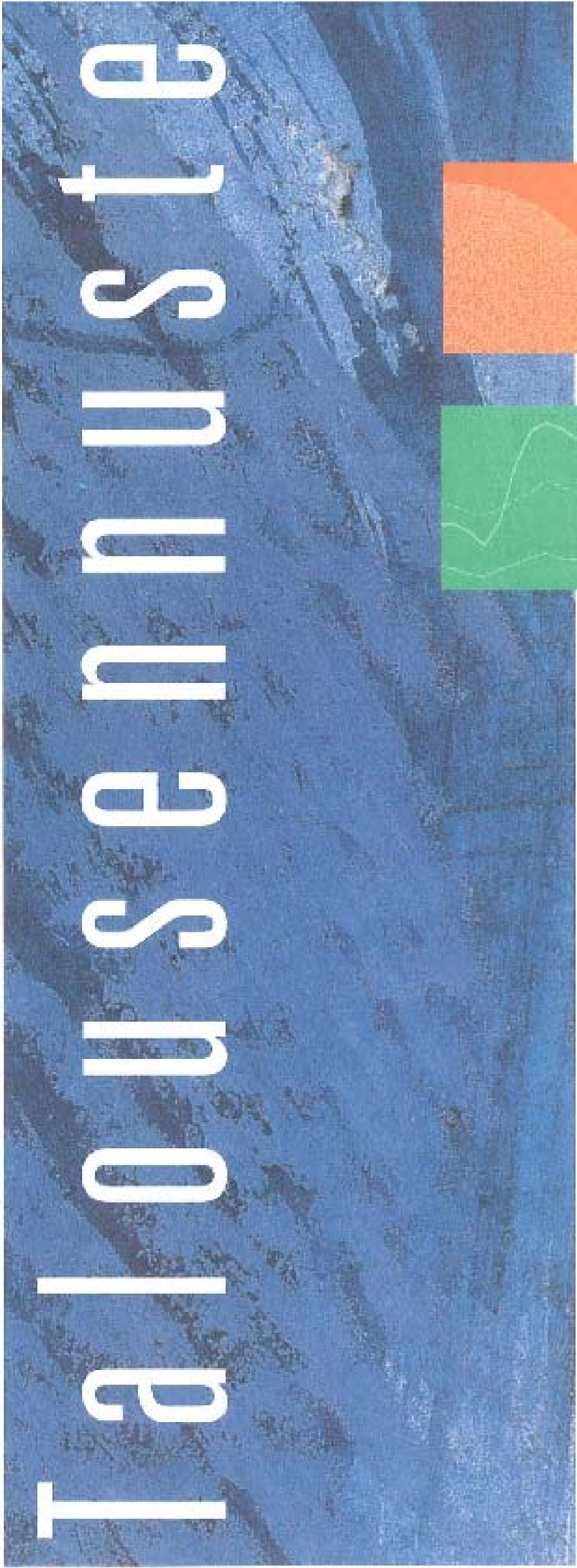


**August 26, 2008**

**Economic Forecast for 2008–2009**

# Finnish economy headed for a downswing but not a recession

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LABOUR INSTITUTE FOR ECONOMIC RESEARCH

**Economic Forecast 2008–2009**

# Finnish economy headed for a downswing but not a recession

*The Labour Institute for Economic Research forecasts that Finnish gross domestic product will grow this year by 3.0 per cent and next year by 1.7 per cent. Last March we forecast corresponding growth figures of 3.0 and 2.8, respectively. Next year growth will slow down especially due to the slowdown in investment growth. Private consumption growth will also slow down. On the other hand, export growth will continue to be rather swift next year. Export performance will be affected by the euro no longer appreciating against other currencies. An upturn in growth in the eurozone in the wake of the slowdown in consumer price inflation will also bolster our export markets.*

The rise in the cost of food raw materials and oil has spurred inflation in the eurozone and Finland to over 4 per cent, which has cut the purchasing power of households appreciably more than forecast. This has dampened private consumption and brought economic growth to a standstill. The euro has continued to strengthen against the dollar so that in June-July it was about 15 per cent stronger than a year ago. During the last year interest rates have also risen considerably in Europe. For example, 12-month Euribor rates at the end of summer were already 0.8 percentage points higher than a year ago. Of this rise, 0.25 percentage points is due to the ECB's interest rate hike in July while the rest is attributable to uncertainty caused by the credit crisis that originated in the U.S.

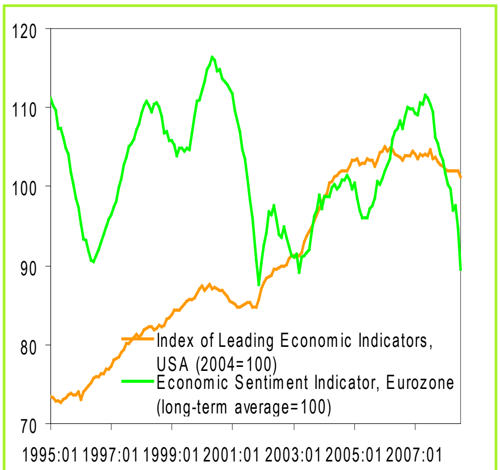
It is clear that the trends depicted above can only serve to dampen growth even in strong economic regions. The effects were evident already in the second quarter of this year as growth in the eurozone almost came to a halt and growth also in Finland slowed down considerably. The direct impact of the weakening of U.S. export demand was nevertheless fairly modest and it was offset by the continuation of swift growth in developing countries.

In Europe these developments have been exacerbated internally by the failure of monetary policy and a fiscal policy that has, for example, even accelerated inflation by raising public tariffs. The booming housing markets in certain countries – e.g. in Spain, Denmark, Ireland and England – and the consequent rise in indebtedness of households has led to a sharp downturn in growth like that in the U.S. A chapter of its own is the rapid deterioration in the Baltic economies. The economic growth witnessed in these countries has not been based on the strengthening of real competitiveness. Finland belongs to the healthy core of Europe with Germany, Austria, the Netherlands and Sweden. In these countries employment has developed favourably and the expected slowdown in consumer price inflation may boost consumer confidence and private consumption faster than elsewhere.

## European economic growth temporarily negative

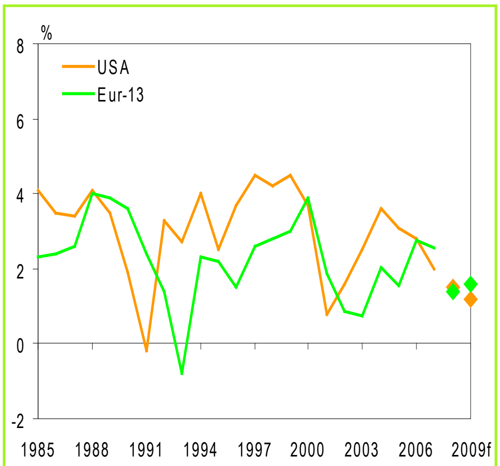
Still in the first half of this year the economic growth in the eurozone grew by about 1.8 per cent compared to the previous year. In the second quarter GDP fell by 0.2 per cent compared to the previous

**International leading indicators 1995:01–2008:07**




Source: Conference Board, European Commission

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




Source: BEA, Eurostat, PT

quarter, which may be indicative of a more sustained downturn. Even though private consumption may pick up already this year as inflation subsides, the decline in investment will keep economic growth slow during the entire second half of this year. This year GDP in the region as a whole will grow by only 1.4 per cent compared to last year.

The rate of economic growth in the eurozone will not reach two per cent on a quarter-on-quarter basis until the second half of next year. Next year the eurozone's GDP will grow by 1.6 per cent compared to this year. Economic growth will be driven by foreign trade, which will be bolstered by the halt in the strengthening of the euro and the fairly modest cost developments in the eurozone. The growth in private consumption will pick up when consumer confidence begins to strengthen as inflation subsides. The sluggishness of investment activity will be affected by the difficulties in countries plagued by high housing debt, like Spain. Growth will be slow this year and next also in certain EU countries outside the eurozone like England, Denmark and the Baltic countries.

The favourable trend in employment in the eurozone and the EU will deteriorate somewhat next year as GDP growth remains sluggish. The rate of unemployment in the eurozone will fall this year to an average of 7.3 per cent but next year rise to 7.5 per cent.

### International economy

| GDP growth (%) | 2007 | 2008f | 2009f |
|---|---|---|---|
| United States | 2.0 | 1.5 | 1.2 |
| Euro-13 | 2.6 | 1.4 | 1.6 |
| Germany | 2.5 | 1.7 | 1.8 |
| France | 2.2 | 1.4 | 1.5 |
| Italy | 1.5 | 0.0 | 0.8 |
| EU27 | 2.9 | 1.6 | 1.7 |
| Sweden | 2.7 | 2.2 | 1.8 |
| United Kingdom | 3.1 | 1.6 | 1.2 |
| Japan | 2.1 | 0.8 | 1.2 |
| Russia | 8.1 | 8.0 | 7.0 |
| China | 11.9 | 10.0 | 9.0 |

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

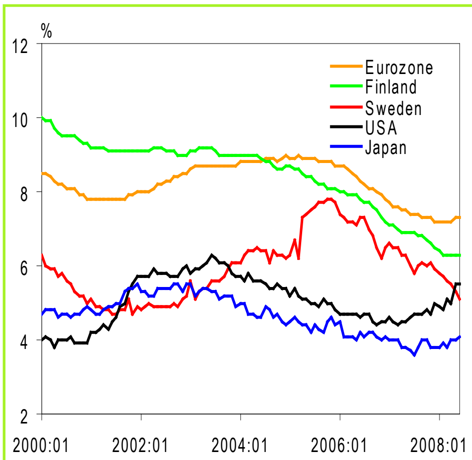
## Eurozone inflation slowing down and interest rates falling

The world market prices for raw materials will still fall toward the end of the year. The price of crude oil will decrease so that it is expected to average 100-105 dollars per barrel, while this year it is has been about 113 dollars. The prices of food raw materials will also fall from their peak in 2008. Next year the price level will in general nevertheless be somewhat higher on average than this year. The decline in world market prices of food raw materials is nevertheless dampening consumer price inflation in many countries.

The value of the euro relative to the dollar will be appreciably higher next year than the average for this year, despite the fact that in August 2008 the euro weakened already by four per cent compared to the level prevailing in spring and early summer. The change in the exchange rate on an average annual basis will thus not have a significant impact on inflation pressures in the eurozone next year. Consumer prices in the eurozone this year are 3.3 per cent above last year's level on average. Next year consumer price inflation will subside to an average of 2.2 per cent.

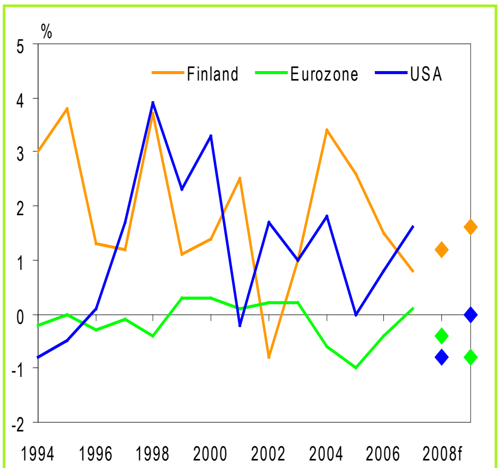
Eurozone consumer price inflation accelerated to four per cent in June, and the European Central Bank (ECB) reacted by raising its repo rate

### Unemployment in assorted countries 2000:01–2008:06



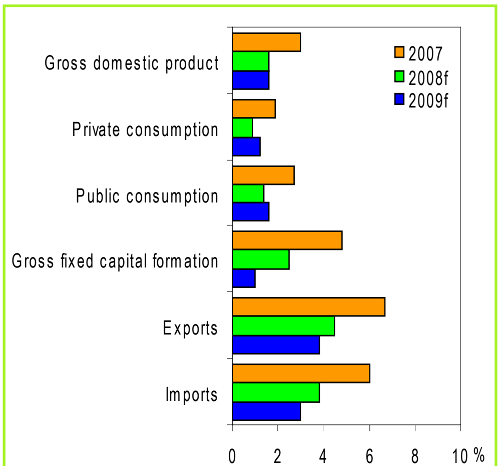

Source: Eurostat

### Change in real earnings 1991–2009




Source: OECD, PT

### Eurozone economic growth 2007–2009




Source: Eurostat, PT

by 0.25 percentage points to 4.25 per cent on July 9. Before this the credit crisis that originated in the U.S. and its spread to Europe had raised, for example, 12-month Euribor rates by almost a percentage point from 4.5 per cent to 5.4 per cent, even though the ECB had not raised interest rates during that period of time. Thus already before the ECB's interest decision the money and financial markets had already tightened appreciably, which had a negative impact on real economic growth.

Against this background the ECB's interest rate hike is difficult to understand. The biggest problem with the ECB's whole policy concept is that no differentiation is made between internal and external shocks generating inflation. In this respect the ECB's analysis and policy differ, for example, from the monetary policy of the U.S. Federal Reserve. As a consequence, it appears that the Fed has fought strongly against recession while the ECP has for the time being hastened the eurozone's slide into a recession.

The substantial slowdown in inflation and aggregate growth will nevertheless prompt the ECB to ease its monetary policy so that its repo rate will decline next year by a total of 0.5 percentage points. In addition the risk premia in the money markets spawned by the credit crisis will diminish in the borrowing rates of loans granted to both enterprises and households. While three-month Euribor rates will average 4.7 per cent this year, they will fall to 4.1 per cent on average next year.

## U.S. economic growth will remain slow

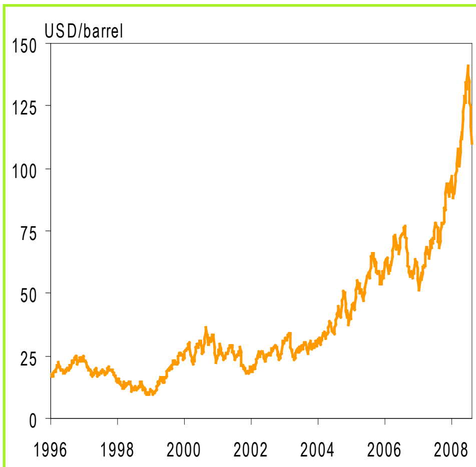
GDP growth in the U.S. already came to a halt in the last quarter of last year. Since then the growth rate within this year has remained rather slow. However, in the second quarter of this year overall output grew by 0.5 per cent from the previous quarter (and 1.8 per cent from the previous year) due to tax cuts aimed towards households and the growth of public expenditures. This effect will be temporary. In the future the credit crisis and the build-up of households' debt associated with it and the collapse of housing prices in addition to the weakened labour market situation will again restrict private consumption growth with full force. Swift consumer price inflation in the U.S., which reached 5.5 per cent in June-July is also curbing private consumption. Not even the improved foreign trade situation, as a result of the weakened dollar is enough to turn the cyclical trend around. The GDP of the U.S. will grow by 1.5 per cent this year and 1.2 next year.

The selection of the U.S. fiscal policy measures is also restricted by the fact that the leeway for easing monetary policy has mostly already been used. The Federal Reserve has already lowered its fed funds rate by 3.25 percentage points from the beginning of last year. The fed funds rate was lowered to the current 2 per cent on April 30th 2008. Accelerating consumer price inflation in the U.S. even temporarily caused pressures to tighten the monetary policy, but with the deceleration of inflation on the horizon these pressures are abating. At the moment it appears that the Federal Reserve will not make significant changes in its fed funds rate next year.

## Growth continues relatively swift in developing countries

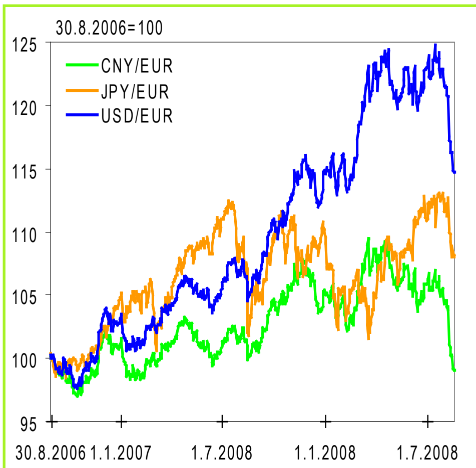
In China the investment level will remain high and will boost economic growth despite the weakening of the export market in the U.S., Europe and Japan. China's GDP will grow by 10 per cent this year and 9 per cent next year. Consumer price inflation has accelerated in China in recent months to slightly over 6 per cent and the annual rate of

**World market price of crude oil (Brent) 1996–2008**



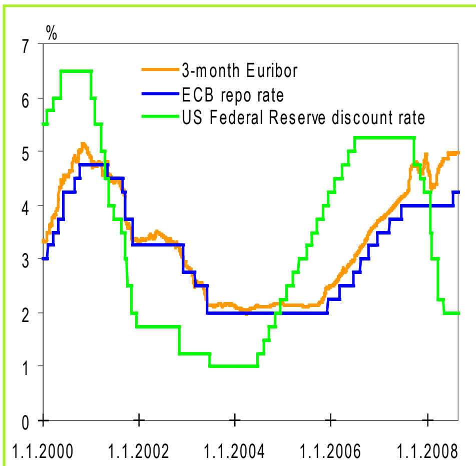
Source: Energy Information Administration

**Exchange rates 30.8.2006–18.8.2008**



Source: ECB

**Short-term interest rates 3.1.2000–18.8.2008**



Source: ECB, Bank of Finland

increase in nominal wages is already reaching well over 15 per cent. Productivity is also rising faster in China than in developed countries, but when measured by unit costs China is continually losing its competitive advantage in relation to developing countries.

In the rest of Asia excluding Japan growth will continue to be comparatively swift. The recession in the U.S. will affect South America the most strongly, so that economic growth there will slow down below 4 per cent already next year.

Russia's growth will continue to be supported by the surplus in foreign trade. Russia's total production will grow by 8 per cent this year and 7 per cent next year. The rapid growth of investments and the distinctly slower real growth of private consumption in comparison are also characteristic of the structure of Russian growth. Inflation in Russia has already accelerated to over 10 per cent and average wages have risen significantly faster than this.

## Exports slowing down toward end of year – next year weakening of euro will boost exports again

The slowdown of economic growth in the EU countries cannot help but reflect upon our foreign trade. The growth in the volume of Finnish exports will slow down this year to 2.5 per cent from last year's 4.8 per cent. The growth of service exports will be appreciably faster than for exports of goods. The growth of exports as a whole this year was based on growth of Asian and Russian exports since exports to the EU region have not grown at all. Next year the markets of the EU region will remain weak and the halting of the appreciation of the euro and modest rise in costs will foster the preconditions for greater exports outside Russia and Europe. Exports growth will pick up to about 3 per cent. The growth of exports will be weighted toward the technology industry and chemical industry.

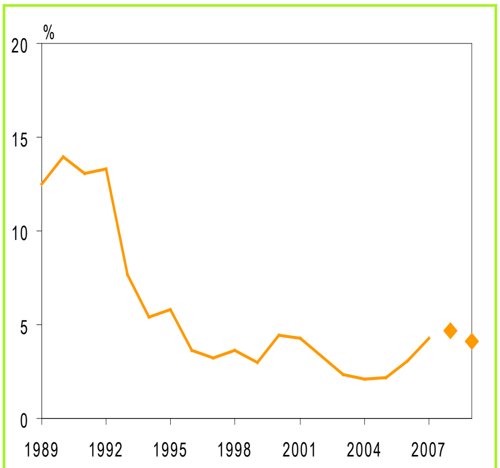
The volume of imports will grow this year by slightly over two per cent compared to last year and next year its growth will slow down already substantially below two per cent as domestic demand slackens. The terms of trade will still deteriorate this year, but next year for the first time in a long time it will strengthen as the fall in the world market prices of raw materials spurs a modest decline in import prices as well.

## This year services and next year industry are engines of growth

The slow-down of growth from last year is decelerating the growth of industrial output. Next year the slackening of construction activity will also cut the output of the wood industry. The technology industry and the chemical industry will continue to grow, and in the latter half of next year the growth of the output of these central export sectors will accelerate once again.

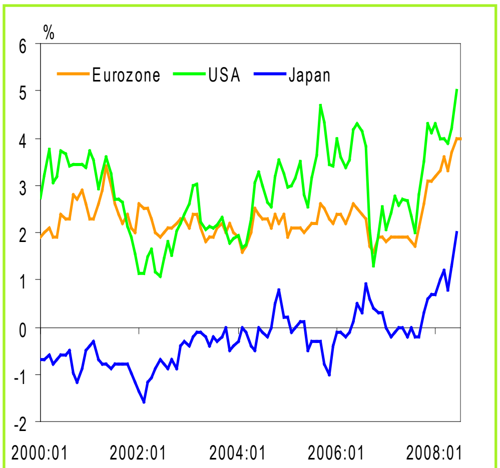
The sharp rise of Russian export customs duties threatens to curtail timber imports from Russia. At the moment, it seems unlikely that the decision concerning the customs duties will be revoked. However, it is still uncertain whether birch with a diameter less than 15 cm will be imported from Russia. The import of raw timber from other neighbouring areas will increase. However, an even more significant compensation than this will most likely be increasing pulp import from far away South America and possibly South-East Asia. Felling activities in Finland's own forests are also increasing as a result of tax concessions for forest income. However, the output of the forest industry will not be growing much even next year, because the production capacity has been restricted and because the demand for products in the export market is sluggish.

### 3-month Euribor 1989–2009



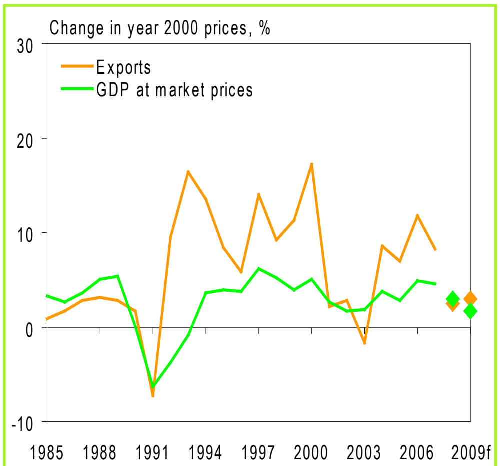
Source: Bank of Finland, PT

### Inflation in assorted countries 2000:01–2008:07



Source: Eurostat, OECD

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



Source: Statistics Finland, PT

Of the other sectors, the growth of construction and the construction material industry will experience the sharpest downturn next year. This effect is strengthened by the slackening demand in the export markets of the Baltics. Even service production, which has been growing at a rate of about 2 per cent at present, will slow down next year due to the slow growth of the real purchasing power of households. Public services will still grow this year at a rate of slightly more than 2 per cent, but next year their growth will subside to less than one per cent. This negative effect of the public sector is indeed one of the key reasons why Finnish cyclical growth and the favourable situation in the labour market will weaken.

## Next year growth of the wage bill will slow down

Union-specific wage settlements will determine wage developments this year and next. Most of these settlements were signed already last year. In the union-level wage round the service sector and public sector ended up with somewhat higher wage hikes than in the export industry. New features of the wage settlements included a lump-sum payment in the beginning of the contract period and increased leeway for agreeing on certain matters at the local level. The local negotiation of pay hikes will significantly decrease wage drift compared to previous years. This year the level of earnings index will rise by 5.3 per cent, of which 4.4 percentage points is the share of the contract wage index. In 2009 the level of earnings will rise by 4.5 per cent and contract wages by 3.7 percent. The difference between the years is attributable almost entirely to the increase in wages carried over from the previous year to 2008.

This year both average hourly earnings and the wage bill will grow faster than earnings: average hourly earnings will rise by 5.6 per cent while the wage bill climbs by 6.9 per cent compared to the previous year. The growth of the wage bill will be boosted by the improvement in employment. This year the growth of the wage bill will also be slightly faster than the operating surplus of the private sector. The share of wages out of enterprises' value added will nevertheless remain below the average level prevailing after the depression in the early 1990s. Next year employment trends will deteriorate and according to our forecast the wage bill will grow by 4.5 per cent from that of this year.

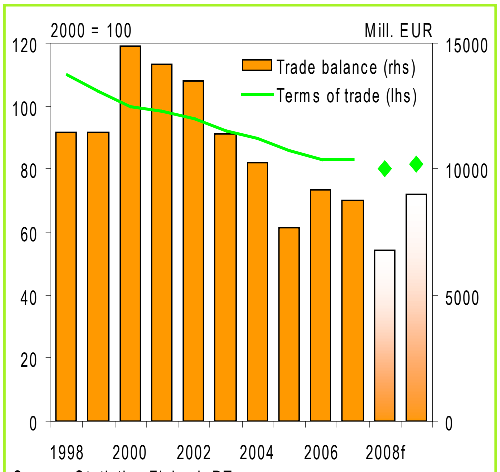
Households' property income will grow this year. The rise in interest rates has increased the popularity of bank deposits and household's equity and mutual fund investments have decreased. On the other hand, interest

### Demand and supply

| | 2007 | 2007 | 2008f | 2009f |
|---|---|---|---|---|
| | Bill. € | Percentage change in volume (%) | | |
| Gross Domestic Product | 179.7 | 4.5 | 3.0 | 1.7 |
| Imports | 73.1 | 6.6 | 2.2 | 1.6 |
| Total supply | 252.8 | 5.1 | 2.8 | 1.7 |
| | | | | |
| Exports | 82.2 | 8.2 | 2.5 | 3.0 |
| Consumption | 128.8 | 2.6 | 2.7 | 1.4 |
| private | 90.6 | 3.2 | 2.9 | 1.7 |
| public | 38.2 | 1.3 | 2.3 | 0.7 |
| Investment | 36.5 | 8.5 | 4.0 | -0.2 |
| private | 31.9 | 8.3 | 3.7 | 0.4 |
| public | 4.6 | 9.4 | 5.9 | -4.2 |
| Change in stocks | 5.3 | 39.2 | 0.0 | 0.0 |
| Total demand | 252.8 | 5.1 | 2.8 | 1.7 |

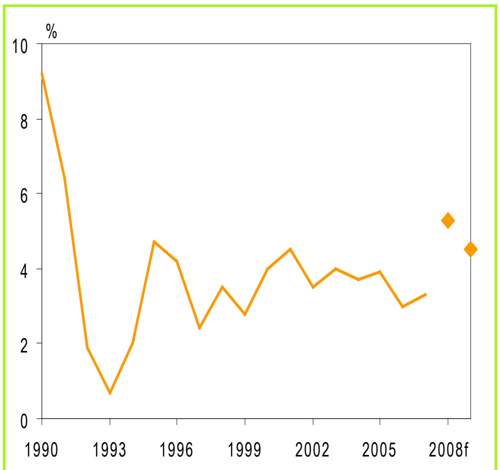
Source: Statistics Finland, Labour Institute for Economic Research

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



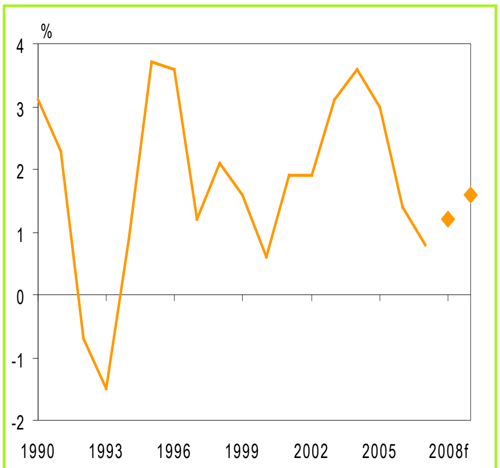
Source: Statistics Finland, PT

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



Source: Statistics Finland, PT

### Change in real earnings 1990–2009



Source: Statistics Finland, PT

expenditures on housing loans have increased significantly. Due to the rise in producer prices, agricultural incomes will develop favourably this year. The temporary tax concessions granted for sales of timber will bolster felling activity, but growth in sales income will be weighted toward next year.

This year only inflationary adjustments will be made to wage earners' income tax scales, but next year income developments will be supported by substantial income tax cuts. In addition, pensioners will gain considerably nominal increases as a result of the acceleration of inflation. We predict that the disposable income of households will grow in nominal terms by 6.3 per cent this year and 5.2 per cent next year.

## Uncertainty and inflation dampen growth in consumption

Private consumption has already for several of years grown faster than average. Growth has been bolstered by consumer confidence, decreasing loan interest rates and the stable economic outlook. For several years already consumption growth has exceeded the growth of disposable income and households have become more indebted. This sort of development cannot continue endlessly.

Although the sales figures of the wholesale and retail trade have witnessed rapid growth in the beginning of this year, consumption growth is on the verge of a downturn. The confidence of consumers has deteriorated rapidly and their expectations regarding their own finances are at a record low since the year 1996. An important reason is the sudden acceleration of the inflation rate and uncertainty spreading from the financial markets. In this situation loan interest rates have risen, the housing market has cooled off and households are postponing purchases and striving to save in their daily expenditures.

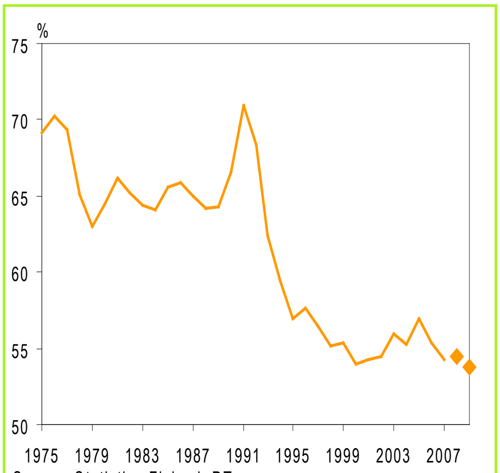
The expected reduction of the automobile taxes postponed automobile purchases over to this year, but its sales stimulating impact has already waned. Purchases of other durable goods are also growing at a slower rate than before. This year the rise in indebtedness of households will come to a halt, and next year the savings rate of households will be -0.5 per cent while it was nearly -3 per cent last year. This year private consumption will grow at a rate of almost 3 per cent, but next year its volume growth will remain at 1.7 per cent.

## Impact of inflation shock will subside next year

In January the taxation decisions of the government spurred inflation. The main factors were the hikes in alcohol taxes and also electricity and fuel taxes. The effects of the taxation changes could be predicted accurately. The inflation rate was also expected to accelerate, while the rise of the world market prices of grain had already widely been reflected in the consumer prices of different countries in Europe. Despite this Finnish inflation after spring has sped up even more than we anticipated. Especially the price of food has risen more than expected in Finland. Second, contrary to our expectations in the second quarter of this year the world market price of crude oil (Brent) broke through the 110 dollar level and temporarily went over the 140 dollar mark. These are the most significant reasons for the difference between our forecast last spring and the realized situation. At the same time Finnish inflation has exceeded eurozone inflation measured using national harmonized price indexes.

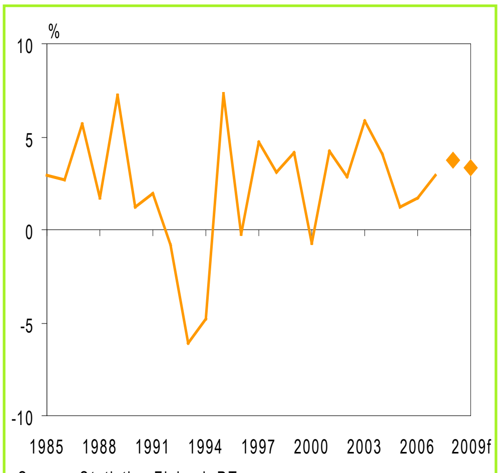
In September the inflation rate is expected to subside. The dollar price of crude oil has rapidly fallen under 120 dollars. We assume that demand will remain high in comparison to the output of crude oil and also next year the price of oil will stay a little over the 100 dollar level. Only the rapid deceleration of the economic growth of Asia can significantly lower its price. In comparison to the average level of this year, the price

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



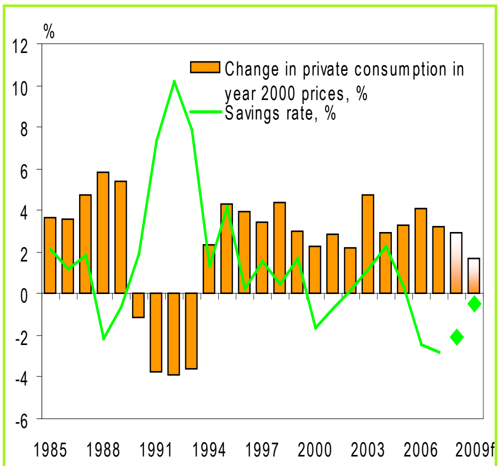
Source: Statistics Finland, PT

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



Source: Statistics Finland, PT

### Private consumption and savings rate 1985–2009



Source: Statistics Finland, PT

of oil will decline by about 10 per cent next year, but in comparison to last year's average level crude oil will be 40 per cent more expensive.

The real prices of housing are on the decline, but the level of rents is rising. Next year borrowing rates are expected to incur a downturn and the inflation effects of January this year will fade away. The world market prices of commodities and food are already descending. The inflation rate will slow down in the latter half of this year, but the annual average will be 4.1 per cent. The average of next year will stay under 3 per cent.

In June of this year the prices of foodstuffs and beverages were about 9 per cent higher than a year ago. The competitive situation of the foodstuffs chain, primary production, industry and the wholesale and retail trade is in a crucial position determining how producer prices are passed on into consumer prices. The reaction seen this year does not offer hope that competition would dampen the rising of prices. We predict an over 8 per cent inflation rate for foodstuffs this year. The threat remains that cuts in the VAT on food to be implemented in October 2009 might not lower the price of food as much as hoped. The tax cut will only partly be passed on into consumer prices.

### Key forecasts

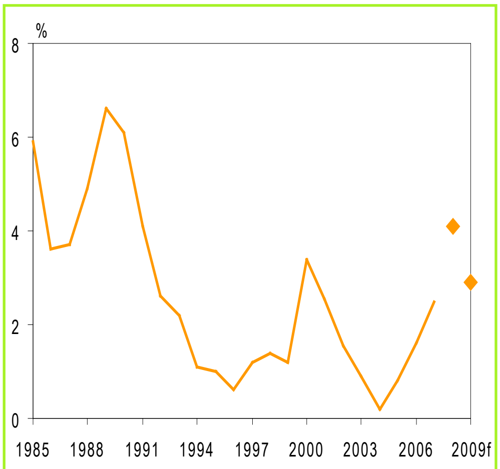
| | 2007 | 2008f | 2009f |
|---|---|---|---|
| Unemployment rate (%) | 6.9 | 6.3 | 6.5 |
| Unemployed (1 000) | 183 | 171 | 177 |
| Employed (1 000) | 2492 | 2530 | 2532 |
| Employment rate (%) | 69.9 | 70.8 | 70.6 |
| Inflation, consumer price index (%) | 2.5 | 4.1 | 2.9 |
| Wages, index of wage and salary earnings (%) | 3.3 | 5.3 | 4.5 |
| Real disposable income of households (%) | 2.9 | 3.7 | 3.3 |
| Current account surplus (Bill. €) | 9.6 | 8.0 | 10.5 |
| Trade surplus (Bill. €) | 8.7 | 6.8 | 9.0 |
| Central government financial surplus | | | |
| Bill. € | 3.8 | 3.5 | 2.2 |
| % / GDP | 2.1 | 1.8 | 1.1 |
| General government financial surplus | | | |
| Bill. € | 9.6 | 9.9 | 7.8 |
| % / GDP | 5.3 | 5.2 | 3.9 |
| Emu debt | | | |
| % / GDP | 35.2 | 32.1 | 29.1 |
| Tax rate (%) | 43.0 | 43.0 | 41.6 |
| Short-term interest rates (3-month Euribor) | 4.3 | 4.7 | 4.1 |
| Long-term interest rates (10-year gov't bonds) | 4.3 | 4.2 | 4.0 |

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

## Employment will not improve any more next year

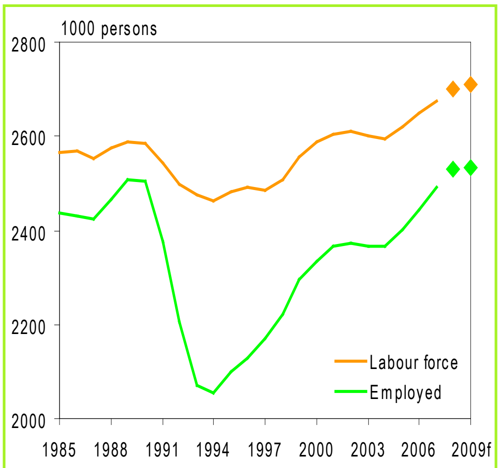
The number of employed persons grew in January-June of this year by an average of 54,000 persons in comparison to the previous year. Jobs have been generated especially in services of the technical sector and business, construction, hotels and restaurants and the wholesale and

### Change in consumer prices 1985–2009



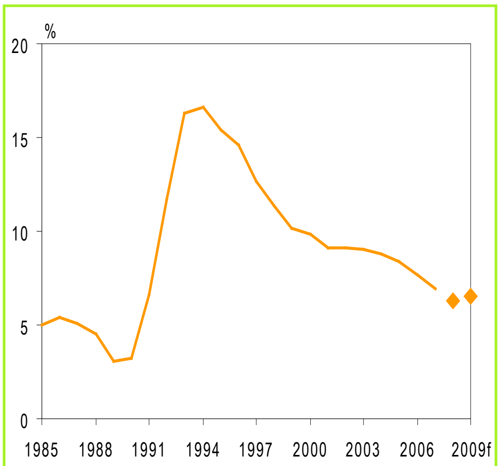

Source: Statistics Finland, PT

### Supply of labour and employment 1985–2009




Source: Statistics Finland, PT

### Unemployment rate 1985–2009




Source: Statistics Finland, PT

retail trade. In industry, however, the number of workers has fallen by about 4000 persons. It should also be noted that the employment of men has improved more quickly than that of women. Of the 54,000 new jobs 37,000 have been men's jobs.

In the latter half of the year the growth of the number of persons employed will most likely remain rather modest while weakening trends begin to affect the labour market. All in all the number of persons employed is forecast to grow by an average of 38,000 persons this year in comparison to the previous year. Population growth and the positive labour market situation will also increase the size of the labour force by 26,000 persons, as a result of which the unemployment rate will descend to 6.3 per cent in the ongoing year, i.e. 0.6 per cent lower than last year. Employment growth will also be visible in working hours, which are anticipated to grow by 1.0 per cent this year in relation to last year.

Next year economic growth will slow down distinctly and employment is no longer anticipated to improve. In construction and industry jobs may even decrease. The weakening economic trend is reflected in the employment rate, which will decline from this year's 70.8 per cent to 70.6 per cent next year. Economic growth will indeed next year be relying on the growth of labour productivity, which is in turn slowing down from the high level of recent years. Despite this the working age population and with it also the labour force will still expand slightly next year. This along with the weakening of labour demand will raise the unemployment level to 6.5 per cent next year.

## Investment growth stagnating

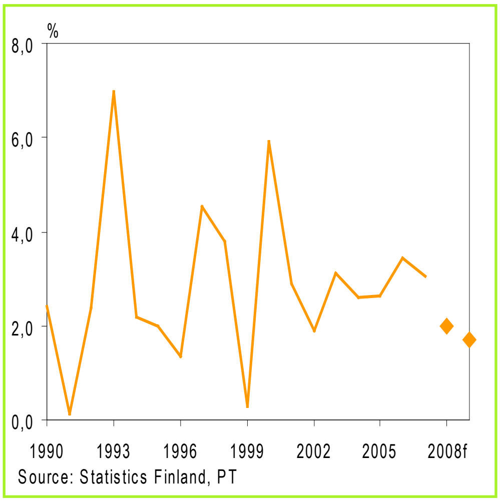
In the first quarter of this year investments grew at a strong annual rate of 8.9 per cent. Growth was strongest in non-residential building construction and machinery and equipment investments. In contrast, housing construction decreased by 4.5 per cent in relation to the previous year. Recent figures for building permits and starts indicates that construction growth is about to subside also in non-residential building construction. Therefore we forecast that non-residential housing construction will still grow distinctly this year but will decrease by about 3 per cent next year. Housing construction will decrease by 5 per cent in the ongoing year but it will remain at this year's level next year. Civil engineering construction will still grow this year due to sizeable public projects such as the Vuosaari Harbour, but next year the growth is expected to come to a halt. The growth of machinery and equipment investments are also anticipated to slow down significantly next year. All in all private investments will grow by 3.7 per cent in the ongoing year and next year by only 0.4 per cent.

## Public sector still running wide surplus this year

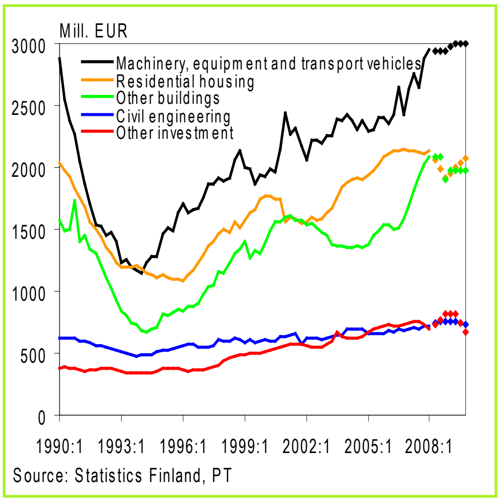
This year it appears that the public sector will run a surplus on par with last year's high level, almost EUR 10 billion, which means slightly more than five per cent of GDP. At the same time the central government's surplus will decrease somewhat, while the surpluses of the municipalities and pension institutions grow slightly.

Domestic demand's strong growth will boost VAT revenues by slightly over six per cent while hikes in alcohol and fuel taxes will boost revenues for the central government substantially. Automobile and asset transfer tax revenues are, on the other hand, declining appreciably. In January-July the central government's income tax revenues have been climbing sharply, by about 10 per cent, and they are anticipated to rise by more than EUR 0.5 billion more than forecast in

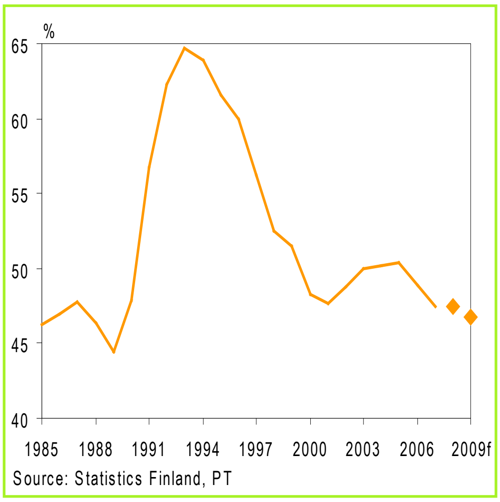
### Productivity of labour 1990–2009




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




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



the budget. This trend stems from robust growth in employment and wages, but also corporate taxes are generating high revenues. Toward the end of this year the growth in tax revenues will nevertheless slow down appreciably. Growth in expenditures will be greatest in investments (about 20%, revenue sharing from the central government to the municipalities (12%) and income transfers to the social insurance funds (about 10 %). The wage subsidies and consumption expenditures paid by the central government will grow substantially this year. The central government will run a surplus of EUR 3.5 billion.

In addition to revenue sharing from the central government, the municipalities' income taxes are increasing substantially this year. According to preliminary figures, they grew at a rate of about 8 per cent in the first two quarters, which will nevertheless subside toward the end of the year. On the other hand, the consumption expenditures of the municipalities will rise by about 8 per cent and investment expenditures by about 10 per cent so that the financial position of the municipalities will rise by only about EUR 200 million, being narrowly on the plus side.

The property income of pension institutes will still grow this year fairly well and, on the other hand, unemployment insurance expenditures will fall substantially. The surplus of pension institutions and other social security funds will rise to EUR 6.4 billion.

## Stringent fiscal stance means public sector still running a surplus next year

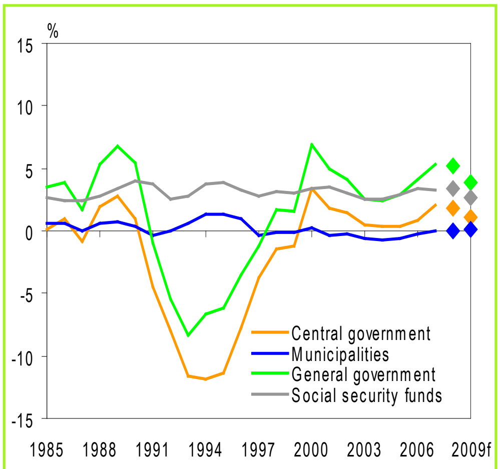
Next year the central government's income growth will slow down both with respect to indirect and direct taxation. Weak growth in private consumption and investment growth as well as the decrease in VAT on foodstuffs going into effect in October will dampen VAT revenues. In the forecast it is assumed that there will be no changes in alcohol, tobacco and other indirect taxes so that their total growth will slow down to a couple of per cent. The central government's tax proceeds will decrease slightly as a result of weakening income trends as regards wage earners and enterprises. Property income will decrease by about EUR 0.5 billion. The central government's revenue sharing with the municipalities will continue to rise fairly sharply, i.e. by slightly over 7 per cent. On the other hand, growth in central government consumption and investment expenditures will remain around two per cent. The central government will nevertheless end up running a surplus of slightly over EUR 2 billion.

Next year the growth in municipal tax revenues will remain under 4 per cent. In the forecast it is assumed that municipal taxes will rise at a rate of 0.1 percentage points, which has been the trend in recent times. As economic growth starts to subside, the municipalities are expected to curb their spending, especially investments. The municipalities will run a surplus of about EUR 100 million higher than previously.

Pension contributions will rise slightly in 2009, but as a consequence of the deceleration of growth in the wage bill the rate of increase in contributions collected by pension institutions and other social security funds will slow down by about one percentage point. At the same time their other property income will start to decline and the social benefits and assistance they paid out increased slightly faster than in 2008.

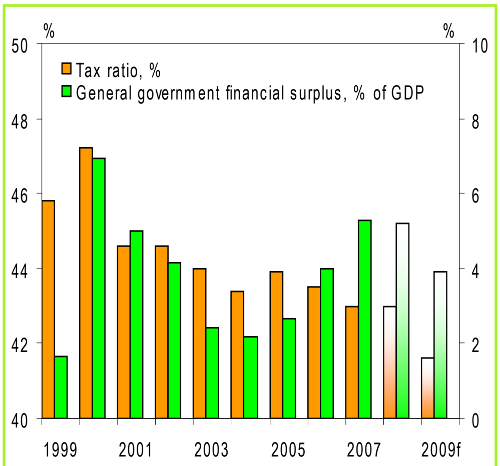
In 2009 the slowdown in economic growth and various tax cuts will weaken the surplus of the public sector by slightly less than 4 per cent relative to GDP. Most of this decline, about EUR 1.3 billion, will take place in the central government, but the surplus of pension institutions and other social security funds will decrease substantially. The gross debt of general government relative to GDP will fall to about 29

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



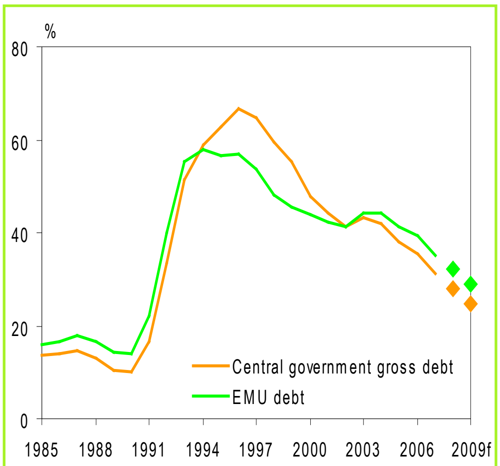

Source: Statistics Finland, PT

**Public finances 1999–2009**




Source: Statistics Finland, PT

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




Source: Statistics Finland, Ministry of Finance, PT per cent. The prolonged surplus of the central government has reduced the burden of the state debt. The debt ratio of the central government will continue to decline sharply and already at the end of next year it will be only 24.6 per cent. The last time central government and general government debt was below these levels was previous to Finland's depression in the early 1990s, when debt ratios were 16.7 and 22.2 per cent, respectively.

## New state highway and railway construction projects starting already next year

Finland's taxes as a percentage of GDP will remain 43 per cent this year, i.e. the same level as last year. Next year the tax burden will be eased and the total tax ratio will decline to 41.6 per cent. In this respect fiscal policy will support domestic demand. On the other hand, public expenditures and investment growth will almost come to a halt and thus curb economic growth. The surplus for the public sector as a whole, which was about 5.3 per cent of GDP in 2007 and 2008, will fall next year to 4 per cent. Most of this decline stems from the significant slowdown in GDP growth.

All in all the fiscal policy reaction to the substantial slowdown in economic growth and deterioration of the labour market appears to be rather cautious. Now when idle capacity and unemployment are increasing in the construction sector, the best cyclical policy would be to start public highway and railway projects sooner than previously planned and to raise the central government's financing shares and ease the burden of municipalities. It is unnecessary in the short and long run to cut the growth of public consumption to almost zero next year.

Next year's easing of earned income taxes is said to be even in all income brackets, so that they are increasing the disposable income of persons with high incomes more than those with medium and small incomes. According to studies, however, the income and employment traps are prevalent more toward the lower end of the income scales. In this respect it is justified to weight tax cuts precisely toward small and medium incomes.

Finland's greatest problems regarding taxation are nevertheless of a structural nature spurred by differences in taxation of earned income and capital income. The government's budget proposal incorporating the easing of earned income taxation is a step in the right direction by narrowing the tax wedge between tax rates for earned income and capital income. On the other hand, there is leeway for raising the tax rates on dividends and capital gains, and no actions have been taken in this direction. On the contrary, early in its term the government even eased these taxes with respect to inheritance taxation and recently in the form of tax concessions for forest sales income.

## Back to forest taxation based on surface area

The likely halt of imports of fibre wood from Russia prompted the government to ease the taxation of timber sales temporarily. A tax concession of 50 per cent is in effect during April 1, 2008 – Dec. 31, 2009, continuing at a rate of 25 per cent in 2010. In 2009 alone the central government's tax revenues foregone will rise to EUR 170 million. According to fresh figures the tax concession has started to boost forest sales in August 2008, after being fairly stagnant for a prolonged period.

The means used to increase the attractiveness of timber sales is an indication of the lobbying power of the forest industry and forest owners. The central government could have and can still compensate for the loss of tax revenues by adopting forest taxation based on surface area once again. This form of taxation, which encourages forest owners to cut and sell timber, was in force in Finland until 2005. Because the tax concession for sales income threatens to become a long-term measure, we should already now seriously considering a return to forest taxation based on surface area.

### EMMA model forecasts for years 2008 and 2009

| | 2008 (%) | 2009 (%) |
|---|---|---|
| Private consumption | 1.8 | 1.8 |
| Private investment | 6.1 | 0.6 |
| Exports | 2.5 | 3.3 |
| Imports | 2.3 | 1.4 |
| GDP[1] | 2.7 | 2.0 |
| Source: Statistics Finland, PT | | |

The economic forecast of the Labour Institute for Economic Research is based on the forecasts generated by the EMMA model. The forecast for next year in particular is based on the figures of the macro-model.

[1] *Public sector growth in forecast of Labour Institute for Economic Research.*

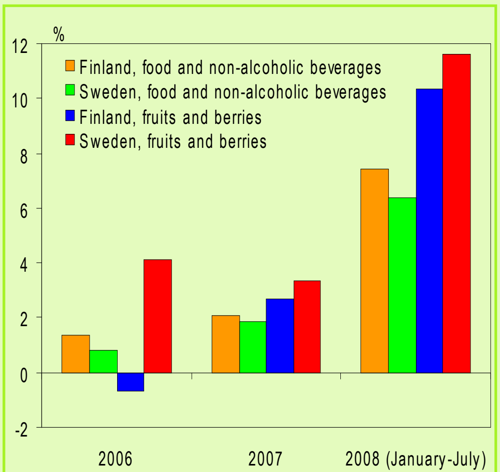
## Food inflation and competition

Consumer prices have risen in Finland since the beginning of 2006 until July of this year by 0.6 percentage points less than on average in the eurozone, while price of food and beverages (excl. alcohol) have climbed by already 1.7 percentage points more than in the eurozone. This prompts the question of why has the increase in world market prices of food raw materials boosted consumer prices of food more in Finland than elsewhere. The phenomenon becomes even more puzzling when we note that the rise in food prices has been faster in Finland than in Sweden and Central European countries, where the consumption structure is closer to that of Finland. It is said that there is not enough competition in the Finnish retail and wholesale trade. This may partly be true. The comparatively moderate inflation in Finland in other consumer goods than food nevertheless indicates that the retail and wholesale trade does not suffer from a widespread lack of competition. Does the problem of weak competition prevail only within the retail trade of daily consumer goods concentrating on foodstuffs?

**Inflation in Finland and Europe 2006:01–2008:07**


Source: Eurostat

**Average inflation in Finland and Sweden 2006, 2007 and 2008**




Source: Eurostat

The adjacent figure compares the rise in food prices during the last two years in Finland and Sweden. This comparison includes fruit and berries, which are typical import goods or retail goods that are not processed in the domestic country. It is remarkable that when food inflation is in general faster in Finland than in Sweden, then this is not the case at all for foodstuffs like fruits and berries, which remain outside the processing chain but are sold in daily consumer goods stores. This indicates that the problem does not derive from the retail trade for daily consumer goods but rather the pricing chain and pricing behaviour for processed foodstuffs.

The very Finnish institution where representatives from the wholesale and retail trade and the food industry agree, nowadays three time a year, on the main retail food prices for the next four months is a major factor behind the Finnish food inflation. This mechanism, which is in obvious conflict with article 4 of the Finnish Act on Competition Restrictions, includes price cooperation between, on the one hand, manufacturers and, on the other hand, the wholesale and retail trade sector. The concentrated structure of the wholesale and retail trade sector and industry indeed augments the binding nature of the above-mentioned agreement. From the standpoint of the consumer this mechanism is unfortunate since it weakens the price lowering impact of consumer's own selection behaviour.

On the basis of the above-mentioned factors, the attempts to affect food pricing by eliminating restrictions on stores' opening hours can be regarded mainly as a way of diverting attention away from more serious problems. The liberalization of shop opening hours would most probably lead to differentiation in opening hours as earlier in Germany. The differentiation of services in this respect would increase the shops' market power relative to the consumer and would raise consumer prices as Inderst and Irmen (2005)[2] have maintained in their study.[3] Larger shops could keep their doors open almost 24 hours a day and the small ones only during the day. It may be that small shops could find their own niche and would not be eliminated from the market. Another possibility is that small shops run into difficulties and lose the advantage they now have. As a consequence the retail trade would become even more concentrated and the price level would decline somewhat, since average costs fall when shop sizes increase. The study nevertheless indicated that the price level rose in this case since the higher number of opening hours raises costs more than the concentration of the retail trade into larger units lowers costs. Consumers would also benefit from the more flexible opening hours. On the other hand, the longer shopping trips in terms of kilometres and time used shopping would raise consumers' "costs". Furthermore, car-less consumers would incur great difficulties.

[2] *Roman Inderst and Andreas Irmen (2005), Shopping hours and price competition, European Economic Review, 49, 1105-1124.*

[3] *Studies of the employment and price impacts of increasing shopping hours are evaluated in more detail in Heikki Taimio's report "Employment effects of increased shopping hours", PAM, Helsinki, 2008. A condensed version of the report has been published in the magazine Talous&Yhteiskunta, 2/2008. This report also found that the increasing of shopping hours is generally deemed to raise prices.*