Analysis

Cost competitiveness is key in replacing lost trade with Russia

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Finland's cost competitiveness has strengthened in recent years, but it has yet to fully recover to the level attained before the 2008 financial crisis. Based on current projections, cost competitiveness will improve slightly in 2022 and remain almost unchanged in the immediate years ahead. Finland's more favourable structure of exports and imports relative to its peers will help in maintaining cost competitiveness in the face of rising costs caused by Russia's invasion of Ukraine. Maintaining cost competitiveness is highly important now and in the coming years as Finnish companies wind down their trade with Russia and look for new markets for their products and services. In the short term, cost competitiveness will be supported by Finland's terms of trade.



Finland's economic competitiveness can be examined from two perspectives: cost competitiveness and non-cost competitiveness. Non-cost competitiveness, or the ability to produce high added value goods that are in demand on global markets, sits at the foundation of a country's success.

Cost competitiveness is also important, especially for countries such as Finland, where exports play an important role in the national economy. Companies that are competitive with respect to costs are more successful in international markets. Higher cost competitiveness contributes to the prospects for output and employment in industries that engage in international trade, which together form the economy's tradable sector. Increasing the income generated by the tradable sector supports output and employment throughout the entire economy. Thus, over time, the impacts of cost competitiveness are also reflected in domestic markets.

Cost competitiveness will play an especially important role now and in the near term as a large number of Finnish companies wind down their trade with Russia and look for new markets for their products and services. This article looks at Finnish cost competitiveness in recent years and how it is projected to evolve based on the European Commission's May 2022 forecast and the June forecasts of the Bank of Finland and the European Central Bank.

Subdued growth in labour costs in recent years has improved Finland's cost competitiveness

The simplest measure of cost competitiveness is the relative labour cost (or price), which compares labour costs per employee across countries, all expressed in the same currency.

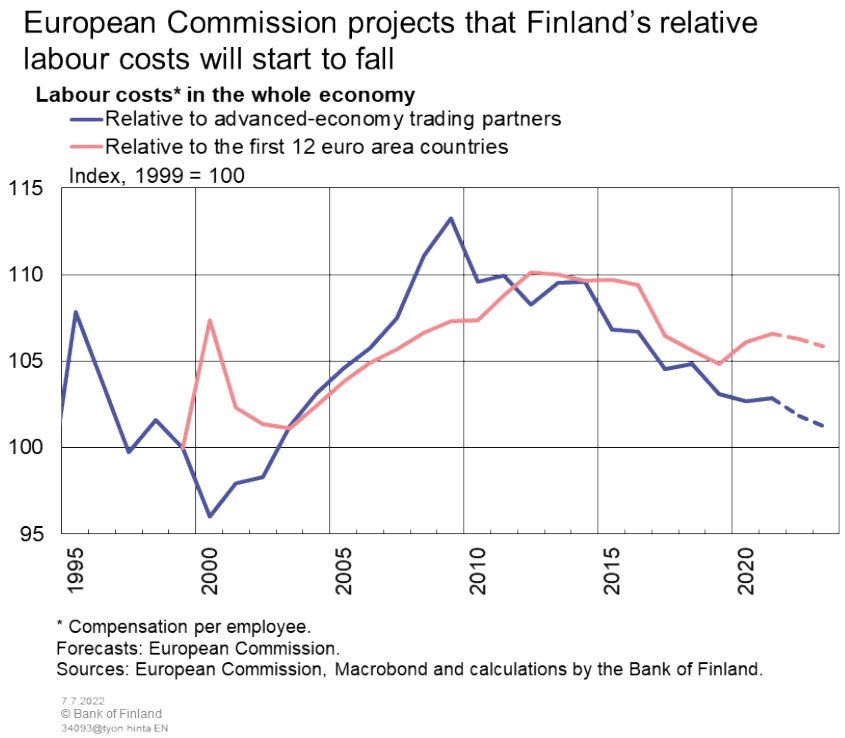
Forecast errors for labour costs in Finland are significantly smaller, on average, than forecast errors for labour productivity, so it might be prudent to weight changes in relative labour costs when forecasting cost competitiveness (Kajanoja and Pönkä, 2021). Given the current environment of heightened uncertainty, forecasting changes in labour costs and productivity is difficult.

As illustrated in Chart 1, Finland's relative labour costs declined in the 2010s compared with the first 12 euro area countries and a larger group of advanced-economy trading partners.[1] Comparisons with the euro area are useful, as a large share of Finnish exports are to markets in the euro area and exchange rate fluctuations can be ignored when comparing countries within the monetary union. In recent years labour costs have grown more slowly in Finland than in the larger group of advanced-economy trading partners. According to the European Commission's latest forecast published in May 2022, labour cost growth will also continue to be slower in Finland than in the advanced-economy trading partners group in the coming years. Contributory factors here are a depreciating euro and rapid wage growth, especially in the United States.

Compared with the first 12 euro area countries, Finland's relative labour costs began to increase slightly around the start of the COVID-19 pandemic. By this measure Finland's relative labour costs have been contributing negatively to Finnish competitiveness since 2019. Before the pandemic, Finland's relative labour costs had been decreasing since 2016, largely as a result of the Competitiveness Pact.

Any comparison of changes in labour costs that occurred during the COVID-19 pandemic is made difficult by the different publicly-funded short-time working schemes introduced by governments to cushion the impact of the crisis. The rise in Finland's relative labour costs will remain short-lived according to European Commission's latest forecast, and a slight decline is projected in 2022–2023. It is worth noting that projections of labour costs in the immediate years ahead are subject to exceptional uncertainty stemming from the economic effects of the war and high inflation.

Chart 1.



European Commission forecast sees Finnish cost competitiveness remaining higher than before

For many years between 2000 and 2015, there was a deterioration in Finland's cost competitiveness measured using relative unit labour costs adjusted for the terms of trade (Chart 2). Cost competitiveness has since improved, especially as a result of the 2017 Competitiveness Pact and moderate wage settlements. Using the same measure, competitiveness remained virtually unchanged during the pandemic years of 2020–2021 relative to both the euro area countries and the larger group of trading partners. Based on currently available data, Finland's competitiveness declined slightly in 2021.

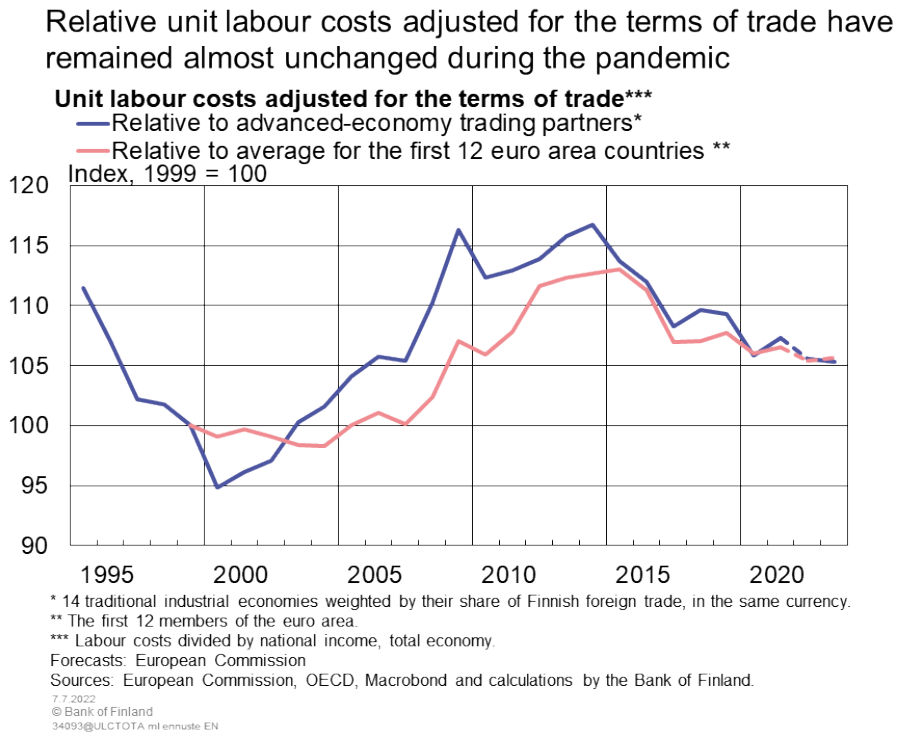
The European Commission's forecast projects that Finnish competitiveness will improve marginally in 2022 and level out in 2023. According to the Commission's projections, Finland's cost competitiveness in 2022 will be better than its 2019 pre-pandemic level relative to both comparator groups of countries.

Measurements of cost competitiveness recorded during the pandemic should be treated with caution. In addition, the economic effects of the Ukraine war make it more difficult to predict changes in competitiveness. Productivity growth, which is needed for calculating changes in unit

labour costs, is difficult to forecast because of the crises but is expected to fall short of earlier projections both in Finland and in other countries. This puts upward pressure on projections of unit labour costs.

Another factor determining the accuracy of the near-term forecasts will be the pay settlements reached in different countries in an environment of high and rising inflation. The Bank of Finland's earnings forecast is based on the collective bargaining agreements made so far in the current round of negotiations, in which wage rises for 2022 are around 2%, but the latest pay settlement for municipal workers was made after the Bank's forecast.

Chart 2.



It has been important that the terms of trade are taken into account when assessing Finnish cost competitiveness, as Finland's terms of trade were on a long decline during the late 1990s and the first decade of the new millennium (Chart 3). The terms of trade are defined as the ratio between a country's export and import prices. As a result of the decline in the terms of trade, relative labour costs were not as useful for measuring cost competitiveness in Finland as they were in most comparator countries (Kajanoja, 2017). When the terms of trade are weakening, changes in the terms-of-trade-adjusted GDP will account for the diminished impact of GDP changes on real domestic income (Kajanoja, 2017).

Finland's terms of trade have improved somewhat during the past decade and in 2021 stood at

about the same level as in 2007.

Chart 3.



Moderate labour cost growth has improved Finland's cost competitiveness since the 2010s

We examine below how different factors have contributed to changes in cost competitiveness as measured by unit labour costs adjusted for the terms of trade. As illustrated in Chart 2, Finland's relative unit labour costs adjusted for the terms of trade have mostly declined since the 2010s, which means that Finnish cost competitiveness has improved. This is largely due to labour costs growing more moderately in Finland than in the comparator countries (Chart 4).

Exchange rates have also played a fairly large role when looking at the comparator group of advance-economy trading partners, which includes countries outside the euro area. While exchange rate movements have weakened Finland's cost competitiveness to an extent during some years, over the review period as a whole they have strengthened Finland's competitiveness. The impact of labour productivity on cost competitiveness has fluctuated during the 2010s, but its cumulative effect has been negative. That is, labour productivity has increased at a slower rate in Finland than in the comparator countries. The terms of trade have had a negative, though rather small, cumulative impact on cost competitiveness, through the 2010s.

In recent years labour productivity has had an increasingly large impact on cost competitiveness. Finland's competitiveness declined in 2021 largely because labour productivity growth was lower in Finland than in the comparator countries. On the other hand, labour productivity had a substantial strengthening effect on competitiveness in 2020, as Finland's economic contraction caused by the COVID-19 crisis was smaller than in most other countries. Similarly, Finland's labour productivity growth lagged behind that of most of the comparator countries in 2021 largely because Finland had less of a pandemic gap to close.

The European Commission expects labour productivity to have only a small impact on Finnish competitiveness in 2022 and 2023. According to the Commission's forecast, productivity will increase at a similar rate in Finland and in the first 12 euro area countries and the larger group of advanced-economy trading partners. However, it should be stressed that productivity forecasts are highly uncertain in the current economic environment and productivity estimates recorded during the pandemic may yet be revised.

Labour costs increased at a slower pace in Finland than in the comparator countries during the first year of the pandemic in 2020 and, after labour productivity, had the second largest positive impact on Finnish competitiveness. When labour costs rise more moderately at home than abroad, domestic companies become relatively more cost efficient and cost competitiveness is improved, provided other factors remain unchanged. In 2021 labour costs had a small but negative impact on Finnish competitiveness. The European Commission forecasts that labour cost growth will be slightly more moderate in Finland than in other countries in 2022 and 2023, suggesting that labour costs will contribute positively to Finnish competitiveness.

In contrast to the 2010s, exchange rates movements in 2020 and 2021 had only a small impact on unit labour costs adjusted for the terms of trade. The European Commission projects that the role of exchange rates will be larger in 2022, with exchange rate movements helping to strengthen Finnish competitiveness, as the euro is projected to depreciate against other currencies.

The terms of trade had a significant strengthening impact on Finnish competitiveness in 2021. The European Commission's forecast projects the same for 2022. Finland's exceptionally strong terms of trade relative to those of comparator countries during these two years are largely a result of the structure of Finland's exports and imports. The rise in energy and raw material prices in 2022 due to Russia's invasion of Ukraine and the pre-existing shortages of intermediate goods have significantly increased the costs faced by companies in Finland and in the comparator countries.

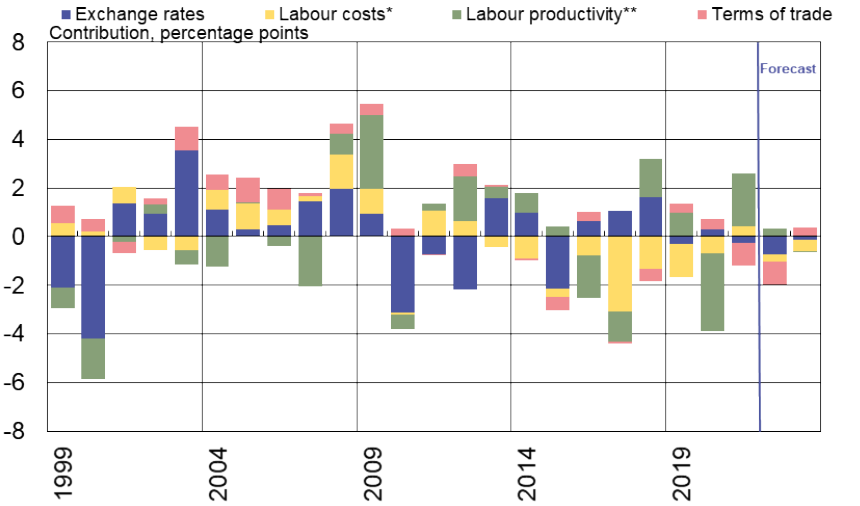
However, unlike many of the comparator countries, Finland is a major exporter of raw materials and petroleum products. While the prices of Finnish imports have risen as a result of the war, so have the prices of Finnish exports. This means that Finland's terms of trade are projected to

strengthen relative to those of most of the comparator countries. This will, as a result, improve Finland's relative unit labour costs adjusted for the terms of trade. Finland's structure of exports and imports will thus support Finnish competitiveness in the short run. In the longer term, however, Finland's economic growth and living standards would benefit from a production structure capable of producing higher value added.

Chart 4.

Labour productivity has had a large impact on cost competitiveness in recent years

Contributions to annual change in relative* unit labour costs adjusted for the terms of trade**



* Compensation per employee. ** GDP per person employed.
*** Finland relative to 14 traditional industrial economies.
Sources: Euroopan Comission, OECD, KLEMS, Macrobond and calculations by the Bank of Finland.

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Table 1 lists the European Commission's projected changes over the period 2019 to 2023 for unit labour costs in the whole economy and for its components labour productivity and labour costs, which are also part of the indicators of cost competitiveness outlined above. Finnish labour costs grew slightly faster than the euro area average in 2020 and 2021 and contributed to the divergence in unit labour costs. In 2022 and 2023 the European Commission projects that labour costs will increase somewhat faster in the euro area. As noted, labour productivity has had a larger impact on cost competitiveness than labour costs during the review period covered in Table 1, as the differential in productivity growth between Finland and the euro area is larger than the differential in labour cost growth. Productivity growth in Finland has mainly been slow relative to the euro area, and the European Commission projects this trend to continue.

Before the COVID-19 pandemic in 2019, Finland's unit labour costs increased at the same pace as the euro area's despite the decline in labour productivity. This was due to Finland's moderate labour cost growth. In 2020 the COVID-19 pandemic caused a sharp dip in the euro area's

productivity, but in Finland productivity weakened significantly less. As stated earlier, this temporarily boosted Finland's competitiveness. Although, at the same time, Finland's labour costs increased at a faster pace than in the euro area, growth in Finland's unit labour costs remained below the euro area average. As the gradual recovery from the worst of the pandemic began in 2021, growth in labour costs picked up quite strongly in Finland and in the euro area. In parallel with this, Finland's productivity growth was substantially weaker than in the euro area, resulting in Finland's unit labour costs increasing at a pace higher than the euro area average.

According to the European Commission's projections, Finland's unit labour costs will grow slightly faster than the euro area average in 2022–2023. Finnish labour cost growth is projected to be lower than the euro area average, and the rise in Finland's unit labour costs will be especially due to Finnish productivity growth falling behind relative to the euro area. However, the projected differential in unit labour costs is very small or even negligible after forecast uncertainty is taken into account.

% change on previous year	2019	2020	2021	2022[f]	2023[f]
Finland					
Labour costs*	1.3	0.4	4.4	3.3	3.0
Productivity**	-0.6	-0.4	1.4	0.6	1.2
Unit labour costs	1.9	0.8	3.0	2.7	1.8
Euro area					
Labour costs*	2.1	-0.7	4.1	3.6	3.5
Productivity**	0.3	-4.9	4.2	1.4	1.5
Unit labour costs	1.9	4.5	-0.1	2.2	2.0

* Compensation per employee
** GDP per person employed
f = forecast.

Sources: Statistics Finland, Eurostat and projections by the European Commission.

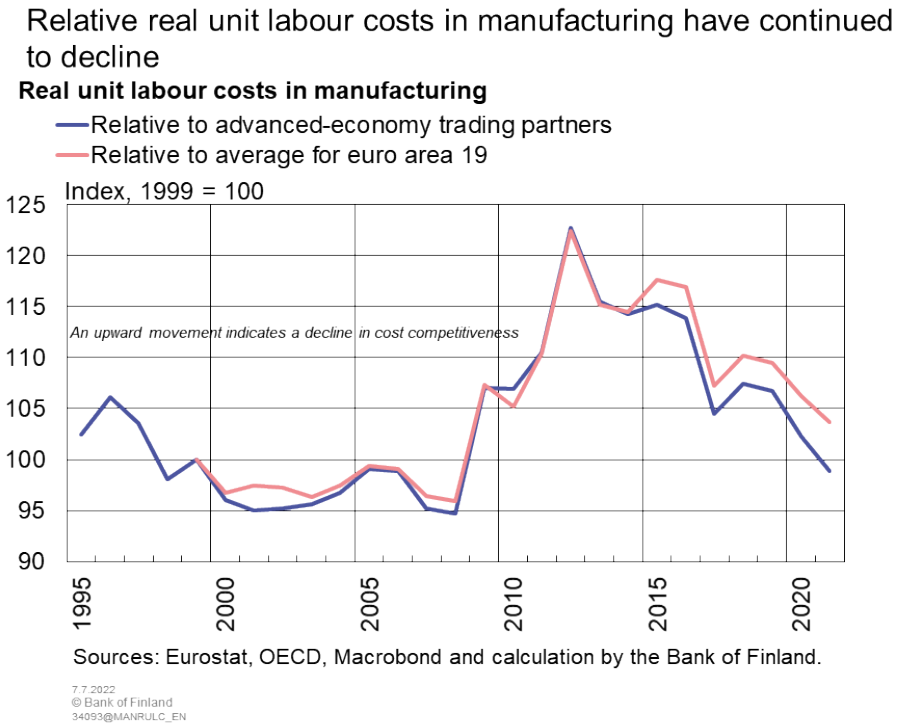
Manufacturing profitability further improved

In addition to relative labour costs and unit labour costs adjusted for the terms of trade, another

common indicator of competitiveness is real unit labour costs in manufacturing, or manufacturing profitability (Chart 5). Compared with relative labour costs, this measure is more closely connected to the prospects for output and employment in the tradable sector, as relative labour costs are looked at in relation to nominal, instead of real, value added. Unit profitability and corporate capacity for labour compensation are not dependent on output volume but on output value growth (Kajanoja, 2017).

The relative profitability of Finnish manufacturing industry remained fairly stable from 1995 all the way up to the financial crisis of 2008. During the financial crisis cost competitiveness as measured by this indicator sharply deteriorated over the period to 2012. In 2012 the manufacturing industry's relative profitability began to recover and continued to improve even during the pandemic years of 2020–2021 compared with both the euro area and the larger group of advanced-economy trading partners. Finnish manufacturing industry's relative profitability has yet to fully recover from its collapse during the financial crisis, which occurred because of a collapse in productivity, higher labour cost growth than in other countries, and persistent weak growth in the price of value added.

Chart 5.

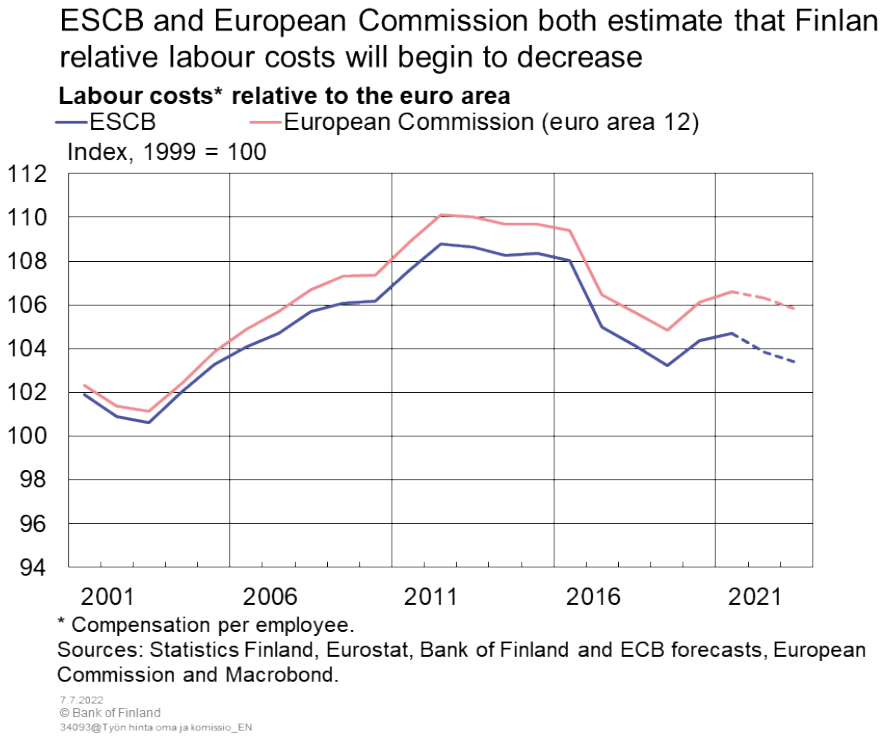


Forecasts by the Bank of Finland and ESCB similarly suggest that cost competitiveness will remain more or less unchanged

In the following we examine Finland's competitiveness in the light of figures and forecasts from the Bank of Finland and the European System of Central Banks (ESCB). The ESCB forecasts a largely similar path for Finnish cost competitiveness as the European Commission (Chart 6 and Chart 7).

Finland's relative labour costs have evolved as illustrated in Chart 6, with figures from the ESCB and the European Commission telling a similar story. The small discrepancy between the ESCB and the European Commission figures is because the first 12 euro area countries are used as a comparator group in the Commission's figures.[2] Both parties forecast that Finland's relative labour costs will decline in 2022–2023. Compared with the time before the pandemic in 2019, relative labour costs are projected to remain almost unchanged.

Chart 6.

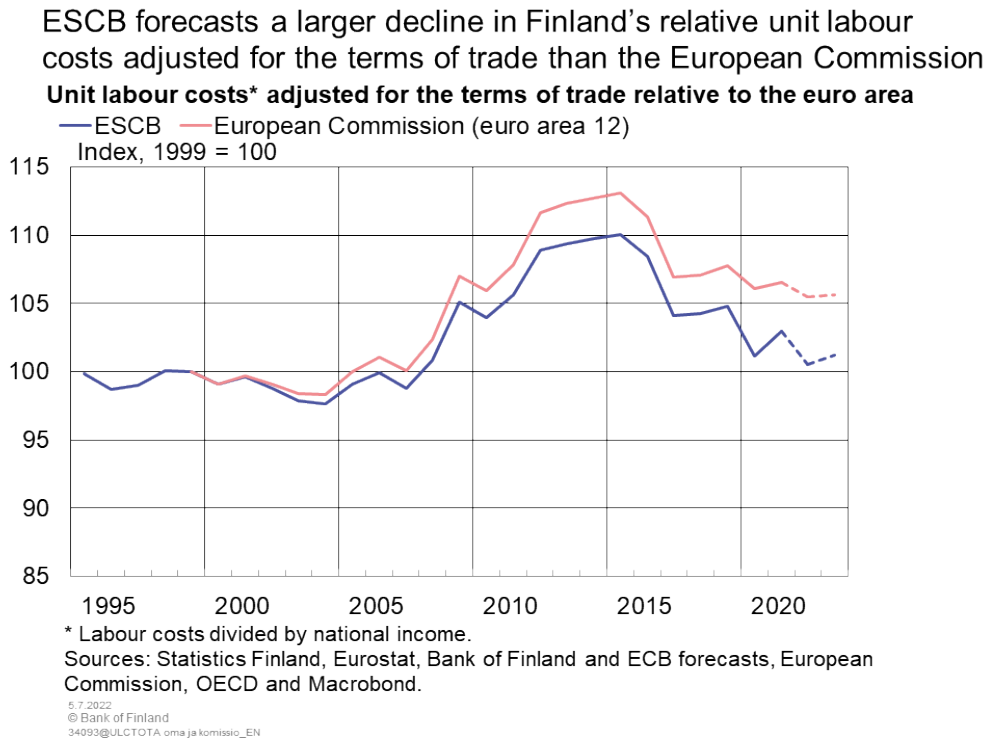


Finland's competitiveness as measured by unit labour costs adjusted for the terms of trade strengthened moderately from 2019 to 2021 relative to the euro area as a whole (Chart 7). It is possible that the larger comparator group used by the ESCB includes countries that have seen a

considerable decline in competitiveness, in which case the growth in competitiveness in the larger comparator group will have been weaker than in the smaller group. It is also possible that further revisions of the data will narrow the gap between the two indicators.

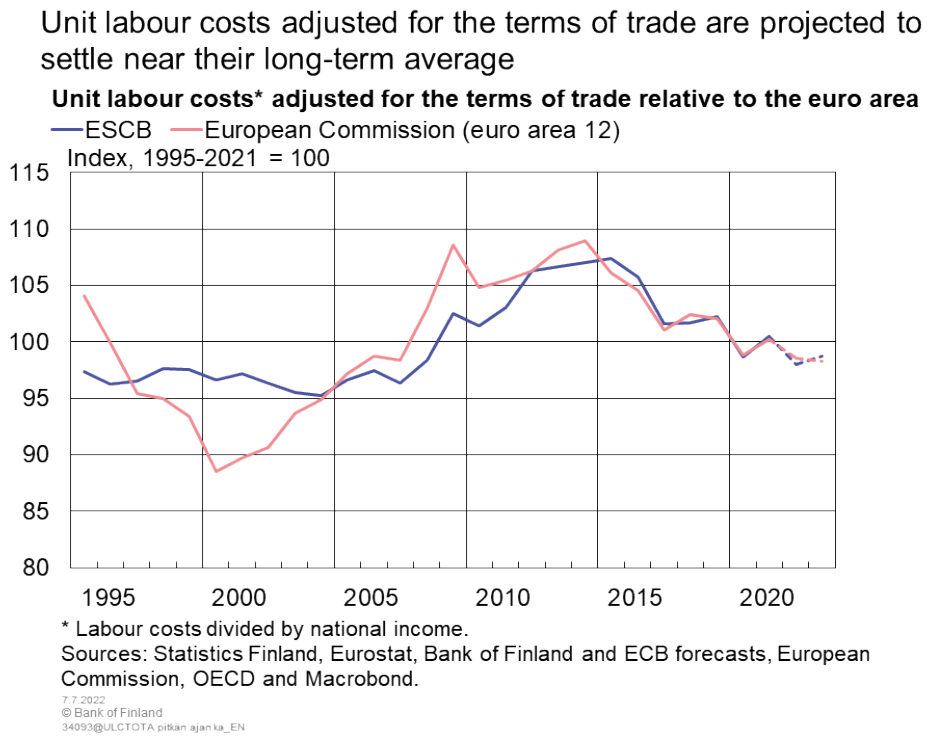
Finland's cost competitiveness is projected to improve relative to the euro area in 2022, before slightly levelling out in 2023. Because of the Ukraine war and the COVID-19 pandemic, productivity growth projections are subject to exceptionally high uncertainly. Labour cost growth may also differ from its projected level due to persistent high inflation. The projections for Finland do not take into account the impact of the pay settlement for municipal workers, and pay settlements in other countries may differ significantly from those projected. Together these contribute significant uncertainty to projections of cost competitiveness.

Chart 7.



When Finland's relative unit labour costs adjusted for the terms of trade are looked at in relation to their long-term average, we see that after a sustained high, Finnish cost competitiveness entered a slump from 2007 all the way until 2019 (Chart 8). In 2020 and 2021 competitiveness as measured by unit labour costs adjusted for the terms of trade has remained close to its long-term average, which is especially due to Finland's higher rate of productivity growth relative to the comparator countries. According to the forecasts by the ESCB and the European Commission, Finnish cost competitiveness is projected to remain slightly above its long-term average during the forecast years 2022–2023.

Chart 8.



It is noteworthy that cost competitiveness has recovered very slowly from its decline following the 2008 financial crisis. In spite of the 2017 Competitiveness Pact and the moderate wage agreements, cost competitiveness has yet to fully recover to its pre-financial crisis level. The short-term rigidity of wages and a sudden decline in the profitability of companies can thus lead to a very long-lasting need for adjustment. Cost competitiveness will play an important role in determining the success of many Finnish companies, now and in the near future, as they look for new markets to replace lost trade with Russia. In the prevailing environment of high inflation, measures aimed at maintaining Finnish cost competitiveness are especially important.

Sources:

Kajanoja, Lauri (2017) Measuring cost competitiveness in Finland. Bank of Finland.

Kajanoja, Lauri ja Pönkä, Harri (2021) Mitkä ennusteet ovat hyödyllisimpiä kun palkkaratkaisuja mitoitetaan. Bank of Finland.

Notes

1. Only the first 12 members of the euro area are included here, in part for data availability reasons and also because later members are not traditionally seen as competitors to Finland due to their different export structures. Wages are also considerably more volatile ↑

in some of the newer euro area countries than in Finland and a rising trend may be attributable to economic convergence. These phenomena do not convey much useful information about Finnish cost competitiveness.

2. The first 12 members of the euro area are Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. The countries included in the comparator group used by the ESCB vary slightly over time, as new countries are added as they join the euro area. Following the first 12 members, Slovenia joined in 2007, Cyprus and Malta in 2008, Slovakia in 2009, Estonia in 2011, Latvia in 2014, and Lithuania in 2015. ↑

Keywords

competitiveness, cost competitiveness, Finland