

Seppo Honkapohja: The current economic situation in Finland

Keynote address by Mr Seppo Honkapohja, Member of the Board of the Bank of Finland, at the conference "Reform Capacity and Macroeconomic Performance in the Nordic Countries", Copenhagen, 20 September 2013.

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Introduction

I first want to thank the organizers of this conference for inviting me to deliver the key note speech this evening. My topic is the current economic situation for Finland.

Finland is the only euro area country with an AAA sovereign credit rating and stable outlook from all major rating agencies. Finland is known as a country with strong growth, strong competitiveness, strong fiscal balance, and strong banks. A common perception – until recently, at least – has been that the Finnish economy is a success story, though exports are currently suffering from the global financial crisis.

Among Finns, the humble attitudes following the deep depression of the early 1990s have long ago given way to a feeling that we are good in almost everything and that we can even teach others how to do things - even how to run an economy.

Is there a solid basis for such perceptions and attitudes? Perhaps you can already guess that the answer is negative. Unfortunately, in some important respects, the Finnish economy is not doing well. Developments during the past 5 years have revealed vulnerabilities in the economy.

Since the autumn of 2008, Finnish growth performance has been disappointing – weaker than the euro area average. Finnish GDP is now 5% smaller than it was in mid-2008. Developments in exports have been particularly poor, as exports are currently about 1/5 smaller than before the financial crisis.

The well-being of many Finns has, however, not been badly hurt by these developments. Unemployment has remained relatively low, and household real incomes have mostly been on an upward trend. Recently the future has become much more uncertain. There are big problems that need to be solved, and difficult political decisions than need to be made.

Current difficulties

The economy is facing new challenges: exports have remained weak, and the current account has turned negative. After 2007 the decline in exports has been the deepest among all euro area countries. In addition, there is one challenge which has not come as a surprise: the demographic change.

Three main reasons for the new challenges are (1) weakness in the international economy, (2) problems of electronics and paper industries, and (3) losses in cost competitiveness.

Weakness in the international economy has hurt Finnish exports, which are dominated by various investments goods. Investments have remained weak in developed economies for the past 5 years.

The problems in the electronics industry have been related to one large company, Nokia, which lost its technological advantage in mobile phones. Paper industry, in turn, suffers from the longer-term decline in demand for printing paper in Europe. Another major factor behind the decline in exports is the weakening of cost competitiveness. Wages and unit labour costs have increased about 10% since 1999 compared to the average of all trading partners and compared to euro area.

How did cost competitiveness end up weakening so much? One part is misjudgment and bad luck regarding timing. Just before the global financial crises escalated, a round of union-level wage agreements took place. Amid rapid growth and with seemingly benign outlook, generous wage increases were agreed upon, and the contracts mostly extended for about two years. Then the financial crisis struck, leading to slowdown in wages in many countries while Finnish wages diverged.

Why was no correction made after the contracts had expired? The reason probably has a lot to do with the relatively muted increase in unemployment in Finland. Employment has been supported by growth in domestic demand, especially household consumption. Domestic demand has also been supported by loose fiscal policies and low ECB interest rates. The low interest rates were transmitted to loan costs of the public by the strong and stable banking system and the system of variable-rate in most loans.

The growth in domestic demand in recent years has been financed to an increasing extent by debt, as households and the public sector have run financial deficits. This has been possible due to the strengths of the economy. Household and public sector indebtedness remained relatively low in Finland in the years before the global financial crisis. However, the recent increases in debt gradually add to the vulnerabilities in the economy.

Competitiveness issues

How much has Finnish cost competitiveness weakened? I already mentioned the increases in wages and unit labour costs for the whole economy. Developments in the open sector of the economy are obviously very significant as manufactured goods account for much of foreign trade. Hence its cost competitiveness is important for the whole economy. Manufacturing unit labour costs in Finland are currently at about the same level as in 1999. However, manufacturing ULCs provide far too rosy a picture of cost competitiveness for Finnish manufacturing.

This misperception arises because of price developments. The price component of value added declined considerably in Finnish manufacturing since 1999. As prices have fallen, the value of production has increased a lot less than its volume. The growth in labour productivity has not been accompanied by a corresponding increase in the ability of firms to pay higher wages.

The main reason for the exceptionally weak price developments is the large share that both paper and electronics industries have had in Finnish manufacturing. Price developments have been exceptional in these two industries. Decline in paper demand, together with overcapacity has depressed paper prices. Prices in electronics, in turn, have declined due to the rapid technological advances leading to better and better products. As prices are measured in quality-adjusted terms, measured prices are declining, which means that measured production volumes increase significantly when compared to current-price production in electronics.

Asymmetric shocks and wage divergence

The possibility of adverse developments such as the current problems was foreseen in the Finnish discussion about the pros and cons of membership in a monetary union. For example, the Report of the Expert group commissioned by the Finnish Prime Minister in 1997¹ raised concerns about the risk of asymmetric negative shocks and about the risk of domestic wage developments diverging from those of other EMU countries.

¹ Finland and the EMU, Publication 1997/26 of the Prime Minister's Office.

Evidently, the two risks have been realized. The decline of Finland's electronics and paper industries are an example of a negative asymmetric shock. Wage developments since 2008 are a clear case of wage divergence between Finland and other EMU countries. To mitigate the impacts of these problems, the Finnish economy must try to create new areas of strength in industrial and service activities. Simultaneously there must be corrections to the wage divergences. The latter is not going to be easy for a monetary union country.

Public finance concerns

Even though the state of Finnish public finances is better than in many other European countries, there has been a clear deterioration. General government deficit has increased considerably. The debt level looks likely to exceed the 60% level soon, perhaps next year, unless new consolidation measures are imposed.

As the problems in the economy can be seen as being largely structural by nature and not only cyclical, the government deficit cannot be expected to be corrected by a recovery in the international economy.

At the same time, the effect of population ageing on the economy has begun to show. The size of the working-age population has started to diminish. Finnish public finances have a long-term sustainability gap of around 5 to 6 percent, by most estimates.

The Finnish economy is expected to suffer more from the effects of ageing than most other European countries. Old-age dependency ratio will be very high by 2030. This is because of the specific features of the intense post-war baby boom.

What economic policies are needed in Finland?

One element should be low nominal wage growth in order to improve cost competitiveness. As wages have increased significantly compared to trading partners, they should increase less in the coming years. Wage increases in the whole economy should be set according to the state of the economy's open sector.

The social partners recently signed a centralized wage agreement with relatively low wage increases. Provided that the individual unions and employer organizations accept the centralized agreement, wage settlements are likely to lead to some improvement in Finnish cost competitiveness during the next two years.

Given that the problems of the Finnish economy are to a large extent structural by nature, structural reforms are needed in addition to improvements in cost competitiveness. The economy needs to make reforms to correct the structural problems.

It is important to emphasize that the economy has major strengths - education, infrastructure, effective government, reliable judicial system, etc. These must be preserved so that there is a solid basis for finding new areas of economic activity. However, one must not forget that structural reforms are needed; these reforms should lead to permanent increases in production potential.

Perhaps most important area of reform concerns the labour supply. Working careers need to start earlier and end later. As the population ages, improving the production and productivity of publicly funded health and care services are a vital area for reform.

Let me mention a few other areas of reform. Competition could be increased in services and construction, with changes in regulations being one part of the possible reforms. Supply of housing and especially of land for housing development could be supported by the government policies. This would increase economic welfare by lowering the pace of growth in house prices and rents and facilitate efficiency of the labour market in bigger cities.

The government has recently laid out its program for structural reforms with the purpose of improving the long-term sustainability of public finances. The program contains wide-ranging

measures, and the goal of the government plans is ambitious. The purpose is to eliminate completely the fiscal sustainability gap.

At this point, the detailed contents of this government program still remain mostly to be decided. However, the government plans to act relatively quickly and I certainly hope that the government will be able to agree on the important details of its program. Success would be a very important step forward in solving the current problems of the Finnish economy.

Final remarks

Rating agencies seem to have strong confidence in the Finnish political system's ability to make difficult decisions. At this point, such ability is badly needed. The difficult decisions can still be made with no external pressure. It is important to make the decisions early enough so that Finland can avoid the situation where the market pressures force the government to make the decisions.

The next months will be a major test for the reform capacity of the Finnish political system. Finland will thus be a case study for the subject matter of this conference. Progress in reforms is needed in order for the Finnish economy to be a success story again. What is certain is that things will change: the Finnish economy will not go back to what it was five years ago.