Eurozone

EY Eurozone Forecast

September 2013

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Finland
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Germany
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Ireland
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Portugal
Slovakia
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Spain

Building a better working world

Outlook for Finland

Lackluster investment and exports to impede growth prospects

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Highlights

GDP growth
2013 -0.1%

GDP growth
2014 2.1%

- The Finnish economy is set to shrink by 0.1% in 2013, despite recent data indicating that it grew by a surprisingly strong 0.7% in Q2. The main driver behind the Q2 result was net exports, but this was only the result of imports falling more dramatically than exports. Fundamentally, weaknesses in external demand and business investment suggest that this pace will not be maintained in the near term.
- Over the medium term, GDP is forecast to grow by some 2.4% a year in 2014–17. External demand will remain fragile, as weak Eurozone investment suppresses demand for Finnish capital and intermediate goods. It is unlikely that export volumes will recover their pre-crisis levels during the forecast period.
- With industry's share in total output having fallen by more than 20% since 2008, the crisis has induced a large structural shift in the economy toward the service sector.
- Industry continues to operate well below historical levels of capacity, while the volume of new orders is declining. We expect investment to fall by 2.2% this year and, despite picking up in 2014, it will continue to be a drag on growth in the medium term.
- By contrast, private consumption remains relatively strong as household spending proves resilient to stagnant real income growth and high unemployment. We forecast consumption will rise by 0.9% this year, although there are downside risks if households start to deleverage accumulated debts (which in 2012 were over 110% of disposable income).
- Despite reaffirming a commitment to pursue fiscal tightening and a deficit of not more than 1% of GDP, the Government is unlikely to meet this target because of lower-than-expected revenue growth. We expect the deficit to peak at 2.3% of GDP this year, before falling in the medium term as economic growth returns.

Exports of goods and services growth
2013 -3.4%

Unemployment
2013 8.1%

Lackluster investment and exports to impede growth prospects

Strong Q2 growth, but caution needed as underlying problems persist …

Growth was considerably stronger than anticipated in Q2 2013, rising 0.7% on the quarter. The cause of this was a substantial contribution in net exports, but only because imports fell more dramatically than exports. In seasonally adjusted euro terms, imports of goods fell 8.6% on the quarter, while exports declined 2.1%.

The dramatic fall in imports is worrying. With retail sales stable since the start of the year, declining imports are probably symptomatic of a drop in intermediate demand. This does not bode well for the prospects of the industrial sector in the near term. We expect industrial production to fall by 4.6% this year, one of the largest drops in the Eurozone. The latest business surveys echo this sentiment. Industrial confidence continues to fall and the number of businesses reporting a drop in new orders is rising dramatically. As a result, we now expect GDP to fall by 0.1% this year, only a little better than 0.4% fall forecast in our June report.

… and external demand hampers growth prospects

As a small and open economy with over half of its exports heading to Europe, Finland's medium-term growth outlook depends heavily on the prospects for other countries. As a result, we forecast GDP growth of only about 2.4% a year in 2014–17.

Of particular concern is the level of Eurozone investment, set to fall by a further 3.7% this year, on top of a 4.2% contraction in 2012. As Finland produces mainly capital and intermediate goods, weak demand for investment goods has a big impact on its industrial production. Indeed, the volume of investment goods production in June fell by 9% year-on-year.

In the medium term, with prospects picking up in the Eurozone, we expect that external demand, particularly from Germany, will provide a much-needed boost to Finland's ailing industrial sector. Overall, we forecast exports will grow by about 3.4% a year on average in 2014–17, but this will not be enough to return volumes to their pre-crisis levels within the forecast period.

Finland (annual percentage changes unless specified)

	2012	2013	2014	2015	2016	2017
GDP	-0.8	-0.1	2.1	2.6	2.6	2.4
Private consumption	0.2	0.9	1.9	2.2	2.4	2.4
Fixed investment	-1.0	-2.2	1.7	2.3	3.5	3.2
Stockbuilding (% of GDP)	1.1	-0.2	-0.1	0.1	0.1	0.0
Government consumption	0.6	0.1	1.0	1.2	1.4	1.6
Exports of goods and services	-0.2	-3.4	2.2	3.9	3.8	3.7
Imports of goods and services	-1.0	-6.4	1.6	3.2	3.7	3.9
Consumer prices	3.2	2.2	1.4	1.5	1.6	1.7
Unemployment rate (level)	7.8	8.1	7.9	7.4	7.1	6.8
Current account balance (% of GDP)	-1.8	-0.3	0.3	0.6	0.8	0.8
Government budget (% of GDP)	-1.9	-2.3	-1.7	-1.1	-0.7	-0.4
Government debt (% of GDP)	53.0	54.7	54.3	53.2	51.7	50.1
ECB main refinancing rate (%)	0.9	0.6	0.5	0.5	0.5	0.7
Euro effective exchange rate (1995 = 100)	115.5	119.4	117.7	114.1	112.8	112.1
Exchange rate ($ per €)	1.28	1.31	1.24	1.19	1.18	1.18

Source: Oxford Economics.

Contrasting fortunes highlighted in domestic demand

Given the fragility of external demand, industry is operating well below historical levels of capacity. Therefore, it is not surprising that businesses are reluctant to invest while short-term prospects are so poor. We expect fixed investment to fall by a further 2.2% this year, before returning to growth in 2014. This will partly reflect improved growth prospects, but also a need to update an aging capital stock that has depreciated for two consecutive years. Investment growth will be modest in 2014–17, however, averaging just 2.7% a year.

In contrast, consumers seem to be faring much better than businesses. Consumption is set to grow by almost 1% this year, as household expenditure is proving robust to stagnant real incomes and an unemployment rate that is unlikely to fall below 8% until 2014.

Industrial weaknesses leading to structural changes ...

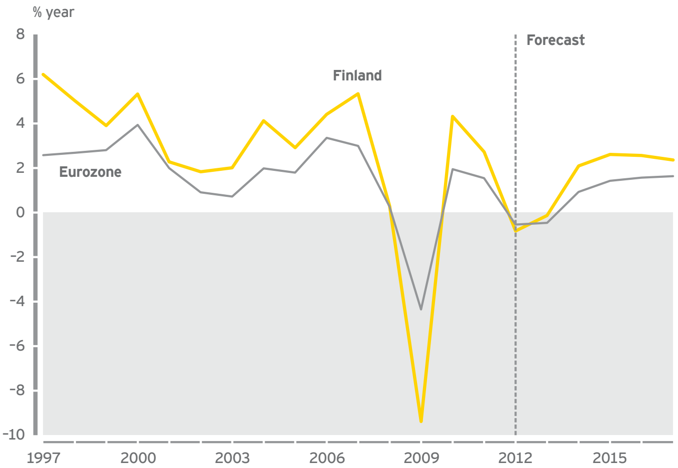
With industrial production in Finland closely linked to external demand, the Eurozone crisis has triggered deep structural changes in the domestic economy. Key sectors are facing numerous challenges. Weak Eurozone investment is inhibiting demand for capital goods and the telecommunications sector is suffering in the face of strong competition from Asia and the US. As a result, industry's share of total output has declined by 20% since 2008.

The Eurozone recovery will be slow, as austerity policies continue to bite and tight credit conditions restrain business investment. As a consequence, Finland's export growth in 2014–17 will be well below the 8% pace experienced in the decade prior to the crisis, and industry will not recoup its share of GDP in the foreseeable future.

The service sector has fared much better and is well placed to pick up some of the slack in the medium term. With a production line of highly skilled graduates emerging from a world-class education system, a business-friendly environment and well-established connections in Northern Europe, the services sector is able to compete on a global scale.

Figure 1

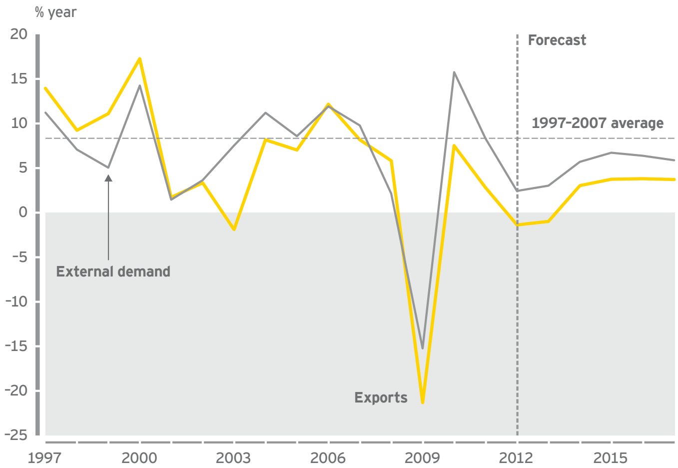
GDP growth



Source: Oxford Economics.

Figure 2

Exports and external demand



Source: Oxford Economics.

… but the need to deleverage will hit consumption

The financial crisis did not impede households' appetite for debt. Household debt as a proportion of disposable income rose from around 60% in 2000 to over 113% in 2012. Private consumption has been relatively strong as a consequence, despite stagnant growth in real incomes. This process also saw to an erosion of household savings, which fell steadily from over 4% of disposable income in 2009, to virtually zero last year, contributing further to the increase in household debt.

We forecast that private consumption growth will pick up gradually to around 2.2% a year in 2014–17, as real incomes rise in line with a stronger labor market and falling inflation. There are risks to this forecast, however — continued economic weakness may finally induce households to address current imbalances and begin the tough process of deleveraging.

Renewed commitment to fiscal prudence

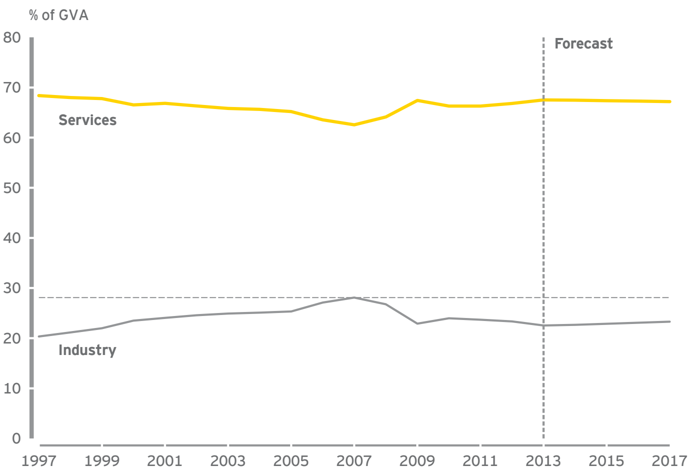
The Finnish Government publically reaffirmed a commitment to arrest the rise in public debt in August. A main objective of the prime minister's economic policy is to reduce public debt significantly by the end of his term in office.

But the Government is unlikely to meet its 1% deficit target by 2015, as revenues may disappoint on the back of sluggish GDP growth. Indeed, it is unlikely that this target will be met until at least 2016. As such, we forecast public debt to peak at around 54% in 2014, before starting to decline as economic growth picks up slowly over the medium term.

With a growing awareness that excessive austerity is impeding prospects in the Eurozone, we believe there is room for the Government to pursue a more expansionary fiscal policy. Finland is the only Eurozone country to still have a AAA credit rating and a stable outlook from all three main ratings agencies. Given that borrowing costs are at record lows, the Government may have missed an opportunity to stimulate the economy in the short term and to leave the bulk of the fiscal adjustment for when the recovery is more entrenched. A second cut in corporation tax from 24.5% to 20%, set for 2014, is heartening and it is hoped that similar initiatives will follow.

Figure 3

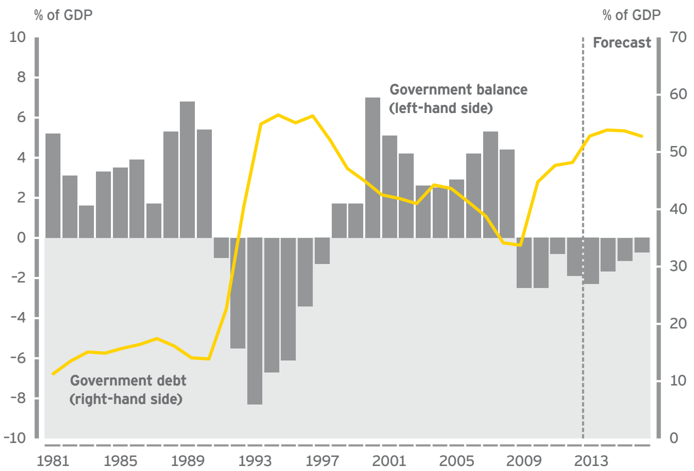
Nominal GVA breakdown



Source: Oxford Economics.

Figure 4

Government balance and debt



Source: Oxford Economics.

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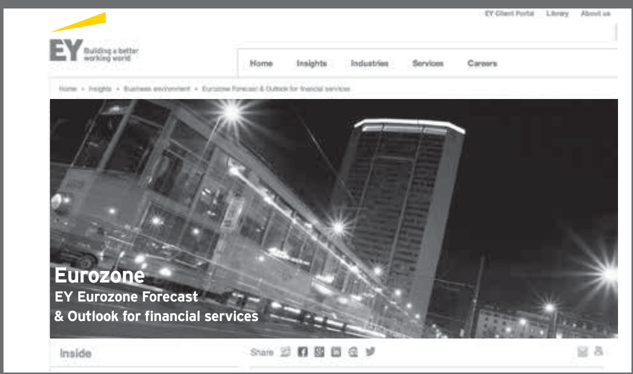

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