Economic Survey

Winter 2014

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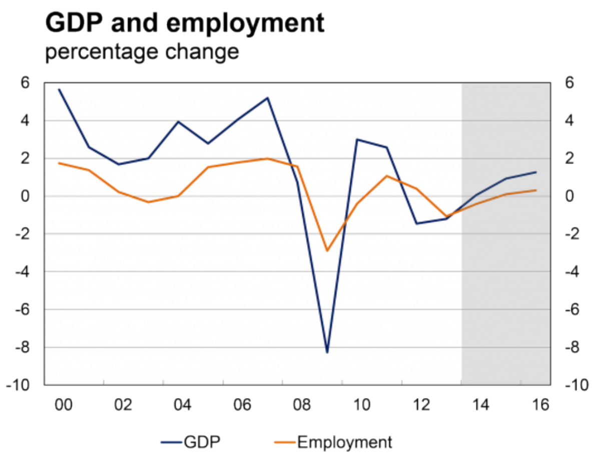
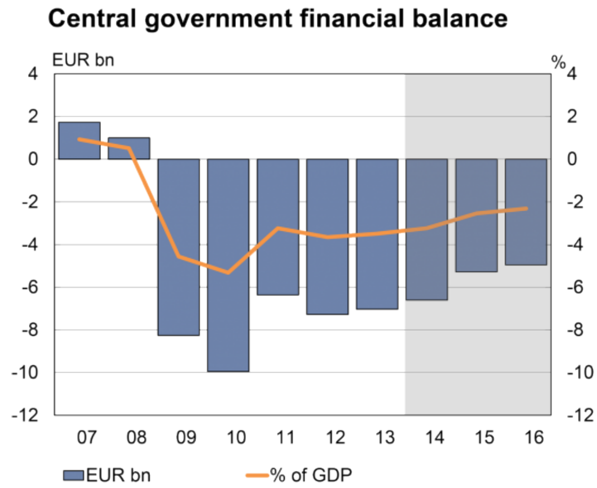
Summary

- Underlying this forecast is the assumption that growth will be very moderate in Q4 2014. The projection for annual GDP growth in 2014 is 0.1%. The labour market will continue to weaken, and the unemployment rate will rise to 8.6%.
- In 2015 growth will pick up to 0.9% and become more broadly based. Exports growth will continue to be slower than world trade growth, and therefore the loss of market shares will continue. In 2016 economic growth is predicted to reach 1.3%.
- The structure of unemployment is increasingly difficult. Compared to 2013, the number oflong-term and structurally unemployed has increased sharply, and it is expected that these numbers will continue to rise in 2015. In October 2014, more than 93,000 people had been registered as unemployed job seekers for more than a year.
- Public finances are in deficit for the sixth year in succession. The deficit will shrink in 2015 in response to adjustment and the slight economic rebound. Nevertheless the deficit is still substantial, and the general government debt to GDP ratio is set to breach the 60% threshold.
- The main domestic risks continue to come from the development of the real economy. An improvement of public finances is only possible under conditions offavourable real economic development. If the economy remains on its projected growth track, it will not recover on its own accord. Finland must urgently put structural reforms in place in order to maintain the credibility ofits economic policy and to boost growth potential over the medium term.
- All future forecast publications from the Economics Department will appear under the title of Economic Survey. As before, the surveys will come out four times a year.



Sources: Statistics Finland, MoF



Source: Statistics Finland, MoF

Key forecast figures

	2013* EUR bn	2011	2012*	2013*	2014**	2015**	2016**
		change in volume, %					
GDP at market prices	201	2.6	-1.5	-1.2	0.1	0.9	1.3
Imports	78	6.0	1.3	-3.2	0.0	2.6	4.0
Total supply	**280**	**3.5**	**-0.7**	**-1.8**	**0.1**	**1.4**	**2.0**
Exports	76	2.0	1.2	-2.3	1.7	3.3	4.2
Consumption	161	2.0	0.3	0.0	0.1	0.3	0.7
private	111	2.9	0.1	-0.7	0.0	0.3	0.8
public	50	-0.1	0.7	1.5	0.3	0.2	0.6
Investment	43	4.1	-2.5	-4.8	-4.4	0.9	3.2
private	34	3.8	-3.3	-6.8	-5.3	1.0	3.9
public	8	5.4	1.6	4.4	-0.8	0.5	0.4
Total demand	**281**	**3.4**	**-0.7**	**-1.4**	**-0.3**	**1.4**	**2.0**
domestic demand	204	4.0	-1.4	-1.1	-1.1	0.6	1.2

Other key forecasts figures

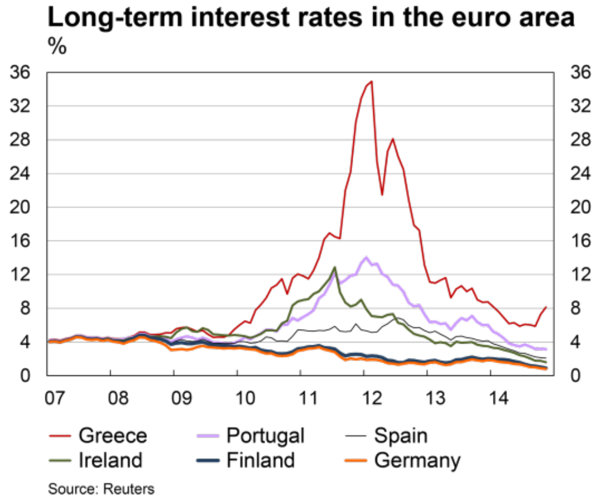
	2011	2012*	2013*	2014**	2015**	2016**
Services, change in volume, %	2.8	0.5	-1.1	0.7	1.3	1.8
Industry, change in volume, %	-0.6	-8.4	-2.0	-0.9	1.6	2.2
Labour productivity, change, %	1.0	-2.1	0.6	0.6	0.8	1.3
Employed labour force, change, %	1.1	0.4	-1.1	-0.4	0.1	0.3
Employment rate, %	68.6	69.0	68.5	68.4	68.6	68.9
Unemployment rate, %	7.8	7.7	8.2	8.6	8.8	8.6
Consumer price index, change, %	3.4	2.8	1.5	1.1	0.8	1.7
Index of wage and salary earnings, change, %	2.7	3.2	2.1	1.4	1.2	1.5
Current account, EUR bn	-3.5	-3.9	-2.9	-3.2	-2.7	-2.7
Current account, % of GDP	-1.8	-1.9	-1.4	-1.6	-1.3	-1.2
Short-term interest rates (3-month Euribor), %	1.4	0.6	0.2	0.3	0.1	0.2
Long-term interest rates (10-year govt. bonds), %	3.0	1.9	1.9	1.5	0.8	1.2
General government expenditure, % of GDP	54.4	56.3	57.8	58.5	58.5	58.1
Tax ratio, % of GDP	42.1	42.9	44.0	44.5	44.7	44.7
General government net lending, % of GDP	-1.0	-2.1	-2.4	-2.7	-2.6	-2.1
Central government net lending, % of GDP	-3.2	-3.7	-3.5	-3.2	-2.5	-2.3
General government gross debt, % of GDP [1)]	48.5	53.0	56.0	58.9	61.1	62.3
Central government debt, % of GDP	40.5	42.2	44.6	46.6	48.0	48.7

[1)] Public debt is estimate by the Ministry of Finance also for years 2011, 2012 and 2013 due to the statistics revision.

Introduction

Recent trends in the global economy present a dual picture. The growth outlook for the United States and the UK is strong: projections are that both these countries will reach growth of around 3% in 2015. In China, on the other hand, growth is projected to slow over the outlook period: the forecast for 2016 predicts a growth rate of less than 7%. The economy in the euro area is expected to remain muted. In 2014 growth will come in at around one per cent, and the forecast for 2015 is only marginally better. The growth outlook in Germany has weakened, and over the next two years growth will struggle to reach 1½%. Sweden will continue to show faster growth than the euro area.

Given the continuing climate of instability, the declining external value of the rouble and falling energy prices, the Russian economy will see no growth in 2014, and over the next two years it is expected to contract. This will be reflected in reduced Russian imports, and therefore it is predicted that Finnish trade with Russia will decline over the next couple of years.



* Download image as a scalable pdf-file.[5]

The assumptions underlying the current outlook are supportive of growth. Both short-term and long-term interest rates are expected to rise very moderately throughout the forecast horizon, i.e. until 2016. In 2016, the three-year Euribor rate is predicted to average 0.2% and the ten-year interest rate 1.2%. The euro to dollar exchange rate is anticipated to fall and stand at around 1.1 at the end of 2016. Oil and other raw materials prices are expected to continue to fall. In 2016 the price of crude oil will average around USD 80 a barrel.

According to Statistics Finland's preliminary quarterly national accounts figures, the Finnish economy recorded growth of 0.2% from Q2 to Q3 2014. The Q2 growth figure was also revised upwards. Assuming zero GDP growth in the last quarter of the year, annual total output in 2014 would still be higher than last year. Underlying the projection is the assumption of very moderate

[5] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Long_term_interest_rates_in_the_euro_area_242752.pdf

growth in Q4 2014, and therefore the forecast for annual GDP growth is 0.1%. Net exports have a positive effect on the forecast for the current year. Private consumption will show zero growth in 2014, and private investment will decline. The labour market will continue to deteriorate, and the unemployment rate will edge up to 8.6%.

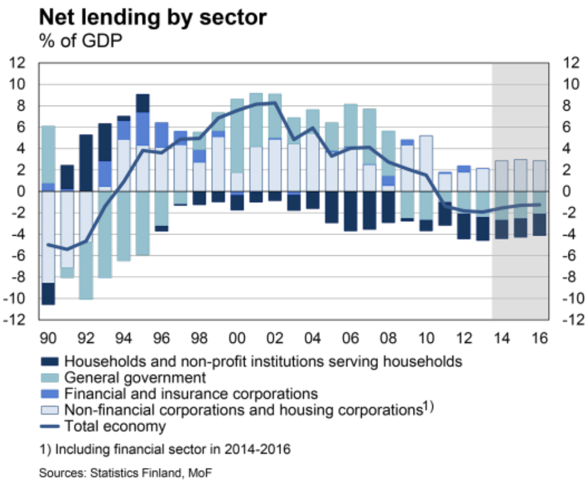
* Download image as a scalable pdf-file.[6]

In 2015, growth is expected to come in at 0.9% and to become more broadly based. Private consumption will edge up by 0.3%, even though household real disposable income will show virtually no growth. The household savings rate will fall slightly towards the end of the outlook period, and the growth of household debt will come to a halt. Exports growth will remain slower than world trade growth, and therefore market shares will continue to decline. Sluggish domestic demand will slow the growth of imports. Private investment will pick up to some extent, mainly on the back of recovering investment in machinery and equipment and R&D investment.

The labour market will deteriorate in 2015. The unemployment rate is projected to climb to 8.8%. The share of the long-term unemployed is continuing to rise, and therefore structural unemployment will continue to grow. Despite the pick-up in economic activity, the mismatch between the demand and supply of labour means that the long-term unemployment problem will persist. Labour productivity growth will be sluggish, increasing by no more than 0.8%. Inflation will come in at 0.8%.

In 2016, the economy is projected to grow at 1.3%. Domestic demand will be a stronger driver of growth than in earlier years. Private consumption growth will accelerate to close to one per cent with the improving employment situation and rebounding household confidence. It is projected that private investment will recover to growth of 4%. In 2016, it seems that overall investment in building construction will also increase. Net exports will have a lesser effect on economic growth than in the two previous years. Downward trends in both the service balance and the factor incomes and current transfers balance mean that the current account will remain in deficit throughout the outlook horizon. The employment rate will improve somewhat, but still remain well below 70%.

[6] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Contribution_to_GDP_Growth_in_Finland_242811.pdf



* Download image as a scalable pdf-file.[7]

The protracted downturn means that general government finances will remain in deficit, although adjustment will help to bring the deficit in check. The general government budgetary position is furthermore weighed down by expenditure growth resulting from population ageing, particularly in the local government sector. The sluggish rate of economic growth over the immediate future will not alone be enough to correct the imbalance in public finances. It is estimated that the general government deficit will remain below the 3% reference value, but the debt ratio is set to exceed the 60% threshold.

The risks of the forecast remain skewed to the downside. Recovery in the euro area has proved to be a painful process, and there are marked differences between individual member states. Recent data on the euro area real economy have been less than encouraging, and the financial position in general governments will hold back growth in the immediate future. If the modest rate of economic growth is compared with the economic recovery in the United States, for instance, it is clear that the problems in the euro area are not just cyclical, but there is a real need for restructuring. Structural reforms designed to bolster competitiveness are needed sooner rather than later because it will take some time for their effects to filter through to the real economy. The situation in the financial markets has eased, but it will take some time to defuse all the known risks.

The domestic risks still stem from the development of the real economy. An improvement in public finances is only possible under conditions of favourable real economic development. If the economy remains on its projected growth track, it will not recover on its own accord. There is an urgency now for Finland to put structural reforms in place in order to maintain the credibility of its economic policy and to boost growth potential over the medium term. In a small open economy, it is paramount to enhance the efficiency of the labour market because international competition cannot be avoided. The availability of labour and all production-related input costs will have a critical role in the competition for market shares.

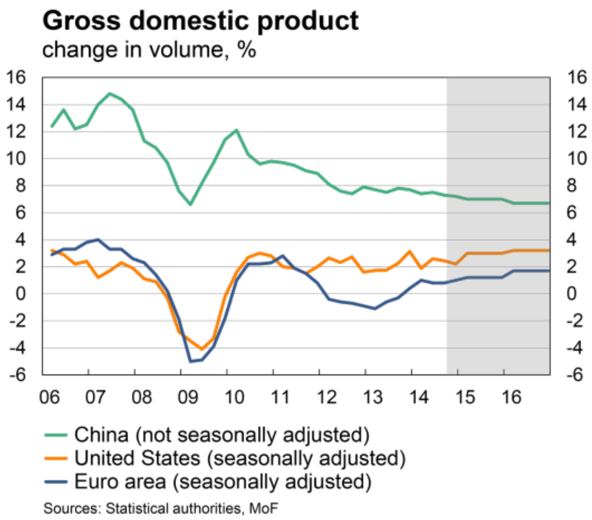
The Ministry of Finance Economics Department has taken the decision to have just one name for all its forecast publications. The Economic Bulletins published in the spring and autumn and the Economic Surveys that come out in the spring and winter will henceforth all be called Economic Surveys. Timetables will remain unchanged.

[7] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Net_lending_by_sector_264842.pdf

Global economy

Recovery overshadowed by geopolitical risks

Growth prospects in industrial countries are overshadowed by geopolitical tensions in Russia, the Middle East and elsewhere. So far, however, confidence has not deteriorated to the same extent as in some earlier political and currency crises. The core drivers of global economic growth are the United States and the UK, which are now shrugging off the long shadow of the financial crisis. The rebound in these countries is supported by improved private sector balance sheets, extremely slack monetary policy and less aggressive fiscal policy adjustment. In many developing economies, by contrast, growth over the forecast horizon will be significantly slower than usual.



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It will be difficult for Russia to avoid recession this year and next, even though the state can resort to a stimulus policy to boost demand, for instance. The sharp fall in oil prices and escalating uncertainty have driven up interest rates, weakened the rouble and accelerated inflation in Russia. Investment and imports will decline significantly. Even earlier, conditions for growth in Russia were held back by the country's inflexible economic system and markets as well as by the absence of innovations and growth enhancing structural reforms. As a result of the crisis the Russian economy and politics have turned in on themselves even more than before, which is further hampering the country's prospects.

In the United States, recovery is continuing but at a moderate rate compared to earlier recessions. Employment is improving strongly, and demand is maintained by very low interest rates, which mean that consumers' debt servicing costs are at historically low levels. On the other hand, high rates of long-term unemployment, the lowered labour participation rate and poor wage growth will hamper demand throughout the outlook period.

In Europe, the most promising economy at the moment is the UK, which has returned to robust growth despite substantial public sector adjustment. The fragility of growth in the euro area stems from the lingering effects of the debt crisis, even though the weakening euro is improving the prospects for recovery. In several member states growth is hampered by poor competitiveness, which is limiting supply opportunities, and by the adjustment of private sector balance sheets, which is holding back the acceleration of

[8] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Gross_domestic_product_245312.pdf

private consumption and investment. High levels of public debt will for some time limit the options available to governments when responding to possible future shocks.

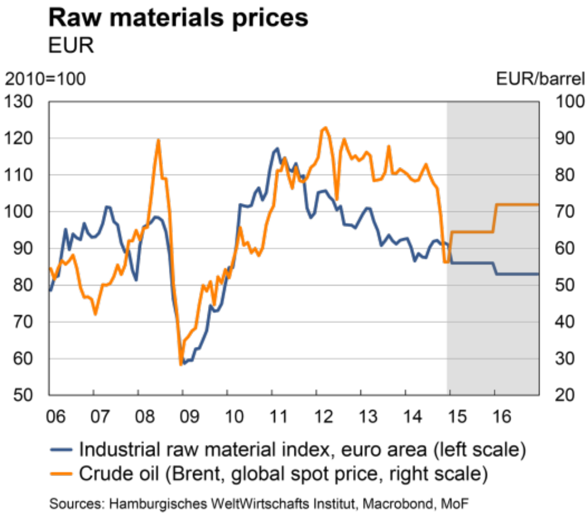
In China, economic activity is dampened by weakened demand from industrial countries and many developing economies, which cannot be fully offset by demand from the domestic market, and by sharply rising costs. Nonetheless growth will remain at around 7% throughout the outlook period, provided that the country is successful in its policy.

World trade continues to remain sluggish

At the height of globalisation in the 1990s and 2000s, imports by industrial countries typically grew at around twice the rate of output growth. This rule of thumb no longer applies in the wake of the financial crisis. In recent years world trade has grown at more or less the same rate as output, partly because of weak investment demand. Trade growth will only slowly gather momentum towards the end of the outlook period as investment demand rebounds. However, the recovery of the global economy will no longer generate in Finland the same kind of demand surge that it used to, especially as we have lost substantial market shares in world trade.

Inflation pressures moderate

Crude oil prices have fallen sharply in the latter half of 2014 following the rapid growth of supply and the reduced demand outlook in developing economies. It is expected that prices will rise only moderately over the outlook period. Prices for industrial raw materials are set to fall with the slowdown of demand in developing economies and high levels of supply.



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Inflation expectations in the financial markets are extremely low, allowing central banks to persist with an unusual monetary policy stance. Crisis countries in the euro area are struggling to avoid deflation. Although falling oil prices will lower the rate of inflation, the weakening of the euro will reduce the risk of deflation. In crisis countries interest rates on bank loans are still significantly higher than in the countries with the best credit ratings, which is deterring both consumption and investment. Interest rates will rise very slowly over the outlook period.

Risks remain on the downside

In the euro area risks are still predominantly on the downside as the recovery of households from the debt and financial crisis may take longer than predicted. Sluggish private sector

[9] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Raw_materials_prices_245342.pdf

demand for credit may push consumption or investment back onto a downward track, and the risks may even cause the crisis to flare up again. It is also unclear how seriously indebted economies will work to restore their balance sheets.

If the crisis in Ukraine persists, that would add to the climate of uncertainty and possibly increase the outflow of capital from Russia, reducing investment, further weakening the rouble and deepening the recession in Russia. In China, indebtedness and the value of homes, shares and other assets have increased rapidly. Under conditions of economic slowdown these trends may cause disruptions in the market.

Low interest rates in industrial countries and an increased willingness to take risks have steered investment flows into the housing and stock market, which may have led to overvaluation. The end of unconventional monetary policy, an incipient rise in interest rates and the strengthening of the US dollar may cause strong reactions in the financial markets.

Supply and demand

Devaluation of the euro supporting export growth

According to Statistics Finland's quarterly accounts published in December 2014, exports contracted by –0.1% from Q2 to Q3. Over the outlook period exports will return to growth, although more slowly than projected in the previous forecast. The downward movement of the euro exchange rate has the effect of supporting export growth, as exports to countries outside the euro area are greater than exports to euro countries. On the other hand, because world trade growth has slowed from the previous forecast, the growth projection for exports is also lower.

In 2015 export growth will reach 3.3% and in 2016 edge up further to 4.2%. As expected, trade sanctions had the effect of reducing Finnish exports to Russia by some 20% in August 2014 compared to the year before. Exports of products subject to trade sanctions continued to fall in September, but exports of investment goods were up from last year. Therefore the decline in overall exports to Russia was down to 6% from the year before. However, the devaluation of the rouble and the slowdown of economic activity in Russia will adversely affect the growth of Finnish exports over the outlook period.

According to the December 2014 quarterly national accounts, imports fell quarter on quarter by –1.1%. Rebounding investment and consumption will drive import growth towards the end of the outlook period. As a consequence, the contribution of net exports to GDP growth will decline during the outlook period.

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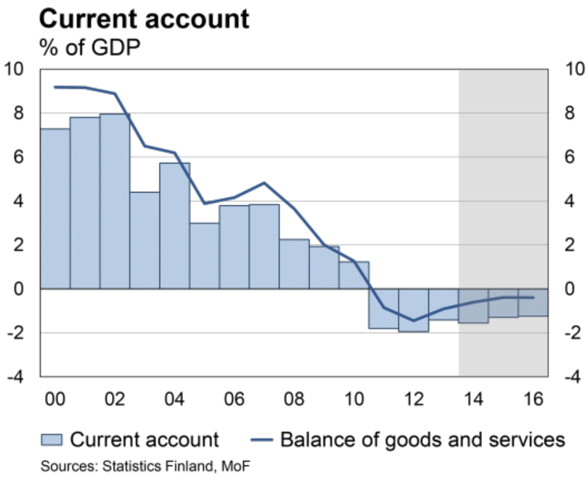
Current account moving towards balance

The current account deficit has continued to deteriorate in 2014 despite the improving trade balance, because the balance of services has moved deeper into negative territory. In Q3 2014, the current account deficit stood at 3.4 billion euros, or almost 2% of GDP. Over the outlook period the deficit will shrink by around 1.2 billion euros on the back of positive net exports. The current account balance will weaken somewhat as the factor incomes balance returns to normal in 2014. In 2016 the current account balance will still show a deficit of 2.7 billion euros, or 1.2% of GDP.

Import prices will continue to fall, but this trend has now slowed, and it is expected

[10] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/World_trade_245323.pdf

that prices will begin to rise towards the end of the year with the weakening of the euro. Falling oil prices will contribute to slow the rise in import prices. Export prices will continue to fall for slightly longer than import prices, and they will return to growth in 2015. The current account will deteriorate over the outlook period.



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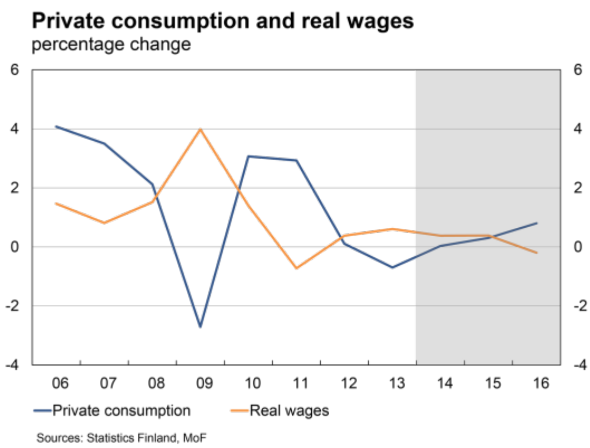
Outlook for private consumption subdued

During the autumn consumers have become increasingly cautious in their expectations. The perceived threat of unemployment has grown as employment trends have continued to weaken, and there is also greater caution about the outlook of the economy as a whole.

Expectations in the retail sector are at record lows. In January–October the volume of retail trade declined by 0.8% year on year. However, the outlook for private consumption looks brighter than in retail, among other things because of the demand for services. Retail sales are also affected by the deteriorating economic situation in Russia, which has resulted in a sharp fall in the number of visits to Finland. In January–September, the number of overnight visits by Russian tourists in Finland was down 17% from the year before. At the same time the amount of tax refunds to Russian tourists dropped by 30%.

The waning of consumer confidence in the latter half of the year is reflected in the demand for new cars. In January–November, the number of new car registrations remained unchanged from last year on the back of strong demand early in the year. Despite the uncertainty, demand for durables will develop more favourably in 2014 than other areas of consumption. Low interest rates are driving up household debt. The slight slowdown in the growth of the stock of housing loans has continued, but demand for consumer credit has risen more sharply than last year. In January–October, consumer credit increased by 4.6%. The number of persons employed will continue to fall this year, although less sharply than last year. Household real disposable income will remain unchanged. There will also be no change from last year in the volume of private consumption.



[11] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Current_account_202471.pdf

* Download image as a scalable pdf-file.[12]

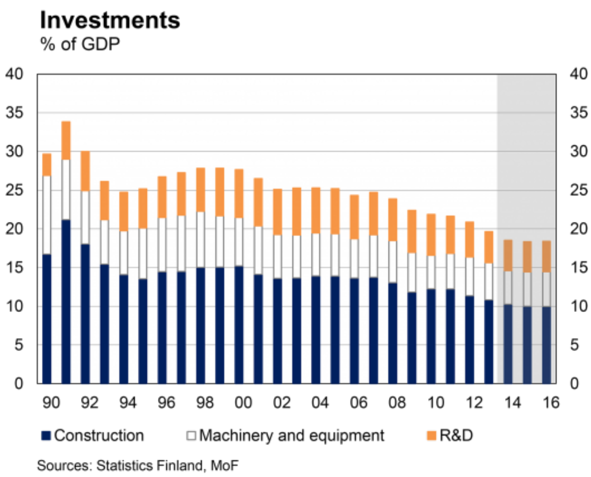
In 2015 household purchasing power will increase only marginally. It is bolstered by an exceptionally moderate trend of consumer prices on the back of falling oil prices, and by tax base changes in central government earned income taxation. The central government earned income tax scale will be revised to reflect rising earnings levels so as to prevent taxes from rising with income tax progression. However, the increase in the municipal tax rate and social security contributions will crimp consumers' spending power. On the other hand, continued low interest rates will support household purchasing power. In 2015 private consumption will increase by no more than 0.3%.

Rebounding global economic growth will gradually increase domestic economic activity through exports. At the end of the outlook period employment will improve and consumer confidence will strengthen. However, real income growth will remain slow. Precautionary saving will decrease and private consumption growth will pick up to 0.8% in 2016.

So far the decline in household confidence has had only limited effect on consumer behaviour. The risk is that if consumer uncertainty becomes protracted, household saving will increase and at once adversely affect the outlook for consumption. The increased debt burden faced by households constitutes another risk. During the past 10 years the household debt burden has almost doubled, but at the same time interest expenses have remained at an exceptionally low level. A faster-than-expected rise in interest rates would slow the growth of consumption.

Exports to drive investment growth

As the global economy has again slowed, the most recent statistics on investment also show weaker-than-anticipated trends. However, it is expected that the downturn in investment will bottom out in early 2015 on the back of favourable interest rate, exchange rate and oil price trends, pushing investment to moderate growth of close to one per cent annually. Growth is projected for all investment items in 2016. The investment-to-GDP ratio will start rising in 2016, with exports driving investment to growth of over 3%, much stronger than GDP growth.



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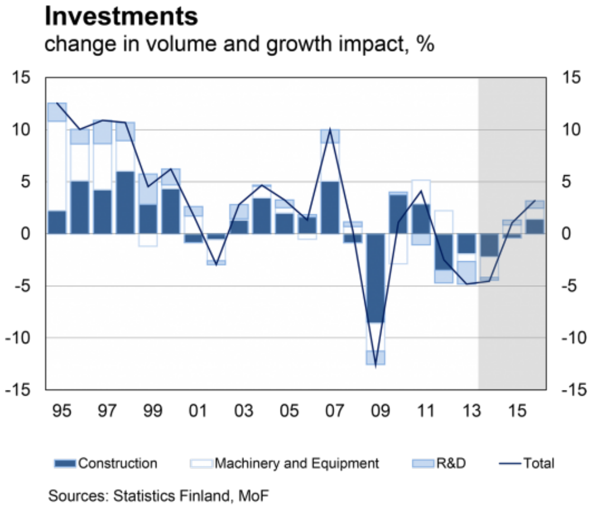
Housing investment will increase in 2015, but only marginally. This is because the backlog of unsold homes means there will be fewer new construction starts than before, and at the same time the growth of renovation

[12] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Private_consumtion_and_real_wages_242861.pdf
[13] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Uu_Investments_of_GDP_26240.pdf

projects is slowing. Low interest rates are lifting the housing market, but on the other hand the market is held back by the climate of uncertainty and fears of unemployment. Other building construction will continue to fall clearly in 2015, as planning permissions are down by almost 20% in January–August 2014. Some major individual projects are ongoing and coming up, but they are not enough to achieve growth for the whole investment item. Real estate underutilisation rates in the metropolitan Helsinki area have hovered around 12% for some time.



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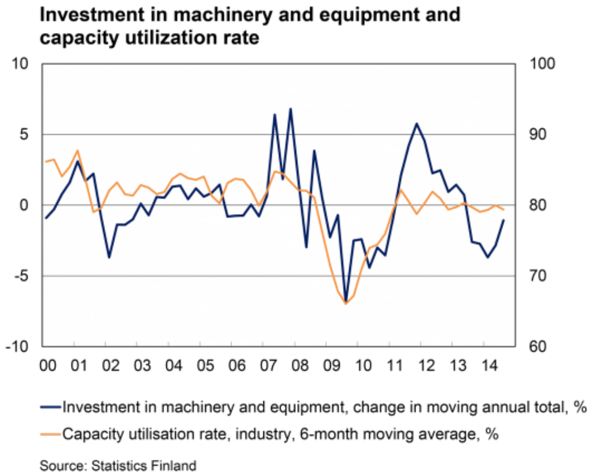
Civil engineering and land development investment will continue to fall in 2014 and 2015, albeit less sharply than predicted earlier because the forecast for local government investment is slightly higher than in the previous outlook.

In 2014 the sharpest fall in investment will be recorded for investment in machinery and equipment, which in turn will show the biggest increase in 2015. In 2014 new registrations of transport equipment have made some positive contributions, recording two-digit and in some cases even three-digit growth figures. One factor behind this trend has been the gradual introduction of LHVs or 'mega trucks'.



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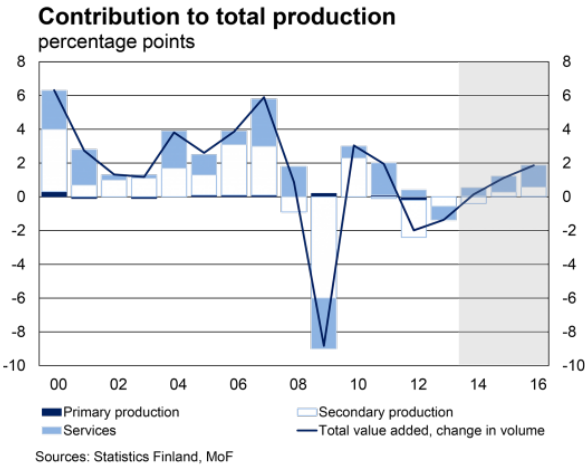
R&D investment returned to growth in Q3 2014, and it is expected to continue to grow from its low level in 2015–2016.

Output growth upheld by services, industry set to rebound

Technically, the economy has moved out of recession. In spring 2014 total output in the national economy, calculated as the sum of sectoral contributions, turned to slow growth compared to the previous quarter, and continued to grow in the summer. However this growth has remained sluggish, and it is mainly driven by a few service branches. In most other sectors output in January–September has remained lower than last year, but the growth recorded in private service branches has meant that total value

[14] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Investments_change_in_volume_and_growth_impact___24465
[15] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Investment_in_machinery_and_equiment_and_capacity_utiza

added in the economy has not fallen from the previous year. As economic growth has mainly come from lower-productivity services, overall productivity per hours worked has declined.



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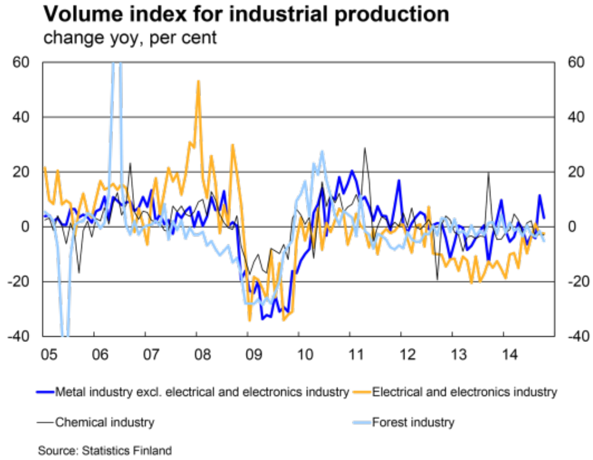
The rebound of economic growth is not uniform across industries. In 2014 growth has only been recorded in a few private sector business and consumer services, as well as in primary production and the chemical industry. Together with the metal industry, these sectors also have the best outlook for the future. Building construction has declined for 11 consecutive quarters, and based on trends in planning permissions there is no turnaround in sight this year, either. However, value added in the economy as a whole is rising and slowly gathering speed with the rebound of the global economy. Therefore average output growth in 2014 will come in at 0.1%. Next year industry will benefit from new orders and return to growth, pushing gross value added for the economy to growth of around one per cent. In 2016 building construction will also grow, and GDP growth at basic prices will approximate 2%, higher than the average for the 2000s.



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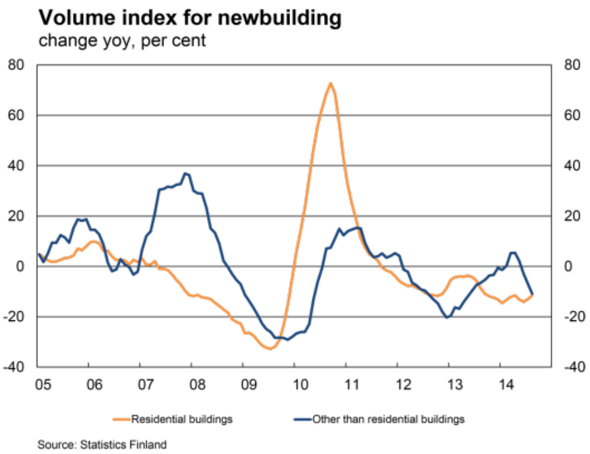
The cyclical outlook in industry is improving sluggishly. The gradual economic recovery in Finland's major export markets is increasing foreign demand. However as the share of the forest industry in the economy and production capacity in the electronics industry have both declined, the rate of industry growth will fall well short of its long-term average of almost 4%. Business tendency surveys indicate no significant improvement in conditions for industrial production, and therefore there is no major growth impetus in sight. However, the value of new orders in industry has increased in January–October this year. This is attributable in part to some major one-off orders, so the order books give no reason to expect a more broadly based increase in industrial production. In markets outside the euro area, growth prospects are benefiting from the weakening of the euro, which in 2016 will be down by two digits from the current level. The outlook is strongest in the metal industry, where production has been rising since the late summer, and order books are continuing to grow. Production is also

[16]http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Contribution_to_total_production_259051.pdf
[17]http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Volume_index_for_industrial_produktion_25057.pdf

turning to growth in the chemical industry. On the other hand, the forest industry is depressed by the dwindling global demand for paper. Indeed, value added in industry will fall by almost one per cent this year. In 2015, the pick-up in export demand will drive industrial production to growth of 1½%, and together with the currency devaluation this figure will climb to over 2%.



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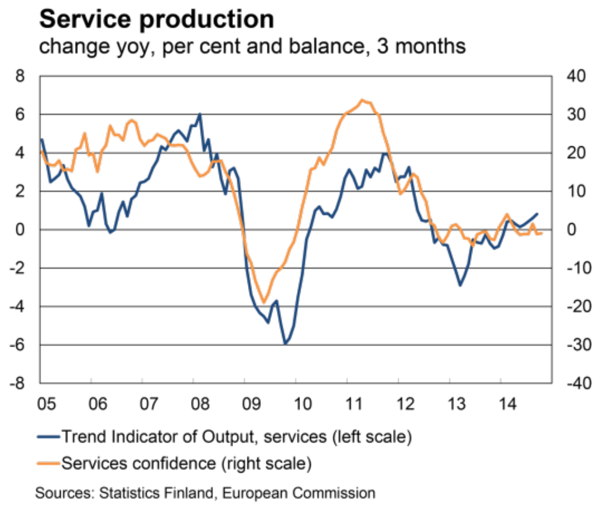
Building construction will decline as businesses and households cut back their investment. In the domestic market, new building construction is hampered by sluggish demand both in the consumer and business market. Indeed, the number of planning permissions granted has fallen by 9% in the early part of the year. The sharpest falls have been recorded for planning permissions for agricultural and public buildings. On the other hand, there are far more residential building starts in the pipeline than last year, especially for multi-storey developments in the metropolitan Helsinki area. Overall value added in building construction will fall by over 3% this year. Because of the post-cyclical nature of new building construction, this industry is usually the last to see the conditions of production change. Therefore in 2015, construction output will continue to fall by around one per cent. As growth gets under way in the rest of the economy, there will be need for increased capacity in the business and household sector. Building construction will only begin to recover more strongly in 2016, when growth will reach 2%. Renovation will be at a much higher level than new building construction, especially this year and next.



* Download image as a scalable pdf-file.[19]

Private service branches are maintaining economic growth. Businesses account for the bulk or some 70% of the demand for service production. Around half of this demand comes from industrial companies, and therefore cyclical movements in industry have a significant impact on the level of service output. This traditional order has been disrupted in 2014 as value added growth has come largely from business and real estate services. Output growth has been particularly strong in ICT industries benefiting from digitalisation as well as in the financial

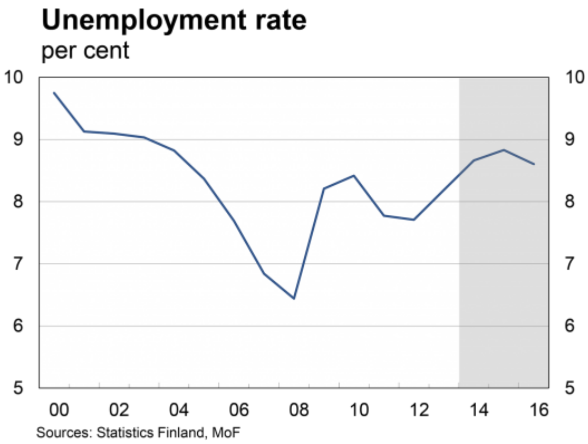
[18] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Volume_index_for_newbuilding_250682.pdf
[19] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Service_production_264462.pdf

intermediation and insurance branch. In these industries conditions for production will remain favourable. However household purchasing power will show only very slow growth, restricting demand for consumer services. Furthermore, transportation and storage services are depressed by the sluggish development of industry. In 2014 value added from services will increase by close to one per cent. Next year service production growth will edge up to around 1½% and in 2016 further to close to 2% with the expansion of the growth base for services.

Employment, prices and wages

Employment trends to remain subdued well into 2015

Employment trends have remained poor in Q2 and Q3 2014. The seasonally adjusted number of persons employed was lower than last year at the same time, falling in line with projections. Towards the end of the year, however, the fall in the number of persons employed was slower than earlier. For instance, the number of persons employed in September 2014 was higher than in September 2013. Nevertheless the number of persons employed in 2014 will remain 0.4% lower than the year before. Unemployment has continued to rise at a slightly faster rate than predicted, according to both the Labour Force Survey (Statistics Finland) and employment service statistics (Ministry of Employment and the Economy). The projected unemployment rate for 2014 is 8.6%.



* Download image as a scalable pdf-file.[20]

Economic growth is set to slow in Germany and many other key export countries in 2015, which will be reflected in employment trends in Finland, too. The economy would also be adversely affected by the prolongation or escalation of international crises. One factor working in the opposite direction is the weakening of the external value of the euro, which is helping to boost exports to countries outside the euro area. Nevertheless employment trends will remain weak throughout the outlook period. It is predicted that the number of persons employed in 2015 will be 0.1% higher than this year. The unemployment rate, on the other hand, is projected to rise to 8.8% in 2015.

Apart from the lingering weakness of the economy in general, another obstacle to an improvement in the employment situation is presented by regional and occupational mismatch problems between unemployed job seekers and job vacancies. Large numbers of jobs have been lost in traditional industries in the process of restructuring. This has adversely affected the employment situation most particularly in regions where industry has been a major employer. The unemployment rate among the higher educated has usually been much lower than in the population with a low level of education. However in recent months unemployment has also increased in higher educated groups.

The structure of unemployment is more difficult than before. Compared to 2013, the number of long-term and structurally unemployed has increased sharply, and it is projected that these numbers will continue

[20] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Unemployment_rate_242692.pdf

to rise in 2015. In October 2014, more than 93,000 people had been registered as unemployed job seekers for more than a year without interruption. The number of long-term unemployed last reached this level in January 2000. In other words, it has become increasingly difficult for large numbers of unemployed people to find work in the open labour market. Prolonged unemployment can even lead to marginalisation from the labour market. It is paramount, therefore, that steps are taken to intervene in unemployment spells at as early a stage as possible and to increase incentives for unemployed people to actively search for work. The longer the duration of unemployment spells, the greater the significance of an active labour market policy. However, the termination of an unemployment spell by labour policy measures cannot, in itself, be considered a successful intervention if upon completion of these measures the individual returns to unemployment or recurring periods of labour policy measures.

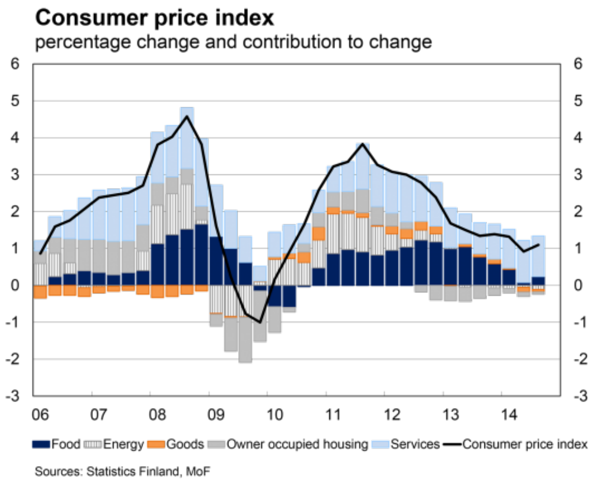
Youth unemployment is also on the rise, but by European comparison the situation among young people is not yet particularly bad. According to Eurostat data, Finland's youth unemployment rate in 2013 was around the EU average, and the long-term unemployment rate was in fact the lowest of all. On average, young people have shorter unemployment spells than other unemployed groups. On the other hand, although long-term unemployment is relatively low among young people, it is noteworthy that the picture changes somewhat when the amount of time spent in active labour policy measures is taken into account. Furthermore, the youth guarantee scheme requires that an active option is offered to all young people under 25 and all newly graduated youths under 30 within three months of the onset of unemployment. This option should preferably be employment in the open labour market or enrolment in the education system. Young people are more mobile than other groups in the labour force, both occupationally and geographically. Young people are keener than other age groups to start training and to move for job opportunities. The proportion of young people not in employment, education or training (the NEET rate) in Finland is lower than the EU average. Nevertheless it is important that special attention is given to young people's employment situation as research has shown that experiences of unemployment in the early stages of employment will have adverse effects at later career stages.

Figures for both the employment rate and labour participation rate convey the worrying message that employment has recently fallen most particularly among people in their prime working age, i.e. 25–54. In the oldest age groups both these rates have risen, which is good news because in the future these age groups will account for a growing proportion of the labour force. Efforts to raise the employment rate among people in their prime working age should concentrate on preventing retirement on disability pension and enhancing well-being in the workplace. In the case of the youngest age groups it might also be useful to explore ways of shortening study times.

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 development of unemployment. Figures for employed job seekers compiled by the Ministry of Employment and the Economy are usually somewhat higher than those given by Statistics Finland. On the other hand, Statistics Finland figures for youth unemployment tend to be higher than the Ministry's figures: people under 25 more often look for work without registering with the employment office. In older age groups, by contrast, Ministry figures are almost always higher. The gap between the two sets of unemployment statistics has been growing for several years. In part the discrepancy is explained by the fact that some unemployed people have given up their active search for work because of the weak economic situation. The Statistics Finland concept of unemployment is based on the criterion of active search for work. The difference in the number of people out of work has grown primarily in the age group over 25. The differences between the two sets of figures are also explained by changes in statistical methods and legislation.

Inflation set to continue to slow in 2015

Inflation or the average annual percentage change in consumer prices in 2014 is expected to come in at 1.1% as measured by the consumer price index. The rate of inflation slowed in the summer from around 1½% to just under one per cent, but was back at over one per cent again in the autumn. The sluggish economy is reflected in the price index via cheaper energy commodities, for instance, and the recent sharp fall in the price of crude will probably be reflected in inflation figures for the last quarter. Furthermore, fresh food prices started falling in the first half of the year from the same period in 2013, following a sustained period of strong rises. On the other hand, there have been no signs as yet of service prices slowing down, despite the moderate wage settlement. The reason for this is that rents, for instance, have continued to rise steadily, prices of health services have gone up significantly, and prices of mobile phone services have turned around and started to rise with the easing of the formerly tight competition. Indirect tax hikes at the start of the year have also contributed to keep inflation ticking over, putting upward pressure of almost 0.5 percentage points on the 2014 inflation rate.



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In 2015 inflation will slow to around 0.8% among other things as a result of the recent decrease in the world market price of crude oil. Low inflation will also be held in check by continued record low interest rates, which will be reflected in the average rate of interest charged on housing loans and consumer credit. Furthermore, it is expected that the moderate wage settlement signed in autumn 2013 will curb price rises. Given the current employment situation and purchasing power trends, domestic demand will show only weak growth. There will again be several indirect tax hikes from the beginning of 2015. Energy

[21] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Consumer_price_index_242772.pdf

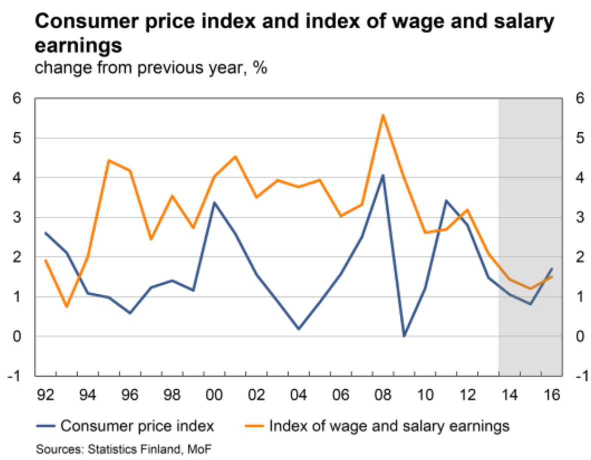
taxes on consumer electricity, transport fuels and heating oil will be increased, as will the tobacco tax. Furthermore, the increase in the annual vehicle tax that takes effect from the beginning of 2016 will, for tax technical reasons, be equally divided between 2015 and 2016. Taken together, these central government measures will drive up average inflation in 2015 by almost 0.4 percentage points.

In 2016 inflation will pick up to 1.7%. Upward pressure on inflation will come mainly from the predicted rise in the euro price of crude oil, as it is projected that the euro will continue to weaken against the dollar and that the dollar world market price of crude will rise moderately. In addition the tax increases will exert upward pressure of almost 0.2 percentage points on 2016 inflation.

Finnish consumer prices, as measured by the EU harmonised consumer price index, will rise by around 1.2% in 2014. Finland's inflation rate in 2014 will be higher than in the euro area on average, where consumer prices are predicted to rise by around half a per cent during the current year. The main reasons why inflation is moving faster in Finland than in the euro area lie in indirect tax hikes and the relatively brisk rise in rentals. However it is expected that the difference in inflation rates will more or less disappear in 2015 and 2016. Finland's 2015 inflation rate in terms of the harmonised consumer price index is expected to come in at 0.8%, accelerating to 1.6% in 2016.

Earnings to rise moderately

Nominal earnings, as measured by the index of wage and salary earnings, increased by 2.1% last year. Contractual wages increased by 1.4% and other factors pushed up the index of wage and salary earnings by 0.7%. The contribution of other factors was up from an average of 0.5% in 2009–2012. In 2014 and 2015 earnings will develop in line with the framework agreement negotiated by the social partners in the autumn of last year. The Pact for Employment and Growth will in its first year push up contractual wages by an average of 0.7%, and in the second year by around 0.5%.



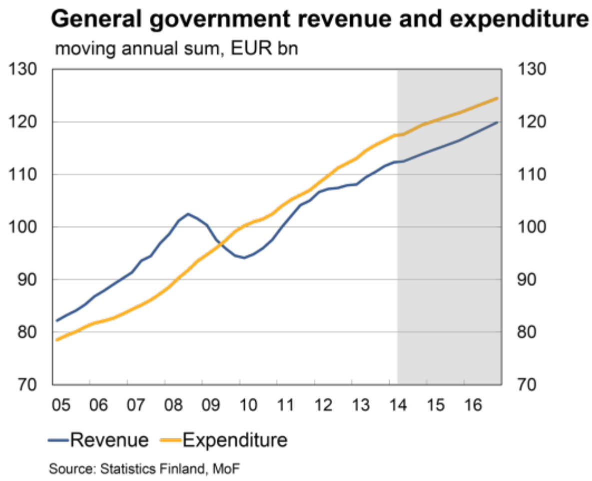
* Download image as a scalable pdf-file.[22]

The forecast for the development of earnings is based on the assumption that the contribution of factors other than contractual wage increases will drive up earnings by over half a per cent in both years. Therefore it is predicted that nominal earnings will rise by 1.4% in 2014 and by 1.2% in 2015 as measured by the index of wage and salary earnings. This is clearly below the average of the 2000s, and well in line with the sluggish economy and slow employment trends. It is assumed that moderate earnings growth will continue in 2016, rising at a rate of 1.5%.

[22]http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/Consumer_price_index_and_index_of_wage_and_salary_earn

Public finances

No turnaround in debt-to-GDP ratio during outlook period



* Download image as a scalable pdf-file.[23]

Public finances have continued to remain in deficit due to the persistent weakness of the economy. The general government budgetary position is furthermore burdened by the growth of expenditure resulting from population ageing, which is affecting local government finances in particular. Economic growth will remain sluggish over the next few years, so much so that this growth will not be enough to correct the imbalance in public finances. General government finances will improve very slowly in the years ahead. General government debt to GDP will rise to a level higher than in decades, and there will be no turnaround in the debt-to-GDP ratio during the outlook period. It is forecast that the general government deficit will remain below the 3% reference value, but the debt ratio is set to breach the 60% threshold.

Central government and local government will remain in deficit, while the earnings-related pensions sector is in surplus and other social security funds more or less in balance. The expenditure rate or public expenditure to GDP has climbed to a very high level in recent years above all because of slow GDP growth, but the expenditure rate is also driven by unemployment-related expenditure, for instance. The tax rate, i.e. the ratio of taxes to output, is in turn driven up by tax hikes.

Central government finances are deeply in deficit for the sixth year in succession, and there is no significant turnaround in sight at least over the next two years ahead. This is due above all to the protracted downturn. Adjustment decisions taken at various stages will take hold on both the revenue and expenditure side and reduce the central government deficit. At the same time, the emerging but still sluggish rebound of the economy will accelerate the growth of tax revenue. The deficit will continue to shrink in 2016. During the outlook period central government debt will increase to over 100 billion euros.

Local government finances will remain constrained in the immediate future. Subdued tax base growth and cuts to central government transfers to the local government sector will slow the growth of local government revenue. On the other hand, the growth of expenditure will be

[23] http://verkkojulkaisut.vm.fi/wp-content/uploads/2013/06/General-govt-revenue-and-expenditure242911.pdf

curbed by the moderate rise in cost levels. In the current difficult economic climate, local governments have no option but to persist with measures designed to curb expenditure growth in 2015. Municipal income tax rates will be increased in a large part of local governments across the country. However, the adjustment efforts will not be enough to reduce the deficit in the local government sector. Local government debt will continue to increase.

The surplus of earnings-related pensions funds will fall from around 2% of GDP in 2013 and 2014 to just over one per cent in 2015–2016. The increasing number of pensioners and the higher average level of pensions will drive up pension expenditure over the forecast horizon. However, the Government's decision to cap pension indexations at 0.4% will curb the growth of pension expenditure in 2015. At the same time, the additional transfer of 500 million euros from the State Pension Fund to central government will bring a one-off increase to the fund's expenditure. Rising pension contributions will keep revenue from contributions on an upward trend in 2015 despite slow wage bill growth. The temporary 0.4 percentage point reduction in the TyEL contribution agreed upon in the recent pension talks will dent earnings-related pension funds' revenue from contributions in 2016. Although the value of pension assets has recently risen sharply, pension funds' property income has fallen because of low interest rates. It is expected that interest rates will remain low in 2015–2016, which will significantly reduce estimates of property income.

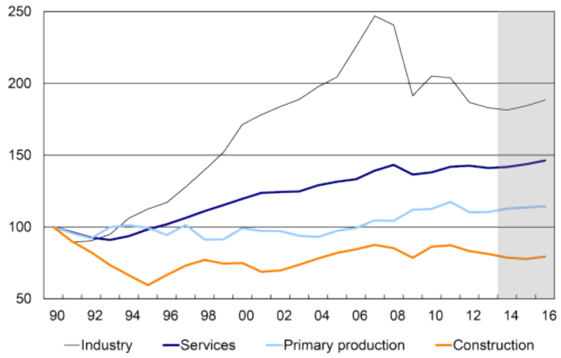
The revenue and expenditure of other social security funds are close to balance throughout the outlook period. Unemployment expenditure has continued to rise in 2014, but it is expected that this trend will be reversed next year as the growth of unemployment levels out. It is anticipated that unemployment expenditure will start clearly to fall in 2016. The decision to cap indexations of social benefits and assistance to 0.4% will slow the growth of other social security funds' expenditure in 2015.

Additional graphs

Exchange rate
EUR/USD

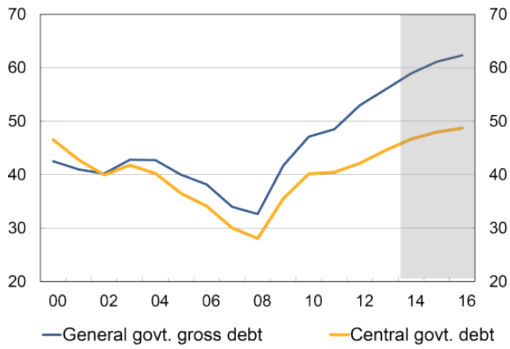
Source: European Central Bank

Production
1990=100



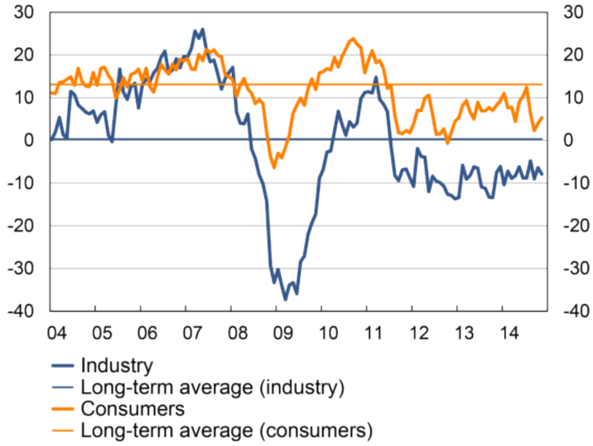
Sources: Statistics Finland, MoF

General and central government debt
in ratio to GDP, per cent



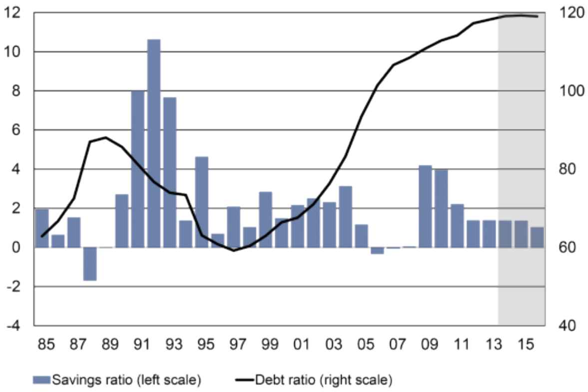
Sources:State Treasury, Statistics Finland, MoF

Industry and consumer confidence
balance, seasonally adjusted



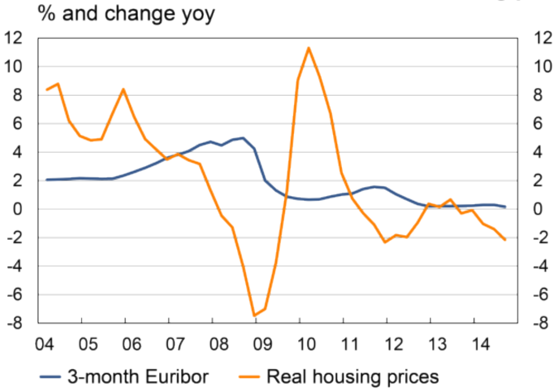
Source: European Commission

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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