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Economic Forecast 2017–2018

Economic growth in Finland faster this year than in euro area

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LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast for 2017–2018

Economic growth in Finland faster this year than in euro area

This year Finland's economic growth has accelerated and become export-driven. On the one hand, this positive upswing is explained by accelerating economic growth in several key export countries and, on the other hand, by sector-specific factors. Our Institute has raised its growth forecast by 1.7 percentage points for the current year and 0.8 percentage points for next year. We estimate that this year Finland's GDP will grow by 3.6 per cent and 2.5 per cent next year. Next year's slower growth might turn into a prolonged phenomenon. The most severe threats associated with it come from outside Finland.

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- This year's rapid export-driven growth will continue less steeply next year and also thereafter
- Income development is moderate, but tax cuts and borrowing will bolster private consumptio
- The employment rate will rise, but the unemployment rate will fall only slightly
- Accelerating economic growth will reduce the deficit of the public sector, although the descent of the tax ratio will slow down consolidation
- It would be justified to increase public expenditure on education and R&D rather than using all leeway generated to lower the tax ratio

Economic growth has accelerated in the beginning of this year, and the picture of last year has also become brighter than it previously appeared. According to the latest data, Finland's GDP grew by 1.9 per cent last year, which is significantly higher than forecast when the Competitiveness Pact was drafted or according to the preliminary figures released by Statistics Finland this spring. Last year economic growth was spearheaded by private consumption and investment instead of exports. This year exports have also risen rapidly, and an increasing amount of investment has taken the form of machinery and equipment investment instead of construction investment.

COST COMPETITIVENESS DOES NOT EXPLAIN UPTURN IN GROWTH

The Competitiveness Pact lowering unit labour costs will boost economic growth over the forecast period. In contrast to a normal individual wage settlement, it may also have growth-enhancing effects in the long run if the cuts in employer's social security contributions are long-lasting.

The fall of GDP in 2012-2014 rebounded into rapid economic growth even before Finland's cost competitiveness had time to make any major improvements. The upswing of economic growth can therefore not be explained primarily by the improvement of cost competitiveness or Finland's past lack of success with low cost competitiveness. In addition, as our Institute's researchers have previously reported (e.g. Pekka Sauramo, Talous ja yhteiskunta 2/2015, pp. 2-9) and as a separate box describes, the quantitative estimates that have been widely publicized in Finland in recent years, on how much Finland is behind its main competitor countries in cost competitiveness, have been based on measurement methods that are problematic in many ways.

The positive shift in the Finnish economy is partly explained by the acceleration of economic growth in the euro area and the US and the economy returning to growth in Russia as well. Also exports focusing on investment goods, which has often been considered a weakness in the Finnish economy, may be an advantage in the current economic climate where demand for investment goods is growing in export countries. In Finland's export countries, however, the upturn has been much more modest than in Finland (and in many there has been no upturn whatsoever), and therefore the development of export countries as a sole explanation for the rapid growth in exports is problematic.

Industry-specific factors such as the surprising success of the Valmet Automotive car plant and the recovery and the strong expansion of the previously crippled shipbuilding industry are at least as important explanations for the upturn. During the forecast period, goods exports will also be boosted by the completion of the Äänekoski bioproduct mill.

The realized development corresponds to the view expressed in our Institute's autumn 2015 forecast. At that time we suggested that Finland's poor economic success over the past few years was mainly due to a number of specific factors that were already declining in significance at the time. According to the then current estimate, Finland would reach other European countries' growth rates by 2017, and perhaps even exceed them for a period of time. This view still holds true.

GROWTH MAY CONTINUE TO BE MODERATE FOR A PROLONGED TIME, BUT IT WILL HAVE LITTLE VISIBLE IMPACT ON UNEMPLOYMENT FIGURES

As the fast economic growth of the current year (3.6 per cent according to our forecast) is based partly on industry-specific "jumps" and more efficient utilization of previously under-utilized production capacity, growth will most likely continue more moderately next year (at 2.5 per cent according to our forecast). Growth is also hampered by the mismatch problems encountered in the labour market, which are examined in more detail from the point of view of education in a separate box below.

It is possible that growth will be more moderate than this year but remain at or above the EU average for a prolonged time. The most probable of the threats that, if realized, would prevent the growth that has now begun, are not related to Finland's inadequate cost competitiveness or Finland's structural problems, but are external: for example, the unpredictable and ever-shifting policy of the US president, tightening geopolitical tensions or the strong appreciation of the euro may lead to a recession that also affects Finland.

The acceleration of economic growth bolstered employment, but the unemployment rate measured through labour force surveys has still only declined slightly. Most of the people who have been employed are therefore persons other than those classified as unemployed by the labour force survey criteria. The active job-seeking model designed by the government may further dampen the decline in the unemployment rate, as it encourages the unemployed who have stopped active job searching to seek jobs and therefore also makes them unemployed in the sense of the definition used in the labour force survey.

PRIVATE CONSUMPTION WILL STILL GROW DESPITE MODEST DEVELOPMENT OF EARNINGS

This year the level of earnings in the public sector will fall due to the holiday pay cut included in the Competitiveness Pact and the rise of earnings will

DEMAND AND SUPPLY

	2016	2016	2017f	2018f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	215.6	1.9	3.6	2.5
Imports	78.6	4.4	5.7	4.6
Total supply	294.2	2.6	4.1	3.1
Exports	76.0	1.3	9.0	6.0
Consumption	170.8	1.6	1.4	1.1
private	119.1	1.8	2.0	1.5
public	51.7	1.2	0.0	0.3
Investment	46.4	7.2	7.6	4.0
private	37.9	7.9	9.0	4.5
public	8.6	3.9	1.4	1.7
Change in stocks[1]	1.1	0.0	-0.3	0.2
Total demand	294.2	2.6	4.1	3.1

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

also be modest in the private sector. Next year's earnings development will depend on the upcoming wage settlements determined in the autumn union-level negotiation round. In our forecast, we have assumed that wage increases will remain fairly moderate despite the upswing, but still such that they sustain the purchasing power of wage earners, while also taking into account taxation and inflation.

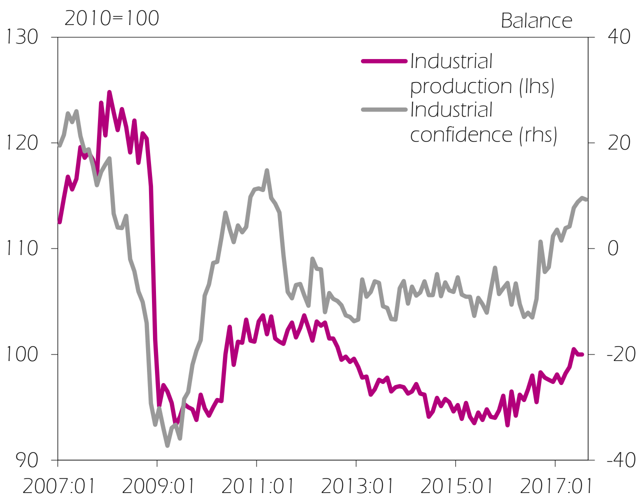
Weak wage development, price competition in foodstuffs and moderate development in both housing expenses and fuel prices will keep inflation low this year. In spite of the fairly sluggish development of expendable income, there is strong consumer confidence in the economy. We estimate that the ECB's low interest rates, which encourage borrowing, will not yet rise in the forecast period, that the savings rate will remain negative and that private consumption will continue to grow rapidly in the forecast period.

PRO-CYCLICAL FISCAL POLICY WILL CURB DECLINE IN PUBLIC DEFICIT

The acceleration of economic growth will reduce the public deficit, although the fall in the tax ratio will slow down consolidation. Instead of making uncompensated tax cuts, it would be justified to use the leeway generated to allocate more public resources to R&D support, education and other labour market measures solving mismatch problems, such as employing unemployed jobseekers who have only received a basic education.

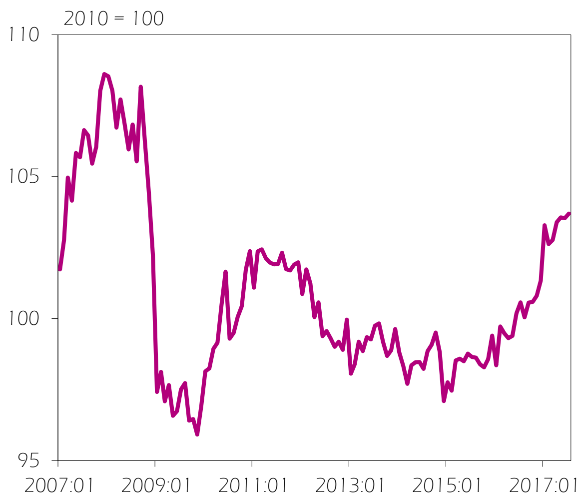
In addition, the tax reductions planned by the government, implemented without compensatory tax cuts, are poorly suited to the cyclical situation, and as is demonstrated in a separate box below, the weakness of the adjustment policy of the public sector carried out in recent years has also more generally been its pro-cyclical nature. The greatest tightening measures in public finances have taken place in a recession or stagnation, and a more expansionary policy is now being carried out in an upswing. ■

INDUSTRIAL CONFIDENCE AND INDUSTRIAL PRODUCTION IN FINLAND 2007:01–2017:08



Source: Eurostat

TREND INDICATOR OF OUTPUT 2007:01–2017:07



Source: Statistics Finland

International Economy

Global upswing is clear but moderate

- The global economy will grow slightly less than 4 per cent this year and next year
- World trade growth will reach more than 4 per cent in both forecast years
- In Europe and the United States, growth will accelerate to more than 2 per cent
- Next year growth will slow down slightly in Japan and China
- Russia, India and Brazil are on the rise

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Global economic growth will accelerate by about half a percentage point this year and still slightly next year. The upward trend is clearly visible in the EU, the United States, Latin America, Russia and many Asian countries. Growth has been fuelled by a two-year halving of crude oil prices to their present level, slightly above 50 dollars a barrel, and the easing of economic policy in many countries. No significant changes are anticipated in oil prices during the forecast period.

EUROPEAN ECONOMIC GROWTH LEVELLING OFF AT SLIGHTLY ABOVE TWO PER CENT

Growth in the EU has accelerated especially in the Baltic countries, Eastern Europe, Finland and Portugal this year. The three largest countries in the euro area have had slower growth rates than average, but at the moment, the French and Italian outlooks are brighter than they have been in a long time. Germany's growth will also accelerate from last year's 1.9 per cent by about 0.2 percentage points during both forecast years, but it is a prime example of how strong confidence in the euro area has not yet spawned economic growth (Chart); For example, the German Economic Research Institute IFO's economic trend indicator has never surpassed GDP growth by so much in the past. According to IFO's investment survey, this year investment growth will accelerate in Germany to its highest level after the financial crisis, to over 6 per cent, which is positive for Finland's exports.

Based on leading indicators, it has already seemed possible for quite some time for Europe's economic development to become much more positive than previously, but there is still no clear evidence of this in economic statistics. Economic growth in the euro area in the first half of the year, 2.3 per cent, was only slightly faster than in the previous half of the year. It was driven by foreign trade alone, which will be undermined in the future through the appreciation of the euro. Simultaneously, export demand in the region will be strengthened by the pickup in global economic growth.

In the management of the euro-crisis, at least for the time being, a strategy called "muddling through" seems to have produced results, wherein emerging acute crises are addressed and cyclical upswings are patiently expected to lift the crisis countries out of their dilemmas. Spain, Ireland and Portugal have indeed already reached very good growth paths, and Italy and Greece also appear to be following. The situation has also been facilitated by the grip of the Commission and politicians in economic policy becoming looser and the easing of political uncertainty brought about by elections in the various countries.

Some alarming signals are also in sight. Alongside the strengthening of the euro, these include the recent weakening in the lending of banks, purchasing manager indexes and the entire euro area investment and retail trade. The uncertainty regarding Brexit is a thing of its own; In the UK, consumer confidence and investment are at rock bottom, but the country still has the lowest unemployment rate it has had for 40 years, and the weakening of the pound is supporting its industrial production.

The Harmonized Index of Consumer Prices in the euro area is projected to increase by an average of 1.5 per cent this year and 1.2 per cent next year. Base inflation is hovering around one per cent, and the overall index is fluctuating due to the price development of energy (mainly oil) and also food (see figure). With the unemployment rate about to fall just below 9 per cent, there will not be any inflationary pressures arising from the labour market. The European Central Bank is not expected to raise its key interest rates until after the forecast period and to begin dismantling its security purchases programme with great caution next year.

WEAKENING OF DOLLAR STIMULATING UNITED STATES

In the United States, expectations about the Federal Reserve raising its key interest rate have been high, despite the fact that the base inflation indicator it closely monitors is declining and the increase of wages has also slowed down. It is now uncertain whether the Fed will raise its interest rate from the current 1.00-1.25 per cent range yet in December, but this is expected to take place at least a few times next year.

US economic growth will accelerate from 1.5 per cent last year to 2.1 per cent this year and 2.4 per cent next year. Two devastating hurricanes will be followed by a small dip in economic growth in the third quarter of this year, which will be more than compensated by reconstruction. The effects of private consumption and public demand are weakening. Construction is also at a low level. However, other investment, foreign trade and industrial output have clearly benefited from the depreciation of the dollar.

OUTLOOK IS FAVOURABLE IN JAPAN AND BRIC COUNTRIES

As China's Communist Party prepares to meet this autumn, it appears that economic policy, in particular the ever-accelerating fiscal stimulus, has slightly boosted economic growth. This year 6.9 per cent will be reached, but next year it is likely that growth will slow down to 6.6 per cent, just barely above the official target. It already seems that growth is decelerating again as monetary policy and the regulation of the financial sector have been tightened due to the enormous debt. However, the debt risks of the financial sector continue to grow.

Japan's economic development has been surprisingly positive this year. The pickup of exports and investment will boost growth by half a percentage point to 1.5 per cent, dropping to 1.2 per cent next year. In the first half of the year, India's economic growth was unexpectedly below 6 per cent. After the confusion caused by the banknote and VAT reforms has settled down, next year it will reach 7 per cent.

Russia reached 1.5 per cent growth in the beginning of this year. Annual growth is projected to be 1.7 per cent and 2.0 per cent next year. Growth is boosted by the current price level of oil as well as record high agricultural crops, decelerating inflation and falling interest rates. Russia has succeeded in adapting to sanctions, which may still have significant disadvantages, especially in oil production.

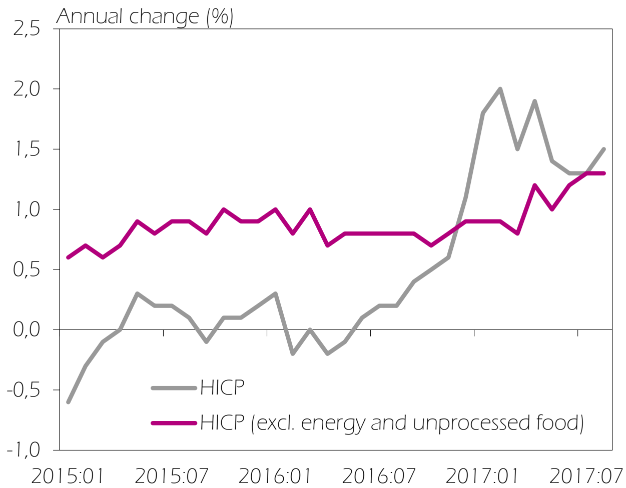
Brazil is recovering from the deepest recession of its history. Its foreign trade has benefited from rising metal prices, inflation has slowed down, interest rates have declined, and industrial output and the retail trade have started to rise again. Economic growth will pick up from last year's -3.6 per cent to 0.5 per cent this year and to 2.0 per cent next year. ■

INTERNATIONAL ECONOMY

	Share of world GDP (%)	GDP growth (%) 2016	2017f	2018f
United States	15.3	1.5	2.1	2.4
Eur-19	11.6	1.8	2.3	2.2
Germany	3.3	1.9	2.1	2.3
France	2.2	1.2	1.6	1.8
Italy	1.8	0.9	1.5	1.6
EU28	16.5	1.9	2.3	2.3
Sweden	0.4	3.2	3.0	3.0
United Kingdom	2.3	1.8	1.5	1.2
China	18.3	6.7	6.9	6.6
India	7.5	7.1	6.2	7.0
Japan	4.3	1.0	1.5	1.2
Russia	3.1	-0.2	1.7	2.0
Brazil	2.5	-3.6	0.5	2.0

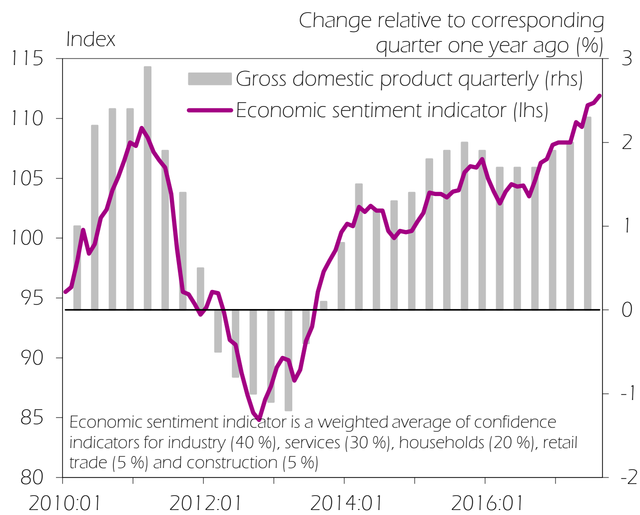
Source: BEA, BOFIT, IMF, Eurostat, Labour Institute for Economic Research

EURO AREA HARMONISED INDICES OF CONSUMER PRICES (HICP) IN TOTAL AND EXCLUDING ENERGY AND UNPROCESSED FOOD 2015:01–2017:08



Source: Eurostat

EURO AREA ECONOMIC SENTIMENT INDICATOR MONTHLY 2010:01–2017:08 AND QUARTERLY CHANGES IN GDP (%) 2010:1–2017:2



Source: Eurostat

Foreign Trade

Exports of goods expanding robustly and faster than imports

- Exports experienced steep growth in the beginning of this year
- Growth is spurred by the acceleration of economic growth in export countries and industry-specific reasons
- Imports are also increasing as demand for production input is growing, but more slowly than exports

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Goods exports grew very strongly in the first two quarters of the current year, by 15.2 and 7.5 per cent in comparison to the corresponding quarters of the previous year. We estimate that more moderate growth will continue throughout the forecast period.

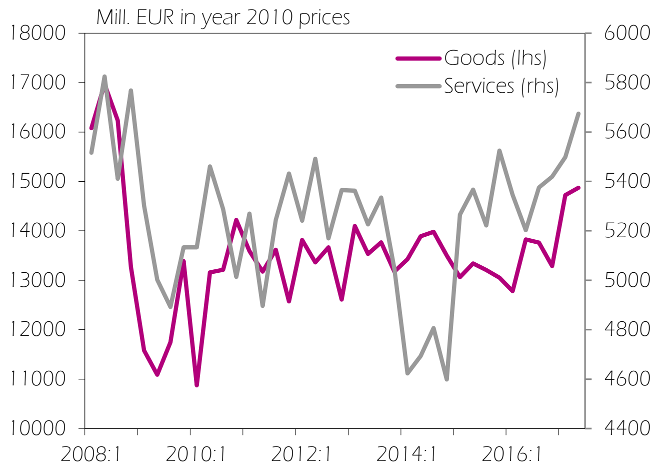
FOREIGN TRADE GROWING SWIFTLY, GOODS EXPORTS THE QUICKEST

According to the export statistics compiled by Finnish Customs, export growth has been strong in the beginning of the year in all major product categories excluding forest industry products. Of the different country groups, exports to EU countries, Asia and North America increased at the fastest pace (18-21 percentage points).

Growth in exports is explained by the acceleration of economic growth in export countries and industry-specific reasons. For example, machinery and vehicle industry exports have been boosted by ship deliveries from the Meyer Turku shipyard (Megastar and Mein Schiff 6) and the increased production of the Valmet Automotive Uusikaupunki car plant. The one-sided focus on investment goods, which is often seen as a weakness in Finland, may well be an advantage in an upswing, where investment typically increases in our main export countries.

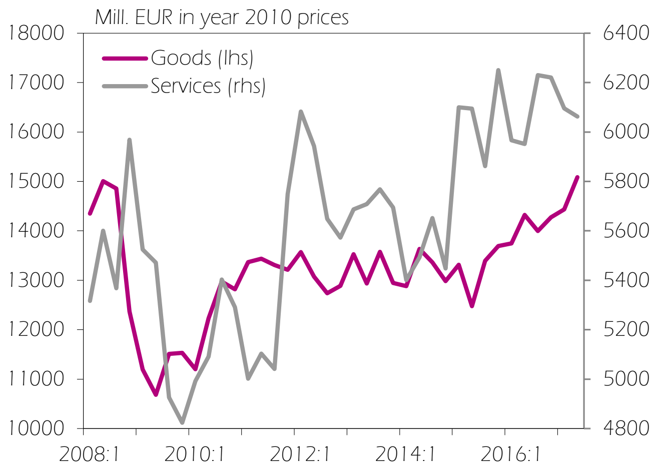
Growth in service exports has been rapid in the early part of the year, albeit slower than growth of goods exports, 2.8 and 9.1 per cent in comparison to the corresponding quarters of the previous year. Statistics on the contribution of different service items to export growth are available only after a considerable lag. However, it is obvious that one of the factors that has contributed most to growth of service exports has been the increa-

EXPORTS OF GOODS AND SERVICES 2008:1–2017:2



Source: Statistics Finland

IMPORTS OF GOODS AND SERVICES 2008:1–2017:2



Source: Statistics Finland

sed popularity of tourism towards Finland. For example, the number of foreigners' hotel stays increased by 15.6 per cent in January-June compared to the same period last year.

Goods imports have also grown strongly in the early part of the year, although more slowly than exports (5.0 and 5.3 per cent). Growth is primarily explained by the increase in investment and exports (utilizing imported products as production inputs) and will continue throughout the forecast period. Service imports nevertheless seem to have declined somewhat in the first half of this year. The result is poorly suited to the cyclical situation, and we estimate that it is either due to the slow updating of data compiled by Statistics Finland or random fluctuation of quarterly figures.

GOODS EXPORTS ARE GROWING IN ALL MAIN EXPORT INDUSTRIES

The future of the export industry now seems unusually bright. For example, in the latest cyclical barometer by the Confederation of Finnish Industries (7/2017), the latest figures regarding the cyclical outlook and export expectations (18 and 21) are exceptionally high.

The aggregate export order stock of the technology industry had strengthened by about a quarter at the end of June, to about 3 billion euros from a year earlier, which is nevertheless partly due to the orders received by the Meyer Turku shipyard for delivery after the forecast period. In the forecast period, the growth in the shipyard's output, such as the recently initiated (September 13) construction of the cruise ship commissioned by Costa Cruises, appears in the National Accounts as stock investment instead of exports. The output of the Uusikaupunki automobile plant will also continue to grow as the plant begins manufacturing a new Mercedes Benz car model next year.

In the beginning of the year, the chemical industry's export growth was mainly due to higher exports of oil products. In these cases, the turnover of exports is heavily dependent on crude oil prices, and in the beginning of the year, the increase in export value was largely explained by the rise in crude oil prices (which also contributed to the import value increase and net export decrease). According to Statistics Finland, production measured through the chemical industry's volume index still increased by 7.1 per cent in comparison to the first half of the previous year, and the current situation is also better in chemical industry on average, according to the Confederation of Finnish Industries' cyclical barometer (7/2017).

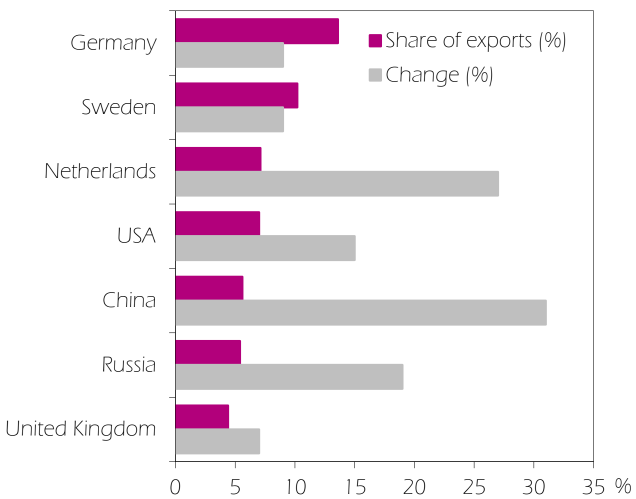
Growth in forest industry exports has long been limited by old-fashioned production capacity and the fall in paper demand. During the forecast period, exports will stage an upturn, primarily owing to the Äänekoski bioproduct mill beginning production in August. Several other forest industry investments have also been planned in Finland, such as Kaidi's biofuel refinery in Kemi and the Finnpulp softwood pulp plant in Kuopio, but at present their funding seems very uncertain.

CURRENT ACCOUNT DEFICIT SHRINKING

Export and import price indexes have declined in recent years, and import prices have fallen faster than export prices. The fall in import prices has been influenced by the previous drop in crude oil prices and the drop in the prices of several other commodities during the period of 2015-16. We estimate that the fall in prices has now come to an end and that the import and export price indexes will start to rise again in the forecast period. However, the growth of export prices is limited by, for instance, the moderate wage development of the current year.

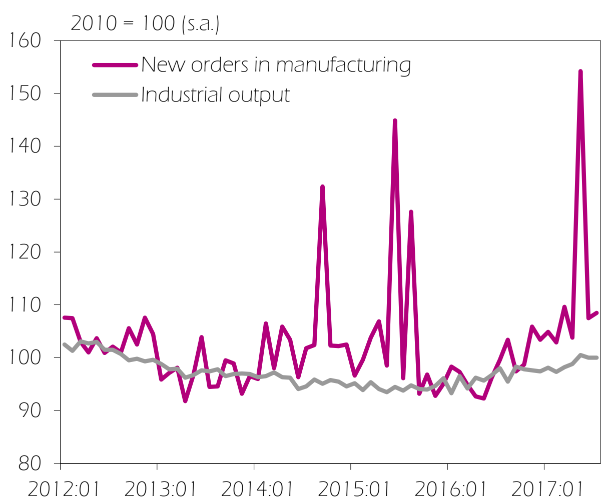
Last year the current account deficit exceeded 2 billion euros. We estimate that the trade surplus will decrease the current account deficit over the forecast period so that next year it will fall to almost zero or the current account will achieve a slight surplus. ■

FINNISH MERCHANDISE EXPORTS IN JANUARY–JUNE 2017



Source: Customs

INDUSTRIAL PRODUCTION IN FINLAND 2012:01–2017:07



Source: Statistics Finland

Investment

Last year's strong investment will continue in 2017

» Investment growth is historically fast, more than 7 per cent for the second consecutive year
» This year's 7.6 per cent growth will slow down to 4 per cent next year
» Machinery and equipment investment is boosted by the upswing and capacity shortage
» Construction activity will expand by slightly less than 8 per cent, and R & D investment is also staging an upturn

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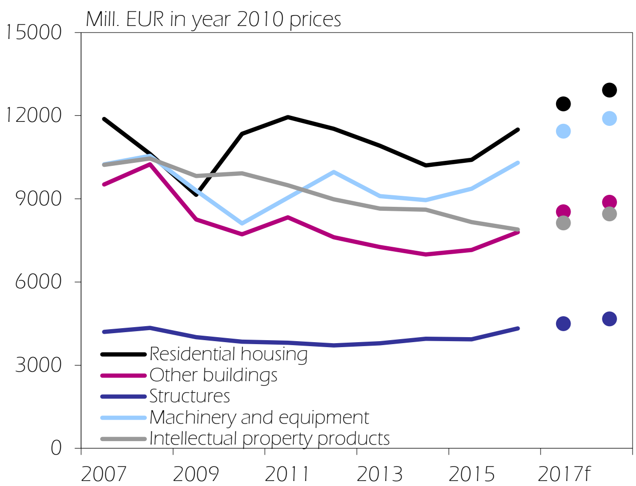
Last year investment grew by 7.2 per cent. The investment forecast for the current year has been revised upwards from last spring's relatively cautious forecast. The faster than previously forecast growth has been spurred by the strong investment figures from the beginning of the year. It now appears that investment will grow at a historically fast pace. During the period of 1975-2016, investment increased by more than 5 per cent for two consecutive years only twice: before the recession of the 1990s during 1987-1989 and after the recession of the 1990s in 1995-1998.

Last year construction investment increased by 9.9 per cent. This year construction investment will continue to increase at a rate of just under 8 per cent. Investment growth is strongest in residential construction and non-residential building construction. In 2018 investment in construction will continue to expand but the growth will already be clearly more moderate. The growth rate of next year will be significantly affected by whether one or more of the pulp mill projects pending in Finland will be implemented (e.g. Boreal Bioref in Kemijärvi or Finnpulp in Kuopio). Civil engineering projects in 2018 will most likely also be boosted by the expenditure increases planned for basic highway maintenance in accordance with the government's 2018 budget proposal.

Machinery and equipment investment increased by 10.1 per cent last year. This year it is even projected to grow slightly faster than this. In the first half of 2017, it increased by more than 20 per cent in comparison to the previous year's figures. In addition, in the last quarter of 2016, growth exceeded 20 per cent. It appears that the economy's upswing will also spawn sizable growth of machinery and equipment investment. This is indicated, among other things, by the fact that more and more companies are running at close to full production capacity. In 2018 machinery and equipment investment will grow but much more slowly than this year.

Based on the figures for the first part of this year, R&D investment has also started to grow, while last year its volume contracted by 3.3 per cent. The long-term decline of R&D investment is forecast to come to a halt due to, for example, the R&D-intensive electrical engineering and electronics industry being expected to start growing again. Consequently, the negative impact of this sector on R&D investments will at least decrease in comparison to previous years. Also the reduction in cuts directed at public sector R&D investment will be smaller this year than in 2016. In 2018 R&D investment will grow at a slightly faster pace than this year. ■

INVESTMENTS 2007–2018



Source: Statistics Finland, Labour Institute for Economic Research

Labour Markets

Statistical methodology and active job-seeking model may distort forecasts

- The lowering the unemployment rate is troublesome – the cause is labour force growth
- Growth in employment rates is slow
- The cut in holiday pay is reflected in the earnings level index

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Improvement in the labour market will lead to a growth in employment this year and next year. In addition, the growth of the working-age population (15-74 years) is also reflected in the supply of labour and hence labour growth. On the other hand, many outside the labour force have returned to active job seeking or directly to employment.

According to Statistics Finland's labour force survey, the number of people outside the labour force dropped by 11,000 people (persons aged 15-74) during January-July in comparison to figures from a year ago. When this is accompanied by moderate growth of the population, the labour force increased by about 12,000 persons. The number of persons employed grew by 16,000, but the number of the unemployed only decreased by 4,000.

There is clearly a mismatch problem in the labour market, since the employment of jobless persons has been so low. The growth in the number of employed people cannot be explained solely by the fact that the unemployed have been employed, but rather the main reason is that the size of the labour force has grown. The employment of unemployed people only accounts for about a quarter

LABOUR MARKET SITUATION IN JANUARY–JULY 2017 COMPARED TO ONE YEAR AGO

	15–64 years old	15–74 years old
Population	-9000	1000
Outside labour force	-20000	-11000
Labour force	11000	12000
Employed	15000	16000
Unemployed	-4000	-4000

Source: Statistics Finland

KEY FIGURES OF THE LABOUR MARKET

	2015	2016	2017f	2018f
Unemployment rate (%)	9.4	8.8	8.6	8.3
Employment rate (%)	68.1	68.7	69.4	69.8
Active population (1 000)	4102	4109	4127	4135
Labour force (1 000)	2689	2685	2701	2713
Employed (1 000)	2437	2448	2468	2488
Unemployed (1 000)	252	237	233	225
Wages, index of wage and salary earnings (%)	1.4	1.2	0.2	1.9
Average hourly wages (%)	1.3	0.7	0.5	1.9

Source: Statistics Finland, Labour Institute for Economic Research

of the total change in employment. The employment rate is projected to rise to 69.4 per cent this year and to 69.8 per cent next year.

The unemployment rate declined to 8.8 per cent last year. Due to the mismatch problem, however, the decline was not in line with expectations. The combined effects of the pickup in the labour market and the sluggishness of shifting from unemployment to employment mean that the unemployment rate will decline by only 0.2 percentage points this year. Next year it will fall to 8.3 per cent.

The official unemployment rate is calculated based on the labour force survey of Statistics Finland, from unemployed people actively seeking jobs, who could and would like to be working. The definition of unemployment in the labour force survey, therefore, does not include hidden unemployed persons who are not actively seeking employment. The government has proposed increasing the job-seeking obligations of the unemployed. According to the proposal, if unemployment continues for more than three months there would be a monthly one day deductible in the unemployment insurance that could be avoided through being active. This would signify a monthly unemployment benefit cut of 4.65 per cent.

The introduction of the active job-seeking model would undoubtedly increase the activity of the unemployed. On the other hand, if the active job-seeking model also forced hidden unemployed persons to seek work actively, the unemployment rate of the labour force survey would be significantly increased. If the active job-seeking model is introduced next year, for example, the predictability of unemployment will be even further complicated.

EARNINGS DEVELOPMENT SLUGGISH THIS YEAR

In accordance with the Competitiveness Pact, wage increases will remain frozen in the current year. Statistics Finland has had to revise the definition of the earnings level index with respect to holiday pay cuts. The earnings level index measures the development of average earnings for regular working hours for full-time employees. The earnings level index also includes performance bonuses and one-time items based on collective bargaining, such as holiday pay. Statistics Finland has introduced the modification of the calculation bases for indexes in a model that measures monthly earnings for both hourly and monthly wage earners.

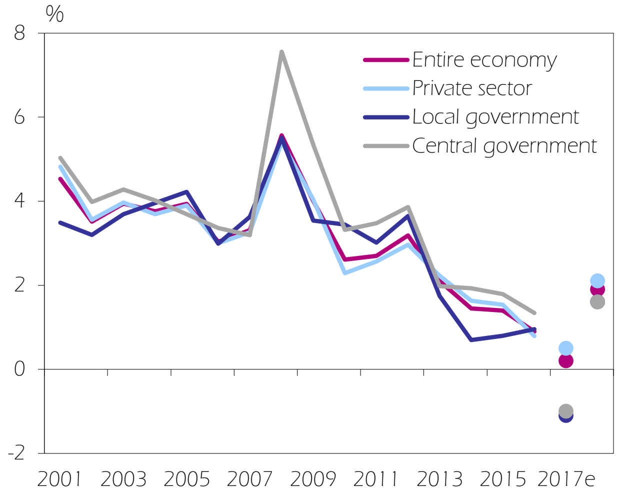
The 30 per cent holiday pay cut in accordance with the Competitiveness Pact lowers the earnings level index by 1.1. per cent in the public sector in 2017, which weighs down heavily on the earnings level index for the entire economy compared to last spring's forecast. In the private sector the earnings level index will remain at about 0.5 per cent, and this growth is mainly based on wage drifts. Therefore, in the entire economy the rise of the earnings level will remain at 0.2 per cent.

It will most likely not be possible to reach a similar wage moderation as in 2015 in the union-level negotiation round, so we forecast that contract wages will rise by one percentage point next year. From the added effects of contract raises and drift, the earnings level will rise by 1.9 per cent at this point. ■

CHANGES IN NUMBER OF EMPLOYED, UNEMPLOYED AND LABOUR FORCE 2000–2018

Source: Statistics Finland, Labour Institute for Economic Research

EARNINGS LEVEL INDEX 2001–2018



Source: Statistics Finland, Labour Institute for Economic Research

Inflation and Households

Acceleration of inflation will remain modest and consumer confidence will spur growth of private consumption

» Consumer price developments will remain below estimates made at the beginning of the year
» Consumer confidence is strong
» Growth of private consumption will fuel household borrowing
» Low inflation, tax cuts and improved employment increase the purchasing power of wage earners

ADDITIONAL INFORMATION

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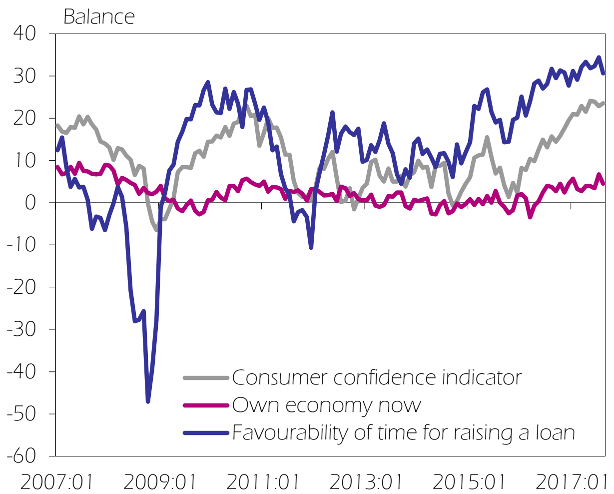
We estimate that the rise in consumer prices (CPI) will remain at 0.8 per cent in 2017, accelerating to 1.4 per cent in 2018. Inflation will continue to be low due to the continuation of keen price competition in foodstuffs and moderate development in both housing costs and fuel prices. The moderate rise in earnings will also dampen the ascent in consumer prices this year. The slow acceleration rate of inflation will bolster the purchasing power of households.

PRICE COMPETITION IN FOODSTUFFS WILL AFFECT TREND OF CONSUMER PRICE INDEX

The development of foodstuff prices has a major impact on the consumer price index, and the mere ending of price reductions will be enough to accelerate inflation in 2018. The level of housing costs will also be determined by developments in rent levels next

CONSUMER CONFIDENCE 2007:01–2017:08



Source: Statistics Finland

KEY FORECASTS FOR HOUSEHOLDS

	2016	Change (%)		
	Mill. EUR	2016	2017f	2018f
Inflation (CPI)		0.3	0.8	1.4
Wages and salaries	84476	1.5	2.0	3.1
Primary income	129449	1.9	1.0	2.6
Household real disposable income		0.9	2.0	1.0
Volume of private consumption	119056	1.8	2.0	1.5
Savings rate		-0.9	-0.9	-1.2

Source: Statistics Finland, Labour Institute for Economic Research

year, as the cost of owner-inhabited housing will fall or remain virtually unchanged due to low interest rates.

Oil price fluctuations and the rapid price development of industrial raw materials cause uncertainties in the consumer price forecast. It is unclear to what extent the rise in producer prices will move to consumer prices in 2018. Goods sales shifting towards online sales could further curb consumer price pressures.

CONSUMER CONFIDENCE IN THE ECONOMY IS VERY HIGH AND HOUSEHOLDS WILL CONTINUE TO BORROW

The consumer confidence indicator of the consumer barometer was at a much higher level in August (23.5) than in the corresponding period a year ago (15.7). The indicator has been rising since the beginning of 2016 and is now clearly above the long-term average (12.1). Consumers' confidence in their own economy has not risen as distinctly as confidence in the Finnish economy in general. According to the consumer barometer, however, time is seen as favourable for borrowing.

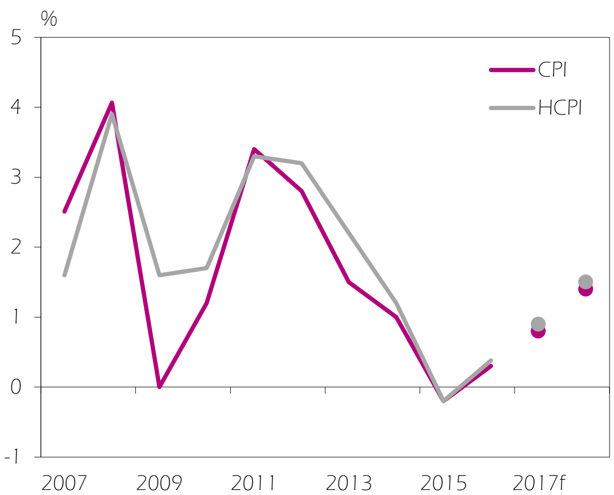
Private consumption continues to be strong in 2017, rising by 2.0 per cent. We estimate that the savings rate will be -0.9 per cent. This is the second consecutive year when private consumption is growing significantly faster than the disposable income of households. The negative savings rate is explained by low interest rates and the moderate earnings development. The improvement of future employment prospects can also partly explain consumption growth.

IMPROVEMENT OF PURCHASING POWER IS DUE TO SEVERAL FACTORS

The Competitiveness Pact reduced social security costs by transferring pension and unemployment insurance contributions from employers to employees. We estimate that the government's decisions will be sufficient in compensating for the decline in purchasing power brought by the Competitiveness Pact during 2017 and 2018. In the light of current decisions, tax and payment changes will boost household purchasing power more this year than in 2018.

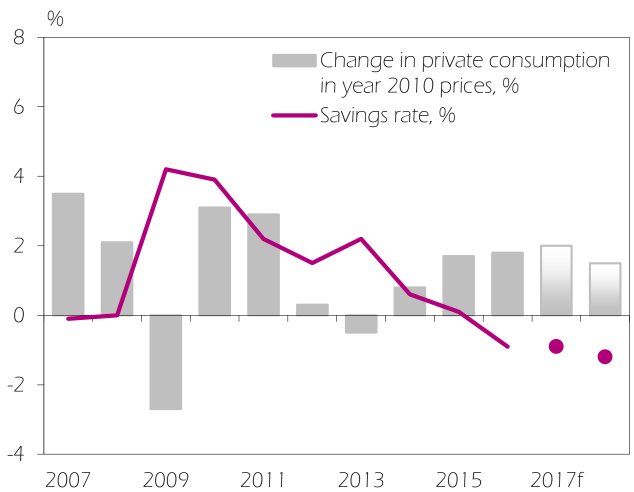
The improvement in purchasing power in 2017 is the result of several factors. Government tax solutions, strengthening employment and low inflation support households so that purchasing power increases despite the moderate rise in employee compensations. We predict that purchasing power will increase in 2018, despite the acceleration of inflation, due to improving employment and rising earnings levels. ■

CHANGES IN CONSUMER PRICES 2007–2018



Source: Statistics Finland, Labour Institute for Economic Research

PRIVATE CONSUMPTION AND SAVINGS RATE 2007–2018



Source: Statistics Finland, Labour Institute for Economic Research

Public Finances

Public deficit will decrease even though decline in tax ratio will slow consolidation

- Central government deficit will decrease next year to 4 billion euros
- Municipalities are still running a deficit and the cuts in revenue sharing will offset the cost savings from the Competitiveness Pact
- Surplus of social security funds will continue to shrink despite cuts in benefits
- Rise in the debt ratio will taper off

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CENTRAL GOVERNMENT FINANCES IN RIPTIDE OF SPENDING CUTS AND COMPETITIVENESS PACT

During this forecast period, the government's saving measures and the strengthening of tax bases will bolster central government finances, but simultaneous easing of income taxation will slow the decline in deficits. All in all, the central government's deficit will nevertheless be reduced. Consolidation will be faster next year than this year due to the timing of the largest tax cuts taking place at the beginning of the forecast period.

The spending cuts carried out in line with the government's programme will total approximately 1.7 billion euros over the forecast period. They are spread out fairly evenly over each of the forecast years with the greatest savings affecting social security. The Competitiveness Pact, on the other hand, will increase expenditure this year in particular, although it also includes expenditure-reducing elements. Expenditure is increased the most by the cut in employers' sickness insurance contributions, which increases the central government's financial contribution accordingly. On the other hand, the pact reduces central government operating costs due to holiday pay cuts and the lowering of sector's employer payroll taxes. The central government's revenue sharing to municipalities will also decrease in net terms.

The Competitiveness Pact also affects the revenue side as cuts in income taxes on salaries and pensions as well as the indirect effects of changes in social security contributions reduce tax revenues. This trend will be partially offset by the rapid growth of corporate income tax. The growth of indirect taxation will also continue to be fairly strong as the favourable development of private consumption boosts the revenues from value-added tax. Other indirect taxes will experience slightly more tightening than cuts. However, growth in government revenues will be faster than that of expenditures this year, and the central government's deficit will decline by a further 700 million euros.

Next year fiscal consolidation will accelerate as expenditure is cut further, indexes are still frozen and economic development continues to be favourable. Tax cuts continue to slow down the balancing of government finances, but the reductions will be much smaller than this year. Alongside the 270 million euro easing of earned income taxation, indirect taxes will be raised with a net effect of about 150 million euros. Expenditure growth will remain at just over one per cent, and the estimated relatively strong development of tax bases will generate growth of central government revenues by about 3 per cent. The central government's deficit will then be reduced to about 4 billion euros.

CUTS IN CENTRAL GOVERNMENT REVENUE SHARING DAMPEN IMPROVEMENT OF MUNICIPAL FINANCES

In recent years, the municipal government deficit has subsided somewhat, and last year the deficit was 0.4 per cent relative to gross domestic product. During the forecast period, the deficit is projected to remain at this level. This year municipal spending will even fall by more than half a per cent, but revenue will also decline. The development of expenditure is affected by cuts in teaching and cultural activities as well as the reduction of operating costs brought about by the Competitiveness Pact. According to the pact, holiday pay is cut and the sector's employer payroll taxes are reduced. However, the benefits of the pact with respect to municipal finances are offset by the cuts in central government revenue sharing.

The rise in the average municipal tax rate will remain small and the effective tax rate (municipal income tax revenues relative to earned income) will fall due to tax changes included in the Competitiveness Pact. Next year municipal expenditures and revenues are expected to increase by a couple of per cent. The general economic development will stimulate the accumulation of municipal government revenue, but the upside in revenues is curbed by the freezing of the central government revenue sharing index stipulated by the government's programme. The growing need for healthcare and nursing services will increase the upward pressure on expenditures, but the tight fiscal situation of municipalities will sustain their need to curb spending.

SURPLUS OF SOCIAL SECURITY FUNDS WILL CONTINUE TO SHRINK

The surplus of social security funds will continue to subside during the forecast period. Even at the beginning of the decade, the surplus relative to GDP was close to 3 per cent, but next year it is projected to fall to 0.9 per cent. At the same time, the contraction of the sector's surplus hampers the consolidation of public finances as a whole.

The underlying trend in the income development of social security funds this year is the slow growth of the wage sum affecting premium income due to zero increases in contract wages and the modest improvement of employment. Insurance premium income is reduced by the reduction of the sickness insurance contribution of employers included in the Competitiveness Pact, but the shortfall is covered by a corresponding increase in the share of the central government's contribution. Employers' earnings-related pension and unemployment insurance contributions are also reduced in accordance with the pact. However, there will be no decline in the net proceeds from contributions because the corresponding payload is transferred to employees.

Benefits paid will increase faster than revenues despite cutbacks in basic security benefits and the reduction of the duration of earnings-related unemployment benefits. Benefits are boosted by an increase in the number of pensioners, a rise in the average amount of pensions, indexed increases in earnings-related pensions and also somewhat by the popularity of new partial old-age pensions.

Next year the burden of pension contributions will continue to be shifted from the employers to employees, but in a way that the increase in the unemployment insurance contribution for employees is slightly less than the reduction in employers' contributions. Growth in expenditures, in turn, is slowing down this year's low inflation and slow rise in earnings, which will spur small indexed hikes in earnings-related pensions next year. Social security funds' revenues and benefits will grow at the same rate next year and the sector's surplus will be about 2.1 billion euros.

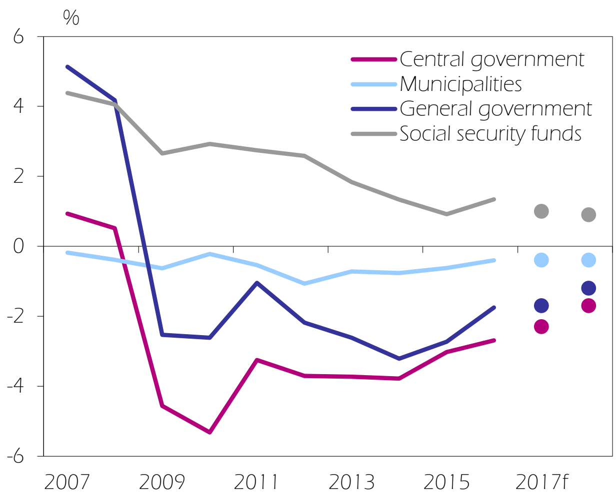
DEBT RATIOS LEVELLING OFF

Public expenditure in relation to gross domestic product will decline clearly in the forecast period, i.e. by about 3 percentage points. Growth is dampened by cuts stipulated by the government's programme as well as cuts in holiday pay and reductions in employers' payroll taxes in accordance with the Competitiveness Pact. On the revenue side, economic growth will boost tax revenue, but tax cuts will curb the rebounding of tax revenue. The revenue of the public sector in relation to gross domestic product will thus be reduced by over 2 percentage points. The general government deficit will decrease from last year's level of 3.8 billion euros to 2.8 billion euros, i.e. 1.2 per cent of GDP.

According to figures published by the State Treasury, the central government debt rose last year to 102.4 billion euros. The central government's fiscal deficit means additional borrowing and a continuation in the rise of the debt, which will reach about 111 billion euros at the end of the forecast period. The ratio of central government debt to gross domestic product will continue to grow by half a percentage point this year, but already next year the reduction of the deficit and economic growth will spawn a slight decline in the debt ratio.

The total consolidated general government debt (so-called EDP debt) was 63.1 per cent of GDP last year. The ratio of EDP debt to GDP will also increase this year, but it will start to decline slightly next year. ■

GENERAL GOVERNMENT NET LENDING % of GDP 2007-2018



Source: Statistics Finland, Labour Institute for Economic Research

KEY FORECASTS FOR PUBLIC SECTOR

	2016	2017f	2018f
Taxes / GDP (%)	44.1	42.8	42.2
Expenditures / GDP (%)	55.8	54.5	52.9
General government net lending (Bill. €)	-3.8	-3.9	-2.8
central government	-5.8	-5.2	-4.0
municipalities	-0.9	-0.9	-0.9
social security funds	2.9	2.2	2.1
Gross public debt, EDP-debt (Bill. €)	136.1	142.4	147.6
% of GDP	63.1	63.6	63.3
Central government debt (Bill. €)	102.4	107.2	110.9
% of GDP	47.5	47.9	47.6

Source: Statistics Finland, Labour Institute for Economic Research

COMPETITIVENESS, LABOUR PRODUCTIVITY AND STRANGE TWISTS IN CYCLICAL DEVELOPMENT

Between 2012 and 2014, Finland's gross domestic product contracted during three consecutive years, while growth accelerated in Finland's peer countries (such as Sweden and Germany). At that time, it was often claimed in the public debate that the reason for the slump prevailing in Finland was the lack of cost competitiveness. In 2016, however, Finland's economic growth surpassed the average growth rate of the total euro area, without any significant change in the cost competitiveness measured by standard indicators, such as the Bank of Finland's unit labour costs adjusted for the terms of trade. Poor cost competitiveness thus does not constitute a valid explanation for the recession of 2012–2014.

INCREASE IN UNIT LABOUR COSTS WAS DUE TO LOWER LABOUR PRODUCTIVITY

Cost competitiveness is a narrower concept than so-called "real competitiveness", which can encompass a wide range of conditions for economic success. For example, the World Economic Forum publishes a 12-pillar index of competitiveness, where the efficiency of the labour market is just one of the "pillars" among others. Other factors affecting competitiveness are, for example, public sector institutions, infrastructure and the educational level of the population. In the World Economic Forum's most recent competitiveness comparison of 2016-2017, Finland is ranked tenth in the world.

It is often claimed that real competitiveness is relevant only for long-term economic success and that in the short term, cost competitiveness is essential. This is only partially true. When, for example, an international conglomerate chooses between Finland and some other country about where it will invest its new production plant, its decision may, in addition to Finland's cost competitiveness, also be affected by elements of real competitiveness such as Finland's uncorrupted public sector and good infrastructure. Thus, components of real competitiveness that are unrelated to labour costs may spawn new investment and jobs in Finland in the short term. However, cost competitiveness is more relevant than the other dimension of competitiveness when, instead of new investment, it comes to the continuation of already existing business activities or the preservation of existing jobs.

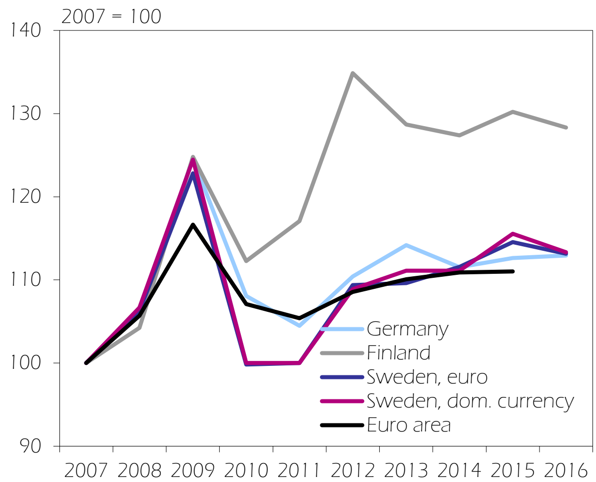
Figure 1 illustrates the development of cost competitiveness in Finland, Germany, Sweden and the total euro area with one standard indicator: nominal unit labour costs of the manufacturing industry. The figure shows how unit labour costs in Finland increased faster than in the peer countries. It should be emphasized, however, that the graphs in Figure 1 show index numbers: the curves begin at the same point in 2007, which has been arbitrarily selected as the point of reference. One obvious criticism, for example, with using 2007 as the base year of comparison or for that matter the year 2000, which serves as a benchmark in Borg and Vartiainen's (2015, 18) report is that it generates spurious results since, in the first decade of the millennium, Finland's price competitiveness was "too good" due, for example, to Nokia's success (see Sauramo 2015).

The definition of cost competitiveness of Figure 1 can be understood by non-economists as well: if Y is the amount of gross domestic product, W is the average nominal labour cost per hour and the amount of paid hours worked per year L, nominal unit labour costs can be defined by the following formula:

$$W / (Y/L)$$

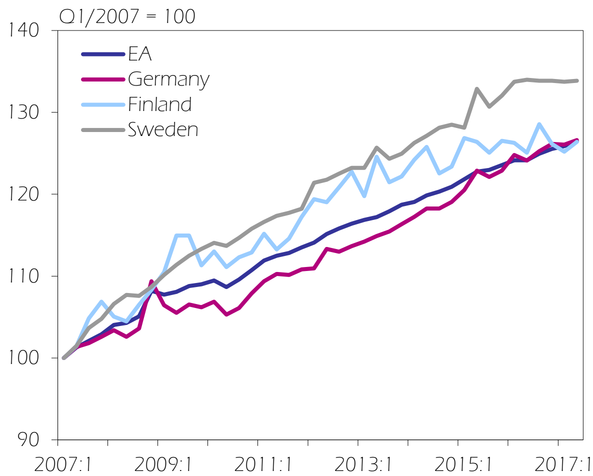
In the formula Y / L is the productivity of labour: it tells how large "piece" of GDP was produced per hour on average. We can intuitively think that when the average price of an hour worked W is divided by the de-

FIGURE 1. NOMINAL UNIT LABOUR COSTS, MANUFACTURING 2007–2016



Source: ECB

FIGURE 2. LABOUR COST INDEX, MANUFACTURING 2007:1–2017:2



Source: Eurostat

rived productivity, one knows how much ”one unit of GDP costs” in the form of labour costs.

Figure 2 looks at the same countries and the same time period as in Figure 1, but it compares labour cost indices instead of unit labour costs. It can be concluded that the swifter growth in unit labour costs in Finland was due primarily to the weak development of labour productivity and not to the hourly cost per hour worked in Finland rising exceptionally fast. The decline in productivity is explained by numerous problems in individual industries such as the shutdown of Nokia's mobile phone business, the decline in demand for paper products and the temporary difficulties of the shipbuilding industry.

Although Finland's cost competitiveness has not been weakened by a widespread rise in wages but rather by sectoral problems, we cannot of course conclude that the Competitiveness Pact and the other moderate wage settlements of recent years have been unnecessary. Moderate wage settlements can be justified simply because they are the only quick way to halt a fall in production or rise in unemployment, regardless of the reason why production originally started to fall or unemployment climbed.

REAL UNIT LABOUR COSTS AND THE SIGNIFICANCE OF THE BASE OF COMPARISON

Real unit labour costs can be defined using the same formula as that used for nominal unit labour costs above, but now Y is the value of the gross domestic product in monetary terms, not its volume. In this case, another interpretation can be given to the definition above: because

$$W / (Y/L) = WL/Y$$

real unit labour costs are the ratio of the labour costs of the total economy WL relative to the value of gross domestic product in monetary terms. The formula describes the functional income distribution, and intuitively it indicates how much of the total GDP the employees will receive.

Figure 3 shows the development of real unit labour costs in Finland since the 1970s and shows that current unit labour costs cannot be considered exceptionally high. Similarly to the nominal unit labour costs presented in Figure 1, real unit labour costs are currently higher than in the first decade of the 21st century, but we have no particular reason to think that the level of unit labour costs at the time would be ”right”.

COST-COMPETITIVENESS INDICATORS WOULD REQUIRE MORE EQUITY

In addition to the above-mentioned indicators, several other ones have been presented for cost competitiveness. The cost competitiveness estimates of the Bank of Finland also include unit labour costs adjusted for the terms of trade, which when applied to Finland produces similar results as those for the above-mentioned indicators. The choice of an indicator is by its nature one between different schools of scientific thought, about which experts have different opinions. There is also disagreement about whether the comparison makes sense by industry – for example, so that the exceptional impact of Nokia's success is eliminated – or whether it is sensible to look at the economy as a whole (see Sauramo 2015, Kajanoja 2015).

In Finland, however, the views of a single player, the Bank of Finland, have gained a position of authority to the extent that the trade unions that took part in the negotiations on the so-called ”Finnish model” in the beginning of this year accepted (from their own standpoint rather unfavourable) indicators used by the Bank of Finland as the starting point for future wage negotiations (see Metalliliitto 2017). The presentation of neutral assessments by the different schools of thought would belong more naturally to, for example, Information Committee on Cost and Income Developments or to a separate working group established under the Economic Policy Council than to the Bank of Finland. ■

Ilkka Kiema

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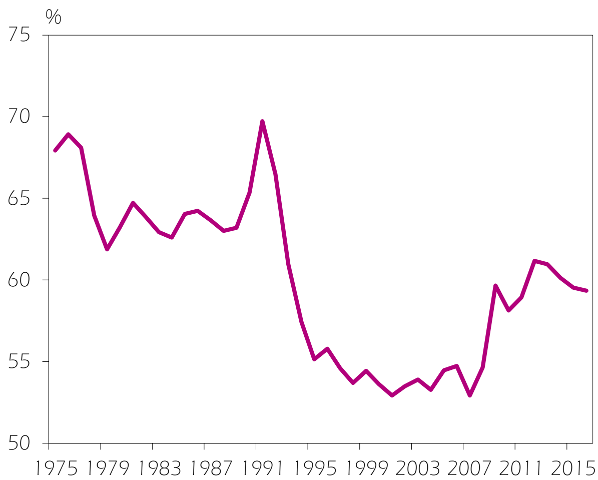
FIGURE 3. FUNCTIONAL DISTRIBUTION OF INCOME IN BUSINESS ACTIVITIES 1975–2016



Source: Statistics Finland

SKILLS SHORTAGE IS A SIGN OF STRUCTURAL CHANGE IN ECONOMY

According to the figures of the Ministry of Employment and the Economy, in July about 76,000 unemployed jobseekers had only a primary education and around 150,000 had a secondary education. The number of unemployed job seekers with university educations was still high, around 52,000. As the economy has experienced an upswing, many companies have nevertheless reported that they are suffering from a shortage of skilled workers. According to the Occupational Barometer, the shortage of skilled workers has already expanded from social and health care to many other sectors, such as construction and the metal industry.

Despite the improvement in the employment situation, the number of unemployed jobseekers is high even in occupational groups of people working as experts, which does not support the tales of a shortage of skilled labour (Table 1). It is nevertheless possible that there is a shortage of expertise in tasks requiring special skills, which is not evident from the aggregate statistics. The situation is also hampered by the problem of mismatches between open jobs and employees.

In the light of current knowledge it is difficult to estimate the extent to which the labour force's mismatch problem could become a supply constraint dampening economic growth on a wider scale. Technological developments and the resulting structural changes in the economy may nevertheless change the skills needed by the labour force in a widespread manner. Structural unemployment rose sharply as a result of the recession of the 1990s, especially as there was no longer demand for the skills of low educated persons in the labour market. There is reason to believe that the skills requirements of working life have also changed during the period after the financial crisis, so that some of the previously acquired education is out of date from the point of view of the needs of working life.

Efforts have been made to respond to the changes in the needs of working life by augmenting the flexibility of the education system. Vocational qualifications and apprenticeship training have enabled the development of secondary vocational training according to the needs of working life and a person's individual abilities. Solutions to problems regarding simultaneous unemployment and shortages of skilled labour have also been sought via supplementary education and retraining at the university level. There are no centralized statistics on retraining, which would facilitate monitoring of the scale and impact of this phenomenon.

Retraining has made it possible for persons already holding a degree to supplement their skills to meet the needs of working life. For example, it is possible to earn a construction engineering degree from a university of applied sciences if a person has a degree in another field of technology or an otherwise significant amount of mathematics-natural science studies. Training that is comparatively fast and flexible to adapt to the needs of working life is only possible, however, if the individual's motivation and basic skills to learn are all right.

The positive structural change in southwest Finland (growth in the shipyard and automotive industry) spurred the quantitative and qualitative development of local education. According to the Ministry of Education and Culture, the aim is to develop vocational training in the area through the use of growth piloting. At the same time, it was decided to increase the number of degrees in polytechnics, and a new Finnish Institute of Technology was established in the area. In the short term, responding to a positive structural change is based on attracting students from other higher education institutions and increasing retraining. It is unclear how much expertise in the technical sector is sufficient for the needs of southwestern Finland, as the economic boom strengthens more widely.

TABLE 1. UNEMPLOYED JOBSEEKERS

	Unemployed jobseekers, July 2016	Unemployed jobseekers, July 2017	Change (%)
Managers	4306	3717	-14 %
Professionals	57540	50688	-12 %
Technicians and associate professionals	36273	31568	-13 %
Clerical support workers	22123	19505	-12 %
Service and sales workers	70575	64295	-9 %
Skilled agricultural, forestry and fishery workers	6627	5713	-14 %
Craft and related trades workers	63924	50933	-20 %
Plant and machine operators, and assemblers	26208	21293	-19 %
Elementary occupations	28507	24534	-14 %
Unknown	62147	56644	-9 %

Source: Ministry of Economic Affairs and Employment, Employment Service Statistics

Demand for labour is expected to continue to grow in certain higher-skilled jobs and occupations entailing provision of personal services such as healthcare. There is nevertheless great uncertainty about the forecasts for future knowledge needs. Recruiting employees from outside Finland is one part of the solution to the potential shortage of the staff, as there are no restrictions on recruiting people from the European Union. However, the labour market for specialists is global and companies are in constant competition for the best professionals in their field. According to the Finnish Immigration Service, only about 1100 residence permits were requested for non-EU specialists in 2016, which can be considered a relatively low figure.

Encouraging students to pursue a master's degree in Finland can also be a way to attract specific skills to Finland relatively quickly. Foreign degree students already constitute an important group of highly educated working-age people in Finland. According to the National Board of Education, some 21,000 people in Finnish universities and polytechnics in 2016 were foreign degree students, of whom approximately 60-70 per cent were still in Finland one year after graduation.

Greater cooperation between the higher education sector and businesses could create new prerequisites for attracting foreign students, especially for the narrow special sectors that suffer from potential shortages of skilled labour. According to the Finnish National Board of Education, it is not clear how well small and medium-sized companies know their opportunities to make use of international degree students in their own recruitment. ■

Hannu Karhunen

FISCAL POLICY STANCE DURING TWO PARLIAMENTARY TERMS

The guiding principle of economic policy in recent years has been to promote the consolidation of public finances in the aftermath of the financial and euro crisis spawned by the Great Recession. In practice, the goal has been to reduce the public deficits and spur a decline in debt ratios (debt relative to gross domestic product).

Prime Minister Katainen's government programme set a goal for its term in office of fostering a decline in the central government debt and GDP, and it also promised that measures would be initiated to eliminate the sustainability gap in its entirety. The task was nevertheless left for the next government's term.

The goal of the current programme of Prime Minister Sipilä's government is to foster a decline in the public debt relative to GDP by the end of its term. This government is also committed to making the savings and structural reforms needed to eliminate the entire sustainability gap. The objectives for public finances of the previous and current governments are thus virtually identical regarding those for both the parliamentary term and the longer run.

The adjustment programs of the two governments differ from a structural perspective, however, as shown in the adjacent table. It presents the Ministry of Finance's estimate of the amount of annual adjustment measures and their breakdown to either the expenditure or revenue side of total public finances. The figures in the expenditure column depict the difference in spending cuts and increases while the figures in the revenue column illustrate the difference in tax hikes and cuts. In both cases a positive figure indicates a tightening of public finances and a negative figure a stimulus.

PUBLIC ADJUSTMENT MEASURES IN TWO PARLIAMENTARY TERMS

Annual changes affecting expenditures and revenues according to Stability Programme for Finland.

	Expenditures (net) Bill. €	Revenues (net) Bill. €	Total Bill. €
Katainen-Stubb			
2012	-0.4	0.4	0.0
2013	0.5	1.8	2.3
2014	0.3	0.7	1.0
2015	1.3	0.8	2.1
Total 2012–2015	**1.7**	**3.7**	**5.4**
Sipilä			
2016	0.8	0.6	1.4
2017	1.1	-1.6	-0.5
2018	0.8	-0.4	0.4
2019	0.8	-0.4	0.4
Total 2016–2019	**3.5**	**-1.8**	**1.7**
Terms together	**5.2**	**1.9**	**7.1**

Source: Stability Programme for Finland 2016–2019 (spring 2015) and 2018–2021 (spring 2017)

TIGHTENING WAS GREATER IN KATAINEN-STUBB'S TERM THAN IN SIPILÄ'S TERM

The adjustment measures of the two parliamentary terms totalled over 7 billion euros and were weighted toward the first term of the decade, during which the total adjustment measures exceeded 5 billion euros. In the current parliamentary term, the amount of adjustment measures seems to be only about a third of this, taking into account both spending cuts and tax changes. On the other hand, all fiscal policy decisions for the rest of the term are not yet known.

The structure of adjustment measures also clearly differs between the two terms. Revenue-side adjustments, i.e. tax hikes and increases in social security contributions, have been implemented in the first term while the biggest spending cuts were carried out in the current one. During the current government's term, tax cuts are clearly higher than tax increases. This year is the only one in which tax cuts exceed spending cuts and fiscal policy is clearly expansionary.

When seeking to consolidate public finances, decision makers have had to make a choice with regard to the timetable for adjustments. On the one hand, there is a risk that adjustments made in the midst of a recession will only deepen the problems by eroding growth, as the tax bases do not recover owing to the sluggish growth and pressure on spending increases due to the persistence of unemployment. On the other hand, the risk of delaying adjustment measures is that this can mean the debt burden becomes too great. The latter risk has dominated the domestic economic policy debate and decision making. The outcome has nevertheless been that the debt has continued to grow despite adjustments.

FISCAL POLICY STRENGTHENS ECONOMIC FLUCTUATIONS

The importance of fiscal policy as a tool for countercyclical policy has lagged behind as the goal has been to dampen the growth of the public debt with a front-weighted timetable. The timeliness of fiscal policy belt tightening is, however, relevant from the standpoint of economic and employment development. In this case, it is also justified to mirror the actual progress made with regard to how the tightening has taken place or is taking place in different cyclical phases. This is assessed in Figures 1 and 2 by describing the tightness of fiscal policy with two different indicators.

The indicator in Figure 1 is based on the figures of the Ministry of Finance presented previously in the table (right column) so they are expressed in proportion to GDP (so-called bottom up indicator). The horizontal axis depicts the growth of the economy with the annual change in gross domestic product, with the figures for the years 2017 and 2018 coming from our Institute's economic forecasts from this autumn.

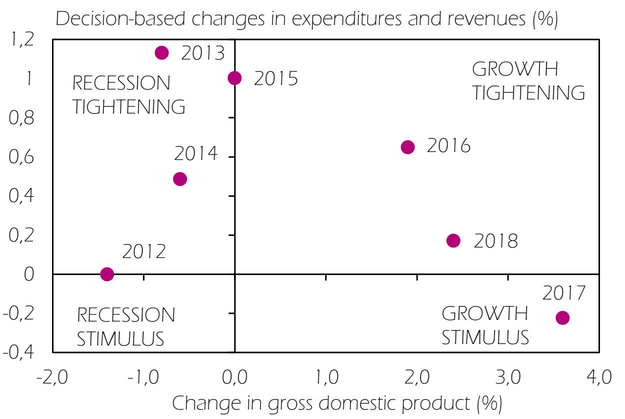
In Figure 2 the tightness of fiscal policy is described by the OECD's most recent estimate of the annual change in the structural balance of Finnish public finances. The structural surplus aims to describe the state of the public finances adjusted for cyclical fluctuations, and its positive change indicates policy is more stringent while a negative change in turn indicates that policy has shifted in an expansionary direction. According to this indicator, fiscal policy appears to be less stringent in general terms than according to the first indicator. One factor explaining the difference is that the change in the structural surplus is also influenced by the trend-wise growth in pension expenditure owing to the change in the age structure, and thus the indicator does not reflect only the government's decision-based fiscal policy changes.

In many respects, the overall picture given by the indicators is the same. For example, 2012 was a year of weak economic growth when fiscal policy as a whole was neutral. Significant tightening took place in 2015 when GDP growth came to a standstill, and in the following year, the tightening took place as the economy was starting to grow. This year will be one marked by strong growth and expansionary fiscal policy as tax cuts exceed the amount of spending cuts, and next year the indicators will show either a slightly expansionary or only a slightly tightening stance.

Such an ex-post analysis suggests that the programme of public finance consolidation implemented in recent years has not been very successful from a cyclical perspective. The most pronounced belt tightening took place during the recession and when growth began, fiscal policy became expansionary. This is not a unique case, but the risk is that when the next downturn takes place a new list of budget cuts will be drawn up. ■

Seija Ilmakunnas

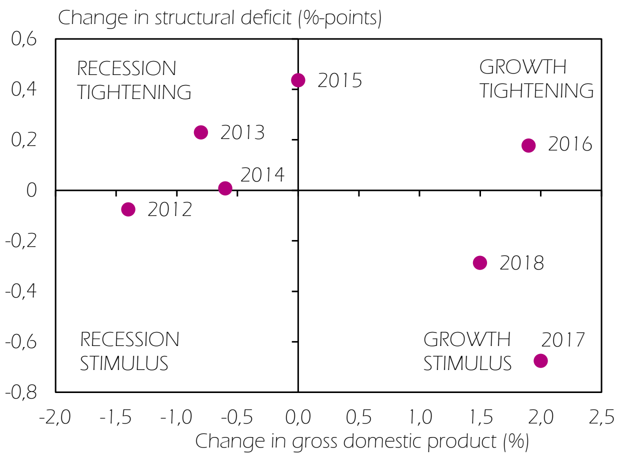
FIGURE 1. IMPACT OF FISCAL POLICY ESTIMATED USING DECISION-BASED CHANGE IN EXPENDITURE AND REVENUE*



Source: Stability Programme for Finland 2016–2019 (spring 2015) and 2018–2021 (spring 2017), 'Statistics Finland, Labour Institute for Economic Research

**Decision-based changes in expenditures and revenues (net) relative to gross domestic product (%); a positive number indicates tightening, a negative number indicates stimulus.*

FIGURE 2. IMPACT OF FISCAL POLICY ESTIMATED USING OECD'S CHANGE IN STRUCTURAL SURPLUS



Source: OECD, Statistics Finland

**For reasons of consistency, the forecasts for gross domestic product in the years 2017 and 2018 are the OECD's most recent forecasts.*