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**Finland—2008 Article IV Consultation  
Concluding Statement of the Mission**

November 3, 2008

1. **Albeit among the best EU performers, the Finnish economy faces the headwind of the international crisis and important structural challenges.** Finnish financial markets and banks have been remarkably resilient to the global turmoil so far, but the spillovers from the persistent upheaval will take a severe toll on 2009 growth. Looking forward, rapid population aging and slowing productivity threaten longer-term growth, competitiveness and fiscal sustainability. Improved pension fund management is needed to cope with aging, while growing financial integration and complexity create new risks and test supervision.

*Macroeconomic situation and outlook*

2. **Economic growth is decelerating and inflation has picked up.**

- After expanding by a strong 4½ percent last year, GDP slowed considerably in the first half of 2008 amid sharply falling consumer and business confidence. Employment growth has also all but vanished in recent months, though labor shortages and mismatches in some sectors remain a problem.
- The recent decentralized wage negotiations led to pay raises much larger than in the previous round. In some cases, including in the public sector, salary adjustments paid little heed to productivity gains. Combined with the price spikes for food and energy throughout the summer, inflation has thus exceeded the euro area average for the first time since 2002. While this also reflects excise hikes, rising unit labor costs and “core” inflation risk swelling price increase expectations, fueling second-round effects that may keep inflation relatively high and erode external competitiveness. Nevertheless, based on various measures, the latter is adequate at present.

3. **Growth is likely to slow further in 2008-09 amid dwindling domestic demand and a flagging external environment.** The mission projects it to dip to about 2 percent this year and ½ percent next year. Lower activity in major trading partners will reduce export expansion. Domestic demand should lose speed too, with consumption constrained by inflationary erosion of real disposable incomes, higher debt servicing, and falling confidence. Capital formation is expected to brake more severely for cyclical reasons, tightening profit margins, and rising financing costs. Inflation should peak at about 4 percent in 2008, before

falling back in 2009, as the pass-through of earlier food and fuel price surges fades, aided by a late-2009 cut in food VAT. Uncertainties regarding this outlook are unusually high, owing to the lasting global turbulence.

### *Fiscal policy*

4. **From a cyclical perspective a modest fiscal loosening is possible.** Current policies, including a cut in labor taxes and in the VAT on food, would result in a fiscal stimulus of about 1 percent of GDP. The mission recognizes that, in the short-term, with negative output gaps envisaged for 2009-11, there is scope for a discretionary budgetary impulse.

5. **Nevertheless, a somewhat smaller relaxation than envisaged by the authorities might be appropriate.**

- With a tight labor market, the effectiveness of demand-enhancing measures in Finland's small, open economy is limited, while budget loosening may exacerbate already strong inflationary pressures.
- Available potential output estimates are based on time-series methods which do not allow for structural breaks, such as the recent run-up in energy and commodity prices or the repeated financial shocks. This suggests that potential output may be overestimated (particularly given Finland's high energy intensity). Accordingly, the room for fiscal stimulus could be exaggerated.

In addition, budgetary margins must be preserved, should the acute global crisis require fiscal interventions by Finland to recapitalize distressed financial institutions. On balance, therefore, it could be prudent to limit the loosening to about ½ percent of GDP. A somewhat larger impulse could be feasible in Finland if a coordinated fiscal relaxation is introduced at the European level.

6. **More important than its magnitude, the fiscal stimulus should be designed to minimize the negative impact on the long-term budget position.** The mission backs actions that reduce economic distortions or can be implemented swiftly and clawed back quickly once growth prospects improve and room for loosening fades. Specifically, rapidly implementable infrastructure projects—e.g. supporting liquidity-constrained firms in housing construction—and earned-income tax cuts to promote labor force participation seem preferable. On the other hand, the cut in the VAT rate on food is not advisable (paragraph 8).

7. **Proposed medium-term fiscal policies are not yet consistent with long-term sustainability despite the enviable initial position.** The fiscal surplus of almost 5 percent of GDP expected this year would already eventually stabilize the ratio of general government's net debt to GDP, notwithstanding anticipated aging-related expenditures likely to exceed 5½ percent of GDP on an annual basis. However, the preliminary 2009 budget and medium-term plan envisage a marked decline in the structural fiscal surplus from 2008 to 2011. Thus, a

permanent improvement in the primary balance after 2011 of 1½ percent of GDP compared to the path envisioned by present policies is needed for long-term sustainability. And this gap will rise if structural relaxation through 2011 turns larger. The mission recommends filling the gap soon once economic activity recovers, because front-loading the fiscal adjustment is desirable for intergenerational equity and to contain the size of the required tightening.

**8. Expenditure restraint is the lynchpin of fiscal sustainability, but tax reform and improved pension fund yields ought to complement it.**

- The bulk of the needed adjustment should rely on containment of spending—since the public-expenditure-to-GDP ratio in Finland remains comparatively high—and improved efficiency of government programs (paragraph 9).
- Lower labor taxes can promote higher labor force participation—and possibly aid fiscal sustainability, if accompanied by a broadening of the bases of less distortionary levies. In this context, the mission does not consider advisable the planned cut of the VAT rate on food, since the VAT is among the least distortionary taxes and revenue losses must be minimized for sustainability’s sake. Indeed, the Finnish VAT base should be expanded, considering that its effectiveness is barely at the OECD average, owing to special treatments for a relatively large share of goods and services. At the same time, it would be useful to increase property taxation, low in international comparison.
- Higher returns on pension assets would also help reduce the sustainability gap. Increasing the real return in the long run to 4 percent a year (from 3 percent assumed in the baseline sustainability scenario) would lower the general government deficit in 2050 by 3 percent of GDP. More flexible investment guidelines introduced in 2007 are consistent with such a goal. The mission proposes additional steps (paragraph 14).

**9. Efficiency enhancements are key to reduce government expenditures without jeopardizing public service provision.** Population aging will boost demand for government services. Sustained productivity increases especially in education, health, and social services, which have been achieved in some other OECD countries, would significantly lower projected spending rises. However, the mission notes that public productivity has declined since 2000 in these areas, which are mainly under the purview of local governments. To improve efficiency, further enhancements to domestic and international benchmarking could help identify best practices. The mission also supports additional measures to contain the demand for public services and strengthening competition in their provision. For example, increasing resort to user charges can moderate demand and stimulate competition among suppliers, while providing them with signals to improve services. And greater recourse to contracting out, outsourcing, and well-designed public-private partnerships can make an important contribution as well.

### *Financial sector*

10. **While banks have been largely sheltered from the turmoil so far, profitability, liquidity, and mortgage lending require attention.** Exposure to US subprime assets, US GSEs, and Lehman is minimal. Except for two Icelandic banks' local operations, which are minor and have already been resolved, banks have not experienced deposit withdrawals and most have actually gained deposits. While liquidity has tightened and profitability declined, interbank markets are not frozen and capital adequacy and loan loss levels remain healthy. Banks have exhibited limited risk appetite and prudent underwriting policies, and stress tests indicate that they can withstand fairly adverse shocks. However, lending margins have been squeezed by strong competition, though more recently banks have moved to increase them. Softer economic growth, reduced non-operating and fee incomes, and rising funding costs may herald lower profitability and higher loan losses. Household and nonfinancial enterprise balance sheets remain strong, and house price increases have been much more moderate than in other European economies. Nevertheless, the increase in household debt, its concentration among younger borrowers with low net worth, and softening house prices bear watching.

11. **The authorities' measures to buttress the financial sector are opportune.** In keeping with euro area agreements, Finland raised deposit insurance to €50,000, announced a €50 billion to guarantee the rollover of term debt issued by banks (subject to compensation on commercial terms and with maximum maturity of five years), and proposed a bank recapitalization fund of €4 billion. The mission supports prompt passage of the related legislation and regulations. The mission also endorses the authorities' intention to implement these measures without distorting competition among Finnish banks.

12. **Rapid changes in the financial landscape will continue to challenge supervision.** Financial market supervision is good in Finland, and the prospective merger of the Financial Supervisory Authority and the Insurance Supervisory Authority should further improve efficiency and effectiveness. With a majority foreign-owned banking system, continued close cooperation with supervisors abroad is crucial. The still evolving harmonization of EU regulations and supervision for large cross-border institutions remains an important concern, as it is for all EU members. The mission espouses the authorities' efforts toward further clarification of supervisory and fiscal responsibility of home-host authorities in crisis resolution. It also encourages: (i) use of supervisory colleges for both subsidiaries and significant branches; (ii) improving harmonization and clarity about operation of deposit insurance schemes; (iii) developing common criteria for intervention measures; and (iv) eventual move towards a European supervisor for major cross-border institutions.

13. **The mission has recommended some improvements to future stress tests.** These aim to: (i) cover more thoroughly market risks, such as valuation losses, counterparty risks, risk concentration, and strategic risks relating to liquidity and new capital issuance; (ii) integrate more completely the insurance sector; and (iii) explore procyclicality implicit in

capital adequacy measures under Basle II. The mission congratulates the authorities for the good progress they are making toward these goals.

14. **Finnish pension funds appear in good financial health, but reforms may be required to cope with changing demographics.** While the industry suffered significant losses during 2008, its solvency levels remain well above the minimum. Recent structural changes—such as higher pre-funding, linking benefits to life expectancy, and encouraging later retirements—have all made the system more resilient. Although fundamentally a defined-benefit system, it now embeds considerable risk-sharing by the employees in terms of future benefit reduction or contribution increases. Accordingly, the merits of raising gradually funding levels and introducing a defined-contribution component option, while preserving an adequate safety net, could be considered. Together with the introduction of the EU “prudent-person rule” standard in 2007, these steps could raise long-term returns, thereby aiding fiscal sustainability. Other reforms that may be considered include: (i) integrating administration and investment functions across funds, for instance, those of local and central governments; and (ii) fine-tuning solvency regulations to reflect better the PAYG nature of the pension system, and the buffer character of its funding.

15. **While still financially sound, the insurance sector is facing the impact of the global crisis and stagnation in the life segment.** Solvency levels for insurance companies remain above minimum requirements but have dropped considerably with the steep market declines in 2008. Finnish insurers’ premium growth leveled off, with falling premia in the life segment in recent years. Accordingly, the mission recommends monitoring insurance capital and cover ratios closely and ensuring proactive recapitalization where necessary.

### *Labor and product markets*

16. **Further improvements in labor utilization and productivity are increasingly important to boost living standards and support fiscal sustainability.** With the working-age population set to decline, labor force expansion will depend more and more upon boosting the participation rate. While participation among older workers has risen sizably in recent years, in part due to the 2005 pension reform, the elderly and youth employment rates lag those in other Nordic economies. Efforts to shorten time spent in tertiary education, to improve training and reduce labor market mismatches, and to lessen poverty traps will continue to be crucial. The next round of wage bargaining ought to reflect more closely productivity increases and differentials. Measures to raise competition, above all in “sheltered” sectors of the economy, will be required to enhance productivity growth.

### *Conclusion*

17. **Initiatives to stanch the financial crisis and stimulate activity must not impede efforts to boost long-term growth and attain fiscal sustainability.** Given Finland’s strong initial position, prudent and foresighted policies should allow the economy to respond to the present shocks better than most other countries. In particular, continued steps are required to

maintain financial stability, consolidate fiscal resilience to population aging, and stimulate labor force participation and productivity. This will ensure preservation of the current social model—embracing the benefits of globalization, while supporting those who face difficult adjustments—which has served Finland well.