Ernst & Young Eurozone Forecast

Finland

Spring edition, April 2011

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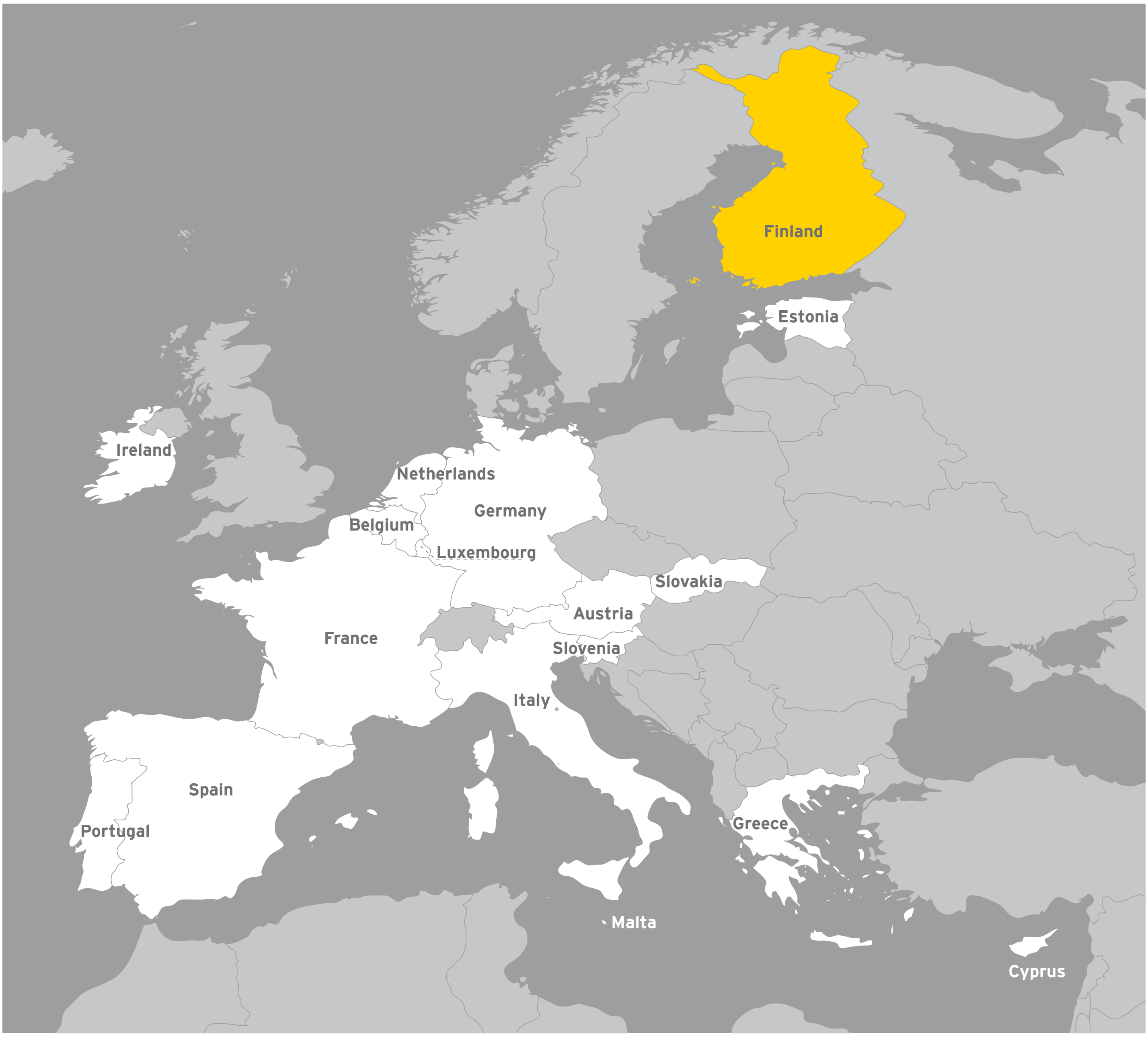
Outlook for Finland

Ernst & Young Eurozone Forecast — Spring 2011

17 Eurozone countries



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Highlights

Strong growth outlook but with medium-term risks related to housing

- With GDP growth at 3.1%, Finland's economy saw one of the strongest recoveries in the Eurozone in 2010. We expect Finland to continue to outpace most other economies in the Eurozone as conditions are in place for both the export and domestic sectors to expand rapidly. We forecast GDP growth at 3.5% this year and 2.9% per year on average in 2012-15. This will make Finland the third fastest-growing economy in the Eurozone, after Estonia and Slovakia.

- Finland's exposure to fast-growing markets, in particular Germany and Sweden, implies that demand for its exports will remain strong, albeit slowing down from the exceptional bounce back seen last year. Combined with strong price competitiveness, this points to robust growth in exports. We forecast exports to rise by 6.4% this year and at around 7% on average in 2012-15.

- With an earlier rebound in domestic demand, Finnish growth in 2010 was more balanced than in many other Eurozone countries. Final domestic demand contributed about half of total GDP growth last year. We expect the composition of growth to shift even more toward domestic demand this year as companies continue to step up investment and the related rise in imports offsets some of the gains in exports.

- Investment started to grow during 2010 after having collapsed by 14.5% the year before. We expect investment to expand further, helped by strong growth in the manufacturing sector and private housing as well as by favorable financing conditions. Minimal exposures to toxic assets during the crisis and a good regulatory and supervisory environment have left the Finnish banking sector in relatively good health. Credit growth was positive throughout the crisis and credit provision is expected to remain robust.

- Inflation is on the rise and is likely to remain high at around 3% on average this year, well above the Eurozone average. Hikes in energy and food prices, combined with energy tax increases, have raised headline inflation. Inflation on a range of non-energy goods has also risen markedly over the past six months, more so than in the rest of the Eurozone. However, given ample spare capacity, inflation should fall gradually as commodity prices decline and the impact of the tax increases disappears. We expect inflation to be below 3% next year. Risks are on the upside as rapid increases in house prices could push rents up.

- Higher inflation will dent real wage growth and thereby consumption growth this year. We expect this to be mitigated by further improvements in job creation and forecast consumer spending to rise by 2.5% in 2011 and 2.8% per year in 2012-15. While in the short term we think that risks to the consumer outlook are small, significant medium-term risks relate to the housing and debt environment. With mortgage rates closely linked to the European Central Bank's (ECB) monetary policy rate, Finnish households will quickly feel the impact of tighter monetary policy. Given high levels of debt (close to 120% of disposable income), this could imply weaker consumption than we currently envisage.

Strong growth outlook but with medium-term risks related to housing

Balanced growth of 3.5% this year ...

With GDP growth of 3.1% last year, Finland saw one of the strongest recoveries in the Eurozone, on the back of both healthy exports and domestic demand. And we expect Finland's economy to continue to outpace most other economies in the Eurozone this year as conditions for rapid expansion are still in place.

Recent survey data on both household and industry confidence point to the very positive growth momentum being maintained in early 2011. Moreover, ongoing robust growth in the world economy adds to Finland's upbeat prospects for 2011. We forecast growth of 3.5% this year and around 3% in 2012-15.

... on the back of strong exports ...

Exports underpinned the recovery in 2010. With export growth of 5%, Finland's export sector benefited in particular from high demand from fast-growing Sweden and Germany. Strong presence in these markets, combined with continued improvements in price competitiveness, points to robust export growth which we forecast at 6.4% in 2011 and at around 7% in 2012-15.

... and a continued recovery in investment ...

Finland's investment boom of 2007 reversed when the financial crisis hit the economy in 2009 and investment plunged by 14.5%. While investment saw a strong rebound in 2010, and stood at 5.8% higher in Q4 2010 than a year earlier, the pre-crisis levels are likely not to be regained for some time to come, despite a solid outlook.

The initial rebound in investment in 2010 came largely on the back of housing construction investment, which increased by 21.3%, boosted by a shortage on the housing market and low interest rates. Other important sectors, such as machinery and equipment were still in decline at the end of 2010. But construction activity is expected to continue strongly in the next years, as many of the projects started in 2010 will only be completed this year and more projects are in the pipeline. And in 2011, with the recovery taking firmer hold, investment activity will extend to the broader economy, in particular to investment-intensive manufacturing with excellent growth prospects of above 7% this year.

Moreover, financing conditions remain favorable for investment. Having performed well during the crisis – owing to minimal exposure to toxic assets and a stern regulatory and supervisory environment – the banking sector is well capitalized and remains solid. Unlike in most other Eurozone countries, credit growth was positive throughout the crisis. Stocks of loans to non-financial corporations declined again after the expansion in the first half, mainly because the need for restructuring was satisfied, but also

Table 1

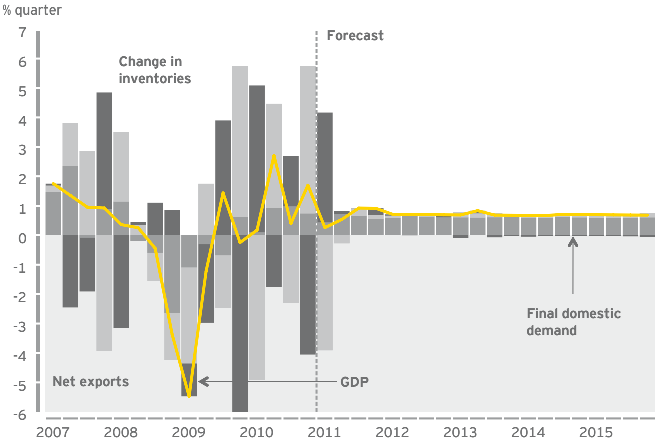
Finland (annual percentage changes unless specified)

Source: Oxford Economics

	2010	2011	2012	2013	2014	2015
GDP	3.1	3.5	3.1	2.9	2.8	2.8
Private consumption	2.7	2.5	2.3	3.1	3.1	2.9
Fixed investment	0.1	6.9	5.6	3.5	3.3	3.5
Stockbuilding (% of GDP)	0.1	1.3	1.6	1.6	1.4	1.3
Government consumption	0.4	0.9	1.1	0.9	1.1	1.2
Exports of goods and services	5.0	6.4	7.1	8.1	6.5	5.9
Imports of goods and services	2.6	9.2	7.7	8.6	6.6	5.9
Consumer prices	1.7	3.0	1.7	1.8	1.7	1.7
Unemployment rate (level)	8.4	7.6	7.3	7.1	6.8	6.7
Current account balance (% of GDP)	2.8	2.1	2.0	2.4	2.5	2.5
Government budget (% of GDP)	-2.5	-2.1	-1.6	-1.2	-0.9	-0.6
Government debt (% of GDP)	44.2	44.2	43.7	43.0	42.1	40.8
ECB main refinancing rate (%)	1.0	1.3	2.3	3.1	3.5	3.9
Euro effective exchange rate (1995 = 100)	120.8	119.4	117.0	116.0	114.9	114.1
Exchange rate ($ per €)	1.33	1.36	1.28	1.25	1.24	1.23

Figure 1

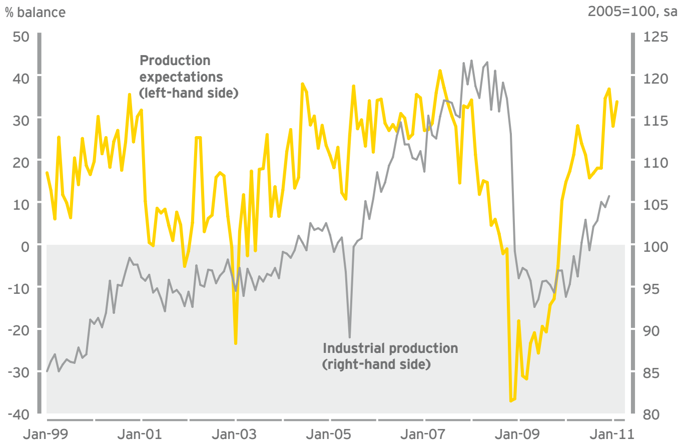
Contributions to quarterly GDP growth



Source: Oxford Economics

Figure 2

Industrial output vs. expectations



Source: The Statistical Office of the European Communy, Haver Analytics

because of increased uncertainty regarding European sovereign debt markets, first time credit provision has remained robust with comparatively low interest rates at around 2.5%-3.3%.

However, because there is still some spare capacity in the economy – in Q1 2011, capacity utilization was 81% compared with 86% during peak times – there is still some scope for increased production before an acceleration of investment growth will be triggered, probably in the second half of this year. For 2011 as a whole we forecast investment to grow 6.9%, before rates gradually fall back to around 3.5% in 2015.

... but inflation on the rise

In February, inflation stood high at 2.9%, mainly on the back of spikes in imported commodity prices at the turn of the year. And inflationary pressures from commodity prices should recede only slowly this year as ongoing tensions in the Middle East are likely to sustain oil prices at high levels during most of 2011. In addition, tax increases on energy are also pushing up headline inflation. We expect inflation to average 3% this year, well above the 2.3% Eurozone average, before falling gradually back to its 1.8% trend rate early in 2012.

Risks to the inflation forecast are on the upside. While core inflation has been steady at 1.6%-1.7% over the past few months, the continued strong expansion in domestic demand – estimated to grow 4.4% this year – could put further pressure on underlying inflation, only partly mitigated by the spare capacity in the economy and the impact of tax increases wearing off.

Additional inflationary pressures could come from the continued boom in the housing market. Limited capacity and low borrowing costs have pushed house prices well above their pre-crisis peak already at the beginning of 2010, and in Q3 they stood almost 10% higher than a year earlier. Increased activity in the construction sector, and government efforts to boost supply, along with likely interest rate increases, should ease the pressure toward the end of the year. In the meantime, however, house prices may start to gradually feed through to rents and thus add to price pressures.

Household spending to slow slightly this year ...

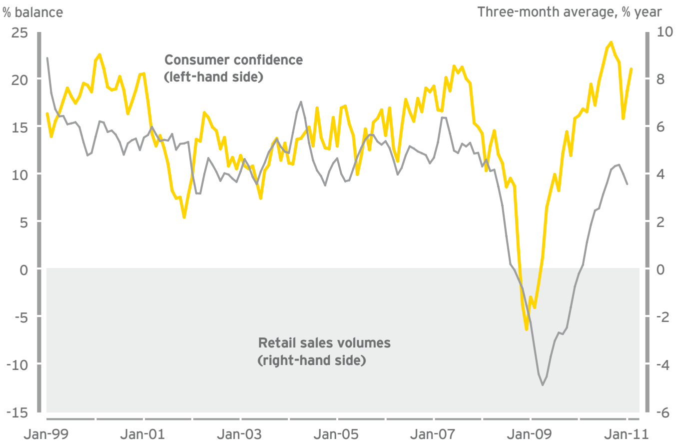
Household spending grew at an average rate of 2.7% last year, helped by initially low inflation. However, while consumer confidence at the beginning of this year was still close to record highs, inflation is likely to outstrip wage increases this year, which will dent real wages and weigh on consumption.

The main reason for moderate wage increases in 2010 was the continued weakness in the labor market, despite the relatively strong growth performance. Recent surveys show that current employment levels are considered sufficient to ensure near-term production. This suggests that unemployment should decline only gradually.

Indeed, the unemployment stabilized at 8% in January somewhat down from its 8.8% peak during the crisis, but is still very high compared with its pre-crisis average of around 6.5%. And because Finland's highly centralized wage negotiating system – governed by the comprehensive income policy agreement – is more likely to take the interest of unemployed workers into account than in less centralized settings, forthcoming negotiations should result in only moderate wage increases. Results from the 2010 collective bargaining round, valid throughout next year, saw an increase in base wages of around 1%.

Figure 3

Consumer confidence and retail sales



Source: The Statistical Office of the European Community, Haver Analytics

... with housing-related downside risks in the medium term

Another factor likely to weigh on household spending this year is an expected increase in the burden of interest on mortgages. Unlike in most Eurozone countries, Finnish mortgage rates are closely linked to short-term money market rates – rates at which banks lend to each other – rather than being fixed or linked to longer-term rates. Indeed, about 75% of the total housing loan stock is linked to these rates. And while mortgage rates have so far benefited from low short-term rates, this arrangement makes them also far more sensitive to rate increases by the ECB, which could raise its key rates as early as April.

The negative impact of interest rate hikes on household consumption is further compounded by household debt, most of which are mortgages, rising to 118% of disposable income in 2010 (compared with 108% in the Eurozone), with growth in consumer credit accelerating to 2.6% on the year in January (from 2.4% in December), and stocks of housing loans increasing by 6.9%. However, while increased interest payments are likely to contribute to slowing household consumption in the coming years, the impact for 2011 will be moderate. We forecast consumption to grow at 2.5% this year, and at about the same rate in 2012-15.

Overall, Finland is among the most robust Eurozone economies, benefiting from strong fundamentals. Beside possible disruptions related to an escalation of the crisis in the Middle East or to renewed financial tensions in the Eurozone, the main source of risks relates to the Finnish housing sector that could become overvalued.

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