Talousennuste

March 20, 2014

Economic Forecast
2014–2015

Finally an Upswing in Europe

Additional information

Chief of forecasting
Eero Lehto
tel. +358-9-2535 7350

Information officer
Heikki Taimio
tel. +358-9-2535 7349

LABOUR INSTITUTE FOR ECONOMIC RESEARCH

Economic Forecast 2014–2015

Finally an Upswing in Europe

The Labour Institute for Economic Research lowered this year's GDP growth forecast for Finland to 0.9 per cent from last September's 2.1 per cent. The forecast was lowered because GDP fell in last year's fourth quarter, contrary to expectations. Industrial production and exports in January of this year were disappointing. Last year, Finland's GDP fell by 1.4 per cent. The poor performance is largely attributable to the prolonged recession in Europe and a substantial decline in investment in our export markets. The Finnish economy will experience an upswing this year in the wake of developments in the rest of Europe. Growth will nevertheless be slower than in Europe. Next year, Finland's GDP is forecast to grow by 2.2 per cent, which is the same rate as, for example, the euro area average. Both this year and next year, Finland's economic growth will be curbed by low wage increases constraining purchasing power and by relatively tight fiscal policy.

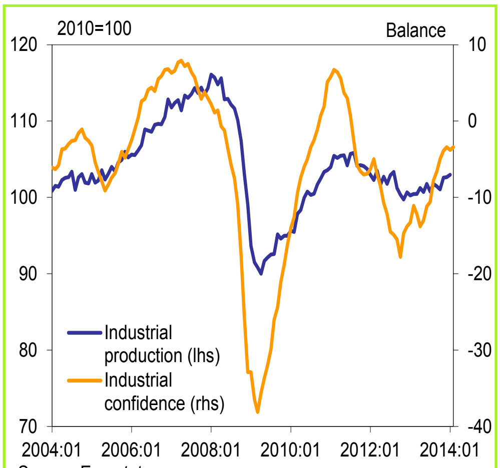
The ECB's conservative monetary policy is one of the reasons for our sluggish economic growth. The exchange rate has been unable to respond to negative shocks (such as Nokia's downfall), which have affected only Finland and not other euro countries. A major risk is the Ukrainian conflict turning into some kind of trade war between Russia and the EU. Finland would suffer from this much more than the EU or the euro area on average, and in the monetary union as well this kind of asymmetric risk would be very problematic for the Finnish economy. Efforts to find a tolerable and the rapid resolution to the conflict are also for this reason of pivotal importance from Finland's standpoint, even if the crisis is not defused without an increase in political tension.

Still last year the GDP of the euro area fell slightly from a year earlier. The euro area pulled out of the recession on average, however, already in the second quarter of last year. Since then, its GDP has increased by 0.1 - 0.3 per cent from the previous quarter. The growth is, therefore, on average, still very slow. Last year, the euro area's growth was based almost entirely on foreign trade. This year, the focus of growth is shifting towards domestic demand, both consumption and investment. At the same time the growth rate will pick up somewhat with the euro area GDP growing by an average of 1.5 per cent. Next year, this trend will continue and GDP will already grow by 2.2 per cent from the previous year. Total EU growth will be a couple of tenths of a per cent faster.

Euro area growth is largely attributable to the region's internal factors, such as the fact that the euro crisis has calmed down, and that the tightest phase of fiscal policy is beginning to be over. It is also relevant that under conditions of prolonged uncertainty businesses have held back on investment, while households have held back on consumption, which has helped to strengthen their financial position. Now that the uncertainty has been reduced, domestic demand will really start to recover, fuelled by more readily available funding. This will nevertheless be held in check by China's economic slowdown and economic problems in certain other developing countries. Also, the current Ukrainian political crisis will have a negative effect.

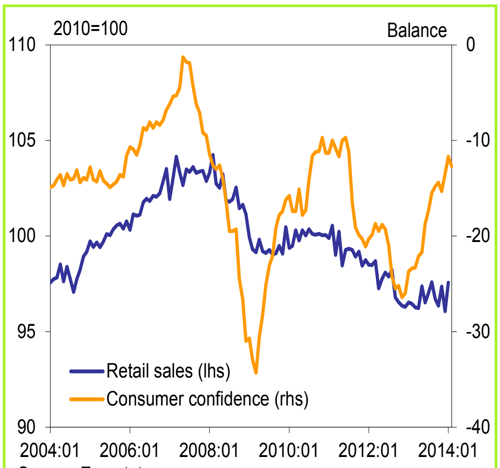
The economic growth of EU countries outside the euro area was faster last year than in the euro area. Thus, the euro area GDP fell last year by 0.4 per cent, while the non-euro area EU's GDP grew by 1.5 per cent. None of the euro countries' GDP grew as fast as the non-euro area EU. It seems that growth is not curtailed only by the tight fiscal policy dictated by the crisis, but also by the fear of the crisis

Industrial confidence and industrial production in euro area 2004:01–2014:02



Source: Eurostat

Consumer confidence and retail sales in euro area 2004:01–2014:02



Source: Eurostat

continuing and deepening. The associated uncertainty was reflected in the firms' investment decisions as well as individuals' consumption decisions. In countries such as Germany and Finland simply the fear that the crisis countries will have to be supported even more led to the notion that fiscal policy will have to cut more domestic demand. It is also possible that having their own currencies, which adapt better to the country's economic situation, is one of the reasons for the success of the non-euro area. This is highlighted right now when the euro area is divided into two camps and monetary policy decisions are based on Germany's interests, on the one hand, and those of other countries.

From the standpoint of the entire euro area, it is comforting that the financial crisis of the area's problem countries eased last year. This is evidenced by the fact that government bond rates have been steadily falling in Italy, Spain, Portugal and even Greece. Last year Spain, Portugal and Italy pulled out of recession. In the case of Spain and especially Portugal this was attributable also to the strengthening of domestic demand. In Italy, positive developments were seen only in foreign trade.

Euro area private consumption will grow by one per cent this year and 1.6 per cent next year. Investment will increase by 2 per cent this year and 3.5 per cent next year. Still last year both private consumption and investment declined in the euro area.

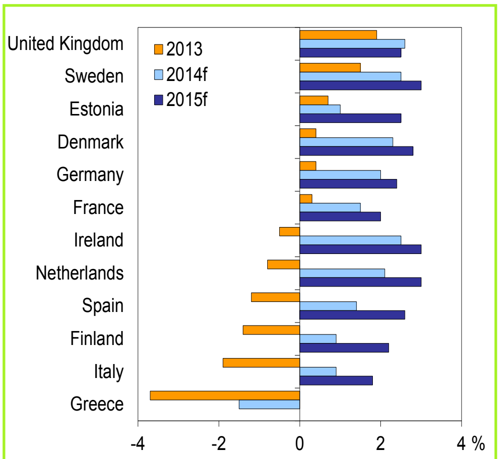
Of the EU's major countries, France has more problems constraining growth than other countries. The situation in Germany is the best of the euro countries. Its GDP will grow this year by about 2 per cent. Great Britain and Sweden's economic growth will reach about 2.5 per cent this year. In Sweden, a substantial turn for the better occurred in last year's fourth quarter, when GDP grew by 1.7 per cent compared to the previous quarter.

The risks of the euro area and the EU are related more to factors outside the area than inside. Of the internal factors, the most significant problem is the ECB's monetary policy, which is deemed at least from the Finnish viewpoint as being too tight. External factors include problems with the economic growth in China and some developing countries, which can derail the euro area onto a worse-than-forecast growth path. The current political crisis in Ukraine and the Russian involvement there can affect the EU countries more broadly if the EU introduces economic sanctions against Russia. In this scenario, we have assumed that a trade war does not unfold between the EU and Russia. This risk cannot be ruled out, but it is small if only for the reason that there is little desire for widescale economic sanctions among Germany, France and Italy, who are dependent on Russian trade and energy supply.

Euro area inflation will remain at one per cent this year

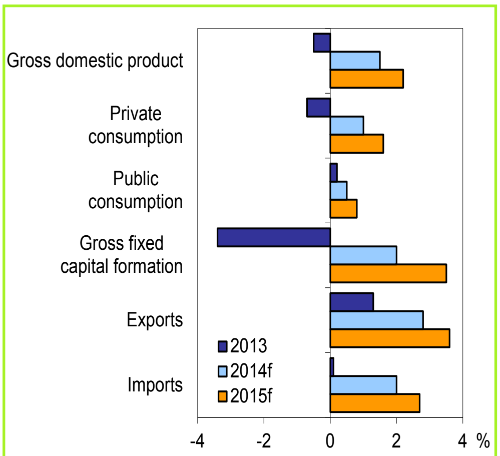
The rise in the harmonized index of consumer prices in the euro area slowed last year on average to 1.4 per cent while in February it was only 0.7 per cent. The main reasons behind this were the decline in energy prices and the appreciation of the euro. High unemployment (about 12%) has been dampening the rise in labour costs, industrial producer prices have been falling, import prices have experienced downward pressure and growth of the money supply has slowed sharply. Also inflation expectations have come down. The external value of the euro against the dollar is expected to remain at the current level. On the other hand, early in the year there was already a small acceleration of core inflation, which excludes food, energy, alcohol and tobacco prices. The pick-up of economic growth is expected to spawn an upswing in inflation. This year inflation will remain at one per cent, accelerating next year to 1.2 per cent.

GDP growth rates in 2013, 2014 and 2015



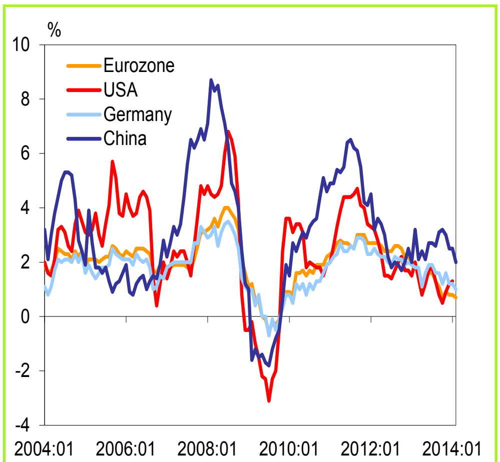
Source: Eurostat, Labour Institute for Economic Research

Eurozone economic growth 2013–2015



Source: Eurostat, Labour Institute for Economic Research

Inflation in assorted countries 2004:01–2014:02



Source: Eurostat, OECD

ECB has confirmed its low interest policy

The European Central Bank lowered its key interest rate a quarter of a percentage point to 0.25 per cent last November. The ECB has like other major central banks recently engaged in pre-announcing by informing the public that it will keep its key interest rate at the current level or lower for a prolonged time. At a press conference held on March 6th, ECB President Mario Draghi announced that the ECB has drawn its attention to the idle capacity, which is decreasing very slowly, and therefore interest rates will remain low for longer than previously anticipated, even though the economy is recovering. This means that real interest rates will fall as the economy recovers, even if no action is taken regarding nominal rates. The markets do not expect the key interest rate to be raised before 2016. As regards bond purchases, the ECB has, however, been more restrained than the central banks in the US and Japan. This is one of the reasons why the euro has so far strengthened against the dollar by about 4.5 per cent since August 2013. The monetary policy followed by the ECB is discussed more extensively in the appendix of this forecast.

Despite the lowering of the key interest rate in November last year, Euribor rates rose slightly at the end of the year. For example, three-month Euribor climbed by slightly less than 0.1 percentage points. The rise of interest rates was attributable to long-term refinancing operations, i.e. repayment of low-interest loans granted to banks over two years ago caused a tightening of the interbank funding market. The 3-month Euribor rate has already slightly exceeded 0.3 per cent, which is expected to become the average for the year as a whole. Next year, it is projected to rise, averaging 0.4 per cent. Germany's long-term interest rates are expected to remain next year well below two per cent on average, while the Finland's corresponding interest rate will fluctuate on both sides of two per cent.

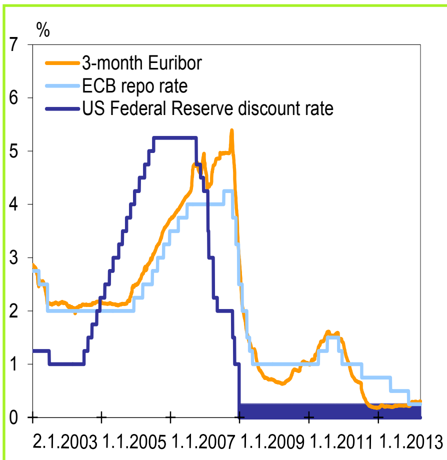
The US Federal Reserve has announced that it will raise rates if the unemployment rate falls to 6.5 per cent or below and if inflation remains below 2.5 per cent. As the unemployment rate has already subsided to 6.7 per cent, an interest rate hike may come soon. On the other hand, the Fed has announced it will halt its quantitative easing when the labour markets have significantly improved and price stability has been maintained. These two rules seem to be slightly conflicting. When the Fed announced in May 2013 that it was seriously considering tapper off its own quantitative easing, i.e. monthly purchases of government bonds, long-term bond yields started to rise in many other countries as well, except for Japan. The rise in rates continued last autumn when the Fed began to taper off its quantitative easing.

Oil prices continue to fall

The average price of crude oil (Brent) last year was just under USD 109 a barrel, or 2.6 per cent below the level of the previous year. Early in the year, oil prices have already fallen by 3.5 per cent from last year's average level and the Ukrainian crisis does not appear to have had an impact so far at least. In the long run, the price of oil is experiencing downward pressure from growth in the US's own domestic production, the improvement of logistics and reduced dependence on imports. On the other hand, the recovery of the world economy will boost the price of oil to some extent. We forecast that oil prices will average USD 106 this year and USD 102 next year.

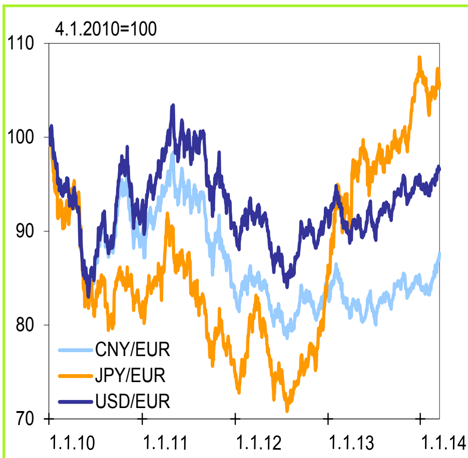
Mainly as a result of a certain increase in pessimism regarding China's economic growth, the prices of a number of industrial raw materials have fallen significantly in recent months. This variation is

Short-term interest rates 2.1.2003–17.3.2014



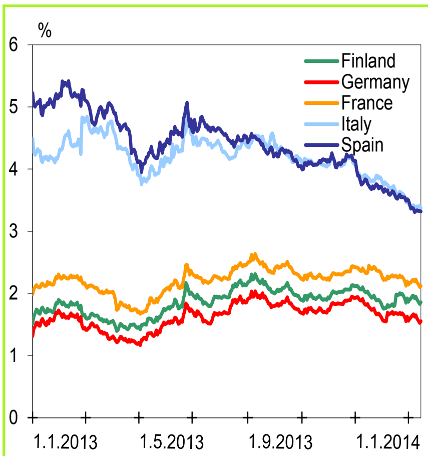
Source: ECB, Bank of Finland

Exchange rates 4.1.2010–18.3.2014



Source: ECB

Government bond yields 1.1.2013–17.3.2014



Source: Nordea

also typical of seasonal trends in the beginning of the year. The main exceptions are prices of pulp and steel, which have for a long time continued to rise. Rising prices has been common among agricultural products, especially coffee and beef. As the global economy picks up, raw material prices will begin to climb, particularly next year.

US economic growth accelerating clearly

Last year, the United States' GDP grew by 1.9 per cent. Several of its economy indicators have weakened at the end of last year. It is still a little unclear to what extent this was due to the poor weather conditions, but subsequently there has already been more positive news. For example, industrial production began to rise again clearly in February.

From a broader perspective, it is difficult to see why US economic growth could not pick up considerably in the near future. Households' debt burden has eased considerably and debt service expenditures relative to disposable income are the lowest in decades. Household net worth has started to grow in the wake of a rise in housing prices. Real earnings have started to rise and the savings ratio fall. Household confidence indicators are improving. Private consumption, which contributed approximately 70 per cent of GDP, is now being curbed by the rise in mortgage rates as long-term interest rates begin to climb, which has cut the applications for housing loans and mortgage-backed consumer loans.

During the severe winter US construction investment growth has been weak and the rise in housing starts has come to a halt. The levels are still very low compared to the past, so there is a lot of room for growth. Other types of investments have experienced some slight acceleration of growth. Both export and import growth accelerated in the second half of last year. Industrial confidence has strengthened in recent times. Employment growth has picked up after the winter, although the employment rate has remained almost unchanged and the labour force participation rate has continued on its downward trend.

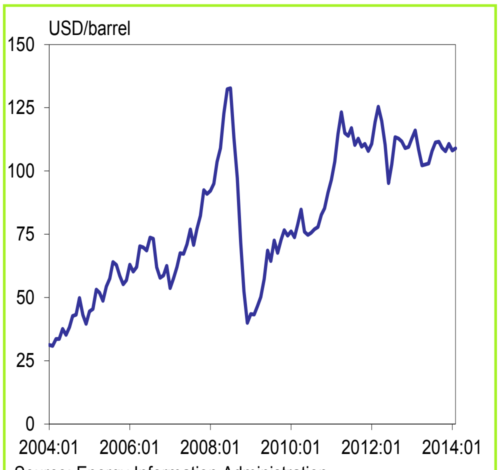
The United States is gaining added impetus to economic growth since local government cuts have almost come to an end and the magnitude of austerity measures carried out at the federal level will not be as great as those of last year.

Table 1. International economy

	Share of world GDP (%)	GDP growth (%) 2013	2014f	2015f
United States	22.8	1.9	3.0	3.5
Eur-17	17.3	-0.4	1.5	2.2
Germany	4.9	0.4	2.0	2.4
France	3.7	0.3	1.5	2.0
Italy	2.8	-1.9	0.9	1.8
EU27	23.4	0.1	1.8	2.4
Sweden	0.8	1.5	2.5	3.0
United Kingdom	3.4	1.9	2.6	2.5
China	12.2	7.7	7.2	7.0
India	2.4	4.4	5.0	6.0
Japan	6.8	1.6	1.6	2.0
Russia	2.9	1.3	1.0	1.2
Brazil	3.0	2.3	2.0	3.0

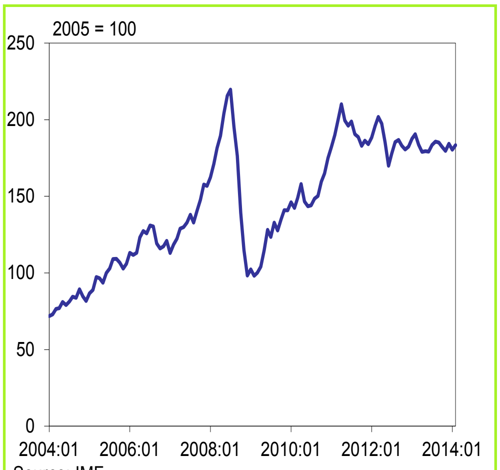
Source: BEA, BOFIT, Eurostat, IMF, Labour Institute for Economic Research

World market price of crude oil (Brent) 2004:01–2014:02



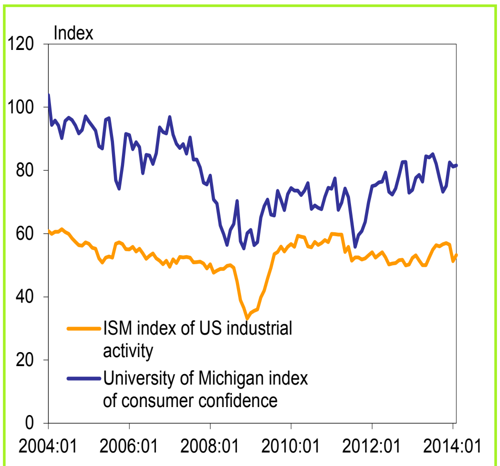
Source: Energy Information Administration

All commodity price index 2004:01–2014:02



Source: IMF

US economic indicators 2004:01–2014:02



Source: ISM, University of Michigan

We predict that US economic growth this year will be clearly faster than last year, 3 per cent. In line with the pick-up in the global economy and acceleration of growth in consumer demand, we expect growth of 3.5 per cent next year.

China will fall slightly short of its growth targets

Last year, China's GDP growth was in line with forecasts, 7.7 per cent. The government's official growth target is 7.5 per cent, but Premier Li Keqiang has repeatedly stated that this level can be relaxed to some extent when pursuing a shift in the growth strategy from investment-oriented output to a more consumption-oriented direction. In early 2014 China has reported figures showing signs of an economic slowdown with respect to industrial production and retail sales. In response to the current situation, China's central bank has put a halt to the strengthening of its country's currency, and even let it depreciate slightly.

In China there are growing concerns about the fragile situation of the financial markets. Banks' non-performing loans have been growing rapidly. Corporate bankruptcies have been allowed, almost as a warning to others. The central bank has tried to root out the shadow banking sector operating largely outside the control of the government. The Central Bank has announced that the interest rates on deposits will be deregulated in 1-2 years, as a result of which they will rise as will interest rates on loans. China's economic growth will fall slightly short of its target, being 7.2 per cent this year and 7.0 per cent next year.

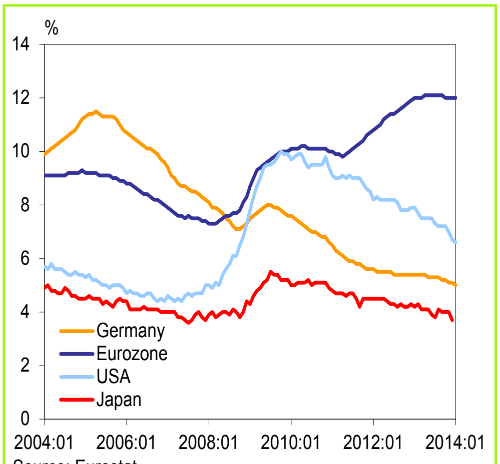
Japan's growth is accelerating slightly

Japan's economic growth remained last year at the previous year's level of 1.5 per cent. Towards the end of the year, growth in consumer demand picked up slightly and housing investment and public investment growth picked up significantly. The acceleration of inflation to nearly two per cent in April in the wake of the central bank's strong stimulus policy and the three percentage point increase in value added tax will reduce this year's consumer demand. The decline in the unemployment rate to 3.7 per cent and information on companies' willingness to raise wages suggest that household consumption possibilities will nevertheless not weaken substantially. Japan's GDP is forecast to grow 1.6 per cent this year, while next year the global economic recovery will boost growth to 2.0 per cent.

Russia is failing to meet expectations

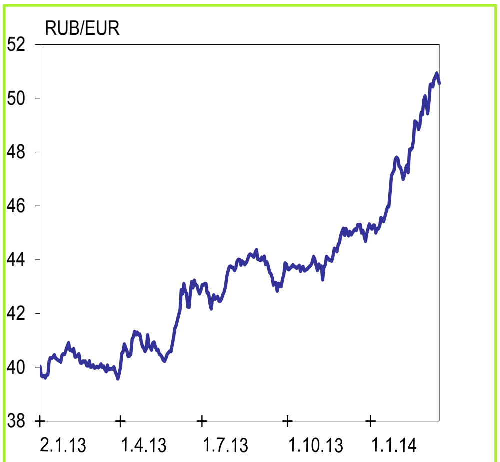
Russia's economic growth last year fell well short of forecasts, reaching 1.4 per cent according to preliminary data. Consumer demand growth slowed and investment began to decline. A slight decrease in the price of oil is harmful for Russia and it suffers from capital flight, but there are a lot of other problems, the greatest of which now is the political risk stemming from the Ukraine crisis. This will accelerate capital flight and may lead to trade sanctions. On the other hand, the rouble has already depreciated against the euro since last autumn by about twenty per cent, which would be expected to improve the economic growth of foreign trade, but at the same time it will lead to higher inflation and prompt the central bank to raise its key interest rate. The forecast is based on the assumption that the crisis in Ukraine will settle down to

Unemployment in assorted countries 2004:01–2014:01



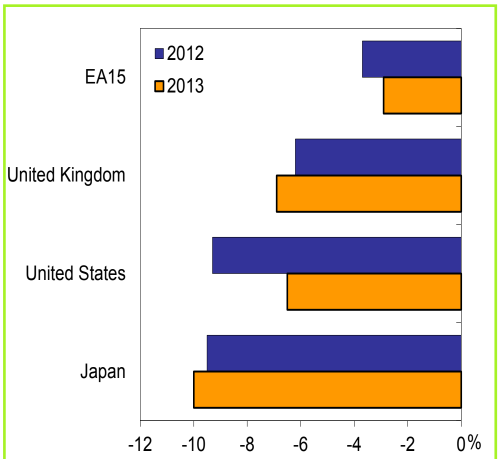
Source: Eurostat

Euro to Russian Rouble exchange rate 2.1.2013–18.3.2014



Source: ECB

Public sector deficit-to-GDP ratio in 2012 and 2013



Source: OECD

such an extent that Russia will not be subject to the third phase of the actual trade sanctions, and that it will not take actions itself that would have a strong detrimental impact on its economic growth. Growth is forecast to be 1.0 per cent this year and 1.2 per cent next year. There are nevertheless significant risks that growth will be much weaker.

Brazil's growth continues to be slow, India's growth is much faster

Brazil's economic growth accelerated to 2.3 per cent last year, driven by investment and exports. Consumption and investment growth during the forecast period will be a little more modest than previously. Brazil's growth this year is 2 per cent while the upturn in the world economy will boost growth next year to 3 per cent.

India's economy grew last year according to preliminary figures by 3.8 per cent. The country's development after the upturn in long-term interest rates resembles that of Brazil, although the Central Bank's reaction came later and was milder. Consumer demand growth has slowed down considerably, but on the other hand, export growth has accelerated sharply as a result of the devaluation of the rupee. India's growth rate will accelerate this year to 5 per cent and 6 per cent next year.

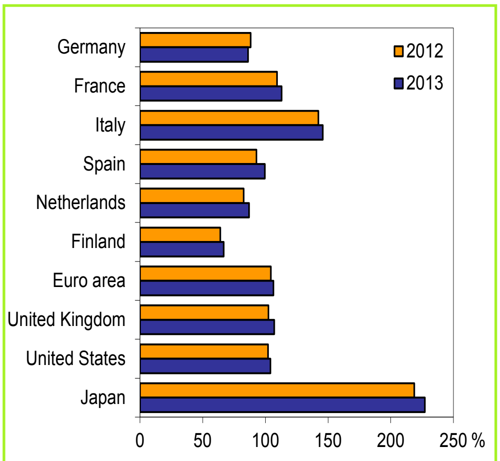
Finnish exports will not rise until end of this year

In 2013, Finland's exports grew by 0.3 per cent, while imports declined 1.8 per cent. In the fourth quarter of 2013 the export of services slumped, but merchandise exports rebounded significantly. At that time, imports also began to recover. The poor performance of Finnish exports last year is attributable to, among other things, the slumping of investment in the export countries. In the euro area investment declined from 2012 to early 2013. The previous year's level was not reached until in the last quarter of last year. As a manufacturer of capital goods and producer of natural resources, Finland has suffered more than others from the weak growth in investment demand and the relatively sluggish growth in the world markets of both the forest industry and metal goods. The situation of Finland's exports and GDP has been weakened by the steep decline in Nokia's operations.

The Labour Institute for Economic Research forecasts that Finland's total exports will grow this year by 3.5 per cent. Merchandise exports will grow by 2.5 per cent and service exports by 6 per cent. The fact that the value added of Nokia phone operations is determined this year starting in the second quarter (roughly speaking) mainly on the basis of labour costs will boost growth in Finland's service exports for the whole year by about 4 percentage points. The contraction in domestic demand will curb imports, which are forecast to grow this year by 1.3 per cent.

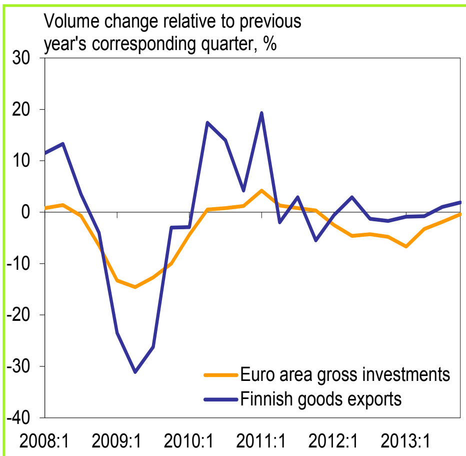
The European economic recovery and reasonable development of the global economy are finally creating the conditions for export growth in the Finnish machinery and equipment industry as well as the electrical equipment industry. This segment of industry is relatively competitive and not very vulnerable to the strengthening of the euro. On the other hand, the weakening of the US dollar and the Russian rouble against the euro has dampened export growth conditions for heavy industries, which includes the chemical forest industry, metal processing and most of the chemical industry. The same effect prevails also in the exports of the wood, food and building materials industries. The combined effect of these trends is that Finland's exports

Public debt relative to GDP in 2012 and 2013



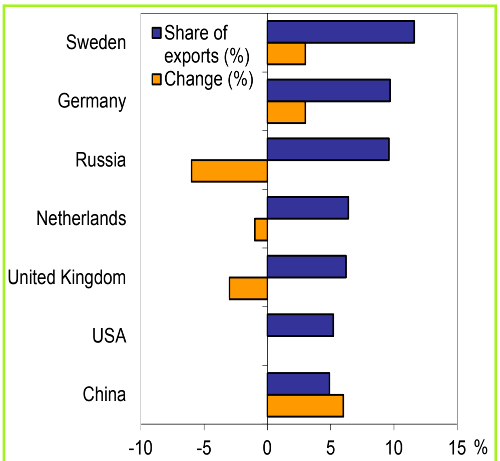
Source: OECD

Demand for investment goods and Finnish exports 2008:1–2013:4



Source: Eurostat

Finnish merchandise exports in January–December 2013



Source: Customs

may even decline in the first half of this year compared to last year's fourth quarter.

The second half of this year and especially next year look better already with regard to foreign trade. Export demand has strengthened further, and it can be assumed that the euro will no longer appreciate against the dollar. The investment cycle in the world has already built up some momentum, which increases the demand for timber harvesting and forest industry machinery. Especially next year, Finland's export figures will be bolstered by the fact that labour costs have risen more slowly in Finland than in our European competitor countries as well as in countries with weakened currencies such as the United States.

Table 2. Demand and supply

	2013 Bill. €	2013	2014f	2015f
		Percentage change in volume (%)		
Gross Domestic Product	193.4	-1.4	0.9	2.2
Imports	77.8	-1.8	1.3	3.7
Total supply	271.2	-1.5	1.0	2.6
Exports	77.6	0.3	3.5	5.5
Consumption	159.2	-0.3	-0.2	0.6
private	109.4	-0.8	-0.5	0.7
public	49.7	0.8	0.5	0.3
Investment	36.6	-4.6	-0.8	2.6
private	31.2	-6.4	-1.2	2.9
public	5.4	6.8	1.3	1.3
Change in stocks[1]	-2.2	-0.4	0.3	0.5
Total demand	271.2	-1.5	1.0	2.6

[1] *Volume change is in percentage points of GDP.*
Source: Statistics Finland, Labour Institute for Economic Research

The Labour Institute for Economic Research forecasts that Finland's goods and services exports will grow by 5.4 per cent next year while imports will rise by about 3.7 per cent. Rather sluggish growth in private consumption will continue to curb imports.

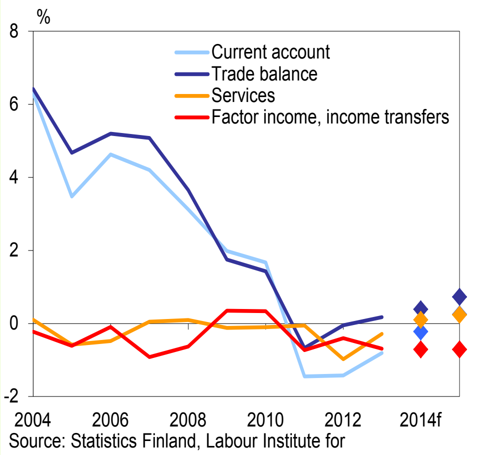
According to our assumptions, the Russian-Ukrainian conflict will not lead to a trade war between the EU and Russia. However, even now the weakness of the rouble is reducing exports of both goods and services to Russia. It is possible that Finnish exports to Russia will decrease from last year by up to 5-10 per cent even without the break-out of a large-scale trade war between our countries.

The implementation of large-scale trade and travel restrictions, to which Finland would also have to commit itself, is nevertheless possible. They could at worst cut our exports to the extent that Finland's GDP this year would be negative for a third time in a row. Large-scale, mutual trade barriers on Russian trade would undermine the Baltic countries' economies, which in turn would only steepen the decline in Finland's exports. All in all, the EU's trade sanctions imposed on Russia and Russia's counter-sanctions would hit Finland much harder than other Western European countries.

Finland's merchandise export prices will fall this year by 1.5 per cent from last year. The terms of trade will deteriorate further because import prices will drop by only 0.8 per cent. Next year, foreign trade prices will start to rise. Import prices will rise by 2 per cent and export prices by 1.2 per cent.

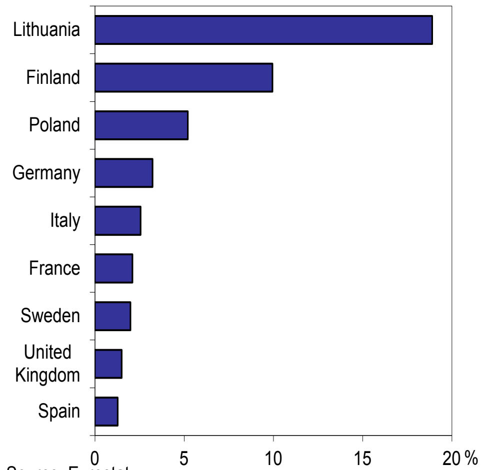
Finland 's trade surplus will grow this year by over 400 million to nearly 800 million. Next year, the trade surplus will already be about 1.5 billion euros. Even if our current account improves, it will remain

Current account surplus relative to GDP by components 2004–2015



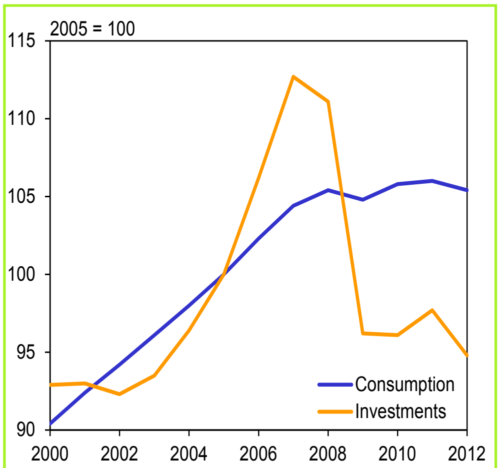
Source: Statistics Finland, Labour Institute for Economic Research

Russia's share of total merchandise exports in 2012



Source: Eurostat

EU27 consumption and private investment volume 2000–2012



Source: Eurostat

this year more than 400 million in deficit. Next year, it will start to run a surplus of approximately 500 million euros.

Production in assorted sectors

Last year, production fell extensively in industry, construction and services. Primary production expanded as did information, communication, and real estate services. This year and next structural change will continue to the extent that the growth of information services such as technical services will be much faster than the growth of GDP. The growth of the wholesale and retail trade catering to domestic demand will be zero this year as will the growth in construction. Next year, construction will grow by a couple of per cent while the recovery in wholesale trade will foster growth in the overall wholesale and retail sector by three per cent. Tight fiscal policies will curb growth of basic services and administration this year to less than half a per cent. Next year, the output of these sectors comprising the activities of the public sector will increase by one per cent.

The shift in the focal point of growth to exports this year and next will spur a recovery in the manufacturing sector. Its production will increase by just over two per cent this year and by more than four per cent next year. Production will grow in almost all industrial sectors. It should be noted that the way in which Nokia's operations are handled in Finland's National Accounts has even exaggerated the GDP impact of Nokia's decline. As regards the statistics on Nokia's mobile phone operations, the situation will be revised back closer to normal when it becomes a part of Microsoft. This revision will increase industrial production via the climb in the output of the electronics industry starting from the second quarter of this year. The impact of the revision on this year's GDP is about 0.4 per cent.

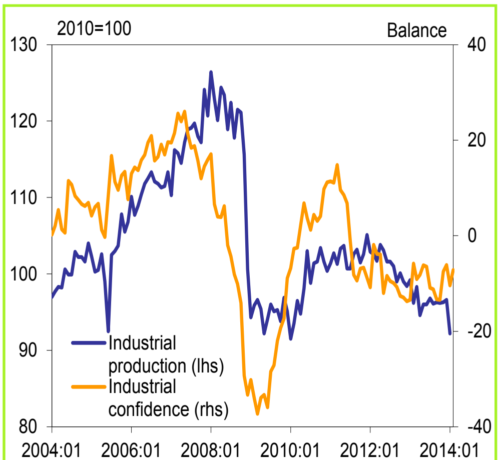
The recovery of investment in the export markets will boost the orders received especially by the machinery and equipment industry, as well as electrical equipment manufacturers. Because delivery times are often long, these orders do not appear quickly in export figures. At first, they are recorded in inventory investment, which will boost GDP this year by 0.3 percentage points. The similar effect next year will be 0.5 percentage points. The recovery in other manufacturing and the wholesale trade will also increases inventories to some extent.

Tax hikes affect inflation

Last year, Finnish consumer prices rose by an average of 1.5 per cent. The lowest inflation figure, 1.2 per cent, was reached in October, after which there was a slight acceleration to 1.6 per cent in January. In February 2014, inflation dipped back to 1.3 per cent. The hike in VAT by one percentage point carried out in the beginning of 2013 is no longer detectable, but the increases in alcohol and tobacco tax at the beginning of this year boost inflation by about half a percentage point, and a small portion of this impact will be carried over to next year. Hikes in taxes on soft drinks, cars and motor fuels have had a relatively small impact. On the other hand, the rise of food prices has slowed down considerably and the cost of owner-occupied housing has declined at the same time as the fall in mortgage rates has appreciably dampened the rise in rent and other housing costs. Consumer prices will rise this year by an average of one and a half per cent.

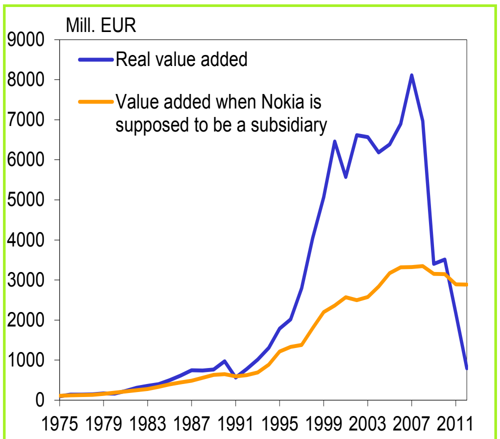
The rise in the euro area harmonized index of consumer prices (HICP) has previously been approximately the same as the HICP at constant taxes, but tax increases in Finland have made the two indexes

Industrial confidence and industrial production in Finland 2004:01–2014:02



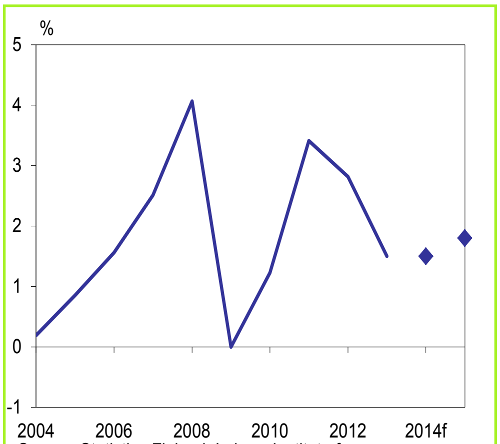
Source: Eurostat

Electronics industry's value added 1975–2012



Source: Labour Institute for Economic Research, Statistics Finland

Change in consumer prices 2004–2015



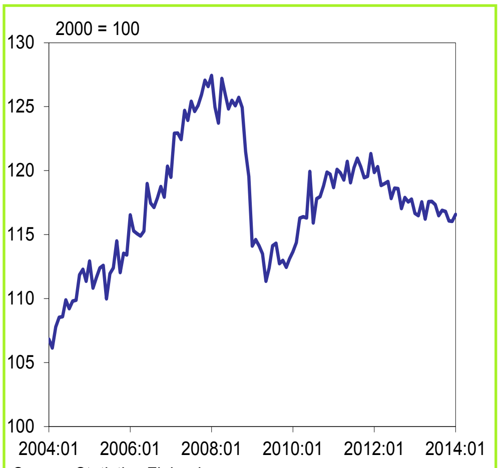
Source: Statistics Finland, Labour Institute for Economic Research

Table 3. Key forecasts

	2013	2014f	2015f
Unemployment rate (%)	8.2	8.4	8.4
Unemployed (1 000)	219	226	227
Employed (1 000)	2457	2450	2462
Employment rate (%)	68.5	68.5	68.9
Inflation, consumer price index (%)	1.5	1.5	1.8
Wages, index of wage and salary earnings (%)	2.0	1.3	1.3
Real disposable income of households (%)	-0.4	-0.3	0.5
Current account surplus (Bill. €)	-1.6	-0.4	0.5
Trade surplus (Bill. €)	0.3	0.8	1.5
Central government financial surplus			
Bill. €	-6.6	-6.2	-5.2
% / GDP	-3.4	-3.1	-2.6
General government financial surplus			
Bill. €	-3.9	-3.8	-2.7
% / GDP	-2.0	-1.9	-1.3
EDP debt			
% / GDP	57.0	59.3	59.6
Tax rate (%)	45.6	46.2	46.3
Short-term interest rates (3-month Euribor)	0.2	0.3	0.4
Long-term interest rates (10-year gov't bonds)	1.9	1.9	2.1

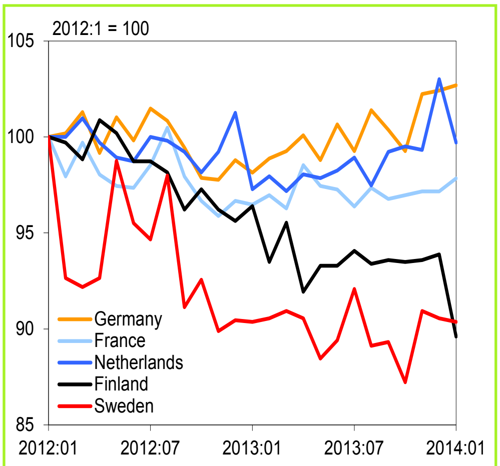
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Trend indicator of output 2004:01–2014:01



Source: Statistics Finland

Industrial production 2012:01–2014:01



Source: Eurostat

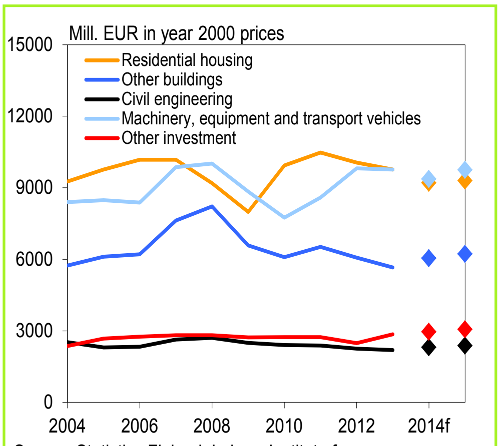
diverge. This year, their impact on consumer prices is just over half a percentage point. The forecast assumes that at the beginning of 2015 further increases in consumption taxes will be carried out, which together with the lagged effects of this year's increases will boost inflation by almost half a percentage point. Inflation will be boosted also slightly by the rise in world market prices of food and the halt in the fall of mortgage rates. Next year the rate of inflation will be 1.8 per cent.

Investment will decline slightly this year

In 2013 the volume of investments decreased by 4.6 per cent. Private investment fell by 6.4 per cent, but public investments grew by 6.8 per cent. During 2013 private investment displayed a downward trend towards the end of the year. Last year's level used as a basis for comparison will also negatively affect this year's growth figures. We predict that the volume of investment will decline this year by 0.8 per cent. Next year, more positive economic developments will boost investment growth to 2.6 per cent. Public investment will grow by 1.3 per cent in both years. Private investment will fall by 1.2 per cent this year and grow by 2.9 per cent next year.

Of the components of construction, housing investment fell last year by 3 per cent and investment in non-residential buildings decreased by 6.8 per cent. Agriculture and civil engineering fell by 2.7 per cent. We predict that this year housing investment will fall by 5.7 per cent. Other building investment will grow considerably as civil engineering grows by

Investments 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

5.6 per cent and non-residential building construction increases by 6.8 per cent. Building permits and starts act as leading indicators for forecast figures. In residential construction, these indicators project a decline this year, but a turn for the better in other construction. Next year, residential construction will expand at a 1.0 per cent pace. Civil engineering and non-residential building construction will grow by 3.0 per cent.

Machinery, equipment and transport equipment investment will decline by 4.0 per cent this year and grow by 4.0 per cent next year. Machinery, equipment and transport equipment investment fell by 5.3 per cent last year. Other investments, which consist primarily of investments in software, will grow by 3.5 per cent this year and next. Other investments will increase proportionally to other components of investment. Other investments decreased by 6 per cent last year.

Unemployment will still rise this year

In Finland the number of employed persons fell last year by over one per cent. At the same time, however, the labour force participation rate fell from 66 per cent to 65.5 per cent. Unemployment rose moderately from 7.7 per cent to 8.2 per cent. This year, employment will continue to deteriorate, especially in the first half of the year. For the year as a whole, employment will decline on average by 0.3 per cent. Next year, employment will rise, but in the beginning of the year the improvement will still be quite slow as a steeper rise is not expected until toward the end of the year. Average employment for the year as a whole will rise by 0.5 per cent.

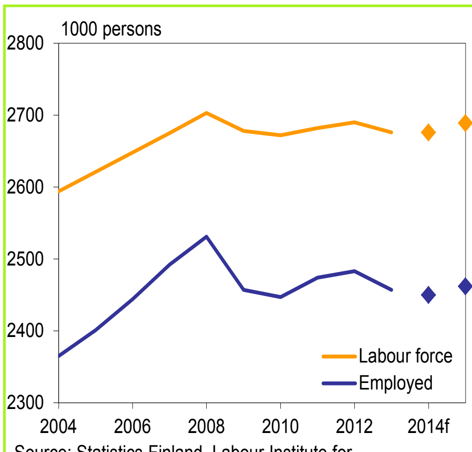
The proportion of the working age population in the labour force (the employed and those actively seeking work) has declined as employment has weakened. The number of job-seekers will increase significantly only when employment starts to improve more strongly than is the case nowadays. This year, the labour force will remain fairly stable owing to the combined impact of population growth and the continuing slight deterioration of the labour force participation rate. Next year the labour force will grow by 0.5 per cent. The unemployment rate, i.e. the share of unemployed within the labour force, will rise to 8.4 per cent this year and remain unchanged next year.

The adjustment of the amount of work in an economy takes place not only via changes in employment, but also via changes in the number of hours worked. Last year, the number of hours worked fell by 1.8 per cent, i.e. more than employment. Working hours are easier to adjust than employment and hours worked typically falls during an economic downturn initially more than employment, while they begin to rise before the employment figures as production once again starts to expand. As growth continues, the development will sooner or later be reversed, i.e. employment will increase by more than the number of hours worked. This year, the number of hours worked will fall slightly more than employment, i.e. 0.4 per cent, while next year they will grow faster than employment, i.e. 0.8 per cent.

Economic expansion and contraction are also reflected in the growth of productivity. Productivity growth has been weak compared to the past average after 2008. In 2012, productivity fell, but last year it climbed slightly, because the number of hours worked fell by 0.5 percentage points more than production. This year, GDP growth of 0.9 per cent and a 0.4 per cent decline in hours worked represent a 1.3 per cent increase in productivity per hour worked. In 2015, labour productivity will grow by 1.4 per cent.

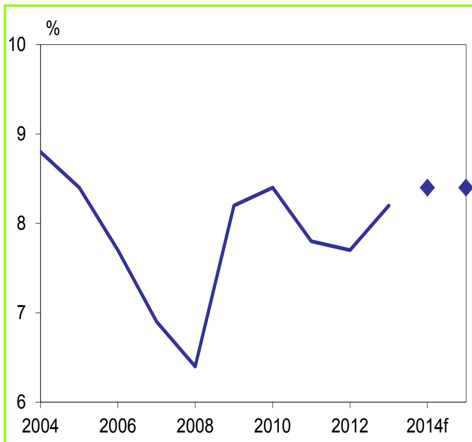
Unit labour costs measure the cost of labour input required to manufacture one unit of output in relation to a base year. Unit labour costs will rise as labour input prices increase relatively more than productivity. Finland's manufacturing unit labour costs have risen quite sharply after 2010. Manufacturing labour productivity has declined during the

Supply of labour and employment 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Unemployment rate 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Change in labour productivity and hours worked 2004–2015

Source: Statistics Finland, Labour Institute for Economic Research

same years, in 2012 by as much as 6.8 per cent in relation to hours worked. In order for unit labour costs to have decreased, labour costs should have fallen even more. The rise in unit labour costs has nevertheless begun to slow down in 2013. The labour cost index shows the industrial labour costs even stated to fall during the second half of 2013. This is likely to help improve the competitiveness of the export industry.

Real earnings will fall in both forecast years

The rise in nominal earnings last year was two per cent while earnings rose by just over one percentage point slower than in the previous year. The fastest rise in earnings continued to occur in the central government. The clear slowdown in inflation boosted real wages, which rose at a rate of half a per cent. Average earnings (wages and salaries divided by the number of hours worked) increased by 2.4 per cent, i.e. faster than the earnings index.

The comprehensive wage settlement stipulating wage increases this year and next is divided into two contract periods, the length of the first being about two years while the second is about one year. In 2014, there will be an euro-denominated increase of approximately 20 per month, or an equivalent hourly wage change, that goes into effect within four months from the beginning of each sector's collective agreement. The wage increases will therefore enter into force in different sectors at different times, because of the staged rhythm of collective agreements. The second increase is 0.4 per cent and will go into force one year after the first increase, in practice in 2015.

Earnings in both forecast years are estimated to grow by only 1.3 per cent, even though wage drift will increase slightly compared to recent years. Such a low rate of increase in earnings was last seen over twenty years ago during the recession of the 1990s. Earnings will rise more slowly than pensions: starting in 2012 the rate of increase in earnings has been lower than inflation adjustments to the pension index, and this trend is expected to continue over the forecast horizon.

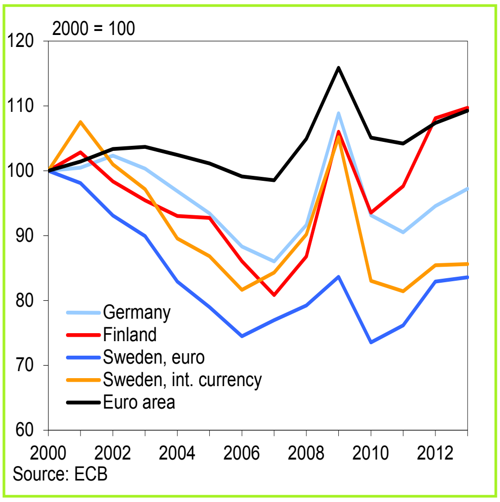
Real earnings will fall in both years (0.2 per cent and 0.5 per cent, respectively) although the rise in prices is relatively slow. Due to structural factors, average earnings are expected to rise by 1.4 per cent in both years, which is slightly faster than the earnings index.

Household purchasing power will fall also this year

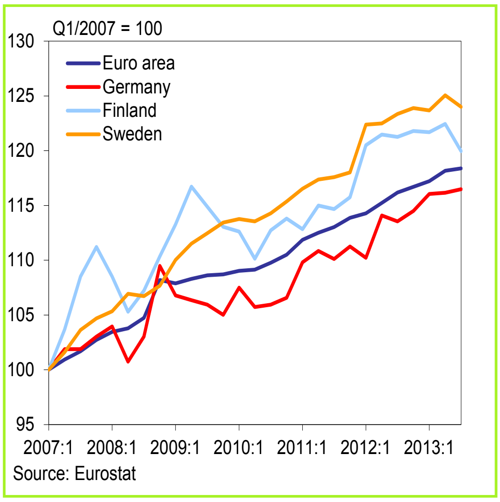
Households' real purchasing power has in practice remained unchanged for several years, and last year purchasing power was at the same level as in 2010. Purchasing power declined by 0.3 per cent compared to the previous year. The growth in the wage bill was one per cent as the rise in earnings slowed down and the number of hours worked decreased. Pension income has grown rapidly in recent years as the number of pension beneficiaries has been increasing each year due to demographic changes. Last year, the increase in pension income by more than five per cent was also spurred by inflation adjustments of almost three per cent. An extraordinary inflation adjustment made to basic benefits due to hikes in VAT, in turn, increased other income transfers. The tax burden was increased by, among other things, municipal tax hikes, the introduction of the broadcasting tax and the lack of inflation adjustments.

Real purchasing power will continue to decrease in the current year, and purchasing power is expected to decrease at the same rate as last year, i.e. 0.3 per cent. Sluggish income trends are attributable to the slowdown in earnings growth, a gentle decline in labour input, and an increase in the tax burden. Nominal wages and salaries will continue to grow at a rate of

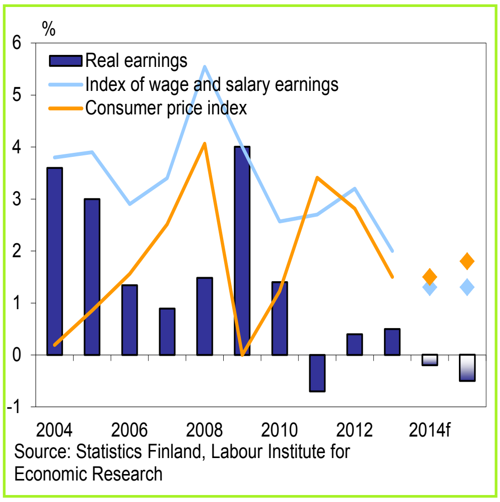
Manufacturing unit labour costs 2000–2013



Labour cost index (manufacturing) 2007:1–2013:3



Changes in level of earnings and consumer price index and real earnings 2004–2015



one per cent as the rate of increase in wages slows down and, on the other hand, labour input decreases more modestly than previously. In real terms, the wage bill will fall by half a per cent, i.e. almost the same as last year. Pension income will continue to grow at a slightly slower rate, as the inflation adjustment of pensions will be lower than in the previous year. The growth of other transfer incomes received by households will slow down over the forecast period. Property and entrepreneurial income will together increase by about two per cent compared to this year and a little bit more than this next year. The increase in the tax burden and the rise in employee pension contributions will erode purchasing power this year. Central government income taxes have been adjusted for inflation, but the increase in municipal income taxes by almost 0.4 percentage points and, among other things, dividend tax changes will increase the tax burden. A similar impact will be prompted by the lifting of the employee pension contribution by 0.4 percentage points.

Next year, real household purchasing power is expected to increase moderately, even though the real income will continue to decline gradually. The rebounding of labour input back onto a growth path, the continued rise of pension income as well as a slight pick-up in the growth of both property and entrepreneurial income will contribute to this development. The wage bill will increase by 2.2 per cent in nominal terms and in real terms by 0.5 per cent. This forecast assumes that earnings will rise on average at this year's rate of 1.4 per cent while the number of hours worked by employees will grow by 0.8 per cent. Pension income will continue to support the combined purchasing power of households, since their growth rate will remain at approximately this year's level of four per cent. Growth in purchasing power will in turn be dampened by the slight increase in the tax burden as a result of growing pressure to increase local government taxation and a lack of inflation adjustments in central government income taxation. Household nominal disposable income is expected to grow by 2.3 per cent, meaning that real purchasing power will grow by 0.5 per cent.

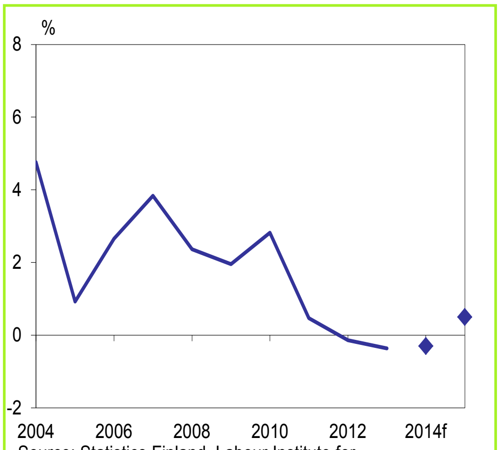
Modest income growth will dampen private consumption

Private consumption fell by 0.8 per cent last year as a consequence of the prolonged modest growth in income. All components of consumption (non-durable, semi-durable and durable goods plus services) declined. In addition to the sluggish income performance, trends are attributable to the deterioration in consumer confidence over the last year, which has been prompted by unfavourable economic news and the weakening of employment. Actual imputed consumption was also affected by the financial reforms carried out by Finnish Broadcasting Company, which reduced private consumption expenditure and increased public consumption expenditure by about half a billion euros. Without this effect, private consumption would have declined less, i.e. by only 0.4 per cent.

Private consumption will continue to decline this year, as household income growth continues to be sluggish as in previous years and real purchasing power will weaken slightly by 0.3 per cent. Private consumption will decline somewhat faster than income, i.e. by 0.5 per cent, since consumer uncertainty will not feed consumption demand at the expense of savings and income development will focus on pension and property incomes more than wage income. The latest quarterly data and information on new car registrations suggest, however, that consumer demand, which has been pent up for some time now, is beginning to affect decisions to buy durable consumer goods.

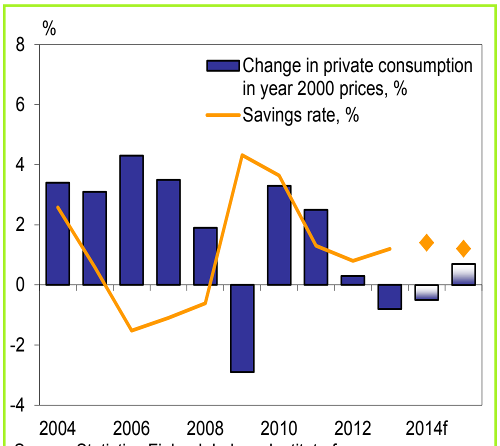
Next year, private consumption is expected to return to growth after aggregate household purchasing power recovers somewhat and the improvement in the employment situation boosts consumer confidence.

Change in households' real disposable income 2004–2015



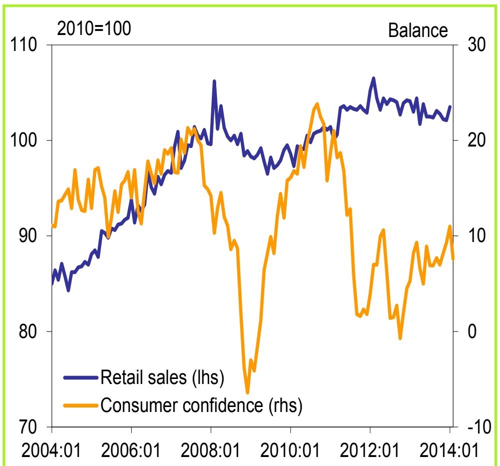
Source: Statistics Finland, Labour Institute for Economic Research

Private consumption and savings rate 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Consumer confidence and retail sales in Finland 2004:01–2014:02



Source: Eurostat

Private consumption is expected to grow by 0.7 per cent, which is slightly stronger than the growth of household purchasing power. The savings rate will rise to 1.4 per cent this year and fall to 1.2 per cent next year.

More government austerity measures ahead

The consumption tax burden is rising this year, as taxes on alcohol, tobacco, beverages, confectionery and ice-cream tax were increased from the beginning of the year. In addition, energy taxes were increased, which is projected to increase the central government's indirect tax revenue by about EUR 170 million this year. Even though the value of private consumption will grow sluggishly this year, tax hikes and the pick-up in car sales are forecast to spawn 4 per cent growth in the central government's revenues from production and import taxes.

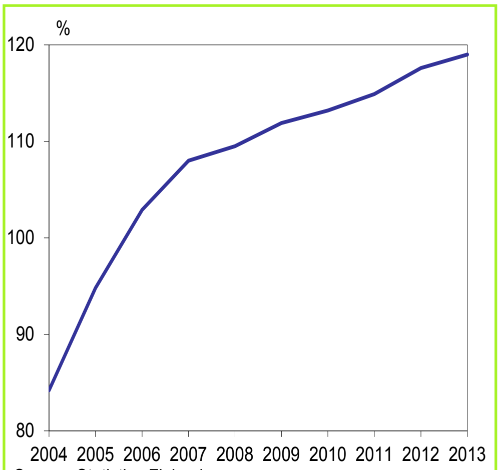
Next year's tax criteria have not yet been decided, but the forecast is based on the assumption that consumption taxes will be increased further, so that the effective consumption tax rate will rise by 0.5 percentage points in 2015. This, together with a pick-up in private consumption will boost indirect tax revenue by 4 per cent also next year.

In conjunction with the wage settlement it was agreed that the central government will make an inflation adjustment to the income tax scales this year. This will keep central government income tax rates effectively the same, but reduce direct central government tax revenues by about EUR 175 million this year. The main change in taxation this year is the lowering of the corporate tax rate by 4.5 percentage points. The lowering of the corporate tax rate will reduce direct central government tax revenue by approximately 870 million euros. Dynamic effects are hoped for cushion this effect, although they are unlikely to be realized, at least not in the short term. In the other direction, tax revenue is being raised by the increasing the tax burden on dividend income as the share of dividend income from a listed company subject to tax was increased from 70 per cent to 85 per cent. This year a number of smaller changes were also carried out in tax rates: the deductibility of corporate entertainment expenses as well as R & D expenditure was eliminated at the same time as the interest deduction of companies was limited even further. Furthermore, as a follow-up to previous changes, the tax deduction for housing loans has been reduced by a further 5 percentage points this year. As the employment trend this year is weak, all in all the direct tax revenues of the central government are expected to grow by 1.2 per cent.

Next year's income taxes decisions are still open. The forecast has been made, however, based on the assumption that there will be no inflation adjustments made in central government income taxation next year. The burden of wage taxation would thus effectively increase somewhat in this respect. Since growth in the wage bill will accelerate next year, the central government's direct tax revenues are projected to grow at a 4.5 per cent pace in 2015.

Government consumption expenditure growth will be moderate this year and especially next year as the government seeks to rein in its spending and balance the budget. The forecast indeed assumes that the government will decide on austerity measures worth half a billion euros next year. At the same time the growth in central government revenue sharing with local government will be reined in so that it that is forecast to rise this year by 2 per cent and next year by just 1.5 per cent. The central government's financial position is improving slightly this year and next year a little more: this year's EDP deficit is forecast to be 6.2 billion euros (last year it was 6.5 billion) while next year it is projected to be 5.2 billion euros.

Household debt ratio 2004–2013

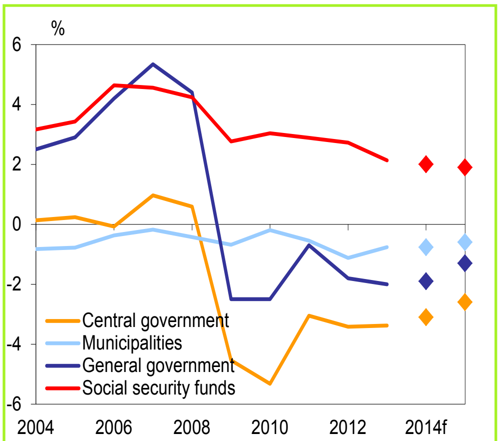


Source: Statistics Finland

Functional distribution of income in business activities 2004–2013

Source: Statistics Finland, Labour Institute for Economic Research

General government financial surplus as percentage of GDP 2004–2015



Source: Statistics Finland, Labour Institute for Economic Research

Municipalities face high expectations

Local government's financial position improved somewhat last year from the low level of a couple of years ago when their combined deficit fell from 2.2 billion to 1.5 billion euros. The pressure on the local government remains high, as the spearhead of the government structural reforms is aimed specifically at the service tasks and productivity of the municipalities.

Tax rates were raised in many municipalities last year, and the same is likely to continue during the forecast period. The municipal income tax rate is expected to rise this year by an average of 0.35 percentage points and the next year a little more modestly, by 0.2 percentage points. It is predicted also that the real estate tax revenue will grow briskly as real estate taxes are raised in many municipalities. The central government will compensate the municipalities this year for the loss of revenues from the lowering of the corporate tax rate; the strengthening of economic growth next year will boost revenues from this particular form of taxation. The growth in the wage sum is still slow, but it will pick up next year. Thus, the municipalities' direct tax revenues are forecast to grow by 3 per cent this year and 3.8 per cent next year.

The slow growth of the central government's revenue sharing with municipalities will suppress the growth of local government consumption expenditure. Pressures in this direction also come from the large structural reforms envisioned by the central government. The moderate wage settlement will nevertheless contribute to the restraint on the municipalities' expenditure side. The local government deficit is projected to remain more or less this year at last year's level of about 1.5 billion euros. Next year, it will fall slightly to 1.3 billion euros.

The contributions received by employment pension institutions will be boosted this year by increases in both employee and employer pension contribution rates by 0.4 percentage points, which also compensates for the weak growth of the wage bill. Next year, the increase will be cut in half, and will still be divided equally between employees and employers, as agreed last year in conjunction with the comprehensive wage settlement. Thus, the contributions of employment pension institutions are growing steadily during both forecast years. The expenditure side of the employment pension institutions will see steady growth as the baby boomers continue to retire. Falling inflation will nevertheless curb pressures on pension expenditures, as the index increases will remain lower than in previous years.

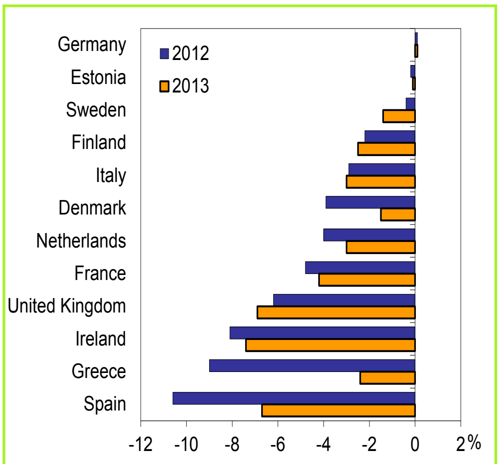
Slow improvement in financial position of general government

Hikes in excise, environmental protection and municipal tax rates as well as dividend taxes will raise the ratio of taxes to GDP this year in spite of the easing of corporate tax. Also next year, the increases in consumption taxes and local taxes will have a similar effect, but the rise in the tax ratio will be substantially more modest. Thus, the tax ratio will rise from last year's 45.6 per cent to 46.2 per cent this year while next year the tax rate is projected to be 46.3 per cent.

The ratio of public expenditure to GDP has been in the public spotlight lately. It will continue to rise this year, but next year it will start to fall owing to spending cuts and especially the pick-up in economic growth. The expenditure ratio is projected to be 58.9 per cent this year and 58.4 next year, which would be the same level as prevailed last year. When assessing the expenditure ratio, it should be kept in mind that it is typically very cyclical and sensitive to changes in the denominator, i.e. GDP.

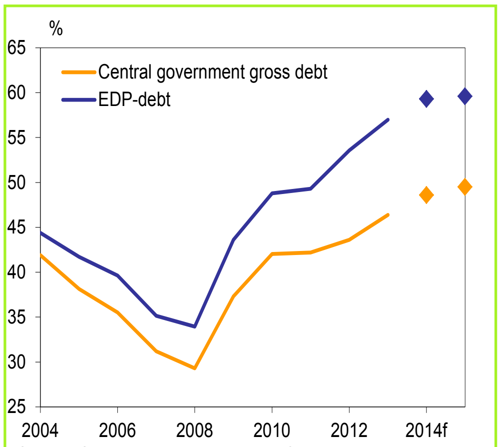
The financial position of the total public sector will remain more or less unchanged this year, but it will improve next year. The improvement in the budget balance next year is due in particular to the relatively stable development of the central government, municipalities and

Public sector deficit-to-GDP ratio in 2012 and 2013



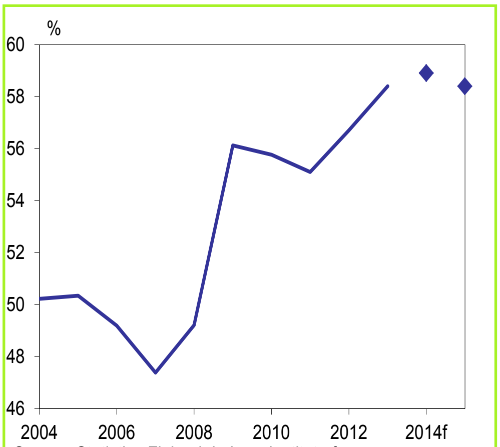
Source: OECD

Central government gross debt and general government EDP-debt as percentage of GDP 2004–2015



Source: Statistics Finland, Ministry of Finance, Labour Institute for Economic Research

Public expenditures as percentage of GDP 2004–2015

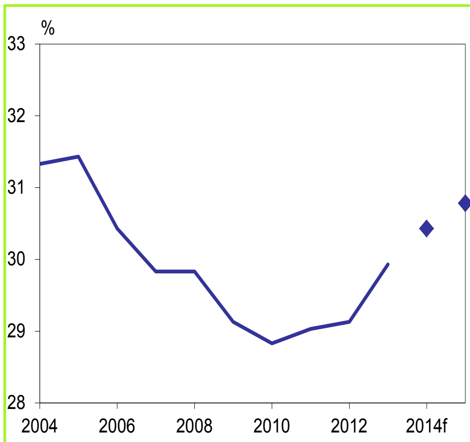


Source: Statistics Finland, Labour Institute for Economic Research

employment pension insurance institutions over the forecast horizon. Thus, the public sector's EDP-deficit-to-GDP ratio will decline from last year's 2.0 per cent to 1.9 per cent this year. Next year the public sector's EDP deficit is forecast to be 1.3 per cent of GDP. The public sector's EDP-debt-to-GDP ratio will rise but remain at just below the 60 per cent EMU ceiling during the forecast period. The central government's debt-to-GDP ratio will not start to decline during the forecast period.

When we evaluate at the size of the public sector's EDP debt, it is necessary to pay attention to a few points. EDP debt is increased by various commitments and responsibilities resulting from the financial and euro crisis that will nevertheless simultaneously increase the Finnish government's assets. These responsibilities stem from the European Stability Mechanism (ESM) and the European Financial Stability Facility (EFSF), a total of around 4.7 billion euros. In addition, the Finnish debt is increased by the bilateral loans to Iceland and Greece, the loans and commitments of the European Financial Stability Mechanism (EFSM), as well as the EU's balance of payments support, and the commitments due to the IMF's financial support to the European crisis countries - all of these constitute a total of about 2.8 billion euros. Thus, the above-mentioned items increase Finland's EDP debt by a total of about 7.5 billion and the debt ratio of just under 4 percentage points. This amount is included in public sector's EDP debt, but it has become and will continue to be a substantial source of income for the central government when the debts are repaid. This is worth remembering when looking at the rise in the debt ratio close to the 60 per cent ceiling.

Wage earners' income tax rate 2004–2015



Source: Labour Institute for Economic Research, Taxpayers' Association of Finland (TAF), VATT

Finland's fiscal policy has become relatively neutral

Finland's fiscal policy during the last couple of years has been only mildly restrictive, and in any case much lighter than the euro area on average. On the basis of negative experiences in Europe with fiscal belt-tightening, this can be considered positive to the extent that the rise in unemployment has nevertheless been moderate in spite of the weak economic situation.

Fiscal policy tightening has so far been focused on tax and not spending cuts. That was the case last year, when the ratio of taxes as a percentage of GDP rose from 44.1 per cent to 45.6 per cent. Total public spending increased last year by 3.5 per cent in nominal terms and in real terms by 1.4 per cent. The figures include the growth in pension expenditure mainly due to structure of the population. If we eliminate this effect, real growth of other expenditures comes to 0.6 per cent. Spending cuts have accounted for only a modest share of the EUR 4.7 billion in austerity measures carried out so far during the government's term in office.

This year, the ratio of taxes to GDP is expected to rise by 0.6 percentage points to 46.2 per cent. The tax ratio will be boosted in particular by hikes in municipal taxation and increases in employee pension contributions. On the other hand, taxation will be eased by the significant drop in the corporate tax rate. Public expenditure is forecast to grow in real terms by 1.3 per cent and if pensions are excluded by 0.9 per cent. Next year an estimated one billion euros in cuts will be carried out in central government expenditure based on past decisions. We assume that next year fiscal policy will be tightened further by approximately one billion euros, of which 60 per cent will be achieved through spending cuts and the rest of it by tightening of the tax burden. Despite this, total public expenditure will increase next year by an estimated 1.2 per cent in real terms and by 0.7 per cent excluding pensions. The ratio of taxes to GDP, in turn, will rise to 46.3 per cent and thus be only 0.1 percentage points higher than this year. Expenditure growth will be well below our forecast for GDP growth, but based on the above figures fiscal tightening cannot be considered excessive.

A stringent fiscal policy reduces total production by less in good times than during a recession. We anticipate that next year Finland will experience a clear upswing, which partly justifies the planned tightening of fiscal policy in a situation where the Finnish public sector's financial position must in any case be strengthened.

Finland's long-term sustainability gap for public finances will decrease significantly, and even disappear if total public expenditure increases in the coming years by about one percentage point less than GDP in real terms. This can be achieved with reasonable effort, in the sense that it is expected European and Finnish economic growth will experience a clear acceleration in the years 2015–2018. This is based on the notion that the economies are recovering after a prolonged recession and will increase their utilization rates of productive resources. Several European countries including Finland have a possibility to achieve even over three per cent growth rates in the next few years. Thereafter economic growth will nevertheless normalise and slow down considerably.

Our projections for taxation as well as on spending limits are based on assumptions at this point. They are based on the assumption that the government will raise consumption taxes next year, so that tax revenues will increase by about EUR 400 million. Instead of raising consumption taxes, fiscal tightening could be allocated elsewhere, such as real estate and energy taxation. The tax refunds of energy-intensive businesses could be reduced with respect to fossil fuels (coal, natural gas, light and heavy fuel oil). At the same time, support for the use of wood chips must be separated from the taxation of peat. The availability of energy for heavy industry could therefore rely more clearly on domestic renewable energy and nuclear power in the future.

When carrying out reforms of economic structures, it is worth noting that economic growth narrowing the sustainability gap in the long term does not depend merely on work incentives and the wage level. Education, research, work environment, stable conditions and small business layoff and recruitment costs are pivotal factors for long-term growth.

Economic restructuring has already taken concrete shape in some of the reforms which are aimed at achieving savings in public expenditure. The impact of these activities on public expenditure will nevertheless remain relatively small. Social and health care reform is the best chance to find a solution which achieves a significant expenditure savings without any reduction in the quality of public services. The quality and availability of primary health services can even be improved. As the National Institute for Health and Welfare has proposed, social and health care reform could rely on the government's initial plans, but in such a way that both the social and health services are transferred to about 20 social welfare and health care regions. Power would thus be shifted to a higher administrative level, which would allow more centralised service production. This will also foster economies of scale and specialization.

Especially in larger urban areas there is also a need to centralize comprehensive administration of land use, housing and transport solutions for the entire region. The most efficient way to do this would be establish a large municipality comprising the commuting area. If this is cannot be done, then a metropolitan government would be an improvement over the current situation. More centralized decision-making would achieve cost savings and make it possible to provide affordable housing so that a shortage of affordable housing would not prevent the labour force from moving after work opportunities. ■

Eero Lehto

ECB should follow easier monetary policy

The European Central Bank (ECB) has without a doubt played a major role in alleviating the euro crisis. After the financial crisis that began in the autumn of 2008, it has lowered its key interest rate by a total of four percentage points, started the crisis countries' government bond purchase programme, granted three-year loans to banks at a one per cent rate of interest and otherwise eased the banks' central bank funding. The most significant action, however, was the ECB's promise in the summer of 2012 to buy, if necessary under certain conditions, an unlimited amount of government bonds in the secondary market. Since then, the crisis countries' government bond yields have fallen by several percentage points.

At its last meeting on March 6th the ECB's Governing Council did not make any new monetary policy decisions. This passivity has raised some eyebrows, since the euro area's inflation rate of 0.7 per cent in February (down by 1.2 percentage points from a year ago) was well below the ECB's target of below but near 2 per cent. The International Monetary Fund, the OECD, and - with a little more moderate phrasing - even the European Commission have called on the ECB to continue its policy easing. It has even been warned of the threat of deflation.

At the press conference held after the meeting held on March 6th, ECB President Mario Draghi noted that the euro zone has not observed a fall in prices of broad product groups nor self-feeding deflation. The price of energy has fallen the most noticeably: according to Draghi of the 1.9 percentage point drop in inflation after the first quarter of 2012, some two-thirds (1.3 percentage points) is due to lower energy prices. The strengthening of the euro by about 8 per cent during the corresponding period has reduced the rate of inflation by about 0.4 to 0.5 percentage points.

The ECB does not base its monetary policy decisions on actual inflation, but rather on medium-term (1.5-2 years) inflation expectations, as monetary policy measures affect with a lag. It makes its own inflation forecasts, and also refers to other experts' forecasts (see adjacent table) indicating that inflation will remain well below two per cent in the near future.

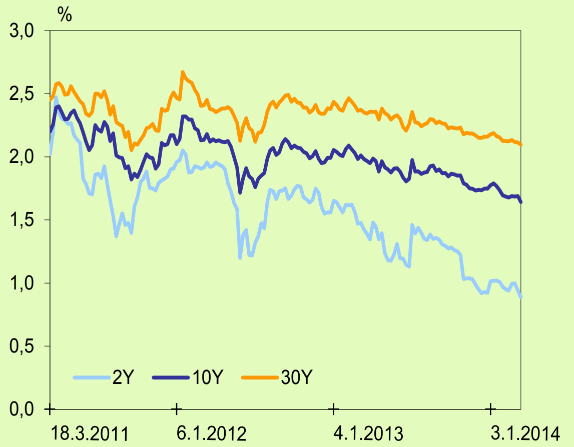
Table. Comparison of forecasts for euro area real GDP growth and HICP inflation

	2014	2015	2016
ECB	1.0	1.3	1.5
Survey of Professional Forecasters	1.1	1.4	1.7
Consensus Economics	1.0	1.4	1.8
Euro Zone Barometer	1.0	1.3	1.8
European Commission	1.0	1.3	-
OECD	1.2	1.2	-
IMF	1.5	1.4	1.5

Source: ECB Monthly Bulletin, March 2014, p. 97.

According to these projections, euro area inflation will accelerate slowly. The ECB forecasts it will rise in the fourth quarter of 2016 to 1.7 per cent, which is already close to its target. According to its forecast the probability of deflation during this period is negligible. At the March 6th press conference, ECB President Draghi argued that the euro area inflation expectations are ”well anchored”.

Figure 1. Average inflation expectations for the next 2, 10 and 30 years as measured by zero-coupon inflation swaps 18.3.2011–13.3.2014



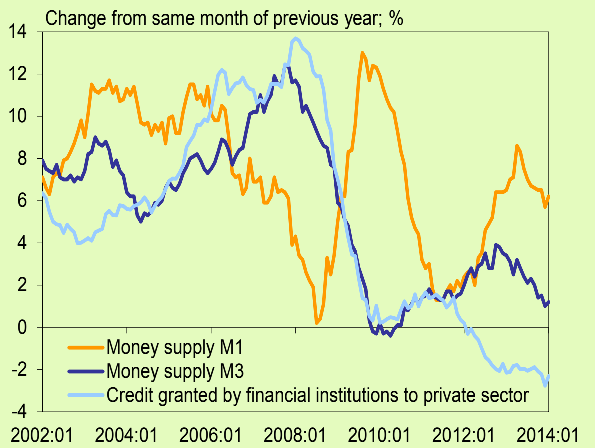
Source: Nordea

Euro area inflation expectations have nevertheless recently come down markedly. Experts' expectations may also be biased. The ECB Monthly Bulletin of July 2006 estimated that they often give too much weight to realized inflation, which means that as inflation slows down (like now), these expectations remain too high. This seems to have taken place: the inflation expectations of the ECB's group of experts formed by the spring of 2012 exceeded actual inflation by 0.2-0.4 percentage points in 2013. The ECB has been warned of similar deflationary experiences that Japan has had since the 1990s. A study published by the Bank of Japan found that it took economists a long time to reduce their inflation expectations to zero and below.

It is striking that the ECB's Monthly Bulletin in July 2006 analysed market inflation expectations, but they are not mentioned at all now. That conclusion of that study was precisely that the market expectations should be taken into account. Financial market inflation expectations (Figure 1) for the euro area for the next two years on average have fallen significantly and are already less than one per cent. The options market considers deflation to be more likely than before. ECB President Draghi insufficiently substantiated claim of ”well-anchored” inflation expectations seem a little strange, if not downright intentionally misleading: he cannot defend the central bank's inaction this way.

Even if the euro area is not sinking into deflation, very low inflation causes difficult problems. It is painful for the crisis countries to improve their competitiveness, because they need lower inflation than the rest of the euro area. Easing debt burdens is more difficult in a low inflation environment. The lowest inflation countries are also the ones where the burden of debt is the largest and real interest rates the highest. High real interest rates make it difficult to reduce unemployment. After the outbreak of the financial crisis in the euro area, the unemployment rate has risen by about five percentage points, on average to 12 per cent. In Greece and Spain it is above 25 per cent.

Figure 2. Growth of narrow money supply (M1), broad money supply (M3) and credit granted by financial institutions to private sector in euro area 2002:01–2014:02



Source: ECB

According to its rules, the ECB could promote employment if the inflation target is not compromised. Some comparisons (for example, like [this one](#)) based on the so-called Taylor rule – which connects the key interest rate to inflation and unemployment (or to the so-called the output gap) – suggest that even if the ECB key interest rate were set at the right level on average, it should be clearly negative for the crisis countries. Such estimates depend on the details of the method used. For example, if it is considered that the unemployment rate's weight and in particular its gap with respect to full employment in the above-mentioned comparison are too small, the Taylor rule says the key interest rate should be lowered.

Finland's inflation is the highest in the euro area and the unemployment rate significantly lower, so according to the above rule, the key interest rate should be much higher in Finland than currently is the case. Nevertheless, in an alternative version of the Taylor rule, Finland's higher inflation stemming partly from increases in consumption taxes and the large output gap (difference between GDP and potential output) could justify a considerably lower key interest rate.

The ECB has always justified its low inflation target by the negative effects of inflation on long-term economic growth. A number of recent empirical studies (e.g. this one), however, suggest that in developed countries the inflation level at which it begins to have an adverse effect on economic growth is well above the ECB's inflation target.

In order to combat too low inflation and deflation, as well as to promote employment, the ECB could follow in a much easier monetary policy. It has already considered a number of alternatives. The key interest rate could be lowered and its pre-announcement could be confirmed. The halting of sterilization of government bond purchases (i.e., mopping up the corresponding liquidity from the banks by other means) is also one of the alternatives on the ECB's list. These two measures would not have a very big impact. More effective actions include expanding the ECB's programme of lending via government bond purchases, but also its extension to private sector bonds. A considerably easier monetary policy would also lead to the depreciation of the euro, which would have a positive impact on foreign trade.

Figure 2 shows how money supply growth has slowed down recently (the growth rate of broad money supply has remained clearly below the ECB's previous target of 4.5 per cent) and lending by banks and other financial institutions to households and firms has declined at an accelerating pace. These factors have contributed to the weak economic development of the euro area and also the subdued rate of inflation in the background.

The German Bundesbank has been very lukewarm to expanding the ECB's lending, which it fears will fuel inflation and weaken the willingness of the crisis countries to carry out structural reforms. The ECB's promise, in principle, to make unlimited government bond purchases last autumn received a lot of criticism from the German Federal Constitutional Court, which nevertheless referred the case to the EU Court of Justice. If the court considers bond purchases to be illegal, the ECB will lose one very important (albeit so far unused) tool if the euro crisis escalates again.

The inspection of banks' balance sheets by next October may lead to a situation where they will have be capitalized with public funds. This would not necessarily require the ECB's purchases of government bonds, but possibly other measures. The ECB is wise to "reserve some punches" for this situation, which may partly explain its current passivity.

Heikki Taimio