Forecast

Forecast: Economy growing in the shadow of the virus

Finnish economy | 02 February 2022

The Finnish economy has made a quick recovery from the steep downturn caused by the COVID-19 crisis. Although the outlook remains overshadowed by the pandemic, Finland's economy is forecast to grow by 3.5% in 2021 and by 2.6% in 2022. Supply bottlenecks and high raw material prices are, however, blunting growth in the economy and fuelling inflation. Growth will slow to 1.3% by 2024, reflecting the muted longer-term growth potential of Finland's ageing economy. Economic growth may be weaker than forecast if global supply-side disruptions persist or the pandemic worsens.



Finland's economy is recovering from the slump caused by the pandemic, driven especially by domestic demand. Private consumption is growing, albeit growth is being dulled by the pandemic and inflation that eats into consumer purchasing power. Investment growth will also pick up significantly in the forecast years. Public demand will support economic growth in 2021, after which its significance will diminish as COVID-related measures are wound down.

Global disruptions in supply chains and the availability of electronic components are slowing the recovery of exports, but, as the disruptions ease and growth continues in the export markets,

exports will recover rapidly. The rapidly deteriorating virus situation in both Finland and elsewhere in Europe increases the uncertainty of households and businesses and is overshadowing the recovery from the economic crisis brought on by the pandemic.

Inflation has increased in 2021. Prices have been pushed up by the strong recovery in demand and the concurrent supply chain bottlenecks. There has also been a broadly based and strong increase in energy prices. The high crude oil price has fed through to consumers at the petrol pumps, and the rise in wholesale electricity prices has to a certain extent been passed on to consumer prices.

Underlying inflation has also increased markedly, especially due to growth in services prices. The impact of supply bottlenecks has been reflected in the prices of consumer goods during the autumn of 2021. Global disruptions in the availability of raw materials and components and in shipping coupled with rising prices of raw materials and many intermediate goods have also significantly increased the costs of export firms.

Inflation will nevertheless slow during 2022, as energy prices are expected to fall and supply bottlenecks to ease. The inflation outlook is still surrounded by significant risks. There have been strong fluctuations in crude oil prices late in the year as news on the new virus variant has increased uncertainty on the market, and it is possible that the supply disruptions will persist.

Cyclical conditions remain strong, but the structures of the economy limit growth potential. The rapid improvement in employment will level off as the economy passes peak growth. On the back of favourable cyclical developments, the unemployment rate will drop below the rate of structural unemployment. Labour availability issues and other production bottlenecks will limit output growth during the forecast period. However, the long-term growth potential of the economy will strengthen once we rebound from the most severe phase of the crisis, driven by a recovery in investment and the easing of supply chain disruptions.

The legacy of the COVID crisis will include an expanded debt burden on Finland's public finances. The general government deficit in relation to GDP will improve from its height during the pandemic to slightly below 3% in 2021. Due to permanent expenditure increases, the structural deficit will remain above the pre-pandemic mark even at the end of the forecast period. At the end of 2021, Finnish public debt will be EUR 25 billion higher and the debt-to-GDP ratio will be more than 7 percentage points higher than before the crisis. During the forecast years, debt will grow due to general government deficits and defence procurement expenditure.

Forecast risks are predominantly on the downside. In the short term, the greatest cause for uncertainty is the deteriorating virus situation, and the threat of new virus variants will sustain uncertainty over the longer term as well, until the pandemic finally wanes everywhere in the world. Uncertainty is also caused by global supply disruptions. It is difficult to predict the duration

of the supply problems or all their effects, especially in a situation where recurrent infection waves keep slowing down the global recovery from the pandemic.

On the other hand, the economy might perform better than expected. In a favourable situation, households may begin to spend the savings accumulated during the pandemic at a faster rate than anticipated. On the back of those savings, private consumption may grow faster and over a longer period than forecast. Investments could also produce a positive surprise, as they are prone to strong fluctuations. If the economic recovery from the recession caused by the virus crisis continues, investments may increase more than anticipated.

Key forecast outcomes

Percentage change on the previous year

	2019	2020	2021[f]	2022[f]	2023[f]	2024[f]
GDP	1.3	-2.9	3.5	2.6	1.5	1.3
Private consumption	0.7	-4.7	2.9	3.3	1.7	1.2
Public consumption	2.0	0.5	2.8	-0.3	-0.1	1.0
Fixed investment	-0.9	-0.7	1.2	4.7	2.1	1.7
Private fixed investment	-1.6	-3.4	2.8	4.6	2.6	1.7
Public fixed investment	2.3	11.0	-5.0	5.0	0.3	1.9
Exports	6.7	-6.8	4.0	5.5	4.5	3.6
Imports	2.2	-6.5	3.5	5.3	4.2	3.5
Effect of demand components on growth						
Domestic demand	0.4	-2.5	2.5	2.7	1.4	1.3
Net exports	1.7	-0.1	0.2	0.1	0.2	0.0
Changes in inventories and statistical error	-0.8	-0.2	0.9	-0.1	0.0	0.0
Savings rate, households, %	0.6	4.8	1.9	1.0	0.2	0.0
Current account, %, in proportion to	-0.3	0.8	1.5	0.0	0.1	0.1

Key forecast outcomes						
GDP						

	2019	2020	2021[f]	2022[f]	2023[f]	2024[f]
Labour market						
Number of hours worked	1.3	-3.0	1.5	2.1	0.7	0.4
Number of employed	1.1	-2.0	2.3	1.3	0.7	0.4
Unemployment rate, %	6.7	7.8	7.7	7.1	6.6	6.6
Unit labour costs	1.1	1.7	3.3	1.8	1.5	1.4
Labour compensation per employee	1.3	0.8	4.6	3.2	2.4	2.3
Productivity	0.2	-0.9	1.2	1.4	0.9	0.9
GDP, price index	1.5	1.3	2.3	2.7	1.7	1.9
Private consumption, price index	1.0	0.5	2.0	2.2	1.6	1.9
Harmonised index of consumer prices	1.1	0.4	2.1	2.0	1.6	1.8
Excl. Energy	1.0	0.8	1.3	1.7	1.7	1.8
Energy	3.0	-5.0	9.7	4.0	-0.1	1.3

Sources: Statistics Finland and Bank of Finland.

Operating environment: forecast assumptions and financial conditions

The outlook for growth in the global economy and the euro area has remained strong, even though supply bottlenecks and the prolonged COVID pandemic are slowing actual growth. Supply disruptions will hold back growth until the global supply-demand imbalance fades, for example through the easing of the pandemic or new investments. With that said, the pandemic will

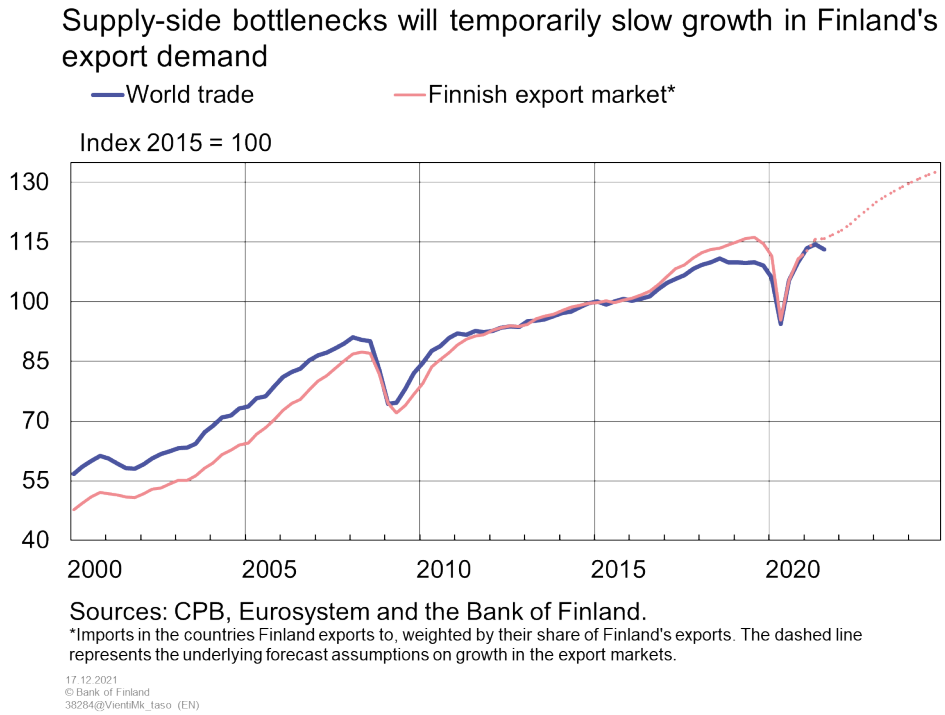
continue to impact the economy until the virus has been brought under control all over the world. Despite these setbacks and the high level of uncertainty, the overall sentiment in the global economy is positive. The forecast is based on data available on 30 November 2021.

Production bottlenecks and the COVID pandemic overshadow the outlook for the global economy

The global economy and world trade have rapidly recovered from the deep recession caused by the COVID pandemic (Chart 1). Supply problems and rising raw material prices combined with a strong increase in demand for goods have led to disruptions in global supply chains. These disturbances have been reflected in world trade, where growth came to a halt in the third quarter of 2021.

The slowdown in world trade will also be reflected as temporary muted demand growth in Finland's export markets. The COVID pandemic has added significantly to the supply disruptions, both by causing problems in supply chains and by shifting the focus of demand from services to goods.

Chart 1.



The forecast assumes that supply disruptions will begin to gradually ease in the second quarter of 2022 and dissipate entirely by the beginning of 2023. Global economic growth and world trade is

consequently predicted to pick up, which will also strengthen the growth prospects for Finland's exports and for the Finnish economy as a whole. The duration and intensity of the supply disruptions, however, is highly dependent on the duration of the pandemic.

In 2024, global growth will stabilise close to the long-term average of around 3.5%. The increase in raw material prices, supply problems and increasing consumer demand will markedly raise prices worldwide in 2021 (Table 2). However, the strong rise in prices will be only temporary.

The COVID pandemic continues to impact economic growth. The pandemic situation has deteriorated towards the end of the year, especially in Europe, disrupting activities in, for example, some service sectors where close contacts are unavoidable. The deteriorating pandemic situation may also weaken economic growth by increasing supply-side disruptions, for example if the operation of factories or ports needs to be restricted and demand remains focused on goods. However, the adoption of new approaches and increasing vaccine coverage have reduced the impact of the pandemic on the economy.

According to the assumptions underlying the forecast, the pandemic situation will gradually ease over the course of 2022. However, there is still considerable uncertainty regarding the development of the pandemic and the spread of new virus variants. The future development of the global economy still hinges on the virus situation and how countries around the world manage to contain it.

The euro area economy continues to recover. Growth remains strong, even though supply bottlenecks and the deteriorating pandemic situation will somewhat slow growth in the near term.[1] Due to the structure of its economy, supply-side disruptions have a particularly strong impact on Germany, one of Finland's major trading partners.

Economic growth in the euro area is particularly driven by private consumption. The dissipation of supply constraints and the easing of the pandemic are expected to support growth in 2022.

Inflation in the euro area is projected to remain high next year, but to moderate to just under 2% in 2023. Underlying inflation, i.e. inflation excluding energy and food prices, is forecast to remain consistently at slightly below 2% over the forecast years. Price pressures are projected to be mainly temporary. Inflation is currently fuelled by a strong rise in energy prices, but also by supply-side constraints and the recovery in consumption of services.

Accommodative financial conditions continue to support growth

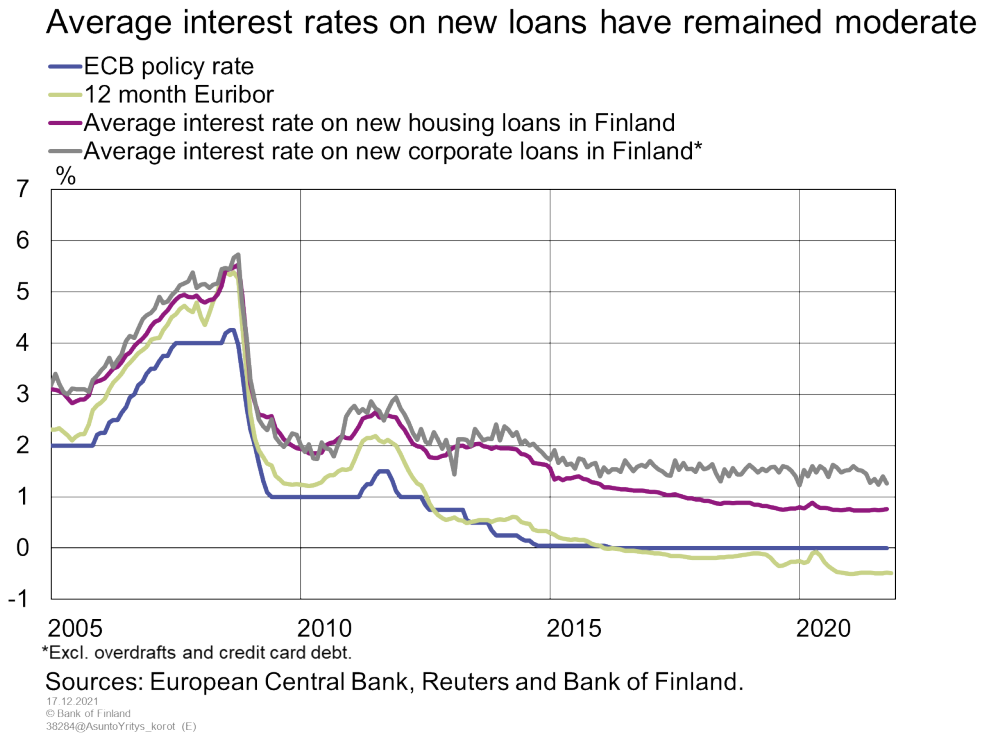
In December 2021, the Governing Council of the ECB decided that the progress on economic recovery and towards its medium-term inflation target permits a step-by-step reduction in the

pace of asset purchases.[2] Interest rates remain low. The interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.50% respectively. As a whole, monetary policy will remain accommodative, in order for inflation to stabilise at the 2% inflation target over the medium term.

Financial conditions in Finland have remained accommodative and supportive of growth. The average interest rates for both new corporate loans and new housing loans remain moderate (Chart 2). The financial markets expect short-term interest rates in the euro area to remain low (Table 2). Continued low funding costs will support household consumption and business investments also through the forecast years.

According to the Bank Lending Survey (BLS), credit standards on corporate loans and consumer credit have not changed significantly in 2021, but on average, the credit standards on mortgage lending have eased. According to the Business Tendency Survey by the Confederation of Finnish Industries (EK), financial difficulties have not become a particularly significant obstacle to output or sales over the last few quarters.

Chart 2.



Forecast assumptions					
	2020	**2021[f]**	**2022[f]**	**2023[f]**	**2024[f]**
Volume change year-on-year, %					
Euro area GDP	-6.5	5.1	4.2	2.9	1.6
World GDP	-2.8	5.9	4.4	3.8	3.4
World trade*	-8.3	10.2	4.5	4.9	3.7
Finland's export markets, % change**	-8.4	9.0	4.6	5.4	3.4
Oil price, USD/barrel	41.5	71.8	77.5	72.3	69.4
Export prices of Finland's competitors, euro, % change	-3.9	8.8	5.5	0.7	1.0
3 month Euribor, %	-0.4	-0.5	-0.5	-0.2	0.0
Finland's nominal effective exchange rate***	108.7	109.3	107.8	107.8	107.8
USD value of one euro	1.14	1.18	1.13	1.13	1.13

**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.

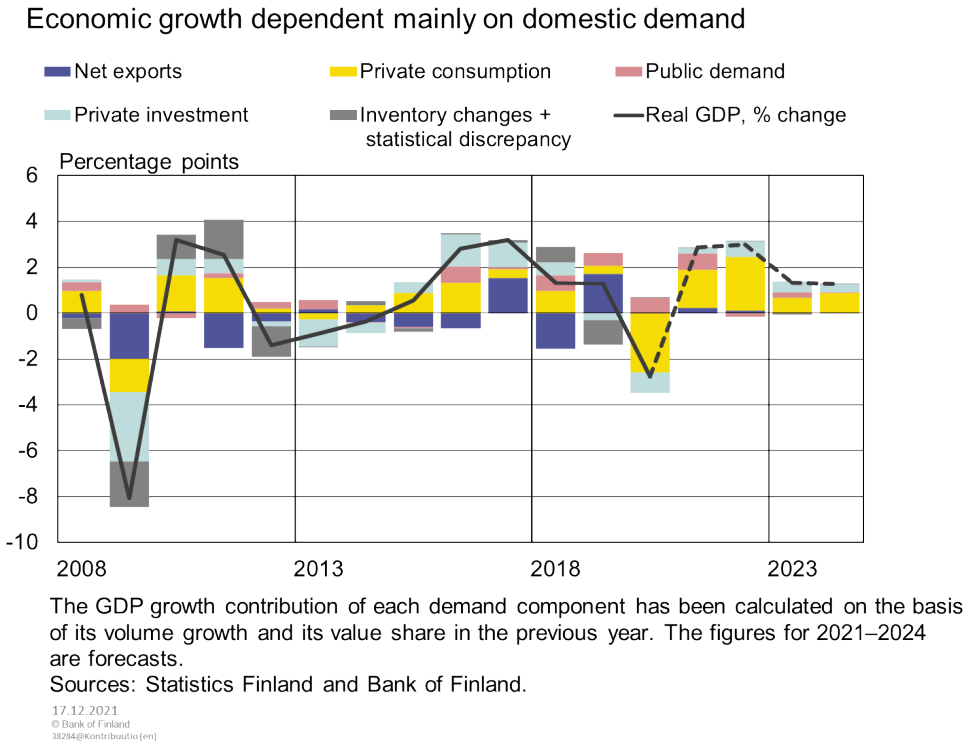
Demand and the public finances

Broadly based economic growth will continue in the forecast years as the pandemic eases. Growth is dependent on domestic demand, in particular (Chart 3). Growth in total demand will hinge on private consumption and investments over the whole forecast period up to 2024. Public demand will support economic growth in 2021, after which its significance will diminish as COVID-related measures are wound down. Global disruptions in the availability of raw materials and components and in shipping will slow down the recovery of exports and total growth in 2021 and 2022. Despite

this, exports will grow rapidly in the forecast period as world trade continues to recover. At the same time, imports will grow at almost the same rate as exports.

However, the recovery in demand is still fragile. The rapidly deteriorating infection situation in both Finland and elsewhere in Europe increases the uncertainty of households and businesses and will in the short term overshadow recovery from the crisis triggered by the pandemic. Prolonged supply disruptions would hamper export growth, in particular, thus slowing overall economic growth.

Chart 3.



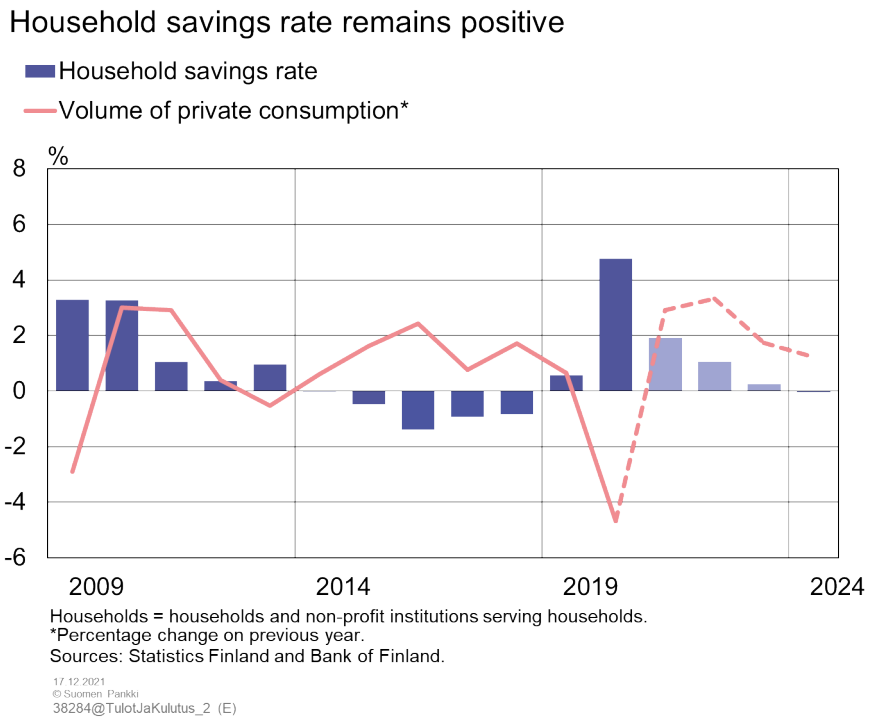
Recovery in private consumption dependent on virus

Over the forecast period, household consumption will recover from the shock caused by the initial phase of the COVID crisis. Private consumption will grow by nearly 3% in 2021, and growth will continue to pick up in 2022. However, the recovery is uneven and the pandemic continues to hamper the consumption of many services, particularly in culture, leisure and tourism. Rising inflation and supply chain disruptions are also limiting consumption growth. From 2023 onwards, private consumption growth will stabilise with the normalisation of demand (Chart 4).

Consumer confidence has deteriorated sharply during the autumn, as the infection situation has

deteriorated rapidly both in Finland and elsewhere in Europe. The rapid deterioration of the virus situation this winter will hold back private consumption growth in the coming months as consumers grow more cautious after the optimism in summer and early autumn.

Chart 4.



Employment will continue to improve over the forecast period, supporting households' earnings development and consumption opportunities. Nominal earnings are expected to grow by close to 2.5% per annum throughout the forecast period, and wages will develop favourably due to growing employment and rising earnings.

However, household purchasing power will suffer from the increased inflation, especially in 2021, which is why the recovery of private consumption will not peak until 2022. Real disposable income is expected to increase at an average rate of 1% per annum over the forecast period, bolstering consumption growth.

During the pandemic, consumers have changed their consumption behaviour significantly and saved more than usual. The household savings rate will remain positive in the immediate years ahead and will only fall to zero at the end of the forecast period (Chart 4).

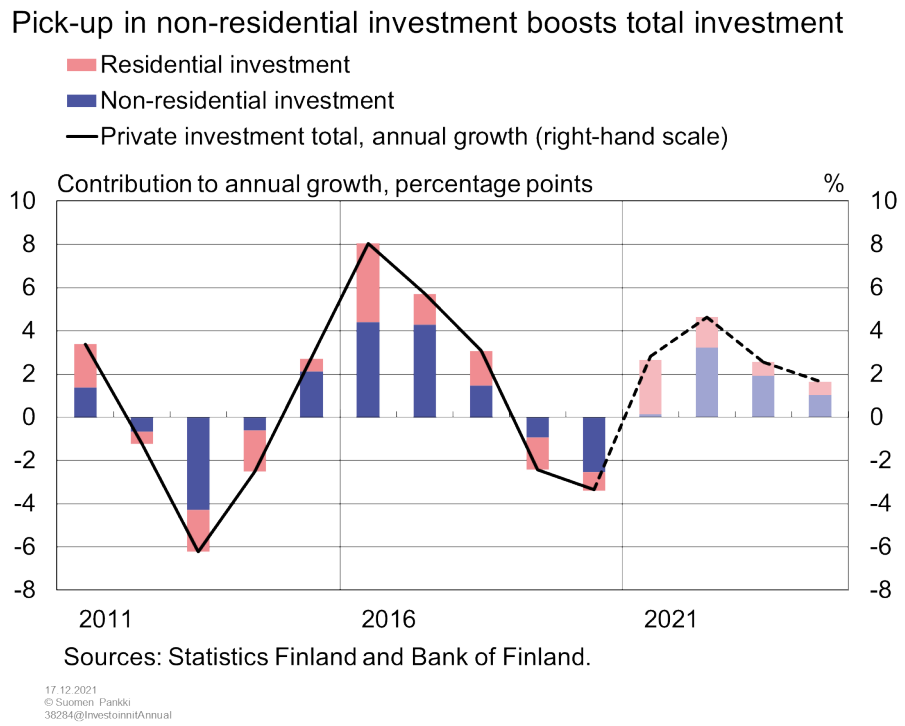
Increased savings and low interest rates give households more economic leeway. Households will not spend all their accumulated savings on consumption over the forecast years, but instead continue to invest a significant part of their savings in financial assets and housing.

Households have accumulated large amounts of cash deposits and other investment assets during the COVID crisis. Both increased savings and increased asset values have boosted household wealth. The net financial assets of the household sector (including non-profit institutions serving households), i.e. the difference between financial assets and liabilities, increased in the second quarter of 2021, reaching an all-time high of EUR 209 billion.

Growth in private investment will pick up

Private investment will resume growth in 2021 as housing construction picks up and will grow by almost 3% in 2021. The pick-up in non-residential investment will boost private investment growth to over 4% in 2022. Growth in private investment will level off towards the end of the forecast period (Chart 5). In the longer term, investment growth will be held back by the unavailability of skilled labour and poor profit expectations.

Chart 5.



Housing construction will grow rapidly in 2021. The number of building permits granted and new construction projects have increased since summer 2020, and growth continued through 2021. The increase in permits and new projects will be reflected in the amount of new-build construction completed, especially in 2021 and 2022. Construction investment growth is supported by strong

developments on the housing market, low interest rates and rising housing prices in growth centres. Growth in residential investment will level off towards the end of the forecast period.

The capital-intensive manufacturing sector has coped with the pandemic better than feared. Over the past year, business confidence in the economy has clearly strengthened across all main sectors. The recovery in fixed investment is bolstered by a strong increase in order books, high capacity utilisation rates, favourable financing conditions and growing exports. However, the increased uncertainty may also affect investment.

The profitability of the corporate sector as a whole has remained good throughout the pandemic, even though there are large industry-specific differences. The profit share of the corporate sector, i.e. the ratio of operating surplus over value added, has remained at around 30%. The good corporate profitability will strengthen investment opportunities as the pandemic eases.

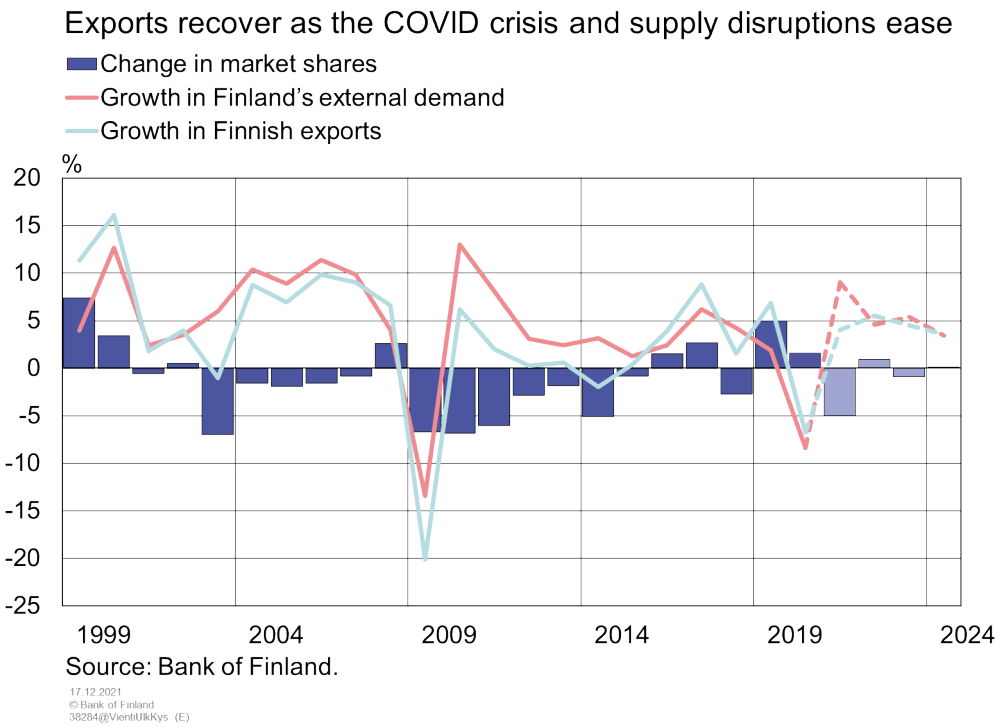
The corporate loan stock has remained almost unchanged since summer 2020, when the growth rate of new corporate loan drawdowns slowed. In contrast, the stock of corporate deposits has grown strongly during the pandemic. Corporate sector indebtedness did, in fact, decline in 2020. According to the Bank Lending Survey, credit standards on corporate loans have eased and demand for corporate loans has increased in 2021. Accommodative financing conditions and access to finance will support investment growth in the forecast period.

Supply disruptions slow export growth

Brisk international demand will boost Finland's export growth in the years ahead. However, the recovery of foreign trade from the pandemic has been hampered by global supply disruptions and uncertainty regarding the development of the pandemic. Disrupted supply chains and logistics have particularly impacted foreign goods trade.

At the same time, supply disruptions coupled with rapidly increasing international demand have raised the prices of raw materials and many products as well as shipping costs. As a result, production costs in the export sector have increased substantially.

Chart 6.



Despite supply disruptions, Finnish exports are making a rapid recovery from the economic crisis brought about by the pandemic. Export growth will pick up to 4% and exports will surpass pre-pandemic volumes in 2021, mainly driven by the recovery of goods exports. However, in 2021, export growth will clearly lag behind growth in the main export markets, as export growth got off to a slow start at the beginning of the year (Chart 6).

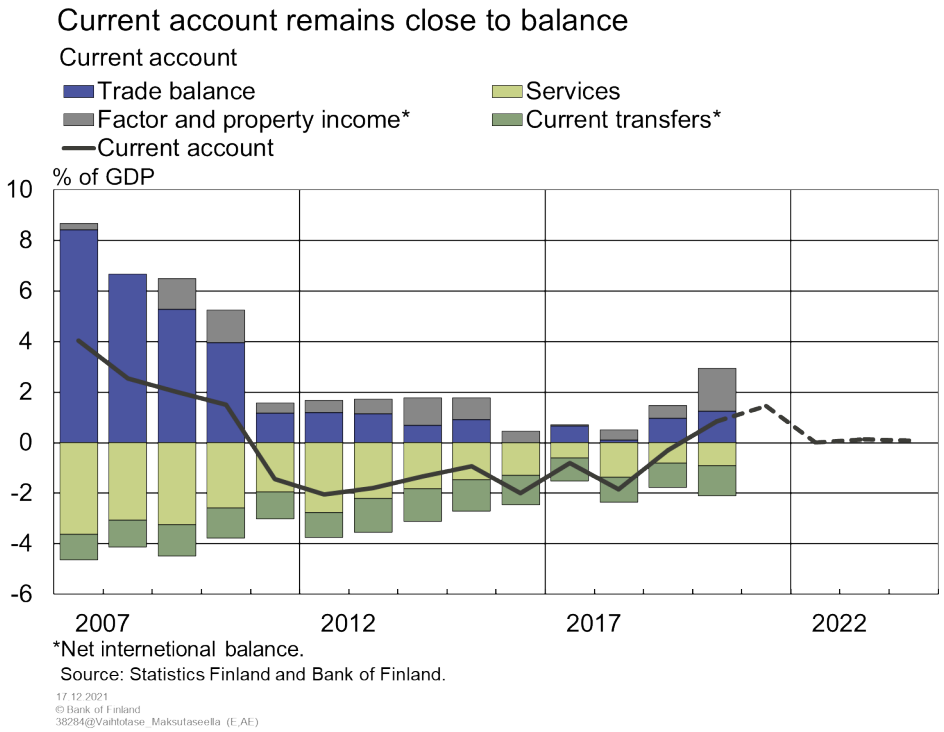
The good growth trend in exports will continue in 2022–2024. The recovery of services exports and the gradual easing of supply disruptions will boost export growth to over 5% in 2022. However, a gradual normalisation in international demand will slow export growth from 2023 onwards, to slightly over 3% in 2024.

Over the forecast period, imports will grow at almost the same rate as exports, leaving net exports weak. Imported inputs play a significant role in the production of exported goods and services. Import growth will be sustained by both positive export growth and strong domestic demand. Brisk investment and rapid growth in private consumption will increase imports and weaken net exports.

The current account entered surplus in 2020 after a long period of deficit. The surplus has continued to grow throughout 2021 but will begin to decrease in 2022 (Chart 7). Contributors to the surplus include several temporary factors, such as a sharp decline in the value of imports from

Russia during the COVID crisis and exceptional dividend flows. Nevertheless, the current account will remain roughly in balance with GDP over the forecast period.

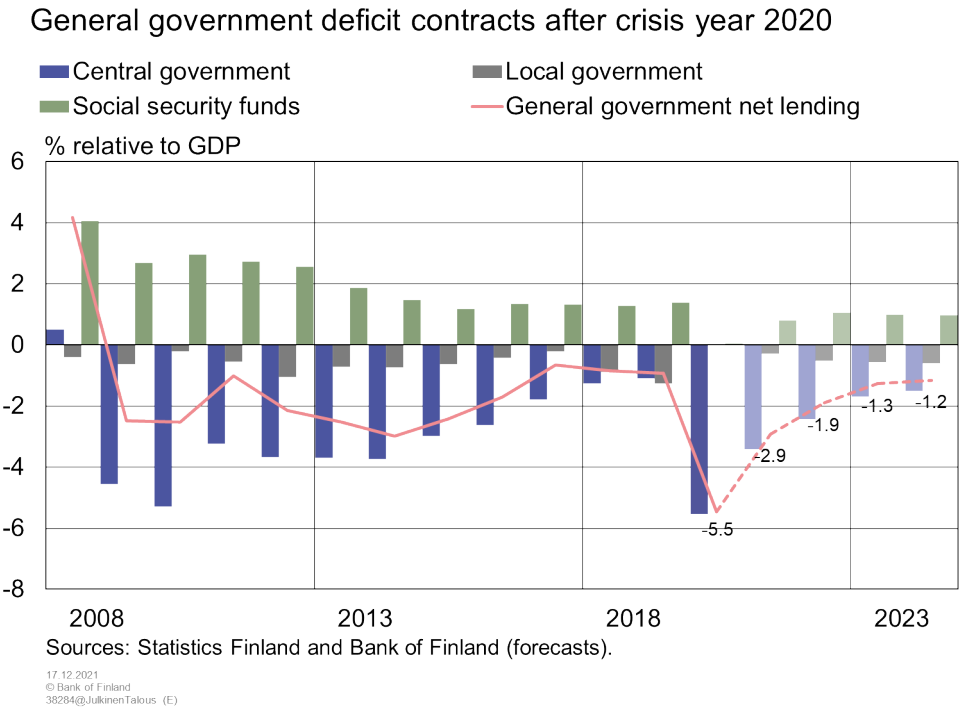
Chart 7.



The COVID-19 crisis will leave a mark on the public finances

The COVID-19 crisis caused a strong increase in the general government deficit in 2020. In 2021, the general government deficit relative to GDP will contract to slightly below 3% and then gradually to just over 1% by 2024 (Chart 8). In the forecast period, good cyclical conditions will reduce the deficit by significantly strengthening general government revenue and moderating expenditure growth as the pandemic eases.

Chart 8.



Growth in employment, earnings and private consumption and improved results for businesses will increase tax revenues for central government and the municipalities. At the same time, employers' social security contributions will rise after the temporary reduction in 2020, unemployment expenditure will decrease and property income will increase. This will bring social security funds back to a surplus of around 1% of GDP from 2021 onwards.

Expenditure allocated to pandemic relief and stimulus measures will remain substantial in 2021. These costs are mainly borne by central government. Even after the COVID crisis eases, public expenditure will grow due to permanent expenditure increases and future-oriented investments in 2021–2022 set out in the Government Programme. Measures in the Sustainable Growth Programme for Finland will also increase public expenditure, but they are entirely funded from the EU's Recovery and Resilience Facility (RRF).

Due to pandemic-related measures, real public expenditure will increase by almost 3% in 2021. In the years ahead, clearing of the healthcare backlog and rising age-related expenditure will sustain the level of public expenditure.

Corporate subsidies and income transfers will remain exceptionally high in 2021 due to COVID subsidies. The volume of public investments will increase in 2022 with Government-initiated projects and investments relating to the establishment of 'wellbeing services counties'. The sharp

rise in capital goods prices will increase investment expenditure in 2021 and 2022.

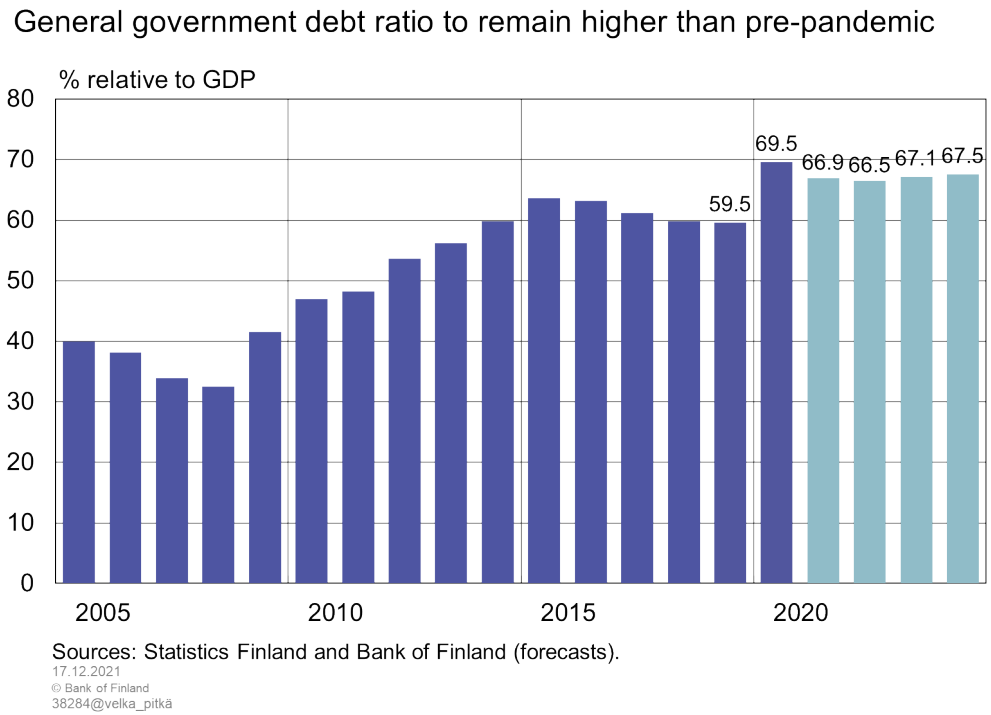
Income transfers from central to local government will gradually decrease after being exceptionally high in 2020. In the forecast, the wellbeing services counties that begin operating in 2023 are included in local government, the deficit of which will stabilise at just over 0.5% of GDP by 2024.

The pandemic has left a major mark, particularly on general government debt. At the end of 2021, the general government debt-to-GDP ratio will be around 67%, which is more than 7 percentage points higher than before the COVID crisis. Total debt has increased by almost EUR 25 billion from before the pandemic. However, the debt ratio will decrease slightly compared with 2020 (Chart 9).

In 2021, the need for borrowing is decreased by the central government debt drawn down in 2020 in preparation for costs that ultimately were lower than expected. In 2022, the debt ratio will continue to decline slightly owing to positive economic growth. In 2023–2024, the debt ratio will resume growth as Finland passes peak economic growth. In general in the forecast years, debt will grow due to general government deficits and defence procurement expenditure.

Although the general government debt ratio will remain fairly stable in the forecast years, in the longer term the debt ratio will face considerable upward pressure. This will be mainly due to the persisting structural deficit in the public finances and the growing expenditure pressures generated by an ageing population.

Chart 9.



Supply and cyclical conditions

Cyclical conditions will remain strong, but growth in potential output will remain modest, due to structural factors in the economy.[3] The brisk growth in employment will level off as the fastest pace of economic growth moderates. Labour supply problems and other production bottlenecks will constrain production during the forecast period. However, the COVID-19 crisis will dampen the economy's growth potential only temporarily. Potential growth will recover from its dip during the crisis, reflecting the recovery of investment and the easing of supply chain disruptions.

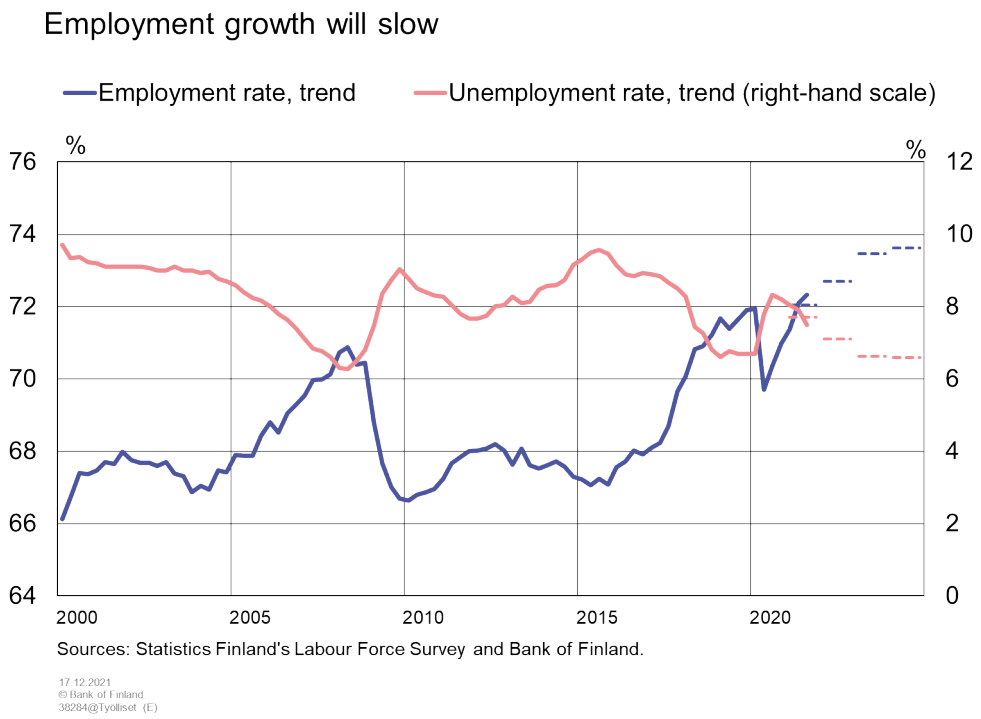
Pace of employment growth has peaked

The labour market has recovered rapidly as demand returns to pre-pandemic levels, but the most rapid phase of employment growth is now over. The employment rate will increase by some 2 percentage points from the level of 2020 during the forecast period, i.e. to 73.6%. The number of employed will increase, and at the end of the forecast period there will be some 117,000 more persons employed than in 2020. In 2021, the unemployment rate will be only slightly below the level of the previous year, i.e. 7.7%, but it will decline to 7.1% in 2022 and will continue through 2023–2024 at 6.6%.

Employment picked up strongly during the spring and summer, driven by the rapid economic recovery. Unemployment has decreased, albeit significantly less than the improvements in employment, due to the increase in labour force participation. Furloughs have decreased, but they are still higher than before the pandemic.

The positive trend in employment is overshadowed by the fact that a larger than normal share of employment growth is due to the increase in the number of part-time jobs and fixed-term contracts. The protracted pandemic has meant continued uncertainty on the labour market and has increased caution in the filling of permanent full-time job vacancies.

Chart 10.



The fastest phase of labour market recovery is, however, now over. The indicators point to continued growth in employment, albeit at a more moderate pace. The number of job vacancies is still increasing, but employment growth is constrained by labour market mismatches. Companies are reporting in surveys a lack of suitable labour and difficulties in filling vacancies.

As mismatch increases, the higher number of vacancies does not result in a significant decline in unemployment. This is reflected also in the Beveridge curve, where, during a boom, an increase in job vacancies is typically accompanied with a decline in unemployment. The curve has steepened, and one of the reasons for this is the weakening of labour market matching (Chart 11).

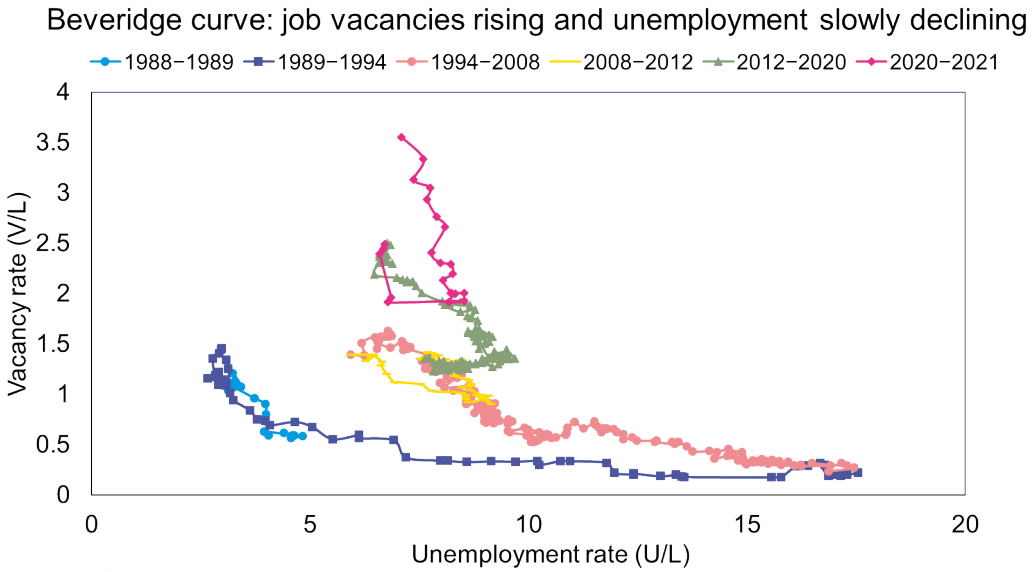
Mismatch differs between industries and professions. For example, in industries involving a lot of

human contacts, the supply of labour may be partly constrained by the reduced attractiveness of these industries. On the other hand, in certain industries that have been hit by COVID-19, there is still room for increased demand if labour supply does not become a critical obstacle.

Due to the rapid recovery of the economy and employment, some of the mismatches may, however, turn out to be temporary, as frictions in the filling of jobs may level off as the fastest pace of growth in labour demand moderates.

Growth in long-term unemployment has levelled off in recent months, but the number of long-term unemployed is still 30,000 higher than before the pandemic. Protracted spells of unemployment make it more difficult to find a job. The working-age population will continue to decline this year and in the years immediately ahead. Due to these factors, growth in employment will slow towards the end of the forecast period, as those furloughed and the unemployed persons more easily employed will have found a job. On the back of favourable cyclical developments, the unemployment rate will fall below the level of structural unemployment during the forecast period.

Chart 11.



The Beveridge curve describes the cyclical situation on the labour market and labour market efficiency in matching job seekers to job vacancies. Shifts in the Beveridge curve are interpreted typically as reflecting cyclical fluctuations (low unemployment and a high number of vacancies during a boom; high unemployment and a shortage of vacancies during a recession). A shift in the Beveridge curve is interpreted typically as reflecting changes in labour market efficiency.

Sources: Ministry of Economic Affairs and Employment, Statistics Finland.

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The economy is entering a boom

The Finnish economy has recovered rapidly from the deep recession caused by the COVID-19

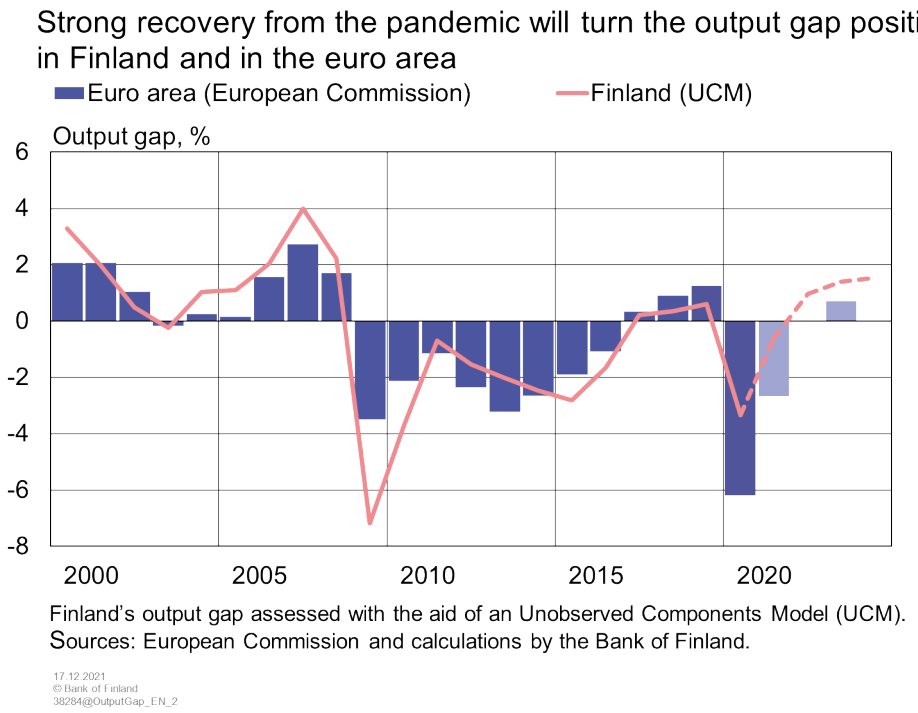
crisis. The rate of recovery does, however, differ considerably between industries. The favourable economic conditions are supported by the global economic recovery. Cyclical conditions will improve both in the euro area and in Finland during the forecast period.

In 2022, Finland's output gap will turn positive (Chart 12).[4] Reflecting improvements in the cyclical situation and the increase in supply disruptions, the domestic production chain will experience bottlenecks and labour supply problems during the forecast period. Developments in the economic cycle are subject to uncertainty that relate to, in particular, the duration of global supply disruptions and the situation with the pandemic.

Global supply disruptions and the rise in raw material and transport prices will inevitably also affect the Finnish economy. Global supply bottlenecks in the production of semiconductor components and raw materials as well as in sea transport have resulted in the closure of plants globally and delayed deliveries. Transport costs and raw material prices have risen since the end of 2020.

In Finland too, manufacturing companies in particular are reporting that supply bottlenecks, for example a shortage of materials, as well as logistical problems are affecting production.[5] Supply disruptions are described in more detail in the article, published in connection with the forecast. The effect of supply bottlenecks on economic growth in Finland is assessed also in the alternative scenario, which shows that, without the supply disruptions, economic growth would be half a percentage point higher in 2021.

Chart 12.



The COVID-19 crisis is expected to slow the economy's potential rate of growth only temporarily (Chart 13). Potential growth will recover from its dip during the crisis, reflecting the recovery of investment and the easing of disruptions in the supply chains. GDP growth is estimated to be close to its long-term potential rate at the end of the forecast period. In the medium term, the level of potential output is not expected to remain significantly lower than forecast before the pandemic. The COVID-19 crisis will thus not leave significant permanent scars on the economy.

Growth in the capital stock was slow during the early phase of the pandemic, due to the weakness of investment, which will erode potential output. The capital-intensive manufacturing sector has, however, coped with the crisis better than feared, and the pick-up in capital investment will bolster the capital stock and output potential.

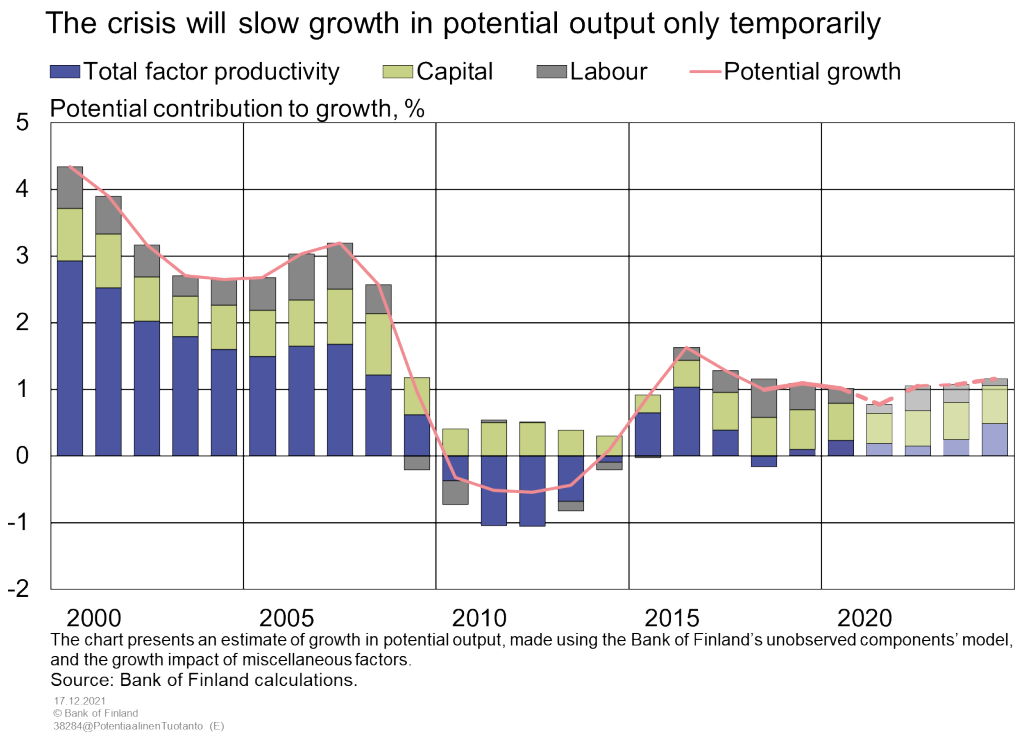
The increase in long-term unemployment and the high level of structural unemployment caused by the pandemic will reduce the importance of labour as a source of potential output during the forecast period. Labour supply will be constrained also by the decrease in the working age population (15–74-year-olds). On the other hand, as a result of positive developments in the participation rate, labour input will continue to support growth in potential output.

Growth in total factor productivity will remain subdued temporarily, due to disruptions in supply chains and lags in the reallocation of resources. In addition to the immediate shortage of

components and other materials, the pandemic may force businesses to look for new sub-contractors and employees to move from withering companies to successful ones.

The effects may become more pronounced if the prolonged supply disruptions were to, for example, permanently weaken the division of labour in the global economy. On the other hand, the pandemic may have accelerated the digitalisation process, which may in turn strengthen the conditions for economic growth. The structural rigidities and frictions in the economy will play an important role in how effectively economic resources are reallocated and how quickly potential output improves.

Chart 13.



Prices, wages and costs

Inflation has picked up in 2021. Demand has recovered robustly, while at the same time supply chain bottlenecks have emerged, which has pushed up inflation also in Finland. Energy prices, too, have been increasing at a strong pace. Inflation will, however, slow, reflecting the expected downward trend in energy prices in spring 2022 and the easing of supply bottlenecks in the second half of 2022. Growth in nominal earnings will be 2.4% in 2021, and the pace of growth is expected to remain unchanged in the subsequent years of the forecast period. Compensation per employee will increase by 4.6% in 2021, but the rate of increase will slow, to some 2.3% in 2024. Finland's cost-competitiveness improved relative to the euro area in 2020, but some of the

achieved advantage will be lost in 2021–2024.

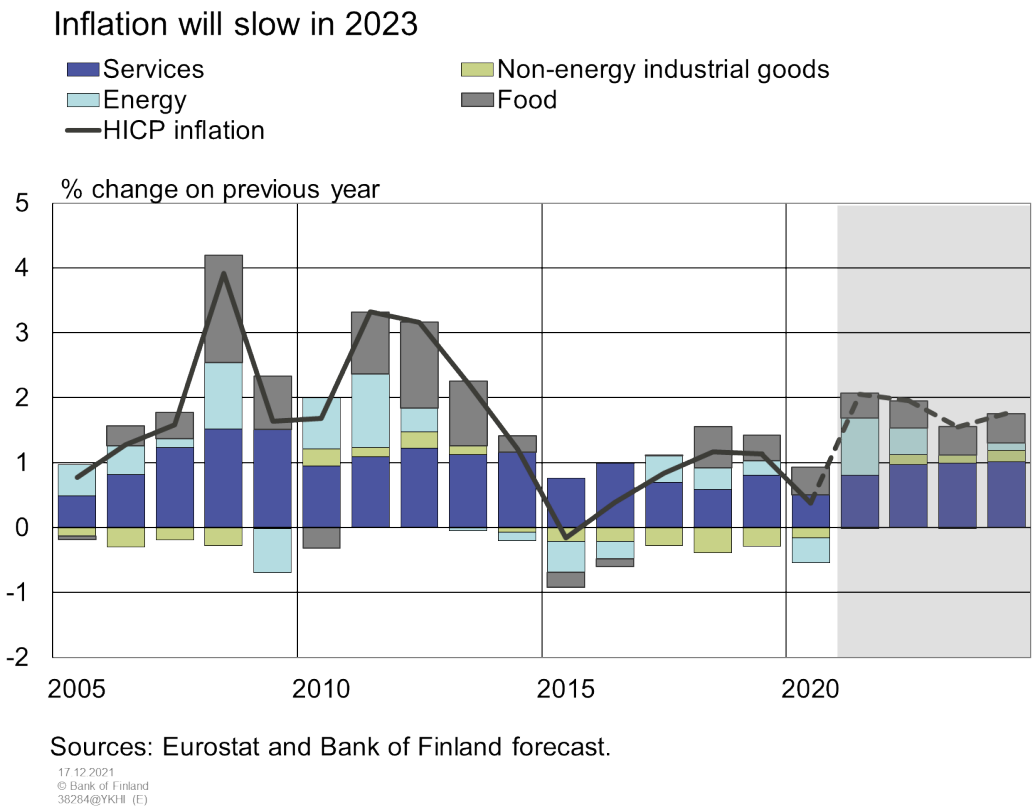
Supply bottlenecks and energy prices will determine the near-term trend in inflation

Consumer prices are expected to rise by 2.1% in 2021 (Chart 14). The annual rate of change in consumer prices, as measured by the harmonised index of consumer prices (HICP inflation) was only 1.0% in January, but it picked up to 3.5% in November. The higher rate reflects, in particular, the broad-based rise in energy prices. The elevated price of crude oil has fed through to fuel prices, and the rise in the wholesale price of electricity has been transferred partly to consumer prices.

Underlying inflation, too, has picked up notably, reflecting the stronger pace of increase in services prices compared with a year earlier. Developments in the prices of services sub-components have been divergent and, for example, the rise in real housing rents has slowed to below 1%. The effects of supply bottlenecks have spilled over to the prices of consumer goods, which started to rise in Finland in autumn 2021. Inflation in Finland has, however, been slower than in the euro area, reflecting in particular the slower rate of increase in the prices of energy and consumer goods compared with the euro area average.

The outlook for inflation is still subject to significant risks. For example, crude oil prices have fluctuated strongly in recent weeks, as news of the new COVID-19 variant have increased uncertainty on the markets. A new wave of COVID-19 infections may impact inflation in a number of ways. On one hand, a deterioration in the epidemic situation may dampen inflationary pressures if demand both in Finland and globally fades significantly. On the other hand, it may also amplify supply bottlenecks, the intensity and duration of which have a significant impact on inflation developments.

Chart 14.



Inflation will remain high still in the first half of 2022 [6], but it will slow towards the end of the year. As a result, the average rate of inflation will be 2.0%. Crude oil and electricity prices are expected to start declining and, towards the end of the year, energy prices will already be making a negative contribution to inflation. The forecast assumes that supply bottlenecks will ease in the second half of 2022, which will slow the upward trend in the prices of consumer goods. Meanwhile, services inflation is expected to accelerate, in response to stronger demand and rising wages.

In 2023, inflation will slow to 1.6%. This is due particularly to the decline in energy prices. Underlying inflation will, however, continue to make a sustained positive contribution to headline inflation, as in previous years, as the economy will grow at a higher rate than potential growth. The rise in prices will also be sustained by the ongoing stable growth in earnings and the strengthening of inflation expectations. Inflation is expected to rise slightly, to 1.8% in 2024.

Inflation will slow growth in real earnings

The round of negotiations for collective labour agreements for the immediate years ahead began

in autumn 2021; in the agreements concluded thus far, the negotiated pay rises are some 1.9%. Nominal earnings are expected to grow by 2.4% in 2021, and the pace is expected to remain unchanged in 2022–2024 (Chart 15).

Preparation of the forecast used an assumption based on a long-term observed correlation, which suggests that the pace of growth in real wages in 2020–2024 will be broadly the same as growth in productivity. Growth in real earnings will slow notably in 2021, reflecting the pick-up in inflation, but real earnings will nevertheless grow during the forecast period. The price of labour, measured in terms of compensation per employee, will rise by over 4.6% in 2021, following the slow growth of the previous year. The fluctuation is due to mainly pandemic-related factors, for example the ending of the temporary reductions in private sector employer pension contributions. The rate of increase in the price of labour will slow during the forecast period, to stand at 2.3% in 2024.

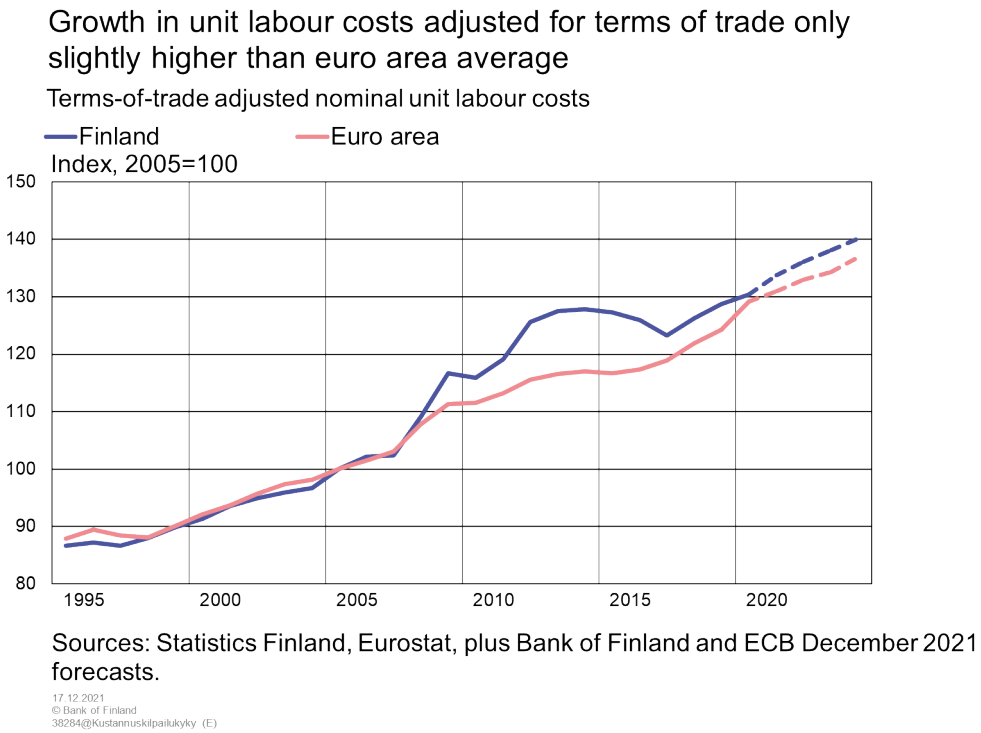
Chart 15.



Nominal unit labour costs will increase by 3.3% in 2021. The higher price of labour will accelerate the increase in unit labour costs, which, on the other hand, will be dampened by improvements in labour productivity. However, the slowing upward trend in the price of labour will also dampen the rise in unit labour costs as of 2022. At the end of the forecast period in 2024, unit labour costs will grow by 1.4%. Forecasts for unit labour costs, adjusted for the terms of trade, for the economy as a whole indicate a slight weakening of Finland's cost-competitiveness relative to the euro area in the forecast period 2021–2024 (Chart 16). Forecasts for the price of labour are, however, subject

to high uncertainty, because during the pandemic, most countries have introduced support measures that affect the measurement of the price of labour.

Chart 16.



Risk assessment: COVID-19 and production bottlenecks threaten economic growth

The risks to the forecast are on the downside. In the short term, the highest level of uncertainty is caused by the renewed deterioration of the pandemic. The steep rise in COVID-19 infections may maintain or increase people's caution and lead to a tightening of containment measures during the winter. This would slow recovery, particularly in those service industries where recovery is most incomplete. In the long term, uncertainty will be sustained by the threat of new virus variants until the pandemic is reigned in globally.

Global supply problems related to the availability of raw materials and logistics have constrained production also in Finland. In addition, the upward trend in the prices of energy, intermediate goods and industrial goods has pushed up inflation. It is difficult to foresee the actual duration and all the impacts of the supply problems, particularly in a situation in which recurring waves of infections are slowing global recovery from the pandemic.

Inflation developments are subject to considerable uncertainty during the forecast period, but the

risks to the outlook for inflation are more balanced than the other risks to the forecast, particularly the risks related to external price pressures. The increase in uncertainty caused by the deterioration in the pandemic situation as well as growing supply have pushed down e.g. crude oil prices, and the trend in raw material prices may also be more subdued than expected during the forecast period. At the same time, the prices of emissions allowances have risen strongly, and therefore developments in energy prices are still also subject to upside risks. Supply bottlenecks, too, are still subject to heightened uncertainty, and they may drive inflation more and for longer than projected.

Of the domestic cost factors, uncertainty about the future pace of inflation comes from the potential inflationary effects of future pay agreements, as wage increases may turn out to be larger than projected. Too large pay increases relative to municipalities' ability to pay would also weaken the public sector balance more than expected, and if pay negotiations were to drag on, the possibility of industrial action would also increase.

Residential construction activity is projected to remain record brisk still next year, reflecting demand for new-build construction, in particular. However, residential construction typically reacts rapidly to fluctuations in demand, and a sharp decline in economic growth due, for example, to a sudden worsening of the pandemic could weaken residential construction activity significantly, particularly in the case of rented housing.

Household debt levels continue to rise, which is explained particularly by the stronger demand for housing loans. In addition to dwellings for owner-occupied purposes, households have increasingly also acquired dwellings for investment purposes, often largely by debt-financing. The largest mortgages are typically taken out by wealthy households who also have assets for covering their debt. In addition to conventional mortgages, housing transactions are increasingly financed by housing company loans, and there is no detailed information on the resilience of those households that have taken out these loans.

The forecast also includes upside risks to the economic outlook. According to the forecast, the household savings rate is expected to decrease gradually, but it is not projected to turn negative. In a favourable scenario, however, households may begin to spend the savings they have accrued during the pandemic more than expected, and, as a result, private consumption may grow at a stronger pace and for a longer period than projected.

Investment growth is projected to pick up, but it is expected to fade at the end of the forecast period, due mainly to structural factors. However, investment typically fluctuates strongly and is difficult to forecast. If the economy continues to recover from the COVID crisis, investment could continue to grow for longer than forecast.

Notes

1. More detailed information on the euro area forecast is available at https://www.ecb.europa.eu/pub/projections/html/index.en.html. ↑
2. More detailed information on the ECB's monetary policy decisions is available on the ECB website. ↑
3. Potential output is the volume of GDP when all the inputs in the economy are in normal use. ↑
4. The difference between GDP and potential output is referred to as the output gap, and it is usually expressed as a percentage of potential output. A positive output gap cannot be maintained without upward pressure on wages and prices. ↑
5. According to business surveys, the amplification of supply bottlenecks in 2021 has, however, affected industrial and export companies extensively: of Finland's goods exports, some 36% are accounted for by industries in which at least half of the companies reported in October 2021 that capacity and materials shortages were disrupting production. ↑
6. The European Central Bank's tool for monitoring inflation is the harmonised index of consumer prices (HICP). Inflation as measured by a broader indicator, i.e. the national consumer price index (CPI), is projected to be 2.4% in 2022. The differences in the rate of increase in the indices is explained mainly by changes in the costs of owner-occupied housing, which have risen at a stronger pace than overall prices. ↑

Keywords

COVID-19, COVID-19 pandemic, economic cycles, economic forecast, economic outlook, economic situation, forecast