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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 for the years 2005 - 2006
ECONOMIC GROWTH STRENGTHENING TOWARD END OF YEAR

Finnish economic growth slowed down in the beginning of the year according to the GDP monthly indicator. This was primarily attributable to a complete halt in industrial output growth. A six-week production stoppage in the forest sector due to a lock-out, the impact of which extended to transportation, was a significant reason for the low level of industrial output. The growth in other industrial sectors was also weaker than anticipated. This trend was partly offset by the swift growth in the service sector, especially in the wholesale and retail trade. This was not enough, however, to compensate for the dampening effect of the slowdown in industrial output on GDP growth. As economic growth was centred on services, employment growth was nevertheless more favourable than forecast. There were 39 thousand more persons employed on average in the beginning of the year than during the corresponding time last year.

Despite the slowdown in industrial growth, merchandise exports grew swiftly in January-June compared to last year. In real terms it grew by 4.7 per cent and without the forest industry's production stoppage growth would have been almost 9 per cent. All in all the development of exports and other components of total demand would indicate faster growth than shown in the production figures. We will have to wait and see whether this inconsistency is explained by a rapid increase in exports' imported inputs or whether the supply side of the National Accounts will be subsequently revised to correspond better with the demand side when more reliable information on this year's economic developments is available.

The economic outlook for the rest of the year and next year has undoubtedly improved compared to the beginning of this year for both Finland and the European Union. In Finland the production outlook especially for the traditional metal industry and construction has strengthened. The improvement in employment nevertheless is largely attributable to the growth in the service sector. The Labour Institute for Economic Research forecasts that GDP will grow by 2.5 per cent this year compared to last year. The forecast assumes that economic growth will accelerate during the latter part of the year. Still in March of this year the growth forecast was 3.6 per cent. The production stoppage in the forest industry cut growth by about 0.9 percentage points, but it will raise next year's figures by the same amount. Growth will remain fairly strong during next year and GDP will be 3.9 per cent higher than this year.

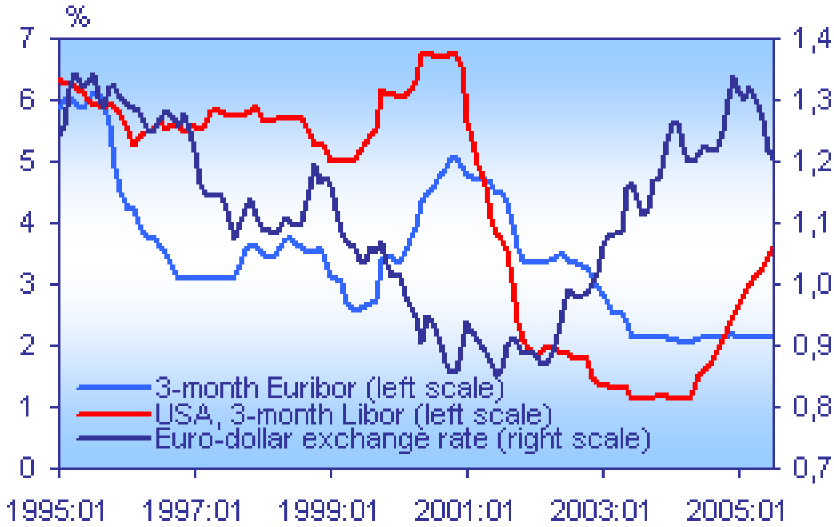
Beginning of year was weak in eurozone

GDP grew in the eurozone by only 1.3 per cent in the first half of this year. Due to the weak performance the growth forecast for this year has been lowered to 1.5 per cent from the previous 1.9 per cent. The realization of the forecast will require an acceleration of growth in the latter part of the year. This trend is indicated by the improvement in the outlook for industry and the service sector. The growth in the eurozone is bolstered by the strengthening of the financial position of households and companies, and this will be facilitated by the weakening of the euro vis-à-vis the dollar and interest rates remaining low long into next year. The rise in oil prices has on the other hand dampened economic growth, and it is also the greatest risk factor threatening growth. It will not hamper growth in the EU as much as for example in the US.

As economic growth accelerates in the eurozone already toward the end of this year, GDP will be 2.1 per cent higher this year than last year. Growth in the non-eurozone EU countries will be appreciably faster than this. This applies especially to the Baltic countries and other former socialist countries, but also Sweden's economy will grow faster than the EU on average. Growth in the UK will slow down but nevertheless remain faster than the EU average.

The consumer price inflation in the eurozone has hovered around 2 per cent. The rise in non-energy prices will remain at slightly over one per cent. Sluggish growth will prevent the rise in oil prices from spilling over into other goods, although the weakening of the euro will put upward pressure on prices. Because there are currently no factors fuelling inflation within the eurozone, the ECB is unlikely to raise interest rates before it is convinced that economic growth has strengthened and begun to generate upward pressure on prices. This means that we will have to wait a long time into next year before interest rates are raised. The budding of growth and depreciation of the euro against the dollar mean, on the other hand, however, that the ECB will no longer lower interest rates.

Figure 1. Interest Rates and Euro-Dollar Exchange Rate 1995:01 - 2005:07



Source: Bank of Finland

The situation in the US differs significantly from that of Europe. GDP is growing steadily and consumer prices climbed at a rate of over 3 per cent in July. Non-energy inflation was only slightly over 2 per cent. In this kind of an economic environment the Federal Reserve will continue raising its reference rates in increments of 25 basis points at a time until at least this coming winter. This means that the Fed funds rate will rise from the current 3.5 per cent to 4.5 per cent by February 2006. A year ago the Fed funds rate was only 1.5 per cent. The interest rate differential between the US and Europe has been widening, which will tend to spur a weakening of the euro vis-à-vis the dollar. This tendency will be offset by the trade deficit plaguing the US, which will augment the crisis sensitivity of the international economy. The trade deficit is not shrinking appreciably, even though economic growth will slow down in the US this year and next. It is anticipated that the US economy will grow this year by 3.6 per cent while next year growth will decelerate to 3.2 per cent. Growth will continue to be driven by domestic demand - household consumption and housing investment as well as investments by enterprises.

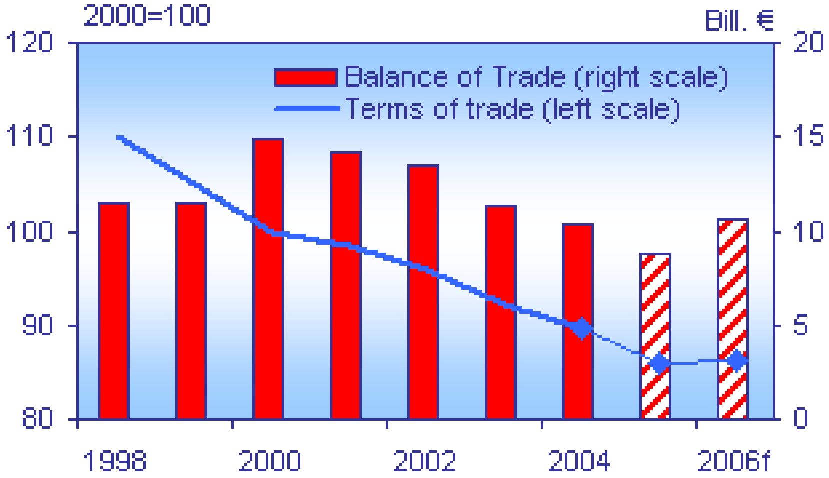
Contrary to widespread expectations, the Chinese economy did not weaken during the beginning of this year. GDP will grow this year by 9.5 per cent and it will not slow down significantly next year either. The decision of the Chinese central bank to revalue the renminbi by 2.1 per cent against the US dollar and to allow its currency to fluctuate against a currency basket (including the euro) instead of being pegged to the US dollar may be a significant first step toward letting the renminbi float on market terms. It is nevertheless premature to decide whether this decision will really lead to a depreciation of overvalued Chinese currency. The growth of another Asian emerging economy, India, is even faster than that prevailing in China. On the other hand, the economic growth of Russia, which is important for Finnish exports, is slowing down somewhat. High oil prices will nevertheless spawn fertile conditions for growth there of around 6 per cent.

Exports driven by strong demand

Finnish exports of goods to non-EU countries grew in the beginning of this year in real terms by about 11 per cent. This meant that the growth of total goods export was surprisingly brisk: in real terms almost 5 per cent, even though the production stoppage in the paper industry cut exports to the EU region. The volume of goods and services exports is forecast to grow this year by slightly less than 5 per cent over that of last year. Next year the weakening of the euro, the positive impact of this year's production stoppage in the paper industry on next year's growth figures as well as a rise in the value of ships completed for delivery by almost a billion euros over this year's level will boost the growth in the volume of exports to almost 7 per cent. Exports to non-EU countries, in particular Russia and China, will continue to display above-average growth.

The value of goods imports grew in the first half of this year by 14 per cent over that of last year. The value of imports was boosted by higher oil prices, but the 8 per cent real growth in the volume of imports has been surprisingly quick considering the moderate growth in total demand. This year the volume of goods and services imports will grow by 5.5 per cent and next year by 5 per cent.

Figure 2. Terms of Trade and Trade Balance 1998 - 2006



Source: Statistics Finland, Labour Institute for Economic Research

Import prices have been rising faster than export prices for several years already. This has been triggered by the steady rise in oil prices and the price erosion of electronics products. Next year the rise in import prices will slow down because oil prices will no longer climb significantly. Since forest export prices will rise, the terms of trade will improve for the first time in a long while. This will tend to bolster the balance of trade.

Electrotechnical industry falling behind projections

The shift of electrotechnical production abroad has spawned a slowdown in the growth of production in this sector and the situation will not change in this respect in the next few years. The slackening of demand for basic metal industry products, on the other hand, is anticipated to be only temporary. There are clear signs of a strengthening of the demand for the output of the metal products industry as well as the machinery and equipment industry, and the shipbuilding industry has already expanded significantly compared to last year. The development of other industrial sectors has been steadier. Energy production has declined by less than expected as the focus of production has shifted to Norway and Sweden as the Scandinavian water basins have been replenished. Next year domestic electricity production will recover somewhat.

Despite getting off to a sluggish start at beginning of the year, construction output will expand this year by 3 per cent. Next year construction output will be 3.5 per cent higher than this year. The growth of service sectors will be swift, 4.8 per cent this year and 4 per cent next year. The structural change in manufacturing activities will continue and growth in manufacturing-oriented services will accelerate to 3.5-4 per cent. The drop-off in forest industry transport will trim growth in transportation output this year. Next year this sector will grow by slightly less than 4 per cent. The growth in health, social and educational services will be about 2.5 per cent this year and next.

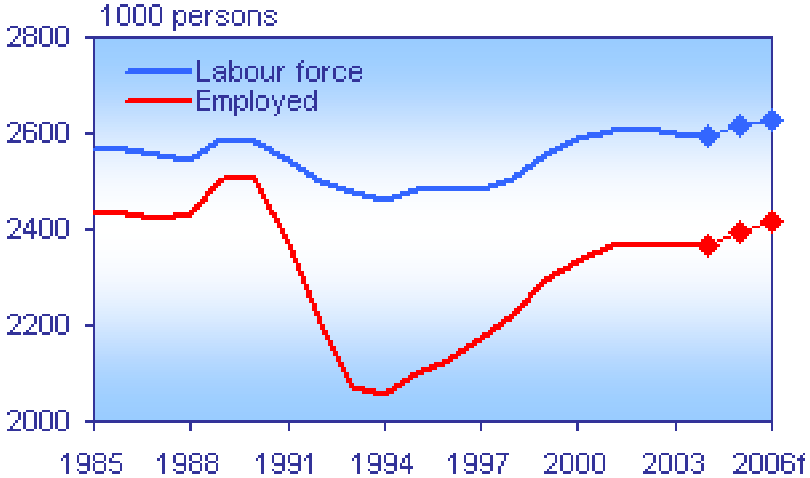
Employment trends positive

The recovery in economic growth in the latter half of last year spurred an upturn in employment. Employment growth continued to be fairly brisk in the first half of this year. In January-June the number of employed persons averaged 39 thousand more than in the same time last year. In line with forecasts, growth has been most prevalent in the services sector. The number of employed persons has increased the most in public and other services as well as in retail trade, reflecting the strong sales performance of the retail trade sector. The favourable cyclical situation in building activity has likewise spurred employment growth in the construction sector. The number of construction employees has increased by over five per cent since the beginning of the year. The decline in the number of manufacturing employees has come to a halt, but a clear upswing has not yet occurred.

Toward the end of the year employment growth will continue to slow down slightly, but thanks to the strong growth in the beginning of the year the number of employed persons will grow this year by 30 thousand and next year by 21 thousand. The employment rate will rise this year to 68.0 per cent and next year to 68.4 per cent.

A noteworthy feature of job market trends is that employment has risen since the beginning of the year by a far greater margin for women than for men. The number of women employed was 26 thousand higher on average in January-June than in the same period last year. The number of men employed climbed by 13 thousand during the corresponding time. The trend is attributable to the strong upturn in demand for labour in women-dominated sectors such as healthcare, social services and retail trade.

Figure 3. Labour Supply and Employment 1985 - 2006



Source: Statistics Finland, Labour Institute for Economic Research

Trends in the supply of labour have followed the trends in the demand for labour. Owing to the favourable developments in the job market, especially women have been prone to re-enter the labour force. The number of persons participating in the labour force in January-June averaged 28 thousand more than in the corresponding time last year. Women's labour force participation rate was 64 per cent, which was a percentage point higher than a year ago. Men's labour force participation rate increased by only 0.1 percentage points. Labour force participation rates rose in all age groups. This year owing to robust demand for labour the labour supply will climb by 0.8 per cent, which will boost the labour force participation rate to 66.3 per cent. Next year the labour force participation rate is projected to rise to 66.4 per cent in the wake of labour demand.

Since the increase in the demand for labour was greater than the rise in the supply of labour, the number of unemployed persons was 10 thousand persons lower on average in the beginning of the year than last year. This year the number of unemployed persons will fall along with the improvement in employment and the unemployment rate will fall to 8.4 per cent. Next year the unemployment rate is forecast to fall to 8.1 per cent.

Construction activity rebounding

Investment rose last year by five per cent after contracting for a couple of years. Investment will continue to grow this year at a rate of three per cent. The cyclical situation in construction has remained good this year. Housing production, industrial construction and civil engineering projects will sustain growth in construction. The significance of renovation in building construction will continue to increase. Next year investment will rise by over four per cent. The growth in investment will be driven by private investment as public investment falls.

Households' purchasing power increasing

The comprehensive incomes policy settlement is determining earnings developments this year and next. In this respect the purchasing power of wage earners is stable and easy to forecast. Taking into account carry-over from previous earnings trends and wage drift, we forecast that earnings will rise this year by 3.6 per cent. In the year 2005 the level of earnings will rise more modestly, 2.6 per cent, but tax cuts will boost purchasing power of wage earners. The wage settlement enables the favourable developments in employment. The number of hours worked will increase this year by 0.8 per cent and next year by 1.6 per cent. The wage bill will rise during these two years by 4.3 and 4.5 per cent, respectively, i.e. faster than the level of earnings. The lock-out in the paper industry has required a clear downward adjustment in the spring forecast and cut the number of hours worked. Next year the impact of the labour dispute will pass over, which will be reflected in a rise in the number of hours worked and faster growth in the wage bill.

Last year preparations for reforms in capital and corporate taxation boosted households' capital income, especially from dividends. This year companies' willingness to pay dividends will decrease and growth in capital income will subside. Next year the upswing in profitability will again boost households' capital income. Households' disposable income, which is determined largely by wage income, will rise this year by 3.8 per cent and next year by 4.1 per cent.

No surprises in consumption demand

Last year's favourable income trends were not reflected in consumption growth with full force, but rather a portion of it was channelled to the housing market. The savings rate also rose. This year households can sustain stable growth in consumption by reducing their propensity to save, even though the labour dispute in the paper industry will dampen the rise in their income.

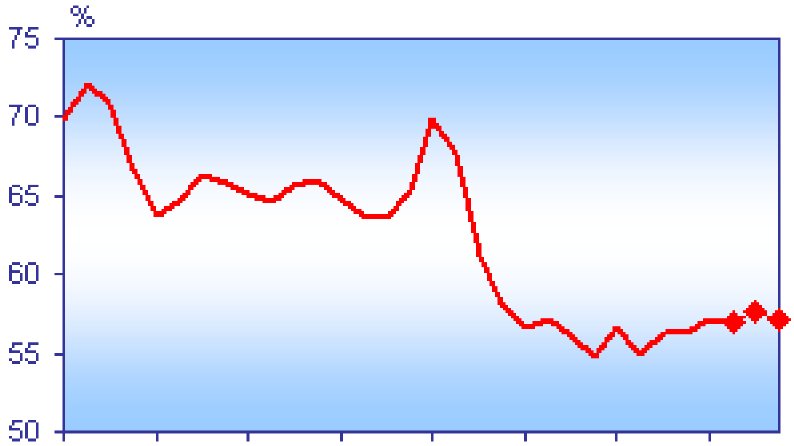
Consumption growth will be boosted by strong consumer confidence, low interest rates and the robust economic outlook. In 2005 and 2006 income developments will facilitate a steady rise in private consumption of about 3 per cent. Our forecast is somewhat higher than the long-term average for consumption growth. Our view is supported by growth figures in the wholesale and retail trade in the beginning of this year.

A significant feature regarding the structure of consumption demand is the levelling off of car sales as the worst consumption pressures have been unwound. Purchases of durable goods will grow more slowly than in recent years and they are focused more than previously on household appliances, electronics and furniture. A sudden fall in housing prices or collapse in consumer confidence is not expected. Neither will interest rate movements endanger the outlook for consumption next year.

Share of wages rising temporarily due to paper labour dispute

The paper industry is capital intensive. The impact of the production stoppage will be reflected in the wage bill most prominently in production and operative surpluses. On the other hand, the weakening of the terms of trade has eroded the profits of enterprises. For these reasons the share of wages within enterprises' net profits will rise this year, but the impact will be short-lived. Next year's wage hikes will be modest, and the operative surplus of the private sector will grow. Wage's share of companies' value added will fall to the same level as it was a couple of years ago.

Figure 4. Share of Compensation for Wage Earners in Private Sector 1975 - 2006



Source: Statistics Finland, Labour Institute for Economic Research

Inflation remaining lower than in eurozone

The price of crude oil has soared to new record highs in August. In contrast, domestic inflation pressures have been low and the rate of inflation in the beginning of the year even fell below our spring forecast. The rate of inflation is now around one per cent. As a result of the cuts in taxes on alcoholic beverages, consumer price inflation has been exceptionally low, 0.2 per cent. Because the tax cuts affected inflation until March, we forecast inflation will be 1.0 per cent for this year and 1.2 per cent next year. Crude oil prices are expected to remain high also next year. The level of interest rates will remain unchanged this year, and there are no signs of inflationary pressures other than from oil prices. Finland's inflation will remain well below that prevailing in the rest of the eurozone.

Public sector still running a surplus due to hike in pension contributions

The net lending of the central government decreased last year by less than expected, by only €200 million owing to the strong growth of income tax revenues and dividends as well as the slowdown in the central government's consumption expenditures. The central government ran a slight surplus. In contrast, the fiscal deficit of the municipalities widened to over EUR 300 million. Owing to tax cuts, municipal tax revenues rose by only 0.7 per cent while municipal expenditures increased by 6.1 per cent. While the net lending of the pension institutions and other social security funds remained at the same level as the previous year, the net lending of the overall general government (EMU surplus) decreased appreciably. As a percentage of GDP the surplus declined from 2.5 per cent to 2.1 per cent. The combined general government surplus (EMU debt) as a percentage of GDP fell by 0.2 percentage points because GDP grew sharply.

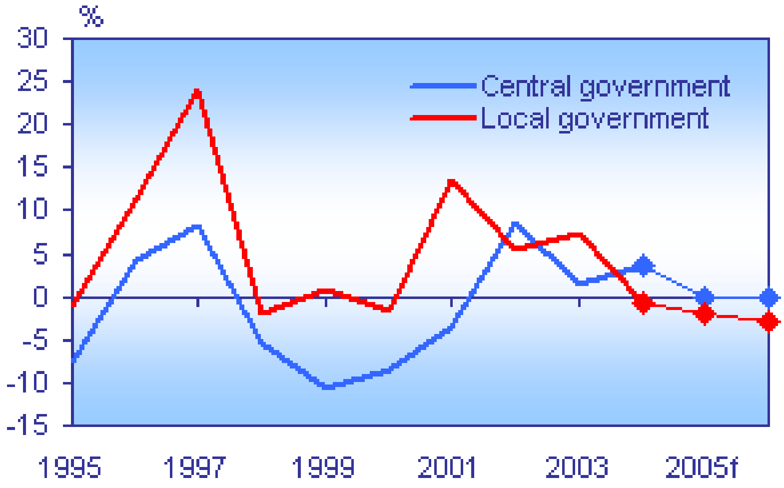
This year the central government will run a deficit of about EUR 200 million. The weakening of central government's financial position is attributable largely to the easing of income taxes. The taxation of earned income has been eased by inflationary adjustments as well as changes in the tax schedules. Revenues from capital income and corporate taxes will be dampened by tax reforms and cuts in the central government's corporate taxes in favour of municipalities. The wealth tax has also undergone reforms and revenues from the wealth tax will decrease. Central government revenues and wealth tax will fall by about EUR 100 million. At the same time the central government's payments to the EU and revenue sharing with the municipalities will grow appreciably.

Municipal finances will be improved also by strong growth in tax revenues, as municipal taxes are not cut, municipal tax rates will rise and corporate taxes will be subject to cuts in deductions and an increase in its percentage of revenue sharing. On the other hand, the municipalities' consumption expenditures will nevertheless continue to grow strongly owing, among other things, to obligatory national healthcare so that their budget deficit will increase only slightly.

The surplus of pension institutions and other social security funds will grow this year by EUR 600 million as certain payment rates are raised slightly, social benefits and assistance will climb at a slower pace and their investments will fall. The net lending of the overall general government relative to GDP will remain unchanged. Despite tax cuts by the central government, the ratio of total taxes as a percentage of GDP will rise by 0.3 percentage points. This is attributable to the faster growth of wage income than national income. Revenues from municipal taxes and social security contributions will climb relative to GDP.

In 2006 the budget deficit of the central government will climb to slightly more than EUR 700 million. Despite the upswing in enterprises' profits spurring growth in the central government's dividends and corporate tax revenues, revenues from income and wealth tax will decline slightly as wealth tax is eliminated completely and cuts in earned income tax are implemented only with respect to central government taxes. The amount of money earmarked for revenue sharing and social security funds will continue to increase appreciably.

Figure 5. Investments 1995 - 2006, change from previous year



Source: Statistics Finland, Labour Institute for Economic Research

The budget deficit of local government will shrink next year by slightly more than EUR 400 million as their tax revenues grow strongly. In the forecast it is estimated that municipal taxes will be raised by 0.2 percentage points. The consumption expenditures of local government will continue to rise owing to their growing statutory obligations. From the figure we can see that the austerity measures of the central and local government in recent years have lead to only very modest growth in public investments (and even to a decrease in local government investment). As the growing obligations of municipalities boosts their consumption expenditures, they will have to cut back on their investments while, on the other hand, the investments of central government will be held in check by budgetary spending ceilings and a political agreement that unbudgeted revenues from privatisation will be used to repay the national debt. This will undoubtedly lead before long to unleashing of pent up demand as occurred in the 1990s and turn of the millennium.

The revenues of pension institutions and other social security funds are expected to grow next year by over 6 per cent as some of their contribution rates are increased further. The impact of support for low-wage labour on revenues is small in a bigger perspective. Unemployment insurance-related expenditures are projected to decrease substantially.

The surplus of the pension institutions and other social security funds will grow appreciably. This trend in combination with the improvement in the financial position of the municipalities will mean that the EMU surplus will rise substantially. EMU debt as a percentage of GDP will fall by 0.9 per cent and the ratio of total taxes to GDP will decrease by half a percentage point.

Room for tax cuts decreasing

The cyclical situation is favourable this year and next from Finland's standpoint. The tax cuts implemented and those decided upon for next year have increased households' purchasing power, curbed wage demands and thereby promoted economic growth and employment. The financial position of the public sector has nevertheless weakened appreciably and is deteriorating further. The municipalities in particular will find themselves caught in a tightening squeeze between growing spending obligations and insufficient tax revenues. Even though the central government is trying to ease the pressure on the municipalities by giving them aid, the disparate financial situation of the municipalities and chronic deficits have forced them to cut back on investments and bolstering of efficiency in the long term. The safeguarding of municipal finances and the need to prepare for a weakening of the cyclical situation will not allow a further erosion of the central government's financial base. This means that there is no reason for new tax cuts in the next few years. It would also be wise to time large-scale infrastructure investments so that they start during a cyclical downturn rather than during a boom.

INTERNATIONAL ECONOMY

GDP growth , %	2004	2005f	2006f
United States	4.2	3.6	3.2
Euro-12	2.0	1.5	2.1
Germany	1.6	1.2	1.8
France	2.3	1.6	2.4
Italy	1.2	0.0	1.0
EU 25	2.4	1.7	2.3
Sweden	3.6	2.8	3.0
United Kingdom	3.2	2.3	2.5
Japan	2.7	1.5	2.0

Russia	7.2	6.0	6.0
China	9.5	9.5	9.0
Source: BEA, IMF, OECD, Labour Institute for Economic Research			

DEMAND AND SUPPLY

	2004	2004	2005f	2006f
	Bill. €	Percentage change in volume, %		
Gross Domestic Product	149.7	3.6	2.5	3.9
Imports	48.5	6.0	5.5	5.0
Total supply	198.2	4.2	3.2	4.2
Exports	56.6	5.6	4.7	6.7
Consumption	111.4	2.8	2.6	2.7
- private	77.7	3.2	2.9	3.1
- public	33.7	1.6	1.8	1.8
Investment	28.2	5.0	2.6	3.6
- private	23.7	5.6	3.9	4.5
- public	4.5	2.1	-4.7	-1.9
Change in stocks	2.0	0.2	0.0	0.0
Total demand	198.2	4.2	3.2	4.2
Source: Statistics Finland, Labour Institute for Economic Research				

KEY FORECASTS

	2004	2005f	2006f
Unemployment rate , %	8.8	8.4	8.1
Unemployed (1 000)	229	221	213
Employed (1 000)	2365	2395	2416
Employment rate , %	67.2	68.0	68.4
Inflation, consumer price index, %	0.2	1.0	1.2
Wages, index of wage and salary earnings, %	3.6	3.6	2.6
Real disposable income of households, %	5.3	2.7	3.3
Current account surplus, Bill. €	6.2	4.1	5.6
Trade surplus, Bill. €	10.3	8.8	10.6
Central government financial surplus, Bill. €	0.4	-0.2	-0.7
% / GDP	0.2	-0.1	-0.4
General government financial surplus, Bill. €	2.8	3.0	4.0
% / GDP	1.9	1.9	2.5
EMU debt, % / GDP	45.1	45.5	44.6
Tax rate, %	44.3	44.7	44.2
Short-term interest rates (3-month Euribor)	2.1	2.1	2.3
Long-term interest rates (10-year gov't bonds)	4.1	3.5	4.0
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research			