CONCLUDING STATEMENT

Finland: Staff Concluding Statement of the 2021 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

Helsinki, Finland – November 19, 2021:

With strong policy support, Finland suffered a relatively mild economic contraction in 2020 followed by a swift recovery which is expected to continue into 2022. The fiscal stance in 2022 is broadly appropriate but policy should remain flexible given the still-uncertain outlook. Over the medium term, and provided the recovery is firmly on track, fiscal policy should aim to bring public debt on a declining path. Boosting employment and growth are key to strengthening public finances, but direct fiscal measures may also be needed. Enhancing the macroprudential toolkit would strengthen macrofinancial resilience.

Economic outlook

Finland has been highly successful in containing the pandemic. The government's re-opening strategy has been flexible and adaptive to developments in the evolution of the pandemic. Around 80 percent of the population aged 12 or over are now fully vaccinated. Despite a fourth wave of infections, the death rate has remained low.

The 2020 recession was one of the mildest in Europe, followed by a swift recovery. Output declined by 2.9 percent in 2020, but the strong vaccination campaign and the removal of restrictions brought it above its pre-pandemic level in 2021Q2. The employment rate has also returned to its pre-crisis level. Labor shortages—amid rising vacancies—and supply chain bottlenecks are now starting to weigh on activity. Consumer prices have increased markedly in 2021, reflecting the global rise in raw materials prices and production bottlenecks.

The near-term outlook is for the recovery to continue but risks remain. IMF staff project GDP to grow at around 3¼ percent in 2021 and 2¾ in 2022, buoyed by the strong rebound in private consumption and investment. The output gap is projected to nearly close in 2022 and, given the strong rebound, the pandemic-induced scarring is expected to be minimal. The recovery could be stronger with a faster unwinding of household savings, but pandemic-related risks to global growth are still high and could negatively impact Finland. Headline

inflation is expected to hover around 2 percent in 2021 and 2022 on the back of higher projected energy prices.

Medium-term growth prospects are less strong, due to adverse demographics and low productivity—trends that precede the pandemic. Staff forecast potential growth to converge to around 1¼ percent in the medium term, similar to pre-pandemic forecasts.

Unwinding pandemic-related support and strengthening public finances

Pre-pandemic, the government embarked on an ambitious program to strengthen the welfare state. The 2019 program included a combination of one-off and permanent spending increases on education, employment, infrastructure, and climate policies, equivalent to an annual average around 1 percent of GDP during 2020-22. Permanent increases were to be financed largely through backloaded measures to boost employment, aiming to balance the budget and start reducing public debt by 2023, after one-off expenditures were scheduled to expire.

Fiscal policy during the pandemic provided timely and needed support. In addition to spending in the government program and automatic stabilizers, during 2020–21 the authorities deployed additional fiscal support amounting to around 4¾ percent of GDP.

But public debt has increased and will likely remain on an increasing trajectory. Public debt is expected to reach over 70 percent of GDP at end-2021. Over the medium term, fiscal deficits will gradually adjust but stabilize at a level which is around 1 percent of GDP higher than before the pandemic, largely reflecting permanent spending increases in the government's program. The planned employment measures will unlikely produce sufficient fiscal gains to help achieve the revised government target to stabilize debt in the middle of the decade.

Fiscal policy should gradually refocus on placing public finances on a stronger footing. The COVID-related support is planned to be unwound in 2022 as health and economic conditions improve, but the structural primary deficit (a measure of fiscal stance stripping cyclical effects) is projected to remain at the relatively high 2020 level of 2¼ percent of GDP. The front-loaded spending from Next Generation EU grants will provide additional support. The accommodative fiscal stance is broadly appropriate to support the recovery and, if downside risks materialize, additional temporary and targeted support may be needed. However, once the recovery is firmly on track, staff recommend a moderately faster consolidation to bring public debt on a declining path over the medium term to rebuild buffers and prepare for the increases in aging-related spending.

Part of the adjustment could come from additional measures to boost employment and growth. Staff recommend continuing with plans to progressively close routes to early retirement for older workers and, more broadly, better targeting of in-work and out-of-work benefits. More should be done to encourage employment among secondary earners—for instance by better targeting the home care allowance and housing benefits while further improving access to childcare—even though it would not generate immediate fiscal savings.

But Finland would also need additional fiscal measures. The tax base for the standard-rate VAT could be broadened and recurrent real estate taxes increased—these are low in Finland relative to other countries. But, as taxation overall is already high, the adjustment effort should focus on reducing expenditure: a spending review could help identify efficiency gains and fiscal savings, including in the context of ongoing health and social services

reform. Though Finland has made progress in policies to support climate goals, further reductions in environmentally-harmful subsidies and higher climate-related taxes could also be considered.

Returning to spending limits would enhance fiscal credibility. Spending limits have been an important anchor for fiscal policy in Finland. While the limits were appropriately relaxed in response to the COVID emergency, they were further increased for 2022 and 2023, partly to accommodate additional spending in the government program. The government already plans some spending cuts in 2023, but IMF staff recommend returning to the original limit in the context of the medium-term fiscal adjustment.

Achieving the goal of net-zero emissions

A more comprehensive suite of policies is needed to reach the climate goal of net-zero emissions by 2035. Estimates from the Ministry of Environment indicate that the current measures would not be sufficient to bring emissions to the target. Additional policies could include increasing and better harmonizing carbon pricing across sectors, reinforced by fiscal incentives across different sectors including the use of feebates.

Enhancing Financial and Macroprudential Policies

The financial system has weathered the pandemic well. Banks are well-capitalized, liquid, and profitable, and the lowering of structural capital buffer requirements at the onset of the pandemic provided additional lending and loss-absorbing capacity. Furthermore, corporate and household balance sheets appear to have been relatively unscathed from the pandemic, after the expiry of support measures. But the banking sector is large and highly concentrated, and banks are highly exposed to residential and commercial real estate, the latter facing headwinds from the pandemic. Also, the increase and changing composition of household debt towards consumer and housing company loans has added to borrower-side vulnerabilities.

Staff recommend that more be done to enhance the macroprudential toolkit. Completing the planned government review of the tax treatment of different housing financing options would help address the compositional changes in household debt. In addition to current proposals on borrower-based macroprudential tools—including, *inter alia*, loan-to-value limits for housing company loans—the toolkit should be enhanced further to include (i) a debt-to-income (DTI) cap reflecting growing household debt vulnerabilities and in line with steps taken in many other countries; and (ii) supplementing the DTI cap with a debt-service-to-income cap once the new comprehensive credit registry is operational. These borrower-based measures could be tailored to account for traditionally less risky borrowers, e.g., first-time homebuyers as suggested by some international experience.

Restoring and reconfiguring capital based macroprudential buffers would also strengthen macrofinancial resilience. IMF staff recommend that structural capital buffer requirements be returned to pre-pandemic levels to rebuild resilience against the structural risks of the financial system. There are currently no obvious signs of real estate overvaluation or a buildup in aggregate cyclical systemic risks, but household vulnerabilities are rising. The authorities could therefore also consider the use of targeted capital requirements to build resilience against rising household vulnerabilities. Finnish legislation that codifies capital buffer requirement settings could be modified to introduce a positive neutral countercyclical capital buffer rate, building macroprudential policy space.

The mission thanks the authorities and our other counterparts for the constructive policy dialogue and productive collaboration.