Eurozone Forecast
March 2015

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Latvia
Lithuania
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain
Outlook for Finland

Economic future depends on election results
The Finnish economy is being buffeted by competing external forces. On the positive side, the country is benefiting from lower oil prices, a strengthening Eurozone economy, and policy measures by the European Central Bank (ECB) to stimulate demand. On the downside, the recession in Russia, Finland’s largest trading partner, is denting export performance and tourism, and is thus undermining confidence.

But the main factors underlying Finland’s economic malaise are domestic. Industry needs to be reoriented to meet the changing nature of global demand — a process that requires supply-side reforms to help boost productivity and restore corporate profitability.

The economy is therefore facing a lengthy period of industrial restructuring, so we expect only a very gradual recovery in activity over the next few years. After a 0.1% contraction in GDP in 2014, our forecast now shows growth of just 0.3% in 2015 and 1.2% in 2016, with a subsequent acceleration to 2.2% by 2019.

Finnish exporters will struggle to take advantage of the projected recovery in global demand. We forecast export growth of just 0.9% in 2015, even weaker than last year, before it rises gradually to a little over 3% a year in 2017-19. Sustained growth over the medium term will require the development of new sectors to meet the changing nature of global demand, and the restoration of cost competitiveness compared with rival countries.

The necessary restructuring of domestic industry will need significant private sector investment, but capital expenditure is being held back by weak demand and the uncertain outlook. We expect a further contraction in total investment of 0.7% in 2015, but then a rise of 1.9% in 2016 and 2.3% a year in 2017-19 as the outlook brightens.

The direction of government policy will be crucial for laying the groundwork for the economy’s medium-term health. The hope is that the April 2015 elections will produce a stronger political consensus on the need for progress with the structural reform agenda.
External developments are pulling the economy in opposite directions ...

Despite some recent favorable external developments, including the sharp fall in oil prices, the weaker euro, strengthening Eurozone demand and the latest ECB policy measures, the Finnish economy remains weak. A 0.2% fall in GDP in Q4 2014 meant that the economy contracted by 0.1% in the year overall.

The positive factors are being offset by the effects of the deep recession now expected in Russia, Finland’s largest trading partner. In addition to the impact on trade, the weak rouble is likely to result in fewer tourists traveling from Russia to Finland, which is important because Russian tourists normally outnumber visitors from the European Union (EU). The economic problems in Russia will also heighten uncertainty for companies and households in Finland, which may act as an additional drag on investment and consumer spending.

On balance, the growth tailwinds generated by positive developments in the global economy are likely to be neutralized by the headwinds emanating from Russia. Our GDP growth forecast for Finland in 2015 has therefore been lowered to just 0.3% from the 0.5% forecast in December.

... but domestic factors will determine the longer-term outlook

More important for the underlying health of the economy are domestic developments. The economic malaise seen in recent years in Finland reflects the decline of its key paper and pulp and electronics industries, together with a loss of cost competitiveness relative to rival countries. Industry needs to be reoriented to meet the changing nature of global demand, a painful process that will require supply-side reforms to help boost productivity and restore corporate profitability.

The economy is therefore facing a lengthy period of industrial restructuring, so we expect only a very gradual recovery in activity over the next few years. Our forecasts show GDP growth accelerating slowly from 1.2% in 2016 to 2.2% by 2019. Moreover, the risks to this forecast are tilted to the downside, as potential output growth could remain stuck at around 1% a year if policy reforms to support the restructuring process do not proceed as planned.

Table 1

Finland (annual percentage changes unless specified)

<table>
<thead>
<tr>
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<tbody>
<tr>
<td>GDP</td>
<td>-0.1</td>
<td>0.3</td>
<td>1.2</td>
<td>1.7</td>
<td>2.0</td>
<td>2.2</td>
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<tr>
<td>Private consumption</td>
<td>0.0</td>
<td>0.3</td>
<td>1.0</td>
<td>1.6</td>
<td>1.8</td>
<td>2.0</td>
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<tr>
<td>Fixed investment</td>
<td>-4.6</td>
<td>-0.7</td>
<td>1.9</td>
<td>2.3</td>
<td>2.3</td>
<td>2.3</td>
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<tr>
<td>Stockbuilding (% of GDP)</td>
<td>0.1</td>
<td>0.0</td>
<td>-0.1</td>
<td>-0.2</td>
<td>-0.1</td>
<td>0.1</td>
</tr>
<tr>
<td>Government consumption</td>
<td>-0.3</td>
<td>0.7</td>
<td>0.9</td>
<td>1.4</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Exports of goods and services</td>
<td>1.4</td>
<td>0.9</td>
<td>2.8</td>
<td>3.2</td>
<td>3.3</td>
<td>3.2</td>
</tr>
<tr>
<td>Imports of goods and services</td>
<td>-0.4</td>
<td>0.4</td>
<td>2.4</td>
<td>2.9</td>
<td>3.2</td>
<td>3.2</td>
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<tr>
<td>Consumer prices</td>
<td>1.2</td>
<td>0.1</td>
<td>1.0</td>
<td>1.1</td>
<td>1.3</td>
<td>1.6</td>
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<tr>
<td>Unemployment rate (level)</td>
<td>8.7</td>
<td>8.8</td>
<td>8.6</td>
<td>8.0</td>
<td>7.5</td>
<td>7.1</td>
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<tr>
<td>Current account balance (% of GDP)</td>
<td>-1.1</td>
<td>-1.0</td>
<td>-0.3</td>
<td>-0.2</td>
<td>0.1</td>
<td>0.2</td>
</tr>
<tr>
<td>Government budget (% of GDP)</td>
<td>-2.8</td>
<td>-2.1</td>
<td>-1.2</td>
<td>-0.6</td>
<td>-0.2</td>
<td>0.0</td>
</tr>
<tr>
<td>Government debt (% of GDP)</td>
<td>58.9</td>
<td>60.0</td>
<td>59.4</td>
<td>57.8</td>
<td>55.7</td>
<td>53.5</td>
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<tr>
<td>ECB main refinancing rate (%)</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
</tr>
<tr>
<td>Euro effective exchange rate (1995 = 100)</td>
<td>123.6</td>
<td>108.6</td>
<td>104.7</td>
<td>105.4</td>
<td>106.6</td>
<td>108.0</td>
</tr>
<tr>
<td>Exchange rate (US$ per €)</td>
<td>1.33</td>
<td>1.07</td>
<td>1.01</td>
<td>1.01</td>
<td>1.02</td>
<td>1.04</td>
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</table>

Source: Oxford Economics.
Export prospects undermined by the loss of cost competitiveness

Although global demand conditions are expected to improve in the coming years, Finnish exporters will struggle to take full advantage of the projected recovery. This mainly reflects the erosion of price competitiveness relative to trading partners, as wage increases in recent years have not been matched by corresponding growth in labor productivity. This weak performance will also be compounded by the composition of exports, which are narrowly focused on capital and intermediate goods mainly destined for mature economies with subdued growth prospects.

We therefore forecast that export growth will weaken to just 0.9% in 2015, before rising gradually to about 3.3% a year in 2018–19. Sustained export growth over the medium term will require the development of new sectors to meet the changing nature of global demand, and the restoration of cost competitiveness relative to rival countries.

Firms remain hesitant to expand investment ...

The necessary restructuring of domestic industry will require significant private sector investment, but capital expenditure is being held back by weak demand and the uncertain outlook. In many sectors, even the existing productive capacity is not being fully utilized. A strong upturn in corporate investment remains unlikely until the outlook for profitability improves, underscoring the need to bring wages and productivity into line to restore profit margins.

Weak demand conditions are also dampening the outlook for housing investment, while the ongoing austerity drive will constrain the expansion of government investment. As a result, we expect a further contraction in total investment expenditure of 0.7% in 2015, before positive growth of 1.9% in 2016 and then 2.3% a year in 2017–19.

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Table 2

| Forecast for Finland by sector (annual percentage changes in gross added value) |
|----------------------------------|---|---|---|---|---|---|
| GDP                              | -0.1 | 0.3  | 1.2  | 1.7  | 2.0  | 2.2  |
| Manufacturing                    | -3.0 | 1.0  | 2.0  | 3.4  | 3.5  | 3.4  |
| Agriculture                      | 2.2  | 0.4  | 0.1  | -0.2 | 0.1  | 0.3  |
| Construction                     | -3.1 | -0.9 | 2.0  | 2.0  | 1.5  | 1.4  |
| Utilities                        | -1.8 | -1.2 | -0.3 | 1.0  | 1.4  | 1.6  |
| Trade                            | -0.9 | -0.3 | 1.0  | 1.9  | 2.0  | 2.0  |
| Financial and business services  | 1.8  | 1.1  | 1.3  | 1.8  | 1.8  | 2.0  |
| Communications                   | 8.8  | 1.7  | 2.5  | 2.8  | 3.2  | 3.5  |
| Non-market services              | 0.8  | 0.5  | 0.8  | 1.3  | 1.4  | 1.5  |

Source: Oxford Economics.
... and sluggish job creation will constrain household incomes

The decline in the profitability of the corporate sector has also resulted in a significant fall in private sector employment. Although official data puts Finland’s headline unemployment rate at 8.7% of the workforce in 2014 (on the International Labour Organization measure), this understates the true jobless total, because of the large number of discouraged workers who are not actively seeking employment. In fact, data on “disguised unemployment” from Statistics Finland reveals that 14% of the potential labor force is currently out of work.

The level of employment does appear to be stabilizing. But we do not expect any significant job growth over the coming year, because firms are likely to want to raise productivity rather than hire immediately. Indeed, modest wage growth and sluggish job creation will constrain household income for some time, although persistently low rates of consumer price inflation will at least offer some relief to consumers. Against this background, we expect consumer spending to expand by just 0.3% in 2015, with momentum building only slowly in subsequent years.

Fiscal austerity drive will further dent economic activity

Although Finland’s public finances remain in better health than most other Eurozone countries, with public debt still a little below the EU’s Stability and Growth Pact threshold of 60%, there has been a clear deterioration relative to the pre-crisis period. The budget deficit was an estimated 2.8% of GDP in 2014, and the structural issues clouding the economic outlook suggest that the Government cannot rely on a cyclical rebound in tax revenues to close this gap. Medium-term consolidation of the public finances is seen as an important issue by the major political parties, especially as the Finnish economy is expected to suffer more from the effects of an aging population than most other European countries.

Additional austerity measures are therefore planned for the next few years. According to the finance ministry, fiscal adjustments will be deeper in 2015–18 (around 3% of GDP) than in 2013–14, when it is estimated that fiscal consolidation efforts amounted to just over 1% of GDP. Although we expect that these measures will result in an improvement in the budget balance, this fiscal tightening will place further downward pressure on the fragile economy.

Structural reforms are necessary to support growth prospects

Wage moderation in the private sector will be essential to improve cost competitiveness in the near term. But Finland also needs supply-side reforms to help the economy overcome the structural problems it is facing. In November 2013, the Government announced a set of measures to raise the economy’s productive capacity and tackle the fiscal sustainability gap. These included plans to consolidate the municipal finances and enhance the efficiency of public service provision, as well as reforms aimed at promoting competition across the economy, extending working careers and enhancing the flexibility of the labor market.

In light of the ambitious and wide-ranging nature of these measures, there is a risk that they will not be implemented in full. With this in mind, the April 2015 election offers the opportunity for a stronger political consensus on the need to progress with the structural reform agenda and so lay the groundwork for the economy’s medium-term health.
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