1 World and Finnish Economic Outlook

1.1 World Economy

The distinctive feature of the global operating environment for the Finnish forest industry in 2000 has been strong economic growth. This is projected to continue to the end of the year and throughout 2001. Both this year and in 2001, real GDP growth in the world economy, weighted according to the distribution of Finnish forest industry exports, is forecast to be about four per cent. This level of growth was last reached in the late 1980s. The International Monetary Fund (IMF) estimates that the growth in the world economy this year will be almost five per cent, and next year over four per cent.

Amongst the Finnish forest industry’s most important export markets, Germany, France, the Netherlands and Spain, in particular, have experienced strong economic growth, which is expected to continue in 2001. Signs of recovery are also finally becoming evident in Japan after a recession lasting a decade. It is generally considered that the greatest risks to continued economic growth are a possible oil crisis and an economic downturn in the United States that is not the anticipated ‘soft landing’ but a ‘hard landing’ instead.

Demand Grows within Euro Area

The upsurge in activity within the euro area* economy has been based particularly on export growth, which is expected to be gradually reflected in rising demand within the euro area. Exports have been driven by the weakening exchange rate of the euro and the strong growth in the world economy. Demand within the euro area has also been boosted by the fall in unemployment. Although the average rate of unemployment in the euro area remains high, it has fallen from 10 per cent in 1999 to about nine per cent this year, and is forecast to fall yet further in 2001, to about eight per cent.

As a consequence of the rise in world market prices of raw materials, in particular, the average inflation rate in the euro area has been rising. In 1999 it was 1.1 per cent and is expected to be over two per cent both this year and in 2001. The dollar-based HWWA aggregate index of raw materials for September 2000 was last at such a high level in 1990. The prices of imported production inputs from outside the euro area have also risen as a result of the weakened euro.

The euro exchange rate in mid-September 2000 was at an all-time low against the US dollar and the Japanese yen. The accompanying graphs present forecasts for the euro exchange rate published by Deutsche Bank on September 18, 2000, showing the anticipated levels for the end of 2000 and for 2001. The forecasts show that the euro is expected to appreciate in value against all four currencies. The percentages given in the graphs indicating the expected strengthening of the euro were calculated by comparing the forecasts for the end of 2001 with the level prevailing on September 27, 2000. These forecasts are in line with most of the economic forecasts

* The euro area comprises those countries which belong to the European Economic and Monetary Union (EMU). In 2000, these countries are Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain.
made in the autumn, although there are some differences in the actual percentages. The euro is expected to achieve parity with the dollar only at the end of 2001 (1 euro = 1 dollar).

Despite the recent increases in interest rates by the European Central Bank (ECB), real interest rates are still below the long-term average. Many forecasting institutions expect the ECB to raise its central rate (three-month reference rate for market interest) at the end of 2000 and during 2001, to about 5.5 per cent from the present 4.75 per cent. The interest rate differentials between the United States and the euro area are expected to narrow during 2001.

Economic growth within the euro area in 2001 is expected to be at about the same level, on average, as this year. GDP growth will continue at about 3.5 per cent and inflation will remain low. Business and consumer surveys undertaken by the European Commission indicate that confidence in the economy is higher this year than in 1999. Indeed, growth in household consumption expenditure is expected...
to be even higher in 2001 than this year. The tax cuts agreed for 2001 in almost all the euro countries will also serve to further the growth in consumption expenditure.

The greatest risk factors for the euro area economy are considered to be risks from outside the area: a rise or no change in the price of oil, and a possible ‘hard landing’ in the US economy.

**Germany and France Driving the EU Economy**

Economic growth in Germany, the most important export market for the Finnish forest industry, has gathered pace this year. Real GDP growth last year was 1.5 per cent, whereas this year and in 2001 it is forecast to be over three per cent. Economic growth is based particularly on a high level of industrial production and on exports.

Although the German inflation rate has recently risen slightly, in particular because of the rise in the oil price, the inflation trend continues to be moderate. Forecasts from Deutsche Bank predict a rise of two per cent in consumer prices this year and in 2001. This trend is supported by the moderate pay settlements already achieved for 2000–2001. Inflation estimates for 2001 assume that oil prices will fall slightly on their September level. The most significant change in fiscal policy will be the tax reductions to be introduced at the start of 2001. Deutsche Bank expects these tax cuts to consist of a total tax relief of DEM 45 billion for businesses and households, boosting economic growth by 0.5 percentage points in 2001.

Despite the growth in the economy and the reduction in unemployment, the German construction sector is still sluggish. For instance, in September, Deutsche Bank forecast that construction output in 2000 would not show any increase at all on the previous year. The impact of growth in the economy will, however, gradually be felt in the construction sector, and next year construction is forecast to be up by 1.6 per cent.

The United Kingdom economy has performed better this year than in 1999 and is expected to continue to do well in 2001. More people are in fact currently employed in the UK than at any time before, and unemployment has fallen to a record low: the ILO unemployment rate in June–August was 5.3 per cent. The level of unemployment is forecast to decline a little further next year.

The UK Treasury produces regular reports on the economic forecasts made by independent forecasting institutions. Its October report shows that the average of the forecasts made by 34 such institutions is a growth of 3.0 per cent in the UK’s GDP for 2000, and 2.7 per cent for 2001; GDP growth in 1999 was 2.0 per cent. The driving force behind this growth has been the relatively good export trend, which has continued in spite of the strengthening of the pound against the euro. However, at the start of September the pound fell to its lowest level against the dollar for 14 years. Fiscal policy has been expansive and consumption is growing in the public sector.

The underlying UK inflation rate stood at 1.9 per cent in August, which is below the Bank of England’s medium-range target (2.5 per cent). Inflation is also at its lowest level for 30 years. The forecasts assembled by the Treasury show the average of the projections for the underlying inflation rate for 2001 to be 2.4 per cent. The Bank of England’s repo interest rate is currently 6.0 per cent, and there will be no pressure to raise interest rates if the economic and inflationary trends in 2001 are in line with forecasts.

Assessments generally indicate that economic growth in the euro area in 2001 will be higher than in the UK. Euro area interest rates are also forecast to rise next year, whereas in the UK they are expected to remain unchanged. If these predictions prove correct, it can also be expected that the pound will weaken against the euro.

In France, steady economic growth has continued in the current year. Exports, in particular, are up sharply, and the indirect effect of this is also being felt in household consumption. In contrast to Germany and the UK, evidence of French economic growth is seen in the construction sector, which has
been very busy. This trend can be expected to continue, as the monthly confidence indicators in the construction sector have been higher this year than at any time in the 1990s. Many other indicators of confidence in the economy have also been at record levels. Moreover, unemployment has fallen to its lowest level for eight years, dropping by as much as 1.7 percentage points in the 12 months to June 2000, to 9.6 per cent. The French National Institute of Statistics and Economics (INSEE) and the OECD have raised their forecasts for French GDP growth this year, the former to 3.5 per cent and the latter to 3.7 per cent. In 2001 the economy is predicted to grow at almost the same rate.

Economic growth in the other EU export markets important to the Finnish forest industry has also been encouraging, and is expected to remain good in 2001. In the Netherlands, Belgium, Spain and Italy, for example, which collectively accounted for 17 per cent of the total export value of Finnish forest industry products last year, estimates by Deutsche Bank put GDP growth in the range 3.1–4.4 per cent for 2000, and 3.5–4.1 per cent for 2001 (see table).

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* IMF forecast published September 19, 2000
** Deutsche Bank forecast published September 18, 2000
Sweden Doing Well

Although Sweden has remained outside the euro area, this does not appear to have had any adverse effects on its economy so far. On the contrary, growth in the Swedish economy in 1999 and this year has been significantly higher than the average growth rate for the euro countries (see table). Growth in 2001 is forecast to be at about the average for the euro area, or about 3.5 per cent. Swedish growth has been driven by the favourable economic situation in the EU, which has boosted Swedish exports. Tax relief, growth in real incomes and a drop in unemployment have also helped to maintain a high level of domestic demand.

Real interest rates in Sweden have been of the same magnitude recently as interest rates in the euro area. In November the repo interest rate was 3.75 per cent, and inflation this year has been running at an annual rate of just over one per cent. The central bank’s October inflation report stated that the Swedish krona is expected to appreciate in value in 2001 against the US dollar and pound sterling, but to remain unchanged against the euro. Inflation is expected to remain below two per cent.

Amongst the transition economies of Central and Eastern Europe, growth in the Hungarian and Polish economies is continuing at a brisk rate. According to a forecast published by the IMF in September, GDP growth in Poland in 2001 should be 5.5 per cent, and in Hungary 5.0 per cent, while in the Czech Republic and Slovakia it should be in the range 3.2–3.5 per cent. In Russia, a turnaround was seen in the economy last year, onto an upward path, and development in 2000 has been better than anticipated. Indeed, the IMF predicts that Russian GDP growth in 2000 will be as much as seven per cent. According to the Russian Central Bank, wholesale trade for the first six months of this year was up by 7.6 per cent, and industrial production by over 10 per cent, on the corresponding period in 1999. Particularly significant from the perspective of the Finnish forest sector, production in the Russian timber and paper industries for the period January–May 2000 was up 18.1 per cent on the corresponding period in 1999. It would indeed appear that the Russian pulp and paper industry has increased its output of products that replace imports. The export trend has also been strong – the rise in oil prices in particular has raised the value of Russian exports.

United States: Soft or Hard Landing?

In recent years a great deal of time – almost too much – has been devoted to discussing when the long period of economic growth in the United States will come to an end, and whether or not it will be followed by a soft or a hard landing. However, these questions are still highly relevant. Indeed, it can be said that the greatest risks in the short-term outlook for the world economy are specifically related to whether the US economy experiences a soft landing or a hard one.

Economic growth in the US continued stronger than expected in the first six months of 2000, but in recent months there have been signs that the growth is slowing up. In a survey published by the Federal Reserve Bank of Philadelphia in August, 32 economic forecasting institutions predict that the economy will grow by 5.2 per cent this year and by 3.2 per cent in 2001. Both figures are somewhat above the corresponding survey results produced in May. Although corporate investment continues to be at a relatively high level, there are already signs of faltering growth in sectors sensitive to interest rates. In particular, growth in household consumption and housing construction appears to have slowed down. In July, investment in new construction fell for the fourth successive month, and employment and industrial purchases have begun to weaken for the first time in 18 months.

Many commentators have, however, viewed this as good news, because it can be interpreted as demonstrating that the soft landing has begun and that the unsustainably high economic growth has finally abated. If the soft landing does materialise, it would provide evidence that the interest rate policy pur-
The Federal Reserve has instituted a number of small interest rate rises in recent years, and the effect of these is expected to start to show at the end of 2000 and in 2001. If this is the case, pressure for further interest rate rises will be reduced. At its October meeting, the Federal Reserve did in fact leave the federal fund rate unchanged at 6.5 per cent.

Some assessments have produced a more unusual, though understandable, refinement to the risk scenario for US economic development in the short term. Deutsche Bank, for example, has stated that the greatest risks for the US economy are that the economic growth in 2001 could be either too high or too low. The first case would mean overheating in the economy and a further rise in interest rates, and the second would mean a recession that would probably also lead to a collapse in share prices.

The booming US economy has also had a positive effect on the Canadian economy. The trends in Canadian exports to the US and corporate investment have been favourable. Exports were up in 1999 by about 10 per cent, and in the current year growth is forecast to be of the same order. Expenditure by households has also increased, and unemployment fallen. The unemployment rate for 2000 is expected to be about 6.5 per cent; in 1998 it was almost two percentage points higher (8.3 per cent). The Bank of Canada expects the current year’s GDP growth to be as much as 4.25–4.75 per cent. In 2001, the GDP growth rate is expected to fall slightly.

**Turn for the Better in Japan**

The ten-year-old recession in Japan appears to have come to an end. Although the economy is still not very strong, clear signs of a change have been detected since as early as last year. As a consequence of the expansive fiscal policy, there has been an increase in public sector investment, and more recently in private sector investment. Industrial production and exports have also clearly begun to grow. However, evidence of the improved economic situation is still not that strong in the private sector. Household consumption and housing construction are still at a low level. According to the IMF’s forecast published in September, the Japanese GDP should grow in 2000 by 1.4 per cent, and in 2001 by nearly two per cent. The risks concerning the Japanese economy are the same as in recent years. Many of the structural reforms in the economy have still not been implemented, and possible bankruptcy and banking crises may still bring economic growth to a standstill.

The economic crisis in East Asia at the end of the 1990s has now passed. Growth was very vigorous in 1999 and continues to be strong in 2000. The growth rate of almost double figures is, in part, a consequence of the low starting point. The IMF has forecast that the current year’s economic growth in South Korea, Malaysia, Taiwan and Singapore will be 6.0–8.8 per cent, and next year 5.9–6.5 per cent. Economic growth in China has continued at a level of 7–8 per cent for several years already, and is expected to continue at the same rate this year and in 2001. The admission of China as a member of the WTO in 2001 will probably lead to an increase in Chinese imports and exports.

**What Might be the Impact of an Oil Crisis on the Finnish Forest Sector?**

An unchanged or higher oil price is recognised as one of the greatest risk factors threatening the prospects for good economic growth. The price of crude oil is now more than three times what it was at the end of 1998. Many economic forecasters believe that the oil price may have already reached its peak, and that it is more likely that prices will decline than rise. For example, the Research Institute of the Finnish Economy (ETLA), the International Monetary Fund (IMF) and Deutsche Bank all forecast a drop in oil prices during 2001 from the September figure of about USD 35 a barrel (Brent crude) to the target set by OPEC of about USD 22–28 a barrel.

The other scenario, in which oil prices do not decline in the near future, is also considered possible. Not only are the oil reserves of the industrial countries at a low level, but, owing to the robust state of
the world economy, the demand for oil has increased markedly, which in turn has diminished the amount of spare oil-refining capacity. If the supply of oil is not significantly increased and this is combined with an unusually cold winter in the northern hemisphere, fuel prices may continue to rise.

What would be the effects of this ‘crisis scenario’ on the Finnish forest sector? The answer to this question essentially depends on how long the price of crude oil remains high and how this, in turn, affects pay negotiations, taxation policy, monetary policies and any interruptions in transportation.

The effects of an ‘oil crisis’ on the forest sector would be both direct and indirect. The increasing cost of oil has already led to unrest in the road transportation sector in Europe and to demands for a reduction in fuel taxes. Further interruptions could be expected as the consequence of any oil crisis, which, in the worst case, could bring the supply of raw materials to the forest industry and the despatch of end products to customers to a standstill. In practice, this situation could mean mills and factories laying idle for the duration of the transportation problem. Production in the Finnish forest industry would thus decrease, and its turnover and profit would probably fall short of the current forecasts. If the transportation problems were to continue for a longer period, this would lead to reductions in forest fellings, income from roundwood sales, and transportation, in relation to the current forecasts.

The indirect and longer term effects of high oil prices could be many and varied. First, a rise in the price of crude oil would eventually increase the forest industry’s raw material and transportation costs. This would also increase pressure to raise the prices of forest industry products. On the other hand, a higher oil price would accelerate inflation and dampen growth in the economy. Based on calculations published by the IMF in September, a 10 per cent rise in the price of oil would weaken GDP growth in both the United States and the euro area by 0.1 per cent and would raise consumer prices by 0.2 per cent. Higher inflation would also add to the pressure to raise interest rates. A general slow down in the economy and a rise in interest rates would, in turn, reduce the demand for forest industry products.

However, the anticipated strengthening of the euro would dampen the negative effects, because the cost implications of a rise in the dollar-denominated oil price would not be transmitted in full to the euro area.

1.2 Finnish Economy

Dynamic export growth will support the strong growth of the Finnish economy in 2000 and 2001. Although inflation and the rise in interest rates have reduced purchasing power, private consumption will grow by 3–4 per cent. Inflation will fall in 2001 as oil prices drop and the euro strengthens. The rise in housing costs will also remain moderate. Moreover, a reduction in income tax will serve to increase household purchasing power. The pay negotiations held at the end of the year will be of critical importance for price stability, employment and competitiveness.

Economy Reaches a Peak in 2000

Growth in the Finnish economy this year has exceeded the level forecast in 1999, due to the excellent trend in exports. GDP growth for 2000 will surpass last year’s figure, reaching 5–6 per cent, according to forecasting institutions. The growth in exports has been substantially above the forecasts, as a result of the improved price competitiveness due to the weak euro. The recovery in emerging economies around the world has also boosted Finnish exports. Electronics industry exports, in particular, have continued to grow vigorously. At the start of 2000, exports from the electronics and electrical industry in fact exceeded those of the forest industry. This was exac-
erobated by the April strike in the forest industry, which affected exports slightly.

In 2001, export growth will be restrained by the pressure on production capacity in the electronics industry and the difficulty in recruiting sufficient numbers of qualified personnel for that sector. The forest industry will also experience a shortage of production capacity, thereby restraining the growth in exports. Total Finnish exports are nevertheless expected to grow by about eight per cent in 2001. The capacity limitations on export growth will also hold back the growth in GDP, which is forecast to be in the range 4.2–4.6 per cent in 2001.

Estimates of the growth in private consumption in 2000 and 2001 vary. The Research Institute of the Finnish Economy (ETLA), for instance, expects a higher growth rate than in 1999, whereas the Ministry of Finance predicts a lower one. The confidence shown by households in their own economic situation remains good. The improvement in employment and the rise in earnings have served to increase purchasing power, whereas the rise in inflation and interest rates have had the opposite effect. Consumption in 2001 will be boosted by a FIM 6.4 billion reduction in income taxes and a lower inflation rate.

The unemployment rate will continue to fall and will be about 8.5 per cent in 2001. In industrial and commercial sectors, the unemployment rate will fall to below five per cent in 2000, but in construction it will fall to just 10 per cent. Unemployment is increasingly structural in nature, as many sectors are beginning to feel a shortage of appropriately skilled personnel.

**Rising Inflation Short-Lived**

Fighting inflation is one of the key challenges for economic policy in the short term. In August the annual inflation rate stood at 3.8 per cent, as measured by the national consumer price index. The inflation rate for 2000 is forecast to be about three per cent, on average. Inflation has been higher in Finland than in the main euro countries and Sweden. Common inflationary factors in the euro area have been the increase in oil prices and the rising price of imports caused by the weak euro. The direct effect of the rise in fuel prices on the Finnish inflation rate in August was almost one percentage point, while house prices and rents accounted for a further 0.5 percentage points, and interest rates for about the same amount. The prices of services have also risen significantly compared to the average rise in prices. This is due not only to the demand-inflationary pressures but also to the effect of the oil price rise on the price of transportation services. The indirect effect of the increase in oil prices on general price levels in Finland has so far been fairly minor, however. If the oil price remains high, the rise in costs will increasingly start to find its way into consumer prices.

In 2001, inflation is expected to slow down to 1.8–2.7 per cent. The inflation rate of less than two per cent forecast by the Research Institute of the Finnish Economy (ETLA) assumes a drop in the oil price to about USD 25 a barrel, a strengthening of the euro by about 6–7 per cent on this year’s level, and a moderate pay settlement that would raise the level of earnings by 3.4 per cent. The autumn collective bargaining pay negotiations are of crucial im-
Importance because wages and salaries are the most important inflationary factor that can actually be influenced in Finland. The worst scenario is an upward wages and prices spiral, which would harm employment prospects and also Finland’s competitiveness.

Migration Fuels the Growth in Construction

Although the majority of Finland’s forest industry production is destined for export, the domestic construction sector has a significant influence on the overall demand for sawnwood. Indeed, 34 per cent of Finnish sawnwood production enters the domestic market and is mostly used in construction. According to the September forecast of the Confederation of Finnish Construction Industries (RTK), total construction output will be up by seven per cent in 2000, and by four per cent in 2001. New construction is clearly growing the most, and building renovation the least. In the future, renovation will, on average, increase at a faster rate than new construction. As renovations today constitute a considerable proportion of all construction activity, and growth in this area is fairly steady, it has an important balancing effect on the cyclical fluctuations in the construction industry.

Activity in the construction sector is concentrated on the growth centres in the country, where new housing and office space are needed. According to contractors, the number of owner-occupied housing starts has been affected most by the insufficiency of demand, the paucity of construction sites in the Helsinki metropolitan area, and the fact that the price level does not necessarily make it worthwhile at current costs. The demand for housing has been affected by the rise in interest rates and house prices. State-subsidised housing starts in 2000 and scheduled for 2001 are slightly below the figure for 1999. In the Helsinki metropolitan area, construction of state-subsidised housing has been limited by the rise in construction costs to a level exceeding the limits set by the government. Despite these restraining factors, housing starts in 2001 will be almost six per cent above this year’s level, measured in cubic metres. The growth in housing starts is, however, slowing down. Housing prices are expected to rise moderately in 2001.

Commercial and office construction and industrial construction have been doing well as a result of...
the migration of people and businesses to the growth centres around the country, and due to the vigorous economic growth. In 2001, however, there will be fewer new construction starts than in the current year. All in all, the volume of construction starts in cubic metres will be up by only one per cent.

Sixteen per cent of Finnish paperboard production enters the domestic market, for example as packaging for the food industry. Production in the food industry is expected to grow this year by three per cent and in 2001 by one per cent. This will be aided by the gradual revival in exports to Russia and by the growth in demand in Finland.