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MEDIA RELEASE

Economic Forecast 2015/1:

THE EURO AREA IS CONTINUING ITS CAUTIOUS RECOVERY – FINLAND'S GDP WILL FINALLY RETURN TO GROWTH

- *The euro area is continuing its cautious recovery, the US economy is undergoing a strong upswing, China's growth is subsiding*
- *Finland's GDP will grow 0.5 per cent in 2015 and 1.6 per cent in 2016*
- *The volume of exports will increase by one per cent in 2015; growth is expected to be approximately 3.5 per cent in 2016*
- *Private consumption will grow by 0.6 per cent in 2015 and by over one per cent in 2016, fuelled by the improvement in consumer confidence and employment*
- *Investment will still decrease by 1.5 per cent in 2015 due to weak demand, but it will rebound to two per cent growth in 2016*
- *The unemployment rate will rise to 8.8 per cent in 2015 and decline to 8.6 per cent in 2016*
- *Finland's consumer prices will rise only 0.3 per cent this year owing to the fall in oil prices; next year inflation will climb to one per cent*
- *The higher-than-anticipated deficit in 2014 will slow down the balancing of public finances*

In 2015 global GDP growth will accelerate from last year's 3.1 per cent to 3.3 per cent. In 2016, growth will accelerate slightly. The United States will be the engine of global economic growth in both years. In Europe, the pick-up of demand in Germany will bolster the recovery. The growth in emerging economies will be curbed by, among other things, the dwindling of foreign capital inflows owing to the tightening of US monetary policy.

GDP growth in the OECD area as a whole increased slightly in the second half of 2014 from one quarter to the next. In the third quarter growth was 0.5 and in the fourth quarter 0.6 per cent. The aggregate figures confirmed the strong recovery of the United States, but growth also strengthened somewhat in the EU countries. According to preliminary figures, GDP grew last year 2.4 per cent in the United States, 1.4 per cent in the EU countries and 1.8 per cent and in the total OECD area.

Total production in the United States, Germany and Sweden, among others, has already surpassed the level prevailing at the beginning of 2008. That level has yet to be reached in the euro area and Finland.

GDP is expected to grow in the US by about 3 per cent in both 2015 and 2016. Housing prices have risen and consumer confidence has improved. The GDP of the total EU area will grow 1.5 per cent this year and by slightly less than 2 per cent in 2016. The sharp fall in the price of oil will provide a boost to energy-intensive and oil importing economies. In Russia GDP will contract by 4-5 per cent in 2015 and a couple of per cent in 2016. Domestic demand will fall significantly more sharply than GDP. Weak growth stems from the low price of energy, the sanctions imposed because of the crisis in Ukraine and the sluggish pace of economic reform. China's GDP will increase by about 7 per cent in the coming years. Uncertainty in financial markets and attempts to curb the sharp increase in borrowing will dampen the growth of output.

World economic growth is expected to continue strengthening if confidence in the financial markets is maintained and the crisis countries are able to bring their deficits to a sustainable path. Fiscal policy is still tight in several countries.

The risk of substantially less favourable development is still high. EU countries' ability to stabilize the problem countries' public sector financing is becoming increasingly critical. It affects the financial markets' faith that the problems can be solved as well as the mutual trust of market counterparties. In the United States it is important that the confidence of the private sector is maintained. The upcoming presidential election may give rise to economic policy tensions.

The crisis in Ukraine is expected to subside gradually. All sanctions will not, however, be lifted in the near future and the crisis will impinge upon the economic relations between Russia and the West for several years. An even gloomier course of events is possible: the worst case scenario would be a military conflict with Russia and the Western powers openly involved. Because of its close economic ties, Finland is particularly vulnerable to Russian economic growth and sanctions on diverse economic activities.

EURO AREA'S ECONOMIC UPSWING HAS STRENGTHENED AGAIN

The euro area's real GDP growth slowed in the second quarter of 2014 compared with the previous quarter. This was due to the poor economic situation of the region's large countries Germany, France and Italy. During the second half of the year the euro area's GDP growth strengthened again, reaching 0.3 per cent in the fourth quarter. Throughout 2014 the euro area's GDP grew by 0.9 per cent from the previous year. The growth's continuation will hinge primarily on the development of business and household confidence. The sharp fall in the price of oil will bolster the economic growth of energy-importing euro countries. A weaker euro exchange rate will strengthen their exports.

The European Central Bank lowered its key interest rate on 4 September 2014 to 0.05 per cent. The bank had already lowered its overnight deposit rate to a negative -0.2 per cent. In addition to interest rate policy, the central bank has when deemed necessary used the so-called non-standard monetary policy measures, by which it has sought to promote the functioning of financial markets and safeguard sufficient liquidity. In January 2015 the ECB announced that in March it will start to buy government bonds from the secondary market. The scale of bond purchases was decided to be EUR 60 billion a month and they will continue until at least September 2016. They may be continued even thereafter until inflation has been elevated towards the Central Bank's inflation target of slightly less than 2 per cent.

The most concrete impact of the ECB's easy monetary policy is that interest rates will remain low and the euro exchange rate will be lower than would otherwise be the case. The lowness of interest rates and abundant liquidity will boost stock prices. In some countries, it may also lead to a rise in housing prices. There is a risk that an asset bubble will evolve in a few years.

The willingness of Greek's new government formed after the recent elections to deviate from the previously agreed adjustment programme causes tension in the euro area countries and at worst may trigger a new crisis. The euro area is, however, now better prepared for market pressures than previously. The ECB announced in the autumn of 2012 that it will buy unlimited quantities of crisis countries' short-term bonds from the secondary market, as long as the crisis countries seek funding from the European Stability Mechanism (ESM). This mere announcement has subsequently calmed the market, as the risk of a break-up of the euro is deemed to have been reduced significantly.

There will also be differences in growth between the Euro economies in 2015. In Italy GDP will grow by half a per cent. In France, the Netherlands and Belgium, the growth will be slightly over one per cent. In Germany and Spain, GDP will expand by a couple of per cent. The fastest GDP growth, 4.5 per cent, is projected for Ireland, which has recovered from its crisis rapidly. The current account deficits continue to shrink and the rise in public debt is slowing down, though not very fast. High public debt makes the economies of many EU countries vulnerable.

Euro area real GDP is projected to grow by 1.4 per cent in 2015. Growth will accelerate to 1.8 in 2016 and to almost two per cent in 2017.

FINLAND'S GDP CONTINUED TO FALL LAST YEAR

Finland's GDP contracted by 0.1 per cent in 2014. GDP grew slightly in the second and third quarters but fell again in the fourth quarter. Total exports fell slightly short of the level reached the previous year. Exports of goods increased by one per cent, but exports of services fell. The value of exports to Russia decreased by 14 per cent. Private consumption fell by 0.2 per cent. Consumption was eroded by unemployment, the slight reduction of real earnings and weak consumer confidence. Investments continued to decline. This was the case for both machinery and equipment as well as construction investment. Investments decreased by 5 per cent, the same as in the previous year. Inventories increased and their contribution to overall output was 0.3 percentage points.

GDP WILL GROW 0.5 PER CENT IN 2015 AND 1.6 PER CENT IN 2016

Total production is expected to grow this year by only 0.5 per cent, which is slightly less than estimated last September (0.8 per cent). This is due, above all, to the downward revision of the investment growth forecast. Last year's weak figures showed that the willingness of companies to invest is lower than expected. A fast turnaround is not expected in this regard, since companies catering to both domestic and export demand have idle capacity. Investment will therefore continue to decline in 2015. The slight growth of overall exports will gradually increase hours worked and will, in time, boost employment. Private consumption will achieve only modest growth after two years of contraction. In 2016, Finland's GDP will grow 1.6 per cent. This requires that the euro area continues to recover and Finnish exports maintain their market shares. In 2017 GDP will increase 1.8 per cent. Growth will by fuelled by strengthening exports, private investment and private consumption. In turn, dampening factors include measures to balance public finances.

FALL IN OIL PRICES BOOSTS EXPORTS TO WEST, EXPORTS TO RUSSIA DROPPING

Exports of goods increased by over one per cent in 2014, but the fall in the export of services spurred a slight decline in total exports. Vehicle exports increased the most, while appreciably more ships and cars were delivered than in the previous year. Also electronics, processed metals, and timber exports increased. The exports of other main industries declined. After experiencing years of strong growth for several years in a row, the exports of the chemical sector also declined due to shutdowns of oil refining for maintenance. The value of exports to EU countries rose by 3 per cent while exports to Russia fell by 14 per cent.

In 2015, the volume of goods exports will increase by 1.5 per cent, but exports of services will still decline. Overall export growth will remain at one per cent. Food industry exports will fall because of difficulties in exports to Russia and metal exports will decline due to the high level of comparison the previous year. Chemical industry exports will remain at last year's level due to a prolonged maintenance shutdown of oil refinement facilities. The exports of other manufacturing industries are witnessing a modest upswing. Exports to Russia will decrease in value by 15 to 20 per cent, i.e. slightly more than last year. There is also a risk of an even sharper decline. Western export growth is expected to strengthen, fuelled by the drop in oil prices and the devaluation of the euro. In 2016, total exports are expected to grow by slightly less than 3.5 per cent. Exports to western countries will strengthen in the wake of market growth. Exports to Russia will continue to decline.

BUSINESS INVESTMENT STILL FALLING DUE TO WEAK DEMAND

Investments decreased last year by more than 5 per cent. Private investment contracted by 6.5 per cent while public investment grew slightly. Residential construction fell by 5.5 per cent. According to Statistics Finland in January 2015, some 79.3 per cent of industrial production capacity was utilized. The figure was 1.3 percentage points higher than a year earlier.

Since the outlook for both exports and private consumption is still uncertain, companies will be curbing investments for some time. Investment is expected to contract by 1.4 per cent this year. Next year, it will increase 2.2 per cent. Machinery and equipment investment will fall a couple of per cent this year. Next year, it will increase by more than two per cent as there will begin to be a shortage in supply. Investment in housing construction will decline in 2015, by one and a half per cent, but in 2016 it will rebound and expand by couple of per cent.

In 2017 total investment growth will strengthen to 2.5 per cent as the economic situation improves. Companies will need to increase production capacity and production investment will grow by 3 per cent. Residential construction will continue to grow moderately. The demand for housing will remain high in growth centres, but the low purchasing power of households and continuing high unemployment will dampen growth.

UNEMPLOYMENT RATE WILL STILL RISE SLIGHTLY

Finland's GDP has declined for three consecutive years. The unemployment rate rose last year to 8.7 per cent from the previous year's 8.2 per cent. The rise in unemployment has been relatively moderate compared to the sharp decrease of GDP. This is because the decline in production has, to a substantial extent, taken place in high-productivity sectors, and the size of the working-age population is decreasing due to aging. The employment rate improved slightly last year to 70.1 per cent. In 2015, the unemployment rate will rise to 8.8 per cent due to this year's weak economic growth and lagging effects from last year. In the short term, the rise of the unemployment rate is dampened by the fact that part of the population has stopped actively searching for jobs and is thus classified as being outside the labour force. In 2016, the unemployment rate will fall to 8.6 per cent. In 2017, the unemployment rate will be 8.5 per cent and the employment rate will be 71.5 per cent.

SLOW GROWTH OF PURCHASING POWER AND WEAK CONFIDENCE DAMPEN CONSUMPTION

Private consumption has decreased slightly for two years in a row. This year, it is projected to grow by 0.6 per cent. The slow growth is caused by poor development in employment, the modest increase in real income and increasingly weak consumer confidence. In 2016, private consumption will grow by 1.3 per cent as employment improves and consumer confidence begins to recover. The real purchasing power of households will grow 1.5 per cent. In 2017, private consumption growth will accelerate to 1.6 per cent due to the improving employment situation. Real earnings will rise one per cent and real purchasing power 1.7 per cent. The growing number of retired persons and the indexation of pensions against inflation will act as stabilizing factors for consumption in the coming years.

FALL IN OIL PRICES DAMPENS INFLATION

In 2014, consumer prices rose by 1 per cent. The inflation forecast for 2015 is 0.3 per cent. Interest rates have continued to decline and international inflation has weakened with the dramatic fall in oil prices. The wage level will rise by 1.1 per cent in accordance with the two-year wage settlement of autumn 2013. EU harmonized inflation, which does not include interest on housing loans, will increase at the same pace. In 2016, consumer prices are expected to rise by one per cent. Inflation will be boosted by the expected moderate rise in oil prices and the strengthening global economy, which will fuel international inflation. In 2017 consumer prices are expected to rise by 1.3 per cent. Interest rates are already expected to be on the increase, which will in turn contribute to higher inflation.

NEXT GOVERNMENT HAS TO MAKE FURTHER FISCAL ADJUSTMENTS

In 2014, the total public sector deficit was 3.4 per cent of GDP, which was higher than generally anticipated and exceeded the 3 per cent EMU ceiling. The central government deficit was 3.9 per cent of GDP while that of the municipalities was 0.9 per cent. The so-called structural deficit of the public sector was estimated to be 1.5 per cent of GDP. The EMU norm is a maximum of 0.5 per cent, but it has its own flexible mechanisms. The general government gross debt was 59.3 per cent of GDP.

In 2015 the public sector deficit will decline to 2.7 per cent of GDP and further to 2.4 per cent in 2016. The debt will rise to 62 per cent this year and the next year to 64 per cent. ETLA's forecasts for the public sector structural deficit based on the EU's methodology ranges between 0.8 and 1.1 per cent of GDP in 2015 and between 1.1 and 1.7 per cent in 2016. We present our forecast as a range, because the figures can be calculated with different assumptions.

Gross public debt will already exceed 60 per cent this year, but support given to the euro area crisis countries is taken into account as a mitigating factor in the EMU criteria. This support is estimated by the Commission to be 2.9 per cent of GDP in 2015. In addition, the economic situation is taken into account. Finland will therefore not be subject to EU sanctions on the basis of the debt criterion. The situation with respect to the structural deficit is more critical. Finland's exceptionally weak economic situation and the potential for a downward trend in the deficit mean that even this criteria can be interpreted liberally for a while. The Commission may, however, give Finland a warning that further action needs to be taken. Fulfilling the criterion will thus require further adjustment measures.

According to our baseline forecast, the general government's gross debt relative to GDP will rise to just over 67 per cent by 2019. The Commission estimates that Finland's GDP will reach its potential level in that year. Finland would clearly exceed the debt criteria at that stage.

To comply with the Stability and Growth Pact, Finland will have to adjust its public finances significantly during the next parliamentary term. We have simulated an adjustment scenario where public spending is reduced compared to the baseline forecast by one billion euros each year from 2016 to 2019. Public expenditure would thus be EUR 4 billion lower in 2019. The adjustment would dampen economic growth so that the debt-to-GDP ratio decreases rather slowly. According to our calculations, this rate of adjustment would mean that the public debt would not be in compliance with the debt criteria until the parliamentary term starting in 2019. The rate of the decrease in debt depends on the magnitude of the so-called fiscal multiplier, i.e. how much growth slows down as a result of the adjustment. Public sector productivity-enhancing structural reforms and moderate wage increases would help to promote fiscal balance.

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Balance of Resources

	Value	Change in volume, %					
	€ Billion	Y/Y				Average	
	2014*	2014*	2015^E	2016^E	2017^E	10 - 14	15 - 19^E
GDP	204,0	-0,1	0,5	1,6	1,8	0,5	1,5
Import	76,9	-1,4	0,2	2,4	2,3	2,2	2,3
- goods	54,9	1,0	1,1	2,6	2,2	3,2	2,5
- services	22,0	-7,1	-1,9	1,9	2,7	-0,1	1,6
Total supply	280,9	-0,5	0,4	1,8	1,9	1,0	1,7
Export	76,0	-0,4	1,0	3,3	3,1	1,6	2,9
- goods	55,6	1,1	1,5	4,0	3,3	2,5	3,2
- services	20,5	-4,0	-0,4	1,4	2,5	-0,5	1,9
Investment	40,8	-5,1	-1,4	2,2	2,5	-1,5	1,9
- private	32,3	-6,5	-1,7	2,7	3,0	-2,3	2,1
- public	8,5	0,6	-0,5	0,5	0,6	1,7	0,8
Consumption	163,7	-0,1	0,4	1,0	1,2	0,8	1,1
- Private	112,7	-0,2	0,6	1,3	1,6	1,1	1,4
- Public	51,0	0,2	0,0	0,2	0,2	0,2	0,3
Changes in inventories	0,4	0,3	0,1	0,0	0,0	0,0	0,0
Total demand	280,9	-0,7	0,4	1,8	1,9	1,0	1,7
Domestic demand	204,9	-0,8	0,2	1,3	1,4	0,8	1,3
Public demand	59,5	0,2	-0,1	0,3	0,3	0,4	0,4

Key forecasts

	2012	2013*	2014*	2015^E	2016^E	2017^E
Consumer price index change, %	2,8	1,5	1,0	0,3	1,0	1,3
Wage level change, %	3,3	2,4	1,4	1,1	1,7	2,2
Unemployment rate, %	7,7	8,2	8,7	8,8	8,6	8,5
Current account surplus, % of GDP	-1,9	-1,9	-1,8	-0,8	-0,7	-0,3
Industrial output change, %	-2,8	-2,9	-0,9	1,2	2,4	2,6
Euribor 3-month, %	0,6	0,2	0,2	0,1	0,1	1,0
EU27 countries, GDP change, %	-0,5	0,0	1,3	1,6	1,8	2,0
EMU-countries	-0,8	-0,4	0,9	1,5	1,8	1,9
EU27 countries, change in CPI, %	2,6	1,6	0,6	0,4	1,4	1,9
EMU-countries[1)]	2,5	1,4	0,4	0,3	1,3	1,8
Finland’s EMU surplus, % of GDP	-2,1	-2,5	-3,4	-2,7	-2,3	-1,9
Finland’s EMU debt, % of GDP	52,9	55,8	59,3	61,9	64,1	65,6

[1)] Harmonised index

Source: Statistics Finland