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Finland: 2001 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Authorities of Finland

- the Staff Report for the 2001 Article IV Consultation, prepared by a staff team of the IMF, following discussions that ended on **June 18, 2001,** with the officials of Finland on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on September 20, 2001.** The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a Staff Supplement of November 7, 2001 updating information on recent developments.
- a Public Information Notice (PIN), summarizing the **views of the Executive Board as expressed during its November 9, 2001 discussion** of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- a statement by the Executive Director for Finland

The documents listed below have been or will be separately released.

Selected Issues
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FINLAND

Staff Report for the 2001 Article IV Consultation

Prepared by the Staff Representatives
for the 2001 Consultation with Finland

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September 20, 2001

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- A staff team held Article IV consultation discussions in Helsinki during June 7–18, 2001, with the Minister of Finance, the Governor of the Bank of Finland, and officials from the Bank of Finland and the Ministries of Finance, Labor, and Social Affairs and Health. The mission also met with members of Parliament's Finance Committee, and representatives of labor unions, employers' organizations, research institutes, and the academic community. The mission comprised Mr. Feldman (head), Ms. Daseking, Mr. Vocke, and Ms. Wagner (all EU1). Mr. Johnston (MAE) participated during June 13–14 to conclude discussions on the Financial Sector Assessment Program (FSAP) conducted as part of this Article IV cycle. Mr. Lehmussaari, Executive Director, also participated in the meetings. The authorities published the mission's concluding remarks, followed by a press conference, and also plan to publish this staff report.

- Finland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system free of restrictions (Appendix I). It subscribes to, and is in observance of, the Special Data Dissemination Standard, and provides high-quality data, adequate for effective surveillance (Appendix II). Finland acceded to the OECD anti-bribery convention and adopted implementing legislation in 1999.

- The previous Article IV consultation was concluded on a lapse-of-time basis on August 22, 2000. At that time, the authorities—commended for their sound macroeconomic policies—were encouraged to complement public expenditure restraint with a significant reduction in the heavy tax burden on labor. These actions, in conjunction with other structural measures to stimulate employment and enhance the supply response of the economy, were seen as essential for avoiding inflationary pressures and adjusting to demographic challenges.

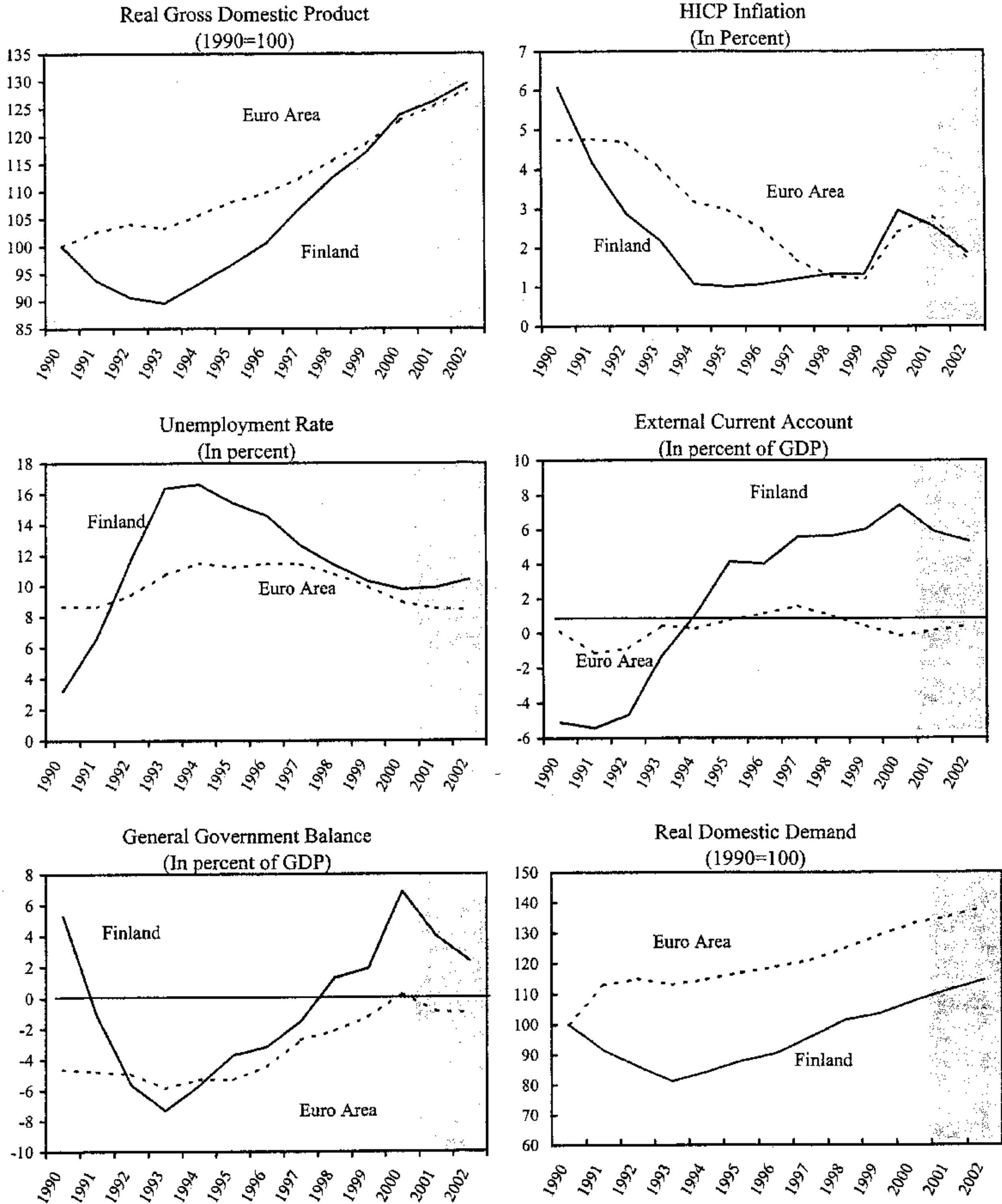
- The five-party "rainbow coalition", led by Mr. Lipponen (Social Democrat), was reelected in March 1999. It has declared raising employment its primary economic policy goal.

I. BACKGROUND

1. ***Sound macroeconomic policies and growing economic openness have been at the root of Finland's remarkable recovery from the recession of the early 1990s.***[1] Since 1994, real GDP growth has averaged almost 5 percent, annual inflation has been in the range of 1 to 3 percent, and the general government balance has shifted from a deficit of 7 percent of GDP to a surplus of the same size in 2000 (Figure 1). Meanwhile, the economy has become increasingly open—the sum of exports and imports rose from about 50 to 75 percent of GDP over the past decade—driven by a dynamic information and communications technology

[1] The recession—aggravated by a severe banking crisis—resulted from the effects of an overvalued currency, the collapse of trade with the former Soviet Union, a terms-of-trade shock, and the bursting of an asset price bubble.

Figure 1. Finland: Selected Economic Indicators, 1990-2001



Sources: World Economic Outlook, European Central Bank; and staff estimates.

(ICT) sector. This sector alone (dominated by Nokia, the world's largest mobile phone producer) has generated one-third of real GDP growth over the past three years and has overtaken the traditional forest industry in terms of both exports and value added. These structural changes have brought large benefits to the economy, but have also raised its exposure to a slowdown in international demand and weaker prospects for the ICT sector.

2. ***High unemployment and rapid population aging present the main economic policy challenges.*** After the large labor-shedding of the recession years, employment has been growing steadily, but the unemployment rate of almost 10 percent remains excessive. At the same time, labor supply is depressed by a low effective retirement age, with less than 40 percent of the people in the 55–64 age group currently employed.[2] As the population is aging rapidly, failure to reduce promptly the incentives for early retirement—and, more generally, raise the rate of employment—would greatly exacerbate demographic pressures and soon curtail growth sharply (Box 1). This would place large strains on the public finances, making it increasingly difficult to safeguard priority spending without burdening future generations with excessive taxes. All of this pointed the discussions toward ways to broaden participation of various segments of the population in the active labor force, including through a combination of structural reforms in the areas of pension, taxes, benefits, wages, and product market.

II. Recent Developments and Short-Term Prospects

3. ***Economic growth in 2000 was boosted by an exceptionally favorable international environment which has now weakened substantially.*** Real output expanded by 5¾ percent in 2000, spurred by a record contribution from the foreign sector, as the current account surplus swelled to 7½ percent of GDP (Table 1). However, when international demand began to weaken in the last quarter, export growth decelerated markedly, and turned negative in the first quarter of 2001 (Figure 2). Since then, some signs of further economic weakness have emerged: business confidence dipped in the face of diminishing export orders, and industrial production weakened—in particular in the ICT sector and the forest industry (which together accounted for more than half of all merchandise exports in 2000). However, on the domestic front, growth in private consumption, which was curbed in 2000 by the effect of higher inflation on households' real income,[3] rose in the first quarter of 2001. Moreover, through midyear, surveys indicate that households have remained optimistic about their own finances, with purchasing power boosted by tax cuts and lower projected inflation—as well as a further moderate increase in employment, which has proven fairly robust to the slowdown in the

[2] This ratio, while in line with the EU average, is low by Nordic standards. The average employment ratio for this age group in Denmark, Norway, and Sweden is above 60 percent.

[3] The national accounts measure of households' real disposable income was virtually flat in 2000, partly due to accounting peculiarities: taxes on proceeds from stock options and capital gains (which were exceptionally high in 2000) are subtracted from households' disposable income, while the proceeds themselves are not included.

Box 1. The Impact of Population Aging

- The demographic shock in Finland, while not as severe as in some other advanced economies, will occur earlier than in most. The old-age dependency ratio (population aged 65 and over as a percent of the working-age population of 20–64) will rise sharply from 2010 on to some 40 percent in 2020 and 50 percent in 2030—almost double the ratio of today and among the highest in the EU during that period. After 2030 the ratio is projected to stabilize, while it will be rising in most other EU countries, with anticipated peaks of around 60 percent in Germany and close to 70 percent in Italy and Spain.

- The potential impact on both economic growth and pension outlays is worsened by a low effective retirement age of 59 years—compared with a statutory retirement age of 65. If unchanged, this would not only advance, but also raise the magnitude of the demographic shock, as the number of people aged 60 and over, in proportion to the age group of 20–59, is projected to rise to 70 percent by 2030.

- The direct fiscal impact, measured by the increase of pension and health expenditures between 2000 and 2030, is projected to be on the order of 4½ and 1½ percentage points of GDP, respectively, if the effective retirement age remains unchanged. If the average retirement age were delayed by a number of years, substantial fiscal savings could be achieved as a result of both lower pension outlays and higher economic growth. The impact on growth and the public finances would depend on how the pension savings were split between the options of (i) retiring public debt (or accumulating assets) to lower net interest payments; and (ii) reducing taxes (preferably on labor) to stimulate employment.

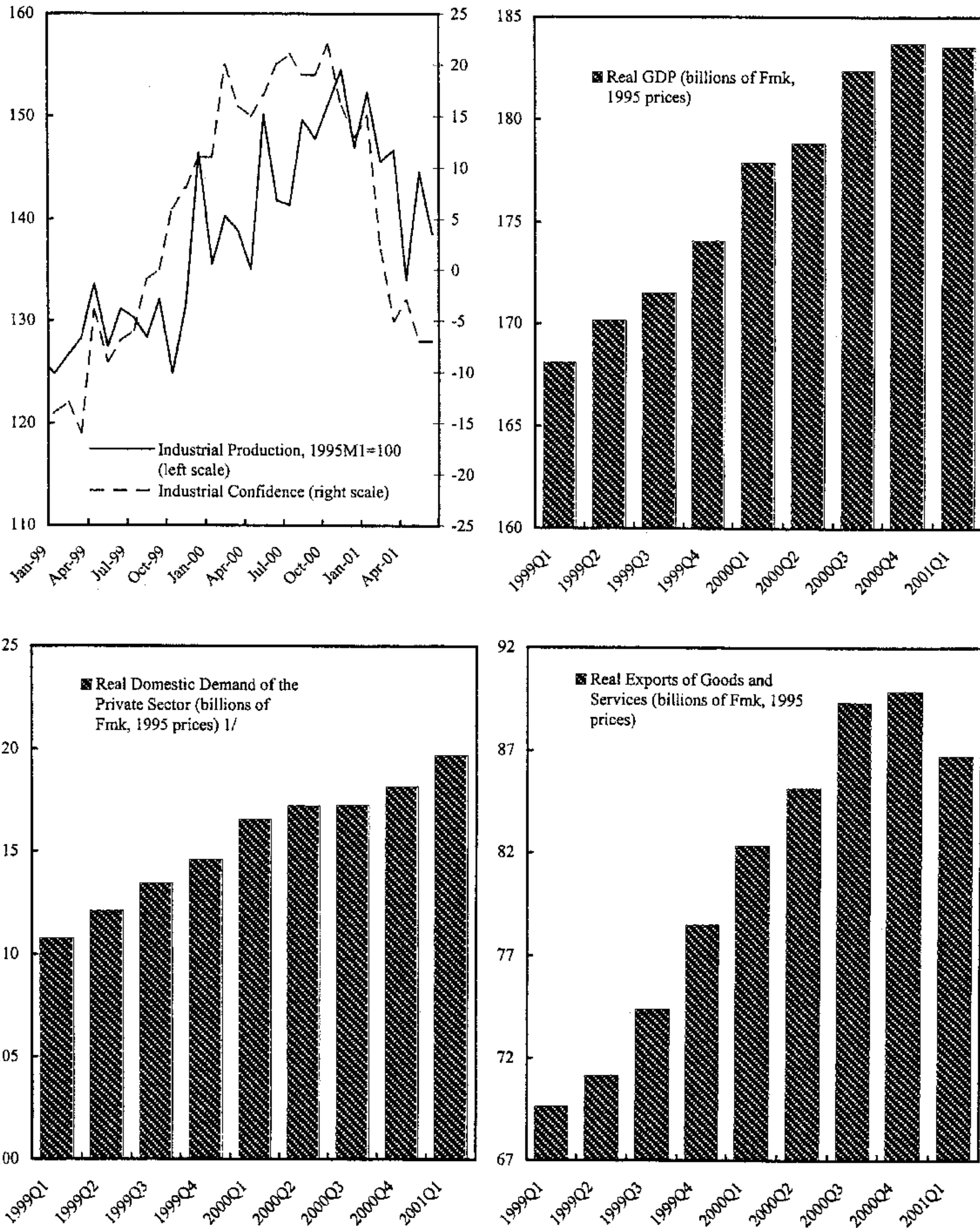
low-employment ICT and forestry sectors. Meanwhile, after brisk growth in 2000, private investment also expanded at a solid pace in the first quarter, but export-oriented industries are now experiencing spare capacity.

4. ***While CPI-inflation picked up in 2000, it is now on a downward trend—but core inflation has move somewhat higher.*** Spurred by rising oil prices and a depreciating euro, CPI inflation (harmonized) accelerated during 2000 and averaged 3 percent for the year. By mid-2001, weaker energy prices started to have a beneficial effect: year-on-year inflation fell to 2½ percent in July. However, core inflation (adjusted for prices of energy and seasonal food), which averaged only 2 percent in 2000, rose to an average of 3 percent in the first half of 2001. These price developments have mirrored those in other euro-area countries, but the core inflation rate in Finland has persistently exceeded the area average by ¾ percentage points.[4]

5. ***Accommodative monetary conditions in 2000 continued into the first half of 2001.*** Notwithstanding rising short-term interest rates in response to the ECB's policy tightening in

[4] Reasons are explored in the Policy Discussions section below (see the last bullet of paragraph 10).

Figure 2. Finland: Supply and Demand, 1999-2001
(seasonally adjusted)



Sources: European Commission; Statistics Finland; and ETLA.
1/ Sum of private consumption and private gross fixed capital formation.

2000, accommodative monetary conditions were driven by a fall in real long-term interest rates and a further depreciation of the real effective exchange rate from an already competitive level (Figure 3). In 2001, after a brief period of tightening, monetary conditions eased again, supported by the ECB's interest rate cuts in May, August, and September.

6. ***The fiscal stance, on the other hand, was clearly restrictive in 2000—but it is turning moderately stimulative this year.*** Despite tax cuts on labor—partly offset by a 1 percentage point increase in the tax rate on corporate income and capital gains—the general government surplus increased by a full 5 percentage points to nearly 7 percent of GDP in 2000. This was almost 2½ percentage points of GDP higher than projected in the authorities' September 2000 Stability Program.[5] A number of factors contributed to this sharp improvement, including a fall in net interest payments by more than ½ percentage point of GDP and a similarly-sized cyclical effect from strong growth. In addition, the surplus was boosted by "exceptional" revenues of an estimated 1¾ percentage points of GDP, which are expected to wind down during the coming years.[6] As these revenues are unrelated to fiscal policy measures, they are excluded from the structural primary balance in Table 1 for the purpose of assessing the fiscal stance. On this basis, staff estimates a fiscal withdrawal in 2000, brought about by a tightening of structural primary spending relative to GDP, of some 2 percentage points of GDP—strongly counteracting the monetary stimulus.[7] By comparison, fiscal policy is estimated to be moderately expansionary this year (as discussed below).

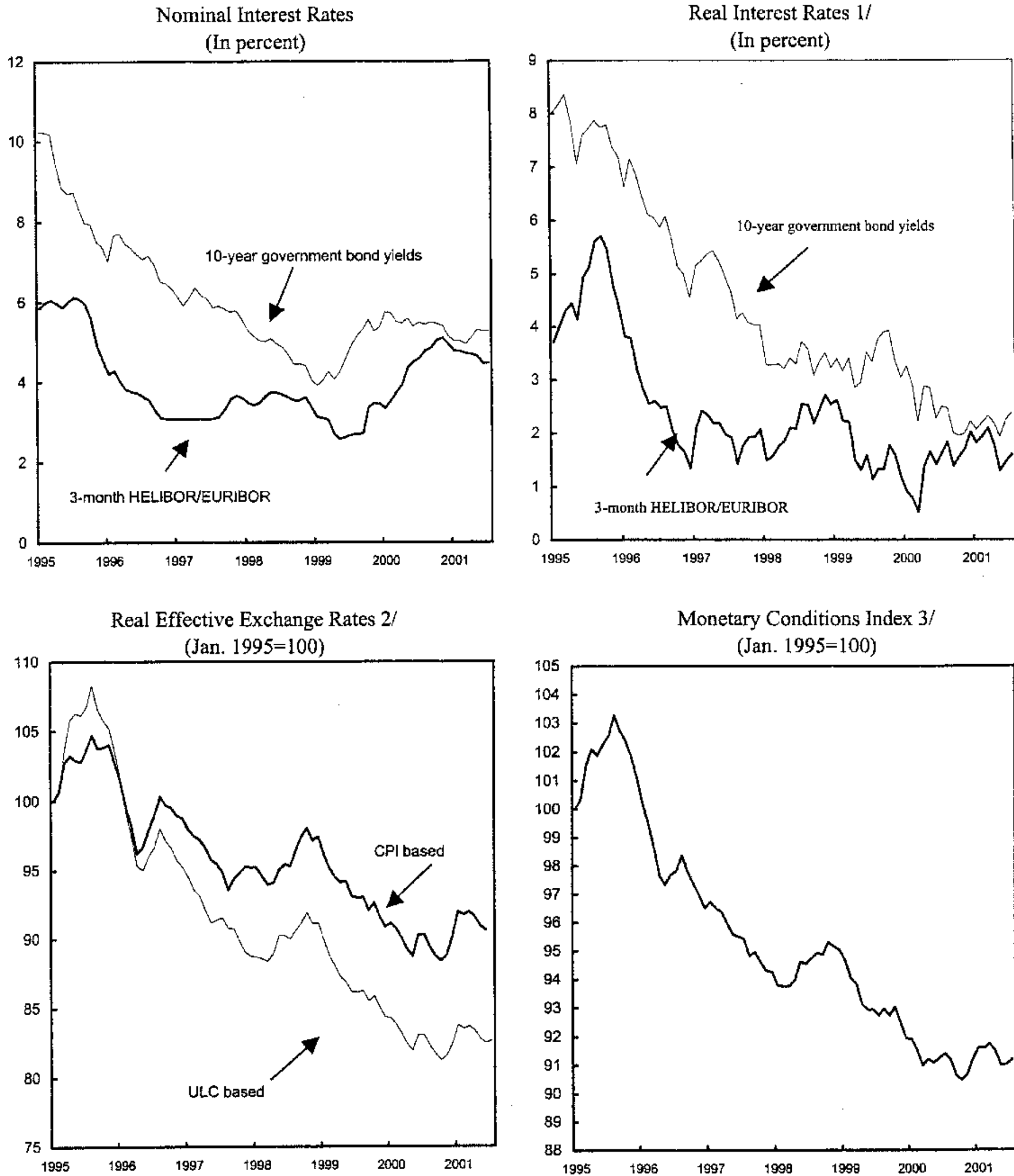
7. ***In light of a weaker external environment, a marked slowdown of growth is expected this year and next from last year's rapid pace.*** The staff's forecast, incorporating the deterioration in economic indicators through early September (prior to the terrorist attack in the United States), sees growth of 2 percent in 2001— ¾ percentage point lower than the authorities' projection of early August. Both the authorities and staff predict growth of 2½ percent for 2002. These forecasts incorporate substantive downward revisions since the consultation discussions, with the staff marking down its projection by 1¾ percentage point for 2001 and 1 percentage point for 2002. Underlying the staff's projections is growth in private consumption that is expected to remain broadly unchanged from 2000, as the effect of faster rising real incomes is dampened by additional precautionary savings in the face of the weaker economic outlook. Investment growth is projected to moderate in 2001, and to slow

[5] The EU Council of Ministers, while welcoming Finland's strong budgetary position, stressed the importance of further reductions in the still heavy tax burden on labor and the removal of disincentives for older workers to remain active.

[6] These exceptional revenues include some one-off items (such as dividend income paid to the government in the context of a merger), and other items that will be recurring, but likely at a lower—though highly uncertain—scale (such as taxes on employees' stock options and capital gains).

[7] The fall in the expenditure ratio in the context of overall spending restraint reflected, in particular, lower public investment and a decline in transfers to households.

Figure 3. Finland: Financial Indicators, 1995-2001



Sources: ETLA, Bank of Finland, Eurostat, and staff estimates.

1/ Derived on the basis of contemporaneous consumer price inflation through 1995 and core inflation (Eurostat definition, excluding price changes of energy products and seasonal food) thereafter.

2/ An increase denotes an appreciation.

3/ Based on staff estimates, using weights for real short-term and long-term interest rates and the real effective exchange rate (ULC based) of one-third each.

further in 2002, as capacity increases adjust to slower growth in industrial production. On the external front, staff projects a negative net foreign contribution to growth of 1 percentage point in 2001 and a small positive contribution in 2002, reflecting the assumption of a gradual recovery of foreign demand starting toward the end of this year.

8. ***Both the staff and the authorities project a fall in CPI inflation (harmonized) to an average of 2½ percent in 2001, and a further decline below 2 percent in the subsequent year.*** Absent a significant increase in energy prices, the projected deceleration in 2001 is expected to continue in 2002, as slower wage growth contributes to a further easing of price pressures. The latest comprehensive wage agreement implies a nominal pay rise of 2.3 percent, after an agreed 3.1 percent in 2001.[8]

III. Policy Discussions

9. ***Discussions focused on three broad issues:*** (i) the macroeconomic policy setting in 2001–02 in light of the cyclical position and short-term risks; (ii) the appropriate medium and long-term fiscal and pension reform strategy, including its implications for policies over the coming years; and (iii) the design of complementary structural measures to foster employment creation and strengthen the resilience and growth potential of the economy. The authorities and the mission agreed that the main task for policy now was to set the stage for prolonged growth over the medium and long term. In this context, to prepare for the demographic shock, the mission fully endorsed the government's primary economic policy goal of raising the employment rate as a prerequisite for sustaining growth, and supported its policy of maintaining sizeable structural surpluses in the general government before the shock seriously sets in. The appropriate policy measures for achieving this goal was a central topic of the discussions: decisive tax cuts on labor, ongoing public expenditure restraint, reforms to the pension system, and to the labor and product markets were identified as key ingredients of an efficient long-term strategy.

A. The Economic Conjuncture, Risks, and Policy Setting

10. ***Authorities and staff agreed that various indicators pointed to a weakening of cyclical conditions in 2001 from a position of little slack in 2000.*** A definite judgment on Finland's output gap is complicated by the large structural changes that have taken place over the past decade—and the authorities have refrained from publishing estimates of the output gap or the NAIRU for this reason. A main complication arises from the dual nature of the Finnish economy, characterized by fairly limited spillovers from a very dynamic (and volatile) ICT sector to the rest of the economy (Box 2). This allowed output to grow at high rates in recent years without overheating. Staff's approach, which links the output gap to

[8] The wage increase in 2002 would be adjusted upward if average inflation in 2001 were to be 3 percent or higher. In this case, the increase in wages would be adjusted upward by the amount by which actual inflation in 2001 exceeded 2.6 percent (e.g., if average inflation in 2000 were 3 percent, wages would rise by 2.7 percent).

Box 2. Finland's Dual Economy[1]

A main complication in determining Finland's potential output growth arises from the impact of the ICT sector. This sector alone has boosted annual GDP growth by 1½–2½ percentage points during the past three years to overall growth rates well above historical trends. As a result, GDP in 2000 is typically above the conventional measures of potential output.[2] On the other hand, domestic demand has risen by much less, and it is doubtful that Finland has already exceeded its full employment level with an unemployment rate of 10 percent—although most of this is indeed believed to be structural.

The main reason for this apparent contradiction is the *dual-economy* nature of Finland's recent growth performance. Not only have the "new economy" spillovers on productivity in the non-ICT sector been negligible, thus far, in addition, two more traditional spillover effects were also contained by the dual nature of the Finnish economy:

(i) The ICT sector still accounts for less than 5 percent of employment. Hence, its rapid expansion created little tension in the overall labor market with the exception of bottlenecks in the high-skill segment that were eased in part by recruiting foreign employees. Moreover, the use of bonus payments and stock options to compensate ICT-employees for the high productivity gains, together with an explicit acknowledgement in the wage bargaining process of this sector's special role, kept aggregate wage demands at bay, despite otherwise tight wage links.

(ii) The stock market wealth created by the ICT sector has mainly benefited foreign investors, and the domestic holdings (some 30 percent of the total market capitalization) have been highly concentrated, with only 1 percent of individuals owning 80 percent of the domestically-held assets. Thus, wealth effects on domestic demand, and therefore spillovers to other sectors of the economy, have been small.

These features taken together have allowed the economy to grow at high rates without overheating. Staff's approach for measuring the output gap captures this, by linking the gap estimate (in an Okun's-law type relationship) directly to the observed tightness in the aggregate labor market as measured by average wage pressures (i.e., wage increases relative to expected inflation and productivity growth).[3] This method implies a negligible gap in 2000. Looking forward, the dual nature of the Finnish economy should also mitigate the negative spillover effects on domestic demand and employment from a deceleration of growth in the ICT sector, provided adverse confidence effects remain small.

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[1] One of the chapters in the Selected Issues paper includes a more in-depth discussion of the ICT sector's role in Finland.

[2] The European Commission estimated a positive gap (i.e., GDP above potential) of 2½ percent in 2000, based on a Hodrick-Prescott (HP) filter, and the latest published OECD estimate was 1¼ percent for 2000, derived on the basis of an estimated production function. Internal calculations by the authorities applying an HP filter also produced a positive gap of about 2 percent.

[3] For a discussion of this and other techniques applied to Finland, see *Finland—Selected Issues*, (9/15/99).

aggregate labor market pressures,[9] helps shield the potential output measure from the volatile developments in the low-employment ICT sector, thus capturing Finland's dual-economy nature. It implies a negligible gap in 2000 that is projected to rise in 2001/02 (with actual GDP growth falling below potential, see Table 1). This result is broadly consistent with the authorities' more qualitative assessment of the gap as well as with recent cyclical indicators, which also portray some dual-economy aspects:

- The labor market, which tightened through 2000 as indicated by a steady rise in the vacancy rate, has recently eased again (Figure 4).[10] Even in 2000, reported shortages remained concentrated in a few sectors—including the ICT industry, construction in regional centers of growth, and some services. The authorities agreed that generalized wage pressures, measured either by the 4 percent increase in the index of wage and salary earnings in 2000, or by the 2001/02 wage agreement, have remained fairly modest. While the rise in average earnings in 2000 on a national accounts basis was somewhat higher at close to 5 percent, this figure was boosted by the ICT sector and its increased use of bonuses.

- Average capacity utilization in manufacturing also rose in 2000, but remained below previous cyclical peaks and has declined in the first half of 2001. To interpret Finland's capacity utilization rate in light of historical trends, however, may be misleading. The shift in activity toward the ICT sector likely raised the threshold at which capacity constraints become binding, as capacity in this sector tended to be fully used (until recently) but was also expanding rapidly.

- Core inflation has been on a rising trend, averaging 3 percent in the first half of 2001. The authorities did not view this as a sign of overheating, however. They explained part of the acceleration by the lagged pass-through effect of higher energy costs on other prices (e.g., those for transportation services) which should moderate alongside falling oil prices. The authorities were concerned, however, about price hikes in other services. They did not attribute these hikes to aggregate demand pressures, but rather to selective cost-push pressures that reflected insufficient differentiation in wage settlements combined with lower-than-average labor productivity growth in many services—and a lack of competition in parts of the sector.[11] Staff agreed that these factors had contributed to inflation above the euro-area average and were also threatening jobs in

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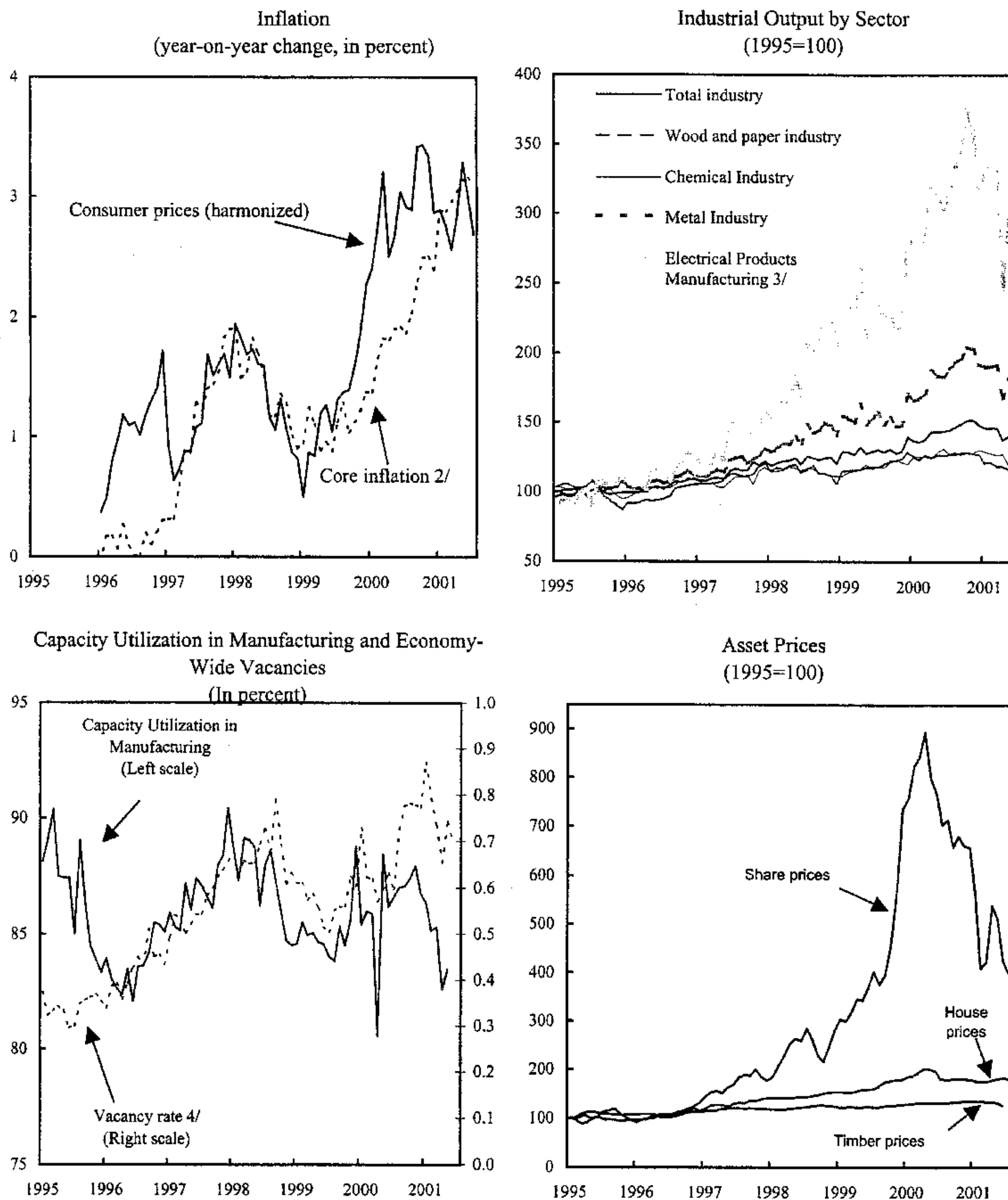
[9] For a description see *Finland—Selected Issues*, (9/15/99).

[10] The rate is still below one percent of the labor force—which seems low by international standards. However, in contrast to many other countries, it captures only the vacancies reported to the employment offices. As such, the vacancy rate is almost back at its pre-recession level, when the unemployment rate was less than 4 percent.

[11] This effect has to be distinguished from aggregate nominal wage pressures, which remained moderate, notwithstanding high productivity gains in the ICT sector.

Figure 4. Finland: Cyclical Indicators, 1995-2001 1/



Sources: ETLA and staff estimates.

1/ Seasonally adjusted.

2/ HICP index, adjusted for prices of energy and seasonal food.

3/ Included in metal industry.

4/ Vacancies in percent of labor force.

low-productivity sectors, as prices could not be raised indefinitely to offset wage increases that were out of line with productivity developments.

11. ***The dangers of higher inflation appeared limited and, on growth, the recent markdowns to the forecast reflect a further weakening of the external environment which was already recognized as a substantial downside risk during the discussions.*** Both parties acknowledged that uncertainties also stemmed from potential spillover effects on domestic demand—although these effects would be moderated by the low employment intensity of the two key export sectors (ICT and forestry) and the high concentration of stock market wealth—which had already dropped in aggregate by some 50 percent between the spring of 2000 and 2001. The staff concurred with the authorities that the comprehensive wage agreement for 2001/02 should keep inflationary dangers in check, provided energy prices declined (in line with assumptions in the WEO) and the euro did not weaken further. However, cost-push pressures in low-productivity jobs—particularly in the services sector, where prices were growing at annual rates of 4 percent—and the potential for accelerating wage drift in the high-skill segment of the labor market were seen to pose a threat to the favorable inflation outlook.

12. ***The mission agreed that the fiscal policy measures envisaged by the government were warranted on structural grounds, and the resulting stimulus is, if anything, even more justified in light of the recent markdown in the growth forecast to well below potential.***[12] Thus, the authorities regarded the current conjuncture as a good opportunity to follow through with tax cut plans, particularly given the strong fiscal balance. The mission agreed that in these circumstances, with growth slowing and lower expected inflation, accommodative monetary conditions should not be seen as an obstacle to needed tax reductions on labor. Broadly in line with the authorities' latest fiscal projections (received in the second half of August), but incorporating staff's somewhat lower growth projections, staff now expects a fall in the general government surplus in 2001 by 3 percentage points to just below 4 percent of GDP. This is about 1 percentage point lower than anticipated during the discussions, reflecting slower growth and, in particular, lower estimated corporate tax revenues. The estimated fiscal stimulus in 2001—taking the projected reduction in corporate tax revenues as cyclical—is close to ½ percentage point of GDP (Table 2).[13] The mission welcomed the composition of this stimulus, combining labor tax cuts (of about ¾ percentage point of GDP) with some structural expenditure tightening. On the basis of the government's current plans (discussed below) a similar stimulus, also in terms of composition, is projected for 2002.

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[12] Potential growth is estimated by staff at some 3½ percent (see Table 1).

[13] The significant (projected) volatility in revenues over the 2000-02 period—while cyclical in nature—is not adequately captured by the standard cyclical adjustment used by the staff. Table 2, therefore, derives the fiscal policy stance by directly quantifying the effects of the government's policy measures (and defining the cyclical effects as a residual).

13. ***Risks of adverse financial sector spillovers were seen as limited in the existing environment, but a rapidly evolving financial market called for stronger regulatory and supervisory arrangements.*** The authorities appreciated the assessment of Finland's financial sector under the FSAP, which suggested that the system was very sound and fairly resilient to large asset price fluctuations and a sizeable external shock (Box 3). They acknowledged that Finland's position—at the forefront of financial innovation and reorganization toward complex cross-product and cross-border conglomerates—called for supervisory arrangements that met, and exceeded, international standards. In particular, the authorities agreed that the independence, accountability, and early intervention powers of the Financial Supervision Authority warranted strengthening, and legislation was already being prepared to address a number of the issues identified under the FSAP. Being well aware of the particular moral hazard problems that existed in most financial markets with systemically important players, they were hopeful that the existing supervisory cooperation across the Nordic and euro area could be further enhanced and legislation harmonized over time.

B. Medium-Term Fiscal Strategy and Pension Reform

14. ***There was a strong consensus that longer-term issues—most notably, the impact of population aging—had important implications for how fiscal policy should be formulated over the coming years.*** As the population ages, there will be a natural tendency for health and pension expenditures to rise, and the balances of the general government to worsen significantly as a result. Pension reforms could go a long way in easing the fiscal pressures of population aging. Beyond that, to avoid growing structural deficits (also in line with Finland's commitment under the EU's Stability and Growth Pact), the government needs to decide whether to maintain sizeable surpluses for some time, to pay back debt and generate interest savings; or shift the burden on future generations in the form of higher taxes, fewer resources to provide public services, or both. Clearly, the first choice would seem more desirable in terms of intergenerational equity. Supplementing this with further progress in rationalizing expenditures would leave room for additional tax cuts on labor, and thereby ease the impact of demographic pressures through stronger employment creation and growth. Pension reforms that encourage a longer working life would have a similar effect in addition to dampening expenditures. Box 4 and Figure 5 illustrate how expenditure moderation, labor tax cuts, and pension reforms can mutually reinforce each other to support the generation of employment, economic growth, and fiscal soundness.

15. ***Against this background, the broad outlines of the government's medium-term strategy are well-advised—though the mission expressed concern about higher spending, including from the further use of revenue windfalls.*** The medium-term strategy for 2002–04, as described in the authorities' September 2000 Stability Program, originally aimed at holding central government spending broadly constant in real terms, while providing for a reduction in labor taxes (by about 1 percentage point of GDP, with a ½ percentage point cut in 2002) and in indirect taxes (by ½ percentage point of GDP over the entire 2002–04 period) However, perhaps in response to the unexpectedly strong revenue outcome in 2000, expenditure pressures have risen since the Stability Program was formulated, and the government's latest spending proposal—announced already during the consultation discussions—implied an increase in real central government spending by about 2 percent in

Box 3. Key Findings of the FSAP

- ***Finland's financial system is currently very sound and fairly resilient to macroeconomic shocks.*** The banking and insurance industries are well capitalized, and profitability of the banking system is good, reflecting strong macroeconomic performance, banking sector restructuring, and generally conservative lending behavior after the banking crisis of the early 1990s (Table 3). Stress tests support this assessment, suggesting that the financial sector is currently fairly robust to sizeable asset price fluctuations and a severe external shock. This reflects the limited financial sector exposure to corporate risks and large reserves held by insurance companies.

- ***The risks for the economy from adverse financial sector developments were also assessed to be fairly low in the current environment.*** This owes, in large part, to the elimination of most exchange rate risks with the adoption of the euro; the solvency of firms and households; and the access of Finnish corporations to international financial markets. In this environment, the direct impact of financial sector distress—abstracting from potentially wider confidence effects—would be felt mostly by small and medium-sized enterprises and households suffering from a reduced availability of funds.

- ***Finland's position at the forefront of financial innovation, however, poses challenges for supervisors.*** The financial system is reorganizing with the creation of complex cross-industry and cross-border financial conglomerates, and is now very concentrated, with three large financial institutions covering most of the market. At the same time, competitive pressures are increasing. In this environment, supervisory arrangements will need to meet and even exceed international standards.

  The FSAP mission concluded that regulatory and supervisory arrangements needed to be strengthened to mitigate potential vulnerabilities in a more demanding financial market environment. Priority should be placed on enhancing the independence, accountability, and early intervention powers of the Financial Supervision Authority (FSA). Preventing regulatory loopholes will increasingly require harmonization of regulatory and supervisory arrangements across different regulatory jurisdictions, both within Finland and more broadly in the Nordic and euro area. This calls for the speedy enactment of new legislation on the FSA and on financial conglomerates, as well as for enhancing the existing cross-discipline and cross-border cooperation among supervisors.

2002.[14] The mission cautioned that additional, particularly recurrent, spending could threaten the success of an employment and growth promoting long-term strategy that relied on meaningful tax cuts on labor as well as sizeable medium-term surpluses.

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[14] The increase in real terms relative to the 1999 budget (the government's own benchmark established under its 1999 program) is 2½ percent—or about ¾ percentage point of GDP—but half of this is explained by higher transfers to the national pension fund, to compensate for cuts in social security contributions.

Box 4. Strategies for Dealing with the Demographic Shock

The strong fiscal balance, aided by the surplus in the pension funds, places the government in a favorable position to deal with rising demographic pressures in the coming decades. However, policy decisions over the next 10 years on public spending, taxes, and incentives to retire will have a strong impact on long-term employment, growth, and ultimately the way the burden of population aging is shared between current and future generations. Two alternative long-term scenarios help illustrate the trade offs (Figure 5).[1]

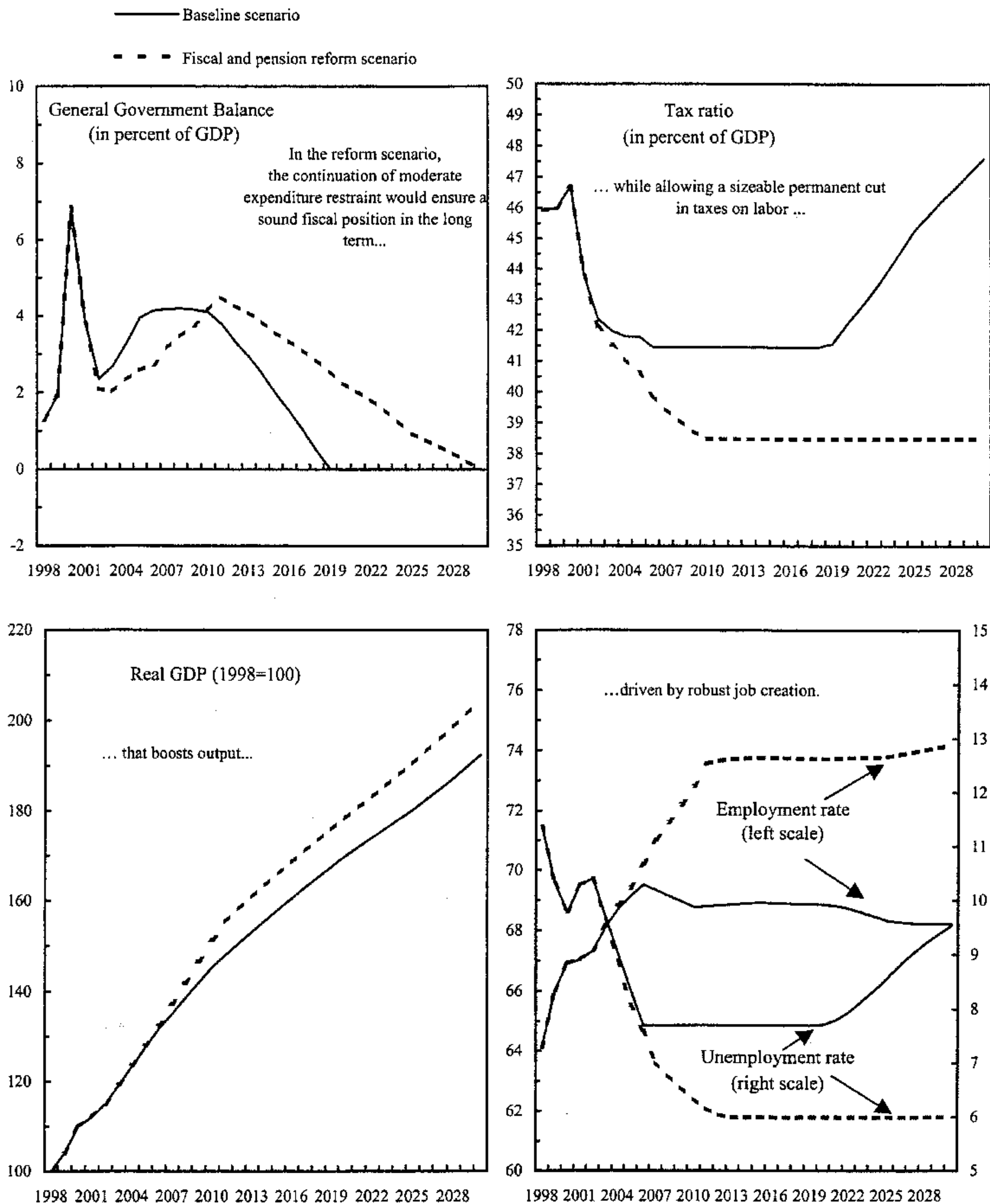
The first (baseline) scenario incorporates the government's expenditure plans and moderate tax cuts (direct and indirect) of 1½ percentage points of GDP over the 2002–04 period, and assumes a small increase in the effective retirement age by one year, as a rough assessment of the impact of recent pension reforms. Under this scenario, with expenditures linked to developments in the relevant population segments (e.g., education spending is proportional to the size of the age group 7–19 and pensions to the age group above 60), the general government surplus would rise gradually over the medium term and hover around 4¼ percent of GDP during the second half of this decade. Subsequently, the surplus would decline steadily, reflecting rising pension and health outlays, and falling economic growth due to a shrinking labor force. In the longer term, the surplus would be depleted, and higher taxes and social contributions would be needed to avoid fiscal deficits or a sharp cut in other public expenditures. As a result, the unemployment rate, which is projected to fall to nearly 7½ percent in the medium term—thanks to moderate tax cuts and recent labor market reforms (described in more detail below)—would rise again above 9 percent by the end of the projection period. Similarly, the employment rate, after approaching the government's target of 70 percent over the medium term, would decline again during the later years, while GDP growth would falter already before the end of this decade, due to the shrinking labor force.

The second (fiscal and pension reform) scenario assumes a more sizeable reduction in tax rates on labor income, combined with modest spending restraint and additional measures to curtail incentives for early retirement. It is assumed that, relative to the baseline, the tax burden is reduced by a further 1 percentage point of GDP by 2004 and another 2 percentage points by 2010; the effective retirement age increases by an additional 2 years (in line with the government's declared goal); and primary spending grows at a more moderate pace than in the baseline.[2] Due to the additional tax cuts, fiscal surpluses would be smaller over the medium term. However, the tax cuts combined with a longer average working life would boost employment and GDP growth while lowering unemployment and pension outlays, so that by 2010 the fiscal position would be identical to that in the baseline, and exceed it thereafter. Without a need for tax increases in later years, the unemployment rate would stabilize at 6 percent and the employment rate would hover around 74 percent, similar to its historical level. This beneficial interaction between employment, growth, and fiscal savings could be further enhanced by complementary labor and product market reforms, as discussed below.

[1] For a description of the framework and the assumptions of the model, see *Finland—Selected Issues*, 9/15/99.

[2] It is assumed that the primary spending ratio falls by another 3 percentage points of GDP between 2004 and 2010 (similar to the adjustment already achieved between 1998 and 2000), while it would remain broadly stable over this period in the baseline.

Figure 5. Finland: Long-Term Fiscal Scenarios, 1998-2030



Source: IMF staff projections.

16. ***The discussion also focused on the advantages of a larger front-loaded reduction in the heavy tax burden on labor.*** The authorities recognized that, by international standards, Finland's tax rates on labor (including social security contributions) are still high across all income levels (Table 4). In line with the reform scenario in Box 4, the mission recommended a doubling of the originally planned reductions in labor taxes to 2 percentage points of GDP in 2002–04, with a 1 percentage point cut in 2002, and equal cuts of half the size in 2003 and 2004. Such tax cuts, while lowering structural surpluses in the general government over the medium term, would still allow a further reduction in public debt and provide sufficient room for the operation of automatic stabilizers in the event of a significant economic downturn. Moreover, when judged against the lasting benefits to employment and growth, any risks from tax cuts of this size providing additional fiscal stimulus would seem well worth taking, provided the government avoids further increases in real spending.

17. ***Subsequent to the consultation discussions, the government decided on additional tax cuts on labor in 2002, while revising downward its projections of the fiscal surplus.*** This revision of 1¾ percentage points to a surplus of 2½ percent of GDP in 2002 reflected (i) a 1 percentage point carry over from the downward revision in 2001; (ii) about ½ percentage point attributed to slower growth projections, including a weaker profit outlook; and (iii) an additional ¼ percentage point reduction in labor taxes (through cuts in employer's social security contributions). Staff welcomes the decision to augment the originally planned tax cuts in 2002 from ½ to ¾ percentage point of GDP, while allowing stabilizers to operate. It is hopeful that this augmentation is not simply a frontloading of original tax cut plans,[15] but represents instead a tax cut that goes beyond the original plans for the medium term. Indeed, with a projected structural surplus of 4 percent of GDP in 2004 under the authorities' original tax cut plans (assuming no additional real spending increases in the central government), staff sees sufficient room for its suggested tax reduction on labor of 2 percentage point of GDP over the 2002–04 period (i.e., 1 percentage point of GDP more than under the original plans). This would imply a structural surplus of 3 percent of GDP in 2004, consistent with the reform scenario in Box 4).

18. ***Regarding the structure of tax cuts, the government remains committed to across-the-board reductions in the tax wedge—a strategy which the mission broadly supported, while emphasizing the merits of additional targeted relief for low-income workers.*** The authorities agreed with the mission that tax relief for low-income groups, particularly if accompanied by changes in the benefits system, could potentially generate the strongest employment leverage, by removing income traps that exist when high taxation of wages makes work unattractive relative to unemployment or a withdrawal from the labor force. However, they also pointed to evidence of incentive problems for middle-income earners—and specifically families—who face high marginal tax rates and the threat of lower income-related support as a discouragement for additional work efforts and the acquisition of new skills. The mission agreed that this was a serious problem in Finland's dynamic

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[15] As noted in paragraph 15, these plans included an overall 1 percentage point of GDP reduction in labor taxes in 2002–04 and a ½ percentage point of GDP cut in indirect taxes.

economic environment, where the skills demanded on the labor market were constantly evolving. Finally, with rising international competition for, and mobility of, high-skilled workers, there was agreement that Finland could not afford to defy the international trend toward lower tax rates at the high-income level.

19. ***The authorities recognized that a marked increase in the average working life is essential for a successful demographic strategy—and that more may need to be done to achieve this goal.*** Past reforms have clearly improved the sustainability of the pension system and have lowered (by some 8 percentage points) the projected increase in the long-term pension contribution rate.[16] Nevertheless, the current system still contains a number of features that have the unintended effect of discouraging a longer working life (Box 5). The government is well aware of the problem, and has announced additional measures if a joint assessment with the social partners over the coming years suggests that reforms already undertaken are insufficient to increase the effective retirement age by the targeted 2–3 years.

20. ***The government's desire to raise the effective retirement age prompted discussions of the reforms needed to correct the incentive problems evident in the pension system.*** Swift action was seen as crucial to affect the decisions of Finland's "baby boomers"—the first of whom are now reaching the age, of 55, at which some of the early-retirement incentives begin to bite. To this end, the mission proposed a number of measures—not new to the domestic debate—that, taken in combination, would greatly improve both the fairness of the pension system and the incentives to work longer, namely: (i) allowing the accumulation of pension rights from the beginning of each person's working life; (ii) abolishing the cap of 60 percent on pension rights along with the higher old-age accumulation rate; (iii) introducing a more flexible retirement age within a reasonable range, while taking into account changes in life expectancy when determining pension benefits; (iv) discontinuing the various subsidized schemes, such as part-time and unemployment pensions, together with the "unemployment pipeline"; (v) enforcing strictly the eligibility requirements for disability pensions;[17] and (vi) reforming the financing system for

[16] Reforms prior to 2000 included a reduction in the indexation base for pensions and a lengthening of the period of working life that determines the pension income (see Country Report No. 99/122 for a more extensive list). In addition, changes introduced in 2000 included a reduction in the level of "unemployment pensions" (available for unemployed aged 60 and over) and an increase in the age limit (from 58 to 60 years) for individual early retirement pensions (a specific form of disability pension for older workers with less stringent eligibility criteria).

[17] Disability pensions have traditionally been the primary channel into early retirement. The sheer number of disability pensioners (equivalent in 1997 to 44 percent of people in the age group of 60–64 and 17 percent in the group of 50–59) suggests that the eligibility requirements may have been interpreted too generously.

Box 5. Incentive Problems Within the Pension System

Several features of the Finnish pension system effectively discourage a longer working life. First, the existing *schemes for early retirement*—while well intended and serving to lessen the social impact of the recession on the older members of the population—are not only turning into a threat to future generations, but are also too often defeating their purpose:

- Part-time pensions enable "pensioners" aged 56 or above to work part time without losing much of their earnings and none of their pension rights. While having been introduced to keep older workers in the active labor force who otherwise would have retired, in practice, they provide strong incentives for those, who otherwise would have remained fully employed, to work less.
- The so-called unemployment pipeline to retirement starts at age 55 with a fairly automatic extension of unemployment benefits at little loss to income, and offers a ready path to the unemployment pension at age 60. In practice, this serves as a blanket discouragement to job search, irrespective of a person's skills and chances to become reemployed, while providing an easy excuse for employers to lay off older workers.
- In the current system of financing unemployment and disability pensions, larger firms face growing social security contributions as the age of their employees rises, and also bear part of the direct cost of unemployment and disability. Thus, they have a strong disincentive for keeping or hiring older workers.

In addition, three more *general features* of the system weaken incentives to join the labor force early or participate until the statutory retirement age of 65. They also add to the system's (actuarial) unfairness, as those who work longer effectively subsidize those with shorter working lives:

- Pension rights accumulate only from the age of 23, irrespective of when a person starts working. This makes early participation in the labor force financially less attractive.
- Pension benefits are linked to earnings over the last ten years of employment. This implies an unduly large penalty for taking on a lower paid job at later stages of the working life, while favoring people—often with better jobs and education—who have a steeper pay scale due to promotions later in their careers.
- Pension benefits are capped at 60 percent of the so-called pensionable wage. This can further diminish the attractiveness of a longer working life for somebody who joined the work force early. This effect is accentuated by a higher rate of pension accumulation rights from the age of 60, implying that a person with an uninterrupted working life, starting at or before age 23, accrues no further pension rights after the age of 61.

C. Complementary Reforms of Labor and Product Markets[18]

21. ***A key issue was the scope for complementary labor market reforms to reinforce the virtuous circle of employment creation, growth, and fiscal savings.*** Past reforms to strengthen labor market performance have included active policy measures (such as enhanced training programs), more flexible working-time arrangements, and various measures to improve work incentives, including tighter eligibility for unemployment benefits and a steady increase in the gap between labor and unemployment income.[19] Nevertheless, at present, the combination of high taxes and income-related social benefits—such as child-care and housing allowances—still means that the additional financial benefits of taking a job are often modest and in some cases non-existent.[20] The authorities acknowledged that these incentive traps were discouraging entry into the labor market and were likely contributing to both a low incidence of part-time jobs and high unemployment among those with little experience and skills (Figure 6). They also agreed that the centralized wage bargaining system with its uniform pay increases—while having delivered appropriate results in recent years in terms of the aggregate wage increase—had detrimental effects on employment in low-productivity areas and was likely adding to the persistence of large regional divergences in unemployment rates. The authorities noted that the experience with sectoral agreements in Finland had been even more problematic, leading generally to higher average wage hikes without delivering the desired differentiation. The mission agreed that branch-wide wage agreements would not produce the appropriate link to productivity and demand developments. This required ultimately more flexibility at the firm level.

22. ***The discussions revealed considerable scope to strengthen employment creation, particularly among the low-skilled who faced the largest difficulties—and disincentives—in finding a job.*** The first priority was to remove incentive traps. While the advocated tax cuts would help, there was also a need to avoid unduly high replacement rates. These were not only costly to the society at large, but also harmful, at least in the longer run, to its recipients whose chances to become (re)employed, gain more experience, and raise their living standards through their own efforts diminished with the time spent out of work. Hence,

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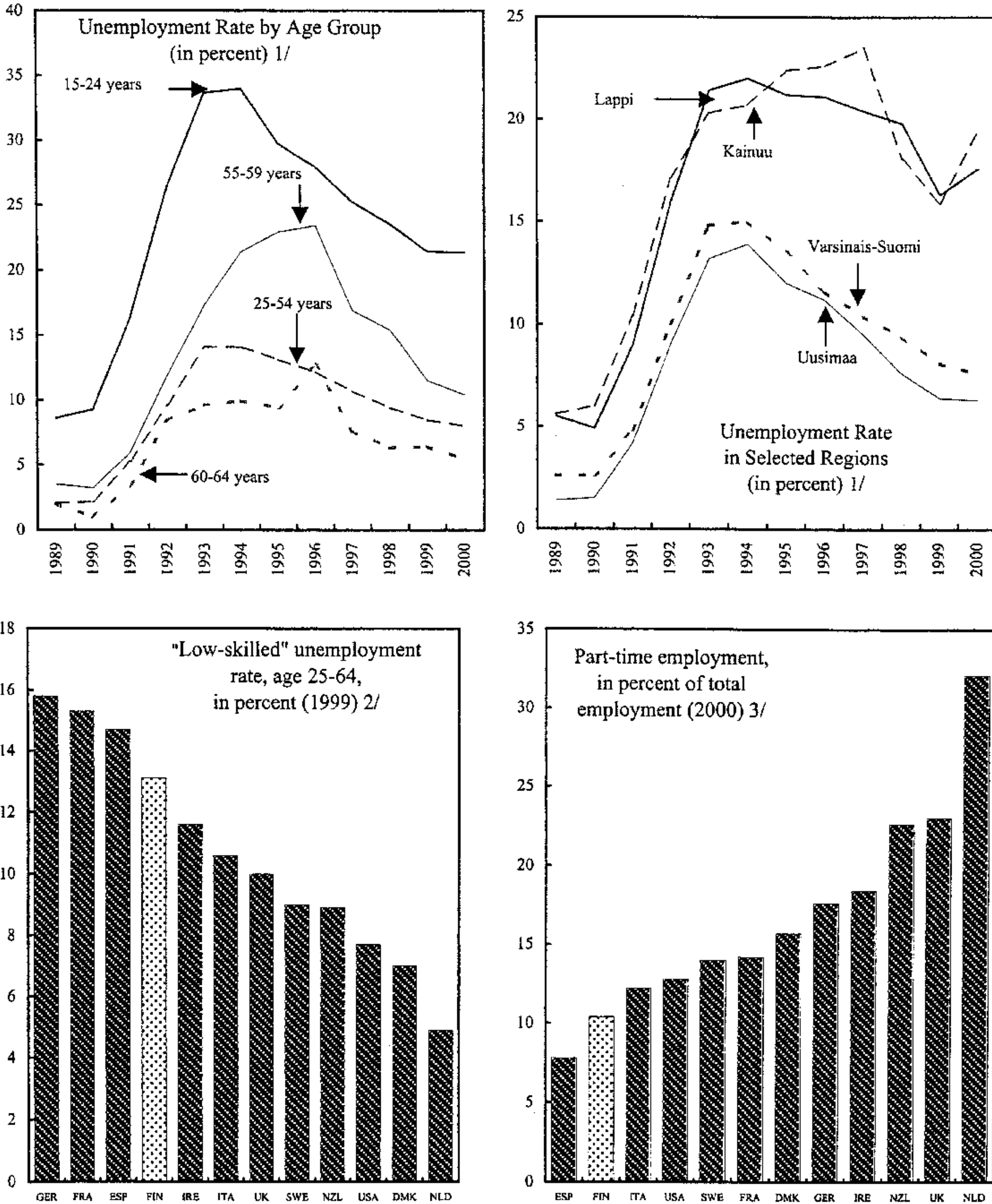
[18] One of the chapters in the accompanying Selected Issues paper provides a more detailed analysis of these issues, with a special focus on the prospects for job creation in the private services sector.

[19] Between 1996 and 1999, the average "threshold wage" (i.e., the gross wage at which work loses its financial advantage over unemployment) fell by 12–35 percent (depending on the family status).

[20] According to OECD calculations, the average replacement rate in 1997, taking into account housing and other allowances, was 84 percent of the average work income for a couple with two children in the first month of unemployment. At two-thirds of the average wage level, the respective replacement rate was 94 percent in the initial unemployment period, rising to 100 percent for long-term benefit recipients.

Figure 6. Finland: Labor Market Characteristics, 1987-2000



Sources: Finnish Labor Market Review; OECD Employment Outlook 2001; and staff estimates.

1/ Lappi and Kainuu are regions in the Northern part of the country; Uusimaa and Varsinais-Suomi are in the South.

2/ Defined as unemployment rate of people with less than upper secondary education.

3/ Defined as less than 30 working hours a week.

the mission advocated measures to encourage swift job search before skills eroded, including the return to a system of gradually declining unemployment benefits over the duration of unemployment,[21] and a redesign of other social benefits to make work pay. To maximize their effect, the mission further recommended that these reforms be combined with enhanced training and counseling, and stricter mobility requirements across regions and occupations—perhaps targeted specifically to the young.[22] Finally, adapting the wage bargaining system to allow wages to respond more flexibly to differences in labor demand across regions and in productivity developments across skills, would be a crucial factor in reducing the regional and skill mismatches in the labor market. The authorities generally shared the thrust of this analysis and recognized the positive net social benefits these measures would have over time. However, as many of the reforms would result in short-term disadvantages for individual benefit recipients or wage earners, sufficient popular support had yet to be established.

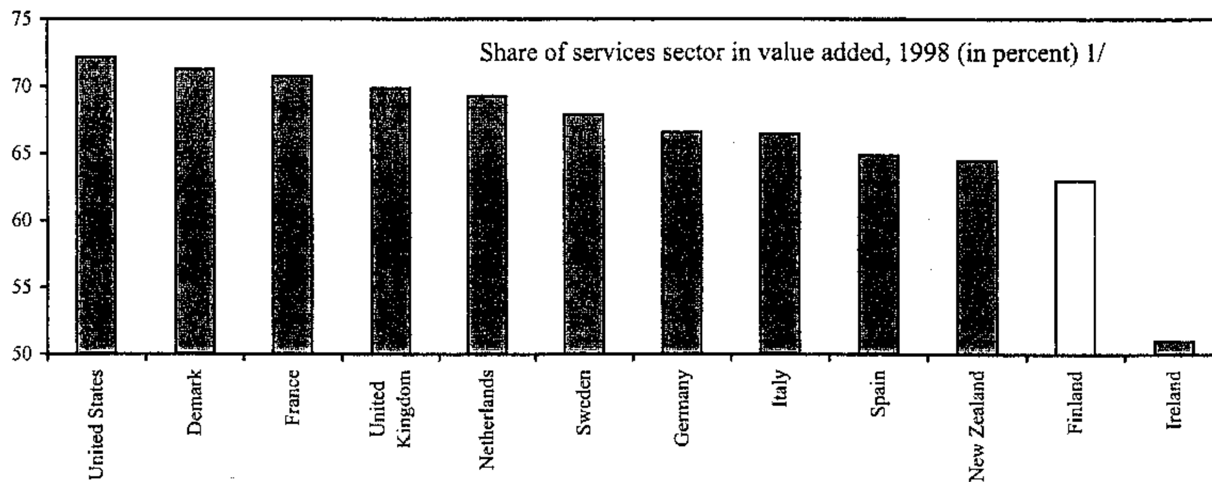
23. ***The authorities offered a number of reasons for the small size of Finland's private services sector.*** Like other participants in the meetings, the authorities explained part of the relatively low output and employment shares of the private services sector (Figure 7) by the Finnish tradition of self-reliance. In addition, they pointed to the same impediments identified above, namely: a heavy tax burden on labor; excessive replacement rates, particularly at lower income levels; and insufficiently flexible wages. The above factors, combined with high indirect taxes, effectively hindered the development of private markets for many (particularly personal) services, as the prices at which the provision of these services would be profitable exceeded the amounts consumers were willing to pay. Alternatively, in areas where competition was (at least temporarily) weak—including social services, where private providers were often crowded out by a dominant public sector—pay increases in excess of productivity gains were feeding inflationary pressures. This explanation for higher overall inflation was similar to the Balassa-Samuelson effect, but with services prices already high in Finland, it could not be viewed as the outcome of a benevolent catch-up process. Finally, the need to stay on top of sometimes complicated labor market regulations was identified as a discouragement for potential employers to start or expand small businesses.

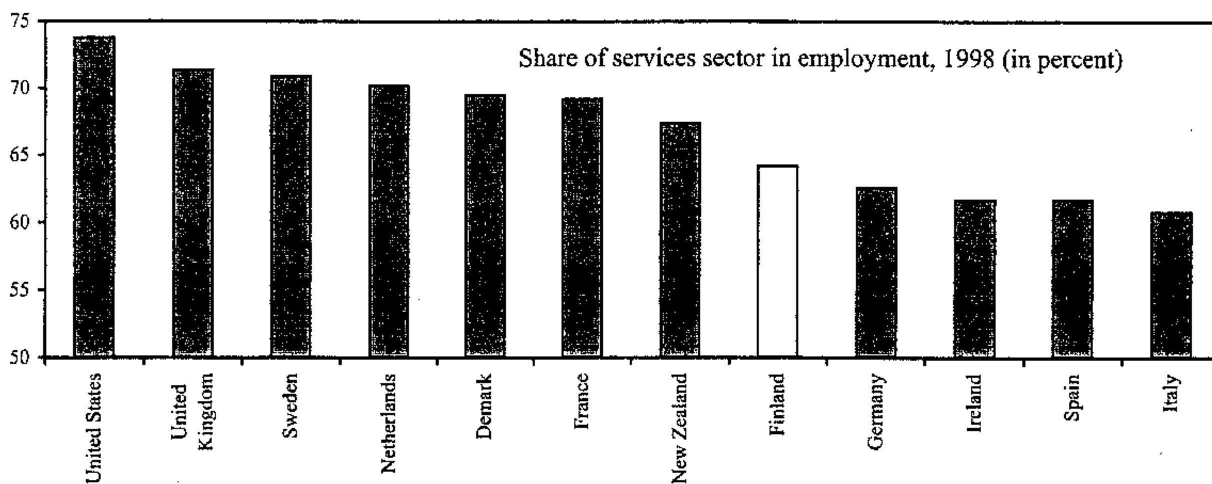
24. ***The authorities shared the mission's assessment that with appropriate incentives, the private services sector had strong potential for employment creation and growth.*** In view of the aging population and rising incomes, the demand for personal and other services should clearly increase. The extent to which this demand will be met by an expanding supply—with strong prospects for employment of low-skilled workers—will clearly depend

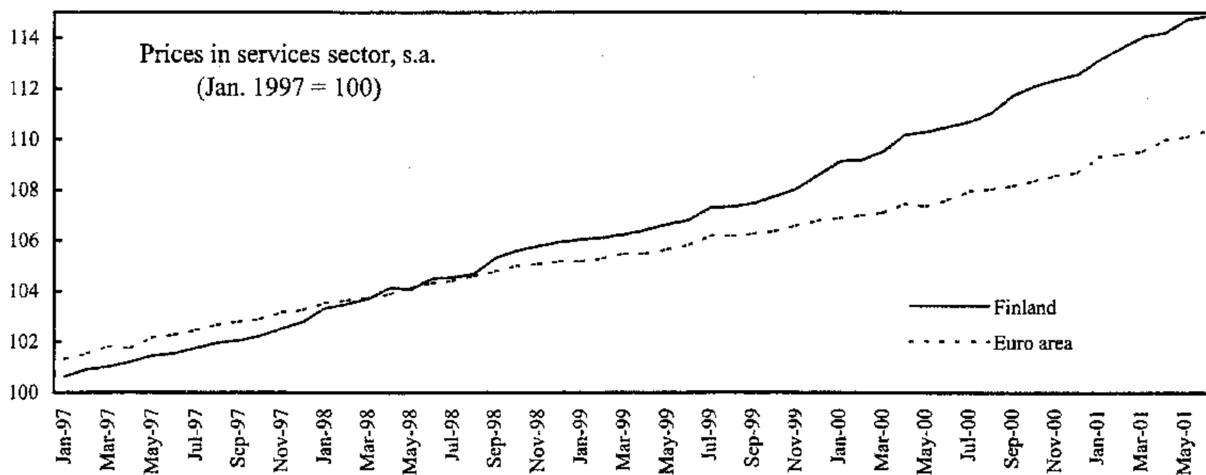
[21] Currently the unemployment benefit level is constant for the first 500 days of unemployment, whereas before 1989, benefits were lowered by 12½ percent after 200 days.

[22] Targeting can also be applied effectively to other reform measures, as was done very successfully in Denmark, where a marked reduction in unemployment benefits to younger workers (after a six-month unemployment spell) contributed to a large fall in youth unemployment.

Figure 7. Comparison of the Services Sector In Selected Countries







Sources: OECD Employment Outlook, 2000; and Eurostat.

1/ Data for the United States refers to 1997; for Sweden to 1996; and for New Zealand to 1995.

on the progress achieved in tax and labor market reforms. In addition, to the extent that the authorities can simplify existing labor market regulations and make them more accessible to (potential) employers, benefits should accrue. The mission also encouraged the authorities to exploit the scope available for reductions in indirect taxes, and advocated the opening of more of the publicly-dominated markets for social services to private competition—pointing to the positive experience so far with respect to the quality of the services provided.

25. ***Further product market reforms, building on past efforts, were discussed as an additional way to improve the functioning of the economy.*** Finland was among the frontrunners in the EU in opening its market for telecommunications and has fully liberalized its electricity markets. However, the pace of privatization has been considerably slower, and—clashing with the profile of a modern and dynamic market economy—the public sector still has considerable direct ownership in various industries.[23] The mission encouraged the government to implement its privatization program mandated by Parliament as quickly as possible, and seek a new mandate to sell most of its remaining equity investments in a timely fashion. In addition, and without claiming to have an easy solution, the mission urged the government to continue its search for ways to alleviate the shortage of affordable housing in high-growth urban centers. The authorities recognized that this shortage was currently hindering lower-income workers from moving to where labor demand was greatest. Municipalities' zoning decisions that tended to favor corporate real estate at the expense of housing appeared to be a crucial factor that needed to be addressed. It was also agreed that a thorough examination of market imperfections, including tax and regulatory disincentives that might hamper the private provision of rental housing, would be useful.

26. ***Finally, the mission encouraged the government to advance the liberalization of trade in services, either unilaterally or as part of a new round of multilateral negotiations.***[24] In addition, it suggested that the authorities support a reduction in the substantial barriers maintained by the EU on merchandise imports from developing countries, in particular in the areas of agriculture and textiles and clothing. The authorities, while not in a position to commit to specific measures, expressed their general support for the further liberalization of trade in both goods and services.

IV. Staff Appraisal

27. ***Finland's performance in the aftermath of its severe recession in the early 1990s has been impressive.*** Sound macroeconomic policies turned sizeable fiscal deficits into

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[23] For example, the state still holds a 47 percent stake in Finland's dominant telecommunications operator—which has been authorized for full privatization—and maintains significant ownership in the financial sector (with a 40 percent stake in the second largest financial conglomerate).

[24] Unlike for trade in goods, where the EU has exclusive negotiating authority, decisions to liberalize trade in service are country-specific.

strong surpluses, and fostered rapid economic growth at low inflation. At the same time, Finland has transformed itself into a dynamic export-oriented economy. This transformation, driven by a rapidly expanding ICT sector, has yielded large economic benefits, but has also raised Finland's exposure to weaker global markets and ICT-specific shocks.

28. ***In light of rapid population aging, a significant and durable increase in the employment rate—in line with the government's goal—is vital over the coming years to ensure that Finland's success story continues.*** Without raising significantly the rate of employment, economic growth would be curtailed sharply in the face of a shrinking labor force, and there would be too few workers to support a growing number of pensioners. Against this background, and with taxes on labor too high, a key tool for achieving employment objectives is a further significant reduction in the tax burden. While cuts are warranted across all income levels, somewhat larger relief for low-income workers would potentially generate the strongest employment response, while also serving social objectives.

29. ***To leave room for needed tax cuts on labor while maintaining sufficiently large fiscal surpluses that would help deal with an aging population, ongoing expenditure restraint is crucial.*** As the population ages, there will be a natural tendency for the public finances to worsen, and it is therefore important that the fiscal balances are sufficiently in surplus beforehand to avoid large deficits after the demographic shock sets in. By allowing the government to pay down debt and generate interest savings over time, fiscal surpluses now will help safeguard priority spending without burdening future generations with excessive taxes. A freeze in real central government spending, along the lines of the government's current medium-term plan, would provide appropriate room for meaningful and durable tax cuts while maintaining appropriate surpluses.

30. ***With both growth and inflation set to slow, the current cyclical outlook offers an excellent opportunity for a taxed-based fiscal easing.*** Weaker international demand has already left its mark on Finnish exports and will trigger a notable moderation in economic growth in 2001–02. Moreover, in the current economic environment, downside risks are considerable. In this context, with inflation set to fall and a strong fiscal balance, short-term policy considerations coincide favorably with the need to lower the still heavy tax burden on labor. The estimated fiscal stimulus in 2001, supplemented by the operation of automatic stabilizers, seems appropriate in this light—and the combination of tax cuts and spending restraint is particularly welcome. Commensurate with the cyclical outlook, further labor tax cuts (of 1 percentage point of GDP in 2002 and another ½ percentage point in the following two years), would be appropriate, consistent with a gradually declining fiscal stimulus.

31. ***Pension reform—aimed at appropriately rewarding a longer working life—would ease the consequences of the demographic shock substantially.*** Building on past efforts, further reforms to the pension system should aim at tightening the link between life-time contributions and benefits. This would increase the system's fairness and, at the same time, strengthen the incentives to work longer, thus mitigating the adverse effect of a shrinking working-age population. Other reform measures should include the discontinuation of various subsidized early-retirement schemes, which too often defeat their own purpose by pushing older workers, who would otherwise have stayed employed, out of the labor market.

With the "baby boomers" approaching the potential age of early retirement, the time to act is now.

32. ***If complemented by further labor market reforms, the virtuous circle of employment creation, growth, and fiscal savings could be deepened significantly.*** Currently, a sizeable part of the working-age population, and particularly those with lower skills, is effectively kept out of work through the combination of insufficiently flexible wages, a heavy tax burden on labor, and excessive replacement rates. In order to reintegrate these people into the work force—and provide them with the chance to raise their living standards through own efforts—a concerted approach in the three areas of wages, taxes, and benefits, coupled with appropriate training and counseling, promises the best results. Therefore, the government and social partners are urged to complement the suggested tax cuts with reforms to the benefits system that encourage swift job search, facilitated by effective counseling, and with a wage system that is more responsive to differences in the demand for labor across regions and in productivity developments across skills. These measures, taken in combination—by encouraging and enabling more people to play an active role in working society—would not only raise living standards and safeguard the resources needed in the future to support the more vulnerable members of the society, but also foster the confidence and skills of its individual members.

33. ***The private services sector, which is underdeveloped in Finland, has very strong potential for employment creation and growth.*** The publicly-dominated markets for health and social services, if opened up to private competition, could expand significantly and offer a wide range of choices for an aging and increasingly wealthy population. To encourage the creation of small businesses that provide such services, the above-mentioned reforms to the tax, benefits, and wage systems could usefully be supplemented by efforts to make existing labor market regulations more easily accessible and understandable, and by reductions also in indirect taxes—the room for which, again, would depend on success in maintaining spending discipline in the public finances. Finally, to ensure that firms are able to recruit workers at acceptable pay, there is a need to address the incentive problems that are currently hampering the provision of more affordable housing in high-growth areas were the demand is highest.

34. ***In the financial sector, the current soundness must not delay reforms to strengthen effective supervision, as markets and products are evolving rapidly.*** With a financial landscape characterized by a few systemically important institutions with complex cross-border and cross-industry structures, supervisors need to have the power and incentives to play a more proactive role at an early stage of emerging vulnerabilities. This calls for swiftly enacting improved supervisory legislation, and enhancing cooperation and harmonizing supervisory arrangements across disciplines and national borders.

35. ***It is proposed that the next consultation be conducted on the standard 12-month cycle.***

Table 1. Finland: Medium-Term Macroeconomic Scenario, 1998-2005 1/ (continued)

	1998	1999	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.
	(Percentage change, unless otherwise indicated)							
Output and demand (volumes)								
GDP	5.3	4.0	5.7	2.0	2.6	3.6	3.5	3.4
Domestic demand	5.8	2.0	4.0	3.4	2.8	3.1	3.0	3.0
Consumption	4.1	3.4	2.3	2.8	2.7	2.9	2.8	2.8
Private consumption	5.1	4.0	3.0	3.4	3.2	3.3	3.3	3.3
Public consumption	1.7	1.9	0.7	1.3	1.6	1.7	1.5	1.7
Gross fixed capital formation	9.3	3.0	5.5	4.7	3.3	4.1	3.9	3.6
Private investment	11.6	3.9	7.4	5.1	3.4	4.5	4.2	3.9
Public investment	-1.4	-2.2	-5.4	2.3	2.7	1.5	1.8	1.8
Export of goods and services	8.9	6.8	18.1	-2.5	3.2	6.5	6.4	6.0
Import of goods and services	8.5	4.0	15.7	-0.5	3.8	6.1	6.0	6.0
Foreign contribution to growth (in percent of GDP)	1.0	1.6	2.7	-1.0	0.2	0.9	0.9	0.7
Prices, costs, and income								
Consumer price inflation (harmonized)	1.3	1.3	3.0	2.6	1.9	2.0	2.0	2.0
Core inflation (excluding energy and seasonal food)	1.4	1.1	2.0	2.9	1.9	2.0	2.0	2.0
GDP deflator	3.0	-0.1	3.4	2.3	1.7	2.2	2.1	2.0
Terms of trade	2.5	-5.0	-4.6	0.1	-1.4	0.8	0.5	0.3
Unit labor cost, manufacturing	-0.8	-3.3	-5.8	1.7	-0.1	-0.7	-0.7	-0.5
Labor market								
Labor force	0.9	2.1	1.1	0.8	0.7	0.5	0.4	0.2
Employment	2.4	3.4	1.7	0.7	0.2	1.3	1.1	0.9
Unemployment rate (in percent)	11.4	10.3	9.8	9.9	10.4	9.7	9.0	8.4
Potential output and NAIRU								
Output gap (in percent of potential output) 2/	-1.2	-1.1	-0.1	-1.6	-2.2	-1.7	-1.2	-0.7
Growth in potential output	3.7	4.0	4.6	3.5	3.2	3.2	3.0	2.9
NAIRU (in percent)	10.6	10.2	9.7	9.2	8.9	8.5	8.2	7.9
	(In percent)							
Money and interest rates								
M3 (Finnish contribution to euro area , growth rate, e.o.p.) 3/	2.5	5.8	-3.8	9.6	...	...	...	...
Domestic credit (growth rate, e.o.p.) 3/	11.9	10.6	5.9	10.7	...	...	...	...
3-month money market rate 4/	3.6	3.0	4.4	4.6	...	...	...	...
10-year government bonds yield 4/	4.8	4.7	5.5	4.9	...	...	...	...
	(In percent of GDP, unless otherwise indicated)							
National savings, investment, and income								
Gross national saving	25.0	25.2	27.5	26.7	26.3	26.9	27.5	27.9
Gross domestic investment	19.3	19.2	20.1	20.8	21.0	21.1	21.3	21.5
Private saving	20.9	20.5	18.2	20.3	21.4	21.7	21.7	21.5
Household saving as percent of disposable income	3.1	4.0	1.7	4.0	4.2	4.3	4.3	4.2
Private investment	16.5	16.4	17.6	18.2	18.4	18.6	18.8	19.1
Government savings surplus	1.3	1.9	6.9	3.8	2.4	2.7	3.3	4.0
Household's real disposable income (increase in percent)	3.5	4.8	0.3	3.6	2.1	1.9	1.8	1.8

Table 1. Finland: Medium-Term Macroeconomic Scenario, 1998-2005 1/ (concluded)

	1998 Prel.	1999 Proj.	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.	2005 Proj.
	(In percent of GDP, unless otherwise indicated)							
Public finances								
General government								
Revenues	49.5	49.1	50.9	47.9	46.3	45.9	45.8	45.8
Expenditure	48.2	47.2	44.0	44.1	43.9	43.2	42.5	41.9
Fiscal balance	1.3	1.9	6.9	3.8	2.4	2.7	3.3	4.0
of which: net interest on public debt	1.7	1.6	1.0	0.8	0.3	0.0	-0.2	-0.4
Primary balance 5/	3.0	3.5	7.9	4.6	2.7	2.7	3.1	3.5
Structural balance (in percent of potential output)	2.0	2.5	6.9	4.7	3.6	3.7	4.0	4.4
Structural primary balance 5/	3.8	4.1	7.9	5.4	3.9	3.7	3.8	3.9
Adjusted structural primary balance 6/	...	...	6.2	5.8	5.3	...	...	...
Debt (EMU definition)	48.8	47.2	44.1	36.6	34.8	32.3	29.7	26.8
Central government								
Revenues	25.5	25.1	27.2	25.3	24.3	23.9	23.7	23.6
Expenditure	27.0	25.8	23.7	23.5	23.9	23.1	22.4	21.7
of which: net interest on public debt	4.5	3.9	3.4	3.1	2.7	2.5	2.4	2.2
Fiscal balance	-1.5	-0.7	3.5	1.8	0.5	0.8	1.3	1.9
Debt	60.2	56.5	48.2	44.5	42.2	39.0	35.6	31.9
Balance of payments								
Current account balance	5.6	6.0	7.4	5.9	5.3	5.8	6.2	6.4
Trade balance	9.7	9.5	11.3	10.4	9.9	10.4	10.8	11.0
Net external debt (excluding equity FDI and shares)	25.3	16.6	11.7	5.3	-0.2	-6.0	-11.9	-17.7
Exchange rates (period average)								
Fmk per US$ 4/	5.3	5.6	6.4	6.7	...	...	...	...
Nominal effective rate (INS, increase in percent) 7/	0.0	-2.7	-5.2	0.9	...	...	...	...
Real effective rate (increase in percent) 8/	-1.4	-3.8	-4.7	0.2	...	...	...	...

Sources: Ministry of Finance, Bank of Finland; and staff projections.

1/ Staff projections based on the authorities' current policy indications, unless otherwise indicated.
2/ A negative value indicates a level of potential output that is larger than actual GDP.
3/ For 2001, annualized increase to July.
4/ For 2001, average rate to August.
5/ Defined as noninterest (structural) revenue minus noninterest (structural) expenditure, with structural components derived using staff's standard cyclical-adjustment technique.
6/ For 2000-02, the structural primary balances are adjusted for exceptional revenue fluctuations to provide a better measure of the fiscal policy stance for these years. The methodology is derived in Table 2.
7/ For 2001, average 12-month increase to June.
8/ Based on relative normalized unit labor costs. For 2001, average 12-month increase to August.

Table 2. Finland: General Government Finances, 2000-2002 1/
(In percent of GDP, unless otherwise indicated)

	Authorities' projections			Staff projections		
	2000	2001	2002	2000	2001	2002
Revenues	50.9	47.9	46.3	50.9	47.9	46.3
Expenditures	44.0	43.8	43.7	44.0	44.1	43.9
Fiscal balance	6.9	4.1	2.6	6.9	3.8	2.4
Primary balance	7.9	4.9	2.9	7.9	4.6	2.7
(1) Change	4.4	-3.0	-2.0	4.4	-3.3	-1.9
(2) Structural primary balance (unadjusted) 2/	...	...	...	7.9	5.4	3.9
(3) Change	...	...	...	3.9	-2.5	-1.5
(4) Discretionary fiscal policy stance (minus indicates stimulus)	...	...	...	***2.1***	***-0.4***	***-0.4***
Revenue measures (minus indicates reduction)	...	...	...	-0.2	-0.8	-0.7
Expenditure measures (minus indicates increase) 3/	...	...	...	2.3	0.4	0.3
Cyclical effect (1) - (4) 4/	...	...	...	2.3	-2.9	-1.5
of which: not captured by standard structural adjustment (3) - (4	...	...	...	1.8	-2.1	-1.1
(5) Cumulative change in cyclical effect not captured by standard structural adjustment	...	...	...	1.8	-0.3	-1.4
Adjusted structural primary balance (2) - (5)	...	...	...	**6.2**	**5.8**	**5.3**
Memorandum items:						
GDP growth (in percent)	5.7	2.7	2.5	5.7	2.0	2.6
Potential output growth (in percent)	...	...	...	4.6	3.5	3.2

Sources: Ministry of Finance and staff projections.

1/ Projections reflecting the government's policy plans as described in the staff report, including the newly announced augmentation of labor tax cuts from 1/2 to 3/4 percentage points of GDP in 2002.

2/ Consistent with the standard measure shown in Table 1.

3/ Defined as the change in the ratio of structural primary expenditures to potential output.

4/ Determined as the residual change in the primary balance not explained by discretionary policy measures.

Table 3. Finland: Indicators of Financial Vulnerability, 1996-2000

	1996	1997	1998	1999	2000
Households					
Total household debt (in percent of GDP)	32.8	30.7	30.5	31.5	31.2
Debt to income ratio	61.1	57.5	58.5	61.2	64.1
Non-financial corporations					
Gross debt (in percent of GDP)	53.7	48.7	46.2	48.2	53.2
Debt-to-equity ratio 1/	97.6	84.1	65.6	67.2	...
Government					
General government debt (EMU definition, in percent of GDP)	57.1	54.1	48.8	46.9	44.0
Central government debt (in percent of GDP)	67.1	65.3	60.2	56.0	48.0
Banking sector					
Outstanding credit to nonfinancial sectors (percent change, e.o.p.) 2/	-0.7	1.0	11.9	10.6	5.2
Of which housing loans (percent change)	1.3	3.5	13.1	15.8	10.6
Housing loans in percent of total lending to nonfinancial sectors 2/	33.4	34.2	34.5	36.2	37.7
Asset Quality					
Non-performing loans / total loans (percent) 3/ 4/	2.8	1.8	1.2	1.0	0.6
Capital Adequacy					
BIS capital asset ratio 4/	11.4	11.9	11.5	11.9	11.6
Equity / total assets (percent) 4/	3.7	4.2	4.9	5.3	5.5
Profitability					
Interest rate margin 2/ 5/	4.1	4.3	4.0	3.5	4.3
Net interest income as a percentage of total income 4/	58.1	62.2	61.8	62.4	61.0
Return on equity (percent) 4/	11.8	17.7	25.8	19.4	22.4
Return on assets (percent) 4/	0.6	0.9	1.2	1.0	1.2
Liquid assets/total assets (percent) 4/	21.9	22.2	19.9	20.3	16.0
Off-balance sheet liabilities/total assets (percent) 4/	15.1	15.5	16.4	16.5	18.4
Stock Market					
Change in stock market index (in percent, e.o.p.)	37.7	35.1	58.8	162.0	-10.6
Change in housing price index (in percent, e.o.p.)	19.0	21.9	9.5	16.2	0.1

Sources: Bank of Finland, The Finnish Bankers' Association, Financial Supervision Authority, Statistics Finland, and staff estimates.

1/ Data are provided by Statistics Finland, and the estimates are based on book value of equity.

2/ Data are provided by Bank of Finland (BoF) and are based on the "Financial Market Statistical Review", BoF. Estimates are based on unconsolidated data, including foreign banks' branches in Finland and excluding foreign branches of Finnish banks.

3/ Based on net non-performing loans (i.e. net of other specific loan loss provisions which are deducted from total assets and are recorded as an expense). Loans are defined as loans to the public and public sector entities plus loans to credit institutions.

4/ Estimates are based on prudential, consolidated, and group level data on domestic banks, collected by the FSA.

5/ Average lending rate minus average deposit rate.

Table 4. Comparison of Tax Ratios in Selected Countries

	Finland	EU	Germany	U.K.	Sweden	Denmark	U.S.	Japan
Tax revenues as percent of GDP 1/	**45.9**	42.3	42.4	37.1	53.0	49.5	29.7	27.9
of which direct taxes and social security contributions	**31.7**	28.5	30.8	23.5	37.3	31.7	22.0	19.6
Marginal tax rate and social security contribution for top bracket earner 2/	**62.0**	54.8	55.9	40.0	59.6	62.4	48.1	65.0
Marginal tax wedges on earned income (single - no children) 3/								
lowest 1/3 percentile wage level	**58.3**	49.8	57.4	38.3	53.4	51.7	34.9	20.7
highest 1/3 percentile wage level	**66.4**	54.6	59.6	31.0	67.4	65.3	47.0	29.8
Marginal tax wedges on earned income (principal earner - two children) 3/								
lowest 1/3 percentile wage level	**61.9**	48.9	56.2	40.1	69.0	47.1	54.4	21.9
highest 1/3 percentile wage level	**61.9**	51.9	59.4	40.1	69.0	51.7	34.9	21.9

Sources: OECD database; and OECD, *Surveillance of Tax Policies: a Framework for EDRC Country Reviews*, Statistical Annex (1999).

1/ Averages in 1997-99.
2/ Tax and social security contributions on earned income from dependent employment, 1998.
3/ The tax wedge is the increase in payment of income tax on wages and of social security contributions associated with an additional dollar of gross labor earnings (gross wages plus employers' contribution to social security and private pension plans).

Finland: Fund Relations
(As of July 31, 2001)

I. **Membership Status**: Joined 1/14/48; Article VIII.

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	1,263.80	100.0
Fund holdings of currency	859.03	68.0
Reserve position in Fund	404.83	32.0

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative allocation	142.69	100.0
Holdings	165.24	115.8

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund**: None

VII. **Exchange Rate Arrangements**

1. Finland is a founding member of EMU, with a euro conversion rate of Finnish markka (Fmk) 5.94573. Finland has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on payments and transfers of current international transactions.

VIII. **Last Article IV Consultation**

2. Discussions for the 2000 Article IV consultation were held in Helsinki during June 5-12, 2000. The Staff Report (8/1/00) was issued to the Executive Board, and discussions were concluded on a lapse-of-time basis on August 22, 2000. Executive Directors implicitly endorsed the staff appraisal, commending the authorities for their sound macroeconomic policies, which had played an important role in Finland's full recovery from the depression of the early 1990s. Serious structural problems, however, needed to be tackled to ensure robust long-term growth and adjust to the impending demographic shock. Continued restraint in the growth of public expenditures needed to be complemented by a significant reduction in

the heavy tax burden and other measures on the structural front that would help expand the effective labor supply and enhance the supply response of the economy.

IX. FSAP Participation

3. A Financial Sector Assessment Program (FSAP) was conducted in the context of the 2001 Article IV consultation discussions. The Financial System Stability Assessment (FSSA) report was issued to the Executive Board on September 25, 2001.

Finland: Core Statistical Indicators

(As of August 31, 2001)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP
Date of Latest Observation	August 31	June	June	July	July	August 31	July	June	June	July	Q1, 2001
Date Received	August 31	July 31	July 31	August 31	August 31	August 31	August 14	August 14	August 14	August 27	Jun. 21
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	Bloomberg	Bank of Finland	Bank of Finland	Bank of Finland	Bank of Finland	Bloomberg	ETLA	Bank of Finland	Bank of Finland	ETLA	ETLA
Mode of Reporting	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

INTERNATIONAL MONETARY FUND

FINLAND

Staff Report for the 2001 Article IV Consultation
Supplementary Information

Prepared by the European I Department

Approved by C. Maxwell Watson

November 7, 2001

1. This supplement provides information on economic developments that has become available since the staff report for the 2001 Article IV consultation was issued. It reviews the economic outlook in light of newly released data on economic activity and the September 11 terrorist attacks on the United States. The new information does not alter the thrust of the staff appraisal.

2. **Information that became available since the issuance of the staff report suggests that real growth will be lower than previously projected, while headline inflation continues to decline as expected (Figure 1).**

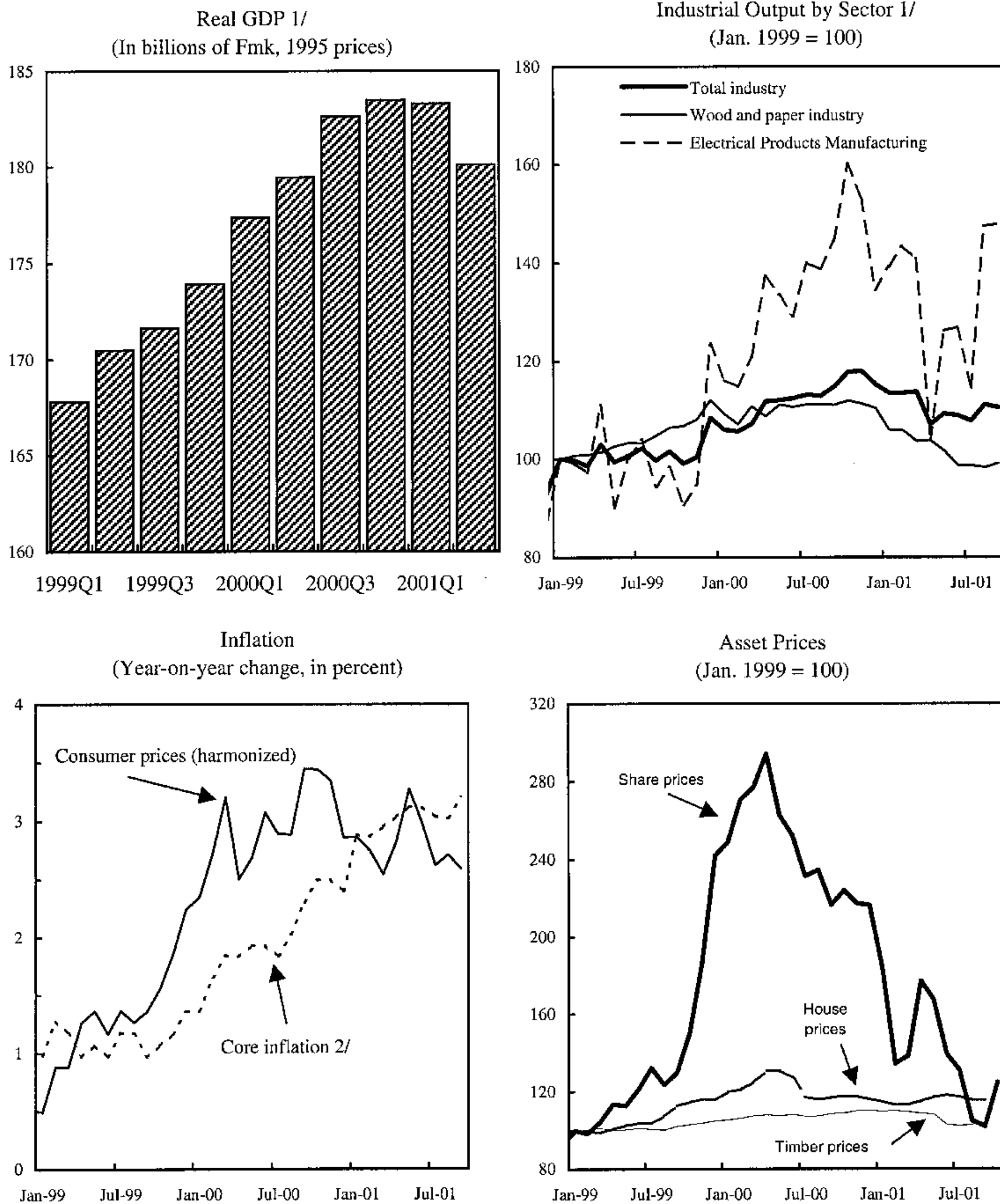
- Second quarter GDP (seasonally adjusted) fell by more than 1½ percent from its first quarter level, reflecting lower foreign demand and an unpredicted marked slowdown in private investment. This implied GDP growth in the first half of 2001 of about 1¾ percent on a year-on-year basis—1 percentage point weaker than expected.

- While the decline in industrial production (seasonally adjusted) was reversed in the third quarter, the rebound was mild: the level of production exceeded that of the second quarter by only about 1¼ percent, and was still more than 3¾ percent below the level in the third quarter of 2000. Capacity utilization in manufacturing (seasonally adjusted) followed a similar trend.

- Unemployment (seasonally adjusted), after having fallen for most of the year, picked up in September, bringing the 9-month average (unadjusted) close to 9½ percent.

- 12-month CPI inflation (harmonized) decreased slightly in September to 2.6 percent, continuing a broad downward trend that started in June. Meanwhile, core inflation remained around 3 percent, broadly unchanged since April.

Figure 1. Finland: Cyclical Indicators, 1999-2001



Sources: ETLA and staff estimates.

1/ Seasonally adjusted.

2/ HICP index, adjusted for prices of energy and seasonal food.

- While both business and consumer confidence weakened further in the third quarter, the latter has remained broadly stable since August—suggesting little impact from the September 11 events. Perhaps surprisingly, households were slightly more optimistic in October about their own economic situation than they were a year ago. Their views on the overall Finnish economy and unemployment remained pessimistic, however.

3. **Monetary and financial market conditions are now more supportive of an economic recovery.** Monetary conditions eased further, as the ECB's interest rate cut in September more than compensated for the modest real appreciation of the exchange rate. The decline in the Finnish stock market reflected in the HEX index continued into September. However, the HEX rebounded after the terrorist attacks, attributed by markets to prospects for higher demand for mobile phones. On average, the index in October was about 15 percent above its pre-attack level in September.

4. **Against this background, staff now projects growth of just below 1 percent in 2001 and some 2 percent for 2002 (Table 1).** The downward revision in the earlier year (from 2 percent in the staff report) mainly reflects pre-September developments such as the unexpected slowdown in private investment and exports. In addition, the latest projections incorporate the assumption of a delayed and more timid recovery of foreign demand in the wake of the terrorist attacks in the United States, with a gradual pick up in the first half of 2002 rather than toward the end of this year. Projected domestic demand is also weaker than previously anticipated, with consumption growth remaining broadly stable, but the recovery of investment following a similar profile as foreign demand. As a result, annual GDP growth in 2002 is now projected to be about ½ percentage point lower than in the staff report. However, the uncertainties to the projections are considerable, in particular due to the unknown extent of the repercussions of the September 11 events on both external and domestic demand.

5. **Consistent with its weaker growth projections, staff now expects a smaller fiscal surplus of about 3¼ percent of GDP in 2001 and 1¾ percent in 2002.** This forecast is based on the government's fiscal projections from August, but adjusts them to reflect staff's significantly lower growth projections. It further assumes that the government will continue letting revenue stabilizers operate freely, implying a fiscal stimulus that is broadly unchanged from the assessment in the staff report. The government is scheduled to issue a revised forecast in the context of its 2001 Stability Program on November 8.

6. **In other developments, the government announced its plan to seek Parliament's approval for the purchase of some 53 percent of new shares to be issued by the majority state-owned telecommunications company Sonera.** The share issue would roughly yield an expected €1 billion, implying a government investment of almost 0.4 percent of projected GDP in 2001.

Table 1. Finland: Main Economic Indicators

	1998	1999	2000	2001 1/	2002 1/
Real economy					
Real GDP (change in percent)	5.3	4.0	5.7	0.9	2.1
Domestic demand (change in percent)	5.8	2.0	4.0	2.0	1.6
Foreign contribution to growth (percentage points)	1.0	1.6	2.7	-0.7	0.4
Harmonized CPI inflation (average, in percent)	1.3	1.3	3.0	2.6	1.7
Unemployment rate (average, in percent)	11.4	10.3	9.8	9.4	9.9
Gross national saving (percent of GDP)	25.0	25.2	27.7	26.8	26.3
Gross domestic investment (percent of GDP)	19.3	19.2	20.3	20.6	20.3
Public finance					
General government balance (percent of GDP)	1.3	1.9	6.9	3.3	1.7
Structural balance (in percent of potential output)	2.0	2.5	6.9	4.4	3.3
Structural primary balance (in percent of potential output) 2/	3.7	4.0	6.2	5.6	5.0
General government debt (EMU-definition, percent of GDP) 3/	48.8	47.2	44.1	39.4	36.0
Money and Credit (end of year, percentage change) 4/					
M3 (Finnish contribution to euro area)	2.5	5.8	-3.8	7.1	...
Domestic credit	11.9	10.6	5.9	10.4	...
Interest rates (percent) 5/					
3-month money market	3.6	3.0	4.4	4.5	...
10-year government bonds	4.8	4.7	5.5	5.1	...
Balance of payments (percent of GDP)					
Trade balance	9.7	9.5	11.3	10.9	10.5
Current account	5.6	6.0	7.4	6.2	6.0
Exchange rate					
Nominal effective rate (increase in percent) 6/	0.0	-2.7	-5.2	1.1	...
Real effective rate (increase in percent) 7/	-1.4	-3.8	-4.7	0.4	...

Sources: Finnish authorities, *International Financial Statistics;* and IMF staff estimates.

1/ Staff projections.

2/ For 2000-02, the structural primary balances are adjusted for exceptional revenue fluctuations to provide a better measure of the fiscal policy stance for these years.

3/ Projections are based on the assumption of unchanged government assets.

4/ For 2001, annualized increase to August.

5/ For 2001, average through September.

6/ For 2001, average 12-month increase to August.

7/ Based on relative normalized unit labor costs. For 2001, average 12-month increase to September.

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 01/122
FOR IMMEDIATE RELEASE
November 21, 2001

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Concludes 2001 Article IV Consultation with Finland

On November 9, 2001, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.[1]

Background

Sound macroeconomic policies and growing economic openness were at the root of Finland's remarkable recovery from the recession of the early 1990s. During 1994–2000, real GDP growth averaged almost 5 percent, with an exceptionally favorable international environment boosting growth in 2000 to 5¾ percent. Annual inflation during the whole period was in the range of 1 to 3 percent. Meanwhile, the economy became increasingly open, driven by a dynamic information and communications technology (ICT) sector. These structural changes brought large benefits to the economy, but also raised its exposure to a slowdown in international demand and weaker prospects for the ICT sector.

In light of the substantially weakened external environment, a marked slowdown of growth is expected this year and next from last year's rapid pace. Economic indicators clearly deteriorated in the course of 2001. Export growth dropped markedly, and GDP growth is forecast to slow to just below 1 percent this year. On the premise of a relatively short-lived fallout from the September 11 events, foreign demand is assumed to start recovering in the first half of 2002, with economic growth projected to pick up mildly to 2 percent in 2002. Absent a

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. This PIN summarizes the views of the Executive Board as expressed during the November 9, 2001 Executive Board discussion based on the staff report.

significant increase in energy prices, CPI inflation (harmonized) is projected to fall to an average of 2½ percent in 2001, with slower wage growth in a weakened economic environment contributing to a further deceleration below 2 percent in 2002. Macroeconomic policies are currently supportive of economic activity. Monetary conditions have been accommodative for some time, which reflects a competitive exchange rate and European Central Bank interest rate cuts since May 2001. The fiscal stance, on the other hand, turned moderately stimulative only this year, after a sizeable withdrawal of demand in 2000.

Finland's main structural problems are high unemployment and the foreseeable consequences of rapid population aging. After the large labor-shedding of the recession years, employment has been growing steadily, but the unemployment rate remains close to 10 percent. At the same time, labor supply is depressed by a low effective retirement age, and rapid population aging will place growing strains on labor markets, economic growth, and the public finances.

Executive Board Assessment

Executive Directors commended the Finnish authorities for their sound macroeconomic policies, that have turned the sizable fiscal deficits of the mid-1990s into solid surpluses and fostered rapid economic growth with low inflation and a strong external position. Directors stressed the benefits of the export-driven transformation of Finland's economy, but noted the economy's increased vulnerability to external shocks, which has led to a marked deceleration of economic growth in the midst of the current global slowdown. They nevertheless considered that the economy remains fundamentally sound and therefore expected economic growth to accelerate again as international demand recovers. Directors encouraged the authorities to step up the pace of reforms to ensure that the benefits of productivity growth of the ICT sector are distributed across the economy.

Directors emphasized that policy responses to the short-term outlook need to be framed in the context of long-term challenges. In view of rapid population aging, they strongly supported the government's goal of a significant and durable increase in the employment rate. Without such an increase, economic growth would be curtailed sharply in the face of a shrinking labor force, and there would be too few workers to support a growing number of pensioners. Against this background, Directors commended the authorities' proactive approach to addressing these problems and urged them to implement a comprehensive set of reforms to stimulate employment creation, including further reductions in the heavy tax burden on labor and reforms of the benefits, wage, and pension systems.

In light of the sharp deceleration of growth and slowing inflation, Directors viewed the current worsening of the cyclical outlook as an excellent opportunity for a tax-based fiscal easing. In this context, they welcomed the government's decision to augment planned labor tax cuts in 2002. Indeed, to support economic activity in both the short and long term, Directors advocated somewhat larger reductions in taxes on labor over the 2002-2004 period than currently planned. At the same time, Directors supported the government's policy of not offsetting cyclical declines in revenues, noting that the associated fall in the fiscal surplus should not be a cause for concern.

To leave room for needed tax cuts on labor, while maintaining sufficiently large structural fiscal surpluses in preparation for the demographic shock, Directors emphasized the need for ongoing expenditure restraint. Fiscal surpluses, by allowing the government to reduce debt and generate interest savings over time, would help safeguard priority spending without burdening future generations with excessive taxes. Directors considered a freeze in real central government spending, along the lines of the government's current medium-term plan, as appropriate to provide room for durable tax cuts while maintaining adequate surpluses.

Directors observed that the pension reform, aimed at appropriately rewarding a longer working life, would substantially ease the consequences of Finland's looming demographic shock. They welcomed the authorities' plans to enact further reforms of the pension system, with a view to tightening the link between lifetime contributions and benefits and thereby strengthening the incentives to work longer, and encouraged them to do so soon. In the same vein, Directors urged a swift discontinuation of various subsidized early-retirement schemes.

Directors emphasized the benefits of labor market reforms to strengthen employment and growth and thereby also the public finances. They recommended a comprehensive approach, complementing labor tax cuts with reforms to the benefits system, to address work disincentives and encourage swift job search, and to the wage bargaining system to allow wages to be more responsive to differences in productivity developments and labor demand. Directors viewed these measures, taken in combination and coupled with effective job training and counseling, particularly for young and unskilled workers, as the most promising way to encourage and enable more people to play an active role in the productive work force. Directors generally supported across-the-board tax cuts, but some Directors suggested that greater emphasis be put on labor tax cuts for low-income workers, where unemployment is concentrated.

Directors noted the strong potential of Finland's underdeveloped private services sector for employment creation and growth. They highlighted the key role of reforms to tax, benefits, and wage systems in realizing this potential and encouraged opening up the publicly-dominated markets for health and social services to greater private competition. To foster the creation of small businesses providing personal services, Directors also saw merit in making existing labor market regulations more easily accessible and understandable, and in reductions of indirect taxes, subject to ongoing spending discipline in the public sector. They also urged the authorities to address incentive problems that hamper the provision of more affordable housing in high-growth areas where the demand for labor, including in the services sector, is highest.

Directors welcomed the Financial System Stability Assessment findings that Finland's financial sector is in a very sound state. They cautioned, however, that this should not delay reforms to strengthen effective supervision. In the country's rapidly evolving financial landscape, characterized by a few systematically important institutions with complex cross-border and cross-industry structures, supervisors would need to play a proactive role at an early stage to counter any potential emerging vulnerabilities. To this effect, Directors urged the swift enactment of improved supervisory and regulatory legislation, and encouraged enhanced

cooperation and harmonization of supervisory and regulatory arrangements across disciplines and national borders.

Directors commended the authorities for their assistance to developing countries, including through their support for the HIPC Initiative and for the European trade initiative to increase market access to low-income countries, and encouraged them to increase their overseas development assistance toward the UN target of 0.7 percent of GDP.

Directors praised the generally high quality, comprehensiveness, and timeliness of Finland's economic statistics.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2001 Article IV Consultation with Finland is also available.

Finland: Selected Economic Indicators

	1998	1999	2000	2001 1/
Real economy				
GDP (change in percent)	5.3	4.0	5.7	0.9
Domestic Demand (change in percent)	5.8	2.0	4.0	2.0
Harmonized CPI (change in percent) 2/	1.3	1.3	3.0	2.6
Unemployment rate (in percent) 2/	11.4	10.3	9.8	9.4
Gross national saving (in percent of GDP)	25.0	25.2	27.5	26.8
Gross domestic investment (in percent of GDP)	19.3	19.2	20.1	20.6
Public finances (general government, in percent of GDP)				
Overall balance	1.3	1.9	6.9	3.3
Primary balance 3/	3.0	3.5	7.9	4.1
Gross debt (EMU-definition) 4/	48.8	47.2	44.1	39.4
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area) 5/	2.5	5.8	-3.8	7.1
Total domestic credit 5/	11.9	10.6	5.9	10.4
Interest rates (year average)				
Three-month money market 6/	3.6	3.0	4.4	4.5
Ten-year government bonds 6/	4.8	4.7	5.5	5.1
Balance of payments (in percent of GDP)				
Trade balance	9.7	9.5	11.3	10.9
Current account	5.6	6.0	7.4	6.2
Fund position (as of end-September 2001)				
Fund holding of currency (in percent of quota)		68.7		
Holdings of SDRs (in percent of allocation)		99.0		
Quota (in millions of SDRs)		1,263.80		
Exchange rate				
Exchange rate regime		EMU Member		
Present rate (October 31, 2001)		US$ 0.90 per euro		
Nominal effective exchange rate (increase in percent) 7/	0.0	-2.7	-5.2	1.1
Real effective exchange rate (increase in percent) 8/	-1.4	-3.8	-4.7	0.4

Sources: Finnish authorities, *International Financial Statistics*; and IMF staff estimates.
1/ IMF staff projections, unless otherwise indicated.
2/ Consistent with Eurostat methodology.
3/ Defined as noninterest revenue minus noninterest expenditure.
4/ Projection for 2001 is based on the assumption of unchanged government assets.
5/ For 2001, annualized increase to August.
6/ For 2001, average to September.
7/ For 2001, average 12-month increase to August.
8/ Based on unit labor costs. For 2001, average 12-month increase to September.

Statement by Olli-Pekka Lehmussaari, Executive Director for Finland
November 9, 2001

I would first like to express my authorities' great appreciation for the reports in the context of the Article IV consultation discussions. In our view, the staff papers accurately highlight the current and future challenges facing the Finnish economy. There were no major disagreements between my authorities and staff, and we share the main concerns raised in the Article IV and the FSSA reports.

Recent Economic Developments and Short-Term Prospects

After several years of robust growth, economic activity in Finland has decelerated substantially along with the slowdown in the world economy and, in particular, reduced demand in the ICT sector. Rapidly deteriorating global prospects and increased uncertainty during the last few months and weeks have led to repeated downward revisions of growth projections for both this and next year. Since April of this year, the manufacturing output has declined in comparison to the same period of last year, and the latest data from September show an annual fall of 3.5 percent. In a small open economy, such as Finland, the effects of weakened global demand are quickly felt in the exporting sector. It is currently estimated that the volume of exports will be considerably smaller this year compared to the record increase of 18 percent reached in 2000. Among the exporters most severely hit has been the electronics manufacturing sector, which has suffered a drastic fall in output in the beginning of this year. This sector accounts for about 30 percent of Finland's total exports. Global sales of mobile handsets have declined for the first time in many years, and demand for mobile phone network systems has also been weak. However, recent data from August and September show signs of recovery in the electronics manufacturing.

Prospects in our traditional export sector, the forest industry, have also worsened, and these exports are projected to decline by 6 percent in volume terms this year. The developments in the traditional metal industry, however, continue to remain relatively good, and the order books stand at comfortable levels.

In the selected issues paper, staff interestingly explores Finland's rapid transformation to become one of the world's leading ICT producers during the 1990s. During this process our industrial base has become increasingly diversified. While Finland has greatly benefited from its rapidly expanding ICT sector, the staff rightly stresses that Finland has also become vulnerable to ICT specific shocks. However, in view of long-term prospects, we believe that Finland will continue to reap further benefits from an expanding ICT sector and increasing the application of ICT more widely in the economy.

Final domestic demand remained relatively strong during the first quarter and continued to grow during the summer, albeit at a slower speed. Private consumption has been supported by good income growth and lower interest rates despite the recent halt in employment growth. Consumer confidence has weakened from the beginning of this year, but seems to have broadly stabilized in October. The already agreed tax cuts in 2002, lower inflation

together with lower interest rates and relatively low household indebtedness are likely to keep private consumption growing in spite of the weakened near term outlook.

Industrial confidence has been weakening since the middle of last year, and is reflected in investment activity. However, we believe that the economy is fundamentally strong, and the foreseen additional structural reforms will help Finland to be better positioned to face the challenges of a rapidly aging population profile. In the short term the performance of the Finnish economy will, to a large extent, depend on the pickup of world economy and demand, in particular, in the ICT sector. Current assessments indicate that GDP growth will most likely be in the range of 0.5 – 1 percent this year and below 2 percent in 2002.

Prices and Wages

Staff rightly points out that in Finland inflation, measured by the harmonized consumer price index, has persistently remained above the euro area average from early 1999 until early 2001. To a large extent, this development is due to the fact that prices in the service sector have been high compared to the euro area average. Lately, however, inflation has moderated toward 2.6 percent, the current euro area average, and it is projected to decelerate further due to lower oil prices and subdued demand conditions. Negotiated wage increases for 2001 and 2002 are 3.1 percent and 2.3 percent, respectively, and these increases should not pose any threat to price stability.

According to preliminary data, private sector labor productivity increased by 5.5 percent in 2000, but is projected to decelerate markedly this year, notably in the electronics manufacturing and forest industry. There are large differences in labor productivity between sectors, and this should, as staff notes, be better reflected in the wage formation. The rigidity of wage formation has undoubtedly negatively affected the employment situation in particular in the service sector. While we share the staff's view on problems of wage formation, only a gradualist approach in reforming the wage setting procedures is realistic. In this context, it is worth noting that in the past Finland has greatly benefited from the centralized wage agreements.

Fiscal Strategy

The consolidation of public finances accompanied by strong output growth generated a sizeable surplus in the general government balances. In 2000, this surplus amounted to 7 percent of GDP. A part of the ample surplus reflected exceptional income from capital gains taxes and tax revenues generated through employees' stock options given high equity valuations. However, the situation in the equity markets has changed dramatically since 2000. This will reduce the tax revenues stemming from the above-mentioned exceptional sources this year. Nevertheless, the general government balance is expected to remain in surplus this year. The budget proposal for 2002 is projected to have a surplus of 2½ percent of GDP for the general government and ½ percent of GDP for the central government.

The issue of amortization public debt has been an object of lively debate. Some would prefer a faster rate of amortization, some a slower one. There are merits in a faster rate of amortization in terms of interest savings. In view of Finland's demographic structure, resulting in the old-age dependency ratio rising sharply around 2010, a faster rate of pay back would be advantageous in containing the need to raise taxes in the future. The authorities are committed to retiring public debt, but at a rate that is consistent with budgetary expenditures and revenues in a given business cycle. As to the medium-term fiscal strategy, staff and we share the common view of the necessity to maintain the general government structural balance in sufficiently strong surplus.

Pension Reform

We agree with staff on the recommendations concerning pension reform. In fact, a working group consisting of representatives from the pension insurance institutions and the central labor market organisations is preparing a reform proposal, which is expected to be finalized in the near future. Under consideration are both benefits and contributions, aimed at reflecting lifetime employment, not only average earnings during the last 10 years' of employment. Currently the effective retirement age is 59 years, while the statutory retirement age is 65 years. Staying employed beyond the effective retirement age should be made financially more attractive, and the rules for early retirement should also be tightened. Perhaps the most important objectives of the pension reform working group are to lengthen the effective retirement age and make the statutory retirement age to range from 62 to 68 years. There is a risk that, if no changes to the current pension system are made, a significant increase of future taxes could not be avoided.

As staff rightly points out, in preparation for the demographic shock, it is necessary to continue to reduce taxes on labor, and to reform the pension system and other social benefits. Staff interestingly explores trade offs in terms of growth, fiscal savings, and employment under two different fiscal policy strategies and pension rules. The calculations illustrate that a firm reduction in labor taxes in combination with more ambitious rise in retirement age clearly results in more positive developments in growth and employment than in the baseline scenario.

Labor Markets and Reforms

Reducing unemployment has been high on the government's agenda for some time. The unemployment rate has continued to decline from its peak of 17 percent in 1994 to 9 percent in August this year. As a result of the sharp deceleration of economic activity, employment growth has come to a halt and unemployment edged up to 9.3 percent in September. In view of the exceptional growth performance of the economy in recent years, the number of unemployed is still too high. The government's objective is to raise the employment rate, which is currently 67 percent, to 70 percent by the end of 2002. Measures to lower the tax wedge on labor income have already been implemented, but there is still room for further tax cuts and changes in the benefits system to remove the so-called income traps. Although

Finland has an extensive system of retraining programs, it has been very difficult to employ long-term unemployed even after training.

A working group is currently preparing reform proposals on the unemployment insurance system. The group is addressing the same problems that are highlighted in the staff report such as the so-called unemployment pipeline problem. This group is expected to finalize its proposals also in the near future.

The service sector has a great potential to increase employment. However, the mismatch in qualifications and skill requirements, and pricing distortions due to taxes and social benefits has resulted in a low employment share in the service sector relative to comparable OECD countries.

Financial System Stability Assessment

My authorities are pleased to have the Financial Sector Assessment Program completed. In light of the findings in the Financial System Stability Assessment, steps will be taken to further strengthen the financial structures both in order to better withstand any adverse developments in the financial sector or system and in order to further strengthen the efficiency and functioning of regulatory and supervisory bodies.

While the text on how the Finnish legal system and administrative practices function is correct and we fully support the thrust of staff recommendations for further work, we would like to indicate some concern about the way our present regulatory situation is presented.

We are very aware of the difficulties of fully appreciating the workings and implications of foreign and sometimes quite involved legal systems. Staff has, indeed, made a heroic and commendable effort to do so. Nevertheless, we would have liked to see a somewhat greater appreciation of the fact that a number of important issues identified as needing correction in fact can be and have been quite adequately handled already under our present legal rules.

Some concrete examples where an even modestly inattentive reader may get an incorrect impression are:

- *the call for requiring a "no objection" statement from non-EEA home country supervisors before granting a branch license for a foreign bank* -- the authorities already have the right to require this statement and it is, in administrative practice, always required even though no explicit legal requirement exists;

- *the call for explicit recognition of the responsibility of the management for ensuring the integrity of financial statements and their external verification* -- this responsibility is according to my Ministry of Finance already truly sufficiently covered by general company law (i.a. by provisions on both civil and criminal liability of the management and auditors);

- *the call for powers to require strengthening a credit institution's risk management system* -- Art. 68 of the Credit Institutions Act already does provide the FSA with explicit powers to issue regulations to ensure the adequacy of risk management systems; furthermore there is also a general requirement for the institutions to have adequate systems for risk management and internal control, on the basis of which the FSA can enforce improvements in individual cases by the means provided generally by the FSA Act.

We do, nevertheless, agree that it could be a good idea to spell out such rights and obligations specifically for financial institutions more explicitly than before.

My authorities consent to the Fund's publication of the staff report, the selected issues, and the FSSA report.