TAPIOLA BANK'S REVIEW OF BUSINESS CONDITIONS 1/2010:
The Finnish economy has technically descended back into recession – economic growth remains zero

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The Finnish gross national product continued to decrease in the beginning of the year. As the growth remained negative also during the previous quarter of the year, the Finnish economy is technically in a recession again. Tapiola Bank lowers the Finnish total economic growth forecast 2010 to 0.0 percent (1.0%). The whole euro zone is suffering from the debt crisis and is currently the weakest link of the world economy. The European debt crisis is also the biggest threat to the Finnish economy. The domestic employment rate has, however, remained better than expected. Tapiola's estimate for the unemployment rate of this year is 9.5 percent (10.5%).

Tapiola Bank lowers the forecast of the GDP development in the Finnish economy because of the weaker-than-expected accounting figures of the first half of the year and the weakening outlook of the world economy. The single primary explanation for the more pessimistic view is the weakening net exports outlook. The export was reduced on the quarterly level by no less than 11 percent. The figure shows, among other things, the effects of the harbour strike in the spring.

"The demand for Finnish exports is still low. Depreciation of the euro strongly improves the competitiveness of Finnish exports outside the euro zone, so there is potential for significant improvement of demand. It must be noted, however, that even the "zero growth" scenario calls for a clearly positive economic growth in the latter part of the year," says **Jari Järvinen**, Tapiola Group's Senior Economist.

Tapiola lowers the growth forecast for the year 2011 by 0.5 percentage points to 1.0 percent.

European debt crisis biggest threat to Finnish economy

The growth of the industrial countries has continued in the beginning of the year, but the anticipatory indicators indicate that the growth will slow down. Next year is going to be weaker than this year. The outlook is weakened by the tightening measures in financial politics aimed at controlling the indebtedness and balancing the economies. However, too early tightening measures may lead to a decline in tax income and an increasing deficit. The outlook of emerging economies has also weakened.

The greatest risk for the Finnish economy is related to the European debt crisis and its management. The Finnish economic situation is quite good compared to the euro zone, but bad news will be reflected on us through exports, the financial and commodity markets, and a drop in trust indicators.

"Special attention should continuously be paid to Finland's economic competitiveness. In the next few years, the competition on new orders in the global market will be extremely tight, and cost development must remain under control."

The employment rate in Finland has remained better than expected, and Tapiola estimates the unemployment rate of this year to be 9.5 percent (10.5%). On the other hand, the unemployment rate is still expected to peak in 2011.

Interest rate remains low – euro should drop further in value

The central banks in United States and Europe, FED and ECB, will continue their current interest policy. Due to the debt crisis, the ECB had to re-adopt unusual measures such as buying government bonds, and to prevent the risk of a new downswing and price decline it must keep its key interest rate low until the end of next year.

“The euro zone is currently the weakest link of the world economy, and the debt crisis threatens to push the euro zone into a new recession and a downward spiral of prices. The weakening of the euro against the main currencies continues, but the euro is still overrated against the dollar. The return of competitiveness would require an underrated currency,” says Järvinen.

Besides the weakening euro, the stability of the monetary union requires growth of the international economy, stimulating financial policies in Germany and other core countries, more stimulating monetary policies from the ECB and tighter coordination of financial policies between the EU Commission and the EU member states.

From the viewpoint of customers with housing loans, interest rates will remain low. For example, having an interest rate cap is currently not in the interest of a customer taking out a loan; it is more advisable to prepare for the increase in interest rates by saving. According to Tapiola’s estimate, the interest rates should rise quickly in the next couple of years to a far higher level than the current one and stay at a high level for a long time for an interest rate cap to be worthwhile.

Metropolitan area housing market heated up at start of year

The prices of residential properties in Europe have not recovered after the decline, which started last year. The recent accelerating increase in prices in Finland is exceptional in the whole continent. In the Helsinki metropolitan area the prices of old properties increased by no less than 15.7 percent and in the entire country by 7.7 percent from the previous year. It should be kept in mind that this time in 2009 prices were still on the decline.

“The historically low interest rates are speeding up the demand and sales of residential properties. As the production of market-financed housing rapidly decreased during the recession, the supply of new apartments is still short of demand. Specially in the Helsinki Metropolitan area, property prices will continue to rise,” estimates **Vesa Immonen**, Managing Director at Tapiola Real Estate Ltd.

According to Immonen, one explanation for the difference between Finland and the rest of Europe is the Finnish convention of using short reference rates for housing loans almost without exception.

“Probably this kind of exceptional price development in Finland would never have occurred if long interest rates of more than 5 years were used for housing loans. In the long range, the euro zone interest rate will rise from the current level. In Finland the risks of increased interest rates are almost completely on households, while in Europe it is more common that the risk is on the financial institution. Therefore the responsible lender should instruct the customer on risk formation and possible means of preparing for them.”

Read the entire economic forecast on the Tapiola website for investment customers at www.sijoitustalous.fi (in Finnish). The next economic forecast will be published in December 2010.

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Table 1. Forecasts for the international economy: Change in the amount of GDP, %
(Changes compared to Tapiola Bank's review from January 2009 in brackets)

	Tapiola 2010	2011	IMF 2010	2011
USA	2.9 (2.5)	1.7 (1.5)	3.1 (1.5)	2.6 (2.8)
Euro zone	0.9 (1.0)	0.4 (0.5)	1.0 (0.3)	1.5 (1.3)
Japan	2.8 (1.5)	1.5 (1.0)	1.9 (1.7)	2.0 (2.4)
World	3.2 (3.6)	2.5 (3.0)	3.3 (3.1)	3.4 (4.2)

Sources: Tapiola Group and IMF

Table 2. Forecasts for the international economy: Inflation, %
(Changes compared to Tapiola Bank's review from January 2009 in brackets)

	Tapiola 2010	2011	IMF 2010	2011
USA	1.9 (1.5)	1.0 (1.7)	2.1 (1.7)	1.7 (1.8)
Euro zone	1.1 (1.0)	0.5 (0.8)	1.1 (0.8)	1.3 (0.8)
Japan	-1.1 (-1.0)	-1.0 (-0.5)	-1.4 (-0.8)	-0.5 (-0.4)
World	2.1 (1.8)	1.5 (2.3)	3.7 (2.9)	3.0 (2.8)

Sources: Tapiola Group and IMF

Table 3: Forecast on Finnish economy
(Tapiola Bank's online financial review forecast from March 2010 in brackets)

	2010	2011
Change in the amount of GDP, %	0.0 (1.0)	1,0 (1.5)
Private consumption	0.5 (-0.5)	1.0 (1.0)
Export	1.5 (2.0)	2.5 (3.5)
Imports	1.0 (0.0)	2.5 (3.5)
Investments	-4.0 (-4.0)	1.5 (3.5)
Unemployment rate, %	9.5 (10.5)	10.0 (11.0)
Inflation, %	1.5 (1.0)	1.5 (1.5)

Source: Tapiola Group
The forecast has been raised or lowered from the previous year

TAPIOLA'S FORECAST FOR 2010–2011
The Finnish gross national product continued to decrease in the first quarter of 2010. GDP decreased 0.4 percent in comparison with the previous quarter and 0.8 percent from the corresponding figure last year. As the growth figure of the previous quarter was also revised negative, the Finnish economy has technically fallen into a recession again.

Tapiola lowers the forecast of the GDP development in the Finnish economy. Tapiola now forecasts that the growth of the total production in 2010 will be 0.0 percent (1.0%). The single primary explanation for the view that is more pessimistic than the previous estimate is the weakening net exports outlook. The growth forecast for the year 2011 has been adjusted down by 0.5 percentage points to 1.0 percent (1.5%).

The outlook for emerging economies has also weakened due to the drop in the prices of raw materials and the possibility of overheating in the Chinese market. The European debt crisis will slow down the growth also in the emerging markets.

In the United States, house prices have continued a moderate rise, but the tightening of lending and the repayment of debts are cutting consumption and investments. The euro zone is the weakest link of the world economy, and the debt crisis threatens to push the euro zone into a new recession and a downward spiral of prices. In Japan, growth has been faster than in the US and the euro zone in the beginning of the year, but the strengthening yen in recent months is decelerating growth in export.

The outlook of the Finnish economy follows with some delay the general trend in the industrial countries, and the economy will get back on a slow growth track in 2010. The mood among companies and consumers has continued to improve in recent months, but the slowdown of the international economy is bad news for the Finnish economy as well.

The FED will continue its zero-interest policy. With the low interest rates, the FED aims to revive the economy and prevent the risk of deflation. The underutilisation of resources (workforce and capacity), the decline in housing and financial wealth, the increase in unemployment and private sector indebtedness are all deflationary factors. The risk of inflation in the review period is non-existent.

The ECB will maintain the current interest rate level. The inflation and money supply targets enable the continuation of the record low interest rate levels. Due to the debt crisis, the ECB had to re-adopt unusual measures. In the current situation, tightening measures in financial politics increase the risk of a new downswing and price decline. To prevent these risks ECB must keep its key interest rate low until the end of the next year. The euro is still overrated against dollar and the return of competitiveness requires an underrated currency. In practice this means levels that are clearly below parity.

Depreciation of the euro has increased the pressure to raise the prices of imported goods. In a small open economy like Finland the inflatory effect of the weakening currency is more extensive than in large euro zone countries. Due to the recent strong depreciation of the euro, Tapiola raises the inflation forecast for the current year to 1.5 percent (1.0%). Tapiola still forecasts the average consumer price inflation in 2011 to be 1.5 percent (1.5%).

The oil price has halved from its peak and the price will remain at an average of 60 to 70 dollars a barrel during the review period. In the long term, the oil price is under pressure to rise due to excess demand and limited refining capacity.

The euro zone debt crisis management requires tighter coordination of financial policies between the European Commission and the member states. As a result, the national freedom of action will be reduced and the significance of wage negotiations in maintaining national competitiveness will increase. Excessive salary increases will reduce both companies' competitive ability and jobs.

The greatest risk for the Finnish economy is related to the European debt crisis and its management. Too tight a budget cap will lead to political tension within and between countries, while the continuation of the current course may lead to disintegration of the euro zone. The bad news is reflected in exports, commodity markets and financial markets and as a drop in trust indicators.

Now we are facing a period of slow growth lasting several years, during which the countries focus on balancing their economies. The good news is that after this "balancing" the long-term outlook is better than before and the euro zone is closer than ever to the objectives of the Lisbon Treaty.

The greatest risk for the growth prospects of the world economy will be too early tightening of the financial politics in the industrial countries. Balancing the economies means a significant decrease in demand, which could in the worst case lead to a new recession, increasing the unemployment rate, decline in tax income and an increasing deficit.

In Finland, the Helsinki metropolitan area housing market heated up in the beginning of the year. In the metropolitan area the prices of old properties increased by no less than 15.7 percent from the previous year. Throughout the country the increase was 7.7 percent. It should be kept in mind that this time in 2009 the prices were still on a decline. A significant factor in the increase of property prices is the historically low interest rate, which speeds up the demand and sales of residential properties.