Finland—Staff Concluding Statement of the 2016 Article IV Mission
October 4, 2016

Finland's economy is slowly emerging from a protracted recession. The recovery is fragile and medium-term growth is projected to remain sluggish. Reviving growth requires raising productivity and labor participation. Recent reforms move in the right direction but further measures are needed, including product market reforms, increased R&D spending, and measures to facilitate labor mobility. Fiscal policy should balance between ensuring long-run sustainability and protecting the recovery. The review under the Financial Sector Assessment Program (FSAP) concluded that the financial sector is broadly sound, but structural vulnerabilities remain. Further strengthening banking supervision, expanding the macroprudential toolkit, and deepening regional supervisory cooperation would mitigate potential risks.

Economic situation and outlook

1. **After three years of recession, Finnish economic growth has turned tepidly positive.** Stronger private consumption and a rebound in private investment have driven modest output growth as the drag from structural shocks has begun to dissipate. However, the output gap remains sizable and unemployment high. Falling food and energy prices have pushed headline inflation below zero and improved the terms of trade, shifting the current account into a small surplus. The fiscal outturn in 2015 was better than expected and the deficit is back under the Stability and Growth Pact's (SGP) 3 percent of GDP limit. While credit growth has slowed—reflecting low demand—debt levels in the economy have risen since the crisis, increasing vulnerabilities, especially in the nonfinancial private sector. At the same time, house price growth has been modest and banks appear broadly sound.

2. **Even as the recovery takes hold, growth is expected to remain subdued.** The mission projects growth will increase to 0.9 percent in 2016 and to 1.1 percent in 2017, before reaching around 1½ percent over the medium term. Private consumption and investment will be the main drivers of medium-term growth, even as consumption is weighed down in the short run by slower real wage growth, reflecting rising inflation and the Competitiveness Pact. The drag from

net exports should gradually lessen as external demand strengthens and competitiveness improves. Unemployment is expected to gradually decline. Inflation picked up in the first half of 2016 and should continue to rise as the effects of falling commodity prices abate.

3. **The outlook is subject to significant downside risks.** Weaker-than-expected global growth, especially in advanced Europe, would constrain exports and uncertainty over post-Brexit arrangements could weigh heavier on confidence and investment than already envisaged. Meanwhile, a shock in one of the other Nordic countries—such as a housing market correction—could spill over into Finland via the regionally interconnected banking system and trade links. Domestically, fiscal consolidation and labor market reforms could weaken the recovery in the near term, even though their long-run impact should be positive.

Structural reform

4. **Recent progress on reforms is welcome but requires close follow up.** Reviving growth remains Finland's preeminent challenge and deep structural reform is critical. The Competitiveness Pact recently agreed by social partners will reduce relative labor costs in the short term. It also provides an opportunity to make the highly-centralized wage bargaining process more flexible at the firm level and better align wages with productivity. This outcome cannot be taken for granted however, and the government should closely monitor the implementation of the pact and take further measures if needed. Meanwhile, the reduction of the maximum duration of unemployment benefits to 400 days should help increase labor supply and the mission encourages social partners to reach agreement soon on additional activation measures. The draft bills on the health and social services reform constitute major progress towards improving public sector productivity, though important elements of the new system remain to be further developed. Given the complexity of the reform, clear and timely communication with stakeholders will be critical and progress should be assessed regularly to identify any potential problems early on.

5. **Reform efforts are also needed in other priority areas.**

- *Product market reforms*. Deregulation in product markets could strengthen competition and yield substantial productivity gains, including through downstream effects on the broader economy. There is ample scope for such reforms, particularly in the retail sector—which is subject to tight zoning and planning restrictions—and in government-dominated sectors such as rail and postal services, where effective barriers to entry restrict competition. The mission therefore welcomes the work on the new transportation code as well as the renewed privatization efforts initiated by the government.

- *Research and development*. Studies show that R&D has a positive impact on productivity growth and the substantial reductions in both public and private R&D expenditures in recent years thus risk further weakening the growth outlook. Reversing cuts to public

R&D spending and creating stronger incentives for private R&D—such as through well-designed and permanent tax credits—would help boost innovation.

- *Labor mobility and housing.* To complement the government's reform of unemployment benefits and facilitate the transition of unemployed workers into new jobs and industries, active labor market programs (ALMPs) should be strengthened. Also, while recent efforts to increase the supply of affordable housing in the main urban areas are helpful, they may not be sufficient. Further measures, such as streamlining planning and development processes, would help improve the housing supply over the medium term.

Fiscal Policy

6. **Fiscal policy needs to strike a balance between long-run sustainability and protecting the recovery.** Aging-related fiscal pressures contribute to a sizable long-run sustainability gap (estimated at about five percent of GDP at the start of the government's term), making structural fiscal adjustment a necessity. Consolidation is also needed in the context of European rules. At the same time, the weak recovery requires that the phasing and composition of the adjustment minimize the potential adverse effects on growth.

7. **The recent recalibration of the consolidation path is appropriate and should help support growth.** An unexpected fiscal overperformance in 2015 is allowing for a slower pace of adjustment in 2016 and a slightly accommodative fiscal stance in 2017 without jeopardizing the medium-term adjustment goal. This is welcome and in line with the mission's past advice.

8. **But more can be done to support the economy in the short term.** For instance, the government should consider a faster implementation of the remaining *growth package* spending. The growth-friendliness of fiscal consolidation can also be improved by reallocating resources toward R&D spending, well-designed ALMPs, and productive public investment, and away from poorly-targeted transfers and tax expenditures. If growth disappoints, automatic stabilizers should be allowed to operate fully. Revenue windfalls should be used to lower borrowing needs.

9. **To close the long-run sustainability gap, effective implementation of the structural reform agenda remains critical.** The earlier-agreed pension reform (effective from 2017) and the government's consolidation plan are estimated to close just over half of the long-term fiscal sustainability gap. The successful implementation of other structural reforms—most notably the reform of health and social services—will thus be key to closing the remainder of the gap and ensuring that public finances are robust to aging-related spending pressures. Advancing these reforms should therefore also be a top priority from a fiscal perspective.

Financial Sector

10. **The FSAP found that while the banking system is well capitalized and profitable, structural vulnerabilities remain.** Immediate financial stability risks appear limited and the level of nonperforming loans is low. However, the Finnish banking system is large relative to the

economy, highly concentrated, and closely interlinked with that of Nordic neighbors. In addition, banks' low risk weights for mortgages may exaggerate the robustness of their regulatory capital ratios. Banks are also relatively reliant on wholesale funding, creating funding liquidity risks.

11. **The mission welcomes the progress made on the policy framework in recent years.** This includes transposing into national legislation the CRDIV and the BRRD, participation in the banking union and the SSM, and the introduction of a new macroprudential policy framework. Following changes in financial sector policies and the regulatory approach since the crisis, financial supervision and contingency planning have become more intense and intrusive (and inevitably more resource-intensive, stretching supervisory resources, especially at the FIN-FSA).

12. **Progress notwithstanding, the FSAP identified a number of areas for improvement.**

- *Bank supervision* should be strengthened, including by ensuring ongoing monitoring of banks' internal risk models by the ECB and FIN-FSA, by intensifying oversight of banks' liquidity positions in foreign currencies, and by introducing liquidity stress tests over different time horizons. The resources allocated to banking supervision should be increased to reflect the growth in regulatory complexity and supervision intensity.

- *Macroprudential policy* should be enhanced by expanding the set of policy instruments. In this context the mission welcomes the authorities' plans to introduce a systemic risk buffer and a floor for mortgage risk weights. Tools based on borrowers' debt service capacity and loan terms should also be considered. To bolster the decision making framework, the macroprudential policy mandate of the FIN-FSA should be more clearly defined while the creation of a household loan registry would facilitate macroprudential policy analysis. Although financial stability risks appear muted for now, it is important to establish the necessary tools before risks emerge.

- *Regional cooperation* should be further deepened. To mitigate risks from regional linkages and Nordea's conversion from subsidiary into a branch it will be key that the pending agreement on systemic branches between the key supervisors provides for sufficiently strong data sharing and supervisory cooperation provisions. It would also be helpful to conduct joint stress tests to capture regional interlinkages between banks, enhance joint crisis planning, run regular crisis simulation exercises, and strengthen collaboration between Nordic macroprudential authorities. Domestically, inter-agency cooperation on national crisis preparedness and management should be formalized.

The mission would like to thank the authorities and other counterparts for their warm hospitality and for candid and high-quality discussions.