

FORECAST MARCH 27, 2002

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Forecast for 2002 - 2003 GROWTH PICKING UP AGAIN – RISKS COMING FROM ABROAD

In Finland expectations regarding an economic upturn have strengthened. Even though there are no clear signs yet of an improvement in the cyclical situation, the recovery in the international economy will begin to have an impact also on Finland this year. Economic growth will be spearheaded by exports. The upswing will be relatively modest and the rate of GDP growth will remain below two per cent. For this reason employment will weaken further and unemployment will increase somewhat. Next year economic growth will nevertheless become stronger, thereby fostering employment once again. The rise in unemployment will thus be brief.

The improvement in the international economic outlook is due to the recovery of the economy in the United States. The turnaround has been unexpectedly quick after the terrorist attacks on September 11. There is nevertheless great uncertainty regarding the strength of the recovery and whether it can be sustained. It is nonetheless very possible that the recovery in the United States will be relatively brief and the economy will slip into a recession again. This would be seen also in Finland as a slowdown in economic growth. Therefore the euphoria surrounding the international recovery may be short-lived.

Economy Recovering in US – but for How Long?

After September 11, the outlook for economic growth in the United States became gloomier. The economic outlook had deteriorated already before the terrorist attacks, which was reflected in forecasts of a fairly deep and possibly prolonged recession.

After the terrorist attacks, the economy has recovered amazingly quickly: instead of contracting, total output grew in the last quarter of last year. Leading indicators also confirm that the outlook has improved considerably recently (figure 1). Consumer confidence weakened substantially after the terrorist attacks, but it has subsequently rebounded. It may also be bolstered by an improvement in employment prospects.

**Figure 1. International economic indicators
1995:01 - 2002:2**



Source: Conference Board, European Commission

Despite the favourable news, the continuation of the recovery is fairly uncertain. For the time being the growth in production has been spurred mainly by the replenishment of depleted inventories. Investment activity has not recovered. There is plenty of unused production capacity in the aftermath of the boom of the late 1990s. The more the recovery is based merely on rebuilding of inventories, the shakier the foundation for an upswing in US economic growth.

Last year economic growth in the United States was fuelled largely by consumers (and the public sector). The easing of monetary policy has bolstered the consumption possibilities of households significantly. The decline in interest rates has reduced the debt servicing costs of indebted households and increased the amount of their income available for consumption.

The continuation of the recovery and a new prolonged period of brisk growth hinges on households. The indebtedness cannot continue to grow forever. The seriousness of the indebtedness is illustrated by the large current account deficit, which will have to be reduced, sooner or later. The need to reduce the indebtedness poses one of the main threats to the continued recovery of the US economy.

We project that the recovery in US total output will continue in the near future, but that average growth will nevertheless remain this year fairly low, i.e. 1.4 per cent. Because interest rates are exceptionally low, the central bank will tighten monetary policy already this spring.

The end to the replenishment of inventories, the low level of investment and debt problems will curb the recovery of the US economy. We forecast that total production will grow in the United States next year by about 2 per cent. There is considerably more uncertainty surrounding economic trends in the year 2003. At that time we will see whether the recovery is sustainable or whether the economy will fall back into recession because of the debt problems.

Europe Recovering too

Last year economic growth weakened in Europe in the wake of the recession in the United States. The downturn was exacerbated also by purely European factors. For example, building investments fell substantially in Germany. The sustainability of economic growth also in the EU countries hinged on households.

This year the recovery of the US economy will foster an upturn also in the euro zone. The signs of this are already reflected in leading indicators (figure 1) and, for example, in an upswing in German industrial output. Whereas total output fell in the euro zone toward the end of last year, growth is anticipated to fall short of that witnessed last year. GDP is forecast to grow by 1.2 per cent this year.

The conditions for stable growth may be better in Europe than in the United States in some respects. For example, the current account imbalance is not a major constraint to growth in the euro zone. Economic growth will accelerate this year and next year GDP will grow by an average of 2.6 per cent. The pick-up in growth will spur the European Central Bank to begin tightening its monetary policy toward the end of this year. Interest rates will nevertheless rise substantially less than in the United States.

The downturn in the international economy will be reflected also in East Asia. Japan will continue to be plagued by a stubborn economic slump, and no solutions to its problems are likely to be found in the near future. Even though Japan's problems are of domestic origin, the recovery of the international economy will improve conditions for growth in the Japanese economy.

Growth Picking Up in Finland

Finland's seven-year period of swift unabated growth came to an end last year. GDP grew by only 0.7 per

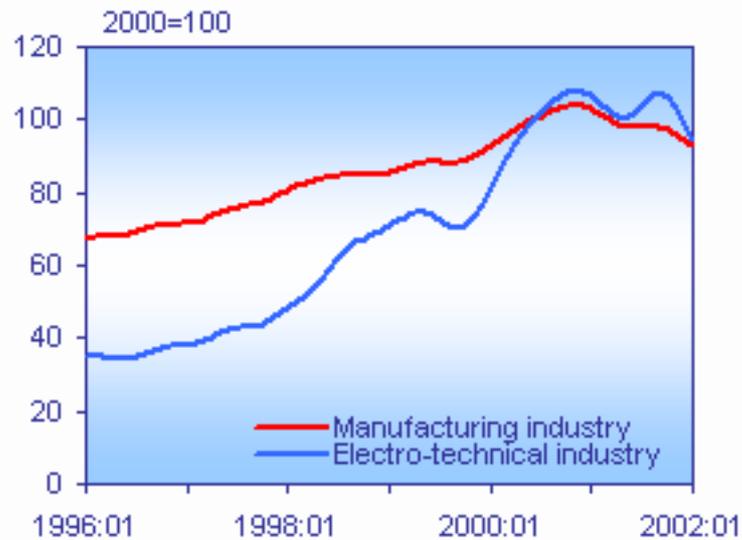
cent, which was clearly less than forecasters projected in the beginning of last year. Even though there was awareness in Finland of the weakening of international economic growth already at the beginning of last year, the significance of the international downturn was underestimated. After steadily rising for many years, Finnish exports fell last year by almost one per cent.

GDP growth was nonetheless marked by two divergent phases. Production fell sharply in the beginning of last year. Production bottomed out in the summer, after which it started to rise again. The turnaround was attributable largely to the recovery in the electro-technical industry. This was not a clear sign of permanent export demand but rather a consequence of a temporary spurt in the demand for new models of mobile phones. Manufacturing output fell last year by almost 2 per cent.

This year the improvement in international growth will begin to have an impact also in Finland. The recovery in exports will foster growth also in total production. The upswing will not pick up momentum, however, until the second half of the year so that average GDP growth will be only 1.6 per cent. Export growth will also remain under 2 per cent. The acceleration of aggregate production will be evident in the average figures next year, when growth is projected to be 3.3 per cent. The driving force will be exports, which will grow by 6 per cent.

Last year exports fell especially in the electro-technical industry and the forest industry. This year the recovery will be the most pronounced in these same sectors. There have not been signs, however, of a recovery in the beginning of this year. The output of the manufacturing industry, which is heavily dependent on exports, has continued to fall and the upturn in the output of the electro-technical industry that began toward the end of last year proved to be only temporary (figure 2). The magnitude of the average growth figures is affected to a great deal by the precise timing of the recovery in the forest industry and the electro-technical industry during this year.

Figure 2. Production in manufacturing industry and electro-technical industry 1996:01 - 2002:01



Source: Statistics Finland

Because the recovery in the international economy is not on a firm foundation yet, there is a great deal of uncertainty associated with the rebounding of Finnish exports. The prerequisites for substantial growth in exports are nevertheless very good. On average, the competitiveness of exports companies is excellent and there is sufficient capacity.

One reason for the relatively sluggish recovery is the weakness of investment activity. Construction of residential buildings will continue to decline this year, but a turn for the better will occur toward the end of the year. Non-residential construction will begin to fall this year owing to the decline in construction of manufacturing plants and warehouses. Only investments in civil engineering will rise. Machinery and equipment investments will also fall. In industry there is plenty of idle production capacity, and the general economic situation does not encourage purchases of machinery and equipment. All in all, private investment will fall this year by about 2 per cent. Next year investment activity will pick up. Construction will pick up as will purchases of machinery and equipment. Private investment will increase by about 3 per cent.

Consumption Growing Steadily

Last year households' purchases of goods and services rose by a surprisingly small margin, only 1.4 per cent. Such small growth means that the savings ratio rose appreciably, since households' disposable real income nevertheless increased by almost 3 per cent.

Growth in consumption was dampened by the substantial decrease in purchases of durable consumer

goods. This was primarily attributable to a sharp fall in car sales stemming from potential car buyers' uncertainty regarding the future level of car taxes. The slackening demand for durable consumer goods was reflected in the deteriorating confidence of households in the future, as illustrated by the consumer confidence survey of Statistics Finland especially in the beginning of last year. On the other hand, the decline in interest rates encouraged households to purchase dwellings. Housing sales were brisk especially in the greater Helsinki area. In recent months the confidence of consumers in the future has improved.

This year private consumption will grow by 2.3 per cent. Growth trends will hinge primarily on the increase in households' purchasing power. A reduction in the uncertainty related to car taxation will not necessarily boost new car sales. It is possible that in the near future prices of new cars will rise compared to those of used cars. This may spur purchases of used cars as opposed to new cars. The difference is significant since sales of used cars do not show up in consumption figures.

Next year private consumption will expand at approximately the same rate as this year. Since growth is not particularly strong in either year, private consumption will play the role of a sustainer of production growth, not an accelerator. As was the case with respect to the slowdown of economic growth, the acceleration of growth will to a large degree hinge on trends in exports.

New Incomes Policy Settlement to Shape Wage Developments

This year households' purchasing power will rise by slightly more than 2 per cent. Since employment will weaken somewhat, the wage bill comprised of the total wages of employees will rise by considerably less than last year. The rise in purchasing power this year stems from this year's wage increases and the easing of taxation. The average earnings of employees will rise by 3.4 per cent. Contract wage hikes account for 2.5 per cent of this increase. Wage drift will lift wages by slightly less than one percentage point.

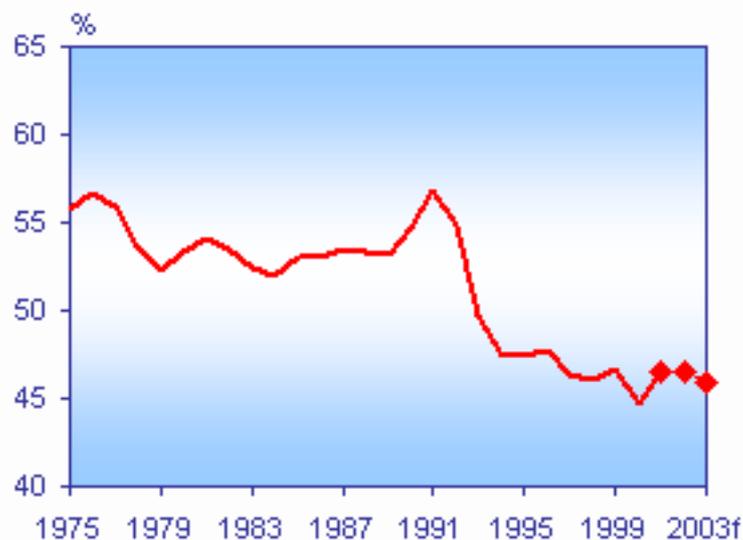
The rise in wages this year is determined in large part by the wage hikes stipulated by the comprehensive incomes policy settlement. Since the current contract period ends in January next year, the magnitude of wage increases next year is still completely open.

Based on the public debate so far this year, it is impossible to decide what the next wage round will be like. For the time being, it is impossible to forecast whether there will be a comprehensive incomes policy settlement or not. It is also impossible to say whether tax cuts will boost the purchasing power of wage earners or not.

Since the situation is still unclear – and since the debate in Parliament regarding sickness insurance contributions was no help in this respect – we start with the assumption that the level of income taxation will remain next year at the same level as this year. Thus the purchasing power of wage earners will be determined by wage increases, inflation and employment.

We project that average earnings of employees will rise next year by about 4 per cent. Average earnings will rise next year by a smaller margin than last year, but slightly more than this year. The real disposable income of households will rise by the same amount as this year, i.e. slightly over 2 per cent.

Figure 3. Distribution of Income between Labour and Capital in Private Sector 1975 - 2003



Source: Statistics Finland, Labour Institute for Economic Research

Even though the slowdown of economic growth weakened the average profitability of enterprises last year somewhat, their profitability remained good. The slowdown in growth also meant that employees' share of national income rose somewhat (figure 3). Since the share of wages fell in the year 2000 appreciably, the rise meant a return to the level prevailing in 1999. This year the share of wages will remain at approximately last year's level. Next year the acceleration of economic growth will trim the share of wages further. The average

profitability of enterprises is thus expected to remain good.

Inflation to Remain Low

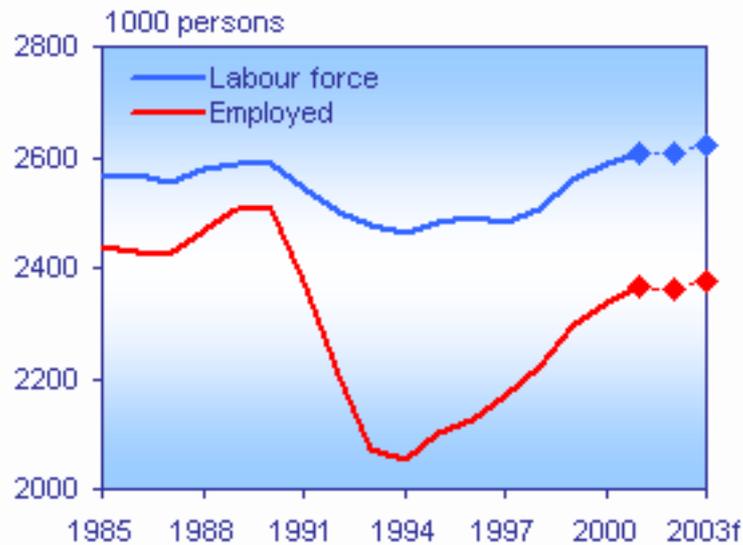
The rise in employees' real earnings was fairly modest in the year 2000 owing to an unexpected rise in inflation. For this reason, trade unions feel that it is important to include an escalator clause in a comprehensive settlement. In the beginning of last year inflation was high and the triggering of the escalator clause was possible. Still in September-October it was uncertain whether the escalator clause would be triggered or not. Toward the end of the year inflation slowed down so the rise in consumer prices no longer gave reason to raise wages.

This year inflation will subside and the cost of living will rise by 1.5 per cent. The rise in costs will remain relatively moderate and extraordinary factors such as the adoption of euro cash will not have a major impact on price developments. On the other hand, inflation will accelerate next year somewhat. The recovery in the international economy will boost prices of raw materials and foodstuffs, which will be seen in the form of rising import prices in Finland. The rise in interest rates will also boost the cost of living.

Rise in Unemployment Will be Brief

Even though economic growth slowed down appreciably last year, employment continued to improve: the number of employed persons rose by 32,000 persons and the employment rate, i.e. the share of all employed of the 15-64 population, climbed to 68.2 per cent. The number of wage earners increased by 44,000 persons. The slowdown in production toward the end of last year was nevertheless reflected in the deceleration of the growth rate of employment, albeit not yet a direct decrease in employment. Whereas the profitability of companies has remained strong and the downturn is expected to remain brief, the export industry has refrained from large-scale layoffs even though production has fallen substantially in this sector. Moreover, domestic demand has sustained employment in the service sector.

Figure 4. Labour Supply and Employment 1985 - 2003



Source: Statistics Finland, Labour Institute for Economic Research

The adjustment in the form of labour inputs to changes in production is more often seen in the form of cutbacks in working hours and temporary layoffs than the permanent discharging of employees. This year the number of employed persons will fall slightly, but next year the acceleration of economic growth will once again increase the demand for labour. If the recovery of the international economy does not take place as expected, employment trends may be appreciably worse than projected in the forecast period.

This year the demand for labour will weaken in manufacturing and construction, among other sectors. The number of employed persons will also decline in agriculture and forestry. The demand for labour will be sustained in the service sector, where jobs will be created in business services as well as in public and other services.

In addition to employment the supply of labour shapes the trends in unemployment during a turning point in the economic cycle. This year the growth in the supply of labour will slow down from that of last year, when 16,000 new job seekers entered the labour market and 67.2 per cent of the population aged 15-74 was in the labour force. Next year the supply of labour will grow at a rate of about half a per cent.

The supply of labour by young persons under 25 years old is sensitive to economic fluctuations. The slowdown in production growth has already dampened the demand for young workers, and the supply of young persons in the labour market (relative to the population) will decrease this year. The labour supply of persons aged 55-74 will continue to show the briskest growth during

the forecast period since this age group is growing the fastest. The labour force participation rate of this age group (30%) has risen higher than it was prior to the depression of the early 1990s. The growth of the labour supply relative to the population in this age group is explained also by a drop in the number of persons participating in early retirement or disability retirement schemes as well as a rise in the number of employees participating in part-time retirement schemes.

The clear slowdown in the growth rate of production was evident in the halt in the decline of the seasonally adjusted number of unemployed persons and the unemployment rate beginning in July last year. Compared to the year 2000 the number of unemployed persons still fell by 15,000 persons and the average unemployment rate fell by 0.7 percentage points to 9.1 per cent. This year unemployment will rise moderately as the unemployment rate climbs to 9.4 per cent. The number of unemployed persons will average 246,000. Next year the unemployment rate will fall to 9.3 per cent. The rise in unemployment will thus be a short-lived phenomenon.

Central Government Continues to Run Surplus

The slowdown in economic growth last year had a visible impact on central government finances. The surplus declined substantially compared to that in the year 2000, partly due to the fact that the surplus had been raised to an exceptionally high level by one-off factors in that year. The central government nevertheless managed to run a surplus of about €2.5 billion.

Compared to other euro countries the Finnish central government's finances are in very good shape. When we widen the scope to include the entire public sector, i.e. central and local government as well as social security funds, Finland's strong position among the euro countries stands out even more. Several euro countries are running a fiscal deficit, but Finland is running a clear surplus. Even though the surplus of the overall public sector shrank last year, it remained fairly large. The surplus amounted to some €6.6 billion, i.e. 4.9 % relative to GDP.

Since the growth rate for GDP will still remain relatively low this year, the central government's fiscal surplus will continue to shrink. The easing of taxation will also curb growth in revenues. The surplus is projected to be €1.3 billion, i.e. 0.9 % relative to GDP.

As regards next year, many of the decisions affecting the central government's surplus (e.g. certain decisions about tax policy) have not been taken yet. If no significant changes are made in taxation, state revenues will grow faster next year than this year. If decisions are not taken to curb significantly the rise in expenditures, next year's surplus will be approximately the same as for this year. The surplus will also enable – if this is deemed important – the reduction of the national debt.

It is clear that the threat of a deficit grows if economic growth is lower than we forecast for this year and next. This may occur if the international economy does not stage a recovery. It is important to realize that in that case the weakening of central government finances would be the result of cyclical developments, not possible structural ones that are on the horizon.

The temporary weakening of central government finances owing to cyclical factors is a poor excuse for both painting bleak scenarios and tightening fiscal policy.

Even though the rise in unemployment is probably a short-run phenomenon, it does not reduce the need for additional measures to foster employment. The improvement of cyclical conditions does not necessarily improve the position of long-term unemployed in danger of becoming increasingly isolated from society. On the other hand, the recovery of the economy is no excuse for neglecting active labour policy and education. Neither does the fiscal position of the central government prohibit greater spending on these types of programs.

INTERNATIONAL ECONOMY

GDP growth , %	2001	2002f	2003f
United States	1.1	1.4	2.1
Euro-11	1.5	1.2	2.6
Germany	0.7	0.7	2.5
France	2.1	1.1	2.6
Italy	1.8	1.1	2.4

Euro-15	1.6	1.3	2.7
Sweden	1.2	1.6	3.0
United Kingdom	2.4	1.8	2.6
Japan	-0.4	-0.7	1.0
Russia	5.0	4.0	5.0

Source: BEA, IMF, OECD,
Labour Institute for Economic Research

DEMAND AND SUPPLY

	2001	2001	2002f	2003f
	Bill. EUR	Percentage change in volume. %		
Gross Domestic Product	135.1	0.7	1.6	3.3
Imports	42.6	-1.0	1.8	4.0
Total supply	177.7	0.3	1.6	3.5
Exports	54.5	-0.7	1.5	6.0
Consumption	96.2	1.5	2.1	2.0
- private	67.6	1.4	2.3	2.2
- public	28.6	1.7	1.7	1.5
Investment	26.7	2.1	-1.3	2.6
- private	23.2	1.8	-1.9	2.5
- public	3.6	3.9	2.4	3.0

	0.3	-0.5	0.2	0.0
Change in stocks				
Total demand	177.7	0.3	1.6	3.5
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2001	2002f	2003f
Unemployment rate , %	9.1	9.4	9.3
Unemployed (1 000)	238	246	243
Employment rate , %	68.2	67.9	68.2
Employed (1 000)	2367	2363	2378
Inflation, consumer price index, %	2.6	1.5	2.0
Wages, index of wage and salary earnings, %	4.5	3.4	4.0
Real disposable income of households, %	3.0	2.2	2.2
Current account surplus, Bill. EUR	8.7	7.4	9.1
Trade surplus, Bill. EUR	14.2	13.0	14.4
Central government financial surplus, Bill. EUR	2.5	1.3	1.3
% / GDP	1.9	0.9	0.9
General government financial surplus, Bill. EUR	6.6	5.1	5.3
% / GDP	4.9	3.7	3.7

EMU debt, % / GDP	43.6	43.0	40.4
Short-term interest rates (3-month Euribor)	4.3	3.6	4.5
Long-term interest rates (10-year gov't bonds)	5.0	5.6	6.2
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			