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Forecast 2000 - 2001
EXPORT-DRIVEN GROWTH CONTINUES - RISKS COME FROM UNITED STATES

The pace of world economic growth is accelerating substantially. The favourable prospects for international growth bolster the outlook for the Finnish economy outlook in the near future. There are nevertheless significant risks in international economic developments that may endanger the continuation of growth in Finland.

Europe Recovers

Europe is slowly recovering in the wake of the upswing of the global economy. Both this year and next economic growth in the EU region will exceed 3 per cent. The fastest phase of growth will take place this year, but next year growth will nevertheless be swifter than in the United States.

Growth will continue to be relatively strong, even though we expect the European Central Bank to raise interest rates in the latter half of this year. In the near future the weakness of the euro will improve the possibilities of EMU countries to export not only to the United States, but also to East Asia.

Of the most important EU countries from the standpoint of Finland's exports, the recovery in the German economy is driven primarily by the export industry. Private consumption in Germany is being bolstered also by the easing of income taxation. The French economy is also picking up considerably. Consumption is boosted there by the decline in unemployment. Economic growth is being spurred in the United Kingdom primarily by growth in exports, but also by domestic-based private consumption and private investment.

World Economy Picking Up, Risks Loom Ahead

One of the greatest risks to the stability of the world economy is the US economy, marked by a widening current account deficit and household borrowing that is insustainable over the long run. Economic growth in the US will continue to be strong this year, but next year growth will slow down. The main reason for this is th tightening of monetary policy. Interest rates will be raised further this year in the US.

The strong fluctuations in stock prices is eroding American consumers' confidence that good times will continue. This will tend to dampen the brisk, debt-driven growth in private consumption. The turbulence in the stock markets may erode the desire of foreign investors to finance the current account deficit, which would exacerbate the situation.

In addition to the economic growth in the US, the continuation of the recession in Japan is another significant risk factor. There are signs of recovery in the Japanese economy, such as the strong upturn in stock prices in 1999 and structural change in the economy fueled by mergers. The persistent slump will nevertheless continue in the near future. The Japanese economy is also vulnerable to other risks in the world economy.

The recovery in East Asia has been faster than anticipated. Except for Indonesia, the industrialized countries of East Asia have achieved strong growth. The growth figures for industrial production are in double digits in many East Asian countries. A key factor behind the recovery in exports has been the continuation of strong growth in the US. The prolonged fall in prices in China has come to a halt, which will support economic growth througout East Asia.

The economic growth of transition economies is stabilizing. After years of a free-fall Russia has rebounded to a growth path, owing primarily to the depreciation of the rouble and rise in oil prices. The upturn in Russian economic growth may nevertheless be only temporary. The commitment of Russia's new president Vladimir Putin to the continuation of economic reforms is uncertain.

Russia's share of Finnish foreign trade is so low that the impact of a possible disturbance on the Finnish economy as a whole is modest. On the other hand, there are certain sectors, such as the food industry, textiles and wearing apparel industries as well as the graphics industry, where a recovery in the Russian economy would have a positive impact on exports and employment.

Exports Boost Growth in Output

The Finnish economy has been marked by divergent trends during the last year. At the beginning of last year exports even fell slightly, because international demand had not improved appreciably. Finland's export outlook began to brighten as the global economy picked up in the second half of last year.

As regards domestic demand, forecasters were surprised the most by the sluggishness of growth in private consumption. This was one of the main reasons why last year's GDP growth of 3.5 per cent was slightly less than forecasters had projected in the beginning of last year.

The acceleration of export growth began to foster the outlook for production growth toward the end of last year, albeit only slightly because of the weakness of consumption. This year economic growth will strengthen and GDP will grow by 5 per cent on average. The rapid growth will subside somewhat next year, so that GDP will grow by about 4 per cent.

The main reason for the strengthening of production growth is the very steep rise in exports. Exports will rise this year by almost 10 per cent. The prime reason for the improvement in export prospects is the strengthening of economic growth in the world economy. Favourable export trends are fostered by the sound price competitiveness, the possible erosion of which is not a significant risk factor endangering growth in the near future. The weakening of the euro has substantially improved the competitiveness of Finnish export companies outside the euro zone.

Exports are driven in particular by the traditional forest and metal industries. The electronics industry is also contributing to export growth, but an increasing portion of the expansion of production occurs outside Finland, which cannot be seen as export growth.

The rate of export growth will remain high next year. The slackening of growth in the US and EU countries will dampen export growth somewhat in 2001.

Domestic demand will grow appreciably in the near future. Private investment will rise this year by 9 per cent. During the last couple of years purchases of machinery and equipment have been relatively modest but this year they will be bolstered by investment growth.

Last year industrial investments fell, but this year they will grow substantially owing to the favourable overall growth outlook. Investment activity will be the most prevalent in the forest and metal industry. Investments in machinery and equipment will pick up also in the service sector. The growth in construction investment will continue to be strong. The focal point of investment in the near future will nevertheless increasingly shift toward non-construction sectors.

Investment growth will continue to be rapid next year. The investment rate, i.e. investment as a percentage of GDP will not achieve the record level of previous decades.

The emphasis of investment activity is shifting in Finland from physical production capital to human capital, which means investing e.g. in education and research and development. An integral part of this development has been raising the efficiency or elimination of inefficiently used capital.

Consumption Booming

The swift economic growth anticipated in the near future cannot occur without support from households, i.e. relatively strong growth in private consumption. We forecast that private consumption will grow this year and next year by 3.5 per cent. Growth will accelerate somewhat from that of last year, but the rate of growth will remain well below that witnessed during the consumption boom of the late 1980s.

It is surprising that in the public debate on Finnish economic policy, recent economic developments have been compared with the overheating in the late 1980s. There are indeed some similarities: for example, the steep rise in stock prices and long lines of people seeking to participate in new shares issues.

There are nevertheless some significant differences. Ten years ago the consumption boom was fuelled by the heavy borrowing of households. This has not been the case in the current upswing, nor do we predict that this will happen in the near future.

Despite rising in the last couple of years, household indebtedness is still relatively low, i.e. at the level prevailing in the mid 1980s. Thus in some respects it is clearly misleading to compare recent developments to the boom years of the late 1980s. Consumers have made their purchases within the constraints of their income so that extravagant spending has been largely confined to the wealthy.

Private consumption and household purchasing power is marked by several surprising features. Private consumption rose last year by only 2.9 per cent, even though households' purchasing power measured by disposable real income grew by 4 per cent.

Households saved a greater portion of their income, i.e. their saving rate rose, even though judging by the cyclical situation it could well have been anticipated to fall - as many indeed forecast. The confidence of households in the future has strengthened according, for example, to consumer surveys, which has given good reason to expect the saving rate to decline somewhat.

There can nevertheless be a natural explanation for the rise in the savings rate. In the National Accounts household income is regarded to include realised gains from job-related options. Last year about FIM 4 billion of these options were exercised. If wages are adjusted for these option gains, the growth of households' purchasing power was about 3 per cent. The rise in the saving rate thus gives a distorted picture of the recent consumption behaviour and income growth of ordinary consumers.

The relatively rapid growth of households' purchasing power has occurred in tandem with strong growth in income differentials. It is reflected also in figures describing the overall development of consumption and income.

Income Distribution Shifting in Favour of Capital

Our forecast for private consumption growth of 3.5 per cent this year and next is based on the projection that household' purchasing power will rise both years by approximately the same margin. This means that no significant changes in the saving rate are foreseen in the near future.

Almost all wage agreements for this year have already been signed. As a result of contract wage increases and wage drift, we forecast that the level of wages will rise by about 4 per cent on average. The forecast for household purchasing power next year is based on the assumption that the wage level will rise by about 4 per cent.

This kind of wage development cannot be regarded as a sign of an acceleration of wage inflation that would endanger balanced economic growth. The rate of increase in wages is too large if it endangers sufficiently good price competitiveness and corporate profitability.

According to our forecast there is no danger of this occurring.

The price competitiveness and average profitability of enterprises will remain very good. The 4 per cent rise in the wage level will not change the (functional) income distribution between labour and capital - at least not in an unfavourable direction from the standpoint of capital. The forecast includes a slight decrease in wages as a percentage of total income.

Because job-related options that are exercised are included in the wage bill, the proportional rise in wages last year gives a distorted picture of recent developments in enterprises' average profitability.

It is difficult to find a period of time after the Second World War in economic history when companies average profitability has been as high as it is now after the recession. In the light of current economic history, it is not easy to find grounds for the view that the clearly diverging functional income distribution should be allowed to become permanent in the name of stable economic growth.

Inflation Temporarily Accelerating

Inflation picked up last year due especially to the rise in world market prices of crude oil toward the end of the year. The rise in prices was boosted also by the appreciation of the dollar. Primarily for these reasons consumer prices will rise this year by 2.6 per cent on average.

The acceleration of inflation will be temporary because crude oil prices have begun to fall this year. Next year inflation will average slightly over 2 per cent. Inflation will be sustained, among other things, by rising housing costs. The projected 4 per cent rise in the level of earnings will raise unit labour costs next year by about 2 per cent, which is in line with the 2 per cent inflation target.

Due to the rise in prices of crude oil and other production goods, import prices will rise this year faster than export prices, even though export prices will climb sharply. Thus the terms of trade will deteriorate substantially this year.

Owing to the robust growth in merchandise exports, the trade surplus will continue to grow, thereby widening the current account surplus as well. The continued strong growth in exports will boost the trade and current account surplusses next year as well.

New Labour Force Slows Fall in Unemployment

Employment improved in the latter half of the 1990s due to the relatively strong economic growth. Favourable economic growth this year and next will increase employment by slightly more than 2 per cent a year. This year the number of employed persons will rise by 52,000 persons and next year by approximately the same amount.

Despite the export-driven nature of aggregate demand, the number of manufacturing jobs has not increased appreciably. Most jobs have been created in private services and construction. The concentration of job creation is illustrated by the fact that the share of part-time jobs within total employment continues to climb. Bottlenecks in the labour market appear primarily in the electronics and information technology sectors.

The supply of labour will grow at an annual rate of slightly over one per cent during the forecast period. Growth will not, however, be quite as swift as last year, when the strong demand for labour and improvement in employment encouraged some 50,000 new job seekers to enter the labour market.

Like last year the increase in supply will be concentrated among young persons. Young persons now account for almost 50 per cent of the labour force, i.e. some 7 percentage points lower than during the boom of the late 1980s. The share of persons aged 15-74 participating in the labour force is still 3.5 percentage points lower than before the recession.

The growth in the labour supply will continue to dampen the decline in unemployment in the future. This year the unemployment rate will fall to 9.2 per cent and next year 8.3 per cent. The unemployment figures for young persons will be lifted by the rising numbers of students seeking work. Almost two thirds (approx. 48,000) of the young unemployed persons in February this year were students.

Thanks to measures directed toward the long-term unemployed and the favourable labour market situation, the share of long-term unemployed out of total unemployed will continue to fall.

The average length of uninterupted spells of unemployment that have come to an end decreased last year to 19 weeks, i.e. slightly more than four months. Under conditions of swift economic growth, the time it takes persons who have been temporarily unemployed to find a job will also decrease in the future. The average length of spells of unemployment will no longer increase; on the contrary, a slight decrease can be expected. The average spell of unemployment decreased in all age groups except for persons over 60 years old. The spells of unemployment nevertheless last an alarmingly long time, especially for older persons.

Public Sector Surplus Widening

The central government's budget deficit has shrunk swiftly as a result of stringent austerity measures and favourable economic growth. This year the deficit will turn into a surplus, which will continue to grow next year due to the relatively strong economic growth. This year the surplus will be about FIM 6 billion. Next year the surplus will widen to some FIM 15 billion.

Even though the situations differ appreciably across municipalities, their financial positions will improve on average. The marginal fiscal deficit of the municipalities will turn into a slight surplus this year and next. Because the financial surplus of the social security funds continues to grow, the financial position of the public sector as a whole will improve substantially this year and next.

The favourable financial position, bolstered for example by the privatization of state-owned companies, will facilitate the rapid decline in the public sector debt. The rate of decline in the debt will nevertheless depend on the choices of decision makers. We project that the central government debt will decline this year and next substantially. At the end of next year it may already be below FIM 380 billion. The public sector's EMU debt will also decrease. At the end of the year 2001 the ratio of EMU debt as a percentage of GDP may be under 40 per cent.

The substantial strengthening of the financial position is based on the dampening of growth in public expenditures. (The forecast does not include any new decisions to ease the tax burden by reducing tax revenues.) Public consumption expenditures will rise this year and next by about one per cent in real terms. The public sector's share of the economy will continue to contract.

Public expenditures as a percentage of GDP is declining to a level last seen in the mid-1980s. Because interest expenses will still decline, it appears that the ratio of public spending relative to GDP will continue to fall - unless there are profound changes in economic policy.

No Great Inflation Pressures from Wage Settlements

Even though the economic outlook appears rather favourable in the near future, the threat of a halt in the debt-driven growth in the US should be taken seriously. Only those who believe steadfastly in the "new economy" can downplay the risks related to US economic growth. There is no reason to disregard this threat.

The weakening of international prospects constitutes the main threat to Finland's economic growth already for the reason that the share of exports within aggregate output has risen exceptionally high during the post-recession years of export-driven growth.

At the risk of oversimplifying matters, current economic developments can be contrasted with the go-go years of the 1980s as follows. During the boom in the late 1980s and recession of the 1990s domestic factors were of paramount importance; nowadays the risks come from outside Finland.

In the Finnish economic policy debate, the threat of wage inflation has gained special emphasis. Some claim that the wage hikes have been so excessive that they may ruin the price competitiveness and profitability of the Finnish export industry. Our forecast does not support this view. The wage agreements signed this spring will help to sustain the average profitability of companies at the exceptionally high level witnessed at the beginning of the 1990s.

The overheating of the economy should thus not be the major worry of economic policy in the near future. Those emphasising the threat of overheating simultaneously downplay Finland's unemployment problem. Even though Finland's unemployment rate will decline this year and next, unemployment will nevertheless remain one of our society's main problems.

Figure 1. GDP and Employment

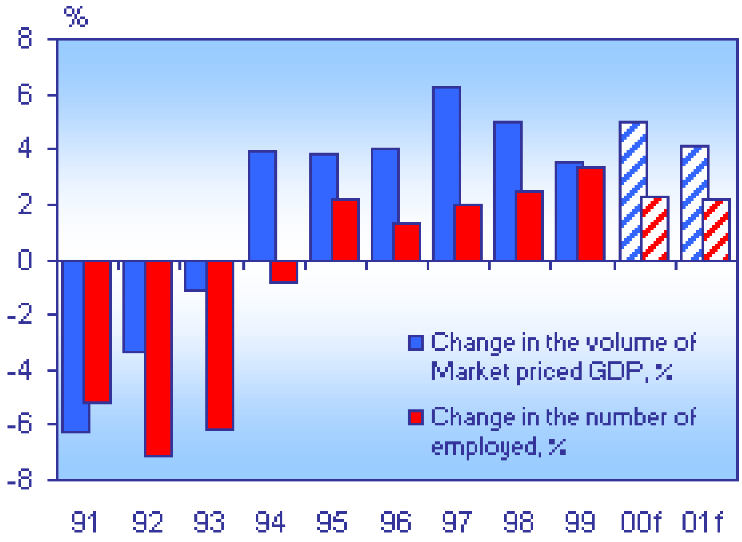


Figure 2. Household Debt Ratio

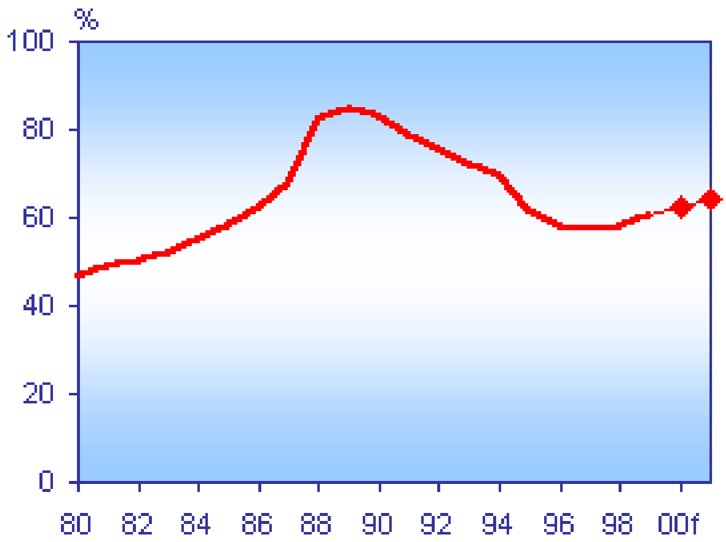


Figure 3. Private Consumption and Saving Rate

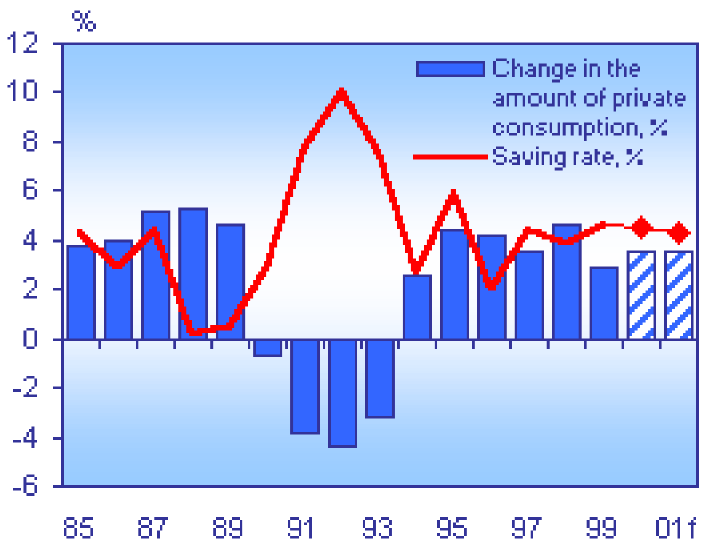
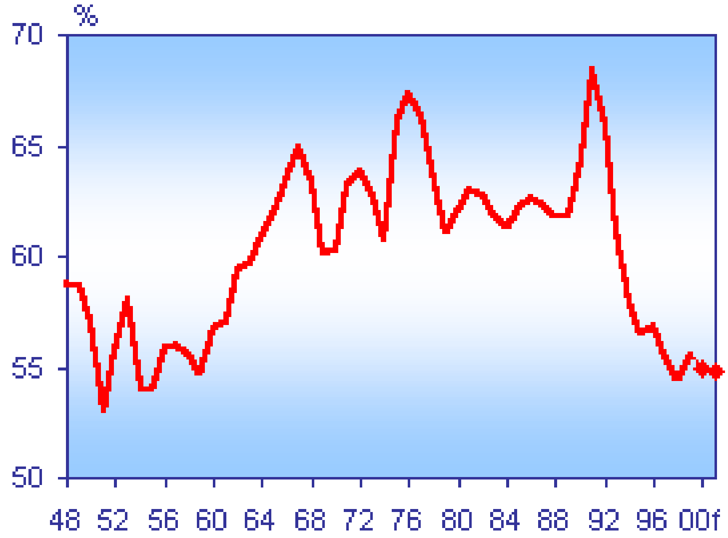


Figure 4. Distribution of Income between Labour and

Capital in Private Sector



DEMAND AND SUPPLY

	1999	1999	2000f	2001f
	Bill. FIM	Percentage change in volume, %		
Gross Domestic Product	718.0	3.5	5.0	4.1
Imports	211.5	3.4	7.8	7.0
Total supply	929.5	3.5	5.7	4.8
Exports	270.9	7.4	9.5	6.9
Consumption	515.8	2.1	2.8	2.8
- private	363.1	2.9	3.5	3.5
- public	152.8	0.3	1.0	1.0
Investment	138.7	4.8	7.8	7.0
- private	119.2	7.0	9.0	8.0
- public	19.5	-6.3	1.0	1.0

Change in stocks	4.1	-0.7	0.0	0.0
Total demand	929.5	3.5	5.7	4.8

KEY FORECASTS

	1999	2000f	2001f
Unemployment rate , %	10.2	9.2	8.3
Unemployed (1 000)	261	239	217
Employment rate , %	66.5	67.7	68.9
Employed (1 000)	2296	2348	2399
Inflation, consumer price index, %	1.2	2.6	2.3
Wages, index of wage and salary earnings, %	2.5	4.0	4.0
Real disposable income of households, %	3.7	3.4	3.5
Current account surplus, Bill. FIM	37.8	40.8	42.1
Trade surplus, Bill. FIM	65.2	69.0	71.0
Central government financial surplus, Bill. FIM	-4.4	6.0	15.0
% / GDP	-0.6	0.8	1.8
General government financial surplus, Bill. FIM	16.2	31.0	44.0
% / GDP	2.3	4.0	5.4

EMU debt, % / GDP	47.1	42.4	37.2
Short-term interest rates (3-month Euribor)	3.0	4.1	4.7
Long-term interest rates (10-year gov't bonds)	4.7	5.1	5.2