

Finland—2010 Article IV Consultation Concluding Statement

1. **Globalization has greatly benefitted Finland over the last two decades, but has also left it particularly exposed to the global crisis.** Given its extensive trade linkages and export characteristics, the economy has been hit hard, although there are signs of recovery. A decade of fiscal surpluses has allowed full operation of automatic stabilizers as well as sizable stimulus measures. The banking sector has weathered the crisis well, thanks to healthy capital buffers and prudent management. Nonetheless, it faces increased risks to profitability and asset quality. Recent international market turbulence in the wake of the Greek crisis adds some uncertainty to the outlook for the financial sector and the overall economy. Looking forward, rapid population aging and recent losses of competitiveness pose increased challenges to growth prospects and fiscal sustainability. Thus, measures to improve budgetary prospects and renewed efforts to increase the effective utilization of labor resources and to boost productivity are called for.

Macroeconomic situation and outlook

2. **Finland's economy contracted by 7¾ percent in 2009, the largest decline in the euro area, reflecting primarily a massive deterioration in external demand.** The latter resulted from the dependence of exports on countries and commodities—telecommunications and capital goods—particularly impacted by the crisis. While investment collapsed, the impact on private consumption was muted by a lower-than-anticipated drop in employment (owing to government-subsidized employment-support programs and concerns about future labor shortages given demographic trends), as well as continuing strong real wage growth from generous multi-year salary agreements and subdued inflation. This led to an erosion of profitability and external competitiveness, which however remains adequate. Inflation, while falling amid a substantial output gap, nevertheless remained above the euro area average.

3. **The mission projects a resumption of activity for this year, although the outlook is unusually uncertain.** Net exports and private consumption have grown in recent quarters, and consumer and business confidence have picked up. Nonetheless, with growth projected at only 1¼ percent this year and around 2 percent in 2011, output is anticipated to remain well below potential and inflation to decline (despite the mid-year increase in VAT rates). Consumption and investment will be constrained by lower and sluggish household net worth, rising unemployment, tighter credit, and large capacity overhangs. At the same time, low interest rates, fiscal stimulus measures, and large automatic stabilizers should continue to sustain demand, leading to a fairly large budget deficit in 2010.

4. **The crisis is anticipated to lower medium-term output levels markedly.** The deep recession is likely to reduce the trend level of output, as noted also by Statistics Finland—the

result of a major drop in investment and the obsolescence of physical and human capital with large unused capacity accompanied by sector-specific negative shocks. Over the medium to longer run, the crisis may also weigh down potential output growth. This will exacerbate the challenges posed by a rapidly aging population, not least to long-term fiscal sustainability.

Financial Sector

5. The Finnish banking sector has weathered the global financial turmoil well owing to healthy capital buffers, prudent management, and strong supervision.

- Finnish banks have limited exposure to opaque structured products or vulnerable countries, including those within Europe. More generally, defaults in any individual foreign partner would trigger negligible or small losses, while only a pessimistic scenario combining defaults in Europe, or the US, or Japan would induce major losses in Finland. Thus, spillover risks appear manageable. Nevertheless, international contagion may still be a relatively important hazard, owing to the high degree of foreign ownership and concentration of the banking system. This concern is now made more acute by heightened risk aversion and international market volatility in the aftermath of the Greek crisis.
- Top-down stress tests indicate that the Finnish banking system is resilient to a variety of shocks. Credit, liquidity, and concentration are the largest sources of risk. Deteriorating asset quality related to the global crisis and associated adverse cyclical conditions will put additional pressure on bank profitability already lackluster from tight interest margins. Sizable reliance on wholesale funding requires greater liquidity buffers. Concentration in exposure to the main clients is also a distinct vulnerability. However, regulatory capital adequacy in the four largest banking groups would not be impaired except under an extreme scenario similar to the 1990s banking crisis.

6. The mission notes that bank support actions have been broadly appropriate and consistent with those of other countries. The enlargement of deposit insurance and liquidity extension on full allocation basis were in accordance with EU-wide measures. Guarantees for bank liabilities and capitalization facilities, although not used, envisage sunset provisions (§19) and are consistent with a sound “fix-it-and-exit” approach aimed at avoiding the persistence of competitive distortions.

7. Improvements in cost efficiency will be crucial to sustain banking profits, while the focus on prudent behavior should continue. Intense competition has reduced banks’ net interest margins, which are lower than in neighboring countries. With prospects of higher funding costs, possibly associated with ongoing nervousness in sovereign borrowing markets but also with adjustments to banks’ funding structures in response to likely international regulatory changes, measures to streamline costs will be important. Moreover, financial firms and households should be cautious in engaging in higher risk activities—including the recent

surge of low variable interest rate mortgages when residential housing prices are already accelerating—in a quest for better returns under the present uncertain environment.

8. The mission underscores that effective supervision and crisis management frameworks for systemic cross-border institutions are key issues for Finland.

- With a mostly foreign-owned banking system, supervisory responsibility cannot be borne effectively by Finnish supervisors alone. The recently completed IMF Financial Sector Assessment Program (FSAP) update noted that some tools used for cross-border supervision could be enhanced, in particular by increasing the effectiveness of supervision of foreign banks' branches and pursuing clear agreements on specific information to be distributed by home supervisors through efficient communication channels. The mission welcomes the authorities' support for the ongoing EU initiatives aimed at more effective cross-border supervision and for the regulatory proposals by the Basel Committee to strengthen financial sector resilience and reduce pro-cyclicality of capital requirements.
- Nonetheless, with several institutions of systemic importance owned by banks incorporated in neighboring countries, design of an effective resolution framework requires close coordination with other Nordic authorities. In this regard, the FSAP update concluded that, should EU-wide agreements in this area be delayed, the authorities ought to consider measures at the Nordic level to mitigate contagion by containing the too-big-to-fail risk.

9. The mission recommends additional improvements in regulation and supervision to buttress the financial system. The FSAP update observed that the adoption of a bank-specific insolvency regime, preferably at the EU level, would enhance the cost-effectiveness and speed of bank resolution. Vigilance on liquidity risk and banks' funding profiles could be intensified. The ongoing integration of banking and insurance supervision in FIN-FSA could be further strengthened, with a view to enhance the assessment of the (consolidated) risk profile of complex financial groups active in Finland.

10. There is also scope to strengthen further the analytical frameworks for stress testing and systemic risk assessment. The FSAP update recommended steps that include: (i) enhanced monitoring of mortgage practices and specific tests on household debt service capacity in light of the likely future increase in interest rates; (ii) strengthened top-down stress testing by modeling the impact of macro-financial variables on a bank-by-bank basis; and (iii) enhanced systemic risk framework by using more granular information on cross-border exposures and non-bank elements of the financial sector.

Fiscal Policy

11. **In reaction to the massive economic downturn, policy makers have shifted priority to support growth through fiscal policy.** Automatic stabilizers have been allowed full operation, with output contraction reducing budgetary revenues and income-support for the newly unemployed rising. In addition, the authorities have actively combated the recession through tax cuts, the expansion of social benefits—including for enhanced training and government-subsidized part-time employment programs—and an acceleration of investment in infrastructure, as well as subsidies and tax allowances for businesses, especially small- and medium-sized enterprises. Moreover, in 2009 the government made available about ½ percent of GDP in the form of “below-the-line” financing to distressed nonfinancial corporations that does not directly worsen the fiscal balance but adds to gross debt. All told, the economic downturn and expansionary policies have turned a 4 percent of GDP general government surplus in 2008 to a projected deficit of a similar magnitude this year. Accordingly, the structural primary balance is expected to decline by 3½ percent of GDP over 2009-10, reflecting the discretionary stimulus measures.

12. **The mission endorses the expansionary fiscal policy implemented in 2009-10 to sustain economic activity.** The discretionary stimulus package—among the highest in the euro area as a share of economic activity—was necessary given the scale of the collapse in output as well as uncertainty regarding the economic recovery. Its impact has been appropriately enhanced by the coordinated expansionary measures—both budgetary and monetary—of European and other trading partners. Indeed, given the small size and openness of its economy, fiscal expansion in Finland alone would have been ineffective.

13. **However, some concerns remain about the composition of fiscal measures.** In principle, fiscal stimulus should rely on actions that can be implemented swiftly and clawed back quickly once growth prospects improve, thus minimizing the negative impact on the long-term budget position. However, only about one-third of the total discretionary expansion in 2009-10 of some ¾ percent of GDP is temporary, implying that it will add about 2 percent of GDP permanently to the structural deficit.

14. **The mission emphasizes that the long-term fiscal position has weakened considerably.** Besides the structural fiscal relaxation in 2009-10 with its permanent features and the below-the-line operations in support of the corporate sector, the global crisis has led to deterioration in potential output and, at least in the short- to medium-term, trend growth prospects. As a result, considering also the expected increase in aging-related spending, the sustainability gap—namely the amount of additional measures necessary to secure the stability of public debt in relation to economic activity—is estimated to have increased from some 1½ - 2½ percent of GDP in 2008 to about 5½-6 percent of GDP now. While immediate full adjustment on this scale is implausible, delaying it would require an eventually higher long-run primary surplus to ensure sustainability.

15. Thus, a measured budget consolidation starting from 2011 is recommended.

While front-loaded fiscal retrenchment is desirable from an intergenerational equity perspective, to contain the size of the ultimate adjustment, and in view of pressures in sovereign bond markets, output is projected to remain below potential through 2014. This requires balancing the twin objectives of reducing the output and fiscal sustainability gaps. A structural adjustment of $\frac{1}{2}$ - $\frac{3}{4}$ percent of GDP in 2011 would appear appropriate, because it would bring the deficit within the SGP ceiling and not jeopardize the recovery. The authorities are considering a somewhat larger adjustment in 2011, which could be indicated if underlying growth turns out as strong as anticipated by them.

16. The mission also counsels a strong and credible commitment to fiscal consolidation for the medium- to long-run. With parliamentary elections in 2011, clear identification of time-bound fiscal adjustment targets for 2012-15 and supporting measures to be enshrined in the program of the new government is essential to make progress toward fiscal sustainability. Given the tradeoff between output and public debt stabilization, the mission believes that an adjustment slightly higher than $\frac{1}{2}$ percent of GDP per annum on average would be desirable and close the sustainability gap by 2020. Nevertheless, these fiscal objectives should be pursued flexibly, with the option to delay somewhat the headline adjustment in exchange for structural measures (such as increasing the retirement age), which improve significantly fiscal sustainability, but have only a modest short-run impact on the government balance.

17. Fiscal adjustment efforts should focus on expenditure retrenchment and tax base broadening. Special tax treatments could be trimmed, for instance by a gradual reduction of mortgage interest deductibility. On the other hand, prevailing tax rates and international tax competition leave little room for rate increases, with the limited exception of the VAT and property taxation. Moreover, the expenditure-to-GDP ratio is fairly high already and set to increase for demographic reasons. Also, expenditure-based consolidations have proven generally more durable. In this light, the central government spending ceilings framework, which has served Finland well, should be maintained, while pension, health- and old-age care reforms, as well as an overhaul of local government, are key to containing expenditures. These should include:

- Raising the effective retirement age (as currently planned), reducing the accrual rate for pension benefits, and tightening access to early retirement via disability or unemployment, all of which can markedly trim pension outlays.
- Reform of municipalities—responsible for most social spending and the government sector with the fastest expenditure increases. Reliance on highly cyclical corporate taxes, which tends to boost spending in good times, ought to be reduced, offset by higher property taxation. A ceiling on municipal income tax rates, and restrained growth in central government transfers, would strengthen incentives for expenditure

consolidation. Efficiency gains are possible through greater use of information technology, outsourcing in service provision, and further mergers of municipalities.

Furthermore, an increase in user fees could moderate growth in health expenditure. Tighter definition of entitlements in long-term care could spawn significant savings in an area where aging pressures will be strong. Also, sustained productivity increases in health- and long-term care would lower significantly projected rises in spending.

Labor and product markets

18. Renewed momentum with structural reforms would alleviate the adverse impacts of the crisis and population aging on growth, and facilitate fiscal consolidation.

The recent downturn has exacerbated the decline in labor's economic contribution, both presently and prospectively. The authorities have responded appropriately with policies to enhance training, alleviate geographic and skills mismatches, and increase labor market participation, especially at the youngest and oldest ends of the age spectrum. Further efforts to limit excessive time spent in tertiary education, and to restrict or eliminate the unemployment pipeline to early retirement would be welcome. Steps to boost competition, especially in services, should be pursued, along with continued programs to raise efficiency in the public administration and local government. Overall productivity growth could be spurred through closer research/business cooperation.

Exit strategy

19. Crisis-related measures have been adequately designed to facilitate exit. In the financial area, most initiatives are set to terminate at a predefined date, with some having already expired (§6). Furthermore, guarantees for bank borrowing have not been issued or called so far and the likelihood of any outflow of public funds in the future appears very low. Importantly, the exit strategy appropriately encompasses the broader fiscal measures taken to support the economy (§15, 16), including the repayment of the resources received by distressed non-financial companies (§11) in line with the respective contractual agreements, while the program itself should be wound down with the revival of financial markets. It also envisages gradual downsizing of temporary employment support programs (§2) as economic activity strengthens.

Conclusion

20. Finland's record of sound economic policies over the past decades has provided substantial buffers with which to address the present economic crisis. Nonetheless, given the magnitude and unprecedented nature of the economic downturn, as well as the significantly worsened fiscal position, sizable challenges loom. Prompt action will enhance the present social model, allowing both for the benefits of globalization and the provision of support to those facing difficult adjustments.