Forecast

Finnish economy would recover more rapidly if exports and consumption pick up

Finnish economy | 05 July 2024 | Mikko Sariola, Harri Pönkä, Hannu Viertola

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At the turning points of business cycles, economic recovery has often turned out to be faster than forecast. According to the Bank of Finland's June 2024 forecast, the economy will make a gradual recovery from the recession. The alternative scenario examines factors that could cause the economy to recover more quickly from 2025 onwards than in the baseline forecast. This could happen if consumer confidence recovers more quickly than expected and households spend more of their savings. Higher export growth than anticipated would also boost growth in the economy.



Finnish economy temporarily improves more than expected in 2025–2026

According to the Bank of Finland's June forecast (see: Finland's economy is gradually moving out of recession), Finland's gross domestic product (GDP) for 2024 will show a year-on-year contraction, but growth will slowly start to recover as the year wears on. The alternative scenario presented here assumes a more rapid economic recovery than in the baseline scenario. This is based on two main reasons: a growth in consumption due to confidence improving faster than was forecast, and an additional boost to exports as a result of world trade growth being more aligned with the composition of Finnish exports than was anticipated (Table 1). In the scenario, the economy will grow by an additional 1% in 2025 and 2026 in comparison with the baseline scenario (Table 2).

The alternative scenario was prepared using the Bank of Finland's Aino model.

Assumptions underlying the alternative scenario			
Households		**Exporting companies**	
Households' confidence will strengthen considerably more than under the baseline scenario	More of the excess savings accumulated during the pandemic will be used for consumption than under the baseline scenario	International demand will favour Finland's export structure	Some of the export markets that were previously lost will be recovered

Source: Bank of Finland.

Under the baseline scenario, consumer confidence will pick up slowly from the current very low levels (Chart 1). In the alternative scenario, consumer confidence will improve more rapidly, leading to increased domestic demand and supporting growth. Economic recovery will also be supported by the country's small open economy, where cyclical fluctuations have traditionally been strong. If exports pick up more quickly than expected, this will have a positive impact on the Finnish economy. In this case, the economy could grow more strongly than forecast.

Chart 1.



Under the baseline scenario, the output gap will still be clearly negative in 2025 and will remain somewhat negative in 2026. The output gap measures how much the actual production in an economy diverges from its potential level, which in turn describes the long-term economic growth potential. A wide negative output gap indicates that there is considerable spare production capacity in the economy, the utilisation of which could benefit the employment rate and households' wellbeing.

Private consumption growth will accelerate when, due to an improvement in confidence, households spend more of their savings accumulated during the pandemic. Under the alternative scenario, the decrease in the savings rate will be greater than in the baseline scenario, in which households use a smaller proportion of their savings.

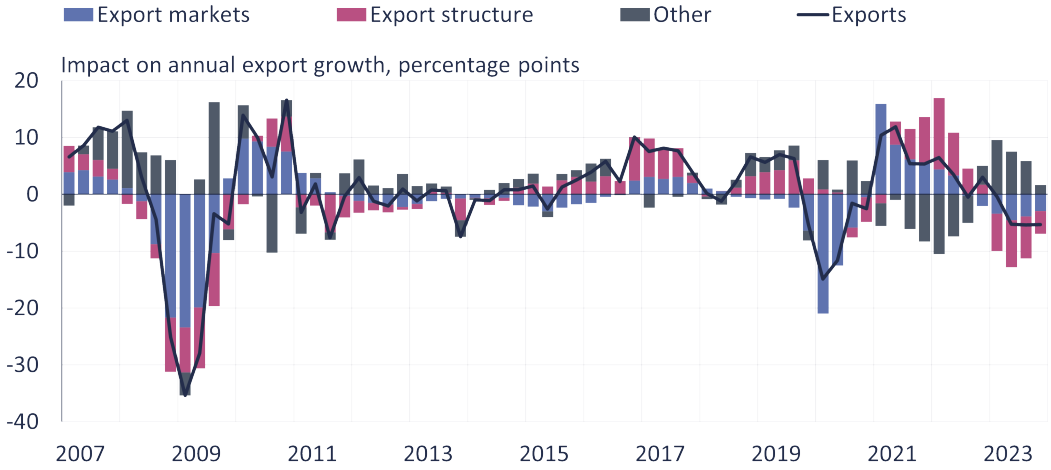
Finland has lost significant export market shares since the beginning of the war in Ukraine. Since 2022, a total of almost 5% in export market shares has been lost cumulatively over two years. While there are many reasons for the modest export success, the collapse of trade with Russia is likely to be one of them. The services-driven growth in the euro area in recent years has not especially favoured Finland's export structure either.

Growth in the export markets refers here to Finland's most important trading partner countries. Finland's exports consist mainly of raw materials and intermediate goods such as investment

goods, demand for which has been low and variable globally. However, demand could start increasing rapidly when international trade picks up and the conditions for investment growth improve. Fluctuations in Finland's exports are often substantial, and, in addition to the growth in export markets (Chart 2, Export markets), are explained in terms of what our trading partners import (Chart 2, Export structure).

Chart 2.

Significant fluctuations in exports are explained not only by the export markets but also by the structure of exports



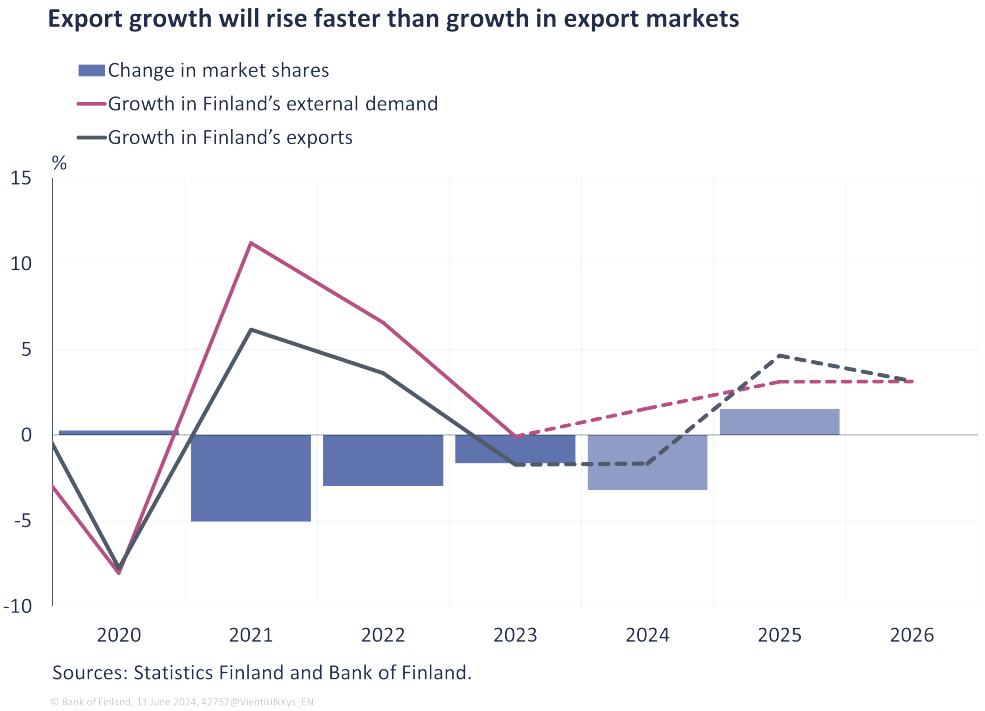
The chart presents the growth in Finland's export volume. This is divided into contributory elements based on various structural shocks in the Bank of Finland's Aino 2.0 model. 'Export markets' consists of Finland's export markets, 'export structure' comprises an export preference shock, and 'other' is made up of the model's other shocks.

Source: calculations by the Bank of Finland.

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Finland's exports will grow more rapidly than expected because demand in the export markets will be more favourable for Finland than in the baseline scenario. In fact, the alternative scenario assumes that growth in the export markets will focus on investment goods and intermediate goods, which comprise a larger proportion of Finland's exports. With export demand focusing on investment goods and intermediate goods, the growth in Finland's exports will be higher than the growth in its export markets in general. This will help Finland recover some of the export shares lost in recent years (Chart 3). A recovery in exports will support faster growth in the economy than was forecast.

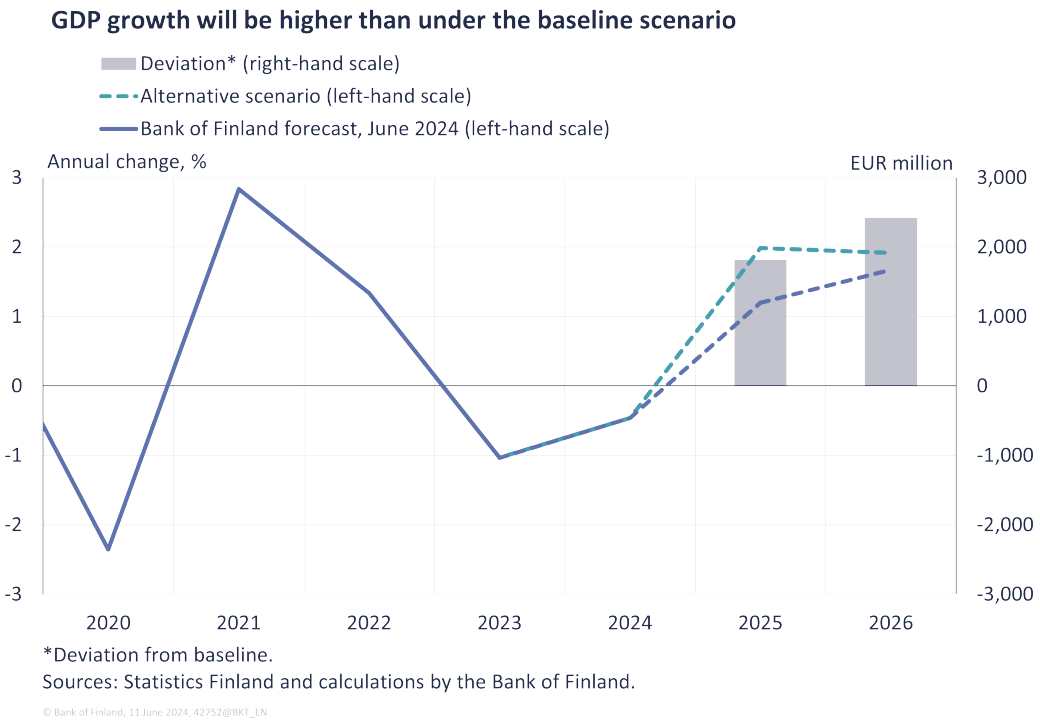
Chart 3.



Growth in export demand and in consumption demand will temporarily boost economic growth

Growth in consumption and exports will also be transferred to domestic production and employment (Chart 4). Investment will also increase compared with the baseline scenario. Imports will rise in the wake of exports, as domestic demand picks up and as significant imported inputs will be required for the production of exports. However, imports will increase more slowly than exports, and so net exports will strengthen.

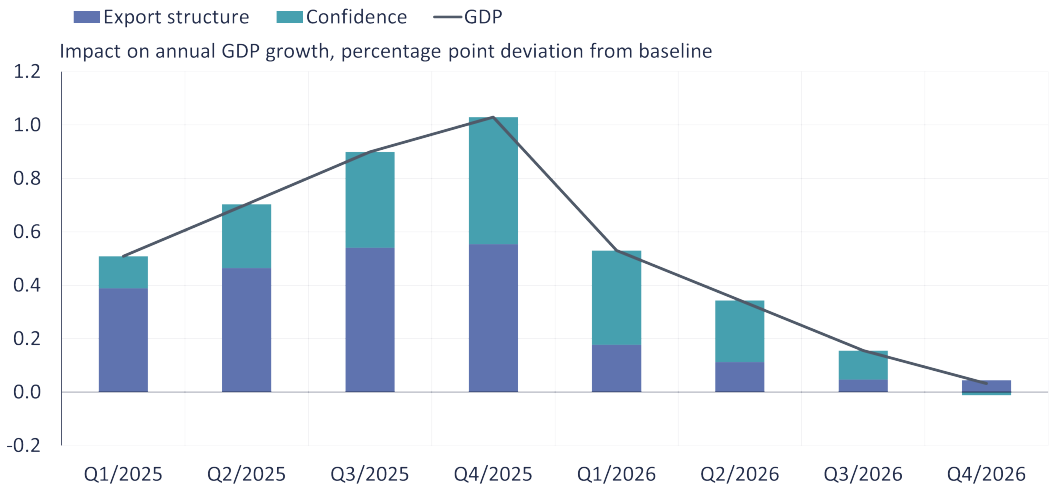
Chart 4.



As a result of growth in exports and private consumption, growth in the Finnish economy will rise to 2.0% in 2025 and 1.9% in 2026 (Chart 5). These GDP growth figures are 0.8 and 0.2 percentage points higher than under the baseline scenario, which corresponds to an additional GDP volume of nearly EUR 2 billion in 2025 and almost EUR 2.5 billion in 2026.

Chart 5.

Alternative scenario: economy will temporarily improve in 2025–2026 by more than forecast



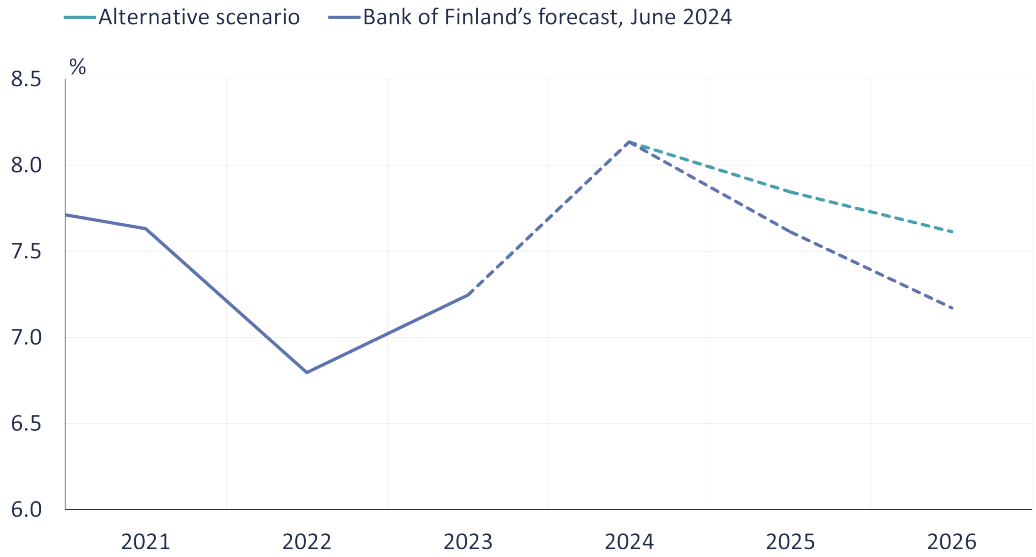
The chart presents the deviation of GDP growth per capita at basic prices from the Bank of Finland's June 2024 forecast. The deviation is divided into contributory elements based on various structural shocks in the Bank of Finland's Aino 2.0 model. 'Confidence' consists of a consumer preference shock, and 'export structure' comprises an export preference shock.
Source: calculations by the Bank of Finland.

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As output increases, the number of hours worked will increase and employment will rise. Employment will improve over the two-year period, with the total number of employed persons at the end of 2026 being 24,000 higher than under the baseline scenario. The unemployment rate will consequently decline (Chart 6). Employment growth will boost household incomes, further increasing private consumption.

Chart 6.

Unemployment rate will decrease in relation to baseline scenario and will fall below level of structural unemployment



Sources: Statistics Finland and calculations by the Bank of Finland.

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Labour productivity will also strengthen slightly. Economic capacity will be better utilised, and the output gap will nearly close by the end of 2026. The economy will then approach its potential output level.

The growth in exports and consumption under the alternative scenario will drive inflation higher in 2025 and 2026, by approximately an additional 0.1 percentage points compared with the baseline scenario. Inflation will then amount to 2.0% in 2025 and 1.7% in 2026. The upward impact of demand growth on inflation will remain moderate as expected, reflecting the fact that the Phillips curve is relatively flat.[1] At the same time, with the output gap nearly closing in 2026, inflation will be near 2% in the scenario.

In the scenario, average hourly earnings increase when the growth in consumption and export demand lead to a growth in the demand for labour. Average hourly earnings in this scenario will rise by 0.1 and 0.2 percentage points more in 2025 and 2026 than in the baseline scenario, which is slightly above the rise in consumer prices. This, in turn, will have a positive impact on the growth in purchasing power.

In conclusion

The Finnish economy could grow more rapidly in the immediate years ahead than assumed in the

baseline scenario, because growth at the turning points of business cycles has previously often recovered surprisingly quickly. In the baseline scenario, GDP in the economy is well below its potential level, and this unused production capacity enables a stronger economic recovery than expected.

The alternative scenario assumes that growth in the export markets will focus on investment goods and intermediate goods, which comprise a large share of exports in the case of Finland. An international economic climate that is favourable for Finland will facilitate the recovery of some of the export shares that Finland has lost in recent years. These factors could cause exports to grow more than under the baseline forecast. Consumer confidence could improve substantially when economic growth is rising and inflation is low. This would increase consumption, as households decide to spend some of the savings they have accumulated in recent years.

An increase in exports and consumption would have a positive impact on the economy and would accelerate GDP growth. Inflation, in turn, would rise only slightly as demand increases. The unemployment rate would fall to just below the level of structural unemployment.

Table 2. Alternative scenario results: economy recovers more quickly

Percentage change on previous year unless stated otherwise		2023	2024^{f}	2025^{f}	2026^{f}	2026 level and deviation (%)*
Gross domestic product	Baseline forecast	-1.0	-0.5	1.2	1.7	236,793
	Alternative scenario	-1.0	-0.5	2.0	1.9	239,216
	Deviation	0.0	-0.0	0.8	0.2	1.0
Imports	Baseline forecast	-7.1	-2.0	2.8	2.7	94,147

Baseline forecast: Bank of Finland June 2024 forecast trajectory.

** = demand components EUR million at 2015 prices. In the export market indicator and price indices 2015 = 100.*

Average hourly earnings EUR per working hour. Employment measured in thousands.

^{f} = forecast.

Sources: Statistics Finland and Bank of Finland.

Percentage change on previous year unless stated otherwise		2023	2024[f]	2025[f]	2026[f]	2026 level and deviation (%)*
	Alternative scenario	-7.1	-2.0	3.8	3.1	95,471
	Deviation	0.0	-0.0	1.0	0.4	1.4
Exports	Baseline forecast	-1.7	-1.7	2.8	3.0	95,088
	Alternative scenario	-1.7	-1.7	4.6	3.2	96,978
	Deviation	-0.0	-0.0	1.9	0.2	2.0
Private consumption	Baseline forecast	0.4	0.6	0.7	1.3	126,896
	Alternative scenario	0.4	0.6	1.5	1.8	128,608
	Deviation	0.0	-0.0	0.8	0.5	1.3
Private investment	Baseline forecast	-4.1	-5.0	2.3	4.2	42,719
	Alternative scenario	-4.1	-5.0	2.6	4.5	42,958
	Deviation	0.0	-0.0	0.2	0.3	0.6
Export markets	Baseline forecast	-0.1	1.6	3.1	3.1	136.1
	Alternative scenario	-0.1	1.6	3.1	3.1	136.1
	Deviation	0.0	0.0	0.0	0.0	0.0

Baseline forecast: Bank of Finland June 2024 forecast trajectory.

** = demand components EUR million at 2015 prices. In the export market indicator and price indices 2015 = 100.*

Average hourly earnings EUR per working hour. Employment measured in thousands.

[f] = forecast.

Sources: Statistics Finland and Bank of Finland.

Percentage change on previous year unless stated otherwise		2023	2024[f]	2025[f]	2026[f]	2026 level and deviation (%)*
Harmonised Index of Consumer Prices	Baseline forecast	4.3	1.2	2.0	1.6	124.3
	Alternative scenario	4.3	1.2	2.0	1.7	124.6
	Deviation	0.0	-0.0	0.1	0.1	0.2
Employment, ages 15–74	Baseline forecast	0.5	-0.6	0.3	0.5	2,638
	Alternative scenario	0.5	-0.6	0.8	0.9	2,662
	Deviation	0.0	-0.0	0.5	0.4	0.9
Unemployment rate, %	Baseline forecast	7.2	8.1	7.8	7.6	7.6
	Alternative scenario	7.2	8.1	7.6	7.2	7.2
	Deviation	0.0	0.0	-0.2	-0.4	-0.4
Average hourly earnings	Baseline forecast	5.4	3.2	2.4	2.6	27.6
	Alternative scenario	5.4	3.2	2.6	2.8	27.7
	Deviation	0.0	0.0	0.1	0.2	0.3

Baseline forecast: Bank of Finland June 2024 forecast trajectory.

** = demand components EUR million at 2015 prices. In the export market indicator and price indices 2015 = 100.*

Average hourly earnings EUR per working hour. Employment measured in thousands.

[f] = forecast.

Sources: Statistics Finland and Bank of Finland.

Notes

1. The Phillips curve illustrates the relationship between changes in aggregate demand and inflation. In this scenario the curve is relatively flat in Finland. In this connection, the Phillips curve refers more specifically to the relationship between inflation and the output gap, and the slope of the curve measures the strength of the relationship. The relationship indicates that, in general, inflation will be driven upwards if output grows higher than potential output. If demand is high in relation to the production capacity of the economy, this will increase companies' production costs. It will also enable costs to be passed on to the consumer prices of products, causing inflation. The original Phillips curve described the relationship between the unemployment rate (as a measure of economic activity) and wage inflation. ↑

Keywords

Aino model, alternative scenario, consumption, exports, GDP, general equilibrium model, inflation