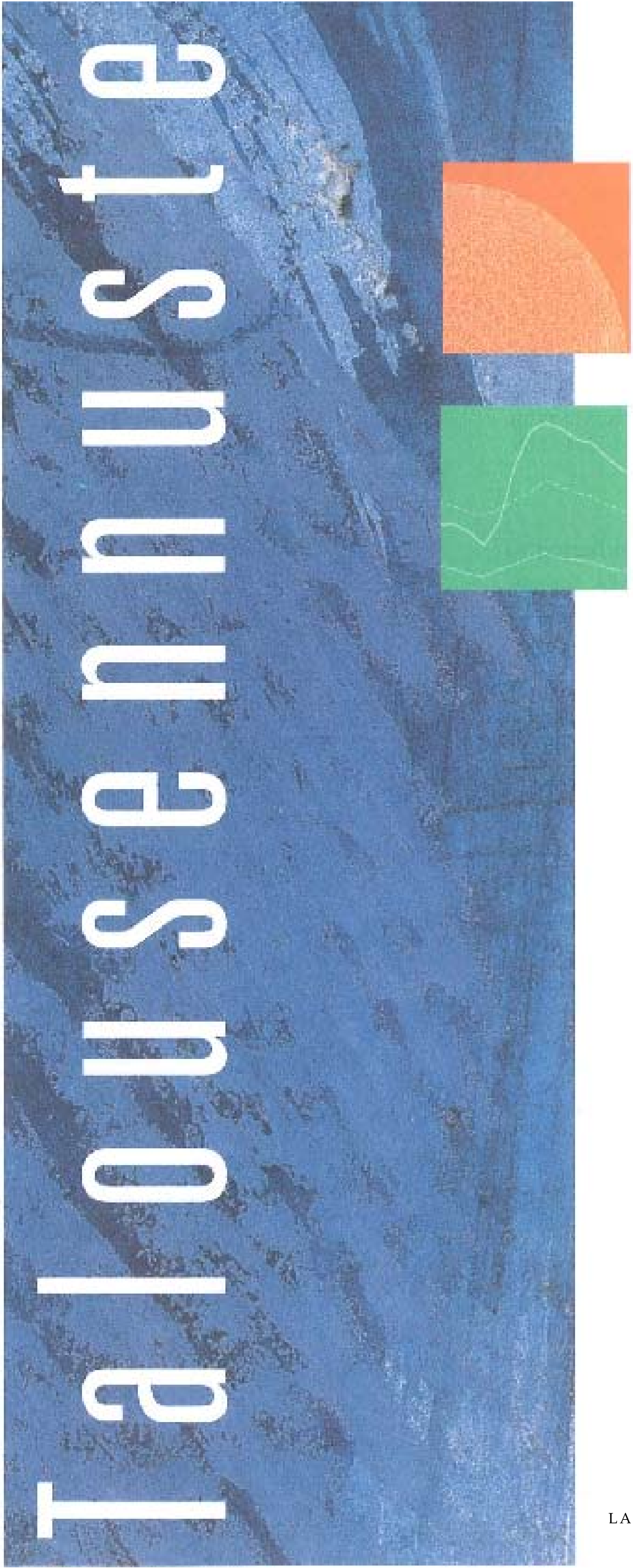

March 29, 2011

Economic Forecast
2011–2012

Finnish economy recovering – public finances running clear surplus already next year

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LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2011–2012

Finnich economy recovering – public finances running clear surplus already next year

Finland's recovery from the recession has gone better than generally expected. The Labour Institute for Economic Research forecasts that Finland's GDP will grow 3.8 per cent this year, i.e. roughly as much as we projected a year ago and last autumn. Next year, economic growth will subside to 3.1 per cent. The relatively favourable economic development will bolster the labour market so that the unemployment rate will fall to 7.8 per cent on average this year and 7.1 per cent next year. The public sector's financial position will improve significantly in the wake of a substantial increase in hours worked, significant improvement in corporate profitability as well as rising tax revenues due to hikes in indirect taxation. Already this year, the finances of the general government as a whole will be almost in balance, and next year it will run a surplus equivalent to about one per cent of GDP. The central government's financial deficit next year will be about 4.6 billion euros, compared to slightly over 9 billion euros last year.

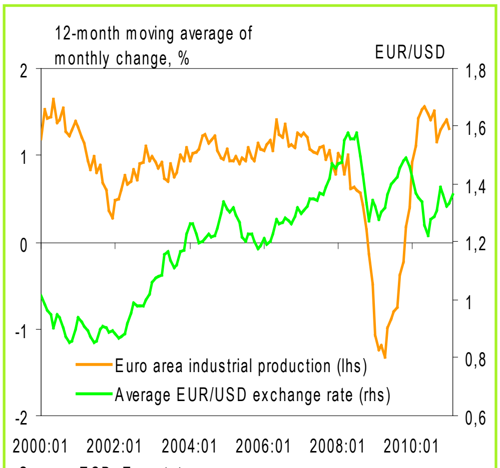
Uncertainty related to economic growth has waned in recent months in developed countries, especially in Finland's main export countries. The most positive development has been the rebounding of the labour market situation in Central and Northern Europe as well as North America. Despite this, the negative risks related to European growth and the global economy in general are still higher than average. The southern European countries are still plagued by over-indebtedness. The Japanese earthquake, tsunami, and the nuclear power plant catastrophe may have a negative impact on the global economy. The unrest in Arab countries, which is particularly evident in crude oil markets, may have a strong adverse effect on the international economy. The upward pressure on raw material prices stemming from rapid growth in developing countries will erode Finland's terms of trade and slow down the recovery of the economy from the recession.

Europe's economy marked by divergent growth trends

The euro area economy grew 1.8 per cent last year and the entire EU economy by 1.9 per cent. The EU countries are becoming increasingly divided into those rebounding from the recession and those bogged down in the midst of a debt crisis. Finnish has benefitted from the positive economic performance in its key export markets of Sweden, Germany and Russia. It is noteworthy that the economy is recovering relatively quickly also in the Baltic countries, whose production fell the most in Europe in 2009. Germany has become Europe's engine of growth. Its GDP grew by 3.6 per cent last year, exceeding all forecasts. At the same time, in many southern and south-eastern European countries, the economy continued to contract.

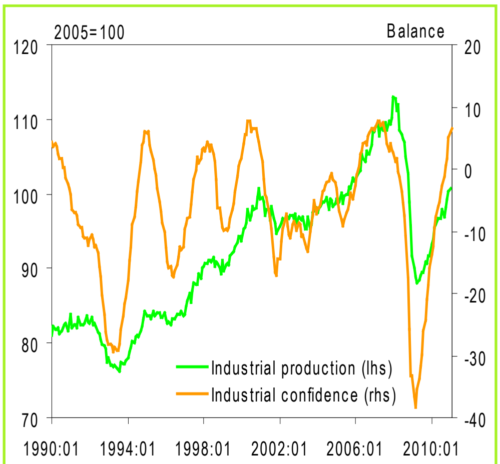
The EU's growth prospects are fairly good next year, though the appreciable tightening of fiscal policy will constrain the recovery of the economy from the recession. Foreign trade will continue to boost economic growth in the EU area. The effect of public demand will slacken, while private consumption growth will accelerate this year and next, despite the acceleration of inflation. Private consumption will be bolstered by the improvement in the labour market situation. Investment will also pick up some in the EU countries. The EU countries' GDP will grow this year at roughly the same pace as last year, i.e. 1.8 per cent. Next year growth will pick up to 2.1 per cent. At that time, growth will accelerate the most

Euro area industrial production and EUR vs. USD exchange rate 2000:01–2011:02



Source: ECB, Eurostat

Industrial confidence and industrial production in euro area 1990:01–2011:02



Source: Eurostat

in the Mediterranean countries. Of the individual countries, growth will continue to be faster than average in Germany and Sweden.

From the viewpoint of the escalation of the European debt crisis, the most important single country is Spain, the strengthening of whose economy depends largely on whether the euro area will survive the current crisis without deeper implications for the real economy. The Spanish real economy seems to have developed fairly well in recent months: tourism is picking up as is industrial production. The nominal wage level has not increased at all, even though inflation is significantly above 3 per cent. Unemployment is nevertheless still rising and the dire situation in Portugal has spurred losses for Spanish banks. The fact that the interest rate differential between Spanish and German government bonds has narrowed in recent weeks suggests that the belief in Spain's ability to cope with the situation has strengthened in the financial markets.

ECB to raise interest rates moderately

The European Central Bank (ECB) has signalled concern about rising inflation in the euro area, so it may raise its repo interest rate from the current 1 per cent by 0.25 percentage points in April. The rate of inflation exceeds the ECB's target already by about half a percentage point, but the ECB tends to looks at inflation expectations extending from 1.5 to 2 years into the future. In this situation it is of crucial importance how the wage increases follow trends set in motion by raw material price developments. Signs of a clear increase in wage demands have been seen, for example, in Germany. On the other hand, the euro area unemployment rate still fluctuates around 10 per cent, so a significant tightening of the labour market is not expected for some time yet. There is reason to expect a relatively modest increase in the ECB's repo interest rate, resulting in a rise in the three-month Euribor rate from the current level by slightly less than a percentage point by year-end 2011. A similar increase is expected next year. The cautious monetary policy is not predicted to drive inflation down to the target level, but rather it will remain at 2.2 per cent in both years.

Table 1. International economy

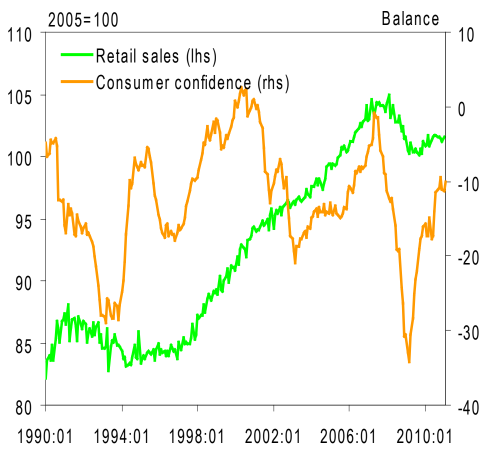
GDP growth (%)	2010	2011f	2012f
United States	2.9	3.3	3.5
Eur-17	1.8	1.7	2.0
Germany	3.6	2.8	2.4
France	1.6	1.5	1.8
Italy	1.1	1.2	1.5
EU27	1.9	1.8	2.1
Sweden	5.5	5.5	3.0
United Kingdom	1.3	1.0	1.8
Japan	3.9	0.0	3.0
Russia	4.0	6.5	5.0
China	10.3	9.0	8.5

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

The exchange rate of the euro is assumed to remain at current levels. Since a solution to the euro area crisis is not expected any time soon, the euro will tend to weaken. On the other hand, the euro will undergo upward pressure since the interest rate differential with respect to the U.S. dollar will widen.

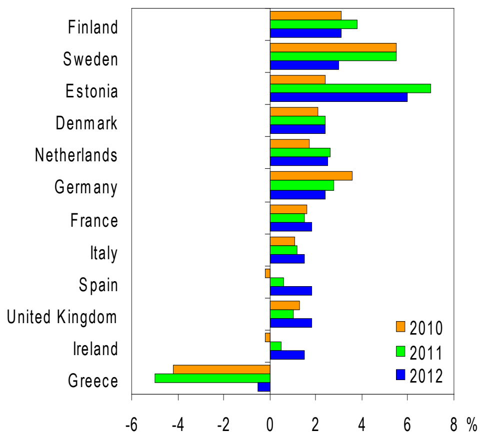
GDP growth accelerated in the U.S. toward the end of last year and was 2.9 per cent for the year as a whole. The total production of the

Consumer confidence and retail sales in euro area 1990:01–2011:02



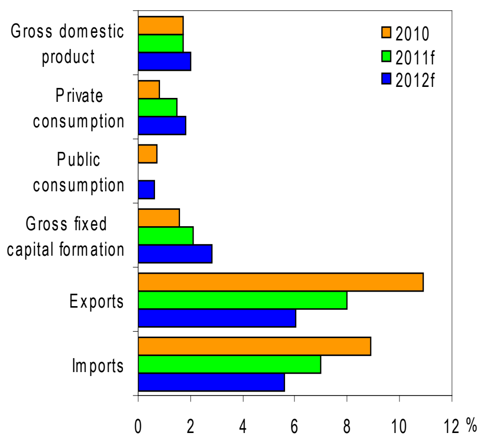
Source: Eurostat

GDP growth rates in 2010, 2011 and 2012



Source: Eurostat, Labour Institute for Economic Research

Eurozone economic growth 2010–2012



Source: Eurostat, PT

U.S. has suffered from the downturn relatively little. On the other hand, the unemployment rate is still close to 9 per cent and falling slowly, so there is no reason to expect that the Federal Reserve will raise its interest rates later this year or even in the first half of next year.

While the U.S. housing market and construction are still in a deep slump, consumption demand and especially investment and industrial production are increasing. The balance of trade is improving considerably. Consumer confidence has strengthened in recent times, although the rise in energy and food prices has undermined expectations somewhat. The recovery is also reflected in the upswing in the purchasing managers' index for manufacturers. In addition, low interest rates and an easing of the debt burden will boost GDP growth to 3.3 per cent this year. Next year it is projected to pick up to 3.5 per cent.

The importance of the major developing economies known as the BRIC countries (Brazil, Russia, India and China) has grown very large for the global economy. Their share of world GDP is 25 per cent when adjusted for the differences in purchasing power. With this share they already rival the EU and the U.S. In 2010, nearly half of world economic growth stemmed from the BRIC countries. Food commodity prices play a significant role in their growth and the prospect of rising prices is curbing their growth. China and India are also suffering from rising oil prices, but Russia will benefit from it.

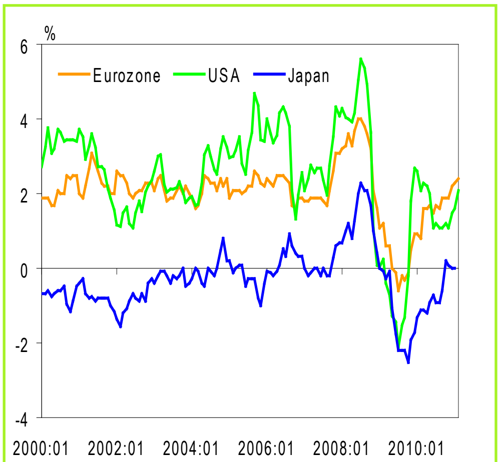
Russia's real GDP growth was only 4 per cent last year, due in large part to the impact of the collapse in oil prices. Now in the wake of the rise in oil prices, Russia's growth will accelerate to 6.5 per cent this year while next year it will decline to 5 per cent. The rise in oil prices and the consequent increase in tax revenue will foster economic growth in Russia. The reduction in unemployment will likewise strengthen aggregate demand. As inflation has accelerated, the Russian Central Bank has begun to tighten monetary policy. This and the rise in oil prices have put pressure on the rouble to appreciate.

Last year, China's GDP grew by 10.3 per cent. The country's leadership has come to the conclusion that this breakneck pace of growth not sustainable, and it must therefore slow down in the long term, e.g. due to the aging of the population. Since 40 per cent of the population still makes its livelihood from agriculture, the growth potential from urbanization and industrialization is nonetheless immense for a long time to come. The rise in prices is expected to accelerate further from the current 5 per cent. In particular, housing and food have become more expensive in the country so fast that the authorities have intervened in price developments. The central bank has tightened monetary policy, while the currency is expected to strengthen slightly. Economic growth will be 9 per cent this year and 8.5 per cent next year.

Growth continues to be strong in India and Brazil, so much so that both economies are overheating. For example, wage increases in India are the fastest in the Asian-Pacific region. Economic policy is being tightened in both countries. In India the growth in both years will still reach about 9 per cent, but in Brazil it will be less than five per cent.

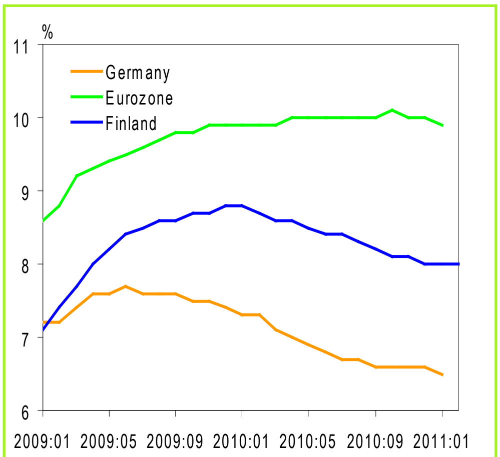
The economic impact of Japan's earthquake, tsunami and nuclear power plant accidents are still unclear. The cost of is now estimated to be around 200 billion euros, but it can still rise. In any case, the country will cope with the disaster, but the result will be a V-shaped development in GDP. Growth will drop quite sharply at first, but thereafter it will accelerate along with the reconstruction and recovery of production at manufacturing plants so that growth for 2011 as a whole will be zero. Next year growth will pick up to 3 per cent, which is higher than previously expected. The yen will tend to strengthen as Japanese investors repatriate their assets, but this will be offset when

Inflation in assorted countries 2000:01–2011:02



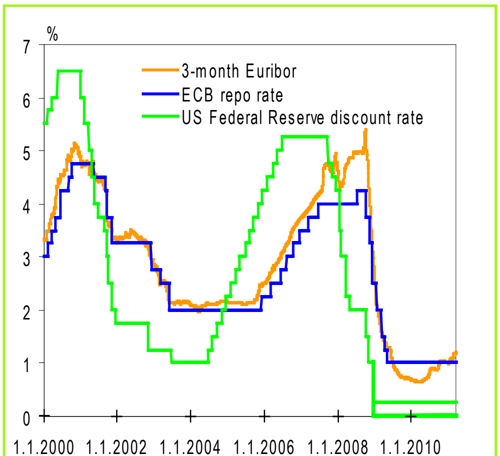
Source: Eurostat, OECD

Unemployment in assorted countries 2009:01–2011:02



Source: Eurostat

Short-term interest rates 3.1.2000–25.3.2011



Source: ECB, Bank of Finland

needed by foreign exchange intervention with the support of other countries' central banks, as has already been carried out.

Finnish exports rebounding to pre-recession level

Last year Finnish exports grew by only 5.1 per cent and imports by only 2.6 per cent. The somewhat unexpected decline of both the export and import of services weighed down the growth rates of exports and imports to a lower level than generally forecast. The export of goods did indeed increase by about 10 per cent from the previous year as did the import of goods. Overall, foreign trade (exports minus imports) boosted economic growth by about 1 percentage point.

Sweden, Germany and Russia have maintained their position as the main export markets for Finnish goods. It is worth noting that last year, in nominal terms, Finnish export of goods increased by 45 per cent and imports by only 9 per cent. However, Finland's trade balance with China was still over 1 billion euros in deficit.

Table 2. Demand and supply

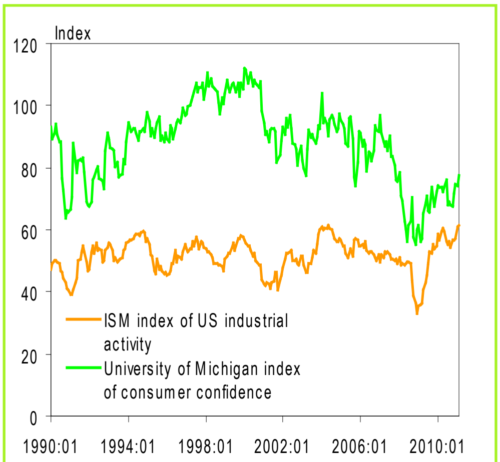
	2010 Bill. €	2010	2011f	2012f
		Percentage change in volume (%)		
Gross Domestic Product	180.3	3.1	3.8	3.1
Imports	65.2	2.6	7.1	5.3
Total supply	245.5	3.0	4.7	3.7
Exports	70.2	5.1	8.0	6.7
Consumption	141.5	1.9	2.0	1.7
private	97.3	2.6	2.5	2.1
public	44.2	0.4	1.0	1.0
Investment	33.4	0.8	7.2	3.7
private	28.5	0.9	8.5	4.3
public	4.9	0.1	0.0	-0.6
Change in stocks[1]	0.4	0.5	0.3	0.3
Total demand	245.5	3.0	4.7	3.7

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

There is reason to assume that as economic development normalizes the export of services, which has grown faster than the export of goods in the medium term, will also increase substantially. Roughly the same applies to the import of services. The Labour Institute for Economic Research forecasts that the export of goods and services will increase this year by 8 per cent and next year by 6.7 per cent. Correspondingly, the import of goods and services will increase by 7.1 per cent and 5.3 per cent. Therefore in both years foreign trade will boost economic growth considerably. The forecast for relatively rapid growth in the ongoing year is supported by the fact that exports picked up clearly at the end of last year and industry has received a significant amount of new export orders during the end of last year and the first few months of this year.

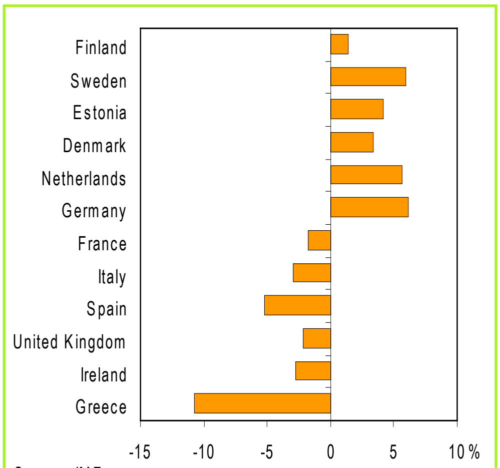
Import prices are expected to continue to rise faster than export prices. Next year this development lowering the Finnish standard of living is forecast to be offset to some extent. This is largely due to the anticipated positive development of the export prices in the forest industry and the fact that the focus of exports will shift to services and products of the machinery and equipment industry, which will not suffer from price erosion as much as the electronics industry.

US economic indicators 1990:01–2011:02



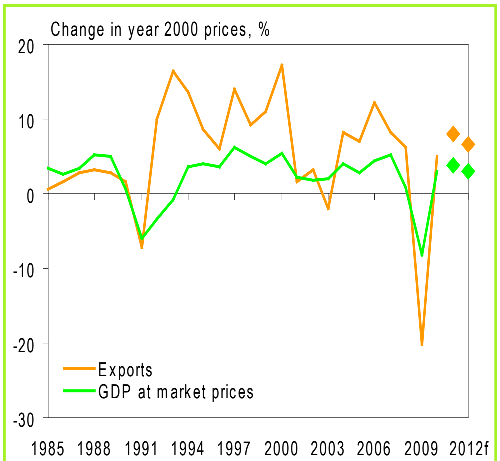
Source: ISM, University of Michigan

Current account deficit relative to GDP in 2010



Source: IMF

Changes in total production and exports in 1985–2012



Source: Statistics Finland, PT

Business services as an engine of growth

While last year economic growth was driven by heavy manufacturing (forest industry, metal refinining and part of the chemical industry) and the retail trade, this year the focus is shifting to the machinery and equipment industry, business services and the wholesale trade. This trend will continue in largely the same manner also next year. Construction will pick up still this year, but its growth will decelerate substantially already next year due to slackening of housing construction.

Housing construction levelling off, machinery and equipment investment expanding

The overall volume of investment increased last year in comparison to the very low level of 2009. Developments nevertheless varied much across the subcategories of investment. During 2010, housing construction increased strongly: especially from the second quarter onwards growth was robust in comparison with the level of the previous year. Non-residential building construction, of which a major part is business and office construction, decreased rather clearly during the first three quarters in comparison to the situation in the previous year, and a slight increase was not visible until the last quarter. Civil engineering construction also fell at an annual rate of almost 9 per cent.

We forecast that the level achieved at the end of last year in housing construction will no longer increase substantially, but due to the weak level of last year, average growth will still remain positive. A 6.1 per cent increase in non-residential building construction will be seen this year, in part due to the low starting point of last year, and in 2012 the increase will continue at roughly the same pace. The contraction of civil engineering construction will also come to an end this year and its volume will rise slightly in 2012.

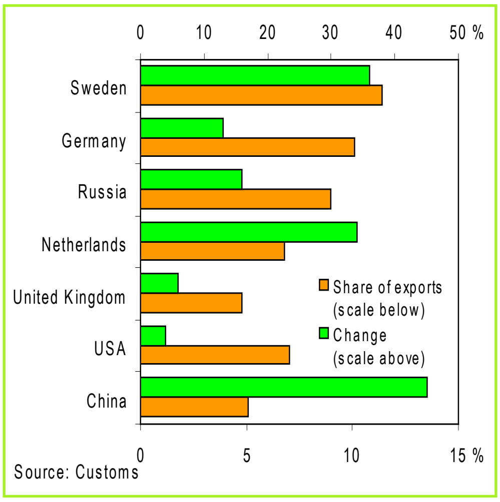
In 2010 machinery and equipment investment experienced a sharp decline. Their volume fell in each quarter compared to the level of the previous year. Of the main subcategories, the investment in transportation equipments grew significantly in the last quarter of the year. The growth of the registration of new motor vehicles in January and February suggests that the development will also continue this year. We forecast that the total volume of machinery and equipment investment will increase overall by 9.4 per cent this year and 7 per cent next year.

Overall the volume of private investment is forecast to increase by 8.5 per cent this year and 4.3 next year. As regards public investment, the changes are fairly minor.

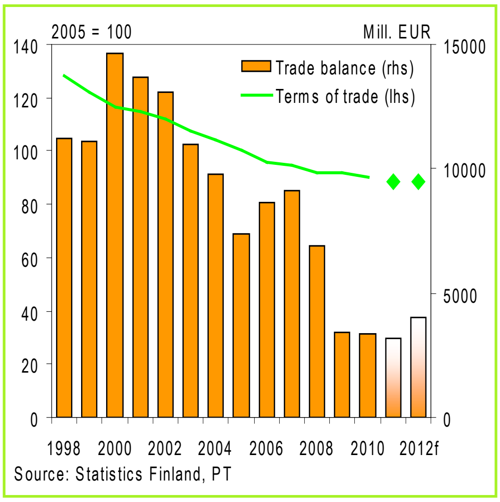
Employment will rise this year and next

The decline in employment bottomed out during last year. On average, employment still fell marginally from the previous year, but during the latter part of the year, with the exception of September and December, employment increased slightly in comparison to figures from the previous year. In January of this year the year-on-year increase in employment was 1.8 per cent and 1.1 per cent in February. We forecast that during 2011 as a whole employment will increase at an average rate of 1.8 per cent. In 2012 growth will continue, although at a slightly slower rate, at an average of 1.5 per cent. In terms of jobs, growth will be 44 000 this year and 37 000 next year.

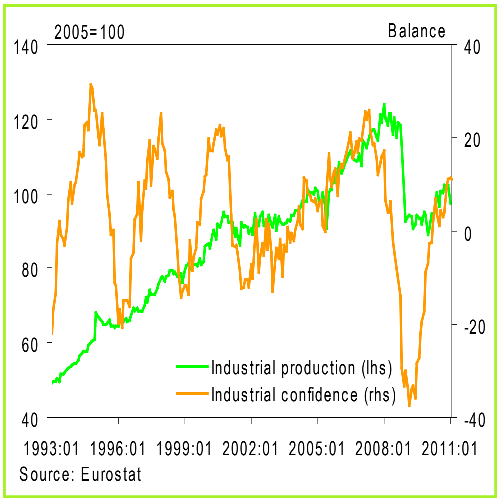
Finnish merchandise exports in January–December 2010



Terms of trade and trade balance 1998–2012



Industrial confidence and industrial production in Finland 1993:01–2011:02



Typically during a recession the labour force participation rate declines, because those left without work exit the labour force as their active search for jobs comes to an end. With the population aging, age structure also contributes to the unfavourable development of the labour force participation rate. As the employment situation improves, the labour force participation rate will increase. This was not yet observed last year, rather the labour force participation rate of women especially continued to decline visibly and the labour force participation rate of men remained the same in comparison to 2009. However, we forecast that this year the labour force participation rate will increase by an average of 0.4 percentage points, from 66.1 to 66.5 per cent. Growth will continue in 2012 and the labour force participation rate will average 66.9 per cent.

Through the combined effects of changes in employment and the size of the labour force, the number of unemployed persons will decrease by 14,000 persons this year from the average level last year. The unemployment rate will drop to an average of 7.8 per cent. Next year the number of unemployed persons will decrease by 16,000 and the unemployment rate will decrease to an average of 7.1 per cent.

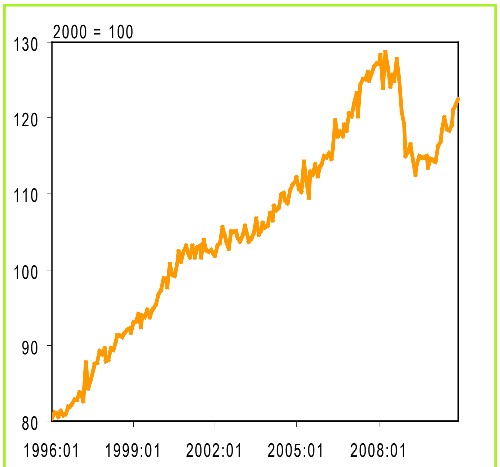
Table 3. Key forecasts

	2010	2011f	2012f
Unemployment rate (%)	8.4	7.8	7.1
Unemployed (1 000)	224	210	194
Employed (1 000)	2447	2491	2528
Employment rate (%)	67.8	69.2	70.4
Inflation, consumer price index (%)	1.2	3.0	2.8
Wages, index of wage and salary earnings (%)	2.6	2.7	3.1
Real disposable income of households (%)	2.8	1.8	1.7
Current account surplus (Bill. €)	5.5	5.3	6.6
Trade surplus (Bill. €)	3.4	3.2	4.0
Central government financial surplus			
Bill. €	-9.2	-6.6	-4.6
% / GDP	-5.1	-3.5	-2.3
General government financial surplus			
Bill. €	-4.4	-0.3	2.2
% / GDP	-2.5	-0.1	1.1
Emu debt			
% / GDP	48.4	45.5	41.6
Tax rate (%)	42.2	43.3	43.2
Short-term interest rates (3-month Euribor)	0.8	1.4	2.3
Long-term interest rates (10-year gov't bonds)	3.0	3.5	4.0

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

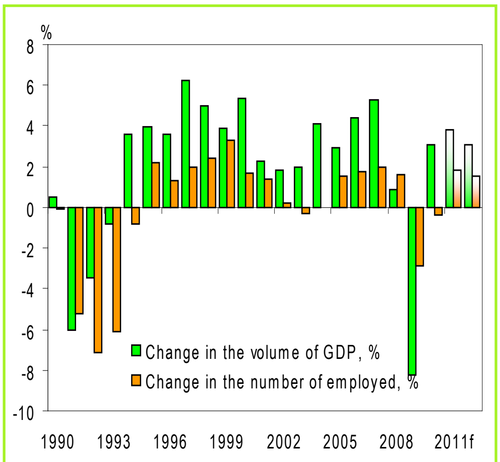
The adapting of the amount of work occurs in the economy not only via changes in employment, but also through the number of hours worked. Typically in cyclical turning points the number of hours worked adapts initially more than employment, and as output increases once more it in turn begins to rise before employment figures because it is easier to adapt hours worked than the number of persons employed.

Trend indicator of output 1996:01–2010:12



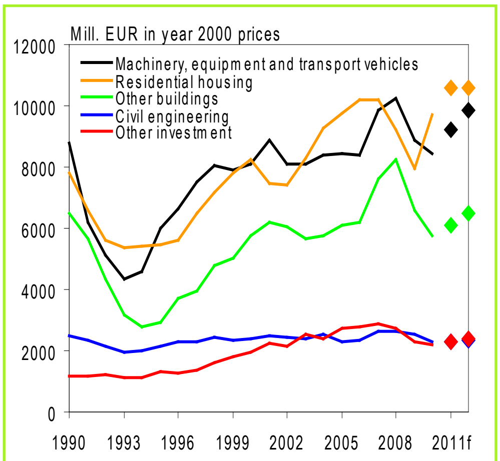
Source: Statistics Finland

GDP and employment 1990–2012



Source: Statistics Finland, PT

Investments 1990–2012



Source: Statistics Finland, PT

The decrease in lay-offs and over-time work becoming more common will continue to contribute to the growth of hours worked. We forecast that hours worked will continue to increase slightly faster than employment this year, i.e. 1.9 per cent. In 2012 the development will reverse slightly so that employment growth will be somewhat faster than the annual growth of hours worked, which is forecast at 0.9 per cent.

Economic expansion and contraction also take place partly through the growth rate of productivity. Productivity declined in 2008 and 2009 and began to increase in 2010. The 3.1 per cent of GDP and 1 per cent growth of hours worked constituted 2.1 per cent growth of productivity per hour worked. Correspondingly, in 2011 productivity will grow by 2.0 per cent and in 2012 by 2.1 per cent per hour worked.

Inflation climbs to three per cent

The rate of increase of Finnish consumer prices has accelerated noticeably in recent months. In February inflation already reached an annual level of 3.3 per cent. This is partly attributable to the hike in VAT last summer in addition to the steep rise of the prices of energy, housing and some foodstuffs. In January taxes were raised on fuel, electricity and soft drinks and the taxation of confectioneries came into effect. Therefore part of the acceleration of inflation was due to international factors, but a significant part of it was endemic.

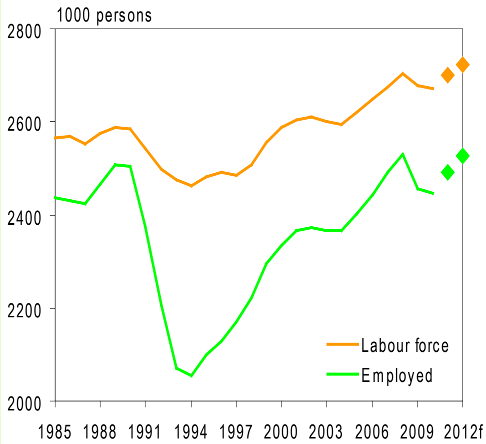
It cannot be expected that the rise of prices would significantly slow down anymore this year because foodstuffs, housing and transport are still becoming more expensive, interest rates are rising and wages have also begun to rise more quickly. This year consumer inflation is forecast to level off at 3 per cent. Next year inflation may slow down somewhat, for instance, as the rise of fuel prices comes to a halt and because taxation changes raising prices are no longer in sight. On the other hand, the improving global economic situation will continue to raise many prices. We forecast that consumer prices will increase next year by an average of 2.8 per cent.

Real earnings of employees falling slightly this year

In recent years, collective bargaining has been carried out at the union level, instead of negotiating centralized agreements. The biggest earnings increases took place in the midst of the economic crisis in 2008-2009. As economic growth started to recover, the rate of wage increases slowed to 2.6 per cent in 2010. The timing of union-level rounds of collective bargaining is more diversified than previously so that wage negotiations are always in progress in some segment of the labour market. In 2010, the contract agreement periods were typically two years, but in the beginning of this year wage increases have been agreed for the current year within the framework of the agreement. The Confederation of Finnish Industries has sought to exert control on wage increases with so-called wage anchors.

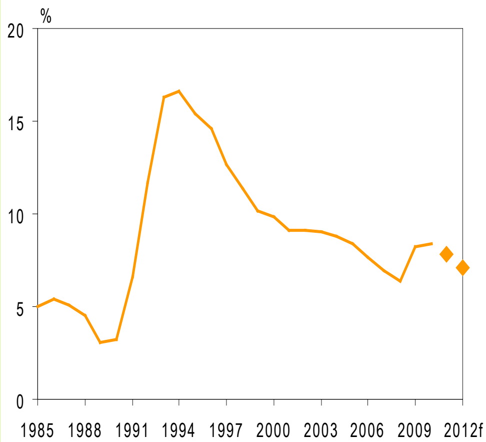
New agreements have followed a very moderate wage-hike policy line, despite the fact that inflation has clearly accelerated since the second half of last year. In addition to a general wage increase, the contract has commonly included a locally agreed element, the share of which has increased somewhat in recent years. Typically, the level of wage settlements has fluctuated in a range from 1.5 to just over 2 per cent. The so-called wage carry-over effect from last year, contract wage increases and wage drift will increase the level of earnings this year by a total of 2.7 per cent. Thus, the increase in wages will be lower than inflation and real earnings will fall slightly. Next year, earnings will rise by slightly more than 3 per cent and real earnings development will

Supply of labour and employment 1985–2012



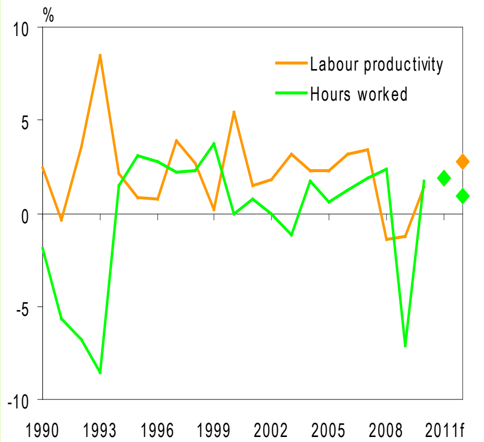
Source: Statistics Finland, PT

Unemployment rate 1985–2012



Source: Statistics Finland, PT

Change in labour productivity and hours worked 1990–2012



Source: Statistics Finland, PT

turn slightly positive again. The improvement in the economic and labour market situation will contribute to the normalization of real earnings developments back to the trend prevailing prior to the economic crisis.

Household purchasing power growing more moderately than in previous years

In 2010 the wage bill increased by only 1.9 per cent and the share of wages within national income fell. In the ongoing year the wage bill will grow more than this, by about 5 per cent, which in part is attributable to the swifter growth than last year of labour input, i.e. the number of hours worked. Next year the increase in the wage bill will decelerate somewhat as the growth of the labour input remains slightly smaller than the corresponding figure of this year. The share of wages within national income will continue to decline in the forecast period.

The dividends and entrepreneurial income received by households are expected to increase faster than wages. The effects of income taxation on the purchasing power of households will remain meagre, because in 2011 income taxation will remain broadly unchanged from the previous year. Major tax cuts are not likely even next year due to the central government deficit.

The purchasing power of households is projected to increase in both forecast years by a scant two per cent in real terms, which is lower than in 2010. The modest growth of real purchasing power is in part influenced by the acceleration of inflation, which is brought on by international price pressures and the tightening of indirect domestic taxation.

Private consumption growth subsiding

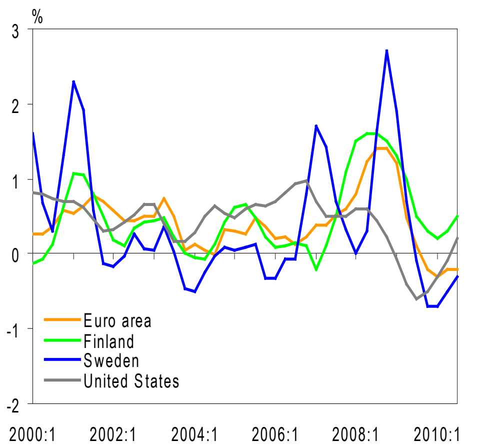
In 2010, private consumption increased by 2.6 per cent, boosted by the purchasing power of households' strengthening by approximately 3 per cent. The low level of interest rates also spurred the rise in consumption. Consumption demand strengthened from the weak development of the beginning of the year to over 3 per cent annual growth in late autumn. Thus consumer demand pent up during the recession was unleashed as the year progressed and the economic situation improved, and the rise of consumer prices did not yet reduce purchasing power. The consumption of durable goods and services strengthened especially during the year.

There is still purchasing demand pent up from the recession, which in part helps maintain private consumption. Indicators measuring the confidence of consumers and the wholesale and retail trade as well as sales statistics from the beginning of this year show that the consumption desires of households have remained steady. Significantly elevated consumer prices together with a modest income level development will, however, mitigate consumption opportunities. In the ongoing year consumption is forecast to increase by 2.5 per cent and 2.1 per cent next year. The savings rate will fall somewhat in both years but it will nevertheless remain at a relatively high level.

Central government deficit falling by total of about 4.6 billion euros this year and next

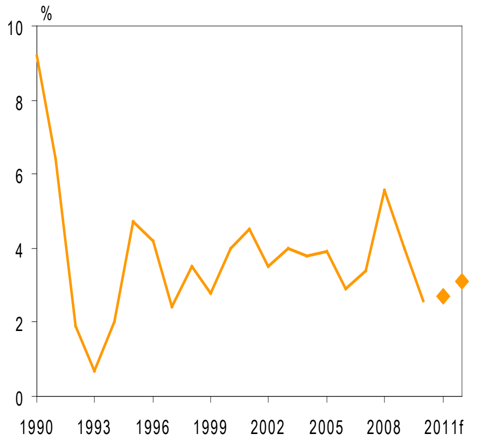
The relatively vibrant economic growth will strengthen the tax base, which together with hikes in indirect taxation will substantially boost the central government's revenues from indirect and direct taxes. The increase in VAT from 22 per cent to 23 per cent and the lowering of VAT for restaurant food sales from 22 per cent to 13 per cent in July

Changes in unit labour costs 2000:1–2010:3



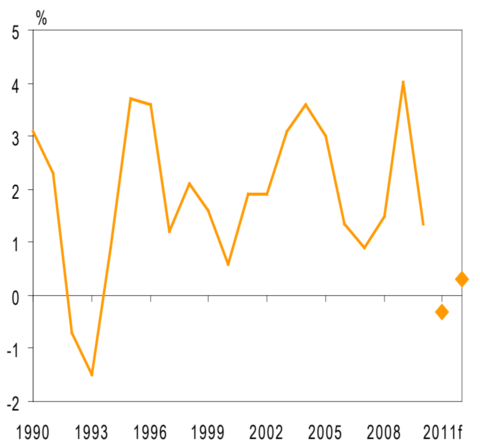
Source: OECD

Change in level of earnings index 1990–2012



Source: Statistics Finland, PT

Annual changes in real wages 1990–2012



Source: Statistics Finland, PT

last year as well as the inverted VAT going into force in the construction sector on April 1, 2011 will increase net indirect tax proceeds by an estimated 350 million euros. Increases in energy taxation at the beginning of this year will boost tax revenues by an estimated 730 million euros. Also the hikes in the confectionary tax, insurance premium tax, vehicle tax, lottery tax and waste tax will increase indirect tax revenue by over 180 million euros. The central government's indirect taxes are expected to grow by more than 10 per cent this year. Next year, the central government's indirect taxes will increase by a further 6.5 percent. The already decided increase in diesel-fuel tax, which will boost tax revenues by approximately 200 million euros, and the reduction in the passenger car and truck engine-power tax, which will spawn tax revenues of about EUR 80 million, are included in this forecast.

Central government direct income taxes will climb this year by nearly 11 per cent from last year. This development is fostered by the substantial increase in the wage bill due to the rise in the number of hours worked and a steep rise in property income back towards pre-recession levels. But, above all, the improvement in the profitability of enterprises and its effect on corporate income tax revenues will lead to an increase in the central government's direct taxes. Next year the improvement in corporate profitability will increase corporate tax revenues further at the same time as positive employment developments boost earned income. The central government's direct taxes will continue to grow by slightly over 10 per cent. This estimate takes into account that the central government's share of corporate tax revenues will return to pre-recession levels.

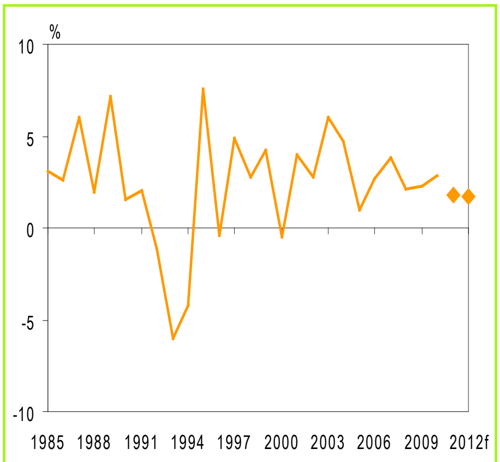
Central government transfers to municipalities will increase this year and next year in nominal terms by only 3 per cent since there is no need to compensate municipalities for reduced tax revenues and since the financial position of municipalities has strengthened considerably. The central government's financial position is also bolstered by the slow growth in its consumption expenditure by a nominal two per cent this year and next. The central government's financial deficit is projected to decline from last year's 9.2 billion euros to 6.6 billion euros this year and 4.6 billion euros next year.

Municipal finances remain balanced – financial surplus of pension insurance institutions over 3 per cent of GDP

The substantial growth of the wage bill and an average increase in the municipal tax rate by about 0.2 percentage points will boost municipal tax revenues, which are rising to nearly a billion euros this year. As municipal corporate income tax and property tax revenues are projected to grow by a total of just over 350 million euros this year, municipal direct taxes will grow by more than 7 per cent. Next year, municipal indirect taxes are growing by almost 4 per cent from the previous year. This is attributable to the fact that the municipalities' share of corporate tax revenue will fall. Both this year and next year the municipalities' consumption expenditures are forecast to grow in nominal terms by only three per cent per year, and thus in real terms by slightly more than one per cent. Due to the relatively favourable economic growth, municipalities will generate financial surpluses of a few hundred million euros this year and next.

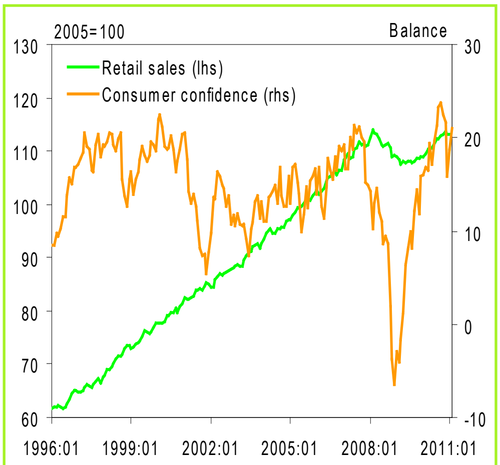
Social security contributions received by pension insurance institutions and social security funds will increase by over 6 per cent this year and next year by over 4 per cent. This year, these contributions will be increased by the strengthening of the payment base as well as hikes in pension and unemployment insurance contributions. Especially this year, pensions and other benefits will still grow much more slowly than contributions.

Change in household's real disposable income 1985–2012



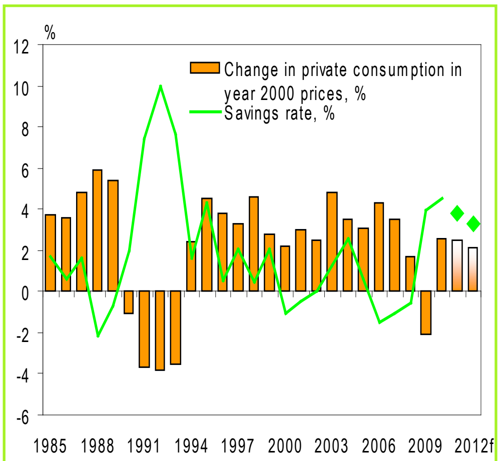
Source: Statistics Finland, PT

Consumer confidence and retail sales in Finland 1996:01–2011:02



Source: Eurostat

Private consumption and savings rate 1985–2012



Source: Statistics Finland, PT

Tax ratio rising to slightly over 43 per cent

The tax ratio will rise this year by about one percentage point due to tax hikes. Next year the tax ratio will remains at slightly over 43 per cent if the new government does not carry out fundamental changes in taxation. A stringent fiscal policy will mean that public expenditures' share of GDP will continue to decline. While this share was 54.7 per cent last year, it is projected to decline further next year to already 52.2 per cent.

The general government's financial balance will climb from last year's -2.5 per cent of GDP to -0.1 per cent this year. Next year will see a surplus of more than 2 billion euros, which is 1.1 per cent of GDP. The strengthening of the government's financial position will trigger a decline in the so-called EMU debt as a percentage of GDP. The central government's gross debt as a percentage of GDP will no longer rise next year after peaking at just under 43 per cent this year.

Public finances in surplus already next year

Public finances will run a surplus already next year. The clear improvement from last year is partly attributable to last year's very divergent trends: payroll and tax revenues did not began to show strong growth until the second half of the year. On the other hand, the clear tightening of indirect taxation will strengthen public finances significantly this year. We estimate that the general government's fiscal surplus in 2015 will be almost 5 billion euros, i.e. about 2.4 per cent of GDP. This view can be considered realistic. Finland's general government surplus in 2006-2008 was 4 per cent or higher. In 2009-2011 the fiscal impact of the reductions in the tax base was approximately 0.7 per cent of GDP. In addition, the recent hikes in consumption taxes have correspondingly increased the central government's tax revenues and in the coming years employment and the tax base will return to pre-crisis levels.

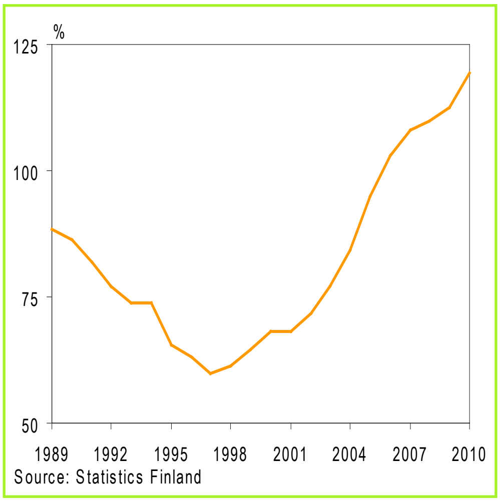
Table 4. Forecasts of public financial balance

	Labour Institute for Economic Research Mar. 29, 2011	
	GDP growth (%)	General government financial balance relative to GDP
2010	3.1	-2.5
2011	3.8	-0.1
2012	3.1	1.1
2013	2.8	1.7
2014	2.5	2.0
2015	2.4	2.4

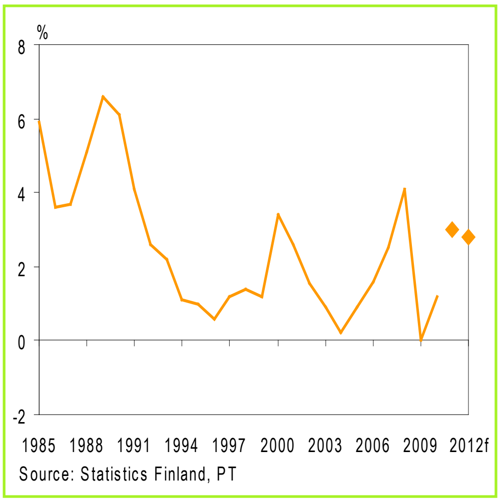
Source: Labour Institute for Economic Research

When making fiscal sustainability gap calculations, one of the key assumptions is the cyclically adjusted primary balance (net lending excluding interest payments) in relation to GDP in the first year. According to our view, this structural surplus would be about be a positive 2 per cent in mid-decade. This reduces our estimate of the public-sustainability gap by about 3 percentage points compared to, for example, that of the Ministry of Finance. We project, moreover, that even in the current system the retirement age is going to rise by almost three years by the year 2060. This further reduces our above-mentioned estimate of the sustainability gap. The sustainability gap is thus well below the 4-5 per cent range.

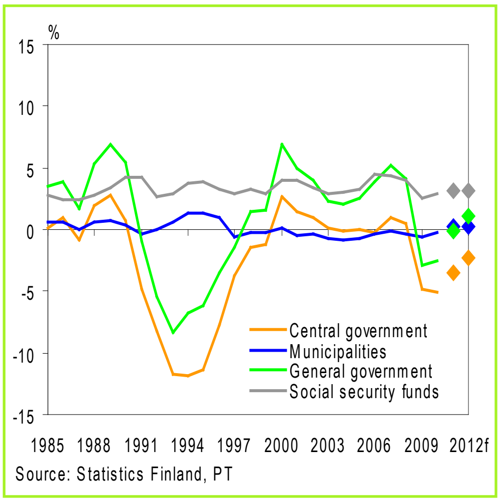
Household debt ratio 1989–2010



Change in consumer prices 1985–2012



General government financial surplus as percentage of GDP 1985–2012



Tax ratio must be raised moderately

The improvement in the economic situation and the need to safeguard the long-term fiscal sustainability of public finances justify the taking of actions to strengthen the fiscal position of the public sector in the coming years. Solutions should be such that they promote a smoothening of the income distribution, but not jeopardize economic growth. Proposals to tighten the taxation of capital income by raising the tax on dividends and by limiting the tax relief of unlisted companies are well suited for this purpose. The tightening of capital income taxation could generate around 0.5 billion euros in additional revenue. The tightening of capital income taxation relative to business taxation, for example, discourages income to be distributed as tax-free dividends and makes profitable fixed investments attractive relative to investments in securities and real estate, which in the current system are carried out in order to increase the size of the balance sheet and benefit from tax exemptions.

A significant proportion of the upward pressure on expenditures is focused on the municipalities, so that safeguarding their financial balance in a prudent manner is pivotal for the public sector as a whole. If no fundamental changes are made, municipal income taxation will continue to tighten. This will further increase the share of proportional taxation in the tax structure. It also increases the share of cyclically sensitive revenues in municipal funding.

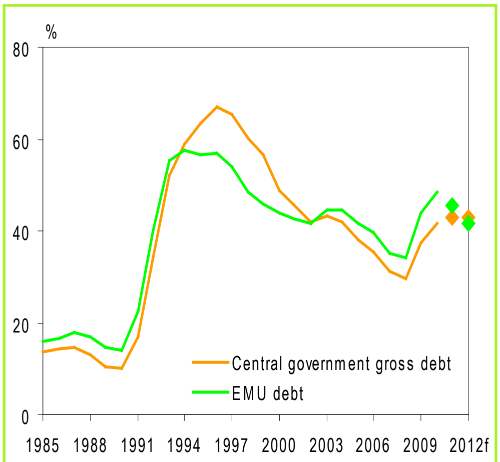
A better option might be to increase the importance of stable sources of income such as property taxes and central government revenue sharing as sources of municipal revenue. In terms of central government revenue sharing this means a reversal of the trend prevailing during the last couple of decades. Raising property taxes would mean focusing funding pressure on a form of taxation whose level in Finland is currently low by international comparison. The assessed values of buildings for property tax purposes, however, should be made to correspond better with the actual market values. This would generate leeway to raise property taxes so that the hikes would not be allocated to property of lower value as heavily as according to the current way property tax values are assessed.

The public sector's sustainability gap thus appears to be is relatively small. Public finances nevertheless threaten to start running a sizable deficit in the coming decades. The gross public debt also threatens to grow too large. The need to strengthen public finances via discretionary policy changes cannot be ruled out. At the very least it should be ensured that after the economy recovers from the recession that the public sector's financial surplus climbs to 2 per cent by 2015. The very fact that public expenditure in real terms will be limited to well below 1.5 per cent, and that the overall tax burden will be raised somewhat should be sufficient to ensure this.

At the operational level, tax and spending decisions affecting public sector financing should not be made permanent over a very long time horizon. The development of public deficits is very sensitive to international and domestic economic uncertainty. Therefore, any government that is committed to take care of the sustainability of public finances should take into consideration that operational activities should also be conditional on how public finances characterized by a very delicate financial position actually develop when faced with external shocks.

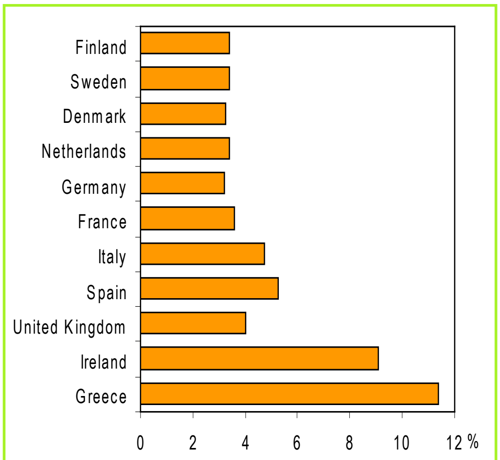
When balancing public finances, we should opt for solutions that are also justified for reasons of structural reforms. The capital income tax reforms proposed by Undersecretary of State Martti Hetemäki's tax task force are a prime example of this. In their proposal tax revenues will be raised not only by raising the tax rate but by also widening the tax base. Even though the proposal would smoothen out income differences, it also aims to increase positive growth effects.

Central government gross debt and general government EMU debt as percentage of GDP 1985–2012



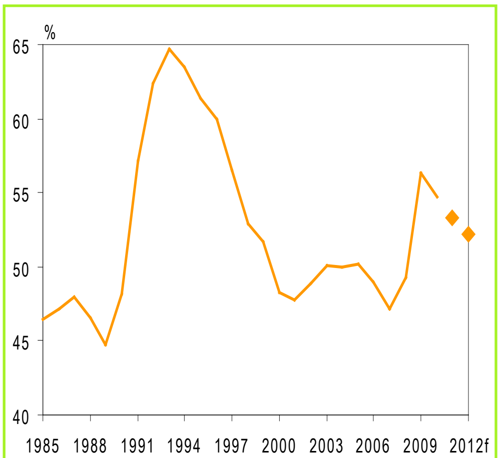
Source: Statistics Finland, Ministry of Finance, PT

10-year government bonds yields in February 2011



Source: ECB

Public expenditures as percentage of GDP 1985–2012



Source: Statistics Finland, PT

200 million euros in extra revenues from underground economy

Weeding out the underground economy has become a central issue in the public debate, largely because tax revenues could be increased directly by curbing the scope of the underground economy. The underground economy also has other extensive negative social effects. A report prepared last year for the Parliamentary Audit Committee estimated that underground economy signifies a loss of 4-5 billion euros in tax revenue. The estimate is based on tax audit files.

In February, Parliament approved an Audit Committee report, which proposed for instance an extensive 25-point program to eradicate the underground economy in the future. Results of a poll conducted to officials as part of the report prepared for the Audit committee shows that a lack of public authorities' resources alongside other factors such as internationalization have contributed to the weakening of readiness to combat the underground economy. According to the report the amount of public resources focused on this segment should indeed be separated from the productivity program.

Future governments must ensure that the list of actions and follow-up measures resulting from the investigations are realized even though they require monetary outlays. In addition to improving the operation of public authorities, weeding out the underground economy requires the commitment of businesses and other economic actors, because possible new rules and regulations could result in some sort of adjustment costs for them, too.

The estimated sum of lost tax revenue is unclear due to the nature of the phenomena, and there is no way to shift all of the underground economy over to the official economy. However, collecting even a small net amount would signify an increase in tax revenue, for example 5 per cent of the lower end of the estimate range would amount to 200 million euros, which could of course also be a rather optimistic estimate. By comparison, the sum of the tax payments assessed after tax audits of the underground economy was about 70 million euros.

Banking crisis is smouldering in Europe

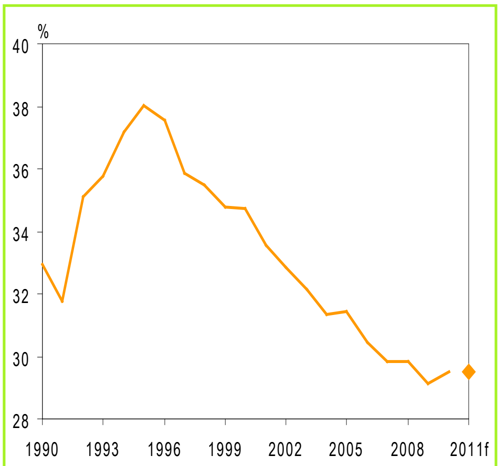
A fairly common view of the euro area's financial crisis is that public finances have been poorly managed via debt financing in the so-called PIGS countries (Portugal, Ireland, Greece and Spain) and that they need to be rescued by loans and guarantees so that employment in other EU countries does not suffer. This perception is partly misleading.

Before the financial crisis, public finances were in surplus in Spain and Ireland, and also Portugal had managed to get below the Growth and Stability Pact's limit of three per cent. Only Greece's public finances were already in a bad way. The financial crisis and the ensuing recession exacerbated, of course, the fiscal position of all countries.

It can certainly be argued that especially the Spanish and Irish governments should have intervened to prevent the overheating of their own economies and the housing market in particular, so that the collapse would not have become so severe. The financial crisis nevertheless came as a big surprise to everyone.

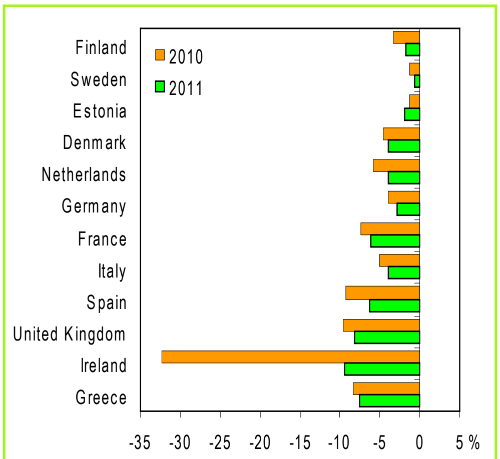
The growth rate of the euro area's broad money supply accelerated from 5 per cent in 2004 to more than 12 per cent prior to the financial crisis. By keeping interest rates low, the ECB fostered rapid growth in lending, which was partly channelled to the PIGS countries

Wage earners' income tax rate 1990–2011



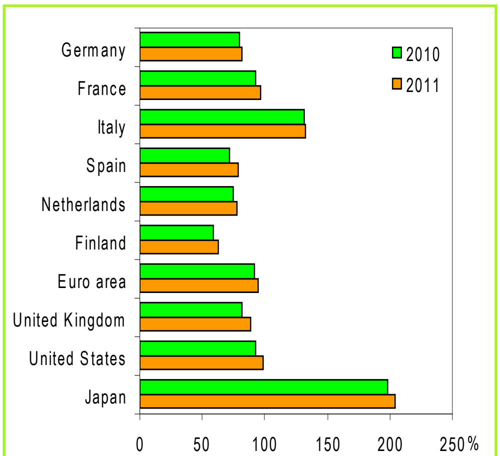
Source: Statistics Finland, PT

Public sector deficit-to-GDP ratio in 2010 and 2011



Source: OECD

Debt-to-GDP ratio in 2010 and 2011



Source: OECD

via banks of other countries. In addition to the private sector, the public debt was financed in this way e.g. in Greece and, after the crisis deepened, also in other countries.

Detailed and up-to-date figures on the euro area's debt problem are difficult to obtain. The latest report by the Bank for International Settlements (BIS) includes information that is already six months old. For the time being the most thorough evaluation has been done by the researchers of the Bruegel think-tank based in Brussels who have compiled the year-end figures in the adjacent table from many different sources. It may be used to make several interesting observations.

First, the ECB has purchased Greek, Irish and Portuguese government bonds in the secondary market worth 93 billion euros. This exposes the ECB to credit risk, which could require capital injections from the national central banks and, ultimately, taxpayers. At the same time it constitutes interest-rate and risk-related subsidies to the banks that originally purchased these bonds from PIGS governments and obtained cheap loans from the ECB. The system actually encourages banks to do so. The same holds for possible government bailout programs, because they reduce the credit risk even though they do not eliminate the interest rate risk premia completely. (The joint issuance of "eurobonds" by European governments proposed by some would have similar effects.) Bank lending to PIGS countries has become a very profitable business, which they have increased recently despite the crisis. The emergency funds safeguard the profitability of this kind of business, at least for the time being.

Second, the PIGS countries' debt held by their own countries' banks is twice as high as the debt held by other euro-area banks. The banking system of the crisis countries should be taken into account in the risk assessments, as the experience with Ireland has already shown.

Third, the PIGS countries' debt held by other financial institutions (e.g. insurance companies and assorted kinds of funds) accounts for almost half the total government debt. It can be assumed that other EU countries' banks have partially funded the banks and other financial institutions of PIGS countries, so their exposure to credit losses is greater than their direct receivables from PIGS governments would lead us to believe. When other types of commitments (such as various kinds of credit derivatives) are included on top of traditional forms of debt, the risks of European banks in crisis countries are apparently much greater.

Fourth, PIGS governments' direct debt to foreign banks is surprisingly small, and accounts for only slightly more than half of their banks' corresponding debt to foreign banks. In practice - as has been said above - these two should, however, be considered together, because the government may have to rescue the banks. The Greek government debt is already of such a magnitude that the government is generally considered to be insolvent.

Fifth, it is easy to see how the debt crisis poses a threat, in particular to German and French banks, and by

Table. PIGS Government and Bank Debt, billion euros Dec. 31, 2010

	Greece	Ireland	Portugal	Spain	Total
Total government debt of which held by	**325**	**153**	**142**	**677**	**1297**
- ECB	50	22	21	0	93
- IMF, EU and official lenders	32	0	0	0	32
- domestic banks	68	11	19	227	336
- rest of euro-area banks	52	14	33	79	166
- other banks	6	9	5	24	43
- non-banks	119	97	64	347	627
Total government debt to foreign banks of which held by	**58**	**23**	**38**	**103**	**209**
- German	20	3	6	24	54
- French	16	6	12	37	71
- Italian	2	1	1	2	6
- Spanish	1	0	7	-	8
- other euro countries	13	3	6	15	38
- British	3	4	2	8	17
- others	3	6	3	15	27
Total bank debt to foreign banks of which held by	**10**	**119**	**43**	**209**	**381**
- German	4	39	14	66	123
- French	1	15	11	41	68
- Italian	1	2	2	8	13
- Spanish	0	3	6	-	8
- other euro countries	1	7	4	39	52
- others	1	10	1	8	19

Source: Darvas, Z., Pisani-Ferry, J. ja Sapir, A. (2011): A Comprehensive Approach to the Euro-area Debt Crisis: Background Calculations, Bruegel Working Paper 2011/05.

far the biggest threat would be the collapse of Spain. A single small country's credit losses and the possible need for capital injections into banks - even with tax funds - might be manageable, but there is a risk of the situation spinning out of control and spreading to Spain and elsewhere. Interest rates might rise, and banks would cut back sharply on their lending to the private sector. This sort of credit crunch and new financial crisis undoubtedly poses a major threat to employment and prosperity.

The initial huge damage has already occurred, and now attention is focused on minimizing its negative consequences. We should avoid measures that make the crisis even worse. In this case, it is important to distinguish between clean-up actions and prevention.

Demands that banks and investors should share in the costs of the debt crisis in the future are problematic in this situation – during the clean-up phase of the crisis – because they weaken the ability of the crisis countries to cope with the current predicament. In the current situation they are not able to borrow on market terms at reasonable interest rates and banks are becoming more conservative in other risk-taking. Giving into political pressures from voters demanding that the forthcoming European Stability Mechanism should be in a preferred position with respect to existing claims on PIGS countries is also problematic, because it increases the risks of private creditors. On the other hand, the bank or transaction tax proposed by the Commission to finance the bailout could also be counterproductive, because it reinforces the belief that risk taking is worthwhile when help is available.

The right kind of prevention would entail banks and other private investors being held liable in such a way that they would no longer – after the crisis has passed – opt to take excessive risks. They would not be bailed out with public money without unpleasant consequences, such as the loss of owners' assets and dividends, governments injecting capital and becoming shareholders, cutbacks in executives' benefits etc. These conditions could be linked to eligibility for tapping the fund established with the proceeds of the banking tax.

The crisis has so far been dealt with as a liquidity problem and not as a solvency problem. This has bought time and avoided the unpleasant solutions of debt restructuring and capitalization of banks, while elections are approaching in Germany, Finland and other countries. The proposed new stress tests for banks evidently do not take full account of the possibility of governments' debt restructuring, which serves to hide the smouldering banking crisis and postpones the taking of necessary actions. In reality, we are facing only bad and even worse alternatives.

The PIGS economies will still stage a turnaround some day, but without an independent monetary and exchange rate policy, it is very challenging and will take many years. The required fiscal austerity measures undermine the prospects for economic growth, at least in the short term, and thereby hamper this process. They also mean suffering for citizens of these countries, fuelling greater resistance.

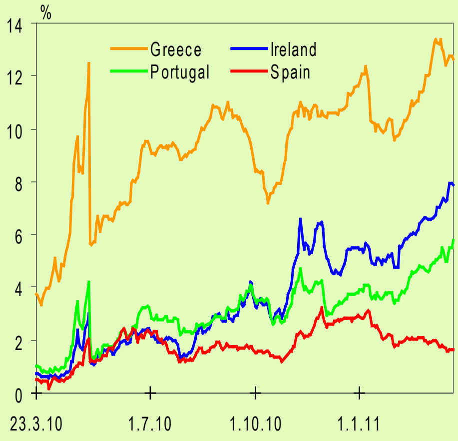
The adjacent graph of 5-year government bond differential relative to the relatively less risky Germany indicates the deteriorating trend recently in the PIGS countries - except in Spain – and the reasonable confidence that a banking and financial crisis will not erupt in Europe. Despite this, the horror scenario of a single event provoking widespread mistrust - such as allowing the investment bank Lehman Brothers go bankrupt on September 15, 2008 - could trigger a devastating chain reaction.

The PIGS countries need relief from their situation so that the crisis could ease substantially. An example of this kind of prudent action is that the interest rate differential relative to Germany showed a more favourable trend in Greece than in Ireland after the interest rate was lowered on Greek crisis loans. This was not done in the case of Ireland because it refused to raise its corporate tax rate. The rapid easing of the debt burden in a crisis country boosts the financial markets' confidence that it will manage to cope with the situation, which may trigger a positive spiral.

PIGS countries and their financiers need to be let off the hook. The interest and other debt burdens should be cut one way or another, e.g. via debt restructuring, before the problems get worse. The big-bang approach to banks' capital adequacy stress tests taking into account the PIGS countries' losses from debt restructuring should be combined with government participation in their ownership and regulation, which could be partly dismantled after the risks have returned to normal levels and the banks are financially sound once again. In this way, taxpayers would not have to inject capital into banks in all countries where the banks pass the stress test.

Heikki Taimio

PIGS countries' 5-year bond yield differential relative to corresponding German bonds 23.3.2010–25.3.2011



Source: Nordea