Talousennuste

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Economic Forecast for 2009–2010

Finnish Economy Headed for a Deep Recession

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LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2009–2010

Finnish Economy Headed for a Deep Recession

According to the economic forecast of the Labour Institute for Economic Research, Finland is sliding into a deep recession. GDP will shrink by 3.7 per cent this year and next year by slightly less than one per cent. The main reason for the plunge in production is the drop in exports by almost 10 per cent this year, but the approximately 10 per cent fall in private investment is also an important factor. Next year exports and investments will continue to fall somewhat. Private consumption will be almost flat and the government's stimulatory measures will be ineffective. This year unemployment will climb to 7.4 per cent and next year to 8.8 per cent. Employment will weaken in two years by 100 thousand persons. Consumer price inflation will slow down considerably, to about 1.4 per cent.

The unexpectedly wide spread of the credit crisis and its deep impact on the real economy came as a surprise. The disequilibria in the world economy were indeed recognized and also the fact that the housing credit boom had got out of hand and posed a threat to sustainable economic growth in many developed countries. Like many economists, we at the Labour Institute for Economic Research forecast last autumn that economic growth would slow down considerably but in a controlled fashion. The risks were certainly recognized, but what actually happened was regarded as relatively unlikely.

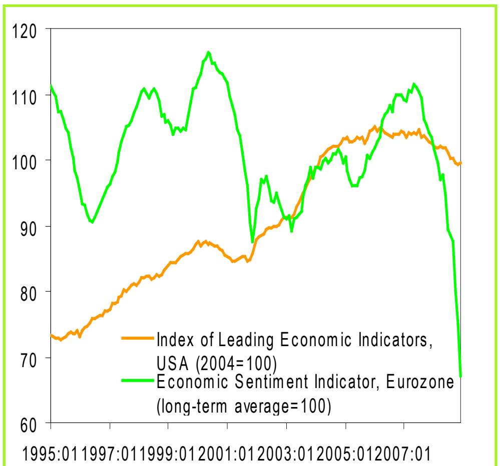
At this moment the economic outlook is bleak. The value of Finnish goods exports collapsed in November as it was down 20 per cent compared to the level achieved in November of the previous year. The annual growth rate of industrial production last year in November-December was already a negative 10-15 per cent. While last year total production grew by slightly less than two percent, this year it will fall by 3.7 per cent and next year by almost one per cent. The rate of unemployment will rise this year to an average of 7.4 per cent from last year's 6.4 per cent. Next year the unemployment rate will already be 8.8 per cent. The risks related to the forecast are greater than normal.

Compared to the Finland's depression in the early 1990s, the drop in exports and industrial production is of the same magnitude. In contrast with then, the service sectors – especially the wholesale and retail trade – will nevertheless not shrink by the same margin. Thus the employment situation will not weaken as much as it did in the depression of the 1990s. Since the expansionary impetus of fiscal policy is based almost entirely on cuts in taxes and employers' social insurance contributions, not on public investments and other spending increases, the economic policy stimulus to the economy will remain rather modest.

International economic outlook gloomy – euro zone production will fall three per cent

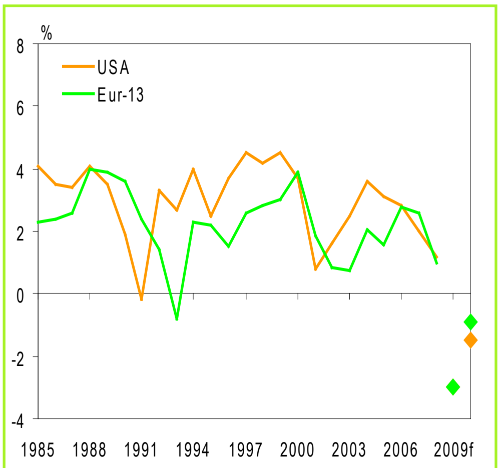
Euro zone production fell by 0.2 per cent compared to the previous quarter in both the second and third quarters last year. The region's total production grew last year by about one per cent. In the autumn the credit crisis triggered a precipitous drop in the area's exports. At the same time consumer confidence and the outlook of assorted sectors took a sharp turn for the worse. In light of current economic prospects, exports and investments will drop off sharply this year. In addition, private consumption will decreases slightly as households increase their savings in the face of uncertain times ahead. The euro zone's total

International leading indicators 1995:01–2008:12



Source: Conference Board, European Commission

Total production in the USA and eurozone 1985–2010



Source: BEA, Eurostat, PT

production will fall by 3 per cent this year. The area's employment is beginning to weaken also at the turn of the year. This year unemployment will average 8.2 per cent, i.e. almost a percentage point higher than last year.

As regards the overall EU region, growth slowed down considerably in Spain, England, Ireland and Denmark, i.e. countries where housing construction was overheating the entire economy. The collapse of the export markets and related fall in demand for investment goods will spur a pronounced decline in economic growth in Europe's major exporting countries. This is the case, for example, in Germany and the Netherlands. The employment situation will nevertheless weaken the most in the afore-mentioned group of countries.

The economic crisis poses a dilemma especially for Germany's neighbours. In the Baltic countries production will fall more sharply than in the overall EU region, and the economic outlook in Sweden is even bleaker than in Europe on average. Sweden's fiscal policy stimulus depends too heavily on tax cuts so that it cannot efficiently combat the slowdown in economic growth.

The depth of the economic recession and weakening of the investment outlook around the world will make the recession comparatively long in duration. Ultimately, the weakening of employment will exacerbate the situation prolonging the time it takes to recover. It is clear that the phase of the crisis where even creditworthy demand is constrained will pass and it will be replaced by a typical slump in demand. In this case the banks can indeed run into financial difficulties as the value of the assets on their balance sheets fall. Thus the production in the euro zone will continue to contract next year, by an estimated one per cent from this year's level. One sort of indicator of the turnaround is the recovery in global raw material markets, which is reflected in the upswing in raw material prices.

The recession and the consequent drop in raw material prices are already reflected in euro zone inflation. Last year consumer price inflation averaged 3.3 per cent. Still last year in July the ECB sought to curb inflation by raising its repo rate. This year consumer prices will rise by only 0.8 per cent, and next year euro zone inflation is expected to be 1.2 per cent. Euro zone inflation will be substantially lower on average than Finland's harmonized consumer price inflation.

The euro zone's economic recession would be even deeper if the governments did not loosen their fiscal policy by increasing public expenditures and easing taxation. Fiscal policy measures, which in Europe are weighted more heavily toward hikes in spending than in Finland, nevertheless typically remain at just one per cent of GDP at the most.

International economy

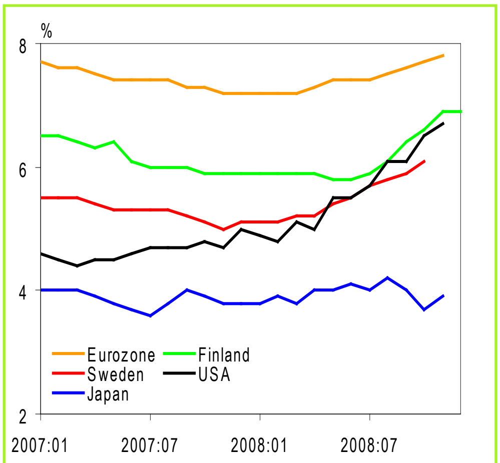
GDP growth (%)	2008f	2009f	2010f
United States	1.2	-3.0	-1.5
Euro-13	1.0	-3.0	-0.9
Germany	1.4	-3.0	-0.6
France	1.0	-3.0	-1.0
Italy	-0.5	-3.3	-1.2
EU27	1.1	-2.8	-0.8
Sweden	0.5	-3.5	-1.3
United Kingdom	0.8	-3.2	-1.0
Japan	0.1	-3.5	-1.0
Russia	6.8	0.0	0.0
China	9.5	5.0	4.0

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

US economic difficulties receding slowly

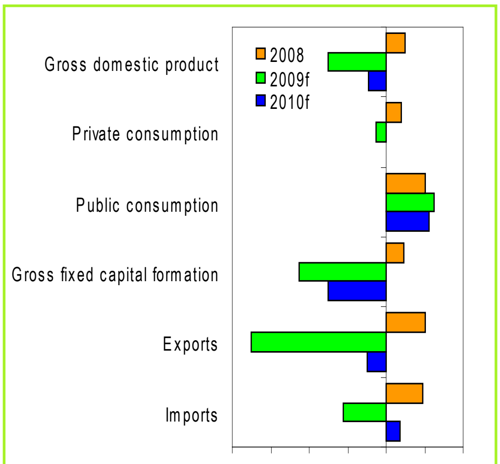
The credit crisis began in the US as loan recipients there were unable to service their housing mortgages. This mechanism was marked by a prolonged credit

Unemployment in assorted countries 2007:01–2008:12



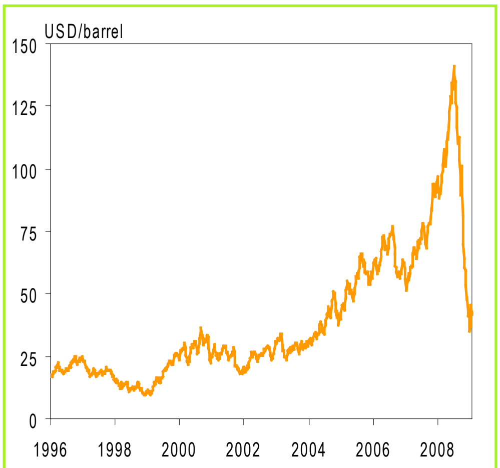
Source: Eurostat

Eurozone economic growth 2008–2010



Source: Eurostat, PT

World market price of crude oil (Brent) 1996–2009



Source: Energy Information Administration expansion, which made it possible to sell these loans as packaged securities that concealed the original credit risk from the buyers. Private loan recipients coped with their over-indebtedness relative to their incomes by taking new loans and using the value of their homes as collateral for their debt. The realization of the risk inherent in the asset-backed securities sold abroad via the bond markets triggered sizable losses, not only for Americans but also for European banks and other financial institutions. The root of the problem can be deemed to be the excessive and uncontrolled lending. This phenomenon is nevertheless closely related to the fact that medium and low-income households that took sub-prime loans almost systematically had unrealistic expectations about their own incomes. Thus it is indeed significant that the US economic growth did not boost the incomes of medium and low-income persons.

The growth rate of GDP in the US slowed down already last year to slightly above one per cent. This year GDP will fall by about 3 per cent and next year by a further 1.5 per cent. The employment situation in the US has deteriorated quickly. In the beginning of this year the unemployment rate is already slightly over 7 per cent while a year ago it was below 5 per cent. The US economy will recover more slowly than that of Europe. The main reason for this is the sharp weakening of households' financial position. The rise in unemployment will cut incomes and spawn uncertainty, which will reduce the desire to consume. The drop in housing prices will make it more difficult for households to borrow and further weaken their possibilities to cope with their debts. Deep-seeded problems like this cannot be solved quickly and it seems that the recession will last longer in the US than in other developed countries. On the other hand, in those European countries where the housing loan boom was excessive, the recovery from the recession will also take a long time.

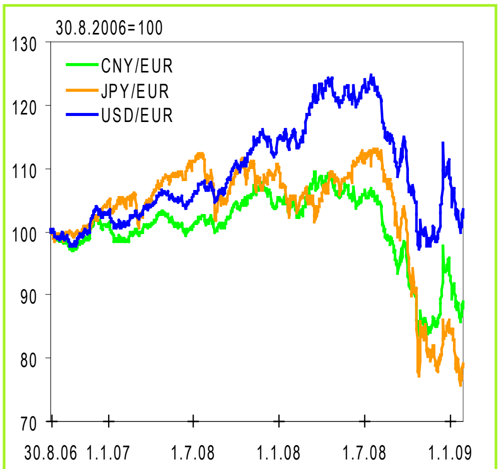
The sharp easing of monetary policy and sizable recovery package for banks and other financial institutions will prevent the further spread of the crisis and calm the financial markets. The greatest opportunities for supporting the economy now lie with fiscal policy. The new president's recovery package of 825 billion dollars amounts to about 5.7 per cent of GDP. The greatest weight in this package, about two thirds, is additional spending and thus there is less emphasis on tax cuts. Stimulatory measures of this magnitude will help the US to get over the crisis, but on the other hand it will limit economic growth in future years as public sector finances will have to be balanced.

Crisis reflected on Russia and Asia, too

The oil-dependent Russian economy has been hard hit by the global economic crisis and the sharp drop in oil prices associated with it. Industrial output began to fall already at the end of last year. Construction and investment activity have also subsided. Russia has already taken action to offset the weakening of its export markets by expanding the width of its currency band and allowing it to weaken. Assets gained through oil exports are nevertheless being used to curb the slowdown in growth. Therefore public and private consumption are still increasing. While overall output in Russia grew by almost 7 per cent last year, this year and next the growth rate will drop to about zero.

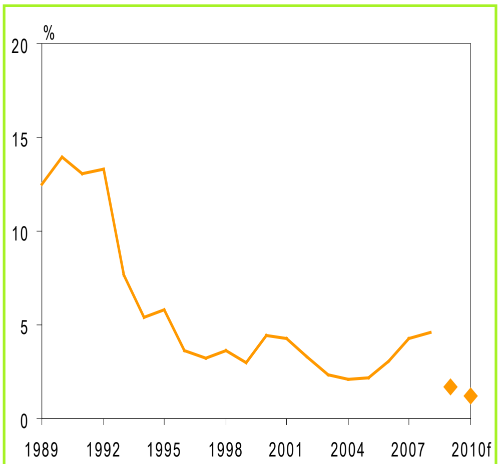
The global crisis has not weakened the operation of regulated financial institutions in China the same way it has in developed countries. China has indeed been affected by the economic crisis mostly through the weakening of its export markets. China's economic growth will drop from the over 10 per cent growth of recent years to about 5 per cent this year and next. In China, attempts have been made to bolster economic growth via fiscal policy measures, which are not believed to have any effect until the latter half of this year. Economic growth will slow down also in other Asian countries and mostly in Japan, whose overall output will fall by 3.5 per cent this year and 1.5 per cent next year as well. Japan belongs to the group of developed economies whose

Exchange rates 30.8.2006–29.1.2009



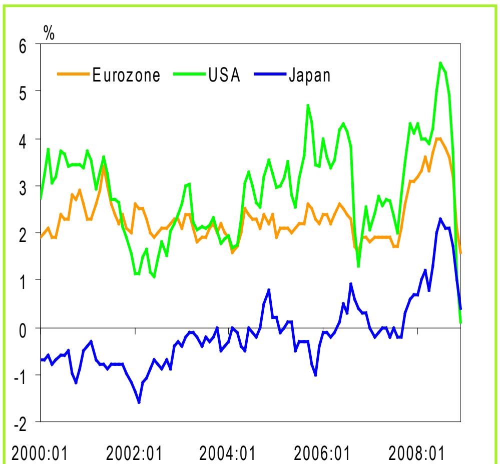
Source: ECB

3-month Euribor 1989–2010



Source: Bank of Finland, PT

Inflation in assorted countries 2000:01–2008:12



Source: Eurostat, OECD

foreign trade has been running a surplus and whose exports have been largely dependent on the exports of investment goods. It is precisely this group of countries that the world investment recession will hit the hardest.

Export markets collapsed

While last year Finnish export markets still grew by a few per cent, this year they will shrink by a couple of per cent. Especially exports will be weakened by investments turning to a clear descent in export countries. The amount of commodity and service exports already turned to a steep downhill at the end of last year so that during last year as a whole it grew by only a few tenths of a per cent. The Labour Institute of Economic Research predicts that the volume of exports will remain almost 10 per cent less than last year. The difficulties of exports will still continue next year. The slow unwinding of the decreasing order-books of ships and machinery and equipment in particular will still be felt next year in decreasing export deliveries. Next year exports will still decline by two per cent although some level of brightening of the economic outlook could already revive the export of, for instance, the products of the electronics and forest industry and iron and steel products.

The reduction of export and domestic demand is reflected in imports so that its volume will fall by 6 per cent this year and it will remain at this year's level next year. The substantial cheapening of raw materials in the world market has already lowered import prices sharply. This year they will remain on average over 12 per cent below last year's level. The global economic crisis is expected to loosen its grip next year, which will quickly raise the world market prices of raw materials so that Finland's import prices too will rise by a generous two per cent. This year export prices will drop but distinctly less than import prices. Next year the terms of trade will weaken again, as export prices will rise by only one per cent.

The substantial drop of oil prices could also have detrimental long-term effects. Low oil prices do not attract investments although there is a screaming need for them especially in Russia. For this reason there is a threat that output will not increase sufficiently when oil demand begins to increase again after the economic crisis subsides. At this point the price can jump to an unrealistic level again.

Demand and supply

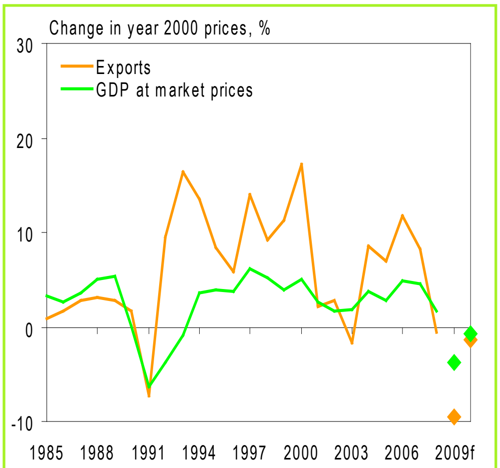
	2008f	2008f	2009f	2010f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	187.8	1.7	-3.7	-0.7
Imports	75.9	0.2	-6.0	0.0
Total supply	263.6	1.3	-4.3	-0.5
Exports	83.1	-0.6	-9.5	-1.3
Consumption	136.4	2.3	0.0	0.6
private	95.7	2.6	-0.2	0.1
public	40.8	1.5	0.6	1.8
Investment	38.8	2.5	-8.3	-2.5
private	33.8	2.6	-10.3	-3.0
public	5.0	1.5	5.2	0.2
Change in stocks	5.3	0.0	-6.8	0.0
Total demand	263.6	1.3	-4.3	-0.5

Source: Statistics Finland, Labour Institute for Economic Research

Unemployment will increase this year and next

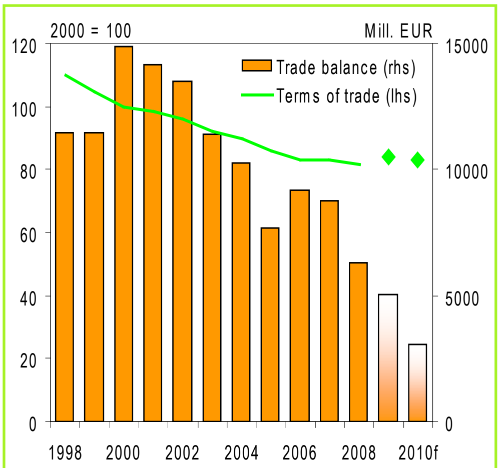
The positive employment development came to a turning point at the end of last year. According to the labour force survey, employment and unemployment did

Change in total production and exports 1985–2010



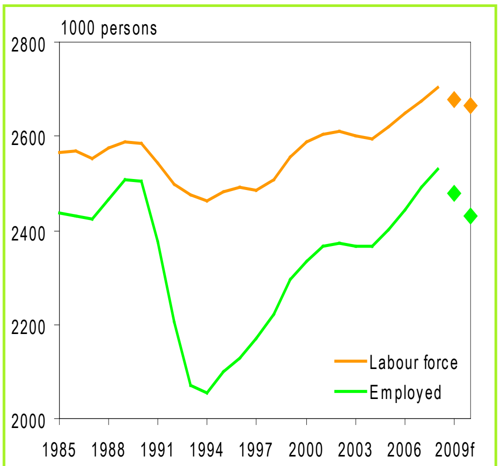
Source: Statistics Finland, PT

Terms of trade and trade balance 1998–2010



Source: Statistics Finland, PT

Supply of labour and employment 1985–2010



Source: Statistics Finland, PT

not change appreciably in the last few months of the year 2008 in comparison to the previous year. In the last quarter there was one per cent more employed persons, being 24,000 more than in the corresponding quarter of 2007 and 2000 less unemployed persons. In December employment increased by only about 0.3 per cent from the previous year. Also, sharply increasing lay-offs and lay-off announcements in the end of 2008 and at the start of 2009 indicate that the weakened cyclical trend has also started to affect the employment situation.

Indeed, the previous growth of employment will turn to a clear descent, and unemployment will start to grow significantly. As overall output declines, employment will weaken at an annual rate of about two per cent in both years. This will mean a reduction of about 50,000 employed persons in both years. Correspondingly, the employment rate of 15-64 year-olds will decrease from 70.7 per cent to 68 per cent by the year 2010.

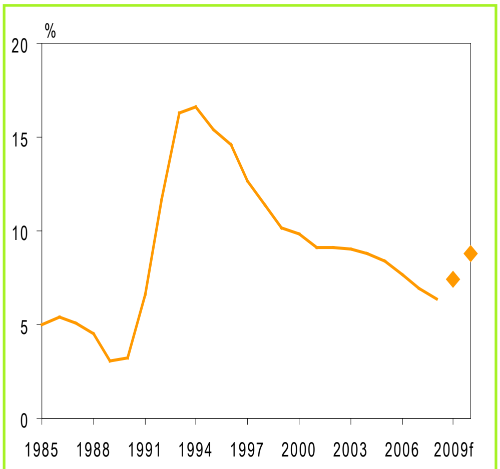
Adjusting to the drop in labour demand will happen both through the descent of employment and realized man-hours. The recession will decrease man-hours per worker through shortening work times and decreased overtime work. Therefore man-hours are forecast to decrease by 3 per cent in 2009 and 2.5 per cent in 2010, being 1 and 0.5 percentage points more than the amount of employed persons in the aforementioned years. The change of overall work hours follows the change of output with a lag, a result of which labour productivity growth will slow down or productivity will even weaken in 2009, but its growth will accelerate correspondingly in 2010 when the descent of the number of man-hours continues more powerfully than the reduction of output.

The labour force participation rate of working aged persons will also begin to decline in the wake of the weakening outlook. Unemployed persons will exit the labour force after they have stopped actively seeking labour. Some will exit into retirement as some move over to studying or household work. The labour force participation rate of 15-74 year-olds will therefore decrease from 67.5 per cent to 66.6 per cent in 2009 and still on to 66 per cent in 2010. Population growth will still increase the amount of 15-64 year-olds in 2009, but in 2010 the amount will turn to a descent, which will in part contribute to the reducing of the labour force, thereby curbing the rise of the unemployment rate. Therefore, the unemployment rate will rise to 7.4 per cent in 2009 and on to 8.8 per cent in 2010.

Investment falling

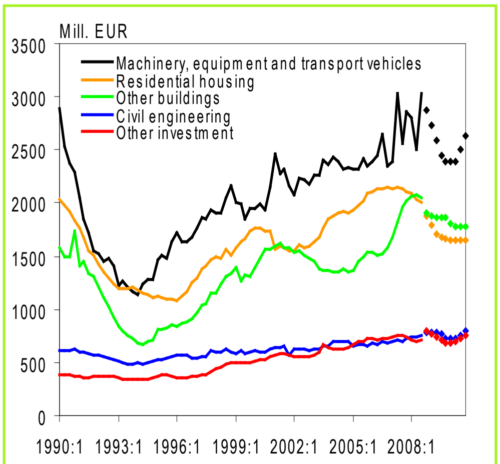
Private investment still grew in the first three quarters of 2008 by an average rate of 4.2 per cent annually. Construction growth was sustained by construction of office and business space, while housing construction was already in a clear descent in the first half of the year. Civil engineering construction grew strongly due to large active public projects such as the Vuosaari harbour. The substantial weakening of the economic outlook has changed investment expectations significantly. Private investment is indeed expected to decrease by about 10 per cent this year. Housing construction, where new starts have already been sharply reduced, will fall the most. In business and office construction the most profound drop will most likely take place towards the end of the year. A full collapse of construction is prevented by renovation construction, which is expected to continue to increase in the ongoing year. This is also being supported by new government measures. Machinery and equipment investment is also going to fall clearly this year despite nuclear power plant investments. The downhill of construction will not make an upturn quickly and private investments are predicted to decrease still by 3 per cent next year from this year's level. Machinery and appliance investments will continue to decline as the crisis of the world economy continues. The slowdown in construction will most likely come to a stop in the latter half of 2010, however, when the economic crisis begins to loosen its grip. Also the positive effects of low interest rates, especially those supporting investment, will begin to be felt.

Unemployment rate 1985–2010



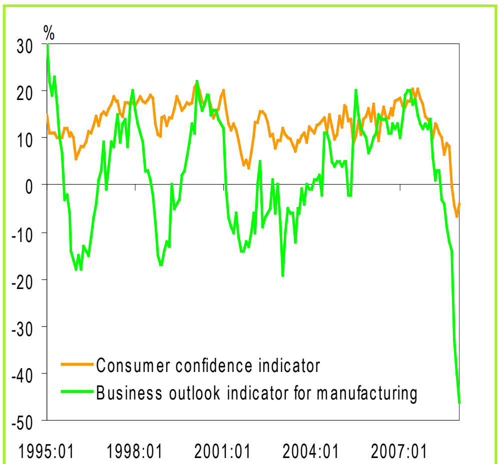
Source: Statistics Finland, PT

Investment by sub-components 1990:1–2010:4



Source: Statistics Finland, PT

Business cycle indicators in Finland 2000:01–2009:01



Source: The Confederation of Finnish Industries, Statistics Finland

Export industry and construction contracting the most, services the least

The global economic crisis will especially reduce the output of industry and construction this year. The weakening of the export market will have an impact on all industrial sectors. In the metal industry new orders already collapsed at the end of last year, and its output is predicted to decrease clearly this year. The export-dependent electro-technical industry will also reduce its output during the ongoing year. The weakening trend will also accelerate reductions in the output capacity of the wood and paper industry, which was already reduced during the economic boom. Closing down production plants and lay-offs will hit hardest on municipalities with a one-sided livelihood structure, where the main employer reduces its operations. The downturn in construction and the construction material industry also took place at the end of last year, and output will continue to decrease all through the year. The weak situation in the housing market does not encourage construction businesses to carry out new starts, while there is still old production left unsold.

The service sector will survive the ongoing year with less damage, although its development will also turn negative towards the end of the year as unemployment increases. The reduction of the VAT on food will soften the impacts of the recession in trade, while the change will impact the restaurant business in exactly the opposite way.

Output will continue to decrease in industry and construction next year. The reduction will remain smaller than that in this year, however, as the most acute stage of the crisis is left behind. In the service sectors activity will decrease almost as much next year as this year and employment development within them will be weaker next year than this year. Of the service sectors, the value-added will decrease the most in transport, warehousing and communications.

Wage growth slowing down as employment trends spawn decline in wage bill

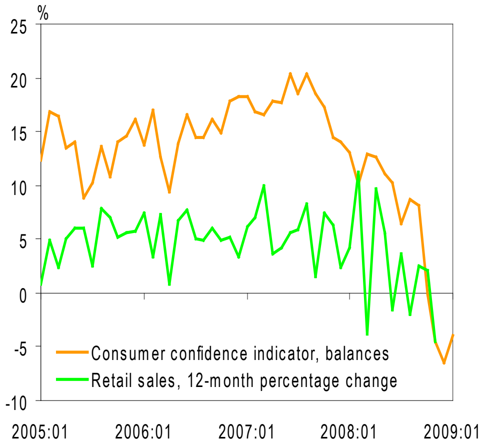
This year most of the two-year union-level pay settlements will come to an end. Last year wages developed very favourably and the level of wages rose by 5.2 per cent. Employment improved and average wages and the wage bill grew appreciably faster than earnings. The wage bill grew by 7.5 per cent last year. A key element of the wage settlements was the increased use of local negotiations on certain terms of the agreements and one-off compensation paid at the beginning of the settlement period. In the wage round the service and public sectors ended up with somewhat higher percentage increases than industry.

This year there will be a new union-level negotiation round. The negotiations for the third year of the wage settlement period carried out in the technology industry will set the pace for other sectors. The negotiation situation is marked by the international economic crisis and the sudden and steep drop in Finnish exports. The locally negotiated terms of the agreements will decrease other wage drift and in this economic situation flexible components of wages such as bonuses will remain moderate. Owing to the carry-over of increases from last year, the level of earnings will rise this year by 3.5 per cent, of which the share of contract wages is 2.9 percentage points. We forecast that the level of earnings will rise by 2.5 per cent in the year 2010.

The economic downturn will reduce the demand for labour and the number of man-hours worked will drop faster than employment. Average hourly wages will also rise more slowly than the level of earnings. All in all, the wage bill will grow this year by 0.6 per cent. In 2010 employment trends will continue to be poor and the wage bill will decrease by 0.1 per cent.

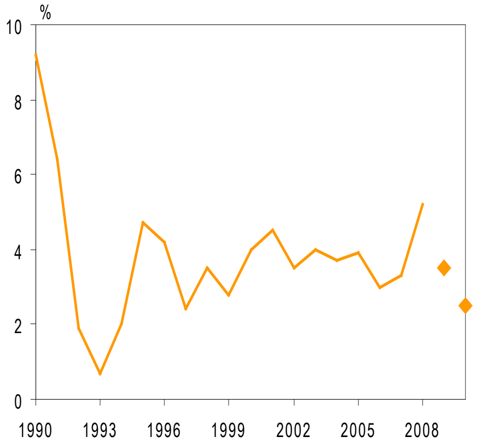
This year the capital income of households will contract strongly. The fall in the stock market and greater uncertainty increased the popularity of de-

Consumer confidence and retail sales 2005:01–2009:01



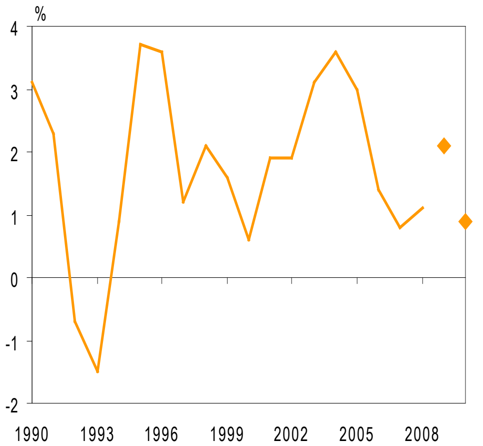
Source: Statistics Finland

Change in level of earnings index 1990–2010



Source: Statistics Finland, PT

Change in real earnings 1990–2010



Source: Statistics Finland, PT

posits substantially last year. Correspondingly, the equity investments and dividend income of households decreased. This year the drop in interest rates on deposits will reduce interest income, but interest on housing loans will also decrease. Agricultural and forestry income will subside. The purchasing power of wage earners is being supported this year by sizable tax cuts, but the weakening of employment will have an even greater impact on the income development of households. We forecast that households' disposable income will rise this year in nominal terms by 2.9 per cent and next year by 2 per cent.

Growth in household consumption and indebtedness will stop

Private consumption has been growing faster than average already for a number of years. This has been supported by strong consumer confidence, a low level of interest rates and a stable economic outlook. Consumption growth has exceeded the growth of the amount of expendable income, and households have increased their indebtedness. Last year the growth of the volume of consumption, which we estimate to be 2.6 per cent, slowed down as inflation accelerated, but households continued to borrow. The savings rate of households was an estimated 1.4 per cent last year. This sort of development cannot go on forever.

In the end of the summer the confidence of households in the Finnish economy collapsed as a result of spreading uncertainty from the financial market and financial news. Expectations of one's own finances were the most cautious since 1996. In this situation the housing market ground to a halt. Households are postponing their purchases and even cutting down on every-day expenses. Despite generous tax returns, the Christmas sales disappointed expectations. New automobile registrations fell by almost 20 per cent in the last quarter of the year in comparison to the normal situation from two years back.

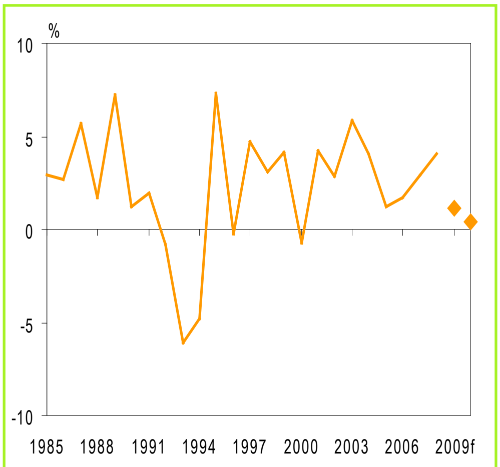
The sales outlook for durable goods and especially cars is weak. In recent years the emphasis of the growth of consumption was toward semi-durable and durable goods, which had a positive impact on central government finances through indirect taxes. In the new situation the change of the structure of consumption and the reduction of the VAT on food will exacerbate the weakening trend in central government finances.

Although decelerating inflation and the descent of lending rates make the growth of the demand of disposable goods and services possible, the 10-15 per cent drop in durable goods purchases will lead to a slight 0.2 per cent reduction in overall private consumption in 2009. Gradually, low lending rates and the low inflation rate will enable the release of pent-up demand for durable goods purchases. In 2012 private consumption could turn to a slow growth while simultaneously households' saving has been balanced.

Inflation is slowing down, interest rates and cost of living are falling

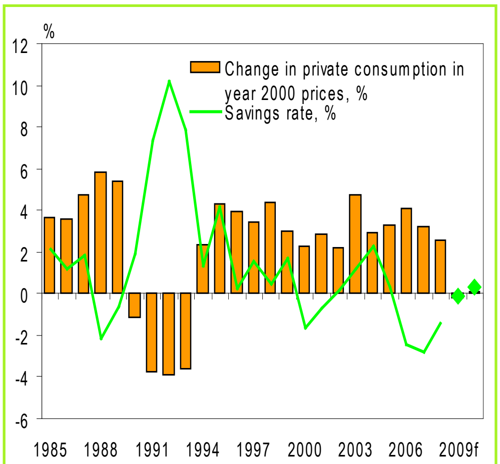
Last year consumer price inflation was 4.1 per cent on average. It was boosted by taxation decisions of the government, the almost 9 per cent inflation of commodities and the price of crude oil, which reached a record high in the summer. Additionally housing loan rates rose in the autumn as a result of the general uncertainty in the financial markets. In the beginning of this year the taxation of alcohol beverages and cigarettes was raised by 10 per cent. This caused a 6 per cent rise in retail prices of both tobacco products and alcoholic beverages. Serving prices will rise by 3 per cent. During the year the rise of consumer prices will decelerate sharply, and in the autumn the inflation rate will descend clearly below one per cent. In the beginning of October the VAT on foodstuffs will be decreased from 17 to 12 per cent. If

Change in household real disposable income 1985–2010



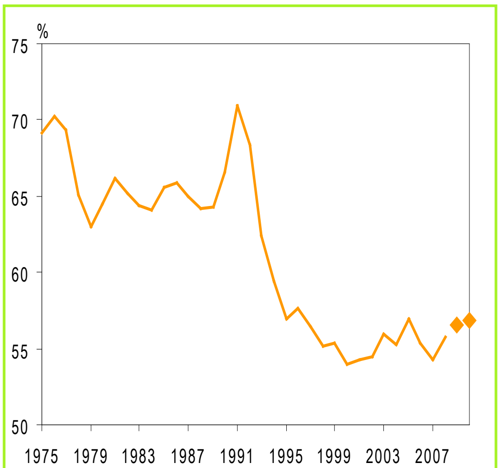
Source: Statistics Finland, PT

Private consumption and savings rate 1985–2010



Source: Statistics Finland, PT

Functional distribution of income in business activities 1975–2010



Source: Statistics Finland, PT

three fourths of this shifts over to retail prices, food prices will decrease by 3.2 per cent and the inflation rate will decrease by 0.4 percentage points. The world market prices of the most important agricultural products have also clearly dropped from their peak of one year ago. Although in January prices were still rising in some product groups, in Finland the price development of food is still significantly slower than last year.

Once again the development of Finnish inflation is being crucially influenced by the prices of fuels and the cost of living in addition to lending rates. Lately oil prices have been fluctuating sharply. In the autumn the OPEC countries decided on a total reduction of 4 million barrels in the daily output of crude oil. As demand declines, it is unlikely that these measures would guarantee an appreciable rise in oil prices. The OPEC target level of 75 dollars per barrel and the 35 dollars per barrel level at the beginning of the year provide a natural price range for an annual average. Last year the average price was 100 dollars, of which it will be half in 2009. This year the drop in transport fuel prices will lower the usage expenses of driving by about 10 per cent. The cost of living and the development of interest rates on housing loans will affect inflation by 0.6-0.9 percentage points this year.

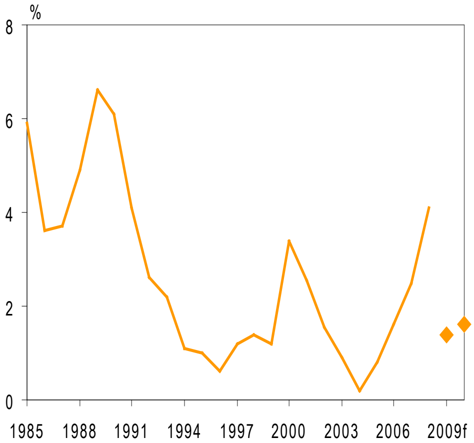
On average consumer prices will rise by 1.4 per cent in 2009. Next year the price of crude oil and the development of interest rates on housing loans will no longer affect domestic inflation, and consumer prices will rise by an average of 1.6 per cent. At this point our own calculation of the rise of prices will no longer exceed inflation that has been calculated based on the harmonized price index, which has been adjusted for the effects of interest rates and housing prices.

Key forecasts

	2008f	2009f	2010f
Unemployment rate (%)	6.4	7.4	8.8
Unemployed (1 000)	174	197	234
Employed (1 000)	2531	2480	2431
Employment rate (%)	70.7	69.2	68.0
Inflation, consumer price index (%)	4.1	1.4	1.6
Wages, index of wage and salary earnings (%)	5.2	3.5	2.5
Real disposable income of households (%)	4.1	1.1	0.4
Current account surplus (Bill. €)	5.3	4.3	2.8
Trade surplus (Bill. €)	6.3	5.0	3.1
Central government financial surplus			
Bill. €	3.1	-4.5	-8.0
% / GDP	1.7	-2.4	-4.4
General government financial surplus			
Bill. €	9.8	-1.8	-7.4
% / GDP	5.2	-1.0	-4.0
Emu debt			
% / GDP	32.2	37.5	45.8
Tax rate (%)	43.5	41.2	40.8
Short-term interest rates (3-month Euribor)	4.6	1.7	1.2
Long-term interest rates (10-year gov't bonds)	4.3	2.8	2.9

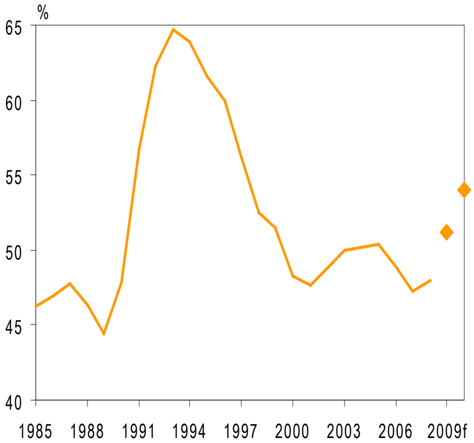
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Change in consumer prices 1985–2010



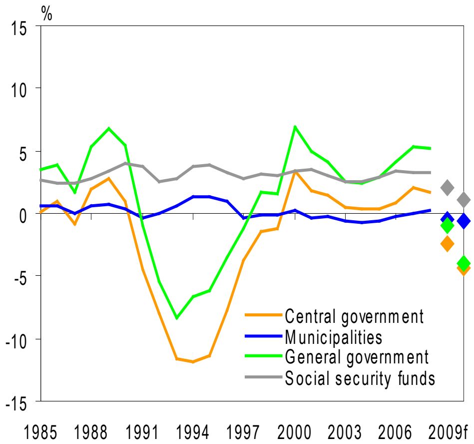
Source: Statistics Finland, PT

Public expenditures as percentage of GDP 1985–2010



Source: Statistics Finland, PT

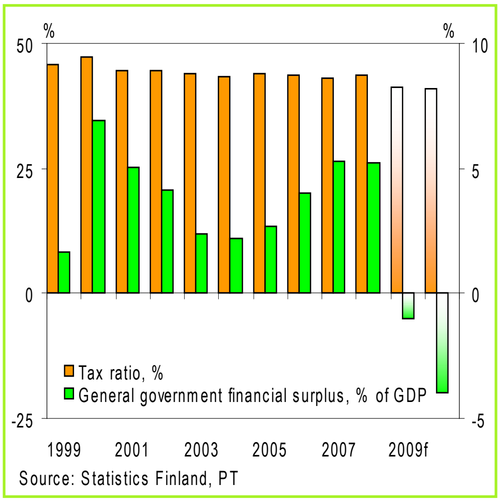
General government financial surplus as percentage of GDP 1985–2010



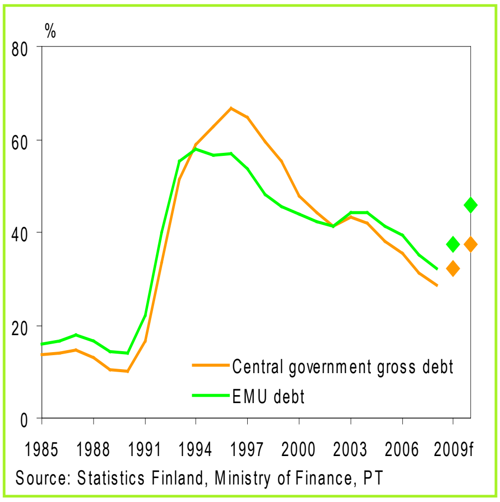
Source: Statistics Finland, PT

Public sector running large deficit

Public finances 1999–2010



Central government gross debt and general government EMU debt as percentage of GDP 1985–2010



The weak development of private consumption and investment this year and next will reflect upon VAT and automobile tax revenues. The impact of the lowering of VAT on foodstuffs is also considerable, while hikes in alcohol and tobacco taxes will generate only about 100 million euros for the state coffers. Total indirect tax revenues will fall by five per cent this year and one per cent next year. Central government income taxes will fall this year by a fifth and substantially next year as well. The main reason is the drop in corporate tax revenues, but the impact of easing earned income taxes this year is also considerable. The forecast for 2010 does not include any assumptions regarding new income tax cuts. The central government dividend income is expected to decline this year by about 800 million euros, while next year the fall will be 200 million euros.

As a result of the tax cuts and decline in corporate tax revenues, the municipalities' tax revenues will decrease this year, but next year they will start to rise moderately. Property tax revenues continue to grow and the forecast for the year 2010 assumes a 0.1 percentage point rise in municipal tax rates. The state's revenue sharing earmarked for the municipalities is forecast to grow this year by slightly more than 7 per cent, but without new decisions their rate of increase threatens to be half as fast in the year 2010.

A final decision has not yet been made on the elimination of the employers' social insurance contributions, but in the forecast it is assumed that in the private sector and municipalities it will be cut in half starting April 1, 2009 and that it will be phased out completely at the beginning of next year. This loss in contributions totalling approximately one billion is assumed to be covered by a state debt-funded income transfer to KELA, the Social Insurance Institution of Finland. Thus the elimination of the contributions will not affect the revenues of the pension fund institutions and other social security funds, which will naturally decrease by few per cent this year and next in the wake of the weak economic growth.

Public expenditures are not expected to rise significantly during the forecast period. The real growth in public consumption will remain around half a percentage point this year, from which it will climb by a percentage point next year. Public investment is forecast to remain around last year's comparatively high level. This will not be possible without additional central government outlays for investment as a part of stimulatory measures and the municipalities' ability to benefit especially from the private sector's idle construction resources.

Despite the considerable increase in the state debt, interest expenditures are not expected to rise appreciably because the interest rates have fallen, which also dampens the costs of refunding of the old state debt. Together with the compensation for the elimination of the employers' social insurance contributions, the rise in unemployment security expenditures will cause a slightly less than 10 per cent rise this year and over 12 per cent increase next year in state transfers to pension insurance institutions and other social security funds. The unemployment security and pension expenditures of the latter will climb substantially in both forecast years.

All in all, public expenditure's share of GDP will rise this year to slightly over 50 per cent and next year already to 54 per cent. In contrast, the ratio of taxes to GDP will fall by 2.3 percentage points in the year 2009 and slightly further in 2010. For the first time since 1997, this year the financial surplus of the combined general government will turn negative and next year the deficit relative to GDP will exceed the three per cent ceiling of the Stability and Growth Pact. This development stems primarily from the plunge of the central government into a steep deficit (already about 8 billion euros next year), but also the surplus in the pension institutions and other social security funds will shrink clearly. The downturn in the municipalities is considerably more moderate, but also their combined deficit will exceed a billion euros next year.

The combined public sector's gross debt relative to GDP will rise by the end of 2010 by about 13 percentage points to 45 per cent. It was last at this level in the year 1999. It should nevertheless be taken into account that such a rapid rise in the debt is partially attributable to the assumption that the central government will obtain net assets this year and next worth almost 8 billion euros. Thus the public sector's net debt will not grow as quickly as its gross debt.

Assessment of government's fiscal policy: recovery programme ineffective

The international credit crisis and its spread into a recession in almost all countries have prompted many countries to stimulate their economies via fiscal policy. The public outlays by the USA and certain European countries such as Spain, Norway and Germany are high relative to GDP. The European Commission is coordinating European public sector actions aimed at implementing large-scale anti-recession measures equivalent to 1.5 per cent of the region's GDP. It appears that there is still a long way to go before this goal is reached. This kind of concerted effort would nevertheless be efficient because it not only boosts each country's domestic markets but also export markets. In addition to the scope of governmental actions, the way the expansionary fiscal policy is implemented is also important.

As the adjacent model calculations illustrate, at least in the short term increasing public demand (consumption and investment) is more efficient than lowering taxes. In the current deep demand recession this difference is augmented even further. The impact of taxes on production is indirect and takes effect with a lag. Its effect is based on growth in purchasing power and lowering of wage demands. In the current uncertain situation, a rise in the propensity to save and a weak labour market situation where wage restraint spreads out of fear of exacerbating the recession tend to curb the effectiveness of stimulatory tax cuts. On the other hand, the impact of public outlays for consumption and investment on production and employment is greater because they do not raise the cost level owing to the shortage of resources. In other words, it does not erode the profitability of the private sector and thereby dampen the impact on total production.

Model simulation of impact of stimulatory measures during recession years: impact on GDP

	2009	2010
Income tax cuts 1 billion €	+0.1 %	+0.2 %
Public investment +1 billion €	+0.6 %	+0.6 %
Public consumption +1 billion €	+0.6 %	+0.6 %

Calculations made with EMMA macroeconomic model of the Labour Institute for Economic Research regarding how stimulatory fiscal policy affects GDP growth during a recession. In the calculations the central government consumption or investment expenditures were increased or tax revenues were cut by about one billion euros in 2009 and 2010. According to the results, public investment or consumption spending boosts GDP by 0.6 per cent during the recession years. The impact of tax-based stimulation, on the other hand, is smaller: tax cuts of a billion euros increased GDP by 0.1 and 0.2 per cent this year and next. Increasing public consumption or investment is thus a more efficient means of bolstering total demand during a recession. The lowering of income taxes nevertheless affects the economy over the long run as the pace of economic growth is determined on the basis of total supply.

According to the adjacent, fairly cautious simulation, a one billion euro increase in spending not only increases production and employment more than lowering of taxes, it also does not weaken the public sector's financial position as much as lowering taxes does. Thus a one billion euro rise in spending, which initially increases the central government's deficit, will spur an indirect increase in taxes by 0.5 billion so that the ultimate cost becomes 0.5 billion euros. Correspondingly, the lowering of taxes entailing a decline in central government (and municipal) tax revenues by an initial one billion euros will spur an indirect rise in marginal tax revenues the following year of only 100 million euros. The ultimate cost to the central government is 900 billion euros.

The government estimates that its new supplementary budget will create 25,000 new jobs. Merely the slightly less than 400 million euro increase in spending is projected to increase employment by 17,000 persons. This estimate is based on the assumption of an almost 1.7 multiplier, which indicates by how much the ultimate employment increase exceeds the direct impact of the rise in public expenditures. It is clear that the government's projections regarding the impact of its actions are widely exaggerated in this respect. The employment effect of the addition spending could be a maximum of 10,000-13,000 new jobs. For example, in the case of renovation of housing companies, it cannot be assumed that all renovation activity would be attributable to the state's monetary incentives. Many housing companies that started projects would have done so anyway without government assistance. In direct infrastructure investments the multiplier effect in a recession could at best rise to 1.2–1.4-fold.

The new measures proposed by the government at the end of January are a step in the right direction as regards additional spending. It can nevertheless be said that the government's fiscal policy is marked by its aspiration to remain within its rather stringent framework for real central government expenditures. It also seems that the government does not see the crisis as a demand recession, but rather as some kind of financial market disturbance or corporate profitability crisis, which explains why its stimulatory package is based almost entirely on cuts in taxes and employer contributions. The government has also resorted to solutions the original aim of which was not counter-cyclical policy, but rather a so-called structural policy (longer horizon) attempt or desire to ease the profitability problems in certain sectors. This also explains why the government's stimulatory measures are weighted toward cuts in taxes and employer contributions.

The adjacent table presents an estimate of the magnitude of active decisions regarding fiscal policy. The estimates of these effects are divided into lowering of taxes and employers' contributions and, on the other hand, into changes in central government spending. The active spending changes take into account the central government's budgeted consumption spending, transfers (excl. compensation attributable to tax cuts) and real investment, i.e. almost all budgeted expenditures minus interest expenditures on the state debt. The spending increases also include changes subsequently made to the original budget. Changes in expenditures are deemed to be stimulatory when their real growth exceeds the trend growth of 1.5 per cent. The adjacent calculations show that as regards the additional expenditures the budget policy is practically neutral.

The reductions in taxes and contributions take into account all tax-based changes that reduce central government and munici-

Table 1. Active central government measures changing spending

Central government budget expenditures	2008	2009
Consumption expenditures	13691	14643
Total transfers	26791	27849
Real investment	558	444
Increases to 2009 budget		726
Less tax compensation to municipalities		-374
Total expenditures	**41040**	**43288**
Nominal growth in expenditures		5.48
Central government spending deflator	1	1.034
Real expenditures	**41040**	**41863**
Growth in real expenditures		2.01
Stimulatory spending according to 1.5 % norm, (-) tightening, (+) easing		248
% of GDP		0.13

pal tax revenues except inflation adjustments of the income tax brackets and the part of the income tax bracket changes that eliminate the tightening of earned income taxation caused by the rise in the level of real earnings. In this calculation the fiscal impacts of earned income tax revenues are adjusted downwards in line with the projected shrinking of the tax base. The calculation also includes an approximately 375 million euro decrease in revenues owing to the elimination of KELA social insurance contributions to be implemented at the beginning of April this year. The government will have to compensate for this shortfall in revenues by increasing its own deficit. The modest downward impact on tax receipts of the easing of depreciation rights has also been taken into account.

As the adjacent table illustrates the impact of the tax-related changes relative to the forecast amount of GDP is estimated to be about 0.9 per cent this year. All in all the fiscal policy is stimulatory. The magnitude of the stimulus nevertheless remains comparatively small. The greatest problem is that the counter-cyclical measures are weighted toward reduction of taxes and employers' contributions. Thus the impact of the stimulus on production and employment will remain modest and it will unnecessarily weaken state finances and the financial position of the rest of the public sector.

In the current situation the stimulatory measures should increase as directly as possible the amount of man-years worked. A certain type of business aid is on average rather inefficient in this respect. It primarily improves corporate profitability but it does not increase activity. Financial aid, the need for which cannot be denied, can nevertheless at best prevent corporate bankruptcies and tide them over this difficult stage. Temporary increases in state investments and consumption expenditures have a direct and therefore efficient impact on employment and their indirect employment weakening effects are now at their smallest since economic resources are for the most part not being used to their full capacity. State aid to municipalities and housing companies – for repair and renovation – is also necessary, although it is difficult to say to what extent this aid boosts employment. The reduction in the KELA social insurance contributions should have been postponed until the beginning of 2011 and tax relief for income from timber sales should be revoked.

Municipal support should be used to safeguard basic expenditures of those municipalities in regions where unemployment has climbed or threatens to increase the most. The elimination of the KELA social insurance contributions in the manner proposed reduces municipal expenditures this year by slightly less than 100 million euros. This support will remain too little and the central government can indeed support municipalities directly. The fact that keeping basic service expenditures on current levels or increasing them is not deemed an acceptable means of stimulation illustrates the reluctance to support municipal economies. This is also indicated by the fact that the implementation of already initially decided new obligations of municipalities will be postponed until "better times".

In its first supplementary budget of 2009 the central government should have increased expenditures for this year by a total of 2 billion euros, of which 200 million euros would have been earmarked for financial support of small and medium-sized companies, about 800 million euros for direct state consumption expenditures and investments (primarily infrastructure such as roads and railways) and the remaining 1 billion euros for municipalities, housing companies and other entities primarily for housing and renovation construction. An additional 2 billion euros of expenditures would create jobs at best for 60,000 persons. Because part of the aid would be channelled indirectly via municipalities, enterprises and housing companies and other entities, the ultimate impact might easily remain somewhat less than this. As the spending-based stimulation spawns greater multiplier effects than tax cuts, its implementation would not weaken state finances as much as tax cuts. The result would be better employment and smaller central government deficits.

Table 2. Active central government measures changing taxes and employers' contributions

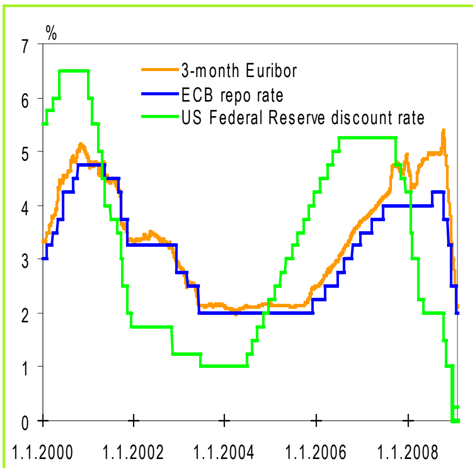
Decrease in taxes or contributions (-), increase in taxes (+)	
Food VAT	-125
Alcohol and tobacco tax	100
Lowering of earned income tax brackets	-825
Decrease in pension income	-200
Increase in household deduction	-72
Increase in own responsibility for travel expenses	29
Use of cultural coupons	-10
Tax relief for income from timber sales	-130
Reduction in return of source tax	-15
Expansion of companies depreciation rights	-70
Shortfall in state budget from elimination of KELA social insurance contributions	-375
Decision-based easing of taxation Excl. inflation adjustments and earned income compensation	**-1693**
% of GDP	**0.91**

Assessment of financial market situation and government's financial package

Global crisis began in the US

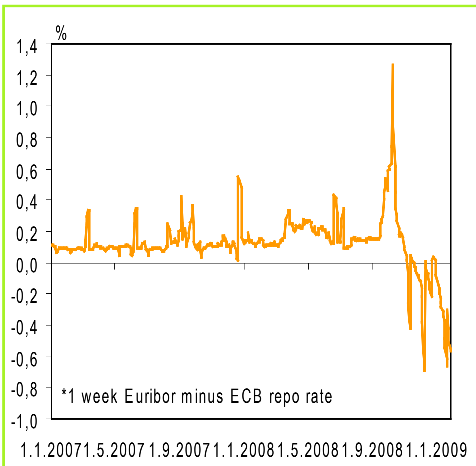
The symptoms of the financial crisis began to surface already in the summer of 2007, when news spread of the inability of American debtors to repay their sub-prime mortgages. In Europe the commercial paper markets began to deteriorate at that point. Last year in September-November the credit crisis began to deepen and several American and European financial institutions ran into difficulties.

Short-term interest rates 3.1.2000–29.1.2009



Source: ECB, Bank of Finland

Money market interest rate spread* 2.1.2007–29.1.2009



Source: ECB, Bank of Finland

This caused a collapse in the inter-bank money markets and commercial paper markets that large corporation have used to finance their short-term credit requirements arising from their daily business activities.

At its worst the credit crisis affected also the availability of credit for households and companies and raised the cost of financing so that it prevented the realization of investments and curbed growth in total production. On the other hand, the credit crisis revealed the overheating of the housing markets in the US and Europe, which spurred a decline in housing prices and slackening of demand for dwellings. At the same time it became apparent that the whole expansion of investment banking activities was based on unfounded optimism and concealment of risks, which exacerbated the economic outlook further.

It appears that the uncontrolled spread of mistrust in the financial markets triggered a strong and ominous negative shock to the real economy. It is nevertheless significant that the prolonged imbalances in the entire world economy had already weakened the real economy and dampened the rate of aggregate production growth. For example, European growth had been curbed by the excessive appreciation of its currency, steep rise in raw material prices on global markets and a stringent monetary policy.

We can also ask whether the tightness of the credit markets is still the prime reason behind the slowdown in economic growth and the recession or has the downward spiral caused by weakening demand become the main growth-dampening factor. According to a report on the US credit markets made by the US Federal Reserve last October, only a fourth of the companies indicated that they incurred difficulties in obtaining credit. The same report indicated that at no point did the stock of outstanding loans ever stop growing in the US. The rate of expansion of new lending did, however, slow down. This report substantiates the impression that the credit crisis spawned the downward spiral in the growth of the real economy, although the main force sustaining the downturn is not the difficulty in obtaining credit, but rather sluggish demand.

Central banks lowered interest rates and funded the money markets

The US Federal Reserve and European central banks have combated the financial market crisis by lowering reference rates and otherwise easing the terms of banks' central bank funding. The European Central (ECB) raised its repo rate last July to 4.25 per cent. Comparatively late, not until last October did the ECB begin to lower its repo rate. In January it was ultimately lowered to 2 per cent. It is anticipated that interest rates will still be lowered to one per cent, where it will remain for a relatively long time. The US Federal Reserve, on the other hand, began to cut rates already in the autumn of 2007, when its Federal funds rate stood at 5.25 per cent. The Federal funds rate had already been lowered to one per cent last October, and since mid-December a target range has been set between zero and 0.25 per cent.

The ECB has also increased the amount of central bank funding by easing its terms in many ways. As a consequence the short-term inter-bank money markets have begun to function. Proof of this comes from the way the short-term Euribor rates has approached the central bank's repo rate and in recent days even fallen below it. The recent developments forebode the more widespread normalization of the financial markets.

The Fed has begun to stimulate the markets for short-term corporate funding by buying short-term debt, i.e. commercial paper, directly from companies. These markets have been completely dependent on the Fed in recent months. This funding had already climbed to 1600 billion dollars by the end of January. The Fed did not begin to revive the secondary market for this paper by selling it to private investors until late January. It is anticipated that the corporate credit markets will recover, but very slowly. The Japanese central bank has begun to fund companies directly by buying their commercial paper since January of this year. The ECB has not taken similar actions even though the commercial paper market is slumping also in Europe. This can be regarded as negligent, because these kinds of recovery-promoting measures would be best suited to the ECB, which could implement the measures by resorting to the aid of national banks.

The collapse of the commercial paper market spawned pressures to increase the direct lending of banks. This in turn has made it more difficult for companies to obtain credit. The large losses also to European banks from subprime loans, the need for banks to bolster their solvency – partly to avoid being taken over by the government – and considerable increases in credit risk premia as a reaction to the uncertain economic situation will increase further the price of funding and exacerbate the availability of credit. In this respect the situation varies from one country to the next. It is clear that the slowdown in economic growth will spur an erosion of the value of assets on bank balance sheets. New banks both in the US and Europe will experience difficulties. The strong intervention by the central banks and central governments will nevertheless perhaps prevent a resurgence of the crisis impinging upon the availability of funding for viable projects. The situation is indeed returning to normal with regard to the availability of credit, even though the action of governments is still needed to safeguard the availability of funding.

In Finland sluggish demand is a worse problem than the availability of credit

It seems that the banks operating in Finland have not nor will they have to face such grave difficulties as the American and European financial institutions, whose balance sheets have a lot of receivables comprised of bad debt.

According to a financial market survey conducted in Finland last August, the international credit crisis, which already then had caused severe problems for many American and European commercial and investment banks, had not exerted a great impact on the availability of credit nor the borrowing costs of Finnish companies except for large companies, which already experienced difficulties to obtain funding from international financial markets.

Last year in October-November when the inter-bank money market collapsed, the difficulties with the availability of credit evidently had a wide impact also on Finnish corporate and household clients. Information on the hardships experienced by small and medium-sized companies, housing companies and municipalities in getting credit indicate that the availability of credit to these customers was unnecessarily difficult on a wider scale. The assessment of the situation in Finland is encumbered by the fact the systematic data on the availability of funding has not been compiled since last August, even though this information would have been sorely needed right now. It appears, however, that anecdotal information on borrowing by SMEs gives a bleaker picture than systematic data compiled on a wider scale. All in all the availability of credit became difficult in October-November, but after that the situation has eased. Owing to the weakening of the real economy the availability of financing for certain investment projects – such as new shopping centres – has also become more difficult owing to the greater inherent risks. These kinds of projects lacking the preconditions for success should not, however, be financed by the central government, but rather domestic demand should be fostered so that these projects would be viable.

Because the availability of financing from the short-term money markets has become more difficult, even large companies are to a growing extent turning to bank credit to satisfy their short-term financial requirements. The same evidently holds for long-term financing, the demand for which has nevertheless weakened as firms have cut back on their investment plans owing to the weak demand outlook. Corporate lending has thus grown swiftly and uncertainty stemming from return on risk bearing investments has prompted households to increase their investments in bank deposits. This and the slackening of demand for housing and other household credit will ease the funding of corporate lending via banks.

Impact of government's financial package on production will remain modest

The Finnish government has sought to foster the availability of financing and shore up the financial markets with various measures. The further the economic crisis has progressed, the clearer it has nevertheless become that the economy is suffering from weakening domestic and foreign demand. Therefore, measures to facilitate the availability of financing cannot have a great direct impact. Government measures already undertaken or planned to support banks operating in Finland and facilitate corporate lending include the following:

- Increasing the limits on lending, loan guarantees and export credit guarantees for the state-owned specialized financing company (Finnvera)
- The government will begin to grant guarantees for funding by Finnish banks
- Banks will be given an opportunity to shore up their solvency and lending ability with capital loans
- The State Pension Fund will be given the right to invest to a limited extent in Finnish companies' commercial paper.

Table 1. Finnish financial institutions' lending and deposits, preliminary figures for November 2008

	Million euros	12-month change, %	Average rate, %
Loans to households, stock	93369	8.6	5.83
Loans to corporations, stock	57925	20.7	5.40
Deposits to households, stock	72963	14.3	2.99
New lending to households	1058	-	5.04

Source: Bank of Finland

These actions will in theory increase the liabilities of the central government by tens of billions of euros. In practice these activities will not inevitably entail new expenditures for the central government. For several reasons, these actions will nevertheless remain as only plans without significant consequences. All in all, the support and oversight of banks operating in Finland will be encumbered by the fact that two thirds of the large commercial banks are under foreign ownership. Already for this reason it is difficult for the Finnish central government to get a grip on the banks.

The government's conditions for bank capital loans – high interest rates and top management pay restrictions – are such that the banks will resort to this alternative only under dire conditions. The banks will be willing to take capital loans only when they have lost their ability to pay a dividend. That means they would not be able to fulfil the terms of the capital loan either. In this hypothetical case, the central government would at the very least lose interest income and possibly suffer even credit losses, nor would it be able to benefit from the possible rise in stock prices. The whole capital loan scheme – which forcludes the possibility of direct state ownership – is not in Finland's and the taxpayers' best interest.

The commercial banks operating in Finland are also unwilling to take guarantees from the Finnish government for their funding from financial markets. The reluctance perhaps stems from the terms of the guarantees stipulating that top management pay schemes must follow the general principles of state-owned companies. It is also possible that the commercial banks do not deem their financing to be facing such problems that force them to participate in this scheme. It remains to be seen whether OP-Pohjola, which has indicated that it may opt to use these guarantees, actually uses them.

Of the government's proposals the most significant and most worthwhile is the increase in Finnvera's limits. On the other hand, the significance of this proposal will remain modest as the sharp drop in exports has reduced the demand for Finnvera's credit and guarantees. The government has already raised the limits with respect to domestic financing from 2.6 billion euros to 3.2 billion euros and from 7.9 billion euros to 10 billion euros in a decision that went into effect on January 1, 2009. At the beginning of the year a scheme was adopted whereby Finnvera's daughter company Finnish Export Credit was given the right to finance Finnish companies' foreign clients via so-called export refinancing. The limit on this refinancing was initially set at 1.2 billion euros, but on January 27 the government proposed that it be raised to 3.7 billion euros. The report submitted to the government by Mr. Antti Tanskanen proposed much higher limits for Finnvera than the government has decided upon. Now that it appears that additional financing is not a solution to the export problems, the fact that the government's limits fall considerably short of those proposed by Mr. Tanskanen cannot be regarded as a great problem.

The responsibility for reviving the commercial paper market in Europe belongs to the ECB, and Finland should be active in this respect. As a European-wide institution, the ECB could have the means to foster a recovery of the secondary market for this paper. The government's proposal for reviving the commercial paper market cannot be deemed a success. The proposal lacks the means to facilitate a recovery of the secondary market. The proposal means that the State Pension Fund would begin to buy commercial paper for which there is no secondary market. This means direct short-term lending to companies. Mr Tanskanen proposed this scheme and indicated that the central government could also buy services needed for managing a commercial paper portfolio from companies in this business. But this is precisely the crux of the question: the central government needs commercial banking expertise and systems for this scheme to work. The State Pension Fund is hardly suited for this task based merely on the grounds that it has capital.

First, it is necessary to determine to what extent has the availability of credit has really dried up. If the situation is regarded as dire and if the difficulties in the availability of credit are anticipated to last a long time, then the central government could rather establish its own commercial bank by offering capital in order to carry out this task. This commercial bank would fund its activities e.g. by selling bonds to pension funds and pension institutions. This scheme would make it possible for a much greater increase in lending than that proposed by the government. Mr. Tanskanen estimated that commercial paper schemes could spawn 5 billion euros of additional credit while the government would limit the amount to 500 million euros.

Based on the above, even the increase in Finnvera's limits cannot be expected to be of very great significance in practice. In a crisis scenario where the banks in Finland and Scandinavia become almost insolvent, plans for other actions than just bank capital loans will be needed. Little can be done in an open crisis, but its outbreak could be prevented by efficiently supporting commercial bank lending. One alternative would be to resort to Nordic cooperation. This is necessary mostly because many commercial banks such as Nordea and Danske Bank operate in several Nordic countries. The Swedish central government is Nordea's largest owner with its share of 20 per cent and the Finnish central government's stake in Nordea is about 2 per cent via its shareholdings in Sampo. The governments could get a tighter grip on this particular commercial bank based on their state ownership. By increasing the governments' stake in Nordea, its lending ability could be bolstered in order to combat the crisis.