Pentti Hakkarainen: Economic outlook – still uncharted waters ahead

Speech by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, at the Norway-Finland Trade Association, Helsinki, 11 April 2011.

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The world economy has been recovering from the deep financial and economic crisis. Recently the rapid increase in energy prices, the natural disaster in Japan, and the once again heightened sovereign debt crisis have all casted a shadow over the global economic prospects.

Should we be optimistic or pessimistic on the current outlook? As Winston Churchill has stated, "A pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty."

Today, I've chosen to be on the positive side, trying to be still a realist.

I'd like to briefly discuss the trends in the world economic outlook and the current situation in Europe. There are quite a number of positive signs. Thereafter I'd like to say a few words on the long-term fiscal policy challenges that the recent crisis has posed to most advanced countries. Finally, I'll present the Bank of Finland's forecast of the Finnish economy.

The global outlook

The world economy has been recovering from the economic crisis during the latter part of 2010 and early months of 2011. According to the Bank of Finland's March 2011 forecast, the world economy and world trade will continue to grow at a brisk pace.

However, growth has remained highly divergent in different regions, with the emerging economies under China's lead still firmly at the forefront. *[Slide 2]* Advanced economies, in turn, have witnessed continued slow recovery by historical standards, and unemployment has remained high.

Recently, differences in growth have also started to appear across the advanced economies. While the economic outlook for the United States and partly for Europe has improved, prospects have remained very weak for some European countries.

The forecast was finalised before the latest increase of uncertainty: the rapid rise of oil price, the tsunami and the nuclear disaster in Japan, and the recent heightening of the sovereign debt crisis. It is still too early to say the full impact of these but the sign is clear: it is negative.

Markets are relatively optimistic: stock indices outside Japan have rebounded *[Slide 3]*. On the other hand, the March PMI (survey) indices show some signs of taming. On balance, it currently looks that these shocks are not enough to derail the recovery of the world economy.

The sustained robust growth in emerging economies has increased the demand for raw materials which has led to the elevation of their world market prices. This has fuelled inflation the world over. Domestically-generated inflationary pressures in advanced economies have so far been held in check by economic slack, as reflected, for example, in low employment and capacity utilisation rates.

There are a variety of explanatory factors behind the rapid growth of emerging economies. Imports of more sophisticated technologies and better models of production have boosted productivity growth. In addition, their economic policy institutions have been upgraded and economic policy has become more coherent.

A strengthening of protectionism in different parts of the world, which was feared during the crisis, remained relatively limited. World trade has expanded rapidly since the crisis, the volume already having reached the pre-crisis level. World trade growth is also expected to continue in the years to come, albeit at a more moderate pace than in 2010.

More divergence in Europe

A large part of Europe continued to recover last year despite widely reported difficulties encountered by peripheral European countries, *[Slide 4]*. The divergence in economic performance between the countries became increasingly apparent. While Germany and its neighbouring countries experienced robust growth, the economies suffering from the debt crisis contracted or grew only very slowly.

However, the growth decelerated towards year-end from the exceptionally high rates observed earlier in the year, as the temporary impetus from inventory replenishment, which had fuelled growth in the early part of 2010, began to recede. Simultaneously, the strong export growth also began to lose momentum. Nevertheless, growth in new export orders picked up again in the last months of the year, and survey results point to firms' expectations of a rebound in export growth in the early part of 2011.

Consumption growth has been curtailed by high unemployment. Differences in unemployment rates between the countries are very large: in the Netherlands, the unemployment rate is slightly over 4%, compared to more than 20% in Spain as the average of the euro area is slightly under 10%.

Europe will continue to see sluggish economic growth in the coming years, as most European countries have to reduce their public deficits. Underlying the robust economic growth of the largest European economy, Germany, is the strong pull of exports, enabled by continued strong competitiveness, which has lifted business confidence indices to all-time highs. Despite expectations, Germany's robust growth has not yet spilled over to private consumer demand, which has expanded only moderately.

Like Germany, Finland experienced a strong rebound in 2010, although it started a little later than elsewhere in Europe, as global demand for capital goods increased. Finland's economic outlook is discussed in greater detail in the following section.

Recent crisis poses a long-term challenge to fiscal policy

Debt problems have come to the fore especially in Europe *[Slide 5]*, where in the past three years eight countries have already found it necessary to seek emergency funding from the International Monetary Fund.

In 2010, emergency funding was also needed in euro area countries. Greece was the first to agree, in May, with the International Monetary Fund and the EU, on a comprehensive financial support package, followed by Ireland in December.

The financial assistance packages were conditional on the countries' commitment to economic programmes aimed at stabilising public finances.

The outbreak of the government debt crisis led to efforts to strengthen European institutions so as to prevent crises from emerging and contribute to minimising the damages when they do occur. At the end of 2010, euro area governments agreed on the establishment in 2013 of a permanent crisis management framework, the European Stability Mechanism (ESM).

Finland's economic outlook

The Finnish economy recovered strongly in 2010, with growth bolstered by both domestic demand and exports *[Slide 6]*. The substantial increase in output over the course of 2010 will also considerably boost the average growth figures for 2011. Growth will continue to be relatively brisk, but will slow noticeably towards the end of the forecast period. GDP will grow 3.9% in 2011, 2.7% in 2012 and 2.5% in 2013.

The recession has caused a contraction in the GDP share of industry, and conversely an increase in the share of service sectors, which are characterised by slower productivity growth. Over the longer term, this structural shift will weaken the growth potential of the economy. Export growth will be bolstered by stronger global demand for capital goods towards the end of the forecast period.

The general government deficit will contract, but government debt will not. At the end of the forecast period the general government deficit will be 0.8% and general government debt 54.0% of GDP. The current account will continue in surplus.

Recent developments in the Finnish economy have been mixed. On one hand, economic growth has strengthened and surveys indicate strongly improved confidence in the future. On the other hand, the rapid growth has touched only some sectors of the economy, and new areas of concern have emerged both internationally and domestically. *[Slide 7]*

The recovery in industrial output has progressed at a very different pace in different industries. The chemical industry appears to have already recovered from the recession. Metal industry output, too, began to grow during the course of 2010, with particularly rapid growth in fabricated metals in response to export demand. There was only slow growth in electrical engineering and electronics, with output still almost 20 % below the level of 2008. There was brisk growth in forest industry output, but cuts in production capacity mean there is no imminent prospect of a rapid return to the pre-recession level of output. Industrial output as a whole grew rapidly, particularly in the second and fourth quarters of 2010.

The prominence of capital goods in Finland’s export structure meant that exports did not immediately respond to recovery in the export markets. The main drivers of Finnish exports in 2010 were forest and chemical industry products and fabricated metals.

Consumer confidence levels recorded in Finland in 2010 reached a record high, even though the euro area debt crisis did at times cause uncertainty among Finnish consumers. The stronger confidence and continuation of low interest rates continued to encourage the taking out of new housing loans. The pace of price rises eased in the second half of the year.

The labour market situation has been improving, but rather slowly. Growth in the number of employed was slower than expected at the end of 2010, and the unemployment rate has remained around 8% since last September.

The key challenge for economic policy in Finland is to restore the sustainability of the public finances, weakened by the recession. The recession caused a deep reduction in both central and local government tax receipts and increased the level of government debt. In addition to the cost of servicing the debt, the general government balance will also be compromised in the future by increasing age-related expenditure.

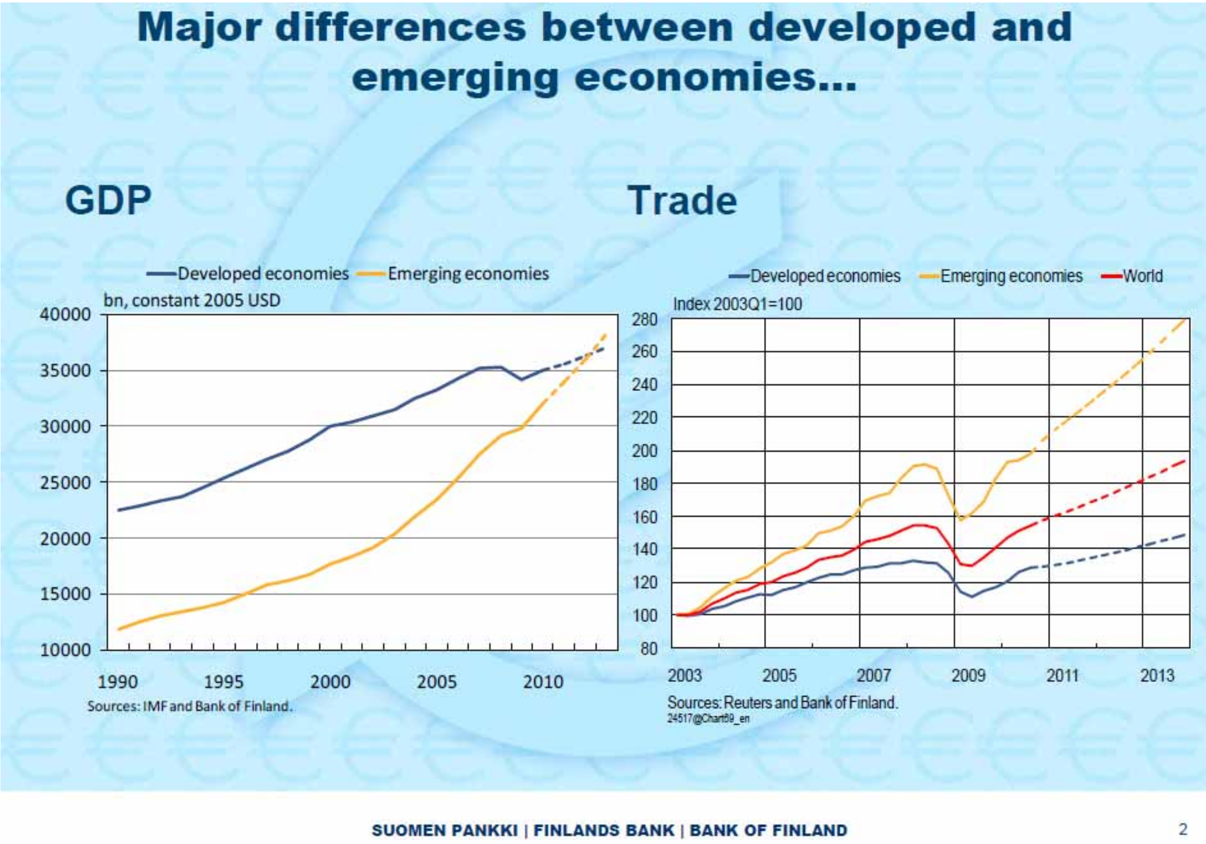
Conclusion

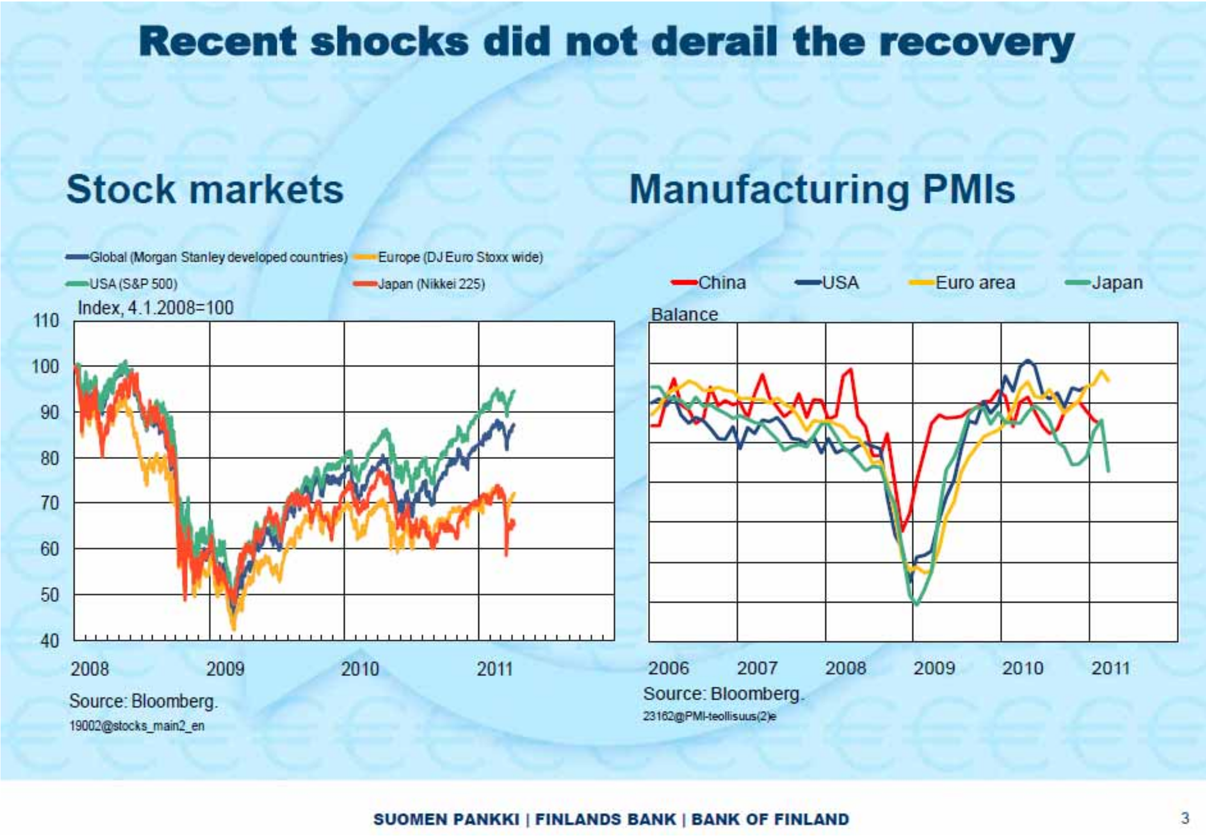
Recent months have seen signs of a renewed pick-up in world growth. Despite the heightened uncertainty and increased downside risks, stock prices and various confidence indicators are still at high levels. It thus looks that these shocks are not enough to derail the recovery of the world economy. However, uncertainty is exceptionally high, as highlighted by the recent developments in Portugal.

Despite the brisk GDP growth numbers many advanced countries are still well below their pre-recession production levels. Looking forward, they are struggling with population ageing, structural problems, and the accumulation of public debt.

All this is clearly visible in the public finances. Therefore for most advanced countries the key challenge is to restore the sustainability of the public finances, which were weakened by the deep recession. As regards this process, it is not at the end yet. The process is not even at the beginning of the end. But perhaps it is at end of the beginning (Churchill).

What can we do in our own countries? We manage to navigate through unchartered waters by simply keeping our house in order; taking care of the competitiveness of our economies, not letting public finances deteriorate too much and by investing for the future.




Recent shocks did not derail the recovery
Stock markets
Global (Morgan Stanley developed countries)
Europe (DJ Euro Stoxx wide)
USA (S&P 500)
Japan (Nikkei 225)
Index, 4.1.2008=100
110
100
90
80
70
60
50
40
2008
2009
2010
2011
Source: Bloomberg.
19002@stocks_main2_en
Manufacturing PMIs
China
USA
Euro area
Japan
Balance
2006
2007
2008
2009
2010
2011
Source: Bloomberg.
23162@PMI-teollisuus(2)e
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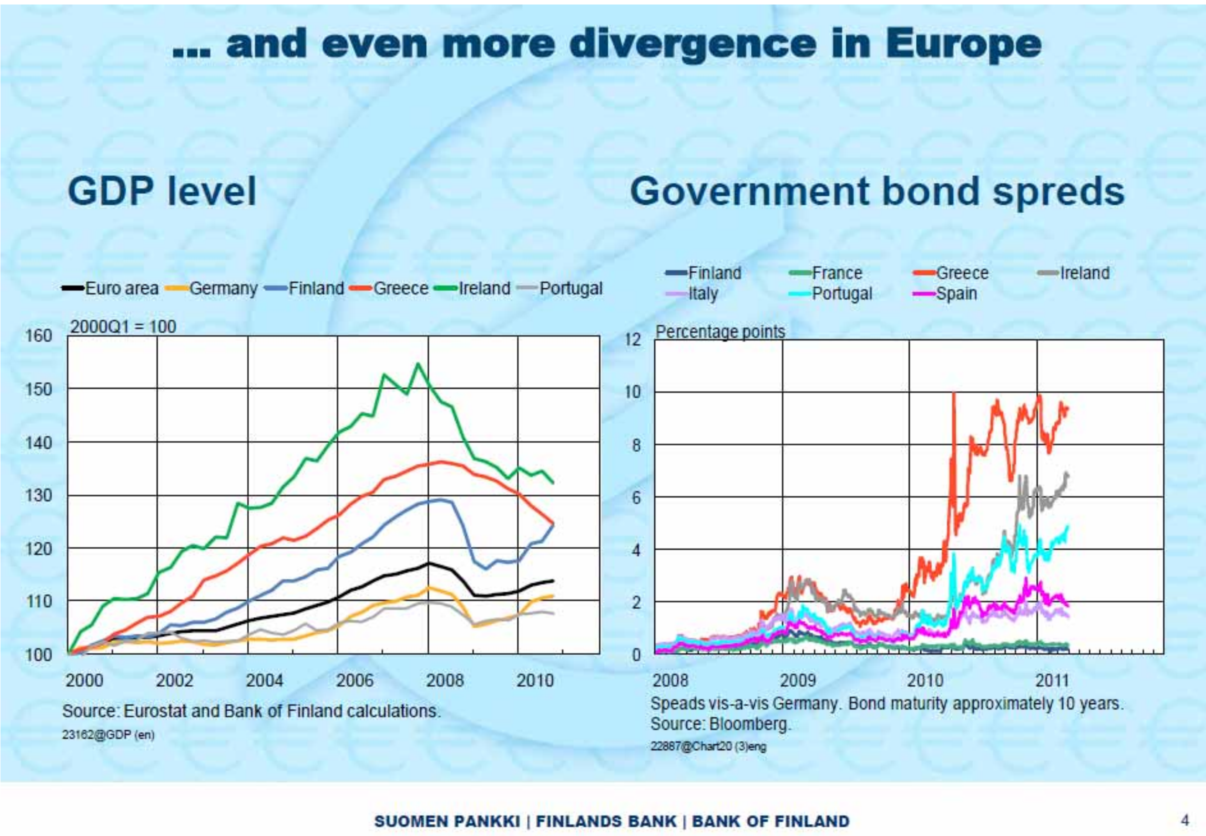
… and even more divergence in Europe
GDP level
Euro area
Germany
Finland
Greece
Ireland
Portugal
2000Q1 = 100
160
150
140
130
120
110
100
2000
2002
2004
2006
2008
2010
Source: Eurostat and Bank of Finland calculations.
23162@GDP (en)
Government bond spreds
Finland
France
Greece
Ireland
Italy
Portugal
Spain
Percentage points
12
10
8
6
4
2
0
2008
2009
2010
2011
Spreads vis-a-vis Germany. Bond maturity approximately 10 years.
Source: Bloomberg.
22887@Chart20 (3)eng
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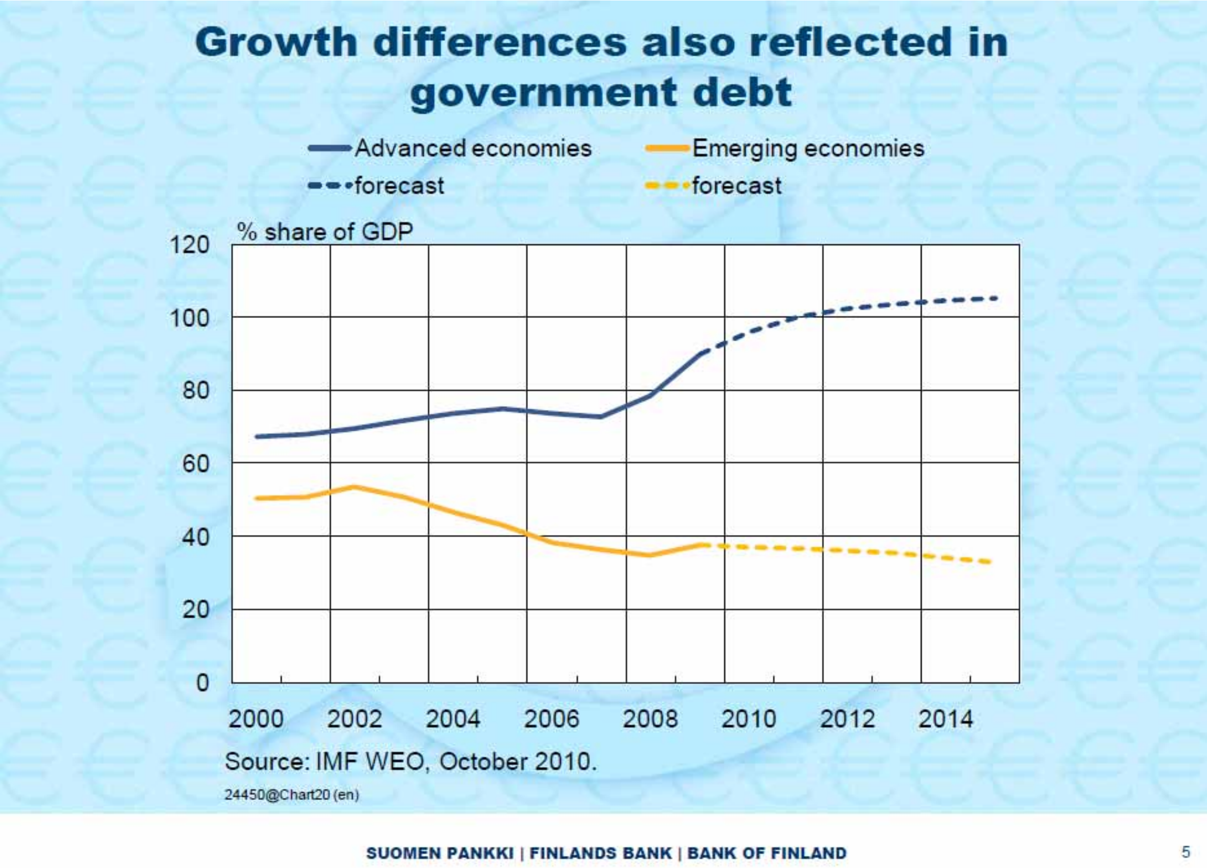
Growth differences also reflected in government debt
Advanced economies
forecast
Emerging economies
forecast
% share of GDP
120
100
80
60
40
20
0
2000
2002
2004
2006
2008
2010
2012
2014
Source: IMF WEO, October 2010.
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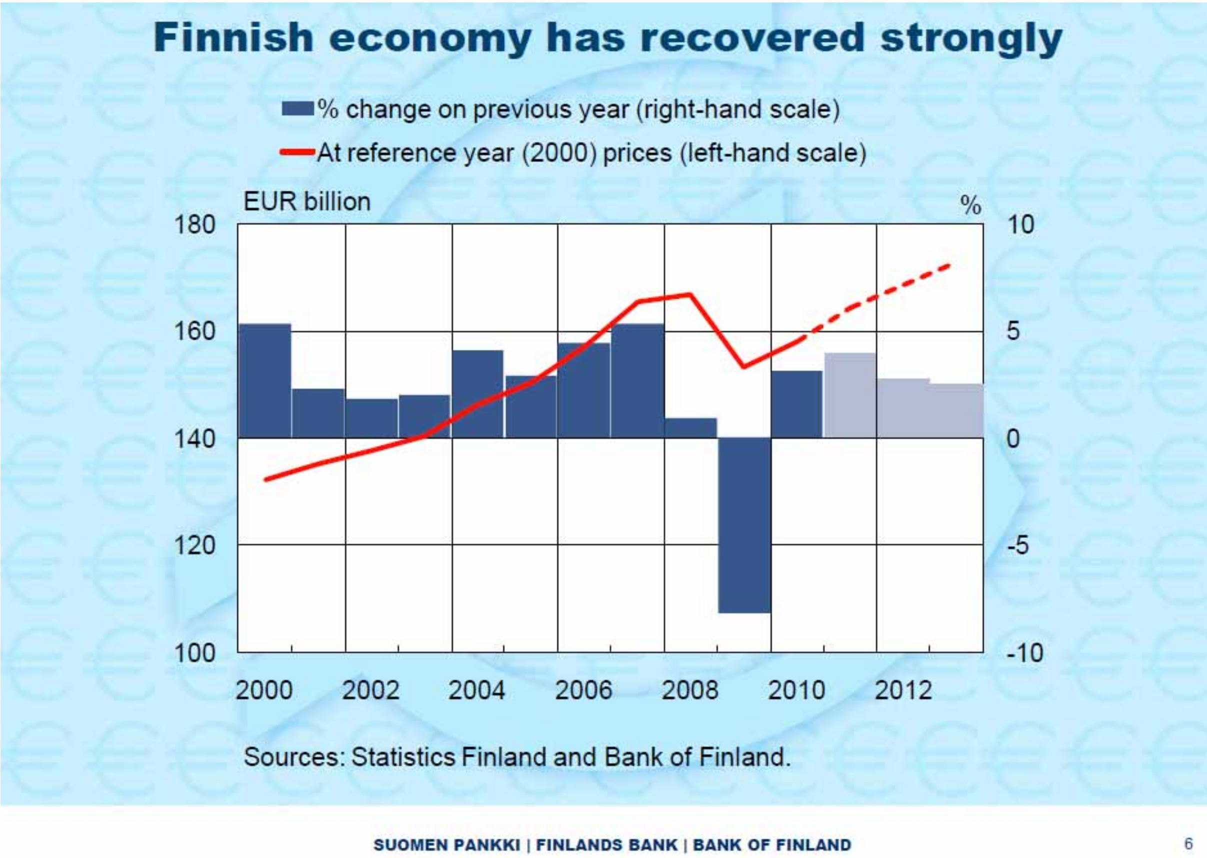
Finnish economy has recovered strongly
% change on previous year (right-hand scale)
At reference year (2000) prices (left-hand scale)
EUR billion
%
180
160
140
120
100
10
5
0
-5
-10
2000
2002
2004
2006
2008
2010
2012
Sources: Statistics Finland and Bank of Finland.
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Supply and demand

	2010	2009	2010	2011f	2012f	2013f
	At current prices EUR billion	Volume, % change on previous year				
Gross domestic product	**180.3**	**-8.2**	**3.1**	**3.9**	**2.7**	**2.5**
Imports	65.2	-17.6	2.6	4.2	6.1	7.0
Exports	70.2	-20.1	5.1	7.4	5.9	6.5
Private consumption	97.3	-2.1	2.6	2,9	2.4	2.0
Public consumption	44.2	1.0	0.4	1.2	0.5	0.8
Private fixed investment	28.5	-17.4	0.9	7.1	7.4	7.3
Public investment	4.9	6.2	0.1	1.0	0.7	-0.2

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