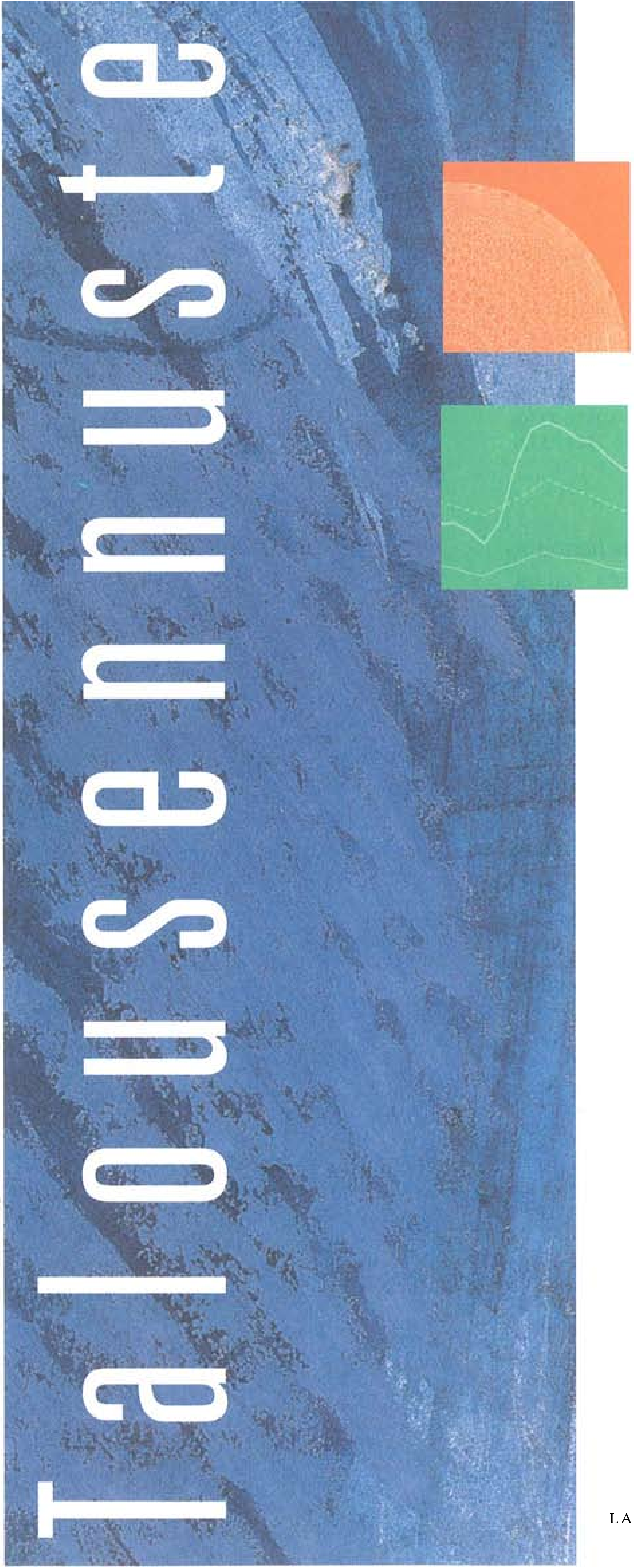

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Economic forecast for 2007–2008

Economic growth will slow down – but still remain fairly fast

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Economic growth will slow down – but still remain fairly fast

Finland's GDP grew last year by 5.5 per cent. The growth rate was exceptionally high even though production shutdowns in the paper industry a couple of years ago due to a labour dispute account for almost a percentage point of this growth. The robust cyclical situation is characterized by the growth in the number of employed by 42 thousand persons last year as the unemployment rate fell by 0.7 percentage points to 7.7 per cent on average. The favourable economic development is attributable to the easing of fiscal policy as well as the strong cyclical situation in the world economy and Finland's neighbouring markets. The greatest surprise compared to the consensus forecasts was Finland's and Europe's growth prospects remaining fairly bright despite the slowdown of economic growth in the US. The Labour Institute for Economic Research forecasts that the economic situation will remain relatively good in the future. As a result, Finland's GDP will grow this year by 3.5 per cent and next year by 3.2 per cent.

Eurozone economic growth surprised many

GDP growth in the eurozone accelerated last year to 2.7 per cent from 1.4 per cent in the previous year. The rate of growth remained fairly swift also in the latter half of last year. Growth in the eurozone was fuelled last year especially by private investment, which rose by about four per cent compared to the previous year. Private consumption growth climbed to two per cent. Economic growth was also spurred by the eurozone's foreign trade.

The Labour Institute for Economic Research forecasts that the GDP of the eurozone will expand this year by 2.5 per cent. Growth will remain relatively swift even though it will be curbed by rising interest rates, the appreciation of the euro against the dollar and the slowdown in growth in the US. Furthermore, the raising of VAT by three percentage points at the beginning of this year will curb German private consumption and total production as well as growth elsewhere in the eurozone. The price effects of raising VAT will be offset by the levelling off of energy prices in the eurozone, the strengthening of the euro and moderate cost developments. In February German consumer prices were only 1.9 per cent higher than those in the previous year, even though most of the upward pressure on prices from the VAT hike had already dissipated. The overall decline in consumer price inflation compared to last year will bolster the recovery of private consumption and economic growth this year. Households' economic confidence and propensity to consume will be boosted by the improvement in the employment situation, reflected by the fact that the average unemployment rate fell last year to 7.8 per cent from 8.6 per cent in the previous year.

Eurozone companies' strong profitability for a prolonged period as well as moderate market expectation will encourage them to increase investment activity this year at the same rate as last year. This view is supported also by fresh figures from the first few months of this year for the eurozone's real economy and economic confidence. Foreign trade – exports minus imports – will also boost economic growth in the eurozone as the rate of growth remains relatively fast elsewhere than in the US. The strong export performance of the eurozone is driven primarily by the improvement in price competitiveness over the years.

Next year the growth rate of the eurozone will accelerate to 2.8 per cent. At that point private consumption's significance as a factor of growth will be emphasized even more, when the effects of Germany's raising its VAT are no longer felt. It is also anticipated that due to the improvement in the labour market situation the collective

Real economy of eurozone, volume change (%)

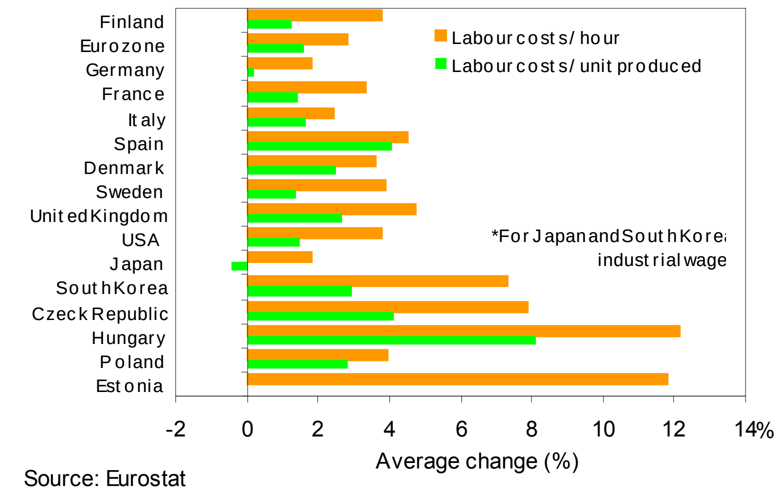
	2005	2006	2007f	2008f
Gross domestic product	1.4	2.7	2.5	2.8
Domestic demand	1.6	2.4	2.4	2.7
Private consumption	1.3	2.0	2.0	2.5
Public consumption	1.3	2.0	1.8	2.0
Gross fixed capital formation	2.7	3.9	4.1	3.7
Exports	4.3	7.9	6.8	5.2
Imports	5.3	7.5	6.5	5.0

Source: Eurostat, Labour Institute for Economic Research agreement's wage hikes will be greater than before, which is contributing to a shift in the focal point of growth from foreign trade to private consumption.

Wage pressure in Europe

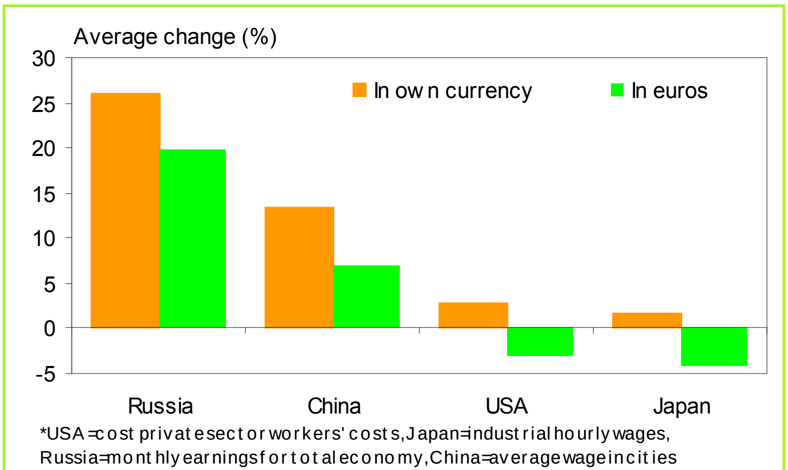
The developments in the eurozone, USA and Japan have been characterized by comparatively moderate wage trends in comparison to the substantial wage increases in the new EU countries, Russia and the emerging economies of Asia. The increase of labour costs per unit produced in the eurozone has also been considerably more moderate than in the new EU countries (Fig. 1). The same should also apply when comparing developed countries to the developing economies of Asia. The Competitiveness of the eurozone itself has been hampered by the strengthening of the euro in relation to other currencies as can be seen from Fig. 2. Strengthening competitiveness, the sizable surplus in the balance trade and improvement in the employment situation has strengthened the pressure for larger nominal wage increases than before, most clearly in Italy, Spain, Germany and Finland. Of these countries, favourable economic developments in Germany and Finland have raised capital income's share of national income by the widest margins.

Figure 1. Labour and unit costs (OECD) 1997–2006



Source: Eurostat

Figure 2. Nominal wages 2002–2006



Source: Eurostat

EKP will still raise interest rates

The European Central bank has raised its repo rate from 2 per cent to 3.75 per cent last year. At first the interest rate hikes were seen as a reaction to the consumer price inflation remaining above the 2 per cent ceiling allowed by the ECB. However, when the fall in oil prices pushed inflation under 2 per cent starting in September 2006, the ECB continued to tighten the economic policy. The slight acceleration of economic growth was seen as a factor in the growth pressure of prices. It currently appears that inflation in the eurozone will remain under or roughly at 2 per cent this year. Despite this the ECB is anticipated to raise interest rates further. This has apparently been influenced, for example, by demands for substantial wage increases in Germany.

All in all the ECB's enthusiasm for interest rate hikes feels excessive, because inflation has stayed moderate and domestic demand has not even had time to strengthen properly in the largest member countries of the EU Germany and Italy. The Labour Institute for Economic Research predicts that the ECB will raise its repo rate by 0.25 percentage points during this year. The short three-month euro interest will average 4 per cent this

International economy

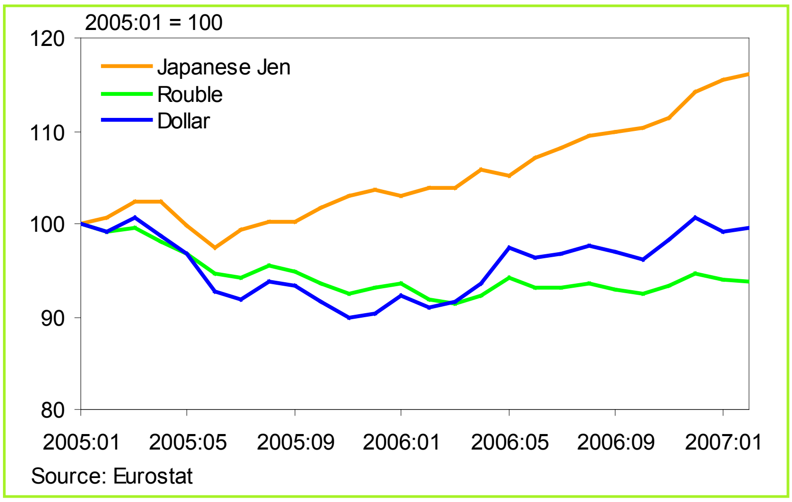
GDP growth (%)	2006	2007f	2008f
United States	3.3	2.2	2.4
Euro-13	2.7	2.5	2.8
Germany	2.7	2.1	2.8
France	2.2	2.2	2.2
Italy	2.0	2.0	2.5
EU27	2.9	2.8	2.9
Sweden	4.4	3.9	3.3
United Kingdom	2.8	2.8	2.6
Japan	2.2	2.2	2.0
Russia	6.7	6.5	6.0
China	10.7	9.5	9.0

Source: BEA, BOFIT, Eurostat, Labour Institute for Economic Research year and slightly above this level next year. The long-term 10-year interest rates will no longer be significantly above short-term interest rates in the eurozone.

US economic growth slackening

The US economy grew by 3.3 per cent last year. Growth is decelerating this year and next to about 2 per cent. US economic growth been curbed foremost by the collapse of residential housing investment. The price decrease of houses relating to this and greater uncertainty related to the financial situation of households have also weakened consumer confidence. However, the deceleration of growth in private consumption has not been very sharp. The employment situation, which has remained relatively positive, has for the time being bolstered the confidence and consumption of households. According to the US Federal Reserve, its Fed funds rate of 5.25 per cent allows sufficiently fast economic growth (slightly below 3 per cent). Because inflationary pressures have not yet subsided, the Federal Reserve will most likely not be willing to shift to an easing of fiscal policy to stimulate the economy. The ECB's interest raises and weakening of the US growth outlook have also spawned an appreciation of the euro in relation to the dollar (fig. 3). The euro should continue to strengthen.

Figure 3. Value of euro in other currencies 2005:01–2007:02

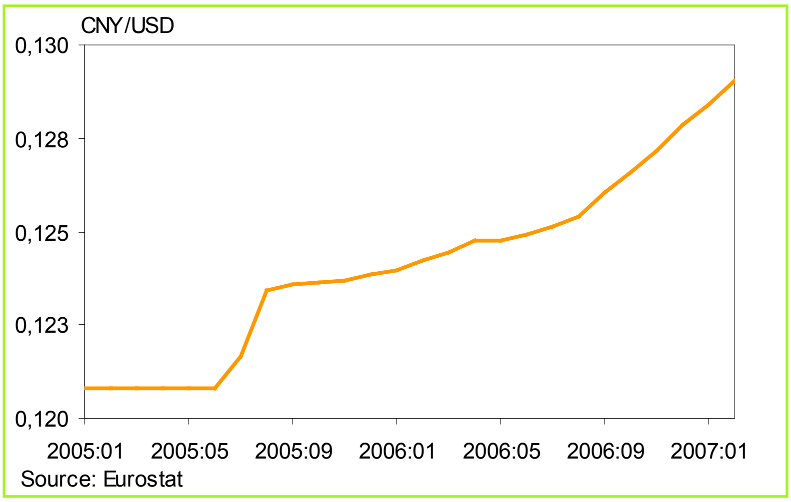


Robust growth in neighbouring countries

For Finland it is significant that the economies of its closest neighbouring countries will grow clearly faster this year and next than for example in the eurozone on average. Sweden's growth will remain at almost 4 per cent while Russia will grow by at least 6 per cent. In Estonia and in all the Baltic countries the growth rate will continue to be close to 10 per cent. Likewise Asia's growth will continue to be swift, especially in populous China and India.

It should also be remembered that risks of the world economy are not associated merely with the imbalances of the US. The longevity of both India's and China's growth can be put to the test by bottlenecks resulting from a lack of professionally skilled labour, a relatively undeveloped transportation network and other infrastructure in addition to increasing pressure to limit the pollution of the environment. For the eurozone it is also significant that China's currency is slowly diverging from its dollar parity (Fig 4). China and also Japan will nevertheless continue to support the dollar with their currency interventions and by doing so strengthening their own currencies' peg to the dollar to ensure their price competitiveness in the US market.

Figure 4. Value of Chinese yuan in dollars 2005:01–2007:02



Influence of foreign trade on last year's growth was significant

The swiftness of Finnish economic growth last year was mostly due to foreign trade. Exports grew by 10.7 per cent in volume and imports by only 5.4 per cent. Export performance was strong, although 2-3 percentage points were accounted for by production shutdowns due to a labour dispute in the forest industry in 2005. The exports of metal products and ships grew very sharply, but also the exports by the machinery and equipment industry grew by almost 10 per cent. Import growth was weaker than expected. Apparently the effect of transit exports, which increased foreign trade in 2005, has no longer increased import growth rates either. Also consumption growth remaining at only 2.3 per cent was evidenced in sluggish growth in relation to import expectations.

The decline in growth of exports and imports of services to close to zero was rather surprising considering the swift growth of the year before last. It is evident that the imports and exports of services, which at present also include the effect of Finnish R&D investment on the value added of foreign subsidiaries, can still be improved significantly, when the figures for the National Accounts are revised.

The terms of trade weakened substantially last year when the increase of energy prices raised import prices in the beginning of the year. The prices of total export rose last year by 2.4 per cent on average compared to the previous year mainly because of higher prices for refined metal products. However, the levelling off of raw material import prices – primarily oil and gas – from the end of last year onwards has decelerated the weakening of the terms of trade. The trade surplus grew last year by almost EUR 2 billion to EUR 9.5 billion despite the rise in prices of imported energy.

Demand and supply

	2006 Bill. €	2006 Percentage change in volume (%)	2007f	2008f
Gross Domestic Product	167.9	5.5	3.5	3.2
Imports	63.6	5.4	4.0	3.5
Total supply	231.5	5.5	3.6	3.3
Exports	74.5	10.7	6.0	5.0
Consumption	121.2	2.3	2.1	2.3
private	85.2	3.0	2.4	2.8
public	35.9	0.9	1.5	1.2
Investment	32.3	5.1	4.1	3.2
private	27.9	5.6	4.4	2.2
public	4.4	1.8	2.4	9.4
Change in stocks	3.5	-0.1	2.1	1.4
Total demand	231.5	5.5	3.6	3.3

Source: Statistics Finland, Labour Institute for Economic Research

Last year Finnish exports grew the most rapidly with respect to the eurozone and especially to Germany and the Netherlands. It should also be noted that Finnish foreign trade with new EU member countries has been growing rather swiftly while remaining in balance. In contrast, the trade deficit with Eastern Asia has been growing. Finland has a sizeable deficit in trade with emerging economies in the area, such as China, but also in trade with Japan and South Korea. These trade structures are also characteristic of other euro countries. The trade terms of both East Europe and the emerging countries of Asia are influenced by the initial low level of labour costs and evidently also the unit costs in the import countries but at the same time also by the abrupt rise in the wage level and labour costs (Fig. 1 and 2).

The fact that trade under these circumstances has remained balanced particularly with new EU member countries but not with the emerging economies of East Asia, is largely due to exchange rate pegs. The value of the new EU member countries' currency has been following the euro firmly, while the currencies of Eastern Asia have weakened in relation to the euro (Fig. 3 and 4). It should also be noticed that Finland's trade with Russia has been rather balanced if oil trade is not taken into account. This has been positively influenced by the weight of the euro growing in the rouble's currency basket.

Export growth will continue

Finnish export volumes will grow by 6 per cent this year and five per cent next year. The influence of foreign trade on the growth of total production is still clearly positive, because imports will grow by only 4 per cent this year and 3.5 per cent next year. Exports are strengthened by the growth of the eurozone stabilizing at 2.5-3 per cent and Finland's neighbouring countries' - Sweden's, Russia's and the Baltic countries' - growth remaining considerably above the EU average. Information about the improvement in the order-books of the traditional metal industry, increasing ship deliveries, Nokia's mobile phone sector's success at the expense of its main competitor and the industry's own estimates, which see the export outlook for the next few months as positive, suggest reasonably swift growth of exports also this year.

The situation will remain about the same next year. This positive general outlook is shadowed by the shutdown of certain assembly plants in the electronics industry and the inevitable sluggishness of the growth of the forest industry. Next year the Finnish forest industry and its foreign exports will be threatened by the possibility of Russia carrying out hikes in raw material export duties.

The levelling off of imported energy prices will also foster the stabilization of the Finnish terms of trade in the near future. This tendency is also supported by the fact that serial production of goods in the electrotechnical industry, which suffered most from price erosion, has largely moved out of Finland. To offset this trend, the share of the machinery and equipment industry, which is sustainable in terms of price, is increasing in Finland's export value. The terms of trade are indeed expected to stay almost the same both this year and next.

The relatively rapid growth of exports and the deceleration of the weakening of the terms of trade will strengthen Finnish foreign trade balances this year and next. This year the trade surplus will already exceed EUR 11 billion, climbing a further EUR 1 billion over this level next year. Correspondingly the terms of trade will strengthen too.

Industrial growth will not subside yet

Industrial output has grown distinctly more that total production. The high growth figure for the forest industry is mainly due to the production shutdown due to a labour dispute two years ago, but the almost 13 per cent growth of the metal industry (incl. the electronics sector) has been even faster than expected and will continue faster than the growth of GDP this and next year. Metal industry production excluding the electrotechnical sector will grow by 9 per cent this year and 6 per cent next year. The growth of the electrotechnical sector will drop to close to zero. The forest industry will continue to grow at a couple of per cent a year, though next year it is threatened by duties set by Russia for raw timber. Last year other manufacturing industries, which includes the chemical industry, the foodstuffs industry, production of refined minerals and the textile and clothing industry, displayed a clear upswing. This positive trend is believed to continue this year and next, when the chemical industry also gaining new capacity.

As regards other sectors, construction growth will continue to be swift. The wholesale and retail trade will continue to expand by 4-5 per cent, and next year growth it will be bolstered by the consumer demand of households. The tendency of industry to outsource its service production from companies specializing in these fields will be reflected in strong growth in business services. The weight of pure information processing in Finland's production structure is increasing for the time being also as a result of the increasing international division of labour. The production of personal services will grow during the forecast period more slowly than other production.

Wage increases slowed down

Last year's wage increases in line with the comprehensive incomes policy settlement did not go into force until June. Taking into account wage drift and carry-over from the previous year, the income level rose by 3.0 per cent. In recent years wage drift in the private sector has been at a normal level and does not show distinct growth. Although the number of job vacancies has been increasing, a shortage of labour has been witnessed only in a few occupational groups. With the improving employment situation the wage bill grew faster last year than wage trends, at an annual rate of 4.5 per cent.

The current comprehensive incomes policy settlement is valid until the end of September and no pay rises have been set for this year. We predict that the level of earnings including wage drift will rise by 2.8 per cent this year, with the wage bill increasing by 4.4 per cent. In 2008 income developments will improve and we estimate earnings will rise by 3.8 per cent on an annual basis. A settlement of this level would be in line with the moderate policies of recent years. As a consequence the share of earnings in value added would remain the same and the wage bill would grow by 4.9 per cent. A settlement at the trade union level would most likely lead to a higher level than this.

Like last year also this year the effect of wage increases on the development of households' incomes is more modest than before, but in turn wage earners' purchasing power is bolstered by tax deductions. Last year the property incomes of households started to rise as we anticipated a year ago. This year the growth of property income will accelerate and dividend income will come close to the 2004 peak. Household interest expenses have on the contrary started to rise swiftly. This reflects both the continuing rapid growth of outstanding loans and interest rates experiencing a considerable and steady upswing. This year households' real income is expected to grow by 2.7 per cent. Next year it will grow slightly faster.

Key forecasts

	2006	2007f	2008f
Unemployment rate (%)	7.7	7.1	6.8
Unemployed (1 000)	204	190	183
Employed (1 000)	2443	2473	2490
Employment rate (%)	68.9	69.4	69.7
Inflation, consumer price index (%)	1.6	1.8	1.5
Wages, index of wage and salary earnings (%)	3.0	2.8	3.8
Real disposable income of households (%)	1.6	2.7	2.9
Current account surplus (Bill. €)	9.9	11.9	13.0
Trade surplus (Bill. €)	9.5	11.4	12.7
Central government financial surplus			
Bill. €	1.6	2.2	2.5
% / GDP	0.9	1.2	1.3
General government financial surplus			
Bill. €	6.3	7.7	8.5
% / GDP	3.8	4.3	4.6
Emu debt			
% / GDP	39.1	37.0	35.3
Tax rate (%)	43.5	43.1	43.2
Short-term interest rates (3-month Euribor)	3.1	4.0	4.1
Long-term interest rates (10-year gov't bonds)	3.8	4.2	4.1

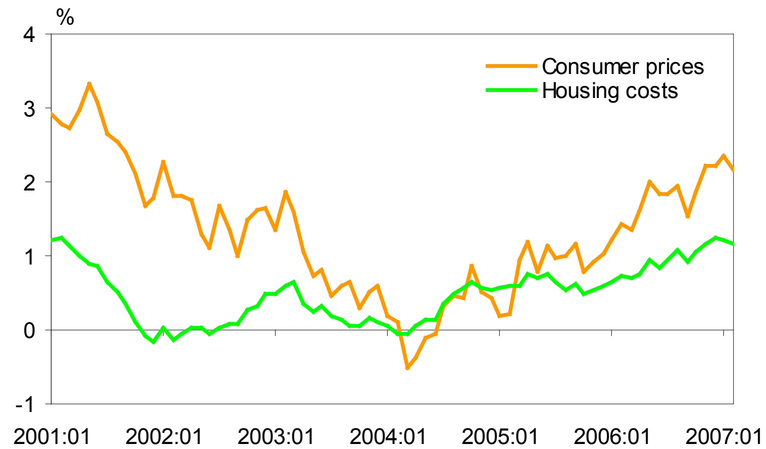
Source: Bank of Finland, Statistics Finland, Labour Institute for Economic Research

Stable economic outlook will sustain growth in consumption

Owing to the comprehensive incomes policy settlement, the financial planning of households has been on a stable foundation. The continuation of the rise in employment has sustained strong consumer confidence and bolstered private consumption. The saving rate dropped last year to a clearly negative level. In the last few years consumption has been focused on semi-durable and durable goods. The structure of consumption has had a favourable impact on economic growth. It has reflected on central government finances since revenues from indirect taxes have been boosted by higher than average growth in consumption. Furthermore, the employment in the wholesale and retail trade sector has grown faster than ordinarily.

The slight slowdown in the growth of real earnings and rise in real interest rates have begun to curb growth in consumption. The expectations regarding car taxation have affected sales of new cars. Registration of new cars has decreased substantially in the beginning of this year compared to last year. Even though sales of used cars have been brisk, this phenomenon will have an impact on sales figures for the year as a whole. Private consumption will grow by 2.4 per cent this year and by 2.8 per cent next year. Even though growth will be slower than the rise in real income, it appears that the savings rate of households will be returning to positive territory during the forecast period.

Figure 5. Consumer prices and housing costs 2001:01–2007:02



Source: Statistics Finland

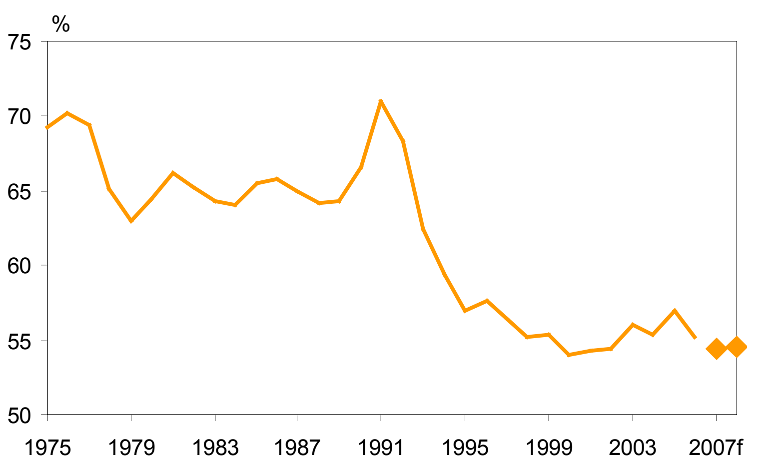
Acceleration of inflation only temporary

Last year consumer price inflation accelerated. In December the rate of inflation was 2.2 per cent, while in January it was below one per cent. Last year's average inflation was 1.6 per cent. In recent years the development of prices has been driven by motor fuel, housing prices as well as interest rates on loans (Fig. 5). Last year the rise in housing costs increased consumer prices the most. This trend stemmed from the rise in interest rates on housing loans, increase in housing prices and hikes in rent. As a whole the impact of the cost of living on inflation was about half a percentage point, of which 0.6 percentage points has already been carried over into this year's inflation.

Housing markets are stabilizing. This is reflected in the slowdown of the rate of inflation. The up-swing in interest rates will boost inflation this year but other significant upward pressures on prices or inflationary surprises are not in sight. The price of Brent crude oil is still well over 60 dollars, but a rapid decline in prices is not anticipated. As interest rates and housing markets stabilize, consumer prices are forecast to rise by 1.8 per cent in the year 2007. Next year inflation will average 1.5 per cent.

Wage increases have been moderate and the wage bill grew last year and this year more slowly than the operative surplus of the private sector. The functional division of labour weakened last year and the share of wages in enterprises' value added fell to the same level prevailing during the boom at the end of the 1990s (Fig. 6).

Figure 6. Functional distribution of income in business activities 1975–2008



Source: Statistics Finland, Labour Institute for Economic Research

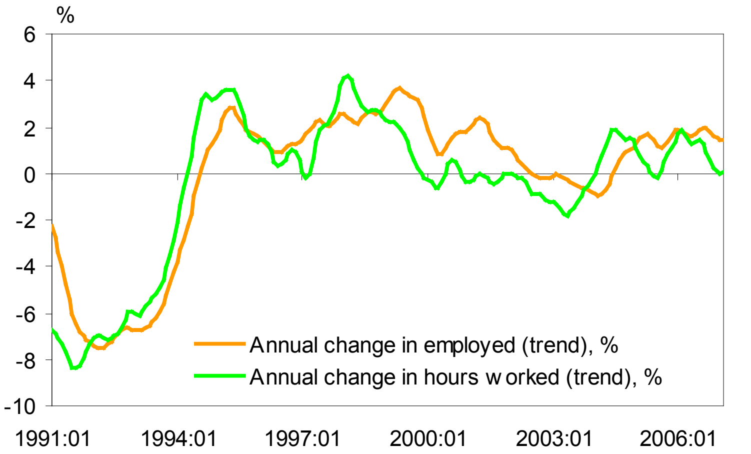
Employment jumped

Last year 42,000 new jobs were created. Employment grew the most in business services, public and other services as well as telecommunications and transport. Employment improved in almost all sectors as the number of employed persons increased also in construction, trade and industry. The favourable employment situation activated persons to enter the labour market, as a result of which the labour force grew by 27,000 persons. Last year the unemployment rate fell to an average of 7.7 per cent. The number of long-term unemployed fell by 10.2 per cent.

This year employment will rise somewhat more slowly than last year but nevertheless by 30,000 persons (Fig. 7). Employment will increase the most in the service sector, especially business ser-vices. In addition construction will still bolster employment somewhat, but in industry the number of employed persons will not change appreciably. The labour force will grow this year by 15,000 persons. Some of the growth in the labour force is attributable purely to statistical factors, such as greater immigration. Part of it is due to the favourable cyclical situation activating persons of work-ing age previously not belonging to the labour force. The unemployment rate will fall this year to 7.1 per cent.

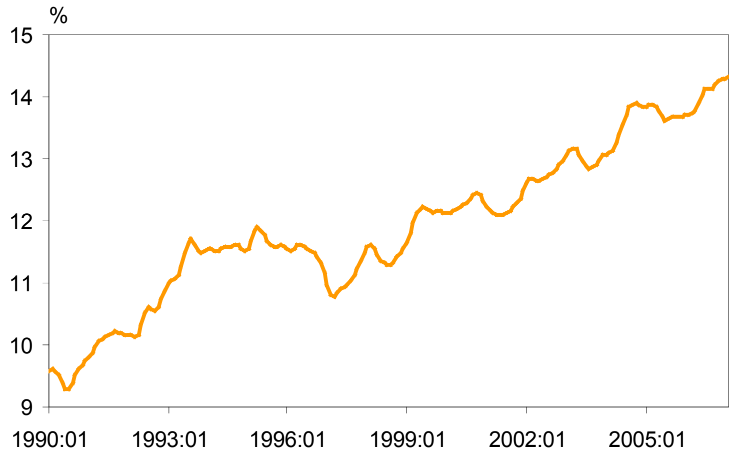
The labour market developments will continue to be favourable also next year, even though eco-nomic growth will slow down somewhat. The number of employed persons will grow next year by 17,000 persons so that the employment rate will be 69.7 per cent. At the same time the labour force will expand by 10,000 persons. As a result the unemployment rate will subside to 6.8 per cent.

Figure 7. Number of employed and hours worked 1991:01–2007:02



Source: Statistics Finland

Figure 8. Share of part-time employees 1990:01–2007:02



Source: Statistics Finland

The labour markets have been in a state of flux in recent years, and increasing attention has been placed on the quality in addition to the quantity of jobs. One of the indicators depicting changes in job relationships is the prevalence of part-time jobs. When we look at the developments since the early 1990s, we notice that the share of part-time jobs has grown from around 10 per cent to over 14 per cent. Internationally the share of part-time jobs is still low, but the trend is upwards. As the de-mand for labour strengthens and its supply is limited, we can expect that the share of part-time jobs will level off or even start to fall again in the next few years.

Despite the increased prevalence of part-time jobs, according to Statistics Finland the number of hours worked has increased at approximately the same pace as employment. The number of hours worked this year will rise at the same rate as employment and next year slightly faster than em-ployment. The fact that the number of hours worked according to the National Accounts has grown faster than the hours worked as reported in Statistics Finland's Labour Force Survey may indicate that the share of foreign labour is increasing. Statistics Finland's surveys do not necessarily reach foreign labourers (especially temporary workers).

Construction activity continues to be brisk

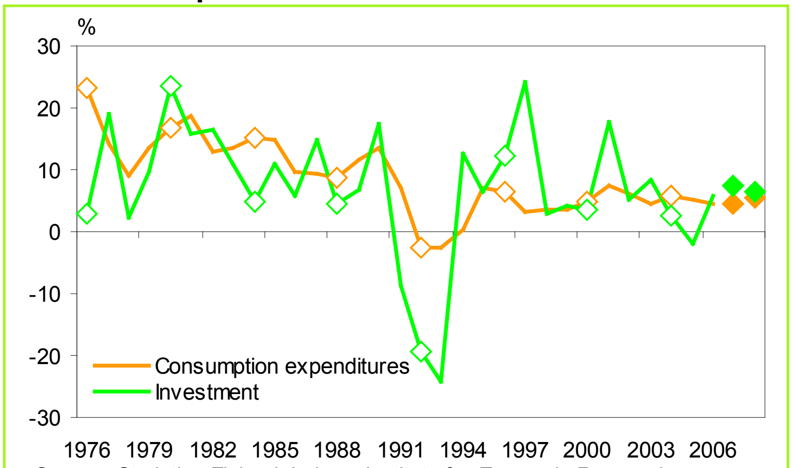
Private investment increased last year by 5.6 per cent. Housing construction grew the most, but growth was almost as swift in other building construction, civil engineering and machinery and equipment investments. Investment activity will remain high also this year. Private investments will grow by 4.4 per cent compared to last year. Figures for construction permits and building starts in-dicate that the focus of construction is shifting from housing construction to other building con-struction, where growth is expected especially in retail and office building construction.

Private investment growth will remain at slightly above two per cent next year. There is neverthe-less a certain degree of tentativeness regarding the investment forecasts stemming from the uncer-tain timing of large-scale investments, such as the nuclear power plant and Finnair's plane pur-chases.

Income tax revenues continued to grow

The financial surplus of the central government grew last year by almost EUR 1 billion. Despite the easing of taxation the revenues from income and wealth tax grew by 1.2 per cent, primarily as a consequence of the greater than expected rise in earned and capital income tax revenues. Of house-holds' taxable capital income, especially dividends and interest income rose sharply. Corporate tax revenues rose 6.7 per cent. Growth in the central government's consumption expenditures fell somewhat short of expectations while its fixed investments grew substantially. State revenue shar-ing with the municipalities grew at a rate of 9.5 per cent.

Figure 9. Municipal consumption and investment expenditures 1976–2008



Source: Statistics Finland, Labour Institute for Economic Research

The situation of the municipalities was eased last year even more than anticipated. Their financial deficit was cut in half to about EUR 0.5 billion. The tax revenues of local government fell by a sharp by 6 per cent. Consumption expenditures increased slightly more slowly than expected, only 4.6 per cent, but investment staged a surprising upturn at the end of the year (Fig. 9).

As a result of rapid growth in paid pensions, the financial surplus of pension institutions and other social security funds grew appreciably more slowly than forecast, but it still reached EUR 5.2 bil-lion. Owing to the strong growth of the economy and hikes in social security contribution rates, social security contributions rose by 8.6 per cent as the contributions of the insured climbed by 14.4 per cent. The investment income of pension institutions grew substantially.

As all three sub-sectors of general government improved their financial positions, the EMU surplus relative to GDP climbed by a percentage point to 3.8 per cent and the EMU debt relative to GDP fell by 2.3 percentage points to 39.1 per cent. Most of this decline in the debt ratio is attributable to the exceptionally robust economic growth.

Public sector's surplus is growing

The growth in the central government's investment and especially consumption expenditures will be fairly modest in 2007. Despite tax cuts, tax revenues will climb slightly faster than spending and the central government's dividend and interest revenues are expected to grow by about EUR 350 million. The growth in the state's revenue sharing with the municipalities will subside to four per cent. This trend will be offset by shifting the earned income deduction from municipal taxation to central government taxation. The central government's surplus will grow by EUR 600 million to almost 2.2 billion.

Municipal tax revenues will rise this year at a rate of 6 per cent. This means that despite the growth in state revenue sharing and slight acceleration in investment, the financial position of municipali-ties will still improve somewhat, by slightly over EUR 100 million.

Social security contribution rates will remain practically unchanged this year. As the growth in the wage bill slows down the growth in the revenues of pension institutions and other social security funds will subside substantially. On the other hand, the growth in their investment income is pro-jected to accelerate. Additional funds will be allocated from the state budget so that their financial surplus will rise by a total of about EUR 650 million to almost EUR 6 billion.

The EMU surplus of the general government will rise by half a percentage point to 4.3 per cent of GDP and the EMU debt ratio will fall to 37 per cent. Total taxes as a percentage of GDP will de-cline by 0.4 percentage points to 43.1 per cent.

Public investment expanding next year

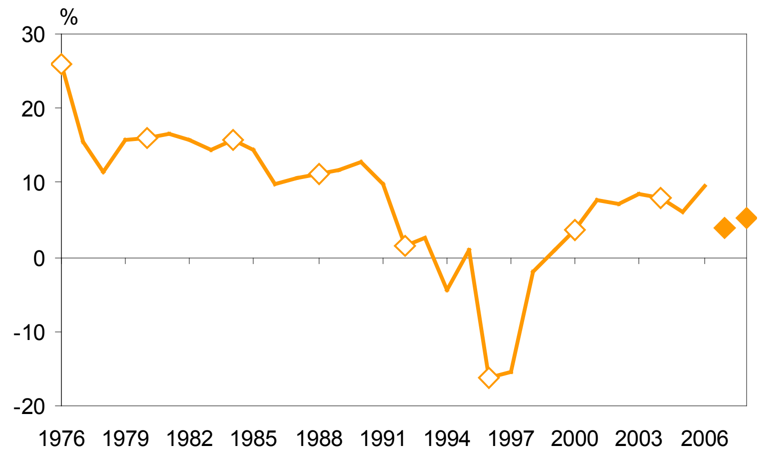
The state taxation for the year 2008 in this forecast has been assumed to be in line with the govern-ment's framework decision on March 8, 2007, according to which earned income taxation would be eased so that related tax revenues as a percentage of GDP remain unchanged. Since the growth of the wage bill will accelerate and growth of corporate tax revenues will continue to be strong, the growth in the central government's income tax revenues will climb to almost 6 per cent. In the fore-cast it is assumed that value-added, alcohol and car taxes as well as any other indirect taxes will not be raised. In 2008 there appear to be exceptionally many road and railway projects where the cen-tral government has a significant financing share. As a result of simultaneous growth in these projects and municipal investments, public investment will grow in real terms at a rate of almost 10 per cent.

The road and railway projects will cause the civil engineering sector to heat up and probably fuel a rise in its cost level so that the spending framework will have to be revised upwards or the realiza-tion of these projects will have to be postponed. The latter possibility has not been incorporated into this forecast. According to the forecast the central government's surplus will continue to grow by about EUR 300 million.

No municipal election year budgets?

According to the spending framework currently in force, the state's revenue sharing with the mu-nicipalities will grow slightly in 2008. That year is an election year and one might easily imagine that it would spawn extraordinarily strong increases in municipal spending and/or state revenue sharing. No systematic trends with respect to consumption and investment expenditures can be dis-cerned looking at figures for the last 30 years. The adjacent graph shows that recognizing any "election" cycle in state revenue sharing requires a very sharp eye.[1] The trend prior and during the depres-sion in the early 1990s can be seen clearly from the adjacent graph. State revenue sharing has grown rather swiftly in the 2000s, and it remains to be seen whether this year's slower 4 per cent growth rate will be an historical aberration, where the one-off drop is offset by cuts in earned income de-ductions in municipal taxation.

Figure 10. State revenue sharing with municipalities 1976–2008



Source: Statistics Finland, Labour Institute for Economic Research

The municipalities' financial surplus is forecast to remain approximately unchanged in 2008. The growth in the municipal tax revenues will be sustained by the strong growth in the wage bill and corporate tax base while consumption and investment expenditures also continue to rise. In the forecast there are no extraordinary increases in the wages or employment of the municipal sector, but municipal taxation is forecast to follow trends prevailing in recent years by rising about 0.1 per-centage points.

No decisions have been made yet about social security contributions in 2008, but in the forecast it has been assumed that pension contributions will be raised by 0.2 percentage points in line with the framework decision. As the wage bill grows faster than this year, the financial surplus of pension institutions and other social security funds will expand further by over EUR 0.5 billion to almost EUR 6.5 billion.

The EMU surplus of the general government will continue to grow also in 2008, climbing to 4.6 per cent of GDP. It will thus be 1.5 percentage points higher than in the Ministry of Finance's sustain-able growth calculations for the public sector and even slightly greater than the target set for the (cyclically adjusted) surplus at the end of the decade.

Aging of the population clouds economic growth – Finland's situation is nevertheless better than in the EU on average

Finland's leeway in economic policy in the near future will be determined by the public sector's cumulative financial buffers, the apparent prolongation of the cyclical upswing as well as the aging of the population and the decline in the size of working aged population. The abruptness of the change in the demographic structure of the population is depicted by Eurostat's forecast (2004) that the working age population (15-64 year olds) will be 300,000 smaller 20 years from now. At the same time the number of persons over age 65 will grow by 600,000.

Based on this population forecast the Ministry of Finance has projected that the public sector will start running a sizable deficit by the year 2050 (4 per cent of GDP) if total taxes as a percentage of GDP remains at 42 per cent. In these projections the rise in pension expenditures spurs a rise in pension contributions, which in turn requires the easing of other taxation. This baseline scenario is deemed to require restraint in public expenditures as well as structural changes that boost the em-ployment rate and productivity.

Recent developments indicate that the working age population will nevertheless not decrease in the projected manner as net immigration increases significantly. The annual net immigration could well be about 5000 persons more than forecast, which would raise the size of the working age population in twenty years by as much as 70,000 persons. In the EU forecast Finland's birth rate is also assumed to be somewhat too low.

Finland's public finances sustainability report also emphasises that the Finnish dependency ratio (over 64 year old relative to 20-64 year olds) will be the highest in the EU countries in 2025. A more detailed evaluation of the population forecasts and a critical look at the assumptions behind the EU population projections indicate that in 2025 Finland's population will not be much older than that of the EU on average. The EU's average dependency ratio will rise after 2025 so much that it will exceed Finland's corresponding figure in 2030-2035. This is attributable to

[1]A technical shift in the level of state revenue sharing occuring in 2002 has been omitted from the graph, EUR 998 million, which is due to the state's refund of VAT revenues to the municipalities changing to state revenue sharing.

the trend that in many large EU countries such as Italy, Germany and Spain the birth rates have been lower than in Finland already for a long time. In recent years only the birth rates in Ireland and France have exceeded Finland's level.

The skewing of the population structure will spur pressures across Europe to raise tax rates. The lower prevalence of pension system funding than in Finland will also contribute to this trend. All in all, in the long run Finland's situation is even somewhat better than in the EU countries on average.

Also from the standpoint of Finland's employment rate there are grounds to be more optimistic than assumed in the Ministry of Finance's sustainability calculations for the Finnish economy. In this report the employment rate is not anticipated to rise to 69.8 per cent until the year 2011, while cur-rent trends indicate that the share of employed working age persons will rise to this level already next year. It appears that the development of the unemployment rate is still affected by the current recovery from the depression of the 1990s: older age groups where there are more persons crowded out from working life on average are approaching retirement age in large numbers and they will be replaced by age groups with better education and job skills.

The employment rate can easily be raised to around 72 per cent already by 2011. The employment rate can be raised not only by lowering the unemployment rate, but also by reducing the share of the working age population not participating in the labour force. The size of the latter portion of the population has changed substantially in tandem with cyclical conditions despite the fact that it in-cludes young persons who are studying. The reduction of this passive portion of the population will also require public action, such as active labour policy measures, the necessity of which was men-tioned in the Ministry of Finance's sustainability report. In fact the development of working life, by investing in education as well as promotion of persons' ability to work by developing health and social services, can also foster the activation of the working age population.

No reason to hurry with easing fiscal policy

Owing to the favourable cyclical situation the public sector this year and next year will run a sur-plus estimated to be about 4.5 per cent of GDP. Under the currently strong cyclical conditions there is no reason to ease fiscal policy to such an extent that the public sector's fiscal surplus would sig-nificantly contract. The time for expansionary measures will come when the macroeconomic situa-tion begins to weaken.

In the current political situation the pressures to lower taxes are nevertheless great. The strong eco-nomic developments might spawn wage hikes that will raise the level of earnings more than has been the case in the last couple of years. This will be seen also in the pricing of the public sector's labour inputs. The public sector nevertheless has sought to exercise restraint with regard to increas-ing its expenditures. This tendency has been spurred by the fear that tying up resources in public activities would limit the expansion of the private sector. This situation might easily lead to exces-sive easing of taxation, thereby exacerbating the public sector's shortage of resources. Despite a great amount of leeway, there might not be sufficient resources to raise the standard of living of those in unfavourable situations. The attempts to promote a rise in the employment rate and foster productivity via science and education as well as social and health policies will require moderate growth of real public expenditures by an average of about 1.5 per cent during the next four years. This growth path would not prevent even fairly swift growth in the private sector.

EMMA model forecasts

The view of the Labour Institute for Economic Research is based on the forecast produced by its macroeconomic model (EMMA). The forecasts given by the model are presented in the adjacent table. The assumptions incorporated in the model regarding interest rates and the international econ-omy are the same as in the actual forecast. In the model forecast it is furthermore assumed that the euro will strengthen somewhat against the dollar. Tax rates are assumed to remain unchanged for the most part.

The forecast generated by the model for private consumption and imports for this year are the same as the Institute's actual forecast. For private consumption the model forecast differs from the Insti-tute's official forecast this year by 0.1 percentage points, while for next year the forecasts are the same. The model's forecast differs the most from the official forecast with regard to foreign trade. The official forecast, which takes into account the figures reported by the Board of Customs for recent months, projects that the volume of exports will grow by 6 per cent this year, while the model's forecast is 6.6 per cent. The model's forecast for private investment next year is clearly lower than the official investment growth forecast, which takes into consideration fresh information on investment plans and the impact of the continuation of certain investment projects until next year.

Emma model forecasts

	2007f	2008f
Private consumption	2.3	2.8
Private investment	4.4	0.7
Exports	6.6	5.8
Imports	4.0	3.3
GDP	3.8	3.4

Source: Labour Institute for Economic Research