Forecast

Economic recovery will be delayed

Finnish economy | 12 October 2023

The Finnish economy is in mild recession. The rise in prices and interest rates, and weaker export demand, are weighing on the economy, and recovery from the recession will be slow. The favourable trend in employment is coming to a halt. Domestic inflation is slowing rapidly. However, the economic recovery will take longer than previously estimated. Risks surrounding the global economy have increased, and if growth falls short of forecasts, this would be also affect domestic output. The slowdown in residential construction could also cause longer term problems.



The Bank of Finland's interim forecast[1] is based on data available on 13 September 2023, and on assumptions updated on 23 August 2023 regarding Finland's external operating environment and key financial market variables in the immediate years ahead.[2]

Forecast in brief

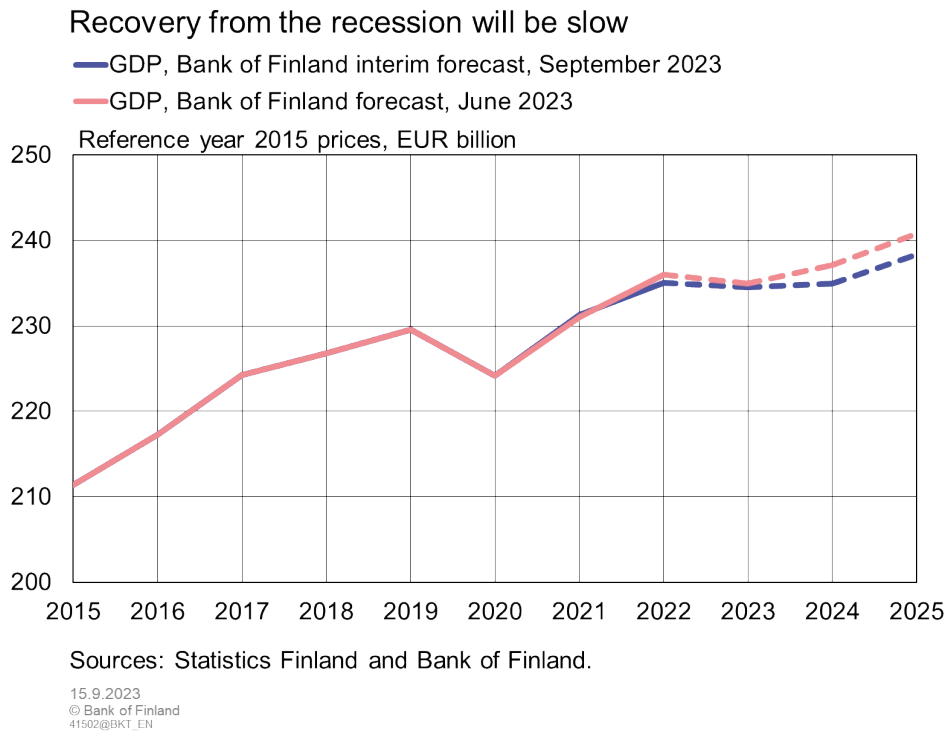
The Finnish economy is in mild recession in 2023. According to the Bank of Finland's September 2023 interim forecast, Finland's gross domestic product (GDP) will contract by 0.2% in 2023. Next year, the economy will slowly start to recover from the recession. GDP growth in 2024 will be just 0.2%, which is lower than projected in the Bank of Finland's June forecast. In 2025, growth in the

economy will gather pace, but only to 1.4% (Chart 1).

Employment was growing for a long time, but is now showing a slight dip while the economy is in recession. The employment rate for the 20 to 64 age group will fall to 77.7% in 2024. The number of people employed will resume growth in 2025 as economic growth strengthens, returning the employment rate close to its 2022 level. Higher prices are a strain on households' purchasing power, but growth in earnings and falling inflation are improving the consumption opportunities of households. Inflation will slow to 1% in 2024, but the prices of services will continue to rise at a faster pace than previously.

The risks surrounding the forecast are predominantly on the downside. Geopolitical confrontation and the ongoing transmission of the rise in interest rates to the economy could adversely affect growth. Slower growth in the global economy would further decrease Finnish companies' export opportunities. Higher interest rates are also curbing investment and affecting real estate market activity. In Finland, the outlook for residential construction has quickly weakened due to the rapid cooling of the housing market, and it is possible that the sector's difficulties could come to a head and affect employment and the economy more strongly than projected.

Chart 1.



1. INTERIM FORECAST SUMMARY

	2021	2022	2023[f]	2024[f]	2025[f]
Annual GDP growth (%)					
Interim forecast, September 2023	3.2	1.6	-0.2	0.2	1.4
Forecast, June 2023	3.0	2.1	-0.4	0.9	1.5
Employment rate, 20–64-year-olds (%)					
Interim forecast, September 2023	76.4	78.1	77.9	77.7	78.0
Forecast, June 2023	76.5	78.1	78.0	78.2	78.5
Inflation (%)					
Interim forecast, September 2023	2.1	7.2	4.3	1.0	1.6
Forecast, June 2023	2.1	7.2	4.5	1.3	1.6

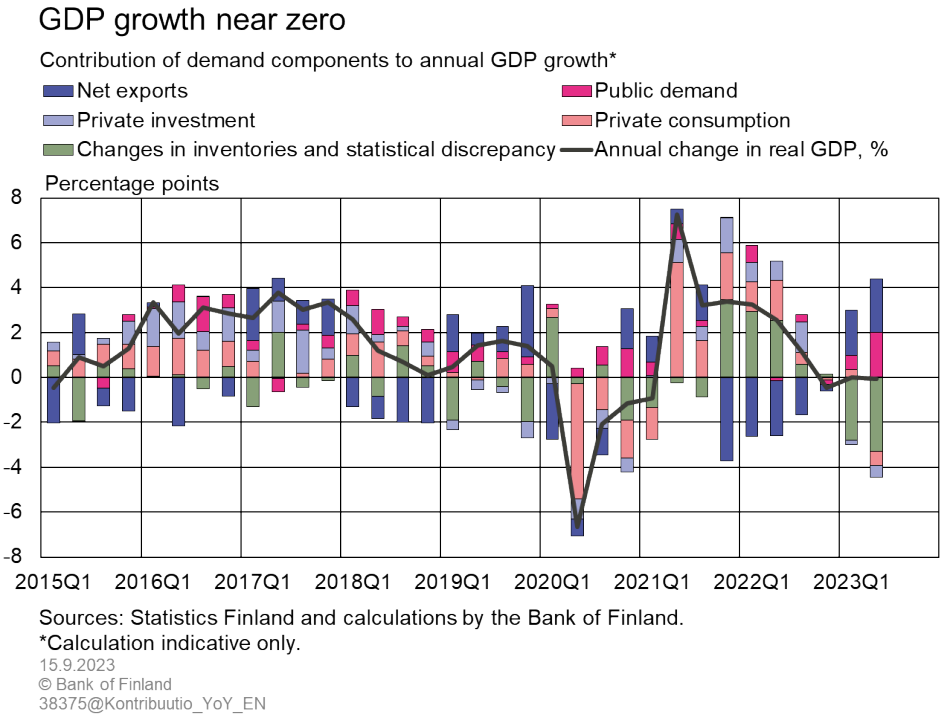
[f] = forecast.

Sources: Bank of Finland and Statistics Finland.

Growth is faltering

The Finnish economy entered a mild recession in the second half of 2022. GDP in the first half of 2023 was up when compared with the end of 2022, however, although it was down slightly year-on-year compared with the first two quarters of 2022 (Chart 2). The growth was mainly attributable to public consumption and net exports, though the latter was due to imports declining more than exports. The improvement in Finland's balance of trade halved the current account deficit during the first six months of the year. The travel account remained substantially in deficit due to the continued high volume of travel abroad by Finns.

Chart 2.



The reduced need for imported inputs indicates a forthcoming decline in domestic production. Accordingly, business confidence regarding the economy has weakened during the year. In manufacturing, order books are diminishing, expanded stocks are being scaled down, and production is being cut back. The outlook for residential construction has weakened rapidly because of the slowdown in the housing market due to the fast rise in lending rates. Considerably fewer new residential construction projects are being started than before, and the steep decline in building permits and the increase in bankruptcies initiated in the construction sector paint a rather bleak near-term outlook for residential construction. Despite the continuing fairly optimistic investment outlook in manufacturing, private investment has contracted in the past three quarters.

After the recession induced by the pandemic, the economy has been underpinned by the positive momentum of the service sector, but turnover growth has been at a standstill for services too in 2023. Confidence indicators for the service industry are already displaying pessimism regarding the future. Turnover volume in the retail and wholesale trade has declined, and inflation has clearly reduced purchases of consumer durables, among other things. Employment in the retail and wholesale trade and in the service sectors has declined during the past year. Private consumption, which was still contributing to GDP growth last year, contracted in the second half of 2022, and has barely picked up since. Household confidence indicators have partially recovered from the pessimism of last year caused by Russia's war in Ukraine. However, the indicators remain

at below average levels.

Public demand underpinned GDP in the first half of 2023. Although public investment has decreased, the level of public consumption has increased. The latter has been attributable to stronger employment in the public sector and to public procurement.

The Bank of Finland's short-term forecasting models ('nowcasting' models) produce GDP growth forecasts for the current and next quarter based on the latest economic statistics (Table 2). These short-term forecasts are taken into account in the preparation of the interim forecast.

2. Nowcasting model results

GDP, quarterly growth				
	2023Q1	2023Q2	2023Q3	2023Q4
BVAR model	0.4%	-0.2%	-1.1%	-0.1%
Factor model	0.0%	-0.1%	-0.7%	-0.7%
Bridge model	0.2%	0.1%	-0.3%	
Financial market model*	1.2%	0.3%	0.4%	0.4%
Model average**	0.2%	0.0%	-0.7%	-0.4%
Actual growth	0.3%*	0.6%*		

Nowcasting models updated 13 September 2023.
**Updated after release of National Accounts 31 August 2023.*
***Average excludes financial market model.*
Source: Statistics Finland, calculations by Bank of Finland.

The nowcasting models indicate that the economy will be in mild recession during the remainder of the year. However, there are differences in the GDP growth figures forecast by the models, which indicates that the coming months are surrounded by quite a high degree of uncertainty. With respect to the fourth quarter of 2023, the uncertainty of the forecasts is compounded by the small amount of data available so far.

Forecast assumptions revised slightly downwards

The interim forecast's underlying assessment of the global economic outlook and of growth in Finland's export markets has been revised downwards (Table 3).[3] It is assumed that the euro's exchange rate will be slightly stronger than before, which will be a strain on Finland's competitiveness.[4] Due to the recent increases in crude oil prices, the price expectations based on what the market expects are at a slightly higher level than in the June forecast. Prices are nevertheless expected to fall in the years covered by the forecast. The financial markets' expectations regarding short-term interest rates in 2024 are also higher than before, but the 3-month Euribor rate is projected to decrease in 2025.

3. FORECAST ASSUMPTIONS

	2021	2022	2023^{f}	2024^{f}	2025^{f}
Volume percentage change on previous year					
Euro area GDP	5.6	3.4	0.7	1.0	1.5
World GDP (excl. euro area)	6.7	3.3	3.2	3.0	3.2
World trade (excl. euro area)*	12.9	5.3	0.2	3.2	3.3
	2021	2022	2023^{f}	2024^{f}	2025^{f}
Finland's export markets**, % change	11.1	6.0	0.2	2.6	3.0
Oil price, USD/barrel***	71.1	103.7	82.7	81.8	77.9
Export prices of Finland's competitors, EUR, % change	9.8	19.1	-3.7	1.5	2.3
3-month Euribor, %***	-0.5	0.3	3.4	3.7	3.1

**Calculated as a weighted average of imports.*

*** The growth in Finland's export markets is the import growth in the countries Finland exports to, weighted by their average share of Finland's exports.*

**** Technical assumption derived from market expectations.*

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

****** Assuming no changes in the exchange rate.*

^{f} = forecast.

Sources: Eurosystem and Bank of Finland.

	2021	2022	2023[f]	2024[f]	2025[f]
Volume percentage change on previous year					
Finland's nominal effective exchange rate****	109.4	106.6	110.6	111.9	111.9
USD value of one euro*****	1.18	1.05	1.09	1.09	1.09

**Calculated as a weighted average of imports.*

*** The growth in Finland's export markets is the import growth in the countries Finland exports to, weighted by their average share of Finland's exports.*

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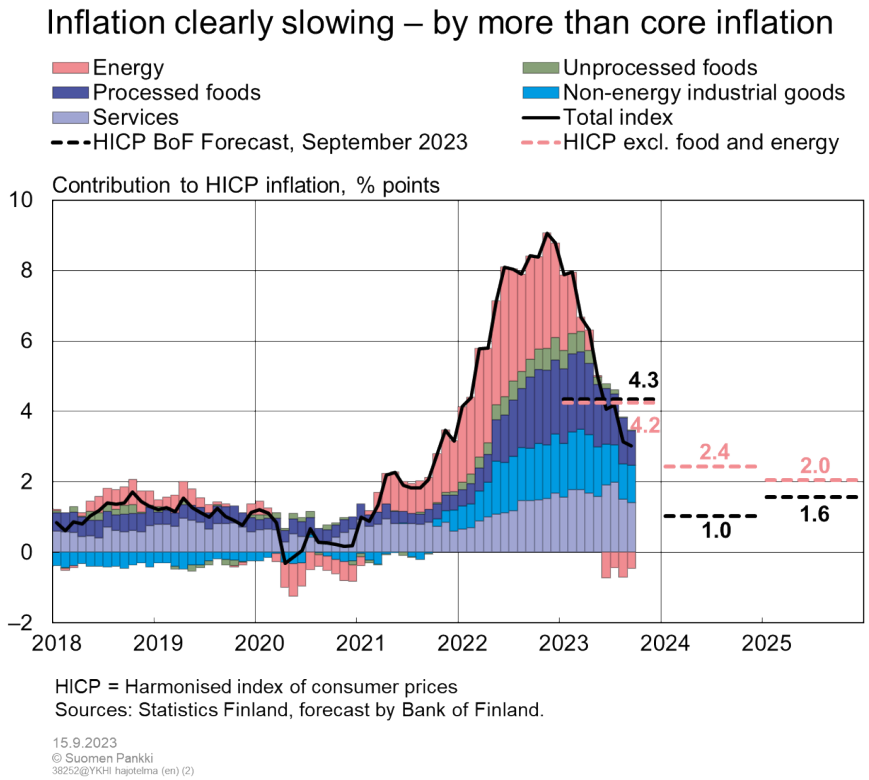
Sources: Eurosystem and Bank of Finland.

Inflation will slow considerably

Consumer price inflation in Finland has slowed significantly this year from its euro era high of 7.2% in 2022, as measured by the Harmonised Index of Consumer Prices (HICP) (Chart 3). The prices of oil and other raw materials have declined, and these price decreases have been transferred to consumer energy prices. Nevertheless, in 2023 inflation will remain at a moderately high average rate of 4.3%. The national Consumer Price Index (CPI) also takes into account the household expenditure impact of the increases in interest rates on housing loans and consumer credit, which means that CPI inflation will remain clearly above HICP inflation in 2023.

Inflation will slow substantially in 2024, mostly because of declining energy prices. However, the prices of services will continue to rise rapidly due to higher rents, among other things, and this will affect core inflation which, at around 2.5%, will be significantly higher than HICP inflation. Weak GDP growth will slow the headline inflation rate, and core inflation will fall to the 2% level in 2025.

Chart 3.

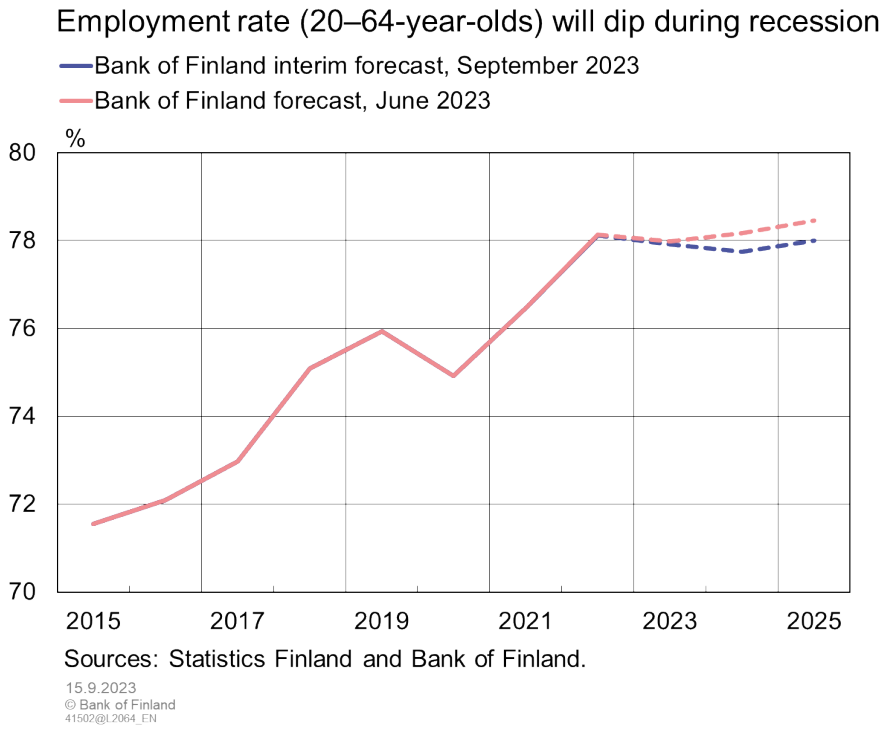


Improvement in employment rate on hold

The favourable employment trend has been a bright spot for the Finnish economy in recent years. The employment rate for the 20 to 64 age group has increased at a good pace since the pandemic, and already reached 78.1% in 2022. In the second quarter of 2023, the number of employed persons grew further in the public sector, but decreased in the private sector. However, the notably weaker data in the Labour Force Survey for July indicate that the trend has shifted.

With the growth outlook weakening, the employment rate will decline temporarily in 2023. Nevertheless, the employment rate will still be as high as 77.9%, but will decrease further to 77.7% in 2024. With economic growth slowly recovering, the employment rate will improve again in 2025 to the 2022 level of 78%.

Chart 4.



Could be worse

The risks surrounding the forecast are predominantly on the downside. Despite the tightening of monetary policy, both inflation and inflation expectations in the euro area remain high and above the ECB's medium-term goal. Due to the response lag involved in monetary policy transmission, it is possible that euro area economic growth will be lower than currently forecast. China's economy has also been faltering, and there are risks concerning projected growth in the economies of Finland's key trading partners Sweden, Germany and the United States. Slower growth in Finland's export markets would adversely affect production in the export sectors, likely leading to an increase in temporary lay-offs and unemployment.

Domestically, there are risks related to the development of the housing market, in particular. Residential construction has decreased, and the low numbers of building permit applications and residential housing starts will quickly reduce construction sector activity. It remains unclear how far the construction sector's employment rate can maintain flexibility through the foreign labour force or lay-offs, and by how much unemployment will rise in the industry. If the rental market tightens due to the reduction in new construction, rents could continue to rise more strongly and for a longer period than anticipated, which would maintain a higher level of underlying inflation. Varying energy prices could also cause inflation to fluctuate in a way that would be difficult to

predict.

Notes

1. The Bank of Finland publishes interim forecasts for the Finnish economy twice a year, in March and September. These are technical updates of the forecast, in which the outlook for GDP, employment and inflation is updated. The interim forecast does not necessarily reflect the views of the Eurosystem. The Bank's more extensive forecasts for the Finnish economy are published in June and December each year. ↑
2. The forecast's underlying assumptions about the development of Finland's external environment and of financial market variables are based on the assumptions of the European Central Bank's (ECB) September 2023 forecast. ↑
3. More detailed information on the most recent euro area forecast and risk scenario is available on the ECB website. ↑
4. The exchange rate is assumed to be unchanged during the forecast period. ↑

Keywords

economic growth, employment, forecast, gross domestic product, inflation, recession