

# FORECAST OCTOBER 17, 2000

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## Forecast 2000 - 2001 GROWTH STILL STRONG DESPITE GROWING RISKS

Last spring the Labour Institute for Economic Research forecast that GDP growth this year would be 5 per cent. According to last spring's forecast, the fastest phase of growth would occur this year, but next year as well the economy is projected to grow faster than in the main competitor countries on average, with GDP growth projected at around 4 per cent. The most recent international and domestic economic indicators do not give reason to change this view. The indicators nevertheless give reason to believe that economic growth in Finland and our main export countries entails more risks than generally anticipated last spring.

Risks in Finland are ultimately linked to one development that has caught many forecasters by surprise: the rapid acceleration of inflation. This has been attributable to two factors: the global rise in oil prices and the weakness of the euro. The cost of living has also been raised by climbing interest rates. The effect of these factors especially on households' financial position and future expectations will shape economic developments in the near term both domestically and abroad.

## DEMAND AND SUPPLY

	1999	1999	2000f	2001f
	Bill. FIM	Percentage change in volume, %		
Gross Domestic Product	723.6	4.0	5.0	4.0
Imports	212.0	3.2	9.1	7.3
Total supply	935.6	3.8	6.0	4.9
Exports	270.7	6.3	10.0	7.0

Consumption	519.7	3.1	3.2	2.8
- private	364.3	3.6	4.1	3.5
- public	155.4	2.0	1.0	1.0
Investment	138.4	4.6	7.5	7.2
- private	118.8	6.2	8.6	8.2
- public	19.6	-3.8	1.0	1.0
Change in stocks	6.8	-0.5	0.0	0.0
Total demand	935.6	3.8	6.0	4.9

## KEY FORECASTS

	1999	2000f	2001f
Unemployment rate , %	10.2	9.6	8.7
Unemployed (1 000)	261	249	228
Employment rate , %	66.5	67.4	68.5
Employed (1 000)	2296	2337	2382
Inflation, consumer price index, %	1.2	3.3	2.5
Wages, index of wage and salary earnings, %	2.7	4.0	4.0
Real disposable income of households, %	3.4	3.5	4.0
Current account surplus, Bill. FIM	37.4	50.4	51.1

Trade surplus, Bill. FIM	65.2	77.4	78.8
Central government financial surplus, Bill. FIM	-5.6	11.5	13.3
% / GDP	-0.8	1.5	1.6
General government financial surplus, Bill. FIM	13.9	38.4	45.1
% / GDP	1.9	4.9	5.4
EMU debt, % / GDP	46.6	40.7	35.7
Short-term interest rates (3-month Euribor)	3.0	4.4	5.2
Long-term interest rates (10-year gov't bonds)	4.7	5.1	5.2

### Global Economy Strong Growth

The world economy is still in a phase of robust growth, which is evident especially in the Far East and the United States. The main threats to favourable growth are high oil prices and the economic outlook for the United States.

According to recent indicators, there have been no appreciable changes in the economic imbalances prevailing in the US economy. The indebtedness of households and ballooning current account deficit are significant problems under conditions of rising interest rates. The rise in interest rates by the Federal reserve has evidently come to a temporary halt, since despite tight labour markets domestic interest rates have remained under control. Growth has been very swift this year, but next year the growth rate will slow down to about three per cent.

The economies in East Asia have recovered faster than expected, which is reflected in the substantial rise in imports from the rest of the world. In many East Asian countries imports are showing double-digit growth. The Achilles heel of East Asia is nevertheless still the Japanese economy, as forecasts for a recovery have been consistently wrong. Of the developing economies

Russia has benefited greatly from the rise in export revenues stemming from the rise in crude oil prices.

Europe has recovered in the wake of the global economy and weak euro. The rise in crude oil prices has been one reason that the European central bank has tightened monetary policy appreciably this year. The European central bank raised rates at the beginning of October against market expectations. Interest rates are still historically low, but rate hikes will inevitably dampen economic growth in the near future. Next year GDP growth in the EMU countries will be slightly less than that of this year, i.e. about 3 per cent. Short-term interest rates will be higher than 5 per cent on average in 2001. Next year we will see whether the European central bank has gone too far in the tightening of monetary policy.

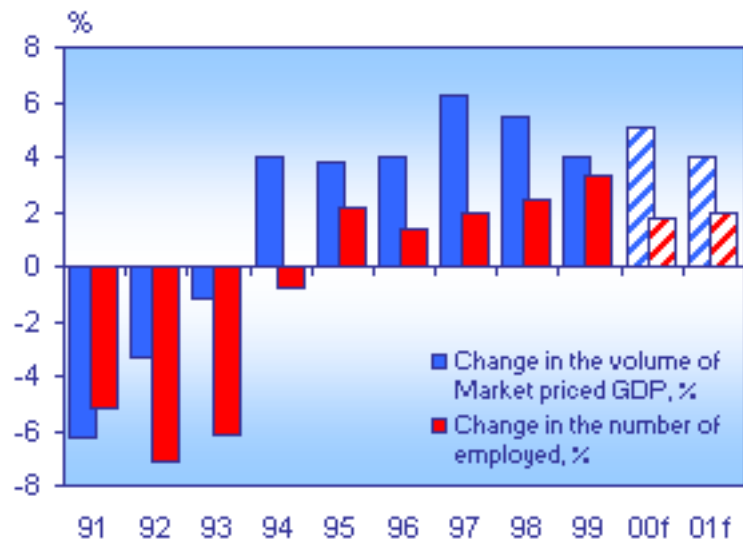
### **Exports Still Strong**

Finnish exports have grown very quickly this year, and growth is not expected to slow down appreciably in the latter part of the year. The growth rate for exports in 2000 as a whole will be about 10 per cent. In addition to the strong expansion of the international economy, export growth has been boosted by good price competitiveness, which the depreciation of the euro has further strengthened this year.

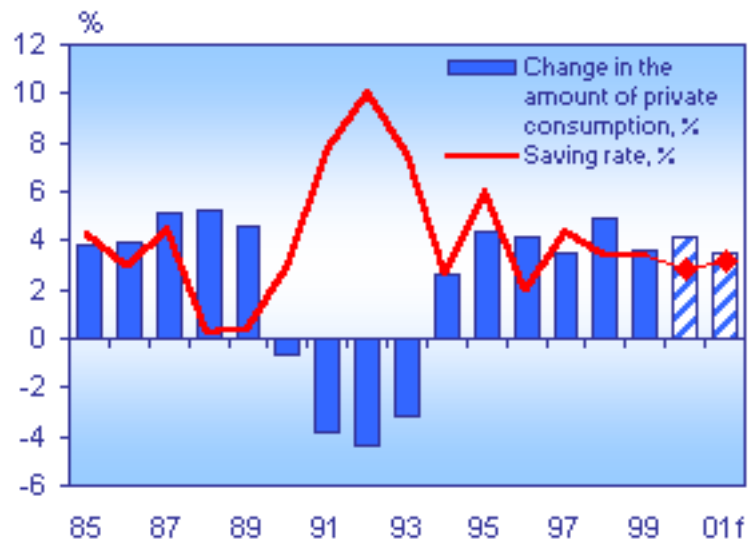
Next year the rate of export growth will slow down but nevertheless remain at relatively high. Export growth will begin to subside as growth in Finland's main export countries starts to peak out. If economic growth slows down in these countries more than expected, this will have a clear dampening effect on export growth.

In addition to exports, GDP growth has been bolstered by domestic demand this year, even though investment in machinery and equipment has been surprisingly low in the beginning of this year. Construction activity has nevertheless been lively. Private investments will increase this year by 8.7 per cent. They will rise substantially next year as well. Growth will be weighted more heavily toward machinery and equipment than this year.

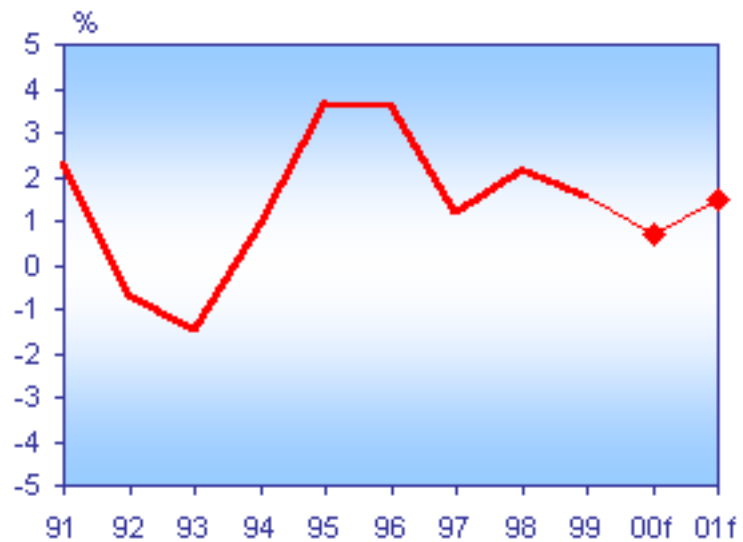
### **Figure 1. GDP and Employment 1991 - 2001**



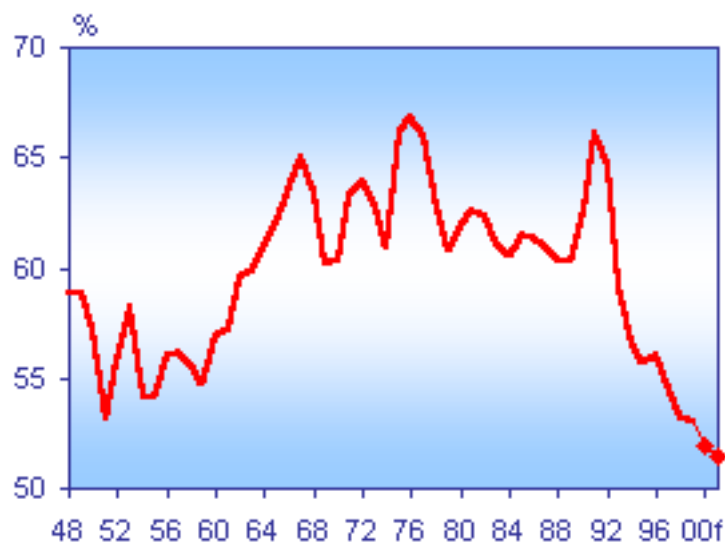
**Figure 2. Private Consumption and Saving Rate 1985 - 2001**



**Figure 3. Annual changes in Real Wages 1991 - 2001**



**Figure 4. Distribution of Income between Labour and Capital in Private Sector 1948 - 2001**



### **Consumer Confidence Subsiding**

From the standpoint of the continuation of rapid economic growth in Finland, strong growth in private consumption would be imperative. In the beginning of this year the rate of private consumption growth has exceeded 4 per cent by a clear margin. New consumer confidence surveys indicate however that the confidence of households in the future has waned appreciably. This is attributable to the acceleration of inflation and rise in interest rates. Short-term interest rates have risen by about two percentage points this year.

Even though the weakening of confidence will be reflected in consumption figures in the near future, private consumption will grow this year by about 4 per cent.

The increasing cautiousness of consumers will be seen more clearly next year. Even though tax cuts will boost the purchasing power of households considerably, the growing uncertainty will be reflected in greater saving: private consumption will increase by 3.5 per cent even though purchasing power will grow by about 4 per cent.

### **Inflation to Subside Sluggishly**

Consumer prices will climb this year appreciably more than anticipated at the beginning of this year. Consumer prices will rise by 3.3 per cent on average. Even though the main reason for the acceleration of inflation is the rise in world market prices of crude oil, the depreciation of the euro and rise in interest rates have exacerbated

the rise in the cost of living.

The multiplier effects of these factors will not be seen until next year so that the rate of inflation will not subside appreciably - e.g. below two percent - even if crude oil prices begin to fall after the winter. A strong slowdown would require a clear strengthening of the euro, which is unlikely. Consumer prices will rise next year by 2.5 per cent on average.

The importance of the depreciation of the euro with regard to recent price trends is reflected in the fact that exports as well as imports have risen substantially. This year export prices of goods and services will rise at practically the same rate as imports prices of goods and services, i.e. slightly under 10 per cent.

Strong growth in exports without a weakening of the terms of trade will lead to rapid growth in imports, but the surplus in the trade balance and current account will remain very wide this year and next.

### **Wages' Share of National Income Declining**

The wage agreement for this year provide for pay increases averaging over 3 per cent. When wage drift is taken into account, the wage level of employees will rise by an average of 4 per cent this year. Because consumer prices will rise by slightly over 3 per cent, the rise in real wages - including wage drift - will be under one per cent. Thus inflation is eroding the rise in the wage level provided by the current pay agreement.

The moderateness of wage increases is illustrated by the fact that wages as a percentage of national income will fall this year to its lowest level since the second world war. It is indeed difficult to find a time in Finnish history when corporate profitability has been as high as it is now.

If the new wage settlements are on par with current agreements in terms of costs, the wage index will rise by about 4 per cent on average next year. The share of wages within national income would then continue its descent.

### **Unemployment Falling Slowly**

Brisk economic growth will increase the ranks of the employed by an average of 40,000 persons this year. The employment rate, i.e. the share of employed

persons within the working age population, will climb to 67.4 per cent. The employment trends are better for men than for women this year. The growth figures for employment are held in check by the fact that the number of entrepreneurs has not grown from last year. On the other hand, the two per cent rise in the number of employees is in line with five per cent economic growth. Next year employment will show slightly more favourable growth than this year, and the number of employed persons will rise by 45 thousand persons. The employment rate will rise correspondingly to 68.5 per cent. The shortage of labour does not constitute a widespread problem, even though bottlenecks appear in various sectors such as electronics, information technology and construction.

The favourable economic development will increase the supply of labour this year considerably. The supply of labour will grow this year by about 30,000 persons. The growth will be concentrated among young persons (aged 15-24), but persons aged 55-74 will also benefit from the increased labour demand. Next year the growth in the supply of labour will be slightly slower as the labour force grows by about 24,000 persons.

The number of jobless persons will fall this year to 249,000 while the rate of unemployment declines to 9.6 per cent. Next year the number of unemployed will decrease to 228,000 as the unemployment rate drops to 8.7 per cent. This year the decline has been less pronounced than expected. Part of this is attributable to the swift growth in the labour supply. Another explanation lies in the structure of growth. Finnish economic growth has been driven primarily by the export industry, which does not create as many jobs as the service sector. Unemployment figures also reflect the fact that the number of persons employed via labour policy measures has declined. The number of those placed in government-sponsored training programs has fallen substantially from the previous year.

### **Public Sector Surplus Growing**

The central government's fiscal deficit turned into a surplus this year. The surplus will be greater than generally believed in the beginning of this year because tax revenues have grown exceptionally quickly. The surplus this year will be about FIM 11 billion. Even though cuts in income taxes will curb the growth in tax revenues next year, the surplus will widen to about FIM 13 billion.

The financial position of the overall public sector will improve considerably this year and next. The fiscal deficit of the local government will turn into a surplus while the surplus of the social security funds will continue to grow.

The leeway provided by the favourable fiscal position of central government has been used to pay off the national debt this year. The national debt will decline appreciably below FIM 400 billion this year. The debt will continue to fall also next year since the tax cuts already decided upon will not curtail the possibilities to reduce the debt. The amount of the debt may fall below FIM 370 by the end of next year.

### **Who is Responsible for Inflation?**

Even though the near future appears to be bright as regards Finland's GDP growth, the economic development cannot be regarded as stable. The surprising acceleration of inflation is a vivid example of uncertainty. Still last spring the acceleration of inflation was generally regarded as temporary, a problem that would ease already toward the end of the year. The acceleration was regarded to stem merely from the rise in world market prices of crude oil. The general acceleration of inflation in Finland - and elsewhere in the euro zone - has nevertheless been compounded by the weakening of the euro and rise in the cost of living due to climbing interest rates.

In light of the depreciation of the euro, the current economic situation has been compared to that prevailing after a traditional devaluation. In the public debate on economic and incomes policy this autumn the responsibility of wage earners has been emphasised. There have traditionally been attempts to link post-devaluation measures with comprehensive incomes policy settlements in order to safeguard price competitiveness and shore up profitability.

Despite the weakening of the euro and the consequent acceleration of inflation, the analogy to the situation prevailing after a traditional devaluation is misleading. The last devaluation was preceded by a crisis in the export industry's price competitiveness and profitability which the devaluation restored. The current situation, however, is different. The price competitiveness was very good already before the depreciation of the euro. That is why the circumstances under which the incomes policy negotiations are conducted this autumn should not be compared with those prevailing after a devaluation.

The current situation is much more complicated than the traditional one. The more the recent acceleration of inflation reflects merely the rise in world crude oil prices, the less wage earners are justified in asking for compensation for the weakening of purchasing power stemming from the acceleration of inflation. The rising cost of oil products weakens the situation of enterprises as well. But the more the acceleration of inflation derives from the depreciation weakening of the euro, the weaker the grounds for placing the burden for fighting inflation sorely on the shoulders of wage earners.