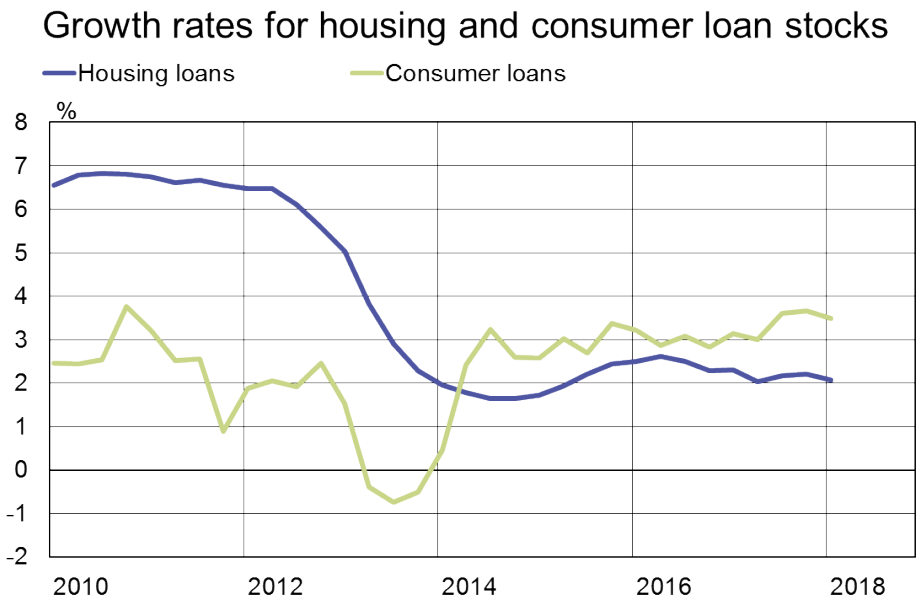


Labour market: Limits of employment growth approaching

Employment grew substantially at the turn of the year 2017–2018, but the rate of growth has already begun to slow. The number of employed will increase in 2018 by about 1.5% and the employment rate will rise. However, employment growth will continue to moderate during the forecast period as the working-age population continues to shrink, with problems of labour supply and demand mismatch persisting and economic growth slowing. Overall, the number of people employed will increase in the forecast years by more than 60,000 and the employment rate will rise to around 72%. The unemployment rate will fall, but the high level of structural unemployment will hinder the reduction of unemployment in the forecast years. However, as the economy continues to grow, the unemployment rate will fall to 7.5% by 2020.

The number of employed and the employment rate have been rising during the past six months much more than foreseen in the previous Bank of Finland forecast in December 2017. The strongest surge in employment growth occurred around the turn of the current year, but since then the momentum has faded somewhat (Chart 10). The rate of growth in employment in the forecast years 2018–2020 will fall well below that of recent.

Chart 10.



A more detailed analysis of the rapid employment growth at the turn of the year is indicative of the possibilities for further employment growth. An analysis by age group shows that the employment rate of 55–64-year-olds in particular has improved, as to a lesser extent has that of 40–54-year-olds. The employment rate of over-55s is markedly higher than before the financial crisis, while that of the 40–54-year-olds has almost recovered to the pre-crisis level.

However, the employment of young adults (25–39-year-olds), which has developed less favourably than the other age groups in the post-financial crisis period, has still not improved a great deal. The employment rate of young adults is still almost 6 percentage points below that of 2008. In order for employment to continue to improve, the employment rate of this age group would also need to return more quickly to the 2008 figures, especially as the trend of older workers' improving employment rate cannot continue indefinitely. However, there is a risk that young adults who lost their jobs during the recession or have never found work since graduation will be marginalised from the labour market for a prolonged period or even permanently.

An analysis of employment rate developments by sector indicates that the growth in the employment rate has taken place across a broad spectrum. At the end of 2017, however, there were many vacancies within social welfare and health care services, public administration and education. Industrial employment also improved in the early part of 2018, having declined continuously since the financial crisis until 2015 and remaining somewhat unchanged thereafter.

Employment growth was also influenced by the fact that employment within trade and hotel and restaurant services was no longer declining at the turn of the year. Employment in other private services sectors began to grow already in 2017, while employment in construction has already been developing positively for a number of years. During the forecast years, economic growth will be driven more than in recent years by industrial sectors with a low labour intensity, while construction activity, which is very labour-intensive, will slow. Service sectors will continue to grow, but labour shortages will undermine the employment effect.

Employment has been growing during the past 12 months across all types of employment, which indicates primarily that the upswing is strong and demand for labour is high. However, employment has increased most in fixed-term part-time work, and this has contributed to the spike in the employment rate figures at the turn of the year. The fact that there are more fixed-term part-time jobs may also be the result of the labour-market activation model introduced at the beginning of 2018. This requires unemployed persons to undertake at least 18 hours of paid work during a 65-day monitoring period in order to avoid having their unemployment benefit reduced. The rapid increase in fixed-term part-time work is likely to be temporary, and this will contribute to a slower increase in employment going forward.

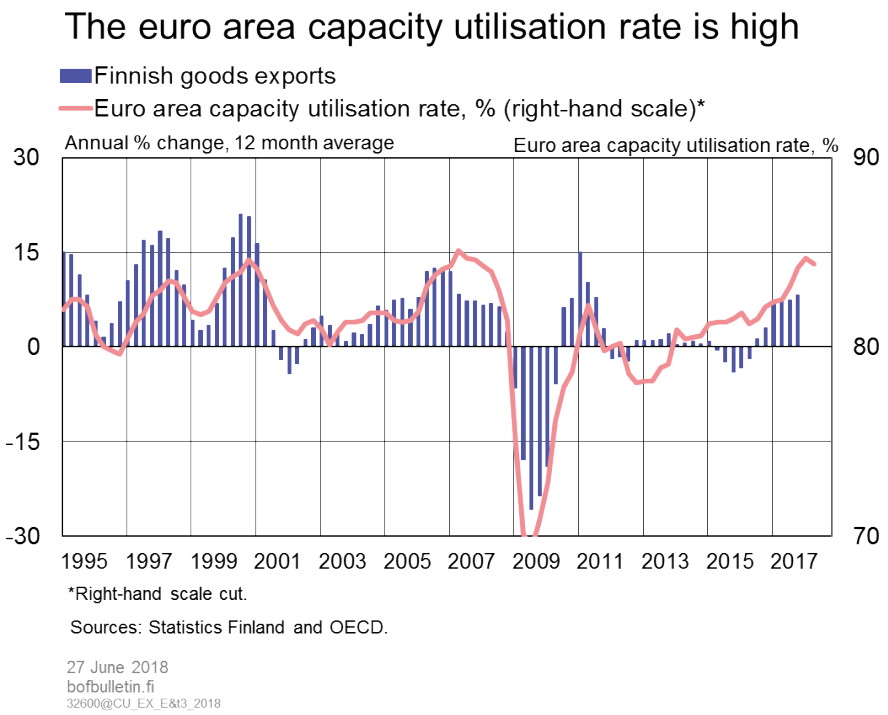
There are growing signs on the labour market that the limits to growth are approaching. Unemployment is already close to its structural level, companies are more widely reporting recruitment difficulties, and it is taking a longer time to fill vacancies. There are fewer and fewer unemployed jobseekers per vacancy. The Beveridge curve, which shows the relationship between unfilled vacancies and unemployment, also indicates that there are problems of matching supply and demand, and the proportion of long-term unemployed remains high.

Between 2019 and 2020, employment will increase by an average of 0.5%. However, throughout the forecast period, the number of people employed will increase by more than 60,000, due to the strong employment growth in 2018. The unemployment rate will fall as economic growth continues, although its decline is slowed by high structural unemployment. By 2020, the unemployment rate will fall to 7.5%. Only part of the increase in employment is due to a reduction in unemployment, and the labour-market participation rate is expected to continue to rise.

The employment rate will rise to about 72% in 2020, i.e. much higher than before the financial crisis. The official employment rate is calculated for the population aged 15–64, not taking into account that the share of the over 65-year-old population is increasing. If the employment rate were to be calculated for the population aged 15–74, the trend would be considerably weaker than the official employment rate (Chart 11), because the employment rate for those aged over 65 years is well below the average. Therefore, the total number of people employed (aged 15–74), which is a key indicator in terms of the funding of the welfare state, will not increase at the same

rate as the official employment rate. As the population ages, attention should also be paid to indicators that take into account those aged over 65.

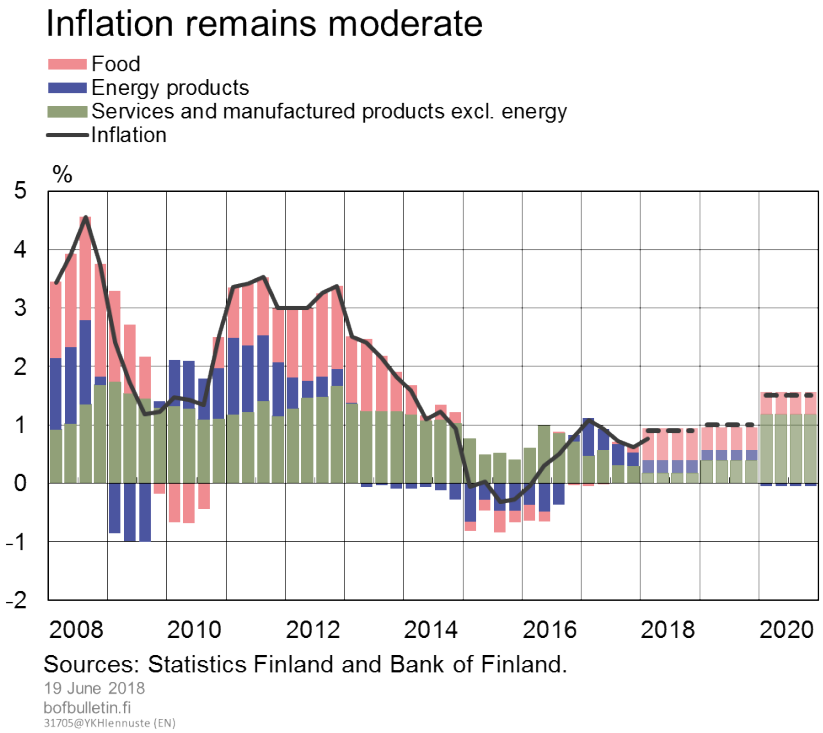
Chart 11.



Wages and prices: Inflation slower than in the euro area

Inflation will remain subdued over the years 2018–2020, but will gather pace towards the end of the forecast period, backed by the booming economy. Inflation according to the harmonised index of consumer prices will reach 0.9% in 2018, before gradually accelerating to 1.5% in 2020 (Chart 12). Consumer price inflation in Finland will remain slower than in the euro area, reflecting moderate domestic cost development. Services prices will play a slightly diminished role in supporting inflation, but the contributions of the energy- and food price components will both increase. The impact of reduced growth in administered prices as well as hikes in indirect taxation will clearly feature in 2018's inflation rate.

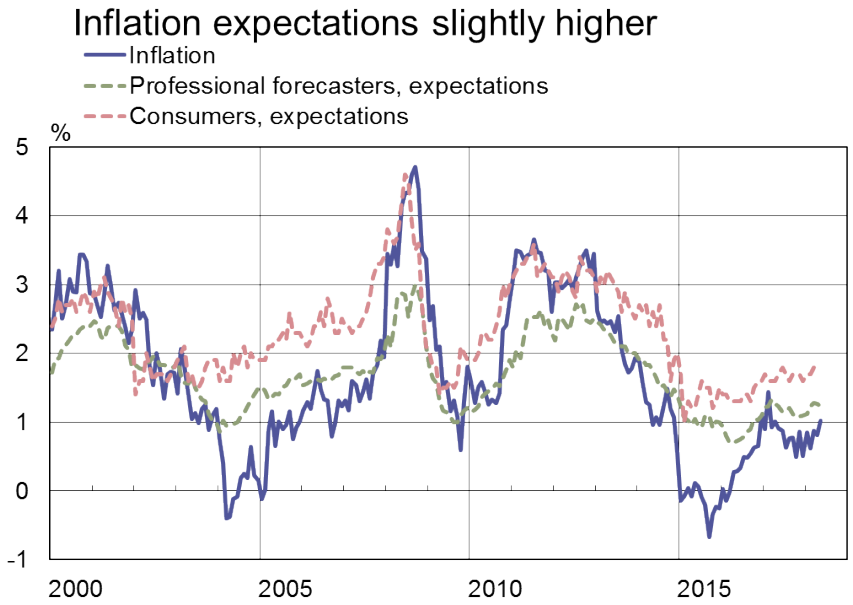
Chart 12.



Growth in the prices of services has decelerated in recent years and will remain markedly slow in the beginning of the forecast period. This development can largely be attributed to an observed moderation in the inflation of rents and housing services as well as a decline in the prices of transportation services. Furthermore, moderate wage growth in recent years has in part curtailed inflation in services prices. The reduction in daycare fees will also slow the inflation rate in 2018.

The prices of energy products will begin to increase following a period of stagnation, buoyed by a rising oil price. The price of crude oil per barrel has reached over EUR 60, increasing by almost half since summer 2017 (Chart 13). According to market expectations, however, the oil price is assumed to slightly fall during the forecast period. The higher oil price's impact on domestic consumer prices will be most evident in rising fuel prices. The decline in the prices of other manufactured goods will continue during the forecast period. The growth rate of goods prices has especially been driven by lower prices in electronics, clothes, vehicles and housing-related goods.

Chart 13.

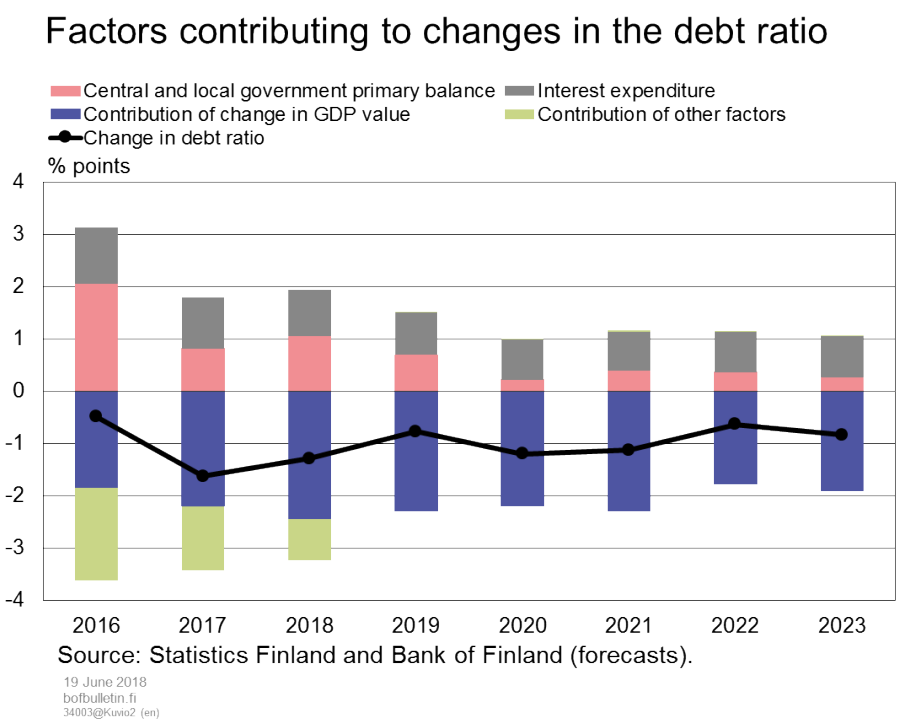


Growth returned to food prices in 2017 following a two-year decline and accelerated in early 2018, especially due to higher excise duties on alcohol. In addition, increases in commodity prices, including energy, will sustain food price inflation throughout the forecast period.

Domestic inflation expectations have slightly recovered in the wake of recent inflation figures. Surveys aimed at both professional forecasters and consumers suggest that inflation is expected to be at a slightly higher rate in a year's time (Chart 14). In addition, expectations concerning inflation in the euro area have also improved.

Inflation will persist at a lower rate in Finland compared with the euro area; by the end of the forecast period, the difference between the respective price-levels will narrow by approximately 1 percentage point.

Chart 14.



Growth in the wage bill accelerated to 2.6% in 2017, backed by favourable employment conditions. Based on national accounts data, average hourly earnings increased at a rate of almost 2%, despite negotiated wage freezes and cuts in public sector holiday bonuses due to the Competitiveness Pact. However, average earnings growth remained far more moderate according to the index of wage and salary earnings, reaching only 0.2%. Public sector earnings contracted by 1%; in the private sector, earnings increased by almost the same nominal amount, as measured by the index.

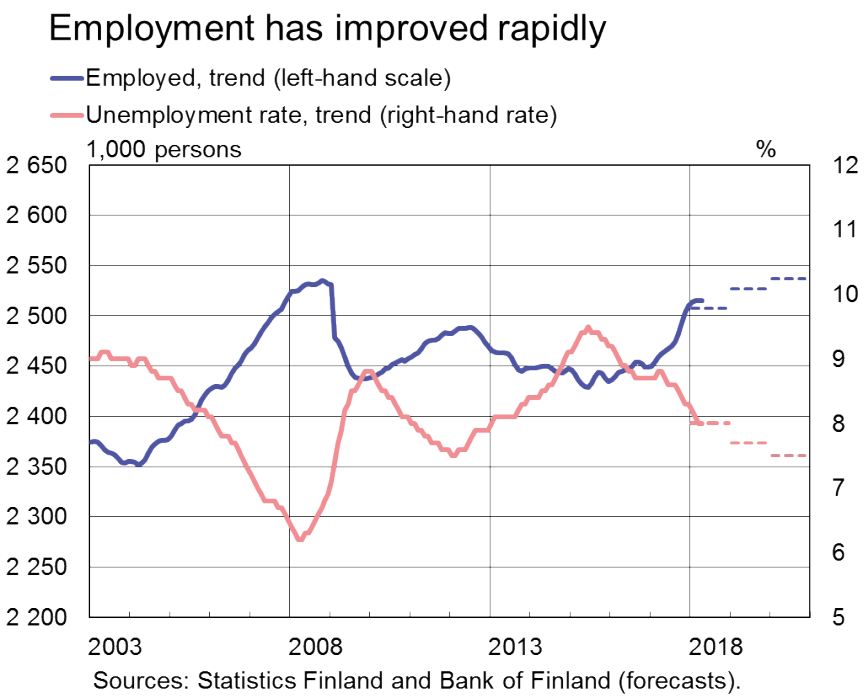
In the years 2018 and 2019, wage growth will be determined by the collective labour agreements implemented at the turn of year, and negotiated wages will accordingly rise by just over 3% over the next two years. Local items stipulated in the new labour agreements may curtail the share of others factors that contribute to wage growth, i.e. the prominence of wage drift. On the other hand, wage drift will gain upward pressures from tightening conditions in the labour market. Overall, earnings will increase at an annualised rate of approximately 2.5% in 2018 and 2019, which is consistent with productivity and price growth. In 2020, private sector real earnings will be determined by productivity growth, but public sector earnings will see a temporary boost in growth as holiday bonuses are reinstated.

In addition to average earnings growth, the wage bill of the aggregate economy rise due to gains from improvements in the employment rate. The wage bill will expand quickest in 2018.

Afterwards, employment growth will begin to deaccelerate and its contribution to the wage bill will mitigate. Labour cost growth, i.e. growth in compensation per employee[2], will remain slower than that of the wage bill in 2018 and 2019, as the accrual of employers' social security contributions will contract in 2018 and will only see marginal growth in 2019.

Unit labour costs[3] will grow only slightly in 2018 and 2019, as output will grow at almost the same pace as labour costs. In 2020, unit labour cost growth will accelerate, as labour costs will increase on the back of earnings growth as well as higher contributions in social security payments, while at the same time productivity growth will decline. Over the forecast period, Finland's unit labour costs will grow at a slightly slower rate compared with the euro area, meaning that Finnish cost-competitiveness will improve (Chart 15). Contrary to the past trend, weakening terms of trade will have little impact on Finland's competitiveness relative to the euro area.

Chart 15.



Public finances: fiscal stance loose relative to the cyclical situation

The general government budget balance improved noticeably in 2017. Besides the cyclical situation, the budget balance was also partly supported by temporary factors, the dissipating impact of which will slightly weaken the position for 2018. The budget balance will improve again

in 2019–2020, backed by economic growth and public sector savings measures. The general government debt-to-GDP ratio will contract below the 60% reference value.

Real growth in public consumption will be moderate in 2018–2020. Growth will be dampened by the Government Programme's consolidation measures and the Competitiveness Pact. Public investment will increase especially in 2018, after which the pace of growth will slow as the key government projects and the action plan to reduce the maintenance backlog of transport infrastructure come to an end. Higher pension expenditure will push up expenditure on social benefits, while on the other hand expenditure on unemployment benefit will decline. The general government expenditure-to-GDP ratio will contract further in the forecast period.

Fiscal stance will be loose, but the requirements of the Stability and Growth Pact will be met

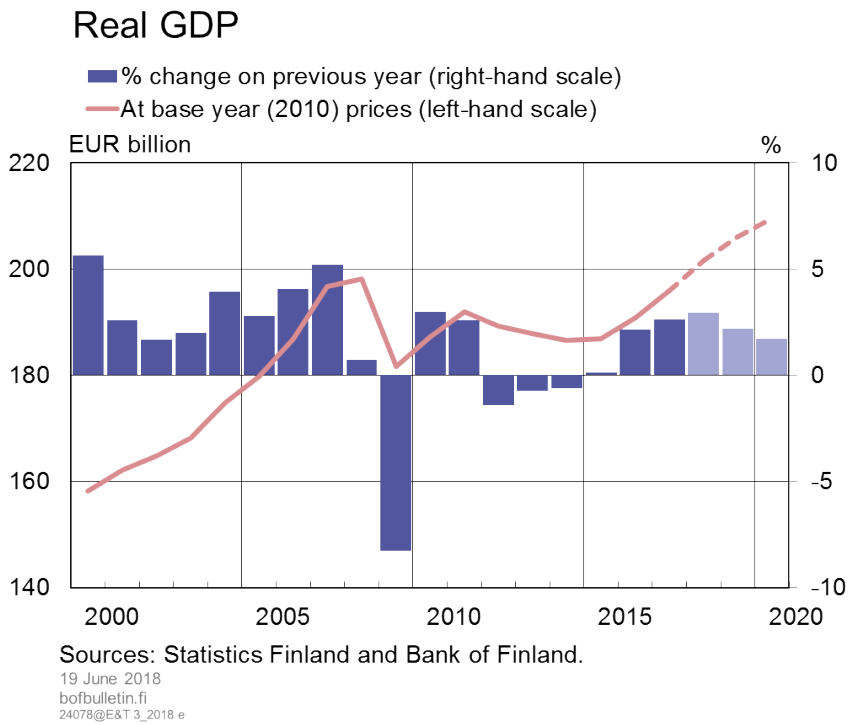
The total tax ratio will decline by about 1½ percentage points, to 42%, in 2018–2020. The decline reflects Competitiveness Pact-related tax cuts and changes in employers' and employees' social security contributions. On the other hand, the favourable cyclical situation will boost tax revenues. Income tax has been cut further during the current year, to mitigate the effects of the Competitiveness Pact. In keeping with the Pact, employers' earnings-related pension, unemployment insurance and health insurance contributions were reduced further. In addition, the financial burden for earnings-related pension and unemployment insurance contributions was further shifted from employers to employees. The public sector savings measures specified in the Government Programme will be continued in 2018–2019, including, for example, a decision not to carry out index increments to certain social benefits and allowances.

The general government structural balance, i.e. the budget balance adjusted for cyclical factors, will remain in deficit (Chart 16). The fiscal stance will be loosened especially in 2018, at a time when the economy is already growing at a robust pace. Because the tax decisions for 2019 will not be taken until autumn 2018, the forecast only takes account of the tax measures specified in the Government Programme. Hence, in 2019, the general government structural balance will remain roughly unchanged, posting a deficit of around 1%. Despite the deterioration in the structural balance in 2018–2019, Finland is likely to be in compliance with the requirements of the preventive arm of the EU's Stability and Growth Pact, due to the deviations granted to Finland earlier.

In 2020, the fiscal stance will be tightened without additional measures, and reaching the medium-term objective (MTO) for the structural balance appears plausible. The budget for 2020 will be drafted by the Government that will take office after the next general election. Therefore, the forecast for 2020 is based on a no-policy-change scenario. The effects of the regional government

reform and the social and healthcare reform have not been estimated either, as the regulations are still under preparation.

Chart 16.



General government deficit contracts

The central government nominal deficit will remain unchanged from the previous year in 2018, after which it will contract to 0.6% of GDP by the end of the forecast horizon. The change compared with 2017 is blurred by large one-off tax revenues received by the government the same year. The improvement in central government finances during the forecast period stems largely from an increase in indirect tax revenues due to the level of economic activity, and expenditure adjustments. Total central government expenditure will not increase at all in 2019 and will grow at a much slower rate in 2020 than revenues. Central government transfers to other general government entities will remain at the previous year's level in 2018, after which they will decrease in 2019–2020.

The local government budget balance will begin to deteriorate again during the forecast period. Central government transfers to local government will decrease due, for example, to a reduction in these transfers related to the Competitiveness Pact and an adjustment of the division of costs between central government and the municipalities. On the other hand, the Competitiveness Pact will further reduce labour costs in the local government sector. The Government Programme's

measures to reduce municipal responsibilities will reduce both local government expenditure and central government transfers to the sector. The lowering of client fees for municipal early childhood education will be compensated by increasing the proportion of revenue from corporation tax going to local government.

Net lending by earnings-related pension funds will contract further in 2018–2020, continuing the trend witnessed since 2007. The surplus on the funds will contract due to relatively strong growth in pension expenditure and, on the other hand, slow growth in asset income amid low interest rates. Other social security funds will continue to post a slight surplus in the forecast period, but the surplus will contract gradually towards more balanced finances. The budgetary position of other social security funds will be strengthened by lower unemployment expenditure, cuts in the maximum duration of earnings-related unemployment benefits as well as freezing of index increments and reductions in benefits.

Table.

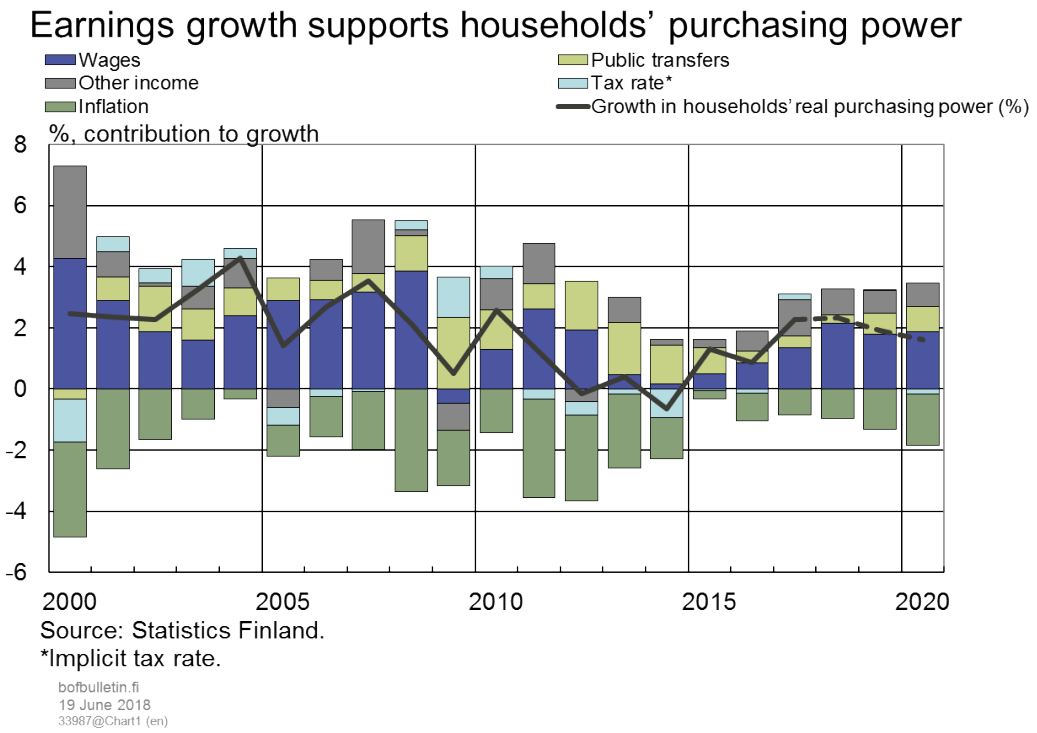
% of GDP	*2016*	*2017*	*2018f*	*2019f*	*2020f*
General government net lending	−1.8	−0.6	−0.8	−0.6	−0.3
Central government	−2.7	−1.7	−1.7	−1.1	−0.6
Local government	−0.4	−0.1	−0.3	−0.4	−0.4
Social security funds	1.3	1.2	1.1	0,.	0.7
Primary balance	−0.7	0.4	0.1	0.2	0.5
Structural balance*	−1.2	−0.3	−1.0	−1.2	−0.8
Revenue	54.2	53.2	52.1	51.3	51.3
Expenditure	56.0	53.7	52.9	52.0	51.6
Total tax ratio, % of GDP	44.1	43.4	42.5	41.9	42.0
Debt (consolidated, EDP)	63.0	61.4	60.1	59.4	58.2
Annual change, %	***2016***	***2017***	***2018f***	***2019f***	***2020f***
Volume of public expenditure	1.8	1.3	0.6	0.1	0.7
Volume of public investment	5.8	−2.9	2.2	0.5	0.4

* Relative to GDP trend. f = forecast.
Source: Bank of Finland.

Growth in public debt decelerates and debt ratio declines

Supported by favourable cyclical conditions, Finland's consolidated general government debt relative to GDP will contract below the 60% threshold in 2019. Therefore, in 2019, Finland will comply with both of the reference values defined in the EU Treaty, namely a deficit-to-GDP ratio not exceeding 3% and a debt-to-GDP ratio not exceeding 60%. In absolute terms, public debt will continue to grow in the forecast period, but the debt-to-GDP ratio will decline on the back of GDP growth and low interest expenditure (Chart 17).

Chart 17.



Risk assessment: protectionism overshadows export growth

Finnish economic growth in the immediate years ahead will continue to rely on growth in both domestic and foreign demand. The main downward risks relate to the international operating environment, where political uncertainty has heightened again. However, if the external risks do

not materialise, short-term developments in domestic consumption and investment may turn out to be better than expected.

Uncertainty about the continuation of euro area economic growth in the immediate years ahead has increased. In the spring, some countries – especially Germany – already witnessed signs of a maturing of the economic cycle. The greatest risks to economic developments relate, however, to heightened political uncertainty and rising protectionism.

The political crisis in Italy continues. The loss in investor confidence in the new government's programme has led to a rapid rise in the interest rates on Italian government bonds. Higher interest rates and potential funding constraints pose a risk especially to Italy's already strained banking system, which also has large holdings of domestic government bonds. The problems of the Italian banking sector, if they were to escalate, could threaten financial stability across the euro area as a whole. Italy's political crisis has been reflected in a depreciation of the euro.

The effects of the United Kingdom's exit from the EU also continue to weigh on the euro area growth outlook. However, it is difficult to make an advance estimate of Brexit effects, due to the uniqueness of the event.

At the beginning of June, the United States introduced tariffs on steel and aluminium imports from the EU, Canada and Mexico. The US market only accounts for about 3% of Finnish steel exports, but an increasing proportion of steel supply could, in the near future, be directed to important markets for the Finnish steel industry in Europe. A potential oversupply of steel would rapidly push down steel prices and weaken the profitability of Finnish companies. The US intentions to restrict world trade and trading partners' countermeasures also increase the risk of a more extensive trade war that would depress global growth prospects for a prolonged period.

Besides export market growth, the outlook for Finnish exports also depends on the cost-competitiveness of Finnish exports. The autumn and winter wage decisions were proportional to productivity developments across the economy as a whole, lending support to continued cost-competitiveness. However, the favourable cyclical situation and the rapid tightening of the labour market will increase pressures for higher-than-forecast wage increases.

Estimating the effects of cost-competitiveness has its own difficulties. The improvement in competitiveness is fully reflected in market shares only with a lag. Therefore, exports may still grow notably faster than expected, especially if the upturn in the global economy turns out to be protracted.

The favourable cyclical situation, combined with favourable financing conditions, may encourage companies to invest more than expected. Investment growth may surprise positively, especially in

the case of the forest industry, where companies have presented preliminary plans for a number of new plants or extensions.

According to the baseline scenario, the housing construction boom will cool in a controlled manner, but the cyclical turning point in construction may turn out to be stronger than expected. Housing construction typically reacts swiftly to changes in the business cycle. The cyclicality of housing construction is further heightened by the fact that investors account for a significant proportion of demand for new housing starts.

Positive employment developments will push up household income, especially in the current year. Higher employment will also fuel consumer confidence, which has remained at a record high for several months already. Therefore, private consumption may grow faster than expected, despite the fact that the household savings rate is already low and households are already willing to spend in excess of their income.

However, household indebtedness will increase the economy's sensitivity to cyclical fluctuations. Regional divergence in both indebtedness and wealth developments has increased. Households in growth centres take out larger housing loans than before, while at the same time real estate prices have declined in more remote regions. Household vulnerabilities to higher interest rates, lower house prices and cyclical fluctuations have increased.

Notes

1. This may be a slight overestimation of households' share of housing company debt, as the share of new flats purchased by housing investors may be higher than estimated. ↑
2. Compensation per employee includes the wage bill as well as all compulsory social security contributions paid by employers. ↑
3. Here unit labour costs are derived from national accounting data as compensation per employee relative to real GDP. They can also be derived from data on the number of wage-earners and employed persons, according to which unit labour costs will still decline in 2018. Currently, different measures of unit labour costs show considerable disparity, as a decline in the amount of entrepreneurs has increased the amount of wage-earners much faster than the employment rate. ↑

Keywords

consumption, economic situation, Finland, firms, forecast, foreign trade, households, inflation, investment, labour markets, private consumption