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**Economic Forecast for  
2008–2009**



**Uncertainty  
spreading –  
also Finland's  
economic growth  
is slowing down**

**Additional information**

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**Economic Forecast 2008–2009**

## Uncertainty spreading – also Finland’s economic growth is slowing down

*The Finnish economy grew last year by 4.4 per cent compared to the previous year. Growth was still much faster than in the EU countries on average. In the future Finnish economic growth will to an increasing extent follow the pace set by international economic developments. Finnish economic growth will react above all to the slowdown in the main export markets in the EU region. Finnish gross domestic product will grow this year by three per cent compared to last year. Next year the rate of economic growth will remain fairly swift even though it will slow down to 2.8 per cent.*

In 2007 Finnish economic growth was driven especially by the relatively swift growth in private investment by about 8 per cent. The impact of foreign trade on economic growth was clearly positive as the volume of exported goods and services grew by 4.8 per cent while imports rose by a slightly smaller margin, i.e. 4.1 per cent. The 3.7 per cent growth figure for private consumption can be regarded as high. This year Finnish exports will slow down considerably. In contrast, both consumption and investment will grow this year comparatively swiftly. Next year the focal point of Finnish growth will shift back to foreign trade.

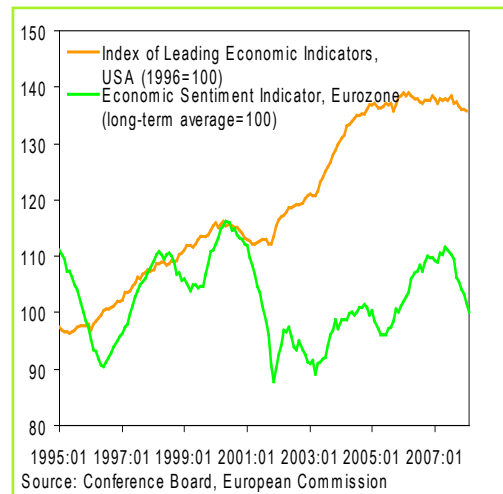
US economic growth is slowing down close to a recession and this reflects also on Europe partly because the euro has appreciated substantially against the dollar. Growth will nevertheless not slow down in Europe as much as in the US. First, this is based on the view that the sub-prime crisis is a liquidity crisis plaguing American not European households. Second, the European economies are more stable on average than the US, for which reason in Europe there is clearly more internal economic growth dynamics than in the US. This is substantiated by the phenomenon that eurozone private consumption growth is not subsiding.

Finland’s economic growth risks are related to the US. Part of the direct effects of the sub-prime crisis on the banks is still unrealized and there is a threat that the crisis will spread further in the financial markets. This compiled with the deterioration of the situation in the housing loan markets could lead to an even steeper decline in the US economy. As a consequence the euro could still appreciate substantially against the dollar and dollar-denominated prices of oil might also rise considerably. In this scenario, the economies in Asia, Europe and Finland could grow much more slowly than projected in the adjacent forecast.

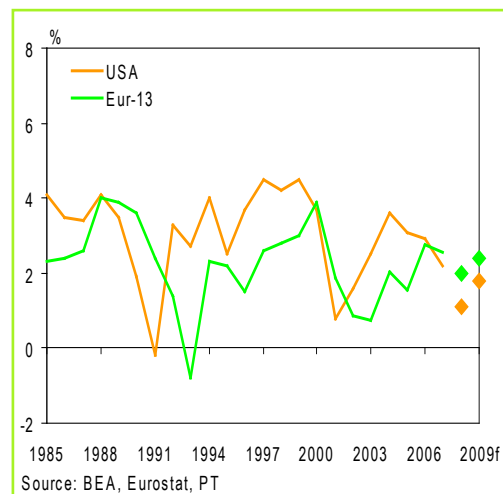
### European economic growth subsiding moderately

The overall output of the eurozone grew by 2.7 per cent last year from the previous year. The growth of the overall EU was 2.9 per cent. The growth rate decelerated somewhat towards the end of the year. Growth in the eurozone and the EU was driven by fixed investments and foreign trade. Private consumption, on the other hand, grew by roughly 2 per cent, being distinctly slower than GDP growth. European countries have differed from each other comparatively much with respect to their economic situations. For instance, the private consumption of Germany even contracted last year partly spawned by the increase of the value added tax rate. Correspondingly, in France, Spain and Great Britain private consumption grew moderately fast.

### International leading indicators 1995:01–2008:02



### Total production in the USA and eurozone 1985–2009



**International economy**

GDP growth (%)	2007	2008f	2009f
United States	2.2	1.1	1.8
Euro-13	2.6	2.0	2.4
Germany	2.5	1.9	2.4
France	1.9	1.8	2.2
Italy	1.5	1.2	1.7
EU27	2.8	2.2	2.6
Sweden	2.6	2.8	3.0
United Kingdom	3.1	2.4	2.6
Japan	2.1	1.9	2.2
Russia	8.1	7.5	7.5
China	11.4	10.0	9.5

Source: BEA, BOFIT, Eurostat, Labour Institute for Economic Research

In the future, European economic growth will decelerate in the wake of the downturn in the US. In addition to the stagnation of US import growth the real economy of Europe is influenced by the significant strengthening of the euro in comparison to the dollar and the steep increase in prices of raw food materials, which has also boosted European inflation. In our basic forecast scenario the euro is only expected to strengthen moderately in comparison to the dollar, so that one euro would cost about 1.55 dollars at the end of the year. As a counterweight to the regression of the US economy, economic growth in Asia, Russia and new EU member countries will remain rapid, thereby supporting the financial development of Western Europe and the eurozone. Also the countries with close trade relations with oil producers will survive better than the others. Additionally the positive employment development of the eurozone will bolster the financial development of the area.

In different countries the growth outlooks again differ from each other somewhat. Spanish growth has been based on lively housing construction. Housing loans are becoming more expensive and households' debt servicing expenditures are climbing in relation to income expectations. These trends are dampening the growth of domestic demand and overall output. In Germany favourable employment trends and the expected moderate real income developments are brightening up private consumption. Therefore the growth rate of Germany will slow down comparatively little despite the dwindling of the contribution from foreign trade to growth.

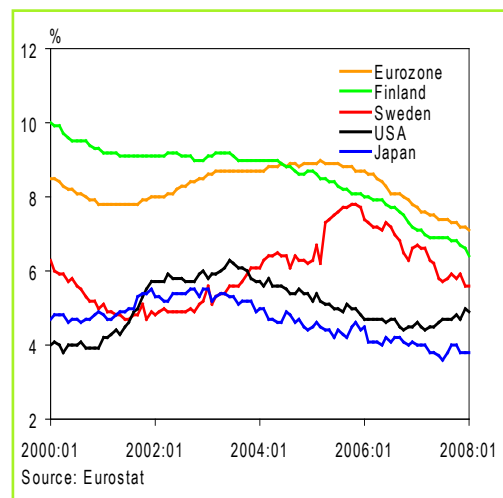
This year the GDP of the eurozone will only grow 2.0 per cent compared to last year. The contribution of exports to growth will weaken due to the effects of the strengthening of the euro. Private and public consumption will continue to grow at a rate of about 2 per cent but the growth of private investments will decelerate to 3 per cent. Next year the growth of the eurozone will accelerate to 2.4 per cent and growth of the entire EU to 2.6 per cent mostly due to the growth of export and private consumption becoming faster.

The employment situation of the EU will remain relatively positive despite the deceleration of the growth rate of GDP. Therefore, the unemployment rate of the EU will decline this year to an average of 7.1 per cent this year and 6.8 per cent next year.

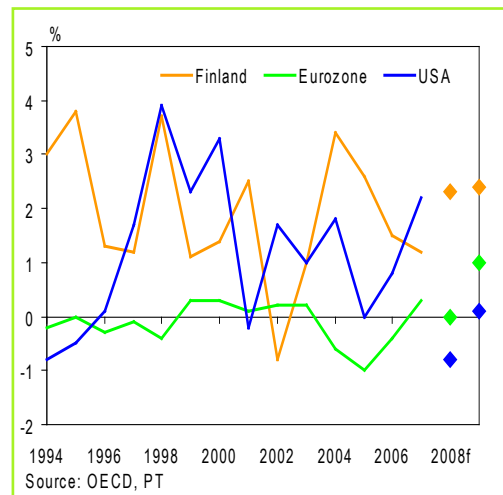
**US economy on the verge of a recession**

The economic growth of the US has slowed down abruptly. Households taking on debt, which has resulted in a housing loan crisis, and the weak competitiveness of the US foreign trade are the clearest reasons for this deceleration. At first the downhill of the US economy could be seen in a sharp reduction in the amount of housing investments. Now the economic difficulties are starting to be more far-reaching, which can also be seen in the weakening of retail sales and the clear

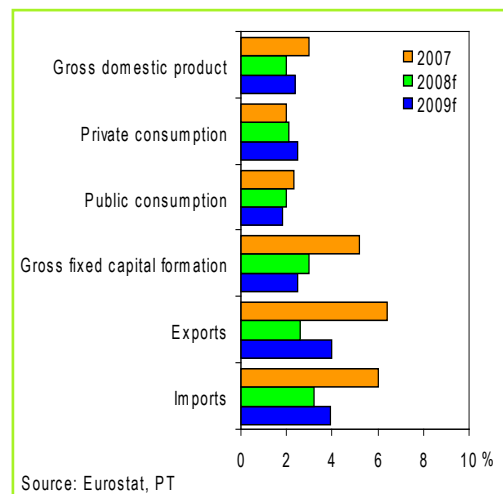
**Unemployment in assorted countries 2000:01–2008:01**

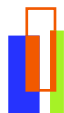


**Change in real earnings 1991–2009**



**Eurozone economic growth 2007–2009**





deceleration of the growth of industry output. On the other hand, the sharply weakened dollar has improved the trade deficit of the US, but despite export brightening up the growth of the US will still remain slow even next year.

This year the growth rate of the overall output of the US will slow down to 1.1 per cent from last years' 2.2 per cent. In the first half of the year no growth will be generated at all. The greatest uncertainty will give way partly due to the influence of expansionary monetary and fiscal policy so that the economy will begin to grow again in the next half year. The improvement of foreign trade as a result of the dollar weakening is also having a similar impact. However, the employment situation in the US will remain weak for the entire year, which already constricts the growth of private consumption. The entire domestic demand will indeed remain feeble long into next year so that economic growth will remain at 1.8 per cent.

### World monetary policies are not in sync

The monetary policy of the European Central Bank is affected primarily by the acceleration of inflation to over three per cent starting in December. Excluding energy and food the rise in inflation would nevertheless have been only slightly more than two per cent. According to the goals of the ECB, inflation must be kept below but nevertheless near a long-term average of two per cent. Because the ECB does not gauge its policy on core inflation adjusted for external factors, it cannot be expected to take in consideration that it is precisely external factors that have raised the rate of inflation to current levels.

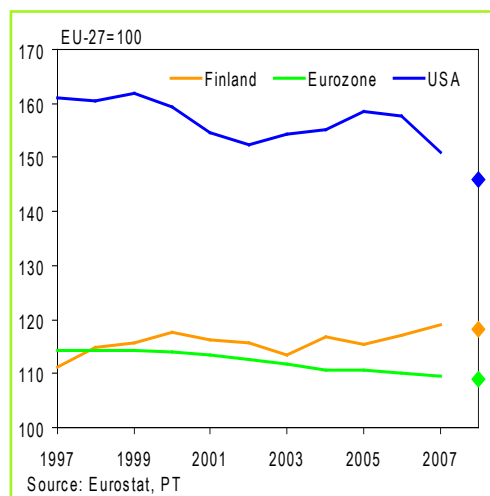
The lowering of interest rates would be justified by the weakening of growth prospects and the sharp easing of US monetary policy, which has led to the significant weakening of the euro. In fact, the dollar has appreciated against the euro by 10.6 per cent (by March 18, 2008) after the Fed began to lower its reference rates (Sept. 18, 2007). It appears that the tapering off of the rise in oil and food prices will dampen inflation during the course of this year, especially starting in the autumn. The price of oil is expected to fall to around 90 dollars per barrel. Against this background the ECB not will lower its reference rate for the first time until autumn. The Labour Institute for Economic Research expects that the ECB will lower its reference rate by a total of only 0.5 percentage points during this year and a further 0.25 percentage points next year.

When it became apparent that the sub-prime crisis is weakening the US economic growth appreciably, the Fed began to lower interest rate last autumn. By now (March 10, 2008) the Fed funds rate has been lowered by 2.25 percentage points. The Fed funds rate now stands at 3 per cent and it is likely that it will be lowered this year by a further 1.25 percentage points and next year a further 0.25 percentage points.

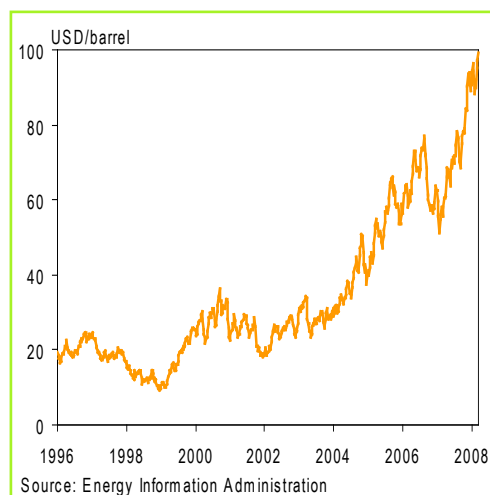
It is worth noting that while the Fed has eased monetary policy, US consumer price inflation has remained about a percentage point faster than eurozone inflation. Correspondingly the ECB's forecast for eurozone GDP growth (1.3 - 2.1%) has been almost the same as the Fed's corresponding forecast for GDP growth in the US. According to the central banks' own projections, the monetary policy stances in the US and Europe should be on par with one another. The fact that the Fed has nevertheless lowered interest rates by such a large margin and so quickly is hardly inconsequential for Europe. Already now we can say that the sharp easing of US monetary policy has reflected strongly on exchange rates and spurred uncertainty in the international financial and currency markets and thus had a negative impact on potential global economic growth.

The sharp appreciation of the euro means that the costs spawned by the crisis have become also Europe's burden to bear. From Europe's standpoint it would have been clearly better if the Fed had eased monetary policy more moderately and that economic policy would have been pinpointed to supporting individual sub-prime customers and financial institutions undergoing

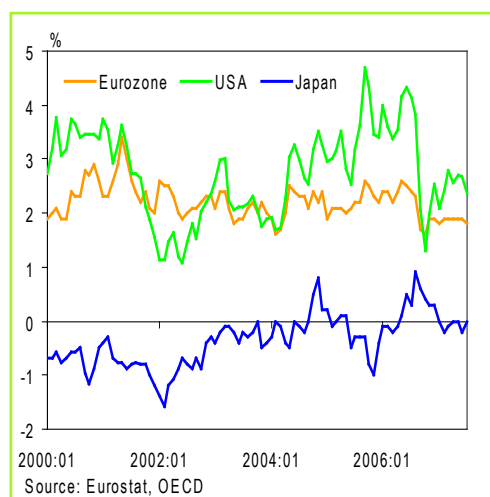
### Purchasing power adjusted GDP per capita 1997-2008



### World market price of crude oil (Brent) 1996-2008



### Inflation in assorted countries 2000:01-2008:01





difficulties. This view is based on the observation that the general effectiveness of monetary policy in the US has decreased significantly as the importance of liquidity has increased strongly in different economic sectors.

In recent days the ECB has announced its concern about the wide swings in exchange rates and negative impact of the appreciation of the euro on eurozone economic growth. For the time being the ECB has not criticized US monetary policy. In contrast, the head of the ECB has hinted that US actions are aimed at promoting a strong dollar. The leadership of the ECB should try to foster a situation where the monetary policy of the key countries and blocs of countries would foster sustainable economic growth.

### Asia's growth continues to be swift

In Asia – except for Japan – economic growth continues to be swift despite the slackening of exports headed toward the US. China's rate of growth is sustained by the expanding domestic market and "internal market" of other Asian countries, exports to which have partly made up for the shortfall in American markets. The channelling of trade surpluses accumulated in previous years to investments gives a possibility to sustain high investment rates. India's growth is based on domestic markets and on the strengthening of other Asian markets. In Russia the revenues from oil and gas are fuelling domestic demand and swift growth of public consumption, which also fosters private consumption. Russia's growth rate will remain this year and next at almost 8 per cent.

### Export demand slackening – Finnish growth slowing down

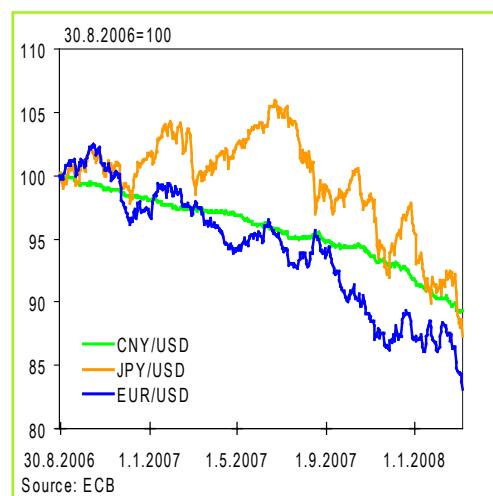
Economic growth decelerating in EU countries cannot help reflecting on Finnish foreign trade. Export volume growth will indeed decelerate this year to 2.8 per cent from last year's 4.8 per cent. Service exports will grow clearly more than the export of goods. Exports to Asia and Russia will grow faster than on average. Also the stagnation of US economic growth will cut Finnish exports. Because the emphasis of exports to the US is on ship deliveries, the effects will only begin to show more clearly beginning 2010. Next year the pick-up in European economic growth will boost Finnish export growth to 4 per cent. The amount of imports will grow by a good 3 per cent both years. Imports will be boosted this year by car sales, nuclear power plant projects and plane purchases. Next year imports will react to the acceleration of export growth.

The rise in oil prices in particular will boost import price inflation still this year. On the other hand, the strength of the euro will lower import prices so that prices of goods import will only rise by 1.5 per cent from last year. At the same time, goods exports will rise by only about 1 per cent. Next year, when the euro is no longer expected to strengthen, goods import prices will rise by 2 per cent. The prices of goods exports are expected to rise 0.5 percentage points more slowly. Export and import service prices, on the other hand, will rise almost at the same pace. Thereby prices of overall exports will rise both this and next year somewhat more slowly than import prices.

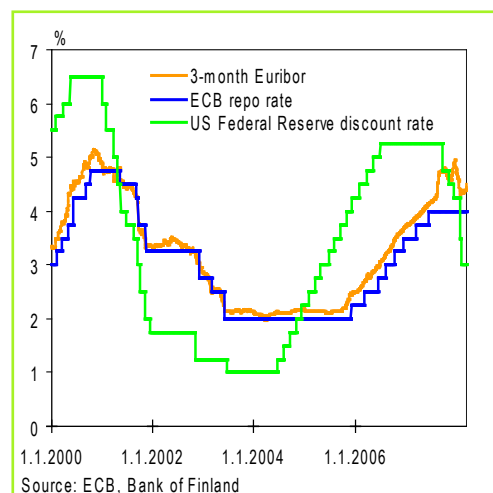
### This year's motor of growth is services, next year industry

Decelerating export growth will reflect almost as such on the growth of industrial production. The growth outlooks of industry have weakened to a certain extent recently. The overall situation is nevertheless still comparatively positive, and also new orders received in January indicate the moderate continuing of

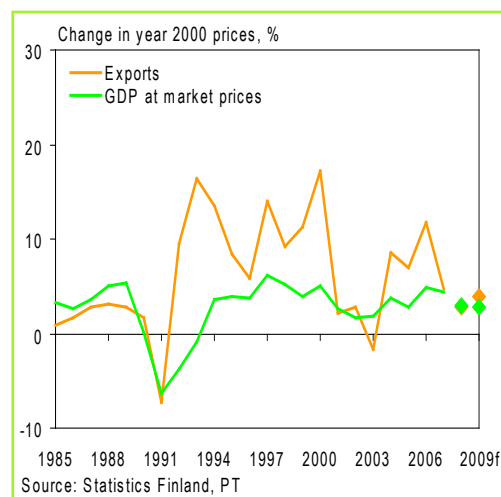
### Exchange rates 30.8.2006–7.3.2008



### Short-term interest rates 3.1.2000–7.3.2008



### Change in total production and exports 1985–2009





growth. Next year the growth of industry will accelerate again. The production of the metal industry will grow by 6 per cent both this and next year. The chemical industry will also grow at a more rapid pace than the rest of the industry. The growth rate of the electro-technological industry will remain at about 3 per cent. The distinct slackening of construction in the US and several European countries has decreased the demand for raw timber, which has been evident in the reduction of the production of the mechanical wood industry. The situation will still remain rather weak even next year. The production of the paper industry will not significantly grow this year, and next year it will already be threatened by Russia's wood customs duties going into effect.

Construction will remain busy this year, but next year its growth rate will slow down to 3 per cent. As regards services, the wholesale and retail trade will still grow at a rapid pace this year. The production of business services will increase substantially both this year and next. Administration and personal services, which include both education and healthcare, will grow 2.5 per cent this year spurred by the growth in expenditures by the municipalities and the central government being distinctly swifter than last year. Next year the growth of the production of these services will decelerate to 1.5 per cent.

### Employment situation still improving

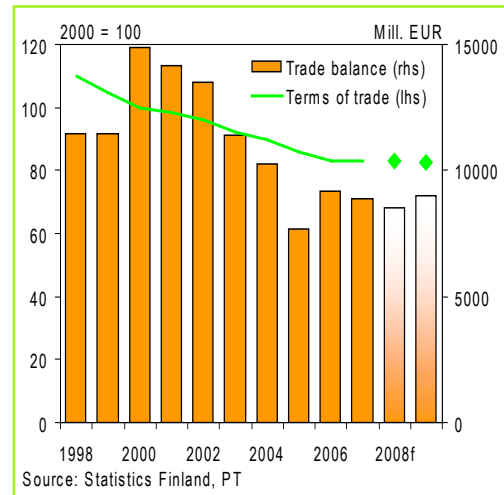
The amount of employed people increased last year by 48 000 persons and the unemployment rate fell to 6.9 per cent. Jobs were generated especially in activities serving business: construction, the wholesale

#### Key forecasts

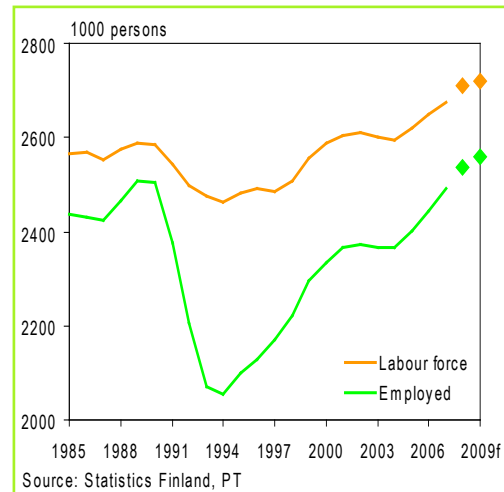
	2007	2008f	2009f
Unemployment rate (%)	6.9	6.3	6.0
Unemployed (1 000)	183	171	163
Employed (1 000)	2492	2538	2558
Employment rate (%)	69.9	70.9	71.2
Inflation, consumer price index (%)	2.5	3.2	2.3
Wages, index of wage and salary earnings (%)	3.3	5.3	4.5
Real disposable income of households (%)	2.4	4.0	3.1
Current account surplus (Bill. €)	7.8	7.4	7.9
Trade surplus (Bill. €)	8.9	8.5	9.0
Central government financial surplus			
Bill. €	3.6	2.7	2.8
% / GDP	2.0	1.4	1.4
General government financial surplus			
Bill. €	9.4	8.2	8.0
% / GDP	5.3	4.4	4.0
Emu debt			
% / GDP	35.4	33.4	31.7
Tax rate (%)	43.1	42.9	42.5
Short-term interest rates (3-month Euribor)	4.3	4.1	3.5
Long-term interest rates (10-year gov't bonds)	4.3	3.8	3.7

Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

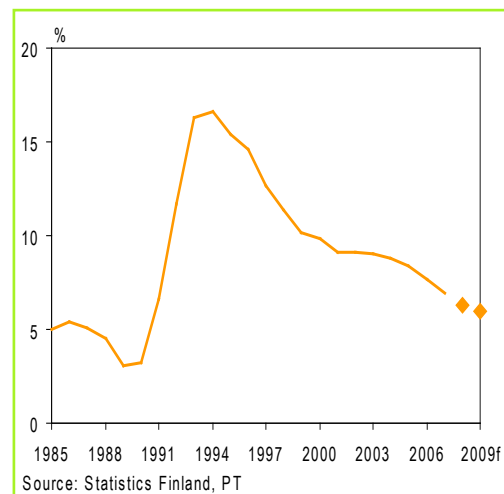
### Terms of trade and trade balance 1998–2009



### Supply of labour and employment 1985–2009



### Unemployment rate 1985–2009



and retail trade and hotels and restaurants. The amount of long-term unemployed dropping by almost 20 per cent was also encouraging.

Employment developments will continue to be favourable also in the current year, so that the number of the employed will increase by 46,000 persons. A positive cyclical situation and growth in the population will also increase the size of the labour force by 34,000 people, and the unemployment rate will decline to an average level of 6.3 per cent. However, the new employment figures are not completely accurate in comparison to the employment figures of previous years because Statistics Finland has renewed the content and gathering of information in its labour force survey. For instance, as a result of the reforms those on alternating and caretaking leave are no longer automatically classified as being outside the labour force as before. Therefore we forecast that the employment growth will not fully be reflected in the number of man-hours worked, which is estimated to grow by 0.9 per cent. Statistics Finland will more specifically inform of the impact of the reforms during this year.

Labour market developments will continue to be positive also next year, although the slackening of the boom and labour force shortage in some sectors are curbing economic growth somewhat. Some 20,000 jobs will be generated and the labour force will increase by 12,000 among other things due to immigration. The unemployment rate will drop to 6 per cent. The employment rate will rise this year to 70.9 per cent and next year to 71.2 per cent.

### Wages rising faster, but functional distribution of income remains unchanged

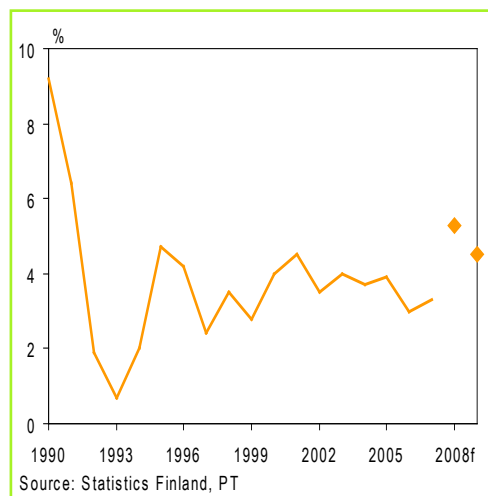
In 2007 the comprehensive incomes policy settlement expired and union-specific wage settlements will determine the development of contract wages during the next two years. Last year the level earnings rose by 3.3 per cent. As employment improved, average hourly earnings and the wage bill grew clearly faster than the growth in earnings. The wage bill increased 5.9 per cent. In the union-level wage round the settlements of the service sector and the public sector were signed later than the most important industrial unions, and these sectors also reached somewhat higher percentage increases.

As a new feature the wage settlements included increased leeway for agreeing on certain matters at the local level and a lump-sum payment in the beginning of the contract period. We estimate that the local negotiation of pay hikes will significantly decrease wage drift. This year the level of earnings index will rise by 5.3 per cent, of which 4.4 percentage points is the share of the contract wage index. In 2009 the level of earnings will rise by 4.5 per cent and contract wages by 3.7 percent. The difference between the years is attributable almost completely to the increase in wages carried over from the previous year to 2008. Economic growth will continue to boost labour demand. In this situation average hour earnings will rise slightly more swiftly than the level of earnings. Overall the wage bill will grow by 6.3 per cent this year. In 2009 employment growth will decelerate and the wage bill will grow by 5 per cent.

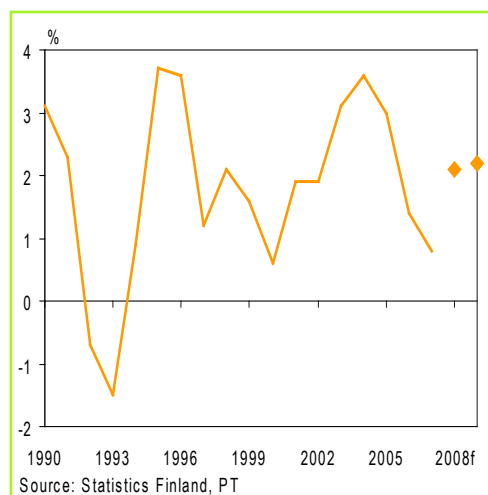
Last year the share of wages in the value added of businesses decreased to the previous record low level of 2001. Although the wage settlements of the union-level round were commonly deemed to be expensive and as increasing cost pressures, they do not actually raise the share of wages in the private sector's value added. The share will remain clearly below the level prevailing in recent years.

This year the growth of households' capital income will slow down. The downturn in the stock market and growing uncertainty are increasing the popularity of bank deposits. A related trend is a decline in households' stock investments and dividend income. As a result of rising prices, forestry and agricultural sector income will continue to grow. On the other hand, households will continue to borrow and the interest expenses

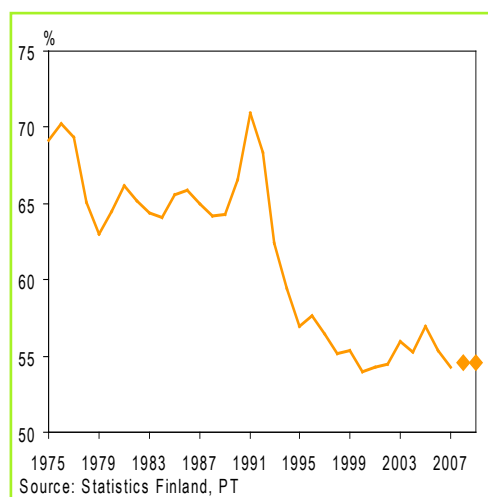
### Change in level of earnings index 1990–2009



### Change in real earnings 1990–2009



### Functional distribution of income in business activities 1975–2009



of housing loans will continue to rise. In the last few years the income development of wage earners has been supported by tax cuts, but this year adjustments made to the income tax brackets will not be enough to ease the burden of wage taxation. However, the taxation of pensioners will be eased. We predict that the disposable income of households will grow by 6.3 per cent this year and 5.2 per cent next year.

### Households more indebted even though consumption growth is decelerating

For many years, private consumption has grown faster than average. Growth has been fuelled by strong consumer confidence, declining interest rates and stable economic prospects. Last year the amount of consumption growth, 3.7 per cent, was clearly above the rate of growth for disposable real income. Although growth will slow down this year to 2.9 per cent as the inflation rate accelerates, household will continue to incur more debt. The saving rate of household is minus three per cent this year. In recent years the emphasis of consumption has been in the direction of semi-durable products and durable goods. The structure of consumption has had a positive effect on the state finances through indirect tax revenues.

#### Demand and supply

	2007	2007	2008f	2009f
	Bill. €	Percentage change in volume (%)		
Gross Domestic Product	178.7	4.4	3.0	2.8
Imports	71.8	4.1	3.1	3.1
Total supply	250.5	4.3	3.0	2.9
Exports	80.1	4.8	2.8	4.0
Consumption	128.4	2.8	2.8	2.3
private	90.5	3.7	2.9	2.6
public	37.9	0.8	2.5	1.5
Investment	36.3	7.6	4.8	2.7
private	31.9	8.1	4.5	3.5
public	4.4	3.4	7.0	-3.0
Change in stocks	5.7	1.8	1.0	0.9
Total demand	250.5	4.3	3.0	2.9

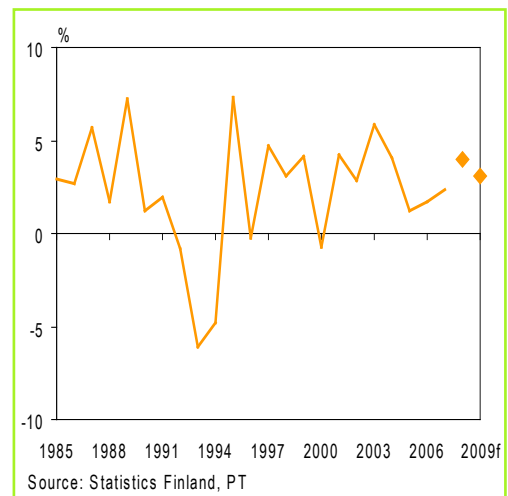
Source: Statistics Finland, Labour Institute for Economic Research

Recently consumer confidence in the economy has significantly weakened as a result of news from the international credit market, but people still believe in their own financial positions. Car sales came to a halt at the end of last year in anticipation of the automobile tax cuts. The pent-up demand will be released in the start of this year. For this reason, the consumption expenditures on durable goods will still grow at a swift pace, although other purchases will increase more slowly than before. By 2009 the growth of private consumption will slow down to 2.6 per cent.

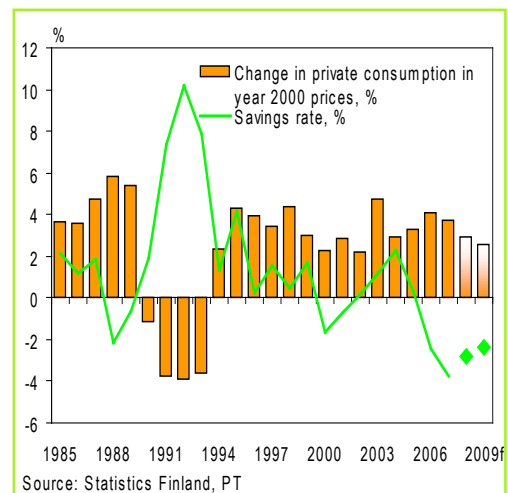
### Taxation and food prices spur inflation

In recent years the prices of liquid fuels, the cost of living and interest rates on loans have been in a crucial position in the development of Finnish consumer prices. The effect of the interest rates on housing loans with respect to domestic inflation was almost a percentage point last year, and the average inflation rate was 2.5 per cent. The rate of

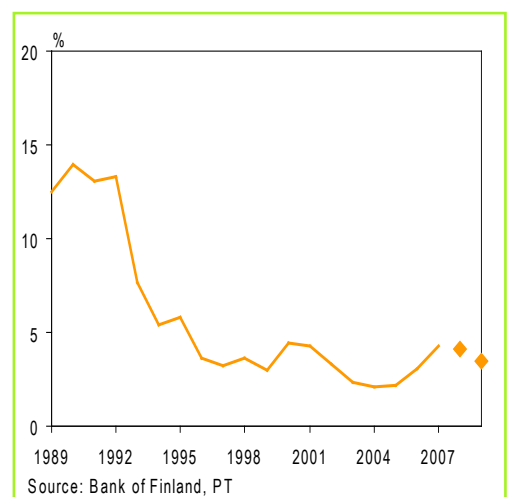
### Change in household real disposable income 1985–2009



### Private consumption and savings rate 1985–2009



### 3-month Euribor 1989–2009







inflation was anticipated to accelerate last summer as a result of the rise of the world market price of grain and the rapid rise of food prices detected in Europe. The Finnish inflation rate did not accelerate until January, but it then rose very distinctly, up by one percentage point. In comparisons based on harmonized price indexes Finnish inflation has come to and exceeded the inflation level of the eurozone.

This year inflation will change its form. In January the taxation decisions of the government spurred inflation by about half a percentage point. The main factors were increases in alcohol taxes and electricity and fuel taxes. Additionally the price of oil (Brent-quality) has climbed to a record level of over 100 dollars per barrel. As a whole the price of energy has risen by almost 19 per cent from one year ago.

The competitive situation of the food industry and trade is in a decisive position with respect to how the increase in manufacturing prices is passed on to consumer prices. The increase in food prices was concentrated toward the end of the year. In January the price of food rose by 5.8 per cent. This sort of reaction does not encourage hope on the competitive situation dampening the rise in prices. For this year we predict an over 6 per cent rise of food prices. Thereby the hopes concerning the value-added tax deduction scheduled for October 2009 on the lowering of food prices will not be fulfilled, because prices will be increasing before this and the tax deduction will only partly be passed on into consumer prices.

The price of owner-occupied housing rose at an average of 4.6 per cent last year. This year interest rates on loans will start to decline and the housing market will become more stable, and the price of living will no longer fuel domestic inflation. In the course of the year the ascent rate of consumer prices will slow down but the annual average will rise to 3.2 per cent. The taxation rises of this year will no longer affect inflation in 2009 when consumer prices will increase by an average of 2.3 per cent.

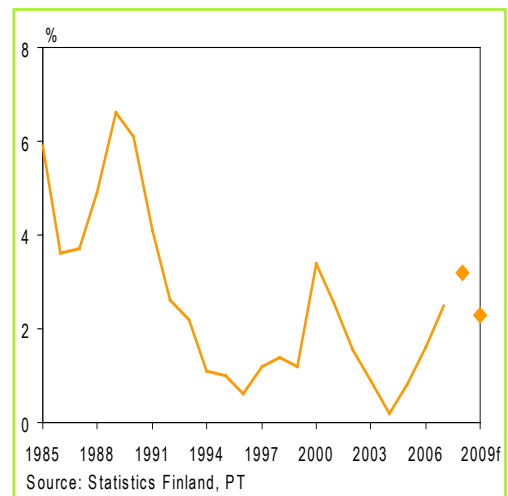
### Investment rate increased more than anticipated

Last year private investment grew at a robust rate of 8.1 per cent. Growth was especially driven by the construction of office space, while residential housing construction faded towards the end of the year. Also machinery and equipment investment grew visibly. Private investments are predicted to increase by 4.5 per cent this year. Growth is sustained, for instance, by growing machinery and equipment investments due to purchases by the Olkiluoto nuclear power plant and Finnair and additionally other construction besides housing. Also planned public projects increase land and water construction. However, new construction permits and starts indicate that housing construction will decline somewhat this year. Next year private investment will increase by 3.5 per cent. While the growth of other investments will slow down from this year, housing construction will recover again as loan interest rates decline.

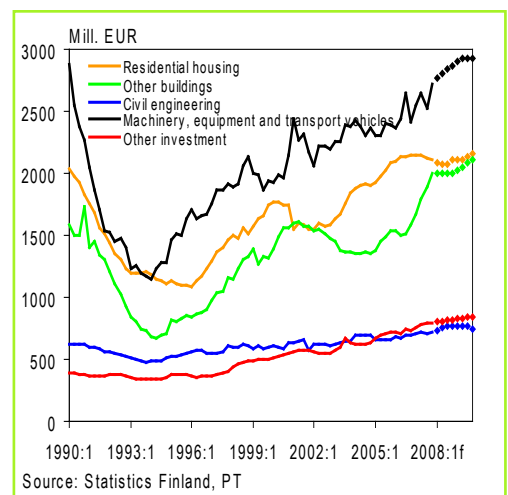
### Financial position of central government still strong

According to preliminary figures the consumption and investment expenditures of the central government in 2007 remained at two per cent, while in real terms they fell. In 2008 central government consumption expenditures are forecast to rise to 7 per cent. The acceleration of growth is affected especially by the strong growth in wage expenditures. Central government investment expenditures will increase by a fifth owing to the rise in the level of costs and several highway pro-

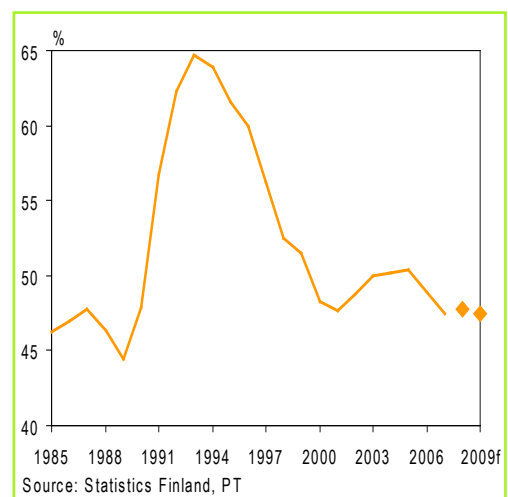
### Change in consumer prices 1985–2009



### Investment by sub-components 1990:1–2009:4



### Public expenditures as percentage of GDP 1985–2009



jects getting under way this year. Next year the growth in the central government's consumption expenditures is expected to slow down substantially and investment expenditures will fall from this year's level.

State indirect tax revenues last year increased by only 3 per cent owing to the slow growth of automobile and value added tax revenues. This year growth will accelerate to 5.8 per cent, from which it will slow down by a couple of percentage points. The impact on indirect tax revenues at the beginning of 2008 owing to the reduction in automobile tax and the increase in alcohol tax will offset each other. These taxes and tobacco tax will not undergo further changes during the forecast period. Value added tax revenues will grow strongly this year especially due to car sales, but they will be curbed next year by the slackening of private consumption and investment expenditures.

The record profits of enterprises in recent years were reflected in the central government's capital and corporate tax revenues. Moreover, as the tax base of wage income increased substantially, the central government's tax revenues as a whole rose by 11.6 per cent. In 2008 despite the growth in the wage bill by over 6 per cent, these revenues will rise much more slowly, which is attributable primarily to easing the tax burden of pension income and a slowdown in enterprises' revenue growth. In 2009 it is assumed that there will be no new easing of taxation except for a 3 per cent inflation adjustment. As growth in the wage bill slows down to 5 per cent and enterprises' earnings improve, total income tax revenues will climb somewhat faster than this year. The already implemented inheritance and gift tax reform will cut central government tax revenues slightly this year and by EUR 100 million next year.

The central government's capital income grew last year by about 30 per cent fuelled in particular by record dividends reaching almost EUR 2 billion. In 2008 the growth in capital income is forecast to come to a halt as the level of interest rates declines and dividend revenues remain at last year's level. Next year dividends paid by enterprises where the state is a shareholder are expected to fall substantially.

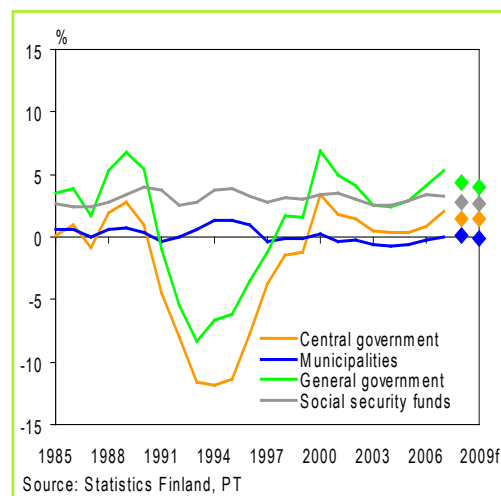
The decline in expenditures related to unemployment last year spurred a two per cent drop in the income transfers paid to state social security funds. In 2008 hikes in pensions and student aid will boost the growth in this spending item by 7 per cent, from which it will slow down substantially next year. The revenue sharing from the central government to the municipalities grew last year exceptionally little, 4.4 per cent, but increases and adjustment for this year will boost its growth to 12 per cent. In next year's forecast it is assumed that the cost level will rise by a corresponding 5 per cent.

Tax cuts and spending increases will reduce the central government's surplus this year by almost EUR 1 billion to 1.4 per cent of GDP. It will remain at this level also next year.

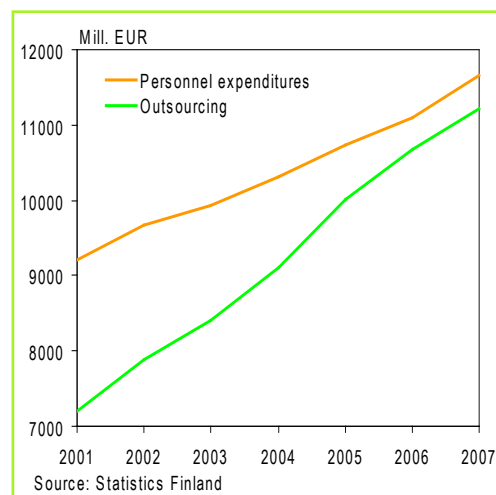
### Municipal consumption expenditure growth will accelerate considerably

In 2007 municipal consumption growth increased by slightly more than 5 per cent and investment expenditures by almost 8 per cent. This year on the basis of the budget summaries it is expected that growth in these expenditures will accelerate by three percentage points. Growth will be fuelled by growth in municipal tax revenues remaining at a good 7 per cent pace and especially the 12 per cent growth in state revenue sharing. In 2009 the growth in consumption and investment expenditures will slow down somewhat as tax revenues and state revenue sharing no longer increase as rapidly as before. The financial position of the

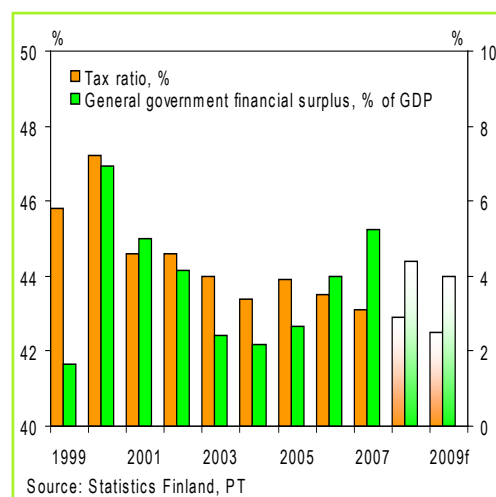
### General government financial surplus as percentage of GDP 1985–2009



### Municipal operative expenditures by components 2001–2007



### Public finances 1999–2009



municipalities will improve as they start to run a slight surplus this year, but next year the municipalities will incur a deficit of EUR 200 million.

Rapid progress has been witnessed in the outsourcing of municipal services this decade. The development is seen in the adjacent figure as purchased service expenditures have grown substantially faster than the municipalities' own personnel expenditures. In recent years the purchases of services have in some quarters even surpassed personnel expenditures and if the trend continues this would be the case permanently. Last year the growth rate of purchases of social and health services fell considerably short of previous levels while the growth in the municipalities' own personnel expenditures accelerated. This may reflect the tapering off of the rate of outsourcing services as well as the acceleration of the rise in wages in the municipal sector.

The volume of total public consumption will grow this year by 2.5 per cent and next year by 1.5 per cent. This year is rather exceptional with respect to public investments as their growth is projected to approach 7 per cent. Next year they will contract by 3 per cent.

### Employment pension institutions' surpluses unchanged – tax ratio declining

The contribution revenues of employment pension institutions and other social security funds will, like last year, show a slightly higher than 5 per cent growth rate this year and next. Pension expenditures will grow this year faster than last year, which will cut this sector's surplus by about one percentage point relative to GDP. The growth in pension expenditures will slow down slightly next year, but since no new increases in contributions have been decided the surplus will remain almost unchanged.

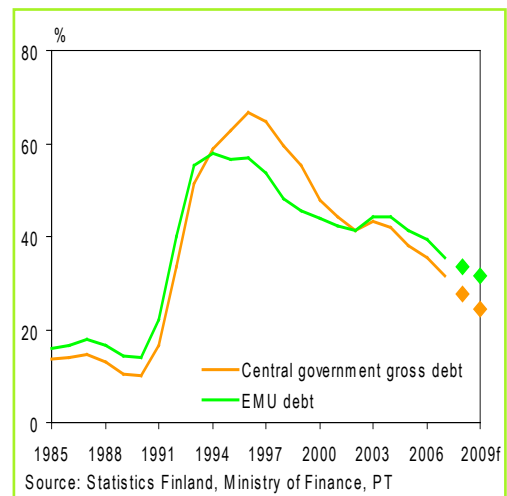
All in all the financial surplus of the general government relative to GDP will fall this year by 0.9 percentage points and next year by 0.4 percentage points, so that it will still be fairly high, 4 per cent. The debt-to-GDP ratio of the central government and the overall public sector will decline substantially. At the end of next year the central government's debt will amount to only 24.5 per cent relative to GDP. The tax ratio will continue to decline this year by 0.2 and next year by 0.3 percentage points.

### State highway and railway projects should be removed from spending framework

In recent years the favourable economic growth and relatively modest growth of public expenditures has fuelled a surplus for the public sector as a whole more than anticipated. Last year the surplus rose to 5.3 per cent of GDP. The economic policy leeway is much greater in Finland than elsewhere in Europe. This means that fiscal policy could even out cyclical fluctuations and, on the other hand, public funds could be allocated to promote long-term growth more efficiently than elsewhere on average.

From the standpoint of evening out cyclical fluctuations it would be good if the real growth in public consumption expenditures and investment in 2008 and 2009 could be held in check in accordance with the adjacent forecasts so that the financial deficit of the municipalities does not grow from current levels. Public investments affect preconditions for growth in the economy as a whole over the long run. Comparing public investments side-by-side with consumption expenditures and including them in the central government's growth framework is not wise since the additional investments reduce e.g. public consumption expenditures by a corresponding amount.

### Central government gross debt and general government EMU debt as percentage of GDP 1985–2009



With respect to taxes there is leeway for a moderate reduction in earned income taxes. This should not be allowed to endanger the financial position of the municipalities. The planned reduction in the value added tax on food also looks attractive in this situation where food prices have risen sharply. The sensibility of this action should nevertheless be reassessed. The steep and sudden rise in food prices at the beginning of this year showed that price formation in Finland exhibits all the signs of a cartel. If we evaluate the food chain – from processing to the retailers – market power is used in pricing so that enough of the reduction on value added tax is not passed on into consumer prices and if food pricing cannot be made competitive, alternative actions should be explored to support low-income persons. In any case steps should be taken to impinge on these mechanisms fostering use of market power in food price formation. Finland's greatest competition policy challenges are related to these phenomena.

Finland's biggest taxation problems are structural and manifest themselves in assorted forms of earned and capital income taxation. There is room to raise tax rates on dividends and capital gains. Moreover, the tax deduction for dividend income of unlisted companies up to 90,000 euros and the under-valuation of taxable dividends by 70 per cent are exaggerated. Related to this, the possibilities of wealthy entrepreneurs to shift taxes completely to capital taxation is not only unfair, it also distorts competition and in this way limits more efficient means to tax profits. The substantial easing of inheritance taxes on company assets now being planned is also a step in the wrong direction. ■



## Background of Sub-prime crisis

Housing investments have risen considerably in some of the industrialized countries during this decade. In addition to the US, these countries include Denmark, Great Britain, the Netherlands, Spain, Ireland, Australia and New Zealand. The amount of outstanding housing loans has also grown correspondingly. As a result of the housing credit boom, the net debt of households relative to total wealth and non-financial assets has climbed to a high level in the US, Denmark, Sweden and the Netherlands. In the USA and the Netherlands this ratio has risen faster than in recent years. For example, in Spain where housing construction has been especially lively, the wealth position of households is still relatively good. Of the largest eurozone countries Germany, France and especially Italy, the ratio of debt to assets has remained low and appreciably below the ratio, for example, in the US.

The share of debt servicing expenditures within disposable income has grown in countries where construction has been brisk. In the US the share of these expenditures was almost 12 per cent in 2006 while in the eurozone it was slightly more than 8 per cent. The share of debt servicing expenditures was nevertheless substantially higher than in the US. In Great Britain the burden of debt servicing expenditures is on par with that prevailing in the US.

On the basis of the above described developments it could not be forecast that the housing loan crisis would occur precisely in the US. The indebtedness of households and growth of debt servicing expenditures relative to disposable income nevertheless constituted one of the basic conditions for the outbreak of an open crisis. This condition was not prevailing, for example, in Germany, Italy, France, Japan nor in certain smaller OECD member countries.

The crisis also stems from special features of the US housing loans market. Housing loans were extended to low-income persons more than in other countries. The

terms of the loans are such that debt servicing expenditures rise sharply after a few years. In the case of the US the poor economic situation – the indebtedness of the entire economy and the weakening of public finances stemming from the war – formed a clear limit to economic growth. This and the concentration of growth in income on high income earners meant that the expectations of creditors and also sub-prime customers were not fulfilled regarding the loan recipients' debt servicing ability.

According to certain analyses the bundling of housing loans into one "mortgage-backed security" that can be sold in the market diversifies risk and makes the bank-dominated system more stable. On the other hand, it has been shown that when the risk reaches the bursting point, it is very difficult to control in a system based on securitization. It is now the case that the crisis, which in the new system should never have been born, spreads very strongly to the real economy and abroad. Thus as a consequence of the steep fall in housing prices the possibilities of American households to use their housing as collateral for consumer loans has been severely constricted, which is one of the reasons for the downturn in consumption.

It has also evident that the bundling of housing loans and resale as mortgage-backed securities has proved to be an avenue via which this crisis has spread to other countries, especially Europe. By spurring high losses also in European banks, weakening the trust between banks and raising short-term interest rates this crisis has widened the risk premium also in Europe, although not by as much as in the US.

All in all the sub-prime crisis will not affect Europe as much as it will affect the US, where the housing credit crisis has put a tight headlock on the basic unit of the economy, the household. The salvation of Europe has been that the countries where the overheating of the housing loan market – such as Denmark, the Netherlands and Spain – nevertheless constitute only a small part of the integrated region. ■