FORECAST MARCH 22, 2005

[GLOBAL ECONOMY – COMPETITIVENESS OF NEW COUNTRIES]()

Additional information:

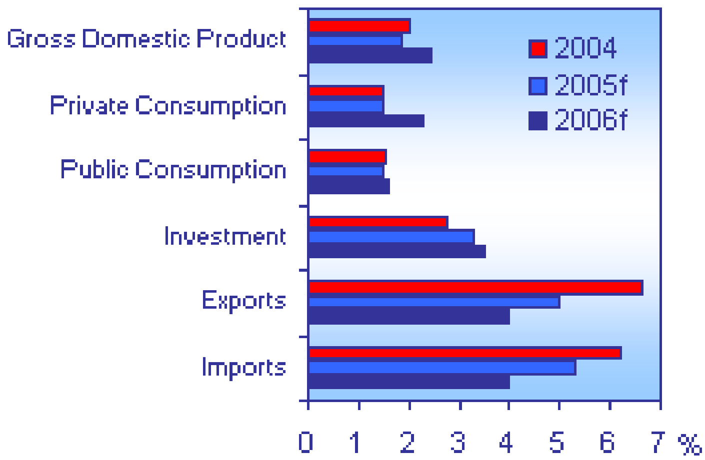
Chief of forecasting
Eero Lehto
Tel. 358-9-2535 7350
e-mail:
Eero.Lehto@labour.fi

Information officer
Heikki Taimio
Tel. 358-9-2535 7349
e-mail:
Heikki.Taimio@labour.fi

Economic forecast for 2005 - 2006
ECONOMIC GROWTH SUSTAINED BY UPSWING IN EXPORTS

The growth rate of production accelerated in the latter half of last year so that Finland's GDP grew for the year as a whole by 3.7 per cent, i.e. 0.4 percentage points higher than forecast by the Labour Institute for Economic Research in August. The growth of exports in particular was surprisingly brisk. Both this year and next exports and industries depending heavily on exports will continue to grow quickly. Economic growth will be fuelled also by private investment. Growth in the world economy will continue to be swift, but it will gradually slow down in the future. Next year the acceleration of growth in Europe will nevertheless compensate for the impact of the slowdown in growth elsewhere on our foreign trade. Owing to the moderate wage settlement and less pronounced tax cuts than previously, households' disposable income will increase more slowly than in previous years, which will curb the growth in private consumption this year and next. Tax cuts will limit the possibilities to increase public expenditures. Despite the slowdown in consumption growth, GDP will grow this year by 3.6 per cent and next year by 3.3 per cent. Our GDP forecast for this year is the same as it was last August.

Figure 1. Economic Growth of Eurozone



Sources: Eurostat, Labour Institute for Economic Research

Eurozone growth will accelerate next year

The GDP of the eurozone grew last year by 2 per cent. Export growth started to slacken toward the end of last year while imports and domestic demand began to strengthen. The contribution from domestic demand nevertheless remained rather modest. The slowdown in economic growth in the US and Asia as well as the appreciation of the euro against the dollar will retard the growth of exports in the eurozone also this year and next. GDP will grow in the eurozone by 1.9 per cent this year. The pronounced acceleration of growth to 2.5 per cent next year will be driven primarily by a pick-up in private consumption.

The development in different countries within the eurozone has been marked by divergent trends. While the economic growth of the small countries and France has been boosted by domestic demand, growth in Germany has been propelled almost entirely by exports. The explanations given by German experts regarding the slowdown in growth and the content of economic policy have begun to diverge. Increasing attention is being focused on the phenomenon that concerns about cost levels, which have even reduced manufacturing unit labour costs in contrast with trends elsewhere in Europe, have eroded household purchasing power and thereby dampened the possibilities for economic growth based on a rise in employment. The public debate on economic policy has simultaneously weakened household confidence, which has curbed domestic demand. The problems with a policy based on bolstering price competitiveness have been exacerbated by the fact that successful export performance, which increases Germany's trade surplus with the US, tends to raise the value of the euro against the dollar, thereby mitigating the impact of lower costs on competitiveness.

The EU countries outside the eurozone, which includes the EU's new members as well as the United Kingdom, Sweden and Denmark, have grown considerably faster than the eurozone. From Finland's standpoint, it is important that Sweden's economic growth remain relatively fast, around 3 per cent per annum.

Slowdown in private consumption curbing US growth

GDP grew in the US by 4.4 per cent last year. This year growth will slow down to 3.7 per cent. The slowdown is attributable to the slackening of private and public consumption. The strong growth of private investment will not be enough to offset this trend. The weakening of the dollar against the euro has also increased the competitiveness of the US vis-à-vis Europe. The weakening of the dollar against the euro is nevertheless not sufficient to erode the US trade deficit, since exchange rates across most of Asia hinge upon the dollar. The weakening of households' financial position in tandem with rising interest rates will dampen private consumption also next year. Economic growth will subside to 3.3 per cent. The slowdown in growth will nevertheless occur in a controlled fashion. The improvement in employment will sustain consumer confidence and the twin trade and public sector deficits will not lead to such a steep rise in interest rates that economic growth would be curtailed completely.

Japan's growth continues to slow down

Japan's GDP grew swiftly in the first quarter of last year. After that growth stagnated and GDP even contracted in the last three quarters of last year. Growth for last year as a whole was probably 3 per cent. The growth prospects for this year are weaker than previously. Even though export growth will accelerate, anaemic consumer confidence does not indicate that private consumption will pick up significantly. Japan's GDP will grow this year by 1.5 per cent, accelerating to 2 per cent next year.

High oil prices will sustain favourable conditions for growth in Russia

Russia's GDP grew by 7.1 per cent in 2004 according to preliminary figures of the country's statistics centre. The rise in oil prices fuelled a rise in the value of Russia's exports by 34 per cent. At the same time imports grew swiftly, by about 26 per cent compared to the previous year. The value of imports was only 52 per cent of the value of exports. Strong foreign trade has also strengthened the financial position of the public sector and its possibilities to support investments in the infrastructure and public services. High oil prices will sustain the favourable conditions for a continuation of rapid growth and allow the central government to carry out its plans to bolster the infrastructure with a sizable investment program. We forecast that Russia's economy will grow this year by 6.5 per cent and next year by 0.5 percentage points less.

China's investment rate is declining

China's GDP grew last year by 9.5 per cent compared to the previous year. Growth in private investment by 26 per cent boosted the share of investments out of total production close to 45 per cent. The investment rate has indeed risen almost continuously since 1990 at the expense of household consumption's share of national income. The growth rate of investment will be dampened significantly already this year by governmental decisions and by rising interest rates. As investments slow down the rate of GDP growth will decline to 8.5 per cent this year and 7.5 per cent next year. Despite its high investment rate China has still been able to run a slight trade surplus. This is indicative of the exceptionally strong competitiveness. China's currency is generally regarded as being 10-30 per cent overvalued, depending on the way of making the estimate. In practice, China's currency, the renminbi, has been pegged to the dollar since 1994 within a very narrow fluctuation band. It appears that the most aggressive phase of economic growth, which has been marked by a high investment ratio and strong foreign trade competitiveness, is coming to an end. The raising of interest rates will not dampen the growth in private and public consumption. Growth in private consumption will not suffice to offset the impact of a slowdown in investment on aggregate production.

Interest rate differential between US and Europe widening

The US Federal Reserve has set an unofficial goal for itself that core inflation will remain within a range of 1.5-1.75 per cent. As the focus shifts to restraining inflation, the Fed's relatively optimistic economic outlook and clear hints that interest rates will be raised also in the future, mean that the Federal Reserve will continue to raise rates. The Federal funds rate was raised in January to 2.5 per cent and it appears that it will be 4 per cent already by the end of the year.

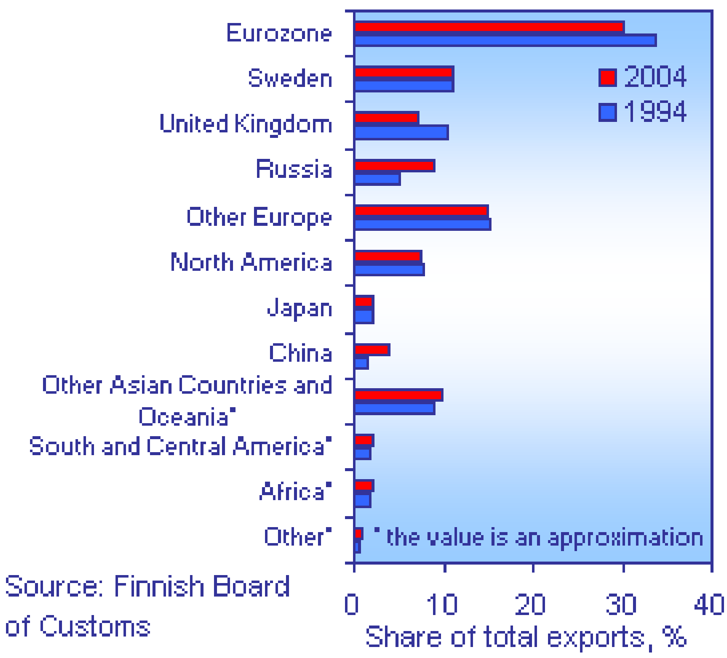
Owing to the impact of rising oil prices, consumer prices in the eurozone were 2.4 per cent higher at the end of last year than a year ago. In January consumer price inflation nevertheless slowed down to 1.9 per cent. In February inflation picked up slightly again due to climbing energy prices. The rate of inflation will nevertheless be in line with the ECB's target of 2 per cent as crude oil prices fall back below USD 50 per barrel.

According to ECB analysis, sluggish economic growth and moderate wage hikes will keep inflation tolerably low and there are no factors putting upward pressure on non-oil prices that in the next few months would endanger the price stability required by monetary policy. The pick-up in economic growth in the latter half of the year will occur in a controlled fashion, thereby safeguarding the fulfilment of the price stability goals. Our interest rate forecast is based on the premise that the ECB will not raise interest rates for a comparatively long time. It will refrain from acting until towards the end of the year, when it raises rates by 0.25 percentage points. Next year interest rates will be raised already more swiftly. On average interest rates will be 0.6 percentage points higher next year than this year. The widening of the gap between US and European interest rates will reduce the tendency of the euro to appreciate against the dollar, triggered by the US current account deficit.

The euro has appreciated against the dollar by some 8 per cent during the last year. At the same time the main Asian currencies – the Chinese renminbi and Japanese yen – have followed the exchange rate of the dollar. In order to curb the overheating of the economy, China is anticipated to loosen its peg against the dollar. It may allow the renminbi to move within a wider fluctuation band. Exchange rate policy will probably be revamped to allow this already next year.

After this the currencies of other East Asian countries will also be unpegged from the dollar. The Japanese central bank will be able to loosen its peg to the dollar brought about in the form of currency intervention. This will weaken the dollar relative to Asian countries and strengthen the possibilities of the US to narrow its trade deficit with these countries. The upward pressure on the euro may abate when the Asian countries' currencies are allowed to appreciate. The strengthening of the euro relative to the dollar will no longer weaken the price competitiveness of the eurozone to such an extent as before.

Figure 2. Structure of Finnish Exports in 1994 and 2004



Exports of main industrial sectors performing well

The volume of Finnish exports grew last year by 3.5 per cent compared to the previous year. Exports of goods grew especially outside of the eurozone, to Russia and China. During the last decade the significance of China and Russia as markets for Finnish exports has increased primarily at the expense of the eurozone.

Sweden has become Finland's most important export partner as exports to Germany have fallen. Last year exports to the EU region remained unchanged on average, but they began to rebound sharply toward the end of the year. Growth in exports to these countries was fuelled especially by the strong performance of the electronics industry.

All in all Finland's export outlook is bright at the moment, even though the appreciation of the euro dampens Finland's export prospects. This year's exports will be significantly higher compared to last year's average, even though growth during this year will be comparatively sluggish. The exports of all main sectors of the technological industries as well as the forest industry and chemical industry are growing. This year inventories will be boosted by trends in shipbuilding. This year exports will be curbed by the low number of ships completed and ready for delivery while next year exports will be boosted considerably by ship deliveries. Exports will continue to grow faster outside Europe this year but next year the significance of the export demand of the euro countries will increase appreciably. We forecast that the export volume of goods and services will grow this year by 5 per cent and next year by 5.3 per cent.

Imports grew sharply toward the end of last year, as a result of which the import volume of goods and services grew by as much as 6 per cent last year. Part of this sizeable growth in imports went to stockpiling of inventories, which grew more than forecast last year. This year the volume of imports will grow by 4 per cent, in line with export trends and the still relatively swift growth of investment. Next year imports will grow by 3.4 per cent.

Terms of trade still weakening, but trade surplus growing

The increase in prices of oil and other raw materials will raise prices of import goods this year. Even though crude oil prices fell appreciably below USD 50 per barrel toward the end of last year, total import prices will be 2.6 per cent higher on average this year than last year. The terms of trade will weaken this year as export prices for goods and services will rise by only 1.3 per cent compared to last year. The export prices of forest industry products and metal products will rise, but like last year the fall in the export prices of the electronics industry will dampen the overall increase in export prices. Next year the terms of trade will weaken only slightly as the slowdown in the growth of the global economy begins to dampen the rise in prices of raw materials.

Owing to the comparatively swift growth of exports, the trade surplus will grow by EUR 0.5 billion this year and next year already by EUR 1.5 billion, as import growth subsides relative to exports. The surplus in the current account will be marked by similar trends, as no great changes are expected in the deficit in the balance of compensation for factors of production.

Large projects boost investment ratio

Investment started to rise last year after falling for a couple of years. The growth of investment was fuelled by robust residential housing construction and civil engineering as well as a pronounced upswing in machinery and equipment investment. All in all investment rose by 4.6 per cent and the investment ratio climbed by 19 per cent. The investment ratio nevertheless remained at a low level. The highest growth was witnessed in machinery and equipment (9.5 %) and residential housing investment (8 %).

Even though residential housing construction will continue to be brisk this year, the growth rate will nevertheless slow down from that of last year. Several large construction projects, such as the Vuosaari harbour project and the Olkiluoto nuclear power plant, will boost non-residential building construction. Machinery and equipment investment will continue to grow this year owing among other things to manufacturing industry investments and the new nuclear power plant. Investment will grow this year by 4.7 per cent. Next year investment is projected to climb by 3.7 per cent.

Purchasing power growing steadily, spurring continuation of consumption growth

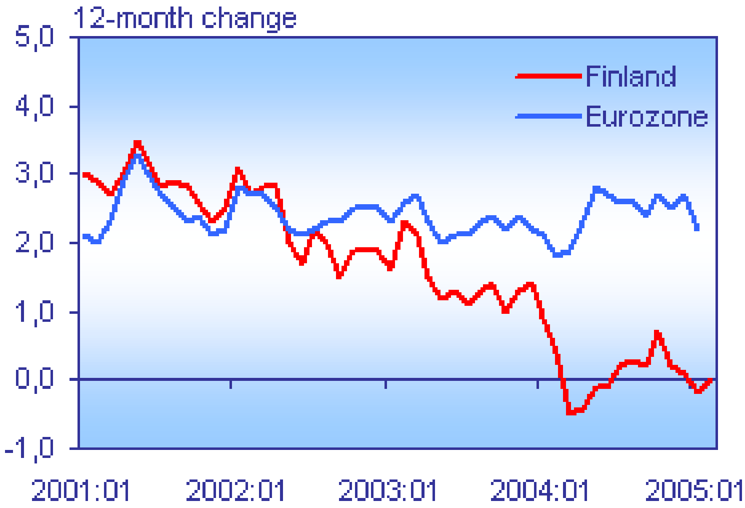
The main trends in earnings development during the forecast period will be determined by the current comprehensive incomes policy settlement. For this reason the growth in purchasing power will be steady and easy to forecast. This year the level of earnings will rise by 3.5 per cent and in the year 2006 correspondingly by 2.6 per cent. Over one percentage point of this year's rise is attributable to wage drift and the effect of wage growth trends carried over from one year to the next. Next year the impact of wage hikes will diminish but the rise in employees' purchasing power will be bolstered by tax cuts. The tax rate of wage earners will thus fall by 0.7 per cent. We forecast that the purchasing power of employees will grow in both years by 2 per cent. The wage bill will grow faster than average wages as the number of hours worked per employee rises.

The income of households continued to rise swiftly in 2004. In nominal terms disposable income grew by 5.5. per cent and in real terms by 4.5 per cent. The rapid growth of property income, especially dividends, was affected by capital and corporate tax reforms. Last year the favourable income development was not reflected in consumption growth, but rather part of it was channelled toward the housing market. There was also an intermittent rise in the savings ratio.

In the forecast period the real income of households is expected to grow steadily, but somewhat more slowly than last year. As the desire to pay dividends decreases we forecast that property income will fall slightly in 2005. The interest expenses of households will start to rise substantially. This is largely the result of the rise in outstanding debt, since interest rates are no longer falling, which means that interest expenses will no longer decline.

Incomes developments will give a possibility for steady growth in private consumption, over 2.5 per cent growth. Our forecast is somewhat higher than the long-term average consumption growth. The growth in consumption is spurred by balanced economic growth and strong consumer confidence. As regards the structure of consumption a significant development is the stabilisation of car sales as the strongest pent-up demand was unleashed already in 2003. For this reason purchases of durable goods will grow this year more slowly as expenditures are focused on household appliances and furniture. In addition we forecast that demand for services will grow faster during the forecast period than private demand on average. The rise in the savings ratio witnessed last year will only be temporary as more property income is used for consumption than in recent years.

Figure 3. Harmonized Index of Consumer Prices



Sources: ECB, Statistics Finland

Inflation rate remaining below that of eurozone

Last year consumer price inflation remained exceptionally low, 0.2 per cent. The main reason for this was a reduction in alcohol taxes. As a consequence there were divergent trends in the purchasing power of various consumer groups and their impression of the rate of inflation. The impact of the tax cut will be over in March and inflation measured at an annual level will accelerate accordingly. Even though crude oil prices are now exceptionally high and may even rise further intermittently, we forecast that consumer prices will rise by only one per cent in 2005. There are no new factors putting upward pressure on prices in the foreseeable future. Inflation will remain appreciably lower in Finland than in the rest of the eurozone. This has been the case for a couple of years already.

Next year inflation will be 1.3 per cent, and the rate of inflation is not anticipated to change after the end of 2005. Thus the gap in inflation compared to the eurozone will shrink somewhat but Finland's inflation will still remain at a lower level.

Employment rising

The recovery of economic growth provided a boost to employment in the latter half of last year. Last year the average number of employed persons was approximately the same as in 2003, but the ranks of the employed rose by three thousand during the year. Employment weakened the most in manufacturing, where the average number of employees was 10 thousand less than in 2003. In contrast, thanks to domestic demand the number of employed persons climbed appreciably in public and other services as well as in retail trade. The employment rate, 67.2 %, was a tenth a percentage point lower than in 2003. The pick-up in economic growth was reflected not so much in the number of employed persons but rather in the number of hours worked as workers' man-hours climbed by over one per cent.

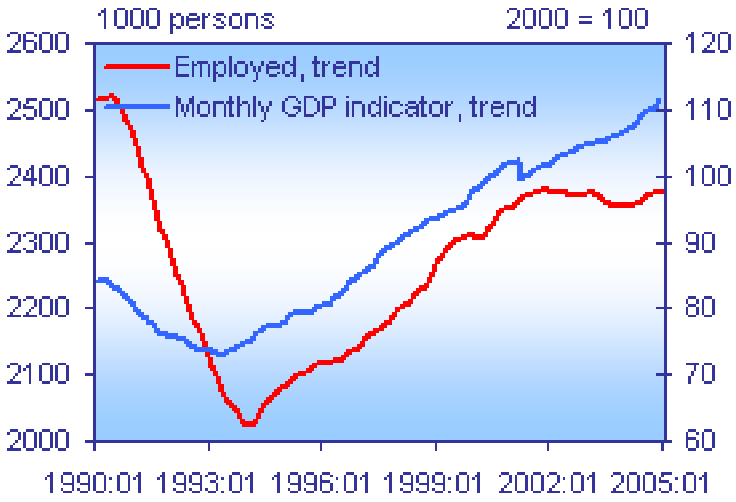
As a consequence of the favourable economic growth, the demand for labour will continue to grow after experiencing an upswing toward the end of last year. As in previous years the growth in the demand for labour is mainly driven by the service sector. The most significant growth in the number of employed persons is in public and other services as well as real estate and business services, the trend in the latter of which reflects favourable developments in industrial production. Employment in construction will start to rise, especially as a result of the construction of the new nuclear power plant. The forecast for the number of construction workers is made difficult by the fact that the labour force rented from abroad might be excluded from the labour force figures compiled by Statistics Finland. Employment will grow by a total of 20 thousand persons this year and 17 thousand next year.

The supply of labour rather closely reflects trends in the demand for labour. As the demand for labour started to rise in the latter half of last year, the supply of labour also began to climb appreciably. Owing to these trends toward the end of the year, the labour force fell for the year as a whole by only 6 thousand. Labour force participation rates declined the most with respect to young persons. This year the supply of labour will continue to grow by 0.6 per cent. The labour force participation rate will rise to 66.1 per cent. Next year the labour force participation rate is projected to climb to 66.3 per cent.

Even though the number of employed persons did not grow at all last year compared to the previous year, the number of unemployed persons fell by 6 thousand and the rate of unemployment fell to 8.8 per cent. This development is attributable to the fact that weak employment trends in the first half of 2004 triggered a decline in the number of persons belonging to the labour force. In terms of age groups, the unemployment rate rose slightly only for persons of prime working age. This year the number of unemployed persons will decline along with the improvement in employment and the unemployment rate will fall to 8.6 per cent. Next year the unemployment rate is forecast to fall to 8.3 per cent.

The slowdown in economic growth and improvement in employment in the early 2000s have curbed the decline in the number of long-term unemployed. Until last year the number of long-term unemployed persons (i.e. unemployed for more than one year) has nevertheless continued to fall. Last year long-term unemployment rose slightly compared to 2003. The average duration of completed spells of employment remained at the same level as in 2003, i.e. 16 weeks. The older the age group of the unemployed persons in question, the longer the duration of unemployment spells. The average duration of ongoing spells of unemployment fell from 47 weeks to 46 weeks.

Figure 4. Production and Employment



Source: Statistics Finland

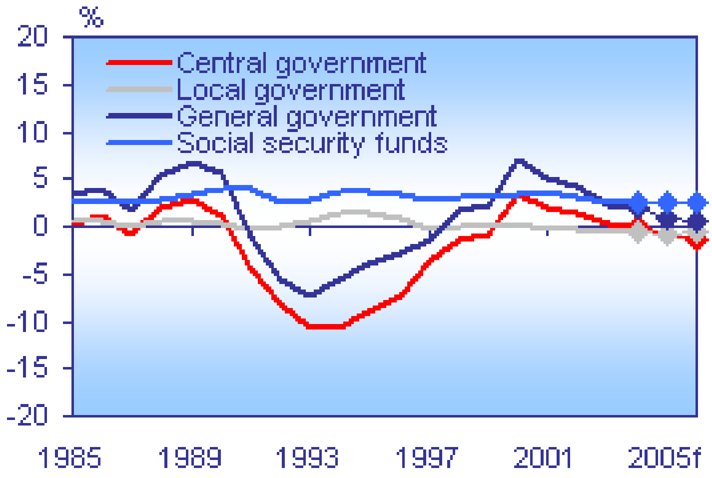
Central government running a deficit

The net lending of the central government decreased last year less than expected, only EUR 235 million, owing primarily to a slowdown in the growth of income taxes and dividend income and a slackening of consumption expenditures. The central government ran a slight surplus. In contrast, the fiscal deficit of the municipalities widened to over EUR 500 million. Owing to tax cuts, municipal tax revenues rose by only 0.7 per cent while municipal expenditures increased by 6.4 per cent. While the net lending of the pension institutions and other social security funds remained at the same level as the previous year, the net lending of the overall general government (EMU surplus) decreased appreciably. As a percentage of GDP the surplus declined from 2.5 per cent to 2.1 per cent. Of the EU countries only the general government of Estonia has a higher surplus. The combined general government surplus (EMU debt) as a percentage of GDP fell by 0.2 percentage points.

This year the central government will run a deficit of about EUR 1.2 billion. The weakening of central government's financial position is attributable largely to the easing of income taxes. The taxation of earned income has been eased by inflationary adjustments as well as changes in the tax schedules. Revenues from capital income and corporate taxes will be dampened by tax reforms and cuts in the central government's corporate taxes in favour of municipalities. The wealth tax has also undergone reforms and revenues from the wealth tax will decrease. Central government revenues and wealth tax will fall by about EUR 150 million. The central government's finances will be weakened also by a decline in alcohol taxes and dividend tax. At the same time the central government's revenue sharing with the municipalities grew by about 7 per cent. This improves municipal finances, as does the raising of average municipal tax rates by 0.18 percentage points. On the other hand, the municipalities' consumption expenditures will continue to grow strongly owing to the obligations of the Public Health Programme so that their net borrowing will increase somewhat. The surplus of pension institutions and other social security funds will grow this year by EUR 200 million as certain payment rates are raised slightly. The net lending of the overall general government relative to GDP will fall by one percentage point. A decline in central government tax revenues will lead to a drop in the ratio of total taxes as a percentage of GDP by 0.9 percentage points.

In 2006 the budget deficit of the central government will climb to slightly more than EUR 2 billion. Despite a clear rise in corporate tax revenues, income and wealth tax revenues will fall by slightly more than one per cent as wealth tax is eliminated completely and cuts in earned income tax are implemented only with respect to central government taxes. The amount of money earmarked for revenue sharing and social security funds will continue to increase appreciably. The budget deficit of the municipalities will shrink by slightly more than EUR 300 million as their tax revenues grow strongly. In the forecast it is estimated that municipal taxes will be raised by 0.2 percentage points and the raising of the upper limit on real estate tax rates will generate more real estate tax revenues. The revenues of pension institutions and other social security funds are expected to grow by 4.5 per cent. The surplus of the pension institutions and other social security funds will grow appreciably. This trend in combination with the improvement in the financial position of the municipalities will mean that the EMU surplus will almost stop decreasing. EMU debt as a percentage of GDP will fall by 0.6 per cent and the ratio of total taxes to GDP will decrease slightly.

Figure 5. Net Lending as a Share of GDP 1985 - 2006



Sources: Statistics Finland, Labour Institute for Economic Research

Structure of unemployment still causing problems

The favourable economic developments are boosting employment, but unemployment is still high and therefore actions to foster employment are still necessary. Unemployment has recently risen especially with respect to those working in technical professions and business administration fields.

The government's actions on long-term unemployment include a reform of labour market support. As a part of the reform, the rights to receive compensation are changed with respect to those who have received labour market support for 500 days (or 180 days after the maximum duration of unemployment allowance). The reform includes an activation guarantee, i.e. an active period is arranged for unemployed persons during which time services and active labour policy measures are increased. The aim is to increase active measures directed toward persons unemployed for very long periods of time. The reforms are expected to increase the number of persons participating in active programs from 20 thousand to 30 thousand, i.e. from an activation rate of 20 per cent to 30 per cent. The costs will be divided between the municipalities and the central government. The reform is intended to be carried out in a cost neutral fashion from the standpoint of the municipalities as a whole. The measures required by the program can be seen as a last resort to employ a person who has been unemployed for a prolonged time. All in all, the activation of unemployed persons nevertheless gets better results when it is focused on persons who have been unemployed for a relatively short spell of time.

Unemployment is still higher among relatively poorly educated persons. Additional actions are needed to spur demand for labour among this group. Employment can be promoted by changing the structure of taxation. This could be done by reducing income taxation or selectively lower employers' contributions with respect to low wage jobs without spawning a significant decline in tax revenues. Favourable employment effects could also be generated by lowering the value added tax on services. The government may earmark EUR 150-200 million in 2006 for strengthening labour demand in low-wage, full-time jobs. The implementation of low-wage support by, for example, reducing the employers' national pension contributions in the first payment bracket would tend to promote employment in labour-intensive sectors, but not so much that it would give reason to change our employment forecast.

Fiscal policy has been expansionary

The central government will run a deficit exceeding EUR 1 billion this year. Next year the deficit will grow. In 2005-2006 fiscal policy will bolster economic activity by spurring an increase in households' purchasing power and by strengthening the finances of municipalities. The same trend prevailed already last year. Now it is nevertheless apparent that the shortfall in tax revenues will limit the growth in public expenditures in the future and thus have a negative impact on aggregate employment.

The municipalities are heading on a path towards structural imbalance. Even though the revenues of the municipalities have developed relatively well, their expenditures have generally grown even faster and more than forecast. In order to stabilise municipal finances the comprehensive planning of basic services and ways in which negotiations between the central government and municipalities are carried out must be made more efficient. This would require that in the ministries responsible for assorted sectors the planning of basic services, revenue sharing and municipal income must be better matched with the expenditures related to provision of obligatory basic services as well as development of productivity in public services.

All in all, the public sector can no longer bear significant tax cuts. It is necessary to maintain a strong tax base in order to avoid a situation where the financial problems of the municipalities are solved by cutting back on expenditures and sharply reducing employment.

INTERNATIONAL ECONOMY

GDP growth , %	2004	2005f	2006f
United States	4.4	3.7	3.3
Euro-12	2.0	1.9	2.5
Germany	1.7	1.4	2.1
France	2.4	2.4	2.8
Italy	1.3	1.2	2.1
EU 25	2.3	2.1	2.6
Sweden	3.7	3.2	3.0
United Kingdom	3.1	2.5	2.6
Japan	4.2	1.5	2.0
Russia	7.1	6.5	6.0
China	9.5	8.5	7.5

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

DEMAND AND SUPPLY

	2004	2004	2005f	2006f
	Bill. €	Percentage change in volume, %		
Gross Domestic Product	149.7	3.7	3.6	3.3
Imports	47.2	4.8	4.0	3.4
Total supply	196.9	3.9	3.7	3.3
Exports	55.6	3.5	5.0	5.3
Consumption	111.0	2.9	2.6	2.4
- private	77.4	3.2	2.8	2.6
- public	33.5	2.1	2.0	1.8
Investment	27.9	4.6	4.7	3.7
- private	23.6	5.7	5.5	4.5
- public	4.3	-1.1	0.0	-0.9
Change in stocks	2.5	0.6	0.1	-0.2
Total demand	196.9	3.9	3.7	3.3
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2004	2005f	2006f
Unemployment rate , %	8.8	8.6	8.3

Unemployed (1 000)	229	223	216
Employed (1 000)	2365	2385	2402
Employment rate , %	67.2	67.7	68.1
Inflation, consumer price index, %	0.2	1.0	1.3
Wages, index of wage and salary earnings, %	3.4	3.5	2.6
Real disposable income of households, %	4.5	2.7	2.4
Current account surplus, Bill. €	6.3	6.6	7.8
Trade surplus, Bill. €	10.8	11.4	12.9
Central government financial surplus, Bill. €	0.2	-1.2	-2.4
% / GDP	0.1	-0.8	-1.4
General government financial surplus, Bill. €	2.8	1.5	1.1
% / GDP	1.9	0.9	0.7
EMU debt, % / GDP	45.1	44.7	44.1
Tax rate, %	44.1	43.2	42.8
Short-term interest rates (3-month Euribor)	2.1	2.2	2.8
Long-term interest rates (10-year gov't bonds)	4.1	3.9	4.8
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			

FORECAST MARCH 22, 2005

FORECAST 2005 - 2006

Additional information:

Chief of forecasting
Eero Lehto
Tel. 358-9-2535 7350
e-mail:
Eero.Lehto@labour.fi

Information officer
Heikki Taimio
Tel. 358-9-2535 7349
e-mail:
Heikki.Taimio@labour.fi

GLOBAL ECONOMY – COMPETITIVENESS OF NEW COUNTRIES

In Western Europe increasing attention has been focussed on curbing labour costs so that the region would be able to meet the challenge of global competition. Owing to high cost levels prevailing in Western countries manufacturing jobs have steadily been shifting to low cost regions. Unit labour costs of low wage countries have nevertheless been approaching the cost levels prevailing in Western countries and this trend is due to the swift rise in wage levels in low wage countries, as indicated by the adjacent table.

Nominal wage costs have risen in the EU's old countries, Japan, South Korea and the United States considerably more slowly than in the EU's new countries, Russia or China. In Germany and Japan unit labour costs have remained unchanged. Price competitiveness expressed as relative unit labour costs is affected also by changes in productivity and exchange rates. Based only on the nominal labour costs it appears that the gap in price competitiveness between low-wage and high-wage countries' labour costs is narrowing.

In the EU's new member countries productivity rose last year by 3-6 per cent. Only Poland improved its price competitiveness compared to the EU's old countries. In other new EU countries relative unit labour costs have risen considerably faster than in the old EU countries. Whereas productivity climbed in Russia by about 8 per cent last year, we can infer that unit labour costs rose there considerably more than in Western Europe or North America. This same trend evidently prevails also in other East European countries not belonging to the EU.

The new members of the EU have not experienced any weakening of exchange rates that would boost their competitiveness relative to the eurozone countries. For example, the currencies of Poland, Czech Republic, Slovakia and Hungary have even appreciated against the euro last year. The EU's new member countries are seeking to become members of the European monetary union. Estonia, Lithuania and Slovenia have already joined ERM II and hey are expected to adopt the euro at the beginning of 2007. Other countries will join the monetary union later.

China's manufacturing production grew last year by about 17 per cent. Because manufacturing employment has declined in China, productivity has increased more than this, by about 20-25 per cent. This indicates in combination with the undervaluation of the renminbi that China has increased its price competitiveness relative to Western countries. It should be remembered in the case of China and other countries undergoing rapid structural change that the swift rise in aggregate productivity is primarily attributable to structural change where state-controlled industry is shut down or turned into new businesses under new ownership. The productivity of manufacturers under Western ownership and other modern plants is not developing significantly faster than in Western countries. Indeed the local infrastructure and logistics as well as improvements of the quality and experience of the labour force may lead to a considerably higher rate of productivity growth than in Western countries. But as labour costs rise more than 10 per cent per annum, it is clear that the unit labour costs of local production representing an alternative to Western production are rising faster in China than in Western countries.

Russia, China and in fact the rest of Asia have improved their price competitiveness relative to the eurozone as their currencies have been pegged against the dollar. It is nevertheless expected that exchange rate movements will no longer boost their competitiveness in the coming years.

CHANGE IN EMPLOYEES' AVERAGE NOMINAL WAGES IN 2004

Country	Annual percentage change
EU*	
United Kingdom	3.4
Eurozone	1.9
Germany	0.9
Finland	3.7
Estonia	8.6
Latvia	11.1
Lithuania	5.9
Poland	1.3
Czech Republic	10.4

Slovakia	4.3
Hungary	8.3
Other OECD**	
USA	4.1
Japan	-0.3
South Korea	2.6
Russia***	22.9
China, average in cities****	14.5
China, private sector in cities*****	9.2

* Figure for EU countries depicts average change in labour costs in 3rd quarter of 2004. Source: Eurostat.
** Change in employees' average wages in private sector. Source: OECD Economic Outlook 2004/2.
*** Change in average nominal wages. Source: Federal State Statistics Service.
**** Source: National Bureau of Statistics of China.
***** Source: Natioanal Bureau of Statistics of China.