MINISTRY OF FINANCE

Economic Survey

Summer 2016

Ministry of Finance publications – 24c/2016

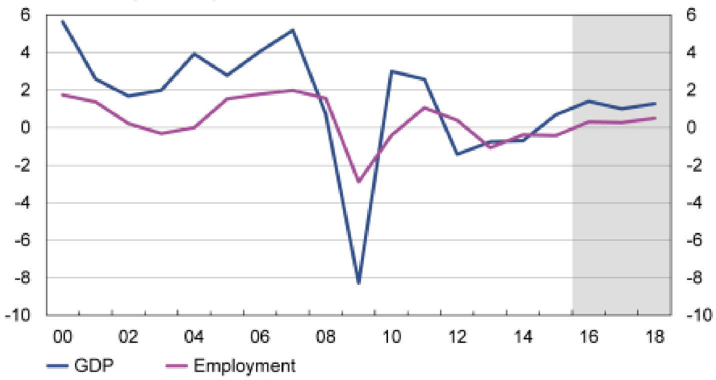
Economic Prospects

Table of Contents

Economic Survey

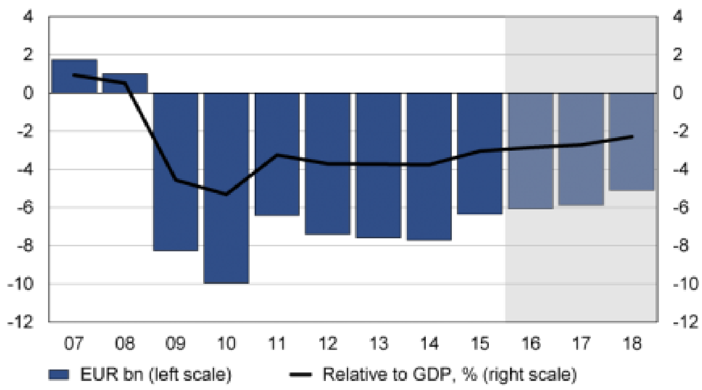
- The forecast for Finnish GDP growth in 2016 is 1.4% and for the next two years 1.0% and 1.3%.
- Global recovery remains sluggish. World purchasing power adjusted GDP growth will reach just 3.1% in 2016 and pick up only marginally in 2017 and 2018. Growth is at its slowest rate since the financial crisis and below the long-term average.
- Private consumption growth is robust for the current economic situation. Consumption growth is supported by rising household real disposable income, improving consumer expectations as well as the falling savings rate. Private investment is also set to increase in 2016: construction investment in particular is expected to post strong growth of over 7%.
- Unemployment growth has come to at least a temporary halt, according to both Statistics Finland's sample-based Labour Force Survey and employment service statistics compiled by the Ministry of Employment and the Economy. In 2015 the unemployment rate climbed to 9.4%, but in April this year the trend of the unemployment rate fell back to 9.1%.
- Output in Finland is finally back on track to growth. Gross value added increased by 0.7% last year, and growth has now been recorded for five consecutive quarters. Economic growth is gathering momentum in an increasing number of sectors, albeit very slowly with the exception of construction.
- The general government deficit decreased to less than 3% last year. The budget balance will remain in the red, even though the deficit will shrink in response to fiscal adjustment. In 2015 public debt to GDP exceeded the 60% threshold, and the debt ratio will continue to increase throughout the forecast horizon.
- The recent agreement of a Competitiveness Pact is a significant first step on the road to restoring confidence in domestic economic policy. However, it will take some time for the benefits of the pact to filter through to the real economy.

GDP and employment
percentage change



Sources: Statistics Finland, MoF

Central government financial balance



Sources: Statistics Finland, MoF

Key forecast figures

	2015 EUR bn	2013	2014	2015	2016**	2017**	2018**
		change in volume, %					
GDP at market prices	208	-0.8	-0.7	0.7	1.4	1.0	1.3
Imports	77	0.5	0.0	-0.4	1.8	2.7	3.4
Total supply	284	-0.8	-0.3	0.0	1.5	1.4	1.8
Exports	77	1.1	-0.9	0.6	0.8	2.9	3.8
Consumption	167	0.0	0.3	0.7	1.0	0.2	0.4
private	116	-0,5	0,6	1.4	1.4	0.7	0.6
public	51	1.1	-0.3	-0.9	0.0	-1.1	0.0
Investment	42	-4.9	-2.6	-1.1	4.4	3.2	3.2
private	34	-6.6	-3.1	-1.0	4.8	3.8	4.1
public	8	2.6	-0.6	-1.2	2.7	0.6	-0.7
Total demand	285	-0.4	-0.1	-0.1	0.9	0.9	1.3
domestic demand	208	-1.1	0.2	-0.4	1.0	0.2	0.4

Other key forecast figures

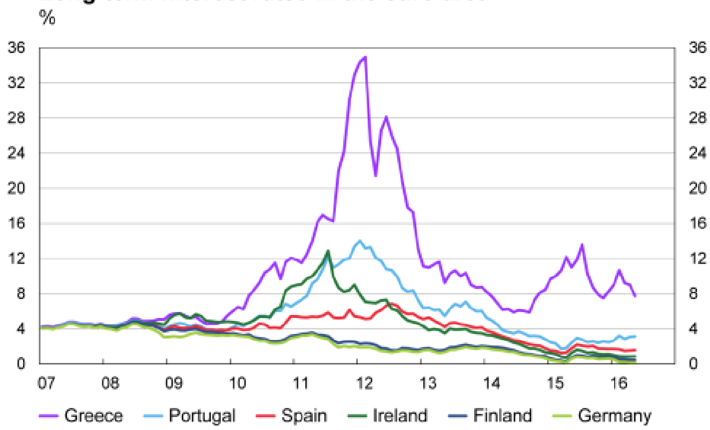
	2013	2014	2015	2016**	2017**	2018**
GDP, EUR bn	203	205	208	212	216	222
Services, change in volume, %	-1.4	-0.2	1.1	1.0	0.8	1.2
Industry, change in volume, %	0.0	-1.7	-0.4	-0.2	1.7	2.8
Labour productivity, change, %	0.5	0.0	0.9	0.5	-0.4	1.2
Employed labour force, change, %	-1.0	-0.4	-0.4	0.3	0.3	0.5
Employment rate, %	68.5	68.3	68.1	68.4	68.7	69.1
Unemployment rate, %	8.2	8.7	9.4	9.2	9.1	8.7
Consumer price index, change, %	1.5	1.0	-0.2	0.5	1.2	1.3
Index of wage and salary earnings, change, %	2.1	1.4	1.3	1.2	0.8	1.2
Current account, EUR bn	-3.3	-1.9	0.3	0.3	0.3	0.4
Current account, relative to GDP, %	-1.6	-0.9	0.1	0.1	0.2	0.2
Short-term interest rates (3-month Euribor), %	0.2	0.2	0.0	-0.2	-0.2	-0.1
Long-term interest rates (10-year govt. bonds), %	1.9	1.4	0.7	0.6	0.8	1.2
General government expenditure, relative to GDP, %	57.5	58.1	58.2	57.9	56.9	56.2
Tax ratio, relative to GDP, %	43.7	43.9	44.5	44.6	43.6	43.2
General government net lending, relative to GDP, %	-2.6	-3.2	-2.7	-2.4	-2.4	-2.0
Central government net lending, relative to GDP, %	-3.7	-3.8	-3.1	-2.9	-2.7	-2.3
General government gross debt, relative to GDP, %	55.4	59.3	63.0	64.6	66.4	66.9
Central government debt, relative to GDP, %	44.1	46.3	48.1	49.8	51.5	52.4

Introduction

The Finnish economy posted GDP growth of 0.6% in the first quarter of 2016, according to Statistics Finland's preliminary quarterly accounts. Figures for the last quarter of 2015 were also slightly stronger than predicted earlier. This growth performance was largely driven by private consumption. The export sector, on the other hand, is continuing to struggle. Despite the slight rebound, the Finnish economy will continue to drag its feet over the next couple of years. The growth prospects are poor and there will be no significant improvement in public finances.

In 2016 the economy is forecast to show growth of 1.4% from last year. The projected growth rate for 2017 is 1% and for 2018 an estimated 1.3%. GDP growth in the current year will be driven by domestic demand. In 2017 public consumption will contract as a result of the reduced public sector wage bill following on the signing of the Competitiveness Pact.

Long-term interest rates in the euro area



Source: Reuters

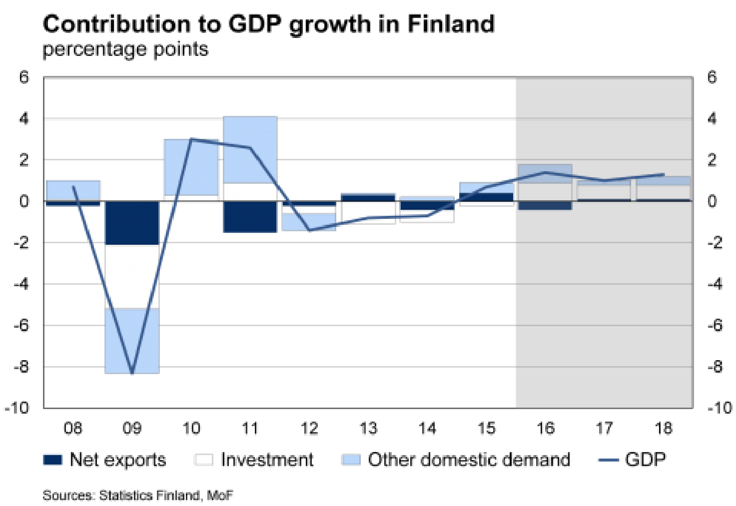
Growth prospects for the global economy and world trade have deteriorated. Overall, global trade growth will remain subdued over the next two years. Raw-material-producing emerging economies have had particularly poor economic performance, and there are no signs of a quick return to a growth track over the outlook period. In China, growth will be slower than previously expected, partly because the country has moved towards becoming a more closed service-based economy more rapidly than anticipated. The Russian economy has now bottomed out, but there are no apparent prospects for robust growth because of inefficiencies in the country's production structure and persistently low raw material world market prices.

Many of Finland's major trade partners, on the other hand, are growing at quite a good rate. The Swedish economy in particular is on a solid growth path, although its growth is mainly driven by strong domestic demand and service exports. Growth in Germany remains reasonably fast as the economy continues to benefit from a broad-based increase in economic activity. The outlook in the United States has weakened somewhat, but growth will nonetheless remain around the 2% mark in the years ahead. The current forecast does not consider a Brexit scenario. If the referendum were to favour a British exit from the EU, the short-term global outlook would be weaker than forecast. In the long term the impacts would depend on how the economy can adapt to the new system.

The assumptions behind the current forecast are largely supportive of growth. Central banks' monetary policy will continue to be calibrated to support growth. The European Central Bank has further expanded its exceptional monetary policy operations, and ECB reference rates will remain at historically low levels. Short-term interest rates will remain negative throughout the forecast horizon, and the ten-year interest rate will also remain exceptionally low, averaging 1.2% in 2018.

The euro to dollar exchange rate is expected to remain highly stable at around 1.1% over the next couple of years. Low energy prices, and oil prices in particular, are bolstering the growth prospects of energy-intensive economies such as Finland. The sharpest falls in energy prices have bottomed out, but the forecast predicts rather moderate price hikes.

As mentioned, Finland's GDP growth forecast for 2016 is 1.4%. Private consumption growth is robust for the current economic situation. Consumption growth is supported by rising household real disposable income, improving consumer expectations as well as the falling savings rate. Private investment is also set to increase in 2016: construction investment in particular is expected to post strong growth of over 7%. The outlook for goods and service exports remains subdued. Export growth is expected to come in at no more than 0.8%, and the performance of exports remains slower than in Finland's export markets. Rebounding investment and consumption will drive imports to stronger growth than exports, and therefore net exports will have a negative impact on GDP.



Industrial output performance will remain weak. Figures for 2016 are expected to show a decline of 0.2% from last year. The sluggish development of industrial production is mainly attributable to the metal industry. Service output growth is predicted to come in at 1.0%. The situation in the labour market will remain weak, although it seems that the unemployment rate is no longer rising. The projected unemployment rate for 2016 is 9.2%, and it is predicted that the number of employed persons will increase by 0.3% from last year. Long-term and structural unemployment is continuing to increase. The development of labour productivity will remain subdued.

It is predicted that prices will increase by no more than 0.5% in 2016. The index of wage and salary earnings is expected to rise by 1.2%.

GDP growth in 2017 is forecast at 1.0%. Private consumption growth in particular will slow because of subdued household real disposable income growth. Inflation is projected to pick up to 1.2% on the previous year. In the short term wage bill growth will remain slow as the Competitiveness Pact begins to take effect. This applies to the public sector in particular, where a temporary reduction in holiday bonuses coupled with a lengthening of working hours will reduce the wage bill.

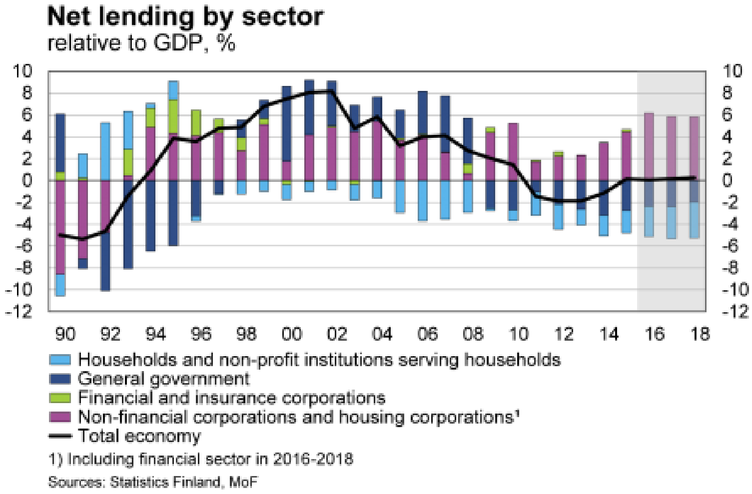
Private investment growth will slow somewhat from last year mainly in response to stagnating growth in construction investment. In 2017 export growth will accelerate to 2.8% as the main locus of growth will be Europe, the United States and other key export markets rather than emerging economies. The effect of net exports on economic growth will turn slightly positive. Public consumption will be 1.1% lower than the year before as a result of the Competitiveness

Pact. This will also contribute to slowing economic growth in 2017.

It is projected that industrial production will finally return to moderate growth of 1.7% in 2017. This is mainly attributable to a rebound across the metal industry, not only in shipbuilding. Service output will remain on a moderate growth path of around 1%. However, economic activity is growing at such a modest rate that it is having no major impact on employment. The number of persons employed will rise slightly, and the unemployment rate is projected at 9.1%. Nominal earnings will rise by less than 1% because of the Competitiveness Pact.

The projected GDP growth rate for 2018 is 1.3%. The effects of the Competitiveness Pact on real economic activity will only begin to take hold towards the end of the forecast horizon, and the greatest benefits will be seen in the years ahead. It is expected, then, that over the next few years the Finnish economy will not be rebounding strongly enough to bring any significant relief to the tight labour market and public finances. Cumulative growth in 2016–2018 is projected to reach no more than 3.7%, and in 2018 GDP will still be around 1% lower than at the previous cyclical peak at year-end 2007.

The general government deficit decreased to less than 3% last year. The budgetary position will continue to improve, but the balance will remain in deficit because of sluggish growth and structural problems in the economy. Population ageing is driving up public expenditure, thereby dampening the effects of the Government's adjustment efforts. It is anticipated that in the short term, the direct effects of the Competitiveness Pact on public finances will be negative. In 2015 the ratio of public debt to GDP exceeded the 60% threshold, and the debt will continue to increase both nominally and as a percentage of GDP.



The uncertainty in the financial market has continued throughout the first six months of the year, for several reasons. Recently uncertainty about the outcome of the Brexit referendum has had a depressive effect on the market. In general the future of the banking and financial sector is causing concern, and there are worries about the health of the Italian banking sector, for instance. During the current year the prices of bank shares have fallen significantly.

The current environment of a growth-supportive light fiscal policy seems to have fuelled a search-for-yield mentality, with investment flows channelled above all into the housing and stock market. In Sweden, for instance, housing prices have risen very sharply, and some analysts believe that a housing price bubble is developing in the country. The financial market currently has a low tolerance of shocks, however, 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 ever before.

The risks to the global economy are still predominantly to the downside. The slowdown of growth and restructuring in China may have surprising repercussions on the global economy. In China private sector indebtedness is continuing to increase rapidly, and the value of homes, shares and other assets has risen rapidly. The Russian economy will remain subdued because of the political situation and the country's backward production structure.

In Finland the recent agreement of a Competitiveness Pact is a significant first step on the road to restoring confidence in domestic economic policy. However, it is necessary to remember that it will take some time for the benefits of the pact to filter through to the real economy. It is also clear that in addition to an agreement with cost-reducing effects, Finland will need a significant amount of innovations to boost the competitiveness of existing products as well as completely new products and structural reforms to ensure that resources are allocated as effectively as possible and to create a competitive operating environment. In the long term reforms designed to create opportunities on the supply side of the economy are highly beneficial for economic growth.

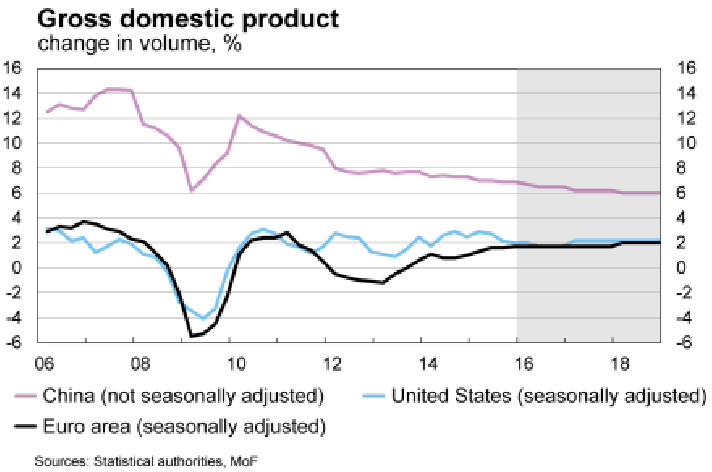
The domestic risks are still predominantly related to the development of the real economy and the labour market. Real economic growth is subdued and will not be enough to turn around the situation in the labour market. Unemployment will remain too high, and the number of the hard-to-employ in particular is rising. The proportion of the inactive population is too high, and the supply and demand match in the labour market needs improving.

A sustainable improvement in public finances will require favourable developments in the real economy. It is necessary to stress that the projected economic scenario will not alone be enough to significantly improve the health of public finances in Finland.

Global economy

World economic growth remains slow

Global recovery remains sluggish. World purchasing power adjusted GDP growth will reach just 3.1% in 2016 and pick up only marginally in 2017 and 2018. Growth is at its slowest rate since the financial crisis and below the long-term average. Growth has slowed appreciably in many emerging economies, especially in raw material producing countries, and the turnaround in advanced economies is still modest because of slow wage development and sluggish investment.



Weak demand growth is reflected in slow world trade growth, low commodity prices and lower-than-targeted inflation in most major economies. Private investment is below the long-term trend in many industrial countries, suggesting that businesses expect demand growth to remain subdued. Raw materials and export prices are also widely falling in response to weak demand, although supply-side shocks in crude oil in particular have been another contributing factor. Low prices are boosting demand from raw material importers, but on the other hand discouraging producers from investing and adversely affecting their financial position. Unemployment is falling only slowly in many advanced economies.

Productivity growth has been slow for a long time now. However OECD data indicate that productivity is increasing at the same rate as before at the technological forefront, but slowing significantly in less effective companies. Productivity is set to play an increasingly significant role in the future, especially in the ageing European labour market.

The euro area has remained on a slow growth track, partly as a result of reduced import prices and a weaker euro exchange rate. These tailwinds will dissipate by the end of the outlook period. The supply of credit and overall financing conditions have also improved, fiscal policy will become expansionary, and monetary policy remain expansionary. These factors are contributing to drive private consumer demand, and investment is also slowly rebounding. The exceptionally high level of immigration will provide a minor additional demand boost, but adversely affect the balance of public finances.

In Spain, Ireland and elsewhere, earlier structural reforms have contributed to a return to brisk growth. Euro area growth is still hampered by persistently high unemployment. In the UK and Sweden, growth is still robust and employment is at a high level.

Broad-based, but slower than anticipated growth is continuing in the United States. The rebound is supported by stronger household balance sheets, favourable labour market conditions and a lighter fiscal policy.

Both nominal and real wages are continuing to rise quite strongly. Consumer confidence has returned to its historical median, but expectations have declined somewhat. Investment is also set to grow at a moderate rate.

The Russian economy remains dependent on oil and gas exports. The country has failed to transform itself or to use the revenue generated from raw materials to diversify its production structure. Its growth potential is effectively hampered by unmade investments and obsolete economic structures, such as public interference in private sector investment and production decisions. Post-recession growth in Russia will remain very muted.

In China, growth in industry, construction and commodity exports has already slowed significantly, and this trend is 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. Historically, corresponding changes have resulted in a marked slowdown of growth. If the country is successful in its policy, the slowdown will be well controlled. On the other hand, China has continued to support old structures, which will slow the process of change.

Japanese exports have failed to recover despite persistent stimulus and a massive devaluation of the yen. Although the population is ageing rapidly, the supply of labour has grown strongly. The labour market remains tight, and rising wages over the outlook period will support household demand.

World trade to remain modest

World trade growth will remain modest. This reflects the slowdown of Chinese manufacturing and sluggish investment in industrial countries. Imports growth will remain modest, especially in emerging economies.

In the 1990s and early 2000s the growth rate for goods trade was more than twice as high as industrial output growth, but at the moment trade is actually growing more slowly than production. Earlier, such slow rates of trade growth have only been seen under conditions of recession. Industrial countries' import elasticity to GDP dipped even before the financial crisis, but has since recovered. In emerging economies, by contrast, it seems that there has been a permanent decline in import intensity, with the exception of Africa and the Middle East.

Finland's market share in world trade has continued to shrink, but this trend is now slowing. In the euro area, Finland has almost regained the same market share as it had before the crisis. Market shares in Sweden, Russia and some other countries are continuing to fall, however. Global trade will not provide a strong demand impetus for Finnish exports.

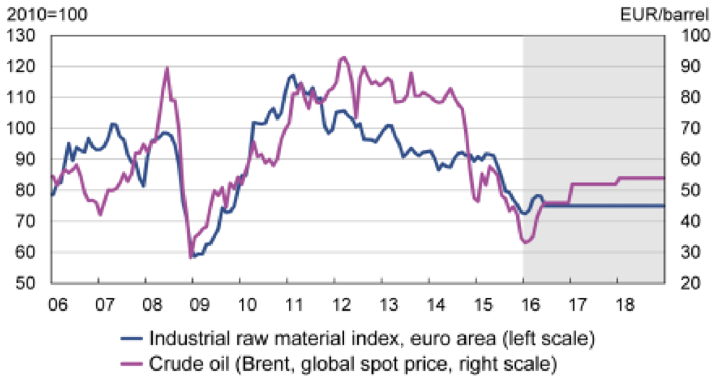
Inflation set to remain very moderate

The price of crude oil has fallen sharply above all in response to the deteriorating outlook in emerging economies and persistently high US and OPEC supply. The supply of crude oil has expanded further following the agreement reached in the Iranian nuclear dispute, and oil prices will rise only very moderately. As energy is an intermediate input in all products and services, the effects of the oil price shock are felt throughout the economy.

Slower than expected growth of demand from emerging economies and continued high supply have caused other industrial raw material prices to fall sharply, too. Raw material prices have apparently reached a bottom.

Furthermore, the slide in producer prices due to excess capacity in China has continued. Together, these factors have turned world export prices into decline. Inflation expectations are extremely low and have continued to fall, 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 have begun slowly to move back to normal. Interest rates in the euro area will rise very slowly over the outlook period and for a long time remain at a clearly lower level than was seen during the pre-crisis period.

Risks remain to the downside

In China, indebtedness has continued to grow rapidly, especially in the private sector. 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 without this leading to a significant slowdown in growth.

The British referendum on EU membership has already affected capital markets, and a possible Brexit might have greater negative repercussions than anticipated not only in Great Britain itself, but globally. In the euro area, too, the risks remain skewed to the downside. Households may struggle even more than anticipated to recover with the waning effects of the current favourable conditions. The ability of the euro area to resist negative shocks will remain weak.

Russia's economic situation remains difficult, and it is unclear how the country will adapt to the period of slow growth that lies ahead.

Extremely low interest rates in industrial countries and a stronger 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 winding down of unconventional monetary policy, the edging up of interest rates and the strengthening of the US dollar may cause strong reactions in the financial market. Many emerging economies in particular may see increased movements of capital as they have taken out large amounts of dollar-denominated loans.

Supply and demand

Export growth to remain slow

Exports contracted by 1.1% quarter-on-quarter in Q1, according to accounts published by Statistics Finland in June 2016. Exports growth in 2016 will come in at just 0.8% as economic growth in Finland's export markets slowed considerably early in the year. Furthermore, the growth of Finnish exports will be slower than growth in the export markets.

In 2017 export growth will pick up to 2.9% and in 2018 to 3.8%. Demand for Finnish exports will accelerate towards the end of the forecast horizon. Economic growth in Finland's major export markets is set to gather momentum, and the foreign trade to GDP ratio in these countries will recover and move closer to long-term averages. This will provide a significant boost to Finnish export demand. Europe and the United States rather than emerging economies will now be the main locus of growth, which will also improve Finland's export performance. Nevertheless Finland will continue to lose market shares in global trade over the outlook period.

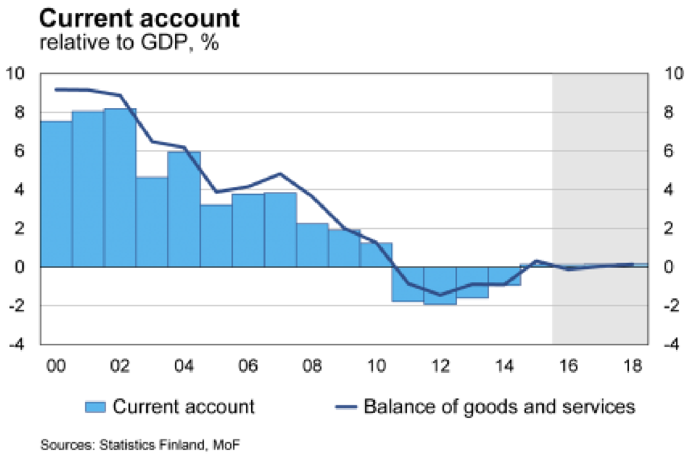
According to the quarterly figures out in June, Q1 imports were down 1.8% quarter-on-quarter. Investment and consumption growth will drive up imports in 2016 so that the effect of net imports on GDP will have a negative effect on GDP. Domestic demand growth will slow towards the end of the forecast horizon, and the effect of net exports will be slightly positive.

Current account to remain close to balance

Import prices will continue to fall in 2016, but it is expected that they will begin to rise on the back of higher oil prices and accelerating global trade in 2017 and 2018. The current account will remain stable over the outlook period.

At the end of Q1 the 12-month current account surplus stood at EUR 0.4 billion, or 0.2% of GDP. The strengthening of the current account is attributable to the influx of capital into Finland. The trade balance, on the other hand, deteriorated somewhat with the accelerating slide in export prices and continued sluggish export development.

In 2016 the trade balance will continue to deteriorate somewhat compared with 2015, but nonetheless show a surplus of EUR 1.6 billion. Towards the end of the outlook period the trade balance will begin to improve again, reaching a surplus of around EUR 2.3 billion in 2018. This will also have the effect of slightly reducing the current account surplus. The current account will remain in marginal surplus over the forecast horizon. In 2018 the current account surplus will stand at EUR 0.4 billion, or 0.2% of GDP.

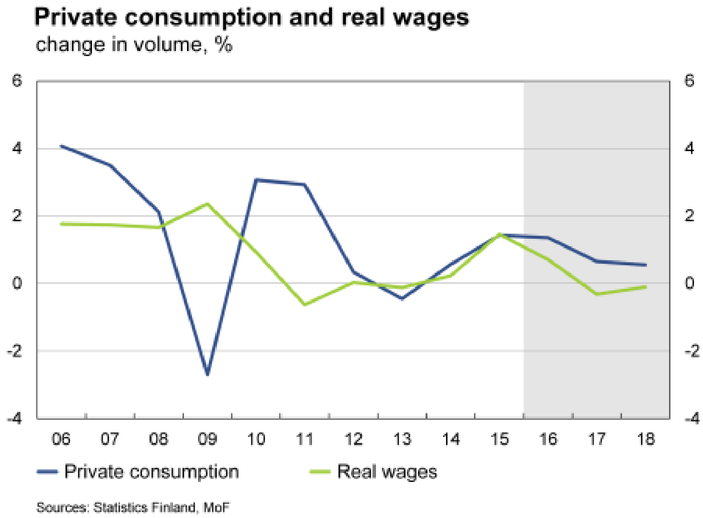


Private consumption driven by indebtedness

In 2015 private consumption growth accelerated to 1.4% on the back of improving household purchasing power. In 2016, private consumption will continue to develop rather strongly as employment returns to growth, consumer sentiments continue to improve and inflation remains at rather moderate levels. Furthermore, consumption growth will be supported by households' propensity to borrow.

Consumer confidence has improved appreciably in the past six months from a lower than usual level at the end of last year. Data from Statistics Finland's Consumer Survey indicate that in May, consumers' confidence in their own finances was very close to the average long-term level. In recent months it is also felt that the threat of unemployment has been reduced. The survey data also indicate that consumers feel now is a good time to purchase durables.

In 2016 private consumption will increase by 1.4%. This increase will be reflected above all in the demand for consumer durables. The number of new car registrations in January–May increased by as much as 17% from the year before. New car purchases have been boosted by moderate cuts to car taxation, improving consumer confidence and demand pressures from the increasing average age of the car stock. In January–April retail sales also increased by 1.4% year-on-year.



In 2017 household real income growth will be limited, and therefore private consumption growth will slow to 0.7%. The growth of purchasing power will be dampened by accelerating inflation. Employment, however, will continue to improve, and as a consequence it is expected that consumer confidence will remain strong.

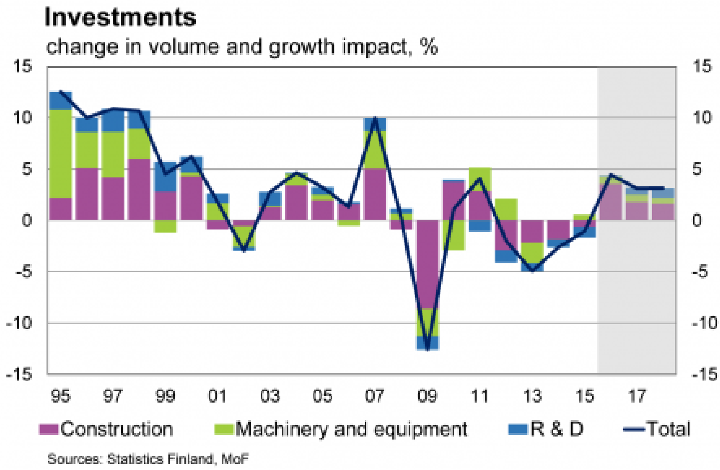
In the short term the Competiveness Pact will contribute to dampen the growth of the national wage bill. It is estimated that temporary cuts to holiday bonuses and longer working hours in the public sector will reduce the total amount of general government spending on wages paid. As part of the Competitiveness Pact, the Government has committed to ease taxes on earned incomes in 2017 in order to offset the rise in the insured employee's social security contributions.

Low interest rates, a rebound in the property market and the option of home loan repayment holidays are continuing to drive the growth of household debt. In a bid to reduce the risks linked to household indebtedness, new rules will be put in place in 2016 to cap the maximum housing loan at 90% LTV.

Salaries and wages are the single most important source of household income. Household wage income growth will accelerate in 2018 on the back of growing employment, which is supported by the moderate development of labour costs coupled with the rebound of the global economy. At the same time taxes on earned income will rise somewhat as a result of the rise in the insured employee's social security contributions. Accelerating prices will further dampen the growth of household purchasing power. The household savings rate will continue to fall as private consumption continues to outpace disposable income growth. Private consumption growth in 2018 will come in at no more than 0.6%.

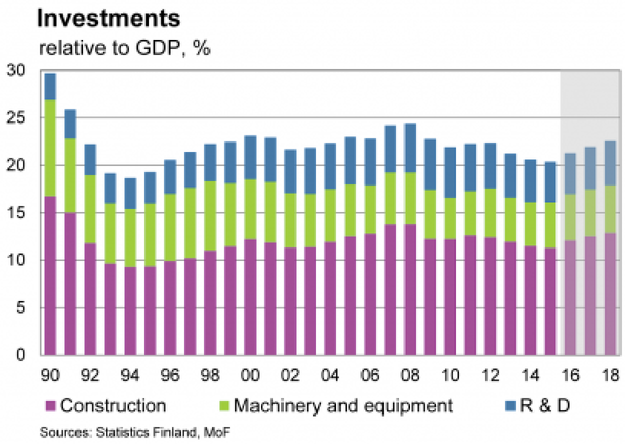
Private investment to retain strong role

Private investment is set to increase throughout the outlook period, with the strongest growth recorded for the current year at almost 5%. The key drivers are new housing construction, which is picking up from a very low level at year-end 2015, and major production-related investment, which will be highest in 2016. Trends over the rest of the forecast horizon will be affected by lower than predicted growth in the world economy and global trade. The Competitiveness Pact, on the other hand, will reduce cost pressures on businesses from the beginning of next year, increasing operating surpluses and so allowing greater scope for revenue investment. Negative real interest rates throughout the forecast horizon will also provide incentive for investment. As interest rate expectations have receded, this factor now has even greater impact than in the March outlook. In 2017 and 2018 investment will increase by some 4% a year.



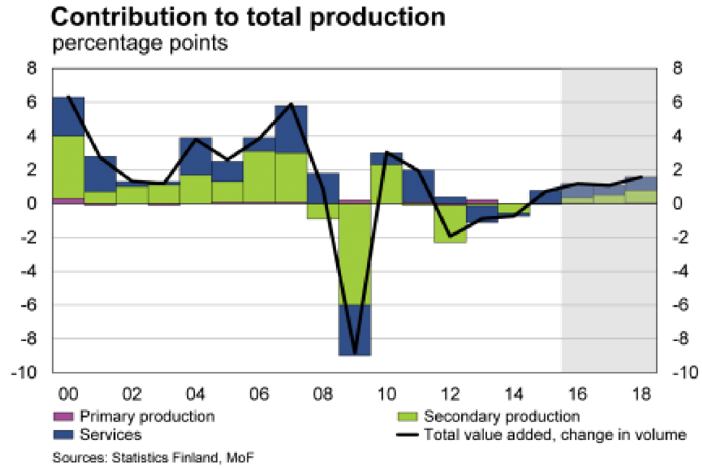
Although investment growth missed expectations in Q1, increasing by just 0.4% from the first quarter of 2015, investment overall remains on an accelerating track. The subdued performance in Q1 was due to the double-digit decline in investment in machinery, equipment and transport equipment as well as weapons systems. Investment figures for the last quarter of 2015 were also revised downwards. Revisions of investment figures are often substantial, and therefore this revision has not been given full weight in the forecast. Strong growth is now expected above all by virtue of investments in machinery and equipment for the bioproduct mill in Äänekoski.

Construction investment, on the other hand, was stronger than previously forecast in Q1. Turnover figures for the construction sector also indicate strong sales in the first part of the year. Growth has been strongest in housing investment: volume growth for new housing production was almost 14% , and the number of new housing starts was up 23% from the year before. Civil engineering investment has also expanded strongly, and the Government announced new projects following its spending limits discussions. R&D investment will only pick up gradually as it continues to be held back by redundancies of product development and research staff and cutbacks in central government R&D spending.

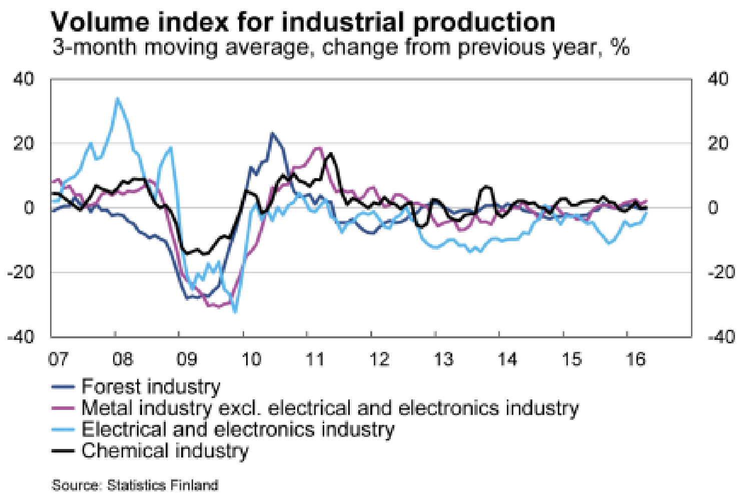


New housing construction to drive growth

Output in Finland is finally back on track to growth. Gross value added increased by 0.7% last year, and growth has now been recorded for five consecutive quarters. Economic growth is gathering momentum in an increasing number of sectors, albeit very slowly with the exception of construction. Forestry, the forest and chemical industry, energy supply, construction and a few private service sectors all posted growth in Q1. At the moment economic activity is largely dependent on domestic demand. Industrial output is still widely decreasing. As economic growth is concentrated in service branches where productivity growth has been lower, overall productivity per hours worked has developed poorly.



Construction and some other branches have posted relatively rapid growth early in the year. However performance in these branches is not expected to accelerate significantly as their growth depends first and foremost on domestic demand. Faster than predicted growth would require a significant pick up in exports. In the light of business tendency surveys and new order books, however, no such acceleration is in sight this year. The performance of the economy is being constrained by a few industry and public service branches. Accelerating global trade and growing demand for investment goods will drive output to more broadly based growth in 2017 and 2018. The restructuring of production especially in the electronics and the paper industry will act to slow growth, despite the improvement in export demand. Gross value added is projected to show growth of just over one per cent a year in 2016–2018.



The cyclical outlook for industry is stable but subdued. With the exception of the textile industry, the number of new orders received in industry early in the year was lower than in 2015. Industrial production will therefore continue to slide this year. The Competitiveness Pact is a step in the right direction, and it can be expected to improve the cost competitiveness of businesses towards the end of the outlook period. Industrial companies and producers of investment goods in particular feel that competition in the EU internal market is tougher than it is in non-EU markets. Output expectations are strongest in the wood industry and the building products industry. By contrast output is expected to contract in the textile and clothing industry over the next few months. Rebounding export demand and steps taken by businesses to improve their competitiveness will help to boost industrial output in the years ahead. In 2016 industry value added will still contract somewhat, but in 2017 and 2018 it is set to rise by around almost 2% and almost 3%, respectively.

Confidence and production in construction
balance and change yoy, %

— Confidence indicator for construction, seasonally adjusted, balance (left scale)
— Value added in construction, volume, seasonally adjusted (right scale)

Sources: Statistics Finland, European Commission

The outlook for construction has continued to improve. Especially in growth centres both residential and other building construction will increase significantly this year. Construction machinery and equipment rental companies are already reporting capacity bottlenecks. Furthermore, more than one-quarter of construction companies say their growth is being hampered by a lack of skilled workforce. The construction of new public, residential, business and office premises has shown rapid growth early in the year. In addition, construction activity is being bolstered by renovation, and there are a number of transport projects in the pipeline. In 2016 value added in the construction sector will increase by 6½%. In 2017 and 2018 construction is expected to post growth of around 2% with the plateauing of other than housing construction activity.

Service production
change yoy, per cent and balance, 3-month

—Trend indicator of output, services (left scale)
—Services confidence (right scale)

Sources: Statistics Finland, European Commission

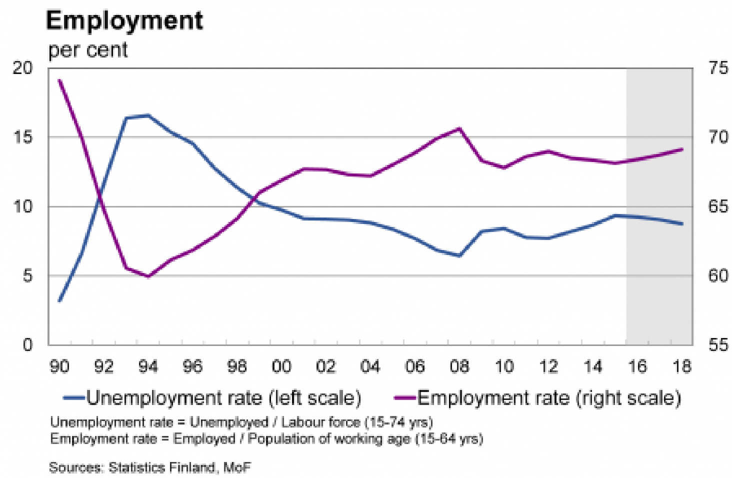
The outlook and sales expectations in services improved slightly in the spring, and sales expectations are stronger in the next few months ahead. Demand for services has rebounded in a few private service branches. The prospects for growth this year are strongest in business services. In particular, the hotels and restaurants sector and information and communication services are expecting to see growing sales momentum in the immediate future. Transport services, by contrast, still have no growth expectations, and the production of public services is set to decline. The sluggish development of household purchasing power lends no support to wholesale and retail trade. In 2016–2018 service production will increase by 1%.

Employment, prices and wages

Employment showing signs of a turn for the better

The employment outlook has improved early in the year. As the Finnish economy emerges from a sustained period of recession and economic activity continues to rebound especially in construction sector, the number of hours worked has already started to increase: the figure for January–April was up 1.8% from the corresponding period last year. Increasing demand for labour especially in construction will turn employment to modest growth of 0.3% this year.

Unemployment growth has come to at least a temporary halt, according to both Statistics Finland's sample-based Labour Force Survey and employment service statistics compiled by the Ministry of Employment and the Economy. In 2015 the unemployment rate climbed to 9.4%, but in April this year the trend of the unemployment rate fell back to 9.1%. This year's accelerating economic growth will not yet bring a significant reduction in the number of people out of work as it is expected that some of the disguised unemployed will return to actively searching for work with the increasing number of job vacancies. The projected unemployment rate for the current year is 9.3%.



GDP growth in 2017 and 2018 will keep employment on an upward trend and push unemployment slowly downward. Nonetheless unemployment will remain high throughout the outlook period. Employment is predicted to improve by 0.3% in 2017 and by 0.5% in 2018. The unemployment rate is expected to fall back to 9.1% in 2017 and further to 8.7% in 2018.

Steps to lengthen working hours under the Competitiveness Pact will increase the number of hours worked by the existing labour force from 2017 onwards, which in the short term may reduce recruitment needs in the private sector and in general government. In the longer term it is thought that longer working hours will have no negative impact on employment, assuming that labour productivity per employed person will improve and that labour costs accordingly will fall. Employment growth is furthermore supported by the agreement of 0% collective wage increases under the Competitiveness Pact as well as reductions to the employer's social security contributions, which will have the effect of reducing the cost of labour from 2017. Overall it is estimated that the measures incorporated in the Competitiveness Pact will have only a minor impact on employment during the outlook period, as it will take some time for the reduced labour costs to filter through and bolster exports. For the most part the positive effects on employment will not be seen until 2018 and beyond.

Long-term and structural unemployment have continued to grow. In April the number of people who had been out of work for more than a year was 121,000, some 17,000 more than one year earlier. According to the Ministry's employment service statistics the number of structurally unemployed people in April was 214,000, or 9,000 more than the corresponding figure last year. In recent years long-term unemployment has increased in all age groups, but most of all among those aged 25–54. Despite the improving economy, the high level of structural unemployment will slow the decline in the unemployment rate.

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. Ministry data for January-April indicate that the number of job vacancies has continued to increase, but this has had little effect on the number of unemployed persons.

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. According to Statistics Finland the number of unemployed persons in January–April averaged 257,500, while figures published by the Ministry of Employment and the Economy were much higher at 355,253.

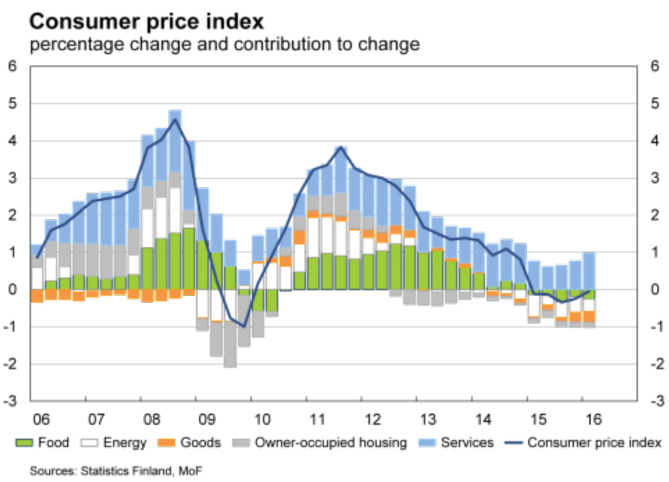
At the moment the discrepancy between the unemployment figures reported by Statistics Finland and the Ministry of Employment and the Economy is further accentuated by the fact that some unemployed people have given up their active search for work because of the weak economic situation. The Statistics Finland concept of unemployment is based on the criterion of active search for work, and the inactive unemployed are classified in the Labour Force Survey as 'disguised unemployed'. The differences between the two sets of figures are also explained by changes in statistical methods and legislation.

Consumer prices to rise moderately

Consumer prices were unchanged in Q1 from the first quarter of 2015, according to both the national and the harmonised consumer price index. The national consumer price index registered an annual decrease of 0.2% in 2015, so it seems that the slide in prices has come to a halt early in the year. There are several reasons why prices have continued to move very slowly, but the single most significant factor is the low world market price of oil compared with last year. In the first quarter of 2016 prices of energy commodities fell by 5.1% year-on-year. Goods and food prices were also down in Q1 from the same period the year before. Service prices, on the other hand, increased by around 2.5% year-on-year.

The inflation forecast for the current year is 0.5% as measured by the national consumer price index, indicating a moderate rise in consumer prices. Having fallen for a sustained period, crude oil prices started rising clearly in Q2. However the forecast assumes that the average price of oil will come in at around 46 euros a barrel in 2016, compared with the average price of just under 48 euros in 2015. It is anticipated that in Q3, the price of oil will begin to push up inflation, and that it will continue to have a upward effect through to the end of the forecast horizon.

As in 2015, the daily consumer goods sector has announced price reductions due to persistent stiff competition. Weak demand and the long-term fall in import prices are also impacting goods prices. Service prices, on the other hand, are expected to rise in 2016 at a rate of over 2%, which is slightly slower than average. Service prices are being driven above all by increases to social and health care client fees and rising maintenance charges for owner-occupied apartments. In 2016 increases to taxes and administrative charges will drive up inflation by an estimated 0.6–0.7 percentage points. In addition to the increase to the annual ceiling for social and health care client fees, other contributing factors are the hike to the annual vehicle tax and increases to the tobacco and fuel oil tax. The reduction of the motor car tax will have the opposite effect.



Inflationary pressures will remain lower than usual over the next few years as there are idle resources in the economy and the output gap is still clearly negative. The Competitiveness Pact will also act to curb inflation in 2017 and 2018 through reduced labour costs, for instance. It is expected that the national consumer price index will increase by 1.2% in 2017 and by 1.3% in the last year of the forecast horizon in 2018. Oil prices will edge up over the outlook period and accelerate inflation. The forecast is also impacted by assumptions of moderate wage increases, a weakening euro and low but gradually rising interest rates. In addition, the forecast incorporates the assumption that the weakening of the euro will be slower than before and that low interest rates will gradually edge up.

In 2015 the euro area inflation rate in terms of the harmonised consumer price index came in at 0.0%, and prices have continued to rise slowly in early 2016. The low level of energy prices has slowed inflation in the euro area, too, while other major items in the consumer price basket have contributed to accelerate inflation. The latest ECB forecast is that euro area inflation will rise to 0.2% in 2016, to 1.3% in 2017 and 1.6% in 2018. The comparative growth forecasts for Finland are 0.5% in 2016, 1.1% in 2017 and 1.3% in 2018, so it is expected that, with the exception of the current year, prices in Finland will rise somewhat more slowly than in the euro area on average.

Earnings to rise moderately

Nominal earnings, as measured by the index of wage and salary earnings, increased by 1.3% last year. Contractual wages increased by 0.6%, and other factors pushed up the index of wage and salary earnings by 0.7%.

In 2016 earnings will develop in line with the framework agreement negotiated by the social partners in June 2015. The Pact for Employment and Growth will push up negotiated wages by an average of 0.6%. The forecast for earnings development assumes that other factors than contractual wages will drive up earnings by 0.6% a year. Therefore it is predicted that nominal earnings will rise by 1.2% in 2016.

It is assumed that moderate earnings growth will continue: earnings are projected to increase by 0.8% in 2017 and by 1.2% in 2018. This is clearly slower than the average rate for the 2000s, which is well in line with the sluggish economy and slow employment trends.

Consumer price index and index of wage and salary earnings
change from previous year, %

Sources: Statistics Finland, MoF

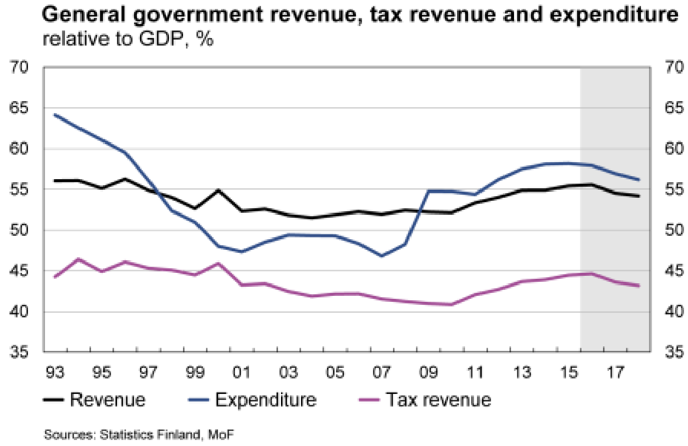
Public finances

Finland's public finances improving slowly

Finland's public deficit decreased last year and came well within the 3% of GDP target in response to fiscal adjustment. Nonetheless the fiscal budget will continue to run a deficit over the outlook period. The slow rate of economic growth will not generate sufficient tax revenue to cover public expenditure. Furthermore, public expenditure is continuing to rise with population ageing. The savings measures taken by the Government will help to curb expenditure growth during the forecast horizon. Public debt to GDP will continue to rise over the immediate future.

The forecast for public finances reflects the Competitiveness Pact signed by the social partners on 14 June 2016 as well as the associated Government plans for employee tax concessions in 2017, when the pact will have reached around 85% coverage. For the present purposes it has been necessary to make technical assumptions about various details of the implementation of the pact; more information will become available as implementation progresses. In the short term the Competitiveness Pact will weaken public finances.

The on-budget balance improved slightly early in the year, mainly by virtue of strong tax revenue. However after the second supplementary budget for 2016 the net borrowing need is still EUR 5.7 billion. Despite the Government's austerity measures and very cautious spending, the deficit will continue to shrink very slowly in 2017 and 2018 because economic growth is set to remain modest.



One of the factors driving up central government expenditure this year is immigration and the associated costs. The commitments included in the Competitiveness Pact to reduce social security contributions and holiday bonuses will reduce labour costs and central government expenditure from 2017 onwards. Furthermore, it is expected that the introduction of longer working hours will reduce the amount of employee compensations paid out by central government. Tax concessions and slower wage bill growth will reduce central government tax revenue. Changes to the distribution of income in favour of private business companies will increase revenue from corporate income tax.

State debt will continue to grow both nominally and as a percentage of GDP, but the rate of growth will slow. Low interest rates mean that interest outlays on state debt are still quite moderate. Apart from the existing debt stock, the stock of state loan guarantees has increased rapidly and now stands at over EUR 40 billion.

The local government budgetary position is set to improve slightly in the years ahead. During 2016 local authorities will continue their fiscal adjustment efforts. Furthermore, the austerity measures set out in the Government Programme will contribute to strengthen municipal finances over the outlook period. However the increased need for services as a result of population ageing is driving up local government health care expenditure. Increased levels of immigration are also causing increased expenditure pressure for local governments.

Local government expenditure is showing very slow growth on account of ongoing fiscal adjustment efforts. Consumption expenditure will fall in 2017 with the introduction of the Competitiveness Pact, which will bring a reduction in holiday bonuses and employers' social security contributions as well as longer annual working hours. This projection is based on the assumption that longer working hours will reduce local government spending and expenditure growth pressures in social and health care services in 2017–2020. The forecast for local government finances does not take into account any additional adjustment measures introduced by local authorities for 2017–2018.

Local government revenue is also set to increase slowly over the next few years. In 2016 tax revenue growth will be slowed by the expiry of the temporary increase in the share of corporate income tax revenue paid to local governments. The Government's adjustment measures will reduce the amount of central government transfers made to local governments. Furthermore, it is assumed that the savings in local government expenditure targeted through the Competitiveness Pact will be taken into account in the level of funding allocated to local governments through central government transfers.

The surplus of earnings-related pension funds fell to 1.4% of GDP last year. The surplus will continue to shrink over the outlook period and drop to below one per cent in 2018. Earnings-related pension expenditure will continue to rise sharply with the growing number of pensioners and the higher average level of pensions. Continued slow wage bill growth will act to slow the growth of revenue from insurance contributions. The 0.4% hike in private sector earnings-related pension contributions will in turn bring increased revenue in 2017. The partial transfer of the burden of payments from employers to employees as agreed under the Competitiveness Pact will have no effect on the financial position of authorised pension providers. Authorised pension providers' property income will remain at a low level in 2016 because of low interest rates. However it is expected that interest revenue will turn to moderate growth from the beginning of next year.

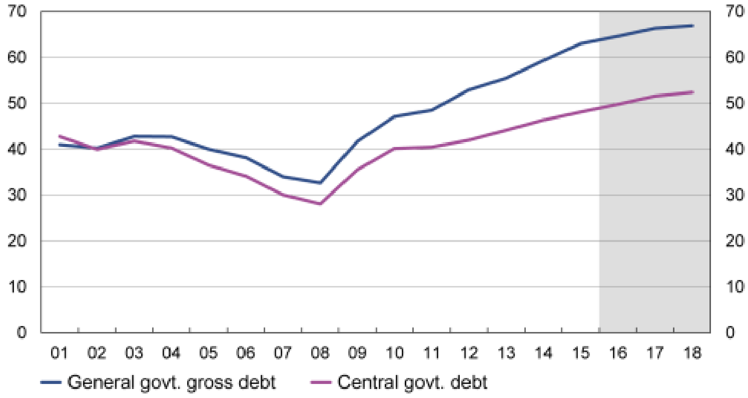
The deficit of other social security funds will shrink in 2016 because the unemployment insurance contribution was increased by one percentage point from the beginning of the year. Furthermore, the growth of earnings-related unemployment insurance expenditure will come to a halt and the growth of basic unemployment security expenditure will slow. It is anticipated that unemployment expenditure will start slowly to fall from 2017 onwards. The savings decisions taken by the Government will curb the growth of other social security funds' expenditure during the outlook period. The reduction to the employers' sickness insurance contribution as agreed under the Competitiveness Pact will dent the Social Insurance Institution Kela's revenue by over EUR 800 million in 2017 and 2018, which will be compensated with additional funding from central government. By contrast the partial transfer of the employer's unemployment insurance contribution to employees will have no effect on the financial position of other social security funds.

Additional graphs

Exchange rate
EUR/USD

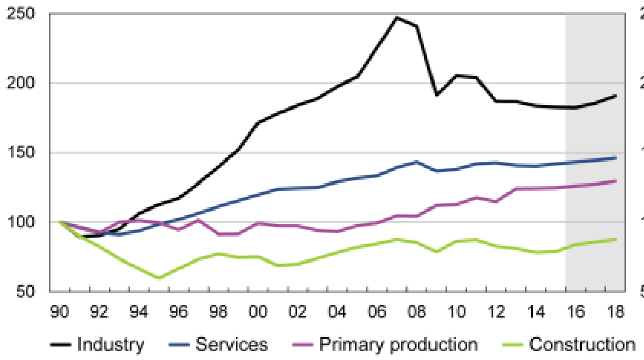
Source: European Central Bank

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



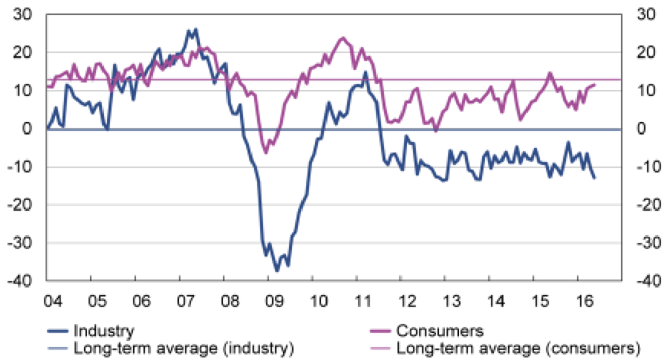
Sources: Statistics Finland, MoF

Production
1990=100



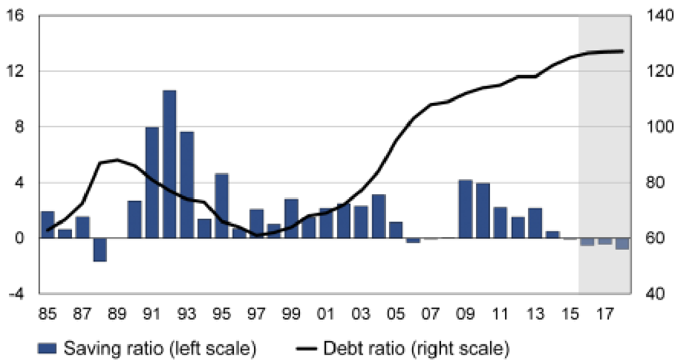
Sources: Statistics Finland, MoF

Industry and consumer confidence
balance, seasonally adjusted



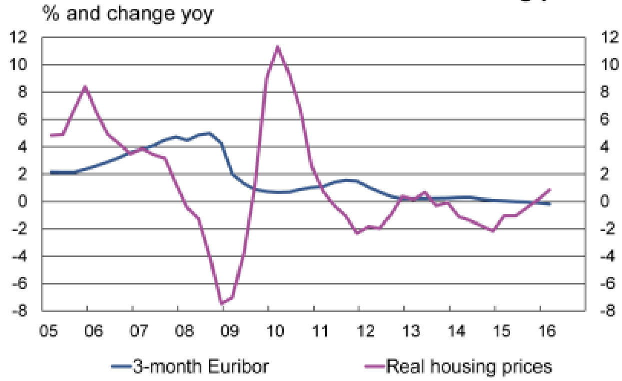
Source: European Commission

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

Inquiries

Mr. Mika Kuisminen,
Head of the Forecasting Unit,
tel. +358 40 502 5107,
+358 02955 30021

Mr. Marko Synkkänen,
tel. +358 02955 30359

Information on Public Finances:
Mr. Mikko Spolander,
Head of the Stability Unit,
tel. +358 40 558 7457,
+ 358 02955 30006

MINISTRY OF FINANCE
Snellmaninkatu 1 A
PO BOX 28, 00023 Government
Tel. +358 295 160 01
vm.fi/en

Economic Survey, Summer 2016
Ministry of Finance publications – 24c/2016
ISSN 1797-9714 (zine)
ISBN 978-952-251-784-5 (zine)

Reading instructions and printable version

This digital publication is readable on all devices regardless of their operating system or screen size (computers, tablets, smartphones and TV receivers with a web browser). The content of the publication is automatically scaled to the currently active screen size. You can enlarge pictures and diagrams to full screen size by clicking them.

When reading the publication on your computer, you can easily move from one page to another using the keyboard arrow keys, and on a touch-screen device by swiping the screen to the right or left.

You can open a printable PDF version by clicking here.