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MEDIA RELEASE

Economic Forecast 2014/1:

THE EURO AREA RECESSION IS OVER –FINLAND'S GDP WILL GROW BY 0.7 PER CENT THIS YEAR

- *The euro area recession is over, but growth is still sluggish*
- *Finland's GDP will grow by 0.7 per cent in 2014 and 2 per cent in 2015*
- *The volume of exports will expand by over 3.5 per cent in 2014, while growth in 2015 is expected to be about 4.5 per cent*
- *Private consumption will climb by 0.4 per cent in 2014, but accelerate to 1.3 per cent in 2015, fuelled by an improvement in consumer confidence and employment*
- *Business investment will decline by 2.5 per cent in 2014 due to weak demand, but the recovery of demand will spawn growth of a few per cent in 2015*
- *The unemployment rate will rise to 8.4 per cent in 2014 and fall to 8.3 per cent in 2015*
- *Finland's consumer prices will rise 1.6 per cent this year: international inflation is low, but hikes in commodity taxes will boost inflation in Finland*
- *Additional austerity measures are expected to trim the deficit by one billion euros per year in 2015-2017; this will put the central government debt-to-GDP ratio back on a declining path in 2017*

WORLD ECONOMY HAS CONTINUED TO RECOVER

The period of weak growth that has prevailed since the 2008 financial crisis finally appears to be coming to an end. The GDP growth rate of the total OECD area climbed to 0.3 per cent in the first quarter of last year on a quarter-on-quarter basis, up from the zero rate of growth at the end of 2012. Growth strengthened somewhat towards the end of last year.

Economic development in the EU countries has also taken a turn for the better. The turning point occurred in the second quarter, with real GDP growth being 0.4 per cent on a quarter-on-quarter basis. Since then, GDP has expanded on average at about the same pace. The continuation of the EU's growth is a sign that the worst difficulties have been overcome. A new escalation of the euro area's problems cannot, however, be ruled out.

For instance, in the United States, Germany and Sweden, GDP has already surpassed the level prevailing in early 2008. In the euro area and Finland, this level has not yet been reached.

GDP is expected to grow in the United States by 2.5 per cent in 2014 and 2015. Housing prices are rising and consumer confidence has improved. The total EU area's GDP will grow this year and next year by 1.5 per cent and by 2 per cent in 2016. In Russia, GDP growth will remain at 1.5 per cent in 2014, but thereafter growth will pick up to a couple of per cent. Weak growth is caused by the low price of energy as well as the slow pace of economic reforms. China's GDP will increase in the next few years by about 7.5 per cent. Uncertainty in financial markets and attempts to curb the sharp rise in debt will dampen growth in output.

In 2014, the world’s total GDP growth will accelerate from last year’s rate of approximately 3 per cent to 3.5 per cent. In 2015, growth will pick up even a little bit more. The United States is the world's main engine for economic growth. In Europe, the strengthening of German demand will foster the recovery. The growth of emerging economies will be dampened by, among other things, the weakening of foreign capital flows due to the partial tapering of US monetary stimulus.

The recovery is expected to continue if the financial market's confidence remains steadfast and the deficits of the crisis countries can be steered to a sustainable path. Fiscal policy is still tight in many countries.

The world economy is still at risk of substantially less favourable development. The EU's ability to stabilize the finances of public sectors in crisis countries is still of critical importance. It affects the financial markets' belief in problem solving and mutual trust between market participants. In the US it is important that the confidence of the private sector is maintained. The political decision-making related to the federal debt ceiling may be subject to new disputes, although an agreement on how to proceed in the short term has been reached. In February-March 2014 the Ukrainian crisis escalated. In our baseline scenario we assume that the crisis will gradually weaken. The worst scenario would be open military conflict. It is more likely, however, that there will be reciprocal economic sanctions. If they are extensive, this would be detrimental to the growth not only of Russia, but also of many EU countries. Due to our close economic relations, Finland is particularly vulnerable to Russia's own crisis and economic sanctions.

EURO AREA RECOVERY HAS STRENGTHENED

The prolonged recession in the euro area began in the fourth quarter of 2011. The recession was exacerbated by over-indebtedness caused by tight fiscal policy. GDP still continued to contract by 0.3 per cent in the first quarter of 2013. During the second quarter, GDP grew from the previous quarter by 0.3 per cent. Growth continued at approximately the same pace during the rest of the year. Growth is just beginning to get under way, and its continuation depends on the development of business and household confidence.

The European Central Bank lowered its key interest rate in November 2013 to 0.25 per cent from the previous 0.5 per cent. In addition to its interest rate policy, when necessary the ECB has conducted so-called extraordinary monetary policy measures to promote the functioning of financial markets and to ensure sufficient liquidity. When the financial market turbulence was at its peak during the summer and autumn of 2012, the ECB announced the purchase of an unlimited amount of short-term debt of crisis countries in the secondary market, as long as the crisis countries take part in the European Stability Mechanism (ESM). The mere statement has calmed the markets, because it is seen that the risk of the disintegration of the euro has been reduced significantly.

There are also differences in growth between euro area countries in 2014. In Cyprus, output will drop by almost 5 per cent and in Slovenia slightly. In Greece and Italy, GDP will increase by half a per cent and in France, Spain and Portugal by about one per cent. GDP will expand in Germany and Ireland by 1.5-2 per cent. The current account deficits will continue to shrink, and at the same time the rise in the public sector's debt will slow down, although not very quickly. High public debt makes many EU economies vulnerable.

The euro area's GDP is forecast to grow by about 1 per cent in 2014. The growth that began last year is expected to strengthen during the course of this year. In 2015, growth will accelerate to one and a half per cent and to two per cent in 2016.

ECONOMIC UPSWING HAS NOT YET OCCURED IN FINLAND

Finland's GDP fell continuously for one year from the second quarter of 2012 to the first quarter of 2013. Since then the level of output has remained more or less unchanged. GDP contracted during 2013 as a whole by 1.4 per cent compared to the previous year. The volume of exports remained at approximately the previous year's level, but started to increase in the fourth quarter. Private consumption fell by 0.8 per cent. Purchasing power was partly cut by the one per cent hike in the VAT rate in the beginning of the year. Weakening consumer confidence also curbed consumption. The decline of investment accelerated during the second half of the year. This was the case in both machinery and equipment investment and construction investment. The volume of investment fell by 4.6 per cent. Compared to ETLA's forecast of last September, imports rose more than anticipated. Due to the slower growth of the wage bill and weakening household confidence, private consumption also fell slightly more than expected. Inventories likewise decreased more than forecast.

GDP WILL GROW BY 0.7 % IN 2014 AND 2 % IN 2015

GDP is estimated to grow this year by only 0.7 per cent, i.e. far less than the 1.6 per cent forecast in September of last year. This revision is attributable to the fact that growth did not pick up last year as expected. Even though the economy will recover during the course of this year, year-on-year growth will remain modest. The growth of exports that began late last year is expected to continue. This will gradually increase work hours and will also, over time, improve employment. Private consumption will strengthen somewhat. Investment will decline further in 2014. This year businesses still have some idle production capacity, but next year more will be needed, and investment is expected to pick up. In 2015, Finland's GDP will grow by 2 per cent. This requires that the euro area continues to recover, and that Finland maintains its market share in exports. In 2016, GDP will increase by 1.9 per cent. Growth will be boosted then by new nuclear power plant investments. Growth-dampening factors, in turn, include spending cuts and tax increases aimed at balancing public finances.

EXPORTS EXPECTED TO EXPAND AS MARKETS RECOVER

Both goods and service exports remained in 2013 at about the same level as in the previous year. Exports of the chemical industry increased, especially due to product development and strong demand for oil refinery products. Paperboard and pulp exports increased as consumption in export countries has been recovering. Exports to EU countries increased especially in the fourth quarter. Growth is expected to continue in 2014. Nokia's closure of its Salo factory of 2012 is no longer visible in the comparison figures. If Nokia is able to improve its operations, an increase in its exports will be reflected mainly in the service export statistics. In 2014, the exports of a number of industries are forecast to return to growth. The machinery and equipment industry exports will improve as the demand for investment goods in the world economy recovers. Finland's exports, however, are facing challenges set by globalization and structural changes in demand. Businesses should be able to improve the quality of their products, develop new products and to improve their cost competitiveness.

Export volumes are forecast to grow by 3.7 per cent in 2014 and by 4-4.5 per cent in 2015 and 2016. This roughly corresponds to market growth. The slight improvement in the price competitiveness of exports brought about by the moderate wage settlement is expected to compensate for the effects of the structural weakness of exports. The threat of trade restrictions caused by the political situation in Ukraine and Crimea is a major risk for exports in the short term.

CORPORATE INVESTMENTS STILL DECLINING DUE TO WEAK DEMAND

According to Statistics Finland, 78.7 per cent of industrial capacity was in use in January 2014. This was 2.1 percentage points lower than a year earlier. Therefore, there is still a significant amount of idle capacity. While the outlook for both exports and private consumption is still uncertain, companies are curbing their investments for the time being. Total fixed capital investment is forecast to decline by 2.4 per cent this year. Next year, it will increase by 2 per cent. Machinery and equipment investment will decrease this year by 6.5 per cent. It will increase by 3 per cent next year when there starts to be a shortage of capacity. Housing investment will decline a couple of per cent in 2014, but it will pick up in 2015, expanding by slightly more than one per cent.

In 2016, the total investment growth will strengthen to slightly less than 3 per cent as the economic situation recovers. Businesses need to expand production capacity and productive investment will increase by 4 per cent. Residential construction growth will continue to be moderate. The need for housing remains high in growth centres, but the weak purchasing power of households and continuing high unemployment will dampen growth. The start of construction work on new nuclear power plants will boost business construction.

UNEMPLOYMENT RATE STILL CLIMBING SLIGHTLY

Finland's GDP has declined for two consecutive years. The unemployment rate rose last year to 8.1 per cent from the previous year's 7.7 per cent. The rise in unemployment has been relatively modest. This is due to the fact that a significant part of the decline in production has occurred in the sectors with high productivity and that the size of the working-age population has begun to decline due to aging. The employment rate fell slightly last year to 70.1 per cent. In 2014, the unemployment rate will climb to 8.4 per cent due to weak economic growth this year and lagging effects from last year. In the short term, a rise in the unemployment rate is being curbed by the fact that a part of the population is no longer actively seeking jobs and are thus classified as being outside the labour force. In 2015, the unemployment rate will decline to 8.3 per cent. In 2016, the unemployment rate will be 8.1 per cent while the employment rate will be slightly below 70.4 per cent.

SLUGGISH PURCHASING POWER GROWTH AND WEAK CONFIDENCE DAMPEN CONSUMPTION

Private consumption is expected to grow by only 0.4 per cent in 2014. The modest increase is due to weak employment trends, real income remaining unchanged and continuing weak consumer confidence. In 2015, private consumption will grow by over one per cent as employment improves and consumer confidence begins to be restored. Households' real purchasing power will increase 0.6 per cent even though employees' real wages fall due to, among other things, assumed hikes in consumption taxes carried out in conjunction with the government's austerity measures. Consumers are willing to borrow to finance pent-up consumption demand, e.g. for car purchases. In 2016, private consumption growth will accelerate to about 1.5 per cent due to the improving employment situation. Real wages will remain at the previous year's level. The growing number of pensioners and the rise of the pension index in line with inflation will act as consumption stabilizing factors during the next few years.

CONSUMPTION TAX HIKES SPURRING INFLATION

In 2014, consumer prices are expected to rise by 1.6 per cent. Interest rates have continued to fall and international inflation has weakened. Inflation is being boosted by half a percentage point due to the increase of commodity taxes at the beginning of this year. The level of earnings will increase by 1.3 per cent as stipulated by the two-year wage settlement last autumn. EU-harmonized inflation, which does not include interest on housing loans, will increase by 2 per cent. In 2015 consumer prices are expected to rise by 1.9 per cent. Inflation will be spurred by anticipated hikes in consumer taxes and the strengthening upswing in the world economy, which will bolster international inflation. In 2016 consumer prices are forecast to rise by 2.1 per cent. At this point, interest rates are already estimated to be on the rise, which will contribute to inflation.

GOVERNMENT EXPECTED TO AGREE ON ADDITIONAL AUSTERITY MEASURES

The central and local government's financial deficit was 4.5 per cent of GDP in 2013. The central government's deficit was 3.7 per cent of GDP. The Ministry of Finance has estimated that bringing about a decline in the government debt-to-GDP ratio in line with the government programme would require additional austerity measures affecting government revenues and expenditures by about EUR 3 billion. A group of experts appointed by the Prime Minister proposed that the fiscal belt tightening should be spread out evenly over the years 2015- 2017. We have assumed in this forecast that this is what the government will decide to do in its spring 2014 negotiations on spending limits. We have also assumed that the government's austerity measures will be divided fairly evenly between actions affecting revenue and expenditure. This will lower GDP growth by about 0.2 percentage points per year during the years 2015- 2017.

In 2014, the central and local government deficit-to-GDP ratio will fall slightly to 4.3 per cent. Owing to tax increases and spending cuts as well as economic growth, the deficit will fall to 3.2 per cent relative to GDP in 2015 and further to 2.1 per cent in 2016. The central government debt-to-GDP ratio will increase to 49.4 per cent in 2015-2016 and start to decline in 2017.

The general government's so-called EMU or EDP deficit will be 2.1 per cent of GDP in 2014 and 1.2 per cent in 2015. In 2016, public finances will already almost be balanced. Owing to austerity measures, the so-called structural deficit of the general government is anticipated to remain at 0.4 per cent of GDP in 2014-2015, which is below the EU's Stability and Growth Pact limit set at 0.5 per cent.

The general government's EMU debt ratio, calculated based on current National Account rules, will exceed the 60 per cent ceiling stipulated by the Stability and Growth Pact in 2015. The ratio will begin to decline in 2017 due to the new austerity measures. National Account reforms going into force in the summer of 2014 will increases the level of GDP technically by a few per cent, meaning that Finland's debt will not trigger sanctions in line with the EU's excessive deficit procedures. In addition, the threshold will be lowered by about 2.5 percentage points by the solidarity payments to the EU crisis countries. The debt ratio is also subject to cyclical adjustment. Without further austerity measures and structural reforms, the debt- to-GDP ratio will continue to rise and Finland would eventually be subject to sanctions.

In August 2013 the government presented its structural policy programme, which aims to reduce the long-term sustainability gap caused by the aging of the population. The programme will not have much time to affect the public sector's fiscal balance during the forecast period. If the programme can be implemented in a credible way, it will reduce the pressure for further austerity measures in the short term.

For additional information:

Research director Markku Kotilainen,

tel. +358 50 351 1192

markku.kotilainen@etla.fi

Balance of Resources

	Value € Mrd.	Change in volume, % Y/Y				Average	
	2013*	2013*	2014F	2015F	2016F	09 - 13	14 - 18F
GDP	193,4	-1,4	0,7	2,0	1,9	-0,8	1,3
Import	77,8	-1,8	2,9	3,0	3,4	-1,4	2,6
- goods	56,0	-0,5	3,4	3,5	3,5	-2,0	2,9
- services	21,8	-5,0	1,6	1,8	3,0	0,3	1,9
Total supply	271,2	-1,5	1,4	2,3	2,3	-1,0	1,7
Export	77,6	0,3	3,7	4,6	4,2	-2,7	3,4
- goods	56,3	0,3	4,5	5,4	4,7	-3,1	3,8
- services	21,3	0,5	1,7	2,4	3,0	-1,5	2,3
Investment	36,6	-4,6	-2,4	2,0	2,8	-1,5	1,1
- private	31,2	-6,4	-2,4	2,7	3,6	-1,8	1,5
- public	5,4	6,8	-2,4	-1,8	-2,1	0,2	-1,5
Consumption	159,2	-0,3	0,4	0,8	0,8	0,5	0,6
- private	109,4	-0,8	0,4	1,3	1,4	0,6	0,9
- public	49,7	0,8	0,2	-0,4	-0,4	0,3	-0,2
Changes in inventories	-0,4	-1,1	0,4	0,0	0,0	0,0	0,0
Total demand	273,0	-1,4	1,5	2,3	2,3	-1,0	1,7
Domestic demand	195,4	-2,3	0,3	1,1	1,3	0,0	0,8
Public demand	55,2	1,4	-0,1	-0,6	-0,6	0,3	-0,3

Key forecasts

	2011	2012*	2013*	2014E	2015E	2016E
Consumer price index change, %	3,4	2,8	1,5	1,6	1,9	2,1
Wage level change, %	2,7	3,3	2,4	1,3	1,0	2,0
Unemployment rate, %	7,8	7,7	8,2	8,4	8,3	8,1
Current account surplus, % of GDP	-1,5	-1,4	-0,8	-0,1	1,2	1,8
Industrial output change, %	3,7	-2,1	-2,7	2,6	4,4	3,6
Euribor 3-month, %	1,4	0,6	0,2	0,3	0,5	1,2
EU27 countries, GDP change, %	1,7	-0,4	0,1	1,4	1,7	1,8
EMU countries	1,7	-0,7	-0,4	1,2	1,5	1,9
EU27 countries, change in CPI, %	3,1	2,6	1,5	1,1	1,7	1,8
EMU countries[1)]	2,7	2,5	1,4	1,0	1,5	1,8
Finland's EMU surplus, % of GDP	-0,7	-1,8	-2,0	-2,1	-1,2	-0,2
Finland's EMU debt, % of GDP	49,3	53,6	56,9	59,6	60,5	60,6

[1)] Harmonised index

Source: Statistics Finland