Economic Survey

Winter 2015

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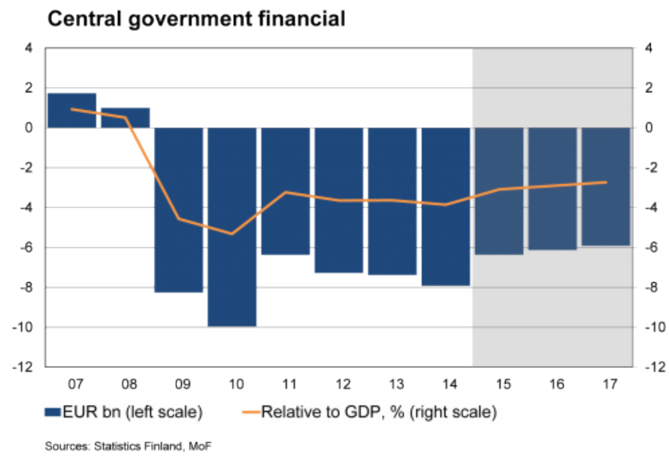
Economic Survey

- The Finnish GDP growth forecast for 2015 is just 0.2%. In 2016 and 2017, it is predicted that GDP growth will pick up to 1.2%.
- The growth oflong-term and structural unemployment presents a very serious concern. In October a total of 113,000 people had been out of work for more than a year, almost 20,000 more than the year before. According to employment service statistics the number of structurally unemployed people in October stood at 206,000, again almost 20,000 more than one year earlier.
- Positive private consumption trends are supported by increasing household real disposable income, which will drive private consumption to growth of 1.3% this year. Over the next two years private consumption growth will slow somewhat, mainly because of modest real income growth.
- World trade growth has slowed, among other reasons because of the slowdown of Chinese manufacturing and sluggish investment activity in industrial countries. Imports growth will remain exceptionally modest, especially in emerging economies. Before the financial crisis, trade growth was around twice as high as output growth, but at the moment trade is actually growing more slowly than output.
- In 2015 domestic industry value added will still decline by more than 2%, but in 2016 and 2017 it is set to rise by around 2% and 3%, respectively.
- Finland's general government deficit breached the 3% of GDP limit in 2014, and will remain over the limit in 2015, despite adjustment measures introduced by the previous and current governments. In 2016, it is expected that the budget deficit will fall below 3%. General government debt is set to exceed the 60 per cent reference level, and there is no turnaround in sight over the forecast horizon.
- The main domestic risks are still related to the development of the real economy and the labour market. In the short term, it seems that Finland will see slower economic growth than its competitor countries. A robust improvement in public finances can only be achieved under conditions offavourable real economic development. It is necessary to stress that the projected economic scenario will not be enough to significantly improve the health of public finances in Finland.



Key forecast figures

	2014 EUR bn	2012	2013	2014	2015**	2016**	2017**
		change in volume, %					
GDP at market prices	205	-1.4	-1.1	-0.4	0.2	1.2	1.2
Imports	79	1.6	0.0	0.0	-2.0	2.4	3.0
Total supply	285	-0.6	-0.8	-0.3	-0.4	1.6	1.7
Exports	78	1.2	1.1	-0.7	-1.1	1.8	2.9
Consumption	165	0.4	0.0	0.3	1.0	0.6	0.6
private	114	0.3	-0.3	0.5	1.3	0.8	0.8
public	51	0.5	0.8	-0.2	0.4	0.2	0.1
Investment	42	-2.2	-5.2	-3.3	-2.1	4.8	3.6
private	33	-3.2	-7.1	-3.9	-2.2	5.8	4.2
public	8	2.6	3.5	-0.9	-1.6	0.6	1.0
Total demand	285	-0.6	-0.5	-0.2	-0.4	1.5	1.6
domestic demand	208	-1.2	-1.1	0.0	-0.2	1.4	1.2

Other key forecast figures

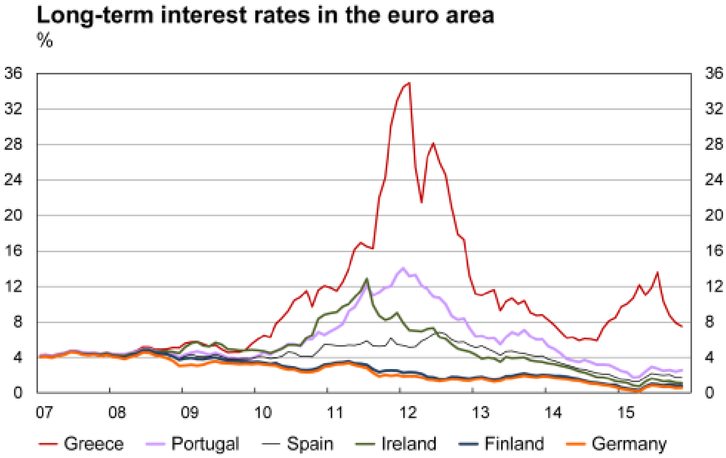
	2012	2013	2014	2015**	2016**	2017**
GDP, EUR bn	200	203	205	206	211	216
Services, change in volume, %	0.6	-1.8	-0.1	0.8	0.7	1.2
Industry, change in volume, %	-8.5	-0.6	-0.3	-2.2	1.7	3.4
Labour productivity, change, %	-2.1	0.0	0.3	0.4	0.4	1.4
Employed labour force, change, %	0.4	-1.1	-0.4	-0.3	0.4	0.4
Employment rate, %	69.0	68.5	68.3	68.1	68.5	68.8
Unemployment rate, %	7.7	8.2	8.7	9.4	9.4	9.0
Consumer price index, change, %	2.8	1.5	1.0	-0.1	0.9	1.4
Index of wage and salary earnings, change, %	3.2	2.1	1.4	1.2	1.2	1.2
Current account, EUR bn	-3.9	-3.4	-1.9	0.9	1.2	1.3
Current account, relative to GDP, %	-1.9	-1.7	-0.9	0.4	0.5	0.6
Short-term interest rates (3-month Euribor), %	0.6	0.2	0.2	0.0	-0.2	-0.1
Long-term interest rates (10-year govt. bonds), %	1.9	1.9	1.4	0.7	1.0	1.5
General government expenditure, relative to GDP, %	56.1	57.6	58.2	59.1	58.7	58.3
Tax ratio, relative to GDP, %	42.7	43.8	43.9	44.6	44.5	44.2
General government net lending, relative to GDP, %	-2.1	-2.5	-3.3	-3.3	-2.9	-2.6
Central government net lending, relative to GDP, %	-3.6	-3.6	-3.9	-3.1	-2.9	-2.7
General government gross debt, relative to GDP, %	52.9	55.6	59.3	62.8	64.9	66.6
Central government debt, relative to GDP, %	42.0	44.3	46.4	48.5	49.9	51.3

Introduction

The difficulties of the Finnish economy are set to continue over the next couple of years. Growth prospects are poor, and the situation in public finances is showing no signs of substantial improvement. It is projected than in 2017, Finnish industrial output will be one-quarter lower than 10 years ago. Indeed, given the existing economic structure, the only chance for economic recovery is through a rebound in industry and manufacturing and exports. Over the forecast horizon, economic growth in Finland is expected to remain slower than in our competitor countries, and the unemployment rate will remain too high.

Statistics Finland's preliminary Q3 figures show that GDP dropped by 0.5% quarter-on-quarter. This was due to falling foreign demand and declining investment across the board. At the same time, Statistics Finland revised upwards its previous Q1 and Q2 estimates by 0.2 percentage points. Based on current figures for the first three quarters, annual GDP growth in 2015 looks set to come in at 0.1%. The Economics Department's growth forecast for 2015 is 0.2%

Long-term interest rates in the euro area



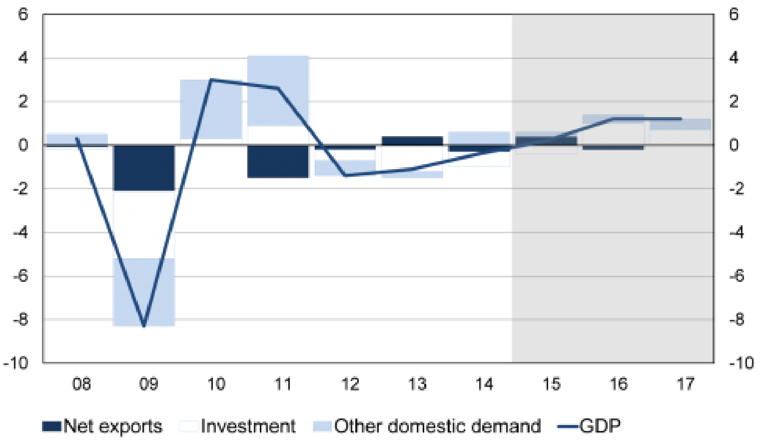
Source: Reuters

Recent trends in the global economy present a dual picture. Growth prospects in emerging economies have clearly deteriorated. In China, growth is expected to slow, partly because the country's movement towards becoming a more closed service-based economy has been faster than anticipated. The Russian economy is severely hampered by its inefficient production structure and by lowered raw material world market prices. Many of Finland's major trade partners, on the other hand, are seeing quite healthy growth. Growth is still fairly robust in both the United States and Germany, which are benefiting from a broad-based growth of economic activity. The Swedish economy is outperforming forecasts, although its growth is largely driven by strong domestic demand and service exports. Sweden's strong growth will therefore not significantly contribute to driving Finnish exports. Overall, global trade growth will remain very subdued over the next two years.

The assumptions behind the current forecast are largely supportive of growth. The monetary policy stance will contribute to support favourable economic activity over the outlook horizon. Short-term interest rates will remain at their lowest level in the history of the euro area, as it is predicted that the three-month Euribor interest rate will remain slightly negative in both 2016 and 2017. The ten-year interest rate will accordingly remain low, standing at 1.0% in 2016 and at 1.5% in the last year of the forecast horizon. The euro to dollar exchange rate is anticipated to weaken further, trading to parity value in 2017. The weakening of the euro will bolster the price competitiveness of exports in markets where payments are settled in dollars. Lower energy prices will also benefit Finland's growth prospects by reducing business costs and increasing household disposable income. It is forecast that the index of wage and salary earnings will rise moderately by just over one per cent over the next couple of years.

Finland's GDP growth forecast for 2015 is just 0.2%. Exports of goods and services will fall by 1.1% year-on-year. Finnish exports are currently distorted by a structural imbalance, and costs are also too high in the competitive world marketplace. The depressed export outlook will also have the effect of curtailing imports. Private and public consumption are the only domestic demand items that will show growth. Positive private consumption trends are supported by increasing household real disposable income, which will drive private consumption to growth of 1.3% this year. Private investment will fall by 2.2%. The only category where growth will be recorded is in civil engineering investment. Investment in machinery and equipment will show signs of picking up by virtue of a few major investment projects. The long-standing slide in industrial production will continue, with output falling by 2.2% year-on-year. Service output growth is predicted to come in at 0.8%.

Contribution to GDP Growth in Finland
percentage points



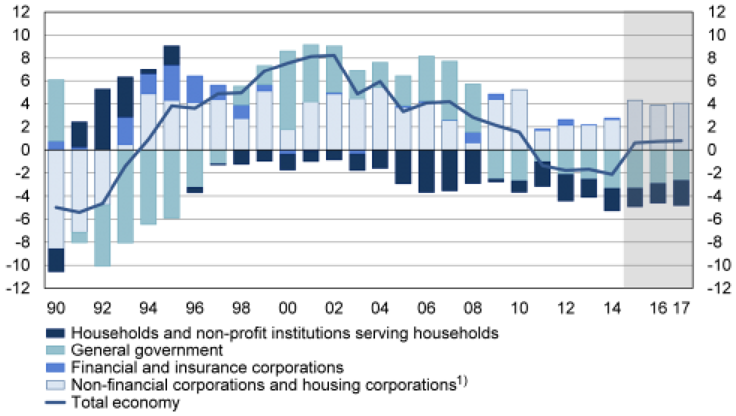
Sources: Statistics Finland, MoF

The labour market situation remains weak. Unemployment will rise clearly from last year, and the projected unemployment rate for 2015 is 9.4%. The number of the long-term unemployed has jumped to around 115,000, while the figure for the structurally unemployed has now exceeded 200,000. It is predicted that the number of employed people will also fall slightly. The development of labour productivity will remain subdued. In 2015 prices will fall by 0.1%, and without tax interventions the figure would show even deeper deflation.

The growth forecast for 2016 is 1.2%. This growth will largely be driven by favourable private investment trends. Decisions already in place mean that industrial construction investment will increase significantly in 2016. Investment in machinery and equipment will also recover to positive growth, driving private investment to a projected growth rate of 5.8%. Net exports will continue to have a negative impact on economic growth next year. Despite the gradual rebound of exports, imports will increase more rapidly on the back of recovering domestic demand. Private consumption growth will slow somewhat from the current year, mainly because of modest real income growth. Inflation will pick up to close to one per cent, chiefly in response to tax policy interventions. It is expected that industrial output will recover to moderate growth of 1.7%. However, the rebound of economic activity will remain tepid and have very little impact on the labour market situation. The unemployment rate will stagnate at 9.4%, and the mismatch problems in the labour market will remain substantial.

The projected 2017 GDP growth rate is 1.2%. This modest growth will be driven in its entirety by domestic demand. Cumulative growth in 2015–2017 will reach no more than 2.6%, and GDP volume will continue to be around 3% lower than at the previous cyclical peak at year-end 2007.

Net lending by sector
relative to GDP, %



1) Including financial sector in 2015-2017

Sources: Statistics Finland, MoF

The persistent downturn coupled with structural problems in the economy mean that general government finances will remain in deficit. Fiscal adjustment has helped to curb the growth of the expenditure, but not stopped it from growing as the local government is facing increasing pressure from age related expenditure. Also, deficit has increased due to the weak income development. The 3% deficit limit was breached in 2014, and the same is going to happen this year again. However the deficit will shrink over the outlook period. Public debt to GDP will continue to rise and exceed the 60% reference limit.

An estimated 35,000 asylum seekers will arrive in Finland during 2015. The projections in this forecast for 2016 are based on the State Budget estimate of 15,000 new asylum seekers. The significantly higher than predicted number of asylum seekers has caused additional costs to central government. The Government therefore submitted to Parliament an amendment to the 2016 budget proposal, which required an additional appropriation of over EUR 450 million compared to the ordinary budget proposal. It is assumed that around one in three asylum seekers will be granted asylum. If these people integrate successfully into Finnish society, they will augment the supply oflabour in the medium term. During the outlook period this effect will remain limited, however. In the longer term immigrants will have the effect of slowing the decline of the population of working age.

As far as the global economy is concerned, the risks to the forecast remain skewed to the downside. Despite the rebound of growth in the euro area and strong growth prospects in the UK and the United States, the global economy is still vulnerable to negative shocks. In China, private sector indebtedness is continuing to rise sharply and prices of homes, shares and other assets have increased rapidly. Under conditions of economic slowdown, these trends may cause disruptions in the market. Russia's economic performance will be weak over the next few years.

An environment of growth-supportive light monetary policy has led to an increased willingness to take risks and directed investment flows into the housing and stock market in particular. The financial market currently has a low tolerance of shocks, and therefore the market sentiment may turn around very quickly and cause sharp changes in nominal prices. Under the current conditions the connection between the financial market and the real economy is perhaps closer than earlier.

The main domestic risks are still related to the development of the real economy and the labour market. In the short term, it seems that Finland will see slower economic growth than its competitor countries. An improvement in public finances can only be achieved under conditions offavourable real economic development. It is necessary to stress that the projected economic scenario will not be enough to significantly improve the health of public finances in Finland.

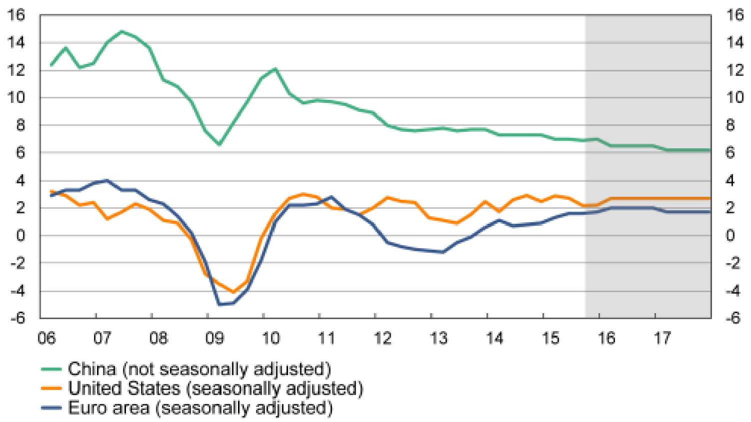
In the economic policy field, priority should be given to promoting the competitiveness of the open sector. The problems caused by the poor competitiveness of the Finnish economy have long been recognized, but efforts to address them have fallen short of a solution. The incentive effects of the tax and transfers system and the efficiency of the labour market are key areas that can be influenced by means of economic policy decisions. Cost structure factors have crucial importance in the competition for international markets shares. Unless structural reforms are put in place, mismatch problems in the labour market are bound to hamper prospects for growth in the very near future, assuming that the economy rebounds.

Global economy

Sluggish growth in emerging economies and investment are slowing down the global economy

The outlook for the global economy is divided. On the one hand industrial countries are seeing accelerating growth, but on the other many emerging economies are slowing down. The Chinese economy is set to slow after an exceptionally long period of strong growth, and Russia and Brazil will remain in recession next year. The slowdown of growth in China and ongoing processes of restructuring will hamper growth in many emerging economies and among raw material producers, especially in Asia, Oceania and the Middle East. Growth will continue in Sub-Saharan Africa, and growth will also pick up in South Africa as the rand has weakened and as raw material prices have stopped falling.

Gross domestic product
change in volume, %



Sources: Statistical authorities, MoF

The euro area is back to growth, partly as a result oflower oil prices and a weaker euro exchange rate. The effect of these favourable factors will begin to fade towards the end of the outlook period. The supply of credit and overall financing conditions have improved, and fiscal policy is hampering growth to a lesser extent than before. These factors are contributing to push up consumer demand, but investment is also slowly recovering. The exceptionally high level ofimmigration to the EU region will provide an additional demand boost, but on the other hand adversely affect the general government balance.

In Spain, Ireland and elsewhere, earlier restructuring has contributed to a return to brisk growth. On the other hand, euro area growth is still hampered by persistently high unemployment, which is dampening supply prospects. In the UK and Sweden, growth remains strong and employment is at a high level.

Broad-based growth is continuing in the United States. This is supported not only by low energy prices, but also favourable labour market conditions, a lighter fiscal policy and stronger household balance sheets. The economy has reached full employment and the rate of new job creation is actually higher than the rates of resignation and recruitment. Both nominal and real wages are rising faster than ever since the financial crisis, and consumer confidence has returned to its historical median. Investment is also set to grow at a moderate rate. The dollar has strengthened on the back ofinterest hike expectations, which will contribute to slow exports and increase imports.

Productivity growth has slowed both in Europe and the United States, which is hampering prospects for supply growth. Productivity is set to play an increasingly significant role in the future, especially in the ageing European labour market. Structural reforms could help to improve the conditions for productivity growth. In China, growth in industry, construction and commodity exports has already begun to slow, and these trends are set to continue. The Chinese economy is now in transition from an export and investment driven model to one led by domestic consumption and services. If the country is successful in its policy, the slowdown will be well controlled, initially to growth of around 6%.

Japan's growth potential is less than 1%. This means that even minor negative shocks can push the economy into technical recession. Japanese exports have failed to recover despite persistent stimulus efforts and a massive devaluation of the yen. The labour market will remain tight, and real wage growth over the outlook period will support household demand.

World trade to remain modest

World trade growth has slowed, among other reasons because of the slowdown of Chinese manufacturing and sluggish investment activity in industrial countries. Imports growth will remain exceptionally modest, especially in emerging economies. Before the financial crisis, trade growth was around twice as high as output growth, but at the moment trade is actually growing more slowly than output. Earlier, such slow rates of trade growth have only been seen under conditions of recession.

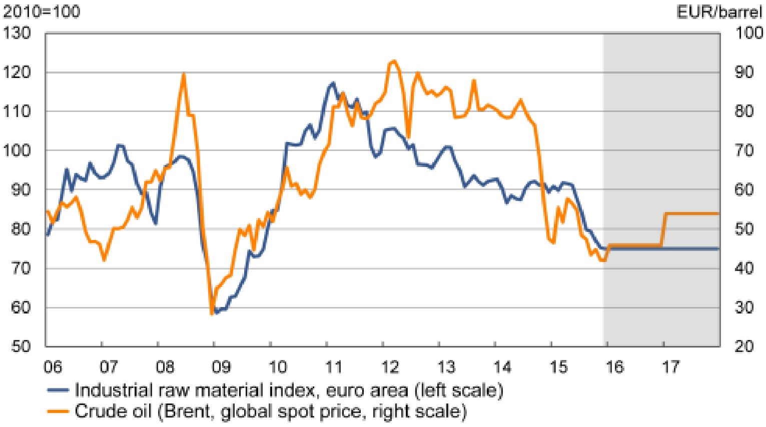
Finland's market share in global trade has continued to shrink, but the slide is now slowing. In the euro area, Finland has almost regained the same market share as it had before the crisis. In Sweden and Russia, on the other hand, Finland is continuing to lose market shares. Global trade will not provide a strong demand impetus for Finnish exports.

Inflation set to remain very moderate

The price of crude oil has fallen sharply above all in response to the deteriorating outlook in emerging economies, increasing US production and continued high OPEC supply. The supply of crude oil will continue to expand following the understanding reached in the Iranian nuclear negotiations. It is expected that prices will rise only very moderately. As energy is an intermediate input in all products and services, the effects of the oil price shock will be felt throughout the economy.

Given the slowdown of demand from emerging economies and continued high supply, prices of other industrial raw materials have also fallen rapidly. Raw material prices are apparently close to bottom. Furthermore, producer prices in China have continued to fall at an accelerating rate. Taken together, these factors have thrown world export prices into sharp decline. Inflation expectations are also extremely low, allowing central banks in industrial countries to persist with the current unusual monetary policy stance. However there is no real threat of a deflationary cycle in sight.

Raw materials prices
EUR



Sources: Hamburgisches WeltWirtschafts Institut, Macrobond, MoF

In the United States, interest rates will begin to move back to normal this year. Interest rates in the euro area will rise very slowly over the outlook period and remain at a much lower level than was normally seen during the pre-crisis period.

Risks remain on the downside

In China, indebtedness has continued to grow rapidly, especially in the private sector. The high and increasing debt burden coupled with slowing growth and economic restructuring may cause shocks that, because of the size of the Chinese market and global value chains, may have wide-ranging effects, particularly on raw materials and investment goods suppliers. In the longer term it is also unclear how successful China will be in reforming its economic model and placing greater weight on domestic consumption and services at the expense of manufacturing, investment and exports. The Chinese slowdown and restructuring may also cause greater than anticipated problems for emerging economies in particular.

In the euro area, risks are still predominantly on the downside. As the favourable conditions continue to wane, households may have even greater difficulty than predicted recovering from the debt and financial crisis. It is unclear how committed indebted member states are to adjusting their public sector balance sheets, and adjustment may have the effect of reducing demand more than anticipated.

Growth prospects remain overshadowed by geopolitical tensions in Russia, the Middle East and elsewhere. Confidence has not, however, weakened to the same extent as in many earlier political and currency crises.

Russia remains in dire economic straits. Growth will remain significantly slower than earlier even as it comes out of recession, and it is unclear how the country will be able to adapt. Political tensions are fuelling high levels of uncertainty and may further deepen the recession in Russia. The geopolitical risks may adversely affect confidence and growth in the EU.

Extremely low interest rates in industrial countries and a search-for-yield mentality have steered investment flows into the housing and stock market, which may have led to overvaluations. In Sweden, for instance, housing prices have risen very sharply. The end of unconventional monetary policy over the outlook period, an incipient rise in interest rates and the strengthening of the US dollar may cause strong reactions in the financial market. Many emerging economies in particular may see strong movements of capital as they have taken out large amounts of dollar-denominated loans.

One upside risk is that falling oil prices may increase demand from oil-importing countries to a greater extent than predicted. Furthermore, productivity may recover to stronger than anticipated growth.

Supply and demand

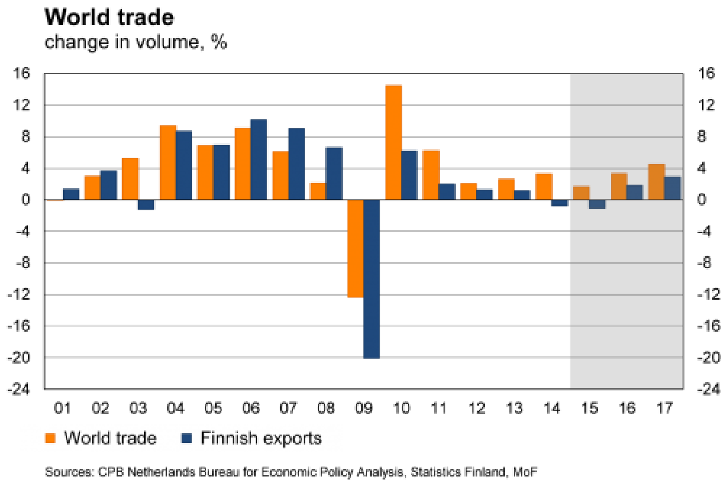
Exports growth to remain slow

Statistics Finland's quarterly accounts in December 2015 show that exports in Q3 contracted by 0.7% quarter-on-quarter. Over the outlook period exports will recover to slow growth as the global economy rebounds. The declining euro to dollar exchange rate has the effect of supporting export growth as most foreign trade is settled in dollars or euros.

In 2015 exports will contract by 1.1%. Russia's weak economic situation and trade sanctions will continue to weigh down on export performance in 2015. Despite the recovery in the euro area export there have not increased as well as expected.

In 2016 and 2017 export growth will accelerate to 1.8% and 2.9%, respectively. Since the world trade growth is faster than exports, Finland will continue to lose market shares in global trade over the outlook period. Demand for Finnish exports will slow as the period offastest growth in emerging economies winds down. During the forecast horizon Finland will be able to hold on to its market shares in the euro area, and therefore the loss of market shares will slow in comparison with previous years.

Q3 accounts indicate that imports were up 1.8% quarter-on-quarter. Rebounding exports, investment and consumption will drive imports to accelerating growth as early as 2016, with net imports having a negative impact on GDP over the outlook period.

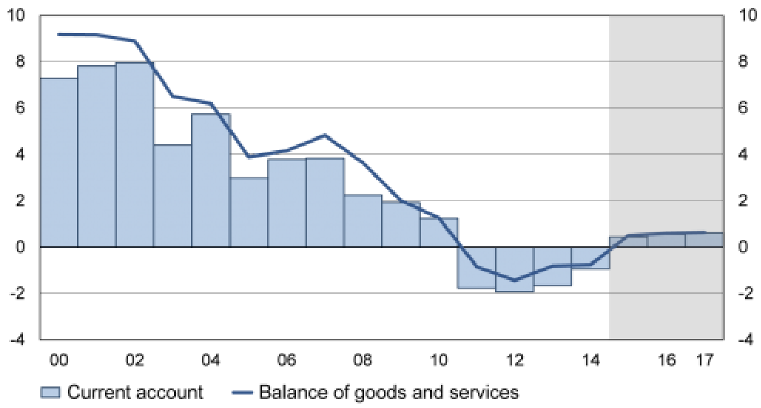


Current account has improved with improving terms of trade

Import prices are continuing to fall, but this trend has now slowed, and it is expected that prices will begin to rise next year on the back of rebounding global trade and the weakening exchange rate. A major factor behind the sharp fall in import prices in 2015 is the declining price of oil. Export prices have fallen more moderately than import prices, and therefore the current account is showing a clearly positive trend. The decline in world market prices will come to a halt during 2016, and as a result both import and export prices will return to moderate growth. The current account will improve slightly over the outlook period.

The current account deficit has improved rapidly in early 2015. At the end of Q3, the 12-month current account surplus already stood at EUR 0.6 billion, or 0.3% of GDP. The strengthening of the current account is primarily attributable to the improving trade balance, but receipts of primary income from abroad have also been positive over the past 12 months. The rapid improvement in the terms of trade has also contributed to strengthen the current account. The trade balance will continue to improve over the outlook period. A slight improvement in the terms of trade will also contribute to increase the current account surplus by almost EUR 0.5 billion. By 2017 the current account surplus will grow to EUR 1.3 billion, or 0.6% of GDP.

Current account
relative to GDP, %



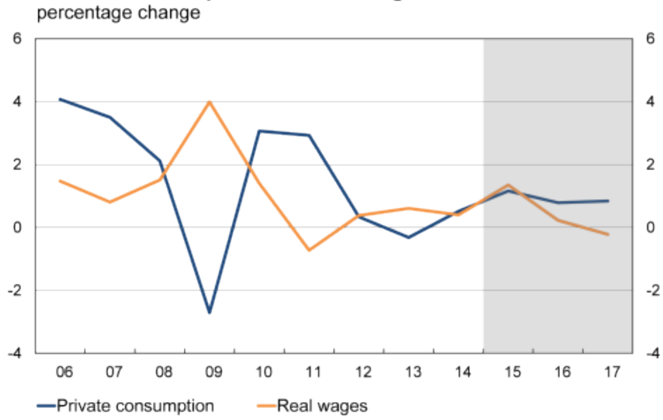
Sources: Statistics Finland, MoF

Private consumption

Despite the deteriorating employment situation, the growth of household real disposable income will accelerate to 1.6% this year. Consumer purchasing power is bolstered by exceptionally moderate price trends, which is due to falling oil and other raw material prices. Even though incomes have developed favourably, consumer sentiment has declined sharply since April. Rising unemployment in particular has contributed to increase the sense of uncertainty. Although confidence in one's own financial situation has weakened appreciably during the autumn, consumers still feel this is a good time to make purchases of durables. This has also been reflected in the demand for cars. Car sales have been boosted by pent-up demand, a temporary experimental car scrapping bonus and discounts offered by traders. Indeed it is anticipated that the demand for consumer durables will increase by almost 5% this year.

Private consumption growth is also bolstered by 6–12 month loan repayment holidays offered by banks to housing loan holders. In February–October the total value of mortgage rearrangements was some EUR 14 billion higher than in the corresponding period last year. Precautionary saving will increase with the waning of consumer confidence. Therefore the growth of household purchasing power will not be fully reflected in private consumption as the saving rate increases. In 2015 private consumption growth will accelerate to 1.3%.

Private consumption and real wages
percentage change



Sources: Statistics Finland, MoF

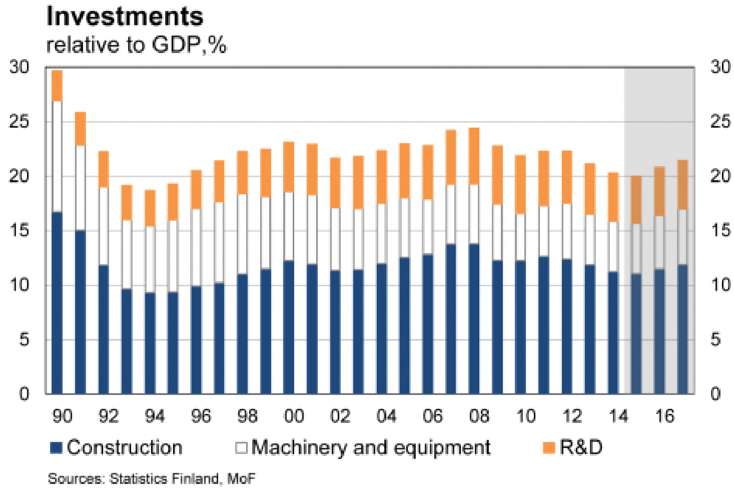
In 2016 accelerating economic activity will bring an improvement to the employment situation, but at the same time the growth of household disposable real income will slow to 0.8% as a result of accelerating consumer prices. To curb the growth of public debt, the Government has committed itself to expenditure cuts of almost EUR 3.5 billion during its term in office. Together with rising public service charges, these cuts will have the effect of reducing household disposable income by EUR 1 million in 2016–2017.

At the same time, the impacts of these expenditure cuts on household disposable income will be alleviated by income tax cuts. In 2016 taxes on earned income will be eased so that the tax burden does not increase with higher earnings levels and tax progression. Employment will continue to improve in 2017, and private consumption will continue to grow at a rate of 0.8%, assuming that consumer sentiment develops favourably.

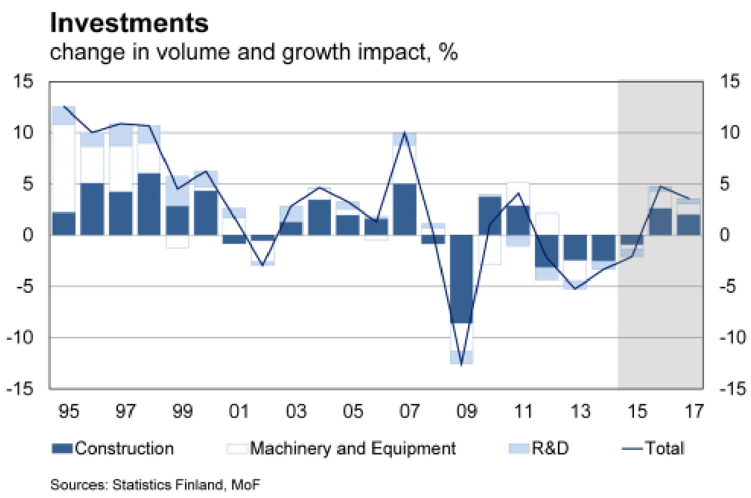
Exceptionally low interest rates coupled with improving employment will uphold household borrowing propensity. Household indebtedness will also increase as a result of their taking advantage ofloan repayment holidays. Indeed over the outlook period household debt will increase slightly more rapidly than disposable income. As a consequence the household debt ratio will rise to 123% in 2017. The slight increase in interest rates towards the end of the outlook period will not suffice to curb the growth of household debt.

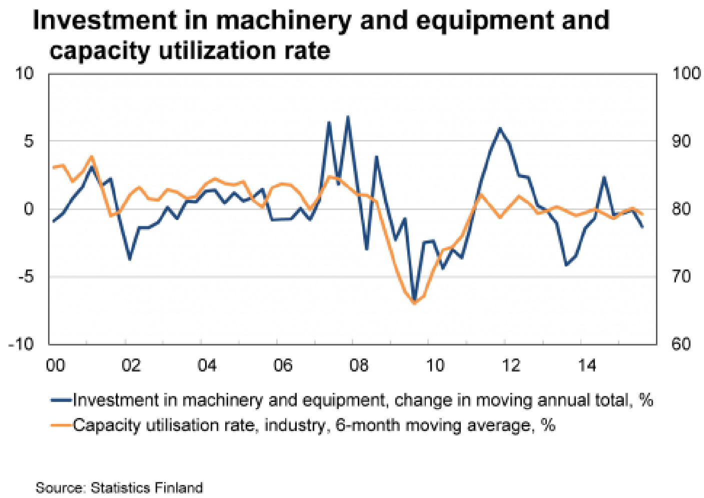
Private investment growth accelerates in 2016

National accounts figures show that investment has declined more than expected in 2015, and therefore the forecast needs to be revised downwards. The new forecast for the current year is –2.1%. It is projected that investment growth will accelerate to around 5% in 2016, mainly on the back ofincreasing investment in production-related construction and investment in machinery and equipment. The single biggest growth factor is the EUR 1.2 billion forest industry investment project in Äänekoski. In 2017 it is estimated that the rate ofinvestment growth will slow somewhat from 2016, but in both years the GDP growth contribution ofinvestment will remain significant. At the same time the investment to GDP ratio will start rising.



Residential housing investment is becoming more heavily concentrated in the metropolitan Helsinki area and other growth centres as urbanisation continues to progress and as increasing numbers of baby boomers continue to move into flats. Even though the medium-term forecast predicts rather modest economic growth, the negative real interest rate and the slight improvement in employment mean that the number of new housing starts will continue to rise. Production-related construction investment consists of both industrial and warehouse projects and shopping centres. Planning permissions for hospitals and schools are also on the rise.





National accounts figures for civil engineering investment show very robust trends for the first three quarters of 2015, and 2015 growth is therefore expected to come in at over 3%. Civil engineering is the only investment item that will record growth in 2015. Over the outlook period it is anticipated that this growth will continue on the back ofincreasing private investment demand and increasing public investment demand in 2016–2017.

Investment in machinery and equipment will increase by as much 7% in 2016 as installation of the main equipment for the Äänekoski bioproduct mill gets underway. In 2017 investment will fall back by a few quarters with the completion of this mega-investment, but the gradual recovery of exports will soon push it back to growth.

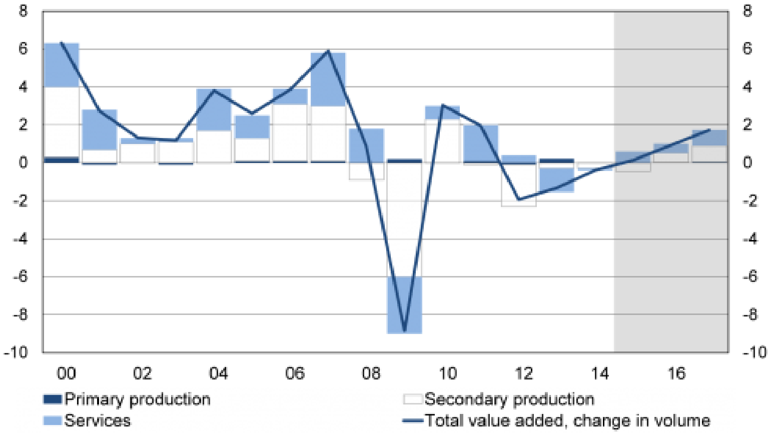
R&D investment has declined for several years in succession, and it will not return to a growth path until 2016. Even then growth will be modest, with cutbacks in public funding having an adverse effect on the investment rate.

Growth base to extend from services to secondary production

National value added has hardly grown at all in four years. The current year therefore is no significant exception, although it is projected that output will increase by 0.1%. Following an upturn early in the year, total value added began to fall again in the autumn as both industrial production and service output contracted after the summer. Among other main sectors of the economy, only construction showed growth in the third quarter, up 0.1% from Q2.

Contribution to total production

percentage points

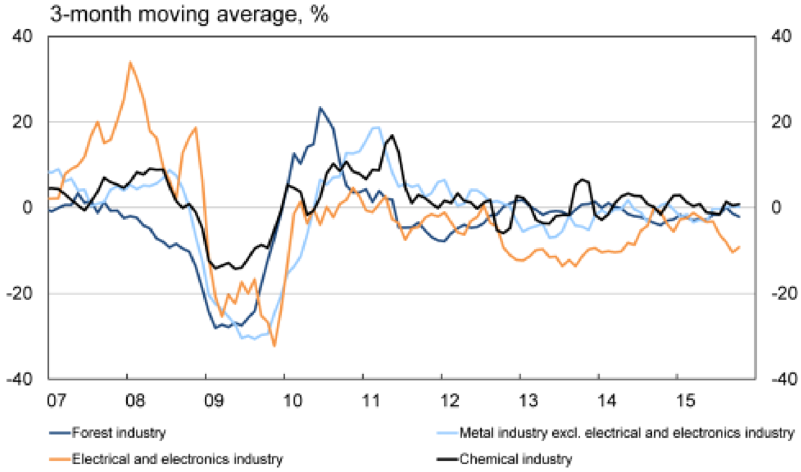


Sources: Statistics Finland, MoF

Private services and construction are helping to drive the economy back to growth. However the rebound is sluggish as it depends on the contribution of only a few branches. In 2015 economic activity is maintained only by a few private service branches and primary production. Declining value added in industrial sectors, on the other hand, is contracting the economy. Accelerating global trade and growing demand for investment goods will drive output to growth of around one per cent in 2016 and just over one and a half per cent in 2017. The restructuring of production especially in the electronics and partly in the forest industry will act to slow growth, despite the improvement in export demand.

Volume index for industrial production

3-month moving average, %



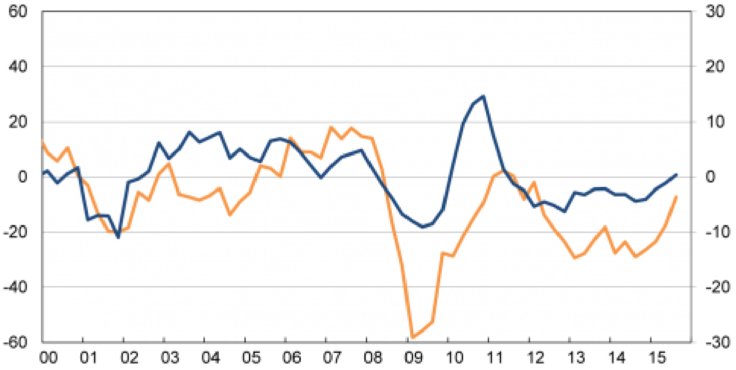
Source: Statistics Finland

The cyclical outlook for industry remained stable late in the year. Output expectations improved only marginally from the autumn, and therefore growth over the next few months will be scarce and sporadic. The number of companies expecting to see growth is highest in the food and chemical industries, while those anticipating decline are mostly concentrated in the textile and wood industries. Rebounding export demand and the weakening external value of the euro are expected to boost industry output in the future. In 2015 industry value added will still fall by over 2%, but in 2016 and 2017 it is set to rise by around 2% and 3%, respectively.

The outlook for construction and production expectations have improved significantly during the course of the year. The number of new orders increased in the third quarter, which brought a double-digit increase in the number of planning permissions. This broad-based growth bodes well for both renovation and new building construction especially on residential building in the growth centres, on public projects and on production-related construction activities. In 2015 construction value added will fall for the fourth year in a row, this time by ½%. In 2016 and 2017 building construction will increase by 2% and 3% on the back of rebounding new housing production.

Confidence and production in construction

balance and change yoy, %



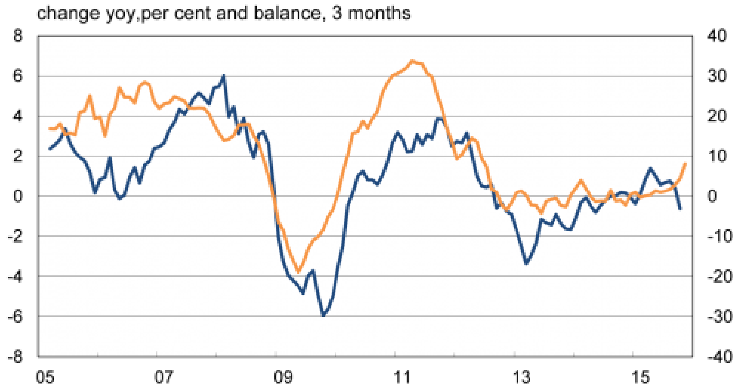
Confidence indicator for construction — Value added in construction, volume

Sources: Statistics Finland

Sales expectations in services have shown a significant improvement towards the end of the year. One in six service companies are expecting to see growth in the next few months ahead, particularly in the financial intermediation and insurance sector and in information and communication services. On the other hand, sales are anticipated to fall in the hotels and restaurant sector, and the sluggish development of household purchasing power lends no support to wholesale and retail trade. In 2015 and 2016 service production will increase by almost one per cent, and in 2017 by around 1½%.

Service production

change yoy,per cent and balance, 3 months



Trend Indicator of Output, services (left scale)

Services confidence (right scale)

Sources: Statistics Finland, European Commission

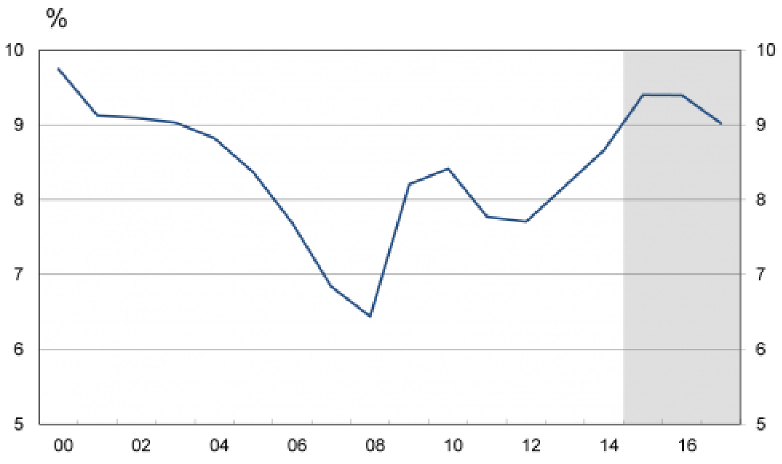
Employment, prices and wages

Deterioration of employment has slowed

The number of persons employed fell rapidly early in the year, but in September–October employment has actually returned to marginal growth. In January–October the number of persons employed was 0.3% lower than during the corresponding period last year. It is projected that the final 2015 figure for persons employed will be slightly lower than last year.

Unemployment increased fairly rapidly in the early part of year, but in the autumn the growth of unemployment has slowed according to both Statistics Finland's sample-based Labour Force Survey and the employment service statistics compiled by the Ministry of Employment and the Economy. In October the trend of the unemployment rate was 9.3%. Figures for the early part of the year were higher and therefore the projected unemployment rate for the whole year is 9.4%.

Unemployment rate



Sources: Statistics Finland, MoF

Employment will return to moderate growth and unemployment will begin to slowly edge down with GDP growth in 2016 and 2017. Nonetheless unemployment will remain high throughout the outlook period. In 2016 and 2017 it is predicted that employment will improve by 0.4% a year. In 2016 it is expected that the unemployment rate will remain unchanged from this year, but in 2017 it will edge down to 9%.

The growth oflong-term and structural unemployment has slowed since early 2015, but the situation remains serious. In October the number of people who had been out of work for more than a year was 113,000, almost 20,000 more than the year before. According to employment service statistics the number of structurally unemployed people in October was 206,000, again almost 20,000 more than one year earlier. Even under improving cyclical conditions the high level of structural unemployment will slow the decline in unemployment.

Apart from the lingering weakness of the economy, another obstacle to an improvement in the employment situation is presented by regional and occupational mismatch problems between unemployed job seekers and job vacancies. Both Ministry and Statistics Finland data indicate that the number ofjob vacancies has increased this year, but this has not reduced the number of unemployed persons. This is an indication of weakened labour market performance.

In the current year unemployment has been more evenly distributed across all regions and occupational groups. Likewise, unemployment has increased more evenly at different educational levels. In fact in recent months unemployment has increased more rapidly in higher educated groups.

Figures for both the employment rate and the labour participation rate convey the worrying message that employment has recently fallen most particularly in the age group 25–54 years. The growth oflong-term unemployment has also been fastest in this age group. In the oldest age groups both the employment and labour participation rates have risen, which is good news because these age groups represent a growing proportion of the population.

Besides restructuring the labour market, efforts to raise the employment rate should focus on preventing retirement on disability pension and promoting well-being in the workplace. The mechanism known as the unemployment pathway to retirement, under which employees are eligible to receive extended earnings-related unemployment security, provides an incentive for employers to lay off older employees before they have reached retirement age, which runs counter to the goal of promoting employment.

The number of people working part-time in Finland is relatively low by international comparison, and it seems that a significant improvement in the employment rate can only be achieved through increased part-time employment. Increasing full-time employees' working hours, by contrast, may actually have the effect of reducing the employment rate under conditions of weak labour demand.

Figures for unemployed job seekers registered with employment offices and Statistics Finland's sample-based Labour Force Survey give a slightly different picture of the level and trends of unemployment. At the moment the discrepancy between the two sets of figures is further accentuated by the fact that some unemployed people have given up their active search for work because of the poor economic situation. The Statistics Finland concept of unemployment is based on the criterion of active search for work, and the inactive unemployed are classified in the Labour Force Survey as 'disguised unemployed'. Changes in statistical methods and legislation also contribute to explain the differences between the two sets of figures.

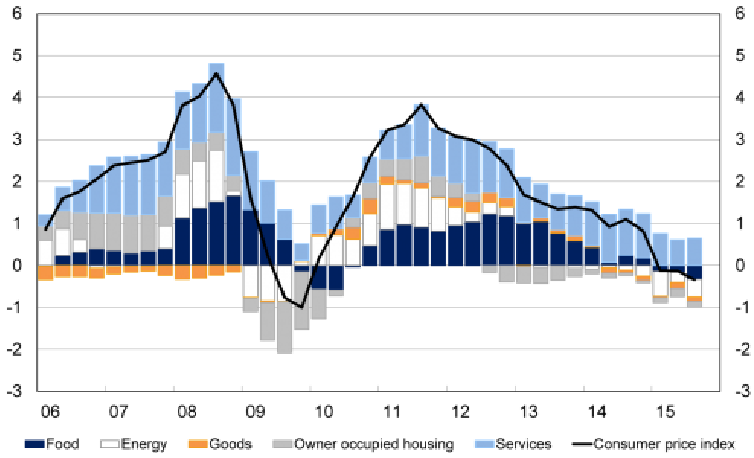
Prices still rising slowly

There is less inflationary pressure than usual over the outlook period because there is an abundance ofidle resources in the economy, the output gap is still clearly negative and because future inflation expectations are moderate. The forecast is based on assumptions of slight increases in the price of oil, a halt in the decline ofimport prices, moderate wage increases and low but gradually rising interest rates.

Inflation began to slow towards the end of last year following the sharp drop in world market prices of oil. In early 2015 the world market price of oil has been clearly lower than last year, and for this reason consumer prices decreased by 0.3% in October from the year before. This is the first time that consumer prices have fallen in Finland since January 2010, in the wake of the international financial crisis.

In 2015 it is expected that consumer prices will remain more or less unchanged from last year. It is projected that prices will fall by 0.1% as measured by the national consumer index. There are several reasons for the slower than usual movement of consumer prices, but the single biggest reason is the sharp fall in the price of oil. It is thought that the average price of oil in 2015 will be just 48 euros a barrel, which will appreciably reduce consumer prices of domestic energy.

Consumer price index
percentage change and contribution to change



Sources: Statistics Finland, MoF

The low price of energy is not the only factor curbing inflation. Weak demand and lowered import prices have also had the effect of reducing prices of goods. Furthermore, it is possible that second-round effects offalling oil prices have played some role. Service prices will rise more slowly than before because of moderate wage growth. In recent years service prices have been rising at a rate of almost 3%, much more rapidly than in the euro area on average (1½%), but this has now slowed to less than 2%.

Tax hikes and rising service charges will drive up price levels over the outlook period. Several indirect taxes, including the tobacco tax and annual vehicle tax, have been raised during the current year. It is predicted that in 2015, indirect tax hikes will increase the national consumer price index by around 0.3 percentage points. In 2016 tax hikes will push up inflation by as much as 0.6–0.7 percentage points. Further increases to indirect taxes will drive up inflation by 0.2 percentage points. The decision to increase the annual ceiling for social and health care client fees by almost 30 per cent will increase inflation by 0.2–0.3 percentage points depending on whether local authorities decide to raise their fees by the full amount or only in part by a selected amount. Furthermore, cuts to the allowances and benefits paid out by the Social Insurance Institution Kela will drive up consumer prices by 0.2 percentage points in 2016.

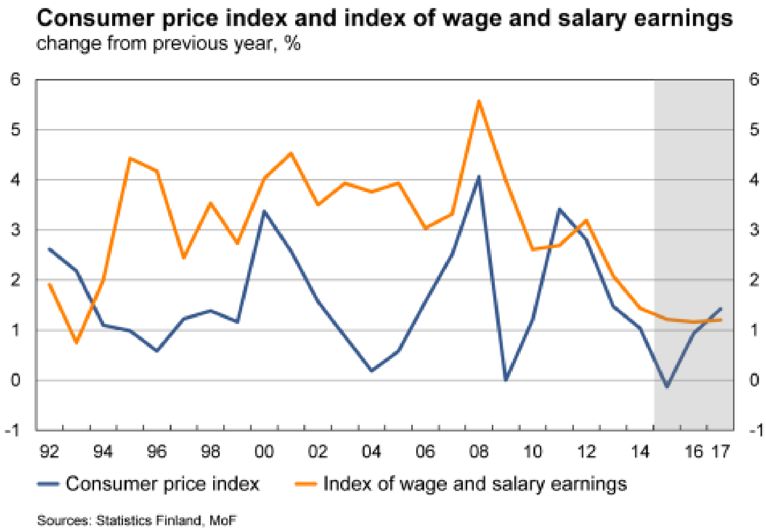
Inflationary pressures will remain lower than usual over the next two years. Inflation will gradually pick up over the outlook period as economic growth gets back on track and the output gap narrows. The output gap will nonetheless remain wide and unemployment will fall only slowly, and therefore inflation will be slower than usual. The rate ofinflation measured by the national consumer price index will edge up to 0.9% next year with rising service prices. In 2017 inflation will come in at 1.5%. The harmonised consumer price index will rise somewhat more slowly towards the end of the outlook period as the slight increase in the interest rate is not directly reflected in this index.

Earnings to rise moderately

Nominal earnings, as measured by the index of wage and salary earnings, increased by 1.4% last year. Contractual wages increased by 0.7% and other factors pushed up the index of wage and salary earnings by 0.7%.

In 2015 earnings will develop in line with the framework agreement negotiated by the social partners in autumn 2013. The Pact for

Employment and Growth will push up contractual wages by an average of 0.5%. It is estimated that the most recent framework agreement negotiated in June 2015 will increase contractual wages on average by 0.5% in 2016.



The forecast for the development of earnings assumes that the contribution offactors other than contractual wage increases will drive up earnings by 0.7% a year. Therefore it is predicted that nominal earnings will increase by 1.2% in 2015. It is assumed that moderate earnings growth will continue in 2016 and 2017, rising at a rate of 1.2% in both years. This is clearly below the average of the 2000s, and well in line with the sluggish economy and slow employment trends.

Public finances

Public finances set for very slow recovery

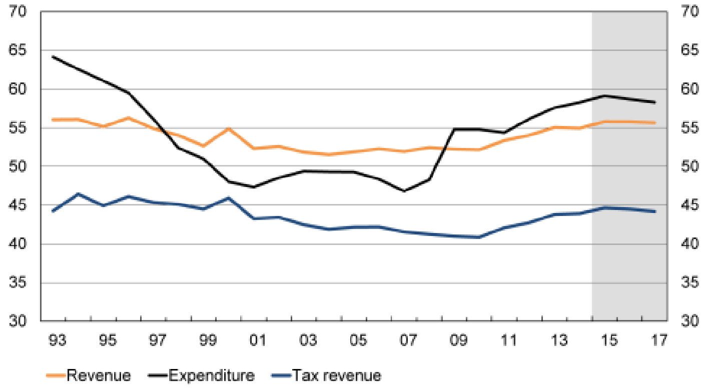
Sluggish economic growth and economic restructuring, coupled with the growth of expenditure caused by population ageing have driven Finland's general government finances into a state of permanent deficit. General government will remain in deficit throughout the outlook period, even though the deficit will shrink in response to immediate spending cuts. The growth of expenditure resulting from population ageing is affecting local government finances in particular.

Economic growth will remain sluggish in the immediate future, to the extent that this growth will not be enough to correct the imbalance in public finances. In 2014 Finland's budgetary deficit exceeded the 3% of GDP reference value. However the current estimate is that during the outlook period, the deficit will fall somewhat below that threshold. Central government and local government are firmly in deficit, the earnings-related pensions sector is in surplus and other social security funds marginally in deficit.

General government debt to GDP will continue to rise and reach a level unprecedented in recent history. The expenditure rate or public expenditure to GDP is being driven by age-related as well as unemployment-related expenditure. On the other hand, spending adjustment measures will contribute to reduce the expenditure rate from 2016 onwards. The tax rate, i.e. the ratio of taxes to GDP, will remain somewhat unchanged over the outlook period.

General government revenue, tax revenue and expenditure

relative to GDP, %



Sources: Statistics Finland, MoF

Despite the sluggish economy, central government finances are set to improve in 2015. This is above all attributable to the adjustment measures taken by the previous government. However, given the continued economic downturn, central government will remain deep in deficit in the next few years, even though the spending adjustments announced by the current government will help to reduce that deficit. It is projected that central government revenue will increase by 1.0% in 2016 and expenditure by 0.5%. Increasing immigration and the growing number of asylum seekers will further add to the central government's expenditure burden both this year and next. State debt is set to exceed the EUR 100 billion mark, and there are no signs of a reversal in this trend over the outlook period. However, low interest rates mean that for the time being at least, interest expenditure on state debt is quite moderate. Apart from the existing debt stock, the stock of state loan guarantees is growing rapidly and now stands at over EUR 40 billion. There are big risks related to the interest expenditure and loan guarantees.

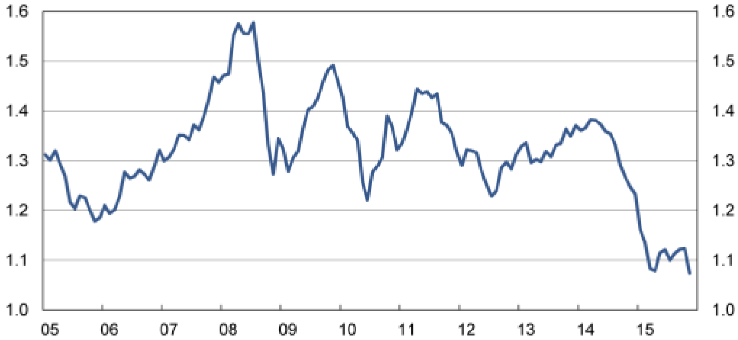
Local government finances will show a deficit of almost 1% to GDP over the outlook period. Municipalities will continue their adjustment efforts and try to keep the growth of expenditure based on the ageing population in check. Direct adjustment measures set out in the Government Programme for the local government sector coupled with moderate cost trends will also help to curb expenditure growth. Local government tax revenue will decrease in 2016 with the expiry of the temporary increase in the share of corporate income tax revenue paid to local governments. In addition, the average municipal tax rate will rise much less in 2016 than in earlier years. Despite the adjustment measures, local government finances will remain tight over the outlook period as expenditure on service provision is set to rise sharply with population ageing. The estimate for local government finances is a pressure projection that does not take into account municipalities' own adjustment measures for 2017.

The surplus of earnings-related pension funds will fall from 1.7% of GDP last year to slightly over one per cent in 2015–2017. The increasing number of pensioners and the higher average level of pensions will continue to drive up pension expenditure. The previous government's decision to cap pension indexations at 0.4% will curb the growth of pension expenditure in 2015. At the same time, the transfer of EUR 500 million from the State Pension Fund to central government will bring a one-off increase to the fund's expenditure. Rising private sector pension contributions will keep revenue from contributions on an upward trend in 2015, despite slow wage bill growth. The private sector pension contribution will be raised again in 2017. Although the value of pension assets has recently risen sharply, pension funds' property income will remain unchanged in 2015 because offalling interest rates. However it is expected that interest revenue will turn to moderate growth next year.

The deficit of other social security funds will increase in 2015 with the continuing growth of unemployment expenditure. The deficit will begin to shrink next year as the unemployment insurance contribution collected from employers and employees is increased in all by one percentage point. In 2017 other social security funds will still run a deficit, but move close to balance as unemployment expenditure begins to fall. The savings decisions taken by the previous and the current government will curb the growth of other social security funds' expenditure during the outlook period.

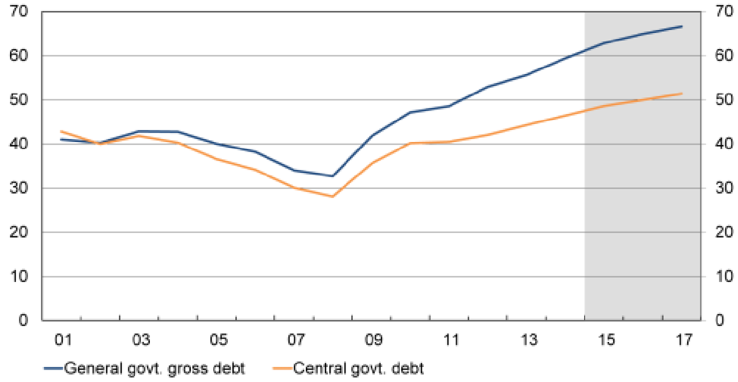
Additional graphs

Exchange rate
EUR/USD



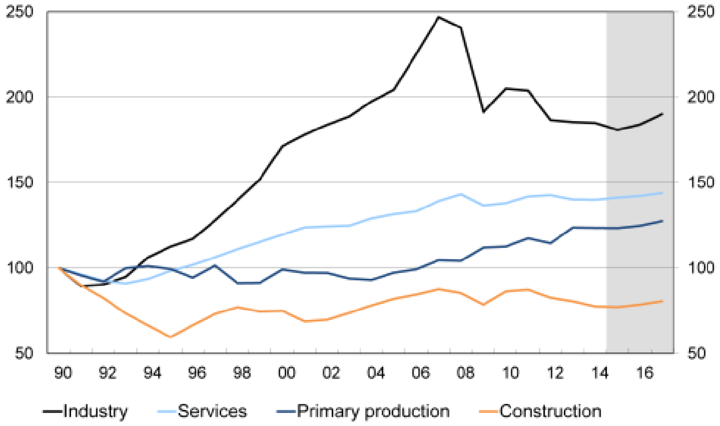
Source: European Central Bank

General government gross debt and central government debt
relative to GDP, %



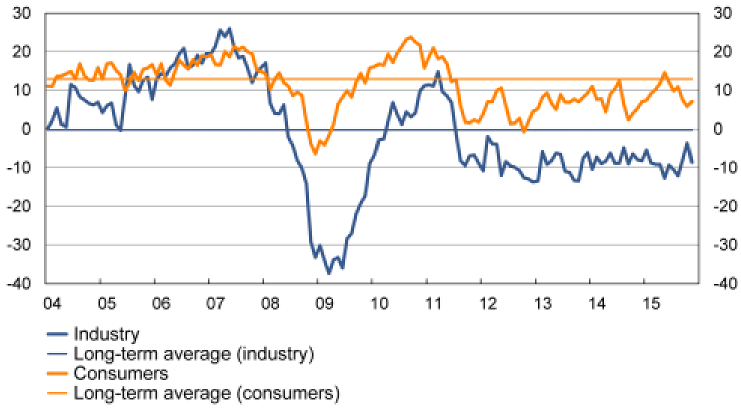
Sources: Statistics Finland, MoF

Production
1990=100



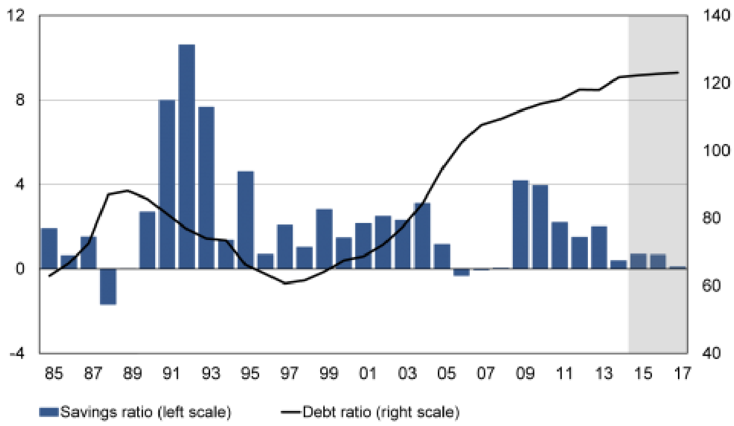
Sources: Statistics Finland, MoF

Industry and consumer confidence
balance, seasonally adjusted



Source: European Commission

Household savings and debt
% of disposible income



Sources: Statistics Finland, MoF

Short-term interest rates and real housing prices
% and change yoy

Sources: Reuters, Statistics Finland

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