INTERNATIONAL MONETARY FUND

Finland: Staff Concluding Statement of the 2017 Article IV Mission

November 1, 2017

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.

Finland's economy continues to recover. Strong growth is expected to continue this year and the next, but employment and productivity need to increase further to raise potential growth and support Finland's social model. Important structural reforms are being implemented, notably to pensions, unemployment insurance, and product markets. But more flexibility in the collective bargaining process to allow more differentiation between firms is needed to maintain competitiveness and to ensure that workers find the most suitable jobs. Health and social services reform is vital to boost public sector productivity and contain age-related pressures on public finances. The current upswing should be used to restore fiscal buffers. The financial sector is sound overall, but the financial supervisor should have more macro-prudential tools to safeguard the financial health of both borrowers and lenders. The relocation of Nordea's headquarters to Finland raises the importance of increasing the supervisor's resources, discretion to set additional capital requirements if needed, close cooperation among Nordic authorities, and further progress in completing banking union in the EU.

Economic Situation and Outlook

1. **Economic growth has picked up considerably,** and broadened to exports and equipment investment. The current account is back to surplus. However, the labor market is yet to improve markedly; unemployment is still high, although long-term unemployment is now decreasing. Inflation remains low, following the 2017 wage freeze and low inflation in trade partners.

2. **Growth is expected to remain strong in the near term, but potential growth is constrained by labor market rigidities and aging.** The mission projects growth of 2.8 percent in 2017 and 2.3 percent in 2018. But, even assuming higher productivity growth than over the past ten years and increased participation in the labor market, a shrinking working age population constrains longer-term growth to about 1¼ percent. Further increases in employment and productivity would be needed to raise this rate.

3. **This outlook is subject to external and domestic risks.** The economy is particularly sensitive to growth fluctuations in key trading partners. Financial shocks remain a risk due to banks' reliance on wholesale funding and close connections to other Nordic economies. Domestically, there is a risk that necessary reforms may stall. Competitiveness and job growth could be undermined if the current bargaining round sets wages ahead of productivity growth.

Structural reforms

4. **Notable progress has been achieved on structural reforms, but further reforms—particularly to labor markets—are needed.** Recent product market reforms have expanded competition. But the prolonged downturn following the global financial crisis revealed weaknesses in the labor market that hold back employment and reduce the economy's ability to rebound from adverse shocks.

5. **Ensuring competitiveness and resilience requires that wage increases are aligned with productivity gains, not only at the national but also the firm level.**

   - Increasingly, individual firms are facing very different pressures, but recent real wage increases have not matched productivity growth in many cases, undermining hiring incentives. Employees change jobs less frequently in Finland than in other advanced economies, constraining productivity growth. The distribution of wages is bunched especially tightly at lower incomes, diminishing job opportunities for those with lower skills.

   - Collective bargaining should aim to maintain external competitiveness and match wage increases to productivity. The recent Competitiveness Pact preserved national wage restraint after competitiveness had slipped post crisis; more flexibility across firms has proved elusive, but would boost employment and resilience.

6. **Improved work incentives could boost labor supply.** Reforms to unemployment insurance aim to raise incentives to search for jobs—these could be strengthened by tapering benefits during the period of unemployment and reducing the overlap among other social benefits. For the young, vocational education reform and better incentives for shorter study times should help, but the transition from secondary to tertiary education should be faster. Participation of women of child-bearing age—notably low in Finland compared to Nordic

peers—could be increased by directing more money to child care provision and less to home care allowances. Closing the possibility of retiring early facilitated by extended unemployment benefits would prolong working lives, reaping the full benefits of the 2017 pension reform. More progress on zoning issues could alleviate housing bottlenecks near job-rich cities, enhancing labor mobility.

Fiscal Policy

7. **The 2018 budget proposal includes welcome growth-enhancing measures, but it is also procyclical.** New measures, such as reductions of child care fees, increased resources for the employment service, and partial reversal of past R&D funding decreases should boost growth over the medium term. However, the budget also implies easing fiscal conditions in 2018—a less procyclical stance would help smooth growth in the near term.

8. **And although the public finances have improved, the need to rebuild fiscal buffers remains.** Budget deficits have been lower than expected. But debt remains above its target, and adverse demographics and high exposure to trade and financial shocks—including from a large banking system—imply a need for robust fiscal resources in times of stress.

9. **To help rebuild fiscal buffers over the medium term, the mission recommends reaching a balanced budget earlier than projected.** The implementation of existing plans for budget savings—including by local government—needs to be monitored closely. Fiscal improvements from further growth surprises should be directed to deficit reduction. New measures could be considered to the extent that they would durably boost employment and growth; these could include further R&D spending, well-targeted active labor market policies, and public investment to fix maintenance gaps. Increased work incentives would also improve the long-run fiscal position. Tax and social benefits policies should target those on low incomes, to improve employment of the low skilled.

10. **Health and social services reform is crucial** to address age-related fiscal pressures. The annual savings—targeted to reach almost 1½ percent of GDP by 2030—would transform the public finances over time. The reform will require close monitoring to ensure that projected cost savings are realized, as will plans to streamline the delivery of public services.

Financial Policies

11. **The banking system remains adequately capitalized and profitable, and progress has been made to reduce some key vulnerabilities.** Immediate financial stability risks appear limited and the level of nonperforming loans is low. But the banking system is highly concentrated, reliant on wholesale funding, and closely linked to financial sectors in other Nordic countries. The introduction of minimum risk weights on mortgages is an important step to greater financial safety, given the high share of mortgages in banks' assets. The new Memorandums of Understanding (MOUs) on the supervision of significant branches between

authorities of Nordic countries enable better supervision of highly-interconnected banks in the region.

12. **Nonetheless, increasing household vulnerabilities make it important to broaden the prudential toolkit.** Household saving rates are negative, unsecured consumer credit is growing rapidly, and a large share of mortgage loans is held by highly indebted borrowers.

- Introducing a Systemic Risk Buffer (SRB) is important to mitigate long-term risks that are not addressed by pan-European rules. Legislation for an SRB is currently under consideration by parliament; the law should give the macroprudential authority flexibility to use its judgement, and not tie the setting of the SRB to mechanical criteria. For its part, the macroprudential authority should make the application of the SRB transparent and as predictable as possible.

- Additional macroprudential measures for borrowers should be introduced to allow the macroprudential authority to better target household vulnerabilities that are not well covered by existing Loan-To-Collateral limits. These could include caps on loans in relation to values of houses and personal incomes, and debt servicing to income. To be applied accurately and fairly, such tools would benefit from more complete data.

- A comprehensive credit registry would be particularly helpful to monitor and assess household credit.

13. **The relocation of Nordea's headquarters to Finland increases the importance of adequate supervisory resources, close regional cooperation, and completion of the banking union**. The Finnish financial system will become considerably larger: Nordea's assets alone are over three times Finnish GDP. Oversight of the whole Nordea Group will fall to Finnish authorities and the ECB, and the Finnish Deposit Guarantee Fund will assume responsibility for insuring not only domestic deposits but also deposits made at Nordea's Nordic and Baltic branches. The resources of the FIN-FSA should therefore be increased; regional cooperation as implemented under the new MOUs, including with respect to data sharing, should continue after the ECB becomes the Nordea's lead supervisor. Much also falls to the full implementation of the banking union, not just in the context of Nordea but all euro area banks. This includes appropriately strict standards on banks' ability to absorb losses through adequate capital—especially as concerns the level and composition of bail-inable liabilities—and the introduction of pan-European deposit insurance, with due regard to reducing risk in euro area banks.

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