FORECAST AUGUST 24, 2004

Additional information:

Chief of forecasting
Eero Lehto
Tel. 358-9-2535 7350
e-mail:
Eero.Lehto@labour.fi

Information officer
Heikki Taimio
Tel. 358-9-2535 7349
e-mail:
Heikki.Taimio@labour.fi

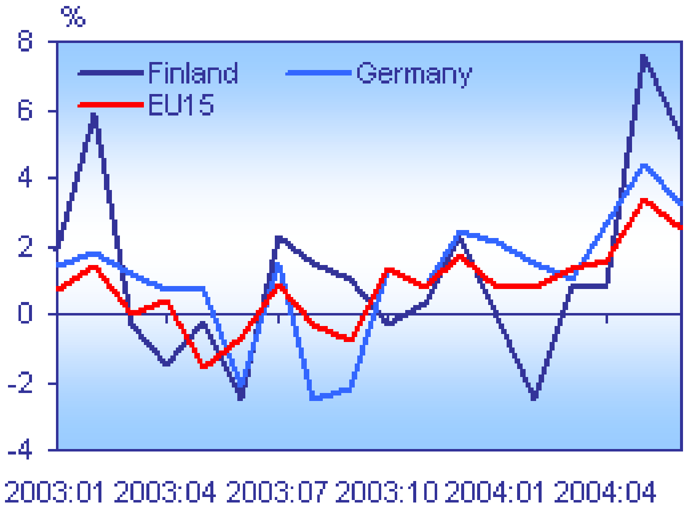
Forecast 2004 - 2005
INDUSTRIAL PRODUCTION RECOVERED – ECONOMY ON VERGE OF NEW UPTURN

The anticipated upturn in the economy took place in May-June, fuelled by industrial output and exports. The three per cent growth in GDP and almost four per cent growth in private consumption forecast by the Labour Institute for Economic Research last March are being realized by and large as planned. GDP is forecast to grow this year by 3.3 per cent and next year by 3.6 per cent. The economic situation in the entire eurozone has also improved. The confidence of eurozone consumers in the future is, on the other hand, still rather shaky and economic growth is not getting enough support from private consumption. The perpetuation of the economic upswing and acceleration of growth to 2.5 per cent will require an improvement in households' confidence. The swift growth in the world economy and the rise in oil prices exacerbated by the conflicts in the Middle East nevertheless constitute a risk that threatens economic growth next year. It is possible that high oil prices will weaken economic growth more in the US than in Europe, which will strengthen the euro in relation to the dollar and weaken the prerequisites for export-driven economic growth in Finland.

European growth still driven by exports

In the eurozone GDP grew in the first quarter of 2004 by 1.8 per cent. In the second quarter GDP in the eurozone was two per cent higher than one year ago. Growth in the eurozone continues to be driven primarily by exports. Industrial production has likewise taken a turn for the better. In the EU countries consumer confidence has bolstered private consumption only in the Nordic countries and Great Britain. On the European continent the cyclical picture is different. There consumer confidence is still shaky and no appreciable upturn in private consumption is expected any time soon. On the basis of retail trade figures, private consumption nevertheless appears to be picking up also in continental Europe.

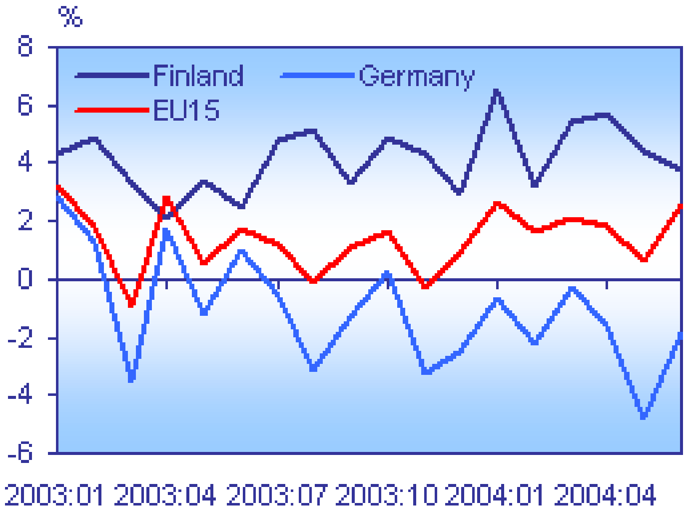
Figure 1. Volume of industrial production 2003:01 - 2004:06, percentage change from previous year



Source: Eurostat

It currently appears that the economic growth of the EU countries will strengthen next year. This view is substantiated by leading indicators. No sharp acceleration in growth, however, is expected. The pick-up in growth will be spurred primarily by a recovery in the domestic markets. The significance of exports as a driving force behind growth will diminish. It is not possible, however, to exclude the possibility that high oil prices and a consequent slowdown in US growth in combination with an appreciation of the euro will stiffle the budding upswing before households and companies increase their consumption and investment activity.

Figure 2. Volume of retail trade 2003:01 - 2004:06, percentage change from previous year



Source: Eurostat

Germany's labour reforms – first impact is weakening of domestic demand

From the standpoint of domestic demand the most difficult situation is that prevailing in Germany, where wide-scale labour reforms do not appear to be bolstering growth at least in the short term. In this significant policy reform with ramifications for all of Europe the period of eligibility for wage-based unemployment was shortened. This reform also included the elimination of a certain form of unemployment benefits, which amounted to about 57 per cent of the beneficiary's last salary. This compensation could be received for an unlimited duration and eligibility of beneficiaries was not affected by their own wealth nor the income of their spouses. After this a long-term unemployed person can receive labour market benefits. The eligibility for this form of benefit is similar to that applied in Finland, but its level is clearly lower than that in Finland and most of the older EU countries. The labour market reform also tightened the obligations to accept work offered and applied fairly severe sanctions for refusal to accept a job. The reform will go into effect in full at the beginning of next year.

As a consequence of the reforms the income of unemployed persons has fallen and the consequent income uncertainty has increased, which has already had a negative impact on retail sales and private consumption. The possible positive employment and demand impact of the reforms will not be seen until later. Let it be mentioned that the tax cuts implemented along with the reforms will not necessarily boost private demand since at the same time the terms of public sickness insurance were weakened, which will force households to compensate by increasing purchases of private health services.

ECB will not raise rates in the next few months

The European Central Bank is hardly likely to raise interest rates this year. Even though the steep rise in raw material prices will spawn upward pressure on prices of refined goods and thus consumer products, sluggish growth and the appreciation of the euro will dampen inflation, which will postpone the need for a hike in the ECB's interest rates. As the cyclical conditions underlying the real economy improve, the ECB will nevertheless tighten monetary policy next year. The tightening of monetary policy by the Federal Reserve in the US will make room for interest rate hikes by the ECB.

US growth subsiding next year

GDP grew in the US in the first quarter of this year by 4.5 per cent compared to the previous quarter (adjusted to an annual basis). In the second quarter growth slowed down to 3 per cent. The number of unemployed persons has not grown appreciably toward the end of summer.

Growth was dampened primarily by the slackening of private consumption. The impact of tax cuts has tapered off and the rise in oil prices has curbed consumption growth in volume terms. This is also a question of households being obliged to cut back on their consumption expenditures owing to the weakened of their financial position. For this reason the slowdown in private consumption will possibly be more permanent. Private investment is nevertheless on the rebound, and housing construction is still brisk, but these factors will not suffice to keep economic growth above a four per cent pace in the latter half of this year. Growth will also be curbed by the weak performance of US exports.

The US Federal Reserve has tightened monetary policy and raised its Fed funds rate to 1.5 per cent. The Fed has raised interest rates twice by 0.25 percentage points, first on June 29 and then on August 10. The Fed funds rate had been at one per cent since June 25, 2003. The tightening of monetary policy was prompted by the clear acceleration of inflation in the US. Robust growth in the beginning of the year and strong employment trends also encouraged the Federal Reserve to raise rates. According to the Federal Reserve's analysis, growth is on a solid foundation and the slowdown in growth in the second quarter is only a temporary phenomenon. The new figures reflecting a slackening of manufacturing orders, the weakening of consumer confidence and a weakening of employment growth substantiate the view that the slowdown in growth is permanent. It is clear that these phenomena will make US officials increasingly wary about tightening monetary policy and we may have to wait long into the autumn for another interest rate hike.

Asia still the engine of growth

Asia can be regarded as the engine of growth of the world economy. China's growth will exceed 9 per cent this year and next year its growth is expected to slow down to 7.5 per cent. The expansion of the economies in China and the newly industrialized East Asian countries has spurred GDP growth also in Japan. India's production has started to grow quickly. Bolstered by high oil prices, Russia's economy is expanding at a rate of over 7 per cent and the pace of its growth is not expected to subside significantly next year either.

Finland's exports picked up in early summer

The volume of Finnish exports grew in the beginning of this year by about 1.5 per cent compared to last year. Export growth figures will nevertheless be held in check by the fact that in the latter half of last year ship deliveries were considerably higher than they will be this year. On the other hand, exports accelerated in May-June and its growth is not expected to slow down any more in the second half of the year. For this reason the export forecast of the Labour Institute for Economic Research was kept the same as in spring, i.e. that exports will grow by 2.8 per cent this year.

Owing to weak domestic demand in the eurozone the value of Finnish merchandise exports to this region fell by 10 per cent in the beginning of this year. This development was offset by growth in exports to other EU countries. Finnish exports to Asia's growing markets have also climbed. Finnish exports to Asia (excl. the Near East and Middle East) have grown in the beginning of this year (January-May) by 19 per cent compared to last year. As an export market Asia is already more significant than North America. Finnish exports to Russia also grew swiftly; exports in January-May were up 20 per cent over those of last year.

Next year total export growth will accelerate to 4.8 per cent. The steep growth in exports already realized this year will spawn considerable carry-over effects for next year's export figures. Next year export growth will be sustained also by the recovery in domestic demand in the eurozone.

The volume of merchandise imports has grown in the beginning of this year by only half a per cent over that of last year. In May-June imports nevertheless appeared to be picking up. The growth in import volumes was held in check primarily by the lacklustre performance of exports in winter and early spring and the consequently sluggish growth of manufacturing output. When manufacturing output and exports recover in the latter half of this year, import volumes will also rise considerably despite the fact that prices of oil and other imported raw materials have climbed sharply.

The import prices of goods and services are expected to be about three per cent higher this year on average than last year. Finland's terms of trade will deteriorate this year because export prices will rise by only slightly less than one per cent compared to last year. As a result, the trade surplus will shrink somewhat from that of last year. Next year export prices will rise by two per cent and the terms of trade will improve. This trend and the substantial acceleration of export growth will boost the trade surplus.

Household purchasing power developing favourably

Household purchasing power will grow this year somewhat faster than in recent years. This is partially due to certain temporary factors impacting on this year. The most important of these are the cuts in excise taxes on alcoholic beverages, which triggered a reduction in consumer prices at the beginning of March by almost one per cent. Interest rates are also staying at a low level. This year's average inflation will remain exceptionally low, only 0.3 per cent, even though inflationary pressures from imports and especially oil have increased somewhat.

This year decreases in central government income tax rates and increases in income tax deductions will decrease the taxes paid by households by about EUR 800 million. These tax cuts increase the disposable income of households by about one per cent. The current comprehensive incomes policy settlement still dictates the main earnings development this year. The earnings of employees will rise this year by 3.5 per cent on average. This rate of increase is affected by bonuses paid in the beginning of the year and other wage drift. The impact of contract wage hikes is 2.2 per cent. Owing to the increase in the number of hours worked, the wage sum will grow this year by 4 per cent, which is slightly more than we projected in spring.

Capital income will grow this year faster than enterprises' profits. The changes in dividend taxation will increase the desire of enterprises to pay dividends this year. The growth of capital income will not spur a rise in household consumption, but rather it will facilitate an increase in savings as assets are shifted to other forms of wealth.

Private consumption continues to grow quickly

As we projected last spring, the disposable income of households will grow in nominal terms by about 6 per cent this year. Even though savings will rise, the favourable income development will facilitate growth in consumption. When we take into account the low rate of inflation, private consumption will grow in real terms by 3.7 per cent this year.

The growth in consumption has been fuelled in the beginning of this year by high sales of durable goods, especially cars. Even though car sales have subsequently tapered off, the most recent figures do not give us reason to change our winter forecast for private consumption. The favourable income development, consumer confidence and low interest rates will sustain growth in consumption as well as housing sales. Housing prices in the Greater Helsinki Region may continue to rise. We also expect the demand for services and semi-durable goods to grow faster than in previous years.

Households will become increasingly indebted, but low interest rates will keep loan servicing costs at tolerable levels. Households' indebtedness will not be a factor dampening consumption yet during this forecast period. Next year car sales will level off as the greatest pent up pressures have already been released. The growth in consumption will nevertheless be relatively swift since part of the impact of exceptionally favourable rise in purchasing power will not be felt until next year. We forecast that private consumption will grow next year by 2.5 per cent.

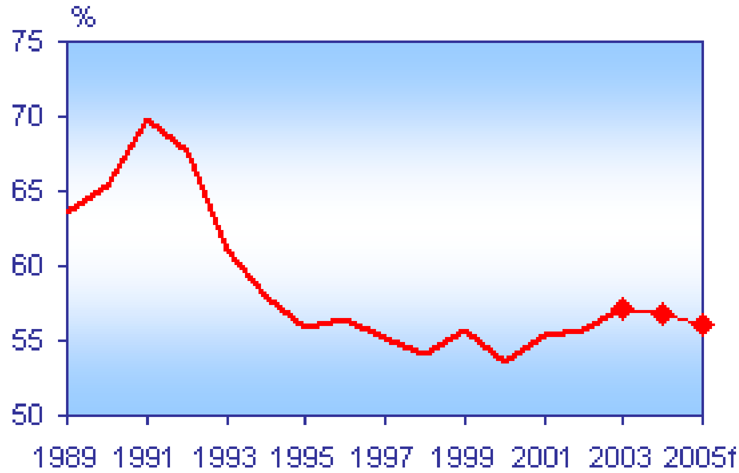
Next year the impact of one-off cuts in alcohol taxes will no longer been seen in annual inflation so the rate of inflation is bound to rise, but it will nevertheless remain well below two per cent.

Purchasing power will still grow regardless of details of labour market settlement

The purchasing power of wage earners can be safeguarded with various combinations of tax and wage agreements. If international economic prospects improve as we forecast, purchasing power trends will foster growth in consumption even without tax cuts. Because the content of the income tax decisions regarding next year are for the time being still unknown, we have not assumed other tax cuts than the normal ones for inflationary adjustment of the tax scales.

The starting point for our projections of purchasing power is a 3.8 per cent average increase in the wage level. Thus households' purchasing power will grow in real terms by around 2 per cent even without appreciable tax cuts. The final figure will naturally depend on the details of tax decisions and wage settlements.

Figure 3. Share of compensation for wage earners in the private sector 1989 - 2005



Source: Statistics Finland, Labour Institute for Economic Research

Share of wages starting to fall in private sector

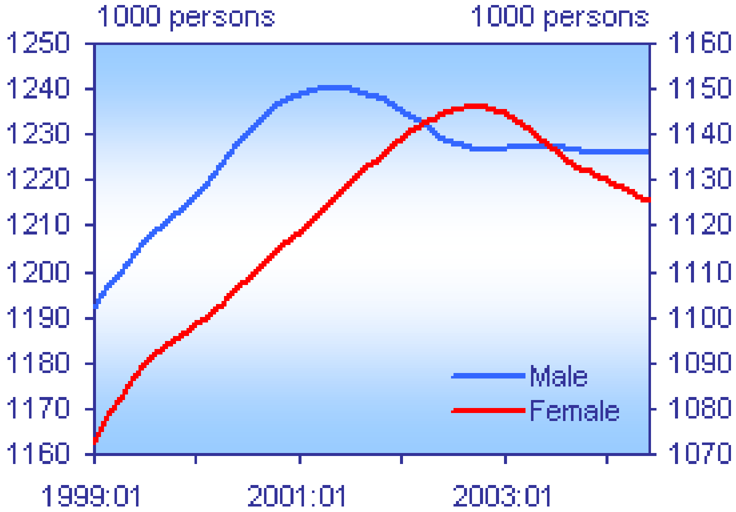
Even though the level of wages will develop more favourably this year than previously and the increase in the wage bill will be fuelled by the rise in employment, the functional distribution of income will not change appreciably. The growth of the wage bill in the public sector will be slightly faster than in the private sector. The total share of compensation for wage earners within the enterprise and financial institution sectors' value added will remain unchanged or fall slightly this year. Next year the rise in export prices and increase of exports will mean that production will grow in the private sector faster than the wage bill if wage hikes are at historically normal levels.

Turn for the better in employment figures

No clear sign of a turn for the better can be seen yet from the employment figures in the beginning of this year. In January-June the number of employed persons was 17 thousand less than in the corresponding period last year. This is partly due to the fact that manufacturing jobs still fell in the beginning of the year by over 14 thousand. Employment developments have been weak also in the hotel and restaurant sector as well as in construction. The number of employed persons has grown the most in public and other services as well as in transport and communications.

GDP growth has picked up during the summer, but for the time being this has only been reflected in a rise in the number of hours worked. During the autumn employment will also start to climb. Even though employment will rise toward the end of the year, this year's average will be lower than that of last year. Next year's swift economic growth will spur a substantial rise in employment of 0.8 per cent.

Figure 4. Employment by gender 1999:01 - 2004:06 (trend series)



Source: Statistics Finland

Despite the weak employment situation, unemployment has continued to fall because the weak demand for labour has prompted persons to exit the labour market. In January-June of this year there were about 5000 less unemployed than in the same period last year, and the unemployment rate was correspondingly 0.1 percentage point lower than in the first half of last year. The unemployment rate will fall this year to 8.8 per cent and next year to 8.6 per cent.

In the beginning of this year there were over 20 thousand fewer persons in the labour force than last year. Participation in the labour force has fallen the most amongst young persons. Participation in the labour force has fallen proportionally more for women than for men. This year the labour participation rate will decline to 65.8 per cent, but next year the upswing in demand for labour will boost the supply of labour and the labour force participation rate will rise to 66 per cent.

Investment will not recover until next year

Investment will climb this year by about three per cent after falling for a couple of years. Next year growth will accelerate to about six per cent. Housing construction will continue to be brisk this year. This year and next the growth in investment will be spurred by large civil engineering works and other construction projects such as the Vuosaari harbour project, new facilities at the Fortum Porvoo refinery and the new nuclear power plant at Olkiluoto. Manufacturing machinery and equipment investment will fall this year but next year it is expected to start growing.

Central government shifting from fiscal surplus to deficit

The surplus in central government finances fell sharply last year, by almost EUR 1.8 billion to EUR 250 million. Despite the increase in central government revenue sharing, the fiscal deficit of municipal governments widened substantially, by about EUR 450 million, as their tax revenues fell and consumption expenditures grew by about 5 per cent. The central government will run a deficit (almost EUR 700 million) for the first time since 1999. In our forecast the proceeds from alcohol tax will fall by almost EUR 300 million. Despite the swift growth in the wage bill, cuts in earned income taxation will keep income and wealth tax revenues at last year's level. On the spending side consumption and investment expenditures as well as the amount of funds allocated to central government revenue sharing will grow substantially. In municipal finances, the increase in central government revenue sharing will be offset by the decline in tax revenues spawned by tax cuts this year. The financial position of the municipalities will not weaken appreciably this year, even though the consumption expenditures of the municipalities will grow by 5 per cent in nominal terms. The shrinking of the surplus of pension insurance institutions and other social security funds will come to a halt as a consequence of the recovery in social security contributions. The EMU surplus for general government finances this year will be only 1.2 per cent of GDP, but the EMU debt relative to nominal GDP will not rise.

Next year the deficit in central government finances will widen appreciably even though in the forecast we have presumed there will be no new cuts in earned income taxation except for the two per cent inflation adjustment. The deficit will be spawned by the increase in revenue sharing with the municipalities as well as growth in consumption and investment expenditures. The downward effect of the reduction of the corporate tax rate will be offset by the improvement in companies' revenues, but capital tax revenues will be increased considerably by reforms whereby dividend income becomes taxable. The deficit of municipalities will begin to shrink next year as municipal tax revenues rise. Pension reforms are not expected to curb growth in pension expenditures appreciably next year, but hikes in certain social security contributions will increase the proceeds of pension institutions and other social security funds so that their surplus will rise slightly. The EMU surplus for the entire public sector will decrease slightly, but the EMU debt ratio will start to fall again.

Taxes as a percentage of GDP falling this year and next

Public consumption expenditures will grow this year by 2.7 per cent, i.e. substantially faster than in recent years. Taxes as a percentage of GDP will decline this year by 0.7 percentage points to 44.2 per cent. Public consumption expenditures will grow next year by 2.3 per cent. Taxes as a percentage of GDP will decline next year to 43.6 per cent primarily owing to the brisk 5.6 per cent growth in nominal GDP.

Employment and welfare

Employment has weakened somewhat in the first half of this year, which is largely attributable to the sluggish economic growth rate around two per cent during last year and the first half of this year. The easing of taxation, which has pushed the central government into a fiscal deficit, has nevertheless promoted employment. From this perspective, the realized trends in employment have not met expectations. It appears that as economic growth accelerates to above three per cent, employment will increase next year by 20 thousand persons. This will raise the employment rate by 0.4 percentage points.

Under conditions of relatively high structural unemployment and pervasive long-term unemployment, the need to foster job creation and reduce unemployment is undeniably urgent. Wage restraint is important from the standpoint of a lasting improvement in employment. For this reason it is hoped that the new wage settlement will be broad-based and moderate in nature.

The central government can to some extent support a moderate wage settlement. The possibilities of the central government are nevertheless limited because it is important to avoid fiscal imbalances in the next few years in order to keep some manoeuvring room for offsetting pressures from future demographic changes. In practice, fiscal policy cannot be used to bolster employment without increasing the deficit.

In employment policy we have to take into account that job creation occurring via an increase in public demand does not lead to a greater deficit than job creation based on tax cuts. Public consumption and investment expenditures are alternatives to tax cuts as a means of boosting employment.

INTERNATIONAL ECONOMY

GDP growth , %	2003	2004f	2005f
United States	3.0	4.1	3.5
Euro-12	0.5	1.8	2.4
Germany	-0.1	1.6	2.2
France	0.5	2.0	2.6
Italy	0.3	1.0	1.6
EU 25	0.9	2.1	2.5
Sweden	1.6	3.0	3.2
United Kingdom	2.2	3.0	2.6
Japan	2.5	4.2	3.5
Russia	7.3	7.5	7.0
China	9.1	9.0	7.5
Source: BEA, IMF, OECD, Labour Institute for Economic Research			

DEMAND AND SUPPLY

	2003	2003	2004f	2005f
	Bill. €	Percentage change in volume, %		
Gross Domestic Product	142.5	2.0	3.3	3.6
Imports	43.8	2.6	2.5	3.8

Total supply	186.3	2.2	3.1	3.7
Exports	53.1	1.1	2.8	4.8
Consumption	106.4	3.5	3.4	2.4
- private	74.6	4.3	3.7	2.5
- public	31.8	1.6	2.7	2.3
Investment	25.9	-2.1	2.9	5.8
- private	21.8	-3.0	3.1	6.8
- public	4.1	2.7	1.6	0.6
Change in stocks	1.0	0.3	0.0	0.0
Total demand	186.3	2.2	3.1	3.7
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2003	2004f	2005f
Unemployment rate , %	9.0	8.8	8.6
Unemployed (1 000)	235	229	225
Employed (1 000)	2365	2359	2377
Employment rate , %	67.3	67.0	67.4
Inflation, consumer price index, %	0.9	0.3	1.6
Wages, index of wage and salary earnings, %	4.0	3.5	3.8
Real disposable income of households, %	4.9	5.2	1.7

Current account surplus, Bill. €	7.4	7.2	9.0
Trade surplus, Bill. €	11.4	11.2	12.8
Central government financial surplus, Bill. €	0.3	-0.7	-1.3
% / GDP	0.2	-0.5	-0.8
General government financial surplus, Bill. €	3.0	1.7	1.4
% / GDP	2.1	1.2	0.9
EMU debt, % / GDP	45.5	44.5	42.7
Tax rate, %	44.9	44.2	43.6
Short-term interest rates (3-month Euribor)	2.3	2.1	2.4
Long-term interest rates (10-year gov't bonds)	4.1	4.3	5.0
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			