INTERNATIONAL MONETARY FUND

Finland—2012 Article IV Consultation
Summary of Concluding Statement

June 11, 2012

Despite strong fundamentals and a sound record of fiscal discipline, Finland's near-term outlook is threatened by intensifying external strains. Economic activity in the euro area is expected to weaken markedly in 2012 due mainly to financial sector stress and also fiscal consolidation. Spillovers to Finland could be significant given its highly open economy. Thus, the key immediate macroeconomic policy priority is to cushion the downturn while mitigating vulnerabilities. In the longer run, Finland faces challenges from a rapidly-aging population, slowing productivity growth, and eroding competitiveness.

The recovery stalled at the end of 2011 and sluggish growth is projected in 2012-13. Activity expanded almost 3 percent in 2011, despite a slump in exports and worsening competitiveness, but came to a standstill in the final quarter. GDP growth is expected to decelerate to around ½ percent in 2012 before picking up again in 2013. In the short run, downside risks emanate from spillovers from Europe. Demand could also be negatively affected by domestic risks, for example in case of significant reductions in real estate prices or continued erosion of competitiveness (with Finland running its first small current account deficit for nearly two decades in 2011). Over the long term, the possible persistence of expansionary monetary conditions in Finland risks overheating the economy.

The financial sector has remained generally sound but vulnerabilities persist. Bank capital ratios are above minimum requirements and non-performing loans manageable. Bank profits, however, have declined. Moreover, the Finnish banking sector is highly concentrated with a majority of assets controlled by subsidiaries of foreign Nordic banks. It is therefore subject to spillover and deleveraging risks even though direct exposures to periphery countries are minimal. The housing and mortgage markets appear relatively stable, albeit vulnerable to growing debt of households, deteriorating unemployment, and a return of interest rates to more normal levels.

Finland should continue to bolster regulatory buffers, cross-country supervision, and reinforce macro-prudential tools. The mission recommends improving capital and liquidity buffers to meet gradually all Basel III requirements and to mitigate risks of potential interruptions to bank funding, which depends largely on foreign sources and wholesale markets, in particular from financial dislocation abroad. At the same time, supervisory arrangements for preventing or alleviating disruptions in cross-border flows should be strengthened. Furthermore, prolonged low rates may encourage more bank risk-taking to increase short-term profitability, including by accelerating credit expansion. In mortgage markets, recent supervisory steps to standardize definitions and limit loan-to-value ratios are welcome and should be made binding. These could be complemented by creation of a national loan register and the planned implementation of countercyclical capital buffers.

The mission endorses the short-term fiscal stance. A broadly neutral 2012 fiscal policy is appropriate, avoiding pro-cyclical withdrawal of support to the economy while preventing damage to fiscal sustainability. Provided economic activity rebounds, the planned moderate structural tightening for 2013 is adequate too. We also support the government fiscal adjustment plan through 2015, although additional measures may need to be identified to attain the objectives. Given downside risks to the recovery, consolidation should be implemented flexibly to avoid harming growth. Automatic stabilizers should be allowed to operate fully and further structural consolidation postponed if the economic recovery falters.

Over the longer term too, fiscal policy must balance the conflicting objectives of supporting growth and making progress toward closing the sustainability gap. The sustainability gap is estimated at about 4½ percent of GDP, driven by the fiscal cost of population aging. Hence, the mission recommends a gradual structural adjustment of about ½ percent of GDP per annum, broadly consistent with the authorities' 2015 goal for the central government. This would eliminate the sustainability gap in 10 years and still ensure the convergence of economic activity to its potential. Medium-term adjustment efforts should focus on reducing the impact of aging on public expenditures, broadening the tax base, as well as containing rapid expenditure growth and smoothing revenues in local governments.

Structural reforms should encourage greater labor force participation and stimulate productivity to enhance growth. Low expansion of working age cohorts in a rapidly-aging population could constrain potential growth. Thus the mission recommends that the minimum and maximum statutory retirement ages be increased and labor market policies and benefits adjusted so that activation takes place earlier. Social partners should ensure that wages rise in line with productivity to prevent further declines in competitiveness. The service and health-care sectors should be opened to more competition.

The mission is grateful for the high quality and openness of the discussions and for the cooperation and hospitality received from the Finnish authorities and private sector.