

# FORECAST OCTOBER 17, 2001

## Additional information:

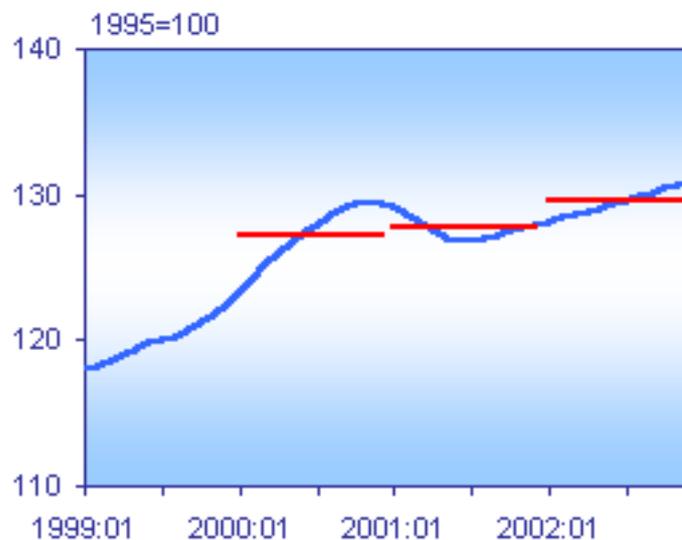
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## Forecast 2001 - 2002 FINLAND IN RECESSION

The Finnish economy is in the midst of a recession. Already before the terrorist attacks the weakening of international cyclical conditions spawned a downturn in Finnish exports. In recent months this has been seen as a clear decline in total production. Our economic forecast must be revised downwards by an exceptionally wide margin, since in our last forecast published in March we projected that GDP would grow this year by about four per cent. On the basis of recent information we forecast that economic growth will be only half of a per cent. The worst phase of the drop in output will be witnessed this year, and production will start to rebound towards the end of this year. The upturn will nevertheless be moderate, and the average rate of increase in total production will remain under 2 per cent next year.

**Figure 1. Monthly Indicator of Total Output  
1999:01 - 2002:12**



Source: Statistics Finland,  
Labour Institute for Economic Research

The terrorist attacks on September 11 dramatically changed the world political situation. It has led to a considerably increase in uncertainty with respect to the economy, which will reflect in the near future on economic growth especially in the United States but also in other countries, Finland included. In terms of economic growth in the near future even in Finland, the key question is the course of economic developments in

the United States.

### **World Economic Outlook Deteriorated Further**

The economic outlook for the United States weakened throughout the beginning of this year. Despite their high indebtedness, households nevertheless increased their consumption, which sustained the growth of total production. The confidence of consumers in the future had nevertheless weakened already before the terrorist attacks. Thus the attacks came in a situation where the conditions for production growth had already deteriorated substantially.

After the terrorist attacks, it will be impossible for the United States to avoid an economic recession. Aggregate output will fall in the last few months of this year. Even though the economy will gain a boost from interest rate cuts and fiscal policy measures, economic growth will be fairly modest even in the best-case scenario. We forecast that GDP growth will remain under one per cent in the United States during both years.

During turbulent times the impact on the confidence of households especially is difficult to assess. The forecasts for economic growth in the United States are thus based on exceptionally uncertain premises. From the standpoint of the entire global economy and Finnish exports, forecasting the economic outlook in the EU region is more difficult than ordinarily.

The situation in the EU region has deteriorated unexpectedly quickly during this year. This is primarily due to the slackening of growth in the United States. GDP growth in Germany will be about one per cent. The average growth rate in the euro zone will not be appreciably higher. The European central bank has eased monetary policy during the autumn and its policy stance will probably be biased in this direction in the near future. This will nevertheless not be enough to revive the economies in the euro zone. Thus economic growth will remain modest next year despite the lax monetary policy, thereby weakening employment. It is nevertheless likely that the downturn will be more modest in the euro zone than in the United States.

Cyclical conditions have weakened around the world and the near future, for example, in Eastern Asia appears gloomy. In Japan aggregate production will fall this year, and the outlook will not be much brighter next year either. Due to the weakening of international conditions, it is unlikely that global prices of crude oil will rise

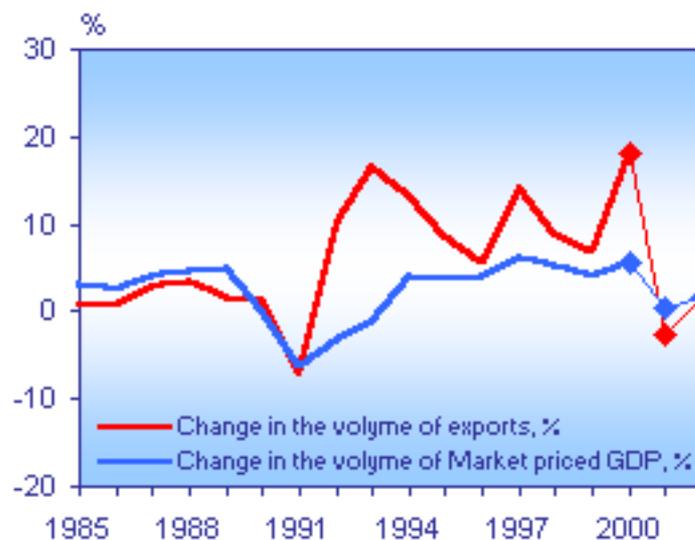
appreciably despite a continuation of the political crisis. The prolongation of the downturn will not result from a possible rise in crude oil prices but rather a slackening of demand stemming from the terrorist attacks.

### Export Difficulties Trigger Slump

The main reason behind Finland's recession is the unexpectedly swift impact of the global downswing on Finnish exports. The current recession is a uniquely clear-cut case in Finnish economic history of an export-driven recession. This goes to show how much exports' share of growth in the economy affects fluctuations in aggregate production in modern Finland.

The collapse of export demand has triggered a decline in production especially in the electro-technical industry. In addition output has fallen sharply also in the traditional forest industry. This year exports will fall by almost 3 per cent.

**Figure 2. Growth of GDP and Exports  
1985 - 2002**



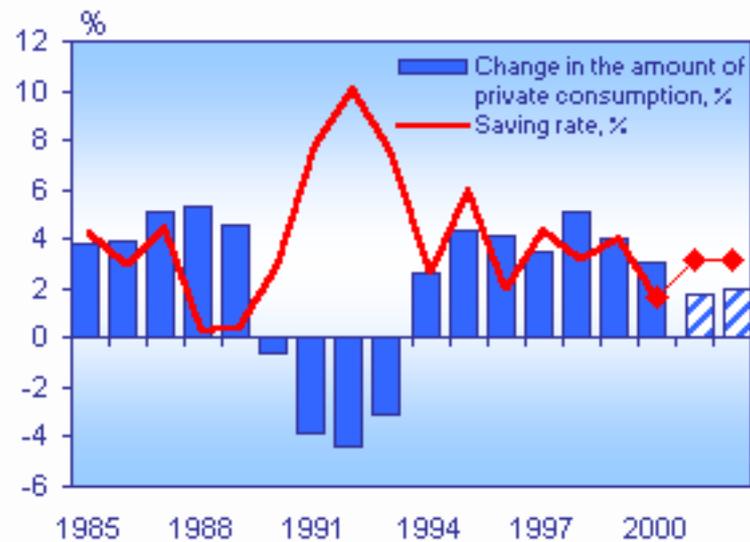
Source: Statistics Finland,  
Labour Institute for Economic Research

The outlook for next year is not necessarily much better. According to fresh indicators the worst is over in the electro-technical industry. Partly for this reason exports will be higher next year than this year. Growth will nevertheless remain modest since cyclical conditions will not improve significantly in the EU countries of pivotal importance from the standpoint of Finnish exports. The continuation and deepening of the international political crisis may in the worst case make the forecasts of even a moderate recovery in exports turn out to be too optimistic. The prerequisites for export growth are

nevertheless very good. The price competitiveness of our industry is excellent and there is sufficient idle capacity.

The moderate recovery in exports is the main reason why we forecast a slight pick-up in growth next year. Even though domestic factors are of key importance in sustaining growth in the near future, their impact on growth next year is approximately the same as this year.

**Figure 3. Private Consumption and Saving Rate 1985 - 2002**



Source: Statistics Finland,  
Labour Institute for Economic Research

This year growth in investment activity is weighted toward machinery and investment. Housing investment, on the other hand, is falling. Next year weak aggregate demand will spur a slow-down in machinery and equipment growth. Housing construction will nevertheless pick up somewhat from that of this year.

### **Consumer Confidence of Key Importance**

As long as exports are falling, private consumption is of great importance from the standpoint of a continuation of economic growth. Consumption has indeed grown this year but nevertheless more slowly than generally expected last spring. The purchasing power of households will expand this year by over 3 per cent, but private consumption growth will remain slightly below 2 per cent. Thus households have saved their money instead of spending it on consumption. This demonstrates the weakening of the households' confidence, as reflected in the consumer confidence surveys. The steep decline in car sales may nevertheless stem from consumer's hope of tax cuts in

the near future.

Next year households' purchasing power will grow by about 2 per cent. We forecast that private consumption will increase by the same margin. This can occur only if the saving rate does not rise from that of this year. The uncertainty prevailing after the terrorist attacks may nevertheless grow substantially even among Finnish households. Thus there are clearly more risk factors clouding the outlook for private consumption than normal.

### **Inflation Slowing Down Next Year**

At the end of last year and still in the beginning of this year the rise in consumer prices was relatively brisk. The fall in import prices that occurred this summer and early autumn dampened inflation. In September consumer prices nevertheless experienced a surprisingly sharp rise. Consumer prices will show a rise of 2.8 per cent this year.

Because political crises have often led to a steep rise in world market prices of crude oil, next year's inflation constitutes one of the main risk factors. We nevertheless anticipate that the economic downswing triggered by weak international demand will dampen the rise in world market prices of crude oil. Furthermore, as among other things interest rates are expected to fall next year, the conditions for a slowdown in inflation are in place. We forecast that consumer prices will rise by an average of 1.8 per cent next year.

Contract wages will increase by about 2 per cent next year. Because wage drift is not very great, the level of earnings will rise by slightly over 3 per cent. The rate of increase in real earnings will thus slow down from approximately 2 per cent this year to about 1.5 per cent next year.

Because exports will fall substantially this year, export revenues will decline significantly. This is the main reason behind the rise in the share of wages in national income. Next year their share will remain at approximately this year's level. The share of wages will therefore rise this year and next above that of last year. The rise will not be so strong that the share of wages will climb, for instance, to the level prevailing in 1999. The average profitability of companies will thus remain strong as the situation is not marked by a traditional export-driven recession stemming from a profitability crisis in the export industry.

## Unemployment Starting to Climb

Even though the Finnish economy has entered into a recession and the employment outlook has weakened during this year, the number of employed persons will nevertheless climb by over 30,000 persons compared to last year. The increase in the number of employed persons has been sustained by the brisk rise in the number of jobs especially in the public sector as well as finance, insurance and business services. In the manufacturing industry except for the IT sector, the adjustment has occurred primarily in the number of hours worked, not lay-offs. In the construction industry the downturn in residential housing construction has nevertheless sparked a decline in the number of jobs in that sector.

The slowdown in growth will be inevitably reflected in a weakening of employment already toward the end of this year. Next year employment will weaken so that the average number of employed persons will be slightly lower than this year. The number of employed persons will increase in the service sector, but at the same time the number of manufacturing jobs will fall, especially in industries dependent upon exports. The number of jobs will fall the most in the electro-technical industry, where also the rise in the number of jobs has been the strongest in recent years.

The weakening of the employment situation will be reflected as a rise in unemployment toward the end of this year. This year the average unemployment rate will fall to 9.2 per cent, but next year it will rise to 9.4 per cent. The number of unemployed persons will then reach 245,000. The rise in unemployment will be curbed by the relatively favourable employment trends in the service sector and a pronounced slowdown in the growth of the supply of labour. This year the supply of labour will grow by about 17,000 persons but next year the growth will slow down to 5000 persons. Especially young persons will react to the weakening of the economic situation by reducing the supply of labour.

### **Figure 4. Labour Supply and Employment 1985 - 2002**



Source: Statistics Finland,  
Labour Institute for Economic Research

### **Public Sector Surplus Evaporating**

Last year the central government's deficit turned into a surplus of FIM 27 billion. The financial position was strengthened by extraordinary factors. Due to the weakening of cyclical conditions and fading impact of extraordinary factors, the surplus is decreasing this year and next year substantially. This year the surplus will dip below FIM 20 billion and next year slightly over FIM 10 billion of it will be left.

The leeway generated by the strengthening of the central government finances has been used to pay off the national debt. This year the debt will fall to slightly over FIM 360 billion. Due to the recession, the opportunities - and possibly also the desire - to reduce the debt are weaker next year than this year. The debt may nevertheless decline below FIM 360 billion. This depends on the cyclical developments as well as economic policy decisions.

The financial position of the overall public sector will weaken somewhat, but the surplus will nevertheless remain sizable. Despite the slump, Finland will have no difficulties in fulfilling the EMU criteria.

### **We Must React to Weakening Employment**

Because the recession this time around is a result of a drop in exports, the possibilities to affect general economic developments are much smaller than in the depression of the 1990s. Then the recession was due primarily to domestic factors, which led to a collapse in domestic demand, i.e. investment and consumption.

Of the export-driven recessions over the years, the current downturn is an exceptional one. Export difficulties have traditionally in Finland been spawned by weak price competitiveness, which could be quickly restored by a devaluation, possibly in connection with comprehensive incomes policy settlements. This year Finland ran into a recession even though the price competitiveness of the export industry is very good. Thus it is understandable that there has been little talk in the economic policy debate about increasing exports via traditional means, i.e. restoring competitiveness as quickly as possible. In the euro world this would mean adjustment via wages.

The export-driven nature of the recession does not mean that decision makers should not react at all to the weakening of employment. Even though the possibilities to make an impact are less than normal, the rise in unemployment can still be held in check.

During the economic boom in the last few years Finland has quite justifiably followed a stringent fiscal policy. The public sector's surplus has risen to a high level and the national debt has fallen. In a situation where international economic events have led us into a recession but our own economy is in sound shape, the situation is now reversed and it is time for an expansionary fiscal policy to boost economic growth and employment. The budget proposal for next year is indeed slightly expansionary.

After the budget was drawn up the news about the economic situation has been so bad that during the autumn there is a need to reassess growth prospects and a need to take action to bolster employment. We should be prepared to implement measures reducing the risk of lay-offs and promoting possibilities for the unemployed to find jobs, while at the same time not weakening the financial balance of the public sector. This would entail additional spending on active labour policy measures and training to alleviate the weakening employment situation, moving up the timetables for public building investments as well as tax support to improve the possibilities for unskilled workers to find jobs and structural reforms of social security contributions.

Even though the above-mentioned means do little to address the basic problem, i.e. the weakness of exports, they would nevertheless shore up employment in the near future. This is especially important at a time when the international downturn threatens to have a long-lasting impact on individuals' confidence in the future also in Finland.

## INTERNATIONAL ECONOMY

| GDP growth , %  | 2000 | 2001f | 2002f |
|---|------|-------|-------|
| United States   | 4.1  | 0.7   | 0.7   |
| Euro-11   | 3.4  | 1.4   | 1.5   |
| Germany   | 3.0  | 0.8   | 0.9   |
| France  | 3.1  | 1.6   | 1.7   |
| Italy   | 2.9  | 1.7   | 1.5   |
| Euro-15   | 3.3  | 1.6   | 1.6   |
| Sweden  | 3.6  | 1.5   | 2.0   |
| United Kingdom  | 3.1  | 2.0   | 2.0   |
| Japan   | 1.5  | -0.5  | 0.5   |
| Russia  | 7.5  | 4.5   | 4.5   |
| Source: BEA, IMF, OECD,<br>Labour Institute for Economic Research |      |       |       |

## DEMAND AND SUPPLY

|                           | 2000         | 2000                              | 2001f | 2002f |
|---------------------------|--------------|-----------------------------------|-------|-------|
|                           | Bill.<br>FIM | Percentage change in<br>volume, % |       |       |
| Gross Domestic<br>Product | 782.9        | 5.7                               | 0.5   | 1.7   |
| Imports                   | 260.6        | 15.7                              | 0.0   | 2.0   |
| Total supply              | 1043.5       | 8.1                               | 0.4   | 1.7   |
|                           |              |                                   |       |       |
|                           |              |                                   |       |       |

|   |        |      |      |     |
|---|--------|------|------|-----|
| Exports   | 334.6  | 18.1 | -2.5 | 1.5 |
| Consumption   | 550.0  | 2.3  | 1.9  | 1.9 |
| - private   | 387.7  | 3.0  | 1.8  | 2.0 |
| - public  | 162.2  | 0.7  | 2.0  | 1.5 |
| Investment  | 151.3  | 5.5  | 2.4  | 2.0 |
| - private   | 131.4  | 7.4  | 3.8  | 2.0 |
| - public  | 19.9   | -5.4 | -6.1 | 1.8 |
| Change in stocks  | 7.7    | 0.2  | 0.0  | 0.0 |
| Total demand  | 1043.5 | 8.1  | 0.4  | 1.7 |
| Source: Statistics Finland,<br>Labour Institute for Economic Research |        |      |      |     |

## KEY FORECASTS

|  | 2000 | 2001f | 2002f |
|--|------|-------|-------|
| Unemployment rate , %                          | 9.8  | 9.2   | 9.4   |
| Unemployed (1 000)                             | 253  | 239   | 245   |
| Employment rate , %                            | 67.4 | 68.2  | 68.0  |
| Employed (1 000)                               | 2335 | 2367  | 2366  |
| Inflation, consumer price index,<br>%          | 3.4  | 2.8   | 1.8   |
| Wages, index of wage and<br>salary earnings, % | 3.8  | 4.5   | 3.2   |
| Real disposable income of<br>households, %     | 0.3  | 3.5   | 2.0   |

|  |      |      |      |
|--|------|------|------|
| Current account surplus,<br>Bill. FIM  | 57.2 | 52.4 | 53.5 |
| Trade surplus, Bill. FIM   | 88.6 | 82.7 | 84.2 |
| Central government financial<br>surplus, Bill. FIM                                     | 27.1 | 18.4 | 10.4 |
| % / GDP  | 3.5  | 2.3  | 1.2  |
| General government financial<br>surplus, Bill. FIM                                     | 53.8 | 40.9 | 31.7 |
| % / GDP  | 6.9  | 5.0  | 3.8  |
| EMU debt, % / GDP  | 44.0 | 42.2 | 40.3 |
| Short-term interest rates<br>(3-month Euribor)   | 4.4  | 4.3  | 3.2  |
| Long-term interest rates<br>(10-year gov't bonds)                                      | 5.5  | 5.1  | 5.0  |
| Source: Bank of Finland, Statistics Finland,<br>Labour Institute for Economic Research |      |      |      |