



Eurozone

EY Eurozone Forecast

December 2013

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Cyprus

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Greece

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Outlook for Finland

Growth resumes, but Finland must strengthen export sector



Published in collaboration with



Highlights

GDP growth

2013 **-1.1%**

GDP growth

2014 **1.3%**

- ▶ Finland's one-year recession is over. The recovery is expected to be slow, although the country is starting from a relatively strong position. After a fall of about 1% in 2013, we expect GDP growth of just 1.3% in 2014, as weaknesses both at home and abroad persist. Over the medium term, GDP will grow by 2.2% a year in 2015-17.
- ▶ Exports are one of the key drivers of Finnish growth. As the export sector is concentrated in capital goods, it is particularly sensitive to the business cycle. This leaves Finland heavily exposed to the fragile recovery in the Eurozone, as ample spare capacity will limit the short-term investment needs of the region. As a result, we forecast exports will grow by a relatively modest 2% in 2014.
- ▶ The budget deficit will continue to rise into 2014, pushing the debt burden above 60% of GDP. But it remains low by Eurozone standards and Finland's AAA credit rating does not seem under threat. This gives the Government scope to further support demand, especially in the short term. Encouraging entrepreneurship and innovation could be most helpful.
- ▶ With its strong competitiveness and highly educated workforce, Finland has the capacity to strengthen and diversify its export sector, and fill the void left by the decline in the forestry and electronics sectors.
- ▶ The need for households to deleverage and modest wage increases will hold back consumption at 0.7% in 2014, and just over 2% a year in 2015-17. Investment is set to increase by just 0.4% in 2014, due to the uncertain outlook.

Consumer prices

2014 **1.0%**



Unemployment

2014 **8.0%**



Slow growth from a relatively strong position

The Finnish economy returned to growth in Q2 2013 after a year-long recession. But even after a pickup in the quarterly growth rate to 0.4% in Q3, this will not be sufficient to avoid a contraction of about 1% in GDP for 2013 as a whole.

The economy is set to grow by 1.3% in 2014, followed by growth of 2.2% a year in 2015-17. The recovery in global economic growth will lead to a gradual pickup in foreign demand for goods and services produced in Finland. But broad-based weaknesses in the economy will take some time to resolve, leading to a slow recovery thereafter. The recession has precipitated

the structural decline of key sectors and exposed a lack of diversification in Finland's exports. At home, high household debt will constrain growth.

The slowdown in economic growth is limiting efforts to consolidate the fiscal position, undermining the cornerstone of the Government's fiscal policy. Despite a series of spending cuts and tax increases, the budget deficit will climb to over 4% of GDP in 2014 as revenues disappoint, which in turn will lift the debt-to-GDP ratio to around 60%.

Furthermore, current growth projections in revenues and expenditure suggest that, without further belt-tightening, the Government will fail in its pledge to bring

about a decline in the level of debt before the end of its term in office. With this in mind, we see government consumption growing by just 1.3% a year in 2015-17. Despite this, the level of public debt remains low by European standards, and Finland's AAA status does not seem under threat. In our view, the Government has plenty of scope to support demand in the short term.

Weaknesses at home and abroad will hold back the recovery

Consumption and positive net exports are underpinning this slow growth. However, the fact that imports fell much more steeply than exports illustrates the fragility of the domestic economy.

Table 1

Finland (annual percentage changes unless specified)						
	2012	2013	2014	2015	2016	2017
GDP	-0.8	-1.1	1.3	2.0	2.2	2.3
Private consumption	0.2	-0.4	0.7	1.9	2.1	2.3
Fixed investment	-1.0	-1.4	0.4	2.5	3.4	3.0
Stockbuilding (% of GDP)	1.1	-1.2	-0.1	-0.1	-0.2	-0.2
Government consumption	0.6	0.6	0.7	1.1	1.3	1.4
Exports of goods and services	-0.4	-1.9	2.0	3.8	3.8	3.5
Imports of goods and services	-1.2	-5.9	3.3	3.6	4.0	3.7
Consumer prices	3.2	2.0	1.0	1.6	1.9	1.9
Unemployment rate (level)	7.7	8.1	8.0	7.8	7.6	7.3
Current account balance (% of GDP)	-1.7	-0.7	0.2	0.5	0.7	1.0
Government budget (% of GDP)	-1.8	-3.2	-4.1	-3.5	-2.7	-1.8
Government debt (% of GDP)	53.6	56.6	59.2	60.6	60.9	60.3
ECB main refinancing rate (%)	0.9	0.5	0.3	0.3	0.3	0.4
Euro effective exchange rate (1995 = 100)	115.5	120.3	119.5	117.6	114.9	113.9
Exchange rate (\$ per €)	1.28	1.32	1.29	1.25	1.22	1.20

Source: Oxford Economics.

Investment will drive domestic demand over the medium term

Current uncertainty surrounding the outlook for consumption and export growth is motivating businesses at home to delay their investment decisions. Investment is forecast to fall by 1.4% this year and, given current spare capacity, its growth in 2014 will be marginal. But as export growth gains traction over the medium term, investment will follow suit, increasing by around 3% a year in 2015-17, as firms look to replace an aging capital stock and ramp up production levels to meet rising demand.

Modest wage increases and household debt restrict consumption

The national labor and employer confederations concluded the latest round of centrally coordinated wage negotiations in August 2013, agreeing upon a set of modest increases over the coming years. A primary aim of the agreement is to restore sustainable economic growth through an increase in employment. And with an unemployment rate of 18% for those aged 15-24, it is hoped that the pact can achieve its objective and arrest the worrying trend of increasing youth unemployment. However, the agreement will do

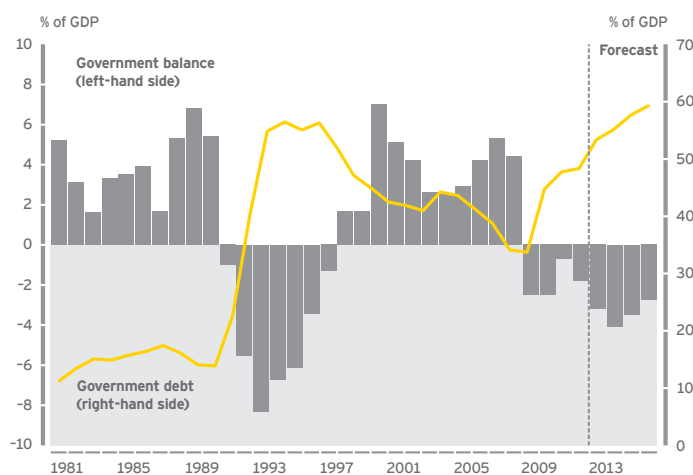
very little for household disposable incomes, already hit by a tighter taxation policy that has included a hike in value-added tax at the start of 2013.

Meanwhile, a sustained increase in house prices has fueled an accumulation of household debt over the last decade. In 2012, the value of households' financial liabilities amounted to over 120% of disposable income, up from 72% in 2002. Households will therefore need to deleverage over the medium term, and we expect a steady increase in the savings ratio as a result. This, coupled with modest income growth, will inhibit private consumption over the medium term. We expect private consumption to grow by just over 2% a year on average in 2015-17.

Diverse export sector will be the key to long-term growth

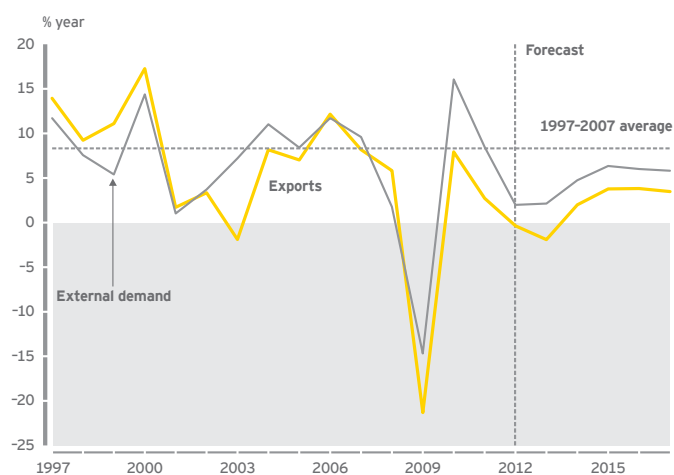
Finland's trade performance has suffered from the structural decline of the electronics and forestry industries, which occurred simultaneously to the Eurozone recession. Its share in the global export market has fallen by over 20% in the last five years as a result, pushing the current account into deficit after posting a surplus of over 8% of GDP just a decade ago.

Figure 1
Government balance and debt



Source: Oxford Economics.

Figure 2
Exports and external demand



Source: Oxford Economics.

Table 2

Forecast for Finland by sector (annual percentage changes in gross added value)						
	2012	2013	2014	2015	2016	2017
Manufacturing	-8.4	-3.6	2.4	2.8	2.9	3.1
Agriculture	-4.3	-1.8	-0.5	0.4	0.6	0.6
Construction	-4.8	-4.0	3.4	2.3	1.6	1.5
Utilities	9.9	-2.0	-1.1	0.2	0.8	1.2
Trade	0.7	-0.9	0.9	2.2	2.5	2.6
Financial and business services	1.7	-0.2	0.9	1.8	2.0	2.3
Communications	3.6	1.0	2.3	3.4	3.8	4.1
Non-market services	-0.7	0.4	0.5	1.1	1.4	1.5

Source: Oxford Economics.

Growth resumes, but Finland must strengthen export sector

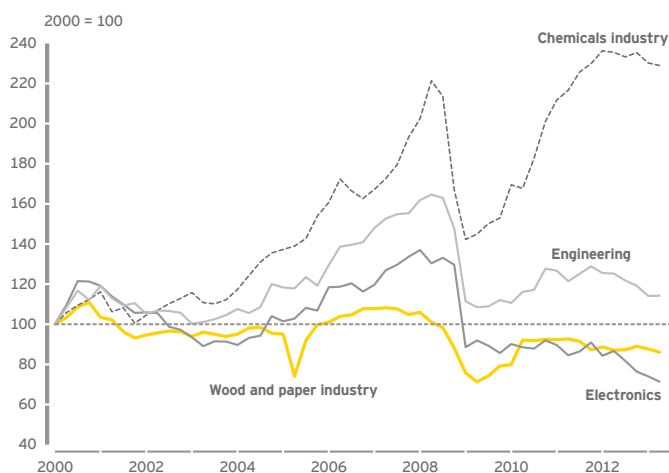
The economy now faces an over-reliance on intermediate and capital goods production, accounting for nearly 80% of total exports – demand for which is volatile and sensitive to the business cycle. With over half of all exports shipped to countries in the European Union (EU), Finland is left exposed to the fragile recovery in the region. Uncertainty surrounding the immediate economic outlook and ample spare capacity in production is limiting the short-term investment needs of the EU. In 2014, new orders will be slow to respond, as the pickup in fixed investment expenditure in Europe will lag behind the projected recovery in output. As such, exports are expected to grow by a relatively modest 2% in 2014.

Ready to adapt to the new market conditions

As a small and open economy, Finland's medium-term growth outlook is still reliant on a pickup in external demand. Export volumes will slowly improve as the global recovery gains momentum from 2014 onwards, supported by improved cost competitiveness through wage moderation over the medium term. We forecast export growth to average 3.7% a year in 2015-17. However, this will remain some way off replicating pre-crisis levels and significant investment will be required in product development to diversify the export offering and fill the gap left by the demise of the key sectors highlighted above.

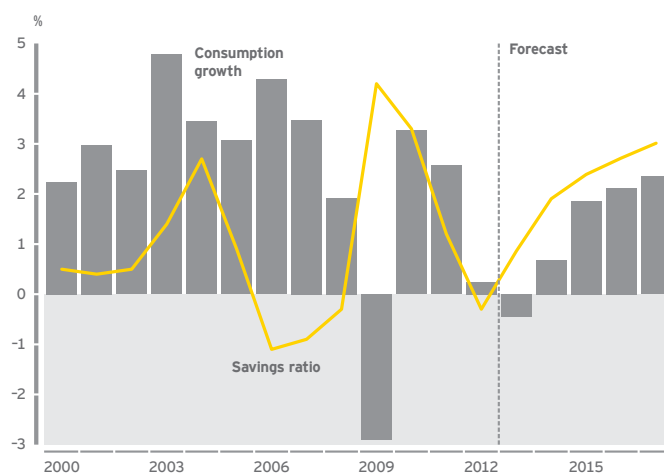
Over the longer term, Finland is well positioned to overcome this period of structural transition. The environment remains highly competitive, as highlighted by the World Economic Forum's latest *Global Competitiveness Report*, which sees Finland retain its top-three position in the overall index. In particular, the country benefits from a very well-educated workforce and a strong institutional framework. The key to regaining market share over the long term lies in encouraging more entrepreneurship and innovation and increasing the number of globally marketable products that emerge from Finland's high research and development capacity.

Figure 3
Key manufacturing sectors



Source: Haver Analytics.

Figure 4
Private consumption and savings



Source: Oxford Economics.

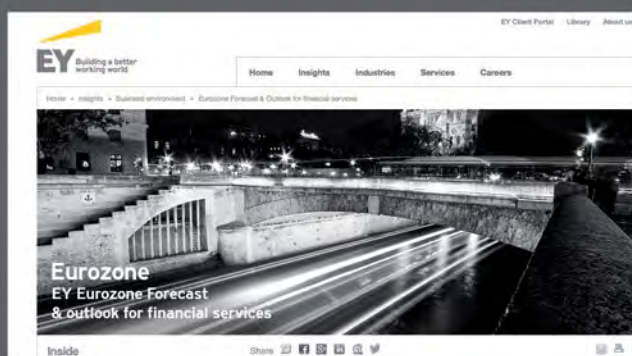
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