ELINKEINOELÄMÄN TUTKIMUSLAITOS
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Economic Forecast 2016/2:

FINLAND'S GDP WILL GROW BY 1.1-1.2 PER CENT IN 2016-2018; THE FOCUS OF DEMAND WILL GRADUALLY SHIFT TO EXPORTS

- *Euro area economic growth will slow down slightly due to the uncertainty of Britain leaving the EU next year, China's economic growth will slow down in a controlled manner; the risks of less favourable development have nevertheless increased*
- *Finland's GDP will grow by 1.1-1.2 per cent in 2016-2018; the focus of demand will gradually shift from the domestic markets to exports*
- *The volume of exports will hardly grow hardly at all in 2016; growth is expected to be 2.5-3 per cent in 2017 and 2018 as investment demand of export countries recovers somewhat and the competitiveness agreement begins to boost exports*
- *Private consumption will grow by 1.3 per cent in 2016 thanks to low inflation; in 2017 and 2018 it will increase by only half a per cent owing to the modest rise in the level of earnings, hikes in employees' payroll taxes and cuts in holiday pay as well as the acceleration of inflation even though income taxes will be cut in 2017*
- *Investments will rebound from a low level to 3.5-4 per cent between 2016 and 2017, but in 2018 the growth rate will subside*
- *Employment will improve sluggishly, the competitiveness agreement will not begin to have much of an impact until the end of the current parliamentary term; the unemployment rate will remain high, in 2016 it will be 9.1 per cent, after which it will fall by 0.2 percentage points per year; the government's employment rate target of 72 per cent will not be achieved during the current parliamentary term*
- *Finland's consumer prices will rise by only 0.5 per cent this year due to lower fuel and food prices, inflation will rise to 1 per cent next year and to 1.5 per cent in 2018*
- *Fiscal consolidation will be slow despite the adjustment measures; the ratio of government debt to GDP will continue to grow*

INCREASED UNCERTAINTY SLOWS WORLD GROWTH

In 2016 global real GDP growth will slow down from last year's 3.1 per cent to 2.8 per cent. In 2017 growth will accelerate slightly to 3 per cent. The growth of emerging economies is dampened by the deceleration of China's growth and weakening inflows of foreign capital as a result of the anticipated tightening of U.S. fiscal policy.

In the U.S. GDP is estimated to increase by 1.8 per cent in 2016 and by 2 per cent in 2017 and 2018. Growth is based on domestic demand, which has nevertheless been somewhat more subdued than anticipated. GDP in the EU area will increase 1.7 per cent this year and 1.3 per cent in 2017. The continued descent of oil prices has a stimulating effect on economies consuming and importing large amounts of oil. Next year uncertainty surrounding Brexit will dampen growth. The slowdown is largest in the UK, but it is also reflected in the rest of the EU.

In Russia, real GDP will contract by over one per cent in 2016. Domestic demand will fall considerably more sharply than GDP. Weak growth is due to low energy prices, economic sanctions imposed because of the crisis in Ukraine and the slow pace of reform. In 2017 the Russian economy will return to a growth of one per cent as the price of oil rises slightly and domestic demand stabilizes somewhat.

China's GDP will increase by 6.6 per cent this year. Uncertainty in financial markets, attempts to stem the strong growth of debt, large amounts of excess capacity remaining after the previous economic stimulus and demand shifting from the export industry to services will all curb the growth of production. In 2017 growth will slow down to 6.2 per cent.

The risk of substantially less favourable development is still great. Recently, a slowdown in Chinese growth and risks related to its financial markets have raised serious concern, even though China aims to combat them through massive stimulus. Uncertainty associated with the forthcoming Brexit is casting a shadow over the economic outlook of the EU economies in particular. The public debt level of many euro area countries is high, which could also spawn crises. The sustainment of private sector confidence is of great importance in the U.S. The approaching presidential election may generate economic policy tensions.

Eastern Ukraine has become a so-called frozen conflict. Sanctions will not be rescinded in the near future and the crisis will have a negative impact on economic relations between Russia and Western countries for several years. Uncertainty is also fuelled by the ongoing war in Syria and its neighbouring region. Given the close economic relations between the two, Finland is vulnerable to Russia's development. The postponement of the recovery of investment activity in EU countries would also curb the growth of Finnish exports.

BREXIT WILL DAMPEN ECONOMIC GROWTH OF EURO AREA

Euro area GDP is forecast to grow by 1.6 per cent in 2016 and 1.4 per cent in 2017 and 2018. Growth is hindered by uncertainty surrounding Brexit. There are considerable differences in growth rates during the forecast period between different economies within the EU. In Ireland, GDP growth is almost 5 per cent this year and 3 per cent in Spain. German growth is 1.7 per cent and 1.3 per cent in France. In Italy it is roughly 1 per cent. Greece is at the bottom as its GDP is not forecast to grow at all. The current account deficits will continue to shrink and public debt growth will slow down, although not very fast. High public debt makes the economies of many EU countries vulnerable.

Due to poor economic news, the European Central Bank lowered its refinancing rate on 10 March 2016 from 0.05 per cent to 0.00 per cent. It also lowered banks' overnight deposit rate, from the previous -0.3 per cent to -0.4 per cent. In addition to interest rate policy, the ECB has carried out so-called non-standard monetary policy measures, via which it aims to boost overall demand and raise inflation closer to its target level. The ECB announced that in addition to the above-mentioned interest rate decisions, it will raise the scale of secondary market bond purchases from 60 billion to 80 billion per month. Purchases will continue at least until March 2017 according to the decision announced in December 2015. They will be continued even thereafter until inflation has been elevated permanently towards the slightly less than 2 per cent inflation target of the ECB. In addition, the ECB announced the launch of four new targeted longer-term refinancing operations (TLTRO II), each of which has a maturity of four years.

The direct effect of the easy monetary policy of the ECB is that interest rates will remain low and the euro exchange rate is weaker than it otherwise would be. Low interest rates and abundant liquidity bolster the rise in prices of stocks and other assets. In some countries, a result of loose monetary policy may be an unhealthy rise in housing prices.

The acute financial crisis in Greece has been contained for the time being. Its impact on the rest of the euro area remained minimal, because crisis management mechanisms in the region have been strengthened, and the private sectors of other countries no longer have a lot of receivables from the Greek government. However, the situation is not completely over, because continuous commitment to the implementation of the adjustment programme is required from Greece's political leadership. The Greek economic situation is also undermined by the considerable inflow of refugees through Greece to other EU countries. An additional risk for the stability of the financial markets in the euro area could come from larger euro area countries than Greece, especially Italy and Spain, and their high level of public debt and increasing political instability. If large countries were to encounter financial difficulties in the euro area, even the new crisis management mechanisms might not be sufficient.

FINNISH GDP WILL BEGIN TO GROW SLIGHTLY

According to preliminary National Account figures, Finland's GDP grew by only 0.2 per cent in 2015. The growth took place in the beginning of the year. The entire export volume was roughly at last year's level, while imports increased. Exports were negatively impacted by the value of exports to Russia declining by one third from the previous year. Neste's oil refinery maintenance shutdown also reduced exports. Exports of services, however, were clearly on the rise. Private consumption increased by one and a half per cent. Consumption was bolstered by low inflation, offers by banks allowing borrowers to postpone principal repayments temporarily on their housing loans and a car scrapping premium. Investments increased slightly. The rise of the unemployment rate and rather weak consumer confidence had an effect in the opposite direction. Consumer prices fell slightly.

GDP WILL GROW BY 1.1 PER CENT IN 2016 AND BY 1.2 PER CENT IN 2017

GDP is expected to rise by 1.1 per cent in 2016. In March 2016 we predicted 0.9 per cent growth. The small upward revision is due to investments and private consumption being stronger than previously expected. The pick-up in investment activity is reflected in both construction and machinery and equipment investment. Consumption has been boosted by a lower savings rate than expected. In the second half of the year exports are estimated to pick up somewhat in the wake of the recovery in euro area investments.

In 2017 GDP growth will pick up slightly to 1.2 per cent, spurred by exports. Exports are strengthened by enhanced investment in the EU countries and gradual improvement in competitiveness supported by the competitiveness agreement. Private consumption growth will slow to just over half a per cent. Real earnings will fall slightly, the employment trend is weak and the competitiveness agreement will increase employees' payroll taxes. Income tax cuts will nevertheless boost consumption. Investment will continue to grow.

The 2018 GDP growth forecast is 1.1 per cent. The growth relies on exports and investment. However, investment growth will slow down from the previous year. Growth of this magnitude requires a continuation of wage moderation and an improvement in competitiveness as well as the recovery of export markets. Private consumption growth continues to be modest.

COMPETITIVENESS PACT WILL SUPPORT EXPORTS

In 2016 the volume of exports will grow slightly less than half a percentage point. Exports of goods and services will increase approximately as much. Paper industry exports will decline slightly. Timber industry exports will increase clearly due to positive Asian exports. In the chemical industry, exports will increase significantly as an oil refinery returned to normal operation after last year's maintenance shutdown. Machinery and equipment exports will be lower than last year, although they are expected to recover slightly towards the end of the year as investment demand strengthens. Exports of motor vehicles will be temporarily reduced due to a change in the brand of the car assembled. Exports to Russia will continue to decrease in value by a few per cent. Western exports are increasing, fuelled by low oil prices and the weak exchange rate of the euro.

In 2017 the total volume of exports is projected to increase by more than 2.5 per cent, supported by the competitiveness pact agreed between the employers, employees and the government. The growth rate is increased by sizable ship and motor vehicle deliveries. Exports to western countries will strengthen as their investment activity becomes stronger. Exports to Russia will already incur a small increase if Russia's GDP begins to rise. In 2018, the volume of exports will increase by approximately 2.5 per cent.

BUSINESS INVESTMENTS AND CONSTRUCTION EXPANDING SHARPLY

While the outlook for both exports and private consumption has been uncertain, companies have held back on their investments. Now, however, investment activity is picking up from a low level. Investment is expected to grow by nearly 4 per cent. Machinery and equipment investment will increase a couple of per cent and residential construction by 8.5 per cent. Large private and public sector investment projects account for a significant share of the increase.

Next year, investment will increase by about 3.5 per cent. Machinery and equipment investment will climb by about 7 per cent while residential building investment will be 2.5 per cent higher than this year.

In 2018, total investment will increase by 2.5 per cent. Companies will need more production capacity. Residential construction growth will continue at a moderate pace of 2-3 per cent. The need for housing will remain high in growth centres, but the modest increase in the purchasing power of households and continuing high unemployment will dampen growth.

UNEMPLOYMENT RATE WILL FALL SLOWLY, COMPETITIVENESS AGREEMENT WILL GRADUALLY BOOST EMPLOYMENT

In 2016, the unemployment rate will average 9.1 per cent, which is 0.3 percentage points lower than last year. This year, the unemployment rate has decreased more than forecast in the spring as workers have shifted outside the labour force, remaining at home or studying.

During 2017-2018, the unemployment rate will fall by only 0.2 percentage points per year. In 2018, the unemployment rate will still be 8.7 per cent while the employment rate is 68.8 per cent. Little by little the competitiveness agreement will foster employment and reduce unemployment. The gradual transition of asylum-seekers to the labour force will raise the unemployment rate by a few tenths of a percentage point. In 2020 the employment rate is estimated to be 70.2 per cent and the unemployment rate 8.3.

SLUGGISH GROWTH OF PURCHASING POWER WILL DAMPEN COMSUMPTION

In 2016 private consumption is forecast to increase by 1.3 per cent. This is slightly less than we predicted in spring. During 2017-2018 private consumption will only grow about half a percentage point. This corresponds roughly to the real disposable income growth of households. The zero increases of wages in 2017, the acceleration of inflation and the rise in employees’ payroll taxes stemming from the competitiveness agreement will affect purchasing power negatively. However, the income tax cuts by over 500 million euros in 2017 and the slightly improving employment situation will keep real purchasing power growth positive. The household savings rate is slightly negative throughout the forecast period.

DAMPENING EFFECT OF FALL IN OIL PRICES ON INFLATION WILL FADE AWAY

In 2015 consumer prices fell by 0.2 per cent from the previous year. International inflation weakened in the wake of a sharp fall in oil prices and the income level rose moderately. In 2016 consumer prices are expected to rise by 0.5 per cent. Inflation will accelerate in particular due to the rising cost of health care. In 2017 consumer prices are forecast to rise by 1.0 per cent rise as oil and other commodity prices increase. In 2018 consumer prices will rise by 1.5 per cent. At this point, the interest rate is already estimated to be on the increase, which will in part contribute to higher inflation.

ADJUSTMENT MEASURES AND STRUCTURAL REFORM WILL BALANCE PUBLIC FINANCES SLOWLY

In 2015 the deficit of the total public sector was 2.8 per cent of GDP. The central government's deficit was 3.0 per cent and local government's deficit 0.7 per cent of GDP. We estimate that the so-called structural deficit of the public sector was 1.5 per cent in relation to GDP. The EMU norm is a maximum of 0.5 per cent, but it can be temporarily exceeded. The gross debt of general government was 62.6 per cent of GDP.

In 2016 the public sector deficit will be reduced to 2.2 per cent of GDP thanks to adjustment measures carried out by the government. The acceleration of economic growth will also reduce the deficit. The decrease is hampered by the rise in expenditures related to asylum seekers. In 2017 the deficit will temporarily increase to 2.5 per cent due to income tax cuts carried out at that time. In 2018 the deficit will be reduced again to 2.3 per cent of GDP.

The gross public debt will rise to 64.4 per cent this year and to almost 66.5 per cent next year. The structural deficit of the public sector will be 1.7 per cent in 2016 and 2.0 per cent in 2017. This estimate is calculated according to the EU Commission's methodology based on Etla's forecast. We estimate that in 2016 Finland will meet the deficit requirements of the stability and growth pact if the cost of asylum seekers of about 0.2-0.3 per cent of GDP is taken into account. The rise in the structural deficit estimated for the years 2017 and 2018, on the other hand, is not easily justified.

The gross government debt already exceeded the 60 per cent limit last year, but EMU’s set of criteria takes into account the support given to euro area crisis countries as a mitigating factor, the amount of which the Commission estimated to be 2.9 per cent of GDP in 2015. In addition, the cyclical situation and the asylum seekers' impact on the public economy will most likely be taken into account. Finland is thus unlikely to face EU sanctions in the coming years on the basis of the debt criterion.

According to our forecast the deficit of the entire public sector, in spite of new adjustment measures, will still be 1.7 per cent in 2020. The government gross debt to GDP ratio will have risen at this point to 68.8 per cent. The debt growth will slow down towards the end of the decade, but growth will not yet come to a halt. The debt is not growing quite at the rate of central and local government deficits, as we expect pension companies belonging to the public sector to buy government bonds in an approximately unchanged manner. Privatizations will also slow down the growth of debt. When Finland's economic situation improves over time and the cyclical adjustment is removed, Finland might violate the debt criterion - possibly the deficit criterion also. The debt-to-GDP ratio will start to stabilize, however, and may start to decline after 2020 if economic growth continues to be moderate.

To comply with the Stability and Growth Pact and to avoid uncontrollable growth of the debt, Finland will have to adjust public finances in the next parliamentary term. According to the government's programme, the agreed adjustments "strengthen public finances by EUR 4 billion on the level of the year 2019." This will require adjustments to expenditure and revenues as well as the implementation of structural reforms and the strengthening of qualitative and cost competitiveness.

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Balance of resources							
	Value	**Change in volume, %**					
	€ Bill. [2)]	**Y/Y**				**Average**	
Huoltotase-erä	**2015**	**2015**	**2016^E**	**2017^E**	**2018^E**	**2011-15**	**2016-20^E**
GDP	209,1	0,2	1,1	1,2	1,1	0,0	1,2
Import	77,5	1,9	1,5	2,1	2,4	2,0	2,4
- Goods	53,0	0,8	2,4	2,4	2,5	1,9	2,7
- Services	24,6	4,6	-0,7	1,5	2,3	2,0	1,7
Total supply	286,7	0,7	1,3	1,5	1,5	0,5	1,6
Export	76,6	-0,2	0,4	2,7	2,6	0,5	2,5
- Goods	54,1	-2,2	0,4	3,1	2,3	0,7	2,5
- Services	22,5	5,3	0,5	1,7	3,5	-0,1	2,6
Investment	42,7	0,7	3,9	3,4	2,5	-1,0	3,0
- Private	34,6	2,2	4,2	3,6	2,6	-1,5	3,3
- Public	8,2	-5,1	2,8	2,5	2,0	1,5	1,9
Consumption	166,7	1,1	1,0	0,5	0,4	0,8	0,6
- Private	115,7	1,5	1,3	0,7	0,5	1,0	0,9
- Public	51,0	0,4	0,3	0,0	0,2	0,3	0,2
Change in inventories[1)]	0,7	0,3	-0,2	-0,1	0,2	0,0	0,0
Total demand	286,7	0,9	1,1	1,5	1,5	0,5	1,6
Domestic demand	210,1	1,4	1,4	1,0	1,1	0,6	1,2
Public demand	59,2	-0,4	0,7	0,4	0,4	0,4	0,4

[1)] Contribution to GDP growth, percentage points, incl. statistical error.

[2)] Current prices.

Sources: Statistics Finland, Etla.

Key forecasts						
	2013	**2014***	**2015***	**2016^E**	**2017^E**	**2018^E**
Change in CPI, %	1,5	1,0	-0,2	0,5	1,0	1,5
Wage level change, %	2,1	1,4	1,4	1,3	0,7	1,2
Unemployment rate, %	8,2	8,7	9,4	9,1	8,9	8,7
Current account surplus, % of GDP	-1,9	-1,3	-0,8	-1,4	-1,4	-1,1
Industrial output change, %	-3,2	-0,8	-1,9	1,4	1,7	2,1
Finland's EMU surplus, % of GDP	-2,6	-3,2	-2,8	-2,2	-2,5	-2,3
Finland's EMU debt, % of GDP	55,5	59,3	62,6	64,4	66,5	68,0
Euribor 3-month, %	0,2	0,2	0,0	-0,2	0,0	0,2
EU28 countries, change in GDP, %	0,2	1,4	2,0	1,8	1,5	1,5
- Euro Area	-0,3	0,9	1,7	1,6	1,4	1,4
EU28 countries, change in CPI, %[1)]	1,6	0,4	0,0	0,2	1,3	1,6
- Euro Area[1)]	1,4	0,4	0,0	0,2	1,2	1,6

[1)] Harmonised index

Sources: Statistics Finland, Etla.