

25. FINLAND

Economic recovery slowing but public finances stable

Strong recovery in GDP after the crisis

Finland's export-reliant economy proved highly sensitive to the collapse in global demand in 2009, with GDP falling by an unprecedented 8% in that year. The subsequent rebound in GDP has also been rapid, with GDP expanding by 3.6% in 2010 and continuing strongly in the first half of 2011. GDP grew by just under 4% y-o-y in the first half of 2011 on the basis of quarterly growth of 0.3% and 0.6% in the first and second quarter respectively.

The strong economic activity in 2010 and 2011 was driven by both a rebound in exports and a rapid recovery in domestic demand (notably household consumption and investment). Household consumption growth has accelerated from 2.7% in 2010 to over 4% y-o-y in the first half of 2011, driven by demand for transport vehicles and consumer durables. Despite a sharp decline in consumer confidence over the course of 2011, with the latest reading from September already well below the long-term average, the latest retail trade reading (from August) still showed robust growth. The resilience of consumption expenditure appears to be influenced by the strength of the labour market, rising wages and a decline in the saving rate (after a temporary rise over the 2009 crisis). Households also benefit from low interest rates, with a vast majority of mortgage loans tied to the variable EURIBOR rate.

House prices and construction volumes have continued to increase in the first half of 2011, albeit more slowly than over 2010 when activity rebounded from the trough in 2009. Taking account of the weakening in consumer confidence and the projected slowdown in activity, the housing market is expected to cool further over the forecast period. The latest data on residential building permits and construction starts indicates a stabilisation of residential construction volumes in positive territory close to the current level, suggesting that the expected cooling of the housing market will be gradual. Business investment is forecast to decelerate, but remain in marginally positive territory, upheld by replacement investment needs after the extended low point in 2009-10.

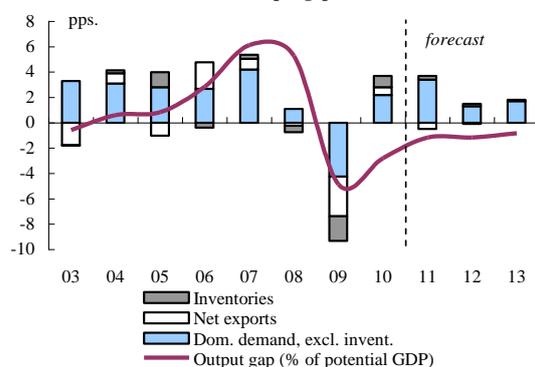
While in 2010 and in the first quarter of 2011 export volumes rebounded by over 10% in year-on-year terms, trade stalled in the second quarter of 2011. Of the main industry sectors, the electronics and paper industries have shown the weakest performance, whereas mining, chemicals, basic metals and the machinery industry have been leading growth. While exports of goods increased, exports of services declined significantly in the first half of 2011. This is most likely partly explained by a Finnish flagship company Nokia, which is downsizing its locally developed software.

The shift towards domestic-demand-driven growth is set to continue

In spite of the rapid rebound, GDP volume is expected to surpass the pre-crisis peak of 2008 only in 2012-13. While household consumption volume has already exceeded its pre-crisis level, export volumes are forecast to remain below the peak even in 2013. The Finnish economic structure, traditionally heavily reliant on industry and its export performance, has been shifting towards services and domestic demand over the past decade, with the trend picking up in the past years. Nevertheless, as the share of industry in the Finnish economy is still well above the euro-area average, GDP continues to be relatively sensitive to external demand conditions.

The global economic slowdown and ongoing structural changes within some of the main Finnish industries will weigh on exports in 2012 and 2013. As imports will be boosted by relatively buoyant domestic demand, the external sector is not forecast to add significantly to growth over the forecast period. Despite the rise in global uncertainty, short-term leading indicators for export growth, industrial new orders and production growth even rebounded somewhat in August, although growth appears low compared to the brisk recovery period in 2010. This suggests that the growth momentum for goods exports will slow in the short term. In the longer term, the projected gradual improvement in global sentiment should back the resumption of recovery in exports. However, the current account is stay close to balance over the forecast period, contrasting with the previous decade when the surplus averaged 5% of GDP (although already on a declining trend).

Graph II.25.1: Finland - Contributions to GDP growth and output gap



While Finland has preserved its solid economic fundamentals (healthy financial sector, strong public finances, resilient labour market), continued uncertainty in global financial markets is likely to eventually take its toll on growth. Quarter-on-quarter GDP growth is forecast to decelerate to marginally above zero in the fourth quarter of 2011 and the first half of 2012. In line with the forecast gradual recovery in the global economic outlook, GDP growth is expected to pick up thereafter. However, taking account of the weakening of the growth potential of the Finnish economy due to its declining working-age population, the recovery will be more subdued than in previous recovery cycles, with annual GDP growth expected to reach slightly below 2% in 2013.

Labour market is set to remain relatively strong

Labour market developments have been positive in the first half of 2011, with unemployment declining from 8.5% in the second quarter of 2010 to 7.9% in the same period in 2011. In spite of slowing economic growth, both employment and unemployment are expected to continue to improve marginally in 2012 and 2013, given that the trend decline in employment in industry is compensated by services.

The Finnish labour market is confronted with a notable demographic shock. Due to the retirement of a large baby-boom generation, the working-age population is projected to decline by over 5% of the current labour force by the end of the decade. Beyond 2020, this demographic shift will level off. By 2013 the decline in working age population is expected to start affecting the labour market more forcefully; unemployment rates are likely to fall even in a context of lower employment growth.

Risks arising from the global outlook

Similarly to 2008-09, trade remains the primary transmission channel of global economic shocks, which would in turn suppress domestic confidence and investment activity. The Finnish financial system is assessed in both domestic and international stress tests as being on a strong footing and thus unlikely to act as a drag on growth.

Although the share of exports in GDP has declined in the aftermath of the 2008-09 crisis, Finland's small and open economy is still highly dependent on external demand. Finnish exports have a bias towards investment goods and are therefore dependent on global investment conditions in emerging markets and in Europe. Should the potential global risk scenarios materialise, growth in Finland would be strongly affected, as was the case in 2008-09. However, given that the main export industries have had time to adjust to volatile global demand (while in 2008 the depth of the shock was unexpected and the economy was entering the recession from a cyclical peak), GDP is not expected to be as sensitive as in 2009.

Prices stabilising in 2012-13

HICP inflation picked up considerably in the first nine months of 2011, averaging 3.4%, also boosted by tax rises on energy, VAT and excises on alcohol, tobacco and sugar, which are estimated to have contributed ½ pp. to annual inflation. Recent falls in global energy and food prices have not yet translated into a decrease in inflation, but are expected to drive down inflation in the fourth quarter of 2011. The government has decided on further increases in taxes on alcohol, tobacco, sweets, energy, cars and some services from 2012, which are estimated to add almost 1 pp. to inflation in 2012. However, as base effects from elevated commodity prices fade, HICP inflation is nevertheless forecast to decline from the peak of 3.2% in 2011 to 2.6% in 2012 and further to 1.8% in 2013.

Relatively high inflation has led to a decrease in real earnings despite rises in nominal wages. This complicates the new rounds of wage negotiations as employee demands for wage growth have increased. Wage growth, which is settled by multiannual collective agreements and is in the short term relatively insensitive to swings in output, is set to remain relatively robust. Nevertheless, second-round inflation effects are

forecast to be relatively small in light of decelerating economic activity.

Public deficit forecast to settle at slightly over ½% of GDP in 2012-13

A buoyant economic recovery and discretionary tax increases of about 0.7% of GDP have boosted public finances in 2011, with the general government deficit forecast to decline from 2.5% of GDP in 2010 to 1% of GDP in 2011. On 5 October the government announced its budget proposal for 2012 and the medium-term spending limits extending until 2015. The government plans a wide range of both increases and decreases to various revenue and expenditure items, aiming to shift taxation from direct to indirect taxation and increase social spending while cutting administrative expenditure and transfers to local governments (the latter is technically neutral in terms of direct impact on the consolidated general government finances, but might indirectly induce budget consolidation at the local governments). At the general government level, the consolidated measures foreseen in the budget proposal improve public finances in 2012 by 0.5% of GDP on account of revenue measures. For 2013, based on measures detailed in the spending limits decision, the current forecast includes revenue-based consolidation measures worth about 0.3% of GDP

and expenditure side consolidation of 0.2% of GDP. Some additional tax measures will likely be detailed over the course of 2012 and included in the 2013 budget in due course.

Fiscal policy is estimated to be broadly neutral in 2012-13, as the consolidation effort by the central government is partly offset by the somewhat looser aggregate fiscal position at the municipal level and by a projected rise in debt-servicing costs in 2013. Even though the general government debt level has been increasing relatively quickly since the 2009 global crisis brought public finances into deficit, a rise in debt servicing costs was averted by exceptionally low effective interest rates on Finnish sovereign debt. The forecast assumes a normalisation of interest costs in 2013 towards the long-term average, adding to expenditure growth in that year. The general government deficit is projected to settle to 0.7% of GDP in 2012-13. The debt ratio is forecast to climb from 49.1% of GDP in 2011 to 53.5% of GDP in 2013. Debt projections also include the impact of guarantees to the EFSF, and the participation in the capital of the ESM as planned on the cut-off date of the forecast.

Table II.25.1:

Main features of country forecast - FINLAND

	2010			92-07	Annual percentage change					
	bn EUR	Curr. prices	% GDP		2008	2009	2010	2011	2012	2013
GDP	180.3		100.0	3.1	1.0	-8.2	3.6	3.1	1.4	1.7
Private consumption	98.5	54.6		2.5	1.8	-3.1	2.7	3.7	1.4	1.9
Public consumption	44.3	24.6		1.0	1.7	0.9	0.6	0.5	0.6	0.6
Gross fixed capital formation	33.9	18.8		2.7	-0.8	-13.5	2.8	6.4	1.9	2.4
of which : equipment	8.3	4.6		2.8	1.3	-12.0	-6.6	7.0	1.0	3.0
Exports (goods and services)	72.6	40.3		8.9	5.9	-21.5	8.6	-0.3	3.4	5.0
Imports (goods and services)	70.3	39.0		7.0	7.3	-16.1	7.4	1.1	3.5	4.8
GNI (GDP deflator)	183.3	101.7		3.4	1.5	-7.1	3.7	2.2	1.3	1.6
Contribution to GDP growth :		Domestic demand		2.0	1.1	-4.3	2.2	3.4	1.3	1.7
		Inventories		0.3	-0.5	-1.9	0.9	0.3	0.2	0.0
		Net exports		1.0	-0.2	-3.1	0.6	-0.5	-0.1	0.1
Employment				0.4	2.6	-3.5	-1.4	1.0	0.3	0.2
Unemployment rate (a)				11.1	6.4	8.2	8.4	7.8	7.7	7.4
Compensation of employees/head				3.0	4.4	2.3	3.5	3.2	3.2	3.2
Unit labour costs whole economy				0.2	6.0	7.6	-1.5	1.2	2.1	1.7
Real unit labour costs				-1.4	3.7	5.8	-1.9	-1.2	-0.7	-0.5
Saving rate of households (b)				9.4	8.1	11.9	11.3	7.5	7.3	7.1
GDP deflator				1.6	2.2	1.7	0.4	2.4	2.8	2.2
Harmonised index of consumer prices				1.6	3.9	1.6	1.7	3.2	2.6	1.8
Terms of trade of goods				-0.8	-2.4	2.8	-3.0	-1.7	0.3	0.1
Merchandise trade balance (c)				7.7	3.7	1.7	1.6	0.6	0.7	0.8
Current-account balance (c)				4.0	3.2	2.7	2.8	-0.1	0.0	0.1
Net lending(+) or borrowing(-) vis-à-vis ROW (c)				4.1	3.3	2.8	2.9	0.0	0.1	0.2
General government balance (c)				0.3	4.3	-2.5	-2.5	-1.0	-0.7	-0.7
Cyclically-adjusted budget balance (c)				0.4	2.5	0.6	-0.6	0.1	0.3	0.1
Structural budget balance (c)				-	2.5	0.7	-0.5	0.1	0.3	0.1
General government gross debt (c)				46.7	33.9	43.3	48.3	49.1	51.8	53.5

(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.