

# FORECAST

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### Forecast 2002 - 2003 INTERNATIONAL ECONOMIC RECOVERY THREATENED

A swift strong recovery of the international economy is in danger. The economic outlook has deteriorated recently in both the United States and Europe. The weakening of expectations is in line with the fall in stock prices and data depicting slackening economic activity in the major countries. The lacklustre performance of the international economy also reflects upon Finland: there has been no rapid acceleration of output growth.

In our previous forecast published in the spring, we projected that the economic conditions would improve enough that total production would grow by 3.3 per cent next year. On the basis of newer data, we now forecast that growth will be slower than we anticipated in the spring. GDP will grow this year by 1.3 per cent and next year by 2.5 per cent.

In the near future the uncertainty about the pace of international economy growth will remain exceptionally high. A relatively weak-growth scenario is currently more likely than forecasters believed in the spring. Economic trends in Finland will hinge decisively on developments in the United States and euro area in the near future. The threat of a war in Iraq poses a considerable risk to the international economy.

### Outlook for United States and Europe Weakened Again

In the United States economic expectations, and especially consumer confidence, rebounded surprisingly quickly after the terrorist attack. Strong growth in total production in the beginning of this year also bolstered hopes of a rapid recovery in the economy. In recent months the outlook has nevertheless weakened again. The fall in stock prices has dampened indebted households' propensity and possibilities to consume. Low interest rates have nevertheless boosted real estate markets and housing investment and housing sales have played a key role in sustaining economic growth.

The main impediment to a swift recovery in the US economy is the high indebtedness of households. Even though low interest rates ease the situation of households, it does not solve the dilemma. The current situation can even be summed up by saying that the bubble in the stock market has been replaced by a bubble in the real estate market. The upswing in production growth in the beginning of this year is turning out to be a temporary spurt of growth spurred by rebuilding of inventories.

We project that total production will grow slowly in the United States in the last few months of this year as well as all next year. This year GDP will grow by an average of 2 per cent thanks to the growth peak last spring, but next year growth will subside to 1.4 per cent. Even though we do not forecast a fall in production, a double dip slump is not a poor way of describing economic developments in the near future.

Also in Europe, especially in the euro area, the economic outlook will remain modest in the near future. Growth in the euro area has been sustained by public demand and exports. Neither of these factors can function as an engine of growth under current conditions. The public sector deficits have, for example, widened in the core countries of the euro area in a worrisome manner. Since consumer confidence has simultaneously begun to weaken, conditions are not ripe for a rapid turnaround in euro area production in the near future. The weakness of economic activity nowadays is reflected by the fall in industrial production in Germany and France.

We forecast that average GDP growth will be only 0.7 per cent this year. Growth will pick up somewhat in the euro area next year, but the sluggishness of economic growth in the United States will reflect also upon the euro area. GDP will grow by an average of 1.4 per cent.

Thus we anticipate that the economic outlook in the euro area will remain relatively weak. The weakness of the economy would give the European Central Bank (ECB) good reason to lower the interest level and foster a recovery in the euro area. We nevertheless forecast that monetary policy will remain unchanged in the near future. The ECB's concern about inflation is probably so high that it will not lower its key interest rates.

The economic prospects outside the United States and the euro area, for example, Russia and Asia, are better than average. The growth of Finnish exports in the near future will be fuelled more than ordinarily by other areas

than by the United States and the euro area.

### Recovery in Finnish Economy to be Fairly Modest

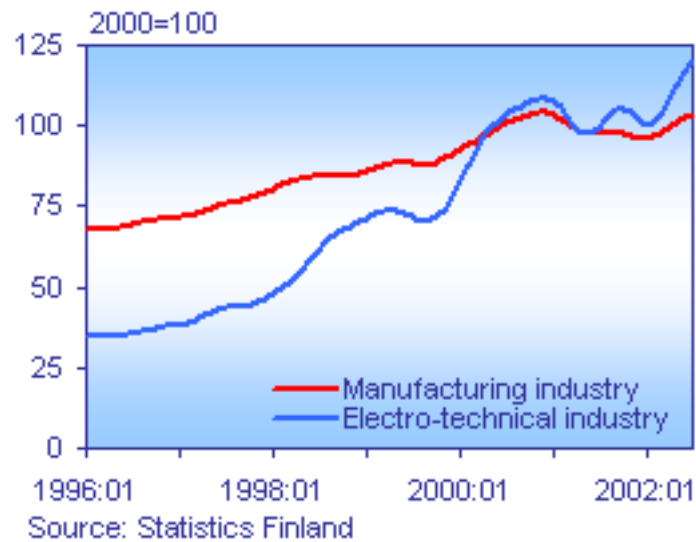
Because international demand will remain fairly weak this year and next, there will be no swift upswing in the Finnish economy. The main reason for the recession was the weakening of international demand, which led to a fall in exports. Exports have already started to climb but growth will remain lower next year than generally believed in the beginning of the year.

**Figure 1. Growth of GDP and Exports 1985 - 2003**



We forecast that exports will grow by 1.5 per cent this year and 4 per cent next year (figure 1). The acceleration in growth is due largely to the recovery in the electrotechnical industry. The growth of production in the electrotechnical industry has been surprisingly swift this year (figure 2). This upswing is largely the result of trends in the volume of products manufactured by Nokia. We forecast that Nokia's strong competitiveness will spur relatively swift growth in the electrotechnical industry's production and exports.

**Figure 2. Output in Manufacturing and Electrotechnical Industry 1996:01 - 2002:07**



Even though the electrotechnical industry is one of the main driving forces behind export growth, the conditions for growth in total exports have remained excellent. Price competitiveness is very good and there is sufficient capacity.

Investment activity has remained relatively modest this year. Acquisitions of machinery and equipment have been low especially in manufacturing, and building investment is also down from that of last year. Residential construction is nevertheless picking up and next year construction as well as machinery and equipment investments will start to climb. Owing to the uncertainty about the economy, growth in machinery and equipment will nevertheless be modest.

### **Households in Key Position**

Owing to difficulties in exports, households have played a pivotal role in sustaining aggregate growth. This year growth in private consumption has even accelerated compared to that of last year. This has been partly attributable to special factors, such as the upswing in car sales. In the near future growth in consumption demand will depend upon the development of households' purchasing power and consumer confidence. Consumers' confidence in the future has remained fairly good, even though it has weakened somewhat in recent months.

We forecast that private consumption will grow next year by about 2 per cent. Households' purchasing power will nevertheless grow slightly more than this. Therefore our forecast includes a moderate rise in the savings ratio, since uncertainty about the economy will dampen households' consumption demand.

## Incomes Policy Shapes Wage Developments

Many important decisions about purchasing power next year have not been made yet. The most important of these are naturally the wage settlements and government's budget proposal, including decisions on taxation and possible adjustments thereof.

We forecast that employees' earnings will rise by about 4 per cent next year. This would be slightly more than this year but less than last year. This kind of rise in the level of earnings will not change the so-called functional income distribution between wage and capital income (figure 3).

**Figure 3. Labour Share in the Private Sector 1975 - 2003**



We forecast that the slightly over 2 per cent of the increase in households' purchasing power will not be included in the budget proposal's tax changes nor in possible future supplementary tax cuts.

The purchasing power of households is affected partly by inflation. The rise in consumer prices has been slightly faster than projected in our March forecast. The slowdown in inflation compared to last year was curbed by the rise in crude oil prices in the beginning of this year. Oil is one of the main factors of uncertainty also regarding future price developments. If the threat of war in Iraq continues to grow or is realized, the global price of oil will rise and consumer prices will climb. We forecast that inflation will average 2.2 per cent next year, but this does not include a significant rise in global prices for crude oil from current levels.

## Unemployment Rising

Given the slow growth in total production, employment trends have remained surprisingly good. In industry the adjustment to sluggish production and export performance has for the time being occurred via the number of hours worked and temporary layoffs instead of dismissals. The delay in the recovery is nevertheless leading to growth during the autumn of this year. Employment has already begun to deteriorate and a quick turn for the better is not expected. Judging by the strong development at the end of last year and the beginning of this year the number of employed persons will rise by about 5000 persons compared to last year. About 10,000 new job seekers will enter the job market this year and therefore the number of unemployed will rise by about 5000 persons this year. The unemployment rate will rise to 9.3 per cent.

Employment has been marked by divergent trends. In industry the slow growth in production has been seen as a clear deterioration in men's employment and a rise in unemployment. The number of jobs has fallen the most in the metal products industry. Despite sluggish construction activity, the number of employees has grown in this sector. The increase in the employment of women has been greater than the decline in the employment of men. Women have found jobs in both the private and public sector. Of the age groups the weakest employment development has been young persons, where despite a fall in the supply of labour unemployment has started to rise.

Even though the economic outlook is better next year, this will not be reflected in the average employment figures. The number of employed persons will not rise from that of this year. The employment trend in industry has continued to weaken from that of the beginning of this year. On the other hand, the number of jobs is rising in the service sector, for instance in real estate and business services as well as the wholesale and retail trade. The financial difficulties of the municipal sector is impinging upon the employment in the public sector, but employment will continue to grow in public services.

### **Figure 4. Labour Supply and Employment 1985 - 2003**



The number of unemployed will rise next year to 248,000 persons and the unemployment rate to 9.5 per cent. As this year the increase in the supply of labour will boost unemployment figures (figure 4).

### Central Government will Remain in Surplus

The economic slowdown has reduced the central government's surplus, which had increased partly due to one-off factors. Compared to other euro area countries the central government's financial position has remained good. This year there will be a surplus of €1.7 billion, i.e. 1.2 per cent of GDP.

Because the economic recovery will only be moderate next year, the central government's surplus will continue to shrink. The surplus will be around €1 billion, i.e. 0.6 per cent of GDP. Possible easing of taxation will reduce the surplus further.

The central government's surplus has been used to reduce the national debt. As this policy will probably continue to be followed also next year – albeit in smaller steps – the national debt will continue to shrink. The debt will be about €60 billion at the end of next year.

Even though the public sector's financial position will remain good, the financial position of municipalities will weaken next year and the deficits will climb from those of this year. The divergence across the municipalities in this respect is nevertheless large.

### Rise in Employment Should be Main Concern of Economic Policy

According to some participants in the public debate, the

shrinking of the central government's surplus is becoming the main cause for concern in economic policy. Excessively worrying about this trend will nevertheless lead us down the wrong path. Of the countries in the euro area, Finland is one where the financial position is still very strong. Finland does not have to worry whether or not it will meet the EMU criteria for public finances or not.

Instead of the central government's financial position, the main concern should be on the rise in employment. For the time being unemployment has increased surprisingly little considering how slow economic growth has been recently. We anticipate that the growth in unemployment will be relatively modest also next year, but a worse scenario could take place. Decision makers should prepare for this.

## INTERNATIONAL ECONOMY

GDP growth , %	2001	2002f	2003f
United States	0.3	2.0	1.4
Euro-11	1.4	0.7	1.4
Germany	0.6	0.4	1.1
France	1.8	0.7	1.3
Italy	1.8	0.6	1.1
Euro-15	1.5	0.9	1.5
Sweden	1.2	1.6	2.5
United Kingdom	2.2	1.8	2.2
Japan	-0.6	-0.2	1.0
Russia	5.0	4.0	4.0
Source: BEA, IMF, OECD, Labour Institute for Economic Research			

## DEMAND AND SUPPLY

	2001	2001	2002f	2003f
	Bill. FIM	Percentage change in volume, %		
Gross Domestic Product	136.0	0.7	1.3	2.5
Imports	43.0	0.1	1.0	3.0
Total supply	179.0	0.5	1.2	2.6
Exports	54.5	-2.2	1.5	4.0
Consumption	96.5	1.4	2.2	1.9
- private	67.9	1.1	2.3	2.0
- public	28.6	2.1	2.0	1.5
Investment	26.9	4.0	-2.5	1.9
- private	23.4	4.6	-3.0	2.0
- public	3.5	0.8	1.0	1.0
Change in stocks	1.1	0.1	-0.1	0.0
Total demand	179.0	0.5	1.2	2.6
Source: Statistics Finland, Labour Institute for Economic Research				

## KEY FORECASTS

	2001	2002f	2003f
Unemployment rate , %	9.1	9.3	9.5
Unemployed (1 000)	238	243	248

Employment rate , %	67.7	67.7	67.6
Employed (1 000)	2367	2372	2372
Inflation, consumer price index, %	2.6	1.7	2.1
Wages, index of wage and salary earnings, %	4.5	3.4	4.0
Real disposable income of households, %	3.7	2.3	2.2
Current account surplus, Bill. FIM	9.3	8.7	9.6
Trade surplus, Bill. FIM	14.1	13.7	14.2
Central government financial surplus, Bill. FIM	2.7	1.7	0.9
% / GDP	2.0	1.2	0.6
General government financial surplus, Bill. FIM	6.7	5.2	4.1
% / GDP	4.9	3.7	2.8
EMU debt, % / GDP	43.4	43.0	41.5
Short-term interest rates (3-month Euribor)	4.3	3.4	3.6
Long-term interest rates (10-year gov't bonds)	5.0	4.9	5.4
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			