FORECAST MARCH 23, 2006

FUTURE OF FINNISH PAPER INDUSTRY – SEARCHING FOR A FATHERLAND?

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Economic forecast 2006 - 2007: ECONOMIC SITUATION FAVOURABLE – GLOBALIZATION DAMPENED INDUSTRIAL GROWTH POTENTIAL

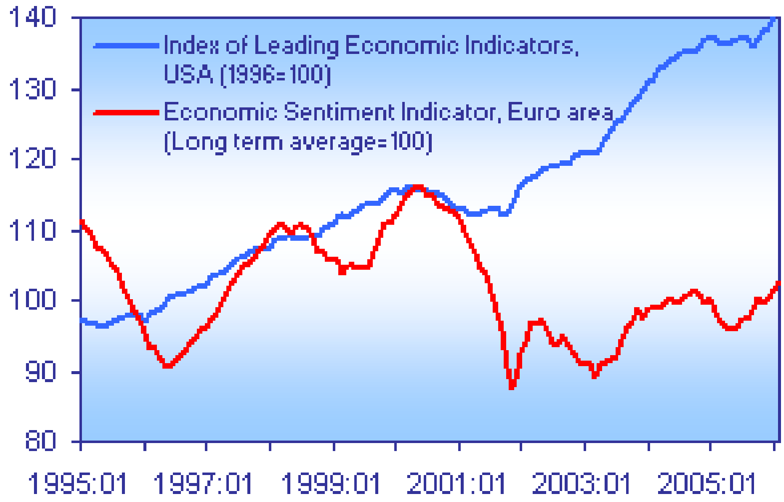
Finland's GDP grew last year by 2.1 per cent compared to the previous year. The production stoppage in the paper industry trimmed the growth figures by slightly less than one per cent. The expansion of industrial output was also otherwise lower than expected. Caution should be used, however, when interpreting last year's figures. Because of delays in National Account reforms, figures based on reliable calculations will not be ready until June-July. It is possible that the figures for last year will still be revised upwards somewhat.

This year and next economic growth will be rather brisk. Partly because of the stoppage in the paper industry due to a labour dispute last year, the GDP growth rate will rise to 3.8 per cent this year. Next year growth will be one percentage point lower. European growth will foster an expansion of output in Finland this year and especially next year. The rebounding of European markets will not, however, be able to spawn growth as fast as that experienced in the latter 1990s. Growth would be even faster were it not for the shifting of telecommunications equipment subcontracting out of the country and capacity cuts of the forest industry. Finnish economic growth in the short run will be even faster in the service sectors such as the wholesale and retail trade as well as business services, which will in turn boost employment.

Growth in the eurozone is picking up

GDP in the eurozone grew last year by 1.5 per cent compared to the previous year. This year growth will accelerate to slightly over two per cent. Growth will not be at its fastest until towards the end of this year. Partly for this reason next year's growth figure will rise to 2.6 per cent.

Figure 1. International Economic Indicators 1995:01 - 2006:02



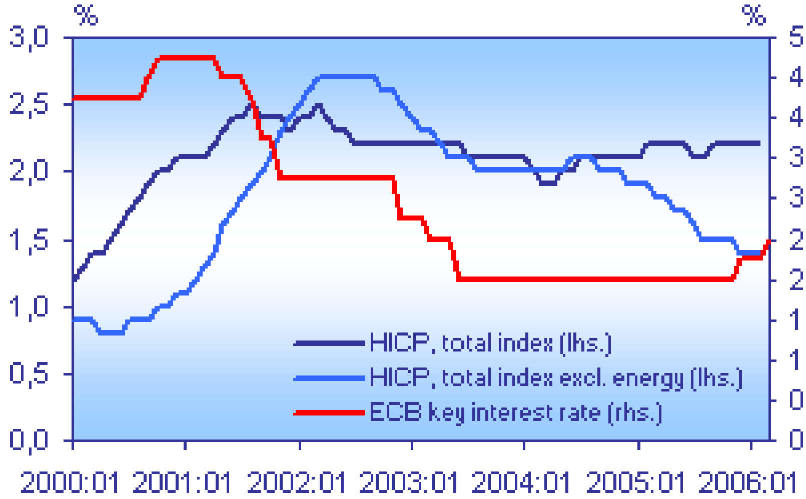
Source: Conference Board, European Commission

The economic outlook for the eurozone is more stable than it has been for a long time. Among other things the moderate wage developments and the depreciation of the euro to a tolerable level from the standpoint of competitiveness have improved the profitability of companies and bolstered their financial position, which in turn has improved the future outlook of companies and encouraged them to increase investments. The consumer confidence of the eurozone, which has been on the decline since the first half of 2002, has improved somewhat in recent months but this trend has not yet been reflected in a pick-up of private consumption. The consumer demand of households has been limited foremost by the modest rise in wages. On the other hand, the government has not been able to spur private consumption because fiscal policy has been geared toward strengthening the public sector's financial position and reducing the public sector's deficit in line with the stability and growth pact. Relatively high unemployment and a fear of losing manufacturing jobs to low wage countries has also sustained uncertainty, which has dampened consumption demand in the eurozone.

In the dynamics of the recovery of production in the core countries of the eurozone the growth of exports will improve the profitability of companies, which will in turn encourage them to invest. Only after this, when investments have increased households' income and created new jobs will private consumption recover. In this scenario, private consumption will begin to strengthen this year but its growth will not be at its fastest until next year. Private investment will grow this year and next by over three per cent compared to the previous year.

The disparity of economic growth trends within Europe will diminish somewhat. Germany's economic growth outlook has improved and its growth is picking up substantially. Regarding the EU as a whole, growth is fastest in the new member countries and in certain small member countries such as Ireland, Sweden and Finland. Cyclical developments in Europe will differ somewhat from those in North America. As a large economy Europe can develop relatively independently, which does not mean, however, that the US and Asian economies will not have any impact on Europe. An unexpected slowdown in GDP growth in America or Asia, which is not built into our basecase scenario, would sabotage also European economic growth.

Figure 2. Eurozone inflation and monetary policy 2000:01 - 2006:03



Source: Eurostat, Statistics Finland

The European Central Bank raised its key interest rates by 0.25 per cent on both December 6, 2005 and March 8, 2006. After being two per cent since 5.6.2003, the ECB's minimum bid rate on the main refinancing operations is now 2.5 per cent. The hike in interest rates was prompted by the acceleration of inflation. Inflation had started to climb beginning in September as prices of crude oil and petroleum products rose. In February inflation had already declined from its highest level of 2.3 per cent as crude oil prices have subsided again. The acceleration of economic growth in the eurozone in the third quarter of last year and the considerable improvement in the outlook of companies at the beginning of this year has also encouraged the hiking of interest rates.

The decision by the ECB can be questioned on the grounds that core inflation excluding energy fell during 2005 substantially below the level of 2 per cent. The rise in energy prices has an impact on consumer prices on the magnitude of about one percentage point. There is a fairly widespread belief that the rise in energy prices has not spawned an appreciable rise in other commodity prices. The ECB emphasized before its second rate hike that certain countries have raised administrative prices and indirect taxes, thereby indicating authorities believe that the threat of inflation is on the rise. These comments indicate that the ECB is prepared to raise interest rates later this year as well. It therefore appears likely that the ECB will raise interest rates by another half a percentage point this year. The desire to raise interest rates will be dampened somewhat by the decline in consumer price inflation.

Fiscal policy of Europe's largest countries marked by consolidation of public finances

The public sector deficits of the largest countries in the eurozone – Germany, France and Italy – have limited the possibilities of fiscal policy to boost economic growth. The deficits have impinged upon Greece, Portugal and to a lesser extent the Netherlands. The fiscal policy of the eurozone has been fairly neutral since 2004 and the fiscal policy stance will not change in this respect this year or next. The possibilities of countries to bring their deficits down below 3 per cent will be augmented in the future by the modest acceleration of economic growth.

US economic growth slowing down but still over 3 per cent

The US economy grew last year by 3.5 per cent, which is almost the same as what the Labour Institute for Economic Research forecast last autumn. Partly owing to the impact of Hurricane Katrina, economic growth slowed down in the last quarter to 1.6 per cent (compared to the previous quarter, adjusted on an annual basis). Last year US economic growth was driven by the swift rise in private investment. Residential housing construction was especially brisk. Private consumption grew by 3.6 per cent, which is still relatively fast. The growth in public consumption, on the other hand, slackened off. The impact of foreign trade (net exports) continued to be negative. Figures for the beginning of this year and the end of last year indicate a substantial slowdown in residential housing investment. Consumer confidence has weakened somewhat and the growth in private consumption is slowing down. Private consumption is projected to grow this year by about 3 per cent. GDP will grow in the US this year by 3.2 per cent and next year by 3 per cent.

US consumer price inflation (compared to last year) was 4 per cent in January, while inflation excluding energy and food raw materials was 2.1 per cent. The new chairman of the US Federal Reserve, Ben Bernanke, has announced that it will continue to raise interest rates in order to dampen inflationary pressures. The Fed funds rate has been raised a total of 14 times since June 2004 and now stands at 4.5 per cent. At the same time as short-term interest rates have risen the yield curve has flattened. The comparatively modest rise in long-term interest rates is attributable, on the one hand, to expectations that US economic growth is slowing down and, on the other hand, to the role of the US dollar as a reserve currency and anchor against which Asian countries have pegged their currencies. Asian central banks have purchased long-term US government bonds, which in turn put pushes bond prices up and their yields down.

The disequilibria plaguing the US economy have not abated. The trade and current account deficits have only increased. The public sector's fiscal deficit fell last year below 3 per cent of GDP but this year it is rising to about 3.5 per cent of GDP and without social security funds to about 5 per cent of GDP.

Russian growth driven by oil revenues

The rise in oil and gas prices has strengthened the Russian economy. The trade surplus rose last year to 16 per cent of GDP. The surplus in foreign trade has spurred an appreciation of the rouble against other currencies, also against the euro. The Russian central bank has not tried to thwart this trend. The proceeds from oil and gas sales have been invested also in other sectors. Household incomes have risen in the wake of the success of the energy sector, which has spurred private consumption. Private consumption grew last year by 11 per cent compared to the previous year, while the overall economy grew at a rate of 6.4 per cent. Fixed investment grew last year by about 10 per cent and it will continue to rise at almost the same rate in the future as well. Especially the government is increasing its investment and fiscal policy is being eased somewhat. The public sector will nevertheless continue to run a surplus. Russian growth will also be driven by strong foreign trade. Russian GDP will grow at a rate of 6 per cent in 2006 and 2007.

China's growth still almost 10 percent

Asia continues to be the engine of growth for the global economy. China's 9.9 percent growth last year exceeded expectations and Vietnam's and India's GDP growth is picking up to around 8 per cent. The economic growth in countries such as Indonesia and other more developed countries will continue to be fast, around 5 per cent even though growth in exports to the US will subside.

China's growth will slow down somewhat but remain at almost 9 per cent this year and next. The investment rate will decline from previous levels. Of the assorted industrial sectors, telecommunications production has witnessed by far the most growth. The production of paper and steel competing at least to some extent with Finnish production has grown faster than the average. As regards industrial products, production of manufacturing machinery and equipment as well as semiconductors needed in the electronics industry has, on the other hand, grown more slowly than the average. According to Chinese statistics the level of wages has increased by about 13 per cent per annum. Most of this is attributable to workers shifting to companies paying better wages. The wage gap between the coast and inland regions has also grown. New calculations regarding the Chinese economy raised the value added by services substantially, simultaneously lifting the level of Chinese GDP by 17 per cent compared to previous figures.

Japan's economy is pulling out of its deflationary downward spiral: the employment situation has improved, consumer confidence is higher than it has been in the last ten years and prices have reversed their downward trend and started to rise moderately. Companies see the future as being bright and their investments have also picked up. Japan's economic growth is still driven by foreign trade, the strength of which is evidenced by the fact that exports to Asian countries still surpasses imports from these countries by a substantial margin. Japan's GDP growth accelerated last year to 2.8 per cent. This year and next GDP will expand at a rate of about 3 per cent.

Transit transportation raised both Finnish imports and export growth figures

The transit transportation of electronics industry products, primarily to Russia, has simultaneously increased both exports and imports of Finnish goods. The volume of goods and services grew last year by over 10 per cent and exports grew by 7 per cent, even though the production stoppage in the paper industry last year and the postponement of final deliveries of certain ships until this year cut exports significantly. The impact of transit transportation on the value of goods exports to Russia was 32 per cent greater than in the previous year. Toward the end of last year and the beginning of this year Finnish exports have grown swiftly also to the EU region.

As economic growth picks up, the growth of Finnish exports to Europe will remain brisk this year and next. Owing to transit transportation goods imports grew last year by well over 40 per cent from Estonia, Hungary and China, i.e. countries where Finnish electronics companies or their daughter companies have started up large-scale production. Simultaneously Finnish exports to these countries have deceased, which is a sign that new Finnish-based production has replaced exports to these countries. A cause for concern is nevertheless Finland's poor export performance in Asian trade. Exports to East and Southeast Asia even fell 11 per cent compared to the previous year despite the fairly rapid growth in the region. The outlook for Finnish exports appears to be fairly good since the euro countries are recovering. Due to numerous ship deliveries and the production stoppage in the paper industry last year, the volume of exports will grow this year by 8 per cent. Next year exports will grow by 4.5 per cent. The growth in imports will be swift but slow down from that of last year.

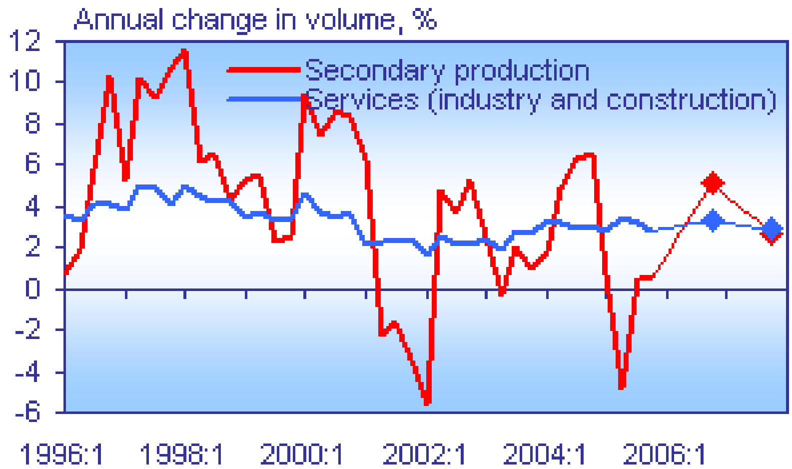
The trade account ran a surplus last year of EUR 8.1 billion. The surplus declined from that of the preceding year owing to the production stoppage in the paper industry. This year the surplus will climb to about EUR 9 billion, while next year the surplus will be EUR 9.5 billion. Last year the price of energy rose sharply, which spawned a further weakening of the terms of trade. According to the National Accounts, the rise in the price of goods imports was nevertheless rather small, only 2.8 per cent. The rise in import prices was hampered most of all by fact that the weight of the electronics products, which have been plagued by price erosion, rose due to the growth in imports in the form of transit transportation. In the future Finland's terms of trade will develop in a steadier fashion. Energy will no longer elevate import prices and the pick-up in the eurozone will foster conditions for a rise in manufacturing export prices, especially in the forest industry.

Service sectors still growing swiftly

Industrial output fell by 1.9 per cent last year. In addition to the production stoppage in the paper industry, the growth in industrial production was trimmed by a substantial decline in electricity production because, among other things, weather conditions favoured importing electricity from neighbouring regions. Without the forest industry, manufacturing output would have grown by only 1.2 per cent. Production of consumer goods such as clothing and foodstuffs is falling. It is also surprising that in spite of favourable demand conditions the metal industry (incl. electrotechnical industry) experienced rather slow growth of 2.4 per cent. This growth rate may well be revised upwards when final National Account figures are available.

The prospects of industry in the future are for the most part bright. Especially the building materials industry, machinery and equipment and shipbuilding are growing swiftly. Global competition and sluggish growth in Europe have also created problems for industry. The profitability problems of the forest industry will not disappear quickly and its production will grow slowly or remain unchanged. Subcontractors in the electronics industry, whose output is based on low skilled labour and modest R&D, are shifting their operations to cheap labour countries such as Estonia, Hungary, China and India. The Finnish electrotechnical industry has nevertheless formed knowhow clusters, which continuously spawn new knowledge-intensive companies generating new jobs in Finland replacing those shifting abroad. Total industrial production will grow this year by 5 per cent as the forest industry and electricity output return to normal growth curves. Next year total industrial production will grow by 2.4 per cent compared to the previous year.

Figure 3. Output of secondary production and services 1996:1 - 2007:4



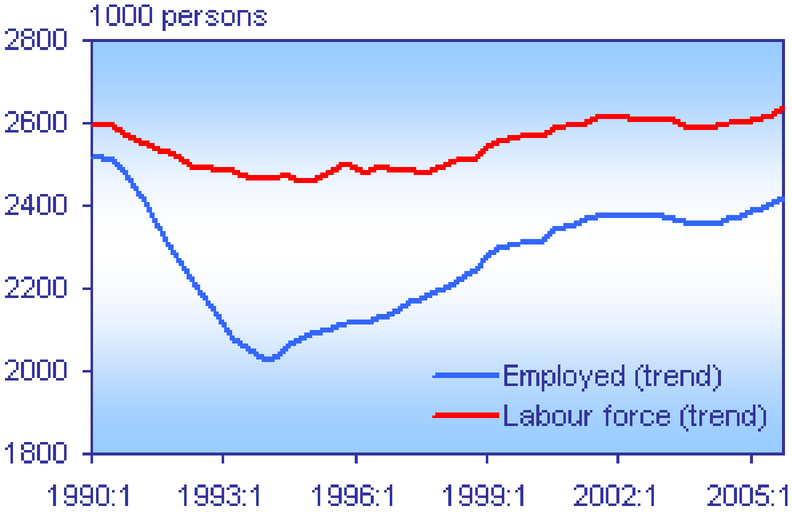
Source: Statistics Finland, Labour Institute for Economic Research

In the service sector, growth in wholesale and retail trade will slacken somewhat, but growth in business services will accelerate. The growth of transportation hit by the stoppages in the forest industry last year will accelerate substantially this year. Next year growth in transportation will return to a level of two per cent. Construction activity will continue to be brisk for the next two years and the growth in social services, including public services, will continue at a steady rate slightly below two per cent per annum.

Number of employed persons climbing by over 40 thousand this year

The labour market situation improved last year. The number of employed persons increased by 36 thousand persons. At the same time the propensity to seek work increased, which was reflected in a substantial increase in the work force. Even though the growth in the labour force dampened the decline in unemployment, the unemployment rate fell last year to an average of 8.4 per cent. The continued robust expansion of economic activity will foster an improvement in employment also this year. Employment will increase especially in construction and services. Despite mass layoffs also in manufacturing – mainly in the metal industry – the number of employed persons will rise this year. In total the number of new jobs will rise by 1.7 per cent compared to last year, which means 42 thousand new employed persons. The employment rate will rise to an average of 69 per cent. The labour force will also increase. This trend will be reinforced by the fact that elderly persons are remaining in the labour force for a longer time than previously. On the other hand, the improvement in the employment situation will activate young persons to enter the labour market. The unemployment rate will fall this year to an average of 8 per cent.

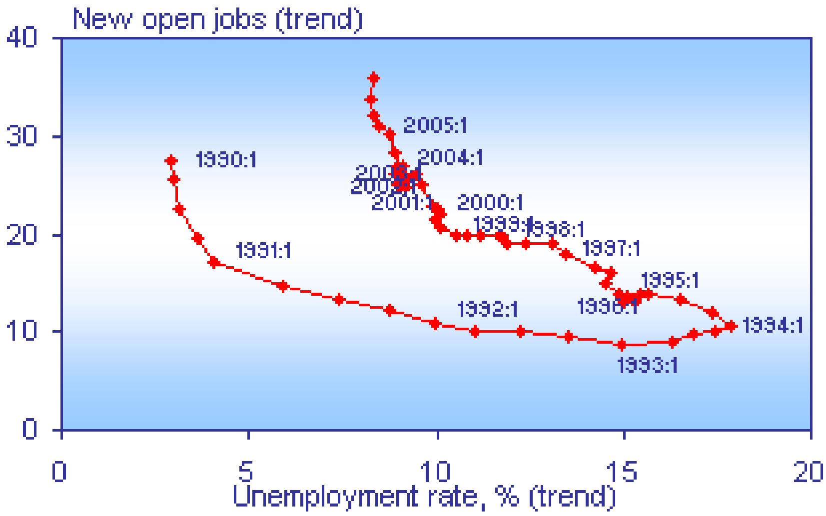
Figure 4. Labour supply and employment 1990:1 - 2005:4



Source: Statistics Finland

The situation in the labour market will remain favourable also next year. The number of employed persons will grow less than this year, i.e. by an average of 27 thousand persons. The boom in construction will begin to taper off, but the positive effect of services on employment will remain more or less unchanged. The size of the labour force will continue to grow, albeit at a more modest pace. As a consequence the unemployment rate will fall to 7.7 per cent. The employment rate will rise to 69.5 on average. The employment rate is beginning to approach the barrier of 70 per cent. During the current Parliament's term from March 2003 until March 2007 it appears that 89 thousand new jobs will have been created. According to this projection the government will fall short by 11 thousand short of its target of creating 100 thousand new jobs on a net basis during its term in office.

Figure 5. Beveridge curve 1990:1 - 2005:4



Source: Statistics Finland

The adjacent Beverage graph shows that a strengthening of demand for labour does not reduce unemployment very quickly. Reasons for this include mismatches in the demand and supply of labour, an increase in the propensity to enter the labour force as the job market improves and the employment of foreigners not belonging to the labour force in construction and shipyards.

Increase in purchasing power and stable economic outlook fuelling rise in consumption

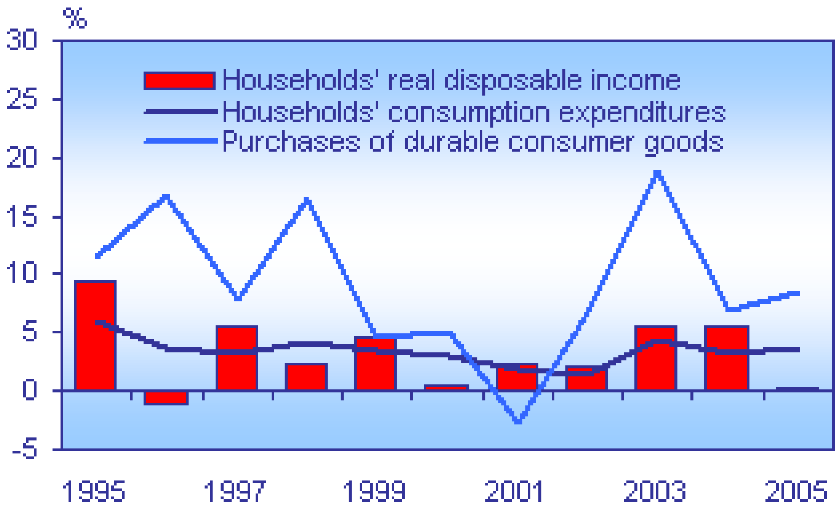
Last year the level of earnings rose by 3.6 per cent. Wage hikes followed the stipulations of the comprehensive incomes policy settlement and were realized as forecast. The trend is expected to continue this year. The wage hikes have been modest and predictable, and there have not been any indigenous price pressures or inflation surprises. The financial planning of households is on a firm foundation. The level of earnings will increase this year by 2.8 per cent. The rise in earnings and growth in employment will foster consumer confidence, fuel consumer demand and thus bolster economic growth.

The comprehensive incomes policy settlement is in force until September of next year and no wage increases have been agreed upon for next year yet. The carry-over effect of this year's wage increases on next year is over one percentage point. We forecast that the wage level including wage drift will increase by 2.4 per cent in 2007. This year and next the impact of wage increases on incomes development will be smaller than in recent years, but tax cuts will correspondingly bolster development of employed persons' purchasing power. As employment rises, the wage bill will grow faster than earnings.

As we forecast a year ago, households' capital income fell last year. This was affected by capital and corporate tax reforms. Preparations for the tightening of taxation were made already in 2004 by premature payment of dividends. These kinds of temporary changes do not affect consumption behaviour so the savings rate first rose in 2004 and plunged to negative levels last year. This year the development of capital income will return to normal. During the forecast period the real income of households will grow steadily. The interest expenditures of households have, on the other hand, experienced a sharp increase. This reflects the continued growth in outstanding debt and a pronounced and steady rise in interest rates.

Our forecast for private consumption growth is somewhat higher than the long-term average for consumption growth. The increase in consumption will be spurred by stable economic growth and strong consumer confidence. This year consumption will grow by 3.1 per cent. As regards the breakdown of consumption growth a significant portion is attributable to purchases of durable goods. This has been the case for several years already.

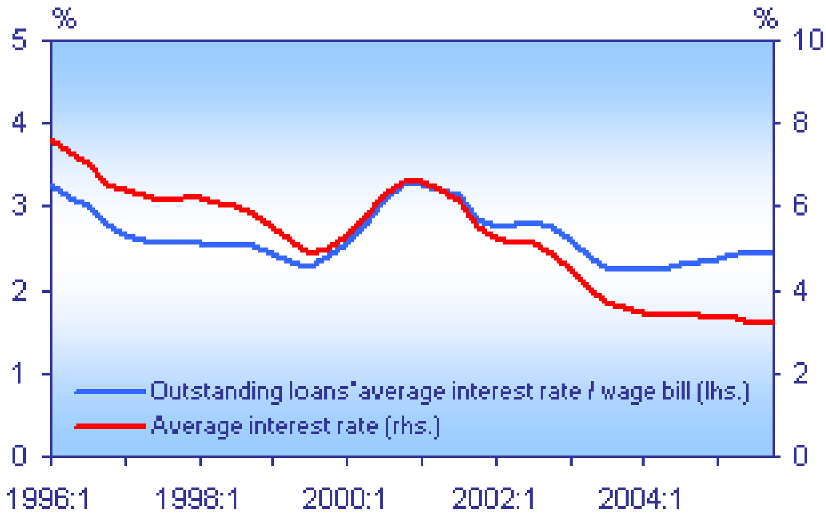
Figure 6. Growth of households' income and consumption 1995 - 2005



Source: Statistics Finland

The structure of the growth in consumption has bolstered the central government's finances since indirect tax revenues have increased faster than consumption on average. In the latter half of last year car sales started to rise swiftly once again. Purchases have been weighted toward home appliances, electronics and furniture. Next year the slight slowdown in growth of real earnings and income as well as the rise in interest expenditures will dampen growth in consumption, projected at 2.5 per cent. The half a percentage point rise in interest rates on housing loans will spur an increase in interest expenditures of households corresponding nowadays to 0.4 per cent of the annual wage bill. Because a large portion of housing loans are annuity loans, the debt servicing costs of households will not, however, increase by a corresponding amount.

Figure 7. Interest expenditures on households' housing loans as a percentage of wage bill
1996:1 - 2005:4



Source: Bank of Finland, Statistics Finland

Machinery and equipment investments are also recovering

Investments increased last year by 1.7 per cent. The growth was driven by building construction as well as civil engineering investments. Building construction was boosted above all by strong demand for housing. Civil engineering works were spearheaded by large public projects such as the E18 highway and Vuosaari harbour.

Investments will grow faster this year than last year. This is indicated by the appreciable rise in the business confidence indicator of the construction industry at the beginning of this year. In addition, new building starts and construction permits indicate strong growth. Large public projects started in recent years ensure that civil engineering will be marked by robust activity. There are also signs that machinery and equipment investment will pick up. According to our forecast investment will rise this year by 5.0 per cent. Machinery and equipment investment will continue to climb substantially in 2007. On the other hand, the slight slowdown in the rise in real interest rates and households' income development will dampen housing construction next year. The growth in other building investment will also slow down. Next year total investment will grow by 3.7 per cent compared to this year.

Inflation remaining lowest in eurozone

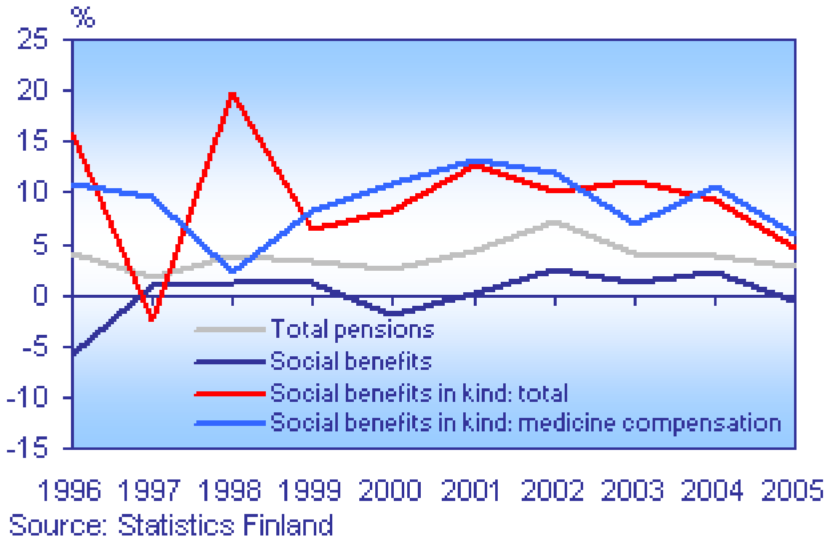
Last year consumer price inflation was clearly lower in Finland than anywhere else in the eurozone, 0.9 per cent. There was nevertheless disparity in the price developments in assorted subgroups. Inflation was fuelled above all by steep rises in housing costs, triggered by sharp increases in prices of dwellings and fuel. On the other hand, inflation has already been curbed for some time by the substantial drop in communications prices. Crude oil prices are currently exceptionally high and a swift decline in prices is not expected any time soon. The tightness and uncertainty prevailing in the oil markets reflecting the conflicts and other disturbances in regions producing crude oil and petroleum products have been reflected immediately in rising prices. The rise in interest rates this year and next is the most significant factor promoting inflation, but there are no other significant trends spurring pressure on prices. Consumer prices will rise by about one per cent in 2006. Inflation will thus be appreciably lower in Finland than elsewhere in the eurozone. This has been the case for several years already. Moderate wage settlements have played a role in this development. Next year inflation will be 1.3 per cent on an annual basis.

Central government financial position temporarily strengthening

The net lending of the central government increased last year by about EUR 600 million and reached almost EUR 1 billion. The growth in central government consumption expenditures was exceptionally slow, only 1.5 percent. Growth in private consumption was weighted toward durable goods with high VAT rates, spurring strong growth in VAT revenues. Revenues from earned and capital income taxes climbed by 7.5 per cent, which surpassed all forecasts by a wide margin. Even if income taxes were eased somewhat, its revenues were boosted by the better than expected growth in the wage bill. Tax revenues were also marked by the increase in proceeds from rising wages and bonuses subject to higher marginal taxes as well as a change in revenue sharing between the central government and the municipalities based on tax revenues realized in 2004.

In 2005 the fiscal deficit of the municipalities increased by EUR 150 million. The consumption expenditures of municipalities increased at the forecast rate of 5.3 per cent. When the central government raised its portion of revenue sharing in connection with the adjustment based on realized tax revenues, the tax proceeds of the municipalities fell short of original projections. The net lending by pension insurance institutions and other social security funds grew by about EUR 0.5 billion. The net lending of the overall general government (EMU surplus) rose by over EUR 1 billion and its ratio to GDP climbed by half a percentage point to 2.4 per cent. The central government was able to reduce its debt considerably and the total debt of the general government (EMU debt) relative to GDP fell by 4 percentage points to 41.1 per cent.

Figure 8. Changes in assorted public expenditures in 1996 - 2005, at current prices



When assessing the public sector and its financial position, the media have placed considerable attention on tax cuts. The adjacent figure presents some interesting features on the expenditure side. An important question is whether the pension reforms that went into effect in the beginning of 2005 will permanently slow down growth in pension expenditures. Social aid (such as welfare, housing and student aid as well as children's aid) have already been frozen in nominal terms for a long time. On the other hand, social benefits in kind (primarily health and social services paid for by the central government, municipalities and KELA) have witnessed rapid growth. The authorities have sought to limit the growth in compensation for medicines, in particular.

The central government's surplus will grow this year by about EUR 350 billion. This is attributable primarily to the already known increase in dividends of EUR 600 million. Revenues from value added, alcohol and automobile taxes are projected to grow at a swift pace by revenues from taxes on transfers of real property and securities may end up being lower than last year. The cuts in earned income are rather large this year and wealth tax has been discontinued, but thanks to strong growth in the wage bill and corporate tax revenues the central government's income and wealth tax revenues will remain almost unchanged. The central government's consumption expenditures will rise moderately and investments will decline slightly. In 2007 the central government's net lending is forecast to fall by about EUR 1 billion. Tax cuts will be less than those of the previous year, but the slowdown in the growth of the wage sum will keep earned income taxes on a downward track. As a result of the slowdown in private consumption growth, the growth in revenues from indirect taxes will also subside. The high level of dividends received by the central government this year is expected to remain a temporary phenomenon. The central government's portion of revenue sharing and funds transferred to social security funds will continue to be marked by strong growth.

The financial position of municipalities as a whole will improve but they will continue to run a deficit. The tax revenues of municipalities will grow steadily but municipal taxes will not be cut. On the contrary, the municipal tax rates will rise and corporate tax revenues will expand considerably. Growth in municipal tax expenditures will in turn slow down by slightly less than one percentage point. Also next year the tax revenues of municipalities will grow substantially. The fiscal deficit of municipalities will decline next year by EUR 400 million. In this calculation it is assumed that municipal tax rates will increase by 0.1 percentage points.

The surplus of pension institutions and other social security funds will increase this year by a little over EUR 400 million as certain contribution rates will be raised slightly and social benefits and aid grow modestly. Next year the contributions to pension institutions and other social security funds are assumed to grow substantially more slowly than this year as no decisions to raise contributions have yet been made. Their net lending will remain unchanged next year.

The net lending of the general government relative to GDP will rise this year by 0.6 percentage points. Taxes as a percentage of GDP will likewise decline by 0.5 per cent mainly as a consequence of central government tax cuts and swift growth in GDP. Next year general government's EMU surplus will decline somewhat. EMU debt as a percentage of GDP will decline by about 1.4 percentage points and the ratio of taxes as a percentage of GDP will fall slightly.

Municipal reforms taking effect slowly

The municipalities will be under pressure also in the future to balance between increasing spending obligations and limited revenue formation. As a solution to this dilemma there are plans to carry out municipal reforms where the average size of the municipalities increases and at least the cooperation between municipalities becomes tighter. Rationalization is always a welcome development, but the benefits of this process will be realized slowly. If the revenue formation of municipalities is not safeguarded, the goals of boosting efficiency will not be fulfilled completely, so that cost savings will have to be generated mainly by weakening the level of services. It must also be taken into consideration that regional development will be rather divergent and the negative shocks brought about by globalization are typically focused on individual local municipalities. This means that the need to level out taxes in favour of weak regions is at least not decreasing.

Towards more uniform tax rates

The favourable economic situation gives a possibility to strengthen the financial position of the central government and the overall public sector and to prepare for the fact that the aging of the population and possible deterioration of cyclical conditions will increase public expenditures in the future. The ratio of taxes as a percentage of GDP should not be lowered any further with new decisions. There is, on the other hand, plenty of leeway for structural tax changes. Capital income taxation could be increased – especially on capital income exceeding a certain threshold – and earned income taxation could be lowered so that the total tax revenues would not change at all. In this solution the highest marginal tax bracket in central government taxation of earned income could be lowered to 50 per cent. As a result tax manipulation would decrease, wage demands would be more moderate, income distribution would be more uniform and the incentives of highly paid experts to work in Finland would improve. The benefits would probably outweigh the downside effects stemming from the fact that incentives to earn capital income would weaken somewhat.

As companies become more international the state aid geared toward enterprises, which is nowadays mostly manifested in R&D support will no longer necessarily foster domestic production or employment. For this reason R&D support should be directed increasingly toward small and medium-sized companies. When making decisions on granting of support, the authorities should take into account the risk that the benefits of the support will leak out of the country.

INTERNATIONAL ECONOMY

GDP growth , %	2005	2006f	2007f
United States	3.5	3.2	3.0
Euro-12	1.3	2.1	2.6
Germany	0.9	1.8	2.6

France	1.5	2.3	2.6
Italy	0.2	0.8	1.7
EU 25	1.6	2.2	2.6
Sweden	2.5	3.2	3.4
United Kingdom	1.8	2.0	2.2
Japan	2.8	3.0	3.0
Russia	6.4	6.0	6.0
China	9.9	9.5	9.0
Source: BEA, IMF, OECD, Labour Institute for Economic Research			

DEMAND AND SUPPLY

	2005	2005	2006f	2007f
	Bill. €	Percentage change in volume, %		
Gross Domestic Product	155.3	2.1	3.8	2.8
Imports	54.6	10.3	7.0	4.4
Total supply	209.9	4.2	4.6	3.2
Exports	60.1	7.0	8.0	4.5
Consumption	116.3	2.9	2.7	2.3
- private	81.3	3.4	3.1	2.5
- public	35.0	1.5	1.6	1.8

Investment	29.8	1.7	5.0	3.7
- private	25.4	3.1	6.7	4.6
- public	4.4	-6.2	-4.8	-2.6
Change in stocks	3.7	0.2	-0.1	0.0
Total demand	209.9	4.2	4.6	3.2
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2005	2006f	2007f
Unemployment rate , %	8.4	8.0	7.7
Unemployed (1 000)	220	211	206
Employed (1 000)	2401	2443	2470
Employment rate , %	68.0	69.0	69.5
Inflation, consumer price index, %	0.9	1.1	1.3
Wages, index of wage and salary earnings, %	3.6	2.8	2.4
Real disposable income of households, %	0.3	2.8	1.7
Current account surplus, Bill. €	3.7	4.2	4.4
Trade surplus, Bill. €	8.1	8.9	9.6
Central government financial surplus, Bill. €	1.0	1.3	0.3
% / GDP	0.6	0.8	0.2

General government financial surplus, Bill. €	3.8	4.9	4.3
% / GDP	2.4	3.0	2.5
EMU debt, % / GDP	41.1	39.1	37.7
Tax rate, %	44.5	44.0	43.8
Short-term interest rates (3-month Euribor)	2.2	2.9	3.5
Long-term interest rates (10-year gov't bonds)	3.4	4.0	4.8
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			

FORECAST MARCH 23, 2006

FORECAST

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FUTURE OF FINNISH PAPER INDUSTRY – SEARCHING FOR A FATHERLAND?

The forest company UPM-Kymmenen intends to lay off 3600 employees, almost 3000 of which are from Finland. The dire measures have been explained by weak profitability and sluggish product demand. Is this necessary and how did they end up in this kind of a situation? Why are the layoffs concentrated on Finland even though UPM has other coated magazine paper factories scattered around Europe?

Mature sector

Paper consumption is estimated to grow by about one per cent per annum over the next 15 year period in Europe, which is the main market for Finnish production. The consumption of paper, which is being crowded out by electronic media, is even slower than this in North America and Japan. The consumption of paper products is growing faster than this in Asia and East Europe, where the point of departure in paper consumption is low and economic growth is faster than average. China and other countries in Asia have increased their own production capacity to satisfy their growing demand. The relatively swift growth in Chinese production, which was last year about 26 per cent, has diverted demand in Asian markets away from Finnish exports. In recent years the European paper industry has suffered from sluggish demand, which has eroded prices and weakened profitability. The pick-up in EU growth will boost demand for paper in Europe and foster the profitability also of Finnish production.

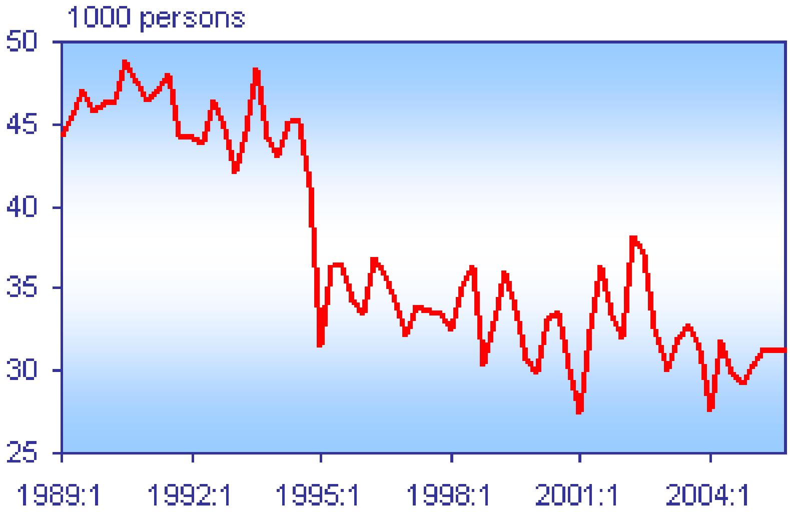
Recycling increasingly common

The use of paper as a source of raw materials is becoming more and more common. In Europe the rate of paper recycling is currently 56 per cent and it is still climbing from this level. This trend is fostering production in Central Europe based on recycled fibres. The growing demand in eastern parts of central Europe is being met largely by expanding capacity using recycled fibres, but paper manufacturers cannot base all of their production on recycled fibres. New and old recycled fibres have to be mixed in order to make higher quality grades of paper. The growth in Eastern European consumption requires the expansion of production based on new fibres. To this extent the expansion of European markets does not reduce the Finnish industry's export markets based on new fibres.

Paper jobs disappearing

Finland's paper industry has steadily expanded its production. The capitalization of production and improvement in productivity in tandem with relatively sluggish market growth have nevertheless reduced employment in the industry.

Figure 1. Number of Finnish paper industry employees 1989:1 - 2005:4



Source: Statistics Finland

Competitiveness is sum of many factors

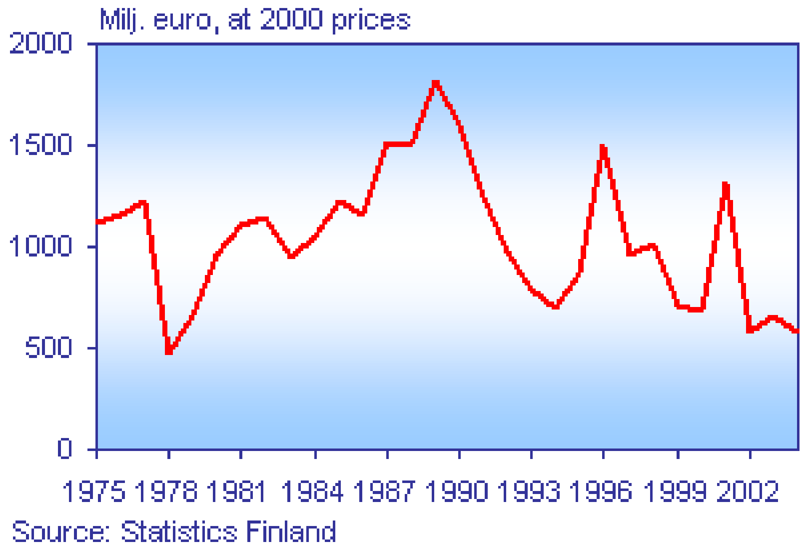
The labour costs of the paper industry are not as important a competitive factor as, for example, in assembly of consumer electronics. Because the sector is capital intensive, process knowhow and efficiency of machinery are of great importance. The cheapness of energy as well as the efficiency of logistics and material supplies are significant. All of this favours long-term industrial traditions and knowhow. The total productivity of the Finnish paper industry has grown faster since 1985 than in Western competitor countries. Since 2000 other countries have been closing the gap with Finland. It is clear that it is easier to disseminate knowhow needed for efficiency within a company than between companies. Thus the expansion of large Finnish companies via acquisitions taking place mainly in other European countries has probably promoted the narrowing of the technological gap. In the mid-1990s a little over 80 per cent of the turnover of the Finnish forest industry was generated domestically while nowadays the share is well below 50 per cent.

Location

When considering the location of the paper industry, the availability of raw materials and location of end users as well as transport costs and logistics are of key importance. Each continent seeks to meet its consumption with its own production. The natural market region for Finnish production is Europe, and from Finland's standpoint it is vital how production is organized in Europe.

The locating of European production in Central Europe appears favourable due to the increasing use of recycled fibres and proximity of end users. Expansion of production in Russia, on the other hand, appears to be justified by availability of vast raw materials. Russian production will perhaps be competing also in the Asia markets, where insufficiency of raw materials, high cost of energy as well as unresolved environmental issues limit the efficiency and competitiveness of expanding production. Finland's advantages relative to Central Europe include abundant raw materials, relatively cheap energy, low harvesting costs and the long traditions of this sector and knowhow this brings.

Figure 2. Gross investment of paper industry in Finland 1975 - 2004



The possible concentration of production in Central Europe is a threat to Finnish industry. Long-term investments can hardly be justified on currently prevailing labour cost differentials. On the other hand, wages are rising in the future in Eastern Europe considerably faster than in Finland. Finnish production in the future will be affected already by investment decisions in the near term. Even though Finnish production capacity is still rather new and efficient, new investment elsewhere in Europe and a lack of investment in Finland bring closer the day when another Finnish plant will be shut down for being old and inefficient. Uncertainty is increased by the fact that the investment strategy depends greatly on view-related factors. The indifference with which

Finnish management has faced uncertainty related to returns on foreign investment is a cause for concern. The acquisitions in North America that turned out to be a mistake have generated losses on the magnitude of a billion euros. The problems experienced related to starting up foreign production are still be downplayed. The most recent example of this is Metsä-Botnia's cellulose factory in Uruguay. On the other hand, the profitability of Finnish production is once again the subject of close scrutiny.

New products are the answer

The profitability problems of the paper industry currently cannot be denied, but the question is how can this dilemma be addressed and solved. Production of traditional large volume goods cannot grow significantly any more. The availability of additional raw materials from Russia could also spur new problems for domestic production. It is entirely justified to keep manufacturing based at least on domestic new fibres. Raising the efficiency of processes is still a viable way of bolstering domestic competitiveness. Substantial growth can in turn be found by developing new refined products such as special paper and board. Success stories of this type can also be found from Finland. The most significant growth potential may also be found from refining of raw wood materials in the chemical industry. The use of raw wood materials can be fostered with state aid policies, for instance with the assistance of Tekes (Finnish Funding Agency for Technology and Innovation). Finnish industry would also like to see more of this kind of activity. The Finnish government should also work in EU circles to promote uniformity regarding state aid to companies. This would help us to avoid situations where in order to foster employment paper industry investments in the new member countries would be subsidized at the cost of higher unemployment in Finland.