Fiscal policy monitoring assessment on management of general government finances

This memorandum includes the spring 2020 assessment of the National Audit Office of Finland (NAOF) on the development and management of general government finances. The assessment takes into account the General Government Fiscal Plan for 2021–2024 and the measures decided by the Government on account of the coronavirus crisis until the second supplementary budget of 2020. The assessment is based on an independent economic forecast produced by the Ministry of Finance and other economic forecasts. The National Audit Office presented its previous assessment in the fiscal policy monitoring report published on 12 December 2019.

It is a statutory task of the National Audit Office to monitor that general government finances are managed in compliance with the Fiscal Policy Act (869/2012) and the provisions issued thereunder, particularly the Decree on the General Government Fiscal Plan (120/2014). To carry out its supervisory task, the National Audit Office has, on the basis of the above regulations, assessed the General Government Fiscal Plan for 2021–2024 and the economic forecast by the Ministry of Finance on which it is based. The General Government Fiscal Plan for 2021–2024 was submitted to Parliament on 16 April 2020. Finland submitted its stability programme to the European Commission on 30 April 2020.

Summary of the assessment

The current fiscal policy is dominated by the coronavirus crisis, which started in early 2020. Supported by the Member States, the European Commission activated the general escape clause in the EU fiscal rules to prevent the rules from limiting the Member States' opportunities to respond to the crisis and its consequences by fiscal policy measures. Because the EU rules are linked with the national ones, the domestic fiscal policy steering instruments are partly dormant as well. For the time being, multi-annual planning of general government finances is not performed in the established manner.

Compared with previous recessions, such as the financial crisis, the corona crisis is different in nature. Therefore, the management of the crisis requires fiscal policy reactions that are suited specifically for it. The restrictions introduced to prevent the spreading of the virus are methods to safeguard public health but, in the present situation, they are also tools of fiscal policy. They strengthen the economic shock in the short term, but in the long term, they will at best reduce the impacts of the coronavirus on both public health and the economy.

In order for the economy to recover as quickly as possible, fiscal policy should be timely and correctly targeted. In addition, the measures taken to mitigate the impacts of the crisis should be extensive but temporary. During the acute phase of the crisis, fiscal policy should focus on safeguarding companies' liquidity and preventing mass employment and bankruptcies. The time for conventional stimulus measures is only later. Fiscal policy in Finland has reacted relatively quickly to the pandemic and to the restrictions taken, in line with the above principles. It is difficult to compare the fiscal policy measures taken by different countries. At present, it seems that Finland's current support package is slightly smaller than, but still in the same ballpark as those of the other Nordic countries, particularly Denmark and Sweden.

Finland has implemented several derogations from its spending limits rule because of the crisis while exceptional circumstances declared by the Government and the President of the Republic have been prevailing in Finland: the central government spending limits system is not valid in 2020, the coverage of the framework has been changed, and the Government is preparing to activate the mechanism for exceptional circumstances, which was added to the spending limits system for the current Parliamentary term. According to the assessment of the National Audit Office, the spending limits were complied with in 2019. It is justified that the spending limits do not restrict the management of the corona crisis. From the standpoint of systematic planning of general government finances, it is nevertheless extremely important to adhere to the spending limits as a key fiscal policy steering instrument when the situation returns to normal.

The information content of the General Government Fiscal Plan is more limited than normal. It does not set objectives for the development of general government finances, and thus it does not serve as a medium-term budget plan. Nevertheless, the exceptional arrangement can be considered justified amid the prevailing uncertainty related to the crisis. The Government should strive to return as soon as possible to a General Government Fiscal Plan that is of a normal scope and that sets out objectives and measures to achieve them, taking into account the crisis situation and the development of the EU fiscal framework. This is particularly important, because the outlook of the sustainability of general government finances was already rather weak before the crisis. In the future, the Government should also consider updating the fiscal policy legislation to better take into account situations similar to the corona crisis.

As the interest rate of general government debt is very low, the rapid growth of Finland's debt as a result of the corona crisis will not significantly burden the general government finances in the current market situation. Even if the government debt-to-GDP ratio grew rapidly, it would therefore not automatically mean an unsustainable debt level. However, once the impacts of the crisis have become less strong, it would be important to achieve a situation where the debt ratio can be reduced during an economic upturn and where it is allowed to increase only for stimulus measures during a downturn. The ageing population highlights the need to continue with the social and health care reform and the employment policy measures during the ongoing parliamentary term, although it is appropriate to prioritize management of the corona crisis in the near future.

Because of the crisis, it is extremely difficult to prepare economic forecasts for the time being. Overall, the economic forecast by the Ministry of Finance included in the General Government Fiscal Plan can be considered realistic. The development of GDP the Ministry forecasts for 2020 corresponds to the estimates of other forecasters. According to the Ministry's forecast, the economic recovery in 2021 will be subdued. As regards the development of Finnish exports, the Ministry's forecast can be considered optimistic. As for the risks related to state guarantees, the probability of their materializing has grown because of the crisis. It is therefore possible that the impacts of state guarantees on public finances will be greater than forecast.

Now that the preliminary data on 2019 are available from statistics, it is possible to present an assessment of the achievement of the fiscal policy objectives set for the previous, 2015–2019 parliamentary term. The objectives set for the structural and nominal fiscal position of general government were not achieved, but the ratio of government debt to GDP reduced according to the objective. The long-term sustainability of general government finances did not improve as planned, whereas the improvement of the employment rate slightly exceeded the objective.

The support measures taken by Finland to manage the corona crisis are in line with those of Sweden and Denmark

The coronavirus pandemic has caused a severe simultaneous demand and supply shock in both Finland and the global economy. Policy measures are taken on two fronts – to fight both against the disease and for the economy. These two targets are contradictory at least in the short term: the measures taken have restricted the spreading of the disease efficiently but have abruptly also restricted economic activities in many sectors. The service sector, which has previously offset several crises, has now taken a deep plunge. The so far unknown coronavirus creates uncertainty, which burdens the entire economy. The present crisis is therefore very different in nature from the previous recessions, such as the financial crisis. Therefore, the management of the crisis requires fiscal policy reactions that are suited specifically for it.

To restrict the spreading of the virus, Finland and other countries around the world have introduced many kinds of restrictions. In the present situation, these kinds of restrictions not only safeguard public health but are also tools of fiscal policy. In the short term, they strengthen the economic shock, but in the long term, they will at best reduce the impacts of the coronavirus on both public health and the economy. Efficient, clearly communicated measures may increase trust in both public authorities and society and lay a foundation for economic recovery.

Fast recovery of the economy sets high requirements for fiscal policy: it should be timely and correctly targeted, and the measures taken should be extensive but temporary. During the acute phase of the crisis, fiscal policy should focus on safeguarding companies' liquidity and preventing mass unemployment and bankruptcies. The time for conventional

stimulus measures is only later. Fiscal policy in Finland has reacted relatively quickly to the pandemic and to the restrictions taken, in line with the above principles. For the time being, the coronavirus measures have been focused on maintaining companies' liquidity, mitigating the shock in the labour market, and safeguarding the operation of health care. The Government has taken either fixed-term or one-off measures.

The cost of the direct fiscal policy measures that the Finnish Government has announced so far to mitigate the economic impacts of the coronavirus pandemic and that have an impact on expenditure and revenue will amount to approximately EUR 3.8 billion in 2020. This is about 1.6 per cent of GDP in 2019. An international comparison shows that, in relation to the size of the economy, these measures are smaller than those taken, for example, in the United States (9.6%), the United Kingdom (4.9%), and Germany (6.9%) (see Table 1).

However, it is difficult to make a direct comparison between the countries, as the unemployment security and health care systems in Finland are different from those of the above-mentioned countries. 'Automatic stabilizers' (e.g. unemployment security, social assistance, and housing allowance) have a more important role in Finland than in the reference countries. Furthermore, different countries will take more actions at different times, as the picture of the development of the epidemic and the economy becomes more clear.

A Nordic comparison, in turn, shows that Finland's current support package is slightly smaller than – but largely in line with – those of the other Nordic countries, particularly Denmark and Sweden. It should be noted, however, that Sweden has introduced less stringent restrictions than the other Nordic countries. In Sweden, restaurants, for example, have stayed open, and Sweden has not restricted gatherings as heavily as Finland. Therefore, the service sector and its employment rate are not suffering in the same way in Sweden as in the other Nordic countries. There is thus less need for direct business support in Sweden.

Table 1: Discretionary measures taken in 2020 on account of the coronavirus pandemic relative to the GDP of 2019. Situation on 16 April 2020.

	Direct fiscal policy measures	Deferred payments	Guarantees, securities, loans*
Finland	1.6%	1.9%	5.7%
Sweden	2.1%	6.7%	4.6%
Denmark	2.1%	7.2%	2.9%
Germany	6.9%	14.6%	38.6%
United Kingdom	4.5%	1.4%	14.9%
United States	9.1%	2.6%	2.6%

* Does not include the reduction of the capital requirements for banks (EUR 30 billion in Finland).
Source: Bruegel, Government Offices of Sweden, the Ministry of Finance, and calculations by the NAOF.

In the same way as in Denmark and Sweden, the support measures taken in Finland are focused on other actions than direct fiscal policy measures. These other actions – i.e. deferred payment of various taxes (incl. employers' social security contributions) as well as increased loan financing, guarantees, and guarantee liabilities – will total about EUR 15–18 billion in 2020–2024, depending on the amount of deferred pension insurance contributions. This is about 6–7.5 per cent of the GDP of 2019.

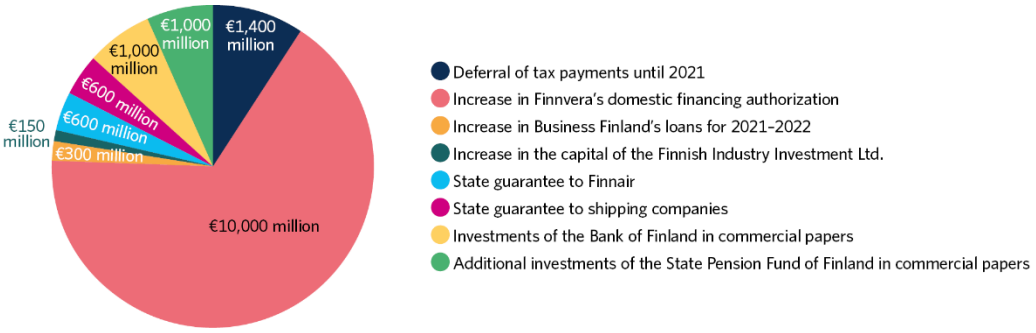

Figure 1: Other actions decided by Finland than direct fiscal policy measures. In addition to the actions shown in the figure, Finland has decided to offer an opportunity to defer pension insurance contributions, to facilitate reborrowing under the Employees' Pension Act, and to ease the capital requirements for banks. Source: Ministry of Finance, Economic Survey, Spring 2020.

The European Commission also took measures to limit economic damage following the spreading of the coronavirus epidemic within the EU. The general escape clause of the Stability and Growth Pact has been activated, and the state aid provisions have been rendered more flexible. The Euro Group has agreed in principle to apply the European Stability Mechanism (ESM) to support the liquidity of the Member States, if necessary. The preliminary capacity reserved from the ESM would be approximately EUR 240 billion. The Euro Group has also supported the Commission's proposal regarding an about EUR 100 billion instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). Furthermore, the Euro Group has expressed its support for the European Investment Bank's new guarantee fund to support small and medium-sized enterprises by lending about EUR 200 billion. Implementation of these decisions made by the Euro Group would mean more than EUR 500 billion for the management of the corona crisis.

In addition to fiscal stimulus, the countries will revive their economies through monetary stimulus. The European Central Bank (ECB) has announced that it will support the euro-area economy with a monetary stimulus programme of EUR 750 billion. The ECB has also decided to lighten its collateralization policy, which will make it easier for banks to receive funding. The capital requirements for banks have also been eased, which supports new lending in the national economies. The US Federal Reserve System (Fed) was among the first to lower the base interest rate. The Fed announced a USD 2.3 trillion lending programme, which includes, for example, buying state government, local government, and corporate bonds. In addition to this, the US Fed has reduced the burden of fiscal legislation in many ways.

The fiscal and monetary measures taken by its trading partner countries are very important to Finland: being a small open economy, the economic development in Finland is highly dependent on the global economy. Through its own fiscal measures, Finland can influence domestic production and demand but has very limited opportunities to influence exports. Nor can Finland influence disturbances in international production chains by its fiscal policy, but the country is dependent on the restrictions taken by other countries. Close cooperation and coordination of restrictions and fiscal policy measures both on the global and EU level play a key role for the recovery of the Finnish economy.

It is important to progress with structural measures

The corona crisis changed the economic outlook abruptly. The economic outlook had already been slowly deteriorating in 2019. However, in March and April, i.e. in the first and second quarter of 2020, the coronavirus outbreak caused a sharp fall. Based on the economic heat map utilized by the NAOF and the cyclical indicator derived from it (Figure 2), the corona crisis thus radically strengthened the economic downturn that started in 2019. The indicator for the second quarter of 2020 that is based on leading indicators dropped clearly below zero.

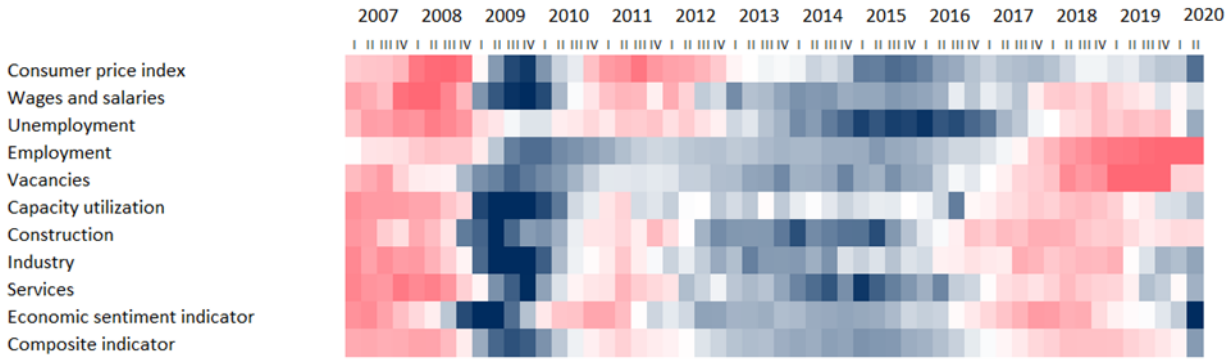

Figure 2: Economic heat map. The heat map consists of ten different cyclical indicators. Changes in the colours of the map reflect changes in the indicator values. Red represents a situation where, based on the indicator in question, the economic activities exceed the average level (e.g. the employment rate improves, and salaries rise). Accordingly, blue represents a slowdown in economic growth. The higher the share of simultaneous red or blue indicators, the more likely the economy is to be experiencing good or bad times. The individual indicators have been combined to form a composite indicator, the value of which is calculated as the average of the cyclical indicators. Sources: NAOF, Macrobond, producers of the original statistics, Eelarvenõukogu.

As a result of the corona crisis and the measures taken to mitigate it, fiscal policy will be strongly expansionary and counter-cyclical in 2020 (Figure 3). In 2016–2019, fiscal policy was slightly expansionary. As the cyclical conditions were positive, the expansionary fiscal policy led to some extent to pro-cyclicality in fiscal policy in 2016–2019. However, the assessments of the cyclical conditions may change even significantly later on if the output gap method is applied. This may later also affect the conclusions about the fiscal policy stance relative to the economic cycle.

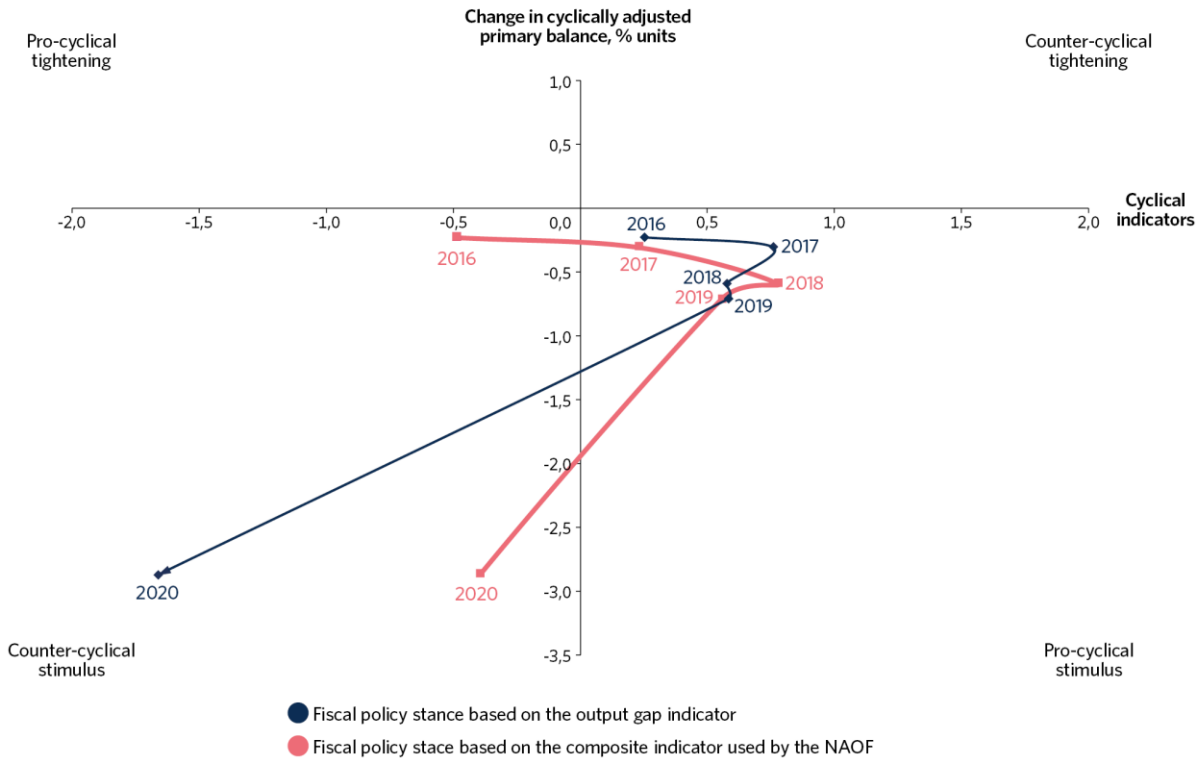

Figure 3: Fiscal policy stance relative to the economic cycle: change in the structural primary balance in relation to the development of two different cyclical indicators in 2016–2019. The NAOF's composite indicator for 2020 is based on data mainly on the first and partly on the second quarter. Part of the data is still inadequate. The composite indicator will thus change when there is new data available, and the change is likely to be negative. An essential difference from the indicator based on the output gap is that the value of the indicator will not change considerably once all data on a certain point of time are complete.

The rapid growth of Finland's government debt will not significantly burden the general government finances in the current market situation. The interest rate of the ten-year loan of the State of Finland is at about zero (Figure 4). The coronavirus outbreak caused at first an increase in the interest rate, but the upward pressure on the interest rate eased as a result of the measures taken by the ECB. The interest rate differential of government bonds vis-à-vis Germany has increased somewhat during the crisis. However, Finland still pays no significant risk premium for its borrowing unlike for instance Italy, where the interest rate of government bonds has deviated from that of the most risk-free euro-area countries since the financial crisis. At the same time, the interest rates of even longer-term government bonds are very low. The interest rate of a bond maturing in 2042, for example, was about 0.2 per cent at the beginning of May.

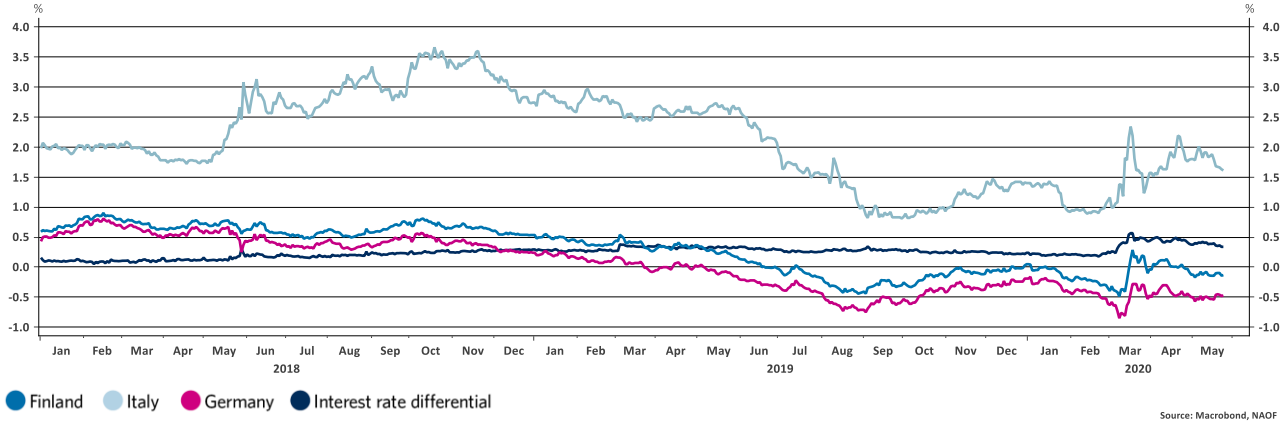

Figure 4: The interest rate of the 10-year government bond of Finland, Germany and Italy, and the interest rate differential between Finland and Germany.

For this reason, even a rapid growth in the government debt-to-GDP ratio does not automatically mean that the debt level becomes unsustainable. It is possible to maintain and refinance even higher government debt with reasonable costs if the interest rate remains stable. It is thus not necessary to start paying down the debt quickly. First, this might have significant social expenses and slow down the economic growth. Second, this might be unnecessary for debt sustainability in view of the current interest rates. However, this does not mean that Finland could rely permanently on low interest rates in the management of its general government finances. Low interest rates nevertheless impact debt sustainability in such a manner that general government can maintain higher debt levels.

After the crisis, the level of government debt will in any case be higher than at present. According to the medium-term projection of the Ministry of Finance, which is based on the assumption that policies will remain unchanged, the debt-to-GDP ratio will be close to 80 per cent in 2024. More essential than the accurate level of debt will then be that Finland can, as soon as possible, achieve a situation where the debt ratio can be reduced during an economic upturn and where it is allowed to increase only for stimulus measures during a downturn. The ageing population causes a long-term pressure for additional expenditure. The Government has also kept the planned reforms set out in the Government Programme unchanged, which will cause additional expenditure. To achieve the above-described stabilization of debt ratio once the impacts of the crisis have become less strong, Finland should take both structural measures and, in the future, possibly also measures that have a direct impact on general government revenue and expenditure. Therefore, it is important that the Government can promote particularly the employment measures and the social and health care reform during the parliamentary term, despite the corona crisis.

According to the General Government Fiscal Plan, the Government is planning to draw up a sustainability roadmap, which will define the potential of different measures to reduce the sustainability gap. It is good that the measures for improving the sustainability of general government finances are prepared systematically. At the same time, it should be noted that the measures to support sustainability – such as the improvement of the productivity of general government services within social and health care, for example, and a large part of the employment measures – are already quite well known on a general level. In view of the uncertainty surrounding the sustainability gap calculation, it will probably

be rather difficult and uncertain to define the sustainability potential of highly detailed measures[1]. Nevertheless, the roadmap can be a useful tool, which would make it possible to plan sustainability improvements beyond parliamentary terms.

The economic objectives set out in the Government Programme provide flexibility, and the General Government Fiscal Plan does not serve as a multi-annual planning tool during the exceptional circumstances

According to the economic policy objectives set out in the Government Programme, the employment rate should improve to 75 per cent, the number of employed people should increase by at least 60,000 by the end of 2023, and general government finances should be in balance in 2023. According to the Government Programme, these objectives are valid in normal global economic circumstances. In its previous assessments, the NAOF considered it useful to link the targets to the global economic situation[2], which now proved to be necessary because of the corona crisis. The Government's statement in the General Government Fiscal Plan according to which the international economy cannot be considered to be in a normal situation can be considered justified. Although the duration of the corona crisis is not yet known, the crisis will in any case cause such a severe shock in the global economy that, based on present information, the global economic circumstances will not be normal in 2019–2023.

The Government issued its most recent General Government Fiscal Plan on 16 April. The General Government Fiscal Plan for 2021–2024 was issued under exceptional circumstances and does not contain a large part of the information content required under the Decree on the General Government Fiscal Plan. The Plan does not include the Government's objectives related to the general government fiscal position (net lending, i.e. surplus or deficit), public spending, and government debt. Nor does it therefore describe the Government’s plans for achieving these objectives. However, in accordance with the Decree, the Plan does include, for example, assessments of the revenue and expenditure of the different subsectors of general government (central government, local government, employment pension institutions, and other social security funds) during the next four years based on the independent forecast of the Ministry of Finance. In accordance with the Decree, the Plan also includes sensitivity analyses of the Ministry's forecast and a comparison with the forecast of the European Commission.

On 20 March 2020, the Commission issued a communication on the activation of the general escape clause of the Stability and Growth Pact concerning both the preventive arm (medium-term objective, which in Finland is at present –0.5 per cent of GDP) and the corrective arm (the reference value of government deficit being 3 per cent of GDP; the reference value of government debt being 60 per cent of GDP). The activation of the escape clause means that deviations from the objectives set for general government finances are now allowed. The aim of the activation of the clause is to ensure that the EU rules steering general government finances do not restrict the management of the corona crisis or economic stimulus measures. On 23 March 2020, the EU Ministers of Finance announced their support for the activation of the escape clause.

The preparation of the General Government Fiscal Plan is not directly steered by EU legislation but by the national Fiscal Policy Act (869/2012) and the Decree on the General Government Fiscal Plan (120/2014) issued under it. It is a statutory duty of the National Audit Office to monitor compliance with fiscal policy legislation. The targets set out in the General Government Fiscal Plan do not directly cease to be valid, although the objectives of the Government Programme provide flexibility under the exceptional circumstances. This is because the targets set out in the General Government Fiscal Plan are based on statutory requirements.

[1] See also the NAOF's observations related to the preparation of the Government’s 2013 structural policy programme: Knowledge base of structural policy decisions (audit report of the National Audit Office 13/2015)
For the uncertainty of sustainability assessments, see for example: Sustainability assessments of general government finances in the knowledge base of economic policy (audit report of the National Audit Office 16/2019)
[2] Separate report to Parliament on fiscal policy monitoring, 12 December 2019.

The Decree on the General Government Fiscal Plan contains one provision related to exceptional circumstances. According to it, the requirements concerning the setting of nominal fiscal position objectives are less strict when the EU Council has declared that exceptional circumstances are prevailing in Finland. However, it should be noted that the aim of the provision has actually been to provide flexibility to the tightness of objectives.[3] The Decree also mentions the EU Council's specific assessment of exceptional circumstances prevailing in Finland, as referred to in the Fiscal Policy Act. The formulation of the legislation does not conform precisely to the Council's role in declaring exceptional circumstances. For the above reasons, it is open to interpretation whether the provision in the Decree on exceptional circumstances is directly applicable to the current situation, where no objectives have been set.

The General Government Fiscal Plan states that, in autumn 2019, the Government set a Medium-Term Objective (MTO) of –0.5% in ratio to GDP for the structural budgetary balance of general government finances. The Government justifiably considers in the General Government Fiscal Plan for 2021–2024 that exceptional circumstances referred to in the Stability and Growth Pact are prevailing in Finland as well. The Government also states that the definition of exceptional circumstances in domestic legislation corresponds to that of the Stability and Growth Pact. The Government considers that, for the time being, it is so difficult to assess the outlook of general government finances that general government budgetary targets cannot be set nor their achievement assessed on a reliable basis. It is stated in the General Government Fiscal Plan that "It has been agreed between the Commission and Member States that the exceptional situation and the high uncertainty associated with it will be taken into account in the Stability Programmes to be submitted in April. Domestic legislation on fiscal policy target setting may be interpreted accordingly."

For the assessment of compliance with domestic legislation, it is essential that the Fiscal Compact concluded between the Member States and the Budgetary Frameworks Directive issued by the Council of the European Union are implemented in Finland through the Fiscal Policy Act and the Decree on the General Government Fiscal Plan. The aim is to support the rules set by these EU instruments on national level particularly by multi-annual planning. During the spring of 2020, EU regulation has, for justified reasons, temporarily allowed the medium-term objective to deviate from the adjustment path and eased the content requirements set for the Stability Programme to be submitted to the EU. In the exceptional situation caused by the corona crisis, it is logical that the role of the domestic legislation created to promote compliance with the EU rules is also assessed based on how the underlying EU rules are interpreted. This also confirms the interpretation that the flexibility provided by the EU-level mechanisms is also included in the national requirements.

It should also be noted that a key element of the Fiscal Policy Act is the correction mechanism to be activated if there is a significant deviation from the objective set for structural balance. For the time being, failure to comply with the target set for structural balance cannot lead to the activation of the correction mechanism. The Decree on the General Government Fiscal Plan, in turn, links the level of nominal fiscal position objectives with the structural balance objective in such a manner that they shall lead to the achievement of the structural balance objective. In view of the correction mechanism, objectives related to nominal fiscal position are therefore unnecessary for the time being, as setting or achieving them would not have any effect on the activation of the mechanism.

On the above grounds, the National Audit Office considers that the General Government Fiscal Plan for 2021–2024 complies with the contents of the fiscal policy legislation, taking into account the prevailing exceptional circumstances. In the future, the Government should consider specifying the legislation to include more clearly defined provisions on exceptional circumstances similar to the present ones. The Government should also strive to return as soon as possible to normal scope planning of general government finances, taking into account the crisis situation and the development of the EU fiscal framework.

[3] According to the Decree: "The General Government Fiscal Plan sets multi-annual objectives for the fiscal position as a percentage of GDP at market prices for the entire general government and, in addition, a separate objective for each sub-sector of general government listed in paragraph 1. The fiscal position objectives shall be set in such a manner that, based on the forecast of the Ministry of Finance, they lead at least to the achievement of the objective set for structural general government fiscal position. Deviations from this can only be permitted if the Council of the European Union has declared, under Section 4 of the Act referred to in Section 1, that exceptional circumstances are prevailing in Finland." (Emphasis added.) According to the explanatory memorandum related to the Decree, this paragraph makes it possible to set such fiscal position objectives during exceptional circumstances that do not lead to the achievement of the structural fiscal position objective.

The GDP forecast for 2020 by the Ministry of Finance is realistic

The General Government Fiscal Plan is based on a cyclical forecast and an assessment of medium-term economic growth by the Ministry of Finance. Because of the corona crisis, some of the economic forecasters have cancelled their forecast or presented a very limited forecast, which typically includes only an assessment of the change in GDP. The most recent economic survey that presents the forecasts of the Ministry of Finance is more concise than the surveys issued during normal circumstances but it contains the forecasts required for planning general government finances. In addition to the basic forecast, the Ministry also presents an alternative scenario where the restrictions are assumed to remain in force for six months.

In the assessment of fiscal policy monitoring, the realism of the forecasts of the Ministry of Finance has been assessed by examining whether they fall within the prediction interval. This time the forecasts have also been compared with the characteristics of previous recessions. This is because the most recent forecast of the Ministry can be compared with those of other forecasters in a sound manner, using statistical methods, only as regards GDP growth. It was therefore not possible to perform a comprehensive technical analysis as in previous reports. As the reference group is missing, the assessment examines, for example, the most essential real economic forecasts of the Ministry, broken down according to the items of the national accounts.

The Ministry of Finance forecasts a 5.5% fall in GDP for 2020 and a 1.3% growth for 2021. In its winter survey of December 2019, the Ministry forecast economic growth of 1.0% and 1.1% for the same years, respectively. Based on the forecast, the economic outlook has thus abruptly deteriorated because of the coronavirus pandemic. This also applies to other forecasts in Finland and the whole world.

Figure 5 shows the latest GDP forecasts for 2020 of the forecasters of the Finnish economy according to the date of issue. Scenario calculations are also taken into account in the figure to the extent that their assumptions broadly correspond to the basic premises of the Ministry's basic forecast. The figure illustrates the development of forecasts over time. In the trend calculations, the NAOF has also taken into consideration whether the forecast was published before or after the Government's press briefing on the coronavirus situation and the extensive set of restrictions (16 March 2020). It is also essential that similar measures were also taken in many other European countries at about the same time. The forecast trend falls by more than five percentage points during this time. The figure also shows that the forecasts were already deteriorating and the Finnish economy was already facing headwinds before the economy was hit by the coronavirus.

In view of this, the GDP forecast for 2020 by the Ministry of Finance can be considered realistic, as it approximately coincides with the trend of other forecasts published at the time it was issued. Compared with other GDP growth forecasts and scenarios published after 16 March, the forecast of the Ministry of Finance falls between the median forecast (−5,4) and the average (−5,9).

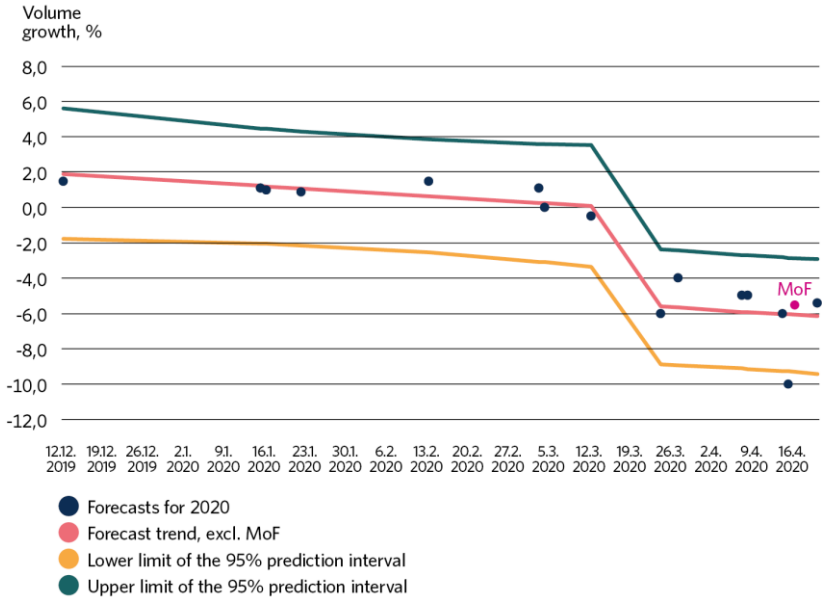

Figure 5: GDP forecasts for 2020, the forecast trend, and the upper and lower limits of the prediction interval. Source: Different forecasters, NAOF.

Although the corona crisis is very different from the financial crises of the recent history, comparing it with them provides useful perspectives for examining economic forecasts. According to the most recent forecasts, the present recession will be less severe based on the decline in GDP than the financial crisis of 2009 or the recession of the 1990s. Figure 6 illustrates the contribution of national economy demand items and imports to the change in GDP. Based on the forecasts shown in the figure, the most important factor influencing the fall of GDP in 2020 will be the exports of goods and services. This was also the case during the financial crisis. According to the Ministry's forecast, the contribution of exports will now be −2,7 percentage points, whereas during the financial crisis, the corresponding figure was −8,6. Imports also decrease during a crisis, which technically mitigates the impact of the decline in GDP. During the financial crisis, the contribution of imports was 6.8 percentage points, whereas now the Ministry forecasts that their contribution in 2020 will be 1.6 percentage points.

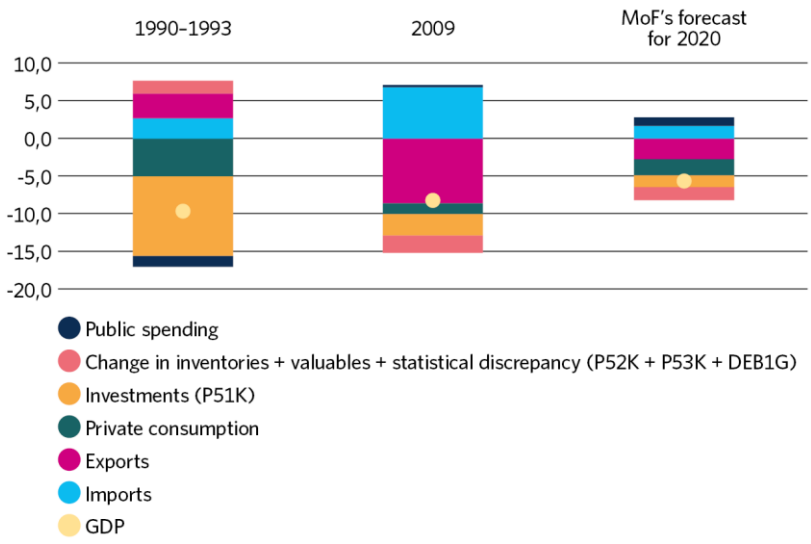

Figure 6: Impact of different factors on the decline in GDP during the recessions of the past few decades. Source: NAOF, Ministry of Finance, Statistics Finland.

As stated above, the crises are very different in nature, and the structure of the Finnish economy and exports have changed during more than 10 years. Nevertheless, Finland is still a small open economy, and its exports are dependent on the global development. In the present situation, the development of exports depends on how Finland's trading partners and other countries around the world manage to cope with the corona crisis, as well as on the fiscal measures taken by other countries. International trade is also suffering from disturbances in the production chains. During crises, Finnish exports have always fallen much more radically than world trade – regardless of the nature of the crisis (see Figure 7). According to the forecast of the Ministry of Finance, world trade will decline this year by 5 per cent. For Finnish exports, in turn, the Ministry forecasts a decline of 6.3 per cent. In view of the above, the latter figure can be considered optimistic.

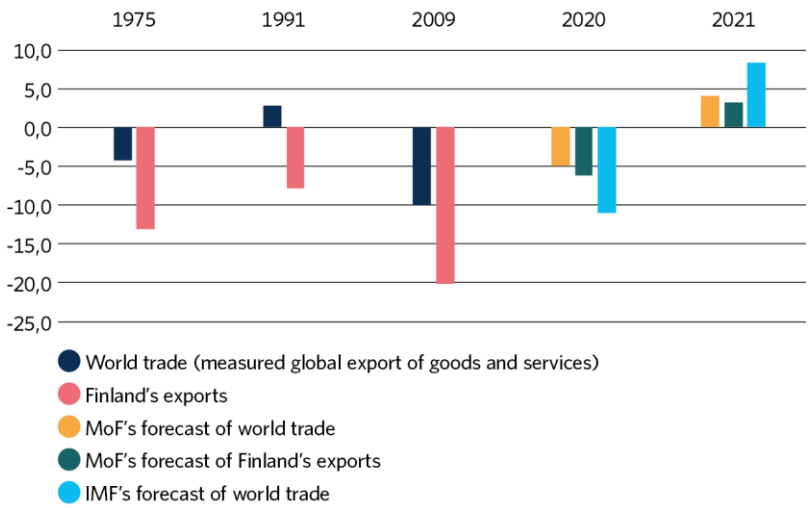

Figure 7: Change in the volume of exports of goods and services during the recessions of the past few decades. Source: Statistics Finland, Ministry of Finance, IMF.

The world trade forecast of the Ministry of Finance is also optimistic compared with that of the IMF. This adds to the Ministry's optimism as regards Finland's foreign trade. The Ministry's optimism about world trade can also be explained by its positive view about the development of output in the United States. The situation in the US is of key importance to the forecast, because the US has served as the driver of growth for the world economy. The economic cycles of Finland and many of its important trading partners, such as Germany, also depend on the US. The Ministry of Finance forecasts that the GDP of the US will shrink this year by 2 per cent, whereas many other forecasters have a more pessimistic view. The IMF, for example, forecasts that it will decline by 5.9 per cent.

Figure 6 shows that investments also have an essential impact on the fall in GDP: their contribution is −1.6 percentage points. They had also been facing headwinds before the crisis hit. Investments are sensitive to uncertainty due to decreasing cash flow and liquidity.

One of the characteristics of the ongoing crisis is that it has hit private consumption directly − not only through restrictions but also through the labour market. The Ministry of Finance forecasts that private consumption will shrink much more radically in 2020 than during the financial crisis. According to the forecast, the contribution of private consumption to the growth of GDP was −2.2 percentage points, while in the financial crisis it was −1.5 and in the 1990s recession −5.1 percentage points. The development of private consumption would thus fall between that of the financial crisis and the 1990s recession; nevertheless, closer to that of the financial crisis. If the restrictions remain in force for roughly three months, this can be considered realistic. An essential difference from the recession of the 1990s is that public consumption will grow rapidly this year. According to the forecast of the Ministry of Finance, the contribution of public consumption to GDP growth will now be 1.1 percentage points, whereas in the 1990s recession it was −1.5 and in the financial crisis 0.4 percentage points.

It is very difficult to forecast the growth of GDP in 2021, as its development even this year is very uncertain. The Ministry of Finance forecasts that Finland's GDP will grow by 1.3 per cent in 2021. In its economic survey of December, the Ministry forecast a growth of 1.1 per cent for 2021. According to the forecast, the corona crisis will thus hit the economy hard this year and prevent a rapid recovery the next year.

Very few GDP forecasts and scenario calculations have been published for 2021 after 16 March 2020. However, all of them forecast some kind of a rebound, i.e. a temporarily more rapid growth rate, for 2021. The phenomenon is based on the idea that private consumption will drive growth to an increasing extent, as consumption is postponed to the future. However, in service consumption, this would be realized only to a limited extent, as services cannot be stored.

Figure 8 shows the contribution of GDP in 2021 and after the 1990s recession and the 2009 financial crisis. It is evident from the forecast of the Ministry of Finance that particularly private consumption and exports are expected to contribute the most to GDP growth. However, the growth in exports would be considerably more moderate than after the financial crisis. Another difference from the financial crisis and the 1990s recession would be that investments would not recover as quickly. This is because investments were already facing headwinds before the crisis. In addition, many companies are currently suffering from a liquidity crisis, and they may continue to experience uncertainty. It is therefore noteworthy that the Ministry of Finance forecasts a longer-term decrease in investments because of the crisis.

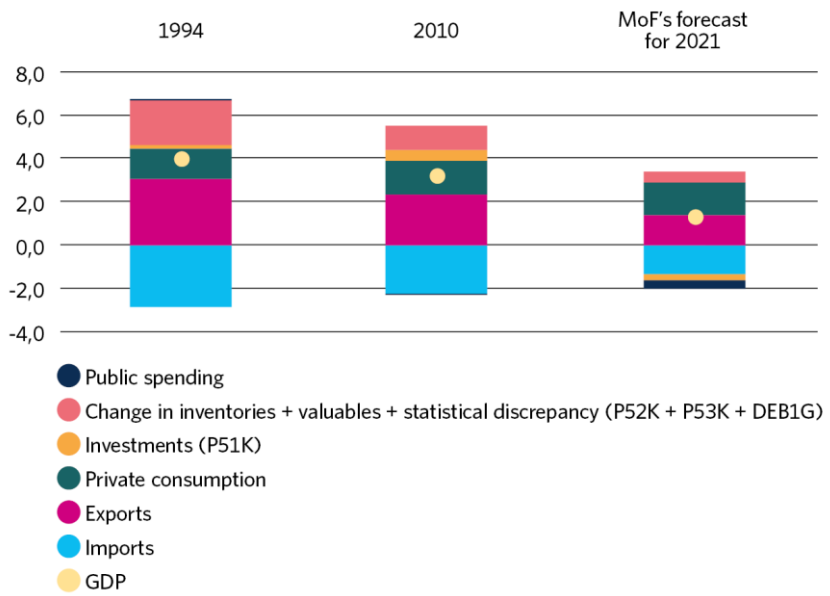

Figure 8: Impact of different factors on the growth of GDP after the recessions of the past few decades. Source: Statistics Finland, Ministry of Finance

According to the forecast of the Ministry of Finance, the output gap is expected to be closed in the medium term by 2024. This means that output would reach its potential level in 2024. According to the NAOF's previous observations[4], the assumptions made by the Ministry of Finance regarding the closing of the output gap in the medium term have varied. The NAOF has been of the opinion that the Ministry should justify its assumption of the prevailing economic cycle (the size of the output gap) more transparently at the end of the forecasting horizon. The Ministry has not presented any justification in the forecast of spring 2020 included in the General Government Fiscal Plan and the Economic Survey, either. The Ministry should therefore pay attention to this in the future.

The corona crisis will leave its mark on public finances. According to the General Government Fiscal Plan, fiscal deficit will grow to EUR 16.6 billion in 2020. Relative to this year's GDP, fiscal deficit will grow by 7.2 per cent. Of the deficit of EUR 16.6 billion, about EUR 12.5 billion would be realized in central government, EUR 3.5 billion in local government,

[4] Fiscal policy audit report: Medium-term projections in the planning of general government finances (audit report of the National Audit Office 17/2019).

and the rest in employment pension institutions and social security funds. The increase in the deficit will be reflected in general government gross debt. According to the forecast of the Ministry of Finance, gross debt would increase this year to 69.1 per cent of GDP. The change in the debt ratio in 2020 would thus be 9.7 percentage points.

In the budgetary forecast, the Ministry of Finance has assessed that, in 2021 and 2022, compensations for Finnvera's credit and guarantee losses will be about EUR 150 million higher than in 2020. The measures the Government has targeted at businesses because of the corona crisis include an increase of EUR 10 billion in Finnvera's domestic financing authorizations. The amount of guarantees (including, for example, export credit guarantees, home and student loan guarantees, and EFSF) was very high in Finland compared with the other European countries even before the corona crisis. A significant number of the guarantees have been provided to shipyards' customers, as they are dependent on the demand for cruise holidays. The corona crisis has hit this industry particularly hard, at least temporarily, although it has also burdened companies' liquidity in general. As regards guarantee losses, the budgetary forecast of the Ministry of Finance for the General Government Fiscal Plan period can be considered optimistic, although the fiscal measures taken by Finland's trading partner countries reduce the risk of export guarantees being triggered. However, the significance of this issue for the entire forecast is limited, when all uncertainties around the forecast are considered.

Exceptions to the spending limits rule of the parliamentary term were made because of the crisis

In connection with the first supplementary budget, the Government decided to abandon the central government spending limits rule for the year 2020. It was not considered justified to adhere to the limits in 2020, as exceptional circumstances declared by the Government and the President of the Republic are prevailing in Finland. Starting from 2021, the spending limits specified in the General Government Fiscal Plan for 2020–2023 will again be in force. The spending limits set for 2020 would have been exceeded in connection with the decision on the second supplementary budget, when the spending limits expenditure exceeded the spending limits rule by about EUR 1.1 billion (Figure 9). Furthermore, expenditure falling outside the spending limits is about EUR 3.1 billion higher than previously estimated. This is mainly due to the growth of unemployment and social security expenditure and the subsidies directed at municipalities and businesses. All of the increases in expenditure in 2020 are not yet known, and thus the expenditure both within and outside the spending limits may still grow in 2020. The increases in expenditure have been direct inputs in health care, social work, the operational reliability and safety of society because of the Covid-19 epidemic, and subsidies paid to businesses, municipalities and agriculture because of the economic crisis and mobility restrictions.

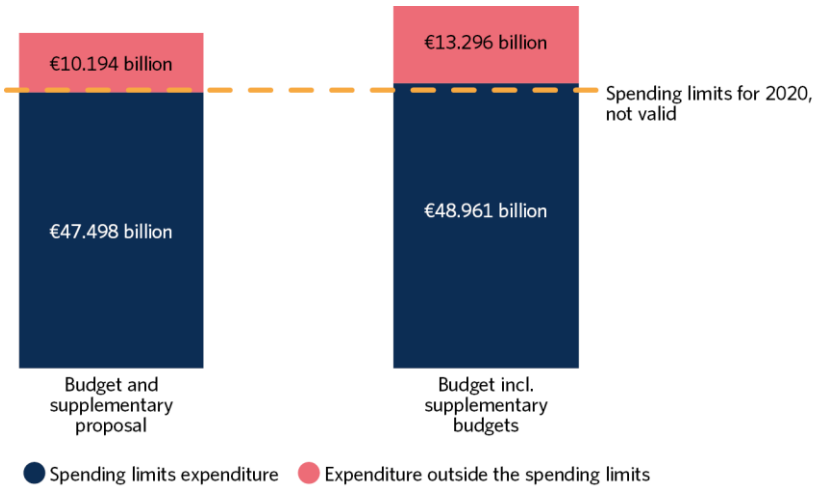

Figure 9: Budget for 2020 in relation to the budget after the supplementary budgets I and II, and the previously valid spending limits. Source: Ministry of Finance, budget data.

Abandoning the spending limits for 2020 to finance the measures required to be taken because of the Covid-19 epidemic seems justified. The increases in expenditure in 2020 seem to be correctly allocated in the circumstances. In view of the credibility of the spending limits procedure, it is important to reinstate the spending limits as soon as the exceptional

circumstances come to an end. The mechanism for exceptional circumstances, which is part of the spending limits rule, makes it possible to take stimulus measures in 2021 and 2022, and the activation of the mechanism has been launched. The Ministerial Committee on Economic Policy decides on exceptional circumstances based on situational assessments requested from the Bank of Finland, economic research institutes (ETLA, PT, PTT), and the Economics Department of the Ministry of Finance. After that, the Committee can recommend the activation of the mechanism for exceptional circumstances to the Government. It seems likely that the criteria for the activation of the mechanism will be fulfilled. The activation of the mechanism makes it possible to increase expenditure on stimulus measures by EUR 1 billion in total. However, the increase in expenditure may not exceed EUR 500 million per year. It will probably be justified to implement the stimulus enabled by the mechanism starting from year 2021, when the restrictions related to the Covid-19 epidemic no longer restrict economic activities and thereby the operation of fiscal stimulus as they do now.

The spending limits level of 2021 and 2022 also takes into account, as provisions, the additional inputs in future-oriented investments planned for the government term. The share of contingent inputs in these investments would be EUR 1.7 billion in total. Even if the crisis dragged on, the spending limits of 2021 and 2022 seem to provide a wider margin of manoeuvre within the scope of the spending limits rule than the rule allowed in 2020. The increases in expenditure decided by the Government in relation to management of the corona crisis are compiled in Table 2 up to the second supplementary budget of 2020.

Table 2: Increases in central government expenditure related to the corona crisis (April 2020)

	2020
The spending limits are not in force	+1.1 billion euros
Automatic stabilizers	+1.4 billion euros
Subsidies for businesses and economic growth	+1.1 billion euros
Support for municipalities	+547 million euros

The preparation of the spending limits for the previous parliamentary term 2016–2019 complied with the Governments' policy lines

The National Audit Office has examined (Table 3) the numeric deduction of the spending limits for the parliamentary term 2016–2019 from the technical spending limits to the final budget for 2019, including the supplementary budgets. According to the assessment, the spending limits were complied with during the parliamentary term 2016–2019.

Prime Minister Antti Rinne's Government took office after the supplementary budget for 2019. At the time, the spending limits of 2019 included an unallocated reserve of about EUR 260 million, which was replaced with a new, EUR 300 million supplementary budget reserve. The spending limits of 2019 were raised by about EUR 40 million at the same time. Unlike discretionary lowering of spending limits, raising them is not allowed during the parliamentary term under the spending limits principles. As the spending limits procedure is based on political commitment, a new Government may, nevertheless, increase the margin of manoeuvre included in the spending limits during the election year.

Table 3: In Table 3, each year's adjustments were deducted from the final spending limits of the parliamentary term to get the first spending limits of the parliamentary term. The changes in expenditure made at the beginning of the parliamentary term were then deducted from the first spending limits of the parliamentary term to get the technical spending limits, on which the preparations had been based. With the exception of small rounding differences, it was possible to trace the figures of the final spending limits back to those of the technical spending limits at the beginning of the parliamentary term. Numeric monitoring of the spending limits figures of the parliamentary term 2016–2019 from the technical spending limits to the end of the parliamentary term

Parliamentary term 2016–2019, year	2016	2017	2018	2019
Final spending limits of the parliamentary term 2016–2019 (the NAOF's calculations)	**45,085**	**44,891**	**44,556**	**44,807**
Adjustments made to the spending limits during the parliamentary term 2016–2019	**269**	**445**	**158**	**1,057**
Price adjustments	–167	–80	220	635
Structural adjustments	437	605	19	502
Discretionary decisions to lower the spending limits	0	–80	–80	–120
Raising of the spending limits by the new Government	0	0	0	40
NAOF: Spending limits of the parliamentary term according to the Government Programme	**44,816**	**44,446**	**44,398**	**43,750**
Ministry of Finance: Spending limits of the parliamentary term according to the Government Programme	**44,815**	**44,446**	**44,397**	**43,750**
DIFFERENCE	**0**	**0**	**0**	**0**
Ministry of Finance: Spending limits in the technical spending limits of 2 April 2015, EUR million	**43,090**	**42,743**	**42,972**	**43,040**
DIFFERENCE NAOF GOVERNMENT PROGRAMME'S SPENDING LIMITS–TECHNICAL SPENDING LIMITS	**1,725**	**1,703**	**1,425**	**710**
Ministry of Finance: Changes in the spending limits expenditure in the preparation of the spending limits of 2016–2019	**1,725**	**1,703**	**1,425**	**709**
DIFFERENCE	**0**	**0**	**0**	**0**

Since 2004, budget expenditure has been divided into spending limits expenditure and expenditure outside the spending limits. Expenditure outside the spending limits includes cyclical expenditure, such as allowances related to the unemployment situation and income security need. In addition, expenditure outside the spending limits also includes central government debt interest payments, compensation to municipalities arising from tax cuts, and expenditure generated by financial investments. Some of the expenditure items outside the spending limits are different types of pass-through items, which means that the budget has allocated revenue to offset the expenditure in question.

The amount of expenditure items outside the spending limits has remained relatively stable: in 2019, they totalled approximately EUR 11.2 billion. Cyclical expenditure related to unemployment security, housing allowance, and pay security decreased somewhat in 2019. Central government debt interest payments continued to decrease as well, and the amount of financial investments was quite low. Compensations made to municipalities for tax criteria changes during the parliamentary term amounted to EUR 1.012 billion. This expenditure item was transferred in full to the spending limits in connection with the change of the government term. The amount of pass-through items has remained stable, at about EUR 3.6 billion.

Changes in the knowledge base make it difficult to assess the development of structural balance

As stated above, the general escape clause of the Stability and Growth Pact has been activated because of the corona crisis. The activation of the clause means that deviations from the objectives set for general government finances are now allowed. For this reason, the National Audit Office does not assess compliance with the EU rules for the time being. However, the following is the NAOF's assessment of the development in 2019 based on the EU criteria.

According to the NAOF's assessment, structural balance decreased from –1.8 per cent of GDP in 2018 to –2.4 per cent in 2019, and it is expected to decrease further to –5.2 per cent in 2020 (Figure 10). If the EU framework had been in force, there would have been a deviation in the change in structural balance in 2019, but it would not have been significant. However, the cumulative deviation in 2018–2019 would have been significant. The expenditure benchmark limit was also in force until the activation of the escape clause. In 2019, there was a significant deviation from the limit value of the expenditure benchmark that was valid in autumn 2019.

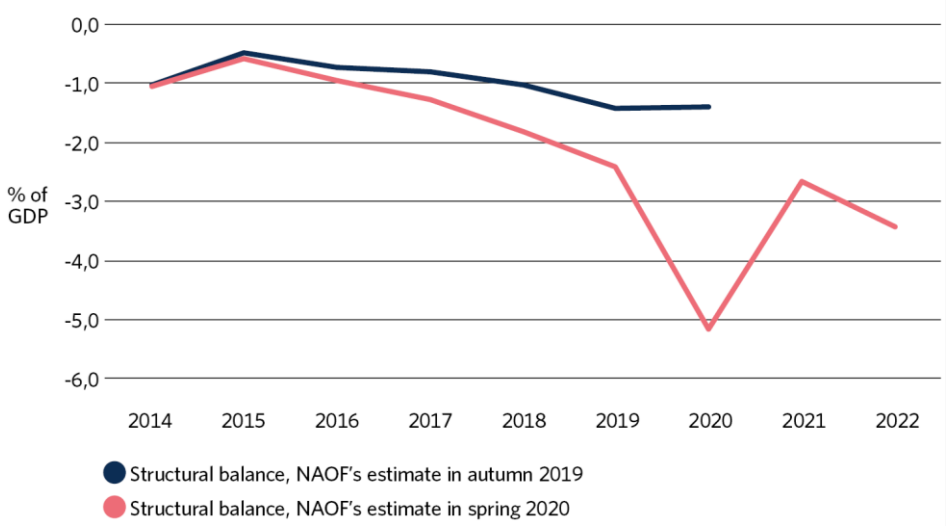

Figure 10: Estimates of general government structural balance.

In autumn 2019, the NAOF's estimate of the structural balance for 2019 was –1.4 per cent of GDP; now the corresponding estimate is –2.4 per cent. The estimates of the structural balance for 2017 and 2018 have also changed this spring. Last autumn, the NAOF's estimate of the structural balance was –0.8 per cent of GDP for 2017 and –1.0 per cent of GDP for 2018; now the corresponding estimates are –1.3 and –1.8 per cent, respectively.

The reason for the change in the estimated structural balance of 2017–2019 is that the assessment of the output gap, i.e. the cyclical conditions, has changed. The output gap is the difference between potential output and actual output, or GDP. If the output gap is positive, the economic capacity is overused, and there are pressures to raise both prices and salaries. If the output gap is negative, the economic resources are underused in view of their potential, and the economy is in a downturn.

In autumn 2019, the output gap was still assessed to be very close to zero, i.e. the economy was assessed to grow at about its potential level in 2017–2019. Based on the output gap, these years are now considered to have been a period of economic upturn. Such a radical change in the output gap estimate is explained by a change in the assessment of the level of potential output. This spring's estimate of the potential output for 2017–2019 was lower than that of autumn 2019. Therefore, the output peak, in turn, is now higher above the potential output than in last autumn's assessment. The estimated potential output has fallen, in particular, because the trend of labour input and total productivity has fallen.

The output gap cannot be observed, but it is assessed using a statistical production function methodology shared by the Commission and Member States. The assessment of the output gap changes when the time series used in this statistical modelling (concerning the capital base and labour input, for example) are updated and supplemented. This is typical in connection with changes in economic cycles, as can now be seen in the case of 2017–2019. The weakness of the framework of the Stability and Growth Pact is that the assessment of compliance with the rules is based essentially on the estimated output gap, which is almost impossible to assess correctly in real time – especially during cyclical changes.

Real-time cyclical indicators would therefore provide a more reliable picture of the ongoing economic cycle. For example, the composite indicator compiled by the NAOF has proved to be more accurate in real time than the estimated output gap. A proof of this is that the output gap updated later on has typically been closer to the picture provided by the composite indicator. This happened even in spring 2020 (see Figure 11). The assessment of the output gap is based on the data available at the time. When the statistical data and forecasts are specified, the picture of the economical cycle can sometimes change considerably. Compared with the output gap series, the difference and advantage of the heat map (see Figure 2) and the composite indicator calculated based on it, is that the heat map is based solely on statistical data, which means that the used data are usually subject only to minor updates.

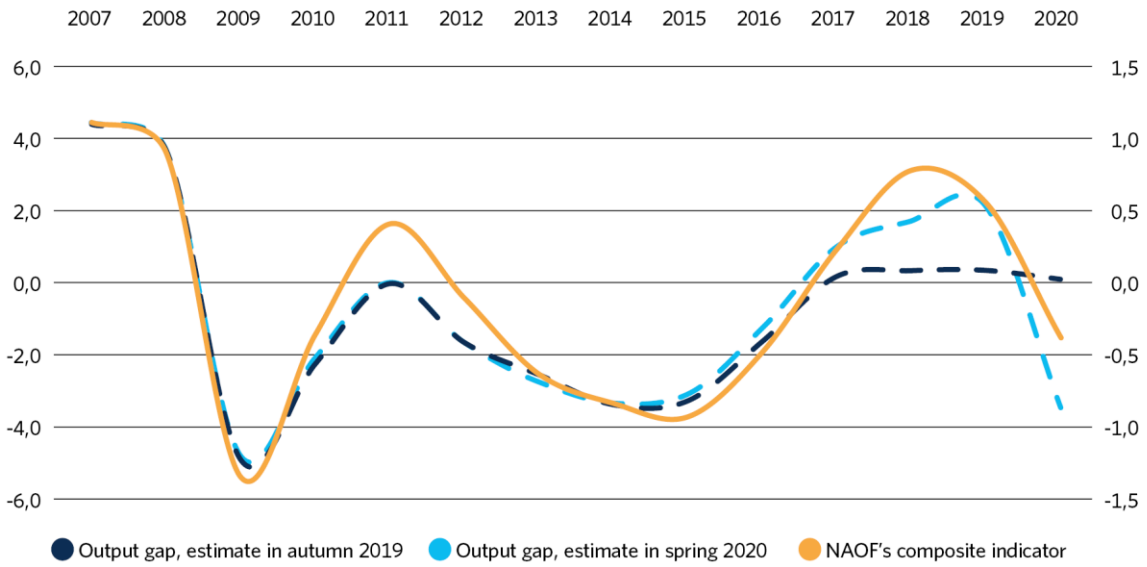

Figure 11: Data illustrating the economic cycle: composite indicator of the economic cycle and output gap estimates of autumn 2019 and spring 2020. Source: NAOF.

Appendix: achievement of the fiscal policy objectives for parliamentary term 2015–2019

Table 4: The fiscal policy objectives set by the Government in 2015 and assessment of their achievement.

Objective	Initial status	Assessment of achievement of the objective
General government structural balance objective for 2019, % of GDP		
–0.5 %	Based on the 2015 data, –1.8 % in 2015. Based on the most recent calculations, –0.6% in 2015	–2.4% The objective was not achieved.
Nominal balance objectives for 2019, % of GDP		
General government in total, 0%	–2.4% in 2015	–1.1 % in 2019. The objective was not achieved.
Central government, max. –0.5 %	–3.0 % 2015	-1.2% in 2019 The objective was not achieved. The objective was missed by –0.7 percentage points.
Local government, max. –0.5%	–0.6 % in 2015	–1.2 % in 2019. The objective was not achieved. The nominal deficit fell to –0.2 per cent in 2017 but grew in 2018–2019.
Employment pension funds, +1%	1.6 % in 2015	0.9 % in 2019. The objective was nearly achieved.
Other social security funds, approximately 0%	–0.4 % in 2015	0.3 % in 2019. The objective was achieved.
General government debt		
The debt-to-GDP ratio starts to decrease by 2019	63.6% 2015	59.4 % in 2019. The objective was achieved.
The amount of debt will no longer increase in 2021	General government debt EUR 134.5 billion in 2015	The objective extended to the present government term. In 2019, the amount of debt grew further by EUR 3.2 billion.
Total tax rate in ratio to GDP		
Total tax rate will not increase during the parliamentary term	43.5 % in 2015	42.1 % in 2019. The objective was achieved; tax rate relative to GDP fell by 1.4 percentage points.
Sustainability gap relative to GDP		
Decisions leading to eradication of the sustainability gap will be made during the parliamentary term	The sustainability gap estimate by the Ministry of Finance was approximately 5% in spring 2015	The sustainability gap estimate by the Ministry of Finance in spring 2019 was about 4%. The sustainability gap did not narrow significantly during the parliamentary term, although the achievement of the objective cannot be assessed directly on the basis of the development of the sustainability gap estimate.
Employment rate target		
The employment rate will be raised to 72 per cent, and the number of people in employment will be increased by 110,000.	Employment rate 68.1% in 2015	The objective was achieved. The employment rate improved to 72.6 per cent, which was higher than the target. The number of people in employment grew by about 120,000.

Sources of the actual and initial data: Statistics Finland, Ministry of Finance, NAOF. The initial data for 2015 have been described according to the current time series, unless otherwise stated.

The structural balance objective was not achieved during the previous government term. According to the calculations made in spring 2020, the structural balance in 2019 was –2.4 per cent of GDP, which fell 1.9 percentage points short of the objective. As can be seen from the assessments of 2015 in Table 4, the assessment of structural balance is surrounded by a great deal of uncertainty. The calculations are based, for example, on output gap calculations, which will continue to be specified years later.

The total nominal balance of general government sub-sectors relative to GDP did not develop according to the target. The nominal deficits of central and local government relative to GDP were both 0.7 percentage points higher than the target. Nevertheless, the nominal deficit of central government decreased during the previous parliamentary term, while the nominal deficit of local government increased. Increase took place particularly in 2018–2019, when the nominal deficit of local government grew by 1 percentage point relative to GDP. The surplus objective of employment pension institutions was nearly achieved, and the balance objective of other social security funds was exceeded by 0.3 percentage points relative to GDP.

General government debt relative to GDP began to fall during the previous government term, which means that one of the two debt-related objectives was achieved. The other debt-related objective, according to which the amount of debt will no longer increase in 2021, extended to the present government term. The amount of debt grew further in 2019 by approximately EUR 3.2 billion. The total tax rate relative to GDP decreased by 1.4 percentage points during the previous parliamentary term. The objective according to which the tax rate would not increase during the parliamentary term was thus achieved.

The sustainability gap did not narrow considerably during the parliamentary term. The objective set for the sustainability gap applied to decisions to eradicate the sustainability gap. Its achievement cannot be assessed directly on the basis of the sustainability gap indicator because of the time lag. The original plan was to achieve the objective to narrow the sustainability gap to a significant extent through the social and health care reform. As the preparations for the reform proceeded, its impacts on the sustainability of general government finances proved to be highly uncertain, and eventually the reform was not implemented. Overall, the targeted decisions that would have led to the narrowing of the sustainability gap were not taken during the previous government term.

The employment objectives were achieved clearly, although it was considered difficult to achieve them during the parliamentary term. The employment rate grew to 72.6 per cent in 2019, and the number of people in employment increased by about 120,000.