1.1 World Economy

The growth prospects for the Finnish forest industry in 2002 have been rather weak. The continuing impact of the sharp downturn in the world economy that started in the United States in the last quarter of 2000 will ensure that the 2002 world GDP growth is still low. Although the bottom of the cycle has already been passed, economic recovery has been very slow. This year’s real GDP growth in the world economy weighted according to the distribution of Finnish forest industry exports will be about 1.5 per cent, little changed since 2001. Among the Finnish forest industry’s key export markets, economic growth has been particularly slow in Germany.

Growth in the world economy will pick up slightly in 2003. Real GDP growth weighted according to the distribution of Finnish forest industry exports is expected to rise to about 2.5 per cent. The brighter outlook will be overshadowed, however, by considerable uncertainties. If growth in the US economy starts to fade, due to a slowdown in private consumption for example, the recovery of the entire world economy would be in jeopardy. A further uncertainty in the euro area is that growth in the largest economies – Germany, France and Italy – may be slow to pick up, lagging behind the other euro countries.

Slow Recovery in Euro Area Economies

Contrary to the general trend in the world economy, economic growth in the euro area in 2002 has been clearly below last year’s level. Euro area GDP growth will be less than one per cent, although the latter part of the year has shown an improvement over the early months. Growth in private consumption and exports in the euro area has been sluggish, and investment is likely to be down for the year as a whole. The low level of growth has also been reflected in higher unemployment in the euro area.

Slow growth has nevertheless reduced the euro area’s inflationary pressures, reinforced by the stable raw material prices and the euro’s strengthening against the dollar, by about 10 per cent. The inflationary outlook for 2003 is also moderate, thus diminishing the need for any immediate tightening of monetary policies as economic growth gathers pace. If growth proves to be weaker than anticipated, a cut in central rates is possible.

The euro rate against the US dollar is expected to remain at its September level (0.98), while the average rate in 2003 is likely to strengthen by about four per cent. Economic prospects for the immediate future are supported by low interest rates, accelerating growth in the US economy and the still quite robust purchasing power of euro area consumers.

Following a poor second quarter in 2002, the US economy has picked up again, and growth is forecast to continue at a reasonable level in 2003. Although the impact of higher US growth will not be felt in the euro area until some time afterwards, total euro area
exports are expected to grow to about four per cent in 2003, supported by an increase in trading between the euro countries. As a result of this export growth, together with new investments and a doubling of growth in private consumption, the euro area’s 2003 GDP growth will pick up to around two per cent.

Unexpectedly slow growth this year has increased the budget deficit of many euro area countries. The 2002 public sector deficit for the entire euro area expressed as a proportion of GDP will be approximately 1.8 per cent. Many euro countries have failed to meet their stability programme targets, which are intended to stabilise public sector finances. The credibility of the EU’s Stability and Growth Pact, established to support monetary policies, is also in the balance. It is estimated that Portugal, for instance, will exceed the three-per-cent limit set for the budget deficit, and Germany’s deficit is also very close to this limit. If the European Commission has to resort to sanctions for violating the Stability and Growth Pact, this will slow the level of economic growth.

The projected improvement in the euro area economies is most at risk from possible developments in the United States. The uncertainties surrounding the US economy are exceptionally great, as they were in 2001. The high indebtedness of households, the fall in share prices, the question marks over corporate accounting, and the possible sharp rise in oil prices linked to the Iraq situation all conspire to make US households and businesses more cautious. Any unwelcome news could easily reduce both household consumption and corporate investment.

Mixed Trends in Finnish Forest Industry’s Traditional Export Markets

The Finnish forest industry’s most important export markets in Europe are Germany and the United Kingdom. In 2001 Germany accounted for 19 per cent, and the UK for 15 per cent, of Finnish forest industry exports by value. Germany is currently experiencing its second successive year of exceptionally low growth: its annual growth for 2002 will be around 0.5 per cent, which is considerably below the level elsewhere in the euro area or the UK. This is very significant for the growth prospects in the rest of the euro area, as Germany accounts for about 30 per cent of the euro area’s GDP. In 2003, however, the German economy is expected to grow by almost two per cent, as the world economy picks up and private consumption rises.

The German economy’s meagre growth rate is largely attributable to the standstill in private consumption growth and the contraction in investment; exports, on the other hand, will actually be up by almost four per cent this year. Consumer confidence in the German economy has fallen dramatically over the past year as a consequence of rising unemployment and falling share prices, and the consumption prospects for 2003 are dampened by the postponement of the planned tax relief due to the costs of repairing the summer’s flood damage. The repair work is to be spread over a number of years, and so the positive effect on GDP in 2002 will remain small.

Germany’s room for manoeuvre is limited because monetary policy decisions are in the hands of the European Central Bank (ECB), and the country’s budget deficit is approaching the critical three-per-cent limit defined in the Stability and Growth Pact, thus restricting public sector spending. German economic growth is therefore heavily dependent on an improvement in the world economy. A poorly performing German economy is a risk to growth in the Finnish forest industry, both directly through the effect on Finnish exports and indirectly through the effect on the European economy in general.

The United Kingdom’s 2002 GDP growth will remain at last year’s level, at just under two per cent. This is distinctly higher than GDP growth in the euro area. The state of the euro area economy is very important to UK industry, as almost half of the nation’s exports are to markets in the euro area. Growth in the UK’s export markets has been slow, and so the main factor boosting the UK economy has been private consumption, up almost three per cent this year. Consumption has been stimulated...
by the lower inflation figures, relatively low interest rates, and consumer confidence in the economy and personal finances. The low unemployment rate has helped maintain consumer confidence in personal finances despite the slow growth in the world economy.

GDP growth in the UK in 2003 is expected to rise to approximately 2.5 per cent. Private consumption is forecast to grow by almost three per cent, although rising inflation will reduce consumer purchasing power. Improved growth in the euro area will lead to higher industrial output and investment in the UK.

Although the pound sterling rate against the euro has remained relatively stable in recent years, the pound has nevertheless strengthened by around 25 per cent since the mid-1990s, boosting the euro area’s industrial competitiveness on the UK market. The pound sterling rate has fallen slightly in 2002 as a result of the general strengthening of the euro. Forecasts and derivatives market data indicate that the average GBP/EUR rate in 2002 and 2003 will be 0.63.

**Economic Growth Comparatively High in Finland’s Competitor Countries**

Sweden’s 2002 GDP growth will reach just short of two per cent and will accelerate to around 2.5 per cent in 2003. Supported by pay increases and low unemployment, private consumption has driven growth in 2002 and will continue to do so next year. 2003 will also see a rise in investment, due to the buoyant level of domestic demand and the revival in the world economy. Export growth is projected to rise further, but the sectoral differences will be significant: exports of communications products will grow considerably, whereas in other sectors exports will be in some difficulty as a result of the strengthening krona. On the other hand, a stronger krona will dampen the inflationary pressures from pay increases, which will allow a more gradual tightening of monetary policies.

Sweden’s EMU referendum in 2003 will be of critical importance for both interest rates and exchange rates: if the prospect of joining grows before the referendum, interest rates will approach those of the euro area and the krona will appreciate in value. The forecasting basis for the krona’s exchange rate against the euro is an average rate of 9.2 this year and 8.9 in 2003.

Russia’s GDP growth for 2002 will be around four per cent, and the same is forecast for 2003. This level of growth has been maintained by the expansion in private consumption fuelled by higher incomes, and by rising exports and export company investments financed mainly through export revenues. Export revenues have grown as a result of rising oil prices, compensating for the slower growth in export demand caused by adverse developments in the world economy. Inflation has remained high, however, due to the growing domestic demand and the weakened ruble. Although the ruble has fallen only slightly against the US dollar this year, it has fallen almost 15 per cent against the euro. So far, exporting companies have benefited from the falling value of the ruble, but if it falls much further they will be hit by high debt servicing costs.

GDP growth in the Baltic countries is slowing somewhat, following the trend in the world economy, but it still continues to be considerably above that of the euro area. Supported by strong growth in private consumption and investment, the Baltic countries’ GDP is expected to grow by about five per cent this year and around 5.5 per cent in 2003.

Canada’s GDP is forecast to grow by over three per cent both this year and in 2003. The Canadian export industry has benefited from the 30-per-cent drop in the value of the Canadian dollar against the US dollar in the past ten years. Although this has now come to an end, Canadian companies will remain more competitive than their US counterparts on world markets for some years to come. Stable employment growth, low interest rates and falling inflation have encouraged private consumption in Canada this year. In 2003, however, the revival in the world economy will increase inflation and
interest rates. The Canadian dollar is expected to appreciate slightly against the euro in 2003, which will improve the relative competitiveness of Finnish forest industry companies on the world market in relation to their Canadian competitors.

United States Driving the World Economy

The US economy has recovered quickly from last year’s downturn, which was worsened temporarily by the September terrorist attacks. Signs of a turnaround were already evident in the last quarter of 2001, and growth accelerated further at the start of 2002. The recovery has been aided by the continued high level of private consumption and the very expansionary fiscal and monetary policies adopted to maintain growth after the terrorist attacks. The economy slowed significantly in the second quarter of 2002, however, and the increase in general uncertainty cast a shadow over the prospects for the remainder of the year. GDP growth for 2002 is nevertheless expected to be about 2.5 per cent.

A key question mark in forecasting US economic growth is the level of private consumption, as this accounts for about two thirds of GDP. Factors restraining private consumption growth are the high indebtedness of households and the shrinkage in household assets resulting from the fall in share prices. For the time being, however, low interest rates and rising property values have maintained the high rate of private consumption.

The unexpectedly slow recovery in the world economy has led the US Federal Reserve to prolong its policy of low interest rates, aimed at offering strong support to consumption and growth. With inflation down to about 1.5 per cent in 2002, real interest rates are close to zero. Low real interest rates have not, however, stimulated investment to the extent hoped for, because companies detect...
uncertainty in demand both at home and abroad. The readiness to invest has also been dampened by the abundance of spare capacity in many sectors, allowing production to be adjusted to meet any increase in demand in the short term.

Although the recovery in the US economy has been quite slow and erratic, the probability of a new downturn is very small. In 2003 the economy is expected to be in better shape than this year. If private consumption continues to increase at its present rate, new investment will push GDP growth to around three per cent.

As the United States is driving the world economy, the uncertainties surrounding the above growth assessment are particularly significant. Considerable uncertainty exists over whether the growth in the world economy will fall short of the anticipated level. In the US, there is further uncertainty over the impact of household indebtedness. Were companies to reduce their labour force, consumer confidence in personal finances would plummet, and in such an uncertain environment households would try to reduce their debts, thus leading to a drop in private consumption. Slower GDP growth could then persist for a longer period.

A further uncertainty in the growth equation is the price of oil, in particular following any US military action against Iraq. An extended conflict would drive up oil prices and heighten the general climate of uncertainty, probably plunging the world economy into a new recession.

Asian Growth More Dependent on Exports

The sustained period of sluggish growth in the Japanese economy has reduced the country’s scope for using monetary and fiscal policies to revive its economy. Although interest rates are negligible, the poor outlook is discouraging companies from investing. No major boost in public sector demand is possible either, because the public sector deficit has already reached 130 per cent of GDP. Although private consumption has picked up intermittently, raising demand in the domestic economy, the prospects for a more sustained period of substantial growth in private consumption remain low as long as consumer prices continue to fall.

A revival in the Japanese economy is thus heavily dependent on export growth. The slight weakening of the yen led to higher exports in the early months of 2002. However, the slowdown in the United States during the summer hit Japan’s US exports as well as its exports to other Asian countries heavily dependent on exporting to the US. If the world economy recovers as forecast, Japan’s GDP growth in 2003 should rise to over one per cent.

GDP growth in Asia (excluding Japan) is forecast to be approximately 5.5 per cent for 2002 as a whole. Exports to the United States have begun to increase again after the severe contraction in 2001, and trade between Asian countries – led especially by China but also Japan – has been growing too. As the world economy picks up, Asian GDP will accelerate to about six per cent in 2003.

1.2 Finnish Economy

The ongoing recovery in the world economy in 2002 has led to growth in Finnish exports. With private consumption also up, Finnish GDP growth for 2002 is expected to be about 1.5 per cent. The higher level of growth forecast for the world economy in 2003 will boost growth in the Finnish economy quite significantly. The prospects for export-led growth will nevertheless be affected by uncertainty over the general economic situation and the level of pay increases agreed in the autumn round of pay negotiations.

Towards Export-Led Growth

Finnish exports began to increase in the second quarter of 2002 in response to the revival in the
The world economy. Although the growth expectations of the spring have not been met, a sound foundation for export-led growth now exists as a result of the moderate GDP growth in export markets in the latter part of the year and Finland’s very competitive position.

GDP growth has been driven not only by exports but also by private consumption. Low inflation, low interest rates and modest tax reductions have all contributed to a growth in net household income in real terms. However, uncertainty about the world economy and discouraging signs in the labour market have reduced consumer confidence in the economy in recent months. Confidence in personal finances is nevertheless good, and so private consumption is projected to be up by a total of about 2.5 per cent for 2002 as a whole.

Despite the improvement in the economy, the level of investment has not grown this year. Industrial investment projects have instead been postponed until 2003 in view of the current excess capacity and the uncertainty over the economy. The August 2002 business survey by the Confederation of Finnish Industry and Employers (TT) showed that 37 per cent of industrial companies had excess capacity in relation to demand.

The increase in exports is expected to raise Finland’s GDP growth to 3.5 per cent in 2003. Growth in Finnish exports will in fact be higher than the GDP growth in export markets. In other words, the demand for Finnish products in export markets will, on average, be growing faster than the demand for other products. Export-led growth in the Finnish economy in 2003 will also be reflected in the domestic market; private consumption will continue to rise, and investment is expected to grow as a result not only of higher exports but also improved domestic demand and a better economic outlook.

The unemployment rate for 2002 will be slightly higher than last year’s figure because companies have been adjusting their labour needs in line with the earlier decline in demand; employment has fallen in the metal and engineering industry in particular. The decrease in construction sector jobs, however, has been turned around: according to the Research Institute of the Finnish Economy (ETLA), employment in the construction sector will increase by a combined total of 10000 jobs in 2002–2003.

### Economic forecasts for Finland

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* Change in volume
** Forecast by Research Institute of the Finnish Economy (ETLA) published September 5, 2002
*** Forecast by Nordea published September 2, 2002
also estimates that some 20,000 new jobs will be created in the same period in the main areas of the private service sector. However, the autumn pay negotiations may have a significant impact on employment, especially in sectors oriented towards the domestic market.

Inflation has fallen significantly in 2002. Inflationary pressures have been kept in check by the slack demand for end products, the strengthening of the euro and the moderate price increases of raw materials (excluding oil). Inflation is projected to remain at this year’s level in 2003.