26. FINLAND

Investment-led growth in 2017 with exports picking up in 2018

Booming construction investment is leading the recovery of the Finnish economy. Household confidence is supporting consumption despite weak income developments this year, but consumption growth is expected to weaken next year. Economic activity is forecast to increase modestly this year and next. In 2018, however, growth is expected to pick up as improved cost-competitiveness boosts exports. After decreasing over 2015-16, the public deficit is expected to increase in 2017 due to the planned income tax cuts decided in conjunction with the recent labour market agreement.

Slow growth in the first half of 2016

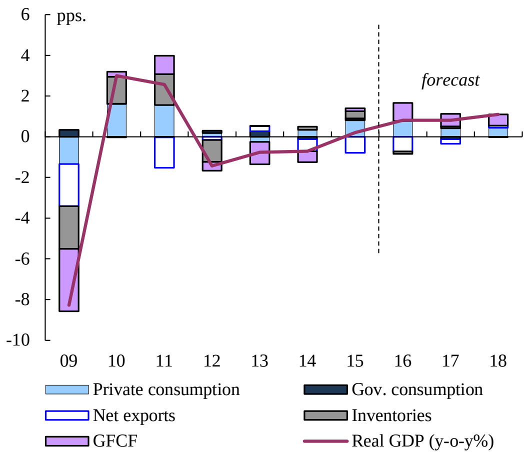
In the first half of 2016, Finland's economy grew by 0.8% compared with the same period one year before. Domestic demand increased on the back of increasing construction investment, which grew by about 8.4% (y-o-y). The increased activity in construction was driven both by pent-up demand for new housing in growing urban regions where building of new apartments declined in 2012-15 and, by increased non-residential construction. Owing to low inflation and gradually improving employment, private consumption also increased at a fairly brisk rate of about 2% (y-o-y) in the first half of 2016. Net exports detracted from growth as imports grew by 2.6% while export growth was flat.

Forward-looking indicators suggest that economic growth should continue in the latter half of 2016. Consumer confidence, which has been on an upward trend, hit a five-year high in September, and more and more construction companies are optimistic about the outlook in the near term. Despite some good news in industries such as shipbuilding, the export order books for manufacturers overall look still rather thin and production expectations remain low. Real GDP is forecast to grow by 0.8% in 2016-17 and by 1.1% in 2018.

Agreement to improve competitiveness...

The Competitiveness Pact that was signed between the social partners in late summer covers more than 90% of salary earners in the public and private sectors. The Pact includes a 12-month wage freeze in 2017 and an increase in annual working time by 24 hours. Employees have also agreed to take on some of their employers' contributions to social security and the annual holiday bonus for public sector workers for 2017-19 has been cut by 30%. To compensate for the higher social security contributions for workers, personal income tax will be cut starting in 2017. Over the longer run, the Pact is expected to have a positive impact on cost-competitiveness, exports and employment. In the forecast period, nominal unit labour costs are expected to fall in 2017 and to remain broadly constant in 2018. Competitiveness relative to other EU Member States is projected to improve which should support an increase in exports from 2017.

Graph II.26.1: **Finland - Real GDP growth and contributions**



...with mixed impact in the short term.

In 2016, exports are expected to continue to fall as goods exports decline, while last year's strong growth in service exports is expected to level off. However, in 2017, export growth is expected to pick up to 1.8% and to increase further in 2018. Due to increasing domestic demand and base-effects, imports are forecast to increase in 2016. While exports are expected to grow in 2017, imports are also set to increase, mitigating the positive growth impulse from foreign trade. Finland's current account is expected to remain negative over the forecast horizon, as the significant improvement seen in 2014-15 was due to the fall in commodity prices.

Employment is expected to start growing again gradually this year and should continue to do so in

2017 and 2018, albeit slowly. The wage freeze and the higher payments for workers restrain, while the income tax cut supports the growth of nominal disposable income. As inflation is expected to pick up due to rising energy prices and hikes in indirect taxes in 2017, real disposable income is forecast to grow only modestly. Although the household saving rate is projected to fall further in 2017, consumption growth is expected to drop to 0.8%. The growth in investment is also forecast to slow down in 2017 as construction activity calms down.

Risks are broadly balanced in the forecast. On one hand, the most recent confidence indicators in manufacturing were very positive which could lead to higher-than-expected activity and exports over the forecast period. On the other hand, the overall uncertainty related to the external environment, including the pace of the recovery of the Russian economy, remains high and could postpone investment which would also weigh on the growth of Finnish exports.

Revenues reduced in 2017

The budget deficit amounted to 2.8% in 2015 and is expected to decline to 2.4% in 2016, as a result of expenditure cuts decided in the general government fiscal plan for 2016-19 and revenue measures such as the increase in unemployment insurance contributions. In 2017, in accordance with the Competitiveness Pact, personal income tax and employers' health insurance contributions are lowered. These measures lead to a revenue loss amounting to 0.7% of GDP. On the account of the implementation of expenditure cuts in line with the fiscal plan and the reduction of holiday bonuses, overall the deficit is projected to worsen to 2.5% of GDP in 2017. In 2018, the deficit is expected to fall again to 2.0% of GDP thanks to increasing economic activity and additional expenditure cuts presented in the fiscal plan.

The structural balance is expected to improve marginally in 2016 but it is projected to worsen by about ¼ pps. of GDP in 2017, before improving by about ¼ pps. of GDP in 2018. Given the continued nominal deficits and sluggishly increasing nominal GDP, Finland's gross government debt-to-GDP ratio is set to increase to 65.4% in 2016, to 67.1% in 2017 and reach 68.1% in 2018.

Table II.26.1:

Main features of country forecast - FINLAND

	2015		Annual percentage change						
bn EUR	Curr. prices	% GDP	97-12	2013	2014	2015	2016	2017	2018
GDP	209.1	100.0	2.5	-0.8	-0.7	0.2	**0.8**	**0.8**	**1.1**
Private Consumption	115.7	55.3	2.7	-0.5	0.6	1.5	**1.4**	**0.8**	**0.8**
Public Consumption	51.0	24.4	1.5	1.1	-0.5	0.4	**0.0**	**-0.5**	**0.0**
Gross fixed capital formation	42.7	20.4	2.6	-4.9	-2.5	0.7	**4.3**	**3.0**	**2.6**
of which: equipment	10.0	4.8	2.1	-8.7	-1.8	7.0	**3.7**	**2.9**	**2.7**
Exports (goods and services)	76.6	36.6	5.0	1.1	-1.7	-0.2	**-0.7**	**1.8**	**3.0**
Imports (goods and services)	77.5	37.1	5.3	0.5	-0.2	1.9	**1.2**	**2.3**	**2.6**
GNI (GDP deflator)	210.9	100.8	2.7	-0.9	-0.1	0.2	**1.0**	**0.8**	**1.1**
Contribution to GDP growth: Domestic demand			2.2	-1.1	-0.3	1.0	**1.7**	**0.9**	**1.0**
Inventories			0.1	0.0	0.2	0.4	**-0.1**	**0.1**	**0.0**
Net exports			0.3	0.3	-0.6	-0.8	**-0.7**	**-0.2**	**0.1**
Employment			1.2	-0.7	-0.5	-0.4	**0.2**	**0.3**	**0.4**
Unemployment rate (a)			8.9	8.2	8.7	9.4	**9.0**	**8.8**	**8.7**
Compensation of employees / head			3.1	1.3	1.0	1.6	**1.2**	**-0.8**	**0.9**
Unit labour costs whole economy			1.9	1.4	1.2	1.0	**0.6**	**-1.2**	**0.2**
Real unit labour cost			0.1	-1.1	-0.5	-0.6	**-0.5**	**-2.0**	**-0.8**
Saving rate of households (b)			8.7	8.6	7.2	6.8	**6.4**	**6.0**	**5.5**
GDP deflator			1.8	2.6	1.7	1.6	**1.1**	**0.8**	**1.0**
Harmonised index of consumer prices			1.9	2.2	1.2	-0.2	**0.3**	**1.1**	**1.2**
Terms of trade goods			-1.4	0.8	1.7	4.6	**1.5**	**-0.1**	**-0.2**
Trade balance (goods) (c)			5.5	0.1	0.2	0.5	**0.2**	**0.0**	**0.0**
Current-account balance (c)			4.1	-1.9	-1.3	-0.8	**-0.8**	**-0.9**	**-0.7**
Net lending (+) or borrowing (-) vis-a-vis ROW (c)			4.1	-1.8	-1.2	-0.8	**-0.7**	**-0.6**	**-0.4**
General government balance (c)			1.9	-2.6	-3.2	-2.8	**-2.4**	**-2.5**	**-2.0**
Cyclically-adjusted budget balance (d)			1.7	-1.4	-1.7	-1.4	**-1.4**	**-1.6**	**-1.4**
Structural budget balance (d)			-	-1.4	-1.8	-1.4	**-1.3**	**-1.6**	**-1.4**
General government gross debt (c)			43.0	56.5	60.2	63.6	**65.4**	**67.1**	**68.1**

(a) as % of total labour force. (b) gross saving divided by gross disposable income. (c) as a % of GDP. (d) as a % of potential GDP.

Note : Contributions to GDP growth may not add up due to statistical discrepancies.