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# Economic Forecast 2016–2017

## Focus of growth shifting from domestic demand to foreign trade

**ADDITIONAL INFORMATION**

Eero Lehto
Chief of forecasting
+358 9 2535 7350
eero.lehto@labour.fi

Heikki Taimio
Information officer
+358 9 2535 7349
heikki.taimio@labour.fi

www.labour.fi

LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast for 2016–2017

# Focus of growth shifting from domestic demand to foreign trade

The Labour Institute for Economic Research has kept its March forecast for Finnish GDP growth unchanged. We forecast that economic growth will be 1.1 per cent this year and 1.3 per cent next year. The competitiveness agreement, which will lower labour costs per hour worked by about 3.5 per cent next year, will increase total production in net terms. Finland's labour costs have already decreased by a few percentage points this year relative to our competitor countries. In the future the main driver of growth will be exports, while the modest development of household purchasing power will constrain the growth of private consumption.

**ADDITIONAL INFORMATION**

Chief of forecasting Eero Lehto
+358 9 2535 7350
eero.lehto@labour.fi

www.labour.fi

For the first time in a long time, a positive deviation from the projected GDP path is even more likely than a negative one. Negative risks, which could lead to slower growth than anticipated, stem from the international economy and international politics. The effects of the UK's leaving the EU and problems surrounding the Brexit negotiations constitute a clear downside risk. The outcome of the US presidential elections may likewise result in increased international tensions, which would have a negative impact on Finland's economy. Better-than-projected economic development can be achieved if the international raw material markets recover significantly from their current state. This would spawn export orders for Finnish industry. A similar effect would take place if our potential production were higher than generally expected. This is possible. We are getting over of the problems triggered by the shutdown of Nokia's mobile phone operations and the collapse of exports to Russia.

## GDP GROWTH WILL SLIGHTLY EXCEED ONE PER CENT IN NEXT FEW YEARS

- Finland's GDP growth rate is converging to that prevailing elsewhere in the euro area
- Construction will grow by about three per cent this year and next
- The fastest growth will continue to be in information and business services

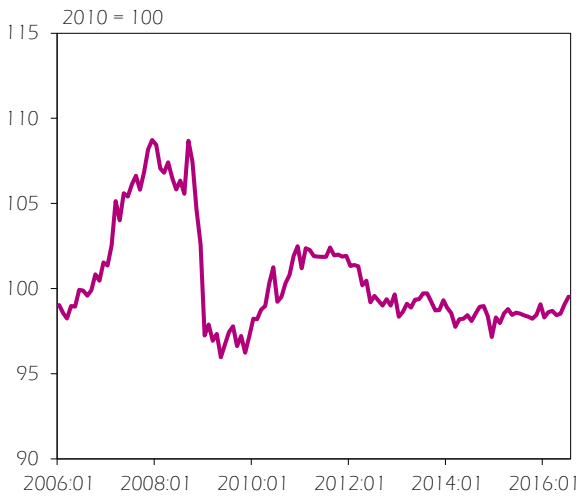
Finland's GDP grew by only 0.2 per cent last year. Manufacturing industry output decreased by as much as 3.1 per cent. This year the manufacturing sector's output will contract by another couple of per cent, but next year it will rebound to growth of just over two per cent. Construction is Finland's main engine of growth, increasing by as much as 7 per cent this year. Next year, growth in construction will subside to four per cent. Other sectors experiencing strong growth this year will be are wholesale and retail trade and hotel services as well as business services, especially technical services. Information services have been declining this year due to, among other things, Microsoft's layoffs, but next year they too will start to rise. ■

## DEMAND AND SUPPLY

| | 2015 | 2015 | 2016f | 2017f |
|---|---|---|---|---|
| | Bill. € | Percentage change in volume (%) | | |
| Gross Domestic Product | 209.1 | 0.2 | 1.1 | 1.3 |
| Imports | 77.5 | 1.9 | 1.8 | 2.7 |
| Total supply | 286.7 | 0.7 | 1.3 | 1.7 |
| | | | | |
| Exports | 76.6 | -0.2 | 1.1 | 3.3 |
| Consumption | 166.7 | 1.1 | 0.9 | 0.4 |
| private | 115.7 | 1.5 | 1.3 | 1.0 |
| public | 51.0 | 0.4 | 0.0 | -1.0 |
| Investment | 42.7 | 0.7 | 3.2 | 2.8 |
| private | 34.6 | 2.2 | 3.8 | 3.1 |
| public | 8.2 | -5.1 | 0.6 | 1.5 |
| Change in stocks[1] | 0.7 | 0.0 | 0.0 | 0.2 |
| Total demand | 286.7 | 0.7 | 1.3 | 1.7 |

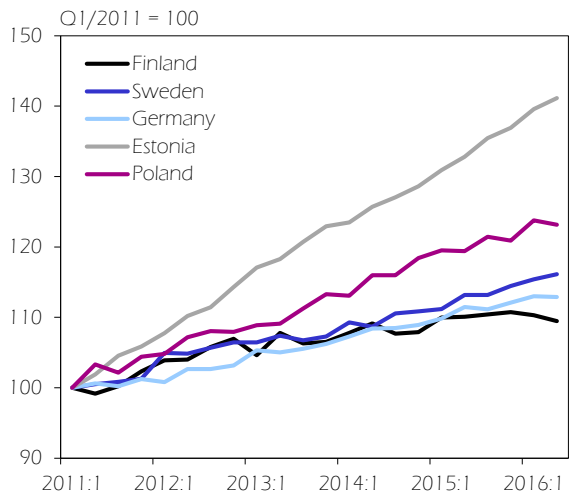
[1] Volume change is in percentage points of GDP.
Source: Statistics Finland, Labour Institute for Economic Research

### TREND INDICATOR OF OUTPUT 2006:01–2016:07




Source: Statistics Finland

### LABOUR COST INDEX (MANUFACTURING) 2011:1–2016:2




Source: Eurostat

International Economy

# Slowdown in international economic growth going to be temporary

- Global economy will grow at rate of 3.1–3.4 per cent in the next two years
- EU growth will be less than 2 per cent
- Euro area's fiscal policy has changed from tight to neutral
- Growth of German domestic demand is still flat despite strong current account

**ADDITIONAL INFORMATION**

Senior Economist Heikki Taimio
+358 9 2535 7349
heikki.taimio@labour.fi

www.labour.fi

The growth of the volume of global trade in goods came to a halt last winter. Thanks to services, total trade continues to grow although more slowly than global GDP, the growth of which will pick up slightly next year from this year's three per cent rate. Weaker growth in the US, EU and China this year represents only a modest dip in the overall global economy, because the rise in prices of several key raw materials and changes in exchange rates support the expansion of many emerging economies and the US economy is also picking up again next year.

## TIGHTNESS OF EUROPEAN FISCAL POLICY EASING

The EU's economic growth was bolstered last year by Ireland's growth spurt. This year and next year the area's economy will grow by just under two per cent. Economic growth is slowing down most noticeably in the UK and Sweden. The euro area economy will grow at a rate of 1.6 - 1.7 per cent this year and next.

Germany's economy will continue grow at a rate of 1.7 per cent. Although German public finances are already in balance and the current account is running a high surplus, its economic growth is based almost exclusively on foreign trade. Domestic demand has not increased, which is reflected in flat growth of imports. It seems that the refugee problem and attempts at solving it dominate German and European policy in such a way that economic policies and aims to foster balanced growth have been pushed into the background. However, the euro area's fiscal policy change from tight to neutral is a positive factor for Finland.

The European Investment Fund has proven to be just as ineffective as originally feared. Funding is circulated through this fund so that the investment is not attributed to expenditures falling under the deficit criterion. But because the fund has very little genuinely new public money, it has not spawned many new investments. The investments supported by this fund would most likely have been carried out in any case.

## FED WILL RAISE INTEREST RATES SOON

In the United States household consumption will continue to fuel economic growth, but growth will slow down significantly from last year's 2.6 per cent. Growth will nevertheless accelerate from this year's 1.4 per cent to 2.0 per cent next year, supported by the positive development of employment, purchasing power of households and some other indicators. The US unemployment rate has already dropped below 5 per cent and wage increases are accelerating. The Fed is monitoring the acceleration of inflation toward the 2 per cent target level and might raise its key rate by 0.25 percentage points in its next meeting in December. This decision, already anticipated by the market, is of great importance for future interest rate expectations, global capital movements and exchange rates against the US dollar.

China's economic growth of 6.7 per cent remained within the new objectives of the government at the beginning of the year. Industrial production growth has slowed considerably and the growth of private investment has stopped. However, the government is expected to succeed in its objective through stimulative policy, including major public investment, easing monetary policy and the controlled weakening of the yuan to support exports.

Japan's unemployment rate is now equal to 3 per cent, which is the lowest in two decades, so GDP growth

remaining at less than one per cent is not a big problem. India has benefited from a decline in interest rates and the prolonged devaluation of the rupee: private consumption is growing strongly, and the trade balance has improved simultaneously. The robust 7.5 per cent growth looks set to continue.

Deep recessions in Russia and Brazil seem to be taking a turn for the better. Industrial production in Russia has recovered better than expected, and a record harvest is anticipated in agriculture. Reserve and welfare funds are shrinking at an alarming rate, but the country has a small central government debt and foreign debt, and it has recently also managed to increase its foreign currency reserves. It appears that Brazil's economic growth will be positive also next year. The country has benefited, in particular, from the powerful weakening of its currency, and also the rise in prices of raw materials will continue to support its foreign trade.

Prices of crude oil (Brent) are expected to increase gradually from the slightly over 40 dollar level prevailing at the beginning of this year to an average of about 50 dollars next year. At the current price level, North American oil production does not seem to be recovering to its former peak level any time soon, new oil fields are being found less often than before and oil demand is increasing globally.

## ECB'S MONETARY POLICY WILL REMAIN LOOSE

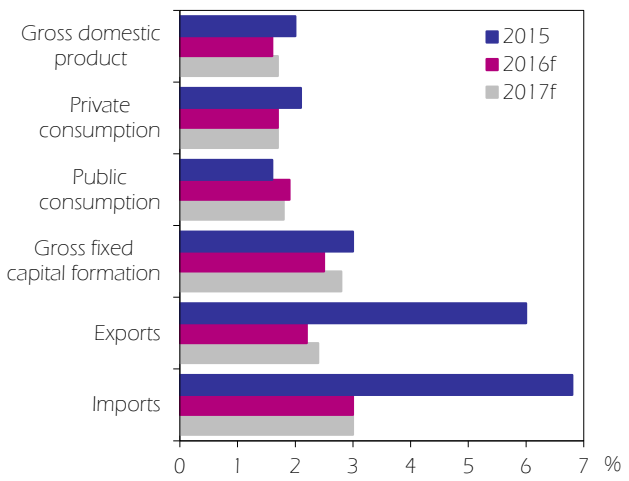
The euro area's harmonized consumer price index will end up rising by only one-tenth of a per cent this year, but it will accelerate next year to one per cent, as the effects of declining prices of energy and raw materials fade away. Bank lending to households and businesses has started to grow – partly due to the ECB's measures as well as increased demand – but the ECB has reason to be concerned about the market's inflation expectations remaining further and further away from its inflation target. In order to boost inflation, it can hardly lower its key interest rate or the deposit interest rate much further (now 0.0 and -0.4%). It could, however, expand the bond purchase programme (e.g. to include mortgage-backed securities), lower their interest rate demands and increase the proportion (now one third) which it is permitted to buy of each benchmark bond and each country's total outstanding debt. ■

### INTERNATIONAL ECONOMY

| | Share of world GDP (%) | GDP growth (%) | | |
|---|---|---|---|---|
| | | 2015 | 2016f | 2017f |
| United States | 15.8 | 2.6 | 1.4 | 2.0 |
| Eur-19 | 11.8 | 2.0 | 1.6 | 1.7 |
| Germany | 3.4 | 1.7 | 1.7 | 1.7 |
| France | 2.3 | 1.3 | 1.3 | 1.5 |
| Italy | 1.9 | 0.8 | 0.8 | 1.1 |
| EU28 | 16.9 | 2.2 | 1.8 | 1.9 |
| Sweden | 0.4 | 4.2 | 3.3 | 2.7 |
| United Kingdom | 2.4 | 2.2 | 2.0 | 1.8 |
| China | 17.1 | 6.9 | 6.7 | 6.5 |
| India | 7.0 | 7.6 | 7.5 | 7.5 |
| Japan | 4.3 | 0.5 | 0.9 | 0.9 |
| Russia | 3.3 | -3.7 | -0.8 | 1.0 |
| Brazil | 2.8 | -3.8 | -3.5 | 1.0 |

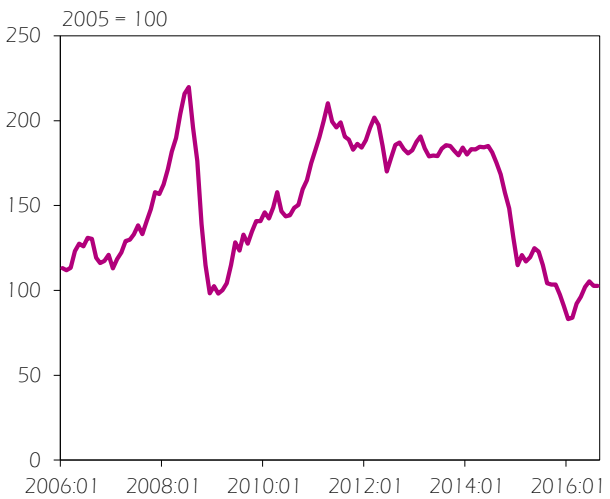
Source: BEA, BOFIT, IMF, Eurostat, Labour Institute for Economic Research

### EUROZONE ECONOMIC GROWTH 2015–2017




Source: Eurostat, Labour Institute for Economic Research

### COMMODITY PRICE INDEX 2006:01–2016:08




Source: IMF

Foreign Trade

# Finnish imports started to increase already this year – exports not until next year

- Imports will grow faster than exports this year
- In 2017 exports will pick up significantly
- Trade surplus is evaporating

**ADDITIONAL INFORMATION**

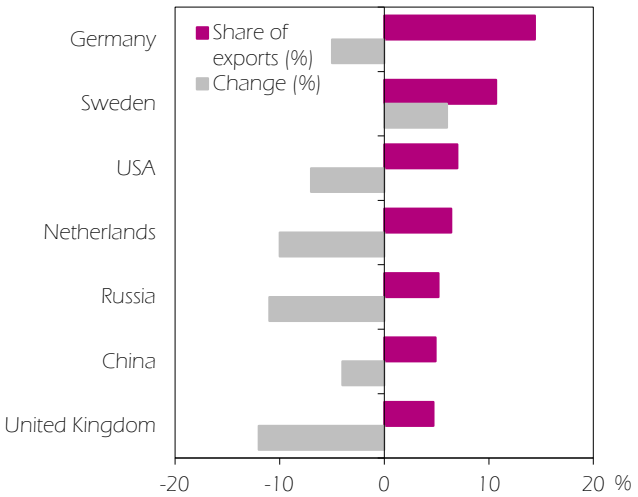
Chief of forecasting Eero Lehto
+358 9 2535 7350
eero.lehto@labour.fi

www.labour.fi

In the beginning of 2016 Finnish goods exports increased 0.2 per cent from the previous year. For the whole year, however, exports will increase by almost one per cent due to exports picking up in the latter half of the year. Next year goods exports will already increase by 3 per cent. Growth is accelerated, for example, by a decline in industrial labour costs in relation to the level in competitor countries prior to and after the implementation of the competitiveness agreement. Brighter export prospects for the chemical industry and sizeable orders received by the machinery and equipment industry in August and September confirm the view of exports accelerating next year. The export of services will grow significantly faster than goods exports both this year and next.

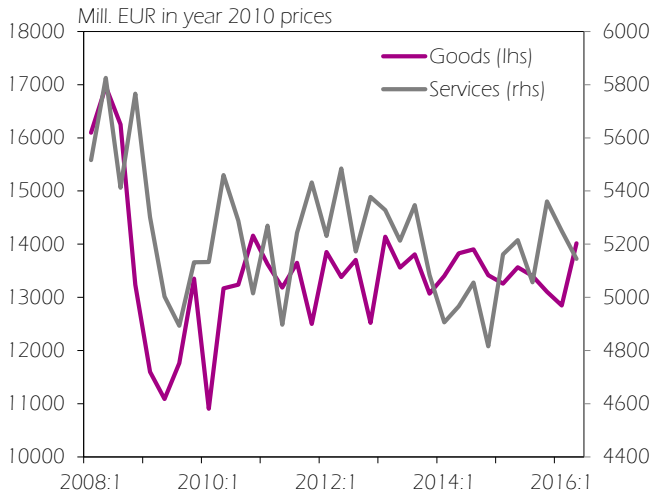
Imports of goods will increase this year in line with the recovery of investment and car sales in Finland. Aircraft purchases in particular have been on the rise. Next year, import growth will remain somewhat slower than the growth of exports. The trade balance is strained this year by a slight weakening of the terms of trade. Export prices have fallen more than import prices. Next year, the pick-up in exports will also strengthen the trade balance. ■

**FINNISH MERCHANDISE EXPORTS IN JANUARY–JUNE 2016**




Source: Customs

**EXPORTS OF GOODS AND SERVICES 2008:1–2016:2**




Source: Statistics Finland

Investment

# Investment rising more briskly than last year

- Investment will grow this year by 3.2% and next year by 2.8%
- Strong growth of construction investment in the first half of this year will continue in second half
- Machinery and equipment investment will remain at last year's level, next year it will grow
- R&D investment will decline this year, in 2017 growth will be stagnant

**ADDITIONAL INFORMATION**

Project Researcher
Sakari Lähdemäki
+358 9 2535 7301
sakari.lahdemaki@labour.fi

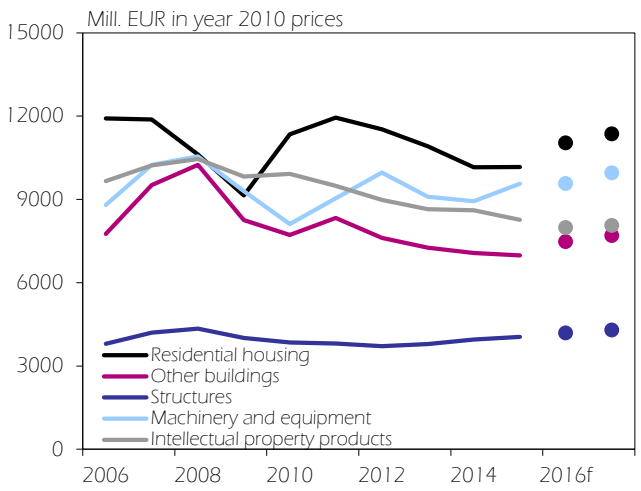
www.labour.fi

According to revised data, investment increased last year by 0.7 per cent, while last spring the preliminary figure was -1.1 per cent. This year's investment forecast has been raised from the spring's 2.5 per cent to 3.2 per cent. The change is explained mainly by the stronger than anticipated rise of construction investment in the first quarter. The fastest growing of these is housing investment, particularly block of flats. Non-residential building investment and civil engineering are also growing at a swift pace.

In 2015 investment increased largely due to machinery and equipment investment, which grew by 7.0 per cent, according to revised figures. This year they are forecast to remain close to the previous year's level. For example, Finnair's aircraft investment mostly took place this year already in the beginning of the year and without them, machinery and equipment investment would have fallen sharply in the first half of the year. Now the decline was just 0.2 per cent.

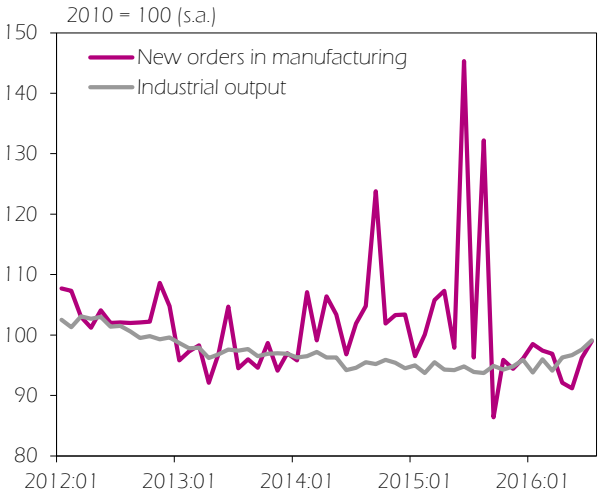
R&D investment has continued to fall in the first half of this year. It is also estimated to decrease in the latter half. This is partly a consequence of the decline in public sector R&D investment. Next year R&D investment is estimated to see modest growth. ■

**INVESTMENTS 2006–2017**




Source: Statistics Finland, Labour Institute for Economic Research

**INDUSTRIAL PRODUCTION IN FINLAND 2012:01–2016:07**




Source: Statistics Finland

Labour Markets

# Unemployment is falling

- Unemployment rate is decreasing and employment increasing
- Competitiveness agreement can dampen employment in the short term
- Wage increases will be minimal next year – wage drift will determine earnings growth

**ADDITIONAL INFORMATION**

Senior Researcher Terhi Maczulskij
+358 9 2535 7306
terhi.maczulskij@labour.fi

www.labour.fi

An improvement in the labour market will lead to growth in employment this year and next. In addition, the growth of the working-age population is reflected in the labour supply. The extension of regular working hours could, however, crowd out employment growth in the short term, when the same output is achieved by using a smaller number of employees. Through the combined effects of labour supply growth, the labour market picking up and the employment crowding out mechanism of the possible extension of working hours, the employment rate is forecast to rise to 68.6 per cent this year and 69 per cent next year.

The unemployment rate rose to 9.4 per cent last year. The pick-up of the labour market will lead to a 0.5 percentage point decline in the unemployment rate this year. The unemployment rate will fall to 8.7 per cent next year. Restructuring of the labour market and the consequent problem of mismatches between jobs and workers could, however, slow down the development of the labour market.

## EARNINGS DEVELOPMENT HINGES MAINLY ON WAGE DRIFT

In times of low wage increases, wage drift pressures increase. In accordance with the Employment and Growth Pact, wage increases are about 0.6 per cent in 2016. Although contract wage increases will be flat next year, small wage increases can be expected in light of history. The minor increases encountered by employees in wages and the extension of working hours will be compensated by higher wage drift in 2017. Wage drift will be 0.6 per cent this year and 0.9 per cent next year. Due to the combined effects of contract wage increases and wage drift, earnings will rise a moderate 1.2 per cent in 2016 and 1.0 per cent in 2017. ■

### KEY FIGURES OF THE LABOUR MARKET

| | 2014 | 2015 | 2016f | 2017f |
|---|---|---|---|---|
| Unemployment rate (%) | 8.7 | 9.4 | 8.9 | 8.7 |
| Employment rate (%) | 68.3 | 68.1 | 68.6 | 69.0 |
| Active population (1 000) | 4095 | 4102 | 4110 | 4127 |
| Labour force (1 000) | 2679 | 2689 | 2685 | 2691 |
| Employed (1 000) | 2447 | 2437 | 2446 | 2456 |
| Unemployed (1 000) | 232 | 252 | 239 | 235 |
| Wages, index of wage and salary earnings (%) | 1.5 | 1.4 | 1.2 | 1.0 |
| Average hourly wages (%) | 1.2 | 1.3 | 1.1 | -0.4 |

Source: Statistics Finland, Labour Institute for Economic Research

### CHANGES IN NUMBER OF EMPLOYED, UNEMPLOYED AND LABOUR FORCE 2000–2017


Source: Statistics Finland, Labour Institute for Economic Research

## STRUCTURAL REFORM OF LABOUR MARKET AND MISMATCH PROBLEM – MORE REGIONAL MOBILITY?

Change in the occupational structure is a key development trend in the labour market. Routine jobs are disappearing at a rapid pace in Finland and other developing countries. The main segments doomed are tasks including a lot of repetition, which are easy to automate with robots. These include occupations in traditional sectors of industry. At the same time, however, new jobs are created in services and tasks performed by experts.

The Finnish labour market has adapted slowly not only to the post-recession development but also structural reforms of the labour market. Unemployment has risen sharply in recent years, although signs of a recovery are on the horizon. High levels of unemployment cannot be explained merely by the fact that companies have shut down their operations. New jobs are in fact being created at a fast pace and there are a lot of job vacancies. High unemployment is compounded by the fact that job vacancies and potential employees do not match.

According to the Confederation of Finnish Industries, a third of its member companies experienced recruitment difficulties in 2015. These recruitment difficulties have hampered the hiring of workers for some 14,000 jobs, most of which are service jobs in the hotel and restaurant sector. One reason for this may be the structural changes in occupations, whereby routine jobs are lost at the same time as new jobs are created in low-paid service professions. The cause of the job mismatch problem is clearly twofold: vacancies are in different industries so that recruitment can be hampered by the lack of skills for new jobs. On the other hand, vacancies are located in different job markets than the unemployed. This development is likely to further increase the amount of structural unemployment.

The labour market mismatch problems can be assessed by looking at the ratio of vacancies to unemployed job seekers. According to the latest reports the ratio has stabilized at 10 per cent, reflecting the low degree of tightness of the labour market. That ratio says nothing, however, about the structure of unemployment (for example, long-term / structural unemployment) or the duration of vacancies. A report released by the Prime Minister's Office this summer revealed that the job mismatch issue has increased in recent years (VM 2016). In addition, there is reason to assess the tightness of the labour market on a regional level.

In the adjacent graph the horizontal axis displays the ratio of vacancies per long-term unemployed broken down by Centres for Economic Development, Transport and the Environment (ELY). The figures on the vertical axis show the structural change of the labour market and the tightness of re-employment. For example, a figure of 10 per cent on the y-axis indicates that that the ELY centre in question has 10 percentage points higher long-term unemployment in disappearing occupations than those of other occupations. All figures are averages for January-June 2016. The graph shows a clear positive link between the tightness of the labour market and the tightness of re-employment owing to the structural change in the labour market. A similar positive correlation is not observed in a model where total unemployed are used instead of the long-term unemployed. This indicates that the underlying labour market mismatch problems may entail structural unemployment.

The graph also shows that the labour market tightness is different in different labour markets. Even if, for example, Uusimaa has been found to have undergone a strong labour market restructuring on the basis of previous research literature, the number of long-term unemployed in this region is the same as those in disappearing and other occupations. On the other hand, for example, in Kainuu there are 25 per cent more long-term unemployed persons in disappearing occupations than there are in other occupations. This reflects the fact that, for example, in Uusimaa it is easier to become employed in a new line of work, which is in line with previous findings.

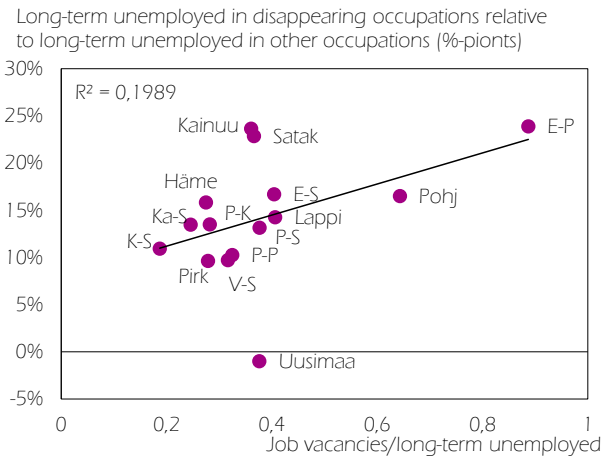
Regional mobility is typically thought to improve the problem of mismatches between jobs and unemployed persons. According to previous Finnish research findings, this is not necessarily the case, because the positive correlation between regional mobility and finding a new job is partly explained by a person's own background, not by moving per se. On the other hand, these previous studies are based on data that does not comprehensively include the period when the restructuring of the labour market in Finland has been strongest, i.e. in the 2000s. Recent research findings suggest that the representatives of disappearing professions can improve their employment opportunities by moving to another community. In Finland, regional migration is nevertheless clearly below average compared to other industrialized countries. ■

*Terhi Maczulskij*

***Source***

*Information Committee on Income and Cost Developments (Ministry of Finance): Economic Outlook and Wage Formation. Prime Minister's Office, Report of the Information Committee on Income and Cost Developments June 29, 2016.*

### TIGHTNESS OF LABOUR MARKETS BY REGIONAL ELY CENTRE IN 2016




Source: Ministry of Economic Affairs and Employment, Labour Institute for Economic Research

Inflation and Households

# Prices are rising again and tax cuts will bolster private consumption

- Deflation switches to low inflation
- High consumer confidence predicts a low savings ratio
- Tax cuts will cushion fall in private consumption stemming from competitiveness agreement's decreasing of transfer payments

**ADDITIONAL INFORMATION**

Senior Researcher Ilkka Kiema
+358 9 2535 7304
ilkka.kiema@labour.fi

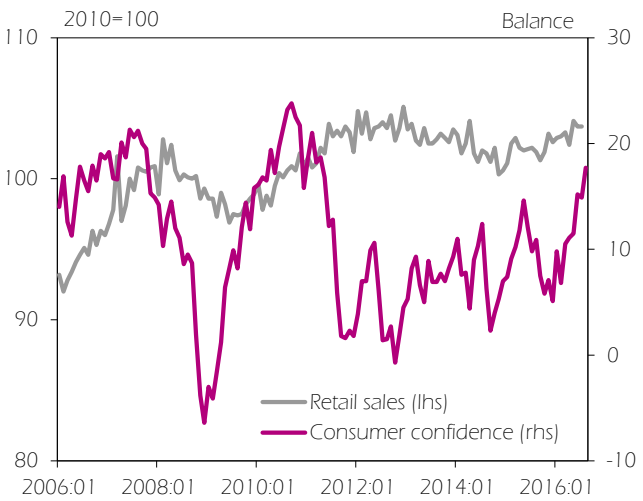
www.labour.fi

Last year's mild deflation (-0.2%) has changed this year to slightly lower inflation than the average for the euro area. Explanations for last year's deflation included keener price competition between grocery stores, reductions in interest rates and the fall in oil prices. The decline of oil prices has ended and we expect prices in other major raw materials to increase moderately over the forecast period. We estimate that during the forecast period inflation measured by the CPI will accelerate, but it will still remain at a low level, being 0.3 per cent in 2016 and 1.0 per cent in 2017.

## CONSUMER CONFIDENCE AND PRIVATE CONSUMPTION HAVE REMAINED HIGH

This year the consumer barometer for measuring the consumer confidence has reached its highest level since 2011. Consumers' confidence in their own finances has improved presumably due to the improvement in the employment situation. In 2015 private consumption increased faster than household disposable income and the savings rate fell by 0.1 per cent. At the same time, household indebtedness (the ratio of debt to

**CONSUMER CONFIDENCE AND RETAIL SALES IN FINLAND 2006:01–2016:08**




Source: Eurostat

**KEY FORECASTS FOR HOUSEHOLDS**

| | 2015 | Change (%) | | |
|---|---|---|---|---|
| | Mill. EUR | 2015 | 2016f | 2017f |
| Inflation (CPI) | | -0.2 | 0.3 | 1.0 |
| Wages and salaries | 83199 | 1.0 | 1.7 | 0.8 |
| Primary income | 126666 | 1.1 | 2.0 | 0.2 |
| Household real disposable income | | 1.0 | 1.4 | 1.1 |
| Volume of private consumption | 115711 | 1.5 | 1.3 | 1.0 |
| Savings rate | | 0.1 | 0.1 | 0.1 |

Source: Statistics Finland, Labour Institute for Economic Research

annual disposable income) increased to an all-time-high, more than 124 per cent.

Private consumption has remained strong this year too, which is also reflected in the high level of the volume index of retail trade sales. The surprisingly high level of household consumption can be explained among other things by borrowing encouraged by the low level of interest rates and banks' marketing of temporary grace periods for loan repayments more actively than previously. Car sales have been spurred by the lowering of the motor vehicle tax and last year's car scrapping premium encouraging the purchase of new low emission cars.

## TAX CUTS OFFSET IMPACT OF NEXT YEAR'S COMPETITIVENESS AGREEMENT

The increase in employees' pension contributions and unemployment insurance contributions stipulated by the competitiveness agreement represent an income transfer from employees to employers. The agreement calls for a 0.2 percentage point increase in employees' TyEL pension insurance contributions and a 0.45 percentage point increase in employees' unemployment insurance contributions, while employers' contributions are reduced by the corresponding amounts. These changes are likely to reduce private consumption, since the marginal propensity to consume capital income is lower than that for wage income. The hikes in TyEL pension contributions carried out in 2014 and the very low rise in contract wages will curb private consumption.

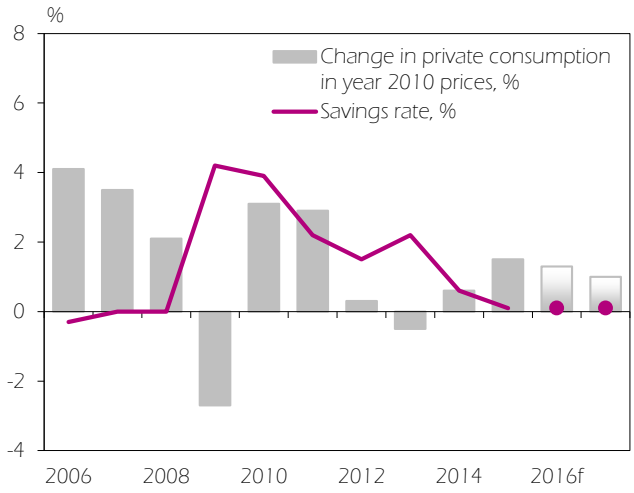
The central government nevertheless intends to carry out tax cuts to compensate employees for their loss of income caused by the competitiveness agreement. In addition, the competitiveness agreement calls for a reduction of employee's health care contributions and increases in sickness benefits, which will ease the net taxation of wage income. According to the central government's 2017 budget proposal, the tax burden on labour will be lowered by a total of 515 million euros as a result of the competitive agreement and tax cuts, which will boost private consumption. Also due to the aging of the population, the growth of pension expenditures regardless of the employment situation as well as low interest rates will keep private consumption on a high level.

We estimate that private consumption will grow by 1.3 per cent in 2016 and one per cent in 2017 and that the savings ratio will remain at the current low but positive level. ■

**CHANGES IN CONSUMER PRICES 2006–2017**

Source: Statistics Finland, Labour Institute for Economic Research

**PRIVATE CONSUMPTION AND SAVINGS RATE 2006–2017**



Source: Statistics Finland, Labour Institute for Economic Research

Public Finances

# General government deficit will remain below 3 per cent

- Central government finances will weaken slightly next year
- Municipal finances will continue to be slightly negative
- Surplus of social security funds will shrink further
- Tax ratio will fall significantly next year

**ADDITIONAL INFORMATION**

Director Seija Ilmakunnas
+358 9 2535 7340
seija.ilmakunnas@labour.fi

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## CENTRAL GOVERNMENT

This year, the central government deficit will decrease by approximately 400 million euros and the deficit will remain a little below 6 billion euros. The cuts in government expenditure relating to the government's adjustment programme will be about 800 million euros. On the other hand, additions to appropriations will act as a counterweight. Funds will be increased to the armed forces and internal security, the financing of high-priority projects and transport infrastructure repairs. Spending will also increase due to growth of the number of asylum seekers. Municipal government subsidies will be increased by the adjustments of cost sharing between central and municipal government. Consumption expenditure will remain at last year's level in nominal terms but decline slightly in real terms. Total government spending will grow by 1.4 per cent. The growth of government revenue is approximately one percentage point faster than the increase in spending, as the increase in the central government's share of corporate tax will boost tax revenues. Tax revenues will also pick up due to growth in private consumption and value-added tax returns and the moderate tightening of other indirect taxes. All in all the tax base changes are, however, lessening taxation in net terms, e.g. due to the raising of the earned income deduction.

Next year central government finances will stop improving despite the cuts in government spending being almost as high as for this year. Tax revenue growth will slow down, even though indirect taxes are being tightened slightly more than they are cut and the continued moderate growth in private consumption will bolster VAT revenues. The labour and pension income tax cuts relating to the competitiveness agreement, as well as the indirect effects of changes in social security contributions will reduce the revenue from direct taxes, but on the other hand corporate tax revenues will rise. On the expenditure side, the competitiveness agreement will reduce the central government's own operating costs and government transfers to municipalities. The effects of the agreement's spending increases are nevertheless greater, because the central government is financing the decrease in employers' health insurance contributions. The central government deficit will be 6.1 billion euros next year.

## MUNICIPALITIES

This year the increase in municipalities' share of corporate taxes will come to an end and the revenues from this type of taxes will subside. The growth in revenues from direct taxes will remain slightly negative, even though municipal tax revenues will grow by more than one and a half per cent. The development of municipal income tax revenues mainly reflects the growth of the tax base, because the prolonged rise in the average municipal tax rates appears to be over and the tax ratio will remain roughly unchanged during the forecast period. Real estate tax revenues will continue to grow slowly during the forecast period. This year municipal finances will be strengthened by a substantial increase in central government revenue sharing as a result of adjustments to the division of expenses. Municipalities will continue their cost

cutting and their expenditure growth will be historically low, as nominal consumption expenditure grew this year by about one per cent.

Next year municipal consumption expenditures will decrease by slightly over one per cent, as the competitiveness agreement has an impact upon municipal expenditure as well as revenues. First, reductions in employer contributions, holiday pay cuts and extending the hours worked will curb growth in consumption expenditure, but corresponding cuts in central government revenue sharing and the negative effects on tax revenues will erode the benefits of the agreement on municipal finances. The ratio of municipal deficits to GDP will remain unchanged during the forecast period at 0.6 per cent.

## SOCIAL SECURITY FUNDS

The surplus of social security funds in relation to GDP has fallen this decade at a rapid pace, and the decline will continue in the forecast period. As recently as five years ago the surplus relative to GDP was three per cent, but next year it is projected to sink to 0.7 per cent.

Revenues will grow faster this year than the wage bill due to increases in unemployment insurance contributions. In accordance with the competitiveness agreement, the employers' pension and unemployment insurance contributions will be reduced next year and the corresponding contribution burden will be transferred to employees. Insurance revenues will be reduced by the lowering of employers' health insurance contributions, but the resulting shortfall will be covered by a corresponding increase in the central government's share of financing. Revenue growth will otherwise be flat because of the slow growth of the wage bill.

The growth of social benefits paid out will be curbed by low inflation and cuts made to benefits. At the beginning of this year, the benefits tied to the national pension index will be decreased by 0.4 per cent and earnings-related pensions will not be increased at all. Next year, the national pension index will be reduced by 0.85 per cent. This year's low inflation will bring small index adjustments also to earnings-related pensions next year. In addition the duration of earnings-related unemployment benefits will be reduced. The increase in the number of pensioners will nevertheless keep benefit payments growing by about 3 per cent in both years.

## PUBLIC FINANCES WILL DETERIORATE SLIGHTLY NEXT YEAR

This year's fairly strong tax revenue performance and a rise in unemployment insurance contributions will increase the tax ratio from last year's 44 per cent to 44.3 per cent this year. Next year the tax ratio will in fall appreciably, i.e. by nearly a percentage point owing to tax cuts and the lowering of employer's health insurance payments in conjunction with the competitiveness agreement.

Public expenditure growth continues to be slow, i.e. over one per cent per annum in both forecast years. Expenditure growth will be slowed down in particular by cuts in accordance with the government's programme and reductions in employer contributions, holiday pay cuts and extending the amount of hours worked due to the competitiveness agreement. The general government deficit will decrease this year by nearly 900 million euros, but next year the deficit will grow again by almost the same amount as the tax ratio decreases.

According to statistics reported by the State Treasury, the central government debt rose last year to 99.8 billion euros. The central government's deficit will decrease this year, but the ratio of central government debt to gross domestic product will grow to 49.6 per cent from last year's 47.7 per cent. Next year's corresponding figure will be 51.2 per cent when the central government debt amounts to 111 billion euros. The general government consolidated debt (so-called EDP debt) was 62.5 per cent of gross domestic product last year. In addition to central government and municipal government deficits, this consolidated debt was increased by the fact that employment pension institutions reduced their investments in Finnish government bonds. The debt in relation to gross domestic product is projected to rise to 67.2 per cent next year.

## GREATER EMPHASIS ON LONG-TERM GROWTH IN ECONOMIC POLICY

Finland's fiscal policy has been tightened at the same time as fiscal policy has been eased elsewhere in Europe. Next year Finland's fiscal policy is going to be tight, at least with respect to expenditure. The volume of public consumption will decline next year by one per cent, while in other European countries it will grow an

### KEY FORECASTS FOR PUBLIC SECTOR

| | 2015 | 2016f | 2017f |
|---|---|---|---|
| Taxes / GDP (%) | 44.0 | 44.3 | 43.4 |
| Expenditures / GDP (%) | 57.7 | 57.5 | 57.0 |
| General government net lending (Bill. €) | -5.8 | -4.9 | -5.7 |
| central government | -6.3 | -5.9 | -6.1 |
| municipalities | -1.3 | -1.2 | -1.2 |
| social security funds | 1.9 | 2.3 | 1.6 |
| Gross public debt, EDP-debt (Bill. €) | 130.7 | 138.2 | 145.7 |
| % of GDP | 62.5 | 65.1 | 67.2 |
| Central government debt (Bill. €) | 99.8 | 105.2 | 111.0 |
| % of GDP | 47.7 | 49.6 | 51.2 |

Source: Statistics Finland, Labour Institute for Economic Research

average of just under two per cent. Savings in Finland will be boosted, above all, by the competitiveness agreement, which will temporarily cut public sector holiday pay and increase working hours, which in turn will give rise to a reduction in the number of jobs, so that the total labour input (in hours) will remain unchanged. The reduction of jobs corresponding to the extension of working time could, at least in the short term, have a negative impact on productivity or quality of service.

A solution to Finland's economic problems would require a change in the present production structures so that the export companies and high-tech companies can grow. This need is highlighted by the bogging down of growth of enterprises operating in many of our traditional industries. On an economic policy level, turning around this trend would require a clearer focus on education, research and innovation. This has not been the case, however, over the past few years: teaching and university expenditures have remained flat and public support for enterprises' R&D activities have been cut sharply.

Education and university expenditure must, however, be increased. R&D support should also be increased and redirected, on the one hand, to basic research and, on the other hand, to small and medium-sized enterprises' innovation. The additional outlays might indeed show up as a temporary increase in the public deficit. This effect could be offset by cutting the tax relief and other support extended to closed-sector companies recently.

Labour market reforms are currently aimed at strengthening labour supply by, inter alia, weakening income security, reducing the mismatching between he labour supply and demand and increasing the possibility of employment for persons with difficulties finding jobs by reducing the costs of an employer hiring them. These actions have often had divergent effects, which reduces their effectiveness. For example, the weakening of income security may not be effective under conditions of weak demand for labour. Fixed-period flexibility in employment practices for the long-term unemployed may be justified. But just like in the case of increasing other types of low-wage subsidies, it is important to realize that these practices may crowd out unassisted employed persons into unemployment. The lowering of day-care payments is desirable in terms of fostering employment, as is promoting a more balanced distribution between fathers and mothers regarding their responsibility for childcare. Alleviating mismatches in labour supply and demand via active labour market policy measures is a welcome step, but it requires additional resources for labour administration. ■

## EUROPEAN COMMISSION'S FISCAL POLICY GUIDELINES NEED TO BE CHANGED

When it joined the European Monetary Union, Finland endorsed the underlying Stability and Growth Pact. Under this agreement, the government's annual deficit must be less than 3 per cent of GDP and the public debt must be less than 60 per cent of GDP. However, for the public debt it is sufficient that the debt ratio is approaching the target quickly enough.

Because the implementation of the narrow deficit and debt criteria proved to be difficult, their interpretation was relaxed in 2005. A country in recession was no longer penalized if it could not reach the objectives of the Stability Pact. The European financial crisis nevertheless resulted in a need to increase financial discipline in the euro area. Thus, the economic policy coordination was extended to include the medium-term sustainability of public finances. The EU Commission developed its regulatory framework so that the cyclical and structural components of general government's financial position were separated from each other. The term "structural deficit" is used to describe the deficit adjusted for cyclical fluctuations.

According to the fiscal policy agreement that went into force in early 2013, the structural deficit must be kept at less than 0.5 per cent in order to safeguard medium-term economic sustainability of finances. In order to identify the structural deficit, first the gap between the actual and potential output is estimated. The greater the absolute size of the (negative) output gap, the smaller the structural deficit, which is also determined in accordance with the actual deficit.[1]

The new practice, in which the output gap is estimated by complex econometrics, will weaken the understanding of economic policy by the average politician and policies by average observers. The method is of course transparent and uniform for all EMU member states. However, the applicable rule is very mechanical, so that it forms a new kind of straightjacket for economic policy.

The most critical assessment of the output gap is the principle whereby the capacity utilization rate of capital is estimated according to industrial confidence. If confidence deteriorates, about 70 per cent of the observed change will be deemed to stem from cyclical fluctuations, and the remaining 30 per cent is interpreted as a loss of potential output. Since the cyclical component is defined auto-regressively (according to the values also of previous periods), the previous period's industrial confidence also affects the potential output in the next period. A lengthy period of sluggish growth and weak confidence ultimately lowers the potential output to an extent that the production gap shrinks and the economy is no longer deemed to be able to recover without structural reforms.

The EU Commission's method of estimating the output gap suits Finland poorly in certain respects. Since 2008, Finland has been hit by two major negative shocks. The first was the shutdown of Nokia's mobile phone operations during the period 2008-2016 and the second was a substantial contraction in exports to Russia from 2014 onwards. Largely due to these factors, economic growth has been slower than elsewhere in the euro area. Due to Finland's slow economic growth, potential production has increased in the EU Commission's calculation framework by only 0.1 per cent a year during 2009-2015 while the structural deficit increased last year to already 1.5 per cent of GDP, well above the permitted 0.5 per cent.[2]

Analysis based on the EU's evaluation framework implicitly assumes that both of the above mentioned Finnish shocks are irreversible, thus reducing potential output. In this respect, the commission's methodology underestimates the potential of Finnish production. We might be able to think that with respect to the shutdown of Nokia's operations, employment and productivity of the workforce laid off will eventually improve over time. Many have found employment in small and medium-sized enterprises or even set up their own business, the productivity of which is typically at a modest level, as several studies have found.

As regards Russian exports, a partial recovery in oil prices as well as adaptation to the Russian sanctions (and eventually the easing of sanctions) will normalize the country's economy. Evidence of this is the appreciable strengthening of the rouble against the euro this year and the fact that the Russian central bank has been able to lower its key interest rates, which have been unbearably high from the standpoint of fostering investment. Finnish exports to Russia will no longer decrease next year, which will strengthen our growth opportunities relative to the rest of the euro area. In this respect, the situation will improve further in the coming years. From the standpoint of estimating Finland's potential output, it should also be relevant that real growth factors, such as population, education and skills, are stronger in Finland than in the euro area on average.

The Commission's recommendations for action were based on the analysis of Finland's potential output and structural deficit explained above. Since no weight is given to the above-mentioned special factors, it is clear that the Commission recommends various types of structural reforms to solve the problems. Structural reform in the rhetoric of the Commission refers to various ways of increasing the labour supply, so that the

[1] *See Havik, K., McMorrow, K., Orlandi, F., Planas, C. Raciborski, R., Röger, W., Rossi, A., Thum-Thysen, A. and Vandermeulen V. (2014), The production function methodology for calculation potential growth rates & output gaps, European Economy, Economic Papers 535, November 2014.*

[2] *See Report from the Commission, Finland, Report prepared in accordance with Article 126(3) of the Treaty, Brussels May 15, 2016.*

[3] *Same as 2.*

preconditions for hiring persons marginalized from the labour market improve.

As such, for example, labour market activation policies and the strengthening of incentives to accept jobs can be regarded as good in present-day Finland, where the number of long-term unemployed is growing. But the measures proposed will hardly enhance economic growth in the medium term, because they do not strengthen the real factors of economic growth. Accordingly, the Commission does not seem at all concerned in its reports about, for example, Finland's educational cuts and the reduction of public support for R&D. The new rhetoric of the EU Commission says that fiscal policy should foster growth[3]. There is thus a certain degree of discrepancy between this goal and the measures proposed.

The economic policies of the European Commission and many of its member states differ from the recommendations of the OECD and the IMF. The latter emphasize long-term growth and the strengthening of demand under conditions of slow growth. For example, in Finland's case the possibilities to boost employment by strengthening of labour supply are constrained by rather weak demand for labour. ■

*Eero Lehto*