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Forecast 2006 - 2007
FINNISH ECONOMIC GROWTH EXCEEDING 5 PER CENT THIS YEAR

Finland's GDP will continue to grow swiftly this year. The favourable development is fuelled by brisk growth in the global economy and strong performance of Finnish technology companies in international competition. A significant factor has been the acceleration of growth in Finland's main export markets. In addition to foreign trade, the main factors driving Finnish economic growth include the relatively rapid growth in private consumption, which has in turn fostered an improvement in the employment situation. Investments have also grown rapidly. Last year's production shutdowns in the forest industry due to a labour dispute will boost this year's GDP growth rate by about one percentage point to 5.1 per cent.

Next year Finnish economic growth will slow down to 3.5 per cent. Growth is still relatively swift as a slight acceleration in European growth will bolster Finnish exports and the growth rate of domestic demand – i.e., consumption and investment – will remain fairly high. The risks regarding Finland's economic growth stem largely from the international economy. The anticipated slowdown in US economic growth will not prevent an acceleration of European growth. If the US nevertheless slides into a deep slump, the international economy may face a crisis.

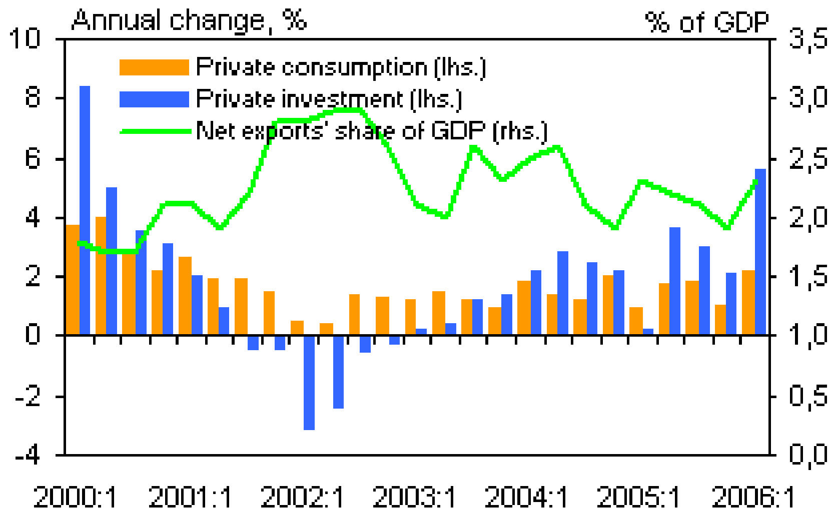
Economic growth accelerating in Europe

In 2005 GDP grew in the eurozone by 1.3 per cent. In the first half of this year GDP in the eurozone grew already by over 2 per cent compared to the previous year and the Labour Institute for Economic Research forecast that it will grow by 2.4 per cent for the year as a whole. Growth is still driven mainly by foreign trade and investment. Growth in private consumption is accelerating somewhat. The outlook for the Eurozone has also improved not just in industry, but also in construction, services and the retail trade. This trend is reflected in an upturn in consumer confidence and rise in capacity utilization rates. In the wake of the upswing in economic growth the employment situation has improved and the unemployment rate fell in July to 6.6 per cent, down from 7.3 per cent a year ago.

Consumer confidence is still fragile in Germany, France and

Italy, which is reflected in the sluggish growth of private consumption. It is nevertheless precisely in these countries where private consumption and sectors catering toward this type of demand will stage an upswing, ensuring that the moderate acceleration of economic growth will continue well into next year. Growth in the eurozone is forecast to reach 2.6 per cent next year. This trend is unlikely to be derailed by Germany's three percentage point hike in VAT next year. The downturn in certain German business confidence indicators does not reflect the positive attitudes that mark households' outlook in Central Europe. Economic growth has already been strong in the Nordic countries, Ireland, Spain and almost all new EU member countries. In these countries the situation will remain relatively bright also next year.

Eurozone economic developments
2000:1 - 2006:1



Source: Eurostat

Consumer prices in the eurozone rose in May-June by 2.5 per cent compared to the previous year. Consumer prices excluding food and energy rose during the same period by about 1.5 per cent. The acceleration of consumer price inflation above 2 per cent is indeed attributable to the rise in oil prices. The European Central Bank reacted on August 3 to inflation remaining above the 2 per cent ceiling by raising its repo rate by 0.25 per cent to 3 per cent. Interest rates have been raised already three times this year by the same increment.

The slowdown in US economic growth will dampen the demand for oil and the price of oil will not rise appreciably from current levels. Eurozone inflation will therefore gradually slow down. Consumer prices in the eurozone will be 2.3 per cent higher on average and next year about 2 per cent higher than in the corresponding preceding years. The decline in inflation and the recent decision by the Federal

Reserve to refrain from raising interest rates will curb the enthusiasm of the ECB to raise rates. The ECB will nevertheless raise rates once or twice by 0.25 percentage points. Short three-month euro interest rates will average 3.1 per cent this year. Next year three-month interest rates will rise to 3.8 per cent on average. Long-term interest rates will also rise, but by less than a percentage point.

Sharp fall in housing construction spurring downturn in US

According to revised figures, GDP grew in the US by 3.2 per cent last year. In the first quarter of this year GDP in the US was 5.5 per cent higher than in the preceding quarter. In the second quarter growth nevertheless slowed down to 2.5 per cent. Toward the end of this year growth will continue to slow down as GDP in the US is projected to be 3.3 per cent higher this year than last year. US growth will be curbed primarily by the slowdown in residential housing construction. Private consumption growth will also subside. Growth has been affected by the tightening of monetary policy due to the acceleration of inflation. In the US, core inflation excluding energy has been about a percentage point higher than in Europe. The Federal Reserve will be seeking to strike a balance between the risks of accelerating inflation and a contraction in economic growth for some time to come. The deceleration of economic growth currently appears to be the dominant trend, which will curb inflation so that there is no need to tighten monetary policy appreciably any more.

Euro appreciating against dollar

The slowdown in US growth and simultaneous recovery in Europe will spur a weakening of the dollar vis-à-vis the euro. This is the main mechanism by which the weakening of the dollar will affect Europe. The direct impact of trade flows is surprisingly small. Europe is a large single market so that internal trade is considerably greater than trade with the outside world. We get an indication of this phenomenon by noting that the exports of the eurozone to Switzerland are a third as large as eurozone exports to the US.

Growth in China remains fast

Economic growth in Asia continues to be rapid. China's GDP will grow this year by slightly over 10 per cent compared to last year, and the rate of growth will not subside appreciably next year either. The balanced nature of China's growth is illustrated by the fact that consumer price inflation has remained low, below 2 per cent, even though the nominal wage level is rising at a rate of about 15 per cent. The rise in the wage level, an internal revaluation, also fosters balanced growth in the international economy. Especially from the standpoint of European competitiveness it is favourable that the rapid rise in the wage level counteracts the weakening of China's currency, the renminbi, against the euro. The renminbi is anticipated to remain closely aligned with the weakening dollar.

The rapid economic growth in East Asia has created a favourable environment for a recovery in the Japanese economy. Japan will continue to run a substantial trade surplus with China. Strong export performance and an improvement in the employment situation ensure a continuation of growth in domestic demand. Japan's GDP will grow this year and next by about 3 per cent compared to the corresponding preceding years. High oil prices will ensure that Russia's economic growth will remain around six per cent.

Exports growing over ten per cent

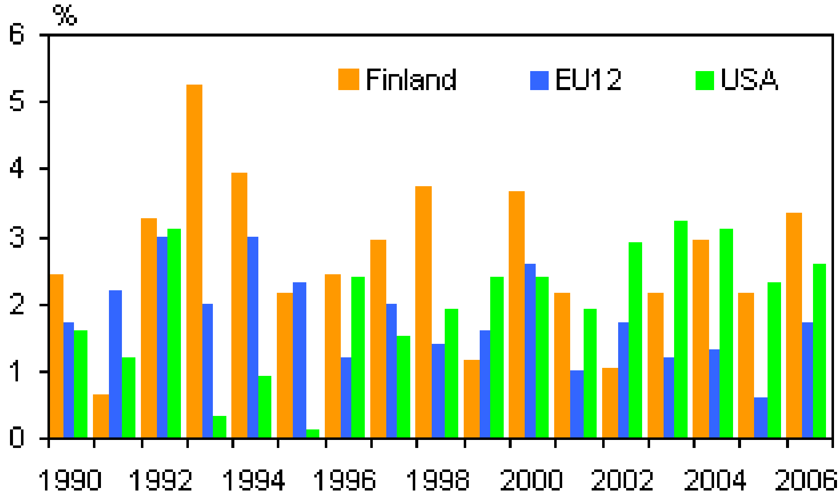
Finnish foreign trade – both exports and imports – grew swiftly last year. This year exports will grow substantially more than imports in volume terms. The exports of goods and services will grow by 12 per cent while corresponding imports grow by slightly less than 9 per cent. Finnish export growth has been boosted by the pick-up in export markets in the EU region as well as the continued rapid growth in Russia. A significant increase in ship deliveries as well as the production shutdowns in the forest industry due to a labour dispute last year will bolster export growth figures. Next year export growth will still be swift, despite slowing to 6.2 per cent. The growth path of exports also reflects on the volume of imports. Both this year and next year imports will nevertheless grow appreciably faster than exports.

High oil prices will spur a rise in prices of Finnish goods and services by almost 6 per cent compared to last year. Export prices will rise at the same time by about 3 per cent. Next year the terms of trade will no longer deteriorate as prices of both exports and imports will rise by the same margin, 2.6 per cent. Owing to swift growth in the volume of exports, the trade surplus will grow significantly already this year compared to last year, even though the terms of trade is weakening. Next year the balance of trade will continue to strengthen, as developments in foreign trade prices no longer dampen this trend.

Technology industry growing strong

The growth rate for output in the technology industry accelerated already last summer. This was not known for certain, however, until National Accounts figures were released this summer. The rate of growth in the technology industry was so fast that it almost completely camouflaged the dip in GDP caused by the shutdowns in the forest industry due to the labour dispute last year. The growth in the volume of technology industry production will be swift also this year, almost 10 per cent. Electricity production will also expand significantly compared to last year, when its consumption was largely based on production from other Nordic countries. Growth in Finland's economy as a whole is wide-based. The wholesale and retail trade, transportation and communications and construction will grow a rate exceeding five per cent this year. Next year production will slow down in the main sectors except personal and business services.

Change in labour productivity, y-o-y total economy, relative to number of hours worked



Source: Bureau of Labour Statistics, OECD, Statistics Finland

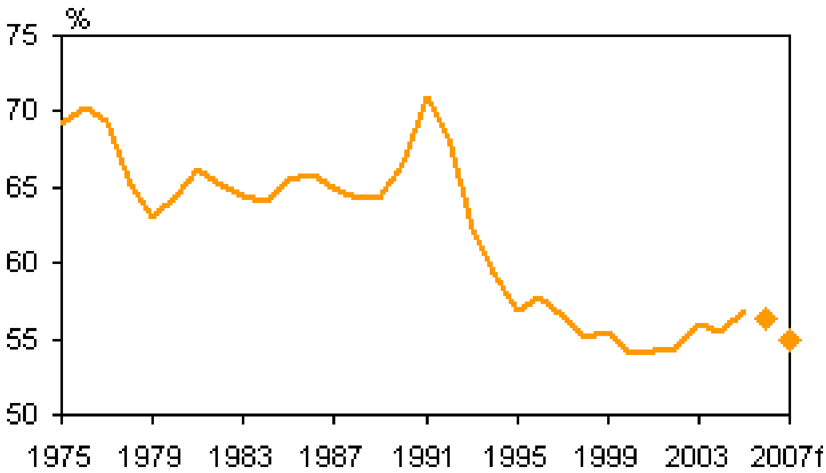
Finland's relatively swift economic growth is based largely on a rise in productivity of labour. Finnish productivity has improved more than elsewhere in Europe (EU-15 excl. Austria, Portugal, and Luxembourg). Finnish labour productivity will rise during the period 2000-2006 almost as fast as in the US.

Purchasing power boosted by tax cuts, share of capital income will rise

This year's pay hikes in the comprehensive wage settlement were moderate and they did not go into force until June. Wage drift and carry-over from previous wage hikes will have a greater impact on the level of earnings than anticipated in the spring forecast. The level of earnings will rise on an aggregate level by 3.1 per cent. Rapid economic growth will bolster the demand for labour and the wage bill will grow this year by 5 per cent. The impact of last year's labour dispute in the paper industry appears in the figures as an acceleration of growth in the number of hours worked.

The comprehensive wage settlement will remain in force until the end of September next year and no new wage increases have been agreed upon for next year. The carry-over from this year's wages increases is nevertheless one per cent and companies favourable earnings development will facilitate an above-normal rise in bonuses and other forms of wage drift. Next year the wage bill is expected to grow by 4 per cent. The rate of increase will remain low if the labour negotiations are delayed and new wage increases are postponed until after the year-end.

Functional distribution of income in enterprise sector activities 1975 - 2007



Source: Statistics Finland, Labour Institute for Economic Research

Wage increases are moderate, given the cyclical situation, and the wage bill will increase this year and next year more slowly than the operative surplus of the enterprise sector. The functional distribution of income will change so that the share of companies' value added will fall to the same level that prevailed in the boom years of the late 1990s.

Last year the capital income of households fell as enterprises took into account capital and corporate tax reforms when paying dividends. This year dividend income will return to previous levels. Forestry income started to climb due to an increase in prices. In addition, tax cuts will bolster the purchasing power of wage earners both this year and next. The real disposable income of households is forecast to rise by 3.2 per cent this year. Next year the growth in income will slow down by slightly less than one percentage point.

Consumption growth slowing down next year

Private consumption has grown faster than average for several years already. Growth has been fostered by strong consumer confidence, low interest rates and a stable economic outlook. This year the volume of private consumption will rise by 3.3 per cent. Next year the rate of increase will subside to 2.5 per cent. In addition to income developments, this trend will be a consequence of climbing interest rates on housing loans and rising debt servicing costs. Car sales are flattening off and purchases of other durable consumer goods will grow more slowly than previously.

Inflation will accelerate but remain among the lowest in the eurozone

In July crude oil prices rose to record levels, higher than forecast in the spring. Disruptions in oil production, consumption growth in China, political conflicts and violence in oil producing regions will keep oil prices high (cf. separate box below). Housing prices continued to rise more than anticipated in the spring. Our forecast for inflation this year and next is 1.4 per cent. As inflationary pressures from oil prices abate, the impact of climbing interest rates will become more apparent. Finland's inflation will remain lower than elsewhere in the eurozone.

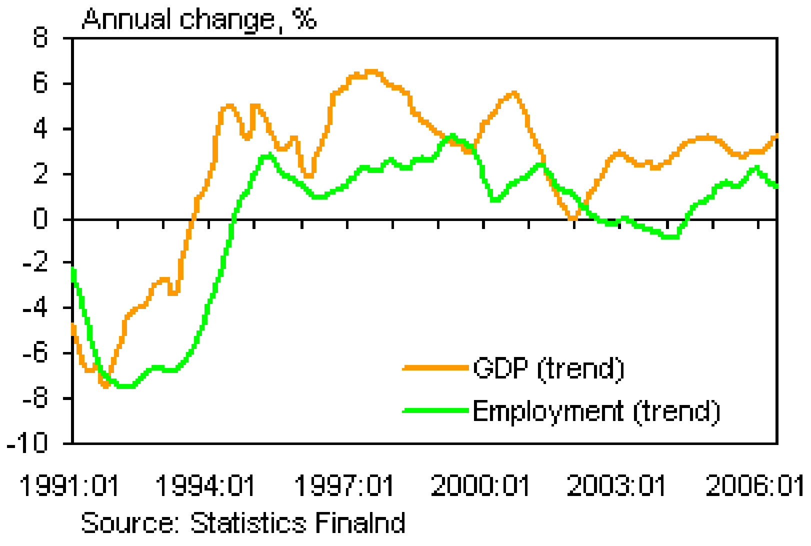
Machinery and construction investment still expanding

Investment will grow appreciably this year. The strongest growth in the beginning of the year has occurred in construction. Even though construction figures and new starts indicate that growth is gradually subsiding, residential housing is anticipated to increase this year by 7.5 per cent and other building construction by 8 per cent. Along with the pick-up in manufacturing, investment in machinery and equipment will grow appreciably this year by a total of 8 per cent. Civil engineering will grow this year by 3 per cent owing primarily to large public projects already under way. All in all private investment is forecast to grow this year by 7 per cent. Next year growth in investment will subside. Both residential and other building construction as well as machinery and equipment investment will nevertheless still grow at a rate of about 5 per cent. Private investment as a whole will expand next year by 4.3 per cent.

Employment improving

The outlook for Finnish employment appears bright. The unemployment rate has been falling appreciably in the first half of this year. Fuelled by the manufacturing and construction sectors, the job market situation for men has improved slightly more than for women. The trends for the number of long-term unemployed also look positive: it has declined by 5.3 per cent in the first quarter of this year and as much as 8.8 per cent in the second quarter compared to one year ago.

GDP and employment 1991:01 - 2006:06



The rise in the number of employed persons has slowed down somewhat in recent months after the steep rise toward the end of 2005. It is nevertheless apparent that new jobs will be created in the second half of this year in the wake of robust economic growth. This year the number of employed persons is forecast to be 1.6 per cent or 38,000 persons higher than last year. Next year as economic growth subsides somewhat the annual growth in the number of employed persons will decline to 24,000 persons.

Growth in the labour force has slackened somewhat in recent months. The favourable employment outlook will nevertheless activate people to enter the labour market or at least remain there, as a consequence of which the average size of the labour force will grow this year by 0.9 per cent compared to last year. This means the labour force will grow by 23,000 persons. The growth trend will flatten off next year as the labour force grows by 15,000 persons. The growth in the labour force is due primarily to demographic factors. According to the population forecast by Statistics Finland the working age population will grow this year by 0.3 per cent and next year by 0.4 per cent with respect to the previous year. According to the same forecast, the ageing of large age groups will not halt the growth in the working age population until around the year 2012.

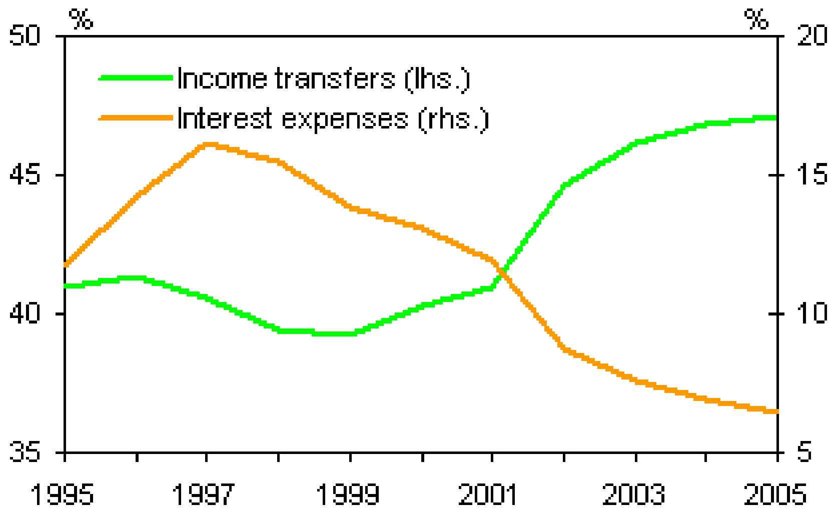
On the basis of employment and labour force projections, the unemployment rate is anticipated to fall this year to 7.7 per cent on average and next year to 7.3 per cent. The rise in the number of employed persons will raise the employment rate this year to 69.0 per cent and next year to

69.4 per cent. The current government appears to be falling short by 10,000 of its goal of creating 100,000 new jobs.

Growth in state tax revenues exceeded expectations last year

Net lending by the central government remained almost unchanged last year at about EUR 600 million. Strong growth in sales of durable goods and private investment spurred a considerable rise in value-added tax. On the other hand, the sharp increase in revenues from earned and capital income taxation by 7.5 per cent exceeded all expectations. This trend was attributable to the substantial rise in capital income and the wage bill, the increase in wages and other compensation of persons in high marginal tax brackets, as well as a shift in tax revenue sharing from the municipalities to the central government. In contrast, the proceeds from corporate taxes fell by 4.4 per cent. Central government consumption expenditures grew somewhat more slowly than expected, by 3.3 per cent. The municipalities' portion of tax revenue sharing climbed by 6.9 per cent.

Share of interest expenses and income transfers in state expenditures 1995 - 2005



Source: Statistics Finland

The adjacent graph illustrates the significant change in the structure of state spending during the last ten years: the share of interest expenses on the state debt and the portion of revenue sharing paid to the municipalities have offset one another to a large extent. After growing in the 1990s, the euro-denominated state debt started to fall in 1999, but in 2005 it was almost the same as 10 years previously, slightly more than EUR 60 billion. At the same time the share of interest expenses out of total state expenditures nevertheless fell by 5.3 per cent. This trend did not stem merely from the reduction in the debt but rather also from the general decline in interest rates over the period in question while total expenditures increase 14 per cent.

The decline in the share of interest expenses created room for a 6.1 percentage point increase in the income transfers paid by the central government during 1995-2005. Over 80 per cent of these income transfers have gone to the Social Insurance Institution of Finland (KELA). The tax revenue sharing going to the municipalities has been raised as compensation for the tax revenues lost due to the increase in earned income deductions in municipal taxation and in order to finance services provided by the municipalities. Funds have in turn been earmarked for the Social Insurance Institution of Finland in order to pay for various types of benefits to households. Recently, the gradual slowdown in the growth of income transfers has encouraged the municipalities to stop cutting municipal taxation while social security contributions to the Social Insurance Institution of Finland have been raised. The decline in interest expenses has also facilitated cuts in state taxation.

Adjustments in the tax revenue sharing going to municipalities mean that last year's growth in municipal tax revenues was slightly lower than forecast, 4.0 per cent. The consumption expenditures of municipalities increased slightly faster than anticipated, at a rate of 5.6 per cent. The halt in investment growth and 6.9 per cent rise in tax revenue sharing nevertheless meant that the net borrowing of the municipalities fell by EUR 143 million. The appreciable decline in public investment was attributable partly to technical factors, i.e. restructuring of ownership in certain pension insurance companies. While the net lending of pension insurance institutions and other social security funds grew almost as projected, by over EUR 1 billion, the net lending of the general government as a whole (EMU surplus) grew by EUR 600 million and its share of GDP climbed by half a percentage point.

Central government surplus growing this year

This year the central government's surplus will rise substantially, by about 800 million. This is primarily attributable to a rise in dividend income received by the central government by almost 500 million. Value-added tax revenues are forecast to grow swiftly, at a rate of about 7 per cent. Cuts in earned income taxation are fairly large this year and wealth tax has been discontinued, but the central government's income and wealth tax proceeds will climb slightly in the wake of strong growth in the wage bill and corporate revenues. The central government's consumer expenditures will grow moderately and investment will decline slightly. The revenue sharing earmarked for municipalities increased by 9 per cent, but the 10 per cent growth in contributions to social security funds was due largely to technical factors. The value-added tax, which was previously paid to the Social Insurance Institution of Finland as a capital transfer, is now paid as an income transfer.

The net lending by municipalities will fall this year by about EUR 350 million. Their tax revenues will increase by almost 8 per cent as the wage bill grows substantially, municipal tax rates have been increased slightly and revenues from corporate taxes will rise appreciably. Simultaneously the consumption expenditure of municipalities will continue to grow strongly. The surplus of pension institutions and other social security funds will grow this year by EUR 1.5 billion. This trend is primarily attributable to growth in the wage bill underpinning contributions and sluggish growth in outlays of social benefits and aid. The overall public sector's net lending relative to GDP will rise to 1.4 per cent. Owing primarily to the central government's tax cuts and strong GDP growth, total taxes as a percentage of GDP will fall by 0.2 per cent.

Growth in indirect tax revenues to slow down next year

The central government's net lending is forecast to decrease by almost EUR 500 million in 2007. Tax cuts will be smaller than in the previous year, but the deceleration in the growth in the wage sum will still leave earned income tax revenues on a slightly negative path. As a consequence of the slowdown in private consumption growth, indirect tax revenues will slow down substantially. The high level of dividends received by the central government is expected for the most part to be a temporary phenomenon. The strong growth in revenue sharing with municipalities and outlays to social security funds is expected to continue. The appropriation of revenues from the State Pension Fund will decrease by EUR 500 million.

Municipalities' net lending will decline again by about EUR 350 million as their tax revenues continue to show strong growth. Municipal taxation is forecast to be tightened further somewhat. The contributions of pension institutions and other social security funds are projected to grow much more slowly than this year. Their net lending will remain almost unchanged next year. The EMU surplus of the general government will start to decline slightly. Taxes as a percentage of GDP will fall by 0.6 per cent.

While the combined debt of Finland's general government (so-called EMU debt) relative to GDP still rose in 2003 by 2 percentage points, in 2005-2007 it will fall by about 4 percentage points. Next year it will be 32 per cent, fairly far from the 60 per cent ceiling of the stability and growth pact.

Strong economic growth gives chance to prepare for downturn

Finnish aggregate taxation has been eased considerably in recent years. In 2000 total taxes as a percentage of GDP was 48 per cent, and next year it will be about 43 per cent. In the wake of the easing of taxation, the public sector's net lending has also decreased significantly. Fiscal policy has thus been expansionary in nature. Despite this the international economy and foreign trade has been the most important factor affecting cyclical conditions in Finland. Greater than expected tax revenues last year and evidently this year as well are attributable to the faster than anticipated economic growth. The unexpectedly favourable revenues should be allowed to strengthen the public sector's financial position as occurred in the latter half of the 1990s. Then we can allow the public sector's automatic nondiscretionary spending to trim the public sector's surplus when cyclical conditions weaken, as occurred in 2001-2003. Owing to the ageing of the population, we should prepare ourselves for upward pressure on public spending in the long run.

Central government spending in the next few years will be kept in check by the government's framework for real expenditures, which nevertheless excludes counter-cyclical social spending. The spending framework cannot, however, be expected to completely dictate the coming developments in real expenditures. For example, last March the framework was adjusted with respect to spending next year. In the years 2007-2011 the spending framework is in any case relatively stringent. The basic expenditures in the central government spending framework (excl. interest expenses) will rise during 2007-2011 in real terms by an average of 0.5 per cent while in 2004-2007 corresponding expenditures rose in real terms by an average of 1.5 per cent. This tightness is reflected in the public sector as a whole, as its consumption expenditures are projected to grow during 2007-2011 by an average of 0.8 per cent per annum. During 2000-2005 these expenditures grew on average by about one percentage point faster.

The real growth in consumption expenditures by municipalities during 2007-2011 may be higher than assumed in the spending framework if they try to even approximately uphold their obligations. In the next few year as economic growth is swift, the municipalities may manage to handle their spending pressures without their financial position weakening and without the central government having to support them more than the spending framework allows. But if economic growth slows down to around 2 per cent during 2008-2011, which is possible, the financial position of the municipalities may weaken significantly. This will place pressure directly on the central government, which nevertheless is ultimately responsible for safeguarding the stability of the municipal sector.

On the basis of the phenomena mentioned above, the central government should prepare for bad times, for which reason it should not proceed in a short-sighted manner with regard to tax cuts. The focus of tax policy should be on the tax structure. Tax rates for capital income are low compared to taxation of earned income. This mismatch distorts the income distribution and encourages tax manipulation. Taxation of capital incomes could be tightened moderately and earned income could be correspondingly eased so that total tax revenues would not change appreciably. If the overall economic situation remains favourable, then total taxation could be eased somewhat.

INTERNATIONAL ECONOMY

GDP growth , %	2005	2006f	2007f
United States	3.2	3.3	2.8
Euro-12	1.3	2.4	2.6
Germany	1.0	2.1	2.0
France	1.2	2.2	2.6
Italy	0.0	1.8	2.4
EU 25	1.6	2.6	2.7
Sweden	2.7	3.7	3.2
United Kingdom	1.9	2.3	2.5
Japan	2.6	3.0	2.8
Russia	6.4	6.0	6.0
China	9.9	10.5	9.5

Source: BEA, BOFIT, Eurostat, Labour Institute for Economic Research

DEMAND AND SUPPLY

	2005	2005	2006f	2007f
	Bill. €	Percentage change in volume, %		
Gross Domestic Product	157.4	2.9	5.1	3.5
Imports	56.9	12.3	8.8	4.5
Total supply	214.3	5.3	6.1	3.8
Exports	65.8	7.3	12.0	6.2
Consumption	116.3	3.2	2.8	2.3
- private	81.5	3.8	3.3	2.5
- public	34.8	1.6	1.5	1.8
Investment	29.5	3.3	6.5	4.0
- private	25.4	5.9	7.0	4.3
- public	4.1	-10.4	-3.4	-1.8
Change in stocks	2.6	0.0	0.0	0.0
Total demand	214.3	5.3	6.1	3.8
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2005	2006f	2007f
Unemployment rate , %	8.4	7.7	7.3

Unemployed (1 000)	220	204	195
Employed (1 000)	2401	2439	2463
Employment rate , %	68.0	69.0	69.4
Inflation, consumer price index, %	0.9	1.4	1.4
Wages, index of wage and salary earnings, %	3.9	3.1	2.8
Real disposable income of households, %	1.0	3.2	2.3
Current account surplus, Bill. €	7.2	8.5	10.4
Trade surplus, Bill. €	7.7	9.6	11.7
Central government financial surplus, Bill. €	0.6	1.4	0.9
% / GDP	0.4	0.9	0.5
General government financial surplus, Bill. €	3.9	6.5	6.3
% / GDP	2.5	3.9	3.6
EMU debt, % / GDP	40.5	36.1	32.0
Tax rate, %	43.9	43.7	43.1
Short-term interest rates (3-month Euribor)	2.2	3.1	3.8
Long-term interest rates (10-year gov't bonds)	3.4	4.0	4.6
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			

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FORECASTS OF MACRO-MODEL

GDP, %	2006	2007	2008
Baseline forecast	4.4	3.7	3.5
Alternative 1	4.5	4.1	4.1
Alternative 2	4.4	3.5	3.2

The adjacent table presents the forecasts of the new macro-model used by the Labour Institute for Economic Research. The model's forecasts are not the official forecasts of the Institute. They are nevertheless used to support the forecasting work. The adjacent baseline forecast, which has corresponding assumptions used in our official forecast, has been solved so that the exogenous factors behave in accordance with our forecasting system. The growth rate for this year's baseline forecast is lower than our official forecast because the model projections do not take into consideration that growth has been faster than forecast in the beginning of this year. In the baseline forecast the dollar is assumed to weaken gradually until the end of 2008 as a reaction to the slowdown in US economic growth. Accordingly, the euro would average 1.30 against the dollar in 2007 and 1.35 in 2008. In the model the euro/dollar exchange rate affects the competitiveness of the Finnish export industry via export and import prices, so that exports decrease as the dollar devalues. This naturally has dynamic effects on other economies.

Two other scenarios were made with alternative assumptions of developments. In the first "optimistic" scenario (Alternative 1), it is assumed that European economic growth this year and in the next couple of years will be slightly faster than recent forecasts and that the dollar's exchange rate remains at the current level. According to this scenario growth in 2006 would be 0.1 percentage points higher and in 2007 some 0.4

percentage points higher than in the baseline forecast. In 2008 GDP growth would be 4.1 per cent, which is 0.6 percentage points higher than the baseline forecast's 3.5 per cent. In the second scenario (Alternative 2) interest rates are assumed to be a percentage point higher in 2007 and 2008 than in the baseline forecast. At the same time it is assumed that economic growth is somewhat slower in the eurozone owing to the higher interest rates. If this scenario comes true, economic growth in 2007 and 2008 would be 0.2 and 0.3 percentage points lower, respectively, than in the baseline forecast.

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OIL AND THE ECONOMY

In mid-July the war in Lebanon raised Brent crude oil prices to a new record, over 78 dollars per barrel. In the beginning of the year prices ranged between 60-65 dollars. Prices were already then appreciably higher than a year previously. The developments this summer were characteristic of the nature of the oil market recently. The threat of violence, conflict and production disturbances made suppliers in the oil market anxious and news were immediately reflected in oil prices. After the war in Iraq, oil markets have become increasingly politicised and prices fluctuate in line with the latest rumours. Prices are currently under upward pressure from the dispute between Iran and western countries regarding the right to enrich uranium, kidnappings and sabotage in the Niger delta region, and cuts in Alaskan oil production. A year ago hurricanes in the Gulf of Mexico were in the headlines.

Even small production disturbances reflect upon prices because the demand for oil products is inelastic. Buffers in the form of emergency oil reserves cannot be made available very quickly. On the other hand, on the production side there are no idle oil refineries that can be taken quickly into use. The equilibrium in the oil market is very delicate. The current shortage of oil is attributable partly to China's rapidly growing demand for oil. The International Energy Association estimates that the global demand for oil will grow this year by 1.4 per cent. Next year this rate of growth will accelerate to 1.8 per cent. The growth is driven by the favourable growth in the world economy.

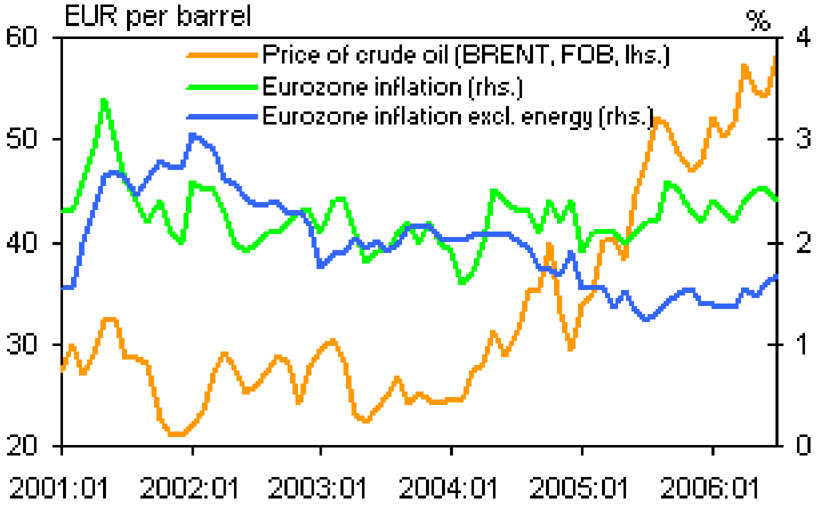
In the OECD countries the growth in the demand for oil is substantially slower than economic growth, 0.3 per cent this year and 0.8 per cent next year. The energy efficiency of economies has gradually increased and the rise in the price of oil will be dampened also to some extent by tends in households' consumption, e.g. with respect to transportation fuels. In Europe, where the relative price of fuel is higher than in the US due to taxation, the demand for fuel is expected to stop growing. In contrast, in China the growth in the demand for oil will accelerate from last year's 2.6 per cent to this year's 6 per cent and next year's 5.5 per cent. Demand is also growing swiftly in India.

OIL DEMAND BY REGION
(MILLION OF BARRELS PER DAY)

	Change in demand, mll. barrels			Annual change , %		
	2005	2006	2007	2005	2006	2007
North America	0.09	0.16	0.39	0.3	0.6	1.5
Europe	0.01	-0.01	0.00	0.0	-0.1	0.0
OECD Pasific	0.10	0.00	0.01	1.2	0.0	0.1
China	0.17	0.41	0.39	2.6	6.1	5.5
Other Asia	0.16	0.10	0.23	1.8	1.2	2.6
Total Asia	0.43	0.51	0.63	1.8	2.1	2.6
CIS Region	0.05	0.05	0.03	1.3	1.3	0.8
Middle East	0.32	0.33	0.34	5.6	5.4	5.3
Africa	0.08	0.07	0.07	3.0	2.4	2.4
Latin America	0.13	0.10	0.11	2.7	2.0	2.1
World	1.11	1.21	1.57	1.3	1.4	1.8
Source: IEA, Oil Market Report, July 2006						

The growth in the daily demand of the world as a whole this year is 1.2 and next year over 1.5 million barrels. Increased production by non-OPEC countries, which this year will amount to 1.1 and next year 1.7 million barrels, will cover the rise in demand. Some 60 per cent of the growth in production is projected to come from Africa or the region of the former Soviet Union. The American continent will account for 30 per cent of this increase. The anticipated increase in production will come from the opening of new oil fields as well as a low base for comparison caused by last year's production disturbances in the Gulf of Mexico and investment problems in Russia's oil companies (Jukos and Sibneft). If the OPEC countries are able to sustain their production levels, the situation is unlikely to tighten in the oil market as a whole. The OPEC countries also have some crude oil production reserves of their own.

Eurozone inflation and price of oil
2001:01 - 2006:07



Source: Eurostat, U.S. Department of Energy

At the current moment the situation in the oil markets is stabilizing. The forward prices of crude oil six months into the future are already declining, but the price level is still well over 70 dollars a barrel. A comparison of growth forecasts for supply and demand of crude oil indicates that no significant decline in the oil prices can be expected next year. The global economy has to adjust to high oil prices. It is of course impossible to predict international political changes around the world: the inherent risks with respect to the price and supply of oil related to such developments are still significant.

The rise in oil prices has had a significant impact on the global economy. The IMF estimates that as much as half of the US's current account deficit during the last couple of years is attributable to the rise in oil prices. In industrialized countries the rise in oil prices directly curbs GDP growth and spurs inflation. The rise in oil prices has had a contractionary impact on world trade as a whole. Even though oil producing countries have benefited from an improvement in their terms of trade, their increasing import demand is insufficient to offset the slowdown in oil importing economies. In the long term there will have to be an adjustment. The current account seeks to bring about a balance via exchange rates. According to the IMF, a permanent rise in oil prices will curb the economic growth of industrialized countries and boost inflation. The real exchange rate will weaken and long-term real interest rates will fall temporarily. In the IMF's model, the imputed impacts on the US economy are somewhat more powerful than for other industrialized countries.

Finland is in a better position than other countries because of its location. Finland's eastern trade has been growth swiftly for several years already. Owing to the growing export possibilities, the negative impact of oil prices has been relatively more modest than in other euro countries. Owing to oil prices, inflation of the eurozone as a whole has risen substantially over its 2 per cent target, recently averaging about 2.5 per cent. If the impact of energy prices is excluded from inflation, the core inflation calculated in this manner is below the target level. Demands for compensation for climbing oil prices are not yet reflected in wage inflation, and price pressures have not spread outside the energy sector.

The European Central Bank may take this into consideration in its monetary policy and curb its interest rate hikes. The situation in the US has been different. Core inflation has been clearly faster there than in Europe and the Federal Reserve has been obliged to raise interest rates repeatedly to dampen inflationary pressures. This gives European monetary policy some room for manoeuvre so the acceleration of economic growth in the eurozone will not necessarily be prematurely nipped in the bud by interest rates hikes called for by strict adherence to the inflation target.