INTERNATIONAL MONETARY FUND

Finland—2012 Article IV Consultation
Concluding Statement

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Despite strong fundamentals and a track record of good policies, Finland's near-term outlook is threatened by intensifying external strains. Economic activity in the euro area is expected to weaken markedly in 2012 on the back of financial sector deleveraging and fiscal consolidation in several European countries. Spillovers to Finland could be significant given its highly open economy and trade and financial linkages with Europe. Thus, the key immediate policy concern is to cushion the downturn, including through a nimble fiscal policy, while mitigating any lingering vulnerabilities. Financial integration and complexity have created new risks and test supervisory abilities, not least in light of Finland's close linkages with other Nordic financial markets. In the longer run, Finland faces challenges from a rapidly aging population, slowing productivity growth, and eroding competitiveness.

Economic situation

1. **After the deep recession of 2008-09, the Finnish economy rebounded robustly in 2010 but stalled at the end of 2011.** The recovery was supported by a strong surge in domestic demand, propelled by rising consumer confidence, low interest rates, and renewed wage growth, although exports never regained their previous vigor. As the euro area sovereign debt turmoil intensified, dwindling demand from trading partners dragged the economy to a standstill in late 2011, despite overall growth of about 3 percent for the year. Activity in the first quarter of 2012 was slightly stronger than expected, but weak investment suggests weakening growth in the near term. Albeit still adequate, competitiveness has worsened significantly in recent years, with contracting export market shares and a small current account deficit in 2011, the first in nearly two decades.

2. **The financial sector has remained generally sound despite the turbulence in the euro area, but vulnerabilities persist.** Bank capital ratios are comfortably above minimum requirements and non-performing loans are manageable. However, banks' operating profits have declined amid weakening interest income and increased competition for retail business. Moreover, the Finnish banking sector is highly concentrated with a majority of assets controlled by subsidiaries of foreign Nordic banks, with attendant large exposures to the latter. These factors contribute to sizable spillover and deleveraging risks for banks owing to the financial strains in the euro area, though direct exposures to periphery countries remain minimal. Credit growth, while slower than before the crisis, is faster than in the rest of the euro area. The insurance and pension fund sectors are weathering well the ongoing crisis, but their solvency margins—though still relatively high—have been reduced.

3. **The housing and mortgage markets appear relatively stable, albeit vulnerable to high and rising household debt.** Household balance sheets have been made riskier by fast increases in indebtedness as a share of disposable income during the last decade. However, default rates have remained low, even if they could deteriorate if unemployment were to perk up markedly. In any case, highly-leveraged households could be forced to curtail their consumption, particularly when current low interest rates return to more normal levels given the dominance of floating rate mortgages, with a negative impact on activity. After some retrenchment in 2009, house prices returned to their pre-crisis growth path. In real terms, they are now comparable to those prevailing at the 1990s peak, though still broadly in line with fundamentals, according to various analyses.

4. **The fiscal position deteriorated sharply during the acute 2009 recession, and while consolidation has now begun, the costs of population aging loom large.** In 2011, the budgetary stance tightened by around 1 percent of GDP in structural terms, but weakening growth still put the headline deficit at ¾ percent of GDP and gross debt ended 2011 at 48½ percent of GDP. Over the longer run, aging costs for the general government are estimated to rise by about 5 percent of GDP, adding to fiscal pressures.

Outlook and risks

5. The mission expects GDP growth to decelerate markedly to around ½ percent in 2012 before picking up again in 2013. Negative growth in the middle of the year reflects weak consumption and investment, marred also by continued sluggish exports. Though activity should start to recover late in 2012, volatile financial market conditions and to a lesser extent structural fiscal consolidation (also in trading partners) will be a continuing drag. Accordingly, output will fall further below potential in 2012 and inflation will moderate. The supply potential of the economy may have been significantly curbed by the crisis as low investment has taken its toll. Potential growth may also be hindered by the recent deterioration in competitiveness.

6. **Risks to the outlook are tilted to the downside, with heightened uncertainties.** In the short run, they primarily relate to uncertainty about financial market developments, with possible tensions for bank funding leading to deleveraging and tighter credit, as well as spillovers from a deeper and more protracted slowdown in the euro area than now projected. Similar negative impacts could derive from a significant reduction in Finnish real estate prices or continued competitiveness erosion. In the longer run, persistence of expansionary monetary conditions in Finland, along with repercussions from safe-haven inflows into the financial system, may overheat the economy and fuel asset price bubbles. Limited expansion of working age cohorts in a rapidly aging population could also constrain potential growth.

Policies

7. **Against this background, Finland must address existing vulnerabilities and long-term sustainability issues, while paying due attention to short-term growth.** Financial

sector policies should include efforts to maintain capital at the levels envisaged under Basel III while more emphasis should be given to liquidity provisioning. Fiscal policy must strike a delicate balance between supporting economic activity and addressing the sustainability gap. Further structural reforms should be implemented to spur potential growth, while wages should rise in line with productivity, thereby preventing more declines of competitiveness.

Financial sector

8. **The mission recommends improving capital and liquidity buffers and continued vigilance to mitigate risks of potential interruptions of bank funding from abroad.** Finnish banks already meet in their core Tier 1 ratios the minimum capital and conservation buffer requirements envisaged under Basel III, but not all credit institutions satisfy the leverage ratio requirement. Furthermore, compliance with Basel III liquidity requirements will entail some additional effort as regards the asset composition of the liquidity buffer and the size of long-term stable funding. Indeed, the Finnish banking system is largely funded through foreign sources and wholesale markets. Hence, banks could benefit from gradually building capital buffers and shifting asset composition toward more highly-liquid instruments. These objectives should be accomplished in measured but steady steps over the medium term to avoid fostering pressures for deleveraging.

9. **The mission commends the authorities' efforts to bolster supervisory practices.** Improvements are being implemented along the lines of the 2010 FSAP recommendations. New liquidity standards have been introduced. The authority of the FSA to impose fines on credit institutions was extended in 2010, while further legislative changes are expected in 2012-13 in line with the EU harmonized framework for supervisory sanctions. Top-down stress testing capacities are also being augmented and work is ongoing to strengthen the analysis of the consolidated risk profile of complex financial groups.

10. **Nonetheless, the mission underscores the necessity of enhanced supervision of nationally systemic banks and reinforcement of macro-prudential tools.**

- Heavy concentration in the Finnish banking sector implies high contagion risk from systemic banks. Contagion analysis based on balance sheet inter-linkages indicates that a few institutions act as liquidity hubs, thus rendering them systemically important for the integrity of the financial system. In this regard, the mission regards as beneficial closer supervision and possibly more stringent prudential requirements for nationally systemic banks, such as additional capital buffers, higher liquidity provisions, and topped-up contributions to the Deposit Guarantee Fund.

- With a majority of loans tied to depressed Euribor rates, interest margins tightened. Very low rates over a prolonged period may encourage risk-taking by banks to increase short-term profits, including by accelerating credit expansion, ultimately with adverse impact on financial sector health. We advise that supervisors scrutinize carefully bank risk-taking behavior. Plans to define national competencies for macro-prudential supervision are a recent important step in this respect. The mission similarly welcomes the in-depth survey of vulnerabilities related to the housing and credit markets as well as publication of standard definitions to calculate the loan-to-value ratio (LTV) and the planned introduction of countercyclical capital buffers. These steps should be complemented by granting the FSA authority to make LTV ceilings binding and implementing a national loan registry to guard against excessive borrowing.

11. **The mission also notes that the effectiveness of supervision and crisis resolution mechanisms can be further buttressed.** Memoranda of understanding (MoU) complying with best international practice have been signed with foreign (mainly Nordic and Baltic) supervisors and supervisory colleges have been active. Nevertheless, these MoU are not binding, which hampers enforcement actions, and consideration should be given to strengthen their legal status. Similarly, enhancing mutual sharing of supervisory information could facilitate preparedness in host and home countries. We recommend that joint contingency planning with other national authorities for cross-border resolution be advanced, containing the risks to Finnish subsidiary activities, with ex-ante burden-sharing guidelines defined to limit contagion. The mission shares the authorities' preference for a common bank-resolution framework at the EU level, but advocates formulating national or regional plans in the interim. Until such frameworks are fully operational, ring-fencing the activities of Finnish subsidiaries remains advisable.

Fiscal

12. **The short-term fiscal stance is broadly neutral, while substantial adjustment is envisaged through 2015, though measures still have to be identified.** The mission projects the general government (GG) structural surplus to remain roughly unchanged in 2012. Over the medium term, the government program aims to set the central government (CG) debt-to-GDP ratio on a declining path and reduce the CG deficit from 3 to 1 percent of GDP between 2011 and 2015 (end of the government's term). However, attaining this goal would require measures beyond those already identified, as, under current policies and macroeconomic assumptions, we forecast the CG deficit to stay above 1½ percent of GDP by 2015.

13. **The mission endorses the authorities' 2012 and 2013 fiscal stances.** The budget for 2012 provides for virtually full operation of automatic stabilizers, leading to an increase in the headline deficit, thereby supporting domestic demand. This is desirable because the outlook for near-term growth is weak and activity appears below potential. On the other hand, the long-term fiscal sustainability gap is estimated at about 4½ percent of GDP, owing to the impact of population aging on public expenditures. Thus, the mission concurs that a broadly neutral 2012 fiscal policy is appropriate, avoiding pro-cyclical withdrawal of support to the economy while preventing damage to long-term sustainability prospects. Similar considerations suggest that the authorities' planned moderate structural tightening for 2013 is

adequate too, provided economic activity rebounds as projected. Given the unusual downside risks surrounding the recovery, the authorities should nevertheless stand ready to loosen budget policy if growth underperforms considerably.

14. **The mission also supports the medium-term consolidation goal.** Over this longer horizon too, fiscal policy must balance the conflicting objectives of supporting growth and making progress toward closing the sustainability gap. Hence, the mission recommends a gradual structural adjustment, of about ½ percent of GDP per annum, which is broadly consistent with the authorities' 2015 goal for the CG, eliminates the sustainability gap in 10 years, and allows for steady reduction and eventual disappearance of the output gap by 2017.

15. **But we stress that such consolidation should be implemented flexibly to avoid harming growth.** If growth falters significantly below potential, automatic stabilizers should be allowed to operate fully and further structural consolidation delayed until a recovery has taken firm hold. It may also be preferable to substitute part of the headline tightening with structural measures that significantly improve fiscal sustainability but only modestly impact activity, such as increasing the retirement age and boosting productivity in public service provision. The need for immediate fiscal consolidation is also lessened by the authorities' strong track record in budget discipline. Despite the sustainability gap and high spreads in a number of other euro area countries, financial markets still regard Finland as low risk. Hence, rollover risks are marginal. Finally, postponing additional adjustment is unlikely to contravene the EU fiscal compact, since under the baseline macro scenario the GG structural balance has a substantive margin above the ½ percent of GDP deficit threshold.

16. **Measures that directly reduce the impact of aging on public expenditures or broaden the tax base should form a key plank of medium-term adjustment efforts.**

- The mission notes that, with a rapidly aging population and associated increase in health care costs, priority should be given to measures aimed at restraining growth in demand for health- and long-term care. By the same token, the generosity of the social and unemployment benefits system could be further moderated, notably by additional tightening of the unemployment and disability pipelines to early retirement as well as increases in the statutory minimum and maximum retirement ages, contributing to an increase in the effective retirement age.

- With an already high revenue ratio, the mission believes there is little scope for further increases in the tax burden. Hence, revenue measures should focus on broadening the tax base, reducing, if feasible, relatively high marginal labor tax rates, and shifting from labor taxation to less distortionary consumption- and property-based taxation. In this connection, the mission supports the one percentage point increase in the standard VAT rate and the energy tax hike, but also advocates reducing the number of items on reduced VAT rates. The mission endorses the authorities' plans to lower mortgage interest deductibility, which subsidizes home ownership and promotes indebtedness by households, potentially heightening vulnerabilities of the financial system. Hiking property tax rates, which are low by international comparison, would provide municipalities with a more stable source of revenue, reducing their dependence on highly cyclical corporate taxes.

17. **The mission encourages reform of the fiscal framework, especially for local governments (LG), to facilitate attainment of sustainability.** Increased attention should be given to contain rapid expenditure growth in LG, for example by moving toward expenditure ceilings for municipalities and by smoothing their revenue stream with the aim of avoiding pro-cyclical spending peaks and troughs and thus strengthening long-term budget planning. Additional mergers of municipalities would pave the way for economies of scale.

Structural reform and other

18. **With the looming decline of working age cohorts due to aging, policies should encourage greater labor force participation and productivity to enhance growth.** Apart from increasing the minimum and maximum statutory retirement ages, the mission recommends that labor market policies and benefits be adjusted so that activation takes place earlier. Moreover, we note the OECD recommendation that public R&D expenditures be refocused on basic research rather than direct support to business R&D. The mission also points out that tuition fees and more reliance on loans rather than grants for students would likely improve the cost effectiveness of higher education. Additionally, the large productivity differential between manufacturing and services should be reduced by opening the service sector to more competition. Similarly, opening the health care sector to competition could improve efficiency and help contain the buildup of aging pressures.

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.