

FORECAST

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Forecast 2003 - 2004

ONLY A SHORT WAR WILL FACILITATE ECONOMIC UPTURN

The war in Iraq is now under way. The already uncertain short-term outlook has become even more uncertain.

The length of the war will have a pivotal impact on international economic developments in the near future. Because international business trends shape Finland's economic outlook, the length of the war will affect developments in the Finnish economy.

The forecast of the Labour Institute for Economic Research is based on the assumption that the war will last a maximum of three months. This would enable an upswing in the international economy toward the end of this year. An improvement in international business trends could boost growth in Finland to two per cent. Economic growth of this magnitude would be sufficient to curb a rise in unemployment.

There is a lot of uncertainty related to economic developments next year as well. The ending of the war will reduce uncertainty in the United States and Europe, thereby bolstering economic growth also in Finland. The acceleration of growth would also prevent a rise in unemployment.

Even though the war in Iraq is the most important source of uncertainty shaping international business trends, it is by no means the only factor weighing heavy on economic growth and expectations. Already before the events of September 11, 2001 the international economy had been led into a recession by the United States. That is why even a short war will not guarantee a swift upturn in the international economy. Both the United States and the euro zone have special features that weaken the conditions for a strong recovery in the international economy. For this reason the economic outlook for the Finnish economy may remain cloudy despite a possible end to the war in Iraq.

There Will Be No Swift Recovery in the US

Economic growth in the United States was subject to

exceptionally volatile swings last year. After the terrorist attacks economic growth began to accelerate surprisingly quickly, but toward the end of the year it began to taper off. The upturn in growth in the first few months of the year turned out to be temporary, fuelled mainly rebuilding of inventories. Economic growth was driven largely by households. Even though the decline in stock prices eroded wealth, the low level of interest rates encouraged households to increase their consumption. Toward the end of the year the growing uncertainty stemming from the threat of war nevertheless began to dampen the rise in consumption. Growth was sustained also by public consumption.

During the beginning of this year the confidence of American consumers has weakened sharply, and in January private consumption declined for the first time in four months. In the near future the slowdown in private consumption and deteriorating employment will dominate economic trends. It is also worth pointing out that the recession during the Persian Gulf crisis in the early 1990s was consumer driven. Economic growth will be boosted by the increase in public expenditures, including military expenditures. The growth in public expenditures combined with an easing of taxation will weaken the already wide deficit in public finances in the near future. It will increase the downward pressure on the dollar and may before long raise long-term interest rates.

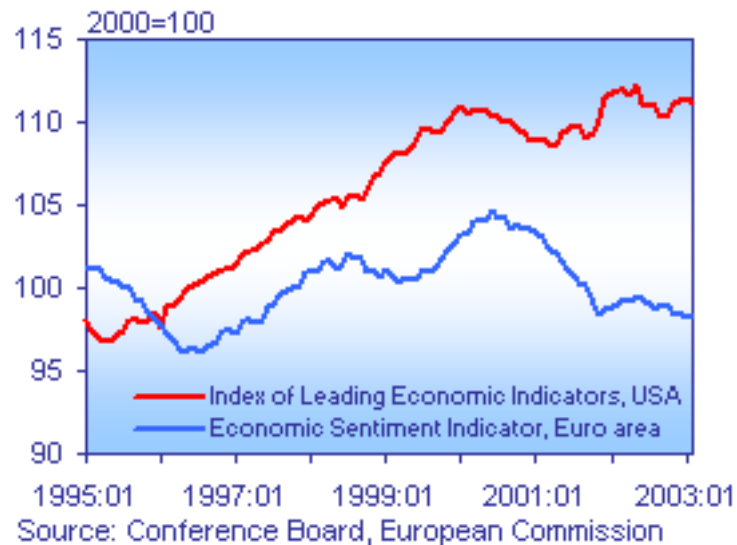
This year economic growth will slow down from that of last year and GDP will grow by 2 per cent. The abatement of the uncertainty stemming from the war will bolster the economic outlook for next year. GDP will increase by 2.7 per cent in 2004. The elimination of the uncertainty will not suffice to put the United States economy back on a fast-growth track. The debt problem of households will dampen growth prospects also after the war.

Core Euro-Zone Countries in Trouble

The economic outlook for the euro zone still looked relatively bright at the beginning of last year as exports to countries outside the euro zone climbed. As the year progressed the outlook nevertheless became gloomier and economic growth subsided. This led to a rise in unemployment. The threat of war has increased uncertainty also in the euro zone. At the beginning of this year consumer confidence has been lower than in many years, and the confidence of businesses has not encouraged investment. The economic difficulties of the euro zone have been exacerbated by the recession in the German economy. Exports have fostered economic

growth, but domestic factors, such as sluggish investment activity, have curbed output growth.

Figure 1. International economic indicators 1995:01 - 2003:02



The European Central Bank (ECB) has reacted to the recession by easing monetary policy. The decline in interest rates has nevertheless been modest, which is attributable to the divergent economic situation in various member countries and also the fact that inflation has remained over two per cent. The economic difficulties of the euro zone have been exacerbated by the marginal fiscal policy leeway in the largest euro zone countries whose deficits are near the ceiling stipulated by the stability and growth pact: Germany, France and Italy.

The economy will remain weak in Europe in the near future. The longer the war lasts, the longer this will postpone hopes of a recovery in the euro zone. A relatively short war will enable an economic turnaround already this year. Merely the unleashing of pent-up demand and investment would give a boost to the economy. Since we forecast that the war will end by the beginning of summer, we project that the economy of the euro zone will stage an upturn at the end of this year. We forecast that the ECB will continue to ease monetary policy, which will bolster the economic recovery. GDP will grow by an average of 1.1 per cent. Next year growth will accelerate to 2.1 per cent. There are nevertheless many factors of uncertainty related to the pick-up in growth. The main prerequisite for growth is that consumer and business confidence improve significantly.

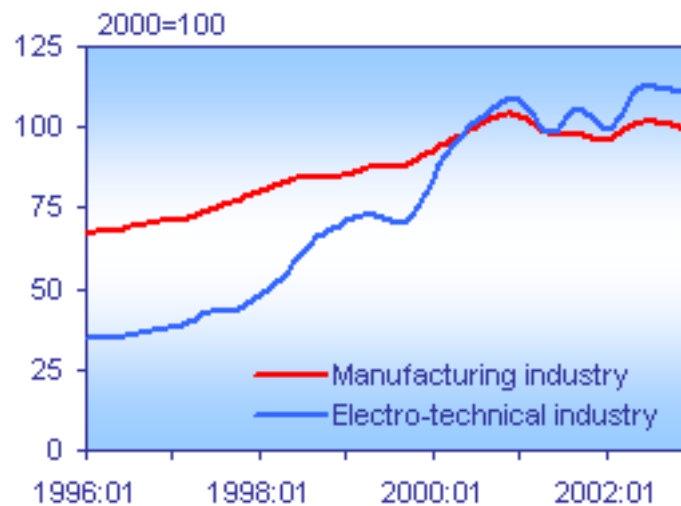
Despite the sluggish international economy, economic growth will remain relatively strong in Asia. Japan will continue to be plagued by difficulties and the economy's growth rate will nevertheless remain around zero.

War Curbs Growth in Finland too

In Finland the recession has continued for already 2 years. Last year GDP grew by 1.6 per cent, i.e. approximately the same as forecasters predicted in the beginning of last year. Growth was nevertheless strongly dependent on exports: the volume of exports grew by 5.6 per cent.

The brisk growth in the volume of exports nevertheless gives a deceptive picture of the growth of export revenues. The value of exports fell slightly, i.e. export prices fell appreciably. Export figures were dominated by trends in the electro-technical industry, where the volume of exports grew sharply, but where the cheapening of mobile phones contributed to a fall in export prices. It is also worth noting that Statistics Finland has had difficulties in breaking down the production and export value figures of the electro-technical industry into volume and price components. Exports nevertheless grew in the traditional manufacturing sectors, for example, the forest industry and the chemical industry. Finnish exports were fuelled by the continuation of relatively strong performance in our neighbouring countries. Even though exports to Germany slackened off, exports to Russia and Sweden, for example, grew relatively briskly.

Figure 2. Output in Manufacturing and Electrotechnical Industry 1996:01 - 2003:01



Source: Statistics Finland

In the near future, the most important phenomenon is that economic growth slowed down in the last few months of last year. This was reflected in a slowdown in the growth in industrial production. In January the volume of industrial production fell appreciably. This was not due to the electro-technical industry but rather the weakening of the export outlook in the traditional manufacturing industries dependent on international

economic developments.

International economic trends depend on how fast the growth rates for exports and total production turn out to be. We forecast that total production will grow this year by 2 per cent. This is possible only if uncertainty abates rather quickly and export demand is at least fairly strong. Export growth is bolstered by the fact that economic growth is faster in our neighbouring countries than in the euro zone and the United States. Next year the growth in exports will strengthen, which will boost growth in total production. We forecast that GDP will grow next year by 2.8 per cent. This kind of growth can be achieved if exports grow by about 5 per cent.

There are exceptionally many factors of uncertainty surrounding export developments, of which the length of the Iraq crisis is only one. Both the United States and the euro zone have factors weakening business trends that may make forecasts of a recovery in exports overly optimistic. The forecasts for export growth are misleading because according to our forecast export prices will continue to fall this year. As a consequence export revenues will continue to slide even if the volume of exports climbs.

This year one significant barrier to growth in total production is sluggish investment activity. Building investment will remain on last year's level. Dwelling construction will pick up slightly this year but construction of office and industrial space will continue to fall. Civil engineering investments will nevertheless grow due to new road and railway projects. General uncertainty and abundant idle production capacity in manufacturing are the main reasons that machinery and equipment investment will remain very low. All in all private investment will grow this year by slightly over one per cent. Public investment on the other hand will fall by about 5 per cent owing to the deteriorating economic outlook for municipalities. Next year investment activity will nevertheless pick up somewhat as among other things growth in dwelling construction strengthens. Sales of machinery and equipment will rise substantially from those of this year. Especially in the manufacturing sector, investment in machinery and equipment will require that growth-dampening uncertainty in the international economy subsides.

Consumption Continues to Grow

Last year the consumption expenditures of households increased by about 2 per cent. Growth followed trends in

purchasing power since households' disposable real income also increased by about 2 per cent.

The growth in consumption boosted sales especially of durable goods. This was attributable primarily to a rise in car sales. A reduction in taxes on imported used cars sparked a swift rise in car sales. The decline in the level of interest rates fuelled consumption and kept car sales brisk especially in the greater Helsinki area. The confidence of consumers in their own economic situation remained fairly stable. On the other hand, confidence in the prospects for the Finnish economy weakened substantially during the year even though this was not reflected in consumption figures. In contrast with the United States, the threat of war did not have any clear impact on Finnish consumer behaviour.

This year private consumption will grow by 2.2 per cent. Growth will follow trends in the growth of households' purchasing power. Sales of new cars will increase sharply owing to the lowering of taxes at the beginning of this year, which will trigger swift growth in demand for durable consumption goods. Falling interest rates will bolster consumption possibilities. Even though the crisis in Iraq has not had a negative impact on the consumption decisions of Finnish households, a prolongation of the war might at some stage begin to have an effect. If the war is fairly short, it will not have time to reduce consumption in Finland.

Also next year consumption will grow by approximately 2 per cent. Private consumption has recently functioned as a stabilizer of economic growth, which has prevented a weakening of employment in service sectors. In the near future it will continue to play a similar role.

Wage Trends Dictated by Pay Settlement

The purchasing power of households will grow by slightly over 2 per cent this year. The comprehensive incomes policy agreement signed last December will set the pace for wage increases this year and next. The average wages of employees will rise this year by 3.7 per cent. Contract wage increases accounted for about 3 percentage points of this. Wage drift will account for the remaining almost one percentage point. This year the significance of pay hikes as a source of purchasing power will be augmented because employment will weaken somewhat and income tax cuts will not generate any significant increase in workers' incomes.

We estimate that the average earnings of workers will

rise this year by 3.2 per cent. Contract wage increases will account for about 2.3 percentage points of this. The rise in earnings will be less than that of this year because the contract wage increases included in the comprehensive incomes policy agreement are lower than those for this year.

Figure 3. Labour Share in the Private Sector 1975 - 2004



The purchasing power of households is forecast to rise this year by about 2 per cent. The making of precise forecasts is hampered by the fact that decisions about taxation with consequences for purchasing power have not been made yet. The forecast does not include changes in taxation other than ordinary adjustments to the tax rates for inflation.

The economic recession that has continued during the last couple of years has weakened the average profitability of companies somewhat. Profitability has nevertheless remained good. Last year, wage earners' share of national income remained at about the same level as in the previous year. This year the share of wages will widen somewhat. This is attributable especially to the continued fall in export prices, which in turn slows down the rise in national income. Next year the recovery in exports will nevertheless reduce the share of wages further. In international comparisons Finnish companies have fared very well, and this is not expected to change in the near future.

Future Course of Inflation Unclear

Last year consumer prices rose by 1.6 per cent, i.e. less than on average in the euro zone. Inflation remained low, even though crude oil prices rose appreciably on international markets last year. Upward pressure on

import prices was nevertheless offset by the appreciation of the euro. In addition, the rate of increase in food prices levelled off after the steep increase of the previous year, and the fall in interest rates curbed the rise in the cost of living.

This year the development of international prices of crude oil is the main factor of uncertainty affecting price trends. If the war in Iraq is short, crude oil prices may begin to fall precipitously. This would slow the rise in prices especially in the latter half of this year. We forecast that consumer prices will rise this year by 1.8 per cent. We project that inflation will slow down substantially as the year progresses. The fall in interest rates will dampen the rise in consumer prices, and contribute to a decline in prices of new cars.

Next year inflation will be affected by one new factor: possible changes in taxes on alcohol and tobacco products. The increase in the import ceilings on alcoholic beverages and tobacco products at the beginning of next year and Estonia's joining the European Union also next year in May will force decision makers to think about how alcohol and tobacco should be taxed in Finland. If officials decide to lower taxes on alcoholic beverages and tobacco products significantly, this will reflect upon the average rate of inflation next year.

Since it is still unclear what officials will do - and what they should do - our inflation forecast does not take into account possible changes in taxes on alcoholic beverages and tobacco products. Even without this special phenomenon, inflation will be slightly lower next year than this year. We project that consumer prices will climb by 1.4 per cent.

Unemployment Will Rise Slightly

In light of the sluggish growth of total production, employment developments were surprisingly good last year. The number of employed persons rose by 5000 persons, and the employment rate remained at the same level as the previous year, i.e. 67.7 per cent. The number of wage earners grew by 8000 persons, but the number of entrepreneurs and relatives working in family-owned businesses fell by 3000 persons.

Employment trends have nevertheless been exceptionally divergent: employment has weakened clearly in industry but a rise in the number of jobs in the service sector has prevented a decline in the total number of employed persons. The employment

developments have also been marked by divergent trends in the employment of men and women. The sluggish growth in industrial production spawned a weakening of employment among men already toward the end of the year and a rise in their unemployment. The growth in the employment of women was nevertheless stronger than the fall in men's employment. Women were employed in private and public services. If we break the figures down by age groups, young persons showed the weakest employment trends.

This year the number of employed persons will remain at the same level as last year. The employment prospects in industrial sectors dependent on exports will be gloomy in the beginning of the year, which will be reflected in higher layoffs and dismissals. The weakest employment trends are in the metal industry. The weakening of labour demand in manufacturing will be offset by the continued growth in employment in the service sector, where jobs will be created in real estate and business services as well as public and other services. The improvement of employment in the construction sector will dampen the fall in men's employment.

Growth in the supply of labour slowed down last year to 0.2 per cent and 66.6 per cent of the working age population participated in the labour force. The supply of young persons will be the most likely to react to the cyclical situation, and the share of young persons in the work force will fall from that of the previous year. The labour force participation rates of men fell in both the 15-24 and 25-54 age brackets. This year the sluggishness of economic growth will continue to put a damper on the labour supply, which will grow by only 0.1 per cent, i.e. about 3000 persons. Next year the supply of labour is forecast to rise by about 0.4 per cent along with the improvement in the cyclical situation.

The unemployment rate remained last year at the same level as in 2001, i.e. 9.1 per cent. The unemployment rate of persons below 25 years of age nevertheless rose. The decline in women's employment and rise in men's employment offset one another last year. The slowdown in the growth of the supply of labour also had the effect that the unemployment rate did not begin to climb.

The number of long-term unemployed, i.e. those unemployed for over one year at a time, has decreased faster than total unemployment in the last few years. Last year the number of long-term unemployed decreased by almost 5000, so that at the end of the year they numbered about 76,000. Uninterrupted spells of unemployment came to an end after an average of 17

weeks last year, down from 18 weeks in the previous year. The average duration of unemployment spells that have not yet come to an end decreased by two weeks to 50 weeks last year.

**Figure 4. Labour Supply and Employment
1985 - 2004**



This year unemployment will start to rise slightly and the unemployment rate will climb to 9.2 per cent. The number of unemployed persons will average 241,000. The cyclical slowdown in the growth of the labour supply and an increase in the number of persons participating in active labour policy measures will curb the rise in unemployment. In particular, the number of persons participating in job training programmes has increased at the beginning of this year.

Next year unemployment will fall to 9.1 per cent along with the improvement in labour demand. There is nonetheless a great deal of uncertainty related to employment trends this year and next. Instability in the international economy may spur a steeper decline in employment this year than we forecast. If the international economy does not take off in the anticipated manner, the employment developments may be gloomier than we project. Even though employment trends have been unexpectedly favourable in the recent past, in the near future they may be unexpectedly bad.

Central Government Finances Remain Stable

The recession has dampened the growth of central government revenues. Despite this, the state of central government finances has remained strong. Last year the central government ran a surplus of EUR 2.4 billion, which was more than forecast a year ago, for example, by the Ministry of Finance or the Labour Institute for

Economic Research. The surplus was only slightly less than that of the previous year. Tax revenues were higher than forecast with respect to corporate, car and energy taxes, among others.

The strong fiscal position of the central government is the main reason why public sector finances as a whole have remained in excellent shape. Several euro zone countries are struggling with deficits. In Finland the surplus for the entire public sector last year was EUR 6.6 billion, i.e. 4.7 per cent of GDP.

Owing to the relatively slow economic growth, the central government's surplus will continue to shrink. For example, corporate tax revenues will decline substantially. The central government will nevertheless continue to run a surplus of about EUR 800 million, i.e. 0.5 per cent of GDP.

Many significant tax decisions affecting central government finances next year have not been made yet. It is possible the taxation will change with respect to both direct and indirect taxation. The pressures to change taxation of alcoholic beverages and tobacco products make it difficult to project growth in tax revenues. On the other hand, the liberalization of imports will reduce tax revenues by a few billion euro even if the tax rates are not changed.

Because the tax policy of the new government is not yet known, our forecast does not include tax changes except for inflationary adjustments of earned income taxation. This kind of assumption of unchanged taxation means that the central government's surplus will continue to shrink. The central government will nevertheless continue to run a surplus.

The decline in the central government's surplus will trim the surplus of the overall public sector. This does not pose a threat to Finland's position of having the largest public sector surplus of any countries in the euro zone.

Economic Policy Must Support Employment

In the best case scenario the rise in unemployment will be a short-lived phenomenon. Despite this, traditional counter-cyclical actions should be taken to bolster employment. Already during the spring the central government should draw up a supplementary budget to foster employment by moving up the timetables for public purchases.

Even though employment may improve already during next year, the upswing will not necessarily help the situation of the hardcore unemployed who are the worst off. Most of these people are long-term unemployed. The new government should focus special attention on alleviating the situation of these people. The employment possibilities of the hardcore unemployed can best be promoted by active labour policy measures: subsidised employment and education. The measures should nevertheless better take into consideration the individual situations of unemployed persons.

In the recent public debate on economic policy, special attention has been placed on the significance of taxation in fostering employment. Decisions on taxation are indeed important because they will have a considerable impact on the central government's tax revenues over the next few years. When discussing tax decisions one should keep in mind that we are simultaneously talking about the size of the public sector. On the other hand, when we talk about expenditures we take a stand also on the leeway to ease taxation.

One of the tasks of the new government should be to reduce the shortcomings in services of importance for people's basic welfare, especially health services. This would create the most jobs. The more important we regard the elimination of these shortcomings, the less room there is for easing taxation of earned income, for instance.

The new government will have to make its tax and spending decisions under more difficult conditions than previously. The government will have to take a stand on an issue related to EU harmonization that is of crucial importance for central government finances, i.e. taxation of alcoholic beverages and tobacco products. Because the taxation of alcoholic beverages and tobacco products is a significant source of tax revenues, the government should be very cautious in cutting taxes.

INTERNATIONAL ECONOMY

GDP growth , %	2002	2003f	2004f
United States	2.4	2.0	2.7
Euro-11	0.7	1.1	2.1

Germany	0.2	0.4	1.5
France	1.0	1.4	2.4
Italy	0.3	1.2	2.0
Euro-15	0.9	1.3	2.2
Sweden	1.7	2.2	3.0
United Kingdom	1.5	2.0	2.8
Japan	-0.7	0.5	1.0
Russia	4.4	4.0	5.0
Source: BEA, IMF, OECD, Labour Institute for Economic Research			

DEMAND AND SUPPLY

	2002	2002	2003f	2004f
	Bill. €	Percentage change in volume, %		
Gross Domestic Product	139.7	1.6	2.0	2.8
Imports	42.2	1.7	2.0	4.0
Total supply	181.9	1.7	2.0	3.1
Exports	53.3	5.6	2.6	5.0
Consumption	100.5	2.7	2.1	1.9
- private	70.3	2.1	2.2	2.0
- public	30.1	4.0	1.7	1.6

Investment	27.8	-1.0	0.5	3.1
- private	23.9	-2.2	1.4	3.7
- public	3.9	7.0	-4.7	-1.3
Change in stocks	0.3	-1.4	0.0	0.0
Total demand	181.9	1.7	2.0	3.1
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2002	2003f	2004f
Unemployment rate , %	9.1	9.2	9.1
Unemployed (1 000)	237	241	240
Employment rate , %	67.7	67.5	67.7
Employed (1 000)	2372	2372	2383
Inflation, consumer price index, %	1.6	1.8	1.4
Wages, index of wage and salary earnings, %	3.3	3.7	3.2
Real disposable income of households, %	2.1	2.0	2.1
Current account surplus, Bill. €	10.0	9.1	9.7
Trade surplus, Bill. €	13.9	12.5	13.1
Central government financial surplus, Bill. €	2.4	0.8	0.5

% / GDP	1.7	0.5	0.3
General government financial surplus, Bill. €	6.6	4.3	3.7
% / GDP	4.7	3.0	2.5
EMU debt, % / GDP	42.7	42.3	41.6
Short-term interest rates (3-month Euribor)	3.3	2.4	2.7
Long-term interest rates (10-year gov't bonds)	5.0	3.9	4.5
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			