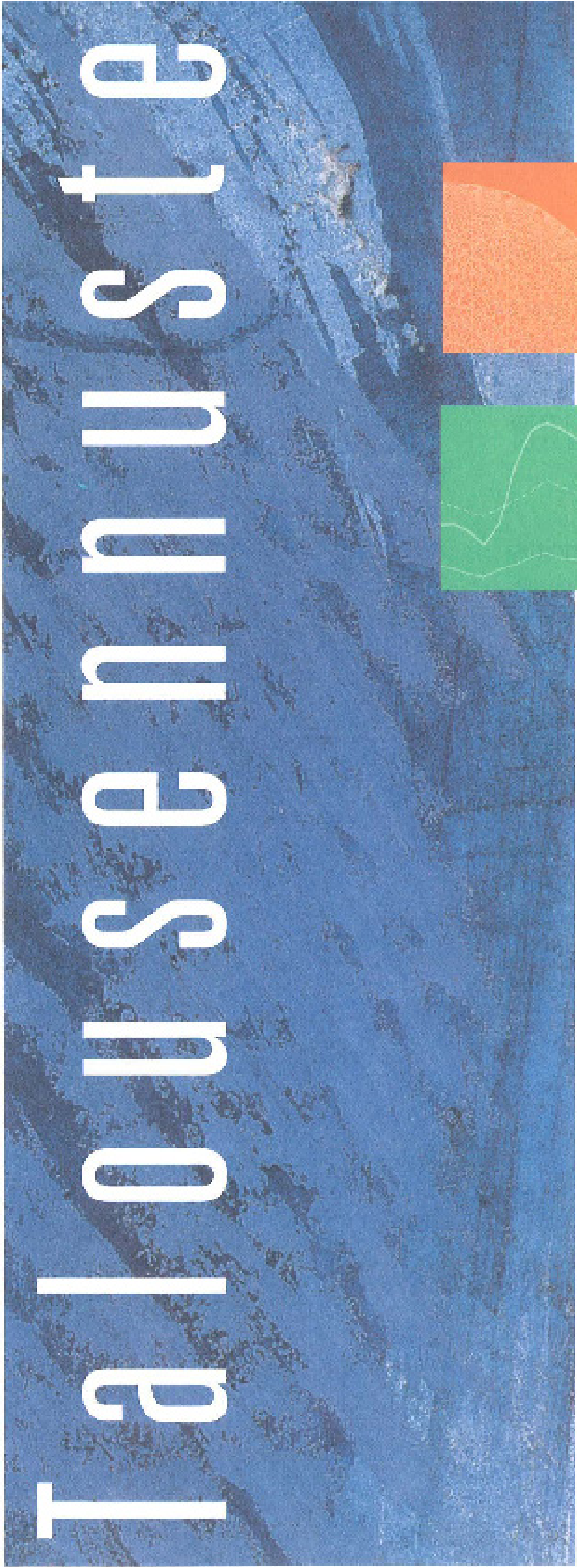

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Economic Forecast
2015–2016

New clouds over Finnish economy – domestic policy near a dead end

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LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2015–2016

New clouds over Finnish economy – domestic policy near a dead end

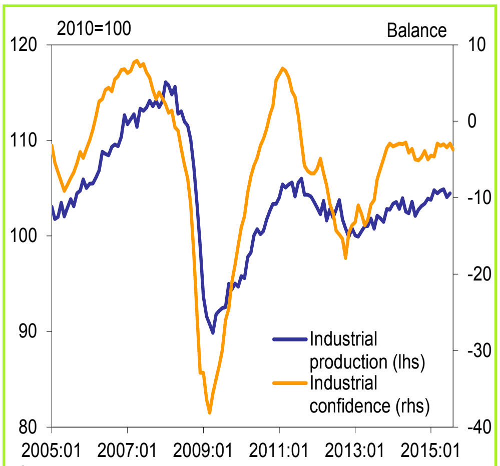
During the first half of this year Finland's GDP has remained on average at the same level as last year. In the second quarter, GDP grew by 0.2 per cent from the previous quarter. Elsewhere in Europe, GDP is growing much faster. The weaker economic growth in Finland relative to the rest of Europe is largely due to the steep plunge in exports to Russia. The economy will start to grow already in the second half of this year, but very slowly. Growth will be fuelled by the upswing in construction and services. The end of production shutdowns for maintenance in industry and the introduction of new capacity will boost growth.

The Labour Institute forecasts that Finnish GDP will grow this year by 0.4 per cent and next year by 1.2 per cent compared to the previous year. Next year also industry and exports will contribute to economic growth. The acceleration of European economic growth will have a positive impact on the Finnish economy at that time. A tight fiscal policy will not leave much leeway for significant growth in consumption in Finland, but investment will pick up as construction stages an upturn. In the international economy, China's incipient economic problems, as well as the difficult situation of the Russian economy and the rouble exchange rate are the major sources of uncertainty.

Finland's economy is overshadowed by the deadlocked situation in the labour market. The government's plans to restrict freedom of contract and the weakening of collective agreements have already led to a labour dispute, and the situation only threatens to grow worse next year. If the new legislation is adopted as the basis for new collective agreements, wage demands will rise. This may have dire consequences for collective bargaining at the end of next year and in early 2017. Production losses might be high. The possibility of social unrest also causes uncertainty, which is reflected in the wider economy.

A more moderate policy than the radical one proposed would ultimately be better for the entire economy. According to this alternative scenario, we would expect Finland's cost competitiveness to improve relative to competitor countries if wage increases are smaller than elsewhere for several years in a row. Analysis of the situation in the Finnish economy supports such a strategy: Finland's cost competitiveness is nonetheless fairly good, and the negative effects of the shocks will fade and even turn positive within a few years.

Industrial conficence and industrial production in euro area 2005:01–2015:08



Source: Eurostat

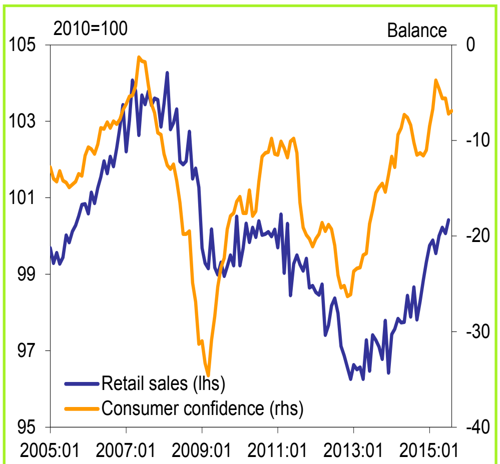
EU countries' growth strengthening

GDP of the EU countries increased by 1.4 per cent in 2014. The euro area grew by just under one per cent. Growth has nevertheless stabilized and has even gained momentum this year. In the first half of 2015 the GDP of the EU countries rose by around 1.8 per cent from that of the previous year. Euro area growth already amounted to approximately 1.3 per cent.

The favourable development of private consumption and exports has fuelled the growth of the EU countries in the first quarter 2015. The fact that government consumption is already much more than one per cent higher than a year earlier indicates that the stringent fiscal policy has already been partially eased in Europe. Investment has also been recovering, but its rate of growth fell in the second quarter of this year compared to the previous quarter.

The EU countries experiencing the fastest growth are new member states whose GDP is still well below that of the old ones. Economic growth has been relatively high also in Spain, which is recovering from a deep recession, as well as in Sweden and Great Britain, whose growth

Consumer confidence and retail sales in euro area 2005:01–2015:08



Source: Eurostat

has relied on the strengthening of domestic demand in addition to foreign trade. The slowest growth has been in France, Italy and Austria. During the past year, economic growth has accelerated considerably in many of the socalled crisis countries such as Spain, Italy, Greece and Portugal.

The Labour Institute forecasts that the GDP of the EU countries will grow 1.8 per cent this year and 2.1 per cent next year. Correspondingly, the euro area's GDP will grow during these years by 1.5 per cent and 1.9 per cent, respectively. In the euro area private consumption will grow by 1.6 per cent this year and two per cent next year. Investment will likewise pick up next year. As the growth of public consumption reaches at least one per cent in both years, it can be said that for the first time in a long time domestic demand will spur growth.

The GDP of Finland's main export countries will grow relatively quickly, e.g. in Germany by 1.6 per cent this year and 2.0 per cent next year and in Sweden by 2.8 and 3.1 per cent, respectively. Sweden has in recent times been considered something of a model country from which Finland should take lessons. The most significant factors that explain the faster growth in Sweden in relation to Finland during the past year are Sweden's own independent monetary policy, a more expansive fiscal policy than that followed by Finland and the minor role of Russia in its exports.

Interest rates and inflation near zero in euro area

The average change in the euro area's harmonized index of consumer prices this year in January–August was exactly zero, but due to the fading of the impact of lower oil prices and the growing impact of the weakening of the euro inflation will accelerate toward the end of the year and end up being 0.2 per cent for the year as a whole. Next year already inflation will climb to about one per cent. Inflation expectations imputed from market interest rates and the European Central Bank's own forecasts suggest that inflation will not accelerate for a long time close enough to two per cent that the ECB would begin to raise its key interest rate from the current 0.05 per cent level.

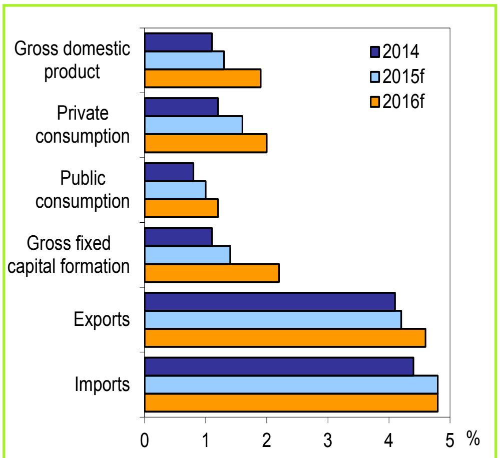
As inflationary pressures remain well under control and the euro area's debt problems have subsided at least so far into the background, mild upward pressure on the interest rates of euro countries' government bonds will only come from US interest rate policy. The start of interest rates hikes will also exert pressure for the weakening of the euro against the dollar, but the improvement in the euro area's growth outlook will have the opposite effect. The euro exchange rate is expected to remain at approximately this year's average level (USD 1.11) next year.

Last March, the ECB began to buy securities, mainly government bonds, worth about 60 billion euros on a monthly basis. In assessing the results of the purchase programme at its meeting on September 3rd, 2015, the ECB's Governing Council decided to ease its terms, as a result of which the cumulative sum of the purchases could rise to about 300 billion euros a year. The rationale for the decision was weaker-than-expected economic growth and low inflation. The ECB's actions have indeed spurred an increase in euro area bank lending to the private sector, but the effects have so far been so modest that the central bank may still decide on new stimulus measures this autumn. The ECB may nevertheless begin to encounter difficulties in finding enough bonds suitable for these operations.

World trade growth at a standstill

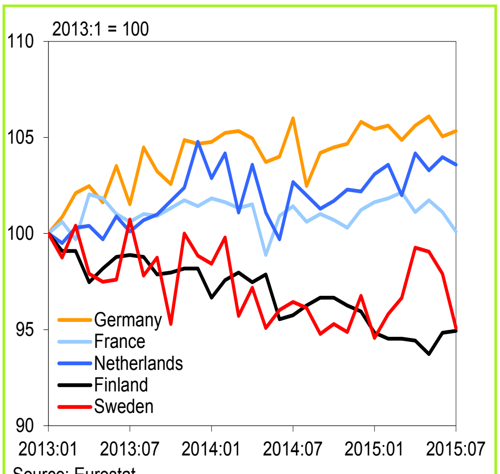
The volume of world trade volume decreased in the first quarter of this year from the previous quarter by 1.5 per cent and by 0.5 per cent in

Eurozone economic growth 2014–2016



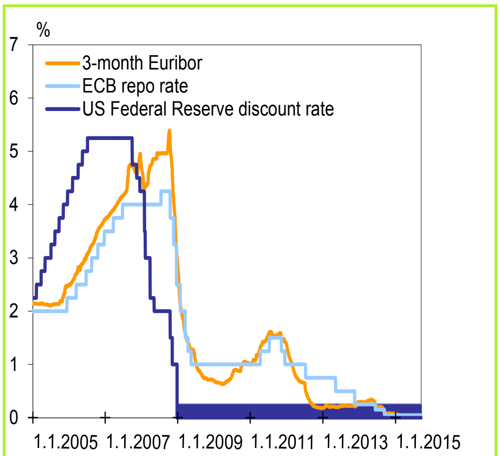
Source: Eurostat, Labour Institute for Economic Research

Industrial production 2013:01–2015:07



Source: Eurostat

Short-term interest rates 2.1.2005–14.9.2015



Source: ECB, Bank of Finland

the 2nd quarter. This development is primarily attributable to a decline in China's foreign trade, but the same trend can be seen also in some other emerging economies. Thus, many have revised their global GDP growth forecasts downwards. The downswing has occurred contrary to expectations, and it has spurred debate about whether the peak phase of globalization has already been passed. But it is still too early to assess how permanent a phenomenon this is. Foreign trade developments are subject to substantial regional variation and, for example, the euro area's foreign trade has continued to grow.

Markets expecting US interest rate hike

From the standpoint of the future development of the world economy, one of the most crucial decisions will be made in the United States: When will the Fed begin to raise its key interest rate from the current range of 0–0.25 per cent? The information on the timeframe for future hikes given in connection with the first interest rate hike will also affect long-term rates. In the financial markets this action and its related expectations will spur capital movements so that the rest of the world's interest rates will tend to rise and their currencies weaken against the dollar. To some extent this has already happened. The Fed may raise interest rates as early as during its September meeting. It can be argued that the rationale behind the move is that it is better to act promptly because of the multiplier effect of monetary policy and because the unemployment rate has already declined to 5.1 per cent, which corresponds to the Federal Open Market Committee's estimate of the natural rate of unemployment; i.e. the level below which inflation tends to accelerate.

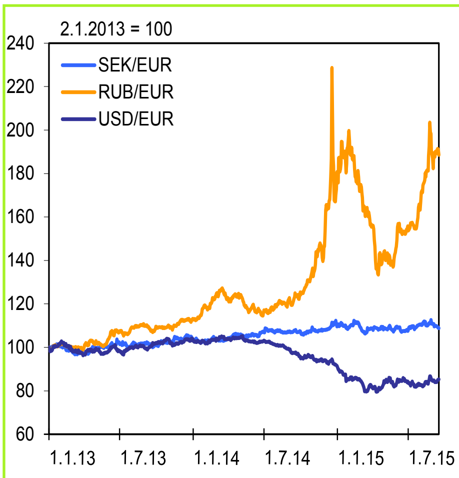
US economic growth will continue at current pace

The foreign trade-weighted index of the dollar has appreciated about 20 per cent over the past two years. This weakening of price competitiveness has led to the deterioration of the foreign trade deficit, which would have been much greater unless oil imports would have simultaneously decreased as the country's own oil production increased. This has also been reflected in a slowdown in industrial output growth, and new orders for industry are showing a marked decline. Domestic oil production in the United States has already been begun to decline.

US economic growth is being fuelled by domestic private demand. Growth of household consumption, which accounts for two-thirds of GDP, accelerated at the end of last year by more than three per cent owing to the slowdown in inflation and the pick-up of real income growth. Meanwhile, the household saving ratio has fallen and the total amount of debt has started to rise. The bullish trend in consumer confidence has recently begun to decline. Retail sales growth has slowed down to 1.2 per cent, a level last witnessed during the recession. The positive impact of the slowdown in inflation on private consumption will taper off toward the end of this year. Private investment growth accelerated in the beginning of the year by over one percentage point to 6.7 per cent. The slump in oil drilling curbed business investment, but housing investment picked up considerably.

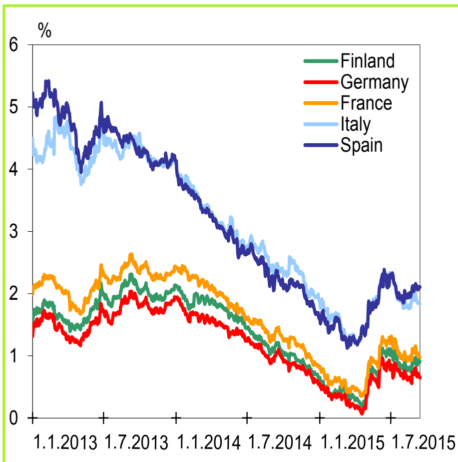
Fiscal policy will continue to dampen US economic growth even though public demand has started to grow since the end of last year. This autumn it once again possible that the Republicans in Congress will seek to stop the growth of the federal debt, which would mean central government spending cuts that could slow down economic growth. So far this is not, however, considered a very likely scenario.

Exchange rates 2.1.2013–15.9.2015



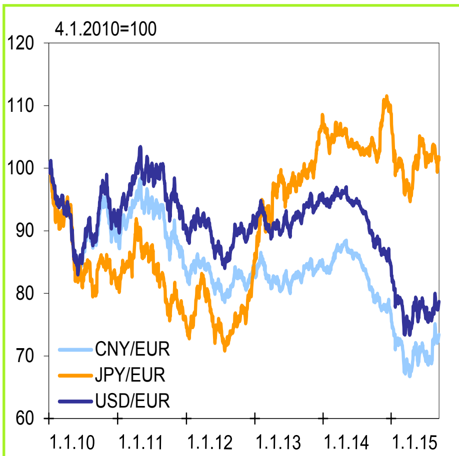
Source: ECB

Government bond yields 1.1.2013–14.9.2015



Source: Nordea

Exchange rates 4.1.2010–15.9.2015



Source: ECB

An increase in US interest rates and demand factors constitute significant risks to economic growth, but especially investment and public demand also have positive prospects. We forecast that US economic growth this year will reach 2.4 per cent, i.e. the same as last year. Next year it will reach 2.7 per cent.

Oil prices subject to conflicting pressures

After falling sharply at the end of last year, the price of crude oil (Brent) has fluctuated around the price of 55 dollars per barrel. According to oil futures prices, the price of oil will remain at a little over 50 dollars this year and next, which is also the assumption used in our forecast. There is nevertheless great uncertainty associated with oil prices. So far China's demand for oil has continued to rise, albeit at a slower pace, but the change in the country's growth strategy and renewable sources of energy can be expected to gradually weaken the demand for oil. However, the world has a number of fast growing emerging countries using a lot of oil. As a result of the removal of Iranian sanctions, the supply of oil will increase, leading to downward pressure on prices. On the other hand, Saudi Arabia, which is the single most influential country in the oil market and which regards cheap oil as being unsustainable for budgetary reasons, has expressed its intention of seeking a "reasonable" price level.

For other raw materials, prices have continued to experience a downward trend during the current year. For example, the prices of copper and nickel have decreased significantly for three years. The price of softwood pulp has decreased from that prevailing one year ago. Exceptions include some agricultural products such as beef, the price of which has been on a prolonged upward trend, and wheat, the fall in the price of which seems to have come to a halt at least temporarily. The slowdown of economic growth in China and some other emerging countries is the main reason for the falling costs of raw materials, but there are always also some special factors involved in their markets. All in all, raw material prices cannot be seen as a source of pressure on the development of inflation.

Table 1. International economy

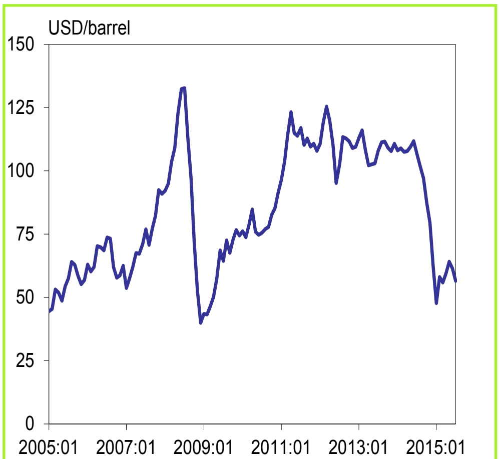
	Share of world GDP (%)	GDP growth (%) 2014	2015f	2016f
United States	16.2	2.4	2.4	2.7
Eur-19	11.8	0.9	1.5	1.9
Germany	3.3	1.6	1.6	2.0
France	2.4	0.2	1.0	1.3
Italy	1.9	-0.4	0.5	1.0
EU28	16.6	1.4	1.8	2.1
Sweden	0.4	2.3	2.8	3.1
United Kingdom	2.3	3.0	2.7	2.5
China	17.0	7.3	7.0	6.5
India	7.0	7.3	7.5	7.5
Japan	4.3	-0.1	0.4	1.0
Russia	3.2	0.6	-4.0	-2.0
Brazil	2.8	0.1	-2.5	-1.0

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

China's difficulties are growing

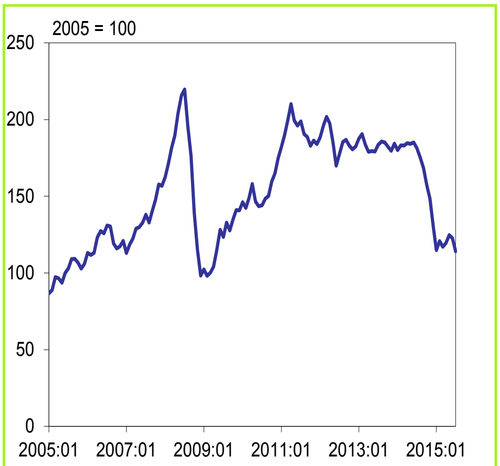
Last week, China lowered its GDP growth rate for 2014 by 0.1 percentage points to 7.3 per cent. China's industrial production growth has decele-

World market price of crude oil (Brent) 2005:01–2015:07



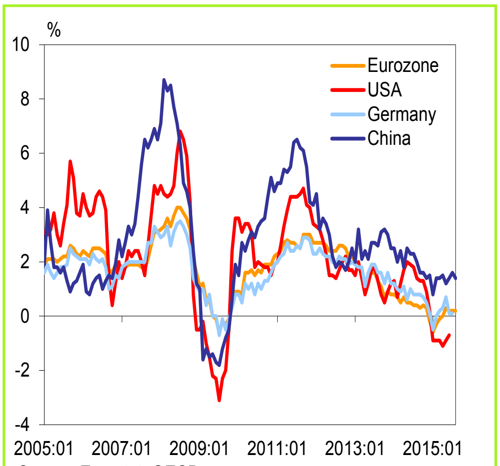
Source: Energy Information Administration

Commodity price index 2005:01–2015:07



Source: IMF

Inflation in assorted countries 2005:01–2015:08



Source: Eurostat, OECD

rated from double-digit figures to a level of about six per cent. Electricity production growth has slowed to three per cent. Investment growth is approaching 10 per cent, which is the slowest in this millennium. Even retail sales growth is only reaching slightly above 10 percent, while three years ago it was still about 15 per cent. Weakening growth prospects have also been reflected in stock prices, although the importance of their drop is reduced by the small size of the stock market and the fact that the government tried to support its prices through their own purchases. The inflation rate has fallen to 1.5 per cent level, which has given room for the relaxation of monetary policy, i.e. lowering interest rates and reserve requirements of banks. China has also been trying to revive its economy by allowing its currency to devaluate by a total of more than 4 per cent.

China's economic slowdown was to be expected as the country's leadership decided to change its growth strategy from being investment intensive towards a more consumption-based direction in which high growth rates are much harder to achieve. The government still has means to stimulate the economy and Premier Li Keqiang has assured that the 7 per cent growth target set for this year is achievable. In the forecast this is assumed to be the official growth figure, but next year China will have to settle for 6.5 per cent growth.

Japan recovers from VAT increase

China's subsiding economic growth has affected Japan's exports, whose growth fell in April–June to 1.5 per cent in contrast with last year's 8.4 per cent. However, Japan has suffered more from the three percentage point increase in value added tax carried out on April 1, 2014: the economy underwent a downturn that lasted four quarters and only in the last quarter did growth rebound slightly. Together with the Central Bank's quantitative easing, the increase in VAT accelerated the rise of consumer prices temporarily to over three per cent, but in recent months the inflation rate has sunk back towards zero. The recovery of private consumption and new stimulus measures will accelerate economic growth from the zero level prevailing in the beginning of this year to 0.4 per cent for the year as a whole and to one per cent next year.

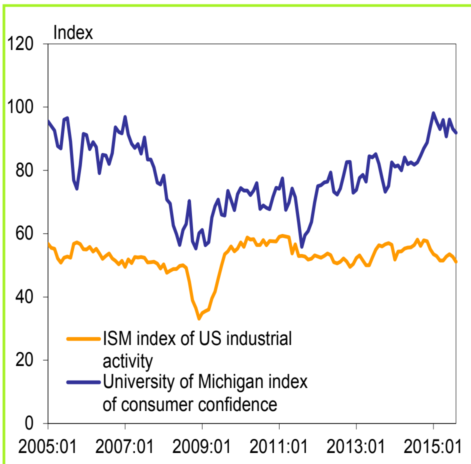
Russia continues to be in recession

Russia's GDP shrank in the first half of this year by 3.4 per cent. Private demand fell sharply and imports even more. The drop was dampened by the stability of public demand and an upturn in exports, which has been accelerated by the weakening of the rouble, which in turn has stemmed from the decline of oil prices. In January–July retail trade output fell by 8.1 per cent and industrial production declined by three per cent. Inflation is soaring above 15 percent, but still the recession has not seen a significant increase in unemployment. The IMF has estimated the long-term cumulative effects of the Russian sanctions to be 10 – 11 per cent of the country's GDP. As Russia's growth potential is already low and the price of oil is slightly above 50 dollars, an end to the recession is still not anticipated next year either, unless a clear turn for the better is seen in the price of oil or the sanctions are eased. GDP will contract by four per cent this year and 2 per cent next year.

India is booming and Brazil is slumping

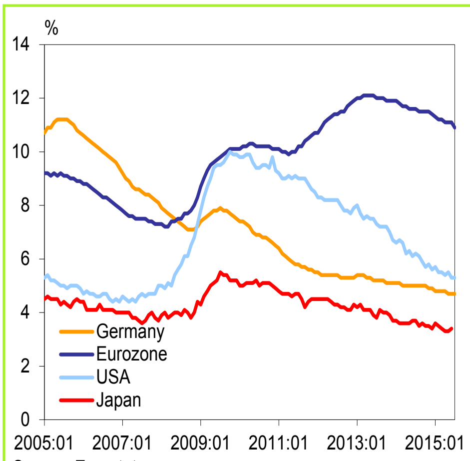
India's economic growth will reach about 7.5 per cent this year and next year, i.e. faster than China for the first time. Growth is driven in particular by

US economic indicators 2005:01–2015:08



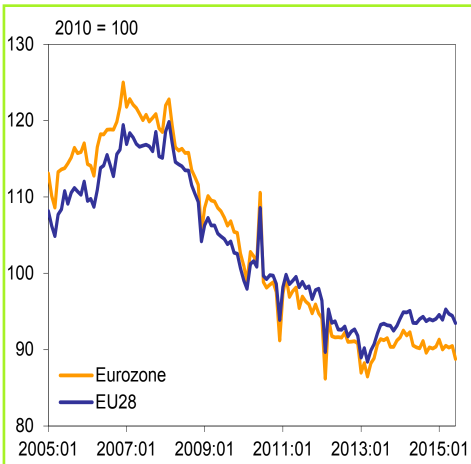
Source: ISM, University of Michigan

Unemployment in assorted countries 2005:01–2015:07



Source: Eurostat

Euro area and EU construction output 2005:01–2015:06



Source: Eurostat

private consumption, which has benefited from a slowdown in inflation from an over 10 per cent level to about 4 per cent, and the decline of the unemployment rate to a historically low level, less than five per cent. India has benefited from the fall in oil and other commodity prices. Private consumption will grow at nearly an 8 per cent rate while investment rises by 4.5 per cent.

As a producer of raw materials, Brazil's exports of raw materials to Asia and Europe declined last year. The acceleration of the decline in Brazil's GDP in the 2nd quarter of this year is nevertheless due primarily to domestic factors. Investments and private consumption have begun to decline. GDP will contract by 2.5 per cent this year and one per cent next year.

Finland's balance of trade strengthening

Finnish exports of goods and services decreased last year by 0.7 per cent while imports remained unchanged. The terms of trade have improved as the price of total imports decreased by 1.6 per cent and the price of exports fell by only 0.7 per cent. Due to the deficit in trade of services, the balance of goods and services ran a 2.5 billion euro deficit in 2014. The balance of trade of goods excluding services once again ran a surplus of slightly less than one billion euros.

In early 2015 the volume of Finland's goods exports remained at last year's level. Exports were weighed down particularly by the escalation of Russia's economic problems, and as a result, the euro has appreciated by about 56 per cent against the Russian rouble by the beginning of September 2015 during the past year. This phenomenon combined with the simultaneous contraction of the Russian economy meant that the value of Finnish goods exports to Russia shrank by 30 per cent during the first half of 2015 compared to the same period last year.

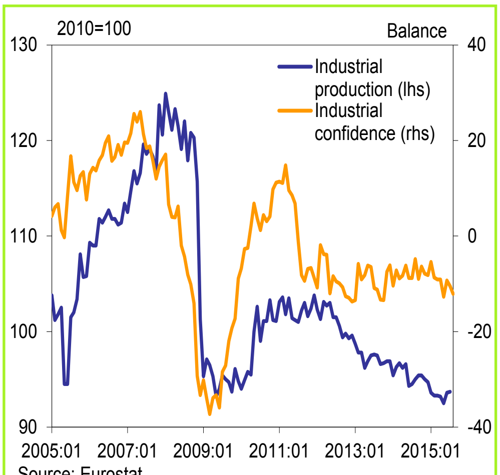
Finnish goods exports also fell noticeably in early 2015 in comparison to Sweden, which was, among other things, influenced by the fact that the euro strengthened against the Swedish krona by more than 6 per cent in 2014 and has not weakened in relation to the krona during this year. In addition, the shrinkage of Finland's own mobile phone production may have reduced our exports to Sweden. The growth in exports to Germany and the US has partly compensated for the abovementioned setbacks.

Table 2. Exports, 10 largest trading partners

	Change in value of exports 1–6/2015, from previous year (%)
Germany	14
Sweden	-18
Russia	-30
USA	8
Netherlands	13
Great Britain	-14
China	7
Belgium	-17
Estonia	-11
Norway	3
Source: Customs	

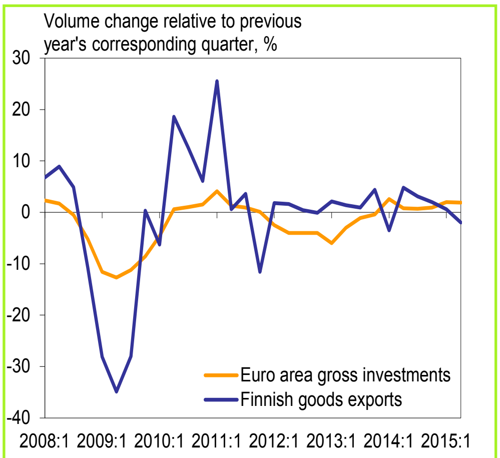
In the second quarter of 2015, the volume of goods exports contracted by a couple of per cent from the previous year. However, seasonally adjusted exports of goods have increased by about one per cent from the previous quarter, even though major maintenance shutdowns in the chemical industry cut its production and exports in the spring

Industrial confidence and industrial production in Finland 2005:01–2015:08



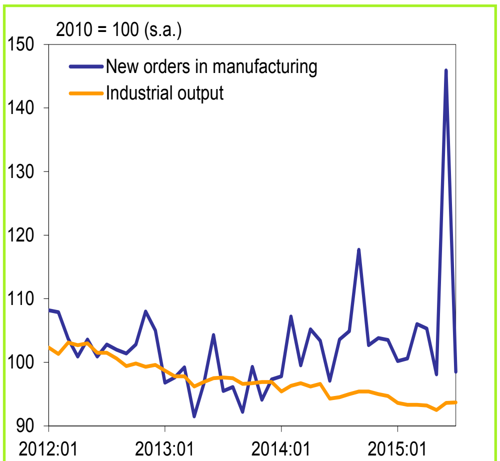
Source: Eurostat

Demand for investment goods and Finnish exports 2008:1–2015:2



Source: Eurostat

Industrial production in Finland 2012:01–2015:07



Source: Statistics Finland

and early summer of 2015. In late 2015 goods exports will increase slightly as chemical industry production normalizes. At this point, the expansion of pulp and paperboard capacity will promote exports in the forest industry, even though the industry's exports were limited in the first half of 2015 by the shutdowns of two paper machines producing magazine paper. Wood industry exports are hit by the supply of Russian goods in our main export markets priced according to the cheap rouble.

Table 3. Value and change of Finnish goods exports in January-June 2015

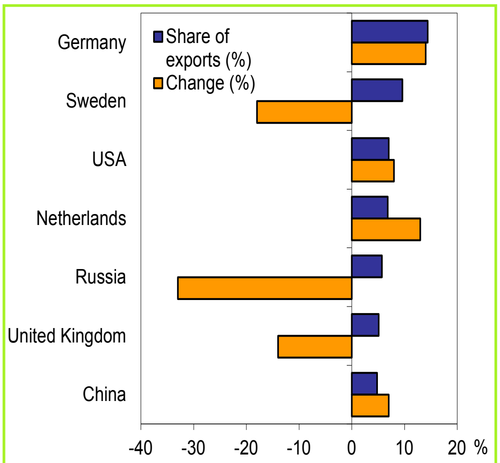
	Million euros	Change (%)
Food industry	609	-14
Forest industry	5805	3
Chemical industry	4978	-25
, of which oil products	1525	-50
Metal refining	3468	5
Metal products	694	7
Machines and equipment	3618	4
Electronic equipment	1280	-5
Electrotechnical equipment	1938	8
Motor vehicles	1222	46
Other transportation equipment	736	-15
Source: Customs		

In other industries, the contraction of food exports in the beginning of 2015 is due to the imposition of sanctions by Russia, and the contraction of other transportation equipment exports due to the fact that the new orders of the Turku shipyard will only be visible in the export figures of the coming years. Metal refining will increase at the end of this year because of the EU import duties imposed on the Chinese and Taiwanese steel industries. The growth of new orders received by Finnish industry during the last couple of years is primarily due to large ship orders. Machinery and equipment industry orders increased last year but are no longer increasing this year. The machinery and equipment industry's outlook is indeed mediocre at best. Russia's weak economic situation and the drop in prices of raw metal materials and oil will weaken the sector's export market. On the other hand, a slight pick-up in investment in Europe will bolster the output of this key sector in Finnish industry.

Exports of goods will start to grow towards the end of 2015, especially as chemical industry exports get back up to speed. Overall, however, the volume of goods exports will remain this year at last year's level. Next year, exports of goods will begin to increase by more than two per cent. Taking into account the weak performance of the last few years, this growth estimate is still quite cautious.

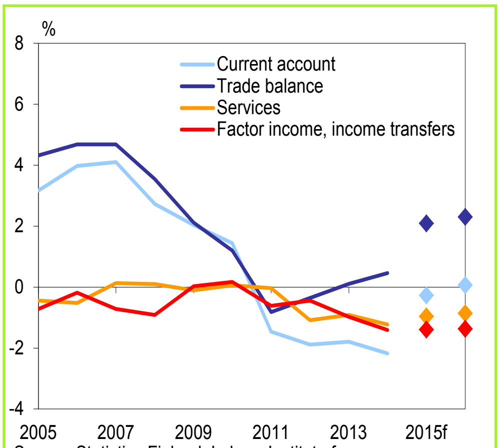
While service exports still fell last year by almost 7 per cent, they have increased by more than a couple of per cent from early 2015 onwards. Towards the end of the year growth will be even more rapid as the growth rate is affected by the very low level of services exports in the fourth quarter of 2014. Next year, growth in exports of services will be dampened by the effects of Microsoft's personnel layoffs on the imputed output and service exports of the electronics industry. On the other hand, the prevalence of services in the industrial structure will continue to grow. This is evident in such a way that new businesses and new activities (e.g. those introduced by foreign businesses) are established specifically in ICT services as well as within research and development. Some of this activity is also oriented towards the export of services.

Finnish merchandise exports in January–June 2015



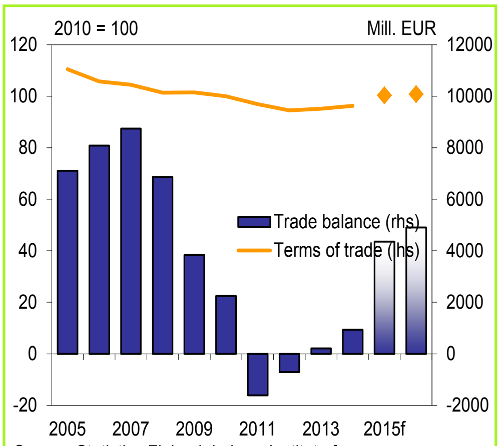
Source: Customs

Current account surplus relative to GDP by components 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Terms of trade and trade balance 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

One major factor in the increase of service exports in 2015 has been the extraordinary success of businesses in the gaming industry. It is difficult to imagine that the success will continue to be as favourable in the future. This is another reason to be cautious about forecasts on service exports next year. This year service exports will grow by just over three per cent, and next year growth will slow down to a couple of per cent.

The volume of the goods import contracted in the beginning of 2015 by about 6 per cent from the previous year. However, rising car sales and aircraft purchases by Finnair amounting to a few hundred million euros will boost imports during the rest of the year. This year the volume of goods imports will eventually decline by more than a couple of per cent. Next year the growth of machinery and equipment investment, for example, will increase imports. The amount of goods imports will indeed grow by a couple of percentage points from that of this year. Imports of services have remained at the previous year's level from the beginning of 2015 onwards. There are no specific reasons for service imports to pick up or contract this year. Service imports are forecast to remain this year at approximately last year's level and increase next year in the wake of goods imports by one per cent.

Prices of goods imports will fall this year by an average of four per cent while prices of goods exports will remain at last year's level. The improvement of the terms of trade (export prices relative to import prices) will raise living standards (purchasing power-adjusted GDP per capita) even if the volume of total output remains unchanged. This development has bolstered the purchasing power of households in the form of low inflation and improved the profitability of companies. Next year, prices of exported goods will rise by 0.5 per cent on average while prices of imported goods will remain at this year's level.

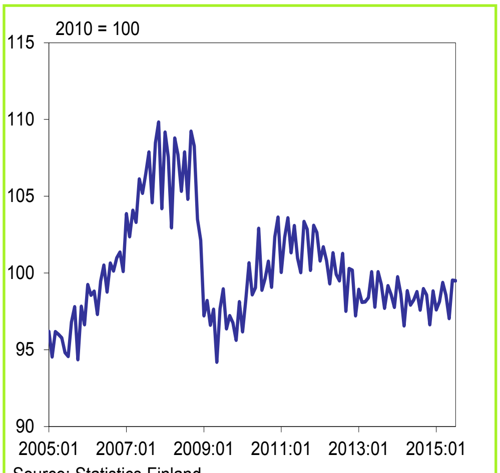
Finland's trade balance (in the national accounts) ran an almost a one billion euro surplus last year. The improvement in the terms of trade and the decline in imports are increasing the surplus of the trade balance. Already in early 2015, the surplus amounted to two billion euros, and it is projected to grow to 4.4 billion euros by the end of the year. Next year, the trade surplus will grow to just under 5 billion euros. The foreign trade balance will end up with a two billion euro deficit this year. Last year, the deficit was more than 600 million euros more than that of this year. Next year, the services balance will run a deficit of 1.8 billion euros. The clear reversal of the balance of goods and services into a surplus will reduce the current account deficit this year to just over half a billion euros from the previous year's 4.5 billion euros. Next year, the current account will already run a surplus of over 100 million euros. However, the deficit in the current account stemming from the redistribution of income, employee compensation and investment income will remain close to three billion euros both this year and next.

Production of public and personal services is not growing in Finland

The production of individual industries developed in early 2015 in the accustomed manner: industry, construction and the public sector declined. There was growth in programming services, the financial sector as well as business-oriented technical services. In late 2015, industry and construction will start on a growth path. Next year production in many sectors will already be growing. Industrial production will recover as exports pick up. Tight budget cuts will mean that public services will see zero growth. It is possible, however, that the "compulsory stimulus" brought by the influx of refugees will boost public services to some extent.

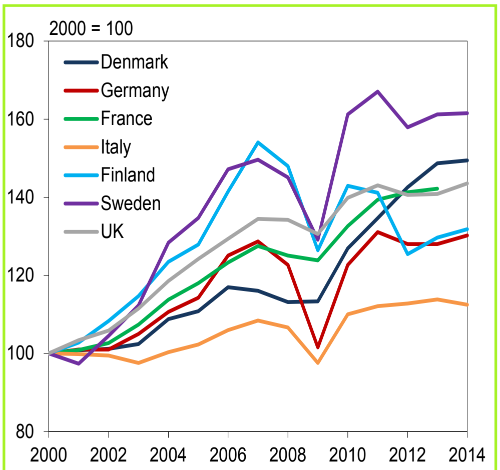
Growth of personal services dependent upon wage-earners' purchasing power, the retail trade and hotel and restaurant will also remain close to

Trend indicator of output 2005:01–2015:07



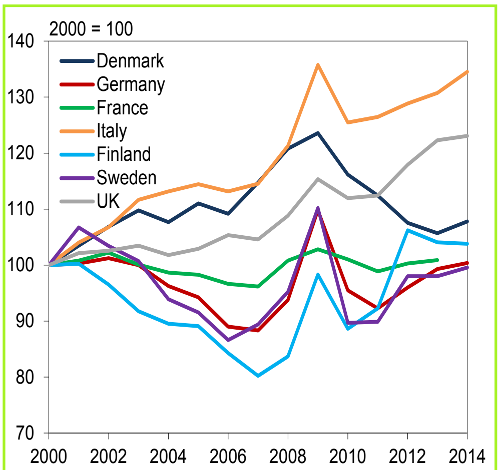
Source: Statistics Finland

Labour productivity in manufacturing 2000–2014



Source: AMECO

Nominal unit wage costs in manufacturing 2000–2014



Source: AMECO

zero. The most pronounced upswing will occur in construction, which will boost production of building materials as well as metal and wood products. Change in the industrial structure will continue to fuel the growth of ICT services as well as technical and professional services catering to enterprises.

Table 4. Demand and supply

	2014	2014	2015f	2016f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	205.2	-0.4	0.4	1.2
Imports	79.4	0.0	-1.5	1.7
Total supply	284.6	-0.3	-0.1	1.3
Exports	77.8	-0.7	0.8	2.2
Consumption	164.5	0.3	0.7	0.8
private	113.6	0.5	1.0	1.1
public	50.9	-0.2	0.0	0.1
Investment	41.6	-3.3	-1.0	1.5
private	33.2	-3.9	-0.9	1.5
public	8.4	-0.9	-1.3	1.2
Change in stocks[1]	0.6	0.2	-0.9	0.1
Total demand	284.6	-0.3	-0.1	1.3

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

Investment will still contract this year

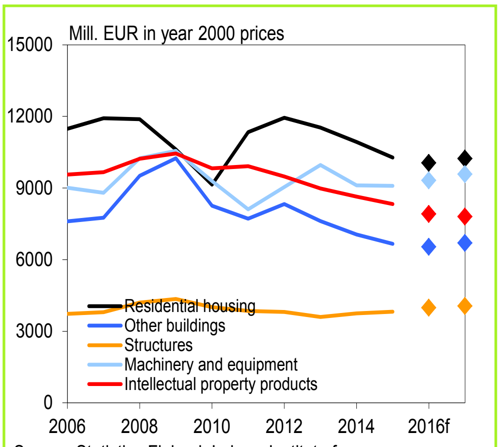
According to the revised data of Statistics Finland, the volume of investment decreased by 3.3 per cent last year. Last year, construction investment declined by 4.5 per cent. Machinery, equipment and transport equipment investment declined by only 0.2 per cent, while still early in the year Statistics Finland reported it contracted by 10.7 per cent. ICT investments (mainly R&D) declined by 3.6 per cent. The economic outlook is still overshadowed by uncertainty, and the volume of investment is projected to contract in the current year by a total of about 1.0 per cent compared to the previous year. In 2016, investment is forecast to experience a spark of modest 1.5 per cent growth.

Housing investments continued to contract significantly in the first half of this year. The improvement in the outlook for construction is projected to spawn an upturn housing investment growth in the latter half of the year. This year, housing investment will decline by a further 2.2 per cent and in 2016 housing investment is expected to rebound to growth of about 1.8 per cent.

Investment in non-residential buildings decreased by 5.6 per cent last year. This year non-residential building investment is projected to decline much more modestly than last year, i.e. by 1.8 per cent. Large building projects that are in the planning stage or already started will begin to show up in non-residential building investment towards the end of this year, and in 2016 these investments will already increase at an annual rate of 2.4 per cent.

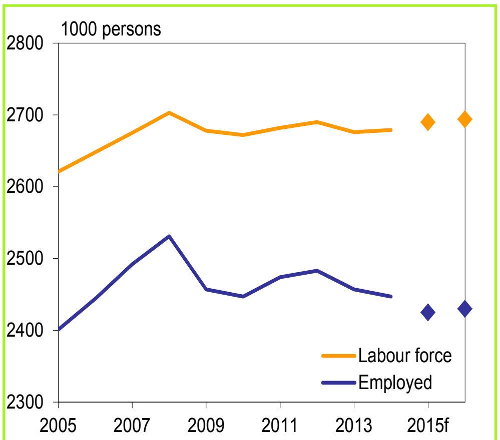
According to revised figures, civil engineering construction investment grew by 1.8 per cent in 2014. During the first half of this year civil engineering investments have been up considerably compared to last year. Underlying this trend is the acceleration of highway construction preceded by a steep fall in earth construction cost levels and major construction projects getting started e.g. in the greater Helsinki area and Tampere. This trend is expected to continue towards the end of this year. Civil engineering is thus projected to grow by 4.2 per cent this year and 1.9 per cent in 2016.

Investments 2005–2016



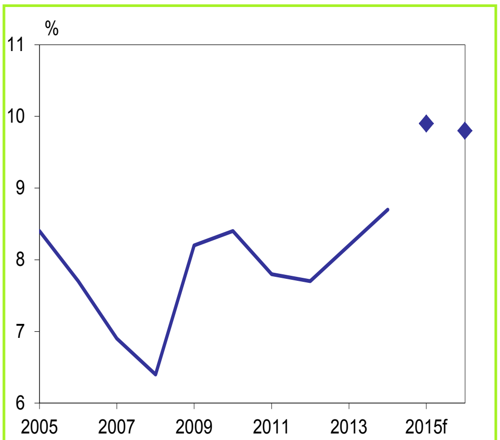
Source: Statistics Finland, Labour Institute for Economic Research

Supply of labour and employment 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Unemployment rate 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Early in 2015, the development of machinery, equipment and transport equipment investment has remained the similar to that of last year. The rest of the year is expected to see a slight upturn. In addition, Finnair's aircraft acquisitions this year will boost machinery, equipment and transport equipment investment, which is expected to grow by 2.5 per cent this year. In 2016, machinery and equipment investment will grow by 2.8 per cent.

ICT investments are forecast to continue declining this year. Government policies bringing about cutbacks in R&D expenditure will reduce public ICT investment. Also private R&D spending is projected to decline as a result of the layoffs from Microsoft's product development units located in Finland. All in all, the volume of ICT investments is expected to fall by 5.0 per cent this year and by 1.5 percent next year.

Government investments contracted in 2014 by slightly less than one per cent as private investment fell by about four per cent. The development of public investment is expected to be similar this year. Private investment will decline again by almost one per cent, i.e. significantly more moderately than last year. In 2016, public as well as private investment is projected to grow by about 1.5 per cent.

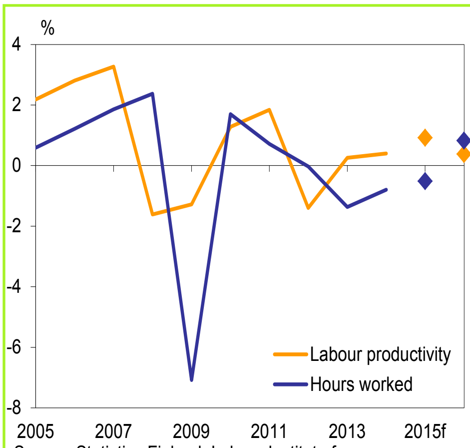
Unemployment will rise this year

The amount of employed persons fell by 0.4 per cent in Finland last year, and the unemployment rate rose from 8.2 per cent to 8.7 per cent. According to the labour force survey, employment has decreased every month in 2015 compared to last year with the exception of January. The weak development of production and layoffs will lead to a steady decline in employment this year. Employment will decline by 0.9 per cent on average for the year as a whole. The slight upswing in production will bolster employment next year, but only towards the end of the year. Average employment for the year as a whole will increase by 0.2 per cent.

The labour force participation rate of the working age population changed very little in 2014, increasing by 0.1 percentage points. The labour force participation rate has increased during the first half of 2015, with the exception of April, and is on average 0.4 percentage points higher in comparison to the previous year. The labour force participation rate will increase by 0.1 percentage points in 2016. The labour force participation rate is affected by the age structure of the population and employment. Although the increasing share of older age groups in the population is bringing down the labour force participation rate, in these groups the labour force participation has grown in recent years. As the economic outlook becomes brighter labour force participation continues to increase as people shift from hidden unemployment and from outside the labour force back to active job seeking. The proportion of those outside the labour force has indeed decreased this year compared to last year. As a result of the decreasing amount of the employed and changes in the size of the labour force, the unemployment rate will rise this year to an average of 9.9 per cent and fall next year to 9.8 per cent.

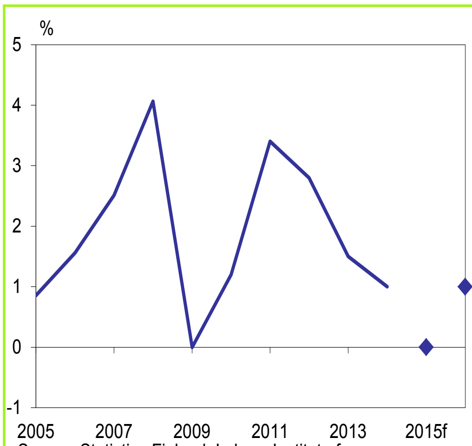
The amount of work in an economy adapts not only through employment, but also through changes in hours worked. Working hours are easier to adjust than employment, for example, by cutting down or increasing overtime. In a recession the number of hours worked typically shrinks more than employment. As output starts to grow, working hours begin to increase before employment does. As growth continues the trend is reversed sooner or later, and employment increases more than the number of hours worked. In 2014, hours worked decreased by 0.8 per cent. This year they will fall at a slightly slower pace than employment, i.e. by 0.5 per cent. Next year as the economy picks up hours worked will increase slightly faster than employment, i.e. by 0.8 per cent.

Change in labour productivity and hours worked 2005–2016



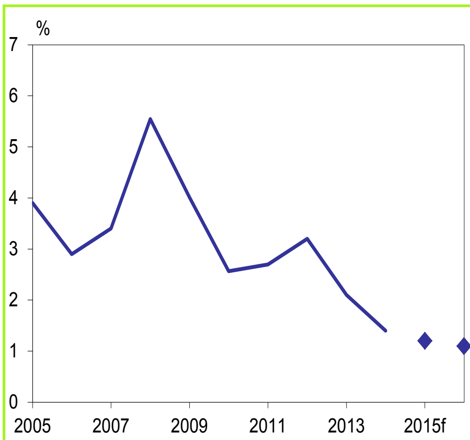
Source: Statistics Finland, Labour Institute for Economic Research

Change in consumer prices 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Change in level of earnings index 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

The meagre growth of the economy and the decline in hours worked will nevertheless be reflected in increased productivity. Productivity growth has been relatively weak since 2008. In 2014, however, productivity increased by 0.4 per cent. This year, the 0.4 per cent growth of GDP and 0.5 per cent decrease in hours worked represents an increase of 0.9 per cent in productivity. In 2016, productivity will grow by 0.4 per cent, as production rises more than hours worked.

Next year real earnings will stop rising

Last year the average earnings index rose by an average of 1.4 per cent in comparison to the previous year. Of this 0.7 percentage points were contract wage increases and the rest was wage drift. The pace for the increase in wages was set largely by the Employment and Growth Pact, covering a large majority of employees. Settlements within sectors outside the pact also widely adhered to its terms. Still this year the earnings index will rise by 1.2 per cent due to the combined effects of contract increases and wage drift. Since this year's inflation rate has been predicted to be 0 per cent, the growth of real earnings will be 1.2 per cent this year.

Next year we forecast the earnings index as a whole to rise slightly more slowly on average than this year in nominal terms, i.e. by 1.1 per cent. However, inflation will remain lower than changes in income and real earnings will increase by 0.1 per cent. In 2016, average earnings are projected to rise at the same rate as the earnings index.

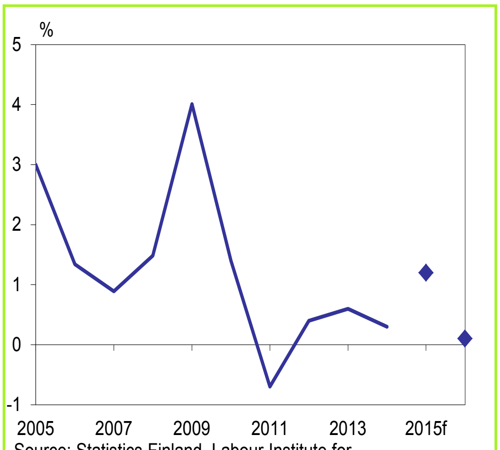
Inflation will remain low despite weakening of euro

This year inflation has changed into modest deflation. The average price level change (compared to the same month of the previous year) measured by the CPI was -0.1 per cent during the period between January and August.

The commodity groups which contributed the most to the reduction in the average price level were food and non-alcoholic beverages (due to keener price competition in grocery stores), housing ownership, private vehicles, as well as leisure-related electronic equipment. Housing ownership costs are made lower by both the low level of interest rates and the narrowing of banks' interest rate margins. Private vehicle expenses are shaped by a tax reform that lowers (car-tax dependent) vehicle purchase prices, but increases (motor vehicle tax dependent) annual private car operating costs. The drop in oil prices also reduces the consumer price index through various commodity groups.

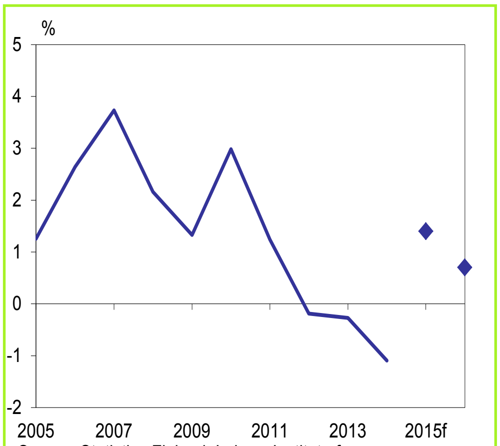
The price of crude oil and the main reference rates are likely to remain low also in the end of the current year and next year. We estimate that even the ECB's expanded asset purchase programme, which the ECB uses as a framework for purchasing euro countries' government bonds, will not significantly increase inflation within the EU this year or next. On the other hand, the low dollar exchange rate of the euro is likely to accelerate inflation, and tax changes implemented in Finland including the motor vehicle tax and tobacco tax hikes will boost inflation next year as measured by the CPI index. We estimate the inflation rate will be 0 per cent in 2015, after which it will rise to one per cent in 2016.

Change in level of real earnings 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Change in households' real disposable income 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Functional distribution of income in business activities 2005–2014

Source: Statistics Finland, Labour Institute for Economic Research

Real household income will increase slightly due to low inflation

During the first half of this year the wage bill for the whole economy grew by about 1.2 per cent compared to the same period last year. Property income growth has been low or negative, except for dividend income, which grew during the first quarter by 22.7 per cent compared to the corresponding quarter of 2014. The reason for the strong growth of dividend income is probably the reduction of corporate taxes carried out in the beginning of 2014, which has prompted companies to distribute funds saved owing to the lower taxation as dividends to its owners (instead of making additional investments). The exceptionally low level of interest rates has affected capital income by reducing both interest expenditure and income.

We estimate that wages and salaries will increase by 1.2 per cent this year and 1.9 percent next year. Property income will grow faster this year than next year (primarily due to higher dividend income). Pension income can be expected to grow at only a moderate pace as the index-based increases for pensions will be small as inflation remains low.

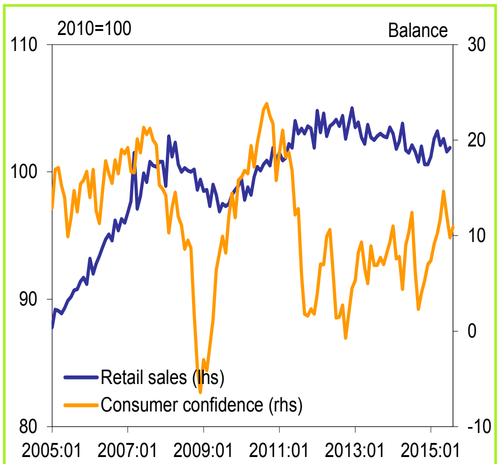
Municipal debt is likely to continue increasing this year and next year, although the average municipal tax rate can be expected to increase slightly next year (about 0.1 per cent). We estimate that total direct tax revenues will grow slightly faster than primary income, rising by 2.5 per cent in 2015 and by 2.4 per cent in 2016. Households' real income will grow by 1.4 per cent in 2015 and by 0.7 per cent in 2016.

Table 5. Key forecasts

	2014	2015f	2016f
Unemployment rate (%)	8.7	9.9	9.8
Unemployed (1 000)	232	265	264
Employed (1 000)	2447	2425	2430
Employment rate (%)	68.3	67.9	68.2
Inflation, consumer price index (%)	1.0	0.0	1.0
Wages, index of wage and salary earnings (%)	1.4	1.2	1.1
Real disposable income of households (%)	-1.1	1.4	0.7
Current account surplus (Bill. €)	-4.5	-0.6	0.1
Trade surplus (Bill. €)	0.9	4.4	4.9
Central government financial surplus			
Bill. €	-7.9	-6.7	-5.9
% / GDP	-3.9	-3.2	-2.8
General government financial surplus			
Bill. €	-6.8	-6.2	-5.3
% / GDP	-3.3	-2.9	-2.5
EDP debt			
% / GDP	59.0	61.2	62.6
Tax rate (%)	43.9	44.0	44.2
Short-term interest rates (3-month Euribor)	0.2	0.0	0.0
Long-term interest rates (10-year gov't bonds)	1.4	0.9	1.1

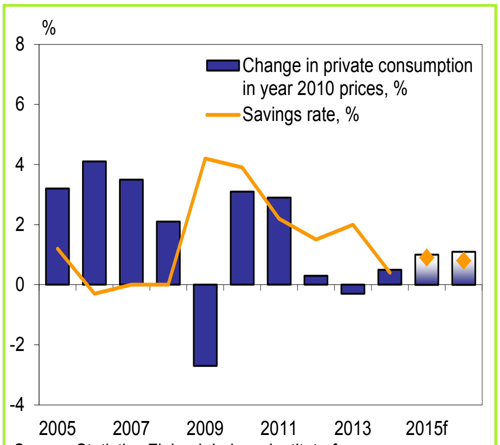
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Consumer confidence and retail sales in Finland 2005:01–2015:08



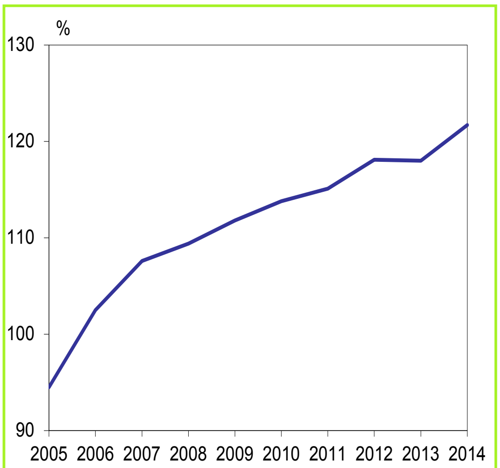
Source: Eurostat

Private consumption and savings rate 2005–2016



Source: Statistics Finland, Labour Institute for Economic Research

Household debt ratio 2005–2014



Source: Statistics Finland

Private consumption will probably grow moderately

During the first half of this year private consumption expenditure has grown about 1.4 per cent compared to the previous year. Consumer confidence measured by the consumer barometer has improved this year but it is still below the long-term average. We estimate that in 2015 the volume of private consumption will grow by 1.0 per cent compared to the previous year.

The government's legislation seeking to lower unit labour costs and wage levels will not have much of an impact until after next year, but they are likely to reduce consumer confidence and private consumption as early as in 2016. On the other hand the refugee crisis can be expected to lead to "compulsory stimulus" in Finland in 2015 and 2016: the public sector's debt will probably rise more than expected as concerns grow about integration of refugees and as households divert funds that would otherwise be saved to individual consumption related to the refugee crisis via non-profit institutions. We estimate that private consumption will grow in 2016 by 1.1 per cent.

Central government finances improving slowly

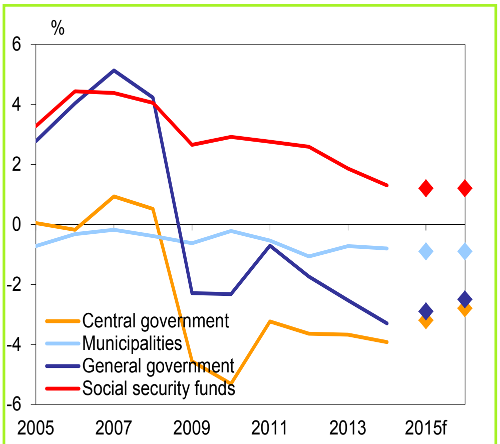
The central government deficit stood at nearly EUR 8 billion last year, and during the forecast period the deficit will only slowly decline, i.e. by slightly more than a billion euros this year and by slightly less than a billion euros next year. This development mainly reflects the slowdown in the growth of the central government's tax revenues owing to the modest growth of the tax base. The cuts mean government expenditure will decline this year and next year expenditure growth will remain modest. In real terms, government spending will decline in both forecast years.

Both direct and indirect taxes of the central government are expected to grow this year at a rate of about two per cent. Direct taxes will grow only slightly faster than the main component of the tax base, i.e. earned income. Numerous changes will be made in earned income taxation: some will increase tax revenues while others will decrease them. The effects of these changes will nevertheless roughly cancel each other out. Capital income taxation will be tightened by the raising of the upper tax rate by one percentage point as well as lowering in the related income threshold. Figures for the beginning of the year indicate that also corporate tax revenue will start to grow this year.

The rise in indirect tax revenues is primarily fuelled by excise duties, since the development of value added tax remains subdued. Indirect tax revenue will be boosted this year by numerous hikes of excise taxes. Among others, the tax rates on tobacco, motor fuels, electricity and fossil-based heating fuels and vehicles have been increased.

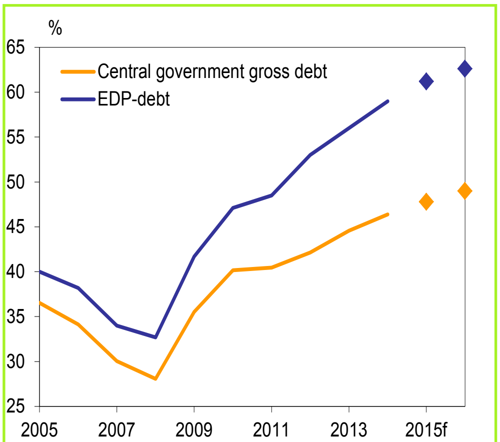
In 2016, the inflation adjustment for earned income tax will be made according to the change of the earnings index and the earned income deduction will be increased by EUR 450 million. Income taxation will tightened by additional cuts in the interest deduction for housing loans and by lowering the threshold for the so-called solidarity tax. The upper rate in capital income taxation will be increased by one percentage point to 34 per cent. Tax hikes are nevertheless weighted toward indirect taxation, as tax rates on tobacco, motor vehicles and heating fuels will be increased. Tax revenue will be reduced, however, by the first phase of cuts in the automobile tax at the beginning of 2016.

General government financial surplus as percentage of GDP 2005–2016



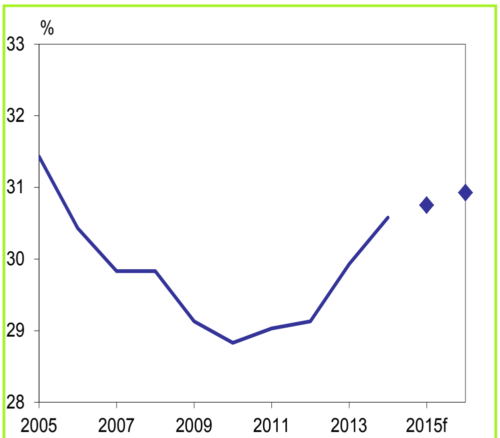
Source: Statistics Finland, Labour Institute for Economic Research

Central government gross debt and general government EDP-debt as percentage of GDP 2005–2016



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

Wage earners' income tax rate 2005–2016



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

All in all, the overall effect of discretionary tax changes will be to reduce central government tax revenues next year. In growth of corporate tax revenue will be fuelled by increases in corporate profits and the fact that the central government will receive a larger portion of the tax revenues as the municipalities no longer get a temporarily higher portion of revenue sharing. As the growth of the tax bases picks up slightly, the growth of central government tax revenues next year will be slightly faster than this year, i.e. 2.4 per cent.

Cuts in government expenditure this year are greater than in previous years, and the net impact of austerity measures is approximately EUR 1.5 billion. Expenditure cuts are focused on a wide range of different administrative sectors. Significant cuts are being carried out, for instance, in municipal government revenue sharing, development aid and child allowances. In contrast, spending increases are taking place in aid for renewable energy and industrial growth-stage companies as well as price and cost adjustments. Low interest rates will constrain the growth of government debt interest expenditures. Central government consumption expenditures are projected to fall by 2.5 per cent while total expenditure will decline by 0.3 per cent.

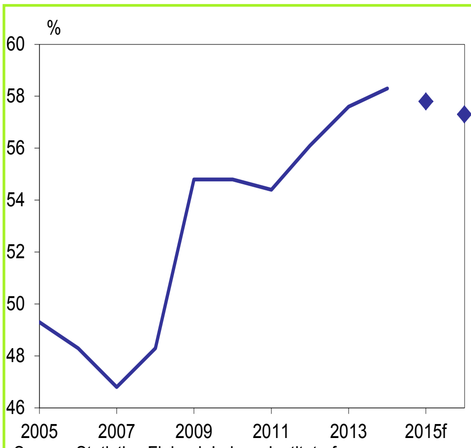
Next year, the central government's spending guidelines will be affected by the new government's fiscal policy decisions. Cuts in government spending amount to a total of EUR 800 million, but their impact is also being offset by increases in budgeted expenditures. The budgeted expenditures of the armed forces and internal security were both increased by EUR 50 million each while the funding for so-called lead projects and road infrastructure was increased by a combined total of slightly over EUR 300 million. In net terms the austerity measures will amount to approximately EUR 400 million, i.e. significantly lower than for this year. Central government spending will also be increased by growth in the number of asylum seekers. Consumption expenditure is expected to fall next year, but government spending overall will increase in nominal terms by 0.5 per cent.

Municipalities still running deficits

Municipal governments are still struggling with upward pressure on expenditures and modest revenue performance owing to the slow strengthening of the tax base. Municipal revenue growth will be 1.6 per cent this year and 2.4 per cent next year. This year nearly one hundred municipalities raised their income tax rates so that the average municipal tax rate increased by 0.1 percentage points. This trend is anticipated to continue next year. Tax revenue will be boosted this year by the moderate growth in corporate tax revenue, but next year the temporary increase in municipalities' portion of revenue sharing will come to an end and tax-based revenues will fall. The gradual rise in real estate taxes is forecast to continue as the statutory upper and lower limits will be increased. Growth of municipal revenues will be kept in check by cuts in central government revenue sharing. Among other things, the municipalities' higher proceeds from real estate taxes will be collected back from the municipalities by reducing their central government revenue sharing.

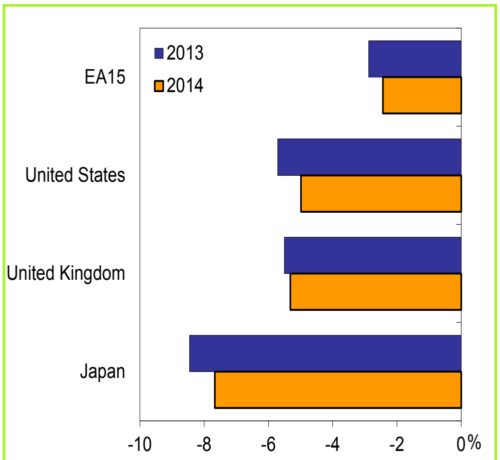
Municipal government expenditure will grow by 2.3 per cent in both forecast years. Upward pressure on spending will be sustained by age-related expenditure resulting from the change in age structure as well as the new tasks previously assigned to the municipalities. Pressure on spending will in turn be alleviated by the slow increase in costs during the forecast period as a result of wage moderation. The dire financial situation of the municipalities and aspirations to improve effi-

Public expenditures as percentage of GDP 2005–2016



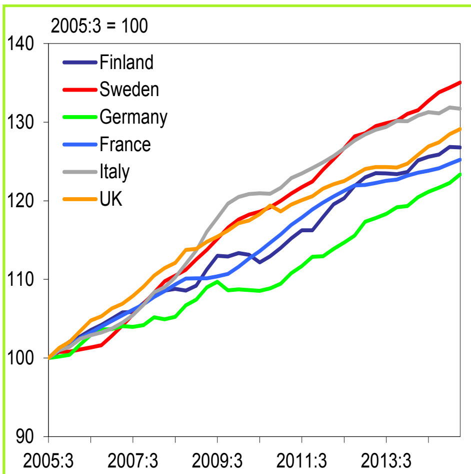
Source: Statistics Finland, Labour Institute for Economic Research

Public sector deficit-to-GDP ratio in 2013 and 2014



Source: OECD

Labour costs (salaries and related expenses) per hour in industry 2005:3–2015:2



Source: Eurostat

ciency will also dampen the growth of municipal spending. The municipal government's deficit was 0.8 per cent of GDP last year. This year, the municipalities' financial situation will even weaken slightly and the deficit will grow to approximately EUR two billion. Next year municipal government revenues and expenditures will grow at the same pace, and the deficit will remain at this year's level.

Surplus of social security funds will remain modest

The surplus of social security funds in relation to GDP in this decade has subsided at a rapid pace from about three per cent to 1.3 per cent last year. This development reflects, on the one hand, the growth of paid benefits stemming from demographic change and unemployment. Insurance contribution receipts have in turn been under negative pressure from weak employment developments and the slow rise in earnings.

Revenues from insurance contributions will grow in both forecast years faster than the wage bill because of changes in the terms for insurance contributions. This year, the revenue side of the pension contributions will be strengthened by hikes amounting to a total of 0.4 percentage points while next year unemployment insurance contributions will be subject to a one percentage point increase. The revenues of social security funds are expected to increase by 2.0 per cent this year and 2.6 per cent next year.

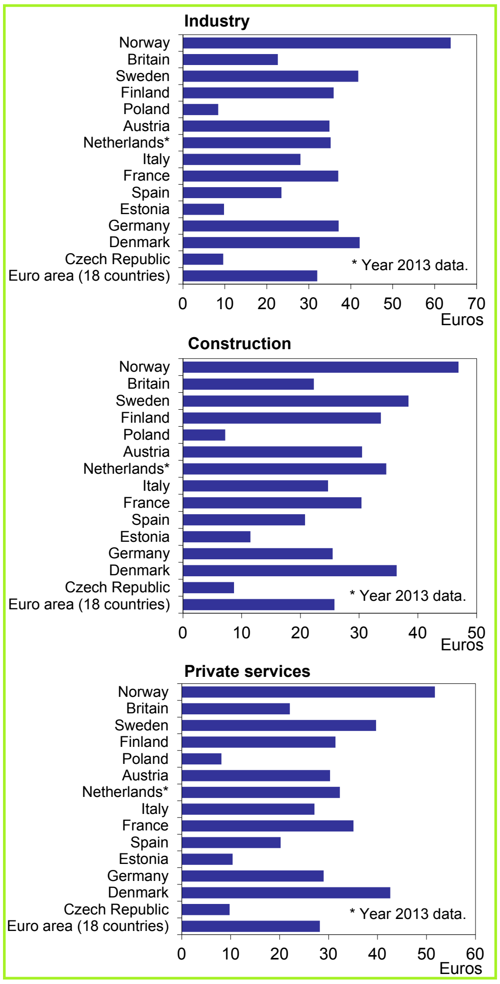
During the forecast period index adjustments will be small or they will not be made at all owing to the slowdown in inflation and savings decisions on benefits paid. This will curb the rise in social security funds expenditure. The increase in the number of pensioners will nevertheless keep pension expenditures rising by about three per cent in both years. Social security funds' expenditures will increase by over 2.5 per cent in both forecast years. The surplus of the funds in proportion to GDP will continue to fall slightly, i.e. by 1.2 per cent this year, while next year it is expected to remain more or less unchanged from this year's level.

Public sector's revenue will increase slightly faster than public spending

This year taxes as a percentage of GDP are expected to rise by a tenth of a per cent from last year's level of 43.9 per cent. Hikes in employment pension contributions, the average municipal tax rate, and excise taxes will boost the tax ratio, although tax revenues will be dampened by the opposite effects of zero inflation and slow growth in the value of private consumption. Next year the tax ratio is expected to rise slightly to 44.2 per cent due, among other things, to the rise of unemployment insurance contributions and the anticipated modest tightening of municipal taxation. The increase in the earned income deduction in income taxation will have the opposite effect. Tax revenues are expected to grow by 2.2 per cent this year and 2.7 per cent next year.

The growth of public expenditure will slow down during the forecast period and the growth rate for expenditures will be lower than for revenues especially in the central government, where this year expenditure will even decline slightly owing to savings decisions. Small inflationary adjustments for benefits will dampen, among other things, the growth of pension expenditure and social security funds' expenditure. The expenditure of the municipal sector, on the other hand, is expected to grow at a rate of two per cent in both forecast years. All in all, public expenditure will grow by one per cent this year and about one and a half per cent next year.

Labour costs per hour in industry, construction and private services in 2014



Average number of hours worked by all employees in 2014

Source: OECD

The general government deficit will fall during the forecast period to 1.7 billion euros from last year's level. The deficit as a percentage of GDP will fall from last year's 3.3 per cent to 2.5 per cent next year. The central government deficit will decline from 3.9 per cent last year to 3.2 per cent this year and to 2.8 per cent next year. The deficit will even grow slightly in the municipal sector, reaching 0.9 per cent of GDP next year. The surplus of the social security funds is expected to be 1.2 per cent in both years.

According to the figures published by the State Treasury, the central government debt was EUR 94.2 billion at the end of August of this year. The central government's deficit will increase the amount of debt, and this year the ratio of government debt to GDP will grow to 47.8 per cent from last year's 46.4 per cent. Next year's corresponding figure is 48.9 per cent, and the amount of government debt will thus be EUR 104.6 billion. The general government's consolidated debt (the so-called EDP debt) will grow this year by EUR 6.7 billion, and debt relative to GDP will be 61.2 per cent. It will thus exceed the 60 per cent ceiling stipulated by the EU's Stability and Growth Pact. Next year, the debt-to-GDP ratio will be 62.6 of per cent, even though the growth in the outstanding debt will slow down slightly.

Economic policy is not supporting growth

Finnish economy is weakened by the relatively slow growth of our export markets, the collapse of the Russian rouble and the strong impact of the Russia's economic downturn on Finland. The prospects for the Finnish export businesses are nevertheless brighter over a few years' horizon than is generally thought. This and the fact that growth will not be fostered over a little longer term by cutting, for example, research and education or by increasing income inequality means that it would be better to follow moderate fiscal policies where government consumption expenditure increases by about half a per cent a year.

The magnitude and timing of public investment, however, presents greater opportunities to support economic growth in the short term. One opportunity is offered by the investment programme of the European Commission (the strategic investment fund, ESIR), whose invested government funding is not included in the Commission's assessment of deficit and debt targets stipulated by the Stability and Growth Pact. The fact that the Finnish government has so far not made any ESIR investments, shows that there is not great interest is stimulus via public investment.

Government's efforts to reduce the Finnish unit labour costs by 5 per cent via legislation entail drastic cuts in the incomes of many small and medium-wage workers. Unlike an actual devaluation, this ”internal devaluation” redistributes income also in the closed sector in favour of employers. In circumstances where insufficient demand is the number one problem of many companies, the hypothetical employment impact of this programme threatens to remain marginal.

While potentially leading to large-scale labour disputes, sticking to this policy causes significant uncertainty for the operating environment of both businesses and households. At worst there will be large production losses during the next year. A more sensible policy would be based on ensuring that Finland has numerous consecutive collective agreements allowing only small wage increases, which would guarantee that our price competitiveness relative to competitor countries improves substantially.

In the new government's spending policy, agriculture and forestry, and defence are the winners. This already shows that structural policies are not very growth-oriented. According to conventional wisdom, the catalyst for growth is first and foremost the capability and prerequisites to generate new knowledge. This in turn can be facilitated by directing resources toward education and research. In Finland, the skilled personnel laid off from Nokia and its subcontractors is still a key resource from the standpoint of our growth potential, whose potential for employment in other companies, setting up their own businesses and getting a chance to carry out demanding product development work has not been supported enough in our industrial policy.

Finnish economy will strengthen in a few years

Finland's economic growth has been weak relative to that of the rest of the euro area during the last three years. People have then drawn the conclusion that the reason for the weak performance has been the weakening of Finnish price competitiveness. The weak development of the Finnish economy can nevertheless be explained largely by special factors. We need to consider whether their negative impact is permanent or temporary and whether the impact could reverse itself and even become positive.

While the slumping of the demand for paper industry products, the collapse of Nokia's mobile phone business and the crisis in the shipbuilding industry explained the difficulties in industry and exports during 2008–2014, from 2014 onwards to the collapse of Finnish exports to Russia has been the factor that explains our weak performance compared to our competitors. Finnish exports to Russia will be about to EUR 2.2 billion lower in 2015 than in 2013. This amounts to slightly over one per cent of GDP and this shortfall cannot be seen as having indirect effects that would diminish it under conditions where export companies' output is being constrained by inadequate demand rather than insufficient capacity.

As regards the forestry and shipbuilding industries, the negative trend is turning into a clearly more positive one. In the shipbuilding industry the turnaround is attributable to the new orders received by the Turku shipyard, while in the forest industry it is due to the construction of additional capacity for the production of pulp and paperboard. A clear upswing will take place in 2017 when a new bioproduct mill will begin operations in Äänekoski. Possible new units in Kuopio and Kemijärvi will reinforce this turnaround.

Owing to the collapse of Nokia's mobile phone operations, the number of persons employed in the manufacture of telecommunication equipment and electronic components decreased by 19,000 from 2006 to 2013 and by about 3,300 in 2014–2015. Next year there will be approximately 1,200 employees engaged in Nokia mobile phone operations acquired by Microsoft. The impact of Nokia's rise and fall has nevertheless spurred much greater swings in the economy than the increase and decrease in the number of employees would seem to warrant. But the negative impact of this process is coming to an end, and even becoming positive as persons laid off find jobs in new companies and establish start-ups. In fact, this ”creative” phase following the ”destructive” one has already started, which is reflected, above all, in the rise in the number of entrepreneurs and employees in the ICT sector after 2010.

It is hard to predict when Russia's difficult economic situation will began to ease. From the standpoint of our eastern trade the situation may nevertheless be normalized in different ways. First, the share of Russian exports has already fallen sharply and its reduction can no longer produce the same kind of negative impact on the Finnish economy already experienced. Second, in a few years the Russian economy can be expected to recover either because the political conflict subsides, Russia becomes integrated more strongly with Asian economies or the price of oil starts to rise from its current level.

On the basis of the above it can be assumed that Finland can reach the growth rate prevailing in the rest of Europe already by 2017. It is even possible that in a few years, our growth rate will be faster than the average for the euro area. As regards price competitiveness, it can be stated that in industry, where exporters compete with foreign companies, labour costs per hour worked have risen since 2005 somewhat faster than in Germany and France, but more slowly than in the UK, Italy and Sweden. According to Eurostat statistics, the level of Finnish industry's labour costs per hour in 2014 was lower than in the main competitor countries such as Germany, France and Sweden.

Nominal unit labour costs - labour cost divided by labour productivity – in Finnish industry have also increased at the same pace as in most competitor countries. The labour productivity of the Finnish manufacturing sector has declined since 2007, but from the beginning of 2000 until 2014 it has nevertheless risen slightly faster than in Germany. It is known that Nokia's effect on Finland's industrial production and its productivity is exaggerated in statistics. For example, in 2007 Finland's industrial productivity has been overestimated while after 2009 it has been underestimated.

It should also be noted that changes in productivity in recent years have been closely following the whole economy's business cycle. When demand decreases, companies' productivity fell because it is difficult to adjust the capital contribution downwards and because the R & D expenditure classified as an investment in the current way of making calculations has already been irrevocably realized.

Eero Lehto

Reduction of employers' health insurance contribution will boost wage demands

Following the failed attempts to get labour unions and employers to agree on a so-called social contract, the government announced that it would seek to reduce the private sector's labour costs by 5 per cent. The government's measures (amounting to 5.2 per cent of the wage bill) consisted mostly of cuts (60 per cent) affecting sickness expenses. First of all, a one-day waiting period for sick leave benefits was added to the first of nine days of sick leave, while the compensation for the remaining 8 days will be reduced to 80 per cent. In addition, employers' health insurance contribution (2.08 per cent this year) will decrease by 1.72 percentage points. The reduction in the insurance contribution cuts the costs of private employers by about 850 million euros. The reduction is significant, being of the same magnitude as the 2009 elimination of the employers' contribution to Kela (Social Insurance Institution of Finland).

The proposed measures are based on the assumption that productivity is independent of the level of compensation and other working conditions. This is not necessarily the case because better wages and terms of employment can increase the motivation to work. Tax cuts can certainly compensate for the net disposable salary, but how net salary is formed is not necessarily insignificant. An employment relationship is an agreement between the employer and the employee that is affected by numerous details related to the actions of both counterparties. If the employer's share of the gross wage denoted on the payslip is reduced, the employee's commitment to a common agreement may weaken, even if the net wage remains unchanged.

There is a link between contributions and benefits also in social insurance. When the labour force undergoes changes, the social insurance system works better if the insured employee and the employers pay for what they get. In addition, the mutual commitment of the labour market participants to the system as its financiers is more vital than an ultimate mismatch of contributions.

The earnings insurance of health insurance covers not only sickness and parental care allowances but also the employer's occupational health care expenses (table below). In 2013 earned income insurance was used to pay sickness allowances amounting to EUR 857 million, of which EUR 364 million went to employers.

Employees paid earnings insurance contributions totalling EUR 627 million. The reduction in the private employers' contribution rate by about 80 per cent shifts the burden of financing the system to the insured employees. The financing of earnings insurance has been roughly in balance and the government has covered the costs of parental care allowances. The government's measures weaken the link between statutory insurance contributions and earnings-linked benefits and increase the share of tax financing. At the same time it will increase dependency on the central government's promises and budgetary uncertainty. Thus, the 2016 budget proposal of the Ministry of Social Affairs and Health includes an upper limit on earned income, for which the benefit rate is 70 per cent, and reduced the increased daily allowances for parental care leave. These changes will reduce insurance benefits by a total of a million euros. In the future, there will be greater pressure to reduce the benefit rates for earnings insurance, as the government unilaterally announced that it will reduce allowances for days 2–8 of sick leave from 100 to 80 per cent.

Social insurance is an affordable way to provide comprehensive insurance protection that the private markets would not be able to organize. That is how it increases the willingness to work. Weakening the scheme leads to higher pay demands, because the employees have to take their own actions to supplement the inadequate social insurance.

Ilpo Suoniemi

Table. Health insurance-related earnings insurance benefits and contributions in 2013 (million EUR)

	Approved costs	Benefits	Contributions
Parents daily allowances		1031	
Benefit recipient: Employer		173	
Benefit recipient: Employee		858	
Employers' occupational health care	776	336	
Paid sickness benefits		857	
Benefit recipient: Employer		364	
Benefit recipient: Employee		493	
Employer's health insurance contribution			1612
, of which local government contributions			350
Employee's income insurance contributions			627

Source: Statistical Yearbook of the Social Insurance Institution of Finland. The local government health insurance contribution is calculated on the basis of the wage bill.

Rise in basic salaries coming from wage supplements by industry

On September 8, 2015 Prime Minister Juha Sipilä's government announced new measures to further improve competitiveness that would replace their plans for a social contract. The list has many cuts affecting wage earners directly such as making Epiphany and Ascension Day unpaid public holidays, making the first day of sick leave unpaid and reducing the pay for the subsequent 2-9 days of sick leave from 100 per cent to 80 per cent and cutting the annual holidays of public sector workers from 38 to 30 days. The plan also includes cuts to working time increments paid on top of the basic salary: extra compensation for working on Sunday is being cut from 100 per cent (double time) to 75 per cent and overtime pay is being cut in half.

The cuts are focused on different employee groups unevenly, which can be considered unfair. In particular, the planned cuts in extra pay for irregular working hours affect different occupational groups and industries in different ways, depending on how much work is done on Sundays or as overtime subject to extra compensation. According to Pärnänen (2015), in 2014 about 11 per cent of Finnish wage and salary earners worked on Sundays, about 240,000 people. The largest groups doing Sunday work consist of the female-dominated health and social services, wholesale and retail trade, and hotels and restaurants as well as male-dominated sectors of industry, transport and warehousing. Some trade unions have published figures on how the cuts will affect their members' average salaries and made calculators for its members so that they can easily estimate the impact on their wages.

Since cuts are now being proposed regarding extra pay for irregular hours, it is interesting to take a look at the significance of extra compensation paid on top of fixed wages in different industries broken down by the type of employment (full-time and part-time) and whether there are differences according to gender. These wage supplements consist of different kinds of extra pay for working hours associated with irregular working hours, such as working shifts, in the evening, at night or on Saturdays as well as extra pay for working Sunday, the taxable value of fringe benefits, contract labour, additional and overtime earnings, and partly also any compensation for being on-call, on-duty or responding to alarms, other irregularly paid allowances and pay for hours not worked.

The table below shows each industry ranked in order according to how important the wage supplements in each policy area are for all wage-earners in total and separately for full- and part-time employees. The table shows that for the magnitude of the supplements re-

Table. Increase in basic wages derived from pay supplements by industry (TOL 2008) in 2013 (%)

	All employees	Full-time	Part-time
All industries	**6.8 (3.5)**	**6.2 (2.8)**	**11.4 (9.3)**
Mining and quarrying	13.5 (6.2)	12.6 (5.0)	22.8 (18.1)
Transport and warehousing	12.0 (7.8)	10.5 (6.2)	25.3 (21.8)
Health and social services	11.2 (7.4)	11.0 (7.2)	12.3 (8.2)
Retail trade	11.2 (10.0)	5.7 (4.4)	19.0 (18.1)
Hotels and restaurants	9.1 (7.9)	6.1 (4.7)	15.9 (15.3)
Electricity, gas, heating and air conditioning	8.2 (3.3)	6.6 (1.8)	22.1 (17.6)
Industry	7.7 (3.3)	7.1 (2.6)	19.5 (14.5)
Wholesale and retail trade, sales and service of motor vehicles	7.4 (5.1)	5.8 (1.9)	17.9 (16.8)
Construction	6.4 (0.7)	6.5 (0.7)	4.4 (0.7)
Administrative and support service activities	5.1 (2.5)	4.6 (1.9)	8.1 (7.0)
Arts, entertainment and recreation	5.0 (2.7)	3.5 (1.9)	7.0 (6.3)
Real estate activities	5.0 (0.3)	5.1 (0.2)	3.4 (1.0)
Public administration, defence and compulsory social insurance	4.5 (2.8)	4.6 (2.8)	2.6 (1.4)
Information and communication	3.3 (0.6)	3.3 (0.5)	2.9 (1.6)
Financial and insurance activities	3.0 (0.2)	3.0 (0.1)	3.0 (1.4)
Professional, scientific and technical activities	2.6 (0.3)	2.6 (0.1)	2.9 (1.6)
Education	2.6 (1.0)	2.8 (1.1)	1.8 (0.6)
Other service activities	2.2 (0.8)	1.8 (0.3)	4.8 (4.4)

Source: Statistics Finland. Wage Structure Statistics. based on which pay supplements are calculated. The figure in parentheses indicates the percentage of wages derived from worktime-related pay supplements (shift, evening, night, Saturday and Sunday).

lative to basic wages in 2014 ranged between 1.8 and 25.3 per cent depending on the industry and the share of full- and part-time jobs. The increase in basic wages brought about merely by different types of working time supplements ranged between 0.1 and 21.3 per cent. The significance of the supplements relative to the basic salary was high in the retail trade as well as hotels and restaurants.

The significance of all pay supplements and worktime supplements relative to basic wages is clearly larger for part-time than for full-time wage and salary earners of industries ranked at the top of this list with the exception of health and social services. The greatest benefits from pay supplements are prevalent in the industries where Sunday and shift work is common. Therefore, the planned cuts would have the greatest impact on workers employed in these sectors. These sectors include health and social work as well as low-wage, female-dominated sectors such as the retail trade and hotels and restaurants, which have a lot of part-time jobs. If implemented, the assorted total cuts could mean a significant reduction in salary, which for low-paid workers might result in a direct increase in the number of persons having difficulties in making ends meet.

A similar analysis of the significance of all pay supplements was also made separately for men and women (not presented here). Clear differences were found between industries as to how much pay supplements increase the basic wages of men and women. In male-dominated sectors, such as industry and transport and warehousing, pay supplements were clearly higher for men than for women regardless of the prevalence of full- and part-time jobs because men and women are employed in different occupations. But even in female-dominated sectors, such as health and social services, the significance of supplements relative to the basic wages was higher for men on average. ■

Merja Kauhanen

Source: Pärnänen Anna (2015), Sunnuntaityö – kuka sitä tekee? Tieto & Trendit, blog, September 14. 2015.