Forecast

Forecast: Russia's war in Ukraine is stifling Finland's economic recovery

Finnish economy | 08 July 2022

Russia's war in Ukraine is weakening the outlook for the Finnish economy and pushing up inflation. Foreign trade with Russia is collapsing as a result of the war, and higher uncertainty and inflation are undermining the prospects for consumption and investment. Finland's economy was growing well before the war started, and this will serve as a good foundation for the year's growth overall. The Finnish economy is projected to grow by 1.7% in 2022, but growth will slow to 0.5% in 2023 due to the impacts of the war. Growth will then pick up to 1.5% in 2024, as the difficulties in the global economy subside and inflation moderates.



Russia's war in Ukraine is weakening growth in the global economy because it is increasing uncertainty, exacerbating supply shocks and raising raw material, food and energy prices. The continuation of the COVID-19 pandemic is also helping to sustain supply chain bottlenecks and uncertainty in the world economy. The forecast assumes that the impacts of the war and the pandemic will gradually subside.

Growth in private consumption is being curbed not only by the uncertain economic outlook but also by the high level of inflation. Rising prices will erode households' purchasing power this year,

although this will be offset in part by the use of savings accumulated during the pandemic. Employment growth, which has been strong so far, may be curtailed by the deterioration in the economy caused by the war. Rising costs will reduce private investment. The volume of exports will be far short of what had been forecast earlier, but new markets will be found in the immediate years ahead to make up for the lost business in Russia.

Russia's invasion of Ukraine has created new expenditure needs in Finland's public finances, which were already weakened by the pandemic. The general government deficit relative to GDP will shrink somewhat in the coming years, but the public finances will remain in deficit and the debt ratio will begin to edge upwards again.

Supply chain bottlenecks and more expensive raw materials will fuel inflation across a broad front this year. The rise in food prices has accelerated on the back of higher world market prices for energy, fertilisers and raw materials, while consumer goods prices have risen due to availability problems. Services prices will also pick up as demand for services recovers and goods inflation is passed on to service prices. In 2023, inflation will slow, however, in response to a gradual moderation in energy prices, better availability of goods and raw materials, slower growth in aggregate demand and the expected rise in market rates.

Cost competitiveness will play an important role in efforts to find new markets to make up for lost business in Russia. Projections of aggregate unit labour costs adjusted for the terms of trade suggest that Finland's cost competitiveness will improve slightly in 2022 and remain almost the same during the last years of the forecast period. However, forecasts of both productivity growth and the price of labour are surrounded by a considerable degree of uncertainty.

The growth in Finland's economy may turn out to be lower than forecast, and even a recession cannot be ruled out. The uncertainty surrounding global economic growth is sustained not only by the war but also by the pandemic, and there are risks related particularly to the Chinese economy. In the near future, inflation may climb higher than forecast, and the increase in market rates may be faster than assumed. On the other hand, the economy may perform better than expected, in spite of the many downside risks. Both exports and domestic demand could pick up by more than anticipated if companies are able to adjust quickly to the supply chain bottlenecks and find new markets to replace those lost.

Key forecast outcomes (1/2)					
Percentage change on the previous year	**2020**	**2021**	**2022[f]**	**2023[f]**	**2024[f]**
GDP	-2.3	3.5	1.7	0.5	1.5
Private consumption	-4.1	3.1	1.7	0.6	1.0
Public consumption	0.4	3.2	1.8	-0.3	0.5
Fixed investment	-0.3	1.2	5.1	-0.7	0.9
Private fixed investment	-2.9	4.6	4.7	-1.3	0.5
Public fixed investment	11.2	-12.0	6.9	2.0	2.5
Exports	-7.5	4.7	1.5	2.1	3.5
Imports	-6.6	5.3	3.5	1.0	1.8
Effect of demand components on growth					
Domestic demand	-2.1	2.7	2.5	0.1	0.8
Net exports	-0.3	-0.2	-0.8	0.5	0.7
Changes in inventories and statistical error	0.2	1.0	0.0	0.0	0.0
Savings rate, households, %	4.7	1.0	-1.0	-0.2	0.2
Current account, %, in proportion to GDP	0.7	0.7	-1.0	-0.6	0.1

f = forecast.

Sources: Statistics Finland and Bank of Finland.

Key forecast outcomes (2/2)					
	2020	**2021**	**2022[f]**	**2023[f]**	**2024[f]**
Labour market					
Number of hours worked	-2.5	1.3	2.2	0.3	1.0

Sources: Statistics Finland and Bank of Finland.

Key forecast outcomes (2/2)					
Number of employed	-2.0	2.6	2.4	0.1	0.6
Unemployment rate, %	7.8	7.6	6.5	6.5	6.4
Unit labour costs	0.7	3.5	4.1	3.3	2.0
Labour compensation per employee	0.4	4.4	3.4	3.8	3.0
Productivity	-0.3	0.8	-0.7	0.5	0.9
GDP, price index	1.6	2.7	5.7	2.4	2.0
Private consumption, price index	0.5	2.0	5.6	2.3	1.8
Harmonised index of consumer prices	0.4	2.1	5.6	2.4	1.8
Excl. energy	0.8	1.3	3.5	3.0	2.1
Energy	-5.0	9.7	26.9	-2.6	-1.5
f = forecast.					

Sources: Statistics Finland and Bank of Finland.

Operating environment: assumptions and financing conditions

Russia's war in Ukraine is curbing growth in the global economy and in the Finnish economy. The war is further exacerbating supply-side bottlenecks caused by the COVID-19 pandemic and continuing to push up inflation. A rise in market rates will tighten financing conditions. Increased geopolitical tensions are clouding both the global and Finnish economic outlook. This forecast is based on data available on 24 May 2022.

Ukraine war is weakening a world economy already suffering from supply bottlenecks

Russia's war in Ukraine is undermining global economic growth because it is increasing uncertainty, exacerbating production and supply chain disruptions, and pushing up prices of raw materials, food and energy. According to the assumptions underlying the forecast, the most intense phase of the war will continue until the end of 2022. The uncertainty stemming from the war is expected to gradually decrease in the second half of 2022, but it is assumed that the

sanctions against Russia will remain in force at least until the end of 2024.

The continuation of the COVID-19 pandemic and especially China's strict restrictions on movement will prolong supply bottlenecks and uncertainty in the global economy. The outlook for the global economy is clouded not only by the war and the pandemic, but also by increased geopolitical tensions and problems in the Chinese economy, for example its real estate sector. Global economic growth is projected to be significantly weaker in 2022 and 2023 than previously estimated, but to stabilise close to its long-term average in 2024 (Table 2).

The slowdown in world trade and the cessation of trade with Russia are reflected in the declining demand on Finland's export markets in the immediate quarters ahead (Chart 1). According to the forecast, the Russian economy will contract by around 13% in 2022 and by around 5% in 2023.

Chart 1.



According to the forecast's assumptions, problems in the supply of goods and raw materials will gradually ease and dissipate by the end of 2023. While Finland's export demand will strengthen as global economic growth picks up, it will not return to its previously projected baseline even by the end of 2024. The war will thus leave a lasting scar on Finland's economic operating environment. The duration and extent of the supply disruptions will be highly dependent on the path taken by the war and the pandemic.

Rising prices of oil and other raw materials are significantly raising production and import prices

across the world (Table 2). Furthermore, the depreciation of the euro against the US dollar will raise euro-denominated prices. However, the prices of oil and other raw materials are assumed to fall in the longer term, in line with market expectations. The forecast assumes that oil imports from Russia to the EU will cease and that euro area countries will secure oil from other sources to fully replace Russian oil.[1]

The war in Ukraine and the supply bottlenecks will have a detrimental impact on euro area foreign trade and investments, particularly in 2022.[2] Inflation will curb economic growth. On the other hand, the ending of COVID-19 restrictions and the use of savings accumulated during the pandemic will boost household consumption in the euro area, which will, in turn, support services in particular. As a result, economic growth in the euro area will continue, although slower than previously forecast (Table 2).

Euro area inflation is projected to rise significantly in 2022, but to gradually moderate later to around 2% in 2024. Inflation has been driven up particularly by the steep rise in energy prices, although rising food prices, production bottlenecks and the recovery of services demand are also contributing to inflation. There are signs that inflation is broadening. Indeed, underlying inflation (i.e. excluding energy and food prices) in the euro area is projected to rise to just over 3% this year.

Interest rates are rising

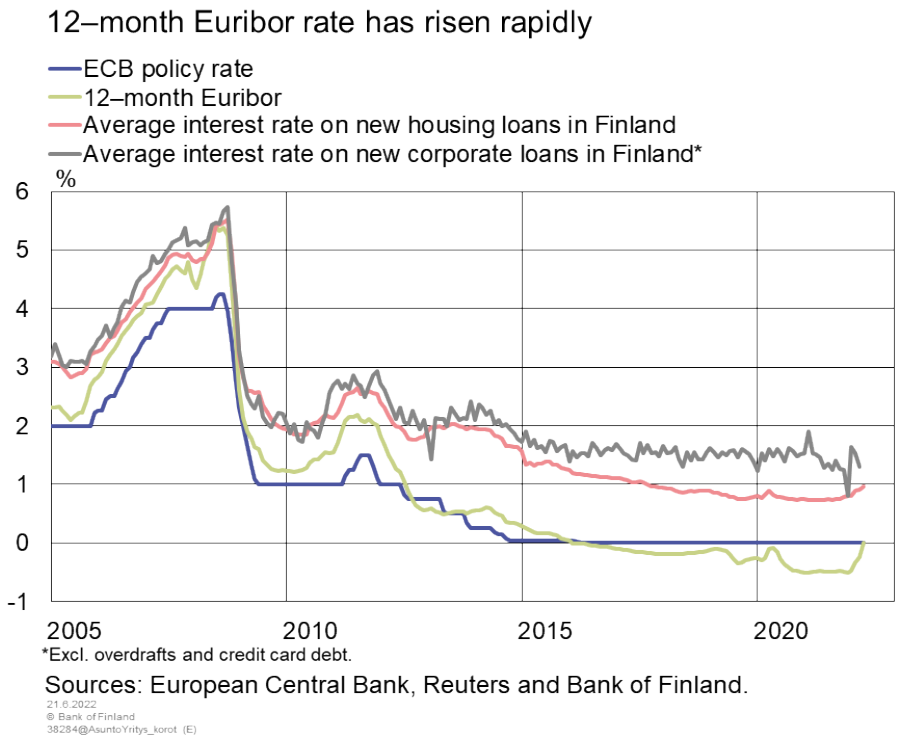
In June, the Governing Council of the ECB decided to end net asset purchases under its asset purchase programme as of 1 July.[3] For the present, the Governing Council will continue reinvesting, in full, the principal payments from maturing securities purchased under the APP. Additionally, the Governing Council announced that it intends to raise the key ECB interest rates by 25 basis points at its July monetary policy meeting and that another rise is to be expected in September. The calibration of this September rate increase will depend on the updated medium-term inflation outlook. The Governing Council is committed to its 2% inflation target over the medium-term, and therefore the pace at which it will adjust monetary policy beyond September will depend on the updated growth outlook and how the Governing Council assesses inflation to develop in the medium term. The interest rates on the main refinancing operations, on the marginal lending facility and on the deposit facility are currently 0.00%, 0.25% and -0.50%, respectively.

Financing conditions in Finland have so far remained mainly accommodative and supportive of growth. However, the average interest rate on new housing loans and the 12-month Euribor rate have begun to rise (Chart 2). The yield on Finnish 10-year government bonds has also clearly increased this year. Financial markets are expecting short-term interest rates to rise in the euro

area in the immediate quarters ahead (Table 2). But while market expectations regarding the pace of short-term interest rate rises have increased recently, markets also expect rates to go on to stabilise next year. Current market expectations regarding the level of short-term interest rates are relatively high in relation to where these rates have been over the last decade, but even the current expectation level is moderate in any long-term comparison.

In the Bank Lending Survey (BLS), some respondent banks reported that credit standards and terms on corporate loans had tightened in early 2022. In the first quarter, credit standards for household loans either eased or remained unchanged on average. 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					
Volume change year-on-year, %	**2020**	**2021**	**2022^{f}**	**2023^{f}**	**2024^{f}**
Euro area GDP	-6.5	5.4	2.8	2.1	2.1
World GDP	-2.8	6.3	3.0	3.3	3.4

Sources: Eurosystem and Bank of Finland.

Forecast assumptions					
World trade*	-8.2	11.4	4.3	3.2	3.6
Finland's export markets, % change**	-8.3	10.5	2.0	2.2	3.5
Oil price, USD/barrel	41.5	71.1	105.8	93.4	84.3
Export prices of Finland's competitors, euro, % change	-3.8	9.9	16.9	2.9	0.8
3-month Euribor, %	-0.4	-0.5	0.0	1.3	1.6
Finland's nominal effective exchange rate ***	108.7	109.4	106.9	106.0	106.0
USD value of one euro	1.1	1.2	1.1	1.1	1.1

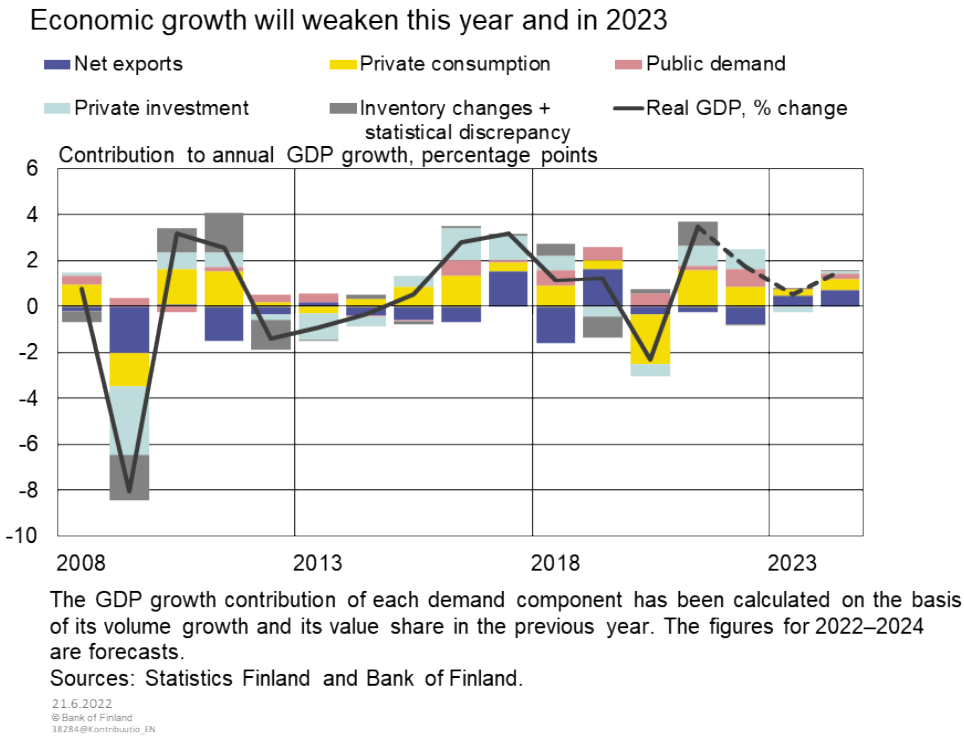
* Calculated as the weighted average of imports.
** The growth in Finland's export markets is the import growth in the countries Finland exports to, weighted by their average share of Finland's exports.
*** Broad nominal effective exchange rate, 2015 = 100. The index rises as the exchange rate appreciates.
f = forecast.

Sources: Eurosystem and Bank of Finland.

Demand and public finances

Finland's economic growth will slow down substantially this year and in 2023 as a consequence of Russia's war in Ukraine (Chart 3). The war is increasing uncertainty in the economy, which is very detrimental for private consumption and investment. High inflation is eroding the purchasing power of households and further weakening consumption, and rising costs are reducing private investment. Foreign trade is also suffering on account of the war. When uncertainty and the problems with the availability of raw and other materials ease, however, Finnish exports will gradually recover. Finland's public finances will remain very much in deficit throughout the forecast period.

Chart 3.

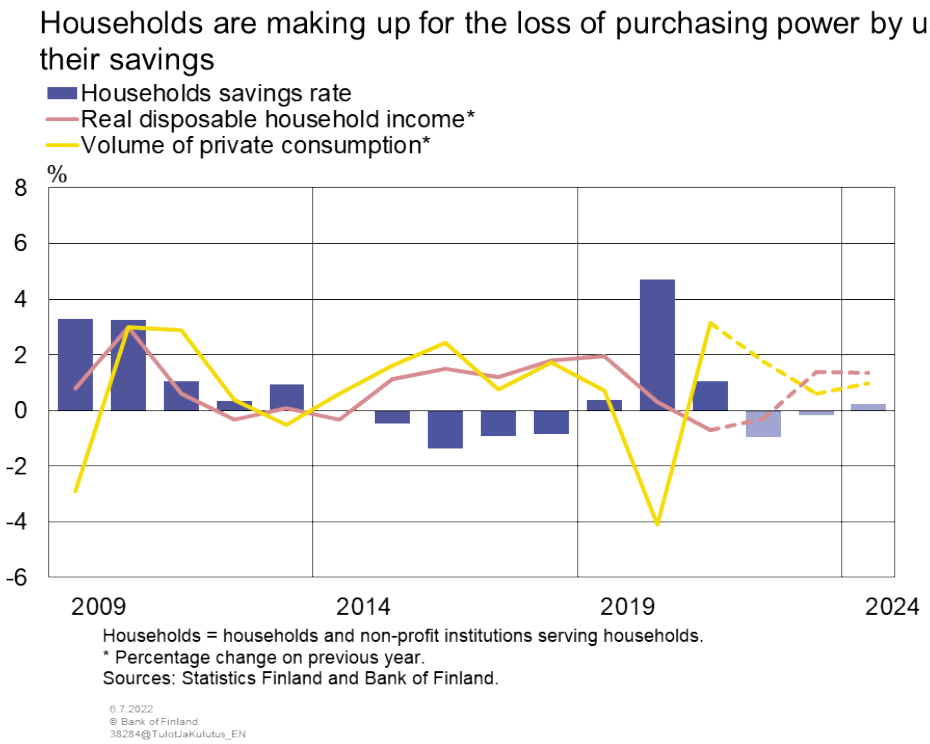


Erosion of purchasing power is slowing growth in consumption

Private consumption in 2021 grew swiftly as the economy recovered from the sudden standstill caused by the COVID-19 pandemic. This year the increase in private consumption will slow down. Rising inflation is eroding the purchasing power of households for the second year in succession, which will curb the growth in consumption. In 2023, purchasing power will start to recover as the peak in inflation passes (Chart 4).

The weakened economic outlook and high inflation undermine consumer confidence, which slumped in the spring after Russia invaded Ukraine. Combined with the uncertainty triggered by the war, this is curtailing growth in private consumption this year.

Chart 4.



On the other hand, worries about the pandemic are fading, and the release of pent-up consumer demand this year should help boost the consumption of tourism and leisure services in particular.

Households have accumulated a considerable amount of savings during the pandemic. Between spring 2020 and autumn 2021 Finnish households amassed an estimated total of almost EUR 6 billion in additional savings. Since then the savings rate has declined. This year especially, households will be compensating for the erosion of purchasing power by using some of their savings, which will mainly be channelled into consumption expenditure. By 2024, most of the additional savings that had been accumulated will have been spent.

Private consumption will also increase next year, but the rise will be modest as there will still be much uncertainty and the supply chain disruptions will continue. Rising interest rates over the next few years will also slow the growth in consumption. In 2024, consumption growth will gradually start to recover as the disruption to the economy caused by the pandemic and the Ukraine war gradually eases and the mood of uncertainty fades.

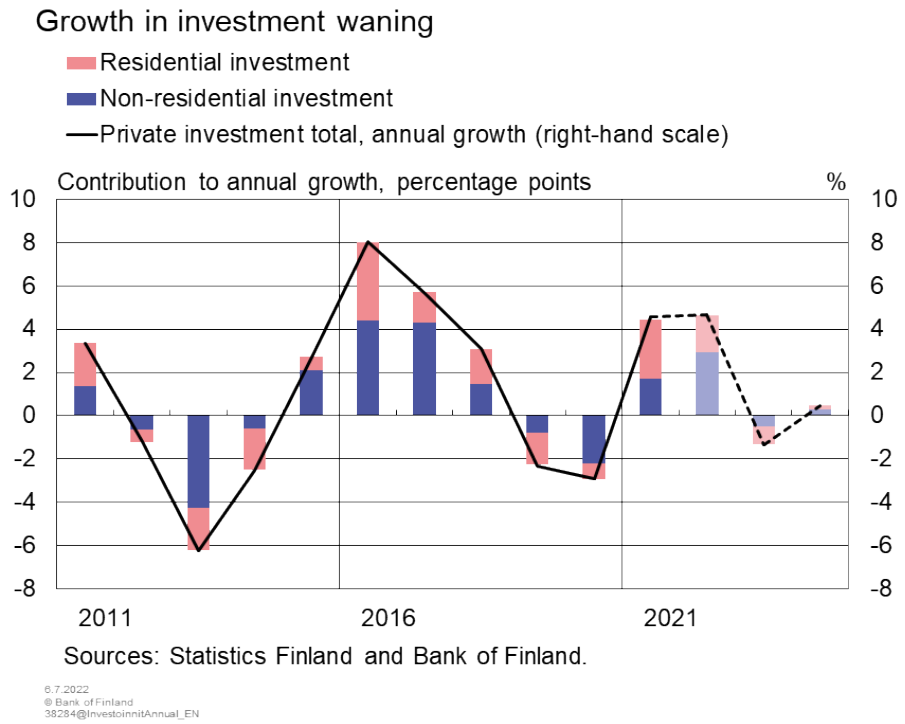
Investment growth will fade and retreat

The economic recovery from the pandemic and the burst of activity in housing construction resulted in a brisk increase in private investment in 2021. Robust investment growth is expected

to continue in 2022 (Chart 5). Investment in industry in particular is expected to increase this year.

The war in Ukraine and rising costs, however, are causing growth in private investment to level off, and investment is expected to fall in 2023. Private investment is normally sensitive to fluctuations in economic uncertainty, although there is always a time lag involved.

Chart 5.



Private investment, however, will start to increase again in 2024, when the level of geopolitical uncertainty gradually dissipates. In the longer term, non-residential investment[4] will be boosted in particular by the needs of the green transition and investment in energy.

Housing construction was exceptionally brisk and new housing starts were at a record high in 2021. With projects launched last year and construction work continuing, housing construction will see strong growth in the current year, too (Chart 5).

The rise in interest rates and expectations of a tightening of monetary policy are reflected in the housing market as a decline in demand on the part of consumers and investors. The unusually rapid rise in the costs of construction and disruptions to the supply of building materials will mean that new projects will be slower to start in the immediate years ahead. In 2024, housing construction will recover slightly, as the increase in costs levels off and uncertainty about the

economy dissipates.

Problems in the global economy will curb export growth

Russia's war in Ukraine, the ensuing sanctions and the collapse in trade with Russia will curb growth in Finland's export markets. Moreover, global disruptions in production and supply chains will serve to weaken foreign trade further. The growth in Finnish exports will slow considerably as a result this year, but will subsequently begin to pick up slowly in the wake of rising external demand. Exports in the period 2023–2024 will increase at the same rate as the growth in Finland's export markets. The slowdown in export growth will thus be significantly less than during the pandemic (Chart 6).

Chart 6.



It will take some time before companies exporting from Finland are able to adapt to the collapse in exports to Russia and to find new, alternative markets. Finding such markets will depend on various factors, such as the structure of the exports and the ability of Finnish companies to compete on costs.

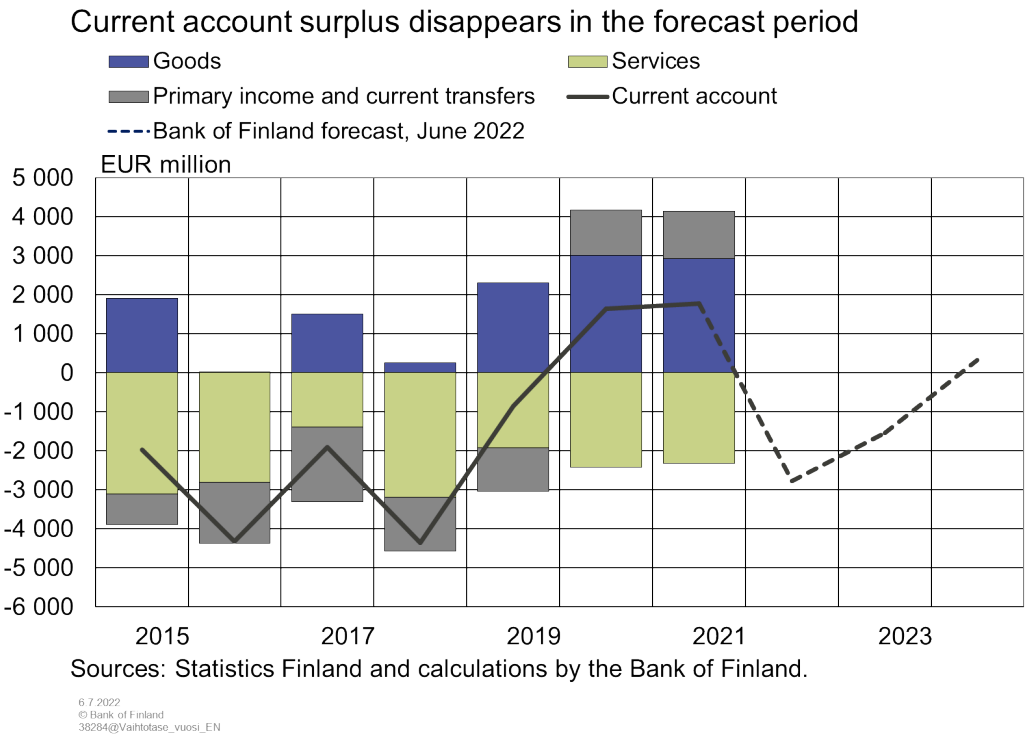
This year, imports will grow faster than exports. This is because of the slowdown in export growth caused by the decline in trade with Russia and because of the continuation in 2022 of domestic demand growth, which supports import growth. Imports from Russia will decrease mainly because

of the fall in imports of energy, although these can be replaced with energy from other markets. The figure for net exports will therefore be low this year. The growth in imports will lose momentum in 2023–2024, due to weak growth in domestic demand.

Rising prices of energy and raw materials have pushed up transport costs and increased the prices of exported and imported products. The production costs of companies that export goods and services have thus risen noticeably. The terms of trade, however, have remained virtually unchanged, as companies have been able to offset the high prices of imports by charging higher prices for their exports. The terms of trade are also expected to remain stable over the forecast period.

There was a current account surplus in 2021 (Chart 7). Both the balance of trade in goods and the balance of primary income have shown a considerable surplus, largely on account of temporary factors connected with the pandemic. The current account for 2022 will show a deficit, as the value of imports will increase faster than that of exports. With growth in the value of imports slowing over the immediate years ahead, the deficit will diminish and in 2024 Finland's current account will be virtually in balance.

Chart 7.

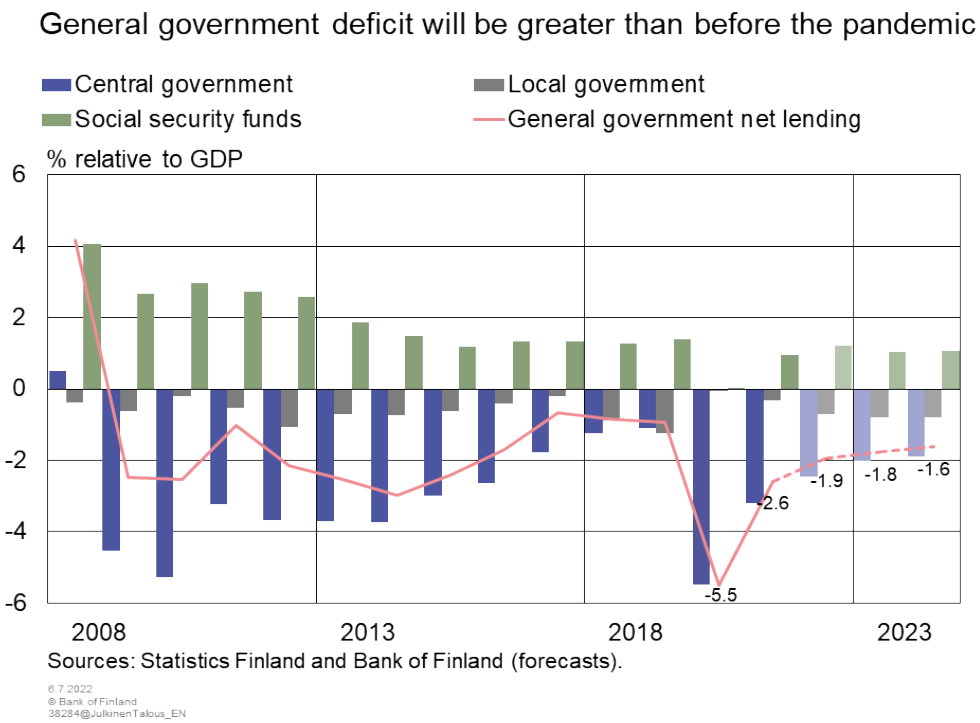


Ukraine war intensifying pressures on public spending

The pandemic increased the fiscal deficit and the level of public debt. Russia's war in Ukraine has triggered new public spending needs with respect to defence, the national security of supply, energy self-sufficiency and the green transition. The general government budgetary position will nevertheless show an improvement in the years following 2021, because the increase in tax revenues and social security contributions will exceed the growth in public expenditure in the forecast period.

Finland's public finances will be in deficit in the immediate years ahead, although the general government deficit relative to GDP will shrink to some extent (Chart 8). But the deficit even in 2024 will be substantially greater than before the COVID-19 crisis. The imbalance between revenue and expenditure is scarcely attributable to the business cycle, but is instead mainly structural. Fiscal policy will thus continue to be accommodative.[5]

Chart 8.



The government's tax policy is fairly neutral, which means that taxation will not change significantly this year or next. However, the measures agreed on following Russia's invasion of Ukraine will push up expenditure by almost EUR 2 billion this year, and by more than EUR 1 billion again in the period 2023–2024. Temporary additional expenditure will mainly be allocated to national defence, the reception of refugees from Ukraine, Finland's national security of supply, and

Government Programme measures for improving public services.

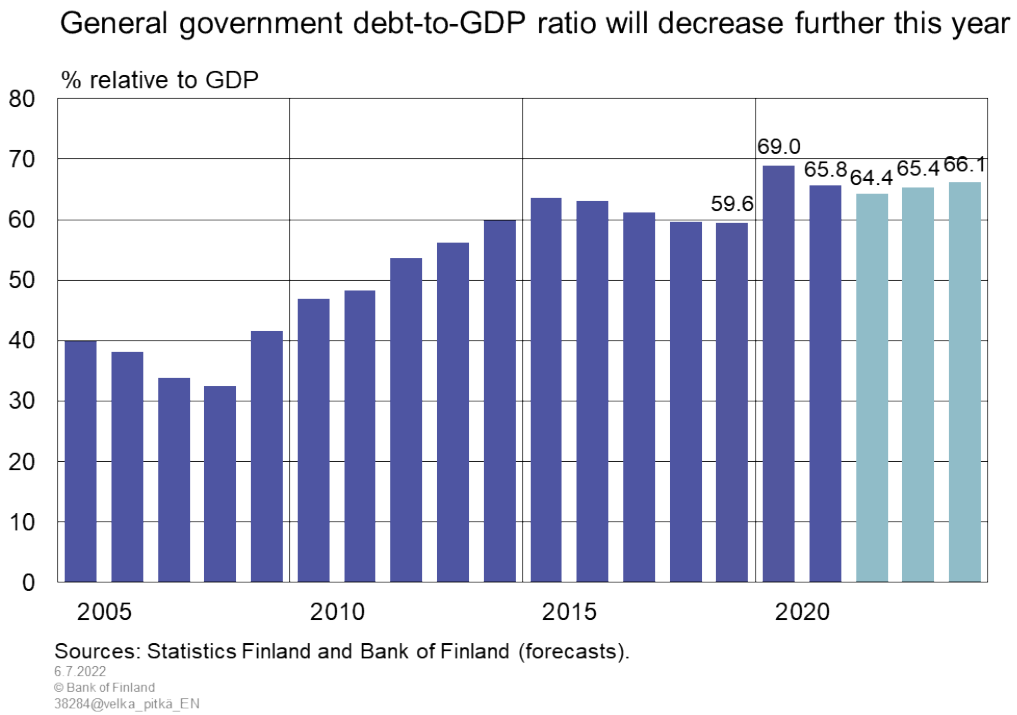
At the same time, the rising prices of intermediate goods and construction costs are increasing public expenditure. Demands for higher wages on the part of municipal employees increase the risk of an even sharper rise in expenditure.[6] Real public consumption will continue to increase with the agreed additional expenditure this year. State-funded investment will expedite the increase in real public investment this year, although rising costs will delay the launch of public investment projects to some extent.

Central government has carried the main burden of the pandemic-related additional expenditure. The preparedness measures agreed as a result of the war in Ukraine will also have to be paid for mainly by the government. The central government deficit will thus remain at around 2% relative to GDP in the period 2023–2024, despite the healthy trend in tax revenues and the rapid growth in GDP at current prices (Chart 8).

The pandemic-related financial support provided to local government by the state will diminish this year. As a result, the local government deficit will increase. There will be changes in local government in 2023, when the responsibility for social welfare, healthcare and rescue services will transfer from the municipalities and joint municipal authorities to the new wellbeing services counties. Thus, a significant portion of local income taxation will come under state taxation, and the government will finance the wellbeing services counties through current transfers. In the forecast, the effect of these reforms on the balance between local government revenue and expenditure is neutral.

The general government debt-to-GDP ratio will decrease further this year, because GDP at current prices will increase dramatically on account of inflation (Chart 9). However, the debt ratio will start to increase as from 2023 due to the considerable general government deficit. Debt servicing costs will rise in the next few years, which will in turn accelerate the increase in the debt ratio.

Chart 9.



Supply and cyclical conditions

Russia's war in Ukraine has caused a clear downward adjustment in the assessment of cyclical conditions. As recently as December 2021, projections were pointing towards a boom, but current estimates suggest that the economy will just barely stay close to its potential growth rate for the next few years. The deteriorating economic situation is also hampering employment growth. Growth in potential output is slow due to structural factors, but investment growth is also on a more cautious path, and supply disruptions persist. The output gap will remain close to zero between 2022 and 2024.

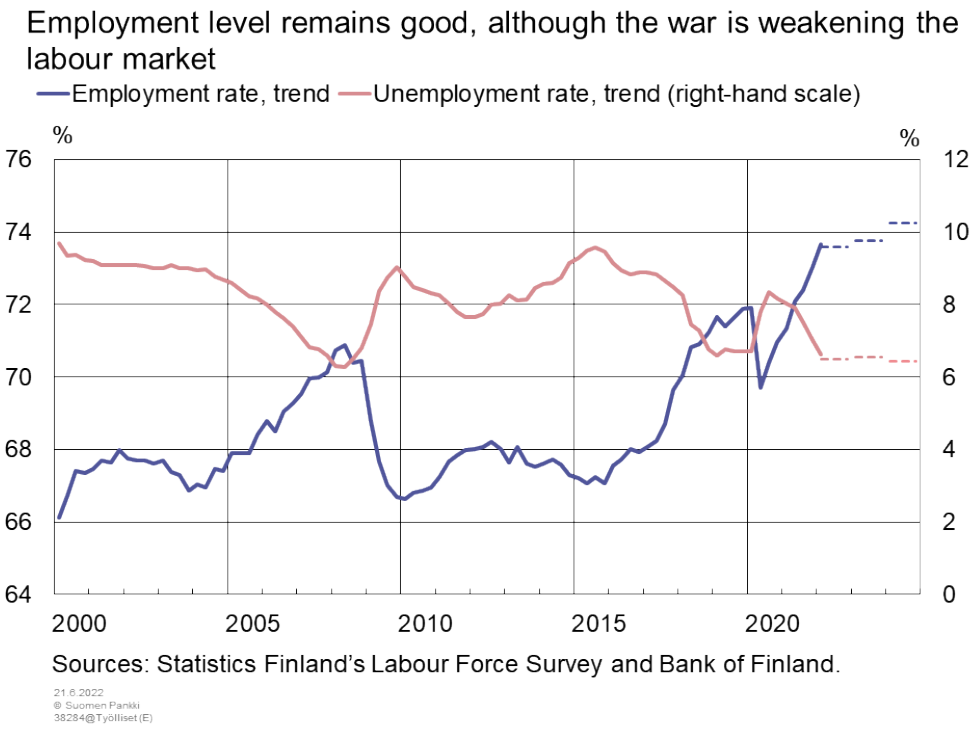
Employment level remains good, although the war is weakening the labour market

Employment has picked up rapidly, driven by the strong recovery from the COVID-19 slump. However, the deteriorating economic situation caused by the war will curb employment growth during the forecast period. The employment rate is expected to rise by just over 2 percentage points over the forecast period, to 74.4%. The number of people employed will increase, and at the end of the forecast period, in 2024, this number will be some 82,000 higher than in 2021, on average. In 2022, the unemployment rate will be 6.7%, almost one percentage point lower than in

2021.It will decrease only slightly in the years ahead and will stand at 6.6% in 2024 (Chart 10).

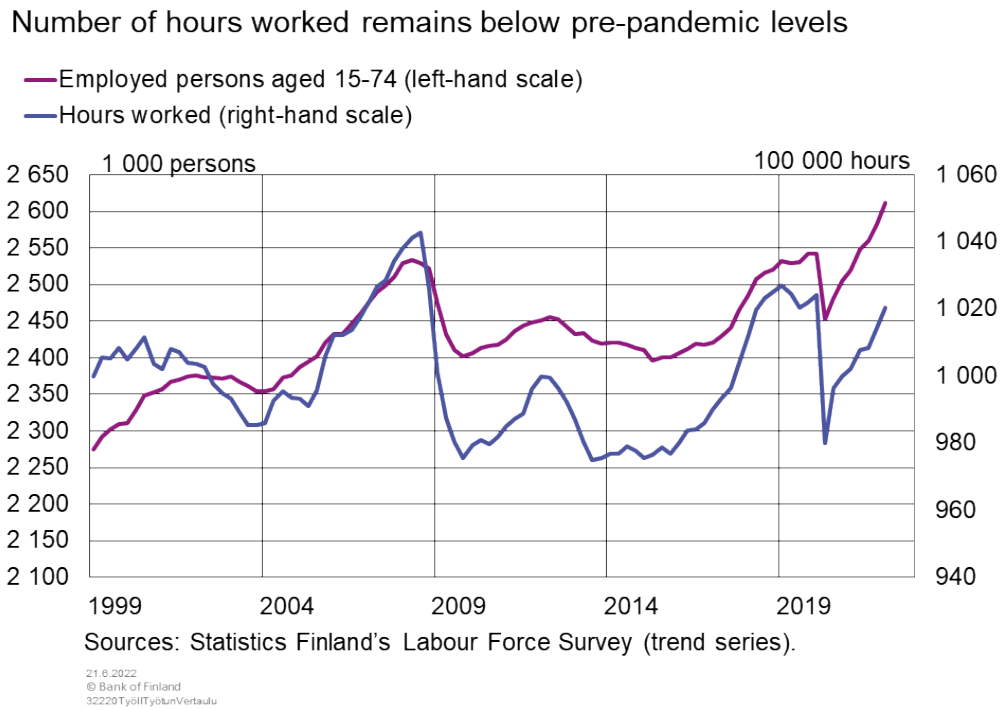
Prior to Russia's invasion of Ukraine, strong growth in services demand and the lifting of pandemic restrictions gave added impetus to the continuing growth in employment over the short term, particularly in services. Unemployment has dropped, but by less than the improvement in employment. In other words, the labour force participation rate has increased. Layoffs have decreased to pre-pandemic levels.

Chart 10.



Although the employment rate and the number of people employed have already exceeded pre-pandemic levels, the number of hours worked is still lower than before the COVID-19 crisis (Chart 11). This may be the result of recent growth in part-time jobs or a reduction in the average working hours of full-time jobs. The protracted pandemic and the outbreak of the Ukraine war have brought continued uncertainty to the labour market, which may have increased caution in creating permanent full-time jobs. The reduction in the average hours worked may, in part, be due to the improved employment situation for older workers who work fewer hours. This observed downward trend in average hours worked will level out towards the end of the forecast period.

Chart 11.



The number of job vacancies has risen to a record high, but growth in the number of people employed is constrained by labour market mismatches. Companies report a shortage of suitable labour in surveys. The continued good level of growth in employment and the reduction in unemployment suggest that some of the labour supply problems may be caused by labour market frictions relating to the need for rapid job creation.

The number of people unemployed for more than a year has decreased, but the number of long-term unemployed is still 30,000 higher than before the pandemic. At the same time, the number of people unemployed for more than two years is growing. The working-age population will continue to decline in 2022 and in the immediate years ahead. Consequently, growth in employment will slow towards the end of the forecast period, because by that time those who were laid off and those unemployed persons who were most easy to employ will already have found work. The unemployment rate will fall slightly below the level of structural unemployment during the forecast period.

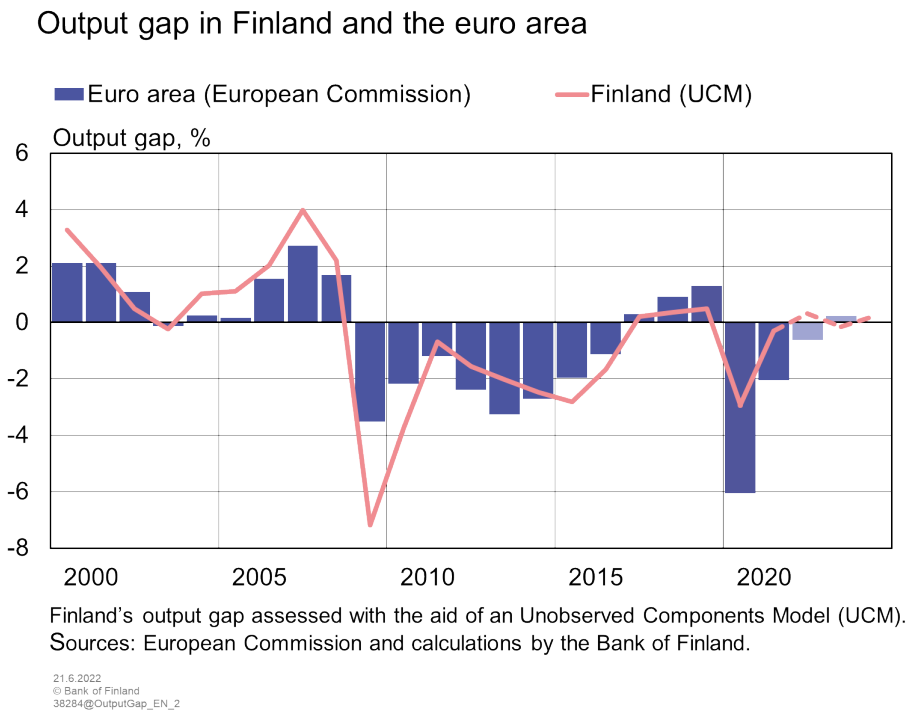
Boom cancelled

With the exception of the public finances, Finland's economy had largely recovered from the deep recession caused by the COVID-19 pandemic when the next crisis hit. Even just before Russia's invasion of Ukraine, it was projected that cyclical conditions would improve in both the euro area

and Finland in the immediate years ahead. Due to the crisis caused by the war, the assessment of cyclical conditions has been adjusted significantly downwards. According to the current estimate, the output gap will be close to zero in 2022–2024 (Chart 12). However, the threat of a recession cannot be ruled out if the war in Ukraine lingers on, energy and raw material prices continue to rise and the economy adjusts only slowly.[7]

The war is undermining growth in the economy by affecting both demand and supply. On the one hand, the uncertainty caused by the war is weakening domestic demand and causing a contraction in export markets. On the other hand, the war is further exacerbating global supply disruptions and raising energy and other raw material prices. In addition to the geopolitical uncertainty, China's strict COVID-19 restrictions continue to hamper the functioning of supply chains, prolong shortages of raw materials and other materials and lengthen delivery times.

Chart 12.



Finland's potential output growth was already recovering from the setback experienced during the COVID-19 crisis when Russia began its war in Ukraine (Chart 13).[8] The growth of potential output will remain slow over the forecast period, partly due to weaker-than-projected investment growth and continued supply disruptions. GDP growth is estimated to remain close to, but slightly above, its long-term potential rate at the end of the forecast period. However, the war is creating

uncertainty in the assessment of potential output and is increasing the downside risks to the forecast.

The increase in long-term unemployment that resulted from the pandemic and the persisting high level of structural unemployment will reduce the importance of labour as a source of potential output during the forecast period.[9] The labour supply will also be constrained by the fact that the working age population (aged 15–74) has already started to shrink. On the other hand, due to a positive change in the participation rate, aggregate labour input will continue to support growth in potential output.

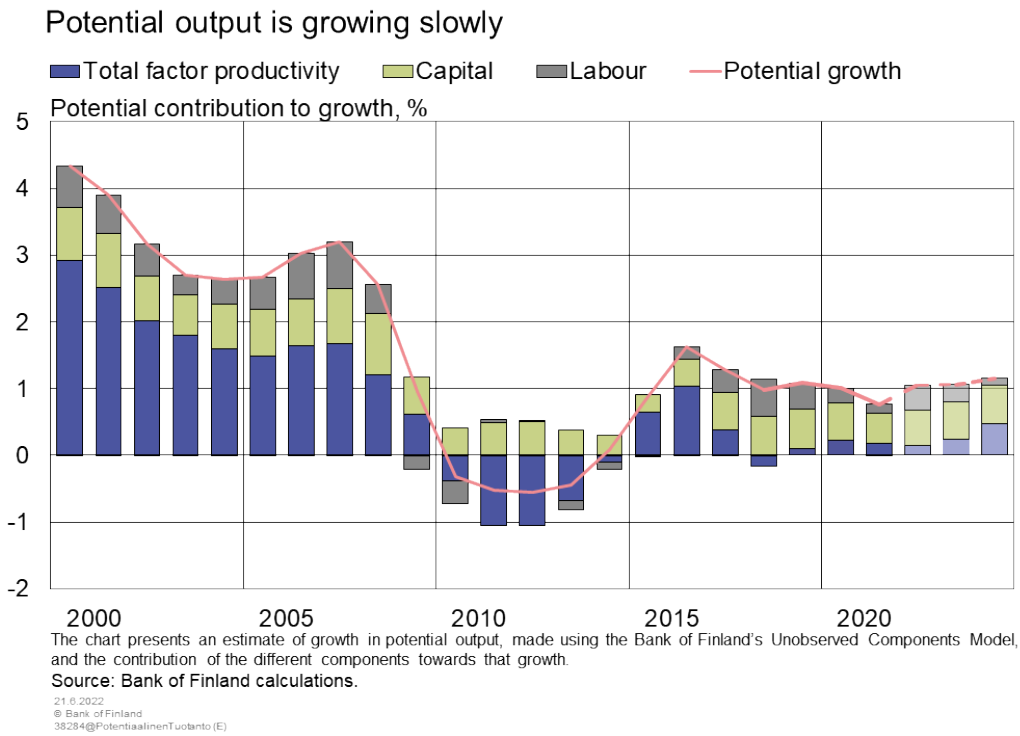
Capital stock is growing slowly, contributing to growth in potential output. Growth in total factor productivity will remain subdued temporarily, due to supply disruptions and reallocation of resources. In addition to the immediate shortage of components and other materials, the pandemic and the war are forcing some businesses to look for new subcontractors and reorganise their supply chains, also forcing them to ensure undisturbed access to energy.

Especially during crises, structural rigidities and frictions in the economy play an important role in how effectively economic resources are reallocated and how quickly potential output improves. In a business survey conducted by Finnish Industry Investment, most businesses replied that they believe they will be able to replace the lost Russian exports with new markets relatively quickly.[10] However, some businesses do not expect to be able to replace lost exports at all.

Russia's invasion of Ukraine may affect potential output in many ways, which is why the assessment is subject to more uncertainty than usual. The war may have an enduring or even a permanent negative impact on the economy's growth potential if it leads to permanently reduced international trade and a less optimal global division of labour. This would contribute to slowing down productivity growth. On the other hand, diversifying critical production chains and moving production closer to the domestic market may reduce the risk of supply disruptions and improve the crisis resilience of the economy going forward.

The relocation of production combined with green transition investments that are larger and quicker than anticipated could strengthen the capital stock. On the other hand, capital stock growth may turn out weaker than estimated if a significant volume of investments are cancelled due to the consequences of the war. Part of the capital stock may become obsolete should there be major disruptions in the availability of oil and gas. Due to the war, uncertainty also surrounds the growth in labour input, for instance in regard to future immigration trends.

Chart 13.



Prices and costs

Inflation, having already picked up last year, has further increased in 2022 as a result of the Ukraine war and the COVID-19 pandemic. Higher raw material prices and protracted supply chain disruptions have led to a widespread rise in consumer prices. Nominal earnings will increase notably less than inflation in 2022, resulting in an uncommon decline in real earnings. In 2023–2024, earnings are projected to grow faster than inflation, which will slow in 2023 as energy prices decline slightly. Finland's cost competitiveness is projected to improve somewhat in 2022 but will remain virtually unchanged relative to the euro area in 2023–2024.

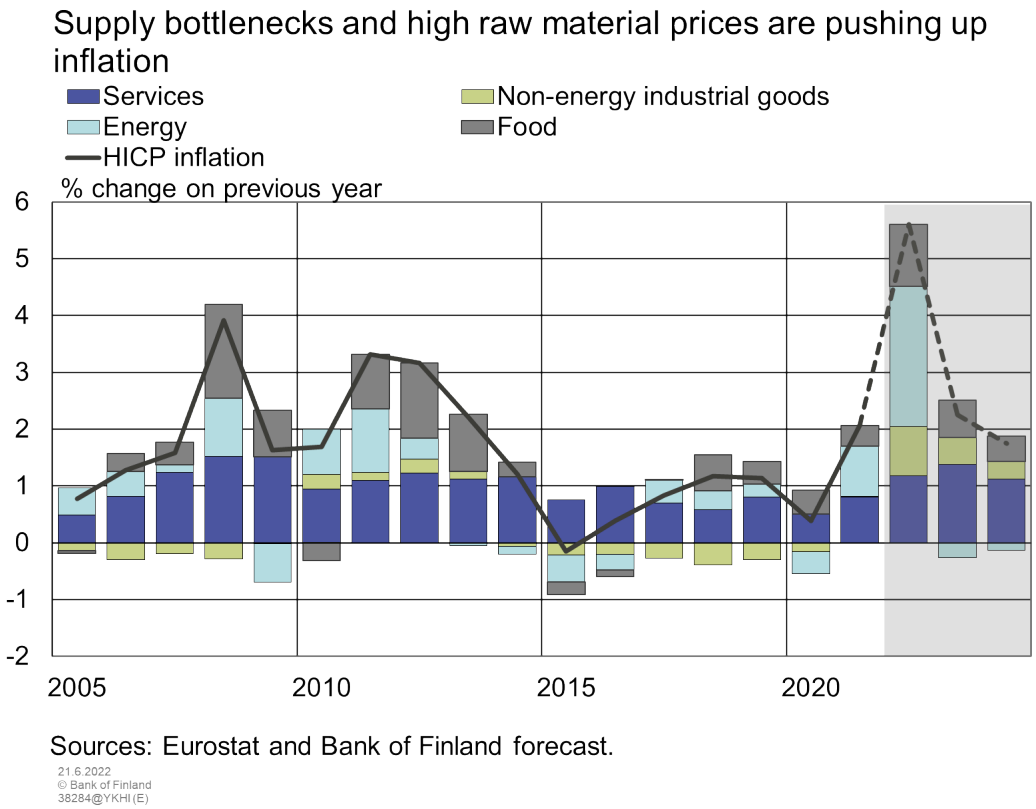
Inflation is being driven up by the effects of the Ukraine war and the pandemic

Inflation has further increased during early 2022 especially because of higher energy prices, but consumer price growth has become more broadly based in recent months (Chart 14). Russia's invasion of Ukraine has driven up energy and raw material prices even higher, and these will be passed on widely to consumer prices in 2022. Food price inflation has accelerated on the back of higher world market prices for energy, fertilisers and raw materials. Because cost factors are passed on to the prices of final goods via a time lag, food prices will continue to rise sharply until

2023.

Supply chain disruptions caused by the pandemic have persisted, and have been exacerbated by the war, which will raise consumer goods prices in 2022. These supply chain disruptions are expected to subside during 2023, and as a result the rise in consumer goods prices will gradually slow. The increase in services prices will accelerate in 2022 as the demand for services recovers and price rises for other goods are passed on to services.

Chart 14.



In 2023, inflation will be lower than this year. The upward impact of energy prices on inflation will abate in 2023, but prices of energy products will remain high. Underlying inflation, which measures price changes in consumer goods and services, will remain close to 3% in 2023. Underlying inflation will begin to fall as supply chain disruptions subside, growth in aggregate demand slows, and as market interest rates are expected to rise. Inflation will slow further in 2024, as energy prices decline in accordance with market expectations and underlying inflation eases.

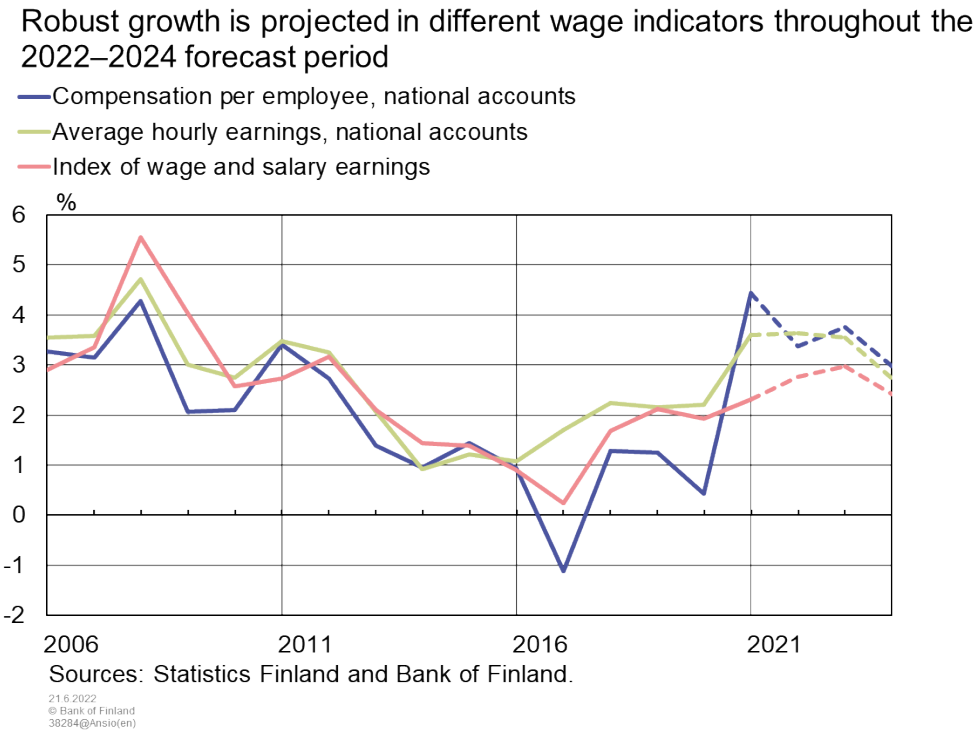
Real earnings will decline in 2022 because of high inflation

Growth in nominal earnings will rise to 2.8% in 2022, as measured by the index of wage and salary

earnings (Chart 15). This forecast is based on the collective bargaining agreements that have been signed so far, in which wage rises agreed for 2022 have been about 2%. At the time of preparing the forecast, wage negotiations for workers in local government were still in progress. In many industries wage rises for 2023 will be negotiated during autumn 2022. Because of the tightness of the labour market, wage drift is expected to be higher in 2022 and 2023 than in previous years, which will accelerate nominal earnings growth.

The forecast takes the long-run observed relationship between wages and productivity as an assumption, where real wages grow at approximately the same rate as productivity. Real earnings will decline in 2022 on account of high inflation but will begin to rise towards the end of the forecast period as inflation slows.

Chart 15.



The cost of labour, or compensation per employee, will increase by 3.4% in 2022. This rise will continue at about the same pace throughout the 2022–2024 forecast period. The higher cost of labour and weak growth in labour productivity will push up nominal unit labour costs in 2022. In 2023 and 2024 labour productivity will return to growth, causing the rise in nominal unit labour costs to abate towards the end of the forecast period.

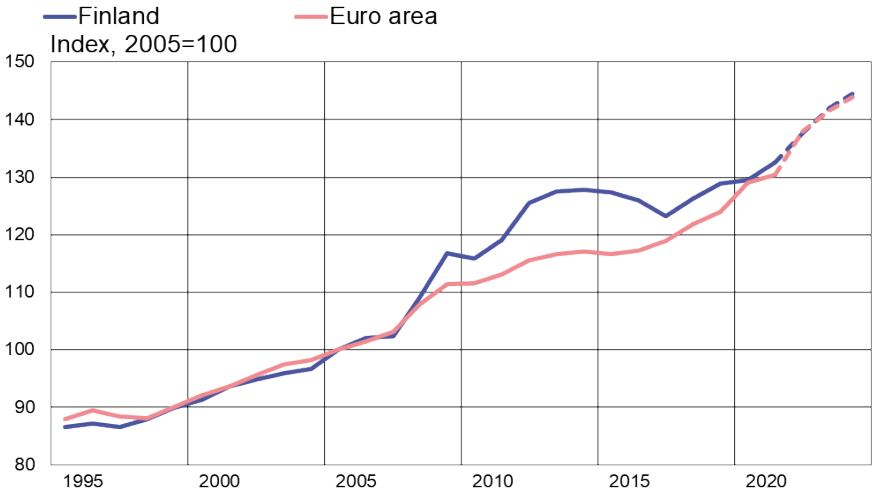
Cost competitiveness will play an important role during the forecast period, especially as companies seek to make up for lost business in Russia with new export markets. Projections of

aggregate unit labour costs adjusted for the terms of trade suggest that Finland's cost competitiveness will improve slightly in 2022 but remain almost the same relative to the euro area in 2023–2024 (Chart 16). Because of the war and the pandemic, projections of productivity growth are subject to significant uncertainty. In addition, the change in labour costs may differ from the projected level due to persistent high inflation. Together these contribute significant uncertainty to projections of cost competitiveness.

Chart 16.

Cost-competitiveness is not projected to change substantially during the forecast period

Nominal unit labour costs adjusted for the terms of trade



Sources: Statistics Finland, Eurostat and June 2022 forecasts by the Bank of Finland and the European Central Bank.

21.6.2022
© Bank of Finland
38284@Kustannuskilpailukyky (E)

Risk assessment

The risks surrounding the forecast are predominantly on the downside. There is great uncertainty associated with the forecast, especially regarding Finland's external operating environment. In private consumption and investment, however, growth may turn out to exceed expectations.

In the short term, the greatest risks concern the consequences of Russia's invasion of Ukraine, which are difficult to assess.[11] There is a possibility of unpredictable and strong fluctuations in energy and raw material prices, and the war may also further hamper the availability of raw materials and supplies. If the war escalates further or spreads to other countries, the economic impact would be even more far reaching. The forecast takes account of the gradual cessation of Finland's export and import trade with Russia. The war will also significantly curtail growth in

Finland's other export markets, especially in Europe. Export growth during the forecast years is largely dependent on how well Finnish companies manage to find new markets for their products to replace the lost Russian markets. There are also uncertainties relating to imports, particularly the availability of energy.

If Finland's NATO membership application process becomes significantly prolonged and complex, the uncertainty affecting households and companies will increase even further. Uncertainty would also grow if there were any Russian attempts to harass Finland. Increased uncertainty could leave consumption and investment growth weaker than forecast. Finland joining NATO, on the other hand, would stabilise the security policy situation, thereby reducing economic uncertainty and potentially improving growth beyond current projections, especially in investment.

In addition, the COVID-19 pandemic is still sustaining uncertainty about the direction of the global economy. In China, in particular, economic growth is further slowing due to strict restrictions. This has affected China's manufacturing and caused new bottlenecks in goods traffic, especially at ports, adversely affecting the recovery of global production chains. China's economic growth is also slowing as the rate of investment normalises, and the real estate sector is also experiencing difficulties. If growth in the Chinese economy grinds to a halt, this could lead to significantly weaker than expected growth in the world economy and the Finnish economy.

Finland might experience a new wave of the pandemic already in summer 2022, as the virus continues to spread strongly. If the capacity of the healthcare system is already under strain at that time, the situation could prompt consumers to become more cautious and, at worst, lead to new restrictions. This could cause private consumption growth to weaken below the forecast level, especially in services.

Inflation remains high worldwide and financial markets' expectations regarding the rise in euro area short rates have recently steepened. Rising inflation and increased global uncertainty may also lead to significantly increased risk premia on the financial markets. A faster than anticipated rise in market rates may curb growth in Finland's export markets more quickly than expected. High inflation and rising interest rates in a situation where companies already suffer from a weak outlook would also increase credit risks, thus further contributing to instability in the financial markets.

There is also significant uncertainty associated with Finland's short-term inflation outlook. Consumer prices could rise more quickly than anticipated, especially if international energy prices climb higher than expected. The inflation rate in Finland also depends on the level of business profitability and particularly on how successful companies are in passing on higher production costs to consumer prices. The extent of the latter may be greater than expected if energy and raw

material prices remain high.

In the longer term, inflation may also be higher than forecast if wage growth is above the level anticipated. Pay rises agreed last autumn and this spring are being overtaken by inflation, and the weak development of real wages and purchasing power are increasing wage pressures for the next round of wage negotiations. Pay settlements in the municipal sector may serve as an indicator for future pay rises in other sectors as well. If wages rise more than in Finland's competitor countries, it will threaten to weaken the cost competitiveness of Finnish export industries. If the profitability of companies improves significantly despite the increased costs, wage demands could be even higher.

Residential construction characteristically reacts quickly to fluctuations in demand. In the forecast years, demand for housing will decline, particularly due to slower economic growth. At the same time, the housing market will also be cooling due to rising interest rates on housing loans, increased caution among households and diminished investor demand. As a result, the slowdown in new construction may be significantly steeper than projected.

Despite the various downside risks, the economy may perform better than forecast. The collapse of consumer confidence due to Russia's war in Ukraine may prove to be temporary, and confidence may build back quicker than expected as the situation calms down or stabilises. It is also possible that companies will be able to adapt to supply-side bottlenecks and find new markets to make up for lost trade more quickly than expected.

Energy and raw material availability problems and their rising prices have accelerated the green transition, which will create new opportunities for Finnish companies as well. Acceleration of the green transition in Finland's export markets will increase demand for Finnish investment goods. Domestic investment in energy efficiency may also grow more rapidly than expected.

Notes

1. The alternative scenario assesses the impact on Finland's economic growth of the production constraints caused by the cessation of energy imports. ↑
2. More detailed information on the euro area forecast is available on the ECB website. ↑
3. More detailed information on the ECB's monetary policy decisions is available on the ECB website. ↑
4. Private investment excluding residential. ↑
5. The fiscal stance is assessed here with reference to the structural deficit. The fiscal stance measured in terms of the change in the structural primary balance is neutral in 2022 and will become slightly contractionary in the period 2023–2024. ↑
6. The negotiated solution reached by the municipal sector on 8 June 2022 was not known at ↑

the time of the forecast. The five-year pay increase scheme, if applied to all municipal employees, would increase the fiscal deficit by up to a few tenths of a percentage point relative to GDP, provided the assumptions in the forecast otherwise remain as before. The negotiations relate to around 425,000 employees, i.e. more than 80% of local government staff.

7. The difference between GDP and potential output is referred to as the output gap and is usually expressed as a percentage of potential output. According to economic theory, a positive output gap cannot be maintained without upward pressure on wages and prices. ↑
8. Potential output is the volume of GDP when all the inputs in the economy are in normal use. ↑
9. NAIRU is estimated to be around 7% during the forecast period. ↑
10. Business survey conducted by Finnish Industry Investment in April 2022. ↑
11. See alternative scenario for an estimate of the war's potential impact on Finland's economy. ↑

Keywords

competitiveness, employment, euro area, Finnish economy, forecast, general government finances, inflation, potential output, supply disruption, unemployment, wages