

Research Finland

Finnish economy adapting to a new reality

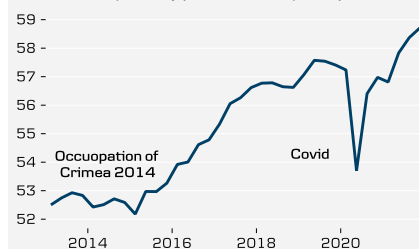
- Russia-Ukraine War has a big negative impact on Finnish economy, which is the most exposed Nordic country measured by value of foreign trade.
- Finnish companies have already begun to adapt to a situation where Russia as a market is insignificant. Material sourcing flows elsewhere and some production will be transferred from Russia to Finland.
- We see downside risks to our 2022 GDP forecast of 2.8% of 0.5-1.0pp, but uncertainty is large. Exports are hit and higher inflation slows down recovery in consumption.
- Finland shares a long border with Russia. Geopolitical risk is apparent, but we see only a small risk of military escalation on Finnish border. NATO membership has become a more popular option in surveys.

The Russia-Ukraine War has a big impact on the Finnish economy, which is the most exposed Nordic country measured by value of foreign trade. Russia was Finland's fifth largest export market in terms of the value of goods exports in 2021. Russia's role in imports has been even greater, especially due to the import of oil and natural gas. Russia has played an even bigger role in the past, but its importance shrank significantly after the occupation of Crimea in 2014. The economic connections between the countries are significant in other ways as well, as many Finnish companies operate in Russia and Russian tourism has been a big source of revenue for the Finnish travel industry and retail trade. However, these connections have also declined in recent years, with many companies closing down in Russia. Ukraine's direct importance to the Finnish economy is small, but the war has indirect effects through global markets in raw materials such as grains. Inflation will be higher for longer also in Finland.

Finnish companies have already started replacing Russian material with other sources. Urals crude oil is being replaced with North Sea Brent. Russian timber is being replaced by domestic sources. In both examples companies continue to operate, but with higher costs and possibly lower profit margin. On the other hand, prices for sawn materials may rise without Russian competition. The degree of adaptation is more challenging for companies that have significant production or other operations in Russia or Ukraine. Several factories in Russia have been closed already, also without a pressure from sanctions. In some cases, these closures are permanent and may imply additional investments in Finland or somewhere else in the West. Accelerated implementation of renewable energy and other energy related projects, attention to defense spending as well as investment into civil crisis preparedness could boost investment. On the other hand, uncertainty and political considerations could put some commercial investment plans on hold. This applies for example to the Hanhikivi nuclear power plant, which is based on a Russian reactor and is one third owned by a Finnish subsidiary of Russia's Rosatom.

GDP has been recovering

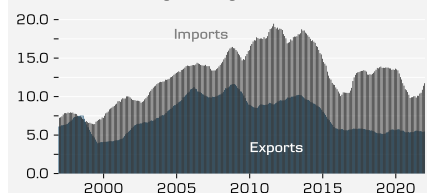
GDP volume quarterly (EUR Bn 2015 prices)



Source: Macrobond, Statistics Finland Danske Bank

Finnish trade with Russia

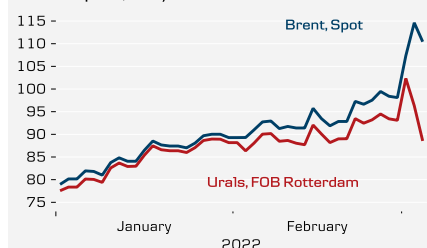
Russia % of Finnish foreign trade in goods



Source: Macrobond, Customs Danske Bank

Alternative sources are more costly

Crude oil price, USD/Barrel



Source: Macrobond, Danske Bank

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Demand from Russia is harder to replace for some companies, but goods are mostly universal in nature and could be sold elsewhere. According to the BEC trade classification, manufacturing production goods exports accounted for 45.5 per cent of Finland's exports to Russia. Capital goods, such as mining and forestry equipment, accounted for 31.3 per cent. Refined fuels and lubricants accounted for 8.9 per cent and transport equipment for 8.2 per cent. The share of consumer goods was only 4.0 per cent.

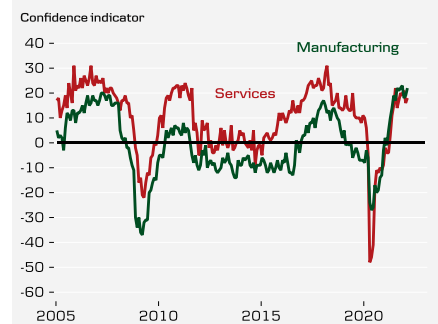
Higher inflation means an additional burden on consumers and slows down the recovery of consumer demand from the collapse caused by the Covid-19. To counter the negative impact, Finnish households have a good employment situation and, on average, more savings than ever before. We can still expect consumer demand to recover especially in services, unless the geopolitical situation gets much worse.

Uncertainty about the future is great and the development of the war is difficult to predict. In the best case for the economy, Russia and Ukraine would agree to a ceasefire, Russia would pack its tanks behind the border, and the situation would calm down. Also, in this case there would be an impact, as many companies have already withdrawn from the Russia and trade flows have been diverted. In the worst case, the war will escalate, energy supplies will be cut off, and Finland, together with the rest of Europe, will fall into recession. There are different scenarios between these outcomes.

The war has both rapid and long-lasting effects on Finland's economic outlook. The magnitude of impact on the Finnish economy as a whole is difficult to quantify. Much depends on the development of the situation and the ability of Western economies to adapt to the closure of Russia's borders. We see downside risks to our euro area GDP forecast in the magnitude of 0.4-0.5pp in 2022. A mere collapse in trade with Russia could cause roughly a similar dent in Finnish GDP growth this year. Additional effects through uncertainty and higher inflation will further weigh on the economic outlook. Danske Bank will publish a new forecast for the Finnish economy in mid-March, but it currently seems likely that this year's GDP forecast will fall by less than one percentage point from the previous 2.8%. Employment growth is slowing down and some companies have already started to discuss layoffs. The expansion and prolongation of the war would mean a recession and a long-term adjustment to time without significant economic relations with Russia. Sanctions are not the only thing limiting trade, other considerations matter too.

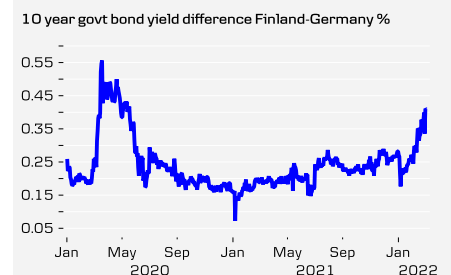
Finland shares a more than 1000km long border with Russia. Finland was part of the Russian empire between 1809 and 1917. Finland has maintained a non-allied but Western oriented foreign policy for a long time. Finland has also maintained an ability to raise a large land army with continued conscription, unlike in most of Western Europe, and recently decided to purchase 64 F-35 fighters from the US to replace old F-18 fighters. Russian authorities have warned that consequences will follow if Finland joins NATO. Finland has had stable relations with Russia for decades. Putin himself has in the past described the relations as extremely good. Due to the unpredictability of Russia's current politics there obviously exists an increased sense of geopolitical risk, albeit small. NATO membership is an issue that is under active discussion and has in surveys become more popular in recent weeks. In terms of geopolitical risk, even under the current political unpredictability, a military confrontation looks unlikely.

Business confidence before the War



Source: Macrobond Financial, EK, Danske Bank

FGB yield pricing in some risk



Source: Macrobond Financial, EK, Danske Bank

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