

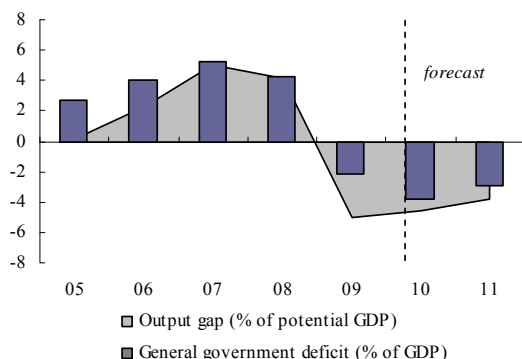
25. FINLAND

Recovery taking hold after a record fall in GDP

Record GDP contraction in 2009

Even though Finland entered the global crisis in 2008 from a relatively strong position, having built up a substantial surplus in the current account and in the government finances, GDP declined in 2009 by 7.8%. This exceeds even the decline observed in 1991, which was the worst year of GDP decline in the economic crisis of the early 1990s. In early 2009 the major export industry branches of metal engineering, electronics and forestry all experienced a particularly sharp drop in global demand. Total export volumes dropped by about one quarter in 2009, the strongest decline in the euro area. However, given that the import content of exports is relatively high and that domestic consumption was also depressed over the year, the fall in exports was similarly mirrored in imports and a current-account surplus position of about 1½% of GDP was still maintained.

Graph II.25.1: Finland - Output gap and general government deficit



The global economic turmoil had immediate consequences also for domestic sectors through negative confidence effects. Investment fell rapidly by over 13%, especially due to cuts in corporate investment. Household purchasing power was supported by relatively strong wage rises agreed in the previous collective wage agreement round and tax cuts arising from the stimulus programme. Having accumulated sizeable surpluses in public finances over the previous economic upswing, Finland allowed the automatic stabilisers to operate fully and in addition provided for a relatively large discretionary fiscal stimulus amounting to slightly below 2% of GDP in 2009 and above 1% of GDP in 2010. This has helped to cushion the impact of the crisis on the domestic

market. Nevertheless, private consumption contracted as households increased saving in an uncertain economic environment.

Labour market has remained resilient

The impact on the labour market has been more subdued than might be expected from the historically steep contraction in economic activity. Unemployment increased from an average of 6.4% of the labour force recorded in 2008 to 8.2% in 2009. Additionally, temporary lay-offs and various schemes to reduce working time have been widely used, amounting to about 2% of the labour force, but which to a large extent are not reflected in unemployment statistics. To some extent the effects of these schemes might eventually be reflected in unemployment statistics in 2010. While the number of employed persons fell by 3% in 2009, hours worked fell by 6%, which reflects more accurately the drop in output.

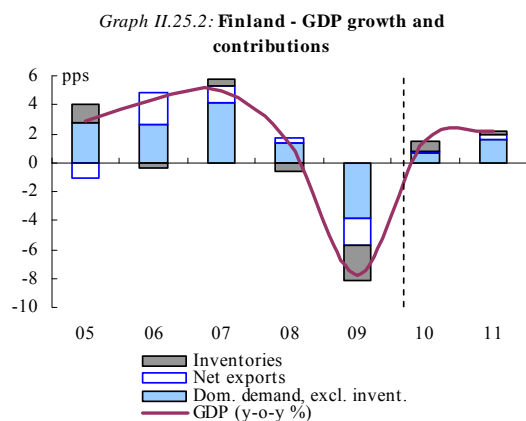
Favourable prospects for recovery

In spite of the exceptionally rapid drop in GDP, the economy has maintained solid fundamentals and is well placed to return to a growth path slightly above the EU average. Even though exports are expected to recover with a lag, domestic demand is forecast to initially drive growth. Consumer confidence quickly rebounded in the course of 2009 to levels exceeding the long-term average. Consumers' purchasing power is being supported by further tax cuts in 2010 and still relatively strong wage growth carrying over from the previous comprehensive multiannual wage agreement. With the saving rate stabilising in an environment of stronger economic confidence, private consumption is set to turn to growth in 2010.

The Finnish financial sector has remained on solid footing throughout the crisis and is in a strong position to respond to the expected upturn in credit demand for both the household and corporate sectors. Overall, corporate balance sheets have withstood the global crisis relatively well, as revealed by the modest rise in non-performing loans. While household indebtedness rose over the past decade to historically high levels by Finnish standards – about 100% of annual disposable income – it is still around average compared to

most other euro-area countries. Since about 90% of mortgages have variable interest rates, the currently low interest rates are effectively passed on to mortgage holders. As furthermore the margins on top of the reference rate have been low by euro-area standards, housing finance has become very cheap.

The real-estate market has rebounded strongly from the dip in early 2009. Both house prices and new building permits have increased strongly over past months, pointing to a resumption of residential investment activity. Housing investment is being additionally boosted by government stimulus measures. However, given that corporate investments are still expected to decline in 2010 due to current manufacturing overcapacity, in the aggregate investment is projected to grow only in 2011. The inventory cycle is also forecast to contribute strongly to growth after sharp destocking over 2009.



Exports are expected to recover with a lag after global economic recovery takes hold. While a moderate recovery in industry confidence indicators is already apparent, the upturn in exports in recent months has lagged the global and European recovery in trade. A strike disrupting Finnish seaports for two weeks in March will also delay the rebound in trade. While the external trade volumes are forecast to rebound to some extent from the present exceptional lows, the contribution to growth from external trade is expected to turn only slightly positive in 2010-11. A stronger contribution to growth is expected to be hindered by the current export structure, with the investment goods sector recovering with a lag and the maturing electronics and forest industry sectors facing longer term structural changes due to globalisation pressures. Additionally, due to the rapid rise of unit labour costs over 2008-09,

Finland has sharply lost external price competitiveness. The main risk to the recovery of domestic consumption is seen to stem from the performance of exporting industries and unemployment developments, which have traditionally played an important role in influencing consumer behaviour.

Wages set to moderate, inflation to remain relatively high

After the relatively fast wage rises over 2008-10, decided under the previous multiannual wage agreements, the next wage negotiation rounds are expected to respond to the change in economic conditions and to result in moderate wage increases for the coming years. While annual wage growth in 2010 is still affected by wage rises carried over from the previous wage agreements, wage growth in 2011 should be already substantially lower, in line with the new agreements. However, aggregate incomes would still rise faster in 2011 compared with 2009-10 on account of the predicted growth in employment and hours worked.

While inflation remained below the euro area average in 2002-08, thereafter it has consistently exceeded the benchmark. Inflation is expected to remain higher also in 2010, partly due to the rapid rise in unit labour costs being passed on to services prices. In addition, an increase in VAT rates in mid 2010 is estimated to contribute to inflation 0.4 pp. and a tax on sugar products from the beginning of 2011 would contribute another 0.1 pp.

Population ageing starting to impact on the labour market and public finances

Finland will be one of the first countries in the EU affected by the ageing of the population, whereby the working age population would be in continuous decline from 2010 onwards. This is expected to have gradual repercussions on the labour market. The costs of population ageing will start to impact government finances already over the forecast period. The surplus in social security funds would gradually decrease as more people take up pensions and local governments will face upward expenditure pressures since they are in charge of providing most of the ageing related services.

The economic crisis has considerably weakened general government fiscal balances, adding to the

challenge of restoring long-term sustainability to public finances. Reflecting the operation of automatic stabilisers and the relatively large fiscal stimulus, general government finances weakened by about 6½ pps. in 2009, falling into a deficit of 2.2% of GDP. The weakening of fiscal balances is largely explained by a shortfall in tax revenues, with expenditure increases accounting only for a minor part. About a half of the tax revenue decline in 2009 was explained by corporate income tax accrual plummeting by over 40%, representing almost 2% of GDP. The deficit is forecast to widen to below 4% of GDP in 2010,

led by further stimulus measures of about 1% of GDP and expenditure pressures arising from public sector wage rises and social expenditure. Based on current policies (including the rise in VAT and some product taxes worth 0.2% of GDP) the deficit would be reduced in 2011 to slightly below 3% of GDP. The government has not yet designed a fully-fledged medium-term consolidation strategy. Driven largely by central government lending, the general government debt ratio would rise by over 20 pps. from close to 34% of GDP recorded in 2008 to about 55% of GDP by 2011.

Table II.25.1:

Main features of country forecast - FINLAND

	2008			92-05	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2006	2007	2008	2009	2010	2011
GDP	184.2		100.0	2.9	4.4	4.9	1.2	-7.8	1.4	2.1
Private consumption	95.5		51.8	2.3	4.3	3.4	1.7	-2.1	1.7	1.7
Public consumption	41.6		22.6	1.1	0.4	1.1	2.7	0.7	0.6	0.8
Gross fixed capital formation	39.9		21.6	2.2	1.9	10.6	-0.2	-13.4	-1.8	2.1
of which : equipment	10.2		5.6	2.1	-1.1	17.9	3.6	-13.6	-4.0	2.5
Exports (goods and services)	86.7		47.1	8.7	12.2	7.9	6.5	-24.3	4.8	6.8
Imports (goods and services)	79.3		43.1	6.9	7.9	6.0	6.6	-22.3	5.0	6.3
GNI (GDP deflator)	185.1		100.5	3.2	4.9	4.0	1.7	-8.3	1.4	2.1
Contribution to GDP growth :										
Domestic demand				1.8	2.7	4.1	1.4	-3.9	0.7	1.6
Inventories				0.3	-0.4	0.5	-0.6	-2.5	0.6	0.2
Net exports				0.9	2.1	1.2	0.3	-1.8	0.1	0.4
Employment				0.1	1.8	2.2	1.6	-3.0	-2.1	0.4
Unemployment rate (a)				11.7	7.7	6.9	6.4	8.2	9.5	9.2
Compensation of employees/head				2.9	2.9	3.7	5.1	2.4	2.6	2.1
Unit labour costs whole economy				0.2	0.3	0.9	5.5	7.7	-1.0	0.4
Real unit labour costs				-1.3	-0.5	-2.3	4.0	7.0	-2.3	-1.6
Savings rate of households (b)				-	-	7.2	7.9	10.3	10.6	9.1
GDP deflator				1.6	0.9	3.3	1.4	0.6	1.4	2.0
Harmonised index of consumer prices				1.7	1.3	1.6	3.9	1.6	1.7	1.9
Terms of trade of goods				-0.6	-4.1	-0.5	-3.3	1.6	-1.9	-0.7
Trade balance (c)				8.1	5.2	5.1	3.7	2.3	1.9	1.9
Current account balance (c)				4.2	4.6	4.3	3.5	1.5	1.1	1.3
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				4.0	4.7	4.0	2.5	1.6	1.2	1.4
General government balance (c)				-0.3	4.0	5.2	4.2	-2.2	-3.8	-2.9
Cyclically-adjusted budget balance (c)				0.3	2.8	2.6	2.1	0.3	-1.4	-1.0
Structural budget balance (c)				-	2.8	2.6	2.1	0.4	-1.3	-1.0
General government gross debt (c)				48.1	39.7	35.2	34.2	44.0	50.5	54.9

(a) Eurostat definition. (b) gross saving divided by gross disposable income. (c) as a percentage of GDP.

Note : Contributions to GDP growth may not add up due to statistical discrepancies.