Talousennuste

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Economic Forecast
2010–2011

Production falling at a record pace

Additional information

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LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2010–2011

Production falling at a record pace – fiscal policy boost to the economy smaller than previously estimated

The Labour Institute for Economic Research has raised its forecast by 1.2 percentage points for Finland's total production growth this year. It now stands at 3 per cent. Growth in 2011 is predicted to be 3.5 per cent. As the international economic outlook brightens, Finland's economy recovery is essentially fuelled by exports, which will increase this year by 7.8 per cent and next year by already 10.3 per cent. Housing investment will also display a clear upswing. There will be 20,000 more unemployed persons this year than last year, and the unemployment rate will rise to 9.1 per cent, but a turn for the better will occur in the labour market already next year. A similar trend will be witnessed in borrowing by the central government and the public sector as a whole, but inflation will accelerate slightly – to 0.9 per cent this year and to 1.8 per cent next year. Interest rates are not forecast to increase until the first quarter of 2011.

Finnish GDP fell last year by a record 7.8 per cent. Foreign trade dominated by investment-oriented exports suffered the most. Although the joint impact of exports and imports on production was only 1.8 per cent, the real impact of domestic incomes formation was larger than this. The fall in stockbuilding alone (excluding the statistical error) reduced total production last year by 2.5 per cent. Such an unusually large negative effect can usually be eliminated already in the next two years if the economic situation normalizes.

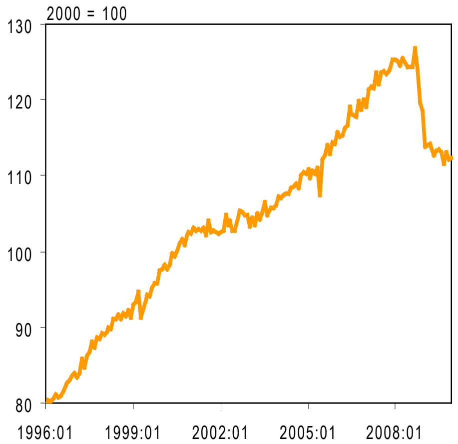
It appears that Finnish GDP will recover from this recession faster than that of the 1990s, and faster than even a year ago generally anticipated. The Labour Institute for Economic Research forecasts that production will increase by three per cent this year and next year by half a percentage point higher. Growth is export-driven, but also the pick-up in housing investment will foster growth.

The Finnish government's fiscal policies bolstered economic growth last year mostly via tax cuts. The stimulus has been relatively modest in terms of spending increases. According to our own estimates, tax changes will stimulate the economy this year, but fiscal policy is no longer expansionary in terms of spending. As a percentage of gross domestic product, the overall stimulatory effect this year will be only 0.3 per cent. The weak employment situation would require a stronger stimulus. The low inflationary pressure would also provide an opportunity for stimulus. Next year, fiscal policy will be contractionary both in terms of taxes and expenditure. It appears that this will not prevent an acceleration of growth in Finland's export-driven economy.

International economic crisis easing

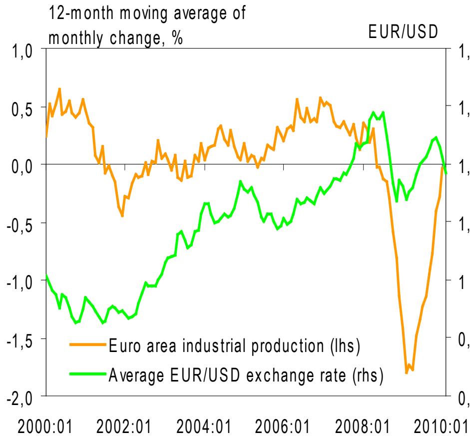
International economic prospects have improved in general. There is now a fairly wide consensus that the economic crisis has been overcome and that developed countries' production is gradually approaching the level from which it fell in late 2008 and early 2009. In the aftermath of the financial crisis, the availability of funding has been restored almost back to normal and interest rates will remain very low for a prolonged time. The financial markets, on the other hand, are still dependent on central bank and government support. In this regard, normalization of the situation will still take a few years. The

Trend indicator of output 1996:01–2009:12



Source: Statistics Finland

Euro area industrial production and EUR vs. USD exchange rate 2000:01–2010:02



Source: ECB, Eurostat

recovery of the real economy and, above all, the labour market to pre-recession levels will nevertheless take several years. The situation is the worst in countries where households were heavily indebted and where housing prices have dropped significantly, thereby weakening the possibilities for households to balance their financial positions.

The EU region suffered more from the recession than the outside world. Thus, the total production of EU region as a whole declined by 4.2 per cent last year, while the production of the entire world fell by just 0.8 per cent. US production declined by 3.2 per cent, i.e. less than in Europe, although the financial crisis started there. What explains the depth of the recession in Europe? A slow growth trend is not a sufficient reason. This development was affected by the excessive appreciation of the euro in the summer of 2008, which together with the ECB's ill-timed (July 9, 2008) tightening of monetary policy brought economic growth to a halt already before the onset of the financial crisis. EU and euro area production began to decline already in the second quarter of 2008. In autumn 2008, when the financial crisis erupted, the European economy was already struggling, and so it relatively easily fell into a deep recession. After the production had fallen significantly during the last quarter of 2008 and the first quarter of 2009, the decline came to a halt and production staged an upturn in the second quarter of last year.

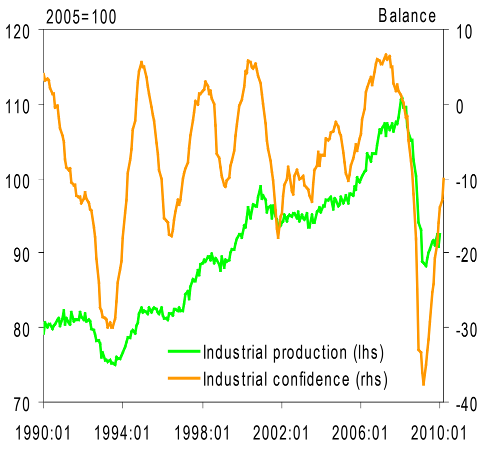
The depth of the downturn in the EU and euro area and the slow recovery this year are partly attributable to the uncoordinated and relatively weak fiscal policy stimulus. For example, while the IMF and G20 countries continue to stress the need for an expansionary economic policy this year, the European Commission and its member countries are concerned about certain member countries, particularly Greece, that have large fiscal deficits and are unable to rein in their deficits. They have hastened to discontinue the stimulus and take actions to promote fiscal consolidation. Officially, the exit strategies should begin by 2011 at the latest.

Fiscal policy stimulus is indeed coming to an end in almost all EU and euro area countries. Only the German fiscal policy will be clearly expansionary next year. The Commission and the euro area governments are resolute with respect to all activities fostering fiscal restraint. On the other hand, the same rigor was not witnessed during the implementation of the stimulus. The member countries' reporting on the expansiveness of fiscal policy during the recession was not based on a uniform indicator, which in turn has made it impossible to coordinate these activities.

A lot of attention has been focussed recently on Greece's high government debt and fiscal deficit, which are for about 120 and 10 per cent relative to GDP, respectively. But in comparison to some larger countries such as Japan, the US, Britain and Italy, this is not so exceptional. As a small and apparently vulnerable country, Greece has nevertheless been obliged to undertake stringent steps to downscale its public demand and cut its deficit. By and large, there is wide variation in the deficits and debt levels of public sectors across the euro area and around the world. The prerequisites for fiscal stimulus are the best in countries where the public sector's financial positions have been strong from the start. Even these opportunities have not been exploited enough. This partly explains why economic growth in recent months has been faster in the US than in the euro area.

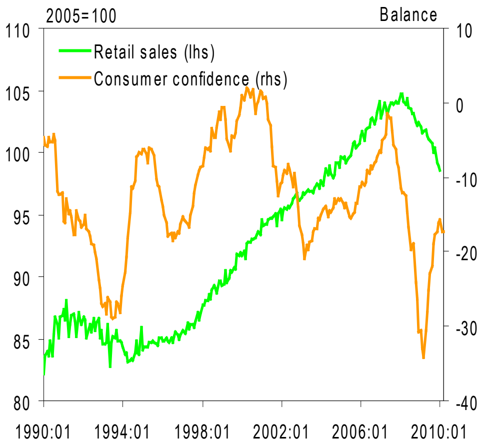
Consumer confidence in the euro area has nevertheless strengthened substantially compared to one year ago. Despite this, the retail trade and private consumption have not yet expanded appreciably. This year, the euro area's private consumption will grow by only 0.4 per cent. The euro area's industrial confidence has improved markedly, and industrial production has been increasing. Led by Germany, economic growth in the region as a whole has been comparatively export-driven.

Industrial confidence and industrial production in euro area 1990:01–2010:03



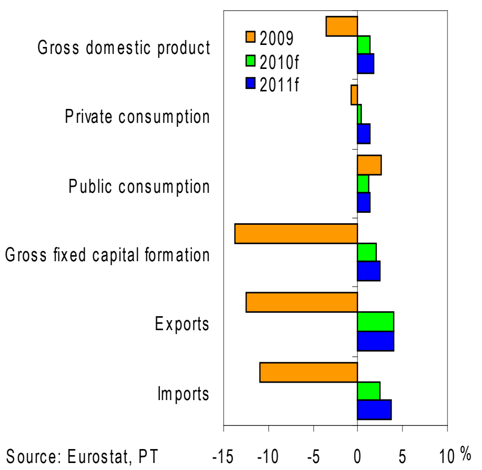
Source: Eurostat

Consumer confidence and retail sales in euro area 1990:01–2010:03



Source: Eurostat

Eurozone economic growth 2009–2011



Source: Eurostat, PT

Public consumption in the euro area grew last year by an average of 2.6 per cent, i.e. considerably higher than in Finland, where growth was a mere 0.7 per cent. Based on this indicator, however, fiscal policy boosted economic growth and employment in the euro area on average.

Table 1. International economy

GDP growth (%)	2009	2010f	2011f
United States	-2.4	2.8	3.0
Euro-13	-4.1	1.3	1.7
Germany	-5.0	1.8	2.2
France	-2.2	1.8	2.0
Italy	-5.0	1.3	1.7
EU27	-4.2	1.3	1.9
Sweden	-4.9	2.5	3.0
United Kingdom	-5.0	1.0	2.0
Japan	-5.0	2.5	3.0
Russia	-7.9	5.0	5.0
China	8.7	10.0	9.5

Source: BEA, BOFIT, Eurostat, Labour Institute for Economic Research

The Labour Institute for Economic Research forecasts that the euro area's GDP will expand 1.3 per cent this year and that growth will pick up to 1.7 per cent next year. Still this year stockbuilding will boost growth. Although fiscal policy's contribution to growth will decrease next year and the impact of the inventory cycle will wane, economic growth will not subside. The improvement in the labour market situation, or at least the outlook for the labour market, will boost the euro area's private consumption to 1.3 per cent growth next year. On the other hand, the export market will continue to strengthen, which will also facilitate an upturn in the growth of production to 1.7 per cent.

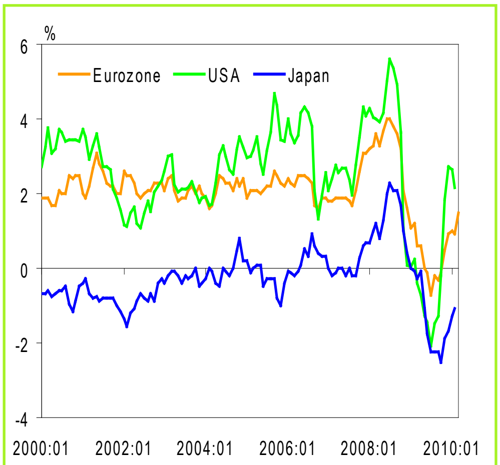
The EU region's economic situation will improve relatively quickly in the Baltic States and several other new EU member countries where total production collapsed as a result of the economic crisis. German and French production will also increase this year faster than the rest of Europe. Growth will be slower than elsewhere in countries where households are indebted and housing prices have fallen steeply and have not yet bounced back. These countries are Ireland, Spain, Denmark and Greece. These factors are further hampering the recovery in the Netherlands and Britain. The situation in Sweden is in this respect, somewhat better, since housing prices have largely recovered from the pre-recession level. In any case, Swedish growth is accelerating appreciably faster than elsewhere in the EU region. Sweden's GDP will grow by 2.5 per cent this year and next year 3.0 per cent.

Monetary policy will not be tightened until early 2011

The euro area's deep recession and slow recovery, which involves a relatively long-term weakening of employment, will postpone the tightening of monetary policy. The Labour Institute for Economic Research forecasts that the ECB will not raise interest rates until the first quarter next year. The repo rate will be raised by a total of 0.75 percentage points, so at the end of 2011 it will stand at 1.75 per cent.

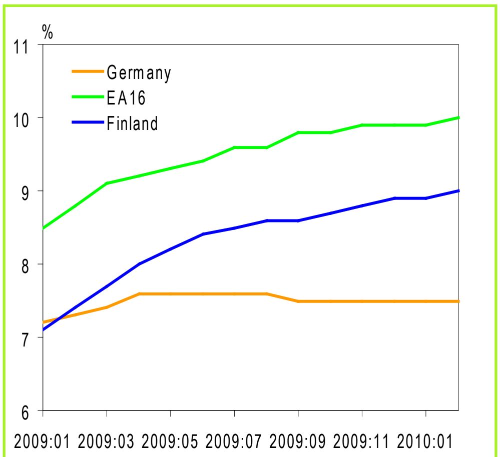
The euro has recently weakened against the dollar partly due to Greece's crisis in public finances. From the standpoint of the euro area's competitiveness this development can nevertheless be regarded as wel-

Inflation in assorted countries 2000:01–2010:03



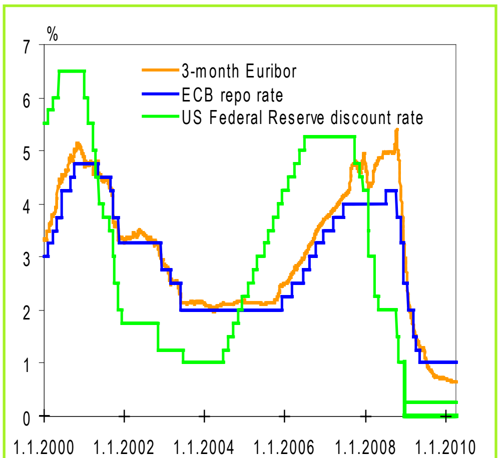
Source: Eurostat, OECD

Unemployment in assorted countries 2009:01–2010:02



Source: Eurostat

Short-term interest rates 3.1.2000–5.4.2010



Source: ECB, Bank of Finland

come. From the perspective of the stability of the global foreign exchange and monetary markets it would be desirable if the Chinese renminbi were unpegged from the US dollar. As a consequence the renminbi would strengthen against the US dollar, which would also reduce inflationary pressures in China. Obviously, the euro would weaken against China's and several other East Asian countries' currencies. It appears that China will not be ready for such action until the US and European financial markets are normalized so that they no longer rely on central bank support.

Financial regulatory reforms are just getting under way

There has recently been a lot of public debate on how to prevent future financial crises and ways to stabilize financial markets. A lot of attention has been focused on the financial market tax, which some economists think would curb short-term speculation and volatility in the financial markets. Some studies suggest that the financial market tax could allow governments to collect significant amounts of money that could be used to offset the costs of future financial crises. On the other hand, the proceeds could be directed to paying off government debt.

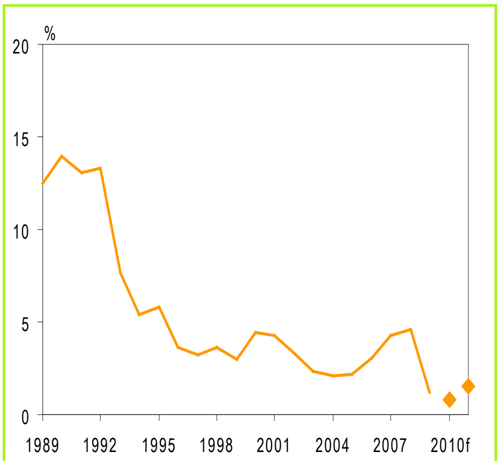
Other means for stabilizing the financial markets include streamlining of banking activities back into a traditional format, adoption of asset-based reserve requirements and breaking up the financial institutions into smaller entities. A narrow scope for banking activities has the advantage of reducing risks faced by depositors as deposit banks and investment banks would be clearly separate organizations. The advantage of asset-based reserve requirements is their countercyclical mechanisms as well as the ability to take into account country-specific cyclical situations. Breaking up financial institutions would eliminate the possibility of a major disaster stemming from banks being too large to fail. This method is nevertheless difficult to implement so that it would be fair and treat the different countries' financial institutions equitably.

GDP to expand in US by almost 3 per cent this year

The US's rapid recovery from the recession is partially explained by the relatively sizable fiscal stimulus. On the other hand, the business cycle there has been for some time ahead of Europe. The rather fast growth achieved in the fourth quarter of last year - 1.4 per cent compared to the previous quarter - was largely attributable to stockbuilding. A similar effect has only recently been witnessed in Europe. US private consumption and private investment are nonetheless already recovering. This is illustrated by the fact that the sharply deteriorated labour market situation is already improving. US economic growth will continue to be fairly swift still next year. At that time, the employment situation will be appreciably better than this year, which helps to bolster the conditions for stronger growth in private consumption.

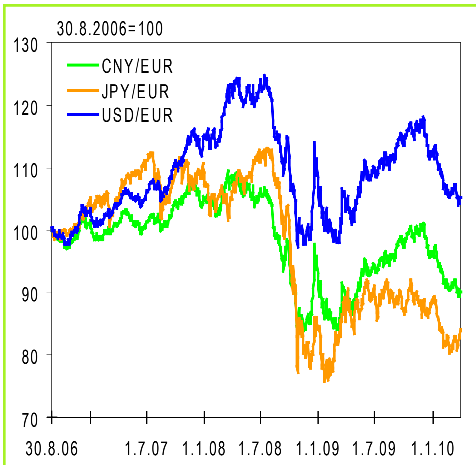
China's and other Asian countries' economic growth continues to be faster than the rest of the world. Japan's economic growth, fuelled by exports to China, will reach 2.5 per cent this year. Russia's GDP fell by 7.9 per cent last year. Key factors contributing to the collapse of Russian production were the turbulence of the financial markets and difficulties in obtaining credit. Now that oil prices and financial markets are returning to normal, Russian production will recover relatively quickly to pre-recession levels.

Three-month Euribor 1989–2011



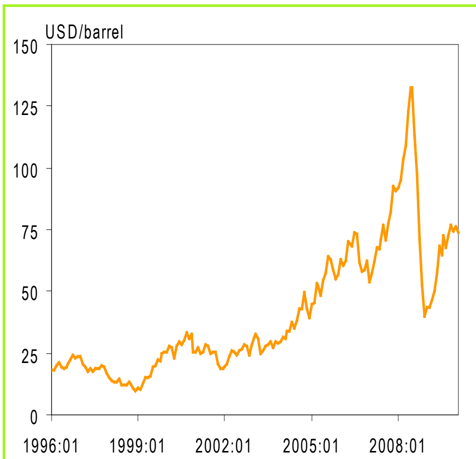
Source: Bank of Finland, PT

Exchange rates 30.8.2006–1.4.2010



Source: ECB

World market price of crude oil (Brent) 1996:01–2010:02



Source: Energy Information Administration

Structure of international economic growth will boost Finnish exports

The volume of Finnish goods and services exports fell last year by 24.3 per cent from the previous year. The collapse of exports took place during the last quarter of 2008 and the first quarter of last year. Exports began to recover in the fourth quarter of last year. The fact that imports also fell by more than 22 per cent indicates that the sharp drop in exports was partly attributable to the slowdown in transit transportation. The net impact of foreign trade on last year's plunge in GDP of nearly 8 per cent was -1.8 percentage points. This seems small, but its multiplier effects can be regarded as significant.

Most of Finland's export decline is explained by the fact that our export markets – measures by export shares weighted by GDP - fell last year by just over 4 per cent, while the entire world's GDP contracted by only 0.8 per cent. The recovery in exports this year and next largely stems from the fact that production is recovering in the Baltic countries hit by the global crisis much faster than in the rest of Europe. Thus, our export markets will grow already at a rate of about three per cent this year and slightly more than 3.5 per cent in 2011.

The fact that the exports are returning relatively quickly back toward pre-recession levels also stems from the structure of Finnish industry. When Finland's capital-intensive production plants, which are typically relatively large compared to the small size of our country, are shut down completely - as occurred last year e.g. in the forest industry and metal processing sector – the impact on the entire country's exports and industrial production is enormous and swift. Similarly, when the capacity of shut down plants is reintroduced, as is happening this year, the recovery is swift.

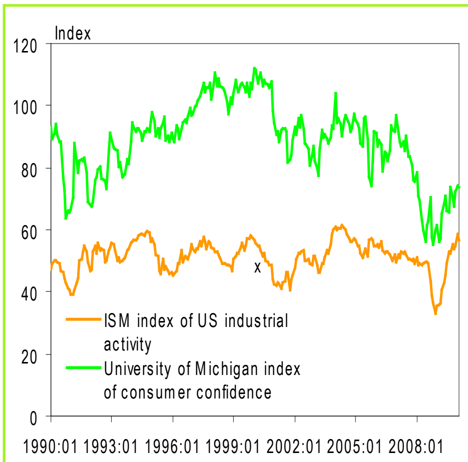
Table 2. Demand and supply

	2009	2009	2010f	2011f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	171.0	-7.8	3.0	3.5
Imports	57.2	-22.3	5.9	7.3
Total supply	228.1	-12.1	3.7	4.5
Exports	61.9	-24.3	7.8	10.3
Consumption	137.4	-1.3	1.4	1.1
private	94.5	-2.1	1.8	1.5
public	42.9	0.7	0.5	0.2
Investment	33.8	-13.4	0.1	3.5
private	29.1	-15.7	0.7	4.1
public	4.7	4.0	-3.4	-0.4
Change in stocks[1]	-4.9	-2.1	1.0	0.6
Total demand	228.1	-12.1	3.7	4.5

[1] *Volume change is in percentage points of GDP.*
Source: Statistics Finland, Labour Institute for Economic Research

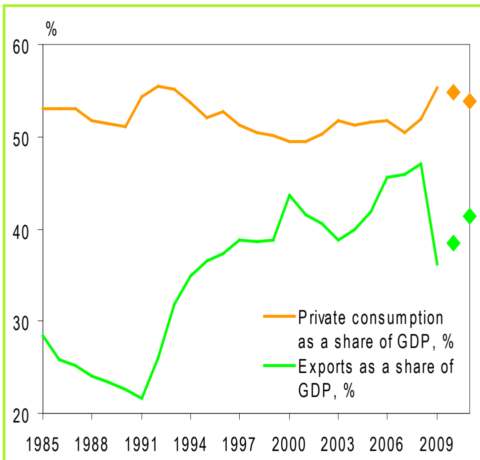
The Labour Institute for Economic Research forecasts that total exports will increase 7.8 per cent this year and next by 10.3 per cent. At that time the exports of the machinery and equipment industry will return to more normal levels. Foreign trade will boost growth in both years, since import growth will be 2 to 3 percentage points lower than that of exports. Export prices will continue to rise more slowly than import prices. This year, the price of imported goods will rise by 3.4 per cent as raw material prices climb on world markets.

US economic indicators 1990:01–2010:02



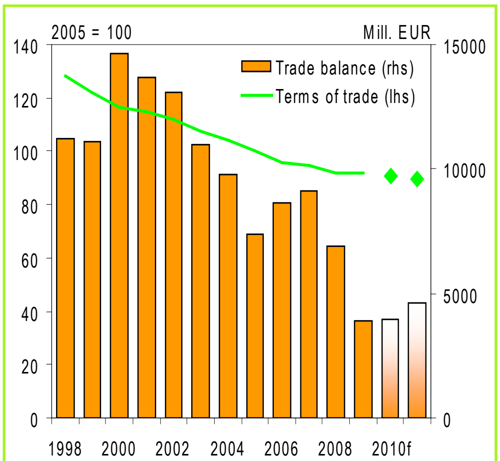
Source: ISM, University of Michigan

Exports and private consumption as a share of GDP 1985–2011



Source: Statistics Finland, PT

Terms of trade and trade balance 1998–2011



Source: Statistics Finland, PT

Significant differences in Finland's and Sweden's growth structure

Finland's development last year can be assessed also via the growth contribution of GDP sub-components. Below Finland is compared to Sweden, which in terms of its structure is the EU country most similar to Finland.

Table 3. Finland's and Sweden's growth structure 2009 (%)

	Finland	Sweden
GDP (%)	-7.8	-4.9
Private consumption	-1.1	-0.4
Public consumption	0.1	0.5
Fixed investment	-2.9	-3.0
Stockbuilding and statistical error	-2.1	-1.5
Foreign trade	-1.8	-0.5

Foreign trade reduced production in Finland more than in Sweden in 2009. The impact of stockbuilding was also high in Finland. Generally, the stockbuilding effect is reversed, and nearly as large, when conditions normalize. Therefore, we expect that in the next couple of years Finnish economic growth will be faster than in Sweden. The growth contribution from public consumption was rather modest in Finland compared to Sweden, which in turn suggests that Finland's fiscal stimulus did not increase significantly even last year. The sizable impact on GDP of the drop in private consumption indicates that last year's tax cuts were not channelled to consumption.

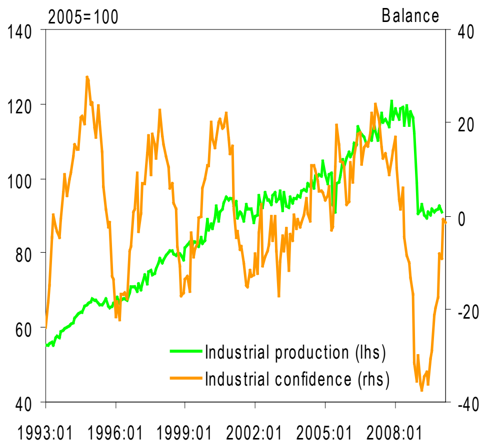
Industrial output falling at record rate

The collapse of Finland's industry last year was historic: it lost a fifth of its value added in comparison to 2008. The metal industry, which had indeed been growing robustly from 2005 onwards, suffered most severely from the global halt of demand. Services were also severely affected, which was most clearly visible in the reduction of trade by an over 11 per cent annual rate. However, the confidence of industry has subsequently risen nearly month by month as growth in the Finnish export market has picked up. The outlook has improved especially in the forest industry, which has been reflected e.g. in the price of pulp.

The low comparison level of output and the recovery of the export market will indeed make room for industrial growth this year. Growth will be most vigorous in the forest industry and the electrical engineering industry, with growth approaching 10 per cent. The metal industry will also be back on a growth path this year, although its recovery is much slower. Other industry is forecasted to grow at an over 5 per cent annual rate in the wake of the upswing in the export market. In services, the growth is considerably more modest due to the poor labour market situation. Business services and both the financial and insurance business are forecast to grow at an annual rate of about 3 per cent, but the value added of the hotel and restaurant trade will be lower this year than last year.

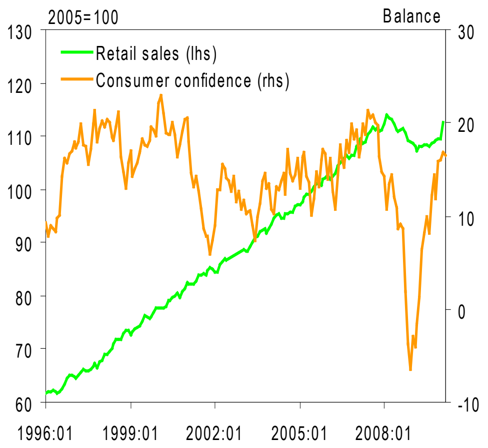
Industry will also increase its output substantially next year, when global economic growth accelerates. The emphasis of growth will, more than this year, be on the metal industry as the demand for investment goods is recovering in our export markets. In turn, the growth of the forest industry will slow down. The service sector will also begin to recover as the

Industrial confidence and industrial production in Finland 1993:01–2010:03



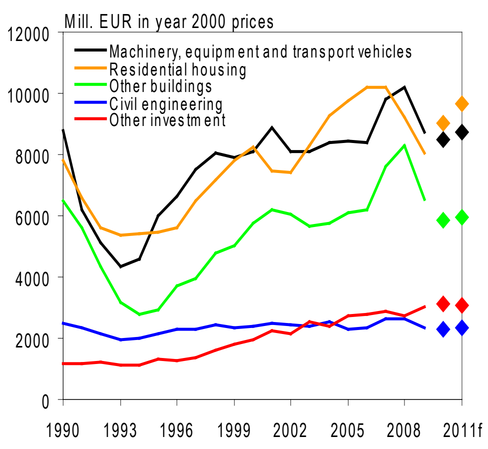
Source: Eurostat

Consumer confidence and retail sales in Finland 1996:01–2010:03



Source: Eurostat

Investments 1990–2011



Source: Statistics Finland, PT

labour market situation improves. However, increases in consumption and energy taxes will cut the purchasing power of households, thus curbing the demand for services. Construction will not yet grow this year appreciably, but next year it will reach a growth figure of about 5 per cent.

Housing construction starting to grow

Private investment decreased by 15.7 per cent last year in comparison to the previous year. The fall was the steepest in office, industrial and warehouse construction. Housing construction also declined clearly, although its descent levelled off towards the end of the year. In turn, civil engineering output decreased by 11.5 per cent in relation to the previous year. It can indeed be said that government stimulus in this respect was modest. On the other hand, state tax exemptions supported renovation. Unused capacity and weak industrial outlooks were also reflected in the significant reduction of machinery and equipment investment.

This year private investment will turn to a slight rise. Positive news has been coming in especially from housing construction, as major construction companies have announced new projects. Housing construction is indeed forecast to increase this year by 12 per cent. The upswing is not visible, however, in other construction, which will continue to decrease this year distinctly. The timing of large public projects will affect civil engineering output so that growth on an annual level will not be witnessed until next year. Machinery and equipment investment will continue to decrease this year, as businesses increase their capacity utilization rates instead of investing in new plants. The cyclical recovery will indeed begin to be more distinctly visible next year. The growth of housing construction will continue at the same time as other construction experiences a modest upswing. However, the end of the central government's stimulative measures and rise in interest rates will curb the growth of construction. The Labour Institute for Economic Research predicts that private investment will increase by 4 per cent next year.

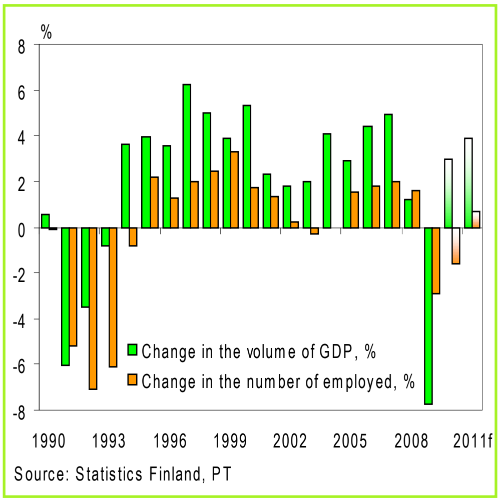
Wage trends remain moderate, growth in purchasing power slowing down

The collective agreements agreed on for the years 2010 and 2011 dictate very moderate increases in nominal wage. The rate of contract wage increases for 2010 varies between 0.5 and 1.0 per cent and there is no reason to expect large raises for next year either. As in previous years, wage hikes are remaining the lowest in the export industry. In the service sector wages are rising slightly more, but the rate of wage increases will slow down significantly in comparison to the years 2008 and 2009. Consequently, the rate of overall income increases is anticipated to average 2 per cent in 2010 and only 1.5 per cent in 2011. In 2010 wage formation is still partly influenced by the magnitude of wage hikes in 2009. The rise of average hourly wages is slightly faster than this.

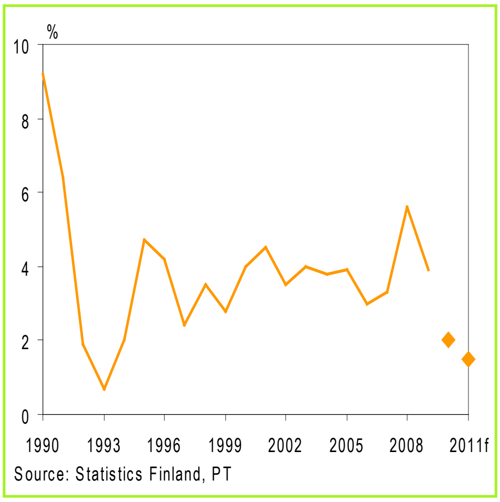
The wage bill will grow by only 1.8 per cent in 2010 because the number of hours worked will continue to decline. In 2011, hours worked and the number of employed persons will begin to rise, spurring a rise in the wage bill by 3.7 per cent, despite the fact that the increase in nominal wage is predicted to remain subdued. The wage bill will rise in 2010 and 2011 more slowly than national income, for which reason the share of wages in national income will start to fall.

The property income of households will start climbing again this year, with the growth continuing also in 2011. Property income and forest sales

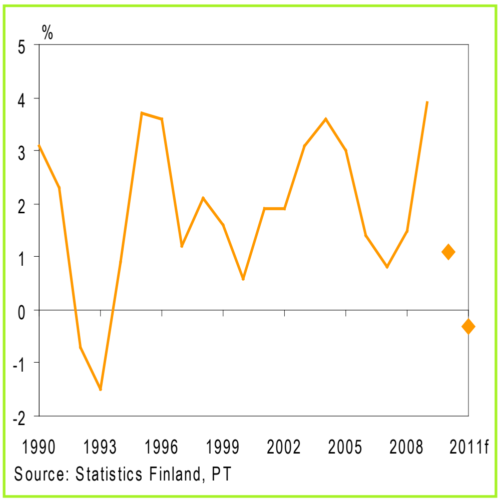
GDP and employment 1990–2011



Change in level of earnings index 1990–2011



Annual changes in real wages 1990–2011



income fell sharply in 2009 owing to the steep economic downturn. During 2010-2011, property and entrepreneurial income will rebound back to their pre-recession level, which will mean a relatively rapid rate of growth. Property income will indeed grow appreciably faster than wage income.

The bolstering of purchasing power through tax cuts is coming to an end. Significant income tax cuts are not anticipated during the forecast period. Instead, it is expected that indirect taxation will be tightened. This will spur a slight acceleration of inflation. Growth in wage earners' real income and purchasing power will remain close to zero in 2011. Owing to rapid growth in property income and in 2011 an improvement in employment, growth in household real disposable income will nevertheless be about 2 per cent in 2010 and 1.5 per cent in 2011.

Private consumption to begin modest growth

The deep recession of 2009 brought about an increase in household saving and a reduction in private consumption. The decrease in consumption was most strongly evident in the case of durable goods, especially in the automotive trade. Consumer confidence, reflecting the expectations of households, has nonetheless shifted in a more positive direction after the recession. The change is visible in the recovery of the housing and automotive sales.

Despite the increase of confidence the savings rate of households is expected to remain almost unchanged in 2009-2011. This is due to the gradual rise in interest rates during the forecast period, which in part decreases willingness to borrow. By and large, private consumption growth is driven by growth in disposable income. The volume of private consumption is forecast to grow by 1.8 per cent in 2010 and 1.5 per cent in 2011. Nominal growth in consumption expenditure will accelerate during the forecast period, but the reason for this is the increase in consumer prices spawned by a substantial hike in indirect taxation in 2011.

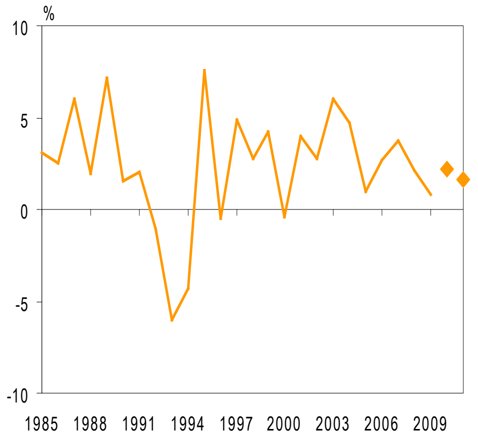
Inflation picking up slightly

The deep recession of the economy pushed inflation down to zero in 2009. The rate of increase in consumer prices will pick up slightly in 2010 but it will still remain rather sluggish at 0.9 per cent. The most significant cost pressures will be brought about by the rise in the world market prices of raw materials, especially oil. The rise of raw material prices will continue in the year 2011 as global economic growth picks up especially as demand increases rapidly in Asian countries. We predict that the world market price of crude oil in 2010 will be 85 dollars per barrel on average and in 2011 already 100 dollars.

Domestic price pressures will remain low in 2010 and 2011. The rise of labour expenses will slow down distinctly in comparison to the level of 2008 and 2009. This is due to the low contract wage increases and the elimination of employers' basic pension contributions. Since labour productivity is experiencing a swift rise, the result will be a decline in unit labour costs during 2010 and 2011.

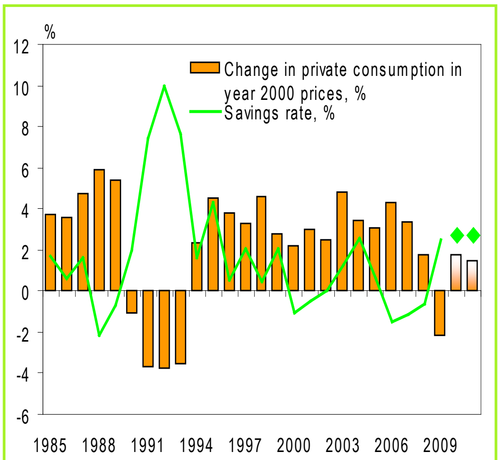
Changes in indirect taxation will affect domestic price pressures during the forecast period. The reduction of the VAT rate on foodstuffs in October of 2009 and the VAT rate on restaurant food in July 2010 will lower price levels. However, the increase of the general VAT rate in July 2010 will have the opposite effect. Additionally the government is planning to raise indirect taxes – mainly energy taxes – in 2011 to compensate for the elimination of employers' basic pension contributions. Together with the increase of the general VAT rate this will accelerate the rate of consumer price increases in

Change in household's real disposable income 1985–2011



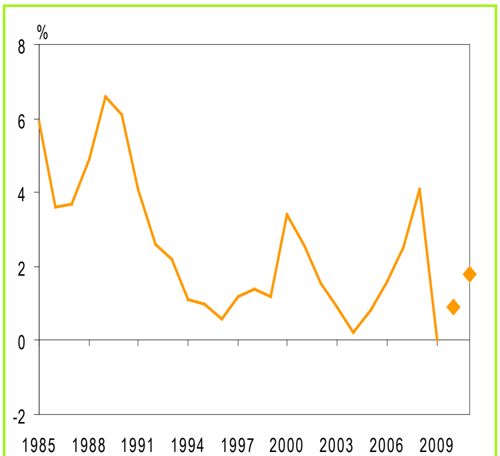
Source: Statistics Finland, PT

Private consumption and savings rate 1985–2011



Source: Statistics Finland, PT

Change in consumer prices 1985–2011



Source: Statistics Finland, PT

2011. Thus we estimate inflation, measured by the consumer price index, to be 1.8 per cent in 2011. The consumer price index will also be slightly boosted by the expected increase in interest rates and housing prices.

Employment still weakening this year

The recession was clearly reflected in employment figures over the past year. The amount of employed persons decreased every month in comparison to figures from the previous year. On average in 2009 employment reduced by 2.9 per cent. The unemployment rate in February of 2010 was 9.2 per cent, while the corresponding seasonally adjusted figure was 9.1 per cent. In February the amount of employed persons had fallen by 1.7 per cent from the year before. However, the descent was slightly smaller compared to the previous months. The reduction in employment from the previous year was about 3.6 per cent in January and 3.5 per cent in December, compared to 4 per cent in November.

Employment will continue to decline on a year-on-year basis in the beginning of 2010, partly because the slackening economy affects employment with a slight lag and partly because the base of comparison is higher employment figures from the beginning of last year. The last few months of 2010 will not see any major changes in employment. In 2010 employment will show a more clear-cut rise, but growth will still be rather slow. This year employment will decrease by an average of 1.6 per cent, or 40 000 jobs, and next year it will increase by 1.7 per cent, or about 17 000 jobs.

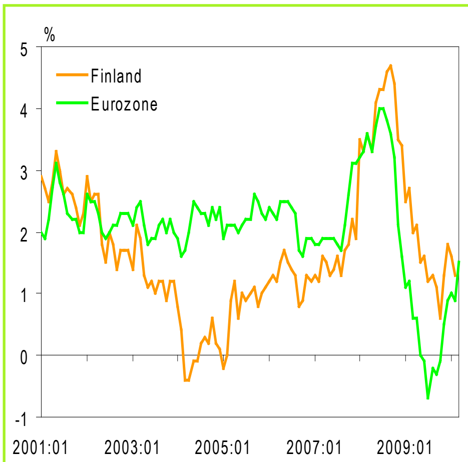
In a recession the labour force participation rate of the work-aged population typically declines, because unemployed persons exit the labour force as active job seeking ends. Some enter retirement and some begin studying or do household work. The labour force participation rate of the work-aged population clearly subsided as 2009 progressed: on average it was 66.5 per cent, being one percentage point lower than in 2008. The decline will continue this year but at a slightly slower pace: in 2010 the participation rate will average 65.8 per cent. Alongside withdrawal from the labour force this is attributable to the growing share of the oldest age group, 66 – 74 –year-olds, in the working age population, and their labour participation is clearly lower than in younger age groups. When employment prospects improve in 2011, the labour force participation of some age groups will begin to increase again slightly. However, in conjunction with the change in age structure the effects of this on overall labour participation will remain rather limited. Due to population growth the size of the labour force will nevertheless increase in 2011 by 0.4 per cent.

Unemployment rate falling already next year

The decrease in the amount of employed persons will raise unemployment this year. On the other hand, the imputed decline in unemployment is curbed by the unemployed exiting the labour force. Overall the amount of the unemployed will increase by 20,000 persons this year from the average level of last year. Therefore the unemployment rate will rise to an average of 9.1 per cent in 2010. Next year the amount of the unemployed will fall by a few thousand already and the unemployment rate will decrease to an average of 8.8 per cent.

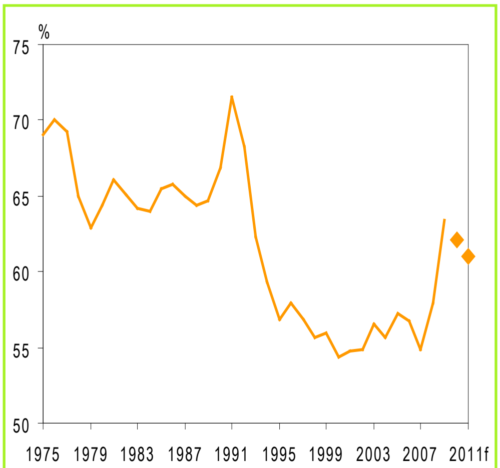
Adapting to the drop in labour demand has taken place not only through the decline of employment but also through the fall in the number of hours worked, which occurs typically in a depression. Hours worked decreased last year distinctly more than the number of employed persons, the decrease being 6 per cent. This has presumably been due to temporary lay-offs and

Harmonized index of consumer prices 2001:01–2010:03



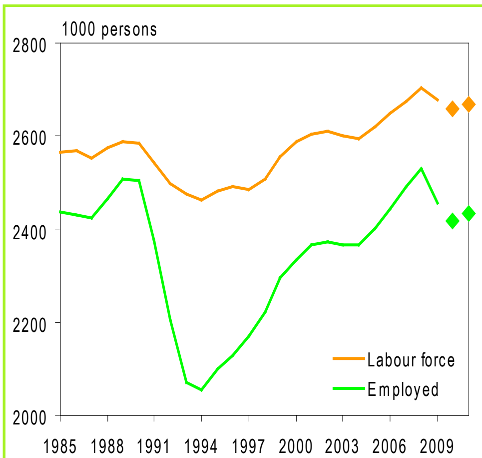
Source: Eurostat, Statistics Finland

Functional distribution of income in business activities 1975–2011



Source: Statistics Finland, PT

Supply of labour and employment 1985–2011



Source: Statistics Finland, PT

overtime reduction. At the same time, labour productivity has weakened, as output has declined even more than the number of hours worked.

As the economy stages an upturn, the adjustment will take place primarily in productivity and the number of hours worked, with employment growth coming last. In 2010 hours worked will only decrease by half a percentage point, which means that the productivity per hour worked will increase by 3.5 per cent while output growth will be 3 per cent. In 2011 hours worked will exhibit an upturn, but the growth will remain at 1.7 per cent less than the growth of output. This signifies an output growth of 1.8 per cent, as output increases by 3.5 per cent.

Table 4. Key forecasts

	2009	2010f	2011f
Unemployment rate (%)	8.2	9.1	8.8
Unemployed (1 000)	221	241	235
Employed (1 000)	2457	2417	2434
Employment rate (%)	68.3	67.2	67.9
Inflation, consumer price index (%)	0.0	0.9	1.8
Wages, index of wage and salary earnings (%)	3.9	2.0	1.5
Real disposable income of households (%)	0.8	2.2	1.6
Current account surplus (Bill. €)	2.5	3.2	5.6
Trade surplus (Bill. €)	3.9	4.0	4.6
Central government financial surplus			
Bill. €	-8.6	-10.2	-8.7
% / GDP	-5.1	-5.8	-4.7
General government financial surplus			
Bill. €	-4.1	-5.1	-2.0
% / GDP	-2.4	-2.9	-1.1
Emu debt			
% / GDP	44.0	45.1	43.7
Tax rate (%)	43.0	42.5	42.9
Short-term interest rates (3-month Euribor)	1.2	0.8	1.5
Long-term interest rates (10-year gov't bonds)	3.7	3.6	4.1

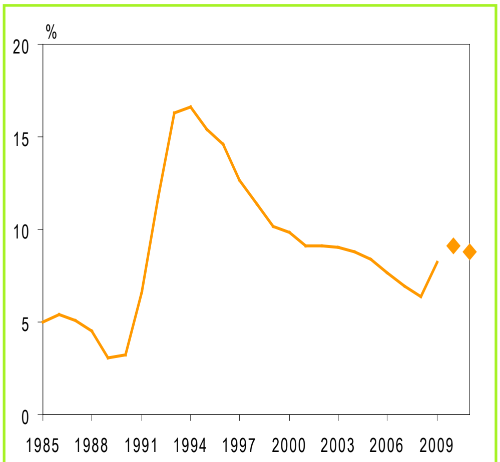
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Finnish price competitiveness strengthening again

Internationally speaking, wage growth in Finland has been relatively moderate until 2007. Especially in 2008, wages rose much faster in Finland than in the euro area on average. New collective agreements signed in late 2009 and early 2010 dampened Finnish collective wage increases more than in other countries in the euro area and even below its average. For example, the rate of increase in hourly wage costs was already below the average in the euro area in the fourth quarter of last year.

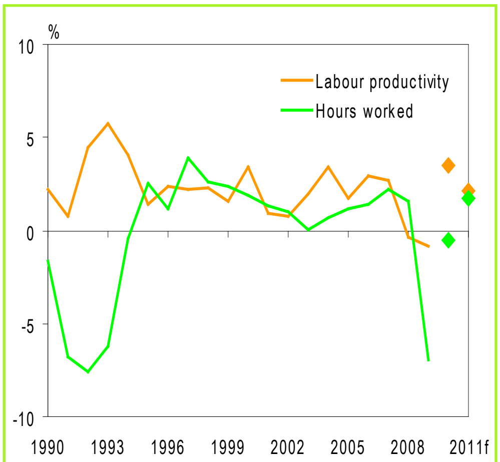
The growth of Finnish labour productivity has been rapid by international standards – higher than e.g. the euro area average – up until last year. The deep recession of last year, however, also reduced Finnish

Unemployment rate 1985–2011



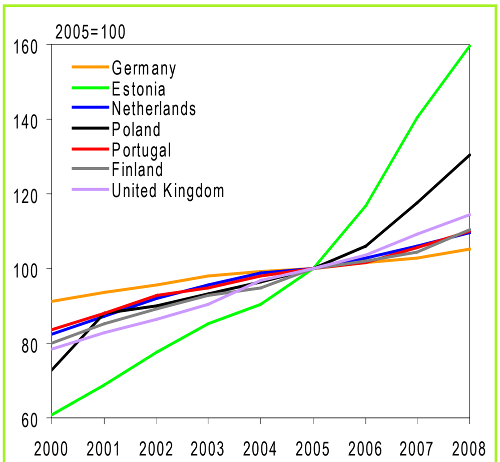
Source: Statistics Finland, PT

Change in labour productivity and hours worked 1990–2011



Source: Statistics Finland, PT

Labour costs per hour worked in total economy 2000–2008



Source: Eurostat

productivity more than in other countries. This output slowdown is nonetheless temporary, as Finnish productivity will improve this year and next, faster than the euro area average. Finnish competitiveness as measured by unit labour costs developed in the early 2000s at the same pace as the competitiveness of the euro area. From 2007 onwards unit labour costs have risen faster in Finland than the rest of the euro area. The situation is nevertheless being remedied in that respect.

Tax revenues collapsed last year

In 2009, the volume of public consumption grew in line with our forecast by only 0.7%. The nominal consumption expenditure growth of both the central government and municipalities was somewhat lower than forecast owing to the lower-than-expected increase in prices. The price level of public investment fell as expected by about 3 per cent, but real growth was surprisingly low, 4 per cent. State revenue sharing with municipalities increased by 5.5 per cent, but income transfers to social security funds rose by as much as 24.5 per cent. To a great extent this is attributable to a technical change where expenditures related to state revenue sharing with Kela (The Social Insurance Institution of Finland) were classified in their entirety as income transfers, while previously a part was classified as capital transfers. Due to a significant increase in unemployment, substantial increases were incurred in unemployment benefits and housing aid.

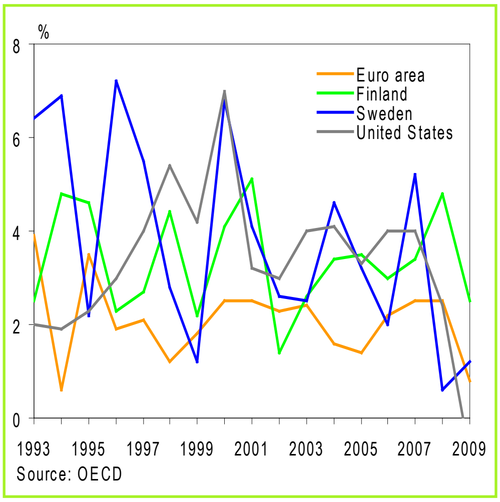
A restrained fiscal policy will contribute to the slow-down in total public consumption to 0.5 per cent this year and 0.2 per cent next year. The trend in public investment is even more downward. It will decline by 3.4 per cent this year and next year 0.4 per cent. This year, the worsening of structural unemployment will boost state revenue sharing directed to unemployment funds and income transfers to Kela. The increases are substantial also in unemployment security, labour market subsidies, housing aid and labour market policy-related training. Also the compensation to Kela for elimination of employers' pension contributions is considerable. Total state income transfers to social security funds will increase this year by nearly 20 per cent. This growth will nevertheless subside in 2011, when the unemployment rate gradually begins to decline. State revenue sharing with municipalities is forecast to rise in both years by around six per cent.

Last year, state tax revenues plummeted 15 per cent. Corporate tax revenues fell by more than half, earned and capital income tax revenues fell by more than 20 per cent while VAT receipts declined by 5.4 per cent. The central government's property income also fell by nearly a third. Municipal tax revenues, on the other hand, developed much more favourably. Owing to growth in municipal and property tax revenues, municipal tax revenues achieved growth of half a per cent.

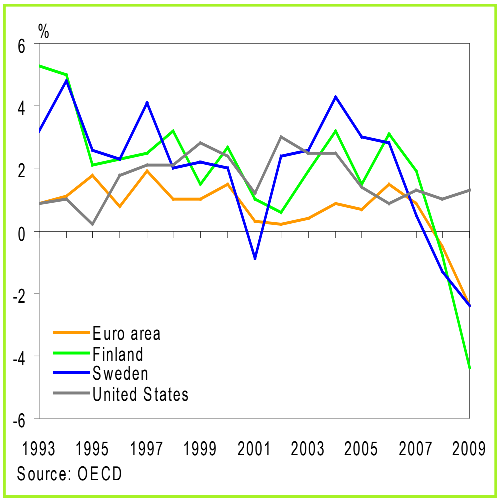
Taxation tightening next year

In 2010, the wage bill is projected to grow by 1.8 per cent already, but as a consequence of the tax cuts the central government's earned income tax receipts will continue to fall. However, the recovery in capital income taxes and corporate tax receipts will be sufficient to spur a clear rise of slightly more than 2 per cent of the central government's direct tax revenues. The reduction in VAT on food will be felt in full force this year, and in the second half of the year restaurants' VAT will be lowered. Collectively, these represent a shortfall of tax revenue equivalent to some EUR 600 million. A general lifting of VAT by one percentage point will compensate for about one half of this. The cuts in VAT will limit its proceeds still this year. On the other hand, in

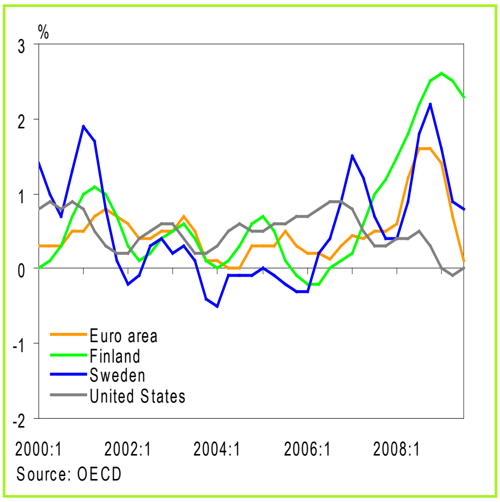
Changes in labour costs per capita in the private sector 1993–2009



Changes in labour productivity in total economy 1993–2009



Changes in unit labour costs 2000:1–2009:3



particular the automotive, energy and alcohol tax revenues are becoming to grow, meaning that indirect taxes are expected to end up this year at about 2.5 per cent on the plus side. In order to offset increases in basic deductions in municipal taxation and easing of pensioners' taxation, the average municipal tax rate will increase this year by 0.39 percentage points. Overall, municipal tax revenues will remain almost unchanged. Corporate and real estate taxes will, on the other hand, generate higher receipts so that total tax revenues of municipalities will increase by 2.4 per cent.

In 2011 there may be changes in the principles behind central government income taxes, but in this forecast only a technical EUR 300 million adjustment to the earned income tax schedule is assumed. Part of this is compensation for the rise in social security contributions. The wage bill is projected to rise by 3.7 per cent already, and as business profits rise then capital income and corporate tax proceeds will increase so much that the central government's income tax revenues will increase by almost 7 per cent. Indirect taxes will climb by 8.5 per cent, while VAT revenues will increase by almost 6 per cent. Also forthcoming is an increase of EUR 750 million derived from energy taxes, certain other tax increases and a substantial rise in automobile taxes. Municipal tax revenues will achieve slightly more than 4 per cent growth, while municipal taxes will climb by nearly 6 per cent.

Contributions to pension insurance institutions and other social security funds declined slightly last year, but this year they will grow already by a little over two per cent. The elimination of employers' basic pension contribution caused a shortfall that was offset by hikes in unemployment insurance and pension insurance contributions. In 2011, growth in pension insurance contributions will still be strong, but decisions on many of the payment rates have not yet been finalized. Social benefits and assistance paid out already reflect the above-mentioned growth in unemployment.

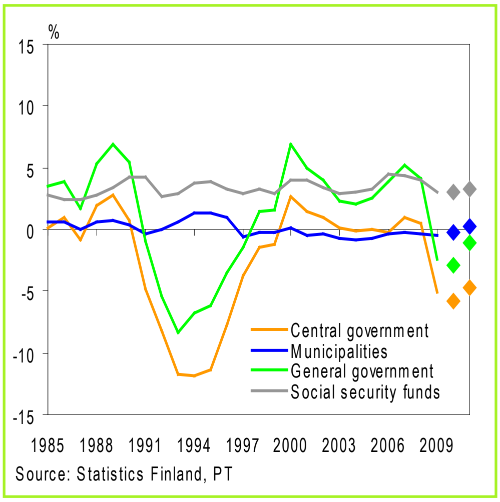
Employment pension insurance and other social security funds will be able to maintain last year's approximately 3 per cent surplus this year and also next year. The municipal sector's deficit will decline this year slightly from last year's EUR 700 million and will disappear entirely next year. The central government deficit will grow this year by approximately EUR 1.6 billion from last year's EUR 8.6 billion level and fall next year by about EUR 1.5 billion, so that the total general government EMU deficit will rise this year by 0.5 percentage points to 2.9 per cent and decline next year to 1.1 per cent relative to GDP. Government debt (EMU debt) will reach its peak this year as a percentage of GDP. Next year it will fall from this year's 45 per cent to below 44 per cent. Taxes as a percentage of GDP will decline in 2010 by 0.5 percentage points to 42.5 per cent, rising in 2011 to 42.9 per cent.

Fiscal policy stimulus is over

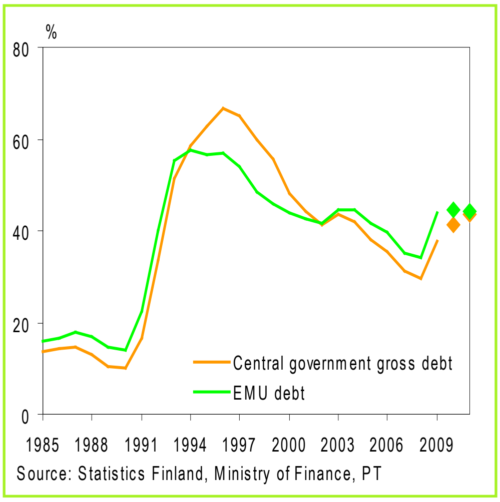
Below is an estimate of the impact of fiscal policy both in terms of changes in the tax principles and expenditures approved in the state budget.

This year taxation is still eased by VAT changes. The VAT on food was reduced from 17 per cent to 12 per cent at the beginning of October 2009 and it will be raised back to 13 per cent at the beginning of July 2010. At that time the VAT on restaurant food will also be reduced from the current 22 per cent to 13 per cent while the overall VAT will rise from 22 per cent to 23 per cent. Another significant tax relief measure is the elimination of employers' basic pension contribution, which will cut the proceeds from social security payments by EUR 600 million. The changes in central government state and municipal income tax schedules will also ease taxes by an estimated EUR 465 million after taking into account the tightening effect of progression on nominal earnings. However, this year

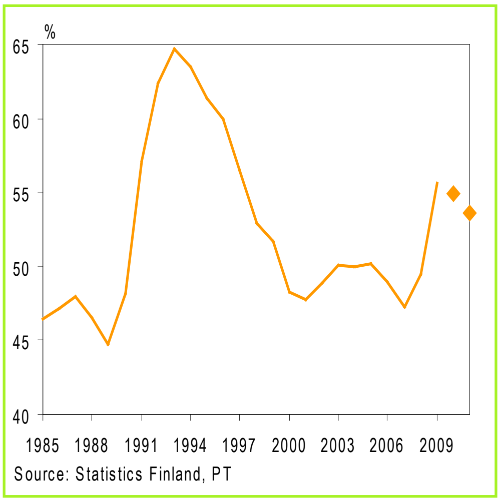
General government financial surplus as percentage of GDP 1985–2011



Central government gross debt and general government EMU debt as percentage of GDP 1985–2011



Public expenditures as percentage of GDP 1985–2011



several raises in social security payments already increase taxation in part. Overall the changes in the tax principles decided by the government will generate about EUR 715 million in tax losses.

Next year the changes in VAT principles will already tighten taxation. Changes in the VAT will increase tax revenues by EUR 215 million and the increased taxation of energy by EUR 750 million. In total, higher taxation will increase tax revenues by nearly EUR 1.1 billion.

Table 5. Central government active fiscal policy

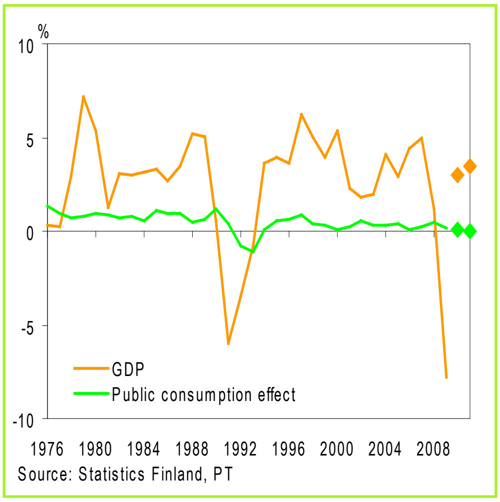
Relative to 2009 nominal gross domestic product, %, expanionary (+), contractionary (-)	2009	2010	2011
Central government budget expenditures	0.6	-0.1	-0.3
Taxes and social security payment changes	0.9	0.4	-0.6
Total effect	1.4	0.3	-0.9

Taxation was indeed clearly expansionary last year. This year, this effect will wane and taxation will be tighter next year.

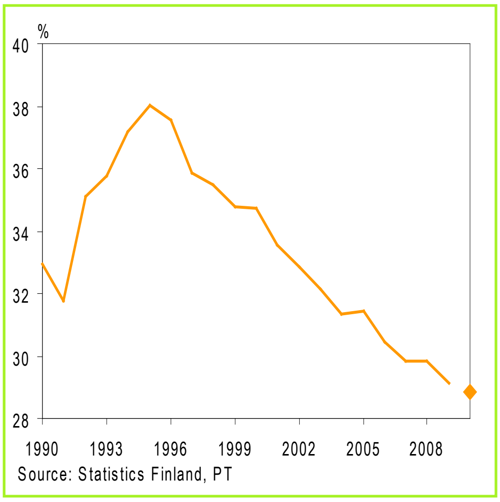
In relation to expenditures, fiscal policy has been estimated based on the state budget. Expenditures include subsidies, net income transfers to other public sector entities (excl. compensation for easing taxation), income transfers to other domestic entities, paid social benefits and aid, consumption expenditure and gross investments. Fiscal policy is considered expansionary if the growth in real budget expenditures exceeds the 1.5 per cent limit considered normal. Expenditure (excl. investments) has been converted into real figures by using the price index of state expenditures as a deflator, which is expected to increase by 2.1 per cent this year and 2.3 per cent next year. The price of investments is expected to fall this year by 0.9 per cent and to rise by 1.1 per cent next year. The calculated deviation from the 1.5 per cent limit has been converted back into nominal figures and calculated in proportion with the value of GDP. According to the estimates made in this manner the expansionary effect of changes in state budget expenditures was 0.6 per cent last year. This year that effect is slightly contractionary (0.1 per cent) and next year already more clearly contractionary (0.3 per cent). Overall, stimulus based on tax relief almost ends this year and becomes clearly contractionary next year.

It has been emphasized in the Ministry of Finance's own forecast that the spending stimulus is based mainly on decisions made within government funds external to the budget such as increases in financial investments. However, the only expenses generated within the funds that could be considered to be spending stimulus are direct subsidies. Last year, the subsidies and accords of the Housing Fund of Finland did in fact grow by EUR 87 million. After taking this into account the spending stimulus would amount to 0.6 per cent of GDP. This year subsidies of the National Housing Fund increased by a scant EUR 63 million from last year after these subsidies were increased by EUR 75 million in the supplementary budget. Again, this increase is so small that it will not affect the estimate of the scale of the spending stimulus. It is difficult to incorporate the decisions of the funds and the expenditures generated by them in a broader sense into the fiscal policy, because they mostly entail business activities which also generate revenue. Overall, the consistent evaluation of the fiscal policy by comparing countries over time would become virtually impossible if the assorted fiscal operations of different countries were taken into account.

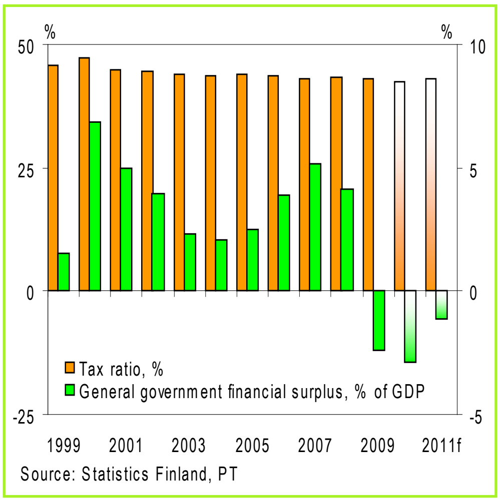
Impact of government consumption on total production 1976–2011



Wage earners' income tax rate 1990–2010



Public finances 1999–2011



No more catastrophes like the 1990s

The impact of fiscal policy on the real economy can be assessed to a limited extent also on the basis of how much the public expenditures of the central government and municipalities affect GDP growth. An adjacent chart shows that last year's and this year's fiscal policy impact measured by the change in consumption expenditures does not differ appreciably from normal. During the worst recession years – 1992 and 1993 – the fiscal policy stance measured in this way was exceptionally contractionary. In this respect, the fiscal policy during the current recession has not been contractionary in the same way. In the 1990s recession employees' taxation was tightened sharply. At the time, an excessively stringent fiscal policy exacerbated the unemployment problem that lasted almost a decade. At its worst, in 1994, the unemployment rate averaged nearly 17 per cent.

Public sector already running surplus in 2012

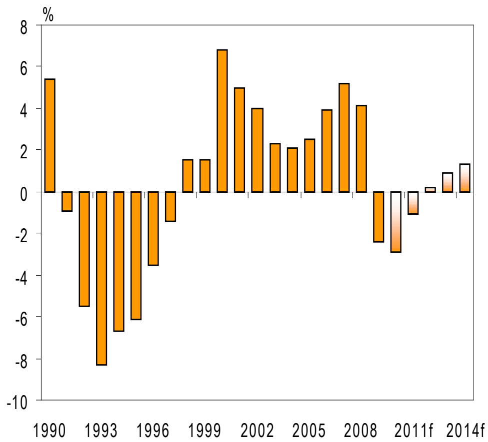
The EMMA model of the Labour Institute for Economic was used to calculate the development of the general government deficit during 2010-2014. In the calculations the international economy and the rest of the environment were assumed to develop in accordance with our forecast. Export market growth was assumed to continue to be brisk also in 2012, but to slacken slightly in 2013 and 2014. General government expenditure was assumed to develop in accordance with our forecasts for the years 2010 and 2011, after which it would continue to rise in line with the 2011 trend. On the income side consumption and energy taxes were assumed to be raised in accordance with government proposals. Similarly, other changes already made in the tax principles - including those for this year - were taken into account. Next year, municipal taxes were assumed to rise an average of 0.2 percentage points but remain unchanged thereafter. Otherwise, taxation was assumed to remain neutral.

The model produces a forecast where production increases 3.0 per cent this year and 3.5 per cent in 2011 and 2012, after which growth slows down gradually in 2013 and 2014. The number of hours worked decrease in the model forecast by 0.8 per cent this year but increase by 1.6 per cent next year and thereafter at a slightly slower rate. Significantly slower growth in hours worked than total production limits the growth in the most heavily taxed component of national income, i.e. earned income. Despite this, the public sector's financial position should improve in the coming years. The public sector deficit as a percentage of GDP will be 2.9 per cent this year and 1.1 per cent next year. The public sector will begin to run a surplus in 2012, and in the following years the surplus will grow so that in 2014 it is 1.3 per cent of GDP. Despite the surplus in the public sector, the central government will nevertheless continue to run a deficit in 2010-2014. On the basis of the model projections it appears, however, that public finances will strengthen considerably more and faster than, for example, the Ministry of Finance has envisioned in its newest forecast.

Table 6. Calculation of general government surplus (%)

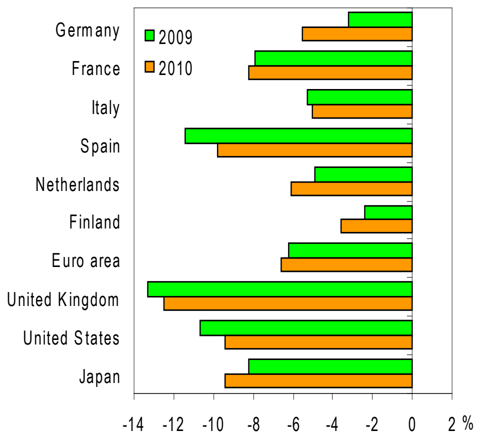
	2010	2011	2012	2013	2014
GDP	+3.0	+3.5	+3.5	+3.0	+2.3
Hours worked	-0.8	+1.6	+1.4	+1.0	+0.7
General government surplus/GDP	-2.9	-1.1	+0.2	+0.9	+1.3

General government deficit 1990–2014



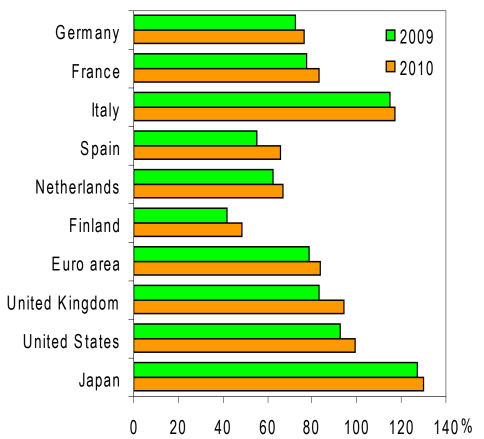
Source: Statistics Finland, PT

Public sector deficit-to-GDP ratio, %



Source: ECB, OECD

Debt-to-GDP ratio, %



Source: ECB, OECD

Finnish public finances still among strongest in euro area

It is worth pointing out that the Finnish public sector is in better shape in term of its financial deficit and its indebtedness than the public sectors of almost all other countries in the euro area and EU. The Finnish government's long-term funding cost has remained comparatively low in the bond market.

Fiscal policy stimulus should still be continued this year

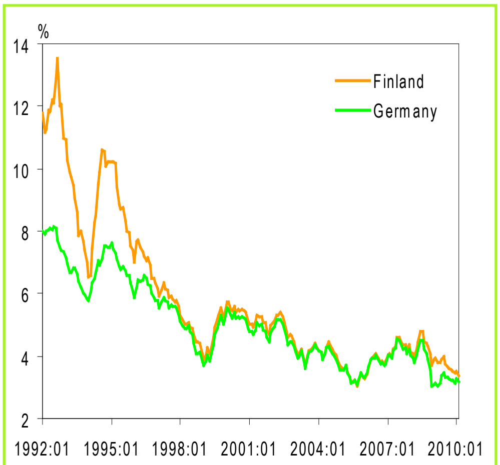
Despite the fact that economic growth is gaining momentum, fiscal policy stimulus is still needed. This is justified by the fact that this year overall output will still be an average of 5 per cent below the level of 2008. This is reflected especially in unemployment, which will still increase this year. Resources are thus still being under-utilized and it is important to promote employment to avoid similar mass unemployment as in the 1990s. Finnish public finances can also withstand the stimulus better than other EU or euro area countries, where public deficits and state debt are high in comparison to Finland. The interest of the state debt is also relatively inexpensive compared to most other euro area countries, and in this respect the situation is not becoming worse.

The taxation policy of the next few years is complicated by rather large tax cuts made by the government, which are meant to be permanent. For instance, the reduction of employers' basic pension insurance contributions should have been just a temporary measure. The decision to tighten energy taxation will reduce this shortfall. This solution will limit energy consumption, which can be considered a viable goal. The energy tax hike will nevertheless be passed on to households, because the enterprises in this energy-intensive industry do not want their costs increased. As it raises consumer prices and also cuts the purchasing power of employees, this tax will in part lead to wage demands and also partly to wage increases.

On the basis of the Labour Institute for Economic Research forecast regarding state finances, there is no need for major new tax hikes. There is need, however, for a substantial increase in capital income taxation. On the other hand, Finland's 26 per cent corporate income tax rate is already amongst lowest in the euro area. Its reduction below 25 per cent would be a step toward tax competition with fateful consequences. It is necessary to take into account that raising consumption-based taxes increases the costs of labour inputs in a similar manner as hikes in earned income taxation. In addition, increases in consumption taxes - at least the general VAT – place a disproportionate burden on low income groups. The prices of factors of production are increased the least by taxing wealth that has already been created. Thus raising the tax burden on real estate, other assets and inheritances must also be considered.

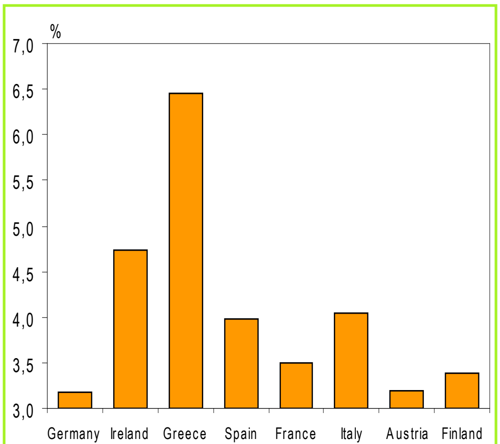
Government's second supplementary budget increased the amount of funds for promoting employment. This is understandable as the employment situation has deteriorated. A better policy, however, would have been to generate new jobs or prevent the loss of old ones. Against this background, the government should not have continued to cut jobs in the name of the state's productivity program. The government should have ensured growth in public investment this year and not let it shrink. In addition, the state could support municipalities this year more than planned and prevent loss of jobs there. It appears that the hike in VAT planned for July will come half a year too soon.

Finnish and German 10-year government bonds yields 1992:01–2010:02



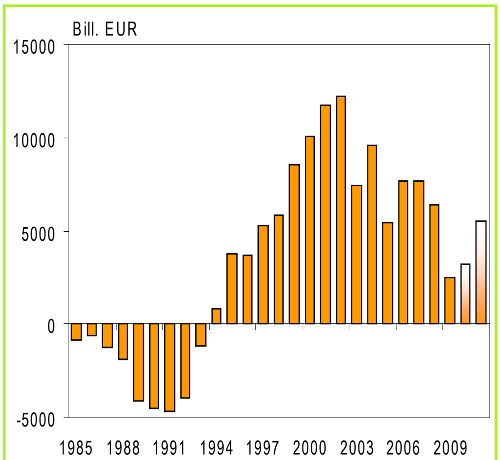
Source: Bank of Finland, Bundesbank

10-year government bond yields in February 2010



Source: ECB

Current account surplus 1985–2011



Source: Statistics Finland, PT