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Preface

In recent years, the Finnish economy has gone through a process of structural change that has been reflected in a weakening of the external balance of the economy. In 2011, the current account went into deficit, which means that total expenditure in the economy was larger than total income. Some household, corporate and general government expenditure was, therefore, funded in net terms from abroad. The current account was last in deficit in 1993.

The current account deficit raises the question of the risks attendant on the direction of the economy. Many of the advanced economies now experiencing difficulties rapidly accumulated foreign debt before their situation deteriorated due to the international financial crisis. In the present situation, it is worth while examining the factors behind the decline in Finland's current account, whether there is reason to expect the deficits to grow in the immediate years ahead, and what sort of economic policy would help avoid the greatest risks.

The deterioration in Finland's current account has several causes. One is the weakening cost-competitiveness of Finnish output. Labour costs grew rapidly in 2007 and 2008, and since 2008 labour productivity growth has been sluggish.

Another underlying factor is the weak trend in forest industry and electronics exports since the turn of the millennium, while the increase in the price of oil has inflated the value of imports and thereby weakened the current account.

Unlike most other euro area countries, since the onset of the financial crisis Finnish household consumption and investment in housing has continued to exceed incomes, and household debt has grown fairly rapidly. This, too, has weakened the current account, as have the general government deficits.

The causes of the current account decline are largely of such a type that there are no grounds to expect they will quickly disappear. The current account deficit is, in fact, forecast to remain close to recent levels over the immediate years ahead.

Finland's mild current account deficit is not in itself an acute problem, at least not yet, as there has for the most part been no difficulty in finding external finance. Unlike some other advanced economies, economic developments in Finland since the turn of the millennium have not been based on the rapid accumulation of foreign debt. Following many years of current account surplus, the net foreign debt of the Finnish economy is not large.

The entry of the current account into deficit and the consequent dependence of the economy on foreign finance will, however, over time increase the level of vulnerability to international disturbances.

At the same time, the current account deficit reflects increasing imbalances in the domestic economy. Recent economic growth has been largely debt-fuelled, with both household and government expenditure exceeding income. Meanwhile, exports have been lower than before the recession, and rapid export growth in the immediate years ahead is unlikely, due in part to the weaker outlook for the forest and electronics industries.

Over the long term, such an economic trend is imbalanced. Household income use could be based on unrealistic expectations regarding the future. Economic growth based on household and general government debt accumulation is not sustainable in a situation where there is a need to save for the future costs of an ageing population.

Imbalanced development can be avoided by the application of economic policies that reduce general government and household deficits, help facilitate economic growth and boost cost-competitiveness.

One plank of such a policy is consolidation of public finances. Another important component is to implement structural changes to augment the labour supply, particularly by extending the length of working life. Economic growth can also be facilitated by measures to improve competition in the different sectors of the economy.

The government decision on spending limits in March included significant steps to consolidate public finances, and the labour market organisations have also accepted a framework agreement that will extend working careers. Balanced economic development and sustainable public finances will require more measures of this sort.

Public expenditure has in recent years risen relative to GDP, and the consolidation measures so far decided will not cause a drop in the ratio in the immediate years ahead. At the same time, the outlook for government revenues will be uncertain if the general trajectory of the economy is not sustainable.

We cannot expect Finland's economic problems to be resolved in the immediate years ahead by rapid growth in the economy – at least in the absence of further structural reforms. With domestic demand based on debt and the weakened state of exports, partly for structural reasons, the economy can no longer be considered to be in a cyclical trough.

Avoiding imbalanced development of the economy also requires controls on the level of household debt. Steps to reduce the tax-deductibility of interest on housing loans should be continued. It could also be necessary to steer the functioning of the financial system in this area. Such an eventuality should be prepared for by eg making it possible to place binding limits on the loan-to-value (LTV) ratios of housing loans.

In addition to the above measures, balanced and sustainable development of the economy will also require improvements in the international cost-competitiveness of domestic output. This can be supported by facilitating the coordination of wage formation at the level of the economy as a whole. At the same time, fostering flexibility in wage formation at company and industry level will also support competitiveness and the adjustment of the economy to changing conditions.

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