

- *The trough of the global recession has been surpassed and economic activity is recovering. However, the rate of growth is expected to remain moderate over the projection period.*
- *Economic activity in Finland fell sharply both late last year and early this year. The cyclical downturn has now bottomed out, and the economy is settling into a slower path of growth than before.*
- *GDP will decrease by 7.6% this year. Next year it will grow by 0.7% and will accelerate to around 2½% in 2011.*
- *The number of employed will decrease by 80,000 people this year and the number of unemployed will increase by over 50,000 people. The unemployment rate will rise to an average of 8½% this year. Job prospects will continue to deteriorate next year and unemployment is expected to rise to an average of 10½%.*
- *Inflation is anticipated to remain moderate over the next two years. Wage earnings will grow by 4% this year and slightly less in 2010 and 2011.*
- *The budgetary position in central government will deteriorate very strongly this year and the need to borrow will remain at over EUR 11 billion even in 2011. The deficit in general government finances is forecast to slide to 3½% of GDP next year. It will contract slightly in 2011 though. Local government finances will be weaker this year and are set to remain so next year too, despite very tough local taxation*

The trough of the recession has been surpassed in the **international economy** and recovery has started. This improvement in the global economy is partly thanks to the massive stimulus measures adopted in both fiscal and monetary policy to sustain growth and to bring stability to the markets. Growing demand is partly explained by stocks being replenished closer to normal levels. When the effect of these temporary measures starts to gradually wear off and as fiscal and monetary policy slowly starts being focussed more on longer term sustainability, the budding recovery cannot be expected to accelerate to a rate similar to that normally witnessed in cyclical upswings.



Other factors that are slowing down growth also exist. Low capacity utilization rates, higher unemployment, a fall in house prices and other asset prices and higher household indebtedness are all hampering investment and growth in consumption. Global imbalances, such as surpluses and deficits in current accounts call for structural reforms; i.e. higher growth in domestic demand in surplus economies and lower domestic demand and more exports in those with current account deficits.

Emerging economies are among the first to recover. Economic growth in China has returned to its usual levels of 8 to 9%, and growing demand is boosting recovery in the rest of Asia too. Growth in emerging economies is expected to rise to about 5% next year. Growth in the advanced economies is likely to remain sluggish well into late 2010 and to start accelerating in 2011. The world economy will decrease by a little over 1% this year and is forecast to increase by over 3% in 2010-2011.

The **euro area** economy, following this year's fall of 4%, foresees growth in the range of 1% in the next two years. Economic growth will be fuelled by an increase in consumer demand and above all in greater export demand.

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The **Finnish economy's** nosedive late last year and early this year was fast and sharp. GDP has plummeted to the same level as it was about three years ago. Output still declined by as much as 9.1% in Q3 compared to the same period a year earlier, but it was up by 0.3% on Q2, accounted for by an increase in public investment and private consumption. Based on this forecast, the current economic cycle has bottomed out and the Finnish economy will slowly start to recover. GDP in 2009 is expected to decrease by 7.6%, in other words more than in any of the recession years of the early 1990s. Growth for Q4 this year is projected at about ½% on Q3. With investment continuing to fall, the Finnish economy will grow by 0.7% in 2010, while in 2011, with all demand items expected to increase, it will grow by 2.4%. Following the sharp fall in level, economic growth will thus be sluggish, and it will not be possible to reach the long-term average rate of growth during this forecast period.

The projected growth path naturally involves certain risks. Being a small open economy, Finland's economic activity is highly dependent on cyclical fluctuations in the global economy. Moreover, in the current situation, where price pressure is modest, exceptionally high pay rises in relation to economic potential can lead to excessive cost pressure and weaker competitiveness.

Finland's economic growth will be one of the weakest in the euro area this year. Ireland, being another small open economy in the periphery, is expected to experience a fall in production similar to the one in Finland. In 2010, economic recovery in Finland is likely to be more modest than in competing countries, supporting the view that Finland will join the path of recovery in international demand later than the rest. Economic activity in Finland is calculated to be slightly higher than the euro area average in the last year of the projection period as compared to OECD forecasts for the euro area, for example.

Owing to the global recession, Finland's **exports** will drop by about a quarter this year. Industrial output will also decrease, by over a fifth relative to last year. The fall has been exceptionally steep. The decrease in exports has been far more drastic than in the early 1990s recession, when exports fell by 7%.

Finland's export countries have already started expanding. In addition, industrial production in the euro area, which is significant for Finnish exports, is now growing. Moreover, recent statistics on the euro area show that the production of intermediate products and investment goods has increased. Exports are expected to grow by 5% next year. Demand in intermediate products and services in Finland's export countries will be the ones to boost Finnish exports the most. Demand in investment goods is anticipated to remain modest next year.

**Imports** will grow by 3½% next year. Imports will grow slower than exports, as imports of consumer goods are sluggish and investment goods imports will not start growing. Thus the current account, which will amount to EUR 1.3 billion this year, will increase to EUR 2.1 billion next year. Investments in the Finnish export markets will accelerate in 2011, perking demand in investment goods.

Export growth is forecast to climb to 5½% in 2011. Imports growth will also accelerate, rising to 4%, as domestic demand is expected to become stronger towards the end of the projection period.

The **current account** will remain in surplus throughout the forecast period and, relative to GDP, this year will be the weakest. The current account surplus will be much smaller than what we have been accustomed to over the past decade.

**Investment** is expected to decrease by an estimated 12%, which is slightly more than predicted in August. This is because investment in machinery and equipment was weaker than anticipated in Q3 of this year. The business cycle in building construction is still sluggish too. Construction in new-building will be about a quarter smaller this year than last year, but renovation will increase to some extent, partly thanks to existing stimulus measures. House starts, on the other hand, are growing slightly from the record low levels, mainly owing to government-subsidized investment. There will be an estimated 22,000 to 23,000 new house starts both next year and the following year, when the stimulus action will further fuel renovation activities. Investment in construction for production purposes and investment in machinery and equipment is likely to perk up at the earliest in 2011. Investment in civil engineering will edge down slightly from a record high level this year but is expected to pick up again next year. Overall investment is anticipated to decrease by just under 5% next year and to increase again by about 2% in 2011.

The number of **employed** is estimated to drop by about 80,000 people this year, i.e. over 10,000 people less than forecast in August. This is partly because fixed-term redundancies, which are classified among the employed in the Labour Force Survey, have not been laid off altogether to the extent that was feared. Most job losses will occur in industry and in private services. Public services, by contrast, will see a slight increase in labour demand. The number of hours worked will fall by 7%, which is over twice as much as the number of job losses. The employment rate will slide to just over 68% and the unemployment rate will reach an average of 8½% (estimated at 9.0% in August) despite a decrease of 25,000 people in labour demand. Youth unemployment is three times as high as that for those aged between 25 and 64.

Labour demand will continue to deteriorate in 2010 in both industry and private services, and the number of employed is estimated to be 75,000 smaller than this year. The risk that temporary redundancies can become permanent ones is higher next year than this year and the number of vacancies will also be half that of 2008. Although labour supply will contract especially in the older age groups owing to more people retiring, as has been the case this year, the unemployment rate will nonetheless rise to an average of 10½%. The unemployment rate is expected to be at its highest in late spring 2010, at around 13%, mainly because students will have greater difficulties in finding work in the open labour market.

Since the labour market is perked by an improvement in production with a lag of about half a year, labour demand is likely to start rising only in late winter and early spring 2011. In this case, unemployment could decrease to a seasonally adjusted 9% in late 2011. Mismatches between labour supply and demand might become a significant problem at the time too.

**Consumer prices** will not increase on average in 2009. Month-on-month price changes have fluctuated around zero. This is because, besides the fall in world market prices, house prices have dropped and loan expenses are down. The cut in VAT on foodstuff introduced in October has been fully compensated, at least in the short term, in a reduction in food prices. Next year consumer prices will edge up slightly, but there is no significant pressure for price rises unless the new pay settlements bring any. The annual rate of change in the harmonized consumer price index is at 1.7% this year and 1.8% next year, which is still faster than in the EU Member States on average.

The **index of wage and salary earnings** will increase by an average of 4% this year. Next year it is expected to slow down. Most of next year's rise in the index will be accounted for by the fact that some of this year's pay rises are timed for the end of the year, and certain sectors will receive wage increases next year based on earlier collective agreements. The majority of all collective settlements will terminate early next year at the latest. Since negotiations are still open, it is difficult to assess to what extent the recession and the fall in employment will actually reduce the room for pay rises on the one hand and the pressure for increases on the other.

The fall in **private consumption expenditure** came to an end between July and September, when consumption grew by 0.3% on the previous quarter. The increase has covered a broad base, because, with the exception of semi-durables, consumption of all goods and services grew. The consumption of consumer durables increased the most. It came as a pleasant surprise to record growth in consumption, particularly in consumer durables, as the outlook was bleak and it was assumed in the autumn that consumption would continue to decline until early next year.

Consumer confidence has continued to improve since August, and with consumption on the increase now, the short-term outlook has improved. Indeed, this year's decline in private consumption will fall short of the August projection and is expected to be about 2% while next year already foresees growth. This is the case even though consumers are saving more now as a precaution against the risk of unemployment, for instance. In short, household purchasing power will increase faster than consumption expenditure. Cuts in income taxation and the offsetting of higher social security contributions are boosting income to some extent. However, the average local tax rate will be significantly higher. It is anticipated that households will spend slightly more on both goods and services next year than this year, with only spending on semi-durables expected to be less active. In 2011 household income is estimated to increase once unemployment starts easing. Should confidence in the future continue to improve, consumption would increase in 2011 faster than income for the first time in five years, meaning that the savings ratio will fall slightly.

In the wake of a weaker economic situation the budgetary position in **general government** will slip into deficit. Net lending as calculated in terms of national accounts will be -3½% of GDP in 2010. Tighter indirect taxation, increases in social security contributions and a recovery in economic activity will all reduce the deficit in 2011. However, the deficit-to-GDP ratio in public finances will still be below the 3% deficit threshold specified in the Stability and Growth Pact. The public debt-to-GDP ratio will rise to 52% by 2011, as borrowing in both central and local government is growing fast.

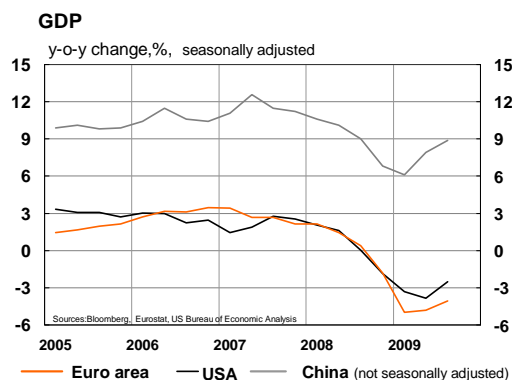
The budgetary position in central government has deteriorated exceptionally fast this year, as the tax bases have declined, unemployment-related expenditure has risen and various stimulus measures were adopted. The deficit will continue to deepen next year, and it is not until 2011 that the improvement in the economic cycle will be reflected in a reduction in the central government deficit. However, the need to borrow will still exceed EUR 11 billion. A marked increase in debt servicing expenses will dampen the effect of an improved business cycle on central government finances. Growth in corporate income taxes and capital taxes will be hampered by tax-deductible losses.

The balance in **local government finances** will weaken to about -½ of GDP this year. In spite of the recession, local government tax revenue will continue to grow and central government transfers to local government will also increase considerably. The deterioration in local government finances is in fact mainly due to a drop in corporate income taxes and because local authorities have used debt money to finance planned investments. The rise in unemployment means that the local tax base will remain weak especially next year, and this will have repercussions on the whole of local government more broadly next year than this year. However, higher local tax rates and property tax rates will perk local government tax revenue by about EUR 500 million, thus boosting the budgetary position in local government. Nonetheless, local government will stay in deficit, creating more pressure for tougher taxation even beyond 2010.

The sustained surplus in the **social security funds** will decrease substantially in the course of 2009, down to 2.6% of GDP, owing to fast growth in pension expenditure, for instance. Spending related to unemployment insurance will grow rapidly in 2010. On the other hand, social security contributions will increase, so the decline in the surplus will slow down. The surplus in the social security funds is forecast to be 2.4% of GDP in 2010. The anticipated improvement in the business cycle is expected to strengthen the balance in the social security funds in 2011.

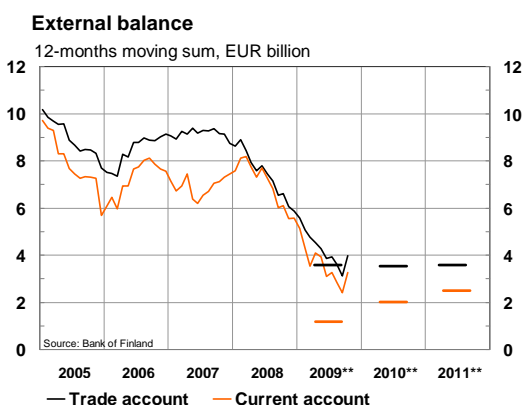
## International economy

The financial crisis that started in 2007 resulted in a sharp and fast drop in **international demand**. The global economy bottomed out in mid-2009 and the recovery in demand has strengthened since then. For instance economic activity in China remained at a high level throughout the recession.



## Economic developments in Finland

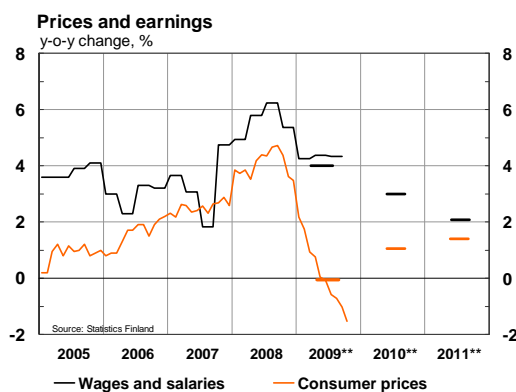
The **trade balance** has stayed well in surplus throughout the recession and this year's surplus is estimated at about 2% of GDP. It is forecast to remain in the range of 2% of GDP over the next two years too. The **current account** will decrease on last year but will still be in surplus this year.



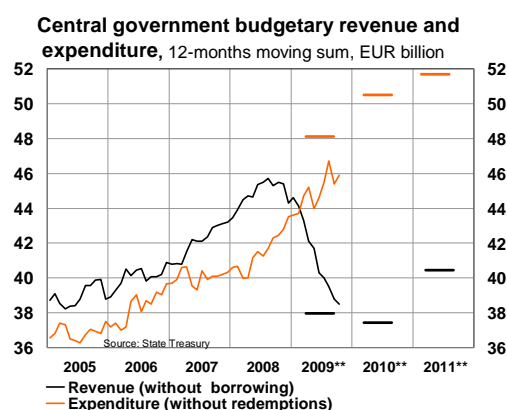
The **unemployment rate** has risen fast but less than anticipated bearing in mind that production has plunged. Unemployment is expected to peak in the coming spring. The unemployment rate for 2010 is forecast at 10.5%, and once the economy starts recovering, the number of unemployed is likely to start decreasing towards the end of the projection period.



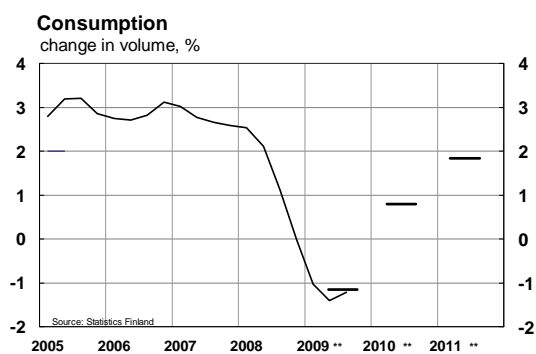
Price pressure in consumer prices will remain moderate throughout the forecast period. The terms of trade will improve this year only to slip back into a weaker path the next two years. The index of wage and salary earnings will rise to an average of 4% this year while in the next two years the rate is expected to decelerate.



Central government tax revenue declined by 14% between January and October on the equivalent period last year. Central government income revenue dropped by 27%. This is mainly because corporate income tax accrual plummeted by 55% on last year as business revenue collapsed. VAT accrual was down by 6% as household consumer patterns became more cautious. Central government expenditure increased by over 7% between January and October.



The year-long fall in private consumption expenditure came to an end in the late summer. Consumer confidence has also continued to improve in the latter part of this year. Household income developments are expected to be favourable in 2011 and consumption is anticipated to exceed income, so that the savings ratio will decrease. Public consumption is virtually at a standstill.



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## Key forecast figures

	2008*	2007	2008*	2009**	2010**	2011**
	EUR bn		change in volume, %			
GDP at market prices	185	4.2	1.0	-7.6	0.7	2.4
Imports	79	6.5	7.0	-22.5	3.7	4.4
Total supply	264	4.9	2.8	-12.1	1.4	2.9
Exports	87	8.1	7.3	-25.7	5.0	5.6
Consumption	137	2.5	1.9	-1.1	0.9	1.9
private	96	3.3	1.9	-2.2	1.2	2.5
public	41	0.8	2.0	1.2	0.2	0.5
Investment	38	8.7	0.3	-12.0	-4.6	1.8
private	33	9.0	0.4	-13.9	-4.8	2.2
public	5	6.8	-0.3	1.6	-3.4	-0.2
Total demand	264	4.9	2.8	-12.1	1.4	2.9
domestic demand	178	3.3	0.6	-5.4	0.1	1.9

	2007	2008*	2009**	2010**	2011**
Services, change in volume, %	2.4	1.4	-3.6	0.3	1.5
Industry, change in volume, %	8.6	0.1	-19.5	3.0	5.0
Labour productivity, change, %	2.5	-0.4	-1.6	3.0	2.0
Employment rate, %	69.9	70.6	68.3	66.2	66.6
Unemployment rate, %	6.9	6.4	8.5	10.5	9.6
Consumer price index, change, %	2.5	4.1	0.0	1.2	1.5
Index of wage and salary earnings, change, %	3.4	5.5	4.0	3.0	2.2
Current account, EUR bn	7.3	4.8	1.3	2.1	2.6
Current account, % of GDP	4.0	2.6	0.8	1.2	1.4
Short-term interest rates (3-month Euribor), %	4.3	4.8	1.3	1.5	2.5
Long-term interest rates (10-year Govt. bonds), %	4.3	4.3	3.7	3.7	4.0
General government expenditure, % of GDP	47.3	49.0	55.3	56.2	56.4
Tax ratio, % of GDP	42.9	43.0	42.7	42.2	43.1
General government net lending, % of GDP	5.2	4.4	-2.2	-3.6	-3.0
Central government net lending, % of GDP	2.1	0.9	-4.5	-5.8	-5.2
General government gross debt (EMU), % of GDP	35.2	34.2	41.8	48.3	52.2
Central government debt, % of GDP	31.2	29.4	37.2	43.9	48.3

Sources:

Statistics Finland, Bank of Finland, EU, OECD

Forecast: Ministry of Finance, Economics Department

