June 7, 2010

Finland—2010 Article IV Consultation
Summary of Concluding Statement

Globalization has greatly benefitted Finland over the last two decades, but has also left it very exposed to the global crisis, given extensive trade linkages. Prudent fiscal and financial sector buffers accumulated during recent years and good policies have allowed for these sectors to stand the turbulence relatively well. Looking forward, though, rapid population aging and recent losses of competitiveness pose increased challenges to growth prospects and fiscal sustainability.

The economy contracted by almost 8 percent in 2009, and while a rebound is expected this year and the next, the outlook is unusually uncertain. The decline, the largest in the euro area, reflected primarily a collapse in external demand. Activity has rebounded in recent quarters, and consumer and business confidence have picked up. Nonetheless, growth is projected at only 1¼ percent this year and at about 2 percent in 2011. The deep recession is likely to reduce the trend level of output, and may also have a negative impact on the growth of potential output. This will exacerbate the challenges posed by a rapidly aging population, not least to long-term fiscal sustainability.

The Finnish banking sector has weathered the global financial turmoil well owing to healthy capital buffers and strong supervision, but challenges remain. Bank support actions have been broadly appropriate and consistent with those of other countries. Improvements in cost efficiency will be crucial to sustain banking profits, while financial firms (and households) should focus on continuing prudent behavior, including for mortgage lending practices, especially in light of recent property price increases. The mission underscores that effective supervision and crisis management frameworks for systemic cross-border institutions are key issues for Finland. Close coordination with other Nordic authorities regarding surveillance and a systemic stability framework remains crucial, all the more so if otherwise preferable EU-wide agreements are delayed.

Given the massive economic downturn, fiscal policies were appropriately shifted to support growth on an EU-wide coordinated basis. The 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 long-term fiscal position has weakened markedly. 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.

Thus, adjustments are needed to secure a sustainable fiscal position starting from 2011. Specifically, a measured structural adjustment of ½-¾ percent of GDP in 2011 would appear appropriate, because it would bring the deficit within the SGP ceiling and not jeopardize the recovery. The mission also counsels a strong and credible commitment to fiscal consolidation for the medium- to long-run, including through maintaining the central government expenditure rule that has underpinned budgetary prudence in recent years. Fiscal adjustment efforts should focus on expenditure retrenchment and tax base broadening, while pension, health- and old-age care reforms, as well as an overhaul of local government finances are key to containing expenditures. Steps to boost efficiency, especially in the provision of public aging-related services, are crucial in this regard.

Renewed momentum with structural reforms would alleviate the adverse impacts of the crisis and population aging on growth, and facilitate fiscal consolidation. Measures to increase the length of working lives, both by entering the labor force earlier and departing later, are appropriate in light of rising life expectancies, while improvements in overall productivity growth will help reduce the need for retrenchment to secure fiscal sustainability.

Finland's record of sound economic policies over the past decades has provided a solid basis from which to address the global crisis and structural challenges. Prompt action will ensure the preservation of the present social model, allowing both for the benefits of globalization and the provision of support to those facing difficult adjustments.