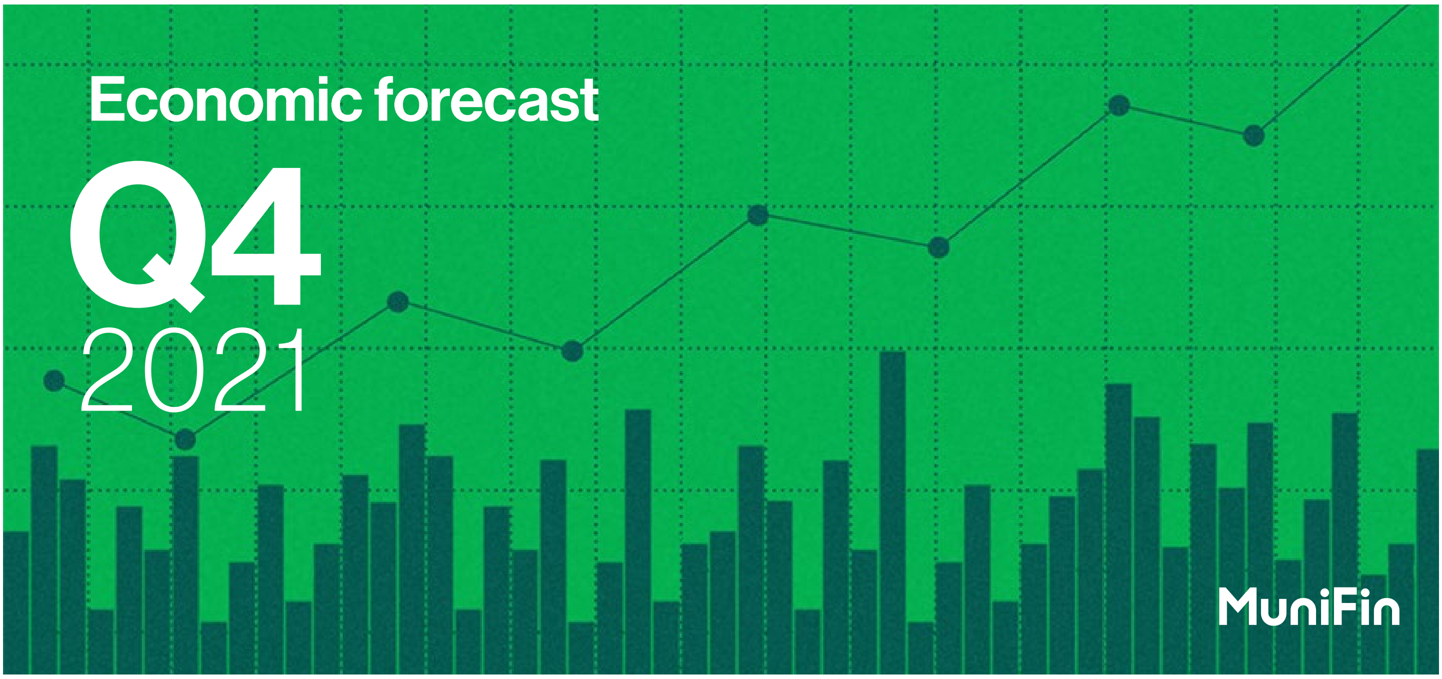

Growth continues, but new virus variants wreak uncertainty – Finland must focus on economic reform

All the basic elements of growth still exist, but the cyclical risks are growing as both the new COVID variant and China's overheated property sector cause rising concern. Central banks in the United States and Europe are balancing between inflation risk and economic recovery. Finland is already nearing its structural growth trend and should shift the focus from damage control to bold reform. Municipalities have enjoyed generous COVID support measures, which are now coming to an end.

MUNIFIN
ECONOMIC FORECAST FOR FINLAND, DECEMBER 2021
Change, %

		2020	2021f	2022f	2023f
Supply	GDP	-2.9	↑ 3.5	↓ 2.6	→ 1.8
	Import	-6.5	↑ 3.0	↑ 7.0	→ 2.5
Demand	Private consumption	-4.7	→ 3.2	↓ 3.0	→ 1.8
	Public consumption	0.5	↑ 3.0	→ 0.0	→ 0.5
	Investments	-0.7	↓ 1.5	↓ 3.5	→ 2.0
	Export	-6.8	↑ 4.0	↑ 7.5	→ 3.0
Other forecasts*	Unemployment rate (ages 15–74)	7.8	↓ 7.6	↓ 6.9	↓ 6.5
	Consumer price inflation	0.3	↑ 2.2	↑ 2.8	↓ 1.6

Arrows: forecast ↑ raised ↓ lowered → unchanged

** Forecasted annual average. Sources: Statistics Finland, MuniFin*

Global growth stabilising, but Omicron leaves much to guess

Global economic growth has calmed down, but the basic elements of an upward trend are still present. Employment is growing, household savings are driving consumption and investments are recovering. Short-term risks in the economic situation have nevertheless been on the rise for some time now. Omicron, the new coronavirus variant discovered in South Africa, has raised uncertainty to a new level.

> ”Because very little is yet known about how dangerous and vaccine resistant the new Omicron variant is, it is difficult to estimate what impact it will have on the economy.”

Every new pandemic wave has caused a smaller financial impact than the previous. The serious nature of the Delta variant outbreak and the ensuing restrictions will inevitably slow down growth in Europe in the coming months. Because very little is yet known about how dangerous and vaccine resistant the new Omicron variant is, it is difficult to estimate what impact it will have on the economy.

Another current risk involves China, whose overheated property sector is cooling down quickly. Construction investments have played an exceptionally large role in China's economic growth. A substantial slowdown of China's GDP growth would reflect negatively on the world economy.

The business environment continues to be hampered by the disparity between the recovery rates in supply and demand. The high price of energy and the shortage of components and transport capacity also continue to cause cost pressures. Rising inflation weakens consumer buying power and thus also takes its toll on economic activity.

Central banks continue their balancing act: Fed to raise rates next year

Inflation has accelerated significantly both in the United States and Europe, forcing central banks to strive to balance the monetary policy under particularly tricky circumstances. On the one hand, central banks must keep future inflation expectations in check, but on the other hand, too many tightening measures imposed too quickly could grind economic recovery to a halt.

The main trends in monetary policy are the same in the United States and Europe, but the central banks will move at a considerably different pace. The risk of the economy overheating is greater in the United States, because private consumption has been heavily supported and job markets suffering from labour shortage are seeing increasing pay rises. The Fed, the central bank of the United States, has already begun to gradually reduce its stimulus measures by cutting its monthly asset purchases. Unless the aggravating pandemic situation causes the short-term outlook to take a significant turn for the worse, the Fed is likely to raise its key interest rates next year, sooner than predicted.

Cost pressures are on the rise also in the euro area, and the steep increase in the price of energy is no longer the only driver of inflation. Inflation is nevertheless still mainly explained by reasons that are expected to be temporary. As the worst bottlenecks in production are being released, their price-increasing effects may soon be replaced by a pressure to decrease prices, returning inflation below the ECB's target level. The uncertain inflation outlook is nevertheless causing the ECB a real headache.

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The ECB's new symmetrical inflation target of two percent leaves the central bank more leeway to ignore temporary cost-push inflation. The ECB is likely to take advantage of this and not make dramatic changes to its recovery policy next year. The scaling down of non-standard measures can begin in 2022, but presumably very gradually. It now seems that a prudent normalisation of the interest rate policy could begin in late 2023, when the euro area should reach its pre-pandemic growth path. But the outlook in monetary policy is highly prone to changes in the pandemic situation also in Europe.

Finland nearing a turning point in growth: Focus must be shifted from damage control to reform

The pandemic has put Finland to a tough test, but its economic impact has remained relatively moderate. Finland's GDP exceeded the pre-pandemic level in the second quarter of this year and has now topped the peak of the summer of 2019. Employment has also recovered briskly, with the total number of people in employment reaching an all-time high in the autumn. Finland's industrial sector has not suffered from the global component shortage as much as that of countries like Germany and Sweden, in which the role of the car industry is greater. So far, Finland has also seen a smaller rise in inflation than the euro area on average.

Because the GDP and employment figures in the third quarter exceeded our expectations, we have revised our growth forecast for 2021, raising it from 3.2% to 3.5%.

The worsening pandemic situation will slow down economic recovery in the winter months, which means that in 2022, GDP growth could mainly take place in the summer and autumn. There is still potential for faster-than-average growth: the hours worked have room for improvement and there also seems to be some pent-up demand left. Despite the risks in the global economy, companies continue to have confidence in the economy. On the other hand, consumer buying power has been slashed particularly by the rising cost of living and fuel. Buying power is likely to become even weaker if the price hike also spreads to cover various other necessities, such as groceries.

> ”Due to the unfavourable COVID situation and the cost pressures proving more persistent than expected, we have lowered next year's GDP growth forecast from 3.0% to 2.6%.”

Due to the unfavourable COVID situation and the cost pressures proving more persistent than expected, we have lowered next year's GDP growth forecast from 3.0% to 2.6%.

Although employment continues to grow, labour shortage is already clearly limiting employment growth. Because the employment trend this year has been much more favourable than we expected, we have slightly lowered our unemployment rate forecasts for the entire forecast period. We currently estimate the average unemployment rate to go down to 7.6% this year, to 6.9% in 2022 and to 6.5% in 2023.

In 2023, Finland will be close to the point in which resource utilisation rate is high and GDP development is largely determined by the potential growth path in economy. Finland's long-term growth potential currently varies between 1.0% and 1.5%. Because it seems that the years of recovery will still give an extra push to the economy in 2023, our growth forecast for 2023 continues to stand at 1.8%.

> ”Finland's long-term growth path is too low to sustain the welfare state as it is. We must shift our mindset from damage control to bold reform.”

If the pandemic permits, the Finnish economy can reach its pre-pandemic growth path quite quickly. The real challenge is that this long-term growth path is too low to sustain the welfare state as it is. For this reason, we must shift our mindset from damage control to bold reform. This means investing in education, research and product development, not forgetting the green transition. We will also need considerably more foreign workers, which calls for an attitude change in the way non-native employees are viewed.

We must create an outlook in which companies have ready access to human capital, now and in the future. Otherwise, our economy will struggle to attract growth investments.

Municipalities have enjoyed generous COVID support measures, which are now coming to an end

Almost all of the key indicators of municipal finances are now looking better than predicted in the Local Government Finances Programme published by the Ministry of Finance in autumn 2019, before the pandemic. The central government has shouldered the main responsibility for mitigating the negative economic impact of the pandemic, ensuring that municipalities will not feel the pandemic's pinch.

> "The central government is to face the lion's share of the stabilisation efforts. Generous COVID support measures are inevitably coming to an end."

Despite the temporary boost in municipal finances, uncertainty over the long-term financial capacity of municipal economy remains great. Central government economy has run into increasing debt during the pandemic – albeit with good reason – but in the future, efforts must be made to gradually stabilise the central government debt ratio. The central government is to face the lion's share of the stabilisation efforts. Generous COVID support measures are inevitably coming to an end.

Finland's health and social services reform will introduce major changes to the financing structure of municipalities. Municipalities with a growing working-age population and a strong tax base will typically lose proportionately more tax income than municipalities with an aged population and a weaker tax base. The outcome is unfavourable. After the reform, municipalities that can now rely on a growing tax income will become increasingly dependent on central government income transfers. And municipalities with a weakening tax base could lose some of their secure transfers from the central government, increasing their reliance on their own, more uncertain tax income. Changes in the financing structure make it difficult to predict municipal finances in the long term.

> "To ensure that we can keep up with the skills competition internationally, education resources should be increased."

The successful implementation of the health and social services reform is worthy of investment because the population is ageing fast and healthcare costs are growing steeply. But it is important to bear in mind that the provision of education, the key basic public service for future growth, continues to be very much the responsibility of municipalities. The average level of education in the age group entering the labour market has stopped increasing. Finland has also fallen below the OECD average in the percentage of tertiary graduates. To ensure that we can keep up with the skills competition internationally, education resources should be increased.

Unfortunately, the capacity of municipalities to maintain and develop education services is at risk. In many municipalities, a marked drop in birth rate is causing a shortage of pupils and pushing up the cost per unit in education. Municipalities showing a large deficit will struggle to find balance even after the health and social services reform. With the reform halving municipal duties, there is a risk that education will take the hit and suffer greater adjustments in these municipalities.

Another important ongoing reform is the extension of compulsory education, because it is very hard to find a job straight out of basic education, without any upper secondary education. But the reform is not without its costs. In order to achieve the goal of a higher level of education for all, more resources will probably be needed in basic education as well. Extending compulsory education to cover the completion of upper secondary education is also not always enough to guarantee that students actually achieve their qualification. Learning challenges and risks of social exclusion must be addressed early on. To do this, municipalities will need more resources, but as of yet, it is unclear where these resources will come from.

MuniFin's Economic Forecast is written by Chief Economist, Doctor of Social Sciences **Timo Vesala**. His economic commentary is available in MuniFin's economic forecasts and market reviews

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