

# FORECAST MARCH 29, 2001

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## Forecast 2001 - 2002

### SLUMP IN THE USA

### DAMPENS FINNISH GROWTH NEXT YEAR

*The economic slowdown in the United States will be longer than generally believed. This will increase the uncertainty surrounding international economic developments and weaken the international economic outlook. This will be evidenced in Finland by a slowdown in export growth. The US recession will have its greatest effect here in 2002, when the growth rate of aggregate production will be clearly lower than in recent years and the effects will begin to be seen in the Finnish labour markets. Employment developments will continue to be favourable, although growth in employment and the decline in the rate of unemployment will taper off. An upswing in unemployment will be prevented by domestic factors fostering growth.*

### When the US Sneezes, Europe Catches a Cold

The international outlook has weakened faster than generally believed last year. The reason for this is the slowdown in US economic growth. The US manufacturing sector is already experiencing a slump and consumer confidence in the economy is simultaneously weakening. The sharp slowdown in the US economic in the form of the so-called hard landing is a significant risk factor affecting the world economy.

The developments in the beginning of this year have forced forecasters to revise their most optimistic forecasts downwards. The hopes of a brief downturn are pinned on one factor: confidence that the Alan Greenspan's policy of cutting interest rates will give a quick shot of relief to the economy.

The widely prevailing view that the US recession would be a short-term phenomenon can be based on the assumption that the slowdown in growth is primarily a question of inventory adjustment, i.e. the running down of excessive inventories. After they decline, production growth could continue to grow at a swift pace. In forecasts based on this type of assumption, an upturn could be expected to occur already in the latter half of this year - i.e. rather quickly.

According to the Labour Research for Economic Research, however, the recession in the United States is not merely a question of inventory adjustment. When assessing the factors behind the recession, one should take into account the heavy indebtedness of the private sector (especially households), collapse in (technology sector) stock prices, as well as the waning confidence of households.

The collapse in stock prices in connection with high debt has weakened the average financial position of households in the last year. When taking into consideration net wealth measured in terms of assets and debt, households have become significantly poorer. Because we think the continued easing of monetary policy will not improve the position of households in the near term, we do not regard a swift improvement in cyclical conditions as likely.

We forecast that total production growth in the US will be around one percent this year and next. Total production growth will begin to pick up in the latter half of next year, but rather sluggishly. The more pronounced the effect of the private sector's debt problems on economic growth, the less likely it is that the US economy will witness a swift upturn.

### **Outlook also in Europe and Asia Weakening Due to US Recession**

The sharp slowdown in US economic growth will inevitably affect economic growth in the Euro zone, which we project will remain at 2.5 per cent this year. The prolongation of the recession next year in the US will hamper a cyclical improvement in Europe. Next year average aggregate growth will be 2.3 per cent in the Euro zone, even though cyclical conditions will improve in the second half of the year. Of the Euro zone countries, the weakening of growth will have a particularly strong impact on Germany, where the economic growth in recent years has been based to a large extent on robust export growth - and thus the boom in the US. The rate of GDP growth in Germany will be 2 per cent this year. We anticipate that the European Central Bank will ease monetary policy this year. The decline in interest rates will nevertheless remain modest.

The recovery in East Asia from the crisis a few years ago has been swift. The recovery has nevertheless been based on export-driven growth. The slowdown in US economic growth will have a major impact on East Asian countries, where the restructuring of the economy has

not yet been completed. Companies are also heavily in debt.

The situation in East Asia affects the prolonged slump in Japan. According to our forecast the Japanese economy will not recover appreciably this year or next. Even though the problems with the Japanese economy are domestically based, the US recession will nevertheless erode the preconditions for a recovery in the Japanese economy.

### **Impact of US Recession will be Seen More Clearly Next Year**

After the depression in the early 1990s, economic growth has been strong, continuing almost unabated for 7 years. Growth has been export driven. It has been fostered by unique price competitiveness, which the weakness of the Euro has bolstered recently. Last year was another in this chain of strong growth: GDP increased by 5.7 per cent. During the last decade, economic growth was faster than this only in 1997. Growth continued to be strong throughout last year even though the weakening of cyclical conditions in Finland's major export markets will dampen the outlook for exports in certain sectors.

The volume of exports increased last year by 18 per cent. Growth was driven by the electronics industry, the production of which increased by almost 40 per cent. The weakening of international growth nevertheless began to be seen at the end of the year.

Compared to exports, domestic factors such as consumption and investment played a relatively minor role in fuelling the exceptionally robust growth. Considering the cyclical situation, investment activity was relatively modest last year. Purchases of machinery and equipment were fairly low. Construction activity was brisk in certain regions, but the differences between various parts of the country were exceptionally wide.

This year the weakening of international demand will begin to have an impact on Finland, but the effects will remain relatively modest. GDP will grow more slowly than in recent years, but nevertheless remain slightly above 4 per cent. The downswing in the international economy will be seen more clearly next year when GDP growth will decline to about 3 per cent.

Growth will still be export driven this year, but the impact of exports will diminish appreciably during the year. Despite this, exports will still grow by around 8 per cent.

The weakening of international demand will have the most pronounced impact on the forest industry and to a lesser extent the electrical equipment and electronics industry. In contrast with the forest industry, the exports of the electrical equipment and electronics industry will not fall, but rather its growth will slow down.

Finland's exceptionally strong price competitiveness makes it possible to offset the slowdown in growth by lowering prices, i.e. by expanding market shares. Even the (unlikely) strengthening of the euro relative to the dollar would not erode our price competitiveness outside the Euro zone. The US recession will begin, however, begin to affect Finnish exports more clearly next year. Export growth will remain around 4 per cent, i.e. half of that projected for this year.

Investments will be higher this year than in the last few years. This will be reflected in manufacturing and many service sectors. Machinery and equipment investment will rise sharply especially in manufacturing. After the last few years of sluggish growth, residential housing construction will pick up somewhat this year but from a longer historical perspective housing investment will remain fairly modest. Construction of industrial plants and commercial buildings is indeed brisker than housing construction. As a whole, private investment will increase this year by almost 7 per cent.

Next year the slackening of economic activity will be felt also in investment. Housing investment may pick up further, but otherwise investment activity will be more modest than this year. Private investment will rise next year by slightly over 4 per cent.

### **Consumption Growing Steadily**

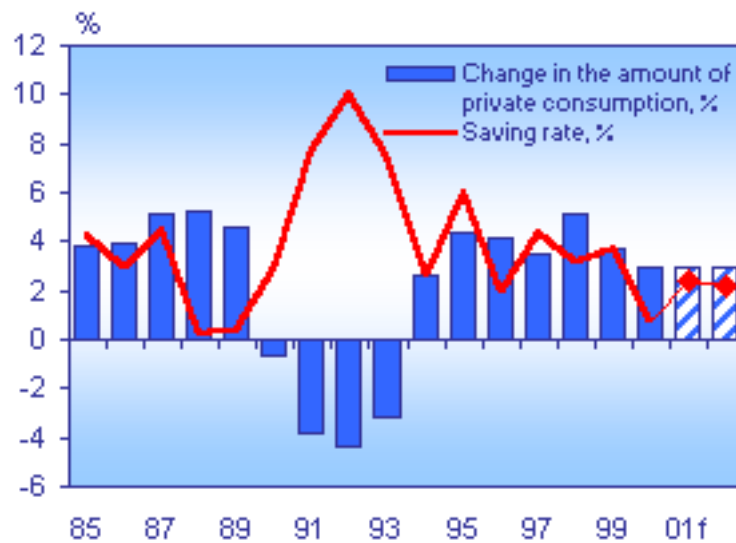
Last year the volume of goods and services purchased by households rose by 3 per cent, i.e. much more slowly than GDP. In the beginning of the year consumption grew swiftly, but the rise in fuel prices began to be seen, among other things, in a slowdown in car sales. The growth in private consumption subsided appreciably in the latter half of the year.

This year and next year the growth in private consumption will remain relatively steady. Compared to the end of last year the growth in consumption will pick up considerably this year, but due to the low point of departure the average growth rate will remain at 3 per cent. Also next year private consumption will grow by 3 per cent, but in the latter half of next year growth will be

slower.

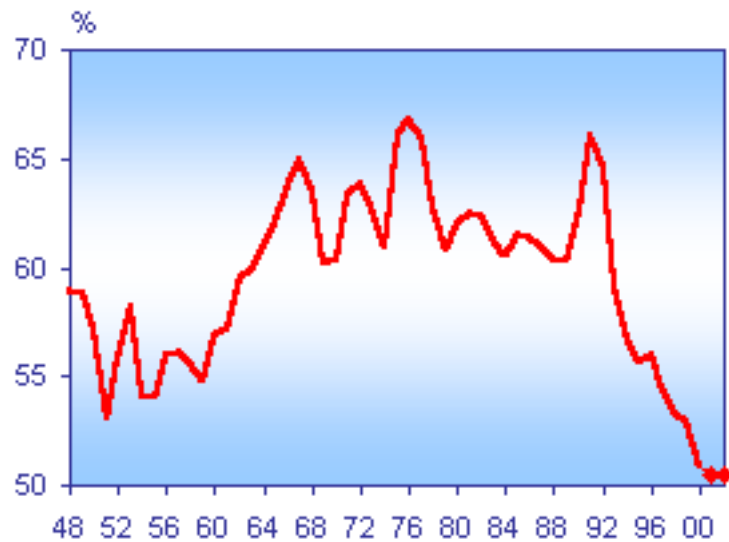
This year and next the growth in household's purchasing power will bolster growth in private consumption. Tax cuts this year will increase the disposable income of households, especially wage earners. This year the purchasing power of households will rise by almost 5 per cent. The uncertainty related to economic developments is evidenced by the rising share of savings within household's disposable income (figure 1).

**Figure 1. Private Consumption and Saving Rate 1985 - 2002**



The interpretation of statistics depicting the disposable income of households is more difficult than previously, because of the growing significance of income from options and capital gains. Nowadays the realized profits from job-related options is not included in the wage bill, but the taxes paid on them - like the taxes paid on capital gains - are included as an income reducing item. Last year these taxes reduced the amount of households' disposable income, so that according to statistics the purchasing power of households decreased slightly. That is also why the savings rate fell appreciably last year (figure 2).

**Figure 2. Distribution of Income between Labour and Capital in Private Sector 1948 - 2002**

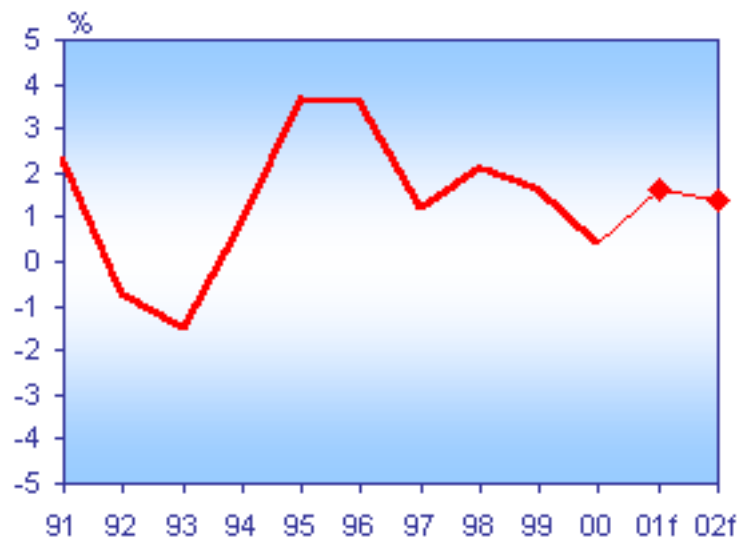


Next year the purchasing power of households will grow by about 3 per cent, i.e. the consumption of households will increase as much as real disposable income. There is a great deal of uncertainty regarding the trends in the purchasing power of households in the near future because of the uncertainty surrounding the amount of taxes to be paid on options and capital gains.

### **Wage Developments Moderate**

From the standpoint of developments in the real earnings and purchasing power of ordinary employees, the new two-year comprehensive incomes policy settlement is naturally very important. We project that the average wages of employees will rise this year by about 4 per cent. Some 3.1 percentage points of this is attributable to contract wages while the rest is due to wage drift. Next year the average wages of employees will rise by a slightly lower margin of 3.2 per cent. Increases in contract wages account for 2.3 percentage points of this.

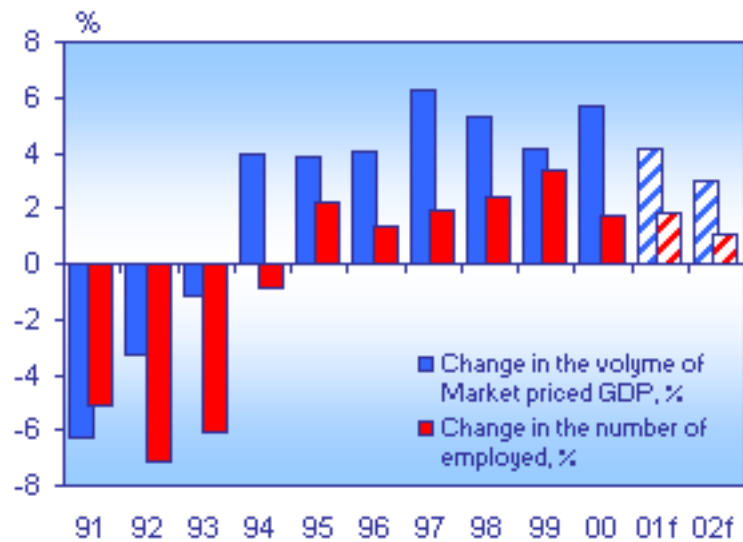
**Figure 3. Annual changes in Real Wages 1991 - 2002**



In the Finnish public debate the wage settlement has already been called too expensive from the standpoint of enterprises. The trends in the (functional) distribution of income between labour and capital this year and next do not, however, support this view (figure 3). This year when economic growth is still relatively swift despite a slowdown, the share of wages will continue to fall. Next year when economic growth slows down sharply, the share of wages will remain at this year's level. The wage agreements included in the new comprehensive incomes policy settlement are thus harmonious with the wage policy based on moderate pay increases. Even if cyclical conditions weaken appreciably next year, the average profitability of enterprises will still remain very good. The moderate wage hikes included in the settlement will be reflected also in the development of real earnings.

In the year 2000 when contract wage increased followed the so-called clump solution, the real earnings of employees rose by about half a per cent (figure 4). The rise in real earnings held the acceleration of inflation to 3.4 per cent. The main reason for the acceleration of inflation was the rise in world market prices of crude oil, but the weakening of the euro and rise in housing prices and interest rates served to boost inflation in the beginning of this year.

**Figure 4. GDP and Employment 1991 - 2002**



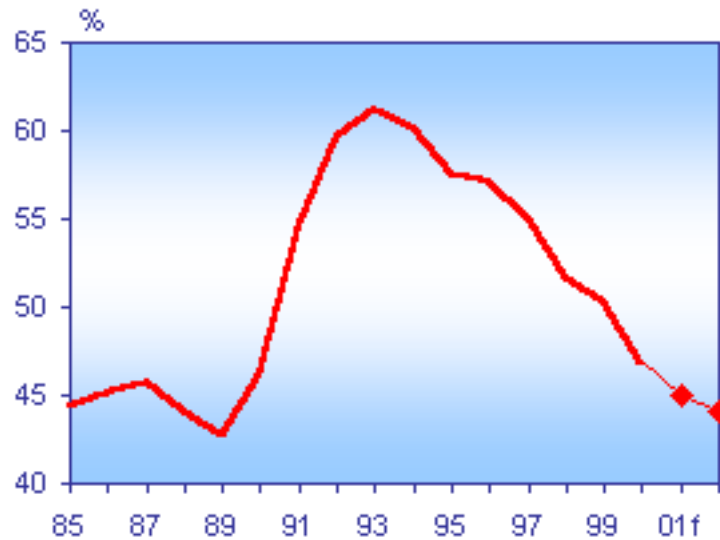
This year inflation will subside and the cost of living will rise by an average of 2.4 per cent. The rise in import prices will not create inflationary pressures this year. Interest rates and housing prices will not boost the cost of living as it has in the last few years. Next year inflation will fall slightly below 2 per cent.

The slowdown of inflation will support the rise in real earnings. Owing to the moderate wage increases, the rise in real earnings this year and next will be relatively modest. Real earnings will rise in both years by about 1.5 per cent.

### US Recession to Dampen Favourable Developments in Finnish Employment

Employment continued to improve last year, spurred by swift economic growth (figure 5). The number of employed persons increased by about 40 thousand persons and the employment rate - i.e., the share of 16-64 year olds in the population - climbed to about 67 per cent. The rise in employment was nevertheless curbed by a fall in the number of entrepreneurs.

**Figure 5. Public expenditures as a percentage of GDP 1985 - 2002**



The relatively swift economic growth will continue to foster the growth in the number of jobs this year. The number of employed persons will increase by 43 thousand, i.e. slightly less than 2 per cent. Next year's slowdown will reflect upon the demand for labour, and the rate of increase in employment will decelerate to about one per cent.

Most of the new jobs will be created (as in recent years) in private services, especially business services. Of the industrial sectors employment will grow primarily in the electro-technical industry. In contrast with last year, the employment in the wholesale and retail trade and construction will now improve. Labour bottlenecks will appear primarily in the electro-technical industry, where there is a shortage of information technology engineers.

The growth in the supply of labour will slow down this year and next. This year supply will grow by less than a per cent and next year by half a per cent. Last year the supply of labour grew by 1.3 per cent and some 32 thousand new job seekers entered the labour market. Thus 66.4 per cent of the 15-74 year old population participated in the labour force.

The growth in the supply of the labour force will be concentrated on persons over 50 years old and young persons. The labour force participation rate of persons below 25 years old is still about 6 percentage points lower than that prior to the recession in the early 1990s. The growth in the labour supply in recent years has been attributable primarily to growth in the labour force of young persons and those over 50 years old.

The decline in unemployment slowed down last year and the unemployment rate fell by only 0.4 percentage points to 9.8 per cent. This was caused by the relatively steep

rise in the supply of labour as well as a halt in the growth in employment in the wholesale and retail trade as well as construction.

This year unemployment will fall more sharply than last year, with the unemployment rate dropping to 9 per cent. Next year the rate of decline will slow down, but the unemployment rate will nevertheless fall to 8.5 per cent. The unemployment rate among young persons aged 15-24 will reflect the large amount of full-time students. Without full-time students the unemployment rate of young persons (21 %) would have been half as high.

The number of long-term unemployed, i.e. persons without a job for over one year, has decreased faster than the corresponding number of total unemployed. Moreover, the duration of uninterrupted spells of unemployment that have come to an end last year fell to 18 weeks. The duration decreased by one week compared to the previous year. This year and next the share of long-term unemployed out of all unemployed (last year 28 per cent) will continue to fall owing to increased active labour policy measures directed toward the long-term unemployed. There will still be sizable differences between age groups with respect to the average duration of spells of unemployment that have come to an end and those that are still continuing.

### **Surplus in Public Finances Remains Wide**

The strengthening of public finances last year was exceptionally pronounced as the central government's budget started to run a surplus. The surplus amounted to about FIM 26 billion, which is exceptionally high. Tax revenues grew sharply while the rise in expenditures was modest. The financial position was also bolstered by privatisation and dividend income. Even though the central government's surplus last year is partly attributable to exceptional factors, the surplus will remain large also in the future, unless there is a major shift in the fiscal policy stance.

The easing of income taxation this year will decrease the central government's surplus somewhat compared to last year, but the surplus will nevertheless remain over FIM 20 billion. The stringent fiscal policy will mean that the central government's surplus will remain large also next year, even if taxation is slightly eased.

The favourable situation in central government finances will also enable the lowering of the state debt. The government has already and will probably use this

possibility also in the future. We believe the state debt will fall from last year's FIM 377 billion to below FIM 345 billion by the end of 2002. The state debt as a percentage of GDP will fall below 40 per cent at that time.

In the near future the financial position of the municipalities will improve on average, but the differences between the municipalities will remain wide. Last year the financial deficit of the local government turned into a small surplus, which is expected to grow somewhat this year and next. Since the financial position of the social security funds will remain exceptionally good, the financial position of the overall public sector will be very strong in the near future. This is likely to be reflected as a decline in the public sector's EMU debt.

The financial position of the public sector - especially the central government - was shored up by exceptional revenue-boosting factors. Of decisive importance for the improvement in the public sector's financial position, however, was the belt-tightening policy aimed at curbing growth in public expenditures. As a result of this policy, the ratio of public expenditures as a percentage of GDP has fallen in recent years. This trend will continue this year and next year (figure 6). The expenditures/GDP ratio will fall below its 1985 level.

The fiscal policy stance will be neutral in the near future from a cyclical perspective. The stance may be put to the test if the US recession turns into a prolonged depression. This is a possibility. If this happens, the fostering of growth by means of an expansionary fiscal policy would be justified.

## INTERNATIONAL ECONOMY

GDP growth , %	2000	2001f	2002f
Euro-11	3.5	2.5	2.3
Germany	3.1	2.1	2.0
France	3.3	2.5	2.3
Italy	2.8	2.3	2.5

Euro-15	3.4	2.5	2.4
Sweden	4.0	3.0	2.4
United Kingdom	3.0	2.4	2.6
United States	5.0	1.0	1.0
Japan	1.7	0.5	1.0
Russia	7.0	5.0	4.0

## DEMAND AND SUPPLY

	2000	2000	2001f	2002f
	Bill. FIM	Percentage change in volume, %		
Gross Domestic Product	785.1	5.7	4.1	3.0
Imports	254.2	12.8	7.0	4.0
Total supply	1039.2	7.4	4.9	3.2
Exports	333.3	17.7	8.0	4.0
Consumption	547.5	2.2	2.5	2.5
- private	386.2	3.0	3.0	3.0
- public	161.3	0.4	1.1	1.1
Investment	149.5	4.8	5.7	4.0
- private	128.4	5.7	6.5	4.3
- public	21.1	0.1	1.0	1.8

	8.9	-0.2	0.0	0.0
Change in stocks				
	1039.2	7.4	4.9	3.2
Total demand				

## KEY FORECASTS

	2000	2001f	2002f
Unemployment rate , %	9.8	9.0	8.5
Unemployed (1 000)	253	235	224
Employment rate , %	66.9	67.5	67.7
Employed (1 000)	2335	2378	2404
Inflation, consumer price index, %	3.4	2.4	1.8
Wages, index of wage and salary earnings, %	3.8	4.0	3.2
Real disposable income of households, %	-0.3	4.9	3.0
Current account surplus, Bill. FIM	60.7	72.5	77.8
Trade surplus, Bill. FIM	85.6	98.5	103.5
Central government financial surplus, Bill. FIM	25.7	23.8	25.2
% / GDP	3.3	2.8	2.8
General government financial surplus, Bill. FIM	52.5	52.1	55.0
% / GDP	6.7	6.2	6.2

EMU debt, % / GDP	44.0	39.9	36.9
Short-term interest rates (3-month Euribor)	4.4	4.3	4.0
Long-term interest rates (10-year gov't bonds)	5.5	5.1	5.0