INTERNATIONAL MONETARY FUND

Finland: Staff Concluding Statement of the 2018 Article IV Mission

November 6, 2018

Finland's recovery continues. Growth is expected to be high this year, but lower next year and over the medium term. Structural reforms have been successful in bringing more people to work, but, given a shrinking population, permanently raising potential growth ultimately requires higher productivity growth. More dynamism in the labor market would help workers find the most suitable jobs and boost the transfer of skills across the economy. The public finances have benefited from the upswing in growth, but maintaining steady and moderate reduction in fiscal deficits is advisable given the prospect of increasing demands on social services from an aging population. A broader macroprudential toolkit would be useful to prevent an escalation of household financial vulnerabilities; stronger powers to protect borrowers should be considered given rapidly-increasing consumer lending, especially through non-bank lenders.

Economic Situation and Outlook

1. **Finland is enjoying its third consecutive year of economic recovery.** Strong growth has continued into 2018. The employment rate has picked up sharply and the unemployment rate has declined to its lowest level since 2011. Wages have started to recover, but inflation remains low. A pick-up in exports has improved external balances, while stronger tax revenues and lower spending, including on unemployment benefits, have improved fiscal balances.

2. **But growth is likely to slow after peaking this year.** Growth in 2018 is expected to be 2.8 percent, then 1.9 percent in 2019 as global demand slows and financial conditions tighten. There are downside risks to this outlook, particularly from the global environment:

an increase in protectionism could weaken demand for Finnish exports and damage confidence, and higher bank funding costs could mean tighter credit.

3. **Over the long term, the challenge is to raise potential growth.** Even assuming some further increases in the number of people participating in the labor market, the labor force is expected to decline as the working age population shrinks. Without a permanent increase in the rate of productivity growth, long-run potential growth is likely to be constrained to around 1¼ percent.

Structural reforms

4. **Recent reforms have boosted trade and employment.** The 2016 Competitiveness Pact helped make Finnish exports more cost competitive. Changes to social benefits enhanced incentives to look for jobs, and new rules for temporary hires have the potential to boost employment and labor flexibility.

5. **Nevertheless, problems remain with productivity and the labor market.** Firms are facing difficulties matching workers to job opportunities. Unemployment rates remain persistently high in some regions despite ample vacancies in others. Job mobility is low and has not picked up. Meanwhile, productivity growth is still below pre-crisis rates, despite the strength of the recovery.

6. **The focus of reforms should be on increasing labor market dynamism while maintaining a strong safety net**. International experience indicates that higher rates of job-to-job movements help to transfer skills and best practices across firms, raising productivity growth and incomes. Enhancing the ability to differentiate wages at the firm level—consistent with the spirit of the 2016 Competitiveness Pact—should help motivate job moves and better match workers to jobs in which their skills can be used more efficiently. Tapering benefits to gradually fall with their duration could increase job search soon after losing employment and reduce the risks of losing skills and falling into long-term unemployment. Other policies may be needed to foster regional labor mobility, such as alleviating housing bottlenecks and improving transport infrastructure in and around fast-growing regions to facilitate commuting.

Fiscal Policy

7. **Long-term sustainability considerations underscore the need to rebuild fiscal buffers**. Public debt has been falling during the past three years, but remains above its pre-crisis level, and contingent liabilities are relatively large. The Finnish economy is highly exposed to trade and financial shocks, with the potential for large demands on fiscal resources in times of stress. Moreover, demands for public services—especially for healthcare—are expected to increase considerably as the population ages.

8. **The 2019 budget implies a moderate tightening of fiscal policy.** It provides for some new expenditure measures to boost employment, R&D, and education, but the deficit will nonetheless shrink because of the effects of previously-agreed measures. At this stage of the business cycle, the budget implies a moderate fiscal contraction in structural terms.

9. **Continued steady deficit reduction is appropriate to boost fiscal buffers**. Revenues are already quite high in terms of GDP, implying limits to debt reduction from raising taxes and/or social security contributions. Public investment has been maintained at relatively high levels compared to other countries, although consideration should be given to the level of R&D spending and transport needs . Hence, in conjunction with policies to boost potential growth, more effort should now be directed toward raising the effectiveness of public spending. The planned health and social services reform targets substantial savings from efficiency gains which, if realized, would make a substantial contribution toward closing the fiscal sustainability gap and restoring fiscal buffers. That said, savings from the proposed reform are uncertain and will depend crucially on implementation, including by the new counties that will organize public healthcare and social services.

Financial Policies

10. **The banking sector is sound, but has distinctive features that pose challenges for supervision**. Immediate financial stability risks appear limited: the level of non-performing loans is low, and bank capital exceeds required levels by a clear margin. However, the system is highly concentrated, interconnected with financial sectors of other Nordic countries, and reliant on wholesale funding. In addition, the size of the banking sector has increased substantially with the recent redomicile of Nordea to Finland.

11. **Household financial vulnerabilities remain a concern**. Household debt has been rising, and some households have become more vulnerable to interest rates hikes as their leverage has increased and with a high share of floating rate loans. The growth in consumer credit raises the question of whether borrowers—especially those dealing with non-bank lenders—are sufficiently informed about the conditions of their loans. Expanding the macroprudential toolkit to debt-based instruments, such as debt-to-income and debt-service-to-income ratios, would be useful to limit household leverage. To properly assess vulnerabilities and set these tools well, the authorities need more data, such as from a positive credit registry. The rapid growth of lending through digital platforms also motivates additional data collection. To mitigate the risks from consumer credit, the authorities should consider extra consumer protection measures, covering loans from non-banks in addition to banks.

12. **The redomicile of Nordea—a systemically-important bank operating across Nordic markets—to Finland increases demands on supervision and heightens the importance of continued close regional cooperation and preparedness for crises.** Nordea is now supervised by the Single Supervisory Mechanism, which already oversees other significant European banks, and the resources of the ECB and the Finnish financial supervisory authority have been increased. The ECB and Nordic supervisors have committed to

continuing their close regional cooperation. The ECB and Finnish authorities have set capital requirements that ensure that Nordea would have the same level of capital as before its redomicile. Work continues at the European level to fully implement the framework for resolving banks in distress; this is particularly important for a large and complex bank such as Nordea.

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