

25. FINLAND

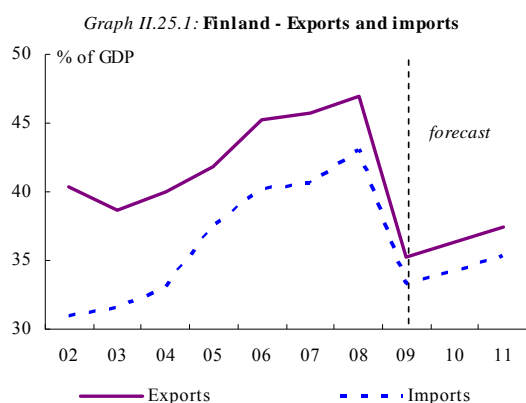
Strong external exposure takes its toll on the economy

From strong growth to rapid contraction

After a decade of rapid export-driven growth, Finland entered the global crisis in 2008 from a relatively strong position, having built up a substantial surplus in the current account and government finances. Nevertheless, the global crisis has had a strong impact on the export-dominated Finnish industry, as well as on the domestic sectors through negative confidence effects. At the outset, the global crisis had a sharply negative impact on consumer confidence, even though domestic factors implied a solid rise in consumer purchasing power in 2008 and 2009. In contrast, over the course of 2009, consumer confidence has rebounded to close to pre-crisis levels. However, that rebound and a more moderate recovery in industry confidence indicators were not yet reflected in actual output data for the first half of 2009. GDP contracted at a quarterly rate of about 3% in both the first and second quarters of 2009, yielding an annualised contraction of about 8½% over the first half of 2009.

Downturn driven by exports of manufactured goods

Finnish industry has traditionally had a highly concentrated structure, with 70% of exports generated by the metal engineering, electronics, and forestry sectors. A strong specialisation in investment goods allowed Finnish exporters to benefit from the global economic boom of the past few years (see Graph II.25.1).



With the global economic cycle turning to bust, demand for investment goods has plummeted and is expected to revive only with a lag after global growth has gained strength. Over the first half of 2009, Finnish exports dropped by the most in the euro area. Apart from the unfavourable composition effect, the sudden appreciation of the euro's exchange rate against the currencies of Finland's main trading partners has had a relatively strong impact on external trade, given that almost 70% of Finnish exports go outside the euro area, which is the highest share of any euro-area country. Additionally, the sizeable forestry industry appears to be in a long-term process of downsizing its production capacity in Finland due to global shifts in demand and production towards Latin America and Asia. Production volumes in the electronics industry have traditionally been highly volatile and correlated with global demand conditions. Because the import content of exports is relatively high and domestic consumption has also declined by over 5%, the drop in exports is similarly mirrored in imports. Since import prices have fallen faster than export prices in 2009, the impact on the current account is somewhat less severe and a slight surplus position of about 1% of GDP is still maintained.

Policy response concentrated on tax cuts

Given the sizeable surplus in public finances recorded in 2008, Finland allowed the full operation of automatic stabilisers and in addition provided for a relatively large fiscal stimulus amounting to 1½% of GDP in 2009 and a further 1% of GDP in 2010. The fiscal stimulus is heavily concentrated on tax cuts (primarily cuts to personal income tax), making up about 80% of the stimulus packages. The expenditure measures designed to boost public investment are therefore relatively smaller. In addition, funding for export financing was sharply increased, as were other measures aimed at reducing financing costs for enterprises. Given that households have sharply increased their savings in the current uncertain economic environment, the effect of the tax stimulus on consumption appears to have been relatively limited.

A muted, domestically driven recovery ahead

While the rebound in household and industry confidence indicators suggests that the economy should return to growth already over the second half of 2009, the recovery is expected to be subdued, with GDP growth below 1% in 2010 and about 1½% in 2011. This would be well below the average growth rates of the previous decade, but broadly in line with the euro-area average. Over the next growth cycle, exports are expected to be less significant as a growth driver than they were in the previous decade. While 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 strength of the euro and the rapid rise of unit labour costs over 2008-2009, Finland has sharply lost external price competitiveness.

Domestic demand is expected to play a relatively stronger role in the initial years of the next growth cycle. The rapid recovery of consumer confidence over the course of 2009 is matched by a relatively robust rise in real disposable income, growing by over 1% annually over the forecast years. Precautionary savings and a rise in unemployment have so far, however, led to a sharp rise in household savings rather than spending. 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 the euro-area average. Moreover, the debt burden on households is mitigated by lower interest rates (about 90% of mortgages are on variable interest rates) and longer debt maturities compared with past decades. Also, the housing sector does not appear to be facing a major price adjustment. While house prices went through a temporary dip at the end of 2008, they have already partly rebounded over the first half of 2009. It is anticipated that an improving economic outlook will result in a stabilisation of the household saving rate and support a modest rise in private consumption by about 1% in 2010 and 1½% in 2011. Given the inherent lags in investment activity, housing investment is expected to turn positive only in 2011. The main risk to the recovery of domestic consumption is

projected to stem from unemployment developments, which have traditionally played an important role in influencing consumer behaviour.

The Finnish financial sector has remained solid and well placed to meet the demand for private and corporate credit. Overall, corporate balance sheets do not face major adjustment needs and would appear to be well capitalised for undertaking investments. Nevertheless, private investment is expected to rebound only in 2011 after the forecast global recovery has firmly taken hold. Government stimulus measures on the expenditure side are relatively limited and are not expected to uphold growth in public investment. Given that about two thirds of public investment is made by municipalities, which are expected to react to financing constraints by cutting investment costs, public investment is expected to contract in 2010-11.

Wages set to moderate, inflation to remain relatively high

Following a decade of relative wage moderation, the previous wave of wage agreements, settled at the peak of the economic cycle in autumn 2007, provided for exceptionally high wage growth over the next 2-3 years. The onset of the crisis has not triggered a notable reduction in agreed pay rises. Wage growth per employee still reached 4½% in the first half of 2009. The following rounds of wage settlements are expected to be mainly negotiated in early 2010 and are likely to attempt to make up for the recent loss of wage competitiveness. An early indication comes from the wage settlement of the technology industry branch, concluded already in autumn 2009, which provided for a 0.5% wage rise over the next year, not counting the effect of a possible wage drift.

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, primarily due to the rapid rise in unit labour costs being passed on to service prices. It appears that food and energy prices have also come down from their peak levels more slowly than on average in the euro area, possibly indicating a lack of competitive pressure. A cut of VAT on food by 5 pp. from 1 October 2009 is assumed to reduce inflation by about 0.5 pp., which is partly offset by a rise in alcohol and tobacco excises. A rise of the general VAT rate by 1 pp. as of July 2010 is estimated to increase

inflation by about 0.2 pp., also partly offset by a 9 pp. cut in VAT on restaurant services.

Population ageing starting to impact on the labour market

The labour market reaction to the crisis has so far been more subdued than might have been expected from the steep fall in output. About half of the decline in employment is explained by lay-offs in industry. In addition, temporary lay-offs and various schemes to reduce working time, mostly not reflected in unemployment statistics, have been commonly used, amounting to almost 3% of the labour force. In the medium term, the Finnish labour market is expected to be seriously affected by the ageing of the population, with the working-age population in steady decline from 2010 onwards. This is expected to tighten the labour market over the forecast period and lead to a reduction in unemployment at a relatively early stage of the economic recovery cycle.

Sharp budgetary easing exacerbates fiscal sustainability challenge

General government finances are set to fall by over 7 pps. from a surplus of 4.5% of GDP in 2008 to a deficit of almost 3% of GDP in 2009. The weakening of government 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 is explained by plummeting corporate income tax accrual, which is forecast to drop by about 44%, representing almost 2% of GDP. The tax cuts as part of the fiscal stimulus amount to over 1% of GDP in 2009. The deficit is forecast to widen further to 4½ % of GDP in 2010, as the expected modest recovery of economic activity would generate only a minor rise in tax revenue, countered 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 2010 budget proposal, the deficit is projected to edge down only slightly in 2011 to below 4½% of GDP, which is above the deficit threshold of 3% of GDP set out in the Stability and Growth Pact and not in line with the government's aim to ensure long-term sustainability of public finances. The government has not yet announced a fully fledged medium-term consolidation strategy. Driven largely by central government lending, the general government debt ratio is expected to shoot up from below 34% of GDP in 2008 to just below 53% of GDP by 2011.

Table II.25.1:

Main features of country forecast - FINLAND

	2008			Annual percentage change						
	bn Euro	Curr. prices	% GDP	92-05	2006	2007	2008	2009	2010	2011
GDP	184.7	100.0	2.8	4.9	4.2	1.0	-6.9	0.9	1.6	
Private consumption	95.6	51.7	2.3	4.1	3.3	1.9	-2.8	1.0	1.4	
Public consumption	41.3	22.3	0.9	0.6	0.8	2.0	1.7	0.7	0.6	
Gross fixed capital formation	38.1	20.6	1.8	4.8	8.7	0.3	-11.0	-2.4	1.9	
of which : equipment	10.4	5.6	2.0	4.1	11.7	8.6	-11.5	-4.4	2.5	
Exports (goods and services)	86.8	47.0	8.8	11.8	8.1	7.3	-25.3	4.6	4.8	
Imports (goods and services)	79.6	43.1	6.9	7.8	6.5	7.0	-22.1	3.8	4.2	
GNI (GDP deflator)	184.3	99.8	3.1	5.4	3.1	0.9	-6.4	0.9	1.6	
Contribution to GDP growth :										
Domestic demand			1.7	3.2	3.6	1.4	-3.3	0.2	1.3	
Stockbuilding			0.3	-0.2	0.5	-0.8	-1.2	0.3	0.0	
Foreign balance			1.0	2.0	1.0	0.5	-2.4	0.3	0.3	
Employment			0.2	1.8	2.2	1.6	-2.9	-2.5	0.1	
Unemployment rate (a)			11.7	7.7	6.9	6.4	8.5	10.2	9.9	
Compensation of employees/head			2.9	2.9	3.4	5.3	3.4	2.7	1.9	
Unit labour costs whole economy			0.3	-0.2	1.5	5.9	7.8	-0.7	0.5	
Real unit labour costs			-1.3	-1.6	-1.7	4.1	5.6	-2.1	-1.1	
Savings rate of households (b)			-	-	6.4	6.7	10.8	11.1	10.9	
GDP deflator			1.6	1.3	3.2	1.8	2.1	1.5	1.5	
Harmonised index of consumer prices			1.7	1.3	1.6	3.9	1.8	1.6	1.5	
Terms of trade of goods			-0.6	-3.8	-1.6	-3.4	1.6	-1.0	-1.0	
Trade balance (c)			8.3	5.5	4.9	3.2	2.0	1.9	1.9	
Current account balance (c)			4.6	4.9	4.0	2.6	1.1	1.2	1.3	
Net lending(+) or borrowing(-) vis-à-vis ROW (c)			5.1	6.0	4.9	3.0	1.1	1.2	1.3	
General government balance (c)			-0.3	4.0	5.2	4.5	-2.8	-4.5	-4.3	
Cyclically-adjusted budget balance (c)			0.3	2.7	2.9	2.7	-0.5	-2.3	-2.4	
Structural budget balance (c)			-	2.7	2.9	2.7	-0.5	-2.2	-2.4	
General government gross debt (c)			48.0	39.3	35.2	34.1	41.3	47.4	52.7	

(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.