Finland—Concluding Statement for the 2015 Article IV Consultation
September 15, 2015

Finland's economy has been in a slump for three years, owing to a combination of cyclical and structural shocks. The recovery is fragile and medium-term growth is projected to remain much lower than before the crisis. Reviving activity by boosting productivity and raising labor participation is Finland's central challenge. This requires comprehensive structural reforms, including to the wage bargaining system, unemployment insurance, and active labor market programs. Meanwhile, fiscal policy should strike a balance between needed consolidation and protecting the recovery. Financial stability risks appear contained, but ensuring adequate instruments are available to deal with potential future shocks is key.

Economic situation and outlook

1. The Finnish economy has been in recession for three years. Following strong economic performance earlier, Finland has suffered a unique confluence of cyclical and structural shocks since the global financial crisis in 2008. Weak external demand and the parallel declines of Nokia and the paper industry have reduced exports, compounded by ill-timed wage increases in 2008–10 that damaged competitiveness. More recently, the recession in Russia has taken a further toll on exports. Rapid population aging has also started to add to the growth challenge. As a result of these shocks, pre-crisis current account surpluses have become deficits and the fiscal position has deteriorated. The 2014 deficit breached the Stability and Growth Pact's (SGP) 3 percent of GDP limit and debt is set to surpass the 60 percent of GDP threshold this year.

2. **The projected pace of the recovery is modest.** GDP is projected to increase 0.4 percent in 2015, partly driven by higher private consumption growth as lower inflation and mortgage amortization holidays offered by major banks support households' real purchasing power. Growth is projected to rise to 0.9 percent in 2016 as private investment starts contributing positively to growth, mainly driven by sizable investments in new technology in the paper industry. The gradual recovery will also be supported by the bottoming out of Nokia's decline and the expansion of its network equipment business. Absent further structural reforms, however, medium-term growth will likely remain much slower than pre-crisis, rising to only around 1½ percent in 2020. Unemployment is forecast to peak in 2016 and gradually decline thereafter. Inflation, which has dropped to around zero, is set to pick-up in 2016 as the effects of falling commodity prices abate.

3. **The upturn could be derailed by further shocks.** Slower-than-expected growth in trade partners, including Russia and the euro area, is a key risk and would be a drag on export growth. Meanwhile, spillovers from a financial shock, whether originating in the region or elsewhere in the euro area, could cause a tightening of financial conditions in Finland, with a potentially significant impact on investment, consumption, and the housing market. Domestically, the main risk is that the pro-cyclical fiscal consolidation would weaken the recovery more than already anticipated.

Policies

4. **Finland's critical challenge is to revive growth.** The precipitous decline of once rapidly growing high-productivity sectors has negatively impacted aggregate labor productivity and TFP growth, with the latter forecast to be only half its pre-crisis average over the medium-term. Facilitating the reallocation of resources from declining industries to growing ones is critical to restoring growth. At the same time, adverse demographic trends will continue to weigh on labor force growth in the years ahead, which calls for higher participation rates to mitigate the negative impact on activity. Fiscal policy should balance consolidation needs against growth objectives.

Structural reform

5. **The new government's comprehensive structural reform plan is promising, but needs to be further developed and implemented**. Last year's agreement on pension reforms will help slow the decline in labor supply and address the long-run sustainability gap in public finances. The new government's structural reform agenda appropriately aims to boost growth through product and labor market reforms and improving public sector productivity. The proposal to parliament to liberalize shop opening hours is a welcome concrete step and could have an immediate positive effect on employment and output. Recently announced plans to reduce the labor tax wedge, overtime pay, and paid leave days will help improve competitiveness, but do not obviate the need for a more comprehensive approach to labor market reform (as described below). Several other reform proposals remain to be fleshed out over the coming months.

6. **In this regard, the mission would highlight the following priority areas**.

- *Wage formation*. The existing centralized collective bargaining system compresses the wage distribution and constrains firms' ability to adjust wages in line with firm-specific productivity developments. This reduces incentives for labor to be employed in higher-productivity activities and hampers the needed reallocation of resources. It also effectively results in a relatively high minimum wage that reduces demand for low-skilled labor, thereby raising structural unemployment. For these reasons, the mission strongly supports the government's intention to increase the flexibility of the wage setting system.

- *Participation*. To increase participation and strengthen work incentives, unemployment benefits reform is key, including by limiting benefit duration and improving monitoring to increase job search and acceptance of job offers. Some of the savings from such reforms could be used to strengthen active labor market programs (ALMP), including through earlier and expanded enrollment. Given rising unemployment, the government's current plan to cut funding for ALMP is therefore a concern. Tightening student aid requirements to reduce the relatively long duration of university education could also be used to promote longer working careers.

- *Housing*. Increasing the availability of affordable housing in growing areas would facilitate labor mobility away from regions with high unemployment. This requires streamlining planning and development rules and increasing land available for development as well as associated public investments, especially in transportation infrastructure.

- *Private sector productivity.* Increasing financing for R&D, including well-designed tax incentives, and SME exports could boost innovation, productivity, and growth.
- *Public sector productivity.* Reviving plans to consolidate the administration of health and social services could reduce overhead, streamline procurement, reap economies of scale, and help contain aging related fiscal pressures. Increasing local government's flexibility in service delivery could improve efficiency, though outcomes should be carefully monitored.

Fiscal

7. **Fiscal consolidation is needed to ensure long-run sustainability and respect European rules, but poses risks to short-term growth.** A sizable remaining fiscal sustainability gap calls for adjustment, which would also help ensure continued compliance with the SGP. To address this, the government's Strategic Program envisages a consolidation of about 2 percent of GDP through 2019. While sensible from a long-term perspective, in the short term the consolidation risks weighing further on already weak economic activity.

8. **Making the pace and composition of consolidation as growth friendly as feasible would support the recovery and improve traction of structural reforms.** Fiscal adjustment should focus primarily on items that address long-term pressures, such as envisaged efficiency improvements and savings in health and social services. The consolidation path could likely also be smoothed, while respecting SGP criteria. If growth disappoints, automatic stabilizers should be allowed to operate. Cuts to infrastructure projects that address well-identified needs, boost demand, and raise potential growth, should also be avoided. On the revenue side, the earned income tax credit increase in 2016 should help support private consumption, but the hike in unemployment insurance contributions will be detrimental as it raises labor costs when labor demand is weak. Delaying the tax increase until unemployment has fallen to normal levels would support employment. More generally, shifting the tax burden from labor to consumption or property taxes could raise medium term output.

9. **The envisaged "growth package" should be frontloaded to the extent possible so as to support growth at the time when it is most needed.** The mission strongly supports the authorities' announced growth package of one-off spending on infrastructure and other projects, which totals about 0.7 percent of GDP over 2016–18 and will partly mitigate the growth impact of the consolidation plan. Bringing forward the currently back-loaded investments envisaged under the package would provide additional support to growth in the short term.

Financial

10. **Financial stability risks appear contained for the moment.** Banks are profitable and well capitalized. Household credit and house price growth have slowed, reflecting the weak economy, and standard metrics suggest that Finnish house prices are broadly in line with fundamentals.

11. **However, ensuring adequate frameworks to deal with future shocks is key.** With the economy in a fragile state, financial shocks (including external ones) could be particularly damaging. It is also important that the authorities have an adequate toolset to contain risks once the recovery gathers steam. The Act on Credit Institutions, passed in 2014, established a macroprudential policy framework and introduced the macroprudential policy tools required by CRR/CRD-IV, as well as a loan-to-value cap for new mortgages effective from mid-2016. This was a major step forward. There remains scope to further strengthen the framework, especially by adding a systemic risk buffer. This would better align Finland with its Nordic neighbors and limit the scope for regulatory arbitrage.

12. **Regional cooperation on financial stability issues and the resolution framework for large cross-border banks should be enhanced.** With regard to the planned conversion of Nordea's subsidiary in Finland into a branch, it is important that the Finnish authorities retain the capacity to closely monitor this systemically important bank for the purposes of financial stability risk analysis and macroprudential policy formulation. Moreover, it would be critical that robust cross-border supervisory cooperation, such as on information sharing, depositor protection, and resolution arrangements, is agreed between the relevant Finnish, Swedish, and European authorities.

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