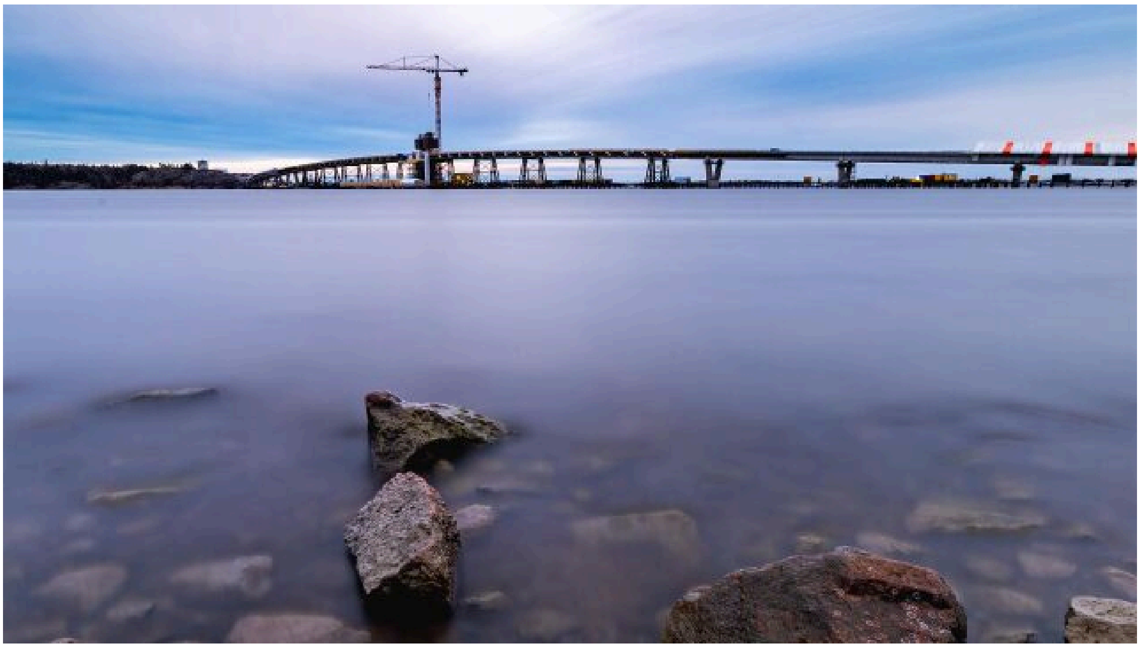
FORECAST

Finland’s economy is gradually moving out of recession

Finnish economy | 05.07.2024

Finland’s economy is gradually moving out of recession. Inflation is low, and consumer spending will recover steadily with the support of stronger purchasing power. Growth in the economy will gather pace in the immediate years ahead as the cyclical conditions improve both in Finland and its export markets. Gross domestic product (GDP) will contract by 0.5% in 2024, but will grow by 1.2% in 2025 and 1.7% in 2026. Public debt will continue to grow, even though fiscal adjustment measures will reduce the general government deficit.



Overview

Low growth in Finland’s main export markets will, for the time being, continue to weigh on the country’s export outlook. There are nevertheless signs of a cautious recovery in world trade, which will gradually boost the growth in demand for Finnish exports as well. Euro area GDP growth will pick up in 2024–2026, driven by private consumption, and inflation will gradually fall to just under 2%. If financing conditions ease as expected by the financial markets and inflation slows, this will support global growth.

Inflation has fallen broadly across the Finnish economy in the first half of the year. However, tax and excise duty changes, in particular the increase in value added tax, will raise consumer prices, and the impact on inflation will be at its greatest in 2025. Price pressures will also begin to increase gradually as the economic environment improves and the disinflationary impact of monetary policy starts to fade. Inflation will rise to 2% in 2025. Nominal earnings will continue to increase in the immediate years ahead, but at a slightly slower pace towards the end of the forecast period. Finland's cost competitiveness relative to the euro area will improve slightly, because labour costs will rise more slowly than in the euro area on average.

Aggregate demand in the economy will start to pick up towards the end of the year. Private consumption will gradually recover as purchasing power strengthens. Many households are still cautious, however, and the fiscal adjustment measures affecting the public finances will dampen the growth in purchasing power. The outlook for the economy is improving and the level of economic uncertainty is slowly dissipating. At the same time the financial markets are expecting interest rates to fall gradually. These factors will all support the recovery in private consumption.

The amount of private investment across the year will again be down substantially in 2024. Housing construction will continue to decline sharply and corporate fixed investment will also fall due to the tight monetary policy and uncertain economic outlook. The conditions for investment growth will nevertheless improve in the years ahead. Both housing construction and corporate fixed investment will pick up.

Exports will slowly start to strengthen as world trade gradually picks up. With the recovery in the export markets, Finland's exports will return to growth in 2025. Growth in goods and services exports will continue in 2026, too. Imports will also increase significantly with the gradual recovery in exports and domestic demand.

The weak cyclical conditions, which have continued for some time, are weighing on the labour market. Employment is declining this year, and unemployment is increasing cyclically. When the recession recedes in 2025, employment will start to pick up again and unemployment will fall. The labour market will then start to tighten towards the end of the forecast period, but growth in employment will be restricted by the already high participation rate of the working-age population.

In the immediate years ahead, general government finances will remain significantly in deficit and the public debt-to-GDP ratio will grow further, despite the Government's decisions on substantial fiscal adjustment measures. The continuing weakness in the economy in 2024 and the still rising level of interest payments on government debt will make it difficult to rebalance the public finances.

Table 1. Key forecast outcomes

Percentage change on the previous year	2022	2023	2024f	2025f	2026f
GDP	1.3	-1.0	-0.5	1.2	1.7
Private consumption	1.8	0.4	0.6	0.7	1.3
Public consumption	-1.0	4.5	-0.0	-0.5	0.6
Fixed investment	2.5	-4.2	-2.5	4.2	3.0
Private fixed investment	2.7	-4.1	-5.0	2.3	4.2
Public fixed investment	1.3	-4.3	9.2	11.8	-1.6
Exports	3.6	-1.7	-1.7	2.8	3.0
Imports	8.4	-7.1	-2.0	2.8	2.7
Effect of demand components on growth					
Domestic demand	1.3	0.3	-0.3	1.2	1.5
Net exports	-1.9	2.6	0.2	-0.0	0.1
Changes in inventories and statistical error	1.9	-3.9	-0.3	0.0	0.0
Savings rate, households, %	-1.6	-0.8	-0.4	-0.2	0.3
Current account, % of GDP	-2.4	-1.4	-0.6	-0.5	-0.5
	2022	2023	2024f	2025f	2026f
Labour market					
Number of hours worked	2.6	-0.5	-1.2	0.5	0.8
Employment rate (20–64-year-olds), %	78.1	78.0	77.0	77.2	77.7
Unemployment rate, %	6.8	7.2	8.1	7.8	7.6
Unit labour costs	3.9	5.1	1.2	1.9	1.7
Labour compensation per employee	2.5	3.5	1.4	2.8	2.9

f = forecast.

Sources: Statistics Finland and Bank of Finland.

Percentage change on the previous year	2022	2023	2024[f]	2025[f]	2026[f]
Productivity	-1.4	-1.6	0.2	0.9	1.1
GDP, price index	5.4	4.8	0.9	1.7	1.8
Private consumption, price index	6.2	4.4	1.3	1.8	1.5
Harmonised index of consumer prices	7.2	4.3	1.2	2.0	1.6
Excl. energy	4.8	5.0	2.0	2.6	1.8
Energy	31.0	-1.8	-7.0	-3.6	-0.7
General government, % of GDP					
General government balance	-0.4	-2.7	-3.8	-3.3	-2.9
General government gross debt (EDP)	73.5	75.8	80.5	82.6	83.5

[f] = forecast.

Sources: Statistics Finland and Bank of Finland.

Operating environment: assumptions and financing conditions

Growth in the world economy is still subdued and is expected to remain moderate in the immediate years ahead. There are signs of a cautious recovery in world trade, which will boost the growth outlook for the Finnish economy as well. The anticipated easing of financing conditions and the slowing of inflation will support global growth. This Bank of Finland forecast is based on data available on 22 May 2024.

Cautious recovery in world trade

Global economic activity is still subdued, even though indicators such as purchasing managers' indices have been signalling positive developments. In advanced economies, nominal wage growth has slowed and household savings have diminished, weakening private consumption. In China, too, growth in private consumption has been slow and the crisis in the real estate sector persists. At the same time, monetary policy has been tightened in many countries and geopolitical uncertainty has increased. Consequently, growth in the global economy will slow somewhat this year. Growth will stabilise at just over 3% in the forecast years (Table 2). Growth in the global economy will thus remain slightly below the post-2000 average. The global inflation rate will decline steadily in the years ahead.

Global trade will gradually recover and begin to gain momentum in 2025 (Table 2). This will also stimulate growth in the demand for Finland's exports (Chart 1). Among Finland's main export partners, Germany and Sweden have suffered from slow growth, but in the United States domestic demand continues to grow steadily. However, the recovery in world trade would be threatened by an escalation in geopolitical tensions.

Chart 1.

Raw material prices have increased during the spring. Oil prices have been pushed up by the OPEC+ production cuts and geopolitical tensions, among other things. In the Bank of Finland's forecast, oil prices are assumed to decline moderately in 2024–2026, coming down to around USD 74 per barrel in 2026, in line with market expectations (Table 2). The prices of food raw materials have recently risen markedly, due, in particular, to the low supply of cocoa caused by drought conditions. Supply-side concerns, such as extreme weather events related to climate change and geopolitical tensions, will continue to cast a shadow over raw material markets in the quarters ahead.

Euro area GDP growth is expected to strengthen, driven by private consumption.[1] Private consumption will be fuelled by the growth in real disposable income and a robust labour market.

Growth in the demand for exports will also continue. The negative impact of the past tightening of monetary policy on economic growth will also gradually fade. Euro area GDP growth will further strengthen to around 1.5% in 2025–2026 (Table 2).

Euro area inflation is forecast to slow in the immediate years ahead, settling at just under 2% in 2026. The easing of cost pressures and the lagged impact of tighter monetary policy on consumer prices will moderate inflation. Underlying inflation, which excludes food and energy prices, will also slow, to 2% in 2026. A key factor behind the drop in underlying inflation is the expected gradual slowdown in nominal wage growth.

Financing conditions are expected to ease

At its June meeting, the European Central Bank (ECB) decided to lower its key interest rates by 25 basis points.[2] The ECB's principal policy rate – the deposit facility rate – was lowered to 3.75%, the interest rate on the main refinancing operations to 4.25% and the interest rate on the marginal lending facility to 4.50%. The ECB's Governing Council assessed that in the light of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission, it is now appropriate to moderate the degree of monetary policy restriction. At the same time, domestic price pressures within the euro area remain elevated, and inflation is likely to stay above the 2% target well into next year. The Governing Council is determined to ensure that inflation returns to its medium-term target in a timely manner by keeping policy rates sufficiently restrictive for as long as necessary to achieve this aim. In particular, future interest rate decisions will be based on an assessment of the inflation outlook, the dynamics of underlying inflation and the strength of monetary policy transmission.

The 12-month Euribor has declined since the second half of 2023 (Chart 2). Average interest rates on new housing loans have not risen in the early part of 2024, and the rise in the average interest rate on new corporate loans has also slowed. The financial markets expect the 3-month Euribor to decline in the immediate years ahead, and to be at around 2.5% in 2026 (Table 2). The expected easing of financing conditions will support the prerequisites for growth both in the euro area and in Finland.

The euro area Bank Lending Survey indicates that Finnish banks have not tightened their credit standards or the terms and conditions for new loans this year. According to the Confederation of Finnish Industries' Business Tendency Survey, the prevalence of financial difficulties among companies has continued to rise slightly in recent quarters, but such situations are nevertheless still unusual. Problems concerning access to finance are still most common in the construction sector, where around 16% of companies reported financial difficulties in the first quarter of 2024. The proportion of non-performing loans has also clearly increased among construction companies, and now accounts for some 6% of the sector's loan stock.[3] In other sectors, the volume of non-performing loans has remained moderate, at no more than around 2%.

Chart 2.

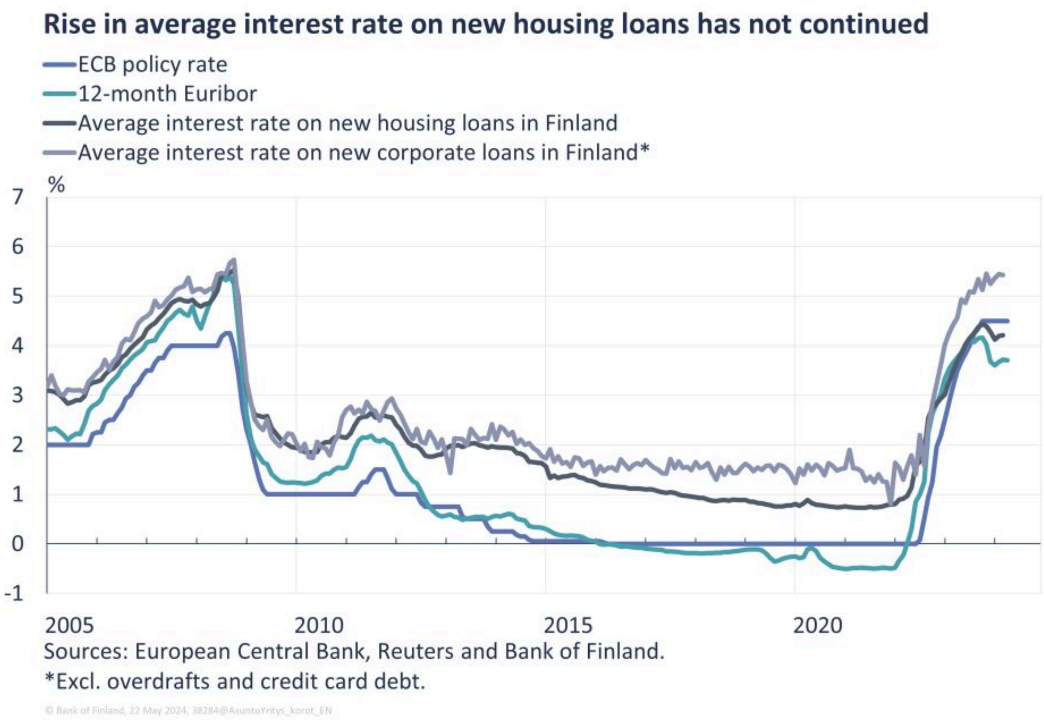


Table 2. Forecast assumptions

Volume change year on year, %	2022	2023	2024[f]	2025[f]	2026[f]
Euro area GDP	3.5	0.6	0.9	1.4	1.6

[1]Calculated as the weighted average of imports.

[2]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.

[3]Technical assumption derived from market expectations.

[4]Technical assumption derived from market expectations. In the longer term, raw material prices are assumed in part to follow movements in global economic activity.

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

[6]Assuming no changes in the exchange rate.

[f] = forecast.

Sources: European Central Bank and Bank of Finland.

Volume change year on year, %	2022	2023	2024[f]	2025[f]	2026[f]
World GDP (excl. euro area)	3.4	3.5	3.3	3.3	3.2
World trade (excl. euro area)[1]	5.6	1.0	2.6	3.3	3.3
	2022	2023	2024[f]	2025[f]	2026[f]
Finland's export markets, % change[2]	6.6	-0.1	1.6	3.1	3.1
Oil price, USD/barrel[3]	103.7	83.7	83.8	78.0	74.5
Raw material prices (excl. energy), USD, % change[4]	6.5	-12.5	11.4	3.9	0.9
Export prices of Finland's competitors, EUR, % change	19.1	-4.8	0.3	2.4	2.3
3-month Euribor, %[3]	0.3	3.4	3.6	2.8	2.5
Finland's nominal effective exchange rate[5]	106.6	110.3	111.6	111.8	111.8
USD value of one euro[6]	1.05	1.08	1.08	1.08	1.08

[1]Calculated as the weighted average of imports.

[2]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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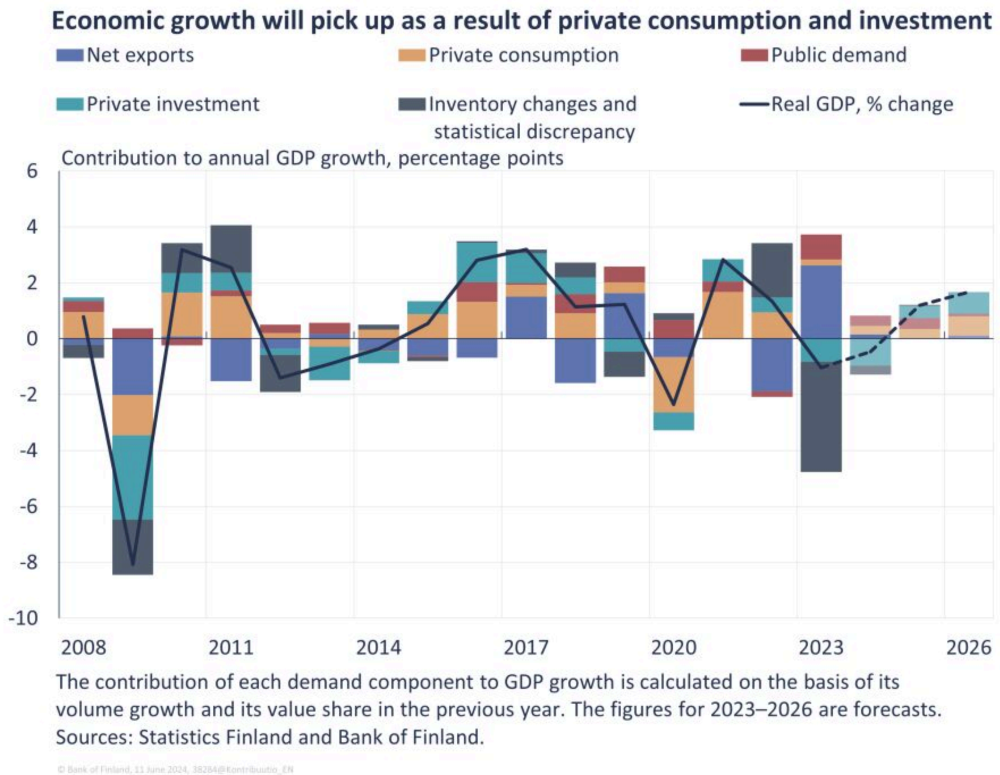
Sources: European Central Bank and Bank of Finland.

Demand and the public finances

The Finnish economy is gradually beginning to grow. Finland's GDP will nevertheless show a year-on-year decline for 2024 (Chart 3). Economic growth will steadily pick up as the year wears on and consumer and business confidence in the economy improves. Inflation in Finland has slowed markedly and will remain moderate in the years of the forecast, which will strengthen the purchasing power of households. In addition, the financial markets are expecting interest rates to gradually fall in the immediate years ahead. Aggregate demand in the economy will return to growth in 2025 and 2026, when private consumption and investment pick up. At the same time, exports will recover, supported by a rebound in world trade. However, as domestic demand improves, this will increase Finland's imports. As a consequence, economic growth will not be supported by net exports to any significant extent in the forecast period 2024–2026. During this period, general government finances will remain significantly in deficit and the public debt-to-GDP ratio will grow further, despite central and local government finances being strengthened by the substantial fiscal consolidation measures decided by the Government.

Chart 3.

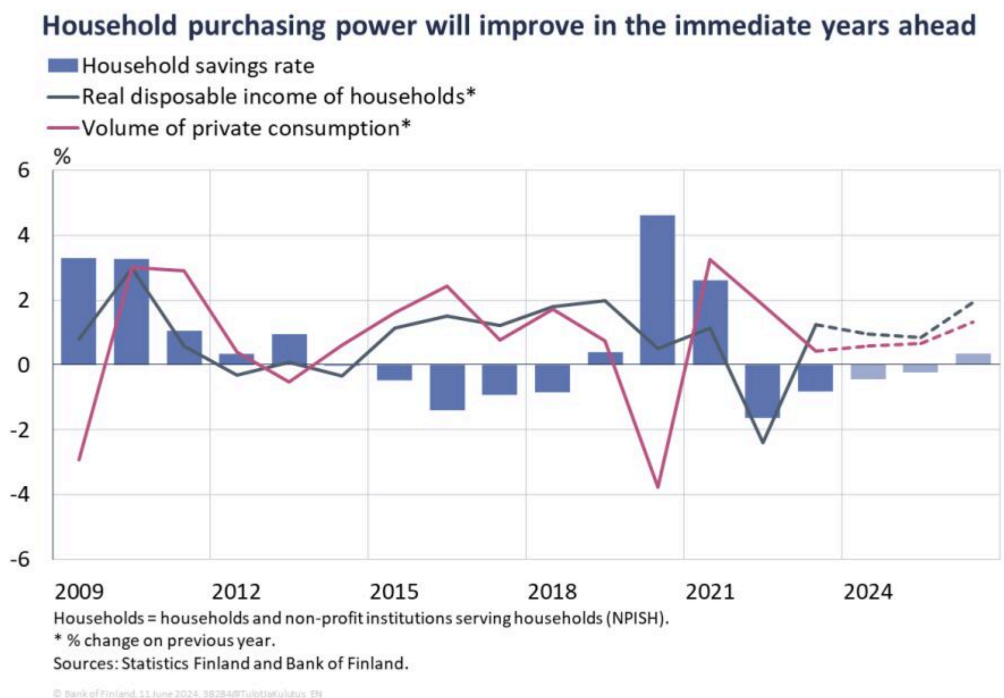


Private consumption will gradually recover

Real incomes of households started to increase in 2023, with an improvement in purchasing power, as inflation slowed markedly and, at the same time, earnings and current transfers increased strongly. Nevertheless, private consumption grew only marginally, despite the recovery in purchasing power. The past few years have seen several major shocks to the Finnish economy and a sharp rise in economic uncertainty. Many households are still cautious and consumer confidence in the economy remains noticeably weak.

Real incomes and the purchasing power of the aggregate household sector will be up in 2024 as well, as inflation stays low. Earnings and pension income will increase on account of the negotiated wage settlements reached earlier and the index-linked increases in pensions (Chart 4). However, tax increases and reductions in social benefits will erode the incomes of many households, and the still high interest rates will continue to weigh on the finances of indebted households.

Chart 4.



Growth in private consumption in 2024 will therefore be subdued but will gradually start to pick up (Chart 4). The outlook for the economy is improving and the level of economic uncertainty is slowly dissipating. The household savings rate will be slightly negative this year, as many households are still adapting to the sharp rise in living costs and interest payments seen over the past few years by tapping into their savings.

In 2025, tax increases and social benefit reductions will dampen the growth in purchasing power. As a result, private consumption growth will not strengthen significantly in comparison with 2024, despite the improvement in cyclical conditions. The savings rate will remain negative in 2025. At the same time, a gradual decrease in interest rates as expected by the financial markets will steadily reduce the interest payments of indebted households. This will bolster private consumption growth.

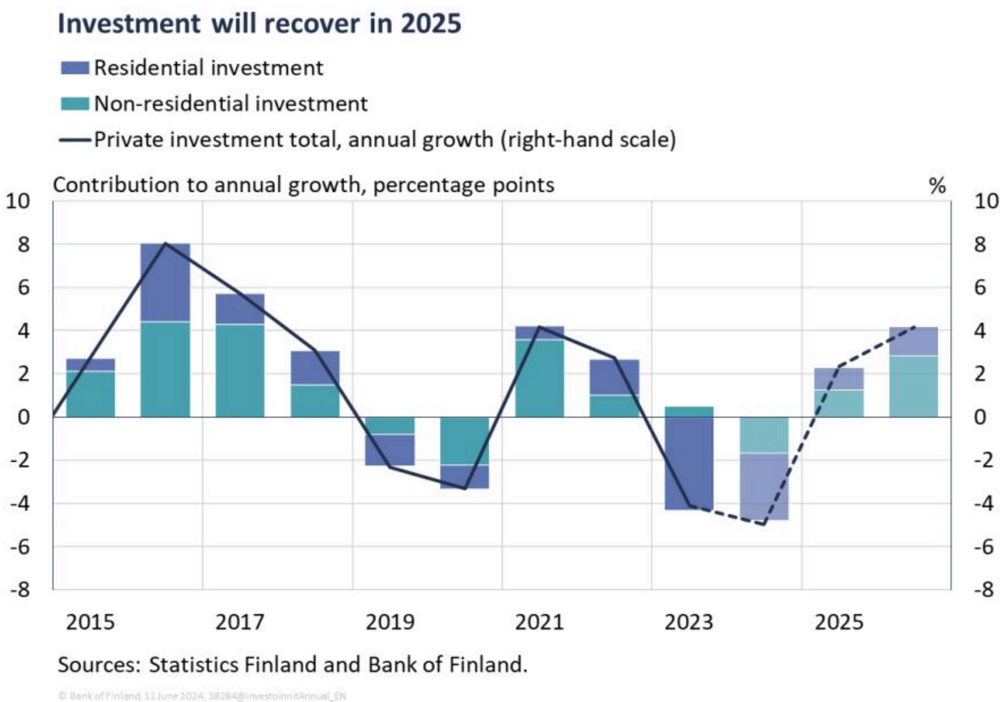
In 2026, employment will improve, household income will increase and purchasing power will rise at a faster pace, prompting private consumption growth to pick up slightly. At the same time, higher incomes will also create room for the accumulation of savings after several years of having to draw on them, and the savings rate will be slightly positive in 2026 (Chart 4).

Investment will recover in 2025

Private investment decreased in 2023 on account of a steep fall in housing construction. Non-residential investment, in turn, increased, although slowly (Chart 5). The investment rate also fell for the second year in succession owing to a substantial decrease in the amount of investment in 2023 (Chart 6).

Private investment will be down substantially in 2024, too. Housing construction will continue to fall sharply (Chart 5). Housing starts are low, and the number of building permits has also remained exceptionally low in the early part of the year.

Chart 5.



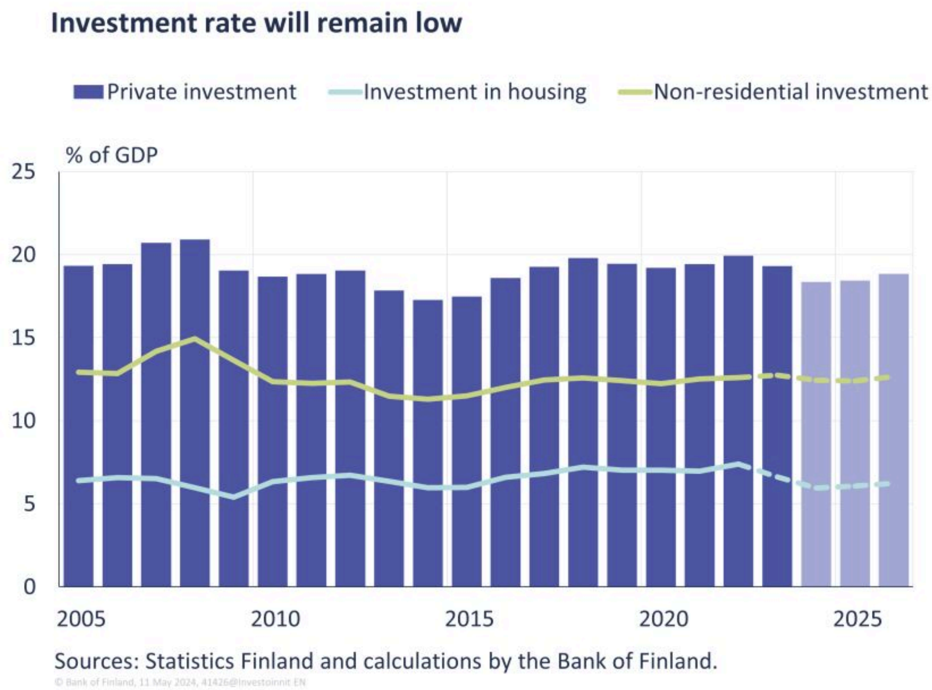
The housing market is still quiet, and the number of new homes constructed but not yet sold has increased. Despite current housing construction projects being completed, there will be a decline in residential investment overall in 2024, because there will be almost no new housing starts. Due to higher interest rates on housing loans and weak consumer confidence in the economy, households have been less willing to borrow and the demand for housing has decreased. The demand for buy-to-let housing has also remained low.

Higher interest rates and the uncertain economic outlook will also curtail non-residential investment over the course of 2024. Investment in the energy industry, in particular, will decrease. Various green transition investments have been postponed or even cancelled. Overall, investment in industry in 2024 will be down from the previous year, and the investment rate in industry will fall markedly. In addition, a growing share of industrial investment consists of replacement investment rather than investment to increase production.

The economic outlook will improve in the immediate years ahead both in Finland and in the global economy, and uncertainty about the direction the economy is headed will gradually dissipate. The conditions for investment growth are favourable, as domestic and external demand are strengthening. Inflation will also remain relatively low and the financial markets are expecting interest rates to fall gradually. The confidence of households in the future is improving, and this will boost housing sales.

Private investment will start to grow in 2025 in response to a pick-up in both housing construction and non-residential investment (Chart 5). Projects associated with the green transition will also begin to attract investment. Private investment growth will gather pace in 2026. The investment rate will also start to rise slowly (Chart 6).

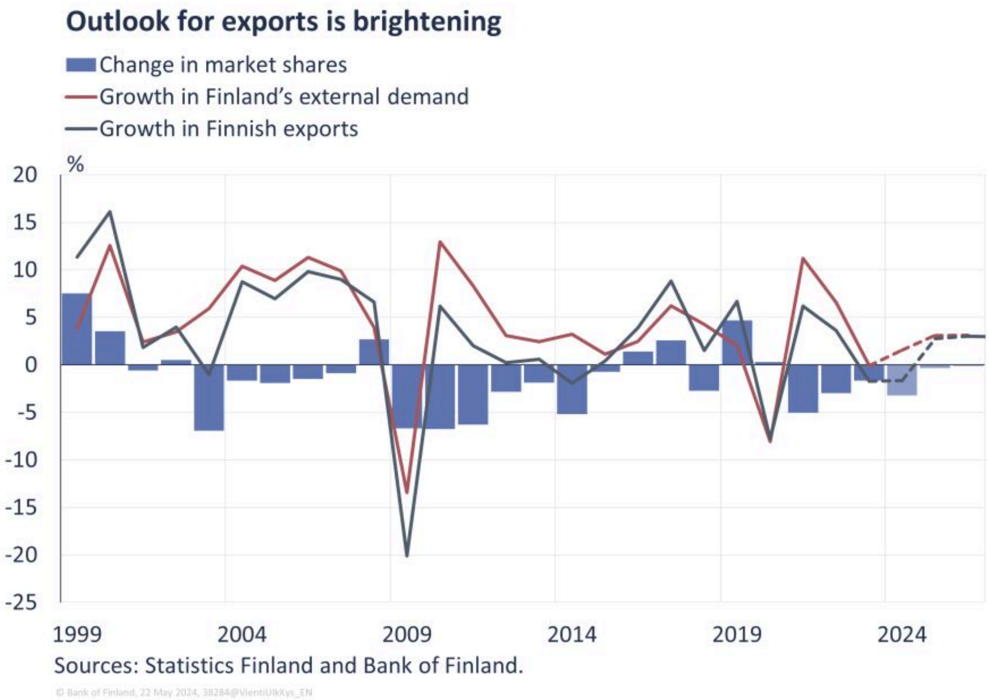
Chart 6.



Exports will pick up

Growth in Finnish exports, which focus especially on capital goods and raw materials, has long lagged behind demand growth in the markets of Finland’s main trading partners (Chart 7). However, there have been many exceptional factors that have dampened export growth in recent times – such as the collapse of trade with Russia. Higher interest rates, uncertainty about the economic outlook and geopolitical tensions have curbed investment growth in Finland’s export markets in recent years, and this has further dampened the external demand for Finnish goods and services.[4]

Chart 7.



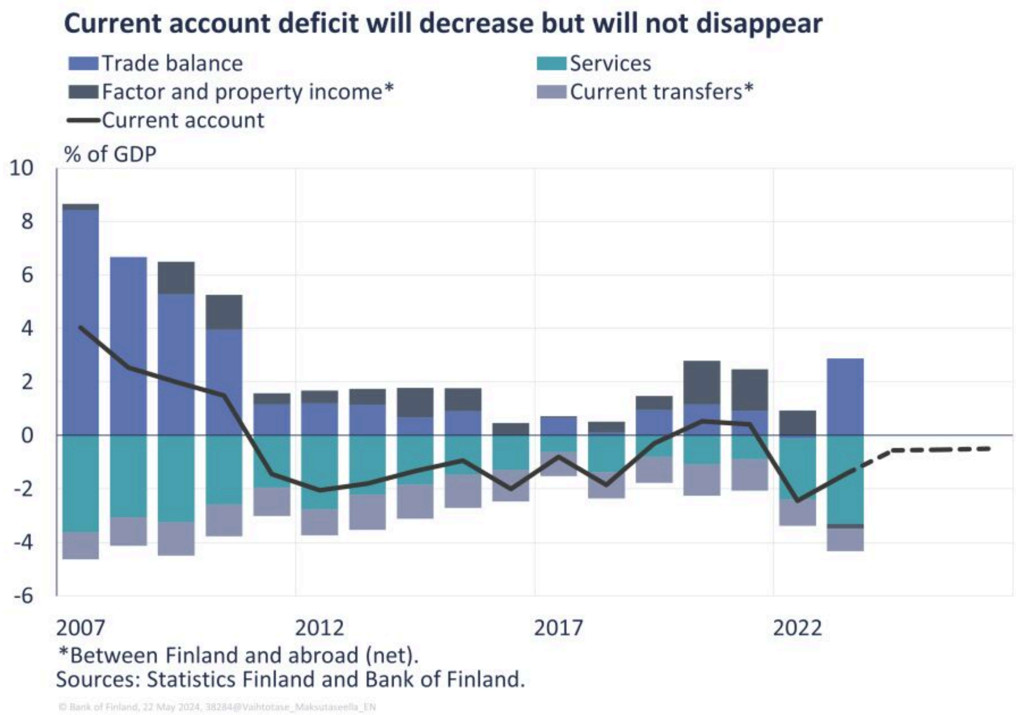
Among Finland's main trading partners, such as Germany and Sweden, investment will remain weak this year on account of the still relatively tight monetary policy and high uncertainty over the economic outlook. Year-on-year, Finland's exports will still show a decline in 2024, because of the noticeably weak trend in exports early in the year, a trend that began at the end of 2023 (Chart 7).

Growth in the euro area economy and in world trade will gradually gain momentum, however. As external demand improves, this will bolster Finland's exports towards the end of 2024 and return them to significant growth in 2025. Finland's cost competitiveness in relation to the euro area will also strengthen. In 2025 and 2026, Finnish goods and services exports will grow at roughly the same rate as its main export markets, and Finland will be able to recover some of the market shares lost in previous years (Chart 7).

The gradual pick-up in exports and in domestic demand will mean a significant increase in imports, however. As a consequence, the impact of net exports on Finland's GDP growth will be minor. In addition, exporting companies will continue to make significant use of imported inputs in their production, which will contribute to increasing imports.

The current account deficit was considerable in 2023, although below 2% of GDP (Chart 8). Nevertheless, the deficit contracted significantly from the previous year on account of a substantial decline in imports. The current account will remain in deficit in the immediate years ahead, but the deficit will gradually decline as the goods and services accounts improve. In 2026, the current account deficit will be less than 1% of GDP.

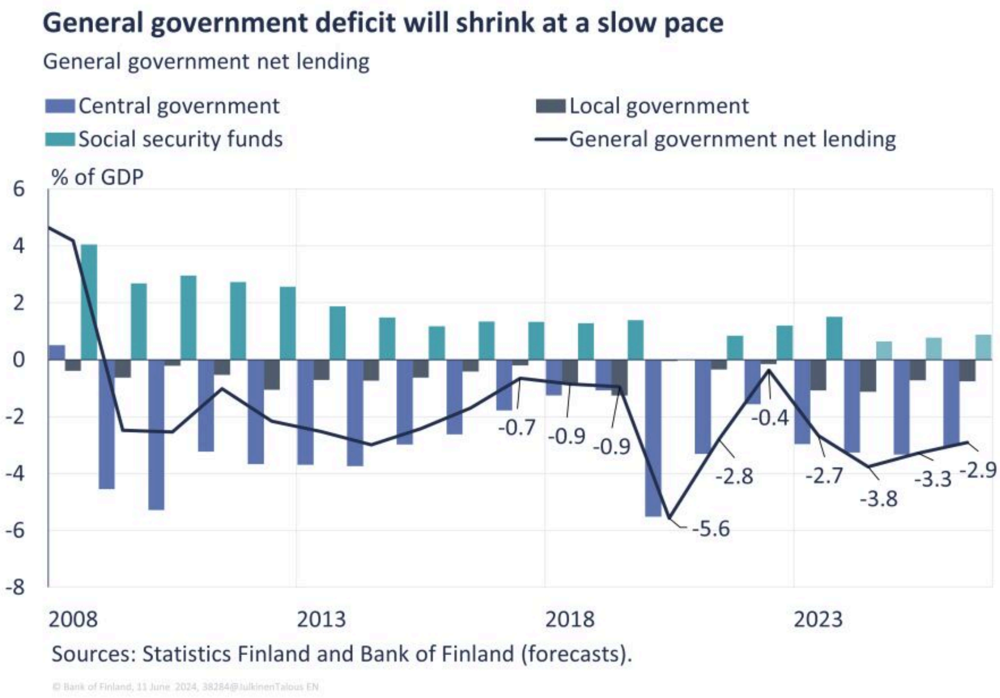
Chart 8.



Public finances will remain significantly in deficit

Finland's public finances have deteriorated rapidly. The general government deficit relative to GDP will be 3.8% for 2024 (Chart 9). The Government has decided on substantial cuts in public expenditure. In addition, increases in value added tax and in other indirect taxes will boost public revenues, especially from 2025 onwards.[5] However, the weakness in the economy and the still rising level of interest payments on government debt will make it difficult to rebalance the public finances. The deficit will gradually decline in 2025–2026, and nominal GDP growth will bring the deficit-to-GDP ratio down to below 3% by 2026. The cyclically adjusted structural deficit will remain close to 2%.

Chart 9.



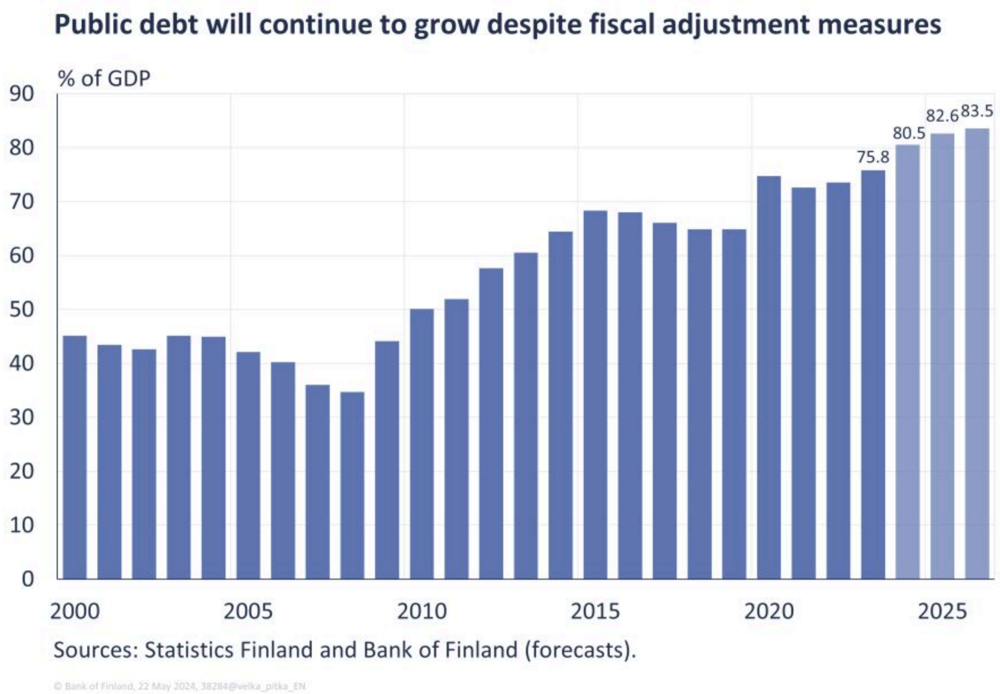
The general government primary balance will strengthen but will still show a deficit of over 1% of GDP in 2026. The fiscal stance, as measured by the change in the cyclically adjusted primary balance, will be almost neutral in 2024.[6] Nevertheless, fiscal policy will tighten due to fiscal consolidation measures, particularly in 2025.

The consolidation measures decided by the Government will strengthen the financial position of central government. At the same time, however, the rising interest payments on government debt and, among other things, the procurements of the Defence Forces will push up expenditures. Final consumption expenditure of local government will continue to grow fairly sharply despite the Government's funding cuts and the wellbeing services counties' own consolidation measures. Expenditure will be driven up by, for example, the wage settlements reached earlier in the municipal and wellbeing services county sectors.

The surplus of the earnings-related pension providers will decrease in 2024 as index-linked increases will push up earnings-related pension expenditure substantially. The financial position of the other social security funds will be weakened in 2024 by considerable reductions in social security contributions. However, the savings measures directed at social security will slow down the growth in monetary social benefits payable.

Public debt will grow further as central and local government expenditure will remain significantly above revenue. The debt-to-GDP ratio will rise very sharply in 2024, by almost 5 percentage points from the previous year. This is partly attributable to the weak growth in nominal GDP. In the immediate years ahead, the growth in debt will slow down slightly and the debt ratio at the end of 2026 will be 83.5% (Chart 10).

Chart 10.



Supply and cyclical conditions

Finland’s economy is in recession this year. Employment is falling and, due to cyclical factors, the unemployment rate will climb above the level of structural unemployment. The recession will nevertheless gradually recede towards the end of the year, and the labour market will also start to improve in 2025. The economic cycle will strengthen in 2025 and 2026. In the upswing in 2026, GDP will grow at an above-average rate. The pick-up in GDP growth will be temporary, however, because growth in potential output is slow and weakened by the crises of recent years.[7]

Employment will gradually start to strengthen

The weak cyclical conditions, which have continued for some time, are weighing on the labour market. The employment rate has gradually declined from the record highs of 2022 and unemployment has increased. The level of employment has remained fairly good, however, relative to the cyclical conditions. Hours worked have decreased at a higher rate than the fall in the number of persons employed. This is partly due to an increase in temporary lay-offs, but there has also been a trend decrease in the number of hours worked per employee, and the amount of part-time work has increased in recent years.

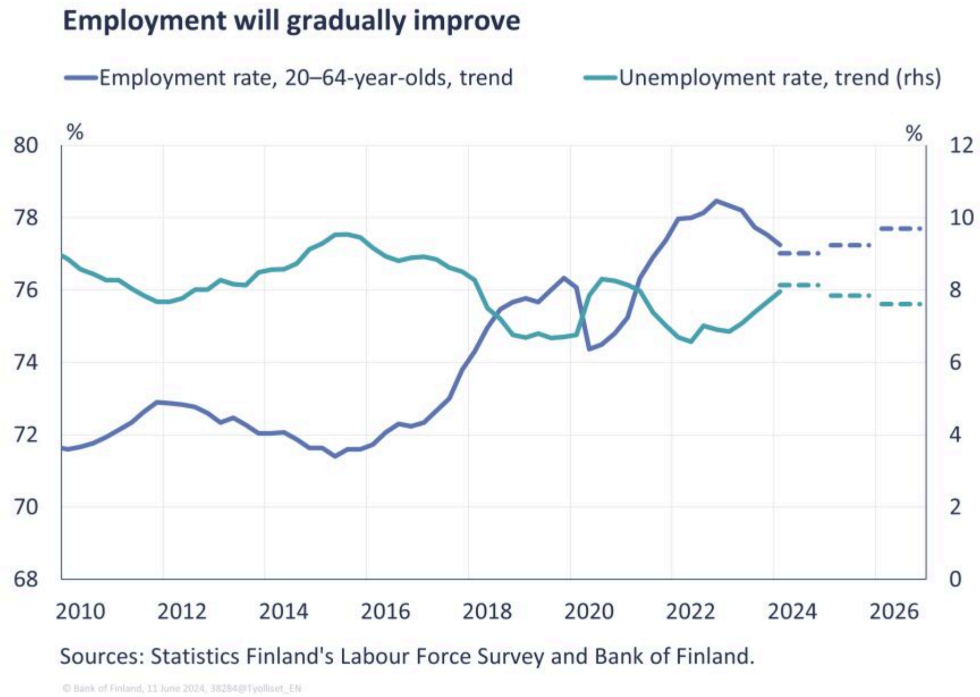
The unemployment rate is estimated to be slightly higher than the level of structural unemployment. The weaker demand for labour is also reflected in the sharp decrease in vacancies and the substantial easing of labour shortages. The labour force participation rate has nevertheless remained high.

The employment rate (20–64-year-olds) will decline in 2024 to approximately 77% and the unemployment rate will rise to 8.1% (Chart 11). Unemployment will increase particularly in construction, where the cyclical conditions remain weak, although this is also the case in other industries. This is indicated by, for example, companies' weak employment expectations, consumers' expectations concerning unemployment, and a decrease in job vacancies to the low levels witnessed during the COVID-19 pandemic. Public sector employment, which is not as cyclically sensitive as private sector employment, has remained stronger. In recent years, a large share of employment growth has been in public services.

Employment will start to rise gradually and unemployment to fall in 2025, when, for example, household and business confidence in the economy strengthens and cyclical conditions improve. There is also a structural need for labour input in the economy, particularly in health and social services.

The employment rate will reach 77.7% in 2026, at which time there will be approximately 8,000 more people in work than the 2023 average. In 2025, the unemployment rate will still be higher than the level of structural unemployment, despite a decline in unemployment. In 2026, the unemployment rate will be very close to the rate of structural unemployment. As a result of the tightening of the labour market towards the end of the forecast period, growth in employment will be restricted by the already high participation rate of the working-age population. The higher immigration of recent years will increase the supply of labour.

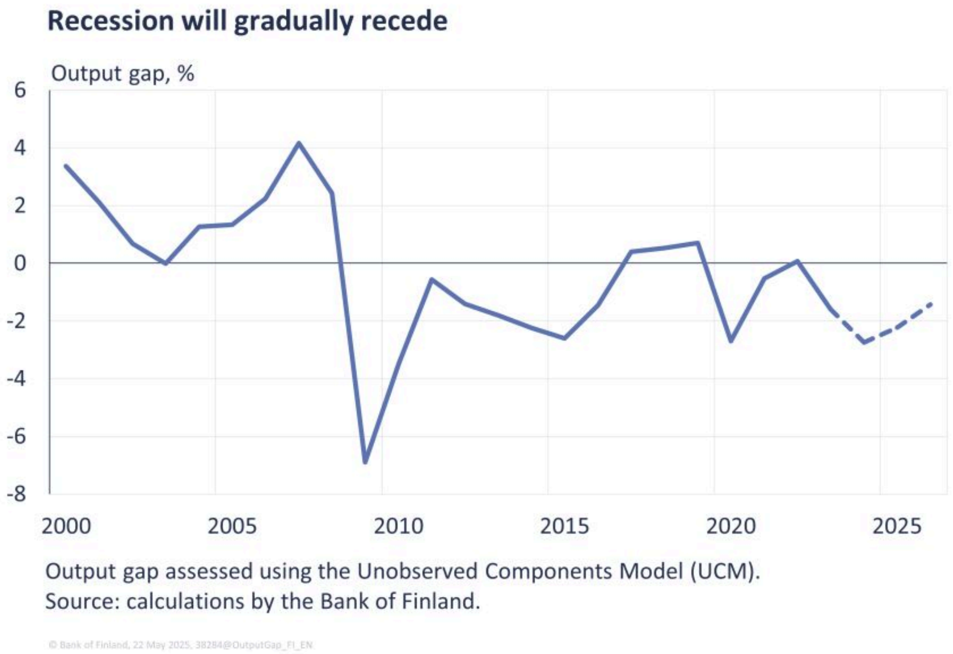
Chart 11.



Recession will gradually recede

GDP growth for 2024 will still be below the economy's growth potential and the output gap will be clearly negative. As a consequence, the Finnish economy will still be in recession this year, but the recession is projected to gradually recede in the course of the year. In 2025, GDP growth will strengthen due to cyclical factors, and towards the end of the forecast period in 2026, GDP growth will be higher than the growth in potential output. As a result, the output gap will move closer to balance (Chart 12).

Chart 12.



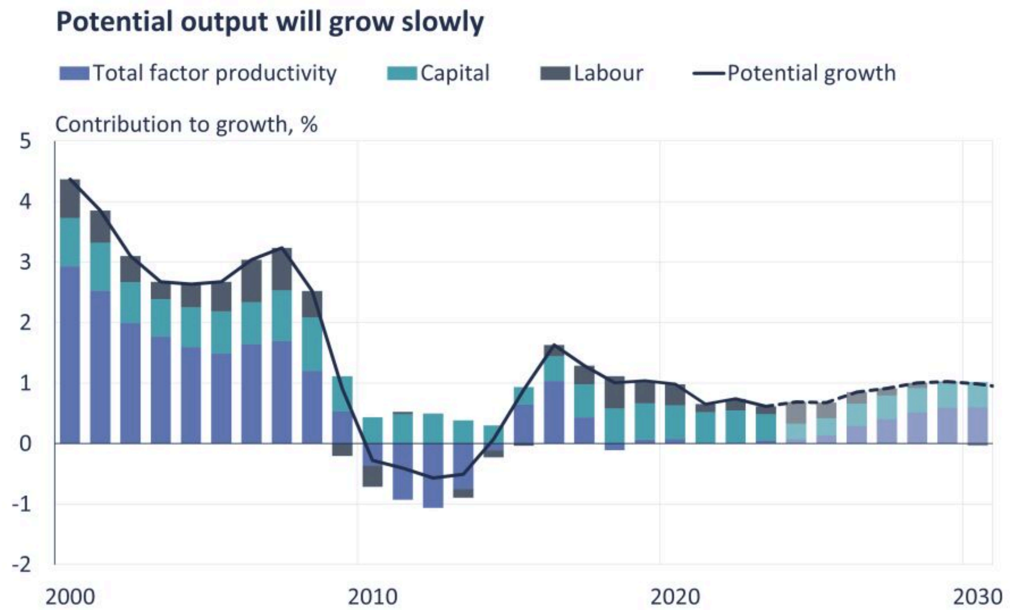
The growth in potential output in Finland will be slow in 2024–2026, rising at an average annual rate of less than 1% (Chart 13). The growth in all production factors (capital, labour input, total factor productivity) will be subdued.

Growth in investment and therefore in the capital stock will be slow, which will curb growth in potential output. The rise in interest rates on corporate loans, for example, has reduced the attractiveness of corporate fixed investment. Growth in total factor productivity will be sluggish owing to the recent crises, among other things. The cessation of trade with Russia and the reorganisation of production chains, as well as the introduction of more expensive inputs, may have slowed productivity growth.[8] Weak productivity growth is also due to the fact that a majority of employment growth in recent years has not been in the private sector but in public services, where productivity growth is below average.

Growth in the supply of labour will be slow. The high structural unemployment rate will reduce the importance of labour as a source of potential output during the forecast period. In addition, the growth in the labour supply will be constrained by the decrease in the working-age population (15–74-year-olds). An exception to the downward trend in the working-age population is the higher than expected increase in immigration in 2023 and 2024.

Despite the weak cyclical conditions, the labour force participation rate remains high and will underpin labour input. However, the supply of labour is weakened by employees working considerably fewer hours on average than before the COVID-19 crisis. Population ageing will also weaken the prospects for growth in the average number of hours worked in the future if it increases the amount of part-time employment.

Chart 13.



The chart presents estimates of the growth in potential output (produced using the Bank of Finland's Unobserved Components Model) and the contributions of the different components.
Source: calculations by the Bank of Finland.
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In recent years, the economy has been hit by various different crises. This gives rise to uncertainty about the future growth potential of the economy. The growth potential could alter if permanent changes occur in, for example, globalisation, production methods, energy prices, household behaviour or immigration.[9] Climate change is also causing uncertainty over the long-term prospects for growth.[10]

Russia's war in Ukraine and geopolitical tensions could have a long-term adverse impact on the prospects for economic growth if this results in a lasting reduction in international trade and leads to a more inefficient global division of labour. This would, in turn, slow the growth in productivity. The allocation of resources to national defence instead of production activity will weaken the prospects for economic growth, too. On the other hand, the growing diversity of critical production chains and efforts to move production closer to the domestic market could lessen the risk of supply-side disruptions. In addition, technological advances, such as the use of artificial intelligence, may improve productivity.

The development of the capital stock will be affected by two opposing forces. On the one hand, the reorganisation of production and the potentially huge investment in the green transition would strengthen the capital stock, but, on the other hand, the cancellation or postponement of potential investments due to the war would, in the short term, hamper any increase in the capital stock.[11]

Some of the capital stock could, moreover, become obsolete if, in the future, there are major disruptions to the availability of oil and gas or the price of energy remains high permanently. Furthermore, the removal of polluting capital stock will weaken the capital stock generally and will require new investment to replace it with something less polluting.

There is much uncertainty over the effects of Russia's Ukraine war on labour input, concerning, for example, the numbers of immigrants to Finland and how immigrants would find employment. Meanwhile, the increase in working remotely, which has resulted from recent crises, may boost the labour supply in the economy if greater flexibility means that economically inactive people start to enter the labour market more than before. The increase in the supply of labour would then strengthen potential output.

Prices and wages

The slowdown in inflation has been broadly based in the early months of 2024. Price pressures are low due to the weakness of the economy but will start increasing as the economy improves during the forecast period 2024–2026. The changes in value added tax will raise consumer prices from the autumn onwards, and their impact on inflation will be at its greatest in 2025. Nominal earnings will continue to grow in the immediate years ahead, but at a slightly slower pace towards the end of the forecast period. Finland's cost competitiveness will improve somewhat, reflecting the fact that growth in labour costs will be slower than in the euro area on average.

Upward pressures on consumer prices are small but will increase as the economy improves

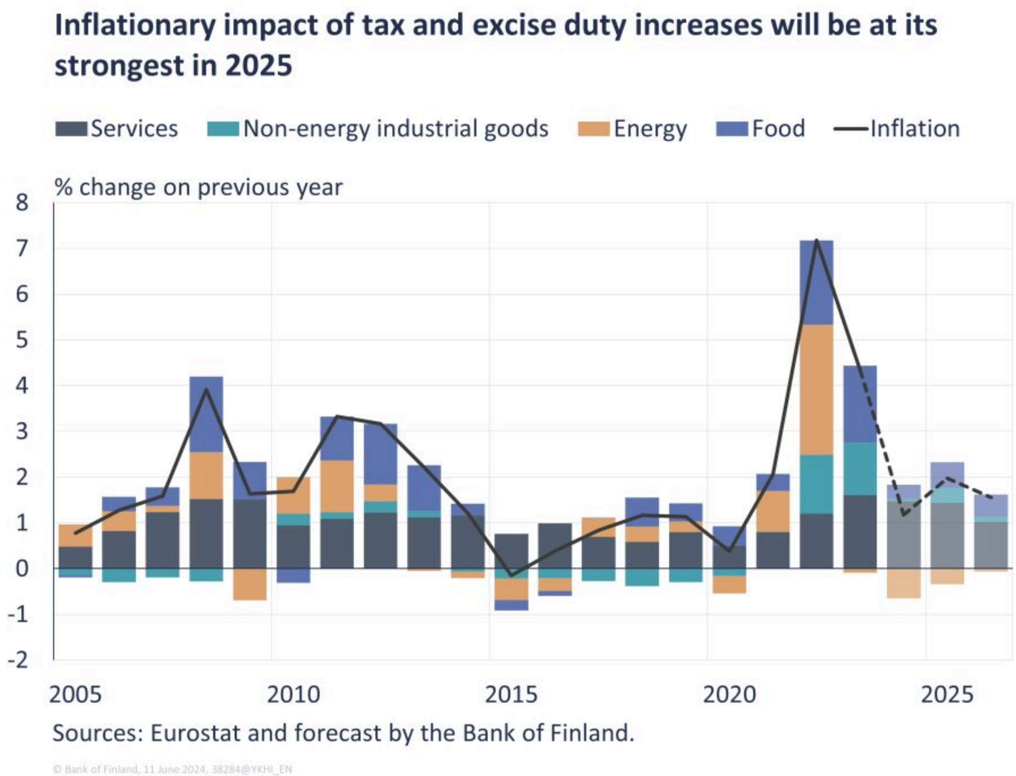
Inflation, as measured by the Harmonised Index of Consumer Prices (HICP), has in recent months slowed in Finland to below 1%. The slowdown has been broadly based. The prices of energy, unprocessed food and consumer goods have declined from a year earlier. Underlying inflation, which measures price changes in consumer goods and services, has also slowed to less than 2%. Due to the high interest rates and weak economy, the upward pressures on prices are very low.

However, consumer price inflation will start to pick up in 2024, and for the year as a whole, inflation will be 1.2% (Chart 14). The increase in value added tax will push up prices starting in September. The rise in the standard VAT rate and the transfer of chocolate and sweets to the standard rate of VAT will push up HICP inflation by approximately 0.7 percentage points if the tax increases are passed through to prices in full.[12]

The upward impact of the tax increases on HICP inflation will be at their strongest in 2025, when reduced VAT rates will be raised and excise duties increased on tobacco products, soft drinks and spirits. In 2025, the economy will improve and the downward impact of monetary policy on inflation will start to fade, which will push up consumer price inflation. Inflation will rise to 2% in 2025. Consumer prices for energy will continue to decline, but at a slower pace than a year earlier.

Inflation will fall to 1.6% in 2026, when the inflationary impact of the tax and duty increases diminishes. Inflation will nevertheless be sustained by the economic upswing and earnings growth and will remain above its pre-pandemic level.

Chart 14.



Earnings growth will slow slightly

The growth in nominal earnings will slow a little in 2024 in accordance with collective agreements already in force (Chart 15). However, many collective agreements will expire this year, and the round of negotiations for collective agreements that starts in the autumn will largely determine the path of nominal earnings in Finland in the immediate years ahead.

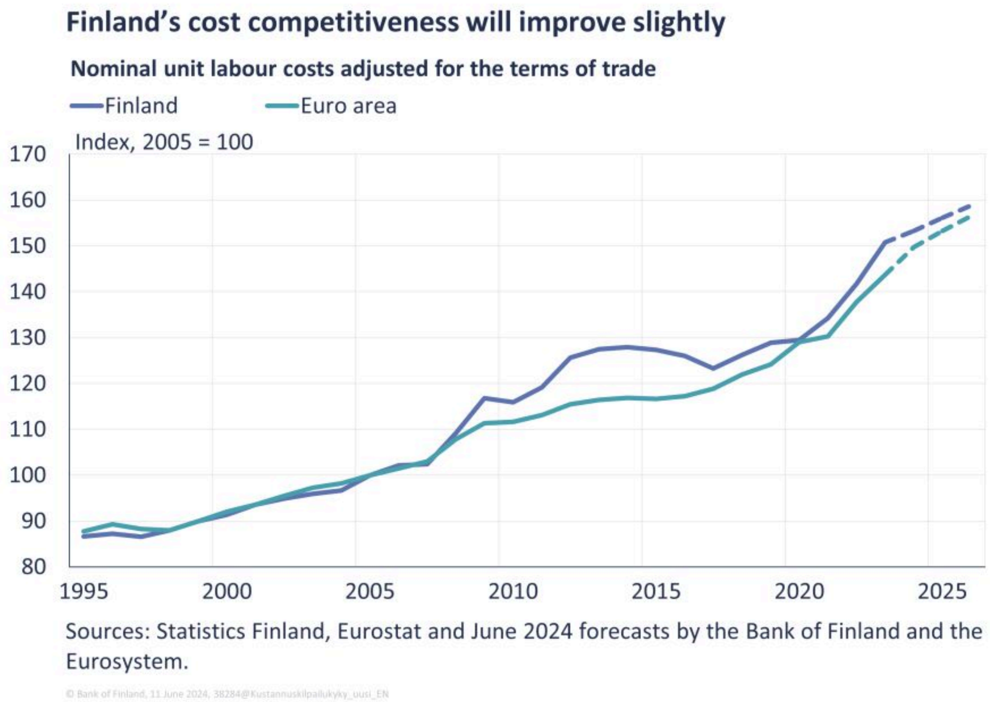
The preparation of this forecast employed an assumption that is based on a long-term observed correlation suggesting that the pace of long-term growth in real wages will be broadly the same as growth in productivity. Growth in nominal earnings is expected to slow somewhat in the forecast period, but real wages will continue to grow markedly.

The cost of labour, measured in terms of compensation per employee, will rise significantly more slowly in 2024 than the other earnings indicators (Chart 15). The difference is comparison with average hourly earnings is explained by the fact that the number or hours worked is decreasing more than the number of wage earners. In addition, the growth in labour costs is being slowed by the reduction in unemployment insurance contributions paid by employers. Towards the end of the forecast period, the cost of labour will rise at a rate of slightly under 3%.

Chart 15.

Finland’s cost competitiveness measured using relative unit labour costs adjusted for the terms of trade will improve slightly in the forecast period in comparison with the euro area average (Chart 16). According to the Bank of Finland’s forecast, the cost of labour will rise more slowly than the euro area average, which will improve cost competitiveness. Labour productivity per person employed will grow in Finland in the forecast period 2024–2026 at almost the same pace as in the euro area on average.

Chart 16.



Risk assessment

The risks surrounding the economic growth forecast are as great on the downside as on the upside. The inflation risks to the forecast are also balanced.

There are various risk factors which could, if they materialise, lead to weaker economic growth than forecast. Geopolitical tensions, particularly the wars in Ukraine and the Middle East, are creating instability in the global economy. The weakening of the economic relations between the United States and China are increasing the risks in international production chains and world trade. If Russia continues its hybrid operations in Finland and the neighbouring areas, it could have adverse effects on households and businesses and increase general uncertainty.

The outlook concerning financing conditions for households and businesses is also uncertain. According to market expectations, market rates will begin to decline in the latter half of 2024, which would contribute to a pick-up in the economy. If, however, euro area inflation is not brought under control as expected, this would delay the reduction in interest rates. In particular, if wage growth is faster than anticipated in the remainder of the year, this could sustain the rise in services prices and therefore drive up core inflation in the euro area. If the decline in interest rates is slower than the markets anticipate, growth in private consumption and investment may be lower than forecast.

The domestic economic outlook is subject to considerable uncertainty, particularly in regard to the recovery of the construction industry. Households may regain their appetite for house purchasing more slowly than expected, especially if lending rates remain above financial market expectations for the remainder of the year. Construction companies still have a large stock of unsold new homes, and it may take them longer than anticipated to sell these.

If the recession in residential construction drags on, more jobs could be lost in the sector than forecast. Other industries are also subject to employment risks. In both manufacturing and services, the labour needs have so far been adjusted through temporary lay-offs, but as the recession has persisted, the lay-offs have already started to turn into redundancies.

The fiscal adjustment to the public finances involves significant spending cuts and tax increases in 2024 and 2025. These measures may have a significant impact on household consumption and the supply of labour. For example, cuts to unemployment benefits and social security could reduce private consumption by more than anticipated. It is, however, difficult to predict all the positive and negative effects that these reforms may have on economic growth during the forecast period.

Unexpected favourable developments in the Finnish economy in the immediate years ahead are also possible. At the turning points of business cycles, economic recovery has often been faster than forecast. Business and household confidence may recover faster than anticipated, which would boost both private consumption and investment. Especially in residential construction, a change for the better could come sooner than expected, as there will be pent-up demand for new homes after the recession.

Growth in Finland's export markets could also provide a positive surprise. The recovery of growth in Finland's export markets may be quicker than expected. There is also a chance that the growth in demand in Finland's export markets will be increasingly weighted toward capital goods produced in Finland, especially if the green transition in Europe takes on new momentum as economic growth recovers (see. Finnish economy would recover more rapidly if exports and consumption pick up).

Investments in the green transition may also grow more quickly than anticipated in Finland, too, especially in energy production and energy-intensive industries. If even some of the currently considered green transition investments are completed, investment growth could clearly exceed the forecast.

Inflation in Finland may turn out to be either lower or higher than forecast. If geopolitical tensions escalate, the prices of energy and raw materials may rise again. If there are no new supply disruptions, the price trend for consumer goods may return to its pre-pandemic downward path.

Any demands for wage increases to compensate for the labour market reforms introduced by the Government could introduce an extra layer of pressure to the autumn 2024 wage negotiations. At the same time, services inflation may be curbed by a slowdown in the rate at which rents are rising in non-subsidised dwellings, as there is now a large supply of rental housing on the market.

Notes

1. More detailed information on the euro area forecast is available on the ECB website. ↑
2. More detailed information on the ECB's monetary policy decisions is available on the ECB website. ↑
3. For more information, see the Bank of Finland Financial Stability Assessment. ↑
4. In addition to cyclical factors, the growth potential of Finland's exports has long been weakened by the composition of Finnish goods exports, which is tilted towards the kinds of products and markets where demand growth has remained relatively modest. For more details, see: Finland struggling to defend its market share in exports. ↑
5. The net impact of the Government's discretionary measures on general government revenue and expenditure that is estimated in the Bank of Finland's forecast amounts to 0.7% of GDP in 2024. The corresponding estimates for 2025 and 2026 are 1.7% and 1.9%, respectively. ↑
6. Primary balance refers to the general government surplus/deficit net of interest payments on public debt. Changes in the cyclically adjusted primary balance reflect the fiscal stance, or the impact of fiscal policy on the general government balance excluding the effects of cyclical revenues and expenditures. Fiscal policy is neutral when the cyclically adjusted primary balance remains unchanged and changes in the general government surplus/deficit are only due to cyclical factors or changes in public debt servicing costs. ↑
7. Potential output is the volume of GDP when all the inputs in the economy are in normal use. The output gap is the difference between the economy's actual and potential GDP. When actual and potential GDP are at the same level and are growing at the same rate,

the output gap will be zero and the economic cycle is said to be neutral. ↑

8. Higher and more volatile prices of energy may weaken potential output through various channels. See e.g. Deutsche Bundesbank (2022b) Impact of permanently higher energy costs on German potential output, Monthly Report, December 2022, p. 29, and the ECB's projections (ECB Bulletin 5/2022, Box 4). ↑
9. European Commission's Spring 2023 Economic Forecast, special issues. ↑
10. See the ECB's article on the impacts of climate change on potential output (How climate change affects potential output), ECB Economic Bulletin, Issue 6/2023. ↑
11. Greater uncertainty and the high cost of energy will dampen the investment appetite. ↑
12. In August 2024, inflation will be affected by the discontinuation of a technical adjustment made a year earlier, in July 2023, to the calculation of the index of electricity prices. ↑

Key words

consumption, economic forecast, forecast, GDP, households, inflation, interest rates