1.1 World Economy

The Finnish forest industry's growth prospects have deteriorated this year. The marked economic downturn in the United States at the end of 2000 has spread to Europe and Asia. Real GDP growth in the world economy weighted according to the distribution of Finnish forest industry exports will decline this year to less than two per cent, about half of last year's figure. Economic growth has slowed in the Finnish forest industry's key export markets, especially Germany.

Growth in the world economy in 2002 will be the same or slightly above this year's level, provided that the US economy begins to recover in the first half of the year. The economic trends in the United States and the impact of these trends on the world economy represent a major uncertainty for the world economic outlook. If the downturn in the US is prolonged, the outlook for the Finnish forest sector next year will be less favourable than anticipated.

Upturn in Euro Area Economy Next Year at the Earliest

A very sharp downward revision has been made to GDP forecasts this year for both the euro area and other countries. The strength and scale of the slowdown in the US economy that began at the end of last year has surprised economic forecasters. Until well into this year it was believed that the euro area would experience only a minor setback. This has not proved to be the case. The 2001 GDP growth rate of about three per cent forecast at the start of the year has been revised downwards to less than two per cent.

The downturn was triggered mainly by the bursting of the investment bubble that had been created by over-ambitious expectations in the IT sector, which was followed by a rapid drop in asset values (share prices). The severe reduction in investment activity especially in the United States has been felt strongly by those countries that depend on exports to the US. Although the euro area's export difficulties have been less acute than in many Asian countries, for example, the slump in export demand combined with the depressed demand on domestic markets has brought economic growth in the euro area virtually to a standstill.

The slowdown in output growth in the euro area has reduced inflationary pressures. This has been reinforced by the halt in raw material price rises. Inflation is expected to continue falling, and so the price stability target of the European Central Bank (ECB) is expected to be met in the medium term. The ECB has also been able to reduce its central rate three times during the current year. With consumer purchasing power still fairly high, this improves the short-term economic outlook.

Euro area exports are expected to start growing in the first half of next year. If the economic impact of the September terrorist attacks against the United States and subsequent events remains short-lived, GDP growth in the euro area can be expected to pick up in 2002 to just over two per cent. However, such
export-led economic growth will be hampered by the moderate strengthening of the euro (the forecasts assume an average USD/EUR rate of 0.90 in 2001 and 0.95 in 2002), which will weaken the competitiveness of European companies on world markets. Inflation will subside next year to below two per cent. If inflationary expectations remain moderate, the ECB may use further interest rate reductions to support economic growth. Such reductions would be small, however, especially if the euro area economy picks up as expected.

The situation in the United States represents the biggest uncertainty for any economic improvement in the euro area in 2002. Unemployment in the euro area has not been greatly affected by the current downturn, because companies have believed that it will be short-lived and that the United States will be leading an upturn in the world economy during the first half of 2002. However, if euro area exports are not boosted by an increase in consumer demand in the US, unemployment could rise quite rapidly. Redundancies would have an immediate adverse effect on consumer confidence, which in turn would be reflected in private consumption, which has continued to keep the economy going this year.

A substantial weakening of the US dollar would represent a further threat to an economic upturn in the euro area. The dollar would be at risk from a continuing serious current account deficit on the US balance of payments if capital flows were to be diverted elsewhere as a result of unexpectedly bad news on the US economy. A weakening dollar would lower the demand for imports in the United States and would handicap euro area companies competing with US companies in world markets.

**Sluggish World Economy Reduces Economic Growth in Finland’s Traditional Export Markets**

The Finnish forest industry’s most important export markets in Europe are Germany and the United Kingdom. Last year Germany accounted for one fifth of the Finnish forest industry’s exports by value, and the UK 15 per cent. In Germany, economic growth has been slower this year than in other euro area countries or the UK. German GDP growth in 2000 topped 3.1 per cent but has slowed considerably in the first half of this year and is forecast to be only 0.8–1 per cent for the full year. In 2002, the figure is forecast to be 1.5–1.8 per cent.

The slowdown in the German economy is partly attributable to the slackening growth in the US, which takes around 10 per cent of Germany’s exports, but partly also to the drop in industrial investment and construction in Germany. The construction boom in the early 1990s triggered by German unification is over and the sector is returning to a more normal level. With increasing unemployment, inflation at almost three per cent and purchasing power being eroded, the growth in private consumption in Germany this year will only be very small. The coming tax relief for consumers as a result of last year’s tax reforms is, however, expected to support the economy after 2001. Inflation is also expected to fall next year, which will add to consumer purchasing power and thus support the growth in consumption.

In the United Kingdom economic growth has, on average, been higher than in the euro area countries. This year, GDP growth in the UK will actually slow to about two per cent. With industrial output falling in virtually every month since the start of the year, the reduction in output for the full year is expected to be 2–3 per cent. Private consumption in the early part of the year was still rising much faster than in Germany or the euro area in general. In the autumn, however, there was a drop in consumer confidence in the economy, signalling a weakening trend in consumption. Growth in the UK economy is closely influenced by developments in the euro area, which is the destination for about half of the UK’s exports.

The Bank of England has responded to the slowdown by reducing interest rates several times from six per cent at the start of the year to 4.5 per cent. This should stimulate the economy and contribute to the forecast increase in GDP growth next year of a
little over two per cent as the world and euro area economies recover somewhat. Inflation has kept within the targeted limit of 2.5 per cent in the last two years. Consumer purchasing power will benefit from low unemployment and low inflation. According to the International Monetary Fund (IMF), the UK inflation rate should again remain within the limits set both this year and in 2002. Forecasts show that UK private consumption will grow by about three per cent this year and next year, which is above the level forecast for Germany or the euro area in general.

The pound sterling exchange rate against the euro has been relatively stable over the last couple of years. The average rate for this year is estimated at EUR 0.63. The rate is expected to remain at about the same level in 2002.

### Economic Growth also Dwindling in Finland’s Competitor Countries

In **Sweden**, forecasts by the National Institute of Economic Research (NIER) show that GDP growth in the current year will drop to 1.6 per cent. Next year, however, the figure is expected to accelerate to 2.7 per cent as the recovery in the world economy boosts demand on world markets. Economic growth in Sweden has been curbed by the drop in exports from the IT sector and in other areas, and the NIER’s forecasts indicate that total exports will fall by about three per cent this year and next year, which is above the level forecast for Germany or the euro area in general.

The forecast growth in household consumption this year is just half of last year’s figure, but in 2002 consumption will rise again, by 3.1 per cent. Consumer prices will rise by 2.6 per cent this year and by a lesser amount next year.

The value of the Swedish krona has fallen against the euro this year, adding to Sweden’s competitive-
ness in the euro area. In 2002, the rate is expected to remain at about the same level.

Economic growth in Russia this year will drop to 4–5 per cent. The slowdown in the world economy led to reduced levels of growth in investment and industrial production in the early part of the year. Forecasts by Nordea indicate that investment growth for the year will be down to six per cent, compared to last year’s figure of almost 18 per cent. As only a small proportion of investment funding comes from the banking sector, investment growth in Russia is dependent on increases in exported raw material prices, especially the oil price. Growth in private consumption in Russia will be higher this year than in the euro area countries. Figures from the Russian Central Bank show that the rate of growth in the early part of the year was around 10 per cent.

Russian GDP growth in 2002 will be approximately the same as this year. Nordea forecasts show that the inflation rate will be 20 per cent, which is considerably higher than the Russian government’s inflation target for 2002. Efforts are being made to keep the dollar exchange rate below 31.5 rubles. Whether this succeeds or not will depend on the level of inflation.

The continuation of reform policies in Russia is encouraging. The Duma has, for instance, approved a cut in corporate profit tax from 35 to 24 per cent and a reduction in obligatory repatriation of export revenues to 50 per cent. The cut in corporate profit tax could, of course, have an adverse effect on tax revenues.

In the Baltic countries economic growth will fall slightly this year on account of the weakening economic situation in Europe, but will nevertheless continue to be above the level of the euro area countries. According to the IMF forecast issued at the end of September, the Baltic countries’ GDP growth for this year will be 4.5 per cent and next year 5.2 per cent.

Economic growth in Canada largely follows developments in the United States, due to the close trade links between the two countries. Growth in the Canadian economy has been curtailed since the early part of the year as export growth has declined. The IMF forecasts that Canada’s GDP growth this year will be down to two per cent, a drop of about two percentage points on last year’s figure. The growth rate will pick up in 2002, provided that the US economy begins to recover. The cut in interest rates this year will continue to support the good level of housing construction activity in Canada in the remaining part of the year.

**United States: Will Recovery Be Delayed?**

The slowdown in economic growth in the United States began a year ago with the slump in investment demand in the IT sector and has spread this year to almost all industrial sectors. GDP growth for 2001 is projected to be 1.1–1.3 per cent. The economic situation in the US does, however, have two sides to it. Although industry’s expectations for the future are rather gloomy, and no change for the better is yet in sight, private consumption this year is forecast to grow by about 2.5 per cent. Consumption has been stimulated by both a reduction in interest rates and the tax reductions introduced in July. This has been extremely important, as private consumption in the US accounts for almost 70 per cent of GDP, which is significantly above the level in Europe. However, the outlook for the rest of the year is considerably gloomier. Consumer confidence about personal finances has diminished in the last few months as redundancies have increased, and the slide has been gathering pace since the terrorist attacks. The faltering economy has gradually made itself felt in the housing market as well. New housing construction, in particular, has declined.

The downturn in economic growth has kept inflationary expectations in check in the short term, which has enabled a very aggressive interest rate policy, one that supports consumption and growth. This year the US Federal Reserve has reduced its federal fund rate nine times already, by a total of four percentage points. However, the federal fund rate
cuts have not led to the desired reduction in long-term interest rates important for investment. This is because the current growth in money supply (M3) is higher than the growth in total output, thus causing inflationary pressures in the medium term. The fear that borrowing will again start to escalate has also prevented a reduction in long-term interest rates. Besides the reduction in investment growth, industrial companies have also been cutting production to reduce their stocks. This means that GDP growth this year is almost entirely attributable to the growth of about 2.5 per cent in private consumption.

The US economy is expected to see an upturn in the second quarter of 2002 at the latest. GDP is forecast to grow by 1.0–2.2 per cent next year, although the threat to a quick recovery has been growing. If redundancies continue despite the initial signs of growth in some industrial sectors, consumer confidence and thus also private consumption could slump quite markedly. There are already some signs of this. The index of consumer confidence has fallen during the last few months, and the number of Americans on unemployment benefit is at its highest for nine years. Any slowdown in private consumption could prevent a quick economic recovery, which would also be felt clearly in the euro area.

Japan’s Difficulties Continue

Growth in Japan has again failed to gather speed. GDP is, in fact, forecast to shrink by 0.5 per cent this year, while next year only a very minor increase is promised. The problems are connected with the sharp drop in exports to the US, resulting in redundancies in Japanese companies. Unemployment has grown to five per cent, which is high by Japanese standards, although its continued rise to as much as 10 per cent in the next few years cannot be dismissed. Growth in household consumption is thus scarcely likely to function as a force for maintaining GDP growth in the near future.

The scope for using monetary or fiscal policies to stimulate growth is also limited. Although interest rates are already close to zero, the willingness to invest is very low because of the poor outlook for the future. The national debt is running at about 130 per cent of GDP, which also precludes the possibility of any significant attempt to boost public demand. Any recovery measures funded by taking on additional debt would be counteracted by an increase in private savings because consumers fear that they would end up footing the bill at some stage. The deflationary trend causing the standstill in the Japanese economy is set to continue. In fact, only an increase in consumer demand in the United States can bring any relief to Japan’s economy. Major structural reforms in the economy are nevertheless inevitable. The main issues are the further opening up of domestic markets to competition and an overhaul of the banking sector.

The countries of East Asia have been badly hit by the bursting of the IT bubble. In Singapore and the Philippines, for example, exports have dropped by an annual rate of about 20 per cent. The region’s GDP growth (excluding Japan and China) this year is expected to drop to about two per cent, but to rise to around four per cent next year as a result of the US recovery. China’s economy has been growing at about 7–8 per cent in recent years and this is expected to continue at the same level both this year and in 2002.

Impact of September Terrorist Attacks on World Economy Still Difficult to Assess

The main economic impact of the September terrorist attacks on the United States and the response of the US is the already evident increase in uncertainty. Households are more willing to postpone their spending plans and companies to delay their investment. GDP growth worldwide, and especially in the United States, will therefore be rather lower than expected at the end of the year.

In the longer term, consumption and investment decisions depend above all on future expectations.
The decline in consumer confidence has become more pronounced following the terrorist attacks on the United States. A major downturn in private consumption growth next year is therefore possible. Private consumption is a key element in the US economy, and so fears of a prolonged recession are well founded.

In the euro area, the economic impact of the terrorist attacks will probably be fairly minor in the long term. Consumer confidence will not be shaken to the same extent as in the US, and private consumption growth next year will be close to earlier estimates. The biggest threat next year will be a prolonged recession in the United States, which would have an impact on the exports from euro area companies and could lead to further redundancies. This would be further exacerbated by continued general uncertainty or a possible increase in oil prices.

Extensive international cooperation is being sought in the effort to combat any longer term threats to the world economy from the terrorist attacks. Immediately after the attacks, the Organisation of Petroleum Exporting Countries (OPEC) announced that it would be seeking to secure the stability of oil prices. The US Federal Reserve has reduced its federal fund rate and the European Central Bank its central rate in an attempt to prevent a long-term world economic recession. Interest rates are currently at a historically low level, but the impact of this on consumption and investment decisions will not become clear until later on. Next year at least, fiscal policy in the US will remain very much oriented towards growth. The USD 40 billion package approved by Congress for the Emergency Response Fund is only the start of a much larger allocation of funding that will benefit the defence industry and other sectors. Tax relief and improvements in unemployment security will be used to boost private consumption. Tax relief to support corporate investment is also being planned. The combined impact of the fiscal policy recovery measures is estimated to be 1–1.5 per cent of annual GDP.

Although the recovery package represents the largest growth injection in the US economy since the Second World War, next year’s GDP figures will depend above all on the behaviour of consumers. If the tax relief is not used for consumption but for reducing indebtedness, economic growth will not pick up significantly. The uncertainty surrounding the forecasts is very high because trends in the US economy are currently affected by psychological factors to an unprecedented extent.

1.2 Finnish Economy

A reduction in exports will mean a considerably lower level of GDP growth in Finland this year. In 2002, growth will pick up as export prospects improve. Nevertheless, the possibility of a prolonged world recession threatens export-led growth. The strong growth in private consumption will continue to support GDP growth this year and in 2002. Consumer purchasing power will be boosted by tax cuts, lower inflation and reduced interest rates.

2001: from Sustained Growth to Downturn

The seven years of high and sustained growth in the Finnish economy came to an abrupt end this year. The revised GDP growth forecast for 2001 is 0.5–1.8 per cent, compared to the initial forecast of about four per cent made at the start of the year. The main factor in this turnaround is the shrinking level of exports caused by the slowdown in world economic growth. This year’s exports from the electronics and electrical industry (31 per cent of all Finnish exports by value in 2000) will be considerably below the estimates made earlier. The fall in export prices, due to the slackening demand, has also exacerbated the position of export companies, although price competitiveness should not yet be a problem. The competitiveness indicator published by the Bank of Finland shows that price competitiveness is lower than
Despite the setback in exports, private consumption will edge upward this year by about 2.5 per cent. Purchasing power will increase largely as the result of tax cuts, lower inflation and reduced interest rates. On the other hand, the slowing of employment growth could weaken households’ confidence in their personal finances and thus reduce consumption.

GDP growth is forecast to accelerate to 2.5–3.0 per cent in 2002. Although this will be supported by the growth in private consumption of about 2.5 per cent, the role of exports will be considerable. A critical factor is the awaited recovery in the US economy. If this is delayed beyond the currently forecast second quarter, the problems of the export industry in Finland, as in the other euro area countries, will continue for longer than anticipated. Redundancies would then also affect private consumption. GDP growth in 2002 could therefore be limited to two per cent or less.

The unemployment rate for the year is forecast to be 9.2 per cent. The 2002 unemployment forecasts made by Nordea and the Research Institute of the Finnish Economy (ETLA) differ from each other, however. Nordea forecasts that the rate will start to rise again, whereas the ETLA forecast shows a continued decline. This disparity is explained by different relationships assumed between the GDP growth components. According to Nordea, next year’s growth will be very much export-led and hence its job-creating impact will be small. ETLA’s forecast shows that private consumption will grow by three per cent next year, creating new jobs especially in the service sector. The falling rate of unemployment in industry and construction, however, will come to a standstill.

The inflation rate is forecast to be 2.6–2.8 per cent this year, which is slightly below the average for the euro area. Inflationary pressures in the euro area have been dampened by the reduction in demand pressure as a result of the world economic slowdown and the drop in import prices due to the recent strengthening of the euro. Inflation is expected to fall further next year and will probably be below two per cent both in Finland and the euro area as a whole.
Risk Scenario for World Economy: Impact on the Finnish Forest Sector
Riitta Hänninen and Maarit Kallio

Greater uncertainty than usual surrounds the forecasts for the world economy next year and thus the forecasts presented here in the Finnish Forest Sector Economic Outlook. The main reasons for the increased uncertainty are the September terrorist attacks on the United States and the subsequent response measures. Some economists believe that the effects on the US and the world economy next year could even be positive if the expansionary monetary and fiscal policies have the intended result. Most economists, however, feel it more likely that economic growth will slow down as a result of the terrorist attacks, because private consumers will restrict their consumption for reasons of caution.

The state of the US economy is dependent above all on consumer confidence, because private consumption is the biggest area of activity in the US economy. Consumer behaviour is difficult to predict as it is also strongly affected by psychological factors, which are influenced by events such as the current conflict. If there is a collapse in US consumer confidence about personal finances, the economic recovery will be delayed and GDP growth in 2002 may even be negative. The Research Institute of the Finnish Economy (ETLA) has estimated that if the US private sector starts paying off its considerable debts instead of increasing consumer expenditure, the United States’ GDP could shrink by an average of one per cent each year up to 2005. Such an adjustment would be as painful as it was in Finland, Sweden and the United Kingdom ten years ago. This would have an adverse impact on growth in the world economy. A prolonged recession in the United States would be most problematic for Asia and Latin America.

It is estimated that the impact of changes in US economic growth on the euro area is equivalent to a factor of 0.25–0.5 for every percentage point, according to figures produced earlier by Deutsche Bank. Calculated in this way, economic growth in the euro area in 2002 would be about one per cent instead of the current forecast of two per cent if the United States’ GDP were to shrink by one per cent next year. If such a risk scenario for the world economy were to materialise, how would the Finnish forest sector be affected?

Most exports of Finnish forest industry products are to Europe, where the euro area countries form the main markets. Less than six per cent of the industry’s exports by value are shipped to the United States. The proportions destined for Asia and Latin America are also relatively small. The impact of developments in the US economy on the Finnish forest sector are thus primarily via their effect on European demand and competition, although a collapse in demand in the United States would also have a direct effect on exports.

If the risk scenario becomes reality, the demand for Finnish forest industry products would be lower than forecast not only in the United States and Asia but also in Europe. Supply would also increase in Europe, as some of the exports from European producers that were previously destined for North America and Asia would remain on domestic markets. Supply to the North American and Asian markets from elsewhere would also increasingly be directed to Europe. With the increase in supply being greater than the increase in demand, pressures for price reductions would emerge in Europe.

The likely strengthening of the euro would further exacerbate the negative effects. The weakening of the US dollar would also be transmitted to the Canadian dollar, thereby improving the competitiveness of Canadian producers on the European market. Canadian imports to Europe have consisted mainly of pulp, newsprint and sawnwood.

The effects of a downturn in the US economy on the Finnish paper industry would be felt most strongly in the form of increased competition on Europe’s export markets. The paper industry is now
more concentrated following a spate of mergers and acquisitions, and this year competition in the industry seems to have been characterised by oligopolistic behaviour aimed at restricting supply. Restrictions have been imposed on production volumes to prevent a drop in prices, which has so far proved relatively successful. Major cuts in production have also been made, especially in fine paper, and exports of Finnish fine paper to many Western European countries have plummeted from their 2000 level. If the market weakens further, even the large producers may be ready to reduce prices in order to retain or regain their market shares. Indeed, we anticipate that even in the risk scenario the export of Finnish paper in 2002 would not fall below this year’s level in tonnage terms. With price competition intensifying there would be pressure for prices to drop from current levels.

Slower economic growth on the Finnish sawmilling industry’s main European export markets would prevent any slight recovery in the construction sector, which is already experiencing a downturn. The construction sector could then slow down even further in 2002. This would weaken the demand for sawnwood and worsen the existing oversupply situation on European markets. Canadian sawnwood exports to Europe could also increase as construction activity declines in North America and Japan and the dollar weakens against the euro. At the same time, the export of European sawnwood to Japan and the United States would become more difficult. The oversupply on Europe’s sawnwood market would force down the price of sawnwood. Finnish sawnwood export prices would fall below this year’s level. Combined with a reduction in demand, the already poor profitability of the sawmilling industry would necessitate cuts in Finnish sawnwood production and exports next year too.

The impact of a decrease in US economic growth would not be restricted to the export markets of forest industry products but would also be reflected in the entire forest sector. The decline in production and prices in the paper and sawmilling industries would reduce demand for roundwood and lead to commercial fellings and stumpage prices in 2002 being lower than forecast. The impact on the sawlog markets would be greater than on the pulpwood markets because production in the sawmilling industry would shrink by more than that in the paper industry. Along with the fall in stumpage prices there would be a drop in the profitability of non-industrial private forestry and a reduction in investment. Reduced output in both the forest industry and forestry activities would also be damaging for employment throughout the entire sector. If US economic growth were to be negative in 2002, all the forecasts given here would most likely be too optimistic.