

Pentti Hakkarainen: Finnish economy – success, challenges and outlook

Presentation by Mr Pentti Hakkarainen, Deputy Governor of the Bank of Finland, to the mission of the Wallonia Foreign Trade and Investment Agency, AWEX, Helsinki, 12 October 2016.

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Original presentation is on the Bank of Finland's website: [Slides](#) (PDF).

Your Excellency, Ladies and Gentlemen

Let me start by welcoming you all to Finland also for my part. It is a pleasure for me to have this opportunity to introduce you to some aspects of the Finnish economy and its present prospects.

We at the Bank of Finland monitor the Finnish economy closely. We also contribute, with our analyses of the Finnish economic outlook, to the forecasts of the Euro area economy which are regularly published by the ECB. So what I am going to say today is based on the work we do in that context.

The central bank also takes part in the economic policy discussion in Finland, in the role of a non-political expert – hoping to advance the level of the economic policy debate in the country. As central banks are independent, we think that this gives us a niche where we can add value to the policy discussion.

Finland and Belgium are similar countries in some respects: Small EU countries, both members of the euro area, bilingual (in our case, the national languages are Finnish and Swedish), and both have almost exactly the same level of GDP per capita. Economically, both countries have only limited natural resources so we both have to rely on the know-how of our people to succeed in the world.

One of the biggest differences between the countries, and this is reflected in our infrastructures, is in population density: Belgium's population density is much higher, about 23 times more than in Finland! The overall picture is a bit misleading however because in Finland the population is quite concentrated in the south.

But even in the most southern province of Finland, Uusimaa, where we are right now, and where almost a third of the population lives, the population density is less than half of the Belgian one. So Finns are accustomed to long distances.

Another difference between our countries, which is also reflected in the infrastructure, is historical: Belgium was the first country on the European continent to experience the industrial revolution. Because of that, it also urbanized early. Finland, by contrast, experienced this big transformation only after the war, although our forest industries have a long history too.

But our infrastructure and our big towns are much younger than their Belgian counterparts.

Let me now turn to the survey of the Finnish economy.

[Slide 2] Finland is a small open economy, where trade has shaped the key trends of our economy. Even if the exports have been falling recently, they still represent about 40% of GDP. Finland's trade with euro area economies has been increasing since the global financial crisis, Germany being currently the largest trading partner. Russia's share of our exports has fallen to 6%, notably because of weak growth performance in Russia since 2013, after the drop in oil prices.

Finland's goods exports consist mainly of paper and wood products, metal and engineering products, and electronics equipment.

In recent years, the structure of the Finnish economy has undergone radical changes in the wake of difficulties encountered by the forest and electronics industries. Export earnings from the mobile phone business, which had long supported our economy, have disappeared, the significance of Russia has diminished, while importance of countries such as Germany have increased. Despite the difficulties of the recent past, the forest industry is still one of the pillars of Finnish exports alongside the heavy engineering metal industry, and high tech electronics. Software industry, like online games, creates a lot of revenue, but employ relatively few people.

[Slide 3] Finland's growth performance was exceptional between 1995 and 2007. It was fueled by Finland's long tradition of investing heavily on human capital and education. The focus on engineering helped too.

Finland was in the good position to ride on the global trend of ICT and mobile phones after the exceptionally deep recession in the early 1990s. Finnish export firms managed to create products enjoying widespread demand and capable of capturing new geographical market areas.

By the turn of the millennium, the electrical engineering and electronics industry had outstripped the forest industry as the largest export sector, its products accounting for about a third of total export value.

EU accession also helped to set up the credible fiscal framework and push through important structural reforms at the time.

[Slide 4] Unfortunately, the tide changed rapidly around the global financial crises. Finland suffered from the decline in foreign markets during the global financial crises. Initially, the recovery was fast, but it lasted only until about 2011. After that Finland entered a period of low growth (or even no growth) and increasing unemployment. This period of low growth was due to a unique mix of asymmetric shocks.

They all contributed to falling productivity growth, low investments and exports. Shocks like this could have had much larger impact on the Finnish economy, but the fortune was that financial sector has been resilient and the balance sheets of households, firms and government were in good shape. Finland had sufficient buffers to overcome large part of these large shocks.

At the same time, one lesson to learn is that labour and product markets should have been much more flexible to adapt to such shocks: This requires more flexible prices and more competition in the domestic markets in particular. This is actually true for many other countries in the European monetary union, too.

[Slide 5] But the period of stagnation may be over. Since late 2015 Finland has however returned back to growth, after very difficult years. In the June forecast, it was projected that Finland GDP will grow around 1% during the next years.

The strongest recovery is observed in domestic investment, especially the construction sector. It is benefiting from the low interest environment and also the continuing migration within the country to the Helsinki Capital Region and other growth poles in the country.

The new data is fairly consistent with this outlook. Upside risk to this forecast arise from the fact that our June forecast did not fully take into account the competitiveness pact, an agreement between employees, employers and the government, which will significantly improve the competitiveness of Finland and remove some uncertainties in the labour markets.

Downside risks mainly relate to external environment and the world economy, which has developed somewhat weaker than was foreseen in June.

[Slide 6] The weak performance of the last years was puzzling for our economists, since the institutional features that are known to be important for growth in the long run are all there: a reliable legal system, a good health and education system, good innovation potential, a resilient banking sector and relatively healthy public finances.

There are of course important weaknesses too. Small countries suffer from small market size, for instance. It is something that Finland cannot do much about. Population growth is stagnant.

Other weakness listed here are something where the policy can make a difference, such as labour and product market efficiency, macroeconomic environment, and business sophistication.

Business sophistication concerns the two elements that are closely linked: the quality of a country's overall business networks and the quality of individual firms' operations and strategies. Traditionally, the share of R&D investment in our Gross National Product has been very high by international standards, and it still is. However it has been declining a bit in the recent years but it is important that this decline be temporary.

[Slide 7] On the policy front, some important steps have been taken to bolster growth.

These include e.g. the competitiveness pact which I mentioned, significant deregulation of trade, and a new transportation code which can open up new possibilities for private companies and strengthen the incentives for infrastructure investments.

The government is working on many other areas too, such as improving the functioning of the labour market, education, the conditions for bio-economy and clean-tech sectors as well as digitalization.

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All in all, the Finnish economy has both problems and strengths. After a long recession, there is now reason for optimism as economic activity is picking up and especially in construction the recovery is strong.

On the other hand, there are structural problems still, which have to do with the ageing population and the need to accelerate productivity growth. Also, our economy is quite dependent on international markets, and the outlook for the world economy is not without risks at this time as you well know.

However, despite these challenges, I would say that in Finland the fundamentals for a sustained recovery are well in place. The two strongest points of the Finnish economy, according to international competitiveness barometers, are our good education system and good public institutions. Both are regularly classified among the world's best by outside observers. They serve well the firms operating in Finland.

These strengths give Finland a good starting point for the coming years, and I trust that your visit to our country will convince you of the forward-looking dynamism and potential of our economy.

Thank you very much for your interest.
