The market outlook for Finnish forest industry products is brighter than it was a year ago. Growth in the world economy picked up at the end of 2003 and has continued well in 2004, although the cyclical peak may already have been reached by the end of the year. Weighted according to the distribution of Finnish forest industry exports, real GDP growth in the world economy in 2004 is expected to be about 3%, up by more than one percentage point on the 2003 level. GDP growth in the euro area, which is important for Finnish exports, is also on a recovery path.

GDP growth in the euro area will continue at about the same rate in 2005. Elsewhere in the world, growth will remain at a good level, although the rate will already be slowing. Demand in the Finnish forest industry’s export markets will therefore be maintained, although there are also risk factors that could affect growth in these markets and the market outlook. The world political situation, for example, could lead to a rise in crude oil prices or ensure that they stay high. In the United States, a continuation in household indebtedness and a possible drop in confidence could slow economic growth by more than the amount forecast, and a large foreign debt could lead to a further weakening of the dollar. In the euro area, GDP growth is under threat not only from the major budget deficits of the euro countries but also uncertainty over whether the recovery in Germany’s growth will continue beyond 2004.

**Slow Recovery in Euro Area GDP Growth**

Growth in the world economy picked up noticeably in the second half of 2003, and the cyclical peak may already be over by the end of 2004. In the euro area, too, GDP growth has finally improved, driven by the growth in the United States and Asia. The European Central Bank (ECB) expects the euro area’s growth to reach 1.6–2.2% in 2004, with the support of exports. Europe’s GDP growth will nevertheless continue to be slower than that of the world economy, and there are considerable differences in growth rates among the euro countries and in the factors underlying their growth. For example, Germany’s GDP growth is reliant mainly on export growth, whereas in France it is also being supported by private consumption. The euro area growth rate for the second half of 2004 is likely to be unchanged from the first six months, and could even decline, because the rise in crude oil prices is slowing the increase in consumer purchasing power.

International Monetary Fund (IMF) forecasts show that euro area GDP growth in 2005 will be at about the 2004 level, as growth in the United States and Asia will already have slowed a little. The euro area growth forecast assumes that there will be growth not only in exports but also in private consumption. With interest rates staying relatively low, a revival in investment after the decline of recent years will help build the foundation for growth.
However, realisation of these forecasts is dependent on what happens to crude oil prices, as this is critical for world GDP growth. According to the IMF forecast, a permanent USD 5/barrel increase in the price of crude oil would reduce world GDP growth by an average of 0.3 percentage points, after a lag of about 12 months.

The ECB reports that the cyclical upswing in the euro area is still slow, and so it may not raise its central rate until 2005. Inflation has accelerated but is expected to remain at about 2% in 2005, provided that the increase in crude oil prices levels off. Europe has become less dependent on oil for its energy needs in recent decades, and the percentage increase in oil prices in real terms is still below that seen during the 1970s energy crisis. The price of crude oil has fluctuated widely, and in October 2004 it rose temporarily to over USD 50/barrel (Brent). However, most forecasting institutions estimate that in 2005 the price will fall to an average of USD 35–40/barrel for the year as whole. With a slight improvement expected in euro area GDP growth and in inflation expectations, the ECB is likely to tighten its monetary policies in 2005. The IMF forecasts a rise in short-term interest rates (3-month market rates with country weightings) in 2005, to 3.1%, from the 2004 level of 2.4%.

The strengthening of the euro against the US dollar will continue, due to the uncertainties in the US economy. As the US balance of payments’ current account deficit continues to grow, pressures to correct it are increasing. The rise in the dollar rate against the euro in 2004 is expected to be about 9%, to an average of USD 1.23. The average rate in 2005 is forecast to rise only slightly, to USD 1.25, due to support from rising US interest rates.

The average 2004 public sector deficit in the euro area is likely to be at about the previous year’s level of 2.7%. With GDP growth continuing to be slow, budget deficits in the euro area have increased, and many countries – including Germany and France – will again exceed the limit set for the deficit (3% in 2004) by a considerable amount. So far, sanctions have not been taken against countries breaching the Stability and Growth Pact; on the contrary, the European Commission has been discussing a slackening of the Pact’s provisions, which in turn would weaken the credibility of the Pact. The continuing deficits are indirectly pushing up inflation, which could eventually lead to a decrease in economic growth.

Forecasts of euro area GDP growth are again subject to various uncertainties, including the presence of a number of imbalances in the world economy. In the United States, for instance, net foreign debt has been growing year on year and could lead to a significant weakening of the dollar and thus a crisis for the world economy as a whole. Another risk factor is the world political situation, which affects the price of crude oil. The current price trend has already led to a rise in raw-material prices and sea freight charges. If oil prices continue to rise or remain high for long, this will accelerate inflation in the euro area too, thus reducing consumer purchasing power and weakening GDP growth.

**German and UK Economies**

The German and UK economies, both important for Finnish forest industry exports, are continuing to grow at different rates. Although the German economy is actually growing now after its shrinkage in 2003, its weak state has held back the level of growth in the euro area, as German GDP accounts for about one third of the euro area total.

Germany’s 2004 GDP growth is forecast to be 1.9%, following the zero growth of 2003. This is based on export growth, because the country’s private consumption (equal to about 60% of its GDP) will actually show a decrease for the year, according to forecasts by Dresdner Bank, among others. Germany’s unemployment figures have not improved since 2003 and investment demand is weak. 2005 GDP growth is forecast to slow by 0.3 percentage points, to a level significantly below the euro area average. A slowdown in the US and Japanese economies is not likely to be reflected in full in the German economy, as demand will be increasing in Germany’s euro area neighbours. Counterbalancing
the weaker position of German exports in 2005, the country’s growth will be supported by an increase in private consumption and investment demand on the home market.

The United Kingdom’s GDP in the first six months of 2004 was growing at the highest annual rate for four years. The forecasts predict a 2004 GDP growth about one percentage point higher than in 2003, although there were signs of a slowdown in private consumption in the summer. The buoyant growth has been supported by higher domestic demand at a time when exports have been adversely affected by the low growth in Europe and the comparatively strong pound. Consumer confidence has been maintained by generous pay increases and a low (4.8%) unemployment rate. Low interest rates have served to increase private-sector investment but have also led to an increase in household indebtedness. Most of this indebtedness is tied up in homes and other real estate; house prices in the second quarter of 2004, for example, were up by 20% on the same quarter the previous year, due to strong demand. Fearing that the property bubble will burst, the Bank of England has gradually raised its central rate from 3.5% in autumn 2003 to 4.75% at the end of August 2004. Rates are expected to continue rising, which will be a contributory factor in the forecast slowing of the economy. The pound’s average rate against the euro in 2005 is expected to be unchanged from 2004 (GBP/EUR 0.68).

### Growth in US Economy Already Peaked

The 4.5% growth rate in the US economy in the first quarter of 2004 was surprisingly high. It then slowed to 3% in the second quarter. The high growth rate was based once again on private consumption and the substantial monetary and fiscal policy recovery measures. During the summer, however, consumer confidence in the future of the economy was weakened, partly because developments in the labour market fell short of expectations, but also because the price of crude oil increased. The index of industrial production also fell during the summer. Despite partially conflicting expectations, US GDP

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**Forecasts of economic growth (real GDP, annual percentage change)**

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** Forecast by International Monetary Fund (IMF) published September 29, 2004.
is nevertheless projected to be up by over 4% for 2004 as a whole.

The central role of households in maintaining growth in the US economy will weaken in the second half of 2004. Households are having to make compromises over purchase decisions and a greater proportion of their income is going on servicing major debts. The tighter monetary policy has already increased the loan servicing costs of households. Growth in overall demand is increasingly relying on private investment and exports in the second half of 2004, and this will continue in 2005. In addition, residential construction will still be relatively buoyant in 2005. GDP growth in the United States in 2005 is expected to be over 3%, or about one percentage point below the 2004 level. By comparison, world GDP growth is forecast to drop by only about half a percentage point.

There are many uncertainties surrounding the US growth forecast. The crude oil price, in particular, is a cause of concern for the economy and is also depressing prices on the equities market. US interest rates were at a historic low of 1% for about a year until early summer 2004, when the Federal Reserve raised its central rate by 0.25 percentage points, which it has since repeated twice. If the economic growth indicators continue to suggest a brighter outlook and the inflation rate looks like rising, the Federal Reserve might feel the need for similar further increases in interest rates, even before the end of 2004. Interest rates in 2005 are expected to rise further.

Imbalances in the US national economy are likely to weaken the country’s economic growth prospects, at least in the longer run. One such problem is the balance of payments’ current account deficit, which has already risen to over 5% of GDP. In trade with China, in particular, considerably more goods are being imported than exported. A further problem is that the national debt in the United States will be over USD 400 billion at the end of 2004. As the deficit grows, it could well become a problem, even in the short term, and exchange rate movements could contribute to stopping the flow of foreign capital that finances the debt.

**Will China Also Slow Japan’s Growth?**

Fluctuations in the world economy are increasingly linked to developments in the Asian economies. The huge annual investment growth and strong demand growth in China, in particular, are already being felt in the world economy. China now accounts for almost 10% of all direct investment in the world, which is a higher proportion than that invested in the United States. Attracted by growing consumption and cheap labour, increasing numbers of foreign companies are investing in industrial plants in China and the newly industrialised countries in East Asia. China’s GDP growth will reach 9% in 2004, while in 2005 the country’s leadership intends to keep GDP growth to a level of 8% in order to control growth in the overheated economy. In Asia as a whole, GDP growth in 2005 will drop to about 6%.

Japan’s improved GDP growth in 2004 is largely attributable to the growth in exports to the booming Chinese economy. However, the slowdown in growth in the United States will weaken the economic outlook for Japan. Japan’s 2004 GDP growth will nevertheless be more than 4%, while in 2005 it will be just below 3%, due to lower export demand. Private consumption in Japan is still not in a position to support GDP growth.