Chamber of Commerce Economic Review

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UNCERTAINTY IS EXPENSIVE

The Chamber of Commerce's Economic Review deals briefly and succinctly with relevant economic issues. The Reviews will summarize the domestic and international economic situation, the phenomena causing the current economic environment and the statistics describing and affecting economic development. This Review focuses on uncertainty and its economic impact. The review is published four times a year.

HIGH UNCERTAINTY INCREASED DUE TO CORONA

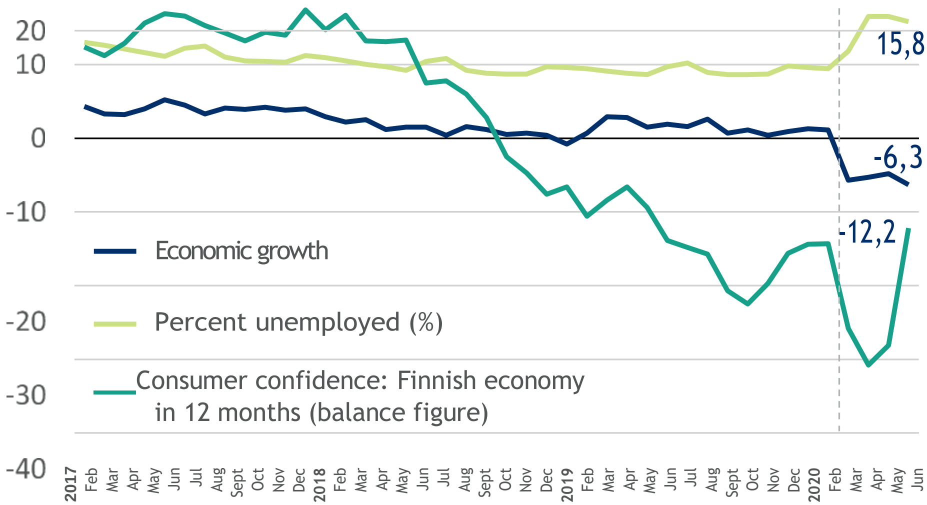
The COVID-19 pandemic has been pummeling the world's economies for several months now. One difficult problem caused by the pandemic is the lack of information and the increase in uncertainty. At the beginning of the pandemic, we knew almost nothing about the novel coronavirus. While we still do not know enough, we do know much more than we did six months ago.

Due to the lack of information, it is also difficult to assess the usefulness of various policy measures. For instance, the corona strategy chosen by Sweden looks poor, or even lousy, considering current knowledge, but back in March, Sweden's strategy looked just as justified - albeit different - as the Finnish strategy. Hindsight is always twenty-twenty.

From an economic and economic policy point of view, uncertainty is of enormous importance. On one hand, a high level of uncertainty affects people's consumption and saving behaviour. On the other hand, companies are more reluctant to invest and recruit due to increased uncertainty about the basis of their choices. Therefore, reducing the uncertainty that is tormenting society is one of the crucial tasks public authorities need to undertake in times of crisis.

> From an economic and economic policy point of view, uncertainty has an enormous impact.

Figure 1 Snapshot of the state of the Finnish economy 2017M01-2020M05.



1 Quick experimental estimate of the business cycle index of production (Statistics Finland)
2 Employment statistics (Ministry of Economic Affairs and Employment)
3 Component of the Consumer Confidence Index (Statistics Finland)

Source: Statistics Finland and Ministry of Economic Affairs and Employment.

THROUGH WHICH CHANNELS WILL UNCERTAINTY AFFECT THE ECONOMY?

Most people are not particularly fond of uncertainty. In general, people would prefer to receive a salary of EUR 3,000 every month as opposed to having a 50 percent chance of either receiving a payment of 0 or EUR 6,000 for the same job. In fact, people are often willing to pay for a reduction in uncertainty. In the study of economics, it is said that people are risk averse in their preferences.

Uncertainty affects the economy through various channels. *For households, consumption of consumer durables, such as cars or homes, is declining*. However, increased uncertainty also increases contingency saving, i.e. saving for a rainy day. Contingency saving is a common occurrence, but when consumers' rates of saving rise at an inopportune time in the economic cycle, the result could be a deepened recession or stagnation - and this is often the case. For example, an increase in the probability of unemployment and a decrease in the value of assets will lead to an increase in contingency saving. During the financial crisis, at least two-fifths of growth in savings in OECD countries was due to labor market uncertainty alone.[1]

For companies, uncertainty reduces the desire to expand into new markets. Growing companies are often more productive, leading to a reduction in productivity and exports when companies experience reluctance to expand into new markets. Furthermore, uncertainty about sales developments contributes to reduced production and a reduced willingness to invest.

> An increase in unemployment and a decrease in the value of assets will result in contingency saving, or the creation of a rainy-day fund. This could further deepen economic stagnation or recession.

1 See Mody et al (2012): Precautionary savings in the Great Recession

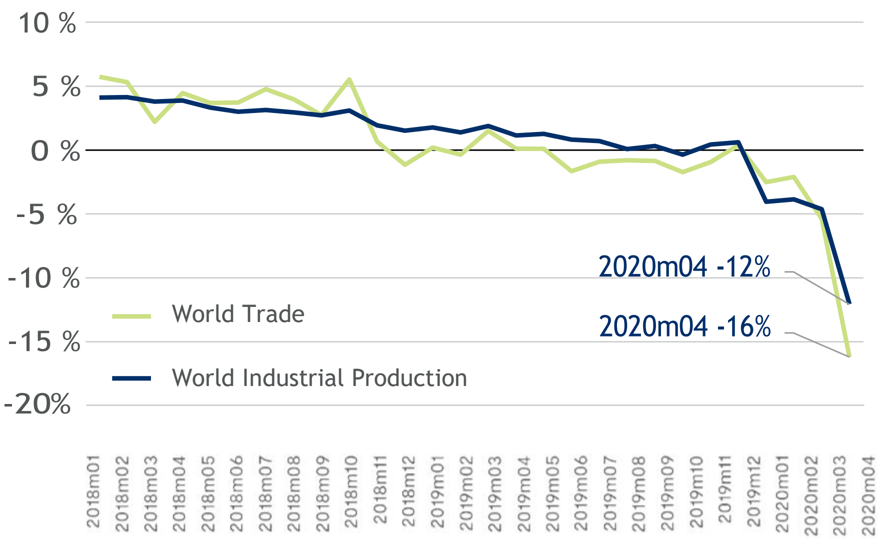
Decreased economic activity caused by uncertainty also has multiplier effects. One of the most significant effects is that employees are increasingly unwilling to change jobs at the same time that companies halt their recruitment efforts. The result is less labor market rotation and less suitable and, thus, less productive employment relationships. At the same time, the labor market becomes tighter, making it even harder for workers to find employment. The interests of these vulnerable people are generally not guarded as vigorously as the interests of those already in the labor market.

Another particularly important and indirect effect of uncertainty comes from the banking sector. If macroeconomic uncertainty increases, banks may be less willing to lend to households and businesses. This causes a decrease in economic activity if the monetary policy transmission mechanisms do not function as desired. In other words, the banking sector may not be as active in issuing debt securities as they would be during better times.

SLOWING DOWN OF WORLD TRADE TO CAUSE PROBLEMS FOR ALL

In small and open economies such as Finland, the slowdown in world trade growth is reflected immediately in the narrowed revenue bases of companies and, indirectly, in the growth of uncertainty. Finland's exports account for about 40 per cent of GDP, making Finland particularly vulnerable to the effects of the slowing down of world trade.

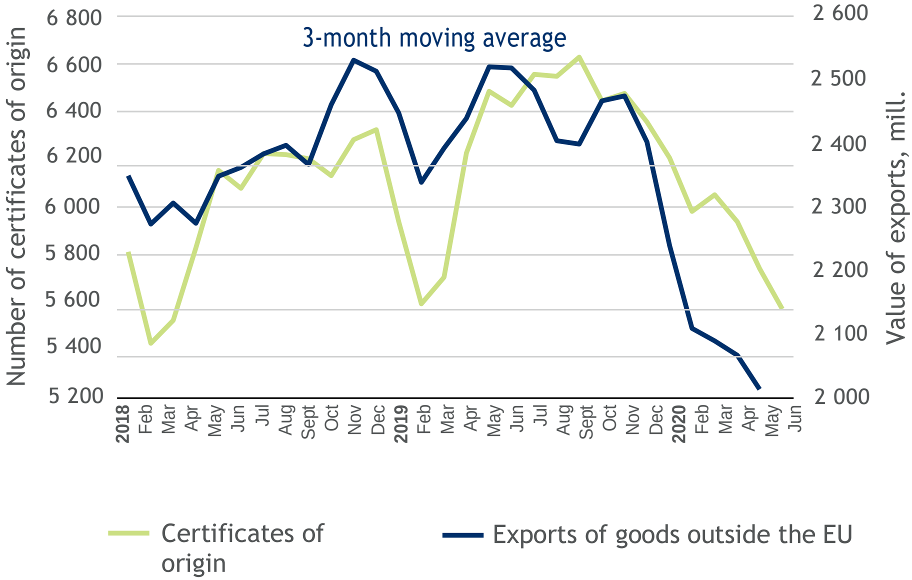
Figure 2 Change in the volume of world trade in goods compared with the previous year.



Source: CPB World Trade Monitor.

It is noteworthy that growth in world trade in goods was already slowing down last year and was projected to decline from around 3.5% in 2018 to 0% in 2019. The International Monetary Fund has forecast a drop of more than 10 per cent in trade in goods in 2020 due to the COVID-19 pandemic. A 10 per cent reduction in world trade in goods would mean a reduction of more than two trillion euros worth of trade, which is ten times the value of Finland's annual GDP. Even relatively small fluctuations in world trade are huge in terms of euros since trade flows are large - not to mention large shocks. The costs are felt especially in open economies.

Figure 3 Value of goods exported and number of certificates of origin issued by chambers of commerce, three-month moving average.



Source: Finland Chamber of Commerce and Customs

FINANCIAL MARKETS MIRROR RISKS

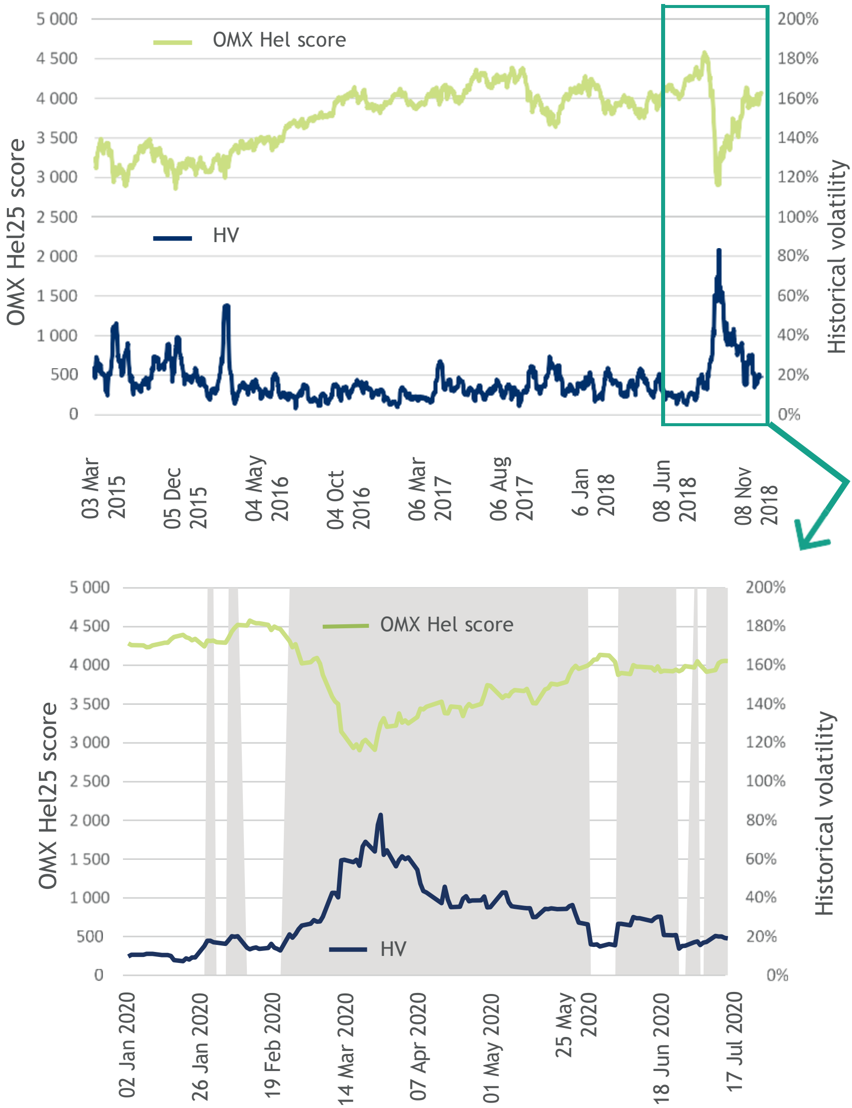
Financial markets are a kind of mirror for the rest of the national economy. The financial market holds a huge amount of information about the future - after all, stock prices reflect companies' expected revenue streams. Therefore, indicators related to stock prices are excellent real-time sources of information on uncertainty.

Perhaps the most famous uncertainty index derived from the financial markets is *the VIX Index, which measures the volatility of options in the S & P500 Index*. From the point of view of Finland and Europe, this index is useful, but not the best possible. However, in a globalized and globalizing world, the increased uncertainty in the United States is reflected in Finland, making the index useful in that sense. But home-grown or Finland-specific sources of uncertainty do not exactly shake the VIX index. In the case of Finland and other similar small markets, the volatility of the local stock exchange actually provides valuable guiding information.

The impact of the COVID-19 pandemic can be seen in the Helsinki Stock Exchange. The OMX Helsinki 25 index reached this year's peak in mid-February, but the index started to fall sharply in the last week of February. The decline was historically steep, with the index falling from about 4,500 points to less than 3,000 points in a month. A comparably low score was last recorded in December 2014. Since then, both the Helsinki Stock Exchange and other stock exchanges have recovered and the Helsinki Stock Exchange has returned back to its previous level from the beginning of December last year. Historical volatility (10 days) has been higher than the long-term average for a large part of the COVID-19 pandemic.

Viewed through financial market volatility, uncertainty has been above average and at times, such as in late March and the first half of April, uncertainty has been much higher than normal.

Chart 4 Historical volatility (HV, 10 days) in Helsinki (OMX HEL25). A gray background indicates time periods when the HV has exceeded the long-term average (17.



Source: Yahoo! Finance, own calculations.

CONSUMER CONFIDENCE AT AN ALL-TIME LOW

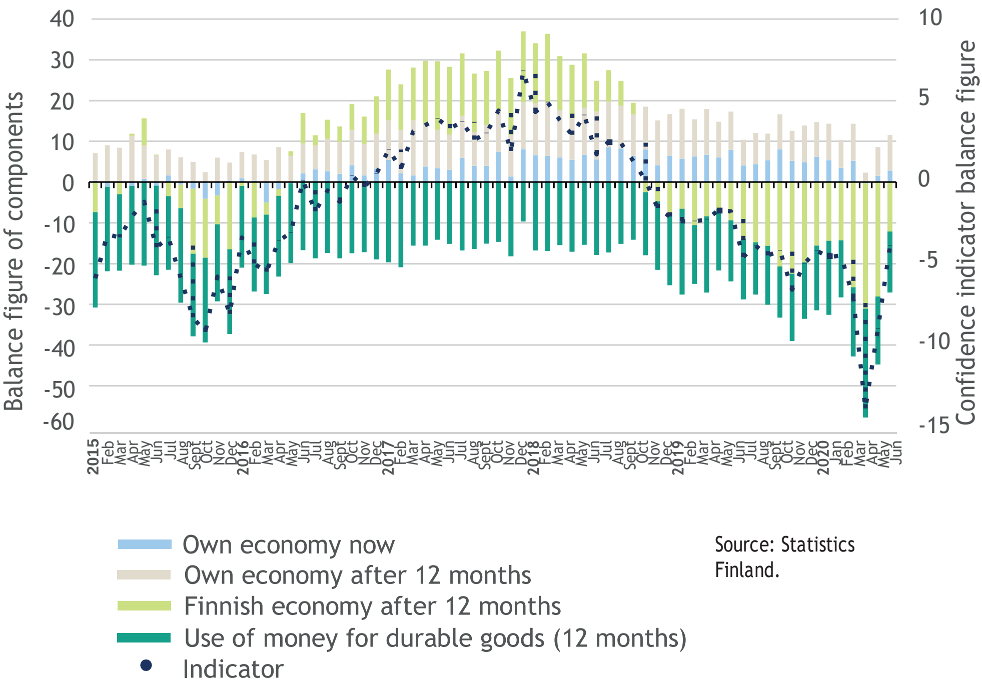
The consumer confidence indicator is a widely monitored survey-based indicator that, as its name implies, measures consumer confidence. Just as financial market developments are linked to the development of the national economy, the consumer confidence indicator is also linked to people's consumption decisions, and thus to private consumption and the business economy.

The consumer confidence indicator consists of the averages of the balance figures of the four questions. The questions are related to 1) one's own economy now, 2) one's own economy in 12 months, 3) the Finnish economy in 12 months and 4) the change in the consumption of durable goods. The consumer confidence indicator has been declining since the end of 2017, but due to the COVID-19 pandemic, recent months have been particularly volatile. From March to May this year, consumer confidence has been exceptionally low. In June, the confidence indicator recovered back to the level seen at the beginning of the year.

All components of the confidence indicator have contributed to the drop, but the single most significant factor has been the expectations about the development of the Finnish economy.

From March to May this year, consumer confidence has been exceptionally low. In June, the confidence indicator recovered to the level seen at the beginning of the year.

Figure 5 Consumer confidence indicator.



Source: Statistics Finland.

ECONOMIC POLICY UNCERTAINTY HIGHER THAN EVER

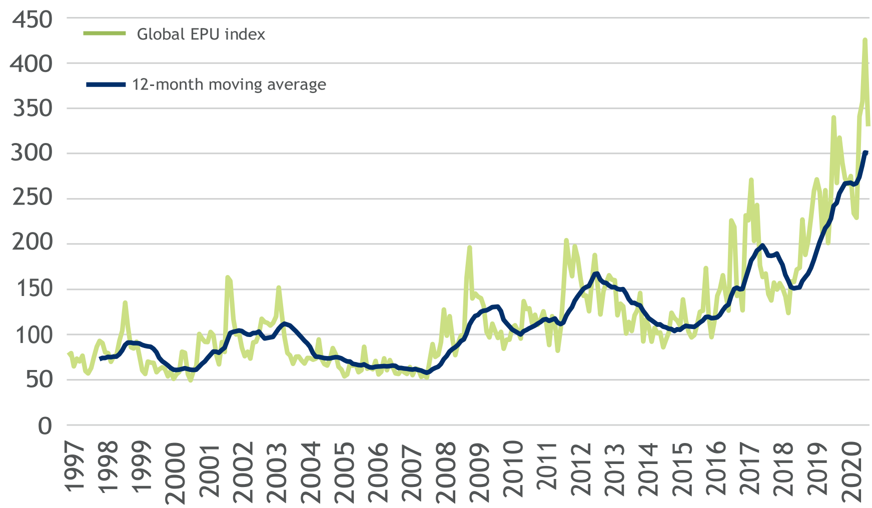
The Global Economic Policy Uncertainty Index (EPU) compiles data on 21 economies, which together cover about 2/3 of the world's GDP. For the index, articles from newspapers of these countries are searched for words related to the following words: “economy", "politics", and "uncertainty". The more often these words appear in a single article, the higher the index value.

Global economic policy uncertainty was at an elevated level before the COVID-19 pandemic. Brexit, Donald Trump’s election as U.S. president, the U.S.-China trade war, and European stagnation are all factors that have contributed to global economic policy uncertainty. But compared with the COVID-19 pandemic, the uncertainty in 2019 is moderate.

The average of the EPU indices for 1997-2015 is 100. In 2017 the index reached a threshold of 250 points, in 2019 the 300-point threshold was broken, and in May 2020, the 400-point limit had already clearly been exceeded. Thus, according to the EPU indicator, global economic policy uncertainty is four times higher than the average from 1997-2015.

Global economic policy uncertainty is a useful indicator in the case of a small open economy, as in Finland, but in order to take into account domestic uncertainty, it is also good to look at Finland-specific indicators. For example, from the end of 2016 and the beginning of 2017 global economic policy uncertainty increased due to e.g. uncertainties in South Korea, Brazil and France, but this uncertainty was not reflected in Finland.

Chart 6 Global Economic Policy Uncertainty Index (EPU) and 12month moving average.

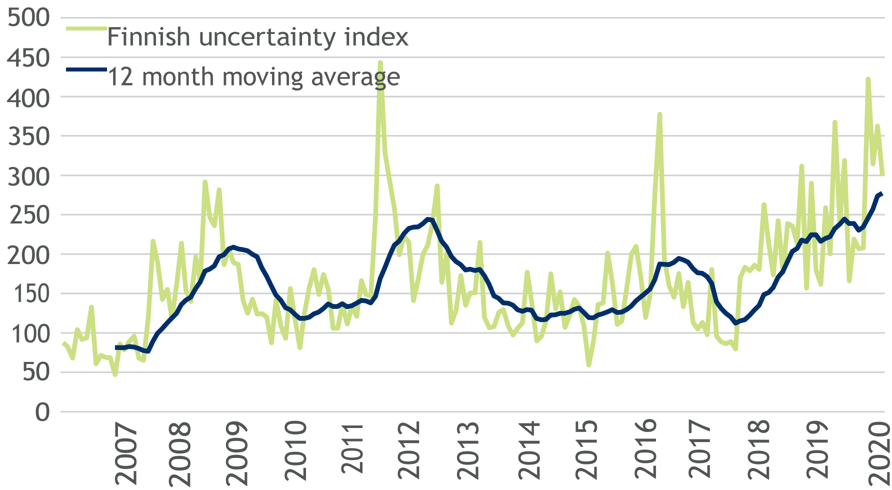


Source: policyuncertainty.com.

Despite small differences, Finland's calculated uncertainty index closely trails the global uncertainty index with a correlation of 0.7. From the high correlation, it can be concluded that global events causing uncertainty are also often reflected in Finland.

The Finnish uncertainty index has been constructed so that the average of the index figures for 2006–2007 is 100. Thus, for example, during the financial crisis in 2009, uncertainty temporarily rose to about three times the level experienced from 2006 to 2007, during the European debt crisis in 2011 the index peaked at 450 points, and the Brexit vote pushed the index to almost 400 points in 2016. Since the end of 2017 there has been an upward trend in the uncertainty index and the uncertainty caused by the COVID-19 pandemic has caused the index to rise again to more than 400 points in March this year. Since then, the value of the index has fallen slightly, but in June the index score was still at 300 points, indicating a tripled uncertainty level compared to the 2006 average.

Chart 7 Finland's economic policy uncertainty index * and 12 month moving average.



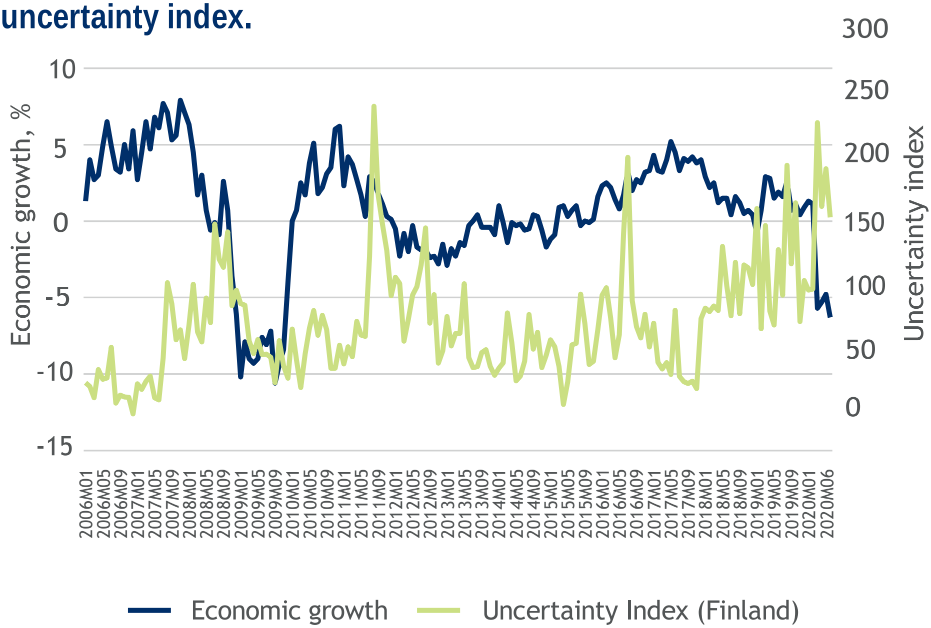
* The index has been compiled by searching the Sanoma archive for newspaper articles containing the words “economy” and “uncertainty” (or some of their forms) and calculating this figure as a proportion of the number of all articles containing the word “economy”.

Source: Own calculations.

UNCERTAINTY REDUCES PRODUCTION AND ECONOMIC GROWTH

The uncertainty index and economic growth appear to be inversely related. For example, during the financial crisis, the European debt crisis, the Brexit referendum and, most recently, the COVID-19 pandemic, the value of the uncertainty index has risen sharply. The correlation coefficient between economic growth and the uncertainty index was therefore-0,17 during the years 2006/01 - 2020/06.

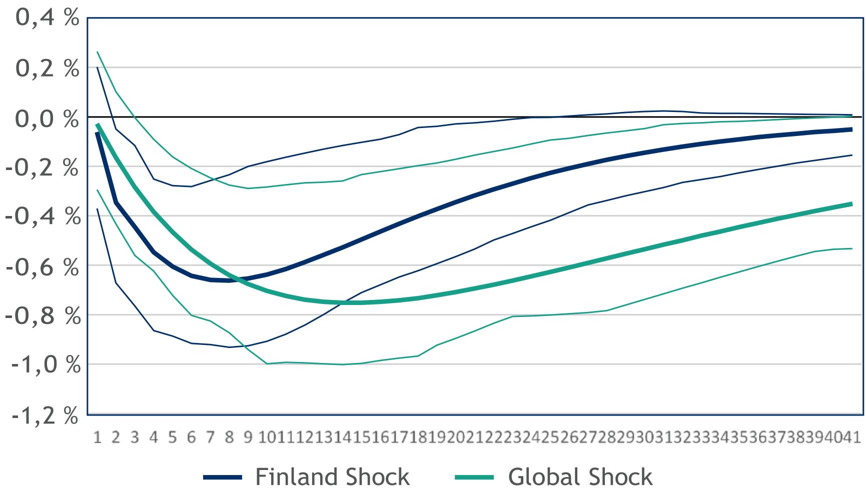
Figure 8 Finland's economic growth and uncertainty index.



Source: Statistics Finland and own calculations.

After an econometric analysis, it is possible to make a few observations about the link between uncertainty and economic growth.[2] First, based on a statistical model, an uncertainty shock causes a decrease in output. A sudden rise of about 50 points in the Finnish uncertainty index is estimated to cause a 0,5-percentage point decrease in economic growth or, with a 90 probability, a 0,2–0,8 percentage point decrease in economic growth. The shock experienced by the Finland-specific uncertainty index has been faster-acting than the global uncertainty shock, but the effects of the global shock are slightly greater and longer-lasting.

Figure 9 Impact of uncertainty indices on economic growth (impulse response of about 50 uncertainty index points).



Source: Own calculations.

2 Following the example of Armelius et al. (2017), the VAR model of two variables (uncertainty index, economic growth) has been estimated, after which orthogonal impulse responses have been calculated using Cholesky decomposition.

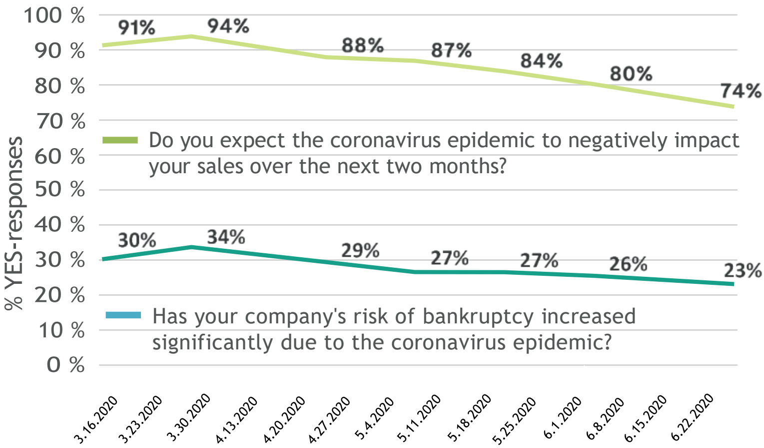
SHORT-TERM EXPECTATIONS OF CHAMBER OF COMMERCE MEMBER COMPANIES

During the COVID-19 pandemic, chambers of commerce have kept themselves aware of the situations faced by their member companies, asking their member companies about their current economic situations and expectations for the future. According to the results of the surveys, the situation in the business field was heated in the early stages of the crisis, but the situation has cooled down slightly since the initial shock.

The first survey was conducted on March 16,2020, and the seventh (and last) survey was conducted on June 23, 2020. The surveys show a clear temporal trend, both in terms of each company's views on the development of their own situation as well as their expectations for the future.

Companies' expectations for the future were at their bleakest at the end of March, when Finland's uncertainty was also at its highest level. At that time, about 94 per cent of the member companies of the chambers of commerce reported that their sales would drop, while around midsummer only 74 per cent held this belief. The companies thus experienced significantly improved situations by mid-June, but expectations among companies as a whole still remain bleak.

Figure 10 Responses of member companies of chambers of commerce



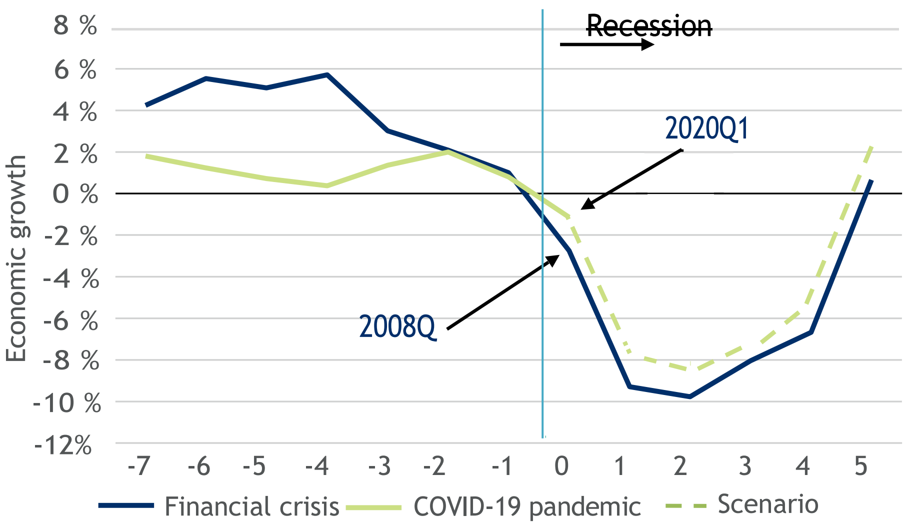
Source: Finland Chamber of Commerce.

WILL THE ECONOMY RECOVER AS IT HAS BEFORE?

While the COVID-19 pandemic is different from previous economic crises, similarities can also be found when compared to the financial crisis, for example. While the root causes of the financial and corona crises are different, in both cases a shock was reflected from outside Finland to Finland through investments and the slowing down of foreign trade, among other things.

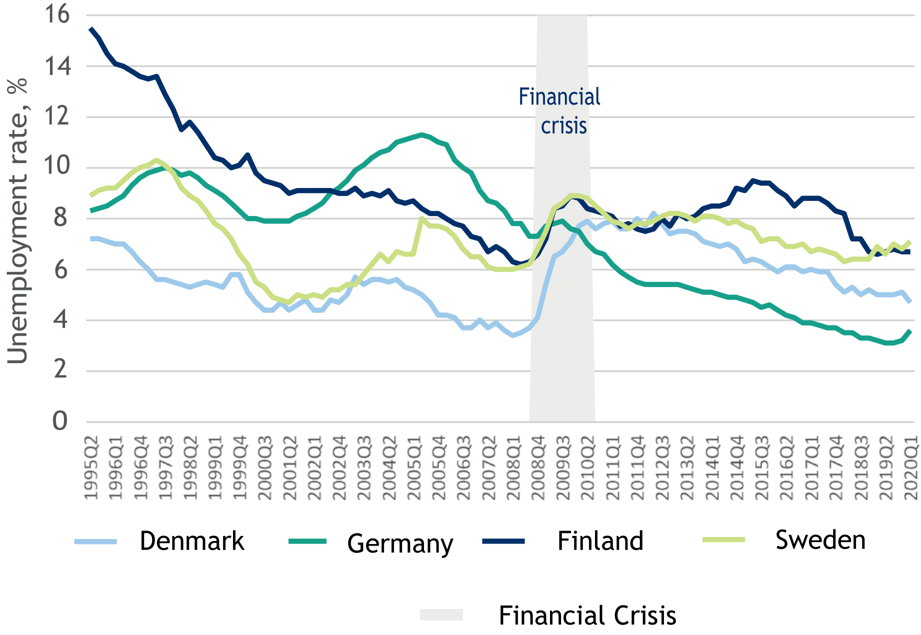
If the economic recovery from the COVID-19 pandemic was to follow roughly the same pattern as the recovery from the financial crisis, it would mean positive economic growth during the second quarter of 2021. The drop in GDP could then potentially stay at around six percent. The assessment would then be in line with, for example, the economic forecasts made by the Ministry of Finance, the European Commission and the International Monetary Fund.

Chart 11 Economic growth during the financial crisis 2007Q1–2010Q1 and during the COVID-19 pandemic 2018Q2–2021Q2.



The situation in the labor market is different due to the numerous rigidities in the labor market. We are talking about hysteresis, during which a temporary market disruption easily becomes a long-term problem. Unemployment typically rises rapidly but falls slowly. The more flexible the labor market, the better suited it is for adapting to negative shocks. In Germany, for example, the labor market recovered quickly from the financial crisis. In Finland, structural unemployment is clearly higher and adjustment slower. The risk is that after the COVID-19 pandemic, Finland will lag behind in terms of economic growth and employment development.

Figure 12 Unemployment rate in Denmark, Germany, Finland and Sweden 1995Q2–2020Q1.



Source: Eurostat

CONCLUSION

- Uncertainty affects both the functioning of households and the decision-making of companies. The increase in uncertainty is linked to recessions and other political turmoil. One important task for decision-makers is to reduce the uncertainty experienced by citizens.
- Increased uncertainty causes increased household contingency saving, alters the content of consumption, and reduces the likelihood of changing jobs. Companies moderate their expansion efforts into new markets, thus, reducing investment and recruiting fewer employees. As uncertainty increases, the operations of the banking sector and the functioning of the monetary policy transmission mechanisms become of great value.
- The more open the national economy, the larger the impact of the slowing down of world trade is on the functioning of the economy. Finland is a small open economy, with exports accounting for about 40 percent of GDP.
- The value of exports of goods and the number of certificates of origin issued by chambers of commerce have fallen significantly this year.
- Macroeconomic uncertainty can be measured, for example, through financial market volatility, consumer confidence, indicators based on press reports or business surveys through chambers of commerce.
- According to the estimated statistical model, a surprising increase of about 50 points in the uncertainty index causes a 0,5 percent decrease in production. At its worst, the uncertainty index has been more than 150 points above the long-term average.
- If the COVID-19 pandemic progresses the same way that the financial crisis did, it would mean a positive economic growth in the second quarter of 2021.

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