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MEDIA RELEASE

Economic Forecast 2014/2:

THE EURO AREA RECOVERY IS SLOW – FINLAND'S GDP WILL CONTRACT BY 0.4 PER CENT THIS YEAR

- *The world economy will grow slowly in the near future*
- *Rapid growth in emerging economies is subsiding, the US is the main engine of world growth*
- *The euro area is recovering slowly, the Russian economy is falling into a slump and the Ukrainian crisis is creating uncertainty*
- *Finland's GDP will contract by 0.4 per cent in 2014 and grow by 0.8 per cent in 2015*
- *The volume of exports will not expand at all in 2014 but it is expected to grow by a couple of per cent in 2015*
- *Private consumption will decline by 0.2 per cent in 2014, consumption will start to grow in 2015 by a half per cent fuelled by an upturn in consumer confidence and employment*
- *Private investment will decline by 3.7 per cent in 2014 due to weak demand, but it will start to increase by a couple of per cent in 2015 in the wake of a recovery in demand*
- *The unemployment rate will rise to 8.7 per cent in 2014 and remain at that level also in 2015*
- *Consumer prices will rise by 1.1 per cent this year, as commodity tax hikes are spurring an acceleration of inflation in Finland*
- *The general government deficit relative to GDP will remain below the three per cent ceiling, but the debt ratio will climb above 60 per cent*

World economic growth will remain at last year's rate of three per cent this year and next. Growth is not expected to pick up appreciably until 2016. The emerging economies will grow slightly below their normal pace. Growth in the US, however, will pick up by half a percentage point to just over 2.5 per cent this year and its economy will continue to expand at the same rate in the years 2015-2016. The US is the world's main engine of economic growth. The expansionary monetary policy measures implemented previously there are already being phased out.

The EU countries' economic development has also taken a turn for the better, even if the recovery slowed down in the second quarter. This year GDP will achieve about one per cent growth, picking up to 1.5 per cent next year. The euro area has pulled out of its crisis, but a new escalation of problems cannot be ruled out. Growth is projected to be lower than in the previous forecast.

The current recovery is expected to continue if the confidence of the financial market is maintained and the crisis countries' deficits can be brought back to a sustainable path. The Ukraine crisis negatively affects the economic development not only of Ukraine and Russia but that of Europe as well.

Russia's GDP will not increase appreciably in 2014. Growth started to decelerate already last year. This year's growth will be affected by the uncertainty spawned by the crisis in Ukraine and Western countries' sanctions imposed on Russia. If the crisis can be resolved, the Russian economy may achieve one per cent growth in 2015 and two per cent in 2016. China's GDP will increase in the next few years by about 7 per cent, which represents a slowdown in the pace of previous years. Uncertainty prevailing in the financial markets and attempts to curb the sharp rise in indebtedness will dampen the growth of production.

The global economy is still facing the risk of substantially less favourable growth. The Ukraine crisis turned into an open war in the spring of 2014. At the time of writing a ceasefire has been achieved in Ukraine and attempts are being made to resolve the conflict, but a new outbreak of hostilities is possible. Mutual economic sanctions by the West and Russia could lead to a situation where they are difficult to remove. In that case they may inhibit growth for a long time. Because of its close economic ties with Russia, Finland is particularly vulnerable to its neighbour's crisis and the assorted sanctions on business activities. The EU countries' ability to stabilize the public sector funding of its problem-ridden countries is becoming increasingly critical. It affects the belief of the financial markets that the problems can be solved as well as the mutual trust of market participants. In the US it is important that the confidence of the private sector is maintained. Political decision-making related to public indebtedness may become subject to a new dispute, even though in the short term an agreement has been reached.

ECB STRONGLY SUPPORTING EUROZONE ECONOMIC GROWTH

The ECB has prepared itself for weak economic growth. In June 2014 the ECB decided to ease its monetary policy after economic growth was lower than expected. ECB prepared itself for even weaker economic growth, which has also been turned out to be the case. Euro area GDP remained unchanged in the second quarter after modest 0.2 per cent growth in the first quarter. The ECB had previously interpreted the deviation of inflation from its long-term target to be temporary, mainly attributable to lower prices in energy and food. In June, the central bank's stance became more cautious and it took steps to accelerate inflation closer to its target. At the same time, economic growth will get a boost.

The ECB decided in June to lower the interest rate on its main refinancing operations by 0.1 percentage points to 0.15 per cent, decided on actions to facilitate private sector lending via targeted longer-term refinancing operations (TLTRO), prepared to buy asset-backed securities (ABS), continued to offer fixed-rate bank financing and discontinued sterilization via the securities market programme (SMP). Over the summer, the euro weakened slightly, but this is probably partly attributable to lower interest rates and the deterioration of the geopolitical situation stemming from the Ukrainian crisis.

In early September, the ECB reacted to the weakening of economic growth in the euro area and the substantial slowdown in inflation by continuing its surprisingly strong monetary policy stimulus that it started in June as well as by lowering interest rates and expanding the money supply by buying bonds. The ECB lowered its key interest rates by 0.1 percentage points with effect from September 10th. The interest rate on its main refinancing operations was thus lowered to 0.05% while the interest rate on its marginal lending facility was lowered to 0.30% and the interest rate on its deposit facility was lowered to -0.20%. Purchases of bonds will be limited starting in the beginning of October to the private sector's asset-backed securities and covered bonds. The purchases of public sector bonds, i.e. the actual quantitative easing or "money printing" is the next alternative if the means employed so far are ineffective, as is to be expected. The decisions made in September were triggered by the weakening of business confidence spurred by the crisis in Ukraine and the associated slowdown of economic growth and inflation.

GDP WILL FALL 0.4 PER CENT IN 2014 BUT EXPAND BY 0.8 PER CENT IN 2015

GDP is expected to decline this year by 0.4 per cent, i.e. the economic situation is significantly weaker than estimated last spring (0.7%). This is due to exports not picking up as expected. In particular, exports to Russia have declined substantially and, on the other hand, the economies of the euro countries have not improved as anticipated. The crisis in Ukraine has increased uncertainty and Russia's economic growth has slackened. In the worst case, if the Ukrainian crisis is prolonged, the sanctions could impede economic growth for several years.

Finland's GDP declined in the beginning of this year by an average of 0.2 per cent. In the second half the level of production is expected to remain almost unchanged, but the annual change is negative due to last year's higher level of comparison. Exports are expected to remain close to last year's level. Private consumption will decline slightly due to weak real household purchasing power. Investment will decline by 5 per cent in the first half of the year, but in the second half of the year the fall of investment is already expected to taper off somewhat.

In 2015, Finland's GDP will grow by 0.8 per cent, providing that the euro area continues to recover and that Finnish exports maintain their market share. GDP will increase 1.8 per cent in 2016. The forecast is based on the assumption that then new nuclear power plant investments begin to boost growth. Growth will in turn be dampened by spending cuts and tax increases made to stabilize public finances.

EXPORTS WILL NOT RECOVER UNTIL NEXT YEAR

In the first half of the year, exports of goods increased by only 0.25 per cent from a year ago. Machinery and equipment, metal products, paper industry and textile and clothing industry exports have declined. Manufacturing of coke and petroleum products and chemicals and chemical product exports remained at last year's levels. Exports of all other industries were growing. The value of deliveries to EU countries rose by 7 per cent in January-June. Finnish exports to Asia, however, declined by 10 per cent, and exports to North America and Russia fell by 11-12 per cent. Exports of goods fell in the first quarter, but in the second quarter they rose by 2.8 per cent from the previous year thanks to deliveries of two ships. The volume of service exports fell 2.5 per cent in the first half of this year compared to last year. Nokia's effect on service exports is very difficult to assess.

The overall volume of export this year is expected to remain at last year's level. Next year, exports are projected to grow already by over 2 per cent, and in 2016 export growth rates are projected to increase to over 3 per cent. Exports of goods will increase somewhat more slowly than market growth this year, as machinery and equipment exports decline sharply due to weak demand. Maintenance shutdowns in the oil industry, in turn, are weakening the chemical industry's export figures. The food industry is hit heavily by Russia imposing its ban on food imports both this year and next year. Machinery and equipment industry exports are expected to improve in 2015 as the demand for investment goods in the world economy recovers. However, there are exceptionally high risks concerning the export forecast due to the Ukrainian and the Crimean political situation.

ENTERPRISE INVESTMENT DECLINING FURTHER DUE TO WEAK DEMAND

The enterprise sector's declining profitability and slackening of both export and domestic demand will cut investment by more than 3 per cent this year. Production-related investment by enterprises will fall by as much as 8 per cent and there will be a 2.5 per cent decline in building construction.

During the first half of next year the decrease in investment will come to a halt and the rest of the year should bring about modest growth. The upturn in enterprise investment, however, will remain weak, at an estimated 1 per cent, as the recovery of demand is sluggish and the increase in demand can be satisfied by increasing capacity utilization. Housing investment is expected to expand by a modest 1.3 per cent next year. Government investment will remain constant because consolidating the financial position of the central and local government requires restraint in all spending growth.

In 2016 growth in fixed investment will strengthen to 2.5 per cent as a result of the improvement in the economic situation. The recovery of exports and domestic demand will fuel slightly over 2 per cent growth in capital investments. Residential housing construction growth will also continue to be slow, because the growth of the purchasing power of households will remain modest.

UNEMPLOYMENT RATE WILL STILL CLIMB SLIGHTLY

Finland's GDP has declined for three consecutive years. The unemployment rate rose last year to 8.2 per cent from the previous year's 7.7 per cent. The rise in unemployment has been relatively moderate. This is due to the fact that the importance of high productivity sectors to the economy has declined, and that the size of the working-age population has started to decline.

This year the unemployment rate will rise at the same rate as last year, by 0.5 percentage points to 8.7 per cent, as both export and domestic demand decline. Next year, the unemployment rate is expected to remain unchanged at 8.7 per cent. In 2016 GDP growth will strengthen and the unemployment rate is expected to fall to 8.5 per cent.

SLOW GROWTH OF PURCHASING POWER CURBING CONSUMPTION

Private consumption is projected to decline by 0.2 per cent in 2014. Our forecast has been revised downwards owing to weaker-than-expected employment trends. In the first half of this year the number of hours worked declined by 1.5 per cent, and the level of earnings rose by an average of 1.5 per cent. Thus, the wage bill grew by only 0.5 per cent. The price of private consumption rose by 1.7 per cent so that the real wage bill decreased significantly.

In 2015 private consumption will grow by less than one per cent, fuelled by rising employment and a recovery in consumer confidence. Real household purchasing power will grow by 0.5 per cent. This year the amount of household's consumer loans has declined significantly and the saving ratio is expected to rise slightly. Next year, low interest rates and the improvement in economic confidence will spur a slight upswing in new consumer loans, thus triggering a slight decrease in the savings rate. In 2016 private consumption growth will accelerate to about 1.6 per cent due to the improvement in employment. Real household purchasing power is expected to grow by over one per cent. The saving ratio is expected to remain at a relatively low level. The growing number of pensioners is expected to act as a stabilizing factor for consumption in the coming years.

PROLONGED SLUMP DAMPENS INFLATION

Consumer prices are expected to increase by 1.1 per cent in 2014. The decline of interest rates has continued and international inflation has weakened. Inflation is boosted by about half a percentage point by increases of commodity taxes carried out in the beginning of this year. Inflation is dampened by food prices declining due to, among other things, a substantial reduction in the world market prices of raw materials. Wage and salary levels will increase by 1.3 per cent in line with the two-year wage settlement of last autumn. The EU-harmonized inflation rate, where interest rates on housing loans are not included, will also increase by over one per cent. In 2015 consumer prices are expected to rise by 1.3 per cent. Inflation is boosted by the increase in consumer taxes. In contrast, external cost pressures are expected to remain subdued. In 2016 consumer prices are projected to rise by 1.6 per cent. At this point, interest rates are already expected to be on the rise, which will lead to higher inflation.

GOVERNMENT EXPECTED TO AGREE ON FURTHER ADJUSTMENT MEASURES

The large-scale adjustment measures implemented during the current government's term in office aimed at shoring up public finances have not worked as desired. GDP growth forecasts have fallen short year after year and government spending has continued to grow swiftly. As previously, it has been difficult to cut back on expenditures, but taxes have been raised in line with the government's programme. Taxes have been increased sharply, which has curbed the growth of earned income and domestic consumer demand.

The general government's financial deficit will increase and the public debt ratio will increase significantly this year. The ratio of the central and municipal government deficit to GDP will rise this year to 4.5 per cent. The central government's borrowing requirement will climb to 3.8 per cent of GDP and the financial position of the municipalities does not appear to be improving according to plan.

Next year taxes will be raised further, by an estimated 1 billion euros. The growth of public expenditure will slow down but it will still be faster than the growth of GDP. By 2013, the ratios of total taxes to GDP and public spending to GDP will rise by 1 percentage point each. The tax-to-GDP ratio will climb to 45.2 per cent while government expenditure as a percentage of GDP will increase to 58.7 per cent. Due to the large deficits incurred by the central and local governments, the public-debt-to-GDP ratio will rise next year to 62.8 per cent, well above the 60 per cent ceiling stipulated by the EU's Growth and Stability Pact. The public sector's so-called structural deficit will also be well above the allowable limit.

The economic forecast is based on the assumption that Finland will be able to avoid the excessive debt and deficit sanction procedures in accordance with the assessment by the EU Commission and the Council next spring. The Stability and Growth Pact and its supplementary economic agreements include a list of extraordinary factors. The sanction procedures can be avoided if the deficit and debt ceilings are exceeded owing to a decline in GDP and at the same time it can be shown that a Member State's budgetary deficit and debt-to-GDP ratio will decline over the medium term. Also long-term measures boosting the financial sustainability of the pension system are considered to be factors mitigating non-compliance with the agreements.

Even if Finland can avoid the sanction procedures, it is clear that all general government entities will be subject to tighter budget oversight during the new EU Semester beginning next year. In practice, this means that after the Parliamentary elections next spring, the new government will have to draft a government programme that is in line with the detailed policy recommendations stipulated by the EU Council next summer.

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Balance of Resources

	Value	Change in volume, %					
	€ Billion	Y/Y				Average	
	2013*	2013*	2014F	2015F	2016F	09 - 13	14 – 18F
GDP	201,3	-1,2	-0,4	0,8	1,8	-1,2	1,2
Import	78,8	-2,5	-0,4	2,3	3,2	-1,5	2,6
- goods	56,3	0,3	-0,1	2,6	3,5	-1,6	2,9
- services	22,5	-9,1	-1,0	1,7	2,4	-1,0	1,8
Total supply	280,2	-1,6	-0,4	1,2	2,2	-1,3	1,6
Export	76,9	-1,7	0,0	2,2	3,3	-3,0	2,7
- goods	55,9	0,4	0,2	2,3	3,6	-3,0	2,8
- services	21,0	-7,2	-0,6	1,8	2,5	-2,7	2,5
Investment	42,6	-4,9	-3,2	1,4	2,6	-3,1	1,5
- private	34,3	-6,8	-3,7	1,9	3,2	-4,1	1,8
- public	8,3	3,7	-0,9	-0,8	0,2	1,8	0,1
Consumption	161,3	0,0	-0,2	0,4	1,2	0,6	0,8
- Private	111,0	-0,7	-0,2	0,6	1,6	0,5	1,1
- Public	50,2	1,5	-0,2	0,0	0,2	0,7	0,1
Changes in inventories	-0,6	0,0	-0,1	0,2	0,2	0,0	0,0
Total demand	280,2	-1,3	-0,6	1,2	2,2	-1,2	1,6
Domestic demand	203,3	-1,1	-0,9	0,9	1,7	-0,4	1,1
Public demand	58,5	1,8	-0,3	-0,1	0,2	0,8	0,1

Key forecasts

	2011	2012*	2013*	2014F	2015F	2016F
Consumer price index change, %	3,4	2,8	1,5	1,1	1,3	1,6
Wage level change, %	2,7	3,3	2,4	1,3	1,1	1,7
Unemployment rate, %	7,8	7,7	8,2	8,7	8,7	8,5
Current account surplus, % of GDP	-1,5	-1,9	-2,0	-1,3	-1,6	-1,6
Industrial output change, %	3,2	-2,8	-3,0	-0,9	2,3	2,9
Euribor 3-month, %	1,4	0,6	0,2	0,2	0,2	1,1
EU27 countries, GDP change, %	1,6	-0,4	0,1	1,2	1,5	1,7
EMU-countries	1,5	-0,7	-0,4	0,9	1,3	1,5
EU27 countries, change in CPI, %	3,1	2,6	1,5	0,5	1,1	1,5
EMU-countries[1)]	2,7	2,5	1,4	0,5	1,1	1,5
Finland’s EMU surplus, % of GDP	-1,0	-2,1	-2,3	-2,8	-2,5	-1,7
Finland’s EMU debt, % of GDP	48,5	52,8	56,2	60,3	62,8	64,2

[1)] Harmonised index

Source: Statistics Finland