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Economic Survey

Autumn 2017

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Economic Prospects

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Economic Survey

Autumn 2017

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Abstract

The Finnish economy is in a phase of rapid growth. In 2017, the Ministry expects the rate of economic growth to clearly outperform that of 2016, after which the projected growth rate will slow to a level of around 2%.

According to the forecast, the Finnish economy will continue to show strong growth in 2018 compared with previous years, albeit at a slightly slower rate than this year. The slowing growth is largely due to falling private consumption demand as purchasing power growth will be slower than this year. Employees' purchasing power will be weakened by accelerating inflation despite at the same time being supported by an upswing in employment.

Domestic inflation will accelerate next year and will be seen more broadly across the commodity groups than in 2017. The biggest price increases will be in services. Price rises will also be fuelled by an upward movement from the current low interest rate environment. The rise in prices will be slowed down by the strengthening of the US dollar and the continued moderate oil prices.

Moderate growth in gross domestic product (GDP) will impact positively on employment, but the decrease in the number of unemployed persons will still be slow. In 2018, the employment rate will rise to around 70% while the unemployment rate will fall to around 8%. Various regional and occupational mismatch problems stand in the way of more favourable employment development.

Export growth will continue at a good rate until the end of the outlook period. The decline in market shares will come to an end and exports are set to grow steadily, driven by growth in world trade. Export growth will continue to arise primarily from exports of goods, which will also increase imports of production inputs. The number of new orders and high confidence reported are indicative of good export prospects.

The growth outlook for the global economy and world trade has improved recently. The positive development seen in emerging economies and the United States will continue, and the role of the euro area will be emphasised in the future. Economic growth in the euro area will climb further to just over the 2% mark next year.

Finland's general government finances have been strengthened by the fiscal adjustment decisions taken by the Government and the economic growth triggered last year. Despite this positive development, general government finances will still remain in deficit until the end of the decade. Due to population ageing, the budgetary position should be clearly in surplus at the beginning of the 2020s.

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Preface

This Economic Survey offers projections of economic developments in 2017–2019. In addition to short-term prospects, it includes a medium-term economic outlook extending to 2020.

The forecast and trend projections in the survey are prepared independently by the Ministry of Finance Economics Department based on the Act on the implementation of the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union and on multi-annual budgetary frameworks (869/2012).

The forecasts are based on national accounts data for 2016 published by Statistics Finland in July 2017 and on other public statistical sources available by 1 September 2017.

Helsinki September 2017

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The source for all data on materialised developments is Statistics Finland unless otherwise indicated.

SYMBOLS AND CONVENTIONS USED

-	nil
0	less than half the final digit shown
..	not available
.	not pertinent
**	forecast
CPB	CPB Netherlands Bureau for Economic Policy Analysis
HWWI	Hamburgisches WeltWirtschafts Institut
IMF	International Monetary Fund
MoF	Ministry of Finance

Each of the figures presented in the tables has been rounded separately.

Contents

Summary

Economic outlook for 2017–2019

The Finnish economy is in a phase of rapid growth. In 2017, the Ministry expects the rate of economic growth to clearly outperform that of 2016, after which the projected growth rate slows to a level of around 2%. Over the next few years, economic activity will be driven by both domestic and foreign demand. The patterns differ clearly, however. Private consumption and to some extent investment demand growth will slow, but exports will pick up. Improving global demand and business cost competitiveness will boost growth prospects for exports. Household consumption demand will be hampered by subdued purchasing power. Investment growth will be held back by a slowdown in housing construction growth but accelerated by major production-related investment projects.

Buoyant mood in global economy growing stronger

Global economic growth is being upheld by emerging economies in particular, but growth is also gaining strength in industrial countries. World trade has developed favourably since late 2016. Trade has been accelerated by emerging economies in particular, but in the future the significance of positive development in the euro area will be emphasised. In the next few years, world trade growth will increase at more or less the same rate as global output. The rate of growth in world trade will, however, be much slower than during the most intensive periods of globalisation seen last decade.

Positive economic development is still taking place in the United States. The Federal Reserve is continuing the normalisation of monetary policy, which is reflected in a rise of short-term market interest rates. In Europe, the economic outlook has strengthened this year, and business and consumer confidence is high. Unemployment in the euro area has fallen to its lowest level in eight years. The consolidation of economic growth in the euro area will, however, need to take place on a more permanent basis before any departure from the unconventional monetary policy.

The debt crisis in the euro area has been put on the back burner as most crisis countries have exited the economic adjustment programmes and Greece has also finally returned to a growth path. During the current year, the euro has strengthened against the other main currencies, reflecting the positive outlook of the euro area. Over the longer term, however, the euro is likely to weaken against the US dollar because the United States will discontinue the light monetary policy earlier than the euro area.

Positive trend continuing

Finland's GDP growth forecast for 2017 is 2.9%. New signs of the continuation of this positive trend were received early in the year. These include the increase in new orders in manufacturing industry and growth in private service production turnover as well as the sustained strength of construction in growth centres.

This year, private consumption growth will continue on the back of improving employment. The focus in private investment is shifting from construction to manufacturing industry's production-related investments. The growth prospects of exports are bolstered because global demand is increasing and the cost competitiveness of enterprises is improving. Foreign trade will take an upturn supporting GDP growth after years of negative reports.

Business tendency surveys indicate that the technology and chemical industries have the best prospects for growth. Forest industry companies anticipate growth to slow towards the end of the year, but the capacity increase in Äänekoski will support forest industry output growth starting from next year at the latest. Overall, industrial output will increase by almost 7% this year due to the strong development earlier in the year and the new orders received. Increased production capacity and efforts made by enterprises to improve the competitiveness of their products will boost manufacturing output in the years ahead.

The broad-based and rapid strengthening of economic activity has increased employment since the beginning of 2017, but there was hardly any decrease in unemployment over the same period. The unemployment rate trend has remained at 8.7%. The standstill in the decline of the unemployment rate is at least in part due to the activation of the disguised unemployed and other persons outside the labour force to become jobseekers, which is normal in the context of economic rebound.

In 2017, earnings development will mainly be determined by the Competitiveness Pact concluded by the social partners, as a result of which there were no increases to negotiated wages and salaries and public sector holiday bonuses were cut by 30%. The net effect of these factors is anticipated to lower the negotiated pay slightly. The earnings level will, however, be increased by other factors, resulting in a 0.3% increase in the index of wage and salary earnings in 2017.

Robust economic growth will continue in 2018, despite GDP growth slowing to 2.1%. The slowing growth is largely due to falling private consumption demand, as purchasing power growth will be slower than this year. Employees' purchasing power will be eroded by accelerating inflation despite at the same time being supported by an upward trend in employment.

Acquisitions of machinery and equipment will result in slightly higher investment increase compared to this year. Strong growth will also continue in construction investment, despite a slowdown in residential housing construction growth.

The rate of export growth will hold up well. The decline in market shares will come to an end and exports are set to growth steadily, driven by growth in world trade. Export growth will continue to come primarily from exports of goods, which will also increase imports of production inputs. Increasing demand in consumer and investment goods will also result in an increase in imports, reducing the positive contribution of net exports to economic growth.

The fact that manufacturing companies have received one fifth more new orders since the start of this year compared with last year is indicative of good export prospects. The highest number of orders has been won by the shipbuilding industry, but growing order books have also been reported by the chemical and forest industries. Industrial output growth will be bolstered by the expansion of production capacity and increasing demand in the forest industry. Service output growth will still be based on increasing business demand.

Retaining the reasonably rapid rate of GDP growth will have a positive effect on employment, but the decrease in the number of unemployed persons will still be slow. The unemployment rate will fall to 8.1% in 2018. In recent years, obstacles to an improvement in the employment situation have been presented by various regional and occupational mismatch problems between unemployed job seekers and job vacancies. A slight decrease in these mismatch problems has been seen due to the stronger economic growth.

In 2018, prices will rise more broadly than in the current year across the commodity groups, but the rise in service prices will continue to have the greatest impact on overall inflation. The moderately increasing price of oil, the strengthening of the US dollar and the low, yet rising, interest rate level are anticipated to accelerate inflation.

In 2019, GDP will grow by 1.8%. Private consumption growth will slow down due to the slowdown in the growth of household real income. Private investment growth will hold up well as production-related investments will increase due to developments including major projects planned by the forest industry. Employment will continue to improve, but the rate will be slightly slower than earlier. The rise in consumer prices will level off to 1.5% in 2019.

Overall, the economic growth outlook for the 2017–2019 period is more positive than in previous years. The general conditions for economic growth and the structures determining these have not, however, changed to such an extent as to increase the economy's growth potential. In 2020 and 2021, the Finnish economy will only grow at an estimated average rate of less than 1½% per year. Economic growth based on a strong increase in labour productivity will keep the rate of improvement in the employment situation moderate. The supply of labour will not on the whole restrict employment growth during the outlook period as the number of the unemployed and disguised unemployed will still exceed 400,000 persons. Nevertheless, a shortage of labour can already be discerned in certain occupational groups.

Despite the economic upswing, Finland's general government finances are showing a deficit

The general government deficit has decreased gradually in recent years. General government finances have been strengthened by the fiscal adjustment decisions taken by the Government and the economic growth triggered last year. The deficit will also continue to shrink gradually in the coming years. The economic upswing will not, however, eliminate the structural problems of general government finances. Despite the positive cyclical position, general government finances will continue to show a deficit.

Public debt has more than doubled since 2008. The rapid growth in GDP and the decrease in deficit will lower the debt-to-GDP ratio in the next few years. Due to the ageing of the population, however, an imbalance between revenue and expenditure will persist in general government finances over the long term. There is a sustainability gap in general government finances due to which the debt-to-GDP ratio will return to an upward trajectory in the coming decades.

Economic development risks

The rather optimistic global economic outlook is overshadowed by the threat of protectionism and pressures directed at the multilateral trading system. In the euro area, too, the risks remain skewed to the downside. Furthermore, the weak financial solidity of some European banks and the large volume of bad loans remain a cause for concern.

A positive risk worthy of note is the prospect of stronger-than-expected growth in industrial countries. This applies particularly to the euro area, but also to countries such as Japan. Growth in demand at a rate faster than anticipated in the euro area would increase inflationary pressures and, consequently, speed up the return to normal monetary policy. Faster-than-projected growth in world trade is also a positive risk.

The domestic risks are related to confidence and the labour market. As there will only be slight growth in household purchasing power, consumption growth will be based on strong confidence that may also be quickly eroded. As regards wages and salaries, the forecast assumes that collectively agreed pay rises will be very modest in 2018 and 2019. Pay rises for 2018 will be negotiated sector-specifically, which increases the uncertainty of the pay forecast. Higher-than-anticipated pay rises may weaken export and employment growth. As regards investment, there is uncertainty arising from potential delays in the major projects planned.

Table 1. Key forecast figures

	2016 EUR bn	2014	2015	2016	2017**	2018**	2019**
		change in volume, %					
GDP at market prices	216	-0.6	0.0	1.9	2.9	2.1	1.8
Imports	79	-1.3	3.2	4.4	2.9	2.6	3.1
Total supply	294	-0.8	0.9	2.6	2.9	2.2	2.2
Exports	76	-2.7	0.8	1.3	4.7	3.7	4.1
Consumption	171	0.4	1.1	1.6	1.6	1.2	1.0
private	119	0.8	1.7	1.8	2.4	1.4	1.2
public	52	-0.5	0.0	1.2	-0.3	0.8	0.4
Investment	46	-2.6	0.7	7.2	4.7	3.7	3.5
private	38	-3.4	2.2	7.9	5.5	4.0	4.1
public	9	0.9	-5.2	3.9	1.0	2.1	0.9
Total demand	294	-0.8	1.1	2.2	2.7	2.1	2.0
domestic demand	218	-0.1	1.2	2.5	2.0	1.5	1.3
		2014	2015	2016	2017**	2018**	2019**
GDP, EUR bn		205	210	216	224	232	241
Services, change in volume, %		-0.4	0.2	1.3	2.0	1.5	1.4
Industry, change in volume, %		-0.2	-1.6	1.1	6.8	2.8	3.0
Labour productivity, change, %		0.1	0.1	1.2	2.1	1.3	1.5
Employed labour force, change, %		-0.4	-0.4	0.5	0.7	0.8	0.5
Employment rate, %		68.3	68.1	68.7	69.4	70.1	70.5
Unemployment rate, %		8.7	9.4	8.8	8.6	8.1	7.8
Consumer price index, change, %		1.0	-0.2	0.4	0.9	1.5	1.5
Index of wage and salary earnings, change, %		1.4	1.4	1.1	0.3	1.4	1.6
Current account, EUR bn		-2.6	-1.2	-2.3	-3.0	-3.2	-3.3
Current account, relative to GDP, %		-1.3	-0.6	-1.1	-1.3	-1.4	-1.4
Short-term interest rates (3-month Euribor), %		0.2	0.0	-0.3	-0.3	-0.2	0.0
Long-term interest rates (10-year govt. bonds), %		1.5	0.7	0.4	0.5	0.9	1.4
General government expenditure, relative to GDP, %		58.1	56.9	55.8	54.1	53.1	52.2
Tax ratio, relative to GDP, %		43.9	44.0	44.1	43.2	42.2	41.8
General government net lending, relative to GDP, %		-3.2	-2.7	-1.8	-1.2	-1.4	-1.0
Central government net lending, relative to GDP, %		-3.8	-3.0	-2.7	-2.3	-2.0	-1.4
General government gross debt, relative to GDP, %		60.2	63.6	63.1	62.5	61.9	61.1
Central government debt, relative to GDP, %		46.3	47.6	47.5	47.7	47.5	46.9

Medium-term outlook

Finnish GDP growth accelerated to almost 2% last year, after several years of weak economic development. This year, economic growth is expected to accelerate to almost 3% before slowing in the 2018–2019 period to a more moderate level of around 2%. In the medium term in the 2020–2021 period, economic growth is projected to return to the level of potential output growth, that is, a little over 1%.[1]

The slowness of potential growth is due to structural factors in the economy. On the one hand, the shrinking of the working-age population and the persistence of relatively high structural unemployment maintain zero growth in labour input despite the more active participation of older age cohorts in particular in the labour market. On the other hand, productivity growth has slowed as the output of high-productivity sectors has declined significantly and the overall structure of the economy has shifted towards services. In addition, the low investment rate that has continued for several years has slowed the generation of new productive capital. However, the rise in investment rates that started in 2016 is gradually beginning to improve the situation.

The 2017 estimate is that the output gap will stand at just over -½% of potential output.[2] When GDP growth clearly exceeds its potential, the output gap will close already in 2018. In 2019, the output gap is expected to be just under +½% and remain at that level in the medium term. The output gap will close in the next period of economic decline.

The rebound of economic growth will decrease the deficit in general government finances, but it is nowhere near enough to bridge it fully as at the same time general government finances will be weakened by population ageing. In addition, the tax concessions introduced under the Competitiveness Pact will lower tax revenue, while on the other hand the adjustment measures adopted by the Government will slow expenditure growth. In the long term, general government revenue will no longer be enough to sustain all the structures and functions of the public sector that were created on the foundations of a more favourable demographic structure.

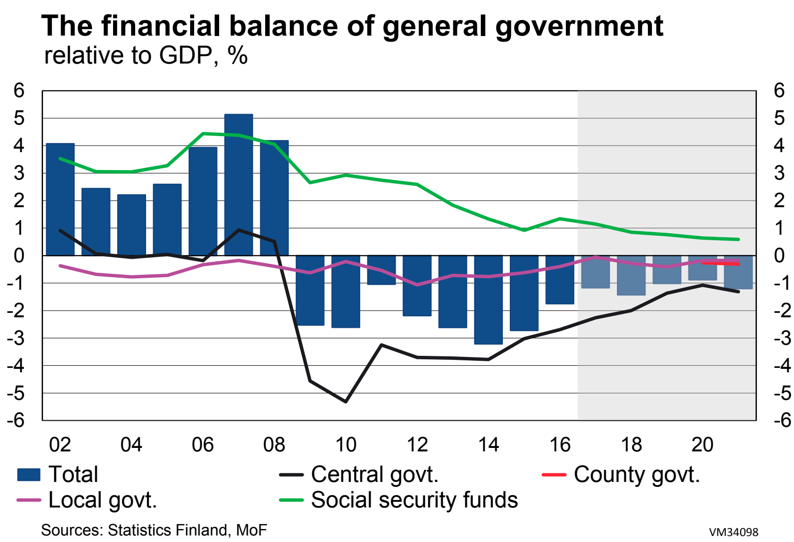
1 The medium-term outlook can be examined on the basis of potential output, because this is thought to determine the economy's growth prospects. In its assessments of potential output, the Ministry of Finance uses the production function method as developed jointly by the European Commission and Member States, in which potential output growth is divided between projections of potential labour input, capital and total factor productivity. Potential output and output gap are latent variables, the assessment of which involves uncertainties, particularly during a strong economic cycle and under conditions of rapid changes in the production structure.

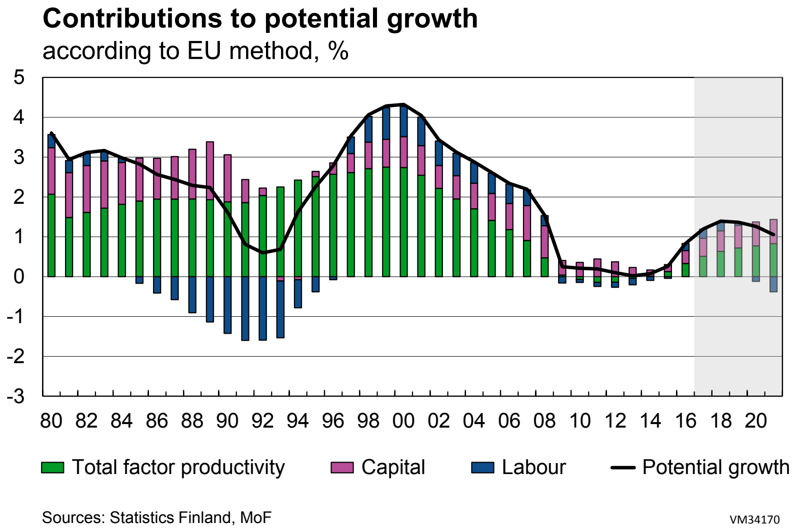
2 The output gap, i.e. the difference between total actual output and potential output, is negative when actual output is lower than potential output. This means there is idle capacity in the economy and output can grow more rapidly than potential output without creating price pressures.

Table 2. Key forecast figures for the medium term

	2015	2016	2017**	2018**	2019**	2020**	2021**
GDP at market prices, change in volume, %	0.0	1.9	2.9	2.1	1.8	1.3	1.1
Consumer price index, change, %	-0.2	0.4	0.9	1.5	1.5	1.8	2.0
Unemployment rate, %	9.4	8.8	8.6	8.1	7.8	7.5	7.3
Employment rate, %	68.1	68.7	69.4	70.1	70.5	70.9	71.2
General government net lending, relative to GDP, %	-2.7	-1.8	-1.2	-1.4	-1.0	-0.9	-1.2
Central government	-3.0	-2.7	-2.3	-2.0	-1.4	-1.1	-1.3
County government						-0.3	-0.3
Local government	-0.6	-0.4	-0.1	-0.3	-0.4	-0.2	-0.2
Social security funds	0.9	1.3	1.1	0.9	0.8	0.6	0.6
Structural balance, relative to GDP, %	-0.8	-0.4	-0.8	-1.3	-1.4	-1.1	-1.4
General government gross debt, relative to GDP, %	63.6	63.1	62.5	61.9	61.1	60.2	59.9
Central government debt, relative to GDP, %	47.6	47.5	47.7	47.5	46.9	46.3	46.1
Output gap, % of potential output [1]	-3.4	-2.3	-0.7	0.0	0.4	0.4	0.4

[1] Estimated according the method developed jointly by the EU Commission and Member States





ALTERNATIVE SCENARIO ON EFFECTS OF HIGHER OIL PRICES

The long slide in oil prices has ended and prices have started to move up. Oil price fluctuations will still play a role as regards inflation, and the impact of energy on consumer prices may take a quick turn from a lowering to a raising effect. This alternative calculation covers the impacts of an acceleration in the rising trend of oil prices on Finland's economic growth.

Oil price movements have in recent years deviated from forecasts. Oil prices have fallen more rapidly than anticipated and are currently around 50% below the level seen in late 2014. Low oil prices have had direct and indirect impacts restraining the rise of consumer prices. Low oil prices and the resulting fall in fuel prices have contributed towards growth in household consumption and reductions in business costs. An estimated EUR 3 billion[1] has become available for other uses as fuel prices have been lower than prior to 2014.

The recent decline in oil prices is thought to result on the one hand from sluggish demand during a slowdown in economic growth and on the other from an increase in oil production itself. Despite production cuts, oil prices have not shown a rapid escalation. The forecast, however, anticipates a slight upturn in oil prices. In 2021, the price of oil is predicted to be around USD 63 a barrel.

Inflation will be driven in 2017 by the price of crude oil, which is at a much higher level than in 2016. It is predicted that the average price of oil in 2017 will be up by around USD 7 a barrel on the average of USD 45 seen in 2016.

Historically there has been a strong correlation between oil price movements and global economic outlook. Low oil prices have had a strong stimulating effect on the global economy in recent years.

This text box examines calculations prepared using the Ministry of Finance Economics Department's macroeconomic model (Kooma) giving oil prices from the first quarter of 2018 onwards at a level 20% higher than predicted in the baseline scenario. This takes the predicted price of oil above USD 75 per barrel for 2021. The calculation also examines a

1 The estimate is based on changes in the value of net imports of petroleum products.

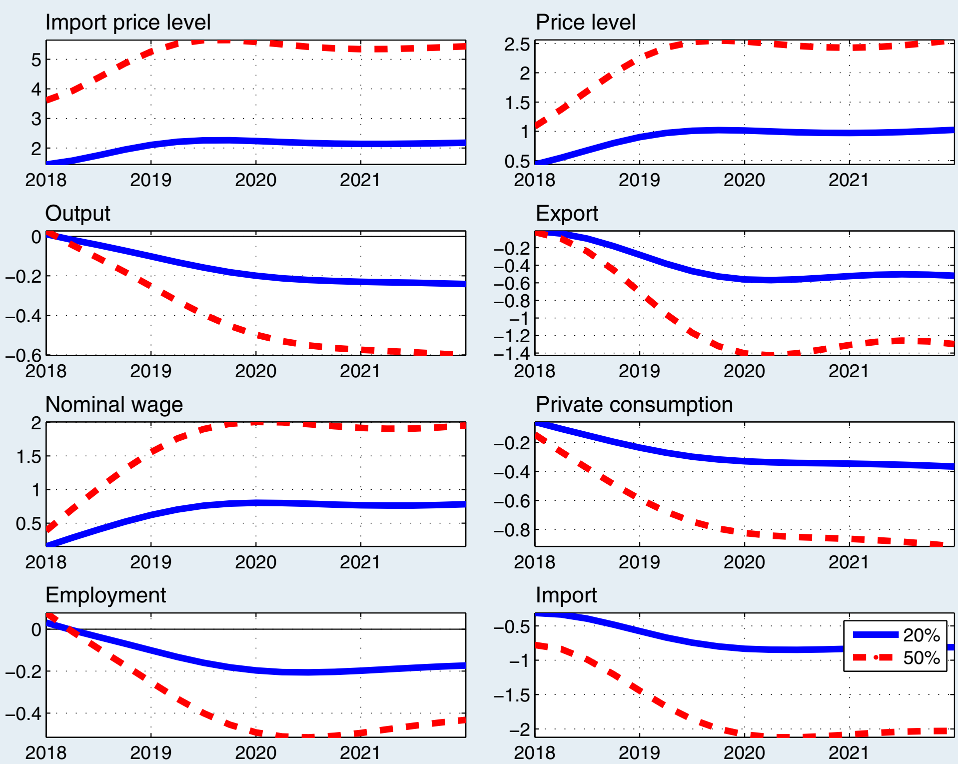
situation where oil price is assumed to increase by 50% and end up at almost USD 100 a barrel in 2021. The channels of influence in the calculations are the same, but the differences in the figures depicting the change illustrate the significance of the impact of oil price increases. Oil prices have a direct impact on consumer prices as well as on export producers' marginal costs. Consequently, the most important channels of influence are consumption and exports.

The impacts of oil price increases are diverse. At the global level, rising oil prices generate stronger increases in production costs, which has a slowing effect on global economic growth. The calculation assumes an equal slowdown in the growth of production costs in Finland and Finland's export markets. In that case, Finland's export price development will hardly differ from that of rival countries.

Oil price rises are strongly reflected in import prices, the increases of which can be seen as a deterioration of the terms of trade. Rising oil prices accelerate the increase in domestic production costs and consumer prices and therefore slow growth in domestic demand.

In addition to direct impacts, multiplier effects also play a major role. When consumer prices increase, households seek to offset part of the increased costs by nominal wage and salary growth. Export prices will also rise and export growth slow compared with the baseline. Investment growth will slow. Import growth will also slow as the movement in relative prices will shift demand from imported to domestic commodities. Due to the high propensity to import in domestic demand and exports, the decrease in domestic production will be relatively small.

Effects of higher oil prices



Fiscal Policy

The Finnish economy is experiencing a strong upswing. The outlook for the next few years is also bright. The economy is clearly growing faster than its potential, and capacity utilisation rates are high. Export markets are growing, companies are receiving plenty of new orders and exports are performing well. Confidence in the future is strong among enterprises and households. The labour market is recovering, employment is picking up and unemployment falling.

The long-awaited economic growth is also improving the state of general government finances. Tax revenue is increasing and the decline in unemployment is reducing unemployment expenditure. The economic rebound does not, however, eliminate the structural factors weakening general government finances, with the most important of these being population ageing, which increases growth in pension, care and nursing expenditure and therefore slows down improvements in general government finances. Despite the economic recovery, general government expenditure clearly exceeds revenue.

The bright economic news does not give grounds for a change in Finland's fiscal policy aiming at balancing general government finances. In its Government Programme, the Government of Prime Minister Juha Sipilä has set itself the target of the GDP-to-debt ratio levelling off by the end of the government term and living on debt coming to an end in 2021. While robust GDP growth will set the debt ratio on a downward trajectory in the next few years, central government indebtedness will still continue in 2021.

To complement the debt objective, the Government has set specific targets for the general government budgetary position concerning each general government sector, that is, central government, local government, and social security funds. For these the targets to be reached, general government finances will need to be more or less in balance at the end of the government term.

To achieve the targets and to ensure the long-term stability of general government finances, it is important that the revenue generated by economic recovery be used to balance general government finances and reduce central government borrowing.

The double-dip recession experienced over the past eight years has left its mark on general government finances. The public debt-to-GDP ratio has doubled and general government gross debt increased by well over EUR 70 billion since 2008. At the onset of the financial crisis in 2008, there was still a surplus that could be utilised to cushion the impacts of the crisis. Today the situation is different. If the economic recovery is not utilised to strengthen general government finances, the expenditure pressures and any future recessions will have to be faced in a situation where the management of general government finances is based on budgets that are already in deficit.

Furthermore, the additional revenue generated by the upturn is temporary. Without measures to improve the conditions for growth, economic growth is set to be in the 1% to 1.5% range in the long term. Population ageing will shrink the working-age population, and economic growth will be reliant on productivity growth. Productivity growth has, in turn, been slowed by the growth in the relative importance of services in the economy.

To generate permanently more robust economic growth requires a reorganisation of societal structures for them to better support growth in the economy's production potential, employment and productivity. Higher production potential would create space for the economy to grow faster without increased price and cost pressures.

An economic recovery is a good time for economic restructuring and strengthening of conditions for growth. Strong economic growth helps attenuate any unfavourable impacts arising from restructuring in the short term.

The cornerstone of the fiscal policy outlined in the Government Programme is bridging the sustainability gap. The sustainability of general government finances will be strengthened not only through direct measures to improve general government finances and measures to boost growth and employment but also through general government reforms. One of the most important of these reforms is the health, social services and regional government reform due to enter into force on 1 January 2020.

As regards employment, the Government has set the target of increasing the employment rate to 72% and the number of employed persons by 110,000 during its term in office. The labour market situation is going to improve in the next few years but, in the light of the forecast, the employment target is not going to be met.

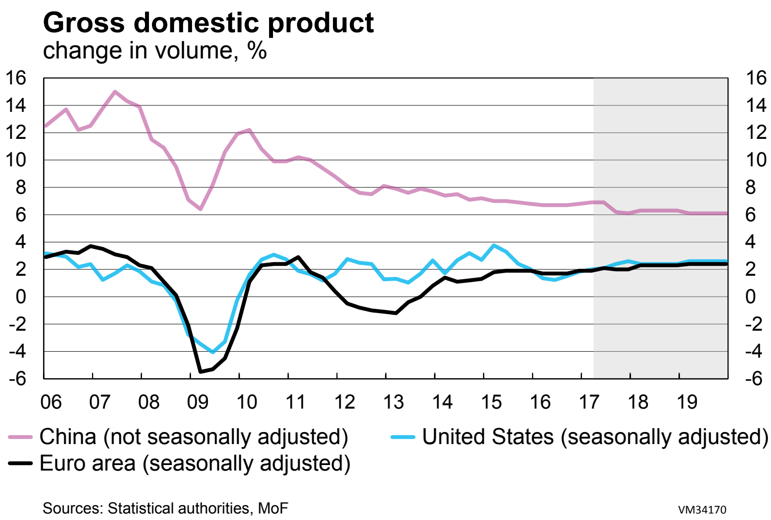
The Government aims to strengthen conditions for employment and economic growth through structural reforms as well as taxation measures. The supply of labour will be strengthened through measures including eliminating incentive traps, increasing labour mobility, reforming the unemployment security system and public employment services, and ensuring that employees' income taxes do not increase. The Competitiveness Pact that entered into force this year will, in turn, improve the competitiveness of Finnish enterprises and increase the demand for labour. The materialisation of the rise in employment enabled by the Pact requires, however, that the competitive advantage gained through the Pact will be taken care of in the wage and salary settlements of the coming years.

1 Economic outlook

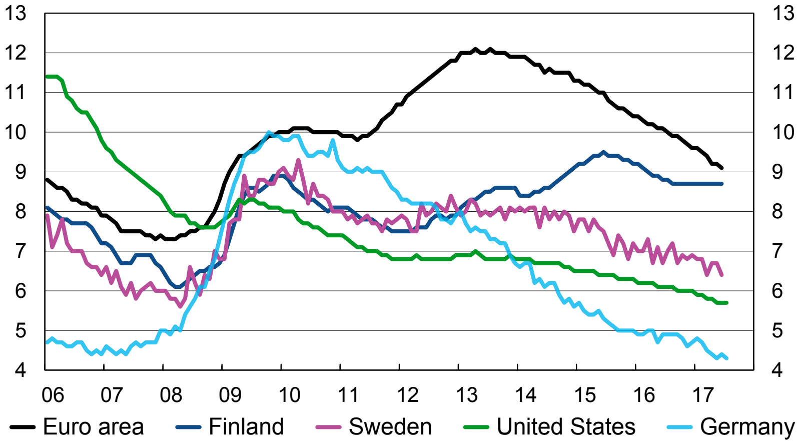
1.1 Global economy

Global economic outlook has improved

The buoyant mood in the global economy has grown stronger during the current year. Economic growth is being maintained by emerging economies in particular, but growth is also gaining strength in industrial countries. The global economy will grow by 3.5% this year, accelerating to 3.7% in 2018 and 3.8% in 2019.



Unemployment rate
seasonally adjusted, %



Sources: Macrobond, statistical authorities VM34170

According to some indicators, stock market volatility is at a record low, reflecting the positive outlook. Particularly in the USA, the Dow Jones stock market index keeps soaring to new all-time highs. In the debt markets, yields are low and prices high, indicating a calm situation. On the other hand, this is also attributable to the policy of quantitative easing, that is, purchases made by central banks in the debt markets. In Europe, a shadow over the prospects in some countries is cast by the high level of non-performing loans, reducing confidence in the soundness of these countries' banking systems.

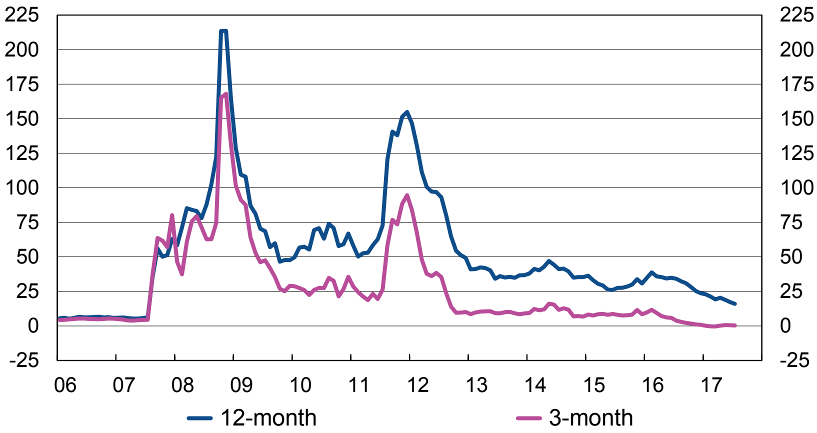
The positive economic development of the United States continues. New industry orders are on the increase, and unemployment has further contracted. The Federal Reserve is continuing the normalisation of monetary policy, which is reflected in a rise in short market rates. In contradiction to this, the US dollar has recently weakened considerably against the euro. This may be against a backdrop of positive conditions in Europe as well as the uncertainty relating to the economic policy of the US administration. In addition, the expectations of US businesses and consumers concerning future economic development are cautious. These factors will be among those curbing the acceleration of growth in the next few years from the current year's 2.3%.

In Continental Europe the economic outlook has strengthened this year. Business and consumer confidence is high. The growth figures reported so far for this year are strong, and growth has been more broad-based than earlier. Unemployment in the euro area has fallen to its lowest level in eight years. The European Central Bank has indicated that unconventional monetary policy measures will continue until economic growth in the euro area becomes more firmly rooted.

The debt crisis in the euro area has subsided as most crisis countries have exited the economic adjustment programmes and Greece has also finally returned to a growth path. Concern is mainly caused by risks relating to the balance sheets of some European banks. During the current year, the euro has strengthened against the other main currencies, reflecting the positive outlook of the euro area. Over the longer term, however, the euro is likely to weaken against the US dollar, reflecting the differences in monetary policy. The euro area is growing around 2% this year, and growth will accelerate in 2018 and 2019.

Banking system risks

difference between secured and unsecured interest rates, basis points

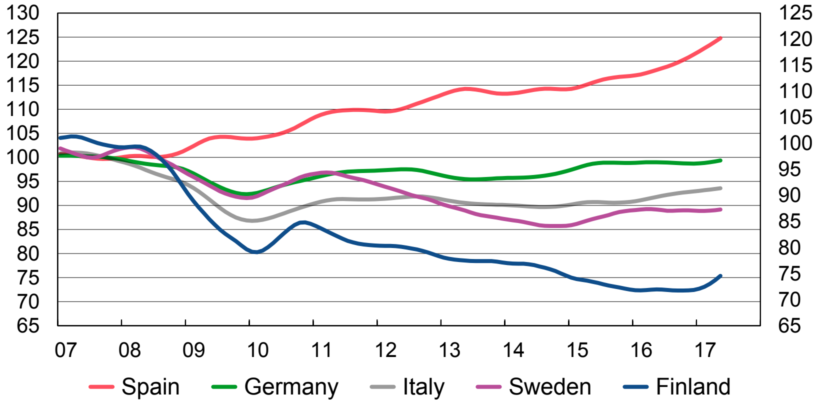


Source: Macrobond

The United Kingdom's economic outlook is overshadowed by the uncertainty relating to Brexit. Consumer confidence is weakening, and business investment is characterised by general caution. The country's economic growth is anticipated to remain weak in the next few years as well.

The strong economic development of recent years is continuing in Sweden, but leading indicators show that the economy is currently at its strongest growth phase. The Purchasing Managers' Indexes for the manufacturing industry as well as the service sector took a slight downturn early in the year, albeit still indicating clear economic growth. In the second quarter of the current year, Sweden's economic growth was very fast and is likely to remain close to 3% throughout the current year as well as the next few years.

Market share in goods exports[1]
2007=100, trend (HP)



[1] Ratio of goods exports growth to world trade growth

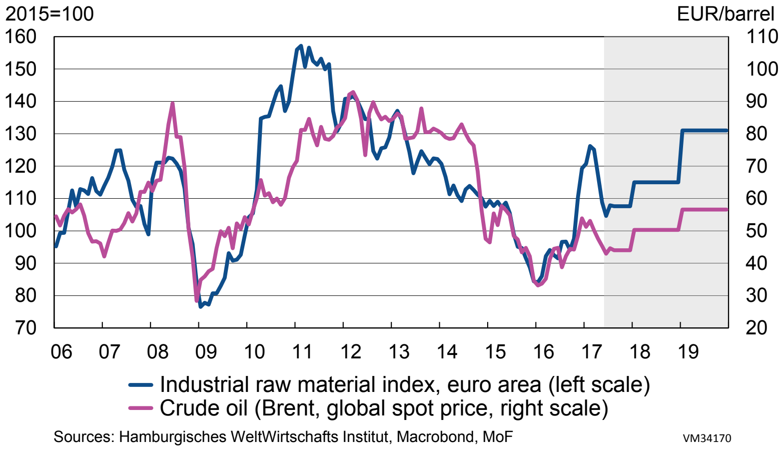
Sources: Macrobond, MoF

VM34170

Japan's economic growth soared in the second quarter of the current year in particular, but it is still uncertain whether the economy will transition to a sustainable growth trajectory. Japan's deflationary concerns are yet to disappear permanently, and the Bank of Japan is continuing its ultra-easy monetary policy. Wage developments play a key role as regards rising inflation. Employment is high and recent indexes have indicated strong consumer confidence. Growth in the Japanese economy will, however, be slow this year and in 2018.

The outlook of the Russian economy is largely dependent on development in the energy sector. The rise in crude oil prices early in the year accelerated economic growth in early 2017. The rouble has made gains against the US dollar following the rise in oil prices from the rock bottom seen in early 2016, but this trend appears to have been reversed recently due to greater fluctuation in prices. The Russian economy's growth potential is weakened by the need for major economic restructuring in which progress is yet to take place. For these reasons, Russia's economic growth will remain subdued in the next few years.

Raw materials prices
EUR



Sources: Hamburgisches WeltWirtschafts Institut, Macrobond, MoF

The first months of 2017 were a strong period for the Chinese economy, but the outlook of slowing growth for the coming years remains unchanged. Economic growth has been maintained by expansionary fiscal policy as China has set an ambitious total output target for the end of this decade. The transition of the Chinese economy from an export-driven model to a consumption-driven one is slowing economic growth, which increases the risks arising from the economy's considerable debt burden.

The outlooks of other emerging economies are predominantly positive. The Indian economy remains on a strong growth track. Despite problems, the outlook for Brazil is turning more positive and the same applies to South Africa.

World trade growth accelerating

World trade has also developed favourably since late 2016. Trade has been accelerated by emerging economies in particular, but in the future the significance of positive development in the euro area will be emphasised. This year in particular will be a year of growth in world trade due to strong performance early in the year. In the next few years, world trade growth will increase more or less at the same rate as global output. The rate of growth will, however, be much slower than during the most intensive periods of globalisation seen last decade.

Risks still mainly to the downside

There are, however, major risks relating to the positive outlook of the global economy. The key risks are the spillover effects of the gradual normalisation of US monetary policy on the global economy, the indebtedness of the Chinese economy in the context of slowing growth, the increased threat of protectionism to world trade, and rising geopolitical tensions.

US monetary policy normalisation will widen interest rate spreads between key economies and strengthen the dollar against the other main currencies over the longer term. Normalisation may have spillover effects on the global economy, as was the case a few years ago in conjunction with the "taper tantrum" episode. The risks are related in particular to the weakening of currencies of developing countries with external debt, which would result in a reduction in their debt servicing capacity.

The heavy leverage of Chinese enterprises and, more broadly, the indebtedness of the entire economy is a key risk in the global economy. When economic growth slows, the risks arising from indebtedness will increase, regardless of the fact that China also has sizable buffers. The growing risk was reflected by the downgrading of China's credit rating for the first time in 30 years that took place in March 2017.

Measures relating to the trade policy of large countries, such as the threat of protectionism that still continues to loom, pose a risk to the positive basic view of world trade growth. The recent escalation in geopolitical tensions has resulted in a rise in the price of gold, which is regarded as a safe-haven asset.

A positive risk worthy of note is the stronger-than-expected economic growth in industrial countries. This applies particularly to the euro area but also to countries such as Japan. Growth in domestic demand at a faster rate than anticipated would increase inflationary pressures and, consequently, speed up the return to normal monetary policy. Faster-than-projected growth in world trade is also a positive risk.

Table 3. Gross domestic product

	2014	2015	2016	2017**	2018**	2019**
	change in volume, %					
World (PPP)	3.2	3.3	3.2	3.5	3.7	3.8
Euro area	1.0	2.2	1.7	2.0	2.3	2.4
EU	1.4	1.6	1.7	1.9	2.1	2.2
Germany	1.6	1.5	1.8	2.0	2.3	2.4
France	0.2	1.2	1.1	1.6	1.9	2.1
Sweden	2.0	3.9	3.0	3.2	3.0	2.9
United Kingdom	2.9	2.2	1.8	1.5	1.3	1.2
United States	2.4	2.6	1.6	2.3	2.4	2.6
Japan	-0.1	1.1	1.0	0.8	1.0	1.0
China	7.3	6.9	6.7	6.5	6.3	6.1
Russia	0.6	-3.7	-0.2	1.2	1.4	1.4

Sources: Eurostat, statistical authorities, IMF, MoF

Table 4. Background assumptions

	2014	2015	2016	2017**	2018**	2019**
World trade growth, %	2.8	2.0	1.6	3.5	3.8	3.8
EUR/USD	1.30	1.10	1.10	1.12	1.09	1.02
Industrial raw material price index, EA, € (2015=100)	112.6	100.1	96.3	112.4	115.3	131.3
Crude oil (Brent), €/barrel	76.4	48.6	40.8	45.9	50.2	56.6
3-month Euribor, %	0.2	0.0	-0.3	-0.3	-0.2	0.0
Government bonds (10-year), %	1.5	0.7	0.4	0.5	0.9	1.4
Export market share (2000=100) [1]	91.2	90.2	90.2	91.2	91.1	91.3
Import prices, %	-1.6	-4.2	-2.8	4.9	2.5	2.7

[1] Ratio of export growth to world trade growth

Sources: Statistical authorities, CPB, HWWI, Reuters, MoF

1.2. Foreign trade

Finland's foreign trade has picked up since the start of the year, with growth seen in exports as well as imports. This reinvigoration can be attributed above all to the positive economic development in Finland's export markets early in the year.

1.2.1. Exports and imports

Finnish exports increased by 1.3% last year and the rate accelerated clearly in the first quarter of 2017 due to growth in exports in goods. The rapid growth in exports is mainly due to the rebound of demand in the export markets. Growth was seen across the board in all traditionally significant export products, such as mechanical engineering and chemical industry products. The volume of goods exports increased by as much as 12.7% during the first quarter of this year compared with the corresponding period a year earlier. According to Finnish Customs statistics on goods exports, January and May were particularly strong months. The volume increase of the first quarter is also explained by the low level reported for the comparison quarter. Service exports, by contrast, remained almost unchanged in early 2017, whereby the total volume of Finnish exports increased by 8.8% in the first quarter.

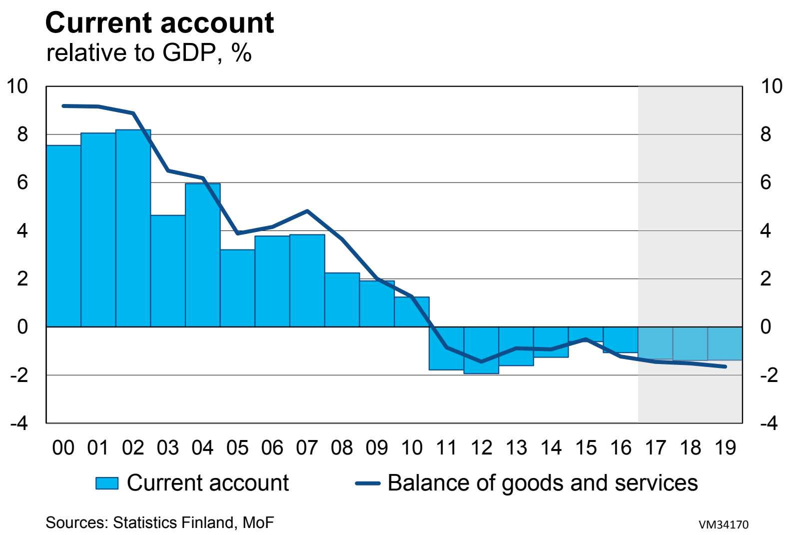
The imports growth figure for 2016 was revised in national accounts data for July, with imports growing by as much as 4.4%. This growth was largely based on imports of goods, up 6.5%, while service imports remained almost unchanged. The growth in goods imports was also broad-based and mainly took place in industrial products. The positive imports trend also continued in the early months of the year as the increase in the first quarter was 3.6% year on year.

Table 5. Foreign trade

	2014	2015	2016	2017**	2018**	2019**
	change in volume, %					
Exports of goods and services	-2.7	0.8	1.3	4.7	3.7	4.1
Imports of goods and services	-1.3	3.2	4.4	2.9	2.6	3.1
	change in price, %					
Exports of goods and services	-0.4	-0.9	-1.9	2.5	1.3	1.5
Imports of goods and services	-1.6	-4.2	-2.8	4.9	2.5	2.7

1.2.2 Prices and current account

In 2016, both export and import prices fell, but the decrease in import prices was smaller than that in export prices. Despite the fall in import prices, the value of imports increased due to an increase in the volume of imports, and imports at current prices exceeded exports by EUR 2.6 billion. Import prices rose strongly in early 2017 due to rises in raw material prices. There has also been upwards pressure on export prices, but the rate of increase has been slower than that seen in import prices. Both import and export prices will rise over the forecast horizon due to higher energy prices. Import prices will also be driven upwards by the strengthening of the US dollar towards the end of the period. In the current year, export growth will outperform the growth in world trade and the long period of declining market shares will end. Exports will grow driven by export demand in 2018 and 2019, albeit at a steadier rate than this year. Exports will continue to be mainly driven by goods exports, which will require imported inputs. In addition to demand in imported inputs, imports will also be increased by other sectors, such as wholesale and retail trade.

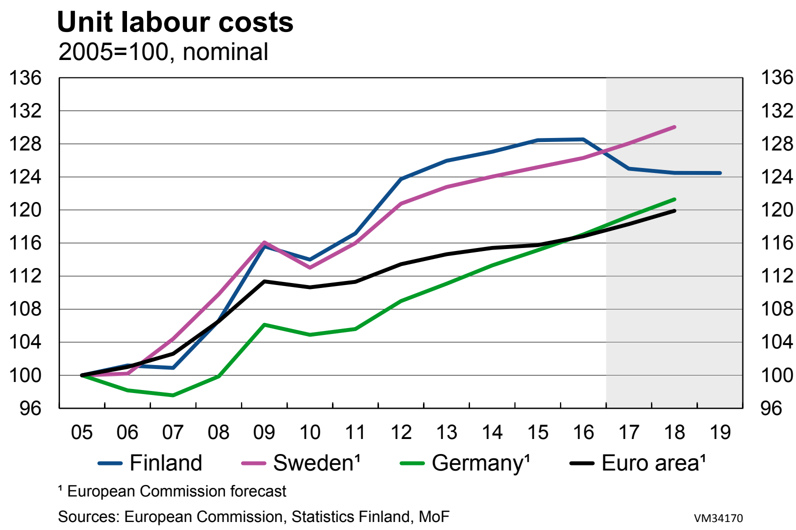


Despite the stronger growth in exports, the current account will remain in deficit throughout the forecast period. This is, above all, due to the deficit in the service account and the secondary income account and the stronger increase in import prices than in export prices.

Table 6. Current account

	2014	2015	2016	2017**	2018**	2019**
	EUR bn					
Balance of goods and services	-1.9	-1.1	-2.6	-3.3	-3.6	-4.1
Factor incomes and income transfers, net	-1.3	-1.2	-0.2	0.3	0.4	0.8
Current account	-2.6	-1.2	-2.3	-3.0	-3.2	-3.3
Current account, relative to GDP, %	-1.3	-0.6	-1.1	-1.3	-1.4	-1.4

The negative risks in the forecast are primarily related to risks concerning international market development, such as an increase in protectionism hampering world trade. The positive risk forecast is related to, among other things, the development of the geographical distribution of exports. Currently focusing on developed economies, and mainly on Europe, exports may gather speed in the markets of emerging economies such as China. There is also a positive risk relating to the structure of exports if growth in service exports exceeds the rate anticipated.>



1.3 Domestic demand

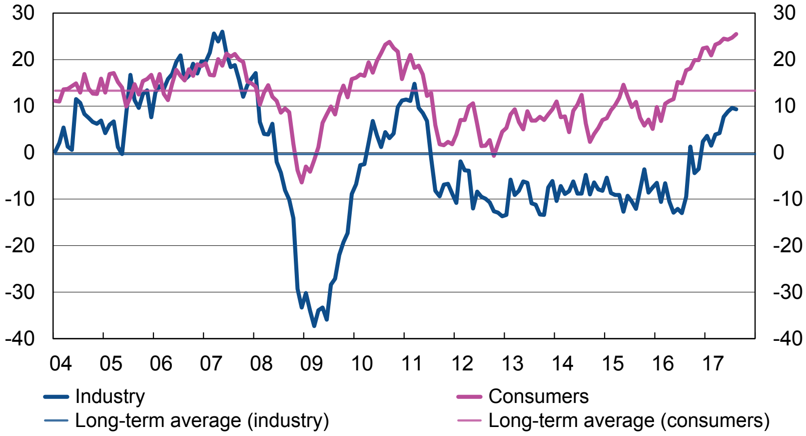
1.3.1 Private consumption

Consumption growth still strong

The growth in household consumption is upholding the growth of private consumption. Purchasing power is boosted by an increase of more than 2% in real disposable income as inflation will only accelerate a little due to the moderate development of energy prices. Growth in private consumption is also supported by improving employment. Although slowing towards the end of 2017, private consumption growth will reach 2.4% this year.

The Consumer Survey indicates that general confidence in the economy's performance has clearly improved in the past year. Confidence in the outlook for the Finnish economy has improved even more strongly than perceptions of personal finances. Expectations of declining unemployment over time have also increased.

Industry and consumer confidence
balance, seasonally adjusted



Source: European Commission
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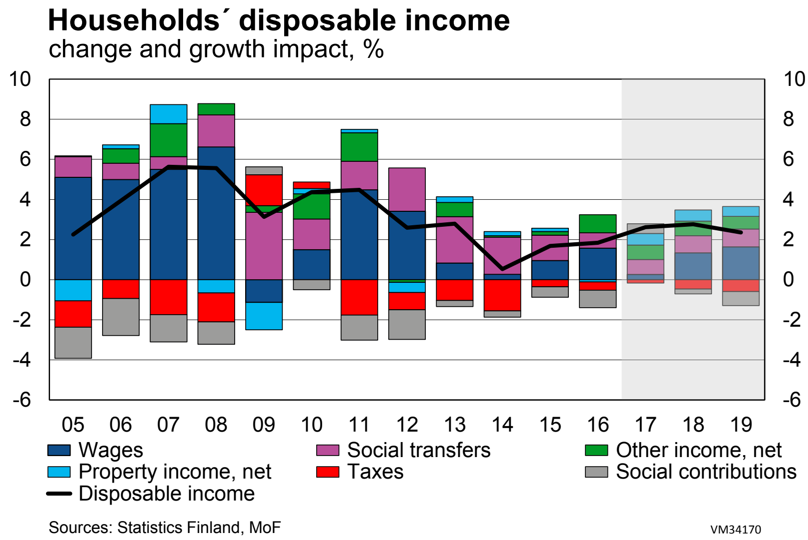
According to Statistics Finland's national accounts data published in July, private consumption grew by 1.8% in 2016. In addition to services, private consumption growth was bolstered by purchases of durables, with car sales being a particularly major factor. The household savings rate has fallen almost without interruption since 2010 and in 2016 ended at -0.9%. The fall in the savings rate is also reflected in the growth of household indebtedness, which in 2016 climbed to over 126% of disposable income.



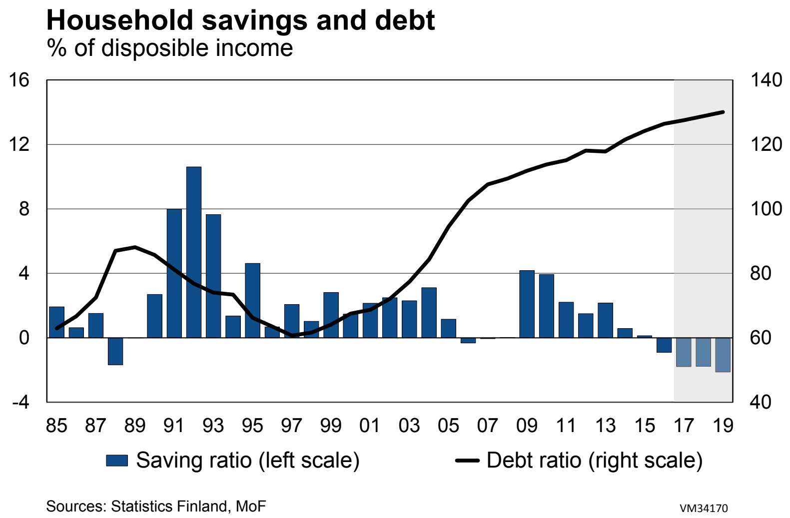
In 2018, employment growth will provide a particular boost to private consumption growth. Increases in labour input and the earnings level will accelerate the increase in the sum of wages and salaries to 2.2%. The growth of household disposable income will be only slightly more subdued than in 2017. Social transfers will continue to grow, despite the gradually falling unemployment rate. Growth in current transfers will be maintained by the increase in pensions as pensions account for almost half of current transfers. Property income will also continue to increase reasonably rapidly as the economy rebounds.

However, accelerating inflation will slow the growth in household disposable real income, decelerating the growth of private consumption. The savings rate will remain negative, and households will continue to add to their debt.

In 2019, the sum of wages and salaries will continue to rise steadily as employment picks up. Real income growth will continue to accelerate despite rising inflation, which together with the easing of taxes will strengthen purchasing power. Private consumption growth will remain sluggish as the negative household savings rate restricts consumption opportunities.

The household savings rate will remain in negative territory during the forecast horizon, despite the slowdown of consumption growth. Low interest rates and ready access to loans have increased borrowing. Long-standing low interest rates coupled with loan repayment holidays have further fuelled the growth of household debt.

A negative savings rate together with an increased household debt burden presents a clear downside risk to the forecast for private consumption. Confidence-driven consumption growth is sensitive to bad news.



1.3.2 Public consumption

Public consumption has accounted for just over 24% of GDP in recent years. This figure is anticipated to drop during the outlook period as the value of GDP will increase more rapidly than consumption expenditure by government. The amount of public consumption is also anticipated to grow more slowly than GDP or private consumption volume.

The largest items of consumption expenditure by government are personnel expenses and intermediate consumption, that is, goods and services purchased. Consumption expenditure by government is divided into individual and collective consumption expenditure. Individual consumption expenditure includes expenditure directly serving citizens, such as education, health, social and cultural services. Collective consumption expenditure includes expenditure relating to administration, defence and public order. Of consumption expenditure by government, two thirds is of the individual and one third of the collective type.

In 2016, central government spending growth was mainly driven by expenditure on asylum seeker reception centres. This year and also next year this expenditure will be reduced considerably, despite the slight increase from the amount included in the spring spending limits decision budgeted for 2018. Consumption expenditure will also be cut by the reduction in social security contributions as set out under the Competitiveness Pact. Furthermore, the introduction of longer working hours will reduce central government operating expenditure due to the smaller number of employees.

Local government consumption expenditure has increased quite moderately in recent years. During the current year, consumption expenditure will even shrink due to measures such as those under the Competitiveness Pact, the 2017 pension reform that will reduce municipal employers' pension contributions as well as adjustment measures introduced by municipalities themselves and by the Government. Consumption expenditure growth will, however, already continue next year as the rising service needs resulting from population ageing will increase the need for care and nursing services and, consequently, add to local government expenditure pressures. The lowering of early childhood education fees from the beginning of 2018 will also have an increasing effect on consumption expenditure.

Consumption expenditure by social security funds consists mainly of social benefits in kind paid out by the Social Insurance Institution of Finland (Kela), which comprise reimbursements for medicines and travel and rehabilitation allowances, as well as of wages and salaries. Savings measures announced by the Government will continue to reduce expenditure on social benefits in kind in the current year as they did last year. Thereafter, expenditure is expected to return to moderate growth.

Table 7. Consumption

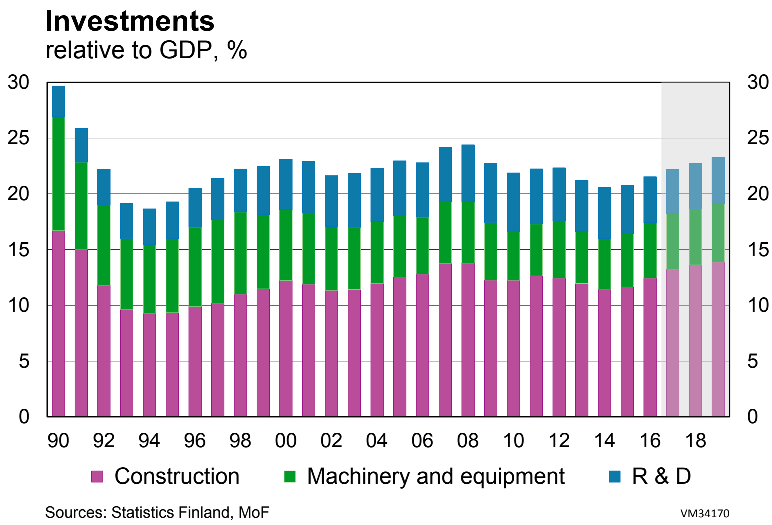
	2016 share, %	2014	2015	2016	2017**	2018**	2019**
		Change in volume, %					
Private consumption	100.0	0.8	1.7	1.8	2.4	1.4	1.2
Households	95.3	0.3	1.9	1.9	2.5	1.4	1.2
Durables	8.1	1.9	2.8	5.8	4.1	2.3	2.2
Semi-durables	7.9	0.3	0.9	2.4	0.3	0.9	0.8
Non-durable goods	25.7	-0.2	0.7	0.6	1.4	1.2	1.1
Services	52.7	0.4	1.3	1.7	3.1	1.4	1.3
Consumption by non-profit institutions	4.7	3.8	-2.0	1.0	0.5	0.5	0.5
Public consumption	100.0	-0.5	0.0	1.2	-0.3	0.8	0.4
TOTAL		**0.4**	**1.1**	**1.6**	**1.6**	**1.2**	**1.0**
Individual consumption expenditure in general government		-0.5	0.9	0.2	-0.2	1.0	0.4
Total individual consumption expenditure		0.4	1.5	1.5	2.4	1.2	1.1
Households´ disposable income		0.5	1.7	1.8	2.6	2.8	2.4
Private consumption deflator		1.3	0.3	0.9	1.0	1.3	1.5
Households´ real disposable income		-0.8	1.4	0.9	1.6	1.4	0.9
	%						
Consumption as proportion of GDP (at current prices)		80.0	79.7	79.2	77.9	77.1	76.2
Household savings ratio		0.6	0.1	-0.9	-1.8	-1.8	-2.1
Household debt ratio [1]		121.5	124.2	126.4	127.5	128.8	130.0

[1] Household debt at end-year in relation to disposable income.

1.3.3 Private investment

Investment growth broadly based

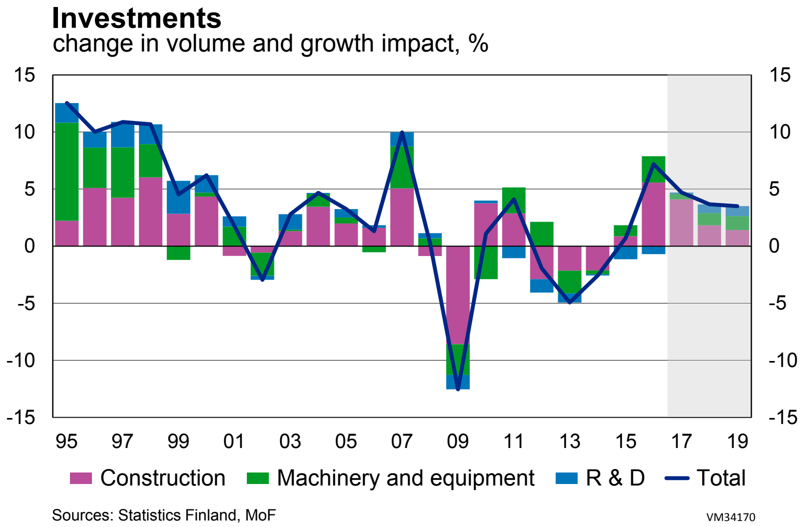
The positive international economic development and the entry of Europe onto a growth trajectory have further improved the cyclically sensitive investment readiness of enterprises. In addition, at home the favourable employment development has boosted consumer confidence, which can be seen in developments including a growing interest in buying residential property. The various construction investment sub-items have so far grown almost at the same rate, but this year and next the fastest growth will be seen in investment in residential housing construction. The growth of production-related investment will also continue to be good. Private investment growth during the outlook period will average 4.5% per year. Increased investment will raise GDP growth by an average of almost 1 percentage point a year. The rapid growth in private investment will restore its rate relative to GDP to the level of around 19% prevailing before the financial crisis.



The national accounts published in July confirmed that last year's investment growth had been even stronger than earlier as the growth in private investment was almost 8% in 2016. The accounts show that the first quarter of the current year was also very strong. The volume of investment in machinery, equipment and transport equipment in particular was high, which is likely to be partly due to the exceptionally large investment project implemented in Äänekoski last year.

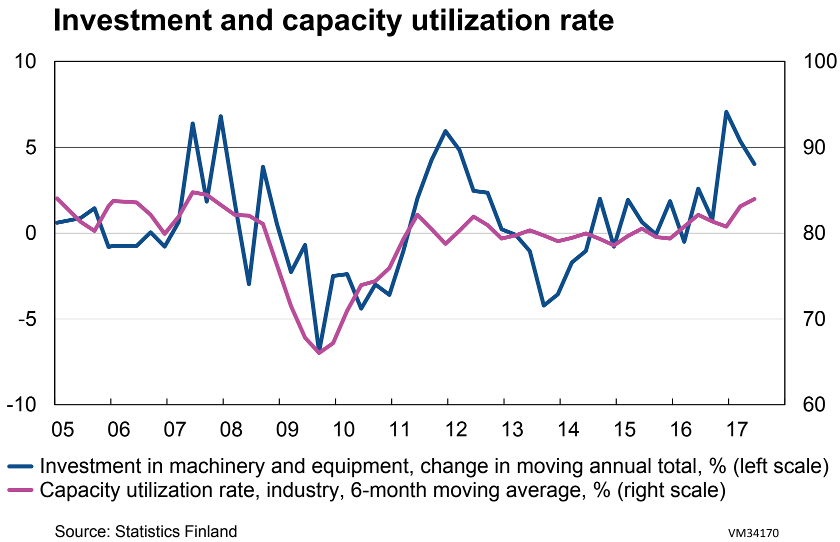
The rate of new residential building projects started has risen to a record level. Construction of apartment blocks started has never been at a such a high level since 1995, although last year was already very active. The start rate is, however, expected to slow towards the end of the year. In addition to investors, residential building construction is currently supported by consumer interest in buying residential property. The forecast shows investment in repair construction to increase at an annual rate of 1½% to 2% throughout the outlook period.

Last year saw the start of many long-term production-related building construction investment projects, such as commercial buildings, storage buildings and hospitals, with these raising last year's investment figures. The number of new starts is, however, anticipated to be lower than earlier. Construction investment is expected to pick up again towards the end of next year as, for example, the launch of a few major projects is scheduled for 2018. It is, however, possible that these major projects may be delayed due to permit procedures or funding decisions. That would postpone the investments forecast for 2018. There are also plans to launch of several major projects in 2019.



Civil engineering will continue to grow as there are major construction projects underway. In addition, investment by the energy supply sector in civil engineering is anticipated to increase further due to investment in the electricity transmission network, liquefied natural gas (LNG) network and wind power, for example.

Industrial capacity utilisation rates have risen, especially in the forest industry but also in the metal industry, and these create the need to add new capacity. This can also be seen in the investment survey published in June by the Confederation of Finnish Industries (EK), reporting two-digit growth in fixed industry investment. When launched, the above-mentioned major projects will also result in a considerable increase in investment in machinery and equipment in the next few years.



Research and development (R&D) investment is forecast to gradually show a clear upturn. According to the EK investment survey, the outlook for industry's R&D investment still remained grim for the current year. On a positive note, however, the expectations of the technology industry, which is the most important sector for R&D investment, have already improved and increases in total investment are also already planned.

The investment focus is shifting from residential housing construction in particular to industrial machinery and equipment and R&D investment by enterprises. The negative real interest rate and easy access to financing will bolster investment throughout the forecast horizon. Uncertainty to the forecast is created by the fact that the implementation schedules of major projects may have a considerable impact on the differences between the investment volumes of two consecutive years. In addition to these, normal cyclical change risks will naturally be material.

Table 8. Fixed investment by type of capital asset

	2016 share, %	2014	2015	2016	2017**	2018**	2019**
		Change in volume,%					
Buildings	47.7	-5.4	2.1	9.9	8.2	3.2	2.4
Residential buildings	28.6	-6.5	2.0	10.5	8.2	4.5	0.3
Non-residential buildings	19.1	-3.7	2.3	9.0	8.2	1.2	5.7
Civil engineering construction	10.1	4.1	-0.9	10.2	1.7	2.4	2.0
Machinery and equipment	23.2	-1.6	4.4	10.1	2.0	4.8	5.5
R&D-investments*	19.1	-0.5	-5.2	-3.3	0.7	4.3	4.9
Total	100.0	**-2.6**	**0.7**	**7.2**	**4.7**	**3.7**	**3.5**
Private	81.6	-3.4	2.2	7.9	5.5	4.0	4.1
Public	18.4	0.9	-5.2	3.9	1.0	2.1	0.9
		%					
Investment to GDP ratio (at current prices)							
Fixed investment		20.6	20,4	21.5	22.2	22.7	23.3
Private		16.4	16,5	17.6	18.2	18.7	19.3
Public		4.2	3,9	4.0	3.9	4.0	4.0

* Includes cultivated assets and intellectual property products

1.3.4 Public investment

The public investment to GDP ratio in 2016 was 4.0%, close to the long-term average. Public investment is anticipated to grow slightly every year during the outlook period. Civil engineering investment and other construction investment both account for 30% of public investment. The share of R&D investment is over one quarter, while machinery and equipment account for around 15%.

The Government's commitment to spend around EUR 600 million in improving existing transport infrastructure will increase the level of central government investment. Appropriations for transport infrastructure maintenance will increase both this year and next. Very few new infrastructure projects will be launched. There is a slight reduction in appropriations for research and development activity in the 2017 Budget. Additional appropriations are allocated for next year for Tekes – the Finnish Funding Agency for Innovation and the Academy of Finland. The temporary additional appropriations for transport infrastructure maintenance will end in 2019. The spring spending limits decision includes an additional appropriation for the Defence Forces' investments for 2019 and the following decade due to the fighter aircraft purchases. Investment will be required for the development of the counties' ICT systems, and these have been taken into account in central government investment from 2018 onwards.

Local government capital expenditure is historically at quite a high level. Maintenance and repairs of the existing local government building stock continue to require substantial investment. In growth centres, new building construction and transport infrastructure investments will continue at a high level in the years ahead. Already taking place at a brisk rate, hospital construction is set to increase further despite the fixed-term legislation that entered into force more than a year ago and made major health and social services investments subject to special dispensation.

1.4 Domestic production

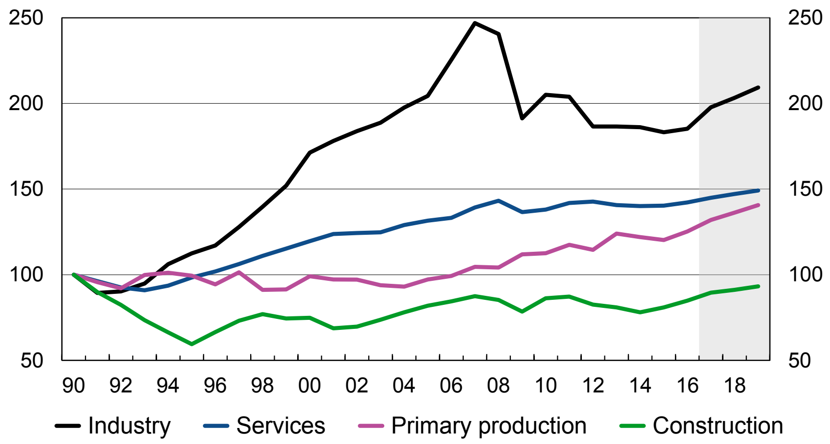
1.4.1 Total output

Strongest economic growth in half a decade

Following four years of contraction, the output of the economy returned to growth posted at 1.6% last year. This growth accelerated clearly in the first months of the year, as gross value added for the economy in the first half of 2017 was 4% higher year on year. Economic growth was based on increased output in many industries since value added rose year on year across all main industries on the back of improved domestic and international demand. Even in the sub-industries, reduction was only recorded in public service production and energy supply (as a result of consolidation measures in general government finances and a mild winter). Unlike the previous year, output development was thus driven also by sectors other than construction. Output in many industries still remains below pre-financial crisis levels, but the most notable exceptions to this are the value-added increases seen in chemical industry, real estate and business services.

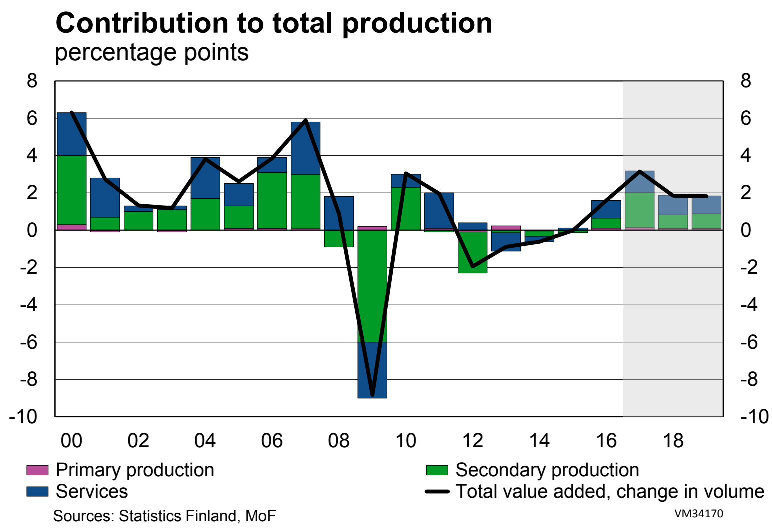
Production

1990=100

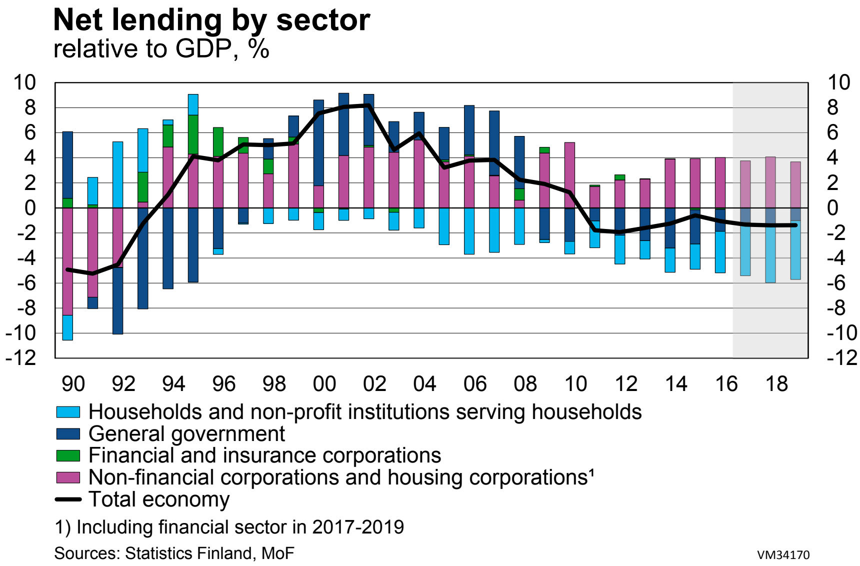


Sources: Statistics Finland, MoF

New signs of the continuation of the positive economic outlook were received in spring and summer. These include the increase in new orders in the manufacturing industry and growth in private service production turnover, as well as the sustained strength of construction in growth centres. The lack of demand that restricted production opportunities for many years appears to hold enterprises back much less these days. Only a year ago one in three or four manufacturing, construction or service enterprises reported that shortage of demand was slowing output growth, but only one in five or six respondents to this summer's survey reported insufficient intermediate or final product demand. In construction in particular, a shortage of skilled labour is already hampering growth opportunities considerably more commonly than the demand level. In manufacturing, a shortage of capacity is also a larger obstacle to growth than a year earlier, particularly in the forest and metal industries, and enterprises in these industries have announced expansions of existing capacity.



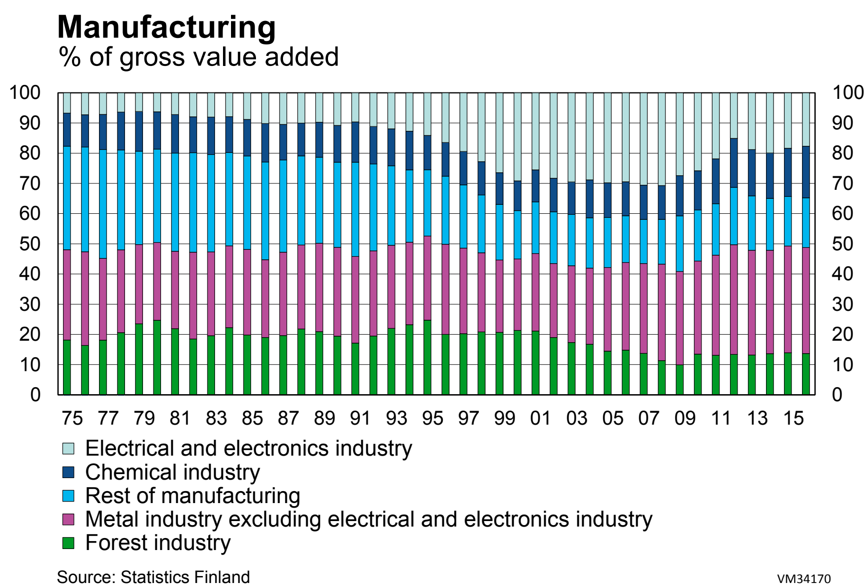
Despite obstacles to output growth, gross value added for the economy is stepping up. Growth is being driven by an increase in orders illustrating strong international demand in manufacturing, progress made in numerous private and public construction projects started, and growth in service production for all main industries. Although the period of fastest growth seen in early 2017 appears to be over, the business tendency surveys of the Confederation of Finnish Industries (EK) indicate that the positive trend will still continue at least for the second half of the year. In addition, the forecast's background assumptions concerning acceleration in world trade and global economy support export-oriented industrial production and therefore, indirectly, business services. Strengthened imports of Finland's most important trading area, Europe, are good news for Finnish industries manufacturing investment and intermediate products. Due to broad-based growth and very strong first months of the year, gross value added for the economy will grow by around 3% this year. The growth rate will level off in 2018 and 2019, but total output will still increase by around 2% per year during those years.



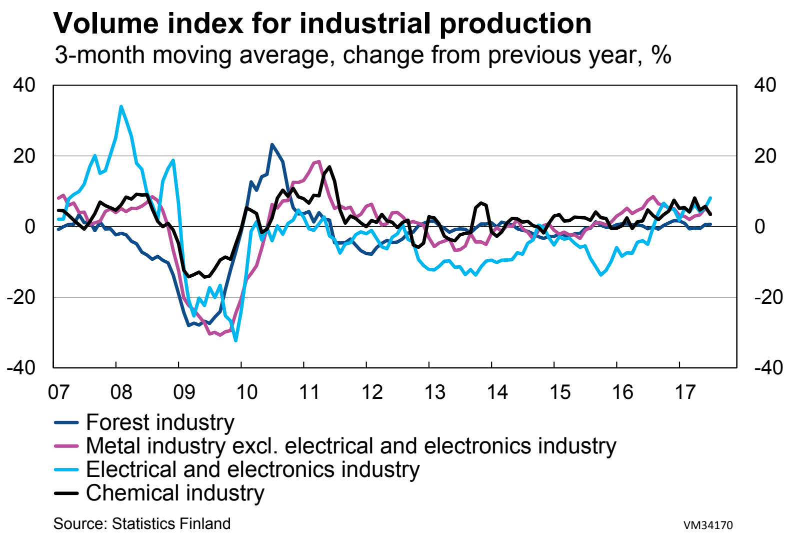
1.4.2 Secondary production

Strongest growth in manufacturing orders and output

Five years of recession in manufacturing came to an end last year as the entire industry's value added increased 1.1% year on year. In the first half of the current year, this growth accelerated clearly, despite a slowdown seen in the growth rate in the second quarter. Growth in early 2017 was particularly strong in the chemical industry as well as in the manufacture of basic metals and in metal industry manufacturing machinery and electrical equipment. The forest industry growth rate also accelerated due to increases in the mechanical forest industry as well as in pulp and paperboard production.



Most of Finland's industrial production comprises raw materials and investment goods for export, the demand for which has improved as the global economy and trade have picked up and capacity utilisation has been increased by economic growth. Finnish unit labour cost competitiveness also improved in early 2017. This is reflected in the large number of orders received by manufacturing companies, up 20% year on year. The highest number of orders has been won by the shipbuilding industry, but increasing order books have also been reported by the chemical and forest industries. The outlook for output in the second half of the year is therefore positive.

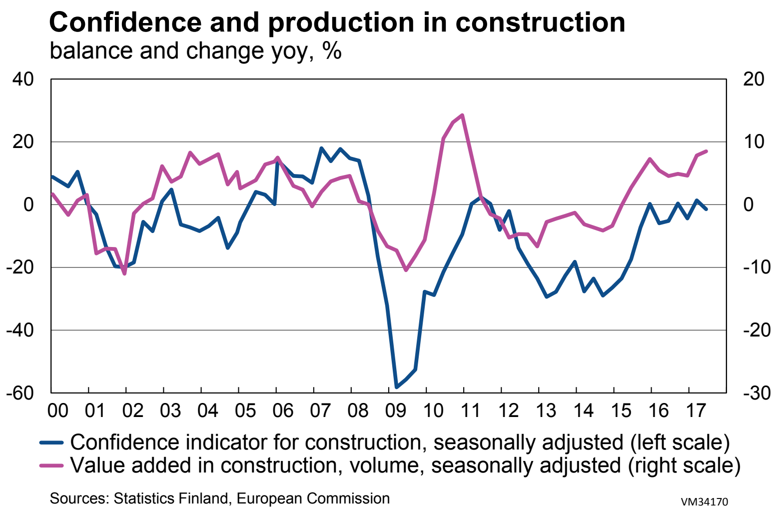


Business tendency surveys show the best prospects for growth are in the technology and chemical industries. Forest industry companies anticipate growth will slow towards the end of the year, but the capacity increase in Äänekoski will support forest industry output growth starting from next year at the latest. Overall, industrial output will increase by almost 7% this year due to the strong development early in the year and the new orders received.

In the coming years, export demand will increase as world trade growth accelerates and import growth is expected to accelerate in 2018 and 2019 in the European market in particular, which is important for Finnish enterprises. Increased production capacity and efforts made by enterprises to improve the competitiveness of their products will boost industrial output in the years ahead. The growth of value added in manufacturing is set to stabilise at around 3% in 2018 and 2019. Despite this growth, the volume of industrial output in 2019 will remain almost one-sixth lower than in the peak year of 2007.

Good trend continues in construction

For the second consecutive year, construction output increased last year at rather strong rate of 4.9%. In early 2017, the rate accelerated further as there were several major construction projects underway at the same time. Growth is also promoted by the diversity of construction. Migration is increasing housing demand in growth centres, municipalities are investing in health care and educational facilities, and enterprises have launched capacity expansion and replacement projects, which can been seen in commercial, office as well as agricultural construction. However, levels of new construction are higher in growth centres than outside them, which means that growth is unevenly distributed across the regions. The need for repair construction is high, particularly as regards residential and office buildings.



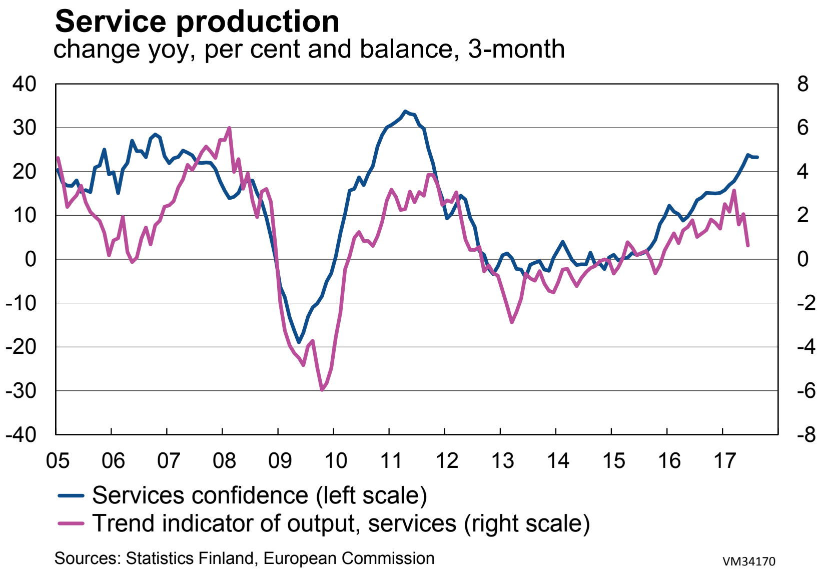
The outlook for construction output still remains quite bright. There is diverse demand for the various building categories, whereby enterprises perceive their order books as stronger than normal. Furthermore, government investment in transport infrastructure is boosting civil engineering works. Indeed, growth is increasingly held back by a shortage of skilled labour. In addition, the number of planning permissions no longer increased in early 2017. Supported by ongoing construction projects, the increase in construction output this year will exceed the increase seen last year and stand at almost 6%.

Construction will remain buoyant in growth centres in both 2018 and 2019, but the number of new starts will no longer increase as much as seen in recent years, slowing down the rate of growth. In the 2018–2019 period, the focus will be on a few major construction projects and the annual increase in construction value added will be around 2%. Growth will drive output this year above the level achieved in 2007, while the overheated level in 1989 was 10% higher.

1.4.3 Services

Broad-based growth in private services

Private service production and, consequently, value added throughout the service sectors has been increasing for the past two years. By contrast, public service provision has contracted for three consecutive years now. Earlier this year, service-sector output growth accelerated year on year and growth was particularly strong in services supporting business operations, such as financing and insurance, planning and design, and information services. Consumer service sales have also increased despite the modest development in purchasing power.



The cyclical position of private services is strong. Sales are on the increase and are generally expected to continue to grow in the second half of the year as only one in five respondents to the business tendency surveys report demand curbing growth. There are hardly any other general obstacles to growth, unlike in the construction sector, which is facing a shortage of skilled labour, or in manufacturing, where capacity is already partly in full use. The best conditions for growth can be found in information and communication services and in accommodation and food service activities. Sales in trade industries are also anticipated to remain strong. The increase in value added in services this year will be 2% year on year.

Looking ahead, service production will be supported by demand in manufacturing and other industries, providing solid conditions for service-sector growth. Consumer-driven services will suffer slightly from the modest development of purchasing power, but international demand will increase service production serving foreign demand and, through intermediate products, also domestic service production. Next year and the year after will only see a slight slowdown in service production growth from this year, with the coming annual growth rate averaging around 1½%.

Table 9. **Production by industry**

	2016 share, %[1)]	2014	2015	2016	2017**	2018**	2019**	Average 2016/ 2006
		change in volume, %						
Industry	20.3	-0.2	-1.6	1.1	6.8	2.8	3.0	-1.9
Construction	6.8	-3.6	3.7	4.9	5.8	1.9	2.2	0.1
Agriculture and forestry	2.7	-1.7	-1.4	4.2	5.5	3.2	3.3	2.4
Industry and construction	27.1	-1.0	-0.3	2.0	6.5	2.6	2.8	-1.5
Services	70.2	-0.4	0.2	1.3	2.0	1.5	1.4	0.7
Total production at basic prices	100.0	-0.6	0.0	1.6	3.1	1.9	1.8	0.0
GDP at market prices		-0.6	0.0	1.9	2.9	2.1	1.8	0.2
Labour productivity in the whole economy		0.1	0.1	1.2	2.1	1.3	1.5	0.1

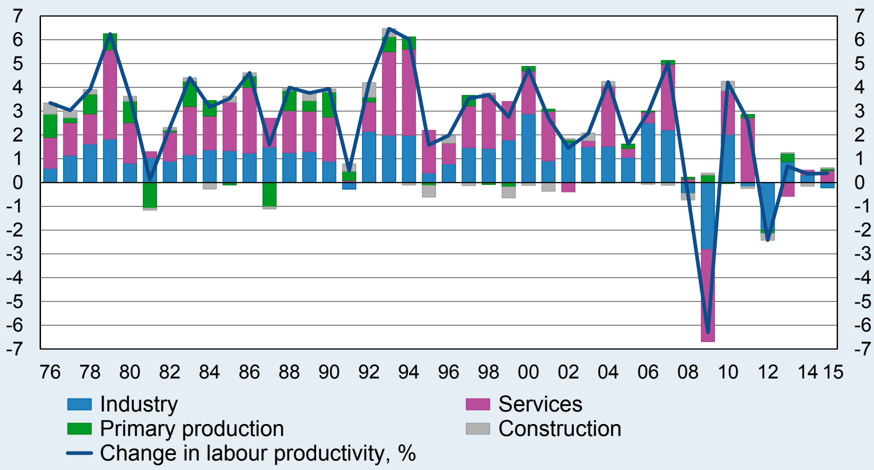
[1)] Share of total value added at current prices.

PRODUCTIVITY DEVELOPMENT BY INDUSTRY

Over the long term, economic growth is based on increases in labour input and labour productivity. In Finland, the size of the working-age population (15–64-year-olds) has been decreasing since 2010, which means the impact of labour input on economic growth will take a downturn, unless labour input is increased by other factors (changes in labour force participation rate, structural unemployment and average working hours). In the future, economic growth in Finland will be based increasingly on higher rates of labour productivity. This not an entirely new phenomenon as, over the past 40 years, almost two thirds of the average annual increase of around 2½% in private-sector value added has come from increased labour productivity and the rest (just over a third) from increased labour input.

In the past 40 years, labour productivity growth in the private sector has been based mainly on the productivity development of manufacturing and service sectors (see graph below). A third of the average annual increase in productivity of almost 3% has been generated in manufacturing industries and around a half in service sectors. The contributions of construction and primary production have been smaller, with more random variation seen in growth impacts. The growth impact of primary production was clearly positive in the 1970s and 1980s, with on average an equal contribution provided by agriculture and forestry. The average impact of construction on productivity growth has been clearly lower than that of primary production.

Contribution of industries to labour productivity growth
private sector



Source: Statistics Finland

Within manufacturing, the impact of the electronics industry was enormous starting from the mid-1990s as, until the financial crisis, it alone contributed an average of one third of the total productivity growth in the private sector. The paper industry has also had a clearly positive productivity impact, especially before the 1990s. On average from 1976 to 2015, these two industries increased private-sector productivity growth by 0.3 and 0.2 percentage points per year, respectively. Both industries have also occasionally weakened productivity development, and so has the oil refining industry. Unlike certain service industries, no manufacturing industry has, however, in the long term permanently slowed productivity development.

Among services, the highest productivity impact has been provided by trade and telecommunications. On average, these two industries together have increased private-sector productivity by around 0.1 percentage points a year. The productivity impact of trade has been very consistent, but the most productive years of telecommunications were seen between 1995 and 2005. The productivity impact – both positive and negative – of real estate activities has also been substantial in certain individual years. Measuring the increase in value added for the industry is, however, more challenging than for many other industries, because a significant proportion of the industry's value added comprises imputed housing services provided by owner-occupiers for themselves. In services, a few industries have also without interruption weakened the productivity development of the private sector. These include certain industries serving business (legal, consultancy and technical services) as well as activities serving financing and insurance activities. This may in part be due to measurement bias, and major productivity differences have been observed between enterprises.

Private sector productivity improved by an average of 2.7% per year in the 1976–2015 period. In the public administration industry, annual productivity growth only averaged 1%, and in human health and social work activities productivity contracted by an average of 0.4% per year. Comparisons between market production and non-market production are not, however, unproblematic.

According to a recent projection, the productivity growth in the Finnish economy as a whole will accelerate clearly in the next few years and average just over 1½% per year in the 2017–2019 period. Growth will be boosted by the strong cyclical upswing. In the 2000–2016 period, average growth only just exceeded 1%. Economic restructuring has slowed down productivity development as production of manufacturing industries generating stronger and broader productivity growth has been discontinued or transferred outside Finland. At the same time, there has been a rise in the contribution of services increasing productivity more modestly and inconsistently to the Finnish economy's value added. This will reduce the improvement of productivity in the future, too.

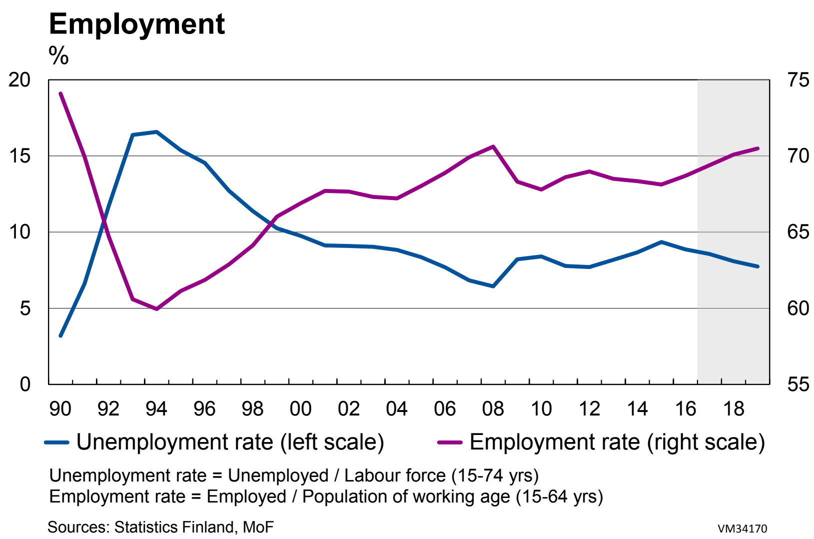
The developments described above are based on analyses of macroeconomic data. Microdata results concerning enterprise-level productivity in Finland indicate major differences between enterprises as regards productivity, including changes in it. According to recent findings based on Finnish data, export growth, a higher employment rate and higher wages and salaries are generated in productive and profitable enterprises. Instead of measures targeted industry-specifically, general policy measures that support enterprises' own productivity development and endeavour for growth would appear to be more effective economic policy measures improving productivity. Securing a level playing field also treats all kinds of enterprises equally. Incentives for investment in human capital will improve productivity in the long term.

1.5 Labour force

Labour market mismatch problems alleviated by economic growth

The broad-based and rapid strengthening of economic activity increased employment in early 2017. From January to June, the number of employed persons increased by 0.6% year on year. The number of working hours, however, did not increase any more in early 2017, despite the introduction of longer working hours under the Competitiveness Pact. The number of job vacancies has remained very high: the seasonally adjusted figure is more than 40,000 vacant positions. Continued strong economic growth and stronger demand for labour will take the number of employed persons in 2017 up 0.7% year on year, raising the employment rate to 69.4%.

According to the Labour Force Survey of Statistics Finland, there was virtually no decrease in unemployment in early 2017 and the unemployment rate trend remained at 8.7%. The Employment Service Statistics of the Ministry of Economic Affairs and Employment, however, show that unemployment fell clearly in early 2017 across all regions and all age and occupational groups. The standstill in the decline of the unemployment rate is at least in part due to the activation of the disguised unemployed and other persons outside the labour force to become jobseekers, which is normal in the context of economic rebound. The pickup in economic growth will push unemployment back onto a downward trajectory towards the end of the year, and the projected unemployment rate for 2017 is 8.6%.



The continuing reasonably rapid rate of GDP growth in 2018 and 2019 will have a positive effect on employment and at the same time the number of unemployed persons will decrease. The number of employed persons is projected to increase by 0.8% in 2018 and by 0.5% in 2019, thereby taking the employment rate to 70.5% in 2019. The forecast assumes that wage and salary increases will remain moderate and supportive to employment during the forecast period.

The activation of persons outside the labour force to become jobseekers is likely to slow the decline in the unemployment rate also in 2018. Correspondingly, the large number of underemployed persons may slow the rise in the employment rate as well as the decline in the unemployment rate if some of the demand for labour is channelled to the current underemployed without increasing the number of new employed persons. This indicates a rather high rate of unemployment throughout the forecast period, despite stronger economic growth. The unemployment rate is expected to fall to 8.1% in 2018 and further to 7.8% in 2019.

The number of the long-term unemployed decreased rapidly in early 2017 across all age groups. Due to strengthening economic growth, the number of the long-term and the structurally unemployed can be expected to decrease further in the next few years, albeit more slowly than in recent months. The number of the structurally unemployed is still high, almost 200,000 persons according to the Employment Service Statistics of the Ministry of Economic Affairs and Employment, which will contribute to slow the reduction in the unemployment rate in the next few years.

In recent years, obstacles to an improvement in the employment situation have included various regional and occupational mismatch problems between unemployed job seekers and job vacancies. A decrease in these mismatch problems can finally be seen due to stronger economic growth as, according to the Employment Service Statistics of the Ministry of Economic Affairs and Employment, unemployment fell in early 2017 across all Centre for Economic Development, Transport and the Environment (ELY) regions and in all occupational groups. The large number of vacancies has therefore begun to erode unemployment on a broad basis, which means improved matching of labour market needs. It can be assumed that the economic rebound will improve the quality of job vacancies as regards pay and terms of employment, attracting unemployed persons to pursue vacancies based further away from their home. Another indicator of a reduction in mismatch problems is the clear downturn in the duration of job vacancies remaining unfilled in recent months seen in the Employment Service Statistics of the Ministry of Economic Affairs and Employment.

The supply of labour will not have a major restricting effect on the increase in employment during the forecast period as the combined total number of the unemployed and the disguised unemployed still remains very large: almost 400,000 persons. Nevertheless, a shortage of labour can already be discerned in certain occupational groups. According to the July 2017 Business Tendency Survey conducted by the Confederation of Finnish Industries (EK), a shortage of skilled labour has become the most common obstacle to increased activity in construction.

Table 10. Labour market

	2014	2015	2016	2017**	2018**	2019**
	annual average, 1,000 persons					
Population of working age (15-74 yrs)	4 096	4 102	4 109	4 119	4 131	4 138
change	9	6	7	10	12	7
Population of working age (15-64 yrs)	3 491	3 476	3 463	3 453	3 443	3 436
change	-17	-15	-13	-10	-10	-7
Employed (15-74 yrs)	2 447	2 437	2 448	2 464	2 484	2 497
of which 15-64 yrs	2 386	2 368	2 379	2 396	2 413	2 422
Unemployed (15-74 yrs)	232	252	237	231	218	210
	%					
Employment rate (15-64 yrs)	68.3	68.1	68.7	69.4	70.1	70.5
Unemployment rate (15-74 yrs)	8.7	9.4	8.8	8.6	8.1	7.8
	1,000 persons per annum					
Immigration, net	18	12	16	17	17	17

1.6 Incomes, costs and prices

1.6.1 Wages and salaries

In 2017, earnings development will mainly be determined by the Competitiveness Pact concluded by the social partners, as a result of which there were no increases to negotiated wages and salaries and public sector holiday bonuses were cut by 30%. The net effect of these factors is expected to lower the negotiated pay by an average of 0.3 %. The forecast for earnings development assumes that factors other than increases to negotiated wages will drive up earnings by 0.6 %. Therefore it is predicted that nominal earnings will rise by 0.3% in 2017.

The increase in the sum of wages and salaries in the Finnish economy on the whole was clearly faster in early 2017 than could be assumed on the basis of the index of wage and salary earnings and the rise in employment. This is primarily due to employment among employees having risen considerably faster than employment among self-employed persons. The sum of wages and salaries of the whole economy is forecast to grow by 1.8% in 2017.

Negotiations on pay rises for 2018 will take place industry-specifically. Earnings are expected to continue to rise moderately, edging up by 1.4% in 2018 and 1.6% in 2019. This is still considerably slower than the average rate of growth in the 2000s, which is well in line with the high unemployment rate. The sum of wages and salaries of the whole economy is forecast to increase by 2.2% in 2018 and 2.1% in 2019.

Table 11. Disposable income

	2016 share, %	2014	2015	2016	2017**	2018**	2019**	Average 2016/2006
		change, %						
Compensation of employees	58.8	0.3	1.0	1.7	0.3	1.5	1.8	2.4
Wages and salaries	47.6	0.4	1.0	1.5	1.8	2.2	2.1	2.5
Employers' contributions to social security schemes	11.2	-0.2	1.3	2.5	-6.1	-1.7	0.6	2.1
Property and entrepreneurial income, net	25.2	6.4	6.3	6.5	10.7	8.8	7.8	0.8
Taxes on production and imports minus subsidies	16.0	1.0	0.2	5.7	0.6	2.0	2.6	3.3
National income	100.0	1.8	2.1	3.5	3.0	3.6	3.6	2.1
Disposable income		1.8	2.2	3.6	3.0	3.6	3.7	2.1
Gross national income, EUR bn		207.3	211.2	217.8	226.2	234.5	243.1	

Table 12. Index of wage and salary earnings and labour costs per unit of output

	2014	2015	2016	2017**	2018**	2019**	Average 2016/2006
	change, %						
Index of negotiated wage rates	0.7	0.6	0.6	-0.3	0.6	0.8	2.1
Wage drift, etc.	0.7	0.8	0.5	0.6	0.8	0.8	0.7
Index of wage and salary earnings	**1.4**	**1.4**	**1.1**	**0.3**	**1.4**	**1.6**	**2.8**
Real earnings[1]	0.4	1.6	0.8	-0.6	-0.1	0.1	1.1
Average earnings[2]	1.2	1.4	0.7	0.8	1.6	1.8	2.2
Labour costs per unit of output[3]							
whole economy	0.9	1.1	0.1	-2.8	-0.4	0.0	2.3

[1] The index of wage and salary earnings divided by the consumer price index.

[2] Computed by dividing the national wage bill by the number of hours worked by wage and salary earners. The figures are affected by structural changes in the economy.

[3] Compensation of employees divided by gross value added in volume at basic prices.

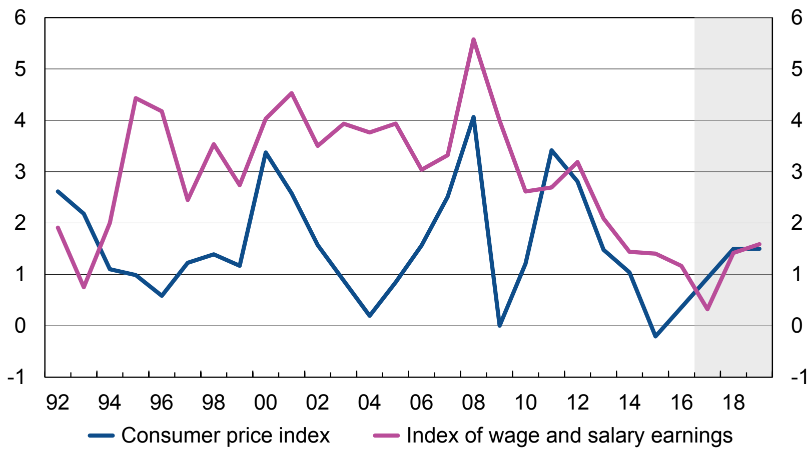
1.6.2 Consumer prices

Based on the national Consumer Price Index, consumer prices rose in the second quarter of 2017 by 0.8% year on year. The increase in consumer prices accelerated in late 2016 and early 2017 but slowed slightly again in the second quarter of 2017. Driven by the increase in the price of crude oil last year, the energy sub-item had a major effect on inflation, with the annual movement being 7.3%. The effect was, however, more moderate than before due to another downturn in oil prices, especially in summer 2017. Service prices rose by

1.7% year on year in the second quarter of 2017, and the corresponding figure for processed food was 0.4%. On the other hand, the prices of goods and fresh food fell by just over a half per cent year on year in the second quarter of 2017.

The inflation forecast for the current year is 0.9% as measured by the national Consumer Price Index. Inflation will be driven above all by the price of crude oil, which is at a much higher level than in 2016. It is predicted that the average price of oil in 2017 will be up by around 7 euros a barrel compared to the average of 40 euros seen in 2016. The second-round effects of oil price hikes will drive up other prices as well. The weakening of the US dollar against the euro will, however, mitigate the effects of the hike in the dollar prices of oil on domestic prices. The impact of energy prices on inflation is projected to remain positive but slightly more moderate than earlier in both 2018 and 2019 as well.

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



Sources: Statistics Finland, MoF

It is projected that service prices will rise by around 1.6% this year, clearly more slowly than the previous year. Contributing factors to this include last year's wage and salary settlement and the slowdown in the rise of rent rates. Last year, service inflation was accelerated by increases in health care service fees, which have no longer taken place in the current year. Service prices will increase at an annual rate of around two per cent in the 2018 to 2019 period.

Food price development has remained more moderate this year due to factors including the abolition of the excise duty on sweets and the falling prices of raw materials. Goods prices are affected by factors such as import prices, which have started rising in 2017 after a long period of decline. This is anticipated to result in a slight rise in goods prices towards the end of the year, but the annual change in prices will still remain negative this year. It is estimated that tax hikes will push up inflation by around 0.2 percentage points in 2017 and tax hikes will, according to estimates, push up inflation even more in 2018 than in the current year. Increases to the annual vehicle tax, the excise duty on liquid fuels and the excise duty on tobacco products will add to inflationary pressure this year, but on the other hand the abolition of the excise duty on sweets and the reduction in car tax will have the opposite effect.

Inflation as measured on the basis of the national Consumer Price Index is expected to increase in 2018 and 2019 by 1.5% as economic growth continues. Prices will rise more broadly than during the current year across the commodity groups, but the rise in service prices will continue to have the greatest impact on overall inflation. The moderately increasing price of oil, the strengthening US dollar and the low, yet rising, interest rate level are anticipated to accelerate inflation during the outlook period.

Inflation in the euro area, as measured by the Harmonised Index of Consumer Prices (HICP), stood at an average of 1.5% in the second quarter of 2017. With the exception of energy price increases and their indirect impacts, inflation has, however, remained moderate, regardless of the gradual strengthening of economic growth in the euro area. According to assessments of experts from the European Central Bank, annual inflation in the euro area is expected to be 1.5% in the current year, 1.3% in 2018 and 1.6% in 2019. The comparative growth forecasts of the Ministry Finance for Fin-land based on the HICP are 0.9% for 2017, 1.5% for 2018 and 1.5% for 2019. Finnish price deve-lopment will remain behind the rate seen in the euro area this year as the economic upturn began later in Finland than in the euro area.

Table 13. Price indices

	2014	2015	2016	2017**	2018**	2019**	Average 2016/2006
	change, %						
Export prices[1]	-0.4	-0.9	-1.9	2.5	1.3	1.5	0.0
Import prices[1]	-1.6	-4.2	-2.8	4.9	2.5	2.7	-0.1
Consumer price index	1.0	-0.2	0.4	0.9	1.5	1.5	1.7
Harmonised index of consumer prices	1.2	-0.2	0.4	1.0	1.5	1.5	1.9
Basic price index for domestic supply	-1.3	-3.2	-1.6	4.3	1.6	2.7	2.0
Building cost index	1.0	0.5	0.5	0.4	2.1	2.2	2.3

[1] As calculated in the National Accounts

BASE EFFECTS IN INFLATION – WHAT ARE THEY AND HOW DO THEY AFFECT INFLATION FORECASTS?

'Base effects' are often discussed in conjunction with current developments in inflation and short-term projections of annual inflation. In the current year, a significant factor affecting inflation referred to in this survey as well is the base effect of energy prices and its weakening during late 2017. This is a technical concept illustrating how much inflation climbed just before the beginning of the current period under review. Base effects therefore affect the inflation forecast mechanically and provide valuable information about anticipated inflation development. This box describes the impacts of base effects on inflation development as measured by the Harmonised Index of Consumer Prices (HICP) in the same manner as for the entire euro area in the Spring 2017 Economic Forecast of the European Commission (Inflation: between temporary effects and slow trends, European Economic Forecast, Spring 2017).

Base effects can also be examined in greater detail. Base effects occur when the change in the annual change of the consumer price index can be attributed to movement a year earlier. Such movements may arise from factors including sudden and significant changes in energy prices or changes in tax rates. Applying the example used in the box on inflation of the European Commission's Spring Forecast, the annual change in consumer prices in period t (π_t) can be written as

$$\pi_t = \pi_{t-1} + \delta_t - \delta_{t-4},$$

where δ_t and δ_{t-4} denote the quarterly inflation in periods t and t-4. The above equation shows the impact of the base effect (δ_{t-4}) on changes in the annual inflation rate[1]. Using the formula, the current annual change in consumer prices can be expressed as the previous period's annual change in consumer prices, and the difference between quarterly inflation in the current period and quarterly inflation in the period one year ago. This difference can be regarded as additional inflation, that is, how much higher the quarterly inflation is in the current period t than the same quarterly inflation was a year ago. Quarterly inflation a year ago, i.e. the base effect, has consequently a negative influence on inflation when $\delta_{t-4}>0$, which can be seen in the equation as a negative sign. From the forecasting perspective it may be intuitive to think of inflation as a phenomenon occurring regardless of price developments in past periods, that is, to talk about internal inflation. On the other hand, if consumer prices are expected to rise, for example, by 1% in a certain year and that year is influenced by a base effect of ½%, internal inflation should only increase by ½%. Therefore a positive base effect can be regarded as a factor with a negative effect on internal inflation.

Although the main focus in inflation forecasting is naturally on assessing future developments, the impacts of base effects on the outlook for inflation should not be underestimated. By writing the above equation for the period t+1 we can examine the role of the base effect in the inflation forecast.

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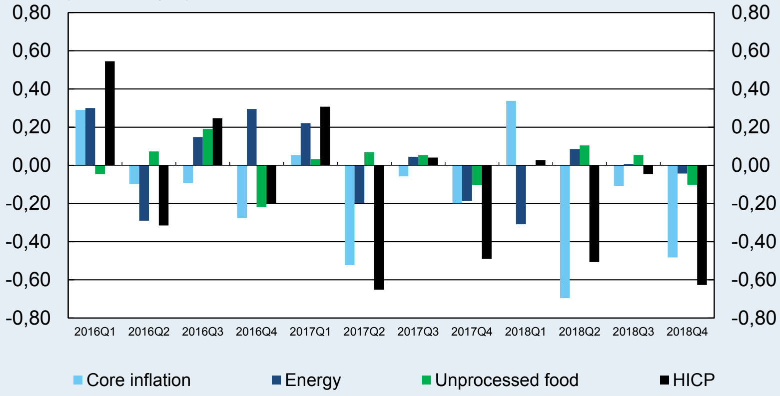
1 Unlike in the Commission's example, in this example we do not divide quarterly inflation separately into a long-term average and the deviation from it, whereby the definition of 'base effect' is slightly different. The box utilises quarterly data because that is also used in the inflation forecast of the Ministry of Finance.

Figure 1 shows the estimated impact of the base effect on actual and projected inflation development in the 2016–2018 period. The HICP subcomponent division into core inflation, energy and unprocessed food is used in the example. Consequently, the graph shows the base effect by changing the sign, whereby a positive value indicates an effect accelerating inflation.

Estimated base effects for HICP and its sub-components

percentage points



Sources: Statistics Finland, MoF

The graph clearly shows the base effect of energy prices caused by movements in oil prices, which had an accelerating effect on inflation development in late 2016 and the first quarter of 2017. In the second quarter of 2017, however, the base effect of energy prices turned to an effect decelerating inflation. After the slight positive base effect in the third quarter, the effect of energy prices decelerating inflation continues again at the turn of 2017 and 2018. The base effect of energy is decreasing gradually over the forecast period because the projected trajectory is more level than past development. However, inflation is projected to accelerate in the forecast period, which is why the base effect of core inflation is negative in the graph towards the end of the period.

2 Economic policy and public finances

2.1 General government finances

The deep general government deficit has decreased gradually in recent years. General government finances have been strengthened by the consolidation measures taken by the Government and the economic growth triggered last year. General government debt has increased significantly in the past eight years. In the next few years, the rate of debt accrual will slow down and the debt-to-GDP ratio will fall.

The problems of general government finances are structural. Despite the positive cycle the general government finances will still show a deficit. In addition, due to the ageing of the population, a major imbalance between revenue and expenditure will persist in general government finances over the long term. For general government finances to move onto a sustainable trajectory in the long term and to enable pension, care and nursing expenditure to be covered without measures to strengthen general government finances or further indebtedness, the budgetary position needs to show a clear surplus in the early 2020s.

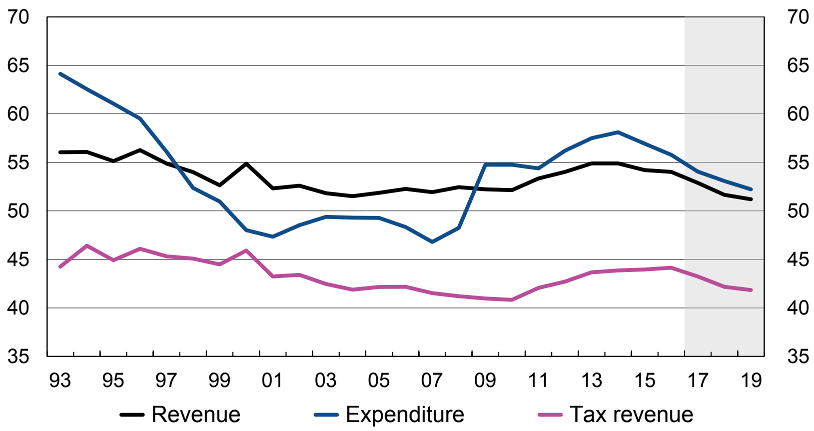
The central government deficit shrunk last year. Central government revenues were increased particularly by good tax revenue growth. At the same time, the development of expenditure remained moderate. Similar development in central government finances will also continue in the next few years. The local government deficit also shrunk in 2016, and the same trend will continue in 2017. Local government deficit will return to growth in 2018. The expenditure pressure caused by the growing service needs of an ageing population will be transferred to counties as the health, social services and regional government reform takes effect. For this reason upward pressure on local government expenditure will be eased from 2020 onwards. The combined deficit of central, local and, later on, county government is projected to be considerable in the early 2020s.

The surplus of earnings-related pension schemes has been reduced in recent years by the increase in pension expenditure and the low interest rate level. The surplus will continue to shrink during the outlook period as the anticipated edging up of interest rates will be insufficient to cover the growth in pension expenditure. The financial position of other social security funds returned to surplus last year due to the increase in the unemployment insurance contribution. In the outlook period, the decrease in unemployment expenditure will strengthen the financial position of other social security funds.

The expenditure rate, that is, the ratio of expenditure to GDP, rose to its highest level to date this millennium in 2014, since when it has been falling steadily due to measures including adjustment. The tax ratio, that is, the ratio of taxes and tax-like payments to GDP, will decrease this year for reasons including the Competitiveness Pact's changes to payment criteria and the tax cuts made. In the coming years, the tax ratio will also decrease to some extent because many tax bases are growing more slowly than GDP.

The general government deficit in ratio to GDP momentarily exceeded the 3% ceiling determined in the EU Treaty in 2014. Since then, the deficit has fallen clearly below the limit. On the other hand, general government debt has risen above 60% of GDP and will remain above the threshold in the next few years. Compliance with EU rules will be described in more detail in the 2018 Draft Budgetary Plan published in October and in the box found on page 60.

General government revenue, tax revenue and expenditure
relative to GDP, %



Sources: Statistics Finland, MoF

Table 14. General government finances[1)]

	2014	2015	2016	2017**	2018**	2019**
	EUR billion					
Current taxes	33.8	34.8	35.6	37.2	37.5	38.8
Taxes on production and imports	29.6	29.7	31.1	31.3	32.0	32.7
Social security contributions	26.3	27.0	28.0	27.4	27.7	28.5
Taxes and contributions, total [2)]	90.1	92.2	95.2	96.9	98.0	100.8
Other revenue [3)]	23.2	22.1	21.8	22.5	22.7	23.3
of which interest receipts	2.1	2.1	1.9	1.9	2.0	2.2
Total revenue	**112.8**	**113.6**	**116.5**	**118.4**	**120.0**	**123.3**
Consumption expenditure	50.7	51.1	51.7	51.4	52.6	53.8
Subsidies	2.7	2.8	2.7	2.7	2.7	2.7
Social security benefits and allowances	40.3	41.6	42.3	43.1	44.1	45.1
Other current transfers	6.1	5.8	5.6	5.5	5.5	5.5
Subsidies and current transfers, total	49.0	50.2	50.6	51.3	52.3	53.3
Capital expenditure [4)]	9.3	9.0	9.0	9.6	9.9	10.2
Other expenditure	10.4	9.0	8.8	8.7	8.5	8.5
of which interest expenses	2.5	2.4	2.3	2.2	2.0	2.0
Total expenditure	**119.4**	**119.3**	**120.2**	**121.0**	**123.3**	**125.7**
Net lending (+) / net borrowing (-)	**-6.6**	**-5.7**	**-3.8**	**-2.6**	**-3.3**	**-2.4**
Central government	-7.8	-6.3	-5.8	-5.1	-4.6	-3.3
Local government	-1.6	-1.3	-0.9	-0.1	-0.7	-1.0
Employment pension schemes	3.4	2.7	2.4	1.8	1.5	1.2
Other social security funds	-0.7	-0.8	0.5	0.8	0.4	0.6
Primary balance [5)]	-6.2	-5.3	-3.3	-2.3	-3.3	-2.5

1) As calculated in the National Accounts, ESA2010.
2) Incl. capital taxes.
3) Incl. capital transfers and consumption of fixed capital.
4) Gross fixed capital formation and capital transfers.
5) Net lending before net interest expenses.

FINLAND AND EU FISCAL POLICY RULES

Finland's general government debt-to-GDP ratio has exceeded the reference value of 60% set in Article 126 of the Treaty on the Functioning of the European Union (TFEU) since 2014, and the ratio has so far not fallen below the reference value of 60% in the Commission's forecasts. Therefore the Commission has, since 2013, already compiled seven reports on Finland's compliance with the debt criterion.

The Commission's latest assessment of Finland's debt development was published in May 2017. Again, the Commission's conclusion in the report was that Finland currently complies with the debt criterion. The reasons for this were the increasing impact of the cycle on general government debt, compliance with the obligations under the preventive arm of the Stability and Growth Pact (SGP) and Finland's commitment to structural reforms enhancing growth and strengthening fiscal sustainability in accordance with the country-specific recommendations (CSRs) determined for it.

The economic upswing will make it easier to comply with the debt criterion in the next few years as the debt-to-GDP ratio will be reduced by higher GDP and increases in tax revenue. The latest figures indeed show that Finland's general government debt-to-GDP ratio already took a downturn in 2016 and, according to Ministry of Finance Economics Department's forecast, this reduction will continue until 2021.

Therefore Finland is still in the preventive arm of the SGP and obligations under the preventive arm apply to it. The preventive arm examines the achievement of the Medium-Term Objective (MTO) set for the structural balance of each Member State and whether the country remains on the required adjustment path towards the MTO. The required annual adjustment is determined in the country-specific recommendations (CSRs) adopted by the Council in July for the current and following year. Adjustment is determined and examined on the basis of two pillars, change in structural balance and the expenditure benchmark .

Finland's MTO for the structural balance is -0.5% of GDP, which the Government aims to achieve no later than in 2019. The annual adjustment requirement towards the MTO determined in the CSRs has ranged between zero and 0.6 percentage points.

Member States that are in the preventive arm may apply for a temporary deviation from the MTO or the required structural adjustment path towards the MTO on the basis of major structural reforms (the so-called "structural reform clause") or comparable investments (the so-called "investment clause"). In autumn 2016, Finland requested the application of both the structural reform clause and the investment clause in 2017. The justification for the use of the structural reform clause was the Competitiveness Pact and the pension reform effective from the beginning of 2017. In spring 2017 the Commission stated that Finland was entitled to utilise both flexibility clauses. The combined scale of the flexibility is 0.6% of GDP.

The granting of the flexibility reduces the annual adjustment towards the MTO required from Finland. According to the CSOs adopted by the Council in July, Finland's structural balance may deteriorate by 0.5% of GDP in 2017 and in 2018 Finland must reach its MTO, taking into account the flexibility granted to Finland.

Table 15. Main economic indicators in general government

	2014	2015	2016	2017**	2018**	2019**
	% of GDP					
Taxes and social security contributions	43.9	44.0	44.1	43.2	42.2	41.8
General government expenditure [1]	58.1	56.9	55.8	54.1	53.1	52.2
Net lending	**-3.2**	**-2.7**	**-1.8**	**-1.2**	**-1.4**	**-1.0**
Central government	-3.8	-3.0	-2.7	-2.3	-2.0	-1.4
Local government	-0.8	-0.6	-0.4	-0.1	-0.3	-0.4
Employment pension institutions	1.7	1.3	1.1	0.8	0.7	0.5
Other social security funds	-0.3	-0.4	0.2	0.3	0.2	0.2
Primary balance [2]	-3.0	-2.5	-1.5	-1.0	-1.4	-1.0
General government debt	60.2	63.6	63.1	62.5	61.9	61.1
Central government debt	46.3	47.6	47.5	47.7	47.5	46.9
General government employment, 1000 person	626	619	614	610	609	605
Central government	139	133	131	130	128	127
Local government	477	475	473	469	470	468
Social security funds	11	11	11	11	11	11

[1] EU-harmonized definition.
[2] Net lending before net interest expenses.

Table 16. Fiscal balance and debt ratios in some EU economies

	2016	2017**	2018**	2016	2017**	2018**
	Fiscal balance			Debt		
	% of GDP					
*Finland	-1.8	-1.2	-1.4	63.1	62.5	61.9
Finland	-1.9	-2.2	-1.8	63.6	65.5	66.2
United Kingdom	-3.0	-3.0	-2.3	89.3	88.6	87.9
Sweden	0.9	0.4	0.7	41.6	39.1	37.0
Denmark	-0.9	-1.3	-0.9	37.8	36.7	36.0
Ireland	-0.6	-0.5	-0.3	75.5	73.5	72.7
Spain	-4.5	-3.2	-2.6	99.4	99.2	98.5
Netherlands	0.4	0.5	0.8	62.3	59.8	57.2
Luxembourg	1.6	0.2	0.3	20.0	22.0	22.3
Portugal	-2.0	-1.8	-1.9	130.4	128.5	126.2
Austria	-1.6	-1.3	-1.0	84.6	82.8	81.2
Germany	0.8	0.5	0.3	68.3	65.8	63.3
France	-3.4	-3.0	-3.2	96.0	96.4	96.8
Belgium	-2.6	-1.9	-2.0	105.9	105.6	105.1
Italy	-2.4	-2.2	-2.3	132.6	133.1	132.5
Greece	0.7	-1.2	0.6	179.0	178.8	174.6

Source: EU Commission Spring Forecast 2017; *Finland: Ministry of Finance, Autumn 2017

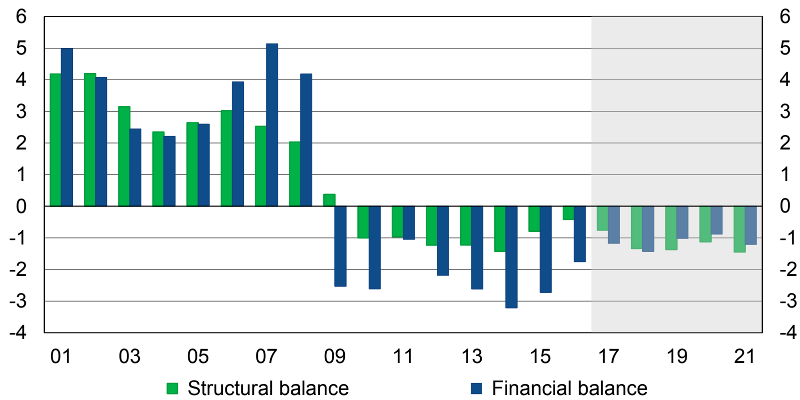
2.1.1 Estimates of fiscal policy impact

Fiscal policy at general government level is somewhat expansionary in 2017. The expansionary effects of the Competitiveness Pact and associated Government decisions on tax cuts amount to around EUR 1.2 billion. On the other hand, around EUR 750 million of the Government's fiscal adjustment measures are targeted at central government. Furthermore, fiscal policy will tighten as a result of local government adjustment measures and the pension insurance contribution hike in the private sector.

As a result of the Competitiveness Pact, the tax ratio is expected to fall in 2017 by approximately 1 percentage point from last year's figure of over 44% of GDP. The tax ratio will continue to fall over the next few years as the most important tax bases, including the sum of wages and salaries, and private consumption, will increase more slowly than GDP. The expenditure rate began to edge down in 2015, and the same trend will continue in the coming years in response to savings measures and reduced cyclical expenditure.

The fiscal stance can also be examined on the basis of changes in the structural balance assessed using the EU's common methodology.[1] An examination based on changes in the structural balance does not necessarily give the exact same picture as an examination focused on individual revenue and expenditure measures. For example, increasing age-related expenditure has the effect of weakening the structural deficit over the outlook period, even in the absence of any decisions to increase expenditure.

General government financial balance and structural balance¹
relative to GDP, %



¹ Based on the European Commission's production function approach

Sources: Statistics Finland, MoF

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1 Structural deficit is calculated by correcting public sector deficit for the business cycle. The remainder describes the effect of the policy pursued and other than cyclical factors on the deficit. Changes in the structural deficit therefore illustrate changes in the overall fiscal stance. When the structural deficit shrinks, fiscal policy is contractionary. When the structural deficit deteriorates, fiscal policy is expansionary. There are, however, major uncertainties involved in the measurement of the structural balance as the assessment of the size of the output gap has a major impact in its calculation.

The structural deficit is estimated to increase clearly this year and next whereby, on the basis of this indicator, fiscal policy can be regarded as expansionary over these years. The structural deficit will increase as the output gap is closing rapidly. From 2019 onwards, fiscal policy can be regarded as more or less neutral as the structural deficit is anticipated to remain at over 1% of GDP.

FISCAL STANCE MEASUREMENT

When wishing to assess the impact of policies on general government finances, the impacts of the decisions made must be identified in the economic structures. Interest is often focused particularly on two indicators: general government budgetary position and general government debt. However, neither of these indicators as such illustrates measures taken by political decision-makers or the fiscal stance. Instead, they also react to factors independent of political decision-makers. For assessment, there is a need to identify the impacts of discretionary measures and the impacts of other factors.

This box describes alternative ways to assess the fiscal stance. Because Finland is committed to the EU's common fiscal rules, the main focus is on comparisons of indicators used in EU contexts. These indicators are by nature either "top-down" or "bottom-up" indicators, although their combinations are also in use. The focus of this box is on structural deficit and its change, the examination of individual discretionary measures as a whole, and the discretionary fiscal effort (DFE) indicator. A more detailed description of the indicators is provided in the Vade Mecum published by the European Commission and in the Ministry of Finance working paper currently under preparation.[1]

Another way of examining the fiscal stance, particularly over an electoral term, for example, is to examine individual discretionary measures and sum up their impacts (the "bottom up" approach). In this, the last spending limits of the previous Government's electoral term can be used as a reference point for central government finances. At the beginning of an electoral term, the new Government decides on several measures affecting expenditures and revenues in the Budget, amendments to the budget proposal and decisions on spending limits. The impact of these measures is obtained by comparing expenditures and revenues in relation to the "technical spending limits" approved at the end of the previous electoral term. Compiled assessments of the impacts of the measures can be found in the General Government Fiscal Plan.

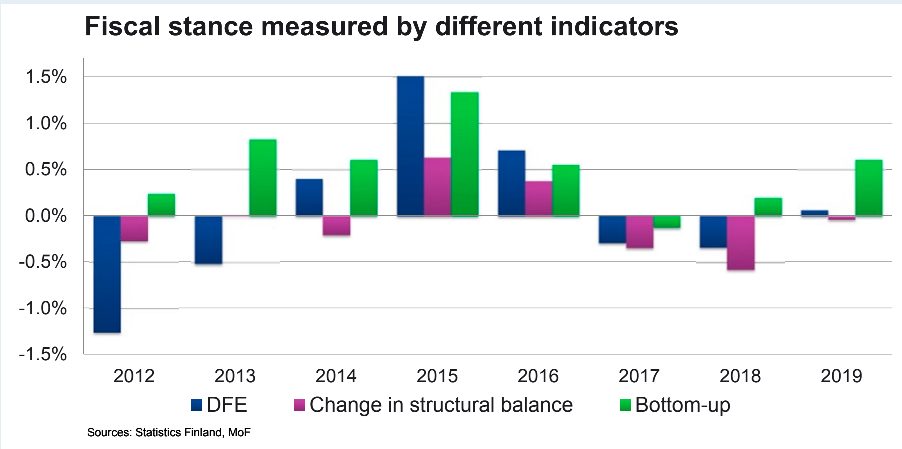
The third way to assess fiscal policy is using the discretionary fiscal effort (DFE) indicator, in which the "bottom-up" and "top-down" approaches are combined. In this indicator, revenue measures are summed up from the impact assessments of individual measures. Public expenditure is corrected for the business cycle, after which the increase in the item is compared with potential output growth. If the increase in public expenditure corrected for the business cycle exceeds potential output, the impact of the expenditure measures is regarded as having

1 EC (2017): Vade Mecum on the Stability and Growth Pact 2017 Edition. European Economy Institutional Paper 052, March 2017. Economic and Financial Affairs.

an expansionary effect. In addition, temporary discretionary measures are netted out on both the revenue and the expenditure sides in the DFE indicator.

All measures of the fiscal stance have their weaknesses. Firstly, impact assessments of all discretionary measures affecting general government finances are required. Impact assessments involve major uncertainty in places, in addition to which the availability of comprehensive information about, for example, measures taken by municipalities is poor. On the other hand, the calculation of the indicator may require an assessment of the cyclical situation, that is, the output gap, calculated as the difference between actual and potential output. Potential output and output gap are latent variables, with several problems involved in their measurement.[2] Also any measurement and forecast errors in the observed variables used in the calculations are naturally also passed on to the indicators derived from them. Due to the uncertainties involved in measurement, the fiscal stance should be assessed using several indicators.

The figure below shows the trajectories of the DFE indicator, the change in structural deficit, and a "bottom-up" indicator calculated on the basis of individual policy measures for the 2012–2019 period. According to the "bottom-up" approach, fiscal policy was contractionary in the 2012–2015 period and, based on current knowledge, would also be contractionary in the 2018–2019 period. The picture of the fiscal policy conducted is in part transformed when looking at the DFE indicator and the change in structural deficit. For the early years of the period examined, these indicators suggest that fiscal policy was expansionary. For the 2012–2013 period in particular, the DFE indicator signals that the expansionary effects were quite substantial.



Awareness of the factors affecting the various indicators is important in fiscal stance assessments. The differences between the indicators are in part caused by differences in calculation methodology and in part by changes in population age structure.

Let us first examine the impact of the calculation method and use the year 2012 as an example. According to the 2012 budget proposal, the then Government decided on an adjustment with a

2 A good review of the (un)reliability of output gap estimates can be found in ECB (2005): Monthly Bulletin, Feb 2005, Box 5.

total net impact of around EUR 900 million, consisting of an expenditure adjustment of around EUR 700 million and a revenue adjustment of around EUR 200 million. In retrospect, the scale of the adjustment has been slightly reduced, which is reflected in the value of the "bottom-up" indicator. In the DFE indicator, the revenue measures have been calculated in the same way by summing up individual measures as in the "bottom-up" indicator. Expenditure measures, by contrast, have been assessed by comparing the increase in expenditure corrected for the business cycle with potential output growth. The fact that Finland's potential output increased considerably more slowly than public expenditure in that period can, according to the DFE indicator, be seen as expansionary policy.

The change in structural deficit calculated purely at the macro level is, in turn, positioned between these two indicators in this case. According to it, policy in 2012 was slightly expansionary as the nominal budget balance decreased by as much as 1.2 percentage points, of which the cyclical component was -0.9 percentage points. This means the nominal budget balance deterioration was clearly larger than suggested by the cyclical situation.

In addition, a key factor regarding Finland that explains some of the differences between the results given by the indicators is the ageing of the population. The increase in age-related expenditure caused by changes in the population age structure automatically increases public expenditure every year without any new decisions made and weakens the general government budgetary position. Ageing does not, however, have any impact on expenditure measures in the "bottom-up" indicator. In those indicators in which the impact of increases in age-related expenditure is included in expenditure (the DFE indicator and the change in structural balance), the indicator provides a more expansionary picture of the policy conducted than the "bottom-up" indicator.

The working paper under preparation at the Ministry of Finance shows that in the 2009–2016 period the annual increase in ageing-related expenditure averaged 0.3% of GDP. Therefore, for example, the fiscal stance measured on the basis of the change in structural balance would on average be around 0.3 percentage points less expansionary if the indicator was adjusted by eliminating the impacts of increases in ageing-related expenditure.

To summarise, due to the automatic expansionary effect of ageing, the change in structural balance and the DFE indicator provide a more expansionary picture of the fiscal policy conducted than the "bottom-up" indicator. Although ageing explains some of the differences between the indicators, the differences cannot be explained by that alone. The indicator calculation method also influences the results. Because, for example, the DFE indicator compares expenditure increases with potential output growth, the picture of the expansionary effect of expenditure depends on the potential output growth assessment. To ensure the comprehensive assessment of fiscal policy conducted, it is useful to calculate several different indicators on which to base the assessment.

2.1.2 General government debt

General government debt rose by only EUR 2.7 billion last year, much less than for several years, and the debt-to-GDP ratio took a downturn. The debt ratio did, however, clearly exceed the 60% reference value. In the next few years, nominal debt will increase, but the debt ratio will continue to fall and may even go below the 60% threshold in the medium term. The debt ratio development is partly explained by the fact that the value of GDP is currently projected to be more than EUR 10 billion higher in 2021 than estimated this spring.

The central government debt forecast forms the basis for the government debt forecast. Most of the general government debt, more than EUR 100 billion, consists of on-budget debt. Municipalities also have debt, with this local government debt amounting to EUR 20 billion. In the regional government reform, the debt of the hospital districts will be transferred from municipalities to counties. Social security funds had previously held no debt at all, but in 2014 and 2015 the Unemployment Insurance Fund was forced to borrow because of increased unemployment benefit expenditure. This was just temporary, however, and much of the debt has already been paid off.

General government debt is also defined as including certain other debt items, such as debts of off-budget units that are nevertheless classified under general government; security deposits in connection with derivative instruments used for purposes of managing the central government debt portfolio; debts related to public-private partnerships; the capital assets of the State Nuclear Waste Management Fund; and coins in circulation. Authorised pension schemes also have collateral related to derivative contracts counted as general government debt.

General government debt-to-GDP ratio decreased by 0.5 percentage points in 2016. The table below shows the factors affecting the change in this ratio. The purpose of the table is to clarify the relationship between general government budgetary position and debt ratio change in the national accounts. A plus sign indicates that the factor has the effect of increasing the debt ratio and a minus sign that it decreases the debt ratio.

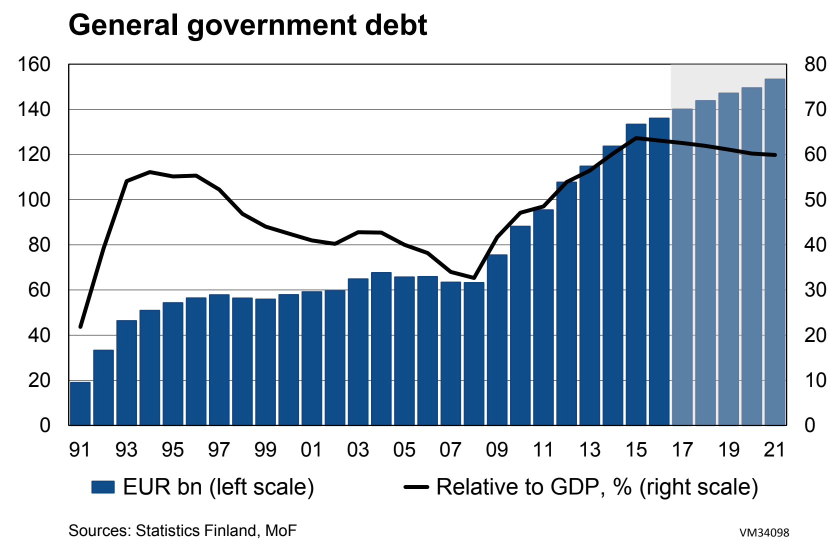
The general government primary balance, that is, total revenue less total expenditure, excluding interest outlays, in 2016 showed a deficit of 0.7% of GDP. This had the effect of driving debt growth by 0.7 percentage points. Interest outlays increased the debt ratio by 1.1 percentage points. When the level of debt is compared with GDP, GDP value growth has the effect of lowering the debt ratio. In 2016, the value of GDP increased by 2.9%, which slowed debt growth by 1.8 percentage points.

In 2016, the financial position of earnings-related pension schemes showed a surplus at 1.1% of GDP ('Acquisition of financial assets (net)'). The surplus of earnings-related pension schemes is not used to pay off general government debt and therefore their surplus has to be eliminated from among the factors affecting the change in the debt ratio. In addition to these factors, other factors also reduced the general government debt ratio by 1.6 percentage points in 2016. The impact of other factors was greater than usual, among other reasons because of the reduction of central government cash funds and the reduced volume of security deposits related to derivative contracts.

Table 17. Change in general government debt ratio and related factors

	2015	2016	2017**	2018**	2019**	2020**	2021**
Debt ratio, % of GDP	63.6	63.1	62.5	61.9	61.1	60.2	59.9
Change in debt ratio	3.4	-0.5	-0.6	-0.6	-0.8	-0.9	-0.3
Factors impacting change in debt ratio							
Primary budgetary position	1.6	0.7	0.2	0.4	0.0	-0.1	0.2
Interest expenditure	1.1	1.1	1.0	0.9	0.8	0.8	0.9
Change in GDP volume	0.0	-1.2	-1.8	-1.3	-1.1	-0.8	-0.7
Change in GDP price	-1.3	-0.6	-0.6	-1.0	-1.1	-1.1	-1.2
Acquisition of financial assets (net)	1.3	1.1	0.8	0.7	0.5	0.4	0.4
Other factors [1]	0.7	-1.6	-0.1	-0.3	0.1	-0.2	0.1

[1] Includes privatization proceeds, lending and factors related to the valuation and timing of revenue and expenditure.
Plus indicates increasing effect on debt ratio, minus a lowering effect on debt ratio.



EXPENDITURE AND TAX CRITERIA DECIDED BY THE GOVERNMENT

The Government Programme aims to reduce indebtedness and strengthen the longer-term sustainability of general government finances. This calls for measures reducing the need to incur debt as well measures strengthening economic growth. The EUR 4 billion savings measures adopted at the beginning of the government term will curb the increase in general government expenditure. Export development and, consequently, economic activity, is being boosted by the Competitiveness Pact signed in 2016 to reduce labour costs. At the same time the Government will bolster employees' purchasing power by easing taxation.

The table below brings together the cumulative impact on central government finances in the 2016–2021 period of the decisions of Juha Sipilä's Government affecting revenue and expenditure, excluding some of the mostly fixed-term appropriation increases decided on within the scope of the spending limits. Measures weakening the central government balance are shown with a minus sign and strengthening measures with a plus sign. The effects are shown in relation to the last General Government Fiscal Plan of the previous electoral term, the so-called technical General Government Fiscal Plan prepared in spring 2015.

Table showing key discretionary central government changes, cumulative, EUR billion

	2016	2017	2018	2019
Decisions lowering central government appropriations	0.9	1.4	1.8	2.1
Decisions increasing central government appropriations	-0.2	-0.4	-0.5	-0.5
Estimated impact of index freezes and replacement savings	0.1	0.5	0.8	1.2
One-off additional investments for key projects, net	-0.3	-0.4	-0.5	0.0
Competitiveness Pact, incl. compensation for tax criteria changes	0.0	-0.9	-0.8	-0.8
Compensation to municipalities in central government transfers for tax revenue changes	-0.3	-0.4	-0.5	-0.6
Decisions increasing central government tax revenue	0.2	0.6	0.9	1.2
Decisions lowering central government tax revenue	-0.3	-0.6	-1.0	-1,2
Other decisions increasing central government revenue	0.0	0.1	0.1	0.1
Impact on central government balance, net	0.1	-0.2	0.3	1.5

Programme

The impact assessments of the EUR 4 billion savings list (Annex 6) of the Government Programme have become more specific during preparation work, in addition to which discretionary changes have also been included in the list. Uncertainty is still associated with the estimate due to, for example, decisions made by municipalities and uncertainty surrounding the impact assessments of some measures. Some measures are also still at the preparation stage.

At the turn of May and June, the Association of Finnish Local and Regional Authorities conducted a survey on topics including the impacts of the Government Programme, according to which the effect of measures of Annex 6 to the Government Programme on general government balance dependent on municipalities' decisions is going to be considerably smaller in 2018 than anticipated. Municipalities have, however, adjusted their finances through other means including permanent human resources adjustment measures.

The largest savings of Prime Minister Sipilä's Government are directed at transfers to households. These savings are scheduled most intensely in the early part of the period. When the measures of previous Governments are included, the intensity of savings is greatest in 2017, the period when economic growth is projected to be at its fastest during the current government term.

Key projects

The strategic objectives of the Government Programme are furthered through measures including key projects. In the 2016–2018 period, a total of EUR 1.0 billion will be invested in key Government projects and EUR 0.6 billion in reducing the transport infrastructure repair debt.

Discretionary expenditure increases

Opportunities for various discretionary expenditure increases are restricted by legislation governing central government tasks and obligations together with the spending limits agreed by the Government. In 2016 the net total of discretionary changes made by the Government within the spending limits system was just over EUR 400 million, while in 2017 the corresponding figure before any expenditure increases in the remainder of the year was a little under EUR 600 million. The most significant individual changes are related to the impact of the Competitiveness Pact on expenditure arising from the Health Insurance Act and financing required by the operations of Terrafame Ltd. These increases have in many respects been of a fixed-term nature.

Tax changes

The revenue estimates of the spending limits period have taken into account the tax criteria changes decided on in the Government Programme of Prime Minister Juha Sipilä's Government. The Government Programme's tax policy aims to boost growth, entrepreneurship and employment. The Government Programme contains both tax-tightening and tax-easing measures. In accordance with the Government Programme, annual adjustments corresponding to rising earnings or inflation will be made in earned income taxation. Taxation of low and medium incomes will be eased by increasing the standard tax credit for work income.

Tax revenue estimates have also taken into account the tax changes associated with the Competitiveness Pact signed by the Government and labour market organisations. In the 2018 budget proposal, index adjustments are made on the central government income tax scale to prevent the tightening-up of taxation due to inflation and the progressivity of the tax system. This will reduce central government tax revenue by around EUR 123 million. In addition to this, the Government has decided to reduce taxation on earned income so that employees' taxation will not be tightened despite the increase in the insureds' social insurance contributions in 2018. The effect of this on central government tax revenue will be around EUR 174 million.

2.2 Central government

Central government finances as recorded in the national accounts have remained in deficit already for eight years, although the deficit has decreased over the past couple of years. Since 2008, central government revenue has increased by one tenth and expenditure correspondingly by a quarter, despite the increase in expenditure having been slowed down considerably by adjustment measures. The acceleration in economic growth will cut the deficit clearly this and next year. Deficits cannot, however, be fully eliminated even in the medium term.

The first half of the current year saw a considerable increase in central government revenue, particularly tax revenue, and a slight decrease in expenditure. Consequently, the budgetary position is clearly improving thanks to good economic growth and adjustment efforts. The economy will continue to grow moderately in 2018, too, reducing the deficit. On-budget expenditure will decrease slightly and tax revenue will grow, albeit not as much as this year.

The preparation of the health, social services and regional government reform, and the establishment of the counties in 2020 will add to central government expenditure at least in the initial phase. New Defence Force acquisitions will also begin to adversely affect central government's budgetary position, particularly in the 2020s.

Central government also includes extra-budgetary funds, that is, government funds excluding the State Pension Fund of Finland. The revenue surplus of extra-budgetary funds has usually been positive but is gradually turning negative, which will slightly weaken the central government budgetary position as a whole.

Central government debt exceeded EUR 100 billion last year. As budgets will continue to show deficits through to the end of the decade, central government debt will continue to rise. The rate of debt accrual will, however, slow. In addition to on-budget debt, debt has also been incurred by Senate Properties and universities' property companies. Finnvera's funding is not included in central government debt.

In addition to debt, the central government has contingent liabilities, especially state guarantees for loans. Final central government accounts data show that outstanding guarantees amounted to a total of around EUR 46 billion or around 21% of GDP. The largest liabilities are related to Finnvera's export financing and the activities of the Housing Fund of Finland. The increase in outstanding state loan guarantees levelled off last year. Data collected by Eurostat show that the ratio of Finland's government guarantees as a percentage of GDP was the highest among the EU Member States in 2015.

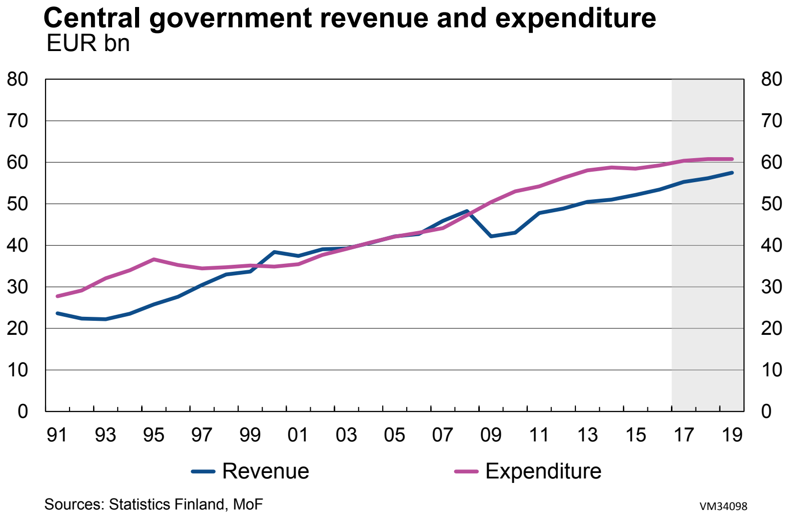
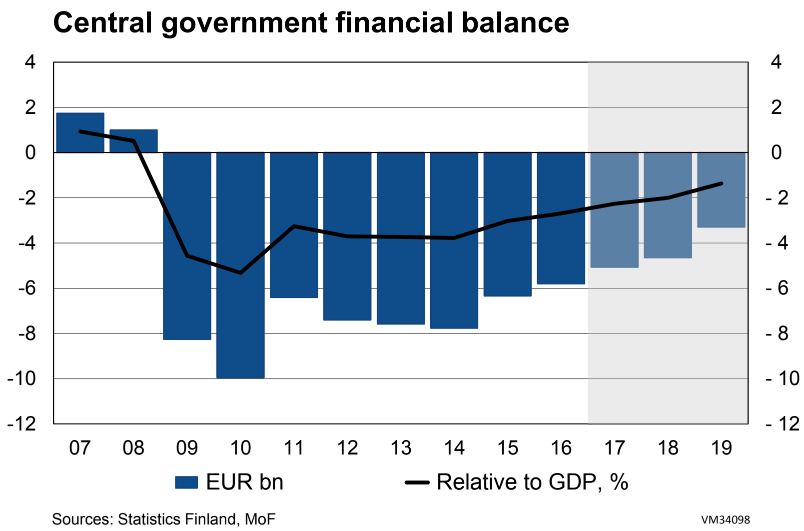
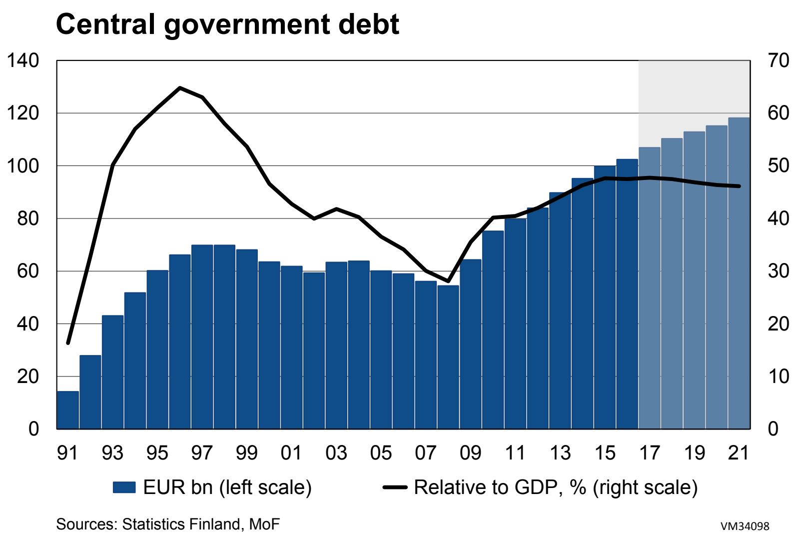


Table 18. Central government[1)]

	2014	2015	2016	2017**	2018**	2019**
	EUR billion					
Current taxes	12.6	13.0	13.7	14.7	14.9	15.5
Taxes on production and imports	29.6	29.7	31.1	31.3	32.0	32.7
Taxes total [2)]	42.7	43.3	45.3	46.9	47.7	48.9
Other revenue [3)]	8.8	9.2	8.6	8.9	9.1	9.2
of which interest receipts	0.3	0.3	0.3	0.3	0.4	0.4
Total revenue	**51.5**	**52.5**	**53.9**	**55.8**	**56.7**	**58.2**
Consumption expenditure	13.7	13.7	14.1	13.9	14.2	14.5
Subsidies and current transfers, total	38.2	38.2	38.8	40.0	40.1	39.7
to general government	26.2	26.2	27.1	28.3	28.3	28.0
Interest expenses	2.4	2.3	2.2	2.0	1.9	1.9
Capital expenditure [4)]	4.9	4.7	4.7	5.0	5.2	5.3
Total expenditure	**59.2**	**58.9**	**59.7**	**60.9**	**61.4**	**61.5**
Net lending (+) / net borrowing (-)	**-7.8**	**-6.3**	**-5.8**	**-5.1**	**-4.6**	**-3.3**
Primary balance [5)]	-5.7	-4.4	-3.9	-3.4	-3.1	-1.7

1) As calculated in the National Accounts.
2) Incl. capital taxes.
3) Incl. capital transfers (excl. capital taxes) and consumption of fixed capital.
4) Gross fixed capital formation and capital transfers.
5) Net lending before net interest expenses.





2.2.1 Central government expenditure

Central government expenditure as shown in the national accounts amounted to EUR 59 billion in 2016, up just over 1% year on year. The biggest increase was seen in transfers to municipalities in particular and in consumption and capital expenditure. Subsidies and interest outlays decreased. More than half of central government total expenditure consists of transfers to other sectors of the economy, primarily to municipalities and social security funds. Consumption expenditure accounts for roughly one quarter, and other expenditure mainly consists of capital expenditure, subsidies and interest outlays.

Central government expenditure will increase moderately in the coming years. The fiscal adjustment measures adopted under the Government Programme will reduce central government expenditure this year and next, as will the reduction in costs associated with asylum seekers. On the other hand, immigration appropriations will be slightly higher than projected in the spring. Savings will also be made following a reduction in employer contributions and temporary cuts to holiday bonuses under the Competitiveness Pact. Furthermore, it is estimated that the extension of annual working hours will reduce the central government payroll and thereby employee compensations paid by central government. Expenditure will also be cut by reduced capitalisation in 2018.

The reduction in the employer's health insurance contribution under the Competitiveness Pact will erode the revenue of the Social Insurance Institution of Finland (Kela), and this will be compensated with additional central government transfers to Kela. In the 2016–2018 period a total of EUR 1.6 billion will be invested in the Government's key projects, including transport infrastructure maintenance. Appropriations for key projects will increase further in 2018. Next year's expenditure will be increased by the preparation of the health, social services and regional government reform as well as by freedom of choice pilot projects. Despite increases in central government debt, interest outlays will remain low due to the low interest rate level.

2018 STATE BUDGET AND CENTRAL GOVERNMENT SPENDING LIMITS

The Government Programme of Prime Minister Juha Sipilä's Government includes a spending limits rule for on-budget expenditure effective throughout the electoral term. The spending limits rule covers some four fifths of total budgeted expenditure. The purpose of the rule is to ensure a responsible and long-term spending policy that contributes to economic stability.

The 2018 budget proposal is based on the General Government Fiscal Plan 2018–2021 of April 2017. The central government expenditure ceiling takes account of the expenditure savings set out in the Government Programme and thereafter.

The 2018 expenditure ceiling is set at EUR 44 453 million, of which some EUR 110 million is set aside as an unallocated reserve after the 2018 budget proposal. A further EUR 300 million reserved for supplementary budget needs. Items excluded from the scope of spending limits include expenditure that fluctuates with economic cycles as well as automatic fiscal stabilisers, such as unemployment security expenditure, pay guarantee, housing allowances, and basic social assistance. However, expenditure effects resulting from changes to the criteria for these items are included in the spending limits. Also excluded from the spending limits are interest outlays on central government debt, VAT expenditure, financial investment expenditure and expenditure corresponding to technically transmitted payments and external funding contributions. Total expenditure outside the spending limits in 2018 amounts to around EUR 11.6 billion.

The 2018 budget proposal puts central government expenditure at around EUR 55.7 billion, up around EUR 0.2 billion from the State Budget for 2017. Government-agreed savings in central government appropriations, as detailed in Annex 6 to the Government Programme, will increase by a net total of around EUR 0.3 billion compared with savings in 2017. The level of expenditure will be increased, among other things, by an increase of over EUR 250 million in appropriations for the Government's key projects from 2017 and by growing pension expenditure. On the other hand, immigration-related expenditure will be reduced by just over EUR 100 million compared with the State Budget for 2017. Unemployment security expenditure will decrease by around EUR 168 million from the current year, mainly due to the improved employment situation. The Competitiveness Pact's increasing effect on appropriations will become smaller. Interest outlays on central government debt come to a little over EUR 1.2 billion, some EUR 0.1 billion less than in the current year.

On-budget revenue for 2018 (excluding borrowing) is estimated to total around EUR 52.8 billion and tax revenue around EUR 44.0 billion. On-budget revenue will increase 4.4 % on the figure budgeted for 2017 (including supplementary budgets) due to improved economic activity. The highest rate of increase among taxes received by central government will be seen in corporation tax revenue.

In its budget session the Government decided to introduce a EUR 270 million package of income tax cuts affecting all income categories. The so-called solidarity tax on high income earners will remain unchanged. An adjustment for inflation and the change in the general level of earnings will be made to the earned income tax parameters.

To finance the reduced burden of labour taxation, the Government decided to raise the tax on alcoholic beverages by EUR 100 million and the energy taxes on heating, mobile machinery and power plant fuels by a net EUR 45 million. In line with the Government Programme, the tax increases on tobacco products will continue in 2018–2019, rising by EUR 68 million in 2018.

The budget proposal shows a deficit of EUR 3.0 billion. This deficit will be covered by increased government debt. It is estimated that at year-end 2018 central government debt will be around EUR 110 billion.

The on-budget deficit has decreased by some EUR 1.2 billion compared with the spring 2017 General Government Fiscal Plan. This can be explained almost entirely by the higher revenue estimates based on the economic outlook having improved clearly since the spring.

Factors affecting change in on-budget balance compared with spring 2017 General Government Fiscal Plan, EUR billion

	2018
Estimated balance, General Government Fiscal Plan of 28 April 2017	**-4.1**
Revision of expenditure estimate	**-0.2**
Change due to immigration expenditure	-0.1
Correction of technical error in central government transfers to local government item of basic services	0.1
Compensation for local government tax losses	-0.2
Other change (net)	-0.1
Revision of revenue estimate	**1.4**
New tax criteria changes	0.0
Changes to miscellaneous revenue and revenue from interests, dividends and sales of shares	0.1
Other factors impacting revenue estimate (incl. tax accrual data and new cyclical forecast)	1.2
Total change	**1.2**
Estimated balance, budget proposal	**-3.0**

2.2.2 Central government revenues

The acceleration of economic growth can also be seen in an increase in tax revenue receipts. The economic growth triggered last year increased central government tax revenue by more than 4%. Many important tax revenue items will also increase at a good rate in the next few years. In recent years, the emphasis of taxation has shifted from direct to indirect taxes.

From the beginning of 2020, responsibility for the organisation of social and health services will be transferred from municipalities to counties. This reform will significantly increase central government tax revenue because some local government revenue will be transferred to central government. Some of both local income tax and corporation tax revenue will go to central government. The Government has also adopted the policy that there must be no increase on anyone's tax burden in conjunction with the reform. For this reason, taxation on earned income will be moderately eased at the beginning of 2020.

Other major sources of central government revenue include property income and transfers from the State Pension Fund of Finland. Transfers from the State Pension Fund cover 40% of central government's annual pension expenditure. Property income received by central government is anticipated to remain approximately at the current level over the outlook period. Revenue from sales of central government assets is entered as financial transactions in the national accounts and therefore not included in deficit-decreasing revenue.

Direct taxes

Revenue from earned income and capital income taxes consists of receipts from progressive earned income tax, capital income tax, public broadcasting tax, and tax at source paid by persons with limited tax liability. Among these, the most significant source of revenue is the progressive tax on earned income, the accrual of which is primarily dependent on employment and wage and salary trends. Capital income items include dividend income, capital gains and rental income.

Annual index adjustments have been made in labour taxation to prevent the tightening of taxation due to the progressive tax system or increases in general earnings or consumer price levels. In the current year, revenue from earned income and capital income taxation will be partly reduced by the tax cuts agreed in 2016 in conjunction with the Competitiveness Pact. The improved employment situation can be seen as a slight acceleration in the increase in earned income, which will also increase earned income and capital income tax revenues. The expiry of the temporary child deduction will also result in increased tax revenue. On the other hand in its budget negotiations for 2018 the Government decided to introduce an income tax cuts affecting all income categories. The earned income and capital income tax forecast assumes also for the medium term that index adjustments will be carried out in the 2019–2021 period to ensure that the tax burden on labour does not increase as a result of higher earnings levels or consumer prices.

The most cyclically sensitive component of tax revenue is corporation tax. Corporation tax has already been reduced by the lowerings of the corporation tax rate that took place in 2014 and before that with a view to safeguarding Finland's competitiveness as a place for investment in international tax competition. Last year, however, corporation tax revenue increased as a result of improved enterprise profitability and recovery of economic growth. Corporation tax revenue is projected to continue to develop positively in the outlook period. In 2020, central government revenue from corporation tax will increase in particular due to the reduction of the proportion of corporation tax revenue apportioned to municipalities in conjunction with the health, social services and regional government reform. There will be no changes to corporation tax criteria in the 2017–2021 period.

Revenue from tax at source on interest income has fallen sharply in recent years due to low interest rates. A gradual increase in tax revenue resulting from a rise in the general interest rate level is only anticipated to take place towards the end of the outlook period.

Indirect taxes

Excise duties on liquid fuels were raised from the beginning of this year. Revenue from other excise duties is usually very steady in the absence of tax criteria changes. The excise duty on tobacco products has been progressively raised since the beginning of 2016, and these increases will continue through to 2019. In 2018 e the tax on alcoholic beverages by and the energy taxes on heating, mobile machinery and power plant fuels will be raised. It is thought that changes in tax criteria will slightly increase revenue from excise duties over the outlook period compared with a situation where there are no hikes. Due to the steering effect of taxation, excise duty bases are estimated to mostly decrease. Consequently, the ratio of indirect taxes to total output will decrease as tax base development will lag clearly behind that of GDP growth.

The rise in household consumption expenditure accelerated the increase in VAT revenue last year, and similar development will continue in the next few years. From the beginning of 2018, VAT on imports will be levied by the Finnish Tax Administration instead of Finnish Customs. This will result in a one-off negative effect in next year's VAT revenue.

The car tax has been progressively lowered since the beginning of 2016, and the tax cuts will continue through to 2019. Revenue from the car tax will fall over the outlook period. The annual vehicle tax was increased from the beginning of 2017.

Table 19. Forecasts for certain revenue and demand items impacting taxable income and the tax base in 2015–2021, annual change

	2015	2016	2017**	2018**	2021/2018**
	change, % per year				
Taxable earned income and capital income	1.8	1.6	2.3	2.4	2.7
Wage and salary earnings and other income	1.1	1.5	1.8	2.2	2.5
Pensions and other social security benefits	3.1	1.7	1.2	2.0	2.7
Capital income	4.9	1.5	7.6	4.1	3.7
Index of wage and salary earnings	1.4	1.1	0.3	1.4	1.6
Operating surplus	6.5	5.3	10.7	9.1	6.5
Value of household taxable consumption expenditure	0.2	1.8	2.9	2.4	2.6
VAT base	0.5	2.8	3.1	2.8	2.8
Petrol consumption	-1.4	-0.2	-2.7	-2.4	-2.2
Diesel consumption	1.6	4.8	0.3	0.9	0.6
Electricity consumption	-0.9	2.0	1.5	0.4	0.4
Duty-paid alcohol consumption	-3.6	0.1	-0.8	1.9	0.1
New passenger cars	4.5	9.1	2.3	3.4	2.0
Consumer price index	-0.2	0.4	0.9	1.5	1.7

Table 20. Impact of change in selected tax base items on tax revenue

Tax category	Tax base	Change	Change in tax revenue, EUR million
Taxes on earned income	Wage and salary earnings	1-pp	385 of which central govt. 126 and local govt. 176
	Pension incomes	1-pp	122, of which central govt. 31 and local govt. 81
Capital income tax	Investment income	1-pp	11
Corporate tax	Operating surplus	1-pp	45, of which central govt. 31 and local govt. 14
VAT	Value of private consumption	1-pp	120
Car tax	Sales of new cars	thousands	7
Energy tax	Electricity consumption *	1%	9
	Petrol consumption	1%	13
	Diesel consumption	1%	14
Duty on alcoholic beverages	Alcohol consumption	1%	14
Duty on cigarettes	Cigarette consumption	1%	9

*excl. manufacturing industries, datacenters and greenhouses

Table 21. **Central government on-budget revenue**

	2016 provisional financial accounts	2017 budget incl. supplementary budget	2018**	2019**	2020**	2021**	2021/2017** annual change, %
			EUR billion				
Total tax revenue estimates	41.8	42.2	44.0	45.3	58.9	61.2	8 1/2
Income and wealth taxes	13.3	13.4	14.5	15.1	27.0	28.5	19 1/2
Taxes based on turnover	18.1	18.3	18.9	19.6	21.3	22.1	4
Excise duties	7.2	7.2	7.4	7.4	7.4	7.3	1/2
Other taxes	3.3	3.3	3.2	3.2	3.2	3.2	-0
Miscellaneous revenue	5.6	5.3	5.5	5.4	5.5	5.6	-0
Interest income and profit entered as income	1.6	2.5	2.8	1.8	1.8	1.8	5 1/2
Total revenue estimates	**49.5**	**50.4**	**52.7**	**53.0**	**66.7**	**69.0**	**7**

Table 22. **Impact of discretionary tax measures on general government tax revenue**

	2016	2017	2018**	2019**	2020**	2021**
	EUR million					
Earned income taxes	-515	-805	-418	44	-559	-426
Average increase in municipal tax rate	36	50	0	0	0	0
Investment income tax	51	2	-9	0	0	0
Corporate tax	122	105	4	6	0	0
Other direct taxes	25	-1	-6	-34	0	0
Value-added tax	0	-156	-200	0	0	0
Energy taxes	103	116	47	-2	0	0
Other indirect taxes	94	140	160	78	34	0
Social security contributions	552	-1033	-314	205	7	-24

2.2.3 On-budget accounts and national accounts

In 2016, the national accounts deficit stood at EUR 5.8 billion, while the on-budget deficit was EUR 4.9 billion. No direct inferences can be drawn from the on-budget balance regarding the corresponding national accounts figures. Neither can central government borrowing always be inferred from the budget deficit. In 2016, the amount of loans taken out by the State Treasury at around EUR 2.3 billion was clearly below that required by the budget deficit at around EUR 4.6 billion. There were several reasons for the difference between the deficit and change in debt, the most important of which was the reduction of central government cash funds by EUR 1.2 billion.

There are also several reasons for the discrepancy between the fiscal budget and national accounts. For example, the national accounts are accrual based, whereas on-budget activities are based partly on the cash-basis principle. Timing adjustments are made to taxes, subsidies and EU payments to book them on an accrual basis. The differences in figures arising from the timing adjustments can only be seen retrospectively.

Financial investments such as central government loans and share purchases are entered in the Budget as expenditures. Correspondingly, loan repayments, revenue from shares, etc., are entered on the revenue side. In the national accounts, these items are usually entered as financial transactions, which do not affect central government's fiscal balance as reported in the national accounts.

Interest outlays in the national accounts are clearly higher than on-budget interest outlays. This is, above all, due to the fact that national accounts interest payments, in contrast to the on-budget figures, do not include the downward effect of interests on derivative instruments. By using derivatives, the Treasury has managed to achieve a significant reduction in the level of real interest outlays from the Budget. In the national accounts, derivative contracts are recorded as financial transactions that have no effect on fiscal balance.

The national accounts concept of central government sector is much broader than the on-budget entities, which mainly comprise central government agencies. In addition to on-budget entities, the central government sector in the national accounts also includes, for example, government funds (excluding the State Pension Fund), universities and their property companies, and Senate Properties. Classifications of various public units are revisited from time to time. In 2017, for instance, Finpro and the new State Business Development Company Vake Oy are classified in the central government sector. A list of all units of central government and, more broadly, general government can be found on the Statistics Finland website.

Deferrable appropriations in the budget are two or three-year appropriations that are entered in the budget for one year only. In the national accounts, deferrable appropriations are entered on an accrual basis on the basis of their use. The net effect of deferrable appropriations can vary widely from year to year.

EU Member States report twice a year to Eurostat on the differences between their on-budget and national accounts figures in conjunction with their deficit and debt reporting. As regards past years, Member States are required to provide satisfactory explanations for the difference between the budgetary position indicated by the central government accounts and the net lending figures indicated in the national accounts. The same goes for other subsectors of general government finances. Furthermore, the reports provide information on so-called debt dynamics, that is, on how closely general government net lending matches with the change in public debt. The next round of reports is due at the end of September.

Table 23. **On-budget balance and central government net lending**[1)]

	2015	2016	2017**	2018**	2019**
	EUR billion				
On-budget surplus (+)/deficit (-) [2)]	**-4,7**	**-4,9**	**-4,1**	**-3,0**	**-2,5**
Privatization proceeds (net proceeds from equity sales)	0,3	-0,1	0,2	-1,1	-0,2
Financial investment, net	-0,6	-0,8	-0,6	-0,5	-0,5
Revenue surplus in off-budget units	-0,9	-0,1	-0,2	-0,2	-0,2
Cash/accrual basis adjustment	0,0	-0,4	0,0	0,0	0,0
Other adjustment items [3)]	-0,5	0,4	-0,3	0,1	0,1
Central government net lending (+) /-borrowing (-)	**-6,3**	**-5,8**	**-5,1**	**-4,6**	**-3,3**

[1)] In National Accounts terms.
[2)] Incl. government debt servicing.
[3)] Incl. debt cancellations, profit on reinvested foreign direct investments, impact of the difference in the recording of deferrable budgetary appropriations, superdividends

2.3 County finances

The health, social services and regional government reform will result in the establishment of 18 counties in Mainland Finland, to which the responsibility for organising social and health care services and several other duties will be transferred from municipalities and central government. Under the updated reform schedule, the counties will become operational at the beginning of 2020, a year later than originally planned. The change of schedule has been taken into account in the forecast for general government finances.

The increased service needs of health and social services caused by population ageing will be targeted at the counties. The counties will need to operate efficiently from the outset to prevent their expenditure from increasing faster than their financing. The counties will initially incur additional expenditure from launching and organising their activities, which creates an extra challenge as regards enhanced efficiency.

The forecast assumes that the counties' current revenue and expenditure will be close to balance. This requires the counties to be able to enhance the efficiency of their activities as appropriate to their revenue as determined in accordance with the Act on the Financing of the Counties.

The county sector's budgetary position will be slightly in deficit in 2020 and 2021, mainly due to extensive capital expenditure on premises. A considerable amount of ongoing or planned investment projects will be transferred to the counties from hospital districts. The estimated level of investment is around EUR 0.8 billion in 2020. The majority of the investments will be implemented by the counties' national service centre responsible for facilities services.

County revenue will consist mainly of central government funding and income from sales and payments from customers. Total county revenue in 2020 will be around EUR 23.8 billion. Most of this will be covered by central government funding. Counties' other revenue will total around EUR 3.3 billion.

Central government funding for counties will consist of the counties' universal funding, VAT refunds, sales income received by the counties, government transfers and separate government funding. In the forecast, separate government funding and related expenditure is not described under the county sector, because most of the separate funding will be related to duties where the county merely acts as a funding intermediary.

Total county government expenditure will be around EUR 24.4 billion in 2020, with more than 90% of this consisting of purchases of services and goods or personnel expenditure. Other significant types of expenditure will be capital expenditure and social benefits.

A substantial amount of debt will also be transferred to the county sector. The estimated total amount of debt at year-end 2020 is around EUR 4.0 billion. This exceeds the current debt of the hospital districts as the debt will be increased by the investments made in the next few years by the hospital districts. In addition, the debt figure is anticipated to increase during 2020. Most of this the debt will be transferred to the facilities services centre jointly owned by the counties.

Table 24. County finances 2020

	Billion EUR
Total revenue	23.8
Total expenditure	24.4
of which capital expenditure	0.8
Net lending	-0.6
Debt	4.0

COUNTY GOVERNMENT IN THE FORECAST FOR GENERAL GOVERNMENT FINANCES

In the forecast for general government finances, the counties are assumed to be classified as part of central government in the national accounts as their operations will be financed by central government. County finances are shown as a separate subsector of central government. In the forecast, the county sector covers the counties and unincorporated county enterprises, companies owned by counties, and national service centre companies. The final decision on the sectoral classification of counties and other units in the national accounts will be made at a later date by Statistics Finland.

The forecast concerning county government is currently of a technical nature. Assessments of economic data concerning the counties are based on several assumptions about the counties' activities and the structure and development of county expenditure. The forecast will be revised as new statistical data become available and the details of the regional government reform become clearer. The forecast does not take into account factors such as the possible impacts of freedom-of-choice legislation or special solution concerning growth services in Uusimaa.

The structure of expenditure and revenue transferred from the municipalities to the counties has been estimated on the basis of the function-specific data of the 2015 statistics on local government finances. That year's expenditure structure has been projected in the forecast for the coming years on the basis of actual and projected development as well as changes in duties. Municipalities' estimates of cost development in the functions to be transferred have also been utilised in the assessment. The county expenditure forecast for the 2020–2021 period is based on an assessment of the increase in the service needs concerning social and health services, changes in duties, the effects of the Government's discretionary measures, and projected movements in prices of production factors. Background information from the preparation process concerning the counties and investment plans of the hospital districts has been utilised in the assessment of the counties' investments.

The expenditure structure of duties transferred from central government is based on data from the 2016 final central government accounts.

Expenditure relating to the preparation of the counties' activities will be divided between central and local government prior to 2020. For example, ICT system development will require major investment, the scale of which is assumed by the forecast to be around EUR 150 million per year in the 2018–2021 period.

2.4 Local government

Local government deficit was 0.4% of GDP last year. This was the second consecutive year of decrease in deficit. Consumption expenditure increased very moderately, which was due, for example, to most of the 2017 holiday bonus cuts having already been recorded for 2016 in accordance with the holiday credit year, and the moderate price development of consumption expenditure. Capital expenditure also increased only slightly. As regards local government revenue, there was an increase in central government transfers to local government in particular, which was affected by the adjustment to shared costs between local and central government, an increase in compensations due to changes in tax criteria and an increase in VAT in the municipal refund system.

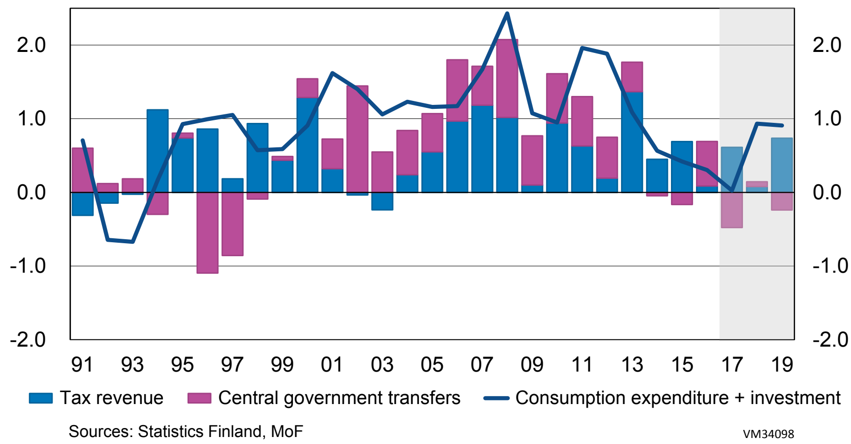
In 2017, the local government deficit will continue to decrease. Measures taken under the Competitiveness Pact, reductions of municipal employers' pension contributions, and adjustment measures adopted by the Government are decreasing local government consumption expenditure. In addition, municipalities and joint municipal authorities will continue to seek greater efficiencies and consolidate their finances by taking steps to curb expenditure growth. Local government revenue will increase due to tax revenue growth picking up. Revenue from corporation tax in particular is proving to exceed the levels projected previously.

Measures agreed in Government Programme falling below target set for 2018

Local government deficit will increase in 2018 and 2019. Local government expenditure pressure will, however, ease from 2020 onwards as health and social services duties are transferred to the counties. The 2018–2021 local government outlook only considers specified and agreed relevant measures included in the spring 2017 General Government Fiscal Plan or the 2018 budget proposal. It does not include municipalities' and joint municipal authorities' own fiscal measures planned for the 2018–2021 period; the impacts of these will be taken into account once the budgets have been drawn up. Furthermore, the average local income tax percentage has been assumed to remain at the 2017 level. The projection takes the health, social services and regional government reform into account by separating county government from local government in accordance with the updated schedule from 2020.

In May–June 2017, the Association of Finnish Local and Regional Authorities conducted a survey on the impacts of the Government Programme's central measures affecting local government finances in municipalities and joint municipal authorities. The survey also covered the implementation of the Competitiveness Pact and municipalities' own adjustment measures. According to the responses received, direct adjustment measures carried out under Annex 6 to the Government Programme will fall behind their estimated savings targets in the next years ahead. The results of the survey show that the estimated savings potential of the working hours extension under the Competitiveness Pact is not going to be achieved in the previously estimated schedule, either.

Local government taxes, central government transfers, consumption expenditure and investment
change on the previous year, EUR bn (at current prices)



Changes in the demographic age structure have increased the need for care and nursing services and added to expenditure pressures in local government for a long time. Accordingly, there will be an upturn in local government consumption expenditure next year, because adjustment measures will be insufficient to offset the added expenditure arising from increased service needs. Consumption expenditure will also grow due, for example, to the reduction in daycare charges paid by low- and middle-income families effective from the beginning of 2018 as the measure is expected to increase the demand for day care. In addition, local government investment needs and repair debt will remain substantial. Hospital construction will continue at a brisk rate despite the fixed-term legislation that entered into force more than a year ago and made major health and social services investments subject to special dispensation.

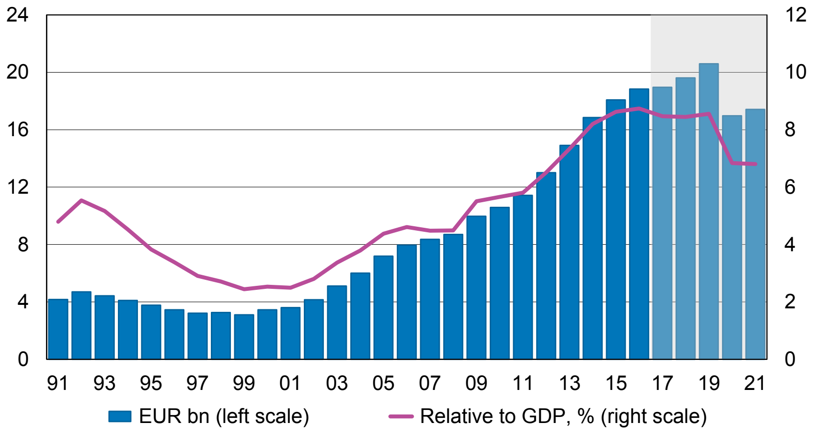
The increase in local government tax revenue is set to be modest next year. Tax revenue will, however, increase due to the compensation of daycare charge cuts to the municipalities through increases in the lower limits of real estate taxes and in the municipalities' share of corporation tax revenue. In addition, the lower and upper limits of the real estate tax will be raised in accordance with the Government Programme in the period 2016–2019 so that real estate tax revenue will increase by EUR 100 million in total or around EUR 25 million per year. There are one-off factors behind the exceptionally strong corporation tax growth seen in 2017 the effects of which will not spill over into 2018. Therefore corporation tax revenue will decrease next year. In addition, growth in local government tax is set to be subdued and central government transfers to local government will grow only marginally due to the adjustment to shared costs between central and local government.

Local government expenditure pressure to be reduced by health, social services and regional government reform

Local government deficit will increase further in 2019 as the growth in the service needs concerning health and social services accelerates. In addition, factors such as the ending of the holiday bonus cuts under the Competitiveness Pact in 2020 will, for the most part, increase local government consumption expenditure already in 2019. In 2020, local government revenue and expenditure will more or less be halved, and the deficit will shrink clearly as the responsibility for organising health and social services will be transferred to the counties. The health, social services and regional government reform will ease the local government consumption expenditure growth pressure as there will be a stronger emphasis in the duties of local government on areas such as education. The ageing of the population creates major health and social services expenditure pressure, but there is no corresponding pressure on the duties remaining with the municipalities. As a result, the growth of local government debt ratio will be halted.

In conjunction with the health, social services and regional government reform, a total of around EUR 0.8 billion of hospital district investments will be transferred from local to county government. In addition, around EUR 3.4 billion of hospital districts' debt will also be transferred from local government to the county sector. This exceeds the current debt of the hospital districts as the debt will be increased by the investments they make in the next few years.

Local goverment debt[1]



[1] Incl. health, social services and regional government reform in 2020

Sources: Statistics Finland, MoF

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Table 25. Local government[1)]

	2014	2015	2016	2017**	2018**	2019**
	EUR billion					
Taxes and social security contributions	21.2	21.9	22.0	22.6	22.6	23.4
of which municipal tax	18.2	18.6	18.7	18.8	18.9	19.5
corporate tax	1.4	1.7	1.5	1.9	1.9	1.9
real estate tax	1.5	1.6	1.6	1.8	1.9	1.9
Other revenue[2)]	18.5	18.5	19.0	18.7	18.9	18.8
of which interest receipts	0.2	0.3	0.3	0.3	0.3	0.3
transfers from central government	13.8	13.7	14.3	13.8	13.9	13.6
Total revenue	**39.6**	**40.3**	**40.9**	**41.2**	**41.6**	**42.1**
Consumption expenditure	33.4	33.8	34.0	33.9	34.7	35.5
of which compensation of employees	21.7	21.7	21.5	20.9	21.0	21.3
Income transfers	3.1	3.2	3.3	2.6	2.6	2.6
of which social security benefits and allowances	1.3	1.3	1.4	0.8	0.7	0.7
subsidies and other transfers	1.7	1.7	1.7	1.7	1.7	1.7
interest expenses	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure[3)]	4.7	4.6	4.5	4.8	4.9	5.1
Total expenditure	**41.2**	**41.6**	**41.8**	**41.3**	**42.2**	**43.1**
Net lending (+) / net borrowing (-)	**-1.6**	**-1.3**	**-0.9**	**-0.1**	**-0.6**	**-1.0**
Primary balance[4)]	-1.7	-1.4	-1.0	-0.3	-0.8	-1.1

1) As calculated in the National Accounts.
2) Incl. capital transfers and consumption of fixed capital.
3) Gross capital formation and capital transfers.
4) Net lending before net interest expenses.

2.5 Social security funds

2.5.1 Earnings-related pension schemes

The surplus of earnings-related pension schemes fell to 1.1% of GDP in 2016, compared with an average of just over 3% in the first decade of the 2000s. Earnings-related pension expenditure has increased rapidly in recent years with the growing number of pensioners. As well as the number of pensioners, pension expenditure is also increasing due to the higher average level of pensions as new pensions starting are larger than old ones in payment.

The weak employment situation and slower rise in earnings have in turn dampened the growth in incomes from contributions, even though pension contribution rates have at the same time increased rapidly in recent years. Low interest rates have reduced pension funds' property income. However, rising asset prices and stock prices in particular increased the total value of pension assets to almost EUR 190 billion at year-end 2016.

The surplus of earnings-related pension schemes will fall during the outlook period from almost 1% to less than ½% of GDP. The main reason for this is that earnings-related pension expenditure growth will remain close to 4%. Although growth in the number of pensioners is gradually slowing, the higher average level of pensions and the annual indexations of pensions will increase pension expenditure.

It is projected that pension schemes' revenue from property income will return to moderate growth during the outlook period as interest rates begin to pick up. In addition, the growth in revenue from pension contributions will accelerate slightly due to the moderate acceleration of growth in the sum of wages and salaries. Contribution revenue will also be increased by the 0.4 percentage point increase in the private-sector pension insurance contribution made at the beginning of the current year. It has been agreed that the contribution will remain at the current 24.4% level in 2018 and 2019 as well. According to the latest long-term calculations of the Finnish Centre for Pensions, there will be slight increase pressures on this contribution level starting from the early 2020s, however.

Table 26. Finances of social security funds[1)]

	2014	2015	2016	2017**	2018**	2019**
	EUR billion					
Investment income	3.5	3.4	3.5	3.6	3.8	4.1
Social security contributions	26.3	26.9	27.9	27.4	27.7	28.4
of which contibutions paid by employers	17.9	18.2	18.8	17.6	17.3	17.4
contributions paid by insured	8.4	8.7	9.2	9.8	10.3	11.0
Transfer from general government	13.9	14.3	14.6	16.1	16.0	15.8
Other revenue	0.6	0.5	0.5	0.5	0.5	0.5
Total revenue	**44.2**	**45.2**	**46.5**	**47.5**	**47.9**	**48.8**
Consumption expenditure	3.6	3.7	3.6	3.6	3.7	3.8
Social security benefits and allowances	34.7	35.9	36.6	38.0	38.9	39.8
Other outlays	3.2	3.7	3.4	3.3	3.3	3.4
Total expenditure	**41.5**	**43.3**	**43.6**	**44.9**	**45.9**	**47.0**
Net lending (+) / net borrowing (-)	**2.7**	**1.9**	**2.9**	**2.6**	**2.0**	**1.8**
Earnings-related pension schemes	3.4	2.7	2.4	1.8	1.5	1.2
Other social security funds	-0.7	-0.8	0.5	0.8	0.4	0.6
Primary balance [2)]	1.2	0.5	1.6	1.3	0.6	0.4

1) As calculated in the National Accounts.
2) Net lending before net interest expenses.

2.5.2 Other social security funds

Other social security funds consist mainly of the Social Insurance Institution (Kela) and the Unemployment Insurance Fund, which are responsible for the provision of basic security and for earnings-related unemployment security, respectively. After running deficits for the two previous years, other social security funds last year posted a surplus of 0.2% of GDP. This was on the back of a 1 percentage point increase in the unemployment insurance contribution from the beginning of 2016 and the end of unemployment security expenditure growth.

The surplus of other social security funds is expected to strengthen slightly this year as unemployment expenditure is reduced by improved employment. The forecast takes into account the proposed cut of 0.2 percentage points to the unemployment insurance contribution starting from 2018. However, in the light of the forecast, the Unemployment Insurance Fund's cyclical buffer is set to accrue funds to the extent that, under current legislation, the unemployment insurance contribution would need to be reduced even more no later than starting from 2020. Therefore the assumption has been made that the unemployment insurance contribution will be decreased by another 0.3 percentage point starting from 2020. For reasons of caution, the size of the contribution cut has been assessed in a manner whereby the cyclical buffer would be filled by 2021 even if the contribution cut already took place from 2019 and the decrease in unemployment expenditure was more moderate than anticipated.

Cuts to earnings-related unemployment security, medical and health care reimbursements, sickness and parental allowances as well as general housing allowance and student financial aid will contribute to reducing the expenditure of other social security funds. In addition, benefits and allowances linked to the National Pensions Index were cut by 0.85% from the start of 2017 and, under a previous decision, will not be increased in 2018 or 2019. These decisions do not, however, apply to basic social assistance, the payment of which was transferred from the municipalities to Kela at the beginning of 2017. The savings achieved will largely be reflected in a reduced level of central government transfers to other social security funds.

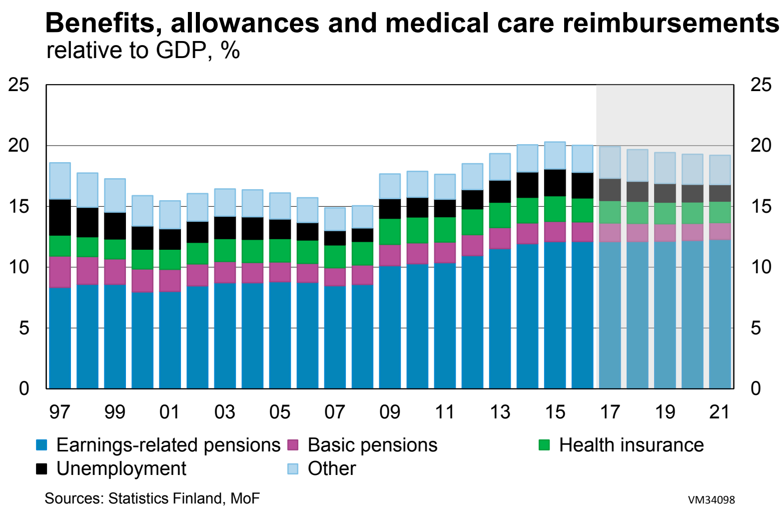


Table 27. Social security contributions rates and pension indices

	2014	2015	2016	2017	2018**	2019**
Social insurance contributions [1]						
Employers						
Sickness insurance	2.14	2.08	2.12	1.08	0.87	0.98
Unemployment insurance	2.20	2.33	2.85	2.40	1.91	1.91
Earnings-related pension insurance	17.75	18.00	18.00	17.95	17.75	17.35
Local government pension insurance	23.79	23.65	23.21	21.95	21.75	21.35
Employees						
Sickness insurance	2.16	2.10	2.12	1.58	1.54	1.67
Unemployment insurance	0.50	0.65	1.15	1.60	1.90	1.90
Earnings-related pension insurance	5.85	6.00	6.00	6.45	6.65	7.05
Benefit recipients						
Sickness insurance	1.49	1.49	1.47	1.45	1.53	1.59
Pension indices						
Earnings-related index (over 65)	2509	2519	2519	2534	2551	2589
National pension index	1630	1637	1631	1617	1617	1617

[1] Annual averages. The contributions of employers and the unemployment and employment pension contributions of beneficiaries as percentages of wages and salaries. The figures are weighted averages.

2.6 Long-term sustainability of public finances

Although the growth in the public debt-to-GDP ratio has taken a slight downturn, balance is still not expected to be restored in general government finances. The challenges of balancing general government finances are greatly compounded by the shift in the population age structure that will have persistent adverse effects in the decades ahead. These changes are driving up pension expenditure as well as health care and long-term care costs to such an extent that they cannot be covered under the current tax ratio. Furthermore, the age structure changes are depleting the working age population whose taxes are paying for welfare services and benefits. The change in the population age structure is being seen earlier in Finland than in other EU countries.

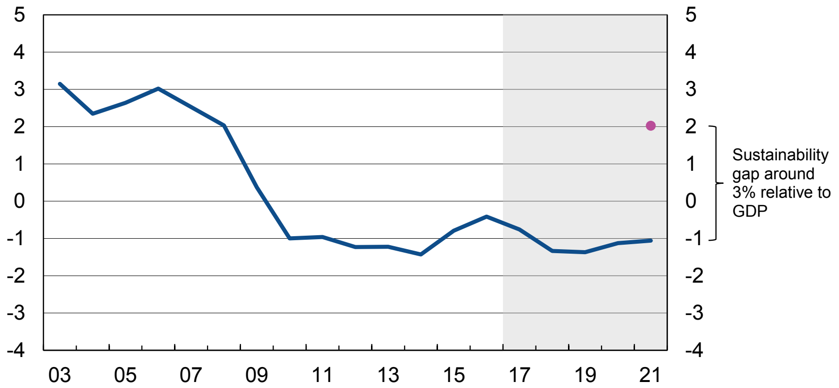
The sustainability gap in general government finances means that, in the long term, general government revenue is insufficient to cover expenditure. A permanent imbalance between revenue and expenditure creates a risk of public debt spiralling out of control. Technically, the sustainability gap can be expressed as the difference between the level of surplus required for sustainable general government finances and the structural deficit in general government finances in the base year, which is currently 2021 (see figure below). The surplus safeguarding sustainability means that general government structural surplus should be around 2% of GDP in the early 2020s for general government finances to manage the expenditure pressures arising from population ageing in the coming decades without additional measures. Excluding the effect of the fighter aircraft acquisitions, instead of 2% surplus, the structural deficit of general government finances is projected to be around 1% of GDP in 2021.

The Ministry of Finance estimates the sustainability gap to be around 3% of GDP or around EUR 8 billion at the 2021 level.[1] Compared with spring 2017, the sustainability gap estimate has increased slightly due to, among other things, the decided tax cuts and the assumed unemployment insurance contribution cut. The sustainability gap calculation does not take into account the long-term measures, such as the health and social services reform, outlined in the Government Programme to strengthen general government finances. Moreover, the calculation does not take into account the appropriation of approximately EUR 1 billion allocated in central government spending limits for fighter aircraft acquisitions for 2021.[2]

1 The Ministry of Finance assessment of the long-term sustainability of general government finances is based on EU harmonised methods and calculation rules. The sustainability calculation is effectively a pressure projection in which developments under current legislation and practices are projected to the future with the help of the population projection, spending breakdowns by age groups, and assessments of long-term economic development. The calculation procedures are described in greater detail in the methodological description for sustainability gap calculations of the Ministry of Finance that can be found at https://vm.fi/en/descriptions-of-methods. The sensitivity of the sustainability gap calculation to the calculation assumptions employed is also examined at the end of the methodological description as the calculation involves significant uncertainty and is sensitive to underlying assumptions about future development. Nonetheless the calculation provides a consistent way of analysing and overcoming the future challenges that lie ahead for general government finances.

2 The effect of the fighter aircraft acquisitions on the sustainability gap has not been taken into account because as yet no firm decisions are in place and because the exact cost of the acquisitions is not known. Although this is a major acquisition estimated at EUR 7–10 billion, its effect on the sustainability gap is rather limited. This is because it does not represent a permanent increase in expenditure but a one-off replacement acquisition if the ratio of maintenance costs to GDP does not increase considerably from the current level.

MoF's sustainability gap estimate
relative to GDP, %



General government structural balance (without the fighter jet acquisitions)
Surplus required to secure sustainability

Sources: Statistics Finland, MoF

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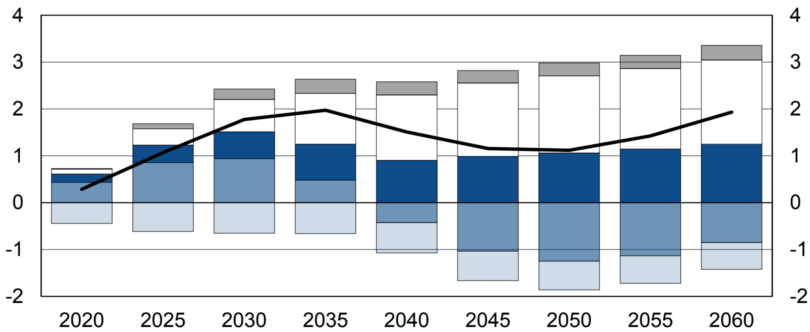
Change in age-related expenditure
from year 2015, relative to GDP, %



Pensions
Healt care
Long-term care
Education
Unemployment
Total

The figure is compiled using the model developed by the Ministry of Social Affairs and Health for social expenditure analysis

Source: MoF

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Appendix

Supplementary statistics

1. **Evolution of forecasts over time**
2. **Outturn data and forecasts used in budget process for 2012-2016, average change, %**
3. **National balance of supply and demand**
4. **Financial balance of the Finnish economy**

Table 1. Evolution of forecasts over time[1)]

	2016				2017**				2018**				2019**			
	es4	es1	es2	es3	es4	es1	es2	es3	es4	es1	es2	es3	es4	es1	es2	es3
GDP at market prices, change in volume, %	1.6	1.4	1.5	1.9	0.9	1.2	2.4	2.9	1.0	1.0	1.6	2.1	-	1.2	1.5	1.8
Consumption, change in volume, %	1.4	1.5	1.5	1.6	0.5	0.7	1.4	1.6	0.4	0.3	0.8	1.2	-	0.6	0.7	1.0
Investment, change in volume, %	4.1	5.2	5.2	7.2	2.7	2.8	3.6	4.7	3.2	3.1	2.9	3.7	-	3.3	3.4	3.5
Exports, change in volume, %	1.0	0.5	1.5	1.3	2.4	2.9	4.7	4.7	3.2	3.4	3.7	3.7	-	3.6	3.9	4.1
Unemployment rate, %	8.9	8.8	8.8	8.8	8.5	8.5	8.5	8.6	8.1	8.1	8.1	8.1	-	7.8	7.8	7.8
Consumer price index, change, %	0.3	0.4	0.4	0.4	1.3	1.2	1.0	0.9	1.3	1.3	1.3	1.5	-	1.4	1.4	1.5
Central government net lending, relative to GDP, %	- 2.6	- 2.7	- 2.7	-2.7	- 2.6	- 2.7	- 2.5	-2.3	- 2.1	- 2.2	- 2.0	-2.0	-	- 1.8	- 1.7	-1.4
General government net lending, relative to GDP, %	- 2.2	- 1.9	- 1.9	-1.8	- 2.5	- 2.3	- 1.8	-1.2	- 2.0	- 2.0	- 1.7	-1.4	-	- 1.7	- 1.4	-1.0
Central government debt, relative to GDP, %	47.7	47.8	47.8	47.5	49.2	49.1	48.5	47.7	50.2	49.7	48.6	47.5	-	50.0	48.6	46.9

[1)] Economic Survey / release date: 22.12.2016 (es4), 28.4.2017 (es1), 21.6.2017 (es2) and 19.9.2017 (es3)
Sources: Statistics Finland, MoF

Table 2. Outturn data and forecasts used in budget process for 2012-2016

	Years 2012-2016		Average forecast errors	
	Forecast averages, % ch.	Outcome averages, % ch.	Forecast under-/over-estimation[1], pp.	Magnitude of forecast error[2], pp.
GDP (volume)	1.5	-0.1	1.6	1.8
GDP (value)	3.5	1.8	1.7	1.8
Private consumption (value)	3.1	2.4	0.7	1.0
Current account, % of GDP	-0.4	-1.0	0.7	1.3
Inflation	2.1	1.1	1.0	1.1
Wage bill	2.5	1.3	1.2	1.2
Unemployment rate	8.2	8.6	-0.4	0.5
Central government debt, % of GDP	47.5	46.0	1.6	1.6
Central government net lending, % of GDP	-2.9	-3.4	0.5	0.6
General government net lending, % of GDP	-1.8	-2.5	0.6	1.1

Forecasts are compared with March/July preliminary national accounts data.
Averages for the past five years are calculated on the basis of spring and autumn forecasts concerning the budget year.

[1] Over- or understimation is indicated by average forecast error. [2] The average of absolute error values indicates the average magnitude of forecast errors, regardless of the direction of error.

Table 3. National balance of supply and demand, EUR million

	Current prices					
	2014	2015	2016	2017**	2018**	2019**
GDP at market prices	205 474	209 581	215 615	223 919	232 232	240 806
Imports of goods and services	78 393	77 481	78 616	84 814	89 205	94 525
Total supply	**283 867**	**287 062**	**294 231**	**308 734**	**321 437**	**335 331**
Exports of goods and services	76 482	76 431	75 967	81 536	85 615	90 445
Consumption	164 346	166 977	170 771	174 540	178 955	183 562
private	113 635	115 856	119 056	123 150	126 500	129 905
public	50 711	51 121	51 715	51 390	52 455	53 657
Investment	42 235	42 713	46 423	49 643	52 749	56 010
private	33 643	34 562	37 860	40 800	43 499	46 433
public	8 592	8 151	8 563	8 843	9 250	9 577
Total demand	**283 867**	**287 261**	**293 861**	**308 364**	**321 067**	**334 961**
	At reference year 2010 prices; not additive					
	2014	2015	2016	2017**	2018**	2019**
GDP at market prices	186 552	186 536	190 130	195 597	199 708	203 396
Imports of goods and services	74 799	77 161	80 577	82 875	85 025	87 690
Total supply	**261 351**	**263 697**	**270 707**	**278 472**	**284 733**	**291 087**
Exports of goods and services	73 495	74 114	75 054	78 561	81 449	84 792
Consumption	148 267	149 954	152 397	154 824	156 679	158 187
private	103 127	104 847	106 771	109 327	110 835	112 179
public	45 136	45 114	45 638	45 523	45 870	46 036
Investment	38 694	38 962	41 757	43 710	45 312	46 900
private	30 885	31 565	34 074	35 948	37 388	38 905
public	7 801	7 393	7 682	7 762	7 924	7 996
Total demand	**261 224**	**264 143**	**269 967**	**277 203**	**282 904**	**288 649**

Table 4. Financial balance of the Finnish economy

	2012	2013	2014	2015	2016
	relative to GDP, %				
Gross investment	**22.3**	**21.2**	**20.6**	**20.4**	**21.5**
households and non-profit institutions	6.5	6.2	5.9	5.7	6.3
non-financial corporations and financial and insurance corporations	11.8	10.8	10.5	10.7	11.3
general government	4.0	4.2	4.2	4.0	4.0
Gross saving [1]	**20.7**	**19.7**	**19.7**	**19.9**	**20.7**
households and non-profit institutions	4.5	5.0	4.2	3.9	3.3
non-financial corporations and financial and insurance corporations	14.3	13.2	14.5	15.0	15.3
general government	1.9	1.5	1.0	1.1	2.0
Financial surplus	**-1.8**	**-1.8**	**-1.2**	**-1.0**	**-1.2**
households and non-profit institutions	-2.3	-1.5	-1.9	-2.0	-3.3
non-financial corporations and financial and insurance corporations	2.6	2.3	3.9	3.8	3.9
general government	-2.2	-2.6	-3.2	-2.7	-1.8
Statistical discrepancy	-0.1	0.0	0.0	-0.1	0.2

[1] Incl. capital transfers (net)

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