Editorial

Editorial: Growth potential and public finances need further strengthening

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The current news on the Finnish economy is positive, and the outlook has improved. Economic growth has continued and is now more broadly based than before. Exports and corporate investment are both growing, in addition to household demand. The employment rate has gradually risen and the general government deficit shrunk. Cost-competitiveness has taken a turn for the better.



The economy is nevertheless still struggling to rise from a level weakened by many years of sluggish developments. Therefore, the objective should be ambitious, building the foundations for growth and improving the outlook for the public finances.

The state of Finland's public finances has improved. The general government deficit and general government debt relative to GDP have both shrunk. The public finances have been strengthened by both the recent improvement in the condition of the economy in general and decisions taken on revenues and expenditures.

General government finances do, however, remain in deficit and are not forecast to achieve balance in the immediate years ahead. General government debt is forecast to remain at a full 60% of GDP.

The longer-term outlook for the public finances remains challenging. According to the Bank of Finland's assessment, the long-term fiscal sustainability gap is still equal to around 3% of GDP. If the outlook for the public finances cannot be successfully strengthened through structural reforms, permanent expenditure savings or tax increases of this magnitude will be required to cover the funding of future public expenditure.

The longer-term outlook for the public finances is muted by both demographic trends and the trend of productivity development. Demographic developments indicate that most of the baby boom generation have now reached retirement age. It is expected that in the 2020s these cohorts will necessitate an increase in publicly funded care services. Moreover, the lengthening of average life expectancy will increase expenditure on pensions.

Labour productivity growth has for several decades been slowing in the advanced economies, and Finland is no exception. The recent acceleration in the pace of productivity growth in Finland is welcome, but it does not significantly change the long-term outlook for the public finances.

With regard to the public finances, the long-term outlook can be improved through structural reforms. The pension reform decided in 2015 made a substantial contribution in this area. Of decisions still awaited, the reform of social and healthcare services has a key role to play. If it fails to subdue rising expenditure, the increasing care needs of the baby boomers will substantially deepen the general government deficit in the 2020s.

Also important are reforms that can affect the employment rate, as this has a sizeable impact on the outlook for the public finances. One concerning trend of recent years relates to young people. In particular, labour market participation among young men born since the early 1980s seems to be lagging behind the participation rate of previous generations.

The poor performance of exports and export income weighed on the Finnish economy for almost 10 years. Exports were hit by the subdued economic trend internationally, the setbacks experienced by particularly the electronics industry and in part also the forest industries as well as the problems in the Russian economy. Exports were also depressed by an increase in domestic costs. This was rapid relative to the other advanced economies.

Finland's exports have now begun to grow. Recovery has been assisted by the strengthening performance of the international economy. Exports and the export outlook also benefit from more moderate developments than previously in terms of costs in the domestic economy. Recent years

have seen moderate pay agreements, and the beginning of 2017 marked the entry into force of the Competitiveness Pact to reduce labour costs.

From the angle of economic growth and employment it is vital that Finland's cost-competitiveness continue to improve in the immediate years ahead. The collective agreements concluded so far in the second half of 2017 would suggest the trend in labour costs could be slightly more moderate than the average among Finland's advanced trading partners. This is partly due to the reductions in employer contributions in 2018 and 2019 included in the Competitiveness Pact.

With regard to cost-competitiveness, the agreements concluded in different sectors of the economy over the next few months will be very important. Most Finnish wage-earners work in industries that have not yet concluded collective agreements for the immediate years ahead.

These are largely industries other than the open sector of the economy. Even so, their labour costs significantly affect the international competitiveness of Finnish output. This is because the open sector industries buy a lot of intermediate goods produced in the domestic economy, particularly a variety of services.

The key factor in the coming round of collective agreements is that the position of the open sector of the economy should define the general trend in labour costs in Finland. In relation to cost developments, the agreements in the open sector should provide the frame of reference for agreements in other sectors. This applies both to the immediate months ahead and to the agreements concluded in coming years.

When seeking to reinforce economic growth, employment and fiscal sustainability, it is useful to exploit the results of economic research. Broadly based participation by economists in the debates around economic policy is to be welcomed. It is nevertheless worth pointing out that objectives regarding the general trend of developments in society cannot be derived from the results of economic research. Such goals and objectives are based on values. A mandate for defining the objectives is sought at democratic elections.

Economic research can, however, help in resolving how to reach the determined objectives and what would follow from the various economic policy options that are available. Research results can also be drawn upon for understanding historical economic developments and observing current problems. Economic research has a lot to offer in policy preparation with regard to both structural reforms and cyclical policy.

A new economics institute is currently being established in Finland. The Bank of Finland has decided to support the project. High-quality economics research and education are key requirements if decision-makers are to be able to rely on the support of cogent economic analysis.

From the central bank perspective, quality teaching and research are needed particularly in the areas of macroeconomics and the financial sector. For decision-making more broadly there are of course also other important areas of economic research.

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Erkki Liikanen
Governor of the Bank of Finland

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