Finland—Concluding Statement for the 2014 Article IV Consultation

March 14, 2014

Finland's strong economic record has stalled with the economy in recession for three of the last five years, largely because of a challenging external environment and structural weaknesses. This has led to high unemployment, and put public finances under pressure. A more comprehensive structural reform agenda will be necessary to strengthen medium-term growth, while the pace and structure of fiscal consolidation should be designed to protect the fragile recovery. Completing and deploying the full macroprudential toolkit will guard against domestic and regional financial stability risks.

Finland's growth dilemma

1. **The strong recovery from the global crisis was short-lived.** The level of real GDP dropped by almost 2½ percent during 2012-13, and unemployment rose to more than 8 percent as more people went without work for longer. The shortfall in growth, coming at a time when peer economies saw GDP improve and unemployment fall, points to deeper, structural problems. Exports suffered from the continued decline of the information and communications technology industry and falling demand for paper and pulp, but also because Finnish wage costs increased when labor productivity deteriorated. Longer-term factors such as a rapidly aging workforce added to the headwinds.

2. **The recovery will be slow**. With the gradually improving outlook in the euro area, external demand is expected to increase in the course of 2014. This should eventually support investment, especially if interest rates remain at low levels. However, GDP growth is likely to pick up more gradually than before—0.3 percent this year and 1.1 percent in 2015 (down from 0.7 and 1.3 percent, respectively). This reflects recent weak data and developments in Eastern Europe, as well as planned fiscal consolidation. With still sizable spare capacity in the economy, unemployment will decline only gradually, while inflation will decelerate to around 1.5 percent through 2015.

3. **The recovery will also likely be fragile**. Weaker external demand could easily derail the recovery—for example, because of negative effects from an escalation of geopolitical tensions, or slower euro area growth. Domestically, high and still rising levels of household debt could make consumers more cautious to spend if interest rates normalize faster than expected. Finally, the growth outcome could also change with the timing and composition of fiscal adjustment.

The right policies will make a difference

4. **More ambitious structural reforms and well-calibrated fiscal consolidation would raise medium term growth.** Finland's extraordinarily strong record of fiscal prudence and a focus on growth-friendly adjustment should help mitigate short-term tradeoffs between consolidation and growth. At the same time, ensuring a robust financial regulatory framework, well integrated in the Nordic and wider European context, will help limit risks to financial stability.

5. **Recognizing the need for action, the authorities are pursuing reforms along a number of dimensions**. The government has set ambitious goals for structural reforms and is finalizing fiscal plans for 2015 and the medium term. Moreover, important decisions have been made regarding the implementation of the macroprudential framework ahead of the advancing European financial stability agenda.

The case for ambitious structural reforms is strong

6. **The obstacles to growth are well known**. Finland remains a high-capacity economy with a highly skilled workforce and generally favorable business environment, but labor participation rates have declined as a consequence of population aging. Structural unemployment is high, reflecting, among other things, matching inefficiencies and constraints to labor mobility, such as a limited supply of affordable housing in urban growth areas. Productivity growth has dropped as economic activity has shifted to less productive sectors despite still sizable R&D spending. Furthermore, high wage agreements just prior to the global crisis have severely limited the competitiveness of an already ailing tradable sector.

7. **The government reform program is making progress, but the full agenda has yet to be implemented**. Job-seeking incentives in the generous Finnish unemployment system are being strengthened and steps to reduce the vacancy/job-seeker mismatch are in progress. Some further labor market measures are being planned—for example, to improve employment services for vulnerable groups and the long term unemployed. The authorities are also discussing reforms that aim to reduce longer-term spending obligations and improve the productivity of local government services, though the full benefit of these measures is difficult to evaluate at this stage.

8. **Bold and rapidly implemented measures will make a difference**.

- *Improving labor market performance.* Pension reform to lift the effective retirement age is crucial for increasing labor market participation. Agreement on the envisaged gradual increase by two years—by 2025—should be reached before the end of this year, and implementation should start no later than 2017, but preferably earlier. To encourage younger workers to enter the labor market sooner, measures such as streamlining university entrance requirements and shortening study times would be helpful. Reducing the duration and replacement rate of unemployment benefits would further raise labor market participation.

- *Boosting productivity*. Plans to improve the comparatively low productivity of public sector healthcare should be specified and implemented quickly, including, for example, by seeking to reduce the fragmentation of healthcare provision. Boosting retail competition would improve overall productivity in the private sector. R&D investment, which is high by international standards, can be better focused to support innovation especially by young firms (e.g., with well-designed tax credits).

- *Fostering adjustment.* It is important that wage bargaining supports adjustment by steering real wages in line with overall productivity growth, while ensuring sufficient flexibility to accommodate variation at the firm and sectoral levels, including in the public sector. The level of employment protection should not become an obstacle to adjustment, in particular in the context of local government reform. Measures to increase the quantity of affordable housing (e.g., by overcoming zoning obstacles) would facilitate labor mobility and matching.

Fiscal policy can balance growth and sustainability

9. **Cyclical and structural factors have weakened the public finances**. Spending has risen by over 11 percent of GDP during 2007-13, driven to a large degree by structural forces, including the relatively rapid increase of public sector wages following the pre-crisis wage agreement and higher structural unemployment. Weaker growth has depressed revenue performance and added to continuing deficits. Over a longer time horizon, lower expected trend-growth and rising aging-related spending have opened a long-run fiscal sustainability gap, estimated to be around 4½ percent of GDP.

10. **Credible fiscal adjustment over the medium-term will ensure sustainability and help protect the fragile recovery**. The broadly neutral fiscal stance in 2014 is appropriate. Staff simulations suggest that adjustment beginning in 2015, gradually increasing in size to match the expected strengthening of the recovery, would minimize the risks to the recovery. The credibility of a phased-in adjustment path depends critically on broad-based and continued support in parliament. Supplementing the central government's expenditure framework with a steering system for local governments would make the effort more effective. And a growth-friendly composition of the fiscal stance would further mitigate short-term tradeoffs between consolidation and growth. This could include a budget-neutral shift towards less-distortionary taxes such as property taxes, which are at relatively low levels in Finland, or investment spending, for example to promote urban-area housing construction.

11. **Structural reforms will help improve the public finances by raising growth over the medium-term**. For example, pension reforms would help contain spending increases while also boosting labor force, growth, and tax revenues. Measures to improve labor market mobility may entail up-front fiscal costs, but will increase productivity and lower unemployment later on. And improving public sector efficiency, especially at the local government level, will also help rein-in expenditure growth.

Securing financial stability

12. **The banking system has proven resilient throughout the double-dip recession.** Banks are well capitalized and non-interest income has provided relief to sagging profits. However, banks are increasingly exposed to the weak economy and low interest rate environment. Household indebtedness continues to rise (reaching close to 120 percent of disposable income in 2013), non-performing loans are edging-up, and deposit growth is subdued. While credit is low overall, housing-related credit growth is still relatively buoyant (at just under 4 percent per annum), but this is not

leading to measurably higher spending or investment. At the same time, the banking system remains highly concentrated and interconnected across the Nordic region.

13. **A robust macroprudential framework is crucial to containing underlying risks and ensuring stability.** Long-needed legislative progress is being made in line with the evolving EU framework. The proposed empowerment of the independent Board of the FIN-FSA, with a permanent voting role for the Bank of Finland, will create a macroprudential authority with comprehensive decision-making powers. The Bank of Finland is well placed to support the policy-making process through surveillance and analysis.

14. **The new instruments should be deployed in full and in line with the requirements of the integrated Nordic banking market**. Legislation should maintain the full scope and flexibility of instruments detailed in CRD IV/CRR. This would ensure the macroprudential authorities' capacity to respond to mounting risks and would leave it positioned to work toward full harmonization of macroprudential tools within the Nordic region. In particular:

- Observing macroprudential minima across the Nordic region will limit regulatory arbitrage. Finland lags behind Sweden and Denmark in legislating the full flexibility of instruments under CRD IV/CRR. In this regard, the systemic risk buffer should be incorporated into national law, and the Board of the FIN-FSA should be given the flexibility to set the countercyclical capital buffer above the mandatory reciprocity threshold. Similarly, liquidity requirements should be harmonized across the Nordic region.

- Rising household indebtedness and banks' exposure to the real estate sector pose risks to both bank and household balance sheets. The planned introduction of Loan-to-Value (LTV) caps for new mortgages will directly reduce demand for a limited portion of loans and help ensure credit quality throughout the cycle. LTV caps will be most effective if focused on property values, as set out in ESRB recommendations. The FIN-FSA Board could also use more binding LTVs at the regional level as needed to reduce localized pressures. Similar to other Nordic markets, higher mortgage risk weights would help adjust lending incentives and limit bank exposures. These efforts could be further supported through the implementation of a national loan registry.

- Regional supervisory cooperation should be maintained as progress toward a euro area banking union continues and the role of the SSM is enforced. Absent binding regional agreements on resolution and burden sharing, the tools afforded under the BRRD should be implemented as soon as they are finalized at the EU level.

The mission would like to thank the authorities and other counterparts for their hospitality and the high quality and openness of the discussions.