Editorial

Conditions for sustainable economic growth must be ensured

Finnish economy | 16 December 2022

Economic policy in the past few years has responded to the COVID-19 pandemic and then Russia's war in Ukraine. These crisis years have demonstrated the importance of maintaining sufficient fiscal space. The swift and robust monetary and fiscal policy measures taken helped avoid a wave of bankruptcies while also supporting the favourable trend in employment and preventing a substantial contraction in household incomes.



The downside is that Finland's general government debt ratio has grown significantly. The Bank of Finland estimates that the country's public debt this year amounts to about 72% of gross domestic product (GDP), and that the debt ratio will continue to grow in the coming years unless corrective measures are taken.

Even before the pandemic, there was a significant structural problem in Finland's public finances. The Bank of Finland's latest estimate of the sustainability gap is approximately EUR 13 billion, or 4% of GDP. The effects of the sustainability gap are already visible as a deterioration in key public services.

During the pandemic, Finland's general government debt ratio grew significantly more than that of

Sweden or Denmark. Finland's debt ratio is considerably above the level in other Nordic countries, but the difference is not explained solely by the pandemic. Unlike the other Nordic countries, the general government debt ratio in Finland has grown for nearly 15 years.

In Finland, economic policy now has to focus simultaneously on resolving both short and longer range problems of major significance. The most important short-term goal is to bring down the exceptionally high level of inflation. Higher energy prices are the main factor behind the surge in inflation, but the rise in prices has broadened out to almost all goods and services.

The European Central Bank's monetary policy is aimed at efficiently reducing inflationary pressures and keeping inflation expectations anchored. By tightening monetary policy, the ECB aims to avoid the emergence of a detrimental upward spiral in consumer prices and wages.

The Governing Council of the ECB has raised key interest rates to stabilise inflation at its 2% target over the medium term. The key interest rates were raised by half a percentage point in July, by a 0.75 percentage points in September and October and by a further half percentage point in December. Interest rates will still have to rise significantly at a steady pace to reach levels that are sufficiently restrictive to ensure a timely return of inflation to our two per cent medium-term target.

Fiscal policy can support the achievement of the inflation target if it refrains from fiscal measures that would boost aggregate demand. The near term is shrouded in uncertainty, but when supply factors constrain the economy, expansionary fiscal policy does not support economic growth or employment but, rather, will lead to a rise in prices and costs.

The scale of support measures taken in Finland to tackle the energy crisis has been moderate by international comparison. The risk, however, is that these measures will raise the wholesale price of electricity and prove costly to the public finances, and without a respective benefit to households. If the support measures will need to be continued, they should be targeted more precisely at the most vulnerable households, while also ensuring that incentives for saving energy are retained.

After the crises it will be important to build confidence in fiscal sustainability and to strengthen the conditions for sustainable economic growth. The public finances must be strengthened to ensure the financing of increasing levels of age-related expenditure. Safeguarding key services will require prioritizing needs and goals and ensuring a comprehensive knowledge base to support the decision-making on these matters.

The aim should be longer term debt sustainability, and to achieve this a coherent economic adjustment programme should be drawn up stretching over several government terms. This will

allow to avoid sudden tightening later on, and economic policy will help support a stable and predictable operating environment.

It is vital to build a strong political commitment to fiscal sustainability and to the resolute implementation of the measures this calls for. The spending limits procedure or other fiscal rules are not intended to take away from democratically elected decision-makers any power to determine fiscal policy, but instead to support the ability of the political system to function and to increase transparency.

Besides debt sustainability, we must also ensure the conditions are in place for sustainable economic growth. The development of Finland's economy has historically been based largely on the expansion of its education system and the general increase in the level of education.

It is therefore concerning that the rise in young age cohorts' education levels has halted, and those born in the late 1970s remain for the time being the most highly educated generation. The emphasis in investment has been on the building stock rather than on investing in areas that enhance productivity. Population ageing is also weighing on the longer term growth outlook for the Finnish economy. If current trends continue, there is a risk than the stock of human capital in Finland will begin to decline in the 2040s.

However, this development can be influenced by investing in education and training and in research and innovation activities. Recruitment of more international experts through an increase in work-based immigration of skilled workers would also help boost human capital. Particular attention should be given to improving the opportunities for those foreign students who are taking higher education degrees in Finland to stay on and use their expertise to the benefit of Finnish society.

***

As a consequence of Russia's brutal war in Ukraine and the energy crisis created along with it, the security policy environment and economic environment of Europe and Finland are currently going through a very tough transition. The rise in energy prices has dramatically reduced living standards. Inflation has become more broad-based and next year's economic outlook is marked by uncertainty. In Finland, the working-age population is shrinking and the outlook for labour productivity is dampened by the fact that the rise in the average educational attainment of the population has levelled off.

In Europe and Finland, economic policy must now seek to resolutely and simultaneously resolve both the short-range inflation problem and longer range structural problems. By tightening monetary policy, the risk of a detrimental wage-price spiral will be reduced and inflation will be

stabilised at its target of 2% over the medium term. Long-term growth prospects must be supported by investing in education, by supporting the creation, adaptation and diffusion of innovations, and by improving the scope for work-based and education-based immigration.

Helsinki, 15 December 2022

Olli Rehn
Governor of the Bank of Finland

Keywords

economic policy, energy crisis, general government finances, inflation, monetary policy, public debt, sustainability of public finances, Ukraine