

FORECAST AUGUST 21, 2003

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Forecast 2003 - 2004

ECONOMY RECOVERING SLUGGISHLY, EMPLOYMENT WEAKENING IN NEAR FUTURE

Optimism about the economy has been increasing in both the United States and in Europe. Even though the optimism is based more on leading economic indicators than solid production figures depicting realised developments, the worst phase of the recession appears to be over. Therefore the conditions for an improvement in the economy are strengthening also in Finland.

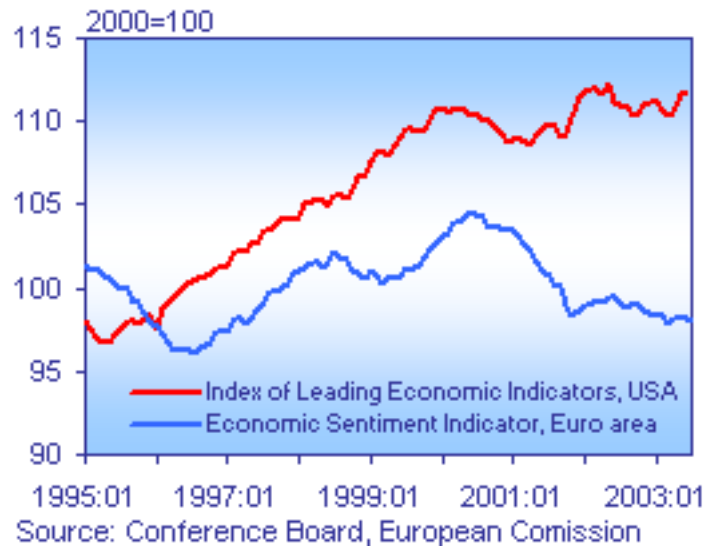
In our previous forecast published in March, we projected that the economy would improve so much next year that GDP would grow by 2.8 per cent. On the basis of fresh information there is no need to change this forecast. This year's GDP growth rate will nevertheless fall short of our spring forecast. At that time we projected that GDP would grow by 2 per cent this year, but it now appears that growth will be around 1.5 per cent.

Even though the economic outlook is improving, uncertainty about future developments is still high. The uncertainty related to the war in Iraq and the SARS epidemic has waned, but hope about an upturn in the economy may prove to be overoptimistic. Because Finland's economic development hinges decisively on international trends in the near future, there is a great deal of uncertainty surrounding our GDP growth forecast. The greatest risk pertains to the euro zone.

In US and Europe hopes of an upswing strengthened

In the United States growth in aggregate output has recently been driven by household and public consumption. Even though households are rather indebted, they have been able to increase their consumption, spurred partially by the low level of interest rates. The weak employment situation has nevertheless eroded the confidence of consumers in the future, which may be a significant factor slowing the recovery in the near future. On the other hand, an expansive fiscal policy, among other things a rise in military expenditures, has been a factor contributing to growth, the significance of which may be considerable in the near future.

**Figure 1. International Economic Indicators
1995:01 - 2003:07**



This year GDP will grow by about 2 per cent in the United States. Next year growth is projected to accelerate to around 3 per cent. The conditions for sustained faster growth are nevertheless dampened by the over-indebtedness of the economy, i.e. the current account deficit, which is reflected in the debt problem of households and the widening public sector deficit.

In March we forecast that economic growth in the euro zone would start to pick up during this year. According to fresh information we do not need to change this view, but the upswing appears to be more moderate than we previously forecast. The upturn will also be of a different sort than we anticipated in spring, since the recovery will be driven by consumption more than exports. The depreciation of the dollar has weakened the preconditions for the euro zone's exports, but on the other hand, it has dampened inflation in the euro zone and thereby bolstered the purchasing power of households. The easing of monetary policy has increased the possibilities of consumers and their propensity to consume.

We project that GDP will grow in the euro zone by 0.8 per cent this year, i.e. somewhat less than in our forecast in the spring (1.1 per cent). Judging by recent data, the conditions for an economic upswing have strengthened so much that we have no reason to change our GDP growth forecast of 2.1 per cent for next year. Reaching this rate of growth nevertheless means that growth will have to accelerate already during this year.

Outside the United States and Europe, in Russia and Asia, economic growth has been unexpectedly robust.

For example, in Russia and Japan economic growth figures have been higher than we anticipated for this year. The significance of Russia for Finnish exports has indeed increased recently by a substantial margin.

Finnish economy staging moderate recovery

Because we forecast that the international economy will recover toward the end of this year, we anticipate that growth in Finnish exports will pick up in the near future. The recovery will nevertheless remain rather moderate, because the upturn in the international economy will not be very sharp. Our forecast for exports is similar to the one we made last spring.

We forecast that exports will expand this year by 2.4 per cent and next year by 5 per cent. Growth will be led by the electro-technical industry in addition to traditional export industries, for example the forest industry. Even though the appreciation of the euro has weakened the competitiveness of the export industry, competitiveness has nevertheless remained very good. The growth in exports has been constrained by the lack of demand, not the weakness of price competitiveness or a lack of production capacity. Next year export growth will be spurred by exports to the euro zone, as economic prospects improve there, too.

Investment activity has been more modest than we forecast this spring. Especially machinery and equipment investment in the manufacturing sector has remained at a low level. Investment will indeed fall this year somewhat even though the activity in the construction sector has remained fairly strong. The low level of interest rates has spurred construction of residential buildings as well as commercial buildings and renovation work. Next year we anticipate that machinery and equipment investment will bolster production growth.

Households spearheading economic growth

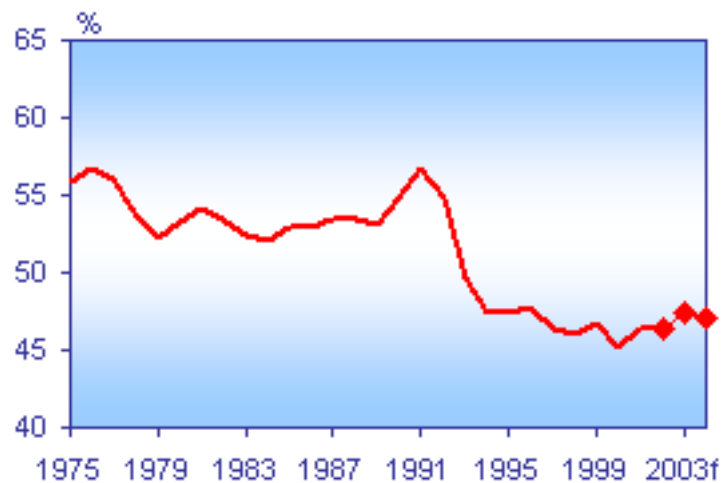
Since the slump in the international economy has hampered exports, the significance of households as the sustainers of economic growth has been exceptionally high. This year consumption has been led by car sales, which have been fuelled by an easing of taxation and the exceptionally low level of interest rates. The weakening of employment prospects has eroded the confidence of consumers somewhat from that of last year, but the weakening of confidence has not become an obstacle to growth in consumption.

We forecast that private consumption will grow next year by 2.5 per cent. Consumption will grow by the same margin as household's purchasing power, which will be affected by wage increases and decisions about taxation.

Purchasing power determined by tax measures

This year the wage level of employees will rise by about 4 per cent. Because contract wage increases will be lower in 2004, the wage level will increase by a smaller margin next year, i.e. 3.3 per cent. A rise in earnings of this magnitude will mean that the share of wages within national income will rise somewhat this year (figure 2). Since economic growth will accelerate again next year, the share of wages within national income will start to fall.

Figure 2. Labour Share in the Private Sector 1975 - 2004



Source: Statistics Finland, Labour Institute for Economic Research

In addition to the change in the levels of earnings and employment, the purchasing power of households will be affected by tax measures next year. We project that the purchasing power of households will increase next year by about 2.5 per cent. The income tax cuts included in the budget proposal of the Ministry of Finance will increase the purchasing power of households by about one per cent. Cuts in income taxation at different wage levels will increase purchasing power by approximately the same margin, i.e. 1.3 per cent.

Inflation has slowed down sharply this year. The rate of increase in consumer prices has been dampened by, among other things, the decline in interest rates, which has substantially reduced interest on housing loans. Consumer prices will rise by about one per cent this

year. Next year the average rate of inflation will be shaped by one very critical factor: cuts in taxes on alcohol and tobacco products. If the easing of taxation is implemented approximately in line with the Ministry of Finance's budget proposal, the rate of increase in consumer prices may remain below one per cent.

Unemployment climbing

Employment has started to decline during the beginning of this year and a turn for the better is not expected during this year. The decline is attributable to the steep fall in employment in manufacturing. The greatest number of layoffs has been seen in the metal industry. Job creation has been driven largely by the service sector catering to domestic demand. The number of jobs created in the service sector has not, however, been sufficient to offset the loss of industrial jobs, and therefore the number of employees will fall this year by about five thousand persons (figure 3).

**Figure 3. Labour Supply and Employment
1985 - 2004**



The rise in unemployment has not been as pronounced as the weakening of employment because the supply of labour has simultaneously decreased. The number of persons participating in the job market will fall this year by 2000 persons and the labour force participation rate will dip to 66.4 per cent. One of the main trends behind the decline in the labour force participation rate in the beginning of this year has been the decrease in the labour supply of 25-54 year olds. Owing to the decrease in the supply of labour and an increase in the number of persons participating in active labour market programmes, the rate of unemployment will not rise higher than 9.2 per cent.

Industrial production will recover next year in line with the improvement in the economic outlook. This will be reflected in industrial employment figures only after a lag, and employment will continue to weaken in this sector in the beginning of the year. On the other hand, domestic demand will sustain the growth in employment in the service sector. The number of employed persons will increase the most in real estate and business services as well as public and other services. All in all, employment will rise next year by about six thousand persons.

The rate of unemployment will remain next year at this year's level, 9.2 per cent, since the supply of labour will start to rise moderately. Trends in the supply of labour reflect the fact that the growth in the working age population will not be as rapid as it has been in previous years.

Central government surplus will decrease

The central government's surplus has shrunk during the recession. Compared to other euro zone countries the central government's fiscal position is still very good. This year the surplus will be EUR 500 million, i.e. 0.5 per cent of GDP (figure 4).

**Figure 4. Net Lending as a Share of GDP:
Central, Local and General Government**



Source: Statistics Finland, Labour Institute for Economic Research

The economic recovery next year will not suffice to stop the surplus from shrinking. We project that the general government's fiscal position will be approximately in balance next year. The central government's tax revenues will be affected by potential changes in taxes on alcohol and tobacco products. Our forecast for next

year is based on the projections of the Ministry of Finance included in the budget proposal.

The general government will remain in good shape overall, but the fiscal position of the municipalities will weaken in the near future. This will be reflected in widening deficits. The divergence between the municipalities will nevertheless remain wide.

Tax revenue losses substantial

Even though the central government's favourable fiscal position would allow substantial reductions in tax revenues without causing fiscal difficulties like in many other euro zone countries, the tax measures planned for next year are not completely unproblematic. The government is in a hurry to implement substantial cuts in alcohol and tobacco taxation without evidence that a substantial easing of taxation is the best solution from a fiscal standpoint. It is possible – and even likely – that smaller tax cuts, even though they would lead to a loss of tax revenues, would be a better solution from the perspective of central government finances and control of adverse health and social effects caused by higher consumption of alcohol than the sharp cuts in taxes proposed by the Ministry of Finance.

The cuts can be defended not only as a necessary consequence of tax harmonisation but also as a measure bolstering household purchasing power and employment. Purchasing power and employment can nevertheless be bolstered in a more cost efficient manner than slashing taxes on alcohol and tobacco products.

As regards the easing of income taxation, the employment situation justifies the concentration of tax cuts toward low and medium-sized incomes. Even though the easing of income taxes in line with the budget proposal will reduce the tax rates of low wage earners slightly more than high wage earners, disposable income will increase for persons with different levels of wages by approximately the same per cent. Therefore, the way income taxes are being eased is not particularly efficient from the standpoint of boosting employment.

INTERNATIONAL ECONOMY

GDP growth , %	2002	2003f	2004f

United States	2.4	2.1	3.0
Euro-12	0.8	0.8	2.1
Germany	0.2	0.3	1.7
France	1.2	0.8	2.1
Italy	0.4	0.8	2.1
EU 15	1.0	1.0	2.2
Sweden	1.9	2.0	2.8
United Kingdom	1.8	2.0	2.8
Japan	0.3	1.0	1.5
Russia	4.3	6.5	7.0
Source: BEA, IMF, OECD, Labour Institute for Economic Research			

DEMAND AND SUPPLY

	2002	2002	2003f	2004f
	Bill. FIM	Percentage change in volume, %		
Gross Domestic Product	139.7	2.2	1.5	2.8
Imports	42.1	1.3	2.1	4.2
Total supply	181.8	2.0	1.7	3.2
Exports	54.0	4.9	2.4	5.0
Consumption	101.4	2.2	2.1	2.2

- private	71.1	1.5	2.4	2.5
- public	30.3	4.0	1.5	1.5
Investment	26.4	-4.0	-1.8	2.7
- private	22.4	-5.9	-1.5	3.5
- public	4.1	8.0	-3.0	-2.0
Change in stocks	-0.1	-0.2	0.0	0.0
Total demand	181.8	2.0	1.7	3.2
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2002	2003f	2004f
Unemployment rate , %	9.1	9.2	9.2
Unemployed (1 000)	237	241	241
Employment rate , %	67.7	67.4	67.5
Employed (1 000)	2372	2367	2373
Inflation, consumer price index, %	1.6	1.1	0.9
Wages, index of wage and salary earnings, %	3.5	3.9	3.3
Real disposable income of households, %	1.0	2.4	2.5
Current account surplus, Bill. FIM	10.5	8.5	9.0
Trade surplus, Bill. FIM	13.9	12.0	12.6

Central government financial surplus, Bill. FIM	2.0	0.5	-0.1
% / GDP	1.4	0.3	0.0
General government financial surplus, Bill. FIM	5.9	3.3	2.8
% / GDP	4.2	2.4	1.9
EMU debt, % / GDP	42.7	42.5	41.5
Short-term interest rates (3-month Euribor)	3.3	2.3	2.5
Long-term interest rates (10-year gov't bonds)	5.0	4.0	4.5
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			