Forecast

Downside risks to the forecast remain

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Growth in corporate investment and exports is expected to be reflected in slowly improving output in the immediate years ahead. Nevertheless, owing to increased uncertainties in the global economy, there is a possibility that exports will not yet begin to rebound. On the other hand, the pick-up in domestic investment may be jeopardised if competitiveness problems cannot be resolved and the high degree of uncertainty surrounding fiscal consolidation persists. For these reasons, another possibility is that economic activity in the immediate future will be weaker than forecast.



Developments in international demand increasingly uncertain

Finland's export outlook is being overshadowed by an increase in global risks. The refugee

question and the weakening of the security situation following terrorist attacks have added to uncertainty in Europe. Moreover, growth prospects in the emerging economies have continued to worsen. In particular, there is a higher risk of deterioration in China's economic situation. Euro area growth may thus be slowing before it even really got started.

Even so, the preconditions for faster-than-projected demand growth in Europe do exist. The ongoing low level of interest rates and continuation of the ECB's asset purchase programme further reduce funding costs and, by extension, the return requirements on investment. Demand growth is also being buttressed by the fall in the price of oil, which may be even greater than assumed. In addition, fiscal policy leeway has increased in many EU countries as fiscal adjustment measures have reduced deficits. The risk of an abrupt tightening of fiscal policy has, therefore, generally diminished, helping to bolster demand growth in Europe. These factors may even lead to faster-than-forecast growth in demand for Finnish exports.

However, uncertainty may impair the effectiveness of the accommodative monetary policy and other factors supportive of growth. As economic predictability weakens, it typically slows most the mobilisation of fixed investment projects. If investment in EU countries were to become bogged down, this would be particularly harmful for Finland's export outlook.

Domestically, economic policy and pay settlements are among the main risk factors

Finland's economic activity in the immediate years ahead will be strongly affected both by the progress made with the Government's policy measures and structural projects to consolidate the public finances and by developments on the labour market. If the programme to cut the growing public debt is effective, this will stabilise the operating environment for non-financial corporations, thereby shoring up investment demand. It is also of utmost importance to have concrete targets for the social and health care reform and the related costs, as the reform will have a significant impact on household finances.

In any case, the overall risk related to the stance of economic policy has increased in response to the higher levels of public debt. Central and local government balance sheets afford less scope than before for the operation of automatic fiscal stabilisers. Even small negative surprises will, therefore, require a reassessment of fiscal policy. In addition, the mild current account deficit could rapidly deepen merely if the price of oil were to rise faster than predicted.

During the forecast period, the functioning of the domestic markets will still be strongly predicated on both public and household borrowing, but pay increases that may be too rapid from the perspective of competitiveness would still support consumer demand growth. During the

forecast period, growth in export earnings will remain slow and, with ongoing population ageing, an increasingly large part of the population will be outside the labour market. As a consequence, the forecast foresees an ever greater part of domestic demand still being based on income from the public sector, financed through taxes, pension contributions and borrowing. This will be reflected in growth in external debt. Clearly, domestic demand growth cannot rest indefinitely on the weakening external balance.

Domestic risk factors can thus be assessed based on what path the economy takes towards a more balanced trend. The forecast scenario is based on a gradual recovery in exports and an assumption that there will be no change in Finland's credit rating. Low interest rates will enable an edging up of debt. If these factors bolstering domestic demand were to begin to break down, the economic outcome would be much weaker than projected (see alternative scenario).

Keywords

economy, Finland, risks