

Eurozone

EY Eurozone Forecast

June 2014

Austria
Belgium
Cyprus
Estonia
Finland
France
Germany
Greece
Ireland
Italy
Latvia
Luxembourg
Malta
Netherlands
Portugal
Slovakia
Slovenia
Spain



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Outlook for Finland

Recovery delayed as exports disappoint



Published in collaboration with

Highlights

GDP growth
2014 | 0.0%

GDP growth
2015 | 1.6%

- The slow recovery in the Eurozone will largely bypass Finland in 2014. Finnish GDP fell 0.4% in Q1 and is now expected to remain flat for the year overall, as the economy struggles in the face of significant headwinds at home and abroad.
- Prospects for a consumer-led recovery are poor. The labor market has continued to disappoint at the beginning of 2014 and will remain weak against the backdrop of lackluster growth in output. Household incomes will experience a small contraction, restricted by the combination of an increasing tax burden and muted earnings growth, despite some relief from lower inflation. And consumer spending will remain broadly flat.
- Finland's export volumes have disappointed in recent years, affected by a loss of cost competitiveness, a stubbornly strong euro, and the decline of key industrial sectors. And with the immediate outlook further depressed by tensions in Ukraine and the impact on the Russian economy, exports are forecast to grow by just 0.4% in 2014.
- Overall investment expenditure is expected to fall by 1.6% this year, as disappointing export orders and spare capacity in production impair business investment expenditure.
- In the medium term, there is no obvious catalyst for growth. In particular, exports will remain below pre-crisis levels, as the industrial sector continues to lose market share. And with domestic demand unlikely to take up the slack, GDP is expected to grow by just 1.6% in 2015 and then about 1.9% a year in 2016-18.
- Meanwhile, in order to bring to a halt the rising public debt burden, the Government recently announced a series of new austerity measures as part of the budgetary plan for 2015-18. This commitment to improving public finances should ensure that Finland's debt-to-GDP ratio remains below the 60% threshold stipulated in the European Commission (EC) Stability and Growth Pact, which will balance the budget by 2018.

Unemployment
2014 | 8.4%

Consumer prices
2014 | 1.2%

Recovery delayed as exports disappoint

Stagnant growth in 2014 amid downside risks

Finland's economy disappointed toward the end of 2013, and there is little evidence to suggest that the environment has improved at the start of this year. Indeed, Q1 GDP data shows a 0.4% fall from Q4 2013. And high frequency indicators suggest that output is still falling modestly. Manufacturing figures have been particularly weak, with industrial production down 3.2% in Q1. Meanwhile, the unemployment rate has ticked up to 8.5% and confidence has receded after reaching an 18-month high in December, according to the EC's Economic Sentiment Indicator.

The crisis in Ukraine also seems to be taking its toll. Goods exports fell by 3.6% in value terms in Q1, with a decline in demand from Russia the most likely reason for the poor

performance. Demand should strengthen a little over the course of the year, both at home and abroad, but overall we now expect the economy to stagnate in 2014. This is down from a 0.6% increase projected in our March report.

As a small open economy with a large manufacturing base, Finland's hopes for a sustained recovery in output rest with a strong rebound in trade. But the conflict in Ukraine and resulting tensions between the European Union (EU) and Russia appear to be putting pressure on Finland's struggling economy. Russia is one of Finland's largest trade partners, taking over 9% of its total exports in 2013. But growth prospects for Russia have declined significantly since the conflict began, with the International Monetary Fund recently suggesting that the country is probably in recession.

Finland's tourism is also in decline. The number of Russian visitors (which normally account for over 25% of all foreign arrivals) fell by 15% on the year in February. Foreign demand should strengthen moderately toward the end of the year as the global recovery gathers momentum and tensions subside in Ukraine. But Finland has experienced a deterioration in competitiveness relative to rival countries due to rising unit labor costs. For this reason, exporters will struggle to capitalize on this pickup in global trade, especially if the euro retains its current strength. We forecast that exports will grow by just 0.4% in 2014, and with imports growing at a similar rate, the net contribution from trade will be negligible.

Table 1

Finland (annual percentage changes unless specified)

	2013	2014	2015	2016	2017	2018
GDP	-1.4	0.0	1.6	1.7	1.9	2.1
Private consumption	-0.8	0.0	1.6	1.6	1.8	1.8
Fixed investment	-4.6	-1.6	3.7	2.3	2.3	2.3
Stockbuilding (% of GDP)	0.0	0.3	-0.3	-0.4	-0.5	-0.5
Government consumption	0.8	0.5	1.1	1.2	1.3	1.4
Exports of goods and services	0.3	0.4	2.5	2.7	2.8	2.9
Imports of goods and services	-1.8	0.7	2.1	2.4	2.5	2.6
Consumer prices	2.2	1.2	1.6	2.0	2.0	2.0
Unemployment rate (level)	8.2	8.4	8.0	7.6	7.4	7.2
Current account balance (% of GDP)	-1.1	-0.7	-0.3	-0.1	0.0	0.1
Government budget (% of GDP)	-2.1	-2.6	-2.1	-1.1	-0.5	-0.1
Government debt (% of GDP)	57.0	59.2	59.5	58.5	56.8	54.6
ECB main refinancing rate (%)	0.5	0.2	0.1	0.1	0.4	1.4
Euro effective exchange rate (1995 = 100)	120.8	125.3	123.7	122.4	121.7	120.9
Exchange rate (US\$ per €)	1.33	1.37	1.34	1.32	1.31	1.29

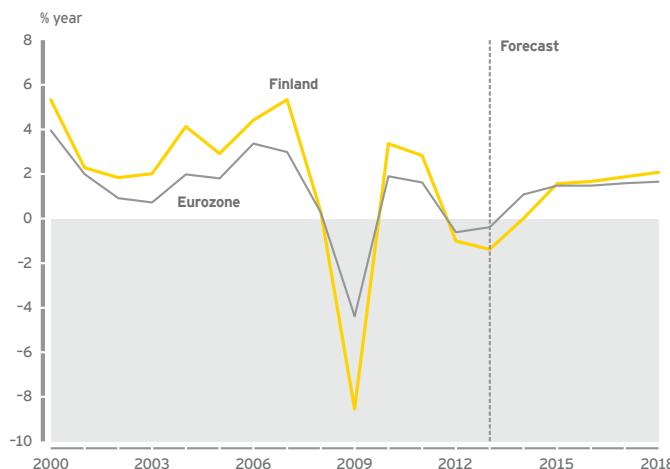
Source: Oxford Economics.

Domestic fundamentals are providing little encouragement. Households underpinned a strong economic recovery in 2010-11, but they are unlikely to be able to repeat this strength this time around. Modest wage growth and an increasing tax burden will result in a small decline in real disposable incomes for 2014, despite a notable slowdown in consumer price inflation, which is expected to average just 1.2% in 2014.

The unemployment rate rose to 8.5% in Q1, and is expected to remain close to this level for most of the year, while youth unemployment now stands at over 20%. Consumer confidence remains low as a consequence, which has led to a marked deterioration in expectations in the retail sector. With demand for consumer credit also weak, despite prevailing low interest rates, we expect consumer spending to remain stagnant in 2014.

Meanwhile, overall investment expenditure is expected to shrink by 1.6%. Disappointing export orders and spare capacity in production will limit business investment, while a 22% annual decline in building permits in January and February combined suggests a slowdown in construction activity also.

Figure 1
GDP growth



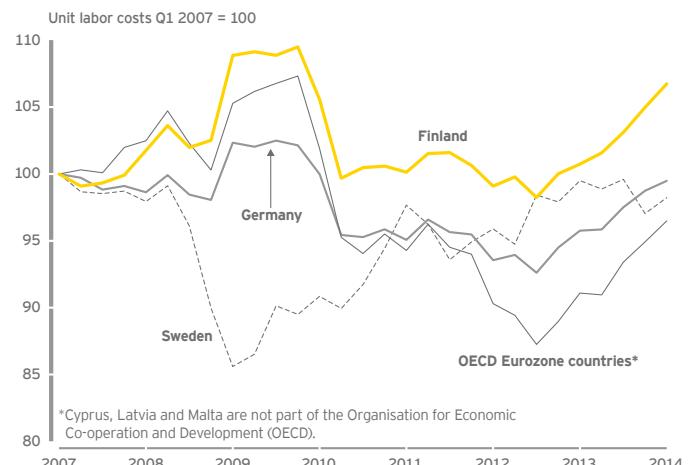
Source: Oxford Economics.

Medium-term outlook lacks obvious catalyst for growth

Finland's export performance has deteriorated in recent years, driven by a loss in cost competitiveness, a stubbornly strong euro, and the structural decline of both the electronics and forestry industries – key growth engines of the pre-crisis boom. As a result, the economy is facing a lengthy period of industrial restructuring. Sustained growth over the medium term will require large investment to develop new sectors and boost productivity.

In the meantime, the country's export mix has been left highly concentrated, and uncertainty in the global economic outlook will limit demand for Finnish capital goods. Indeed, private sector business investment expenditure (in real terms) in the Eurozone is not expected to reach 2008 levels for another six years. And it will take time for future wage restraint, following the Pact for Employment and Growth (the national agreement on wages and salaries for the next three years), to have an impact on the cost competitiveness of the industrial sector. As such, Finland will continue to lose global market share at a worrying rate, with export volumes forecast to grow by just 2.5% in 2015, and 2.8% a year in 2016-18, well below pre-crisis levels.

Figure 2
International competitiveness



Source: Oxford Economics; Haver Analytics.

Table 2

Forecast for Finland by sector (annual percentage changes in gross added value)

	2013	2014	2015	2016	2017	2018
GDP	-1.4	0.0	1.6	1.7	1.9	2.1
Manufacturing	-3.3	-2.3	4.4	3.7	3.6	3.6
Agriculture	2.6	-2.9	-1.5	-1.1	-0.7	-0.3
Construction	-2.7	2.3	2.1	1.4	1.2	1.4
Utilities	0.7	-1.0	0.1	0.5	1.0	1.4
Trade	-3.6	0.8	0.9	1.3	1.6	1.8
Financial and business services	-0.7	-0.6	0.5	1.1	1.5	1.8
Communications	2.4	1.2	2.1	2.4	2.8	3.2
Non-market services	-0.7	1.5	0.9	1.1	1.3	1.4

Source: Oxford Economics.

Recovery delayed as exports disappoint

The Pact for Employment and Growth was heralded as a success for Finland's struggling industrial sector, as it targets an improvement in international competitiveness. But the agreement prescribes a series of modest wage increases over the next three years, which will prevent any strong growth in household disposable incomes. In addition, we expect households to maintain a high level of savings over the medium term. Household debts have risen steadily in recent years, pushing up to a level in excess of 120% of disposable incomes in 2013. So a positive savings ratio will allow households to begin the steady process of deleveraging over the forecast period. This will further limit growth in consumer spending, which is expected to average just 1.7% in 2016-18, after a rise of 1.6% in 2015.

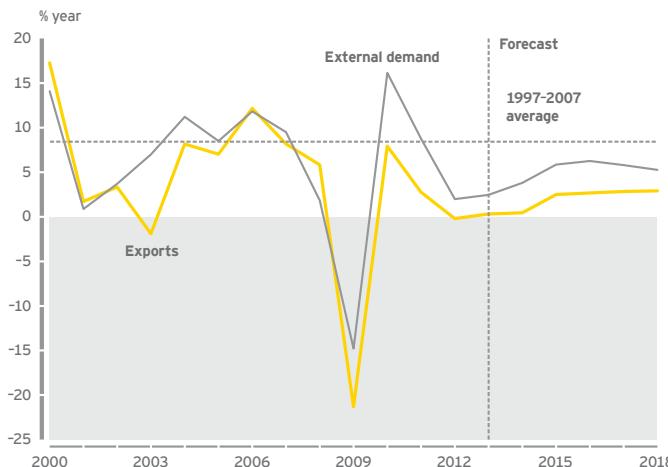
Fixed investment expenditure should experience a better turnaround in response to a higher level of capacity utilization and a more sustained pickup in external demand, albeit with a delay and from a very depressed level. We expect GDP to grow by just 1.6% in 2015, accelerating to about 1.9% a year over 2016-18. This may be enough to outperform the Eurozone average slightly, but will be disappointing by historical standards for Finland.

Further austerity measures to improve public finances

After a decade of running a surplus, government finances slipped into deficit in 2009, following the onset of the global financial crisis. And despite continued consolidation efforts, the size of the government debt has steadily risen from 32% of GDP in 2008 to 57% last year. In response, the Finnish Government recently announced a series of new austerity measures as part of its fiscal plan for 2015-18. The new package, which includes a series of small changes to a number of revenue and expenditure items, means that the combined fiscal consolidation efforts will amount to €6.6b by 2017 (equal to 3% of GDP). As a result, we expect Finland to maintain its AAA sovereign credit rating, despite Standard and Poor's recent downgrade of its outlook to negative.

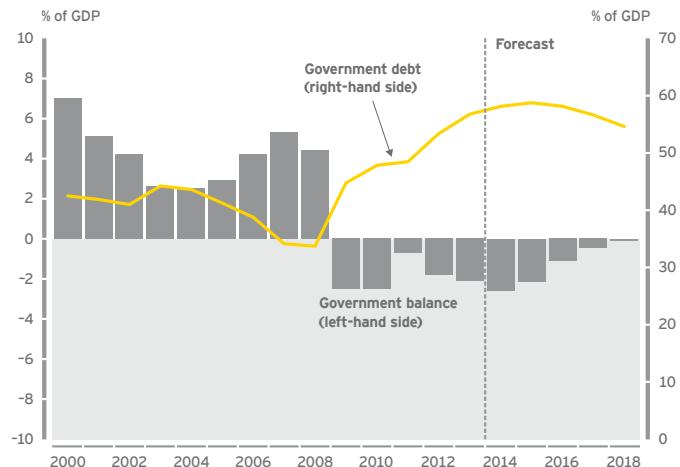
The new austerity package, which is expected to eliminate the fiscal deficit by 2018 (and in the process prevent the debt burden from rising above the 60% threshold stipulated in the EC's Growth and Stability Pact), has led to some political uncertainty within the ruling coalition, especially with Prime Minister Jyrki Katainen due to step down in June to seek a position within the EU.

Figure 3
Exports and external demand



Source: Oxford Economics.

Figure 4
Government balance and debt



Source: Oxford Economics.

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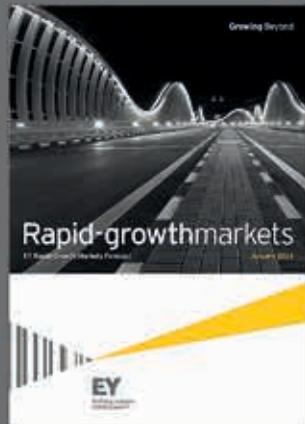


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