Real GDP growth in the world economy in 2005, weighted according to the distribution of Finnish forest industry exports, will be about 2.5%, and is expected to rise to almost 3% in 2006. GDP growth in the euro area, so important for Finnish forest industry exports, is also picking up and is likely to be about 2% in 2006, rising from the 2005 figure of approximately 1.5%. Among the forest industry’s key export markets, Germany’s GDP growth will continue to be weaker than that of the other euro countries in 2006, despite the slow recovery in its economy, and the United Kingdom’s GDP growth will slow to just over 2%. Interest rates in Europe will remain low in 2006.

China’s economy is continuing to grow at an annual rate of almost 10%, while Japan’s GDP growth is expected to be nearly 2% in both 2005 and 2006. GDP growth in the United States’ debt-driven economy is estimated to be 3.5% in 2005 and over 3% in 2006, although there are many uncertainties surrounding these forecasts. The debt burden of US households and the higher price of energy may lead to a contraction in domestic demand, and there are further uncertainties in the form of a possible weakening of consumer confidence and the massive budget and balance of payments’ current account deficits, which, through their impact on exchange rates, share prices and interest rates, could affect the entire world economy. Although the structure of national economies and their ability to withstand energy price increases have improved since the 1970s oil crises, a rise in oil prices to over USD 50/barrel would reduce household purchasing power in real terms and encourage general uncertainty about the world economy.

Only a Slight Recovery in Euro Area GDP Growth in 2006

Euro area GDP growth in 2005 is expected to be about 1.5%, following the 2% growth recorded in 2004. The lower figure is the result of a weakening in the export competitiveness of the euro area due to the faltering world economy, the rise in oil and other energy prices, and the stronger euro. Lacklustre domestic demand and structural problems in the euro economies have also contributed to the slower growth. In order to encourage growth, the European Central Bank (ECB) has refrained from raising interest rates, which has widened the gap between European and US rates, in the latter’s favour. The difference in short-term market interest rates is already almost two percentage points. In recent months this has boosted demand for dollar investments and led to a slight weakening of the euro, which, in turn, has improved export competitiveness in the euro area.

Euro area GDP growth is expected to pick up slightly in 2006, to just short of 2%. However, this will still be below the growth rates in the rest of the world. The latest statistics point to a modest growth in euro area demand and investment. Both consumer and corporate confidence in the economy have also
risen. Not wishing to smother the emerging economic recovery, the ECB is scarcely likely to raise its central rate before the first half of 2006. With the US Federal Reserve likely to increase interest rates further in late 2005 and early 2006, the interest rate gap with Europe will widen and a further slight weakening in the euro can be expected. Consumer prices are expected to rise in 2006 by somewhere in the region of 2%. If there are no energy and oil price increases, inflation will probably remain at about 1%.

Although the euro area’s overall price competitiveness in real terms will improve in 2006 as the result of low inflation and a weakening euro, the effects of this will be felt in the area’s economies in different ways because of their structural differences. The impact of a rise in crude oil prices will also differ from one country to the next. With its traditional role of driving the euro area’s exports, the German economy has been export-led, whereas growth in the French economy, for example, has been stimulated by strong domestic demand. By contrast, Italy’s labour-intensive economy has lost market share in many sectors to low-cost countries, and so an increase in price competitiveness will improve the prospects for Italian exports.

GDP growth in the countries that joined the European Union in May 2004 will be lower in 2005 than the previous year. With falling domestic demand, rising inflation and structural economic problems, in addition to slack demand in the euro area, the GDP growth in these new member states is estimated to average 3.5% in 2005, rising to about 4% in 2006. The Baltic countries form an exception, however, as their GDP growth is forecast to remain at over 6% in both 2005 and 2006; in Latvia, the 2005 figure will be as much as 7.5%. This level of growth is sustained by private consumption and above all by investment and export growth, which are in excess of 10%. The underlying reasons are a stable rise in employment, low interest rates, an increase in domestic purchasing power and the stability brought by the pegging of Baltic currencies to the euro. High inflation and a rapid rise in credit portfolios are nevertheless a cause for slight uncertainty over the growth forecasts.

Among the EU countries not belonging to the euro area, Sweden’s GDP growth for 2005 will be down to just over 2% but will return to close on 3% in 2006. The country’s fiscal policy measures and its low inflation will increase domestic purchasing power and household consumption in 2006. Investment will be maintained due to low interest rates and the level of confidence in the economy. Construction will be up by over 10% for the full 12 months of 2005, and will be well over 5% in 2006. With low inflation prevailing, the Swedish central bank, the Riksbank, is unlikely to be under any pressure to raise interest rates before mid-2006. Although the krona weakened by a little over 3% against the euro in January–September 2005, it is expected to regain this as it strengthens in 2006, but Sweden’s export competitiveness will remain high.

**German Economy Almost at a Standstill and UK Growth Slowing Down**

Germany and the United Kingdom are the most important European export markets for the Finnish forest industry. Growth in the German economy has been below the euro area average in recent years and has slowed almost to a standstill in the second quarter of 2005. The country’s economy has traditionally been export-led. The weak trend in consumer purchasing power, together with gloomy consumer expectations, has reduced domestic demand and encouraged precautionary saving by households. Nevertheless, there has been a slight improvement in indicators of corporate production expectations and order books, and the growth prospects for the second half of 2005 show an improvement on the first six months. The impact on the economy as a whole, however, will be felt more slowly. Indeed, Germany’s GDP growth for 2005 is estimated to be
a modest 1.2%, and the projected growth for 2006 is only a little higher, at about 1.5%. Employment is improving on the German domestic market, and consumer confidence in the economy has grown slightly in recent months, which should lead consumer demand to pick up somewhat in 2006. The structural changes in the German economy and labour market will gradually increase corporate productivity, competitiveness and profitability, and, together with an improvement in real price competitiveness, will create the right conditions for an increase in exports.

The United Kingdom’s 3.2% GDP growth in 2004 was significantly higher than in the euro area. Low interest rates, an increase in real earnings and a low unemployment rate have together maintained consumer confidence in the economy, and, with UK exports feeling the effects of the weak demand in the euro area, most of the GDP growth has been based on an increase in private consumption and household indebtedness. The halt in rising house prices experienced in the second half of 2004 led to a slowing of private consumption, which appears to be continuing in 2005, as indicated by the increase in the rate of saving. The UK’s GDP growth for 2005 is therefore expected to be down to about 2%.

In 2006, UK growth is forecast to be very similar to that in the euro area economies. To ensure that growth continues, the Bank of England is unlikely to raise its central rates, and so the interest rate gap in favour of the United States will grow and the pound will weaken a little against the dollar. Even if the euro rate against the pound remains unchanged, the improvement in price competitiveness in real terms and the recovery in euro area demand will lead to a turnaround in the UK’s trade balance with euro area, turning the UK into a net exporter. Investment and private consumption will also be up on the 2005 figures. The UK’s GDP growth for 2006 is forecast to be 2.2%.

**Slowdown in Russian GDP Growth Due to Inability to Increase Oil Exports**

The value of Finnish forest industry exports to Russia in 2004 amount to EUR 380 mill., and this is expected to increase substantially in the coming years. Russia has also become a significant forest industry competitor for Finland, especially on the export market for sawmill products. Assisted by oil revenues, Russia’s GDP growth was over 7% in 2003 and 2004, and its domestic demand and investment have also increased. The growth has been concentrated very much in the major cities and a number of key industrial areas. The increase in foreign exchange earnings has led to a strengthening of the ruble against the euro/dollar basket in recent years, which, together with an annual inflation rate of 10%, has weakened the price competitiveness of Russia’s exports in real terms. Despite interventions by the Russian Central Bank resulting in a devaluation of the ruble in January–August by 13.9% against the euro and 2.9% against the US dollar, the ruble is forecast to strengthen in 2006.

Russia’s oil production capacity is today almost fully utilised, and so the country’s oil exports cannot be increased in the future without considerable investment. Russian GDP growth is in fact forecast to slow down in the near future and to be increasingly based on rising consumer demand. The country’s GDP growth in 2005 is expected to drop to 5% and to be slightly less than 5% in 2006.

**US GDP Growth Continues, but Uncertainty Increasing**

GDP growth in the United States in the first six months of 2005 was 3.6%, down on the previous year’s figure of 4.2%. The main reason for this slowdown was the slight reduction in private consumption. Investment, on the other hand, has continued to grow at a brisk rate. The good level of growth in the economy has also produced a lot of new jobs.
Provided that consumer confidence in the economy remains good, the estimated 3.5% GDP growth for 2005 should materialise.

The growth prospects for the US economy are subject to uncertainty because of a number of factors, and these could therefore also affect the world economy in general. GDP growth in the United States has for many years been based on growth in household consumption, which has largely been financed through debt. However, at some stage, households must start to improve their financial position by repaying their loans, which will inevitably mean a reduction in consumer demand. With low interest rates and high GDP growth, house prices have also risen rapidly in many parts of the country. Interest rate increases by the Federal Reserve and a possible drop in demand could cause a fall in property values and in the value of other real assets.

Major, macro-scale problems in the US economy remain unresolved. The federal budget has long been in deficit and has been financed largely by overseas borrowing. Alongside a massive balance of trade deficit, the US balance of payments’ current account deficit was as much as 6% of GDP in the first half of 2005, which by international standards is alarmingly high. The 2.1% revaluation of the Chinese renminbi has had no significant effect on the US trade deficit and did not produce any relief for US domestic industry in its competition with imports.

The Federal Reserve has gradually raised its federal fund rate in order to control domestic demand and rising inflation. The three-month market interest rate is close to 4%, and long-term rates are a little higher still. Interest rates higher than those in the rest of the world have attracted international investment in the dollar. The widening interest gap in relation to euro area rates means a further strengthening of the dollar, which will further slow the growth in exports and add to the debt burden, because US debt is primarily in dollars while its receivables are in other

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

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<td>New EU member countries (10)</td>
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<td>3.5</td>
<td>4.1*</td>
<td>4.0</td>
<td>4.4*</td>
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<td>3.5</td>
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<td>6.1</td>
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<td>Other</td>
<td>10.9</td>
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* Include Bulgaria, Romania and Croatia

Forecast by Research Institute of the Finnish Economy (ETLA) published September 8, 2005.
Forecast by International Monetary Fund (IMF) published September 21, 2005.
currencies. Any increases in interest rates could also have a negative impact on household confidence, which is already under threat from the higher crude oil and liquid fuel prices, a drop in purchasing power and the destruction caused by the autumn storms.

In spite of all these uncertainties, it must be assumed that international investors will continue to bankroll the United States. With neither the euro area nor Japan being ready to drive the world economy, there is no desire to upset the US economy and plunge the rest of the world into recession. To maintain a balance, the Federal Reserve will, however, have to raise its federal fund rates in 2006 as well. This will keep domestic consumer demand in check, generate pressure for a strengthening of the dollar and slow the GDP growth to something in excess of 3% in 2006.

Among the Finnish forest industry’s competitors, Canada has benefited from the growth in the US economy. Canada’s 2005 GDP growth is expected to be at the 2004 level of about 3%. Although the Bank of Canada is expected to tighten its interest rate policy before the end of 2005, to guard against inflation and overheating of the economy, the country’s domestic consumer demand and investment will continue to be high in 2006. Canada’s exports will also be helped by the slight weakening of the Canadian dollar against the US dollar (by about 2%) and by a continuation in the level of consumer demand in the US economy. Canada’s GDP growth in 2006 is forecast to accelerate to 3.5%.

China Continues to Drive Asian Economy, while Japan’s Economy Sees a Slow Recovery

In the last few years, the Chinese economy has been growing at an average annual rate of almost 10%, and China has partially displaced Japan as the driving force in the Asian economy. This growth is mainly the result of an increase in exports and domestic investment, and efforts have been made to keep the latter under control by raising domestic interest rates. China’s export growth has been very strong. Exports in January–February 2005, for example, were 36% higher than in the same period in 2004. Exports have been boosted by strong price competitiveness as a result of the country’s low labour costs and the weakness of its currency against the US dollar and the euro. The increased demands from the US and Europe for an exchange rate adjustment led to a 2.1% revaluation of the renminbi in spring 2005 and its pegging to a basket of currencies. In practice, the main outcome of such a small revaluation was to allow China to buy time for political manoeuvring and avoid a trade war breaking out; it is not likely to have any marked affect on trade flows between China and the rest of the world. This, and the fact that domestic investment and consumption will also remain high despite the measures to keep them in check, means that China’s strong GDP growth is expected to remain at almost 10% in both 2005 and 2006.

Although Japan’s GDP growth in 2004 amounted to 2.6%, total output in the second and third quarters of 2004 was actually down on the corresponding figures for the previous year. Output picked up in the final quarter, and in the early part of 2005 it was growing at an annual equivalent of 5.3%. The reason for this growth was an increase in exports, especially to China and the United States. Domestic demand has remained lacklustre as a result of deflation and consumers’ poor expectations about the future. The scope for using monetary and fiscal policy to revive demand has been limited on account of the already low interest rates and the high public sector deficit. Although the Japanese economy has not performed as well as in 2004, the outlook in the latter part of the year is already improving, and Japan’s 2005 GDP growth will reach almost 2%. This is the result of structural reforms in the economy, growth in retail sales, a steady reduction in the unemployment rate and a positive trend in corporate investment. Despite the slow recovery on the domestic market, growth in Japan’s economy is strongly dependent on the trend in the rest of the world. If trade with the United States and China continues to be good, Japan’s GDP growth in 2006 should remain at about 2%.