

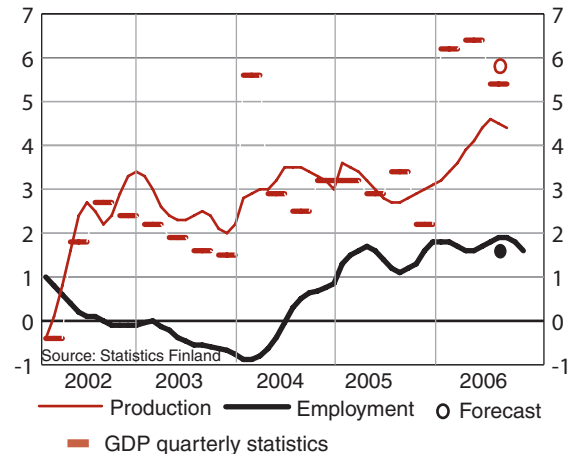


ECONOMIC BULLETIN

Ministry of Finance Economics Department, Finland
December, 2006/4

The Finnish economy is still growing strongly. In the first three quarters of this year, GDP growth exceeded last year's level by 6 per cent, and the growth figure for the whole of 2006 is expected to be over one percentage point higher than this summer's 4.5 per cent forecast. The economy is growing at a record rate similar to the one witnessed in 1997-98, except employment, growing at a rate of 1.6 per cent, is slower by half than during the boom a decade ago, whereas productivity growth is correspondingly higher. GDP growth will slow down to around 3 per cent next year and the overall economic upswing is likely to remain intact.

Total output and employment
y-o-y change in trend, %



The **international economy** remained strong this autumn. Business and consumer confidence in the euro area was high, rising even further towards the end of the year. Apart from Spain and Italy, expectations have been better than before in most larger member states. With domestic demand having perked up and export-oriented industrial output still growing steadily, economic activity has been boosted. In the third quarter of this year, GDP in the euro area exceeded last year's level by 2.7 per cent and growth for the whole of the year is estimated at 2½ per cent – the fastest rate since the end of the last millennium. Even though the euro has appreciated in value, next year's prospects in Europe also look favourable. Fuelled by strong output, employment is improving at a rate of over 1 per cent and unemployment will edge down below 8 per cent.

House prices in the United States have started falling and production growth has slackened. However, lower oil prices have bolstered growth in demand and slowed down price rises. Economic growth in China and Russia remains strong.

In Finland, growth in total output soared early this year. Although exceptional factors such as the forest industry stoppage last year partly explain the high figures recorded early in the summer, underlying growth has nonetheless been both robust and extensive. In the third quarter output still grew at a rate of 5½ per cent, and in the first three quarters of this year GDP exceeded last year's level by 6 per cent. Private investment has increased more than was projected in the summer while imports have grown less than anticipated. GDP growth will decelerate towards the end of the year but will nonetheless climb close to 6 per cent for the whole of the year. With no more exceptional factors expected and international demand dampening, GDP growth is expected to slacken next year, but will nevertheless grow at a rate of about 3 per cent.

The surge in output growth and high figure in terms of the prevailing business cycle is explained not only by favourable demand factors but also by an exceptional boost in productivity. Productivity growth

accounts for altogether 4½ percentage points of the 6 per cent increase in output while labour input accounts for a mere 1½ percentage points of the rise. The high growth figure is partly also explained by changes in the way the national accounts are computed.

Foreign trade remains brisk. The increase in metal products exports coupled with the technical rise in the forest industry boosted growth in the volume of goods exports to 15½ per cent between January and September. The drop in service exports brought overall exports growth down to 11 per cent, however. Goods imports, in turn, were up by 8 per cent, although total imports growth edged down to just over 5 per cent. On the whole, exports have increased as predicted in the September forecast whereas imports have fallen short of the September projection. The import figures for the first part of the year were recently lowered in the national accounts.

The hikes in world market prices in energy and raw materials have pushed import prices up more than export prices. With the fastest growth rate in international demand peaking soon, export growth will slacken next year. With the growth pace in goods transit trade through Finland having slackened, growth in both exports and imports is dampening. The current account will remain well in surplus both this year and next.

Household consumption expenditure has continued to grow fast. In the early autumn consumption was up by over 3 per cent on the year before, which is just a little less than earlier this year. The increase in consumption expenditure between July and September was mainly based on goods, as growth in purchases of services decelerated to under 1 per cent. The number of registrations of new cars dropped whereas purchases of household commodities and daily consumer goods rose.

Stronger household confidence and a rapid improvement in employment prospects coupled with a sharp rise in household borrowing has kept consumption growing strongly at a rate of nearly 4 per cent. Cuts in earned income taxes for 2006 and 2007 will also give a good boost to the purchasing power of wage earners. Growth in consumption will slow down next year, as the ratio of household debt to income is close to 100 per cent and there has been negative saving for the three years running, curbing growth in consumption and housing investment. House investment is already starting to show signs of leveling off, although new mortgages are still growing.

The period of rapid growth in **industrial** production levelled off in October, when output in the electronics industry dropped significantly. However, with activities having remained brisk through to September, this year's growth in industrial output will prove higher than that predicted in the summer. With the business cycle in industry remaining favourable, the level of production will be high next year too, even though growth is likely to slow down on this year.

Domestic trade is still brisk and in the third quarter of this year sales volumes were up by 7 per cent on last year's third quarter. Retail trade confidence is likewise buoyant and sales are not expected to slow down to any significant degree in the next few months. Turnover growth in private services has been faster this year than in nearly five years and is likely to slightly exceed the previous projection. The pace is expected to slacken slightly next year.

Growth in **employment** has slowed down since last winter but remains at the projected annual rate of 1.6 per cent. Labour demand has been brisk in recent months especially in private services. With nearly 40,000 job gains in 2006, the employment rate will climb to 68.8 per cent. This, combined with last

year's job creations, will raise this government's job gains to around 80,000 by the end of this year. Employment will continue to grow next year too, although at a slower pace, and the government's aim of creating 100,000 new jobs during its term in office will fall just a little short of the target. On the other hand, with labour supply continuing to grow fast, the overall unemployment rate for 2006 is estimated at 7.8 per cent, which is 0.1 percentage point higher than predicted in September.

In spite of persistently high unemployment, production potential in the economy is fast reaching maximum capacity, because although goods imports have risen and the use of foreign labour has increased, resource constraints and the risk of overheating have both mounted in some areas. There were nearly 41,000 job vacancies in the third quarter of this year, 6,000 more than a year ago, and almost half of them were difficult to fill.

Inflationary pressure has not risen to the extent feared in the early autumn. World market prices of crude oil and prices of oil products have dropped since the summer. A stronger euro has curbed price rises in imports to some extent too, and thanks to heavy rains, the pressure to raise the price of electricity has decreased. For the first time in five years, the annual rate of growth in the consumer price index exceeded 2 per cent, but is expected to decelerate in the early months of next year. Consumer prices are calculated to rise by 1.6 per cent on average in 2006.

This year the ratio of **general government** tax and social security contribution levies to GDP will come down by over one percentage point and debt ratio will decrease even more, down to 38 per cent. The public sector expenditure-to-GDP ratio is estimated to diminish to 48½ per cent this year. The public sector financial surplus settled at 2.5 per cent of GDP last year, from where it is anticipated to edge up to close to 3 per cent this year and next.

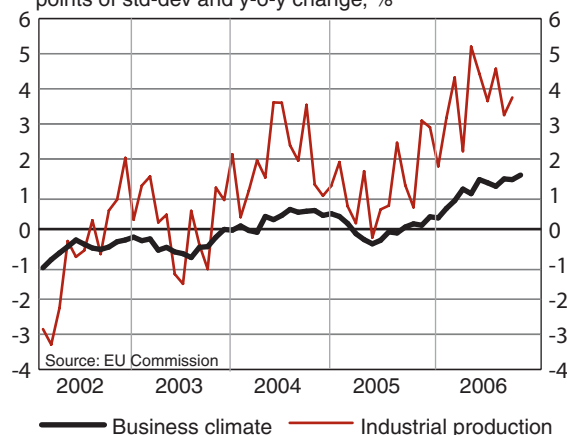
Central government finances, showing a surplus this year, will remain in surplus over the whole of this government's term of office. The third supplementary budget will bring central government debt down more than previously estimated. Debt will be reduced by altogether 1.5 billion euros in 2006, bringing the debt down to an estimated 58.6 billion euros, 34.8 per cent of GDP.

Expenditure in local government has continued to grow strongly this year, and particularly purchases of services picked up speed much more than anticipated. Thanks to faster than expected growth in tax revenue, the deficit in local government will diminish from last year. Slower growth in payroll expenses will ease expenditure pressure in the municipalities next year. The surplus in the social security funds promises to remain virtually unchanged, ensuring a surplus for the whole public sector. The growing investment portfolio of the employment pension funds reached 65 per cent of GDP at the end September.

International economy

Euro area business confidence was high especially in industry, services and retail in November. The favourable outlook was reflected in industry in terms of higher stock order volumes and in the level of finished goods inventories. Stock orders, however, were lower in September. Industrial output grew by a good 3 ½ per cent in October.

Euro area business climate and industrial output,
points of std-dev and y-o-y change, %

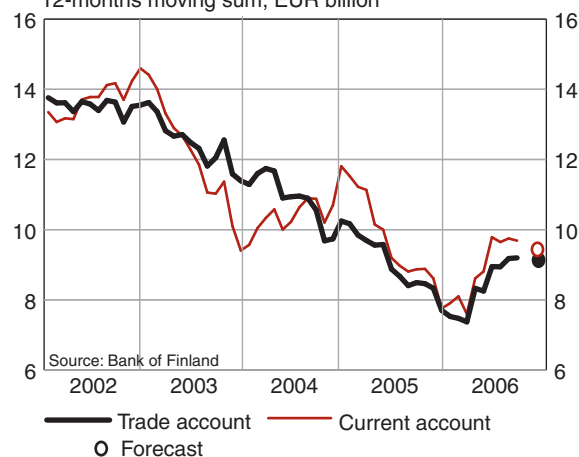


Economic development in Finland

The 12-month moving total in the **current account** surplus stayed at 9.6 billion euros in October, in other words slightly higher than predicted. The trade account surplus totalled 9.2 billion euros, as anticipated. The value of exports grew slightly more than that of imports. An increase in factor incomes and income transfers together with strong export growth has boosted the current account surplus.

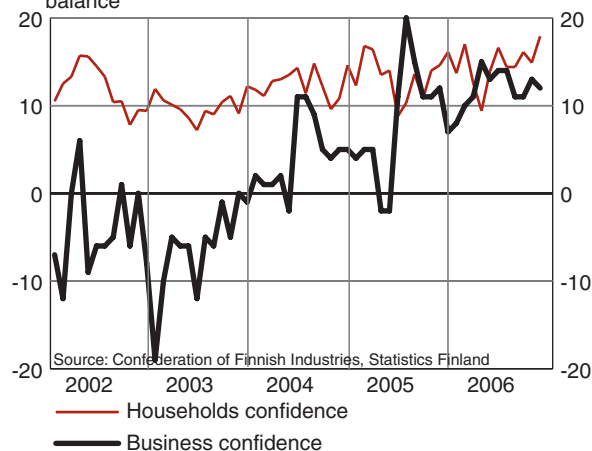
External balance

12-months moving sum, EUR billion



Cyclical expectations remain very positive. Industrial confidence was still good in November but stock orders levelled off and the stock of finished goods grew. Following the slight dip early this year, consumer confidence rose in November to the highest level since January 2001. Household confidence in both their own prospects and those of the Finnish economy remains more positive than average.

Industrial and households confidence
balance



The annual rate of growth in the **consumer price index** was 2.1 per cent in November. Producer prices in industry have continued to increase much faster than consumer prices. Despite labour supply shortages, wage drift would appear to stay moderate and the earnings level of wage earners will rise by an average of 3 per cent. The decrease in unemployment has slowed down below the 8 per cent threshold.

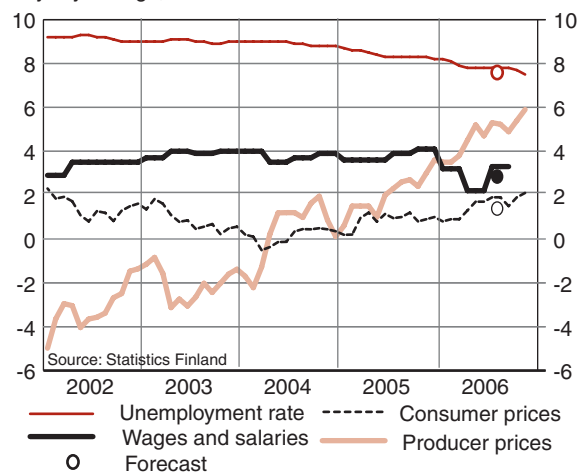
On-budget tax revenue grew by 7 per cent between January and November on last year. VAT receipts were up by 15 ½ per cent, half of which is explained by the fact that VAT accrual is not longer remitted to the Social Insurance Institution. Dividend income in central government almost doubled on last year, partly due to one-off items, such as the sale of Kapiteeli plc. hotel property, which brought an extra 200 million euros in dividends to central government in September.

Revenue grew by altogether 9 per cent between January and November. Expenditure excluding debt redemptions was up by 4 per cent. Transfer expenditure grew the fastest, partly because VAT entries to the Social Insurance Institution were replaced by direct budget transfers. There was an on-budget surplus of 3.1 billion euros between January and November.

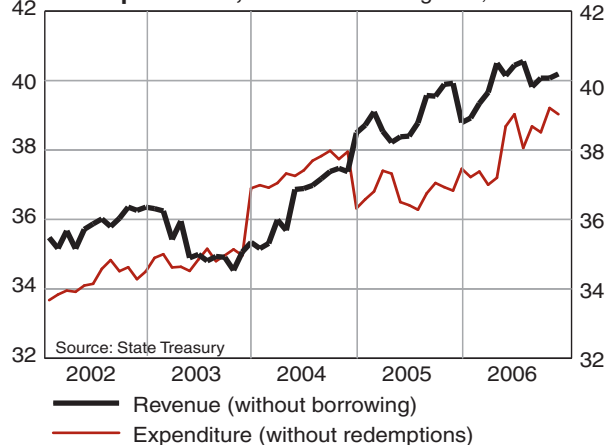
Short **interest rates** have been rising but long ones have remained low. The average interest rate on mortgages is over 4 per cent, exceeding the under 3 per cent rate of 18 months ago. Mortgage growth is gradually easing, edging down to the tune of 14 per cent, having peaked at nearly 17 per cent before.

The house markets show signs of slight levelling off. In the third quarter of this year, the prices of old flats rose by 0.9 per cent on the second quarter in the whole country and by 1.3 per cent in the Helsinki metropolitan area. The rise was still over 9 per cent on last year in the Helsinki area.

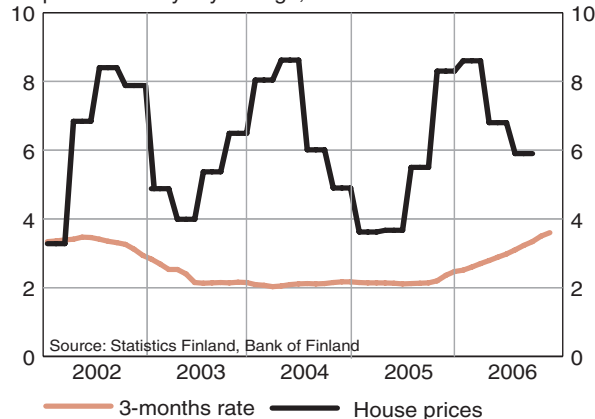
Unemployment rate, prices and earnings
y-o-y change, %



Central government budgetary revenue and expenditure, 12-months moving sum, Eur billion



Short interest rates and real housing prices
per cent and y-o-y change, %

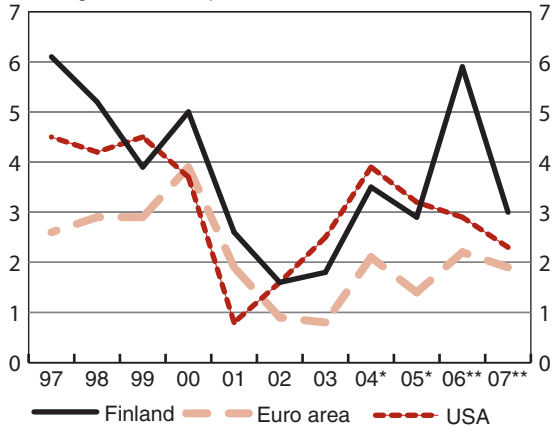


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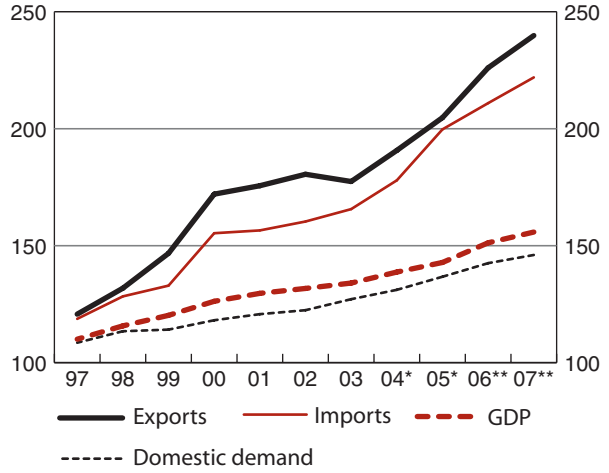
GDP

change in volume, per cent



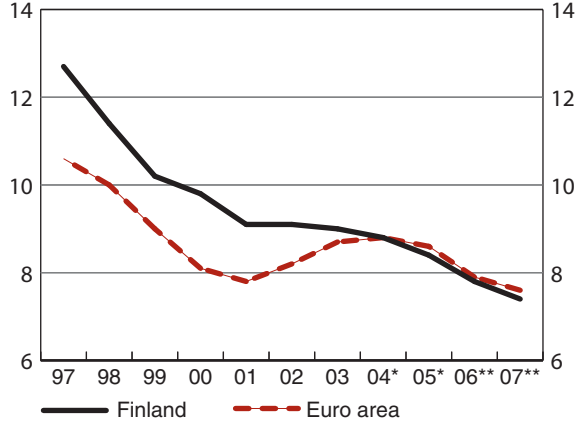
Supply and demand

1995=100



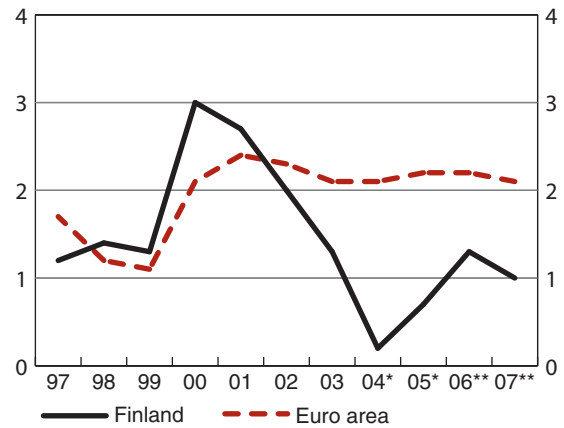
Unemployment rate

per cent

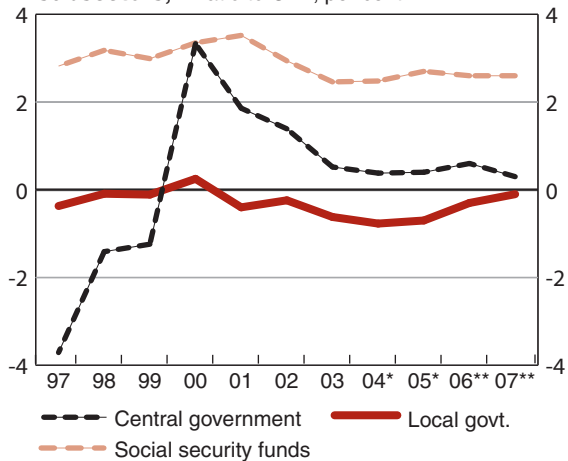


Inflation

per cent

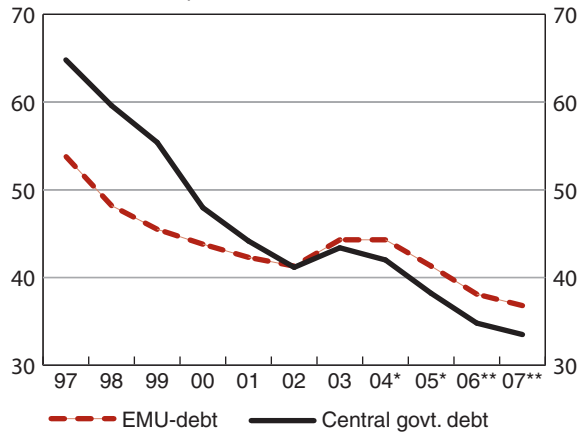


The financial balance of general government subsectors, in ratio to GDP, per cent



General and central government debt

in ratio to GDP, per cent



Key forecast figures¹⁾

	2005*	2003	2004*	2005*	2006**	2007**
	EUR bn	change in volume, %				
GDP at market prices	157	1.8	3.5	2.9	5.9	3.0
Imports	57	3.3	7.4	12.3	5.6	5.2
Total supply	214	2.1	4.4	5.2	5.8	3.6
Exports	66	-1.7	7.5	7.3	10.4	6.1
Consumption	116	3.8	2.8	3.2	2.9	2.1
private	81	4.8	3.2	3.8	3.6	2.7
public	35	1.5	1.7	1.6	1.0	0.8
Investment	30	4.0	4.9	3.3	6.4	3.7
private	25	3.2	4.9	5.9	7.1	4.0
public	4	8.4	4.5	-10.4	1.8	1.5
Total demand	214	2.1	4.4	5.2	5.8	3.6
domestic demand	148	3.8	3.1	4.2	4.3	2.4

¹⁾ The figures were calculated using the revised national accounts method.

	2003	2004*	2005*	2006**	2007**
Services, change in volume, %	0.4	3.2	2.6	4.0	3.0
Industry, change in volume, %	2.6	4.4	3.9	9.3	4.7
Labour productivity, change, %	1.2	2.8	2.1	4.2	2.4
Employment rate, %	67.3	67.2	68.0	68.8	69.1
Unemployment rate, %	9.0	8.8	8.4	7.8	7.4
Consumer price index, change, %	0.9	0.2	0.9	1.6	1.4
Index of wage and salary earnings, change, %	4.0	3.8	3.9	2.9	2.5
Current account, EUR bn	8.7	11.6	7.2	9.6	8.7
Current account, % of GDP	5.9	7.6	4.6	5.7	5.0
Short-term interest rates (3-month Euribor), %	2.3	2.1	2.2	3.1	3.7
Long-term interest rates (10-year Govt. bonds), %	4.1	4.1	3.4	3.8	4.1
General government expenditure, % of GDP	50.0	50.3	50.1	48.5	48.3
Tax ratio, % of GDP	43.8	43.5	43.8	42.6	42.4
General government net lending, % of GDP	2.3	2.1	2.5	2.9	2.7
Central government net lending, % of GDP	0.5	0.4	0.4	0.6	0.3
General government gross debt (EMU), % of GDP	44.3	44.3	41.3	38.1	36.8
Central government debt, % of GDP	43.4	42.0	38.2	34.8	33.5

Sources: Statistics Finland, Bank of Finland, OECD, EU
Forecast: Ministry of Finance, Economics Department