Talousennuste

September 17, 2014

Economic Forecast 2014–2015

Ukrainian crisis hits Finnish economic growth

Additional information

Chief of forecasting
Eero Lehto
tel. +358-9-2535 7350

Information officer
Heikki Taimio
tel. +358-9-2535 7349

LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2014–2015

Ukrainian crisis hits Finnish economic growth

The Labour Institute for Economic Research is lowering this year's economic growth forecast for Finland to -0.3 per cent from last March's 0.9 per cent. GDP is forecast to grow next year by one per cent, while in March we predicted growth of 2.2 per cent. The downward revision of the forecast is largely due to the escalation of the crisis in Ukraine. The negative impact of the Ukraine crisis on Finland's economic growth is turning out to be greater than projected. The conflict affects the economy through sanctions, cutting Finland's GDP by about one and a half per cent. Of this amount, half a per cent will be realized this year and one per cent next year. Manufacturing's strengthening order intake in the first half of this year indicates that the conditions for an acceleration of growth indeed existed at that time. The direct and indirect effects of sanctions and counter-sanctions are nevertheless increasing during the end of the year. Finnish exports to Russia will contract this year by about 20 per cent from last year. The situation will remain poor in this respect far into next year. Even if the Ukrainian conflict subsides, sanctions will be removed only very gradually.

The desire of the EU countries and the EU Commission to further strengthen public finances at the expense of short-term growth will also affect economic growth in Finland in the coming years. Also for this reason the Finnish export market growth will remain limited. The European Central Bank's decision in September to increase bond purchases, which has already weakened the euro, supports the Finnish economy while our own stringent fiscal policy weakens it.

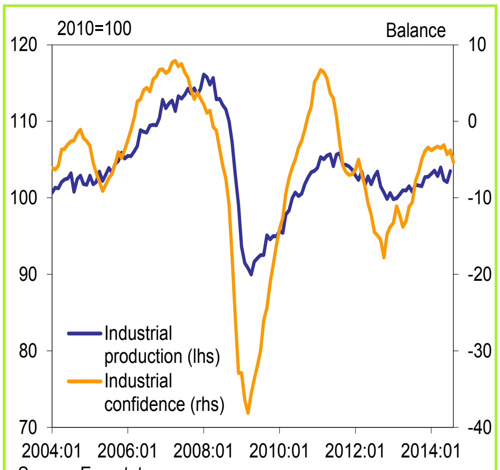
European economies in trouble again

The euro area's GDP grew by 0.4 per cent in the first quarter of this year compared to the previous quarter. The region's fixed investment, which had already started to increase in the second half of last year, continued to increase. This also bolstered Finnish manufacturing's orders received from the euro area. By and large the uncertainty stemming from the crisis in Ukraine as well the strengthening of the euro nevertheless brought the euro area's economic growth to a halt in the second quarter. Mainly as a result of Great Britain's relatively rapid growth, the overall EU area nevertheless expanded by a further 0.2 per cent with respect to the first quarter. Symptomatic of the growing uncertainty, the euro area's investment began to decline rapidly once again.

It is noteworthy that German GDP fell by 0.2 per cent in the second quarter of this year from the previous quarter, so that it was only 1.3 per cent higher than last year. The decline from the previous quarter was partly attributable to the unusually mild winter, which made very weather-sensitive construction in Germany brisker in the first quarter than usual. In addition to Germany, also Italian and Danish GDP shrank in the second quarter. France's economic difficulties continued and its GDP growth remained near zero for the second time in a row. Swedish GDP growth has also slowed markedly in the first half of this year.

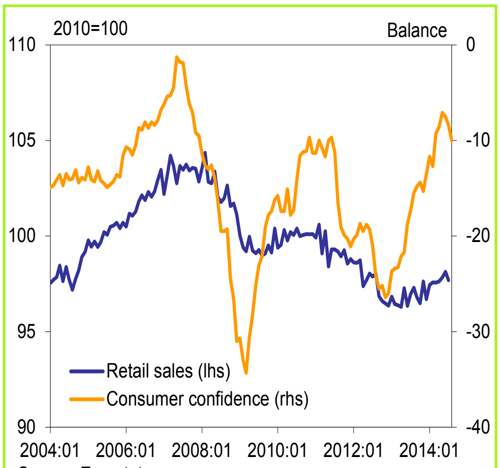
As regards the other euro area countries, economic growth has nevertheless accelerated in the second quarter of this year, for instance, in the Netherlands and Spain. Economic growth in the beginning of this year in countries dependent on Russian trade such as the Baltic countries and Poland was clearly faster than the rest of the EU. Economic growth in these countries will nevertheless slow down sharply as sanctions imposed on Russia and countersanctions imposed by Russia begin to have an impact.

Industrial confidence and industrial production in euro area 2004:01–2014:08



Source: Eurostat

Consumer confidence and retail sales in euro area 2004:01–2014:08



Source: Eurostat

The geopolitical crisis will continue to impede the economic growth of the overall EU and the euro area. However, the decisions made by the ECB in September to lower interest rates and to begin supporting the region's small and medium-sized enterprises financing via specific asset-backed bond purchases are once again boosting the area's growth. The growth effects of the ECB's decisions are transmitted largely through the weakening of the euro. We estimate that the exchange rate of the euro against the dollar is going to be 1.25 on average next year, while this year it will average 1.33. It is usually wise to refrain from forecasting exchange rates, but in this case there are good reasons to expect the euro to weaken in the near future, which will be caused by the economic growth and interest rate differentials between the United States and the euro area as well as the upcoming steps taken by the central banks.

Euro area public consumption will grow this year and next by about 0.7 per cent from the previous year. Even in 2012, when the fiscal stance was the tightest, these expenditures decreased by 0.6 per cent. In this regard, the fiscal policy stance will be eased on average. The ratio of the euro area's total taxes as a percentage of GDP is expected to remain at last year's level and to fall next year to some extent. Likewise from this perspective, fiscal policy is not being tightened.

The Labour Institute for Economic Research expects that the euro area's GDP will grow this year by 0.6 per cent compared to last year. Next year growth will accelerate to 1.4 per cent. The forecasts made last March have thus been revised downwards by slightly less than a percentage point.

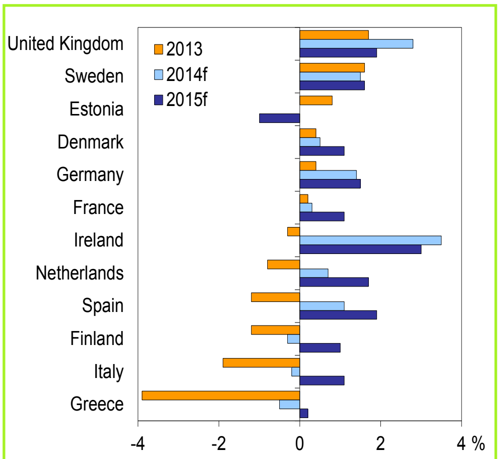
Italian and French public sector deficits approaching risk limits

The slowdown of the euro area economies once again mainly due to the Ukrainian crisis has also affected the public deficits and debt of euro area countries. The euro area fiscal deficits will reach about 2.5 per cent of GDP this year. Next year, the average will fall a couple of tenths of a per cent. It is noteworthy that the German public finances are already in balance this year while the deficits in many euro area countries – such as France, Spain and Portugal – are clearly above three per cent in violation of the European Stability and Growth Pact. The UK is still running a fiscal deficit of more than 5 per cent of GDP, even though the country's economic growth this year is already almost three per cent.

Why is economic impact of Ukrainian crisis so great?

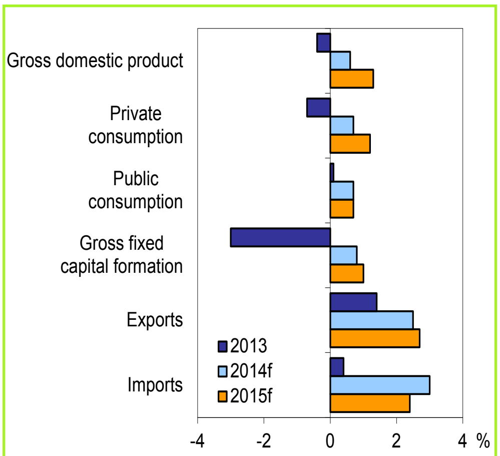
Germany's exports to Russia account for only slightly over one per cent of its GDP. The corresponding figure in the case of Italy is a bit less than one per cent while the figures for France, the UK and Spain are already less than half a per cent. Even though Poland, Finland and the Baltic countries are significantly more dependent on trade with Russia, it was not easy to imagine that the faltering of Russia's economic growth stemming from political and economic sanctions would have a widespread impact on the economic outlook of the euro area as a whole. The already fragile state of the euro area's economy and the vulnerability of its public sector made it sensitive to new uncertainty. Half a year of continuous conflict, which not only jeopardizes exports to Russia but also poses a threat to European energy supply and security, has weakened the area's domestic demand as companies and households have become more cautious. Since the crisis is still in an acute phase, it is difficult to assess its overall impact.

GDP growth rates in 2013, 2014 and 2015



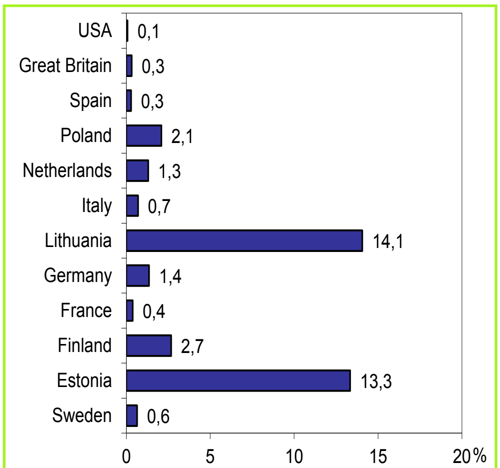
Source: Eurostat, Labour Institute for Economic Research

Eurozone economic growth 2013–2015



Source: Eurostat, Labour Institute for Economic Research

Share of certain countries' exports to Russia relative to GDP 2013



Source: Eurostat, International Trade Centre

Sanctions imposed on Russia have from the outset been aimed at cutting investment. This goal became even clearer when the sanctions were extended to banks and finance companies. In this regard, the sanctions have a negative effect on Germany, Italy and Finland, i.e. countries that export capital goods to Russia. It should be noted that already at the beginning of this year it was precisely Russian investment and imports that fell. The fall in GDP has nevertheless been alleviated by the weakening of the rouble, which has boosted production of substitutes for Russian imports. Restrictions on food imports have had the same effect.

So far, it appears that with its sanctions policy the EU tried to flex muscles it does not have. The resulting disturbance has put the most vulnerable countries to a precarious situation, which also reduces the political effectiveness of sanctions. Since the EU countries' public finances are on average in poor condition, the EU does not have the resources to compensate for the disproportionately large impacts that the Russian sanctions have on the Baltic countries, Finland and Poland.

Table 1. International economy

	Share of world GDP (%)	GDP growth (%) 2013	2014f	2015f
United States	19.3	2.2	2.5	3.2
Eur-18	13.1	-0.4	0.6	1.4
Germany	3.7	0.4	1.4	1.5
France	2.6	0.2	0.3	1.1
Italy	2.1	-1.9	-0.2	1.1
EU27	18.7	0.1	1.2	1.5
Sweden	0.5	1.6	1.5	1.6
United Kingdom	2.7	1.7	2.8	1.9
China	15.4	7.7	7.5	7.2
India	5.8	5.0	6.0	6.2
Japan	5.4	1.5	1.5	1.5
Russia	2.9	1.3	0.0	1.0
Brazil	2.8	2.5	1.0	2.5

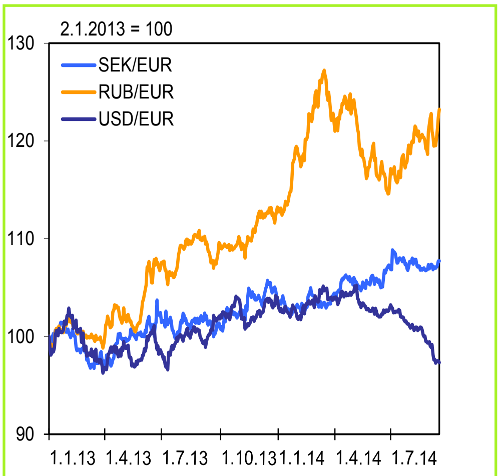
Source: BEA, BOFIT, Eurostat, IMF, Labour Institute for Economic Research

Without taking a stand on the foreign policy grounds for the sanctions, it can be said that the policy pursued would have required that the euro area is economically roughly as strong as Germany currently is. It is the European Commission's task to take responsibility for this policy and recognize its effects on the region's economic development and employment. The Commission has enthusiastically implemented the sanctions and encouraged dissenters to join the sanction front, but in the autumn it nevertheless began to reprimand those countries whose public finances are deteriorating again. It can be said that the left hand does not seem to know what the right hand is doing. At least it should try to assess the realization of targets for public deficits and indebtedness taking into account the fact that the EU's foreign policy has weakened its member countries' public finances.

ECB expands its stimulus measures

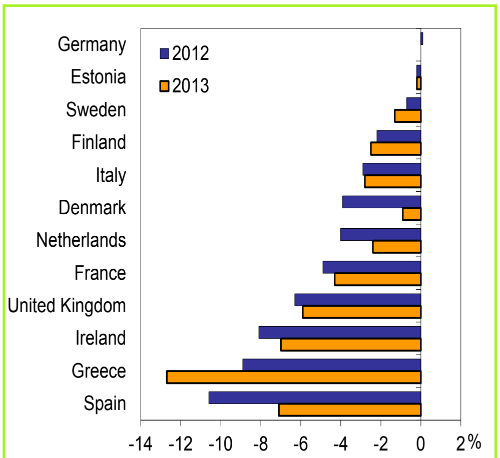
The ECB's interest rate on its main refinancing operations will no longer decline from the 0.05 per cent level, to which it was lowered on September 4th. The interest rate on its deposit facility is -0.2 per cent. Because the inflation expectations it monitors are not expected to be higher than two per cent in the near future, its key interest rates are not expected

Exchange rates 2.1.2013–15.9.2014



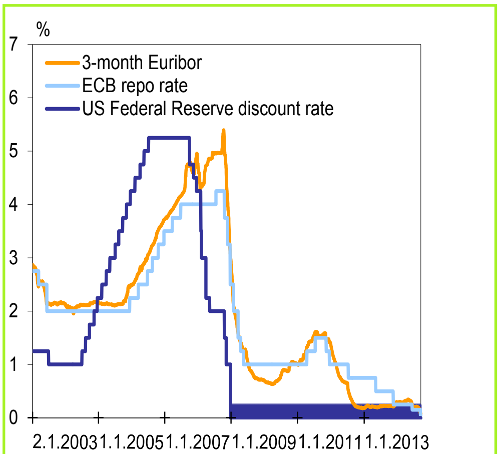
Source: ECB

Public sector deficit-to-GDP ratio in 2012 and 2013



Source: OECD

Short-term interest rates 2.1.2003–12.9.2014



Source: ECB, Bank of Finland

to be raised. The shortest-term Euribor interest rates are already below or near the rate on the main refinancing operations, and longer-term Euribor interest rates will undergo further downward pressure as the ECB takes action to increase money market liquidity in the next few months.

In September and November, the ECB shall grant a total of 400 billion euro in loans to banks for four years at an interest rate of 0.25 per cent, with more to follow in the second quarter of 2015. In October, it will start purchasing covered bonds and asset-backed securities. Together, this means the ECB's balance sheet will expand to about 1000 billion euros and thus return to the level of two years ago.

The ECB's stimulus measures will probably stem the fall in euro area bank lending. Even though to some extent the ECB requires banks to increase lending in the corporate sector in exchange for purchases of securities, the impact of the stimulus measures is reduced by the fact that it cannot take big risks, i.e. ease the burden of banks by buying their problematic loans. Banks are likely to use the ECB's four-year long-term refinancing operation loans (LTRO) to replace other short-term funding, and the stock of asset-backed securities is still very small.

The ECB's next more effective step would be to buy government bonds on the secondary market. The Governing Council of the ECB could make such a majority decision, even if its German members are opposed, and at the same time the ECB could follow President Mario Draghi's proposal to support an expansionary fiscal policy in the euro area. So far there have been no plans made for more far-reaching measures such as printing money or US government bond purchases, which would quickly weaken the euro and boost inflation. Of these measures, however, only the latter would fit the ECB's mandate, under which it has announced it will exercise all possible means.

Developed countries' government bond yields have fallen significantly this year. In summer, the yield on 10-year German bonds dipped below one per cent while Finnish bonds were close to that level. The trend in interest rates reflects the slowdown in inflation as well as the phenomenon that monetary policy is expected to be less stringent than previously anticipated in the US, Japan and the euro area. The fall in long-term interest rates nevertheless has already shown signs of coming to a halt. Next year's average will be slightly lower than this year, except in the US, where the Federal Reserve is expected to begin raising interest rates in the second half of next year at the latest.

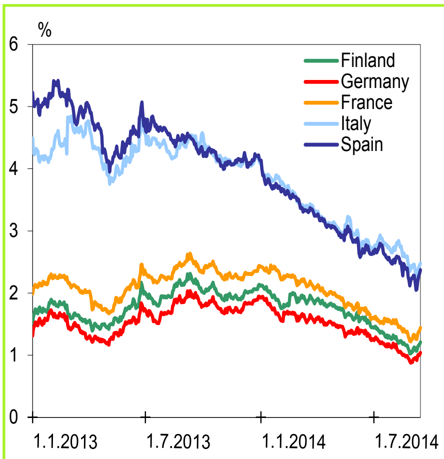
Euro area inflation will accelerate slightly

The euro area's harmonized index of consumer prices was 0.6 per cent higher in January-July than in the corresponding period last year, and the August preliminary figures shows only a 0.3 per cent increase from the year before. It is noteworthy that core inflation, excluding energy, food, alcohol and tobacco, has recently followed the general index, while it previously tended to be on a clearly lower level. Last summer, the unexpected slowdown in inflation was, however, mainly attributable to lower food and energy prices, which is likely to be temporary. The pick-up of economic growth will boost the rate of inflation, but even more important will be actions taken by the ECB, particularly if they result in a substantial depreciation of the euro. The latter is not, however, considered to be the most likely development. This year's inflation is expected to average 0.6 per cent, from which it will accelerate to 1.0 per cent next year.

Price of oil will remain above 100 dollars

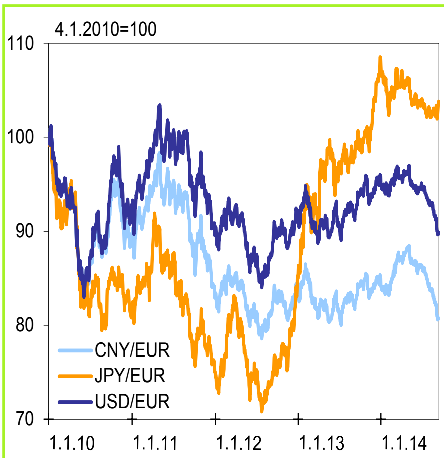
The price of oil has declined this year from last year's 109 dollar level and it has recently fallen already well under 100 dollars. The Middle

Government bond yields 1.1.2013–12.9.2014



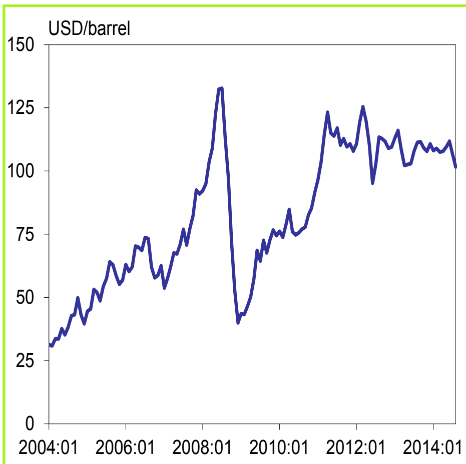
Source: Nordea

Exchange rates 4.1.2010–15.9.2014



Source: ECB

World market price of crude oil (Brent) 2004:01–2014:08



Source: Energy Information Administration

East and the Ukrainian crises have so far not raised the price of oil, but there is reason to expect that Saudi Arabia in particular will try to get it to climb above 100 dollars in the near future. The price of oil is predicted to average 106 dollars this year and 104 dollars next year. Prices of coal, many metals, agricultural products and coffee have been on a clear decline this year, but just recently the direction has no longer been as clear. Steel, beef and pulp prices have been rising for a long time. As the global economy picks up next year, the rise in raw material prices will begin to be more widespread.

Many positive signs of growth in US

Last year the United States' GDP grew by 2.2 per cent. The harsh winter dampened growth to 1.9 per cent in the first quarter, but it reached a total of 2.5 per cent growth in the second quarter. The most positive upswing has occurred in private investment. Housing investment growth has slowed this year, but business investment growth has nonetheless picked up significantly. The high figures in the Manufacturing Purchasing Manager Index are a positive sign for continued growth in industrial production. The prolonged tightening of public demand has declined and no new cutting measures are expected so far.

In the United States the unemployment rate is already at 6.1 per cent, well below the Federal Reserve's previous target of 6.5 per cent. The Federal Reserve is about to tighten its monetary policy, as it is phasing out its security purchases, but raising the interest rate from the current 0-0.25 per cent range is being delayed, because the state of the labour market is not deemed to be as positive in all respects as the unemployment rate implies. The increase of the interest rate will probably not take place until after the first half of next year. US economic growth will accelerate in the last part of the year so that growth for 2014 as a whole will be 2.5 per cent. Growth will continue to accelerate next year to 3.2 per cent.

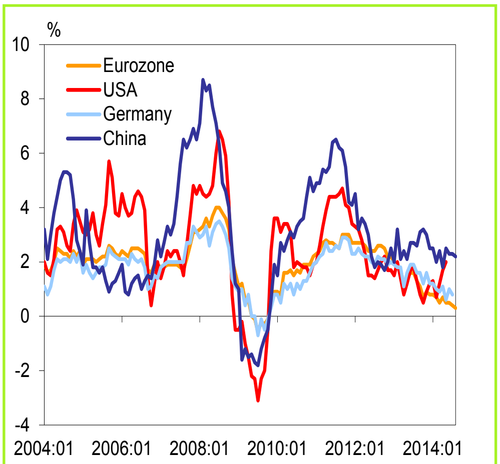
Chinese growth slowing down slightly

China's economic growth slowed slightly from last year's 7.7 per cent in the beginning of this year. In general, China has ensured that growth targets are met by implementing regulatory and stimulus measures towards the end of the year. In the future, China's economic growth may be hindered by the fact that its cost level is already relatively high compared to its southern competitors. Attempts to curb borrowing and shift it away from the regulatory control of public authorities to the grey banking sector have also slowed bank lending and industrial production. Inflation has also declined to a couple of per cent, which in turn makes room for the central bank to ease its monetary policy. China's economic growth is forecast to slow slightly to 7.5 per cent this year and next year to 7.2 per cent.

VAT hikes trigger wide swings in Japan

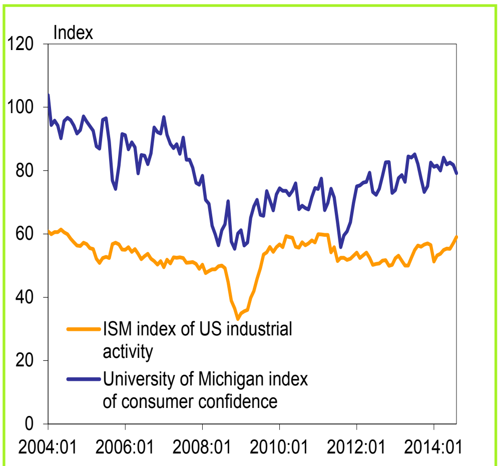
Anticipation of the VAT being raised from 5 to 8 per cent in early April boosted Japanese private demand and led to GDP growth of 3 per cent in the first quarter of this year. Demand subsequently waned and the country's GDP contracted by 0.1 per cent in the second quarter. Since inflation accelerated simultaneously, real household incomes fell, and

Inflation in assorted countries 2004:01–2014:08



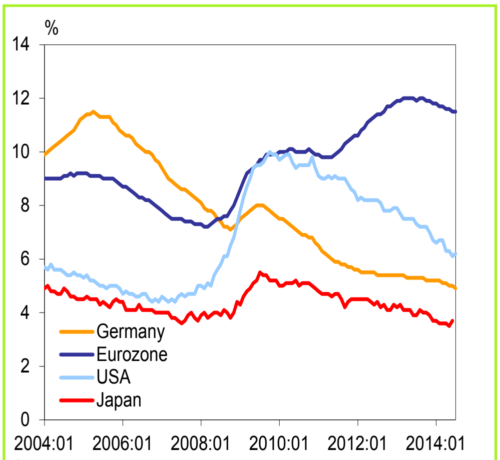
Source: Eurostat, OECD

US economic indicators 2004:01–2014:08



Source: ISM, University of Michigan

Unemployment in assorted countries 2004:01–2014:07



Source: Eurostat

they have so far not shown significant signs of improvement through nominal appreciation. The yen has been weakening sharply due to aggressive easing by the Bank of Japan. Exports and investment development are so good that Japan will reach 1.5 per cent growth this year. The same will occur next year, when a new VAT increase of two percentage points takes place in October.

Russia growth coming to a halt this year

Russia's economy grew at an almost one per cent rate during the first half of this year. Investment decreased clearly and the growth of both exports and private consumption slowed down considerably. As a result of the crisis in Ukraine, the flight of capital from the country has accelerated, which in combination with tightened sanctions will continue to harm investment in particular as well as private consumption. The central bank's measures to control inflation are not promoting economic growth either. On the other hand, the exchange rate of the rouble has depreciated sharply, which is likely to promote exports and domestic production, meaning that the economy is far from collapsing. Growth this year will be zero, and one per cent next year, providing the crisis does not escalate substantially further and lead to strong new sanctions.

Brazil's growth will slow down temporarily, India is driven by exports

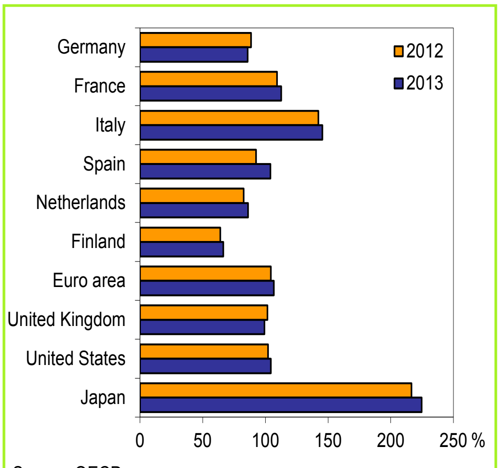
Brazil's economy slowed down during the beginning of this year, showing negative growth of 0.9 per cent in the second quarter. The exchange rate of the country's currency, the real, has supported exports, however, and most likely the uncertainty concerning the country's future economic policy will dissipate after the presidential elections in October. Brazil's growth this year will be one per cent, accelerating again next year to the level of 2013, i.e. 2.5 per cent.

The significant weakening of the Indian rupee has boosted export growth to double-digit figures since the second half of last year, while imports have declined a few per cent. This has also been reflected in the country's industrial production. Economic growth has picked up significantly to almost six per cent in the first half. Although the country's infrastructural problems are getting worse to some extent, growth may continue to accelerate, possibly exceeding six per cent next year.

Finnish exports to Russia falling – export orders nevertheless rising

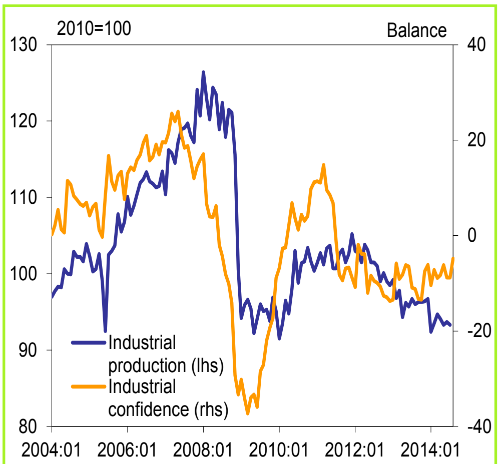
Already during January-June of this year Finnish goods exports to Russia fell by 12 per cent. The Russian counter-sanctions that came into effect in August preventing almost all food exports to Russia as well as a further decline in investment goods exports mean that Finnish exports to Russia will fall 20 per cent from last year, by about one billion euros. Finnish exports to Russia already fell last year by 6 per cent, but this year hopes were high and exports were even believed to increase to a certain extent. It can be said that this year's drop is entirely a result of the crisis in Ukraine, transmitted to the economy through sanctions and counter-sanctions. It appears that exports to Russia will continue to decline next year.

Public debt relative to GDP in 2012 and 2013



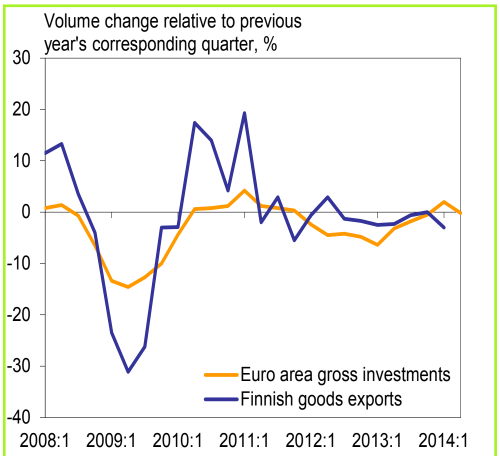
Source: OECD

Industrial confidence and industrial production in Finland 2004:01–2014:08



Source: Eurostat

Demand for investment goods and Finnish exports 2008:1–2014:2



Source: Eurostat

Rising Finnish exports to EU countries have offset the loss of Russian exports in the beginning of this year. Goods exports have increased the most in Germany and the UK: they are up by more than 30 per cent from last year in both countries. In contrast, exports to Sweden have remained at last year's level. This development is attributable to Sweden's economic slowdown and the related devaluation of the krona against the euro. Exports to North America and developing countries have mainly dropped in the first quarter. This is a result of weakening investment activity in these countries and the strengthening of the euro against the dollar up until May. Towards the end of this year the weakening of the euro will, however, strengthen Finnish exports to the euro area. The impact of the weakening euro on exports outside the monetary union is still very high. All of Finnish exports' value added is indeed generated in euros.

The Labour Institute for Economic Research predicts that Finland's goods and services exports will grow by 0.5 per cent this year. In March exports were still expected to increase by 3.5 per cent. Exports of goods will decrease somewhat, but service exports will grow by more than three per cent. It is possible that the service exports will rise even higher this year, as Statistics Finland has to take into account Nokia's unprofitable mobile operations becoming part of Microsoft in the National Accounts. After the change, the value added of these activities is based on the subsidiary's normal compensation, determined mainly by the wage bill. The economic impact of the Ukraine crisis is deemed to have an impact well into next year, which will keep next year's export growth at less than two per cent. In March the forecast figure was still 5.5 per cent.

There are great risks associated with the export forecast. Future developments depend largely on the development of the crisis in Ukraine. Next year holds the potential for significantly faster export growth than predicted, although this would require the sanctions being lifted. The preconditions for higher-than-forecast growth stem from the positive export order intake during February to August this year. While especially machinery and equipment exports have had a bumpy ride this year, mainly due to last year's poor order intake, next year machinery and equipment exports will gain new momentum from the positive order intake of this year's February - August. Exports will once again be weaker than forecast if the spiral of sanctions escalates.

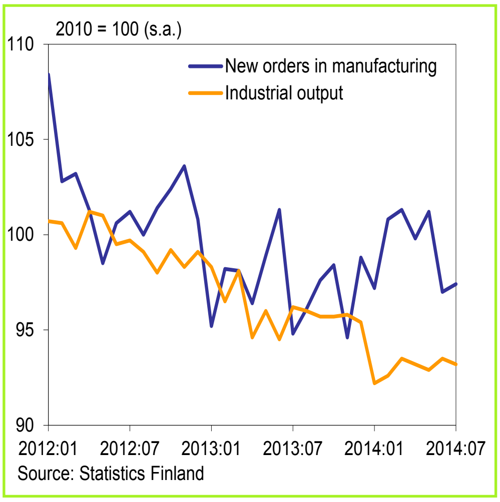
In addition to the problems of the Finnish dairy product company Valio stemming from the ban on Russian food imports, export companies providing mining equipment and mining solutions are also having a hard time. Manufacturers of wood processing and forest harvesting machinery as well as the chemical industry have been the only bright spots. Also the expanding production of the car plant in Uusikaupunki and the normalization of shipbuilding activity brought by new ship orders offer important support to our exports.

Import forecasts have also been revised downwards. Imports of goods and services are projected to grow by 0.6 per cent this year and 1.4 per cent next year. The trade deficit will increase this year by about one billion euros from last year's half a billion euros. Next year the deficit will fall a couple of hundred million euros from this year's level. The current account deficit this year is projected to be 4.1 billion euros, the same as last year. Next year it will narrow to 3.8 billion euros. The price development of the export and import of goods is relatively uniform, so that the weakening of the trade balance prevalent in recent years will no longer erode our standard of living.

Industrial production still decreasing this year

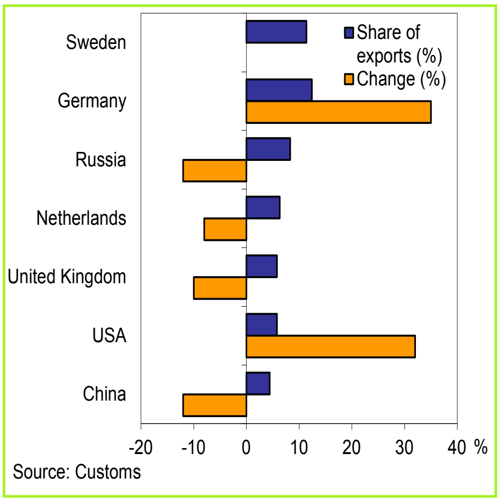
Industrial production will decrease this year by about one per cent. Next year exports will foster growth of slightly less than two per cent.

Industrial production in Finland 2012:01–2014:07



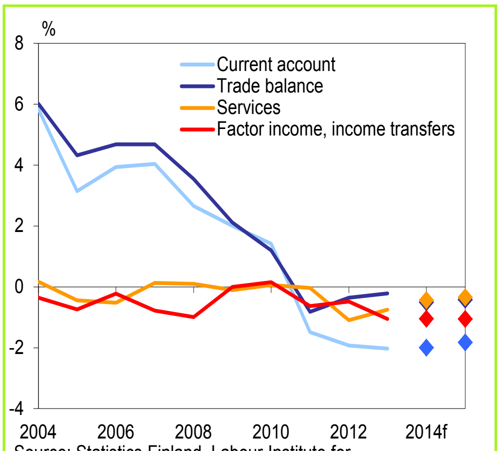
Source: Statistics Finland

Finnish merchandise exports in January–June 2014



Source: Customs

Current account surplus relative to GDP by components 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Of the main subsectors, the metal industry's situation will improve relatively the most. Construction will also decline this year due to the slump in housing construction. Next year housing construction will pick up somewhat, and because non-residential construction will continue to grow, construction as a whole will achieve two per cent growth.

Of the service industries, telecommunications will continue to grow this year and next at a 2-3 per cent rate, which is indicative of the production structure becoming more and more service-dominated. Also technical services, the output of which includes significant export deliveries, will continue to achieve moderate growth. Growth of retail sales, constrained by the poor development of purchasing power, will remain close to zero next year, whereas wholesale growth will already be swifter next year as investments are initiated. Public service output will fall this year by just under two per cent, and next year growth will be close to zero, because municipal services are hardly increasing due to the stringent fiscal policy.

Investment still falling this year

The volume of investment declined by 4.9 per cent last year. Construction investment dropped 3.6 per cent while and machinery, equipment and transport equipment investment fell by 3.1 per cent. Investments in knowhow (mainly R & D) decreased by more than 10 per cent. Total investments decreased by 6.6 per cent in the first quarter of 2014 and a further 3.5 per cent in the second quarter compared to the corresponding quarters last year. Geopolitical uncertainty and sanctions imposed against Russia weaken economic prospects, and the volume of investment is expected to continue to decline this year by a total of 2.3 per cent compared to last year. Investment is forecast to grow in 2015 by about 1.6 per cent.

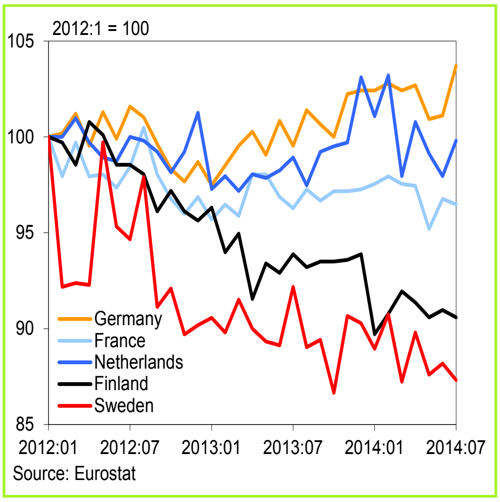
Investment in residential housing has declined significantly this year. All in all residential construction is expected to decline by 3.5 per cent this year. In 2015, however, residential investment is expected to grow by about 3.7 per cent. The turnaround will be spurred by lower interest rates on new residential housing loans and the dissipation of economic uncertainty. Investments in non-residential construction have stood out positively. They have already been growing slightly and this year's growth will be 0.5 per cent as a whole. Next year, non-residential construction will grow by 2.1 per cent. Civil enginee-

Table 2. Demand and supply

	2013	2013	2014f	2015f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	201.3	-1.2	-0.3	1.0
Imports	78.8	-2.5	0.6	1.4
Total supply	280.1	-1.6	-0.1	1.1
Exports	76.9	-1.7	0.5	1.8
Consumption	161.3	0.0	-0.1	0.5
private	111.1	-0.7	-0.3	0.6
public	50.2	1.5	0.4	0.2
Investment	42.6	-4.9	-2.3	1.6
private	34.3	-6.8	-2.9	2.1
public	8.3	3.7	0.1	-0.4
Change in stocks[1]	-0.6	0.0	0.2	0.1
Total demand	280.1	-1.6	-0.1	1.1

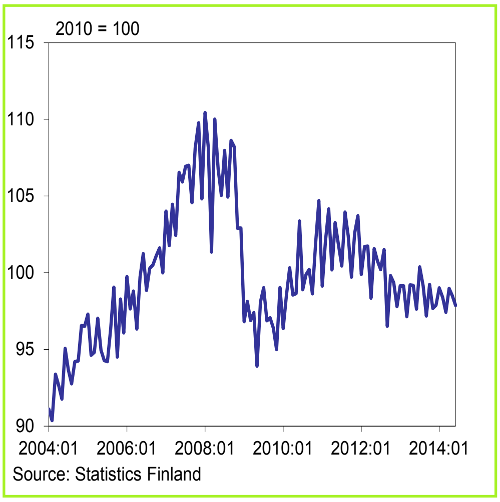
[1] *Volume change is in percentage points of GDP.*
Source: Statistics Finland, Labour Institute for Economic Research

Industrial production 2012:01–2014:07



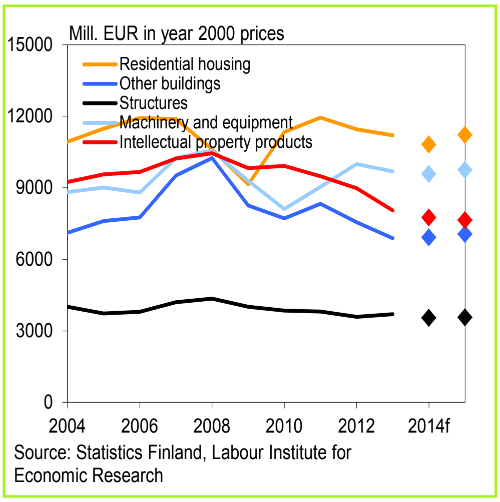
Source: Eurostat

Trend indicator of output 2004:01–2014:06



Source: Statistics Finland

Investments 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

ring construction investment is forecast to decline by 4.0 per cent this year and to increase again next year by about half a percentage point.

Machinery, equipment and transport equipment investment (including weapons systems) have fallen by more than 10 per cent in the first half of this year compared to the same period last year. Many companies currently have idle capacity, which is reflected in a decrease in new investment. For instance, wholesale trade figures suggest that the decrease in investment has come to a halt so that a decline of only about one per cent is projected for this year. Next year, this sector's investment will increase by 1.7 per cent. Investment in intellectual property products, mostly comprised of R&D investments, was down by about 1.3 per cent in the first quarter of this year compared to the same quarter last year. This investment subcategory has experienced a clear decline since 2008 and this trend is expected to continue. A 3.7 per cent decrease is forecast for 2014 while 2015 is projected to see a decline of slightly over one per cent.

Public investment will remain this year at last year's level while next year it will dip by 0.4 per cent. Private investment will in turn decline this year by 2.9 per cent, but next year it will increase already by 2.1 per cent.

Unemployment rising

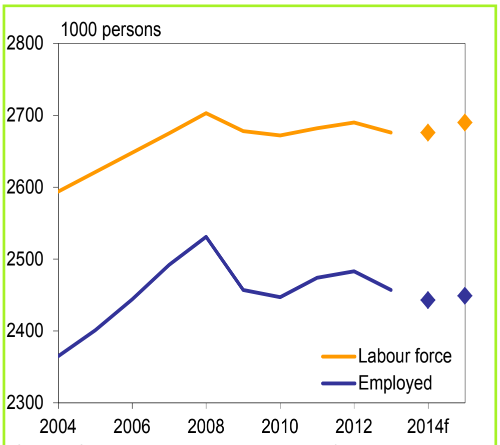
The number of employed persons decreased last year by one per cent. According to the labour force survey, employment has continued to fall during 2014 almost every month compared to one year ago with the exception of March. The poor development of production has prompted a steady but relatively moderate decline in employment this year. The average decrease in employment will be 0.6 per cent for 2014 as a whole. Next year employment will rise particularly towards the end of the year, but rather slowly, by an average of 0.2 per cent.

The labour force participation rate of the working-age population has declined in the beginning of this year with the exception of March and June, and this trend has slightly dampened the rise of unemployment. The labour force participation rate is also affected by employment and the age structure of the population. Prolonged unemployment and weak prospects cause people to refrain from active job search, and the decline in labour force participation rates smoothens out fluctuations in employment. As prospects become brighter, people return to the labour force from hidden unemployment or from outside the labour force to active job search. Due to changes in the number of employed and the labour force, the unemployment rate will rise to an average of 8.7 per cent this year and to 9 per cent next year.

The adjustment of work in the economy takes place not only via employment changes but also via the number of hours worked. Hours worked are easier to adjust than employment, for example, by cutting overtime. Typically, the number of hours worked initially declines during an economic downturn more than employment and as production starts to growth they begin to rise before the employment figures. As growth proceeds, the trend sooner or later reverses itself so that employment grows more than the number of hours worked. In 2013 the number of hours worked fell by 1.9 per cent. This year they will fall only slightly faster than employment, i.e. by 0.7 per cent. Next year the number of hours worked will in turn increase slightly faster than employment, i.e. by 0.6 per cent.

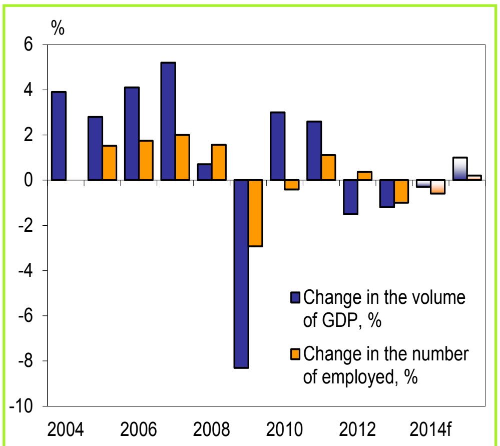
Economic growth and decline were also reflected on the economy-wide productivity growth. Productivity growth has been relatively weak by historical standards since 2008, and in some years productivity has actually fallen. Last year, productivity grew by only 0.7 per cent. This year the 0.3 per cent decline in GDP and 0.7 per cent fall in the number of hours worked means productivity will grow by only 0.4 per cent. Next year productivity will increase by the same amount.

Supply of labour and employment 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

GDP and employment 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Unemployment rate 2004–2015

Source: Statistics Finland, Labour Institute for Economic Research

Unit labour costs measure the cost of labour inputs needed to manufacture one unit of a product relative to a certain base year. Unit labour costs rise when the cost of labour inputs increases proportionally more than productivity. Finnish manufacturing unit labour costs have risen quite sharply after 2010. This is partly due to the weakening of labour productivity in 2011 and 2012. Last year manufacturing unit labour costs nevertheless rose by just 1.2 per cent. The labour cost index also shows that manufacturing labour costs even declined during the second half of 2013. In the first two quarters of this year they have nevertheless started to rise once again.

Subdued inflation will accelerate slightly next year

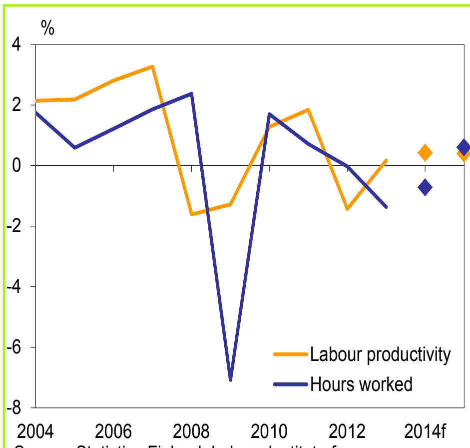
The increase in Finnish consumer prices compared with the same month a year ago was half as high in July as it was in January, when it was 1.6 per cent. In the beginning of this year the average inflation rate was 1.1 per cent. The surprisingly steep deceleration stemmed largely from the halt in the rise of food prices from last year's rate of 6.2 per cent. There was even a decrease in the subcategory of transportation. By contrast, there was a slight acceleration from 0.3 per cent to 1.1 per cent in the largest subcategory of housing, which has a share of around 22 per cent. The average rate of inflation is forecast to be 0.9 per cent for 2014 as a whole. In 2015 as a result of the rise in world market prices and tax increases, the rise in food, housing and transport prices is forecast to accelerate so that the rate of inflation will be 1.3 per cent.

Table 3. Key forecasts

	2013	2014f	2015f
Unemployment rate (%)	8.2	8.7	9.0
Unemployed (1 000)	219	233	241
Employed (1 000)	2457	2443	2449
Employment rate (%)	68.5	68.3	68.6
Inflation, consumer price index (%)	1.5	0.9	1.3
Wages, index of wage and salary earnings (%)	2.2	1.3	1.2
Real disposable income of households (%)	-0.6	-0.4	0.4
Current account surplus (Bill. €)	-4.1	-4.1	-3.8
Trade surplus (Bill. €)	-0.4	-1.0	-0.9
Central government financial surplus			
Bill. €	-7.0	-7.1	-6.1
% / GDP	-3.5	-3.5	-2.9
General government financial surplus			
Bill. €	-4.7	-5.2	-4.1
% / GDP	-2.3	-2.5	-2.0
EDP debt			
% / GDP	56.2	58.8	59.8
Tax rate (%)	44.0	44.7	45.1
Short-term interest rates (3-month Euribor)	0.2	0.2	0.1
Long-term interest rates (10-year gov't bonds)	1.9	1.4	1.0

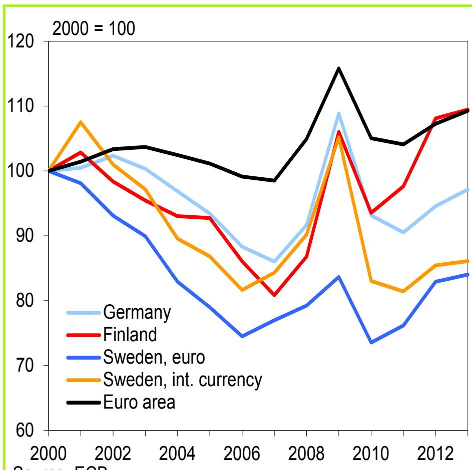
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Change in labour productivity and hours worked 2004–2015



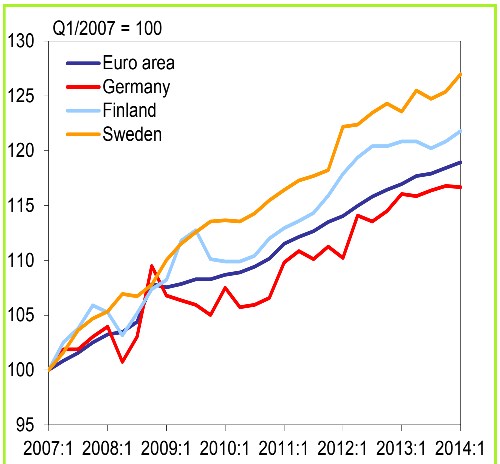
Source: Statistics Finland, Labour Institute for Economic Research

Manufacturing unit labour costs 2000–2013



Source: ECB

Labour cost index (manufacturing) 2007:1–2014:1



Source: Eurostat

A rather exceptional phenomenon is that the rate of increase in rents accelerated in recent months as much as 3.3 per cent (January-July to 3.0 per cent), while owner-occupied housing costs fell in January-July by 1.5 per cent. The rise in taxes and costs will be reflected in rent next year, too, but the owner-occupied housing costs will decline in line with lower market interest rates and narrower bank margins. Since the private consumption price index used in the National Accounts takes into account only the rent but not owner-occupied housing, this means there will be a considerable difference between it and the consumer price index. Last year the gap widened to 1.1 percentage points, but this year and next it will narrow to 0.7 and 0.8 percentage points, respectively.

Sluggish inflation bolsters real earnings

In the first half of this year earnings rose by 1.4 per cent compared to the corresponding period a year earlier. Wage growth has slowed as earnings rose by 2.1 per cent last year. In the beginning of this year earnings improved the most in the private sector (1.7 per cent) and the least in the municipal sector (0.7 per cent), reflecting the different timing of contract wage increases in different sectors.

Wage trends are determined by last autumn's centralized collective agreement, which covers a wide range of sectors' employees and is aimed toward employment-friendly wage restraint. The Pact for Employment and Growth covers a total of about 93 per cent of employees, but the settlements of non-participating sectors are largely similar to the above-mentioned pact in terms of their cost effects.

The pact is divided into two periods, the first of which lasts about two years on average. This year there was an increase of 20 euros per month or an equivalent hourly wage change. It takes place within four months after the beginning of each sector's collective agreement. Despite the low contract wage increases, wage drift is likely to remain modest owing to the weak labour market situation. Average earnings are expected to rise this year by 1.3 per cent. Even this year, real wages will rise moderately, i.e. by 0.4 per cent, since inflation has also clearly slowed down.

The second wage increase of the pact will take place mainly next year. The second increase is 0.4 per cent, and it will come into force one year after the first increase. Next year, earnings are expected to rise by an average of 1.2 per cent. Real earnings will begin to decline as next year's inflation rate accelerates slightly compared to this year.

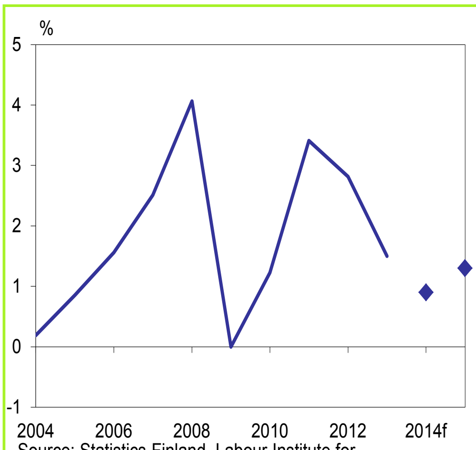
Average earnings will increase in all sectors slightly more rapidly than earnings, and this trend is expected to continue throughout the forecast period. Changes in the occupational structure, particularly in the public sector towards high paying professions, partly explains the faster rise in average earnings.

Growth of household purchasing power will continue to be slow

Households' real purchasing power declined last year by 0.6 per cent as it did the previous year, and the development of purchasing power will continue to be sluggish during the forecast period. The modest growth in wages and salaries and increased taxation are the main factors determining this development. The decline in inflation has, however, dampened the effects of weak income growth on consumption possibilities.

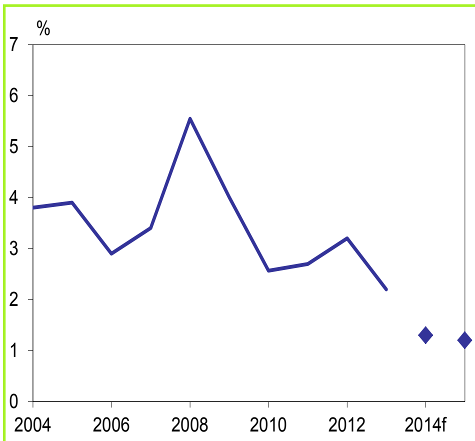
The wage bill is estimated to grow by only 0.7 per cent this year as the rise in earnings has slowed down and labour input has decreased. Pension income will continue to grow at a slower pace than last year, although it will still clearly outstrip the rise of wage and salary income.

Change in consumer prices 2004–2015



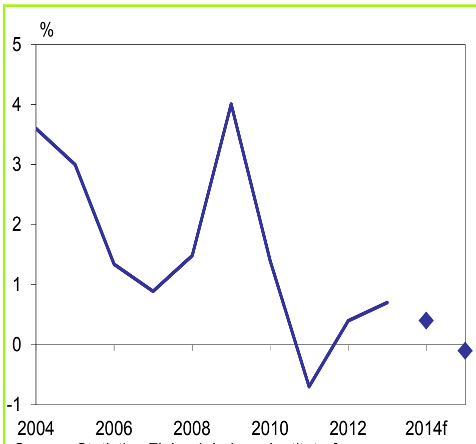
Source: Statistics Finland, Labour Institute for Economic Research

Change in level of earnings index 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Change in level of real earnings 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Growth of pension income will be dampened by smaller index increases in line with lower inflation, but the number of pensioners will continue to grow over the forecast period due to the population structure. The rise in unemployment will mean that other current transfers will increase clearly. Property and entrepreneurial income will increase this year by a total of about two per cent and next year a little faster, i.e. 3 per cent.

Hikes in taxation and the increase of employee pension contributions by 0.4 percentage points will cut purchasing power. Central government income taxes have been adjusted for inflation, but the average municipal tax rate increase is approximately 0.4 percentage points. Direct taxes paid by households are expected to grow by 4 per cent.

All in all, household nominal income will grow 1.2 per cent this year. Real purchasing power is nevertheless expected to contract this year by 0.4 per cent, which is slightly less than last year. The price index used in this assessment is the price deflator for private consumption according to the National Accounts. Accordingly, its price will rise more (1.6 per cent this year) than the rise indicated by the consumer price index (0.9 per cent) owing to the different handling of housing costs.

Next year, however, aggregate real household purchasing power is estimated to increase slightly. This upturn is attributable to labour inputs returning to a growth path, the continued rise of retirement income as well as a slight recovery of property and entrepreneurial income. The growth of the wage bill will strengthen to 1.9 per cent, as average earnings are expected to rise at approximately this year's rate of 1.3 per cent and the working hours of employees are expected to increase by 0.6 per cent. The growth rate of pension income will remain nearly four per cent. The development of purchasing power will nevertheless be dampened by a moderate increase in the tax burden, mainly due to the anticipated rise in municipal taxation and increase in employee pension contributions. In turn, central government income tax will be adjusted for inflation, which affects the vast majority of income earners. An increase in the pension income deduction and the introduction of child deductions will likewise reduce taxation. Households' nominal income will rise 2.5 per cent. The rate of inflation according to the private consumption price index is forecast to be 2.1 per cent, so real purchasing power will grow by 0.4 per cent.

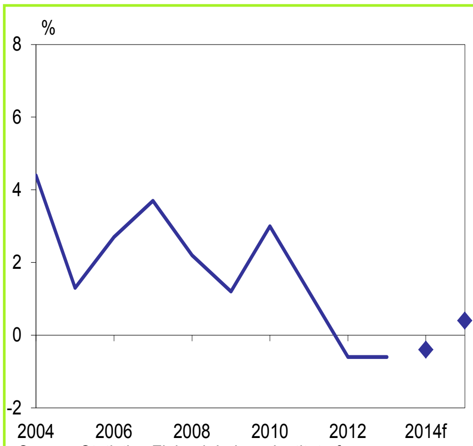
Prospects for private consumption are weak as purchasing power remains stagnant

Private consumption fell last year by 0.7 per cent. The decline was attributable to the prolonged modest growth of household income and the reform of the Finnish Broadcasting Company's funding, which reduced private consumption expenditure and increased government consumption expenditure by about half a billion euros. Consumption of durable goods remained unchanged as other subcategories of consumption (non-durable, semi-durable and services) fell. In the first half of this year consumption of durable goods slightly exceeded the level of the corresponding period last year, but other subcategories of consumption decreased.

Consumption will fall by 0.3 per cent this year in the wake of the slight weakening of real household income. This year has been marked by fluctuations in consumer confidence reflecting their uncertainty. Consumer confidence has nevertheless remained below its long-term average, and also the consumer sentiment indicates that consumers will remain cautious as incomes growth is fairly limited. The saving ratio is expected to be 1.3 per cent, only slightly lower than last year.

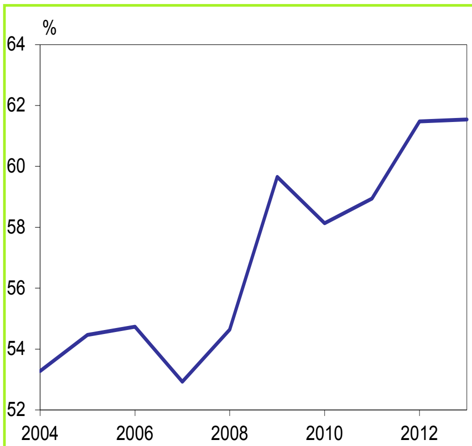
Private consumption is expected to decline in the beginning of next year, when real household income growth picks up a little and the revival

Change in households' real disposable income 2004–2015



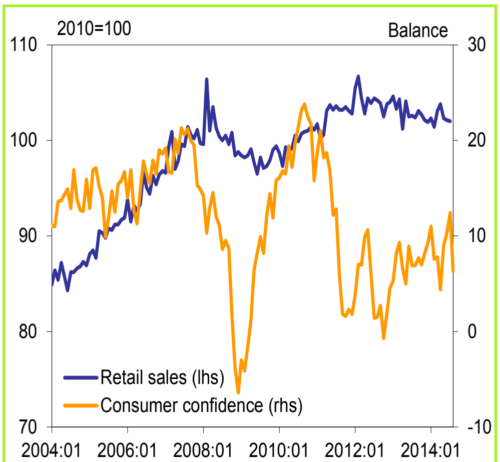
Source: Statistics Finland, Labour Institute for Economic Research

Functional distribution of income in business activities 2004–2013



Source: Statistics Finland, Labour Institute for Economic Research

Consumer confidence and retail sales in Finland 2004:01–2014:08



Source: Eurostat

of economic growth bolsters overall consumer confidence. The slump in consumption during the previous two years will also increase the need for consumption and purchasing demand. Private consumption is thus expected to increase a little more strongly than real income. Consumption will increase next year by 0.6 per cent as the saving ratio dips to 1.1 per cent.

Improvement of central government financial position delayed

Indirect taxes were raised at the beginning of this year. Taxes on alcohol, tobacco, soft drinks, candy and ice cream were increased at the same time as energy taxes were raised. Indirect taxes have been continuously increased since 2010. Thus, the central government's indirect tax receipts are projected to grow by 3 per cent this year, despite the fact that the volume of private consumption will decrease at the same time.

On the basis of decisions taken in August, taxes on tobacco, candy and energy will still rise next year. These increases are expected to increase government tax revenues by a total of approximately 370 million euros. At the same time, the motor vehicle tax will be increased, the fiscal impact of which is estimated to be 180 million euros on an annual basis. The modest recovery of private consumption in conjunction with tax increases will increase the central government's indirect tax revenues by a total of 3.5 per cent next year.

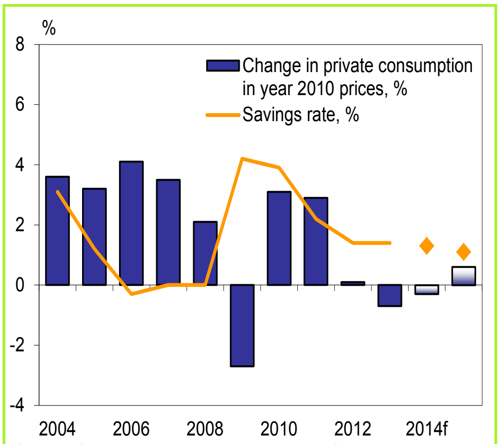
The government made inflation adjustments to the income tax scales this year, which will effectively keep the central government's income tax rates at last year's level. The greatest change in the tax base during the government's entire term in office, the lowering of the corporate tax rate by 4.5 percentage points, went into effect at the beginning of this year. The static effect will lower central government tax revenues by 870 million euros. The aim is that the dynamic effects of the tax relief will cushion this fall – if not immediately, then at least in the long term. The dynamic effects are nevertheless difficult to assess.

At the same time another tax change was implemented in the other direction – also relatively significant – when the share of dividend income from listed companies subject to tax was raised from 70 per cent to 85 per cent. At the beginning of this year some smaller changes were also made in the tax base as the tax deductibility of business entertainment expenses as well as R & D expenditure was eliminated and the tax deduction for enterprises' interest expenses was decreased. Many wage earners were again affected by the cut in tax deduction for interest on housing loans by a further 5 percentage points this year. The latter changes will have a positive impact on the central government's direct tax revenue. The lowering of the corporate tax rate and the expected slow growth in the wage bill nevertheless carry the most weight so the central government's direct tax revenues are projected to decline by 0.3 per cent this year.

Next year, inflation adjustments will be made to the income thresholds of the three lowest marginal tax brackets of the central government's income tax scales. Consequently, income tax rates will remain unchanged for most wage earners. At the same time, however, the threshold for the top marginal tax bracket of the tax scales will be reduced. Capital income taxation will be increased so that the higher tax rate will be raised by two percentage points and the threshold for the higher tax rate will be reduced. In addition, there will be small increases in the basic and earned income deductions. The tax rates in the inheritance and gift tax scales will also be raised by one percentage point. As a result of all these tax changes and the slight acceleration of growth in the wage bill, direct central government tax revenues are projected to grow by 4.1 per cent next year.

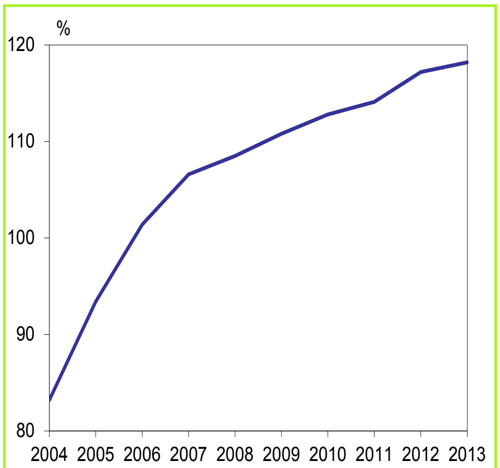
The central government's consumption expenditure is growing very moderately in the forecast period. In particular, next year's spending limit is

Private consumption and savings rate 2004–2015



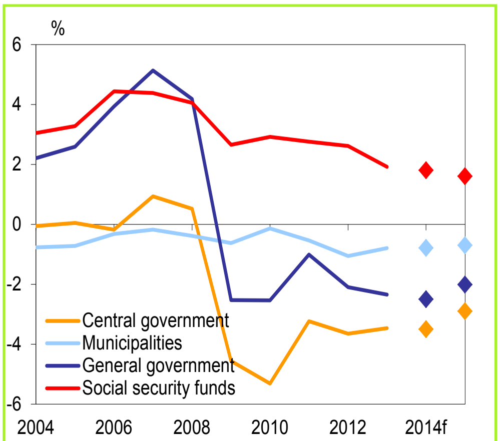
Source: Statistics Finland, Labour Institute for Economic Research

Household debt ratio 2004–2013



Source: Statistics Finland

General government financial surplus as percentage of GDP 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

tight. Pressure on the expenditure side is reduced by the continuation of the decline in interest rates on government bonds, but on the other hand among other things the EU's net payments will increase during the forecast period. The central government's expenditures will nevertheless be curbed the most by cuts in revenue sharing with municipalities, which will be made during both forecast years. All in all, the central government's financial position will weaken slightly, and a deficit of 7.1 billion euros is forecast for this year. Next year the deficit is predicted to decrease to 6.1 billion euros.

Municipal financial situation remains tight

The government expects a lot from reforms of municipal service tasks and development of productivity. Meanwhile, the municipal reform is proceeding with difficulty. The combination of cuts in central government revenue sharing and the deep recession are causing difficulties for many municipalities.

This year the municipal tax rate will rise by an average of 0.36 percentage points, and the same trend can be expected to continue next year. The Labour Institute for Economic Research predicts that next year the municipal tax rate will rise by an average of 0.2 percentage points. In addition, municipalities will seek to raise their property tax rates to cope with the financial situation. Municipalities will get some relief as the central government compensates them for tax revenue losses this year stemming from the lowering of the corporate tax rate. Modest wage and salary growth in combination with tax increases will generate a 2.4 per cent increase in direct tax revenues for municipalities this year. The improvement in the economy will boost the growth of municipalities' direct tax revenues next year, when tax revenues are projected to grow by 3.5 per cent.

The moderate wage pact will help municipalities to save: municipal consumption expenditure is projected to rise by 1.9 per cent in both forecast years. This is clearly less than the trend of consumption expenditure in recent years. From the standpoint of the future development of expenditures, a crucial factor is how cutbacks are made in provision of municipal service tasks. All in all, municipalities' total deficit is forecast to be 1.6 billion euros this year, i.e. just as high as it was last year. Next year the municipal government deficit is projected to decline slightly to 1.5 billion euros.

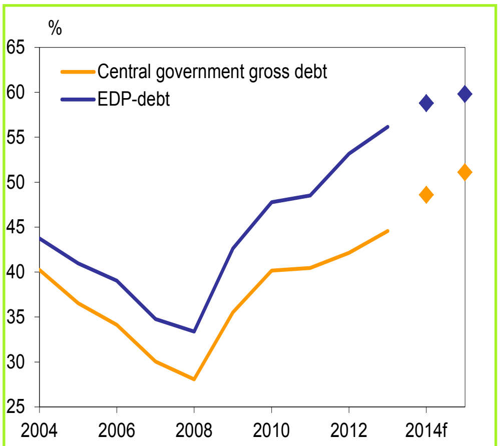
Pension contributions by both employers and employees rose this year by 0.4 percentage points. This shows up positively in the revenues of employment pension institutions and smoothens out the otherwise poor development of the wage bill this year. Next year earnings-related pension contributions will increase by half as much, which is consistent with the earlier agreement. All in all, the revenues of employment pension institutions will develop steadily, but at the same time the rising number of retiring baby boomers will reduce their surplus in the forecast period. This will be the case despite the fact that lower inflation will reduce index adjustments.

Financial position of general government will get weaker before it gets stronger

Corporate tax cuts do not change the big picture that the tax burden is increasing this year. In particular, increases in indirect taxes will boost total tax revenues as a percentage of GDP. The tax-to-GDP ratio will rise from 44.0 per cent this year to 44.7 per cent. The tax-to-GDP ratio will rise in line with indirect tax increases next year as well, albeit more moderately. Next year's tax-to-GDP ratio is forecast to be 45.1 per cent.

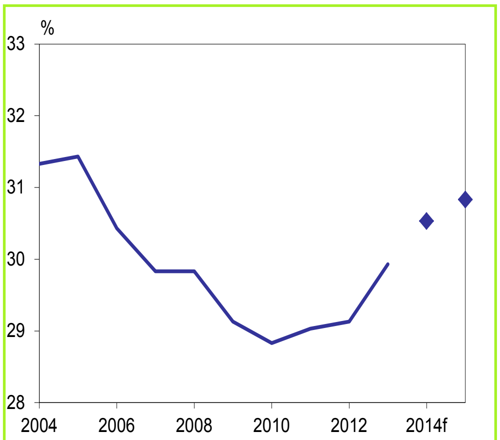
The economic slump is reflected in the fact that the public expenditure ratio (total public expenditure in relation to GDP) will continue to

Central government gross debt and general government EDP-debt as percentage of GDP 2004–2015



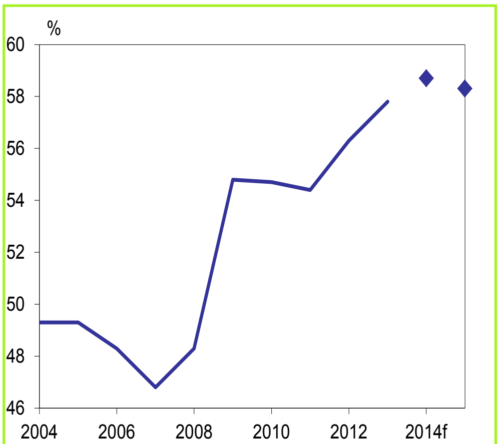
Source: Statistics Finland, Ministry of Finance, Labour Institute for Economic Research

Wage earners' income tax rate 2004–2015



Source: Labour Institute for Economic Research, Taxpayers' Association of Finland (TAF), VATT

Public expenditures as percentage of GDP 2004–2015



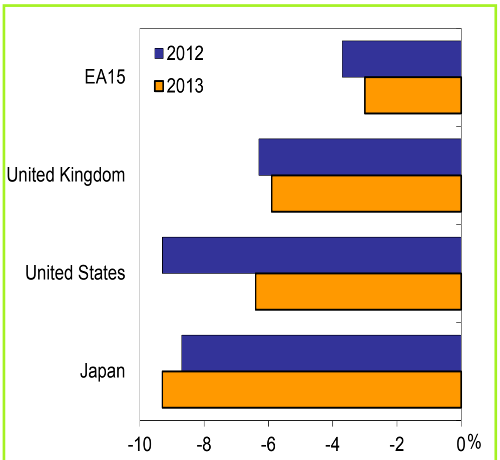
Source: Statistics Finland, Labour Institute for Economic Research

rise this year despite the tightness of spending in all public finances. The public expenditure ratio is thus expected to be 58.7 per cent this year, while last year it was still 57.8 per cent. Next year the upturn in the economy in conjunction with tight spending means that the public expenditure ratio will decrease to 58.3 per cent.

The total public sector's deficit will grow this year, mainly due to a reduction in the surplus of pension institutions, but the central government's deficit will also widen slightly. Next year, the public sector deficit will already fall, which in turn is a result particularly of the improved central government budget balance. All in all, the overall public sector deficit (EDP deficit) relative to GDP will decline from last year's 2.3 per cent to 2.5 per cent this year. Next year the deficit will subside slightly to 2.0 per cent of GDP. When evaluating these figures it is worth remembering that in conjunction with National Accounts reforms (ESA 2010), the swap-adjustment of government interest expenditure has been removed from the definition of the EDP deficit, which will increase the public sector deficit-to-GDP ratio by about 0.3 percentage points each year.

Government debt as a percentage of GDP will rise in both forecast years. The same is also true of the general government debt (EDP debt). ESA 2010 reforms will nevertheless change the figures for public debt as well as GDP. At the moment, it appears that the statistical reform will lower the Finnish EDP debt-to-GDP ratio, since the debt level is likely to be revised upwards less than GDP levels are corrected. Final information on the amount of the debt calculated using the new method will be available at the end of September. According to our forecast, the public debt-to-GDP ratio will remain next year just below the 60 per cent ceiling stipulated by the Stability and Growth Pact.

Public sector deficit-to-GDP ratio in 2012 and 2013



Source: OECD

Economic policy

Based on the slowdown in the growth of government consumption, Finland's fiscal policy is deemed to be more stringent this year than last year, and next year it will be tighter than this year. The ratio of taxes to GDP will rise this year and next year compared to last year, which also indicates a tightening of fiscal policy.

Public investment will not increase appreciably this year, and next year it will even decline. In this case, too, fiscal policy is mainly aimed at the strengthening the public sector's financial position at the expense of employment. The impact of the government's package announced in June providing for an increase in residential building and transportation construction worth 370 million euros is remaining small. These additional investments will not be carried out until the period 2015- 2018, which is too late. To the extent that the decisions extend to the term of the next government, they cannot be considered very binding. For example, 240 million euro earmarked by the central government for the western metro does not have to be paid until 2017 at the earliest.

The government has had little room for manoeuvre in investments as it has stuck to its spending limits, which also included investments. It would be better to separate investments from the central government spending limits and the planned limits for municipalities, which would make it easier to carry out counter-cyclical measures in the form of public investment projects that support long-term growth. Right now this would have been necessary.

Assessing the impact of the Ukraine crisis creates additional problems for the conduct of fiscal policy. Now that Finland's economic situation has deteriorated again, it is evident that the Ministry of Finance has raised its estimate of Finland's structural deficit from 0.7 per cent to well over one per cent. Since the official estimate assumes that the effects of the crisis in Ukraine have been and probably will be marginal, any further weakening of public finances can be interpreted as the result of structural economic shortcomings. This gives, for example, the European Commission, grounds to require additional savings in public expenditure. It is obvious that the threat of a downgrading of Finland's credit rating will be used to hasten the implementation of these demands.

Facilitating structural economic reforms in a way that promotes overall productivity should be the goal of all governments at all times. There are nevertheless few reforms actually supporting growth and well-being in the long term that can also be decided at the political level.

Structural reforms have been justified by the Ministry of Finance estimates that the sustainability gap in Finland's public finances is 3-4.5 per cent of GDP. Since the sustainability gap estimates are very uncertain and change all the time in line with the cyclical situation, policy for the coming years cannot be handcuffed by policy programmes based on current sustainability gap estimates.

Any estimate of Finland's public finances sustainability gap is very sensitive to how the Finnish economy's potential is assessed at the point of departure, i.e. right now. If the euro area debt crisis does not escalate further and trade relations with Russia are normalized, Finland's sustainability gap is probably only a few per cent of GDP. The official estimate of the sustainability gap is reduced by the fact that careers are becoming longer in the current pension system than in previous estimates. This is indicated by the results obtained by Statistics Finland in its Working Conditions Survey, which found a great willingness to continue working above 63 years of age, and data reported by the Labour Force Survey regarding a substantial rise in employment rates for age groups 55-64 and 65-74 year olds. In this year's second quarter, the employment rate rose to a record level for the age group of 55-64 year olds, and almost to a record level for 65-74 year olds, while employment has declined in other age groups steadily since 2011.

The already occurred prolongation of working careers should be taken into account in connection with pension system reforms. The system should continue to be flexible so that the retirement age can move within a broad age range. In order to really promote longer working careers, working life should be developed in a way that continuing to work is appealing.

In order to strengthen Finland's public finances in the longer term, the social and health care reforms now being considered should be carried out at least on schedule. To ensure cost savings, the system should be centralized and overlapping activities eliminated in both government and self-service production. In conjunction with the social and health care reforms authorities could consider changing the funding structure of services. Shifting the emphasis from the local to central government would increase efficiency. Creation of metropolitan governments for the greater Helsinki area, Tampere and Turku is far more important in making regional administration more efficient than revamping the rural municipal structure. ■