

Finland: 2003 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Finland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with Finland, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **June 18, 2003**, 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 5, 2003.** 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 statement of **October 8, 2003** updating information on recent developments.
- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its October 8, 2003 discussion** of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for Finland.

The document(s) listed below have been or will be separately released.

Selected Issues Paper

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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FINLAND

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives
for the 2003 Consultation with Finland

Approved by Alessandro Leipold and Martin J. Fetherston

September 5, 2003

- The 2003 Article IV consultation discussions were held in Helsinki during June 9–18, 2003. The mission met with: the Governor of the Bank of Finland; the Minister of Finance; officials from the Bank of Finland and various ministries; members of Parliament’s Finance Committee; various financial supervisory and other authorities; and representatives of the labor unions, research institutes, and the academic community. The authorities published the mission’s concluding remarks, organized a press conference, and plan to publish this staff report.
- The mission comprised Mr. Feldman (head), and Messrs. Berger, Billmeier, and Kuijs (all EU1). Mr. Andersen, Alternate Executive Director for Finland, and Ms. Nikitin, of his office, participated in meetings.
- 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).
- With the new coalition government—led by the conservative Center Party with the Social Democrats and the small Swedish People’s Party—still in the process of detailing its policies, Prime Minister Jäätteenmäki resigned in mid-June amid allegations of improperly leaking documents on the previous prime minister’s position on the Iraq war. The Center Party moved quickly to install Defense Minister Vanhanen as the successor, but the spirit of cooperation between coalition partners may have been weakened.

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I. BACKGROUND

1. ***The Finnish economy has made enormous strides since the severe recession and banking crisis of the early 1990s.*** The economic restructuring and expansion after the crisis reflected a combination of private sector initiative, solid macroeconomic management—including the shift from large deficits to significant surpluses of the general government—and structural reforms. This, against the background of excellent physical and social infrastructure, allowed Finland to converge successfully to the euro, and to outperform euro-area partners in the recent past in terms of economic growth and the public finances. Based on prudent policy choices, increased external competitiveness, and favorable export performance, including both traditional industries and the dynamic information and communications technologies (ICT) sector, real GDP growth averaged almost 5 percent during 1994–2000; inflation was 1–3 percent.

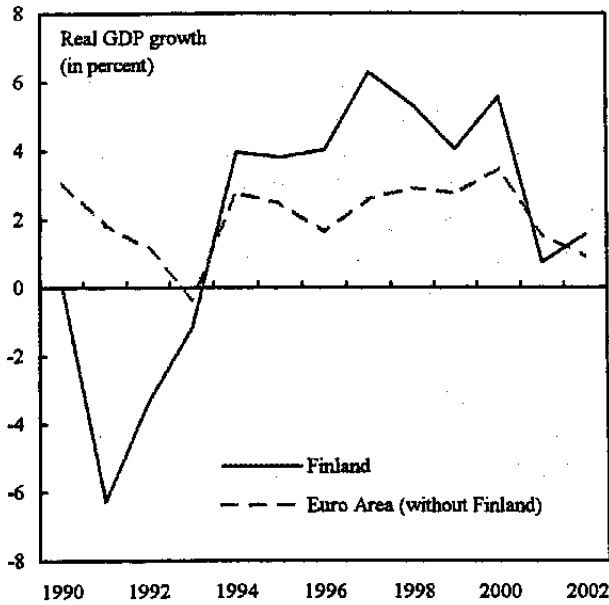
2. ***Finland has generally responded appropriately to many policy challenges identified in previous Article IV consultations, though expenditure control has been elusive and further structural reforms remain needed.*** The Fund has long supported Finland’s goal of accumulating large general government surpluses in light of imminent pressures from population aging. It has also supported the goal of curbing spending in order to make room for much-needed tax cuts, especially on labor, with a view to raising employment. However, departures have been evident, particularly with regard to spending, leaving little or no scope for credible, growth-enhancing tax cuts, and the fiscal surplus has narrowed significantly since 2000. For their part, structural reforms have contributed to a strengthened economy. Among the reforms implemented were the bank restructurings and the widespread adoption of new banking technologies in the 1990s, the liberalization of markets, reforms to improve labor market performance, and pension reform. Financial supervision in the banking sector has also been improved along the lines recommended in the 2001 FSAP. However, further structural reforms—many of which were recommended in past consultations and discussed in this report—are needed to raise both actual and potential growth, as well as to support the public finances.

3. ***The economy, under difficult circumstances, performed reasonably well during 2001–02—though the pace of activity slowed considerably and remains subject to volatility.*** Real GDP growth slowed to 0.7 percent in 2001, before rising to 1.6 percent in 2002 (Figure 1 and Table 1).¹ Growth in 2002 was bolstered by robust private consumption and a rebound in exports. Notably, ICT exports played a prominent role in the export recovery, contradicting some of the global pessimism surrounding this sector as Finland gained market share. Meanwhile, output has recently been below potential, contributing to a decline in inflation.

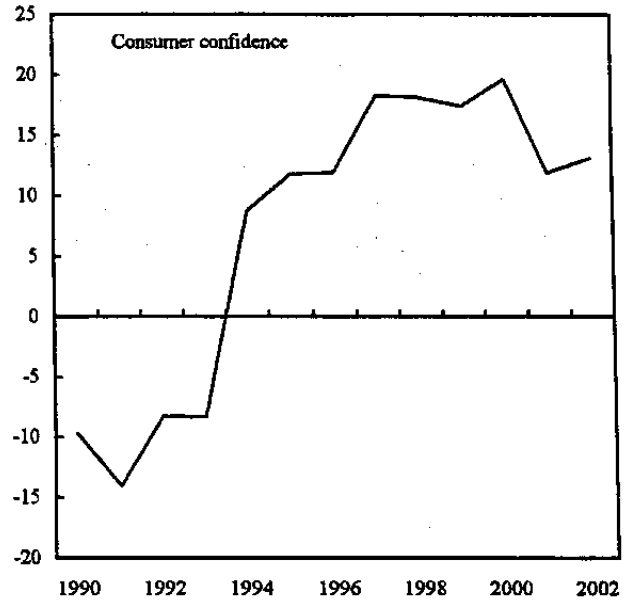
¹ The national income accounts are currently being revised back to the mid-1990s and there are preliminary indications that the growth rates for these two years may have been higher.

Figure 1. Finland: Selected Indicators, 1990-2002

Growth, which has been more volatile than in the euro area, was higher in Finland in 2002...



...helped by robust private consumption as consumer confidence was high...



...not least because of continued real wage growth...

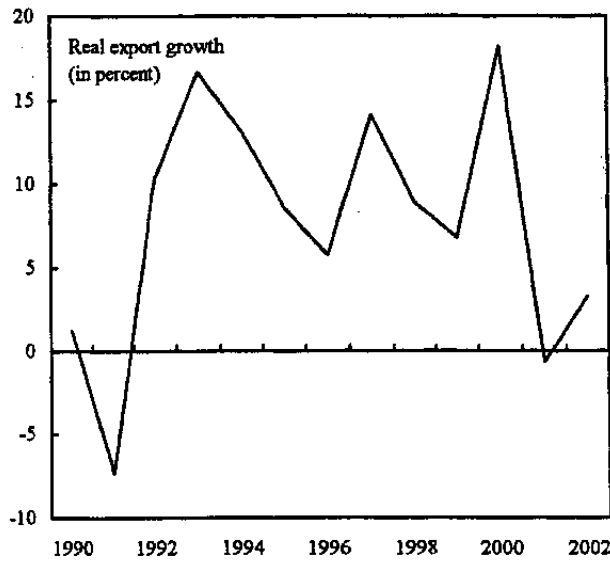


...and a broadly stable unemployment rate, as firms held on to their workforce in anticipation of a recovery.

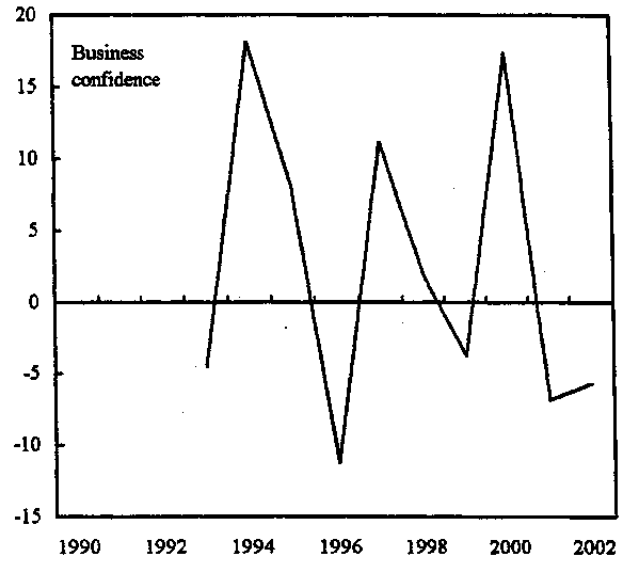


Figure 1. Finland: Selected Indicators, 1990-2002 (concluded)

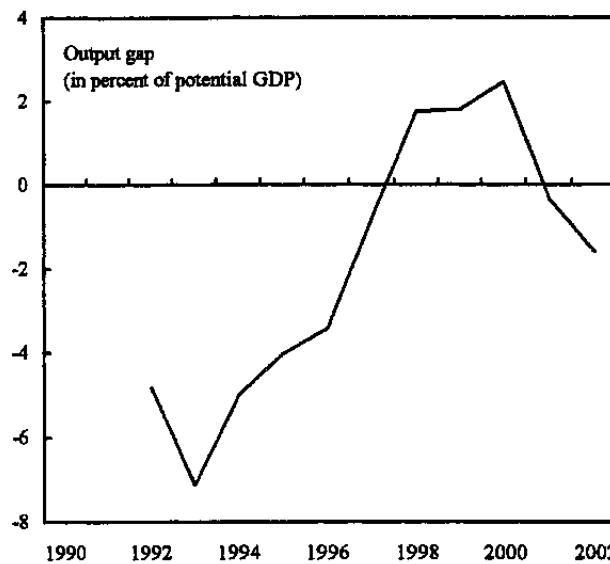
A rebound in exports, including in the ICT sector, also contributed to GDP growth in 2002,...



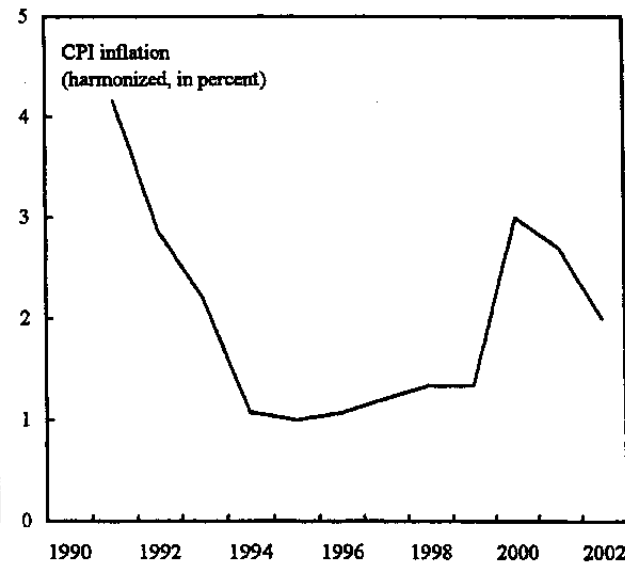
...while private investment fell amid low business confidence.



With the slowdown in real growth, output was below potential,...



...contributing to a decline in inflation.



Sources: Statistics Finland; ETLA; and Fund staff calculations.

4. ***High unemployment is one indication that structural rigidities continue to hamper Finland's output potential.*** The official unemployment rate (seasonally adjusted) has hovered somewhat above 9 percent so far this year and may have been higher except for labor hoarding. Broader measures, which take into account individuals who left the labor force early and participants in active labor market programs, put the unemployment rate around 16½ percent. High labor taxes (Figure 2) and the lack of wage differentiation have made much of the unemployment structural. This is reflected in its persistence across time and regions, as well as the lack of jobs for low-skilled labor (Figure 3) and the high number of long-term unemployed. At the same time, a low effective retirement age (now about 59½ years—among the lowest within OECD countries) has been one of the factors depressing the supply of labor.

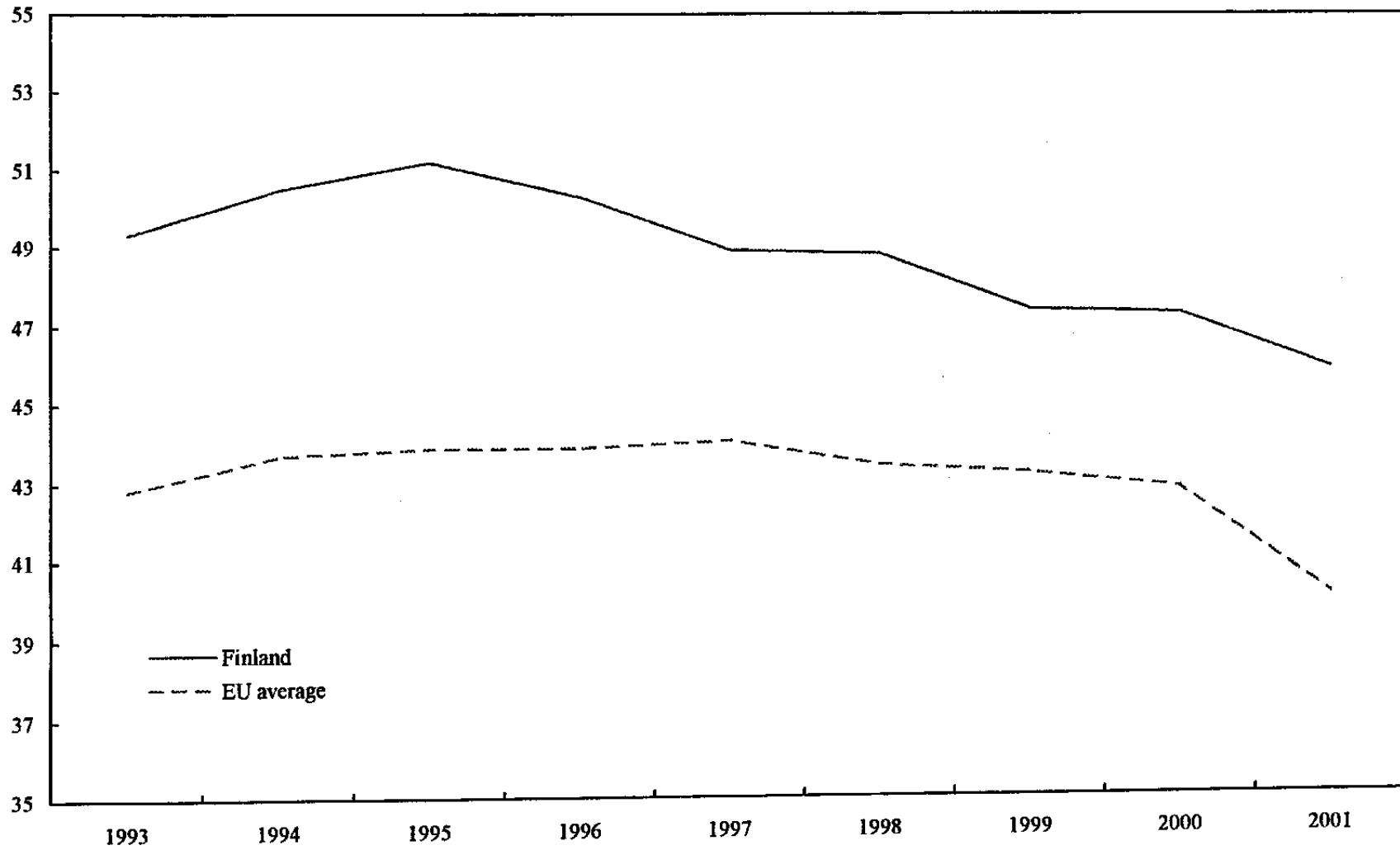
5. ***The Finnish population is also aging rapidly, exerting downward pressure on the labor force, with adverse implications for potential economic growth and the public finances.*** The old-age dependency ratio will rise to 40 percent in 2020 and 50 percent in 2030. This is almost double the ratio today and among the highest in the EU during that time.

6. ***Fiscal discipline has slipped in recent years.*** In 2002, the general government surplus was still high at 4.6 percent of GDP, compared with 7 percent in 2000. However, one-off factors were an important but fading contributor.² Moreover, while the public finances are in considerably better shape than in many other euro area countries, slippages have been evident. For example, with the election year approaching, overruns occurred across all spending categories in 2002, raising real central government expenditures to an estimated 4 percent above the original target. Figure 4 illustrates, more generally, the weakening trend in expenditure discipline as spending, especially in the form of higher social benefits and increasing transfers to local governments (which shoulder the majority of health and education expenses), has ratcheted up.³ While staff had successively supported the expenditure ceilings and stability program targets set in 2000–01, policies have clearly drifted in the opposite direction. Based on Finance Ministry estimates for the 2003 supplementary budget, staff expects that the general government surplus will decline further, to about 2 percent of GDP, as the central government balance swings to a small deficit of 0.3 percent of GDP. In addition to a budgeted increase in expenditure of about 4 percent in real terms, this deficit also reflects tax cuts of a half percentage point of GDP.

² These largely reflected (lagged) exceptional tax revenues due to income from stock options from the asset boom ending in 2000.

³ On average, real spending on social security benefits and other transfers to households increased by 4 and close to 8 percent annually during the 2000–03 period, respectively. Central government transfers to other government sectors, mostly local governments, increased by an average of 10 percent annually in real terms during this period.

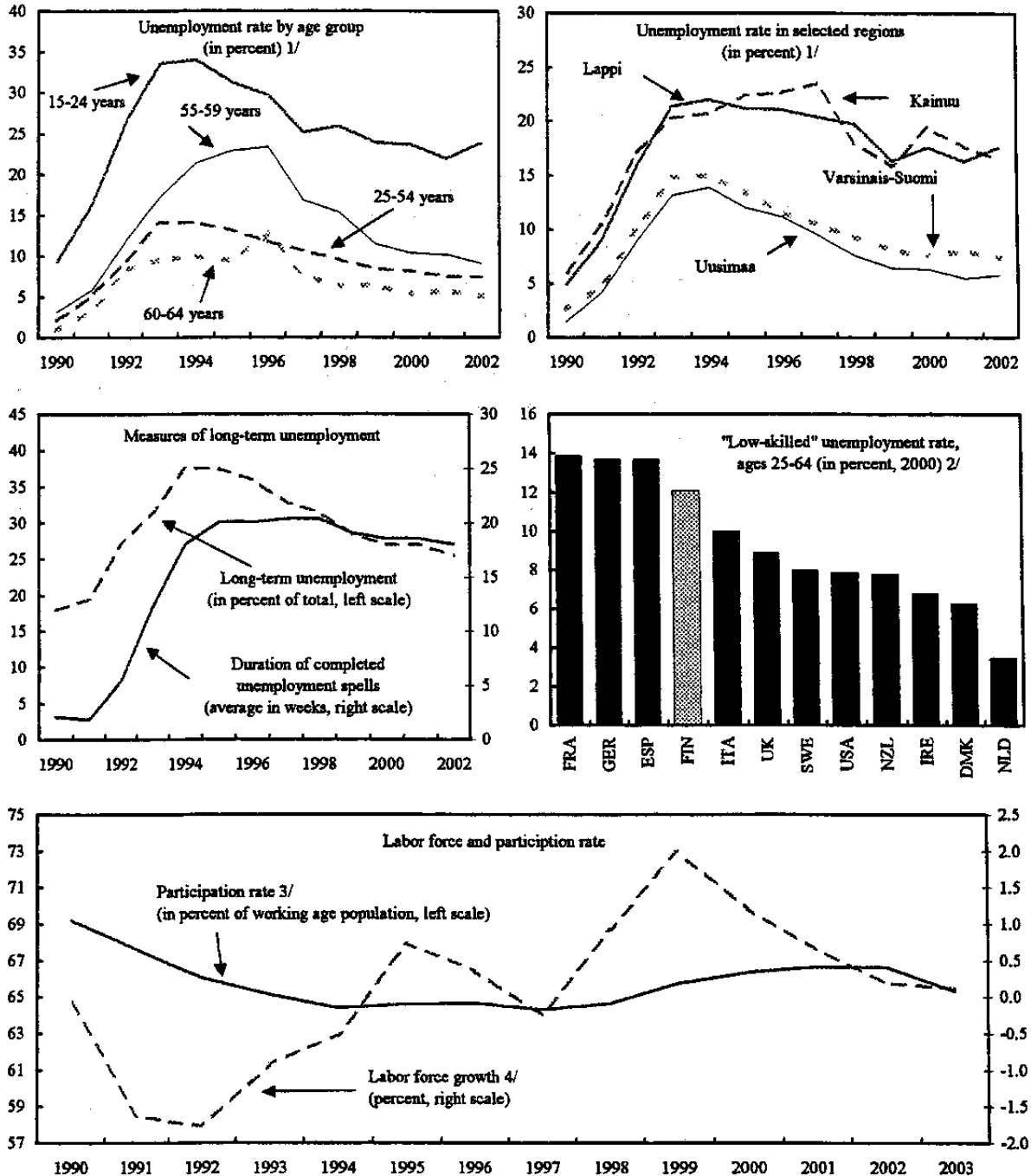
Figure 2. Finland and the EU: Tax Wedge, 1993-2001 1/
(In percent of labor costs)



Sources: OECD; and Fund staff calculations.

1/ Income tax plus employee and employer contributions (as a percentage of labor costs); single persons without children.

Figure 3. Finland: Labor Market Characteristics, 1990-2003



Sources: Finnish Labor Review; OECD Employment Outlook 2002; and Fund staff calculations.

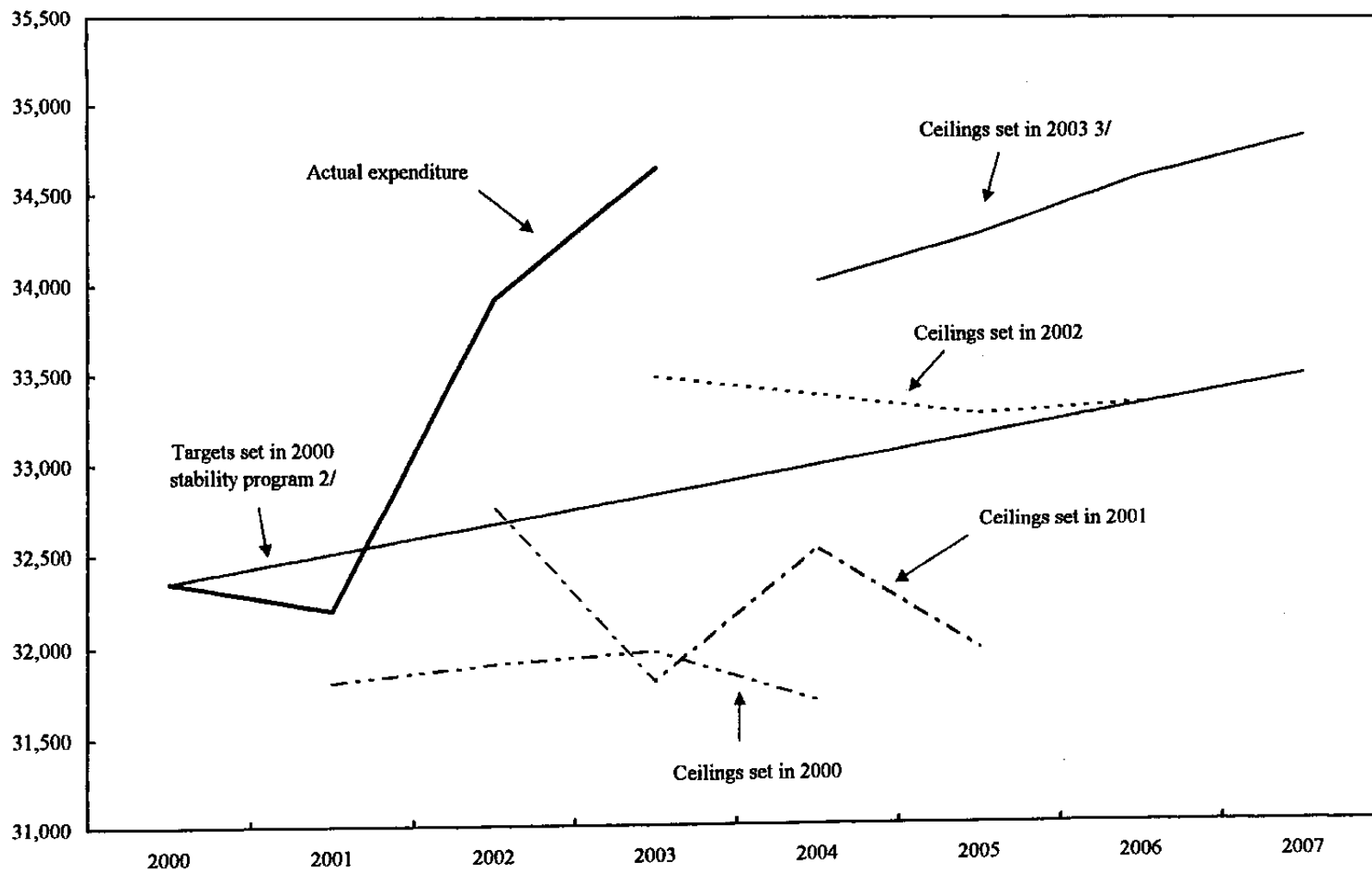
1/ Lappi and Kainuu are regions in the Northern part of the country; Uusimaa and Varsinais-Suomi are in the South.

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

3/ 2003 data are for first quarter only.

4/ 2003 data are annual growth rate for the first quarter.

Figure 4. Finland: Central Government Expenditure Ceilings and Actual Expenditure, 2000-07 1/
(In millions of euros, constant 2000 prices)



Sources: Ministry of Finance; and Fund staff calculations.

1/ In line with the authorities' definitions. Actual expenditure for 2003 preliminary.

2/ The government's original benchmark established under its 1999 stability program aimed at constant real expenditure relative to the 1999 budget, but this was relaxed somewhat in the 2000 update.

3/ These are the ceilings set by the old government. The expenditure ceilings of the new government exclude cyclical components and interest payments and are therefore not comparable. However, total expenditure in the government's supplementary budget for 2003 is above the earlier ceiling.

II. POLICY DISCUSSIONS

7. ***In the face of high unemployment and rapid population aging, the discussions focused on supporting medium-term growth while securing long-run fiscal sustainability.***

It was recognized that the boom years were exceptional, and that various policy actions must be taken to keep the economy growing, create new jobs, and sustain Finland's well-developed welfare system. In this context, the discussion took up several interrelated elements, comprising the need to: (i) raise the employment rate by increasing work incentives for all age and skill groups; (ii) establish and maintain a record of expenditure discipline to make room for credible tax cuts without compromising the public finances; (iii) on this basis, reduce taxes, notably on labor, as an important component of raising employment, safeguarding competitiveness, and enhancing growth; (iv) implement further pension reform to make a longer working life more attractive and thereby increase the effective retirement age; and (v) reform the product market to enhance the economy's efficiency and generate employment. Most of these elements are contained in the government's economic program, although, in the short term, more immediate concerns about slowing growth are dominating the policy agenda. How the various elements come together, in terms of the timing and ambition of their implementation, has important implications for economic performance and the health of the public finances.

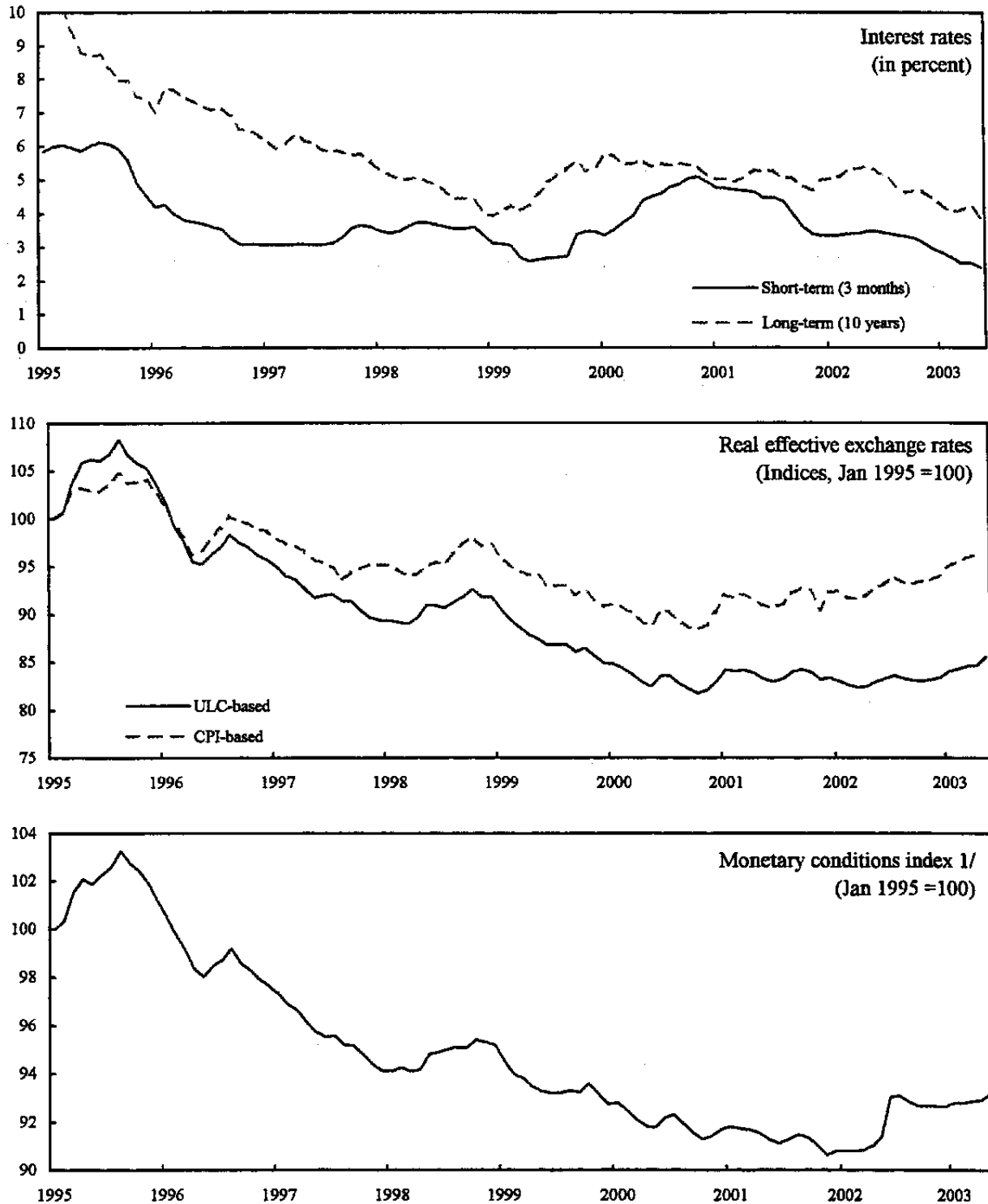
A. Short-Term Outlook

8. ***Real growth is likely to be moderate in 2003, but should gather pace in 2004.*** Staff projects real GDP growth of 1.3 percent in 2003, driven by private consumption (with recent data showing continued strong consumer confidence)⁴ and some, albeit moderate, growth in exports. While investment is projected to decline in 2003, the projection incorporates a modest pick-up in the second half of the year, reflecting the postponement of earlier planned investments. Higher investment and accelerating export growth (which contributes to investment activity) lie behind staff's projection of 2.6 percent growth in 2004. Monetary conditions are estimated to remain largely unchanged, with the lagged effects of the decline in interest rates being offset by the strengthening of the real effective exchange rate (Figure 5). While Finland's external competitiveness nevertheless remains solid,⁵ downside risks still stem mainly from the external environment—with questions hanging on the

⁴ Private consumption is holding up despite the recent sharp decline in equity prices during 2000–02, which have yet to recover (Table 3). This decline largely reflects a pronounced drop in the ICT sector, which dominates the Finnish stock market. However, the impact of equity price changes on Finnish households is limited, as about two-thirds of the ICT sector's total market capitalization is held abroad, and domestic holdings are highly concentrated.

⁵ This view is buttressed by Finland's continued strong showing in international competitiveness comparisons. For instance, the World Economic Forum ranked Finland second in its 2002–03 competitiveness survey, reflecting, inter alia, the high quality of public institutions, an innovative research environment, and good ICT infrastructure.

Figure 5. Finland: Monetary Conditions, 1995-2003



Sources: ETLA; IFS; Bank of Finland; and Fund staff calculations.

1/ Using weights for real short-term and long-term interest rates and the real effective exchange rate (ULC based) of one-third each.

upswing in the euro area and possible further euro strength against the U.S. dollar and other currencies.⁶ The possibility of continued business investment weakness, and of a softening of strong consumer confidence should significant layoffs occur, would also affect domestic demand. By the same token, while there are major uncertainties about the prospects for the ICT sector, upside surprises are not out of the question.⁷ The projections by the authorities were somewhat higher, but the authorities put the staff's projection well within their confidence interval, and stressed that the existing differences would not affect policy conclusions.⁸

9. ***Inflation is expected to be subdued.*** The authorities and staff agreed that consumer prices were likely to increase by less than 2 percent during 2003–04, reflecting moderate wage growth and a persistent output gap. The likelihood of a broad-based decline in prices seemed remote, however. And while the authorities, like staff, saw the possibility of deflation as deserving of careful monitoring, they viewed the risks as low. The disinflation visible in headline figures partly originated outside of Finland (e.g., a decline in the prices of oil and other tradables in euro), could be temporary, and should boost real demand. At the same time, certain domestic components of the CPI, notably services prices, were showing increasing rates of growth. Finally, despite excess capacity and a significant drop in equity prices in the recent past, other characteristics often associated with more imminent deflationary pressures were absent: there was no sign of a slowdown in domestic credit growth and, after a moderate decline in 2000–01, real housing prices have more recently rebounded (Tables 1 and 3).

⁶ About two-thirds of Finnish goods exports go outside the euro area.

⁷ The export-oriented ICT sector, which generated about one-third of the exceptional real GDP growth during the late 1990s, remains important for Finland's economic performance. On the one hand, for example, a further deterioration in demand for network equipment, as (especially European) network operators continue to struggle under the debt accumulated before the burst of the telecommunications bubble in 2001, would reduce prospects for growth. On the other, higher-than-expected demand for communication equipment—namely for third-generation mobile telephones—and further significant gains in market share could boost demand for Finnish exports beyond staff's baseline projection.

⁸ The authorities' projections were made before the release of preliminary, and weaker-than-expected, real GDP data for the first quarter. It showed a 1.3 percent decline (seasonally adjusted) from the previous quarter, mostly reflecting a drop in both investment (of 1.5 percent) and exports (of 1 percent); consumption was broadly constant (rising by 0.1 percent). Subsequent to the Article IV discussions, the Ministry of Finance revised its projection to 1.2 percent for 2003 (from 1.8 percent in the spring); and 2.4 percent for 2004 (from 2.9 percent).

B. Fiscal Policy and Pensions

10. *Reflecting concerns about slowing growth, frontloaded expenditure increases and tax cuts were at the center of the fiscal policy debate.* While the authorities' fiscal program was still being fleshed out, it included expenditure ceilings for 2004–07, which allowed for rapid expenditure growth in 2004, and a focus on reducing the tax burden, particularly on labor, as an essential element for raising the employment rate.

- The new expenditure ceilings—which, in contrast to the previous ones exclude cyclical components and interest rate payments—imply real expenditure growth for the items covered of 1.3 percent per year on average over the period, and 3.2 percent in 2004. Taking into account government projections of the spending items that are excluded from the new ceilings, overall expenditure would be looser than under the previous ceilings.
- On revenues, preliminary budgetary plans for 2004 envisaged significant tax cuts, equivalent to 0.6 percent of GDP—on labor to a significant degree, though the exact size of the cuts was still under discussion. In addition, mainly as a result of Finnish adjustments to EU regulation, indirect tax receipts (notably from revenues on alcohol, tobacco, and cars) will decline.
- The Finance Ministry envisaged that the central government will be in balance in 2007 if 100,000 new jobs can be created. Meeting this ambitious target would add to revenues and lower spending, leaving, according to Finance Ministry estimates, the general government in surplus by about 3½ percent of GDP in 2007. However, the specific measures to meet this target for jobs were not explicitly identified and matched to estimates of their impact on job growth, or costed out in terms of their impact on the fiscal accounts.⁹ Thus, achieving the job target lacked a well-specified strategy.
- Substantial job creation is crucial: in its absence, the Finance Ministry's projection (assuming moderate job growth of 25,000 jobs) foresaw central government deficits of 1.1 to 1.3 percent of GDP in 2004–07, corresponding to a surplus for the general government of only 1.7 percent in the latter year. This projection, which is based in the staff's view on conservative estimates of revenue, implies fiscal stimulus, measured by the change in the primary structural balance, of about 1.2 percent of GDP in 2004 according to staff calculations, and little change in this balance afterward.

⁹ The government had also adopted a limit of 2¾ percent of GDP for the central government deficit. However, the expenditure ceilings were expected to be the binding constraint, and balance for the central government was expected to be achieved “under normal circumstances,” assuming 100,000 new jobs would be created.

11. *The discussions reviewed the choices facing the authorities between accumulating substantial fiscal surpluses now or, in the absence of reform, imposing higher taxes and contribution rates in the future.* Recent studies by the Bank of Finland and the Ministry of Finance were revealing on this score (Box 1). In the scenarios in both studies, the general government runs a surplus of about 4 percent of GDP on average over the 2003–10 period (broadly consistent with the targets of the previous government, and a half percentage point of GDP above the surplus envisaged by the new government by 2007 under its rapid job growth scenario). In the Ministry of Finance study, taking into account the effects of various recent reforms (including to pensions, agreed in 2002),¹⁰ gross public debt would double between 2020 and 2050, rising to almost 80 percent of GDP, because of population aging. The Bank of Finland study, which also takes into account the 2002 pension reform, suggests that the ratio of both pension contributions to wages and the tax-to-GDP ratio would each have to be increased by about 4 percentage points over the next two decades to cover higher age-related spending while keeping the central government balance out of deficit and securing a surplus in the social security funds of around 2–3 percent of GDP.¹¹ Simulations by staff reached broadly similar conclusions, illustrating the advantages of raising the fiscal surplus to 4 percent of GDP or more to end up in a sound fiscal position in the long-term after the full effects of population aging are realized.¹² The simulations also showed that tax cuts (relative to baseline) can improve economic performance over time, with positive feedback effects on the fiscal position. However, staff noted, expenditure restraint is essential, to make room for tax cuts, avoid that they lead to unwanted deterioration of the fiscal position, and to enhance their credibility and hence their economic effectiveness.

12. *Against this background, staff concluded that a general government surplus of at least 4 percent of GDP would constitute a useful medium-term norm, which was, however, not at hand on current policies.* The authorities' fiscal strategy—notably the level at which the expenditure ceilings are set and the lowering of taxes—implied surpluses below this norm for a number of years. Indeed, in the baseline scenario in Figure 6, the general government surplus would not exceed 2 percent of GDP during 2003–07. With the output gap not yet closed, staff suggested a phased-in approach to meeting the medium-term norm, targeting an adjustment in the structural primary balance of ½ percent of GDP per year, while

¹⁰ The 2002 pension reform is described in more detail in paragraph 17.

¹¹ With Finland being a small and open economy with volatile growth, the EC estimated that a minimum general government surplus of 0.8 percent of GDP is called for to ensure compliance with the Stability and Growth Pact.

¹² These simulations are in *IMF Country Report No. 02/186*. Though not necessarily as large as 4 percent of GDP in all cases, other Nordic countries have chosen to run substantial fiscal surpluses to address population aging—for example, Denmark, Norway (also to prepare for falling oil revenues), and Sweden.

Box 1. Aging and the Finnish Public Finances in the Long Run

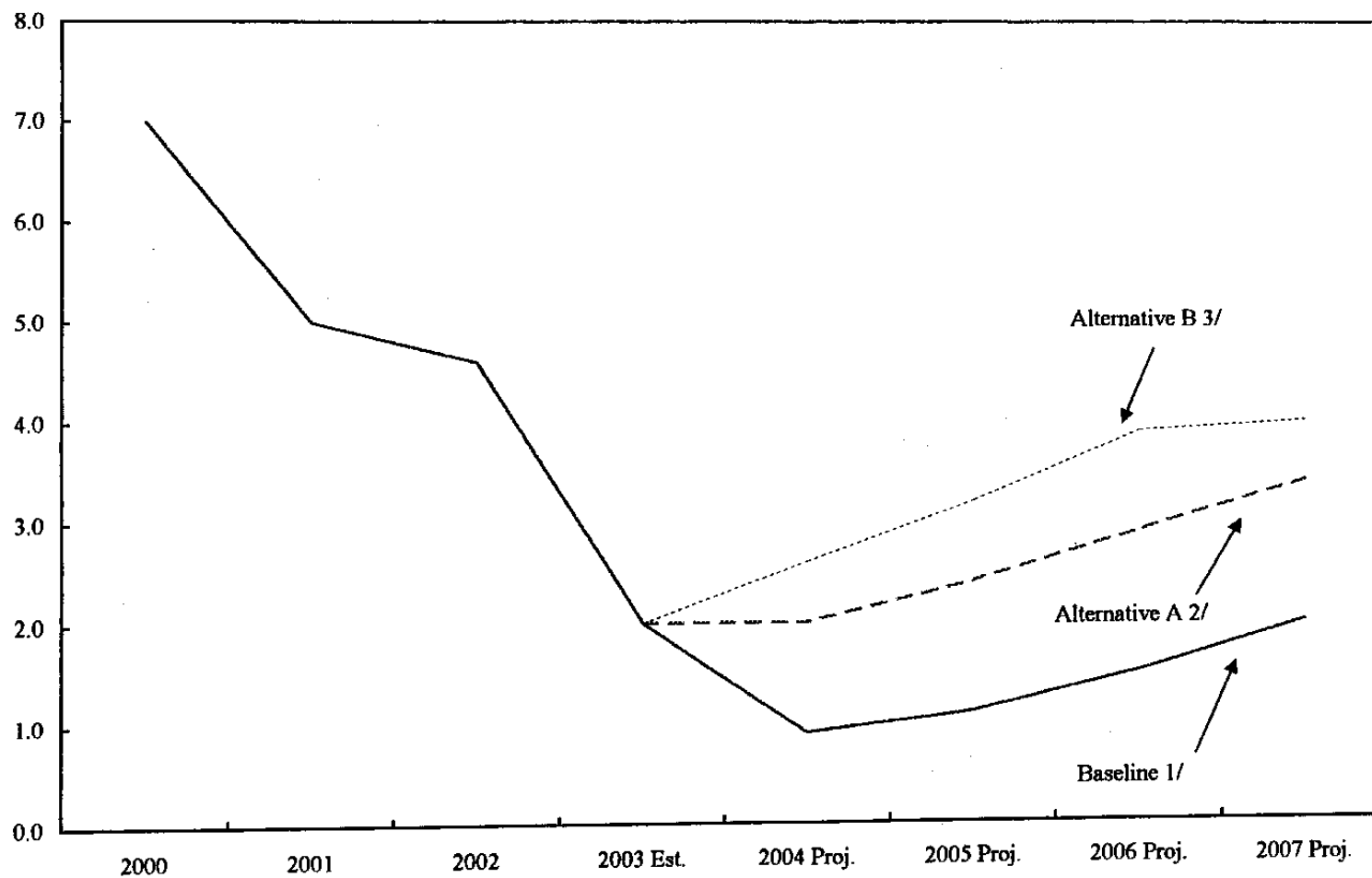
Two recent studies by the Ministry of Finance and the Bank of Finland discuss the implication of aging. The scenarios in both studies are broadly compatible with a general government surplus of about 4 percent of GDP on average over the 2003–10 period. Nevertheless, an increase in taxes and contribution rates or, alternatively, in public debt is needed to cope with the demographic shock. The results also suggest that the recent pension reform is insufficient.

The baseline scenario in the *Finance Ministry* study finds that public spending on pensions and aging-related health costs could increase by as much as 8 percentage points of GDP by 2050. In this scenario, holding other expenditures as well as taxes and social security contributions constant as a share of GDP, the general government surplus would steadily decline, falling below 4 percent of GDP after 2010 and turning negative by 2035. As a consequence, gross public debt would double between 2020 and 2050, rising to almost 80 percent of GDP. This is despite taking into account the effects of various reforms (including to pensions in 2002), estimated to increase the average effective retirement age by about 3 years, and increases in labor market participation through linking pensions rights more closely to career earnings.

The *Bank of Finland* study is similar in nature, but assumes that tax and social security contribution rates would be adjusted to keep the central government balance out of deficit and to secure a surplus in the social security funds of around 2–3 percent of GDP. The results suggest that the ratio of pension contributions to wages would have to be increased by an additional 4 percentage points over the next two decades while the tax-to-GDP ratio would be increasing by about 4 percent of GDP to cover higher age-related spending. Without the 2002 pension reform the estimated increases in the former would have been 7 and 6 percent, respectively. But even after the reform, the tax and social security contribution increases required to keep the public finances in balance remain high.

The *Bank of Finland* study is also helpful in gauging the sensitivity of these results to changes in the underlying assumptions on GDP. A gradual increase in the employment rate by about 3½ percentage points during 2010–50 would, all else equal, increase the end-period level of GDP by about 3 percent compared to the baseline. This would allow a reduction in the ratios of contributions to wages and of taxes to GDP by 1 percentage point—suggesting that a formidable effort would still be needed to keep the public finances healthy.

Figure 6. Finland: The General Government Balance Under Alternative Fiscal Scenarios, 2000-07
(In percent of GDP)



Sources: Ministry of Finance; and Fund staff calculations.

1/ The baseline scenario is in line with the authorities' central government expenditure ceilings, and staff projections for revenue.

2/ Alternative A holds real central government expenditure constant at its 2003 level.

3/ In alternative B an adjustment in the structural primary balance of 1/2 percent of GDP per year is achieved through further expenditure consolidation.

allowing the automatic stabilizers to play around the consolidation path.¹³ Given staff's projection for output—which sees growth broadly constant during 2004–06 as export performance remains solid, investment continues to take hold, but imports also increase—this would imply raising the actual general government surplus in broadly equal increments from its estimated 2003 level (2 percent of GDP) to reach 4 percent of GDP by 2006.¹⁴

13. *The authorities were not in disagreement with the benefits of higher fiscal surpluses in the medium term, but more immediate concerns tended to dominate the policy agenda.* In particular, with boosting employment so important, tax rates high by international standards, and tax competition increasing, the government felt that early tax cuts were crucial. At the same time, expenditure increases were in line with election commitments. Moreover, it was felt that the previous expenditure ceilings had been too tight and were particularly difficult to adhere to politically in the face of the slowdown in growth and large fiscal surpluses. With inflation low and external demand weak, the authorities felt that the cyclical outlook mitigated any near-term problems associated with the fiscal stimulus resulting from running down the fiscal surplus. They nevertheless also recognized the adverse consequences of future expenditure slippages and stressed the seriousness with which they intended to hold to the spending ceilings. Staff emphasized the importance of further structural measures (both in labor markets and pensions as discussed below) as quickly as possible to make the targeted increase in employment a more realistic prospect. On the latter, the authorities—though perhaps to varying degrees—agreed, seeing merit in such reforms, while cautioning that it would take time to muster the necessary political support for any additional reforms.

14. *Various actions to more decisively approach the medium-term norm were discussed.*

- Revenues: with revenue estimates by the Ministry of Finance possibly on the conservative side, staff urged the authorities to use higher-than-projected revenues to raise the general government surplus and lower debt (projections by the Bank of Finland as well as staff suggest that revenues could be higher than projected by the Finance Ministry). In light of the overruns to past expenditure ceilings, staff also advised that tax cuts be put on hold until the authorities were convinced that expenditure (and the fiscal balance) was well under control.

¹³ An accompanying Selected Issues paper analyzes the impact of fiscal policy changes on growth.

¹⁴ As discussed in another accompanying Selected Issues paper, there is considerable uncertainty about the size of the output gap. While this makes it difficult to set the target in terms of the structural surplus, targeting an *adjustment* in the structural balance is much less sensitive to the size of the output gap.

- Expenditures: a freeze on real spending at its 2003 level would move part of the way in the direction advocated by staff. Moreover, such a move would be less stringent than might appear at face value, because of recent expenditure overruns. Staff estimated that this action would raise the fiscal surplus relative to GDP by about 1.1 percentage points in 2004 and by 1.3 percentage points by 2007, ultimately implying (assuming moderate job creation) that the 4 percent of GDP norm would be achieved by 2008.
- To achieve the norm by 2006, some combination of even greater spending restraint, frontloaded structural reforms to make the target of creating 100,000 new jobs as realistic as possible, or other measures on the revenue side would need to be considered. In particular, in cases in which the fact that services are free creates overspending in the public domain, measures that raise revenues while potentially keeping public spending in check—such as user fees—deserved careful evaluation. Other sources of revenue could include raising property taxes; Finland ranks among the lowest in the OECD in terms of property taxes as a percent of GDP.

15. *Areas where spending can be scaled back are being identified.* Finland's level of expenditure is lower than the high level of other Nordic countries, but a comparison with the EU average suggests room to reduce across spending categories, particularly on social protection (also with a view to making work more attractive), and on education (Table 2). While the authorities stressed that education was key to Finland's innovative role in the ICT market, they also indicated that there was room for efficiency gains, including at the university level, where the average time taken to complete a degree in higher education is among the longest in the world. Moreover, a significant share of public employees at all levels of government will be retiring in the coming years. This should provide a catalyst for restructuring the public sector. And the evidence suggests, according to the discussions with the Ministry of Finance, that if all municipalities were to provide services as efficiently as the best one, cost reductions of 20–30 percent appear possible. Better use of economies of scale through enhanced local cooperation (e.g., in health, which more generally is an area for lowering expenditure) is one way for local governments to achieve fiscal savings. Another way is by encouraging greater use of procurement and tenders for the private provision of public services, in addition to providing municipalities with greater know-how to undertake such tasks. A working group has started to make initial recommendations on how to improve the efficiency of the public sector and is moving forward in developing specific recommendations.

16. *With respect to the expenditure framework, there was consensus on the advantages of expenditure ceilings in general, but staff noted the need to increase their effectiveness.* The positive features of the government's new ceilings were recognized: they extend over the government's term in office; they exclude cyclical components and interest payments so the expenditures covered by the ceiling are controllable; and they have been well publicized. However, staff suggested ways to strengthen their effectiveness and garner broader political commitment, including by submitting them to parliament as part of the regular budgetary process along with a description of the underlying rationale and the strategy to achieve them. Staff also suggested expressing the ceilings in nominal, rather than real, terms. This approach

would avoid the complications that have arisen in monitoring ceilings because of difficulties in translating nominal into real spending, and enjoyed some support in the discussions. However, the authorities noted that real ceilings were more flexible in determining actual spending, which could reduce the potential for losing credibility from overruns.

17. ***More ambitious pension reform would be an extremely helpful addition to the policy agenda.*** The 2002 pension reform significantly enhanced sustainability. It comprised: an increase in the effective retirement age through raising the legal retirement age to 68 and sharply increasing the accrual rate after 62; better incentives to enter the workforce early by allowing an earlier start of earnings-related pension accrual; a reduction in pension benefits through changing indexing mechanisms and factoring in increasing life expectancy (i.e., reducing the annual flow of benefits so that lifetime receipts are not increased by longer life expectancy); and measures to curtail existing options for early retirement, in particular through changes in the unemployment and disability pensions. However, the “baby-boom” cohorts are largely shielded from the effects of the reform. To further raise the effective retirement age, staff proposed: (i) eliminating the subsidized component of the part-time pension scheme; (ii) tightening eligibility criteria for disability pensions; and (iii) reducing disincentives to hire older workers. The latter would require limiting the extent to which larger firms face both rising contributions and increasing payments for the direct cost of unemployment and disability as the age of their employees’ increases. Consideration could also be given to shortening the transition periods that shield large parts of the “baby-boomer” generation from the 2002 reform. The authorities acknowledged that the 2002 pension reform would not solve all the tensions from population aging. However, some aspects of the pension system, such as the factoring in of changes in life expectancy and the indexation mechanisms for benefits, would allow for adjustments to benefits in the years to come if needed. The point that any additional reform would take time to muster the necessary political support was reinforced by union representatives who felt that the 2002 pension reform package, agreed by social partners, was a major effort, and that further reforms would have to await a thorough assessment of the 2002 package.

C. Labor and Product Markets

18. ***While many of the problems are not new, there was agreement that tackling unemployment and raising the employment rate has become especially pressing against the background of slower potential growth.*** Indeed, the ICT sector made a substantial contribution to growth over the 1990s, but a repeat on that scale is unlikely. In addition to reducing the tax wedge and incentive traps at the lower end of the skill scale, the discussions took up several other important reforms.

- The first relates to the centralized wage bargaining system. Staff noted that, while it has helped to deliver moderate average wage increases, greater wage differentiation, so that wages would be more in line with the differences in the demand for labor across regions and in productivity developments across skills, remained crucial. It would help create conditions that would tend to reduce regional and skill mismatches, enhance the attractiveness of hiring lower-skilled workers, provide the opportunity to gain greater work experience to enhance future employability, and improve the

chances for increasing living standards through own efforts. The discussions suggested that one way to achieve greater wage differentiation within the existing wage bargaining framework might be to agree on lower base wage increases, while accepting greater wage drift at the firm level.

- Greater wage flexibility and resulting differentiation, along with a greater effort by the public sector to promote private services, would also improve the prospects for developing the private market for personal services (including, for example, services to households). With an aging population, the demand for these services will increase and, with the right reforms, could contribute to alleviating unemployment at lower skill levels.¹⁵
- Other measures discussed included encouraging job search by tapering off unemployment benefits; enforcing job acceptance requirements more strictly, possibly to include part-time work; and reducing the time spent before entering the labor market, for example by improving the efficiency of education so that students would leave university at an earlier age.

19. *The authorities pointed to steps under way, especially in the education sector.* Initial steps had been taken to streamline university entry exams (which have tended to delay the start of studies, shorten working lives, and add to fiscal pressures). Measures were also under consideration to reduce the duration of studies, including better counseling for long-time students and conditioning financial support on progress. The potential benefits of user fees were understood, but the authorities also stressed that the idea had very limited political support, especially with respect to education, with the principle of free education firmly implanted in the political consensus.

20. *The authorities explained their efforts to increase privatization and enhance the functioning of product markets.* Competition policy was key in liberalizing markets. In this regard, the authorities pointed to local telecommunication as an area in which intense activity to increase competition had most recently contributed to opening markets. Looking forward, strengthening the enforcement of existing laws and raising the prospect of higher sanctions would help to ensure an appropriately competitive market place. On privatization, the authorities noted that, after little activity in 2001, the pace increased significantly in 2002: privatization proceeds were about €1.5 billion (or 1.2 percent of GDP), mostly realized in the first half of the year when market conditions were perceived as favorable.

D. The Financial Sector

21. *The discussions revealed that the Finnish financial system had weathered the slowdown in economic growth and decline in equity prices fairly well.* The authorities noted

¹⁵ See *Labor Market Challenges: Job Creation in the Services Sector (IMF Country Report No. 01/215)*.

that notwithstanding some decline in profitability in 2002 (Table 3) and the first quarter of 2003, bank balance sheets remained healthy. Looking ahead, while all agreed that bank profitability would be adversely affected by a serious economic downturn, stress tests conducted recently by the Bank of Finland suggested that the banking sector could withstand further distress. In response to questions on the insurance sector, the supervisory authority indicated that the decline in equity prices has had a stronger impact on the insurance sector than the banking sector, and the solvency ratios of some less-established companies are only at a satisfactory level. However, solvency ratios remained quite good in general, and the authorities stressed that, while cross-ownership links some banks to the insurance sector, the potential for systemic problems remains very limited. The authorities also envisaged future cooperation between various institutions involved in the supervision and regulation of financial markets generally to undertake comprehensive stress testing.

22. ***The Act on the Financial Supervisory Authority (FSA) has been revised and the authorities are working to strengthen cooperation among Nordic supervisors.*** In line with the recommendation from the last consultation, the institutional setup of the new FSA board and the FSA's independence and powers to take prompt corrective actions were strengthened. The latter would be further enhanced by the adoption of the EU's financial services directive and the Basel-2 accord, though the authorities explained the difficulties that arise in the legal implementation, including constitutional considerations. While the authorities also recognized the possible benefits from unifying supervisory authorities across the insurance and banking sectors, political obstacles existed. Finally, recent progress made in Nordic supervisory cooperation, both by financial supervisory authorities and central banks, was noted. It was also recognized that developing more fully a crisis management framework and further harmonizing regulatory and supervisory arrangements—not just across the Nordic countries but in the euro area too—are important items for the policy agenda.

23. ***Finland keeps its framework on combating money laundering and the financing of terrorism up to date.*** Finland has implemented all the relevant international directives and recommendations in this area, and has a good track record in investigating suspicious transactions. Its legislation is in line with the OECD's anti-bribery initiatives. In addition, while the actual cases to test the effectiveness of implementation have been limited and there may be room for some improvement, the authorities noted that evaluations by the OECD indicate that Finland is doing well on implementation.

E. Other Issues

24. ***While critical of the proposals for initial CAP reform, the authorities supported the agreement reached in Luxembourg in late June.*** From the Finnish perspective, the most important change to the original proposal was the softening of the decoupling principle with regard to cereals and beef. The compromise allows Finland to continue its practice of partly linking subsidies to the production of these products. The authorities also supported increasing market access for developing countries, including through the participation by

developing countries in the setting of sanitary and phytosanitary standards, and through building their capacity to implement such standards.¹⁶

III. STAFF APPRAISAL

25. *Finland's recovery from the severe difficulties of the early 1990s exemplifies the virtues of sound economic policies, which need to be safeguarded, including by avoiding recourse to short-term stimulus.* At the heart of Finland's successes were the consolidation of the public finances—which has been impressive, especially when compared with other euro area economies—and structural measures that fostered increased openness, competitiveness, and flexibility. While Finland has weathered the slowdown in the world economy well, growth in recent years has declined and output is below potential. In these circumstances, there is the temptation to use fiscal stimulus. However, the impact of such stimulus would be limited in a small and open economy and would run counter to the need to gear policy to the longer-term challenges related to a rapidly aging population.

26. *Unemployment, which is high and largely structural, is a key concern.* The persistence of unemployment reflects a number of factors, including, most importantly, the lack of wage differentiation across skill levels and high taxes on labor, as well as various other disincentives to work.

27. *Against this background, several measures are essential to support growth over time while securing long-run fiscal sustainability.* This entails a number of interrelated elements, centering on two key requirements. The first is the need to raise the employment rate, involving increasing work incentives, pension reform, and labor tax cuts. The second is the need to establish and maintain a record of expenditure discipline, to make room for credible tax cuts without compromising the public finances in light of the inevitable rise in age-related spending. How these elements come together has important implications for economic performance and fiscal sustainability.

28. *A useful medium-term norm is a general government surplus of at least 4 percent of GDP—achieved through expenditure restraint.* A surplus of this size would help to keep the public finances healthy after the demographic shock sets in. Credible tax cuts would be an important component of raising employment, safeguarding competitiveness in circumstances in which tax rates are already high by international standards and tax competition is increasing, and enhancing growth. This, in turn, would have positive feedback effects on the public finances. However, without sufficient expenditure restraint and confidence in the underlying fiscal position, tax cuts would be less credible and effective—and could, more generally, jeopardize Finland's fiscal position.

29. *To secure sufficiently large fiscal surpluses while leaving room for tax cuts, expenditures would need to be much more tightly contained than now planned under the*

¹⁶ Sanitary standards relate to human and animal health; phytosanitary standards to plants.

new government's spending ceilings. While the authorities' strategy rightly emphasizes job creation, the approach of cutting taxes while also frontloading expenditure increases and letting the fiscal surplus fall needs to be reconsidered. This is especially the case in light of Finland's mixed record on spending discipline, which also underscores the risks of greater fiscal deterioration than planned. Tax cuts should thus be put on hold until the authorities are convinced that expenditure is well under control. At the same time, higher-than-projected revenues, including any additional revenues from introducing new user fees or higher property taxes, should be used to strengthen the fiscal position. Combined with more decisive expenditure restraint, consistent with raising the primary structural balance by a half percentage point of GDP per year, a general government surplus of 4 percent of GDP is achievable by 2006 on staff projections—though the automatic stabilizers should be allowed to play around the consolidation path.

30. ***There are several areas that provide scope for expenditure savings, and a strengthened expenditure framework would also be beneficial.*** In this regard, social protection, education, and health are areas for savings that deserve attention, including by achieving greater economies of scale through enhanced cooperation at the local level. In addition, the operations of the most efficient municipalities suggest that more general cost saving can be achieved. In this connection, the contributions of a working group on how to improve the efficiency of the public sector are most welcome. However, it will take time to put reforms in place and realize fiscal savings. Thus, in the short-term, general cuts across spending categories may need to be considered. The expenditure framework could be strengthened by, for example, switching to nominal rather than real ceilings to improve transparency and monitoring; and by including the ceilings as part of the regular budgetary process.

31. ***Additional pension reforms would support efforts to raise the employment rate and reduce social security spending.*** The 2002 reform package was a significant step in the right direction. However, the "baby-boomers" were largely shielded, and further reforms are pressing to support employment growth, including by raising the effective retirement age, and to consolidate the public finances. Consideration will thus need to be given to: eliminating the subsidized component of part-time pensions and disincentives to hiring older workers; tightening eligibility criteria and enforcement for disability pensions; and shortening the transition periods for "baby-boomers." Without an adequate accumulation of fiscal surpluses now, difficult choices on further reforming benefits—for example, by adjusting the parameters related directly to the benefits paid to pensioners—would ultimately be needed if large increases in taxes or debt are to be avoided.

32. ***The authorities' ambitious target of creating 100,000 new jobs will likely remain beyond reach without commensurately ambitious labor market reform.*** In addition to reducing the tax wedge and incentive traps that make work unattractive, greater wage differentiation is essential. This, along with encouraging greater development of the private market for services, would also help enhance the working opportunities for lower-skilled workers. Encouraging job search by tapering off unemployment benefits, and stricter enforcement of job acceptance requirements, would further help to raise the employment rate.

33. *The financial system, which is basically sound, has benefited from a strengthening of supervisory arrangements and further efforts would be helpful.* Bank balance sheets are healthy, and stress tests indicate resilience if adverse shocks were to occur. Moreover, while some problems have arisen in the insurance sector, solvency ratios are quite good in general and the sector is monitored closely. Meanwhile, efforts to strengthen the financial supervisory authority and Nordic supervisory cooperation are welcome. Nevertheless, to the extent possible, the authorities are encouraged to find the legal means to adopt the EU's directive on financial services, which would strengthen supervision further. Developing more fully a crisis management framework, across the Nordic countries and in the euro area too, is another important item on the policy agenda. With a view to comprehensive and coordinated oversight of financial markets, unification of the supervisory authorities across the banking and insurance sectors is also worthy of consideration. Finally, the efforts in Finland to combat money laundering and financing of terrorism are commendable.

34. It is recommended that the next Article IV consultation with Finland remain on the 12-month cycle.

Table 1. Finland: Main Economic Indicators, 1999-2006 1/

	1999	2000	2001	2002	Est. 2003	Proj. 2004	2005	2006
(Percentage change, unless otherwise indicated)								
Output and demand (volumes)								
GDP	4.1	5.6	0.7	1.6	1.3	2.6	2.5	2.5
Domestic demand	2.0	3.6	0.7	1.3	0.9	2.1	2.2	2.2
Consumption	3.4	1.5	1.5	2.1	1.8	2.3	2.2	2.2
Private consumption	4.0	2.2	1.4	2.1	1.7	2.5	2.5	2.5
Public consumption	1.9	-0.2	1.7	2.0	2.1	1.7	1.5	1.5
Gross fixed capital formation	3.0	4.8	2.1	-0.2	-2.6	1.4	2.0	2.0
Private investment	4.0	6.8	1.8	-0.3	-2.4	1.6	2.0	2.0
Public investment	-2.4	-6.3	3.9	0.5	-4.3	0.0	1.8	1.8
Export of goods and services	6.8	18.2	-0.7	3.3	2.3	4.5	4.5	4.5
Import of goods and services	4.0	16.2	-1.0	1.7	3.0	4.1	4.5	4.5
Foreign contribution to growth (in percent of GDP)	1.6	2.6	0.0	1.0	0.1	0.7	0.6	0.6
Prices, costs, and income								
Consumer price inflation (harmonized)	1.3	3.0	2.7	2.0	1.8	1.7	1.9	2.0
Core inflation (excluding energy and seasonal food)	1.1	2.0	3.1	2.2	1.9	1.9	1.9	2.0
GDP deflator	-0.2	3.2	2.2	1.3	1.0	0.6	1.9	2.0
Terms of trade	-5.0	-4.6	2.3	-3.3	-2.1	-1.9	-0.8	0.0
Unit labor cost, manufacturing	-3.3	-5.8	3.6	1.1	1.1	-0.1	0.1	0.3
Labor market								
Labor force	2.0	1.2	0.6	0.2	0.1	0.0	0.0	0.0
Employment	3.4	1.7	1.4	0.2	-0.2	0.0	0.1	0.3
Unemployment rate (in percent)	10.2	9.8	9.1	9.1	9.3	9.3	9.2	8.9
Potential output and NAIRU								
Output gap (in percent of potential output) 2/ 3/	1.8	2.5	-0.3	-1.6	-2.9	-2.9	-2.6	-2.4
Growth in potential output 3/	4.0	4.9	3.6	2.9	2.6	2.6	2.3	2.2
NAIRU (in percent)	10.2	9.7	9.2	8.9	8.5	8.2	7.9	7.7
(In percent)								
Money and interest rates								
M3 (Finnish contribution to euro area , growth rate, e.o.p.) 4/	-0.8	-3.7	4.8	5.4	2.9	...	...	...
Domestic credit (growth rate, e.o.p.) 4/	14.2	6.4	6.9	7.8	9.6	...	...	...
3-month money market rate 5/	3.1	4.5	4.2	3.3	2.2	...	...	...
10-year government bonds yield 5/	4.6	5.4	5.0	5.0	3.3	...	...	...
Monetary condition index 6/	93.3	91.9	91.3	92.0	93.2	...	...	...
(In percent of GDP, unless otherwise indicated)								
National savings, investment, and income								
Gross national saving	25.2	28.2	27.1	26.9	25.8	25.7	25.7	25.8
Gross domestic investment	19.2	20.6	20.0	20.0	19.7	19.9	20.1	20.1
Private saving	20.6	18.8	19.5	19.6	21.2	22.2	22.1	21.8
Household saving as percent of disposable income	3.8	1.6	3.3	3.3	3.6	3.8	3.7	3.7
Private investment	16.4	18.1	17.2	17.3	17.1	17.3	17.5	17.6
Government savings surplus	1.8	6.9	4.9	4.6	2.0	0.9	1.1	1.5
Household's real disposable income (increase in percent)	4.5	-0.4	2.9	2.6	1.8	2.2	1.7	1.8

Table 1. Finland: Main Economic Indicators, 1999-2006 (continued) 1/

	1999	2000	2001	2002	Est. 2003	Proj.		2006
						2004	2005	
(In percent of GDP, unless otherwise indicated)								
Public finances								
General government 7/								
Revenues	49.1	50.8	49.7	49.6	48.0	47.2	47.2	47.1
Expenditure	47.2	43.7	44.7	45.0	46.0	46.3	46.1	45.6
General Government balance	1.9	7.0	5.0	4.6	2.0	0.9	1.1	1.5
<i>Of which: net interest on public debt</i>	1.6	1.0	0.7	0.0	0.0	-0.1	-0.1	-0.2
Primary balance 8/	3.5	8.1	5.6	4.7	2.0	0.8	1.0	1.3
Structural balance (in percent of potential GDP) 9/	1.1	6.0	5.1	5.4	3.5	2.4	2.6	2.8
Structural primary balance (in percent of potential GDP) 8/ 9/	2.7	7.1	5.8	5.4	3.5	2.3	2.4	2.6
Adjusted structural primary balance (in percent of potential GDP) 10/	2.7	5.1	5.0	4.3	3.5	2.3	2.4	2.6
One-off factors 10/	...	2.0	0.8	1.1	...	...	...	...
Debt (Maastricht definition) 11/	47.3	44.5	43.8	42.7	44.9	45.4	44.3	42.3
Central government 7/								
Revenues	25.1	27.2	25.6	25.8	24.7	24.0	24.0	23.9
Expenditure	25.8	23.8	23.6	24.1	25.1	25.5	25.1	24.6
<i>Of which: net interest on public debt</i>	3.9	3.4	3.0	2.3	2.3	2.2	2.1	2.1
Central Government balance	-0.7	3.5	2.0	1.7	-0.3	-1.5	-1.1	-0.7
Debt 11/	56.5	48.7	45.5	42.4	44.2	44.3	43.6	42.3
Balance of payments								
Current account balance 12/	6.0	7.6	7.1	6.9	6.1	5.8	5.7	5.6
Trade balance	9.5	11.4	10.5	9.2	8.3	8.2	8.3	8.4
Net external debt (excluding equity FDI and shares)	16.2	13.5	5.8	-1.2	-7.3	-12.8	-17.9	-22.8
Exchange rates (period average)								
Euro per US\$	0.94	1.09	1.12	1.06	...	...	...	...
Nominal effective rate (INS, increase in percent)	-2.7	-5.2	1.9	1.3	...	...	...	...
Real effective rate (increase in percent) 13/	-3.8	-4.8	0.7	-0.8	...	...	...	...

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

1/ Projections are staff estimates based on the authorities' current policy indications.

2/ A negative value indicates a level of potential output that is larger than actual GDP.

3/ As discussed in an accompanying selected issues paper, there is considerable uncertainty about the size of potential output growth and the output gap, partly reflecting that the volatility of GDP growth—not least due to the development and swings in the performance of the ICT sector—has tended to be higher than in other euro-area countries. The figures reported in this table are based on a standard production function approach, using staff estimates of the future growth of investment, labor force, and TFP (with the behavior of the ICT sector heightening the uncertainty of the TFP estimates).

4/ For 2003, based on data for April, annualized.

5/ For 2003, latest available data (June).

6/ Using weights for real short- and long-term interest rates and the real effective exchange rate (ULC) of one-third each. For 2003, latest available data (May).

7/ On ESA95 basis. 2002 data preliminary.

8/ Defined as noninterest (structural) revenue minus noninterest (structural) expenditure.

9/ Corrected for the influence of the business cycle as measured by the output gap.

10/ Adjusted for one-off factors, mostly exceptional tax revenues due to income from stock options.

11/ Reflects stock-flow adjustments, including changes in the portfolio allocation of Finnish pension funds. Also note that the pension funds, which generate much of the general government surpluses, are accumulating assets rather than reducing debt. In addition, the 2003 data reflects a one-off change in the methodology of computing the fiscal accounts in line with national legal requirements.

12/ Over the medium term, through 2008, staff expects the current account balance to stay above 5 percent of GDP.

13/ Based on relative normalized unit labor costs.

Table 2. Finland and Selected Countries: Expenditure Structure, 2001 1/
(In percent of GDP)

	Finland	Denmark	Sweden	EU 2/
Total	49.0	55.3	59.0	46.1
General public services	6.4	4.5	8.8	7.9
Defense	1.5	1.7	2.3	1.4
Public order	1.4	1.0	1.5	1.5
Economic affairs	4.6	3.6	4.6	5.0
Environmental protection	0.3	n.a.	0.3	0.8
Housing and community amenities	0.6	0.9	1.0	1.1
Health	6.0	5.4	6.9	5.3
Recreation	1.2	1.7	1.2	0.8
Education	6.3	8.3	7.9	5.1
Social protection	20.6	24.2	24.6	17.3

Sources: Eurostat; and Fund staff calculations.

1/ Definition differs slightly from Table 1. Data for Sweden is for 2000.

2/ Unweighted average, excluding the Nordic countries.

Table 3. Finland: Indicators of Financial Vulnerability, 1997-2002

	1997	1998	1999	2000	2001	2002
Households						
Total household debt (in percent of GDP)	30.7	30.5	31.5	30.2	31.8	33.7
Debt-to-income ratio	57.5	58.5	61.2	63.7	65.3	70.7
Non-financial corporations						
Gross debt (in percent of GDP)	48.7	46.2	48.2	52.8	53.0	51.1
Debt to equity ratio	44.2	38.9	30.3	...	...	...
Debt to equity ratio 1/	60.9	57.9	60.2	...	...	...
Government						
General government debt (EMU definition, in percent of GDP)	54.1	48.8	47.3	44.3	43.8	42.7
Central government debt (in percent of GDP)	65.3	60.2	56.5	48.3	45.7	42.3
Banking sector						
Outstanding credit to nonfinancial private sector (percent change, e.o.p.) 2/	4.0	12.1	14.2	6.4	6.9	7.8
<i>Of which</i> housing loans (percent change, e.o.p.)	3.5	13.1	15.8	10.6	11.5	12.9
Housing loans in percent of total lending to nonfinancial private sector	36.2	36.5	37.0	38.5	40.1	42.0
Asset Quality						
Non-performing loans/total loans (in percent) 3/	1.8	1.2	1.0	0.6	0.6	0.5
Capital Adequacy						
BIS capital asset ratio	11.9	11.5	11.9	11.6	10.5	11.7
Equity / total assets (in percent)	5.6	5.7	5.8	6.0	5.9	5.6
Profitability						
Interest rate margin 4/	4.3	4.0	3.5	4.3	3.5	3.2
Net interest income (in percent of total income) 5/	59.6	57.1	58.5	46.8	61.4	65.4
Return on equity (in percent) 5/	16.7	25.8	20.1	22.4	13.5	10.7
Return on assets (in percent) 5/	0.7	1.2	1.0	1.2	0.7	0.5
Liquid assets/total assets (in percent) 6/	21.6	19.3	19.6	15.2	14.0	10.7
Off-balance sheet liabilities/total assets (in percent)	15.4	16.0	15.9	18.7	20.4	19.6
Stock market						
Change in stock market index (in percent, e.o.p.)	32.3	68.5	162.0	-10.6	-32.4	-34.4
Change in housing price index (in percent, e.o.p.) 7/	15.1	9.6	10.5	-0.2	1.3	8.7

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

1/ Defined as total debt as a percentage of common equity. Data source is Worldscope database. Estimates are based on accounting or book value of equity.

2/ Euro-denominated lending only, which accounted for about 98 percent of total lending in 1999 and 2000.

3/ Loans are defined as the sum of claims on: credit institutions, the public, and public sector entities.

4/ Average lending rate minus average deposit rate.

5/ 2001 adjusted for large intra financial conglomerate transactions.

6/ Liquid assets are defined as the sum of bills discounted by the central bank, debt securities, and the balance sheet item "liquid assets".

7/ Housing price index has been changed. The new index more accurately reflects the price development of all dwellings in the whole country.

Finland: Fund Relations
(As of June 30, 2003)

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

II. **General Resources Account:**

	SDR Million	Percent Quota
Quota	1,263.80	100.00
Fund holdings of currency	784.79	62.10
Reserve position in Fund	479.07	37.91

III. **SDR Department:**

	SDR Million	Percent Allocation
Net cumulative allocation	142.69	100.00
Holdings	149.52	104.78

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

V. **Financial Arrangements:** None

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

VII. **Exchange Rate Arrangements**

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. In accordance with Executive Board Decision No. 144-(52/51), Finland notified the Fund on September 5, 1990 and July 6, 1992 of exchange restrictions pursuant to UN Security Council Resolutions against Iraq and the Federal Republic of Yugoslavia (Serbia/Montenegro), respectively. On July 27, 1995, Finland also notified the Fund of exchange restrictions imposed against Libya, and of changes in the exchange restrictions pursuant to UN Security Council Resolutions on Iraq and the Federal Republic of Yugoslavia (Serbia/Montenegro) as well as on certain areas in the Republic of Bosnia and Herzegovina. Finland has since removed restrictions imposed against certain areas of the Republic of Croatia, the Republic of Bosnia and Herzegovina, and the Federal Republic of Yugoslavia (except for the prohibition on the satisfying of certain claims). The UN Security Council Resolution on food for oil (Iraq) was implemented in December 1996.

VIII. Last Article IV Consultation

Discussions for the 2002 Article IV consultation were held in Helsinki during May 30–June 10, 2002 and the Executive Board concluded the consultation on August 13, 2002. The Staff Report (SM/02/245, 7/30/02), and a PIN (PIN/02/91) summarizing the views of the Executive Board, were published.

Finland: Core Statistical Indicators

(As of August 19, 2003)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money 1/	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP
Date of Latest Observation	19-Aug	July	July	June	June	July	July	June	June	2002	May
Date Received	19-Aug	August	August	July	July	August	August	July	July	May	July
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annual	Monthly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Monthly	Annual	Monthly
Source of Update	Bloomberg	Bank of Finland	Bank of Finland	ETLA 2/	ETLA	ETLA	ETLA	ETLA	ETLA	ETLA	Statistics Finland
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	Monthly	Monthly	Monthly	Monthly	Annual	Monthly

1/ Finnish contribution to euro area M3.

2/ ETLA is the Research Institute of the Finnish Economy.

Statement by the IMF Staff Representative
October 8, 2003

1. This staff statement provides information on economic developments that has become available since the preparation of the staff report for the 2003 Article IV consultation. The new information does not alter the thrust of the staff appraisal.

2. **On GDP:**

- According to preliminary revisions by Statistics Finland, real growth in 2001 and 2002 on a year-average basis was considerably stronger, at 1.2 and 2.2 percent respectively, compared with the previous figures of 0.7 and 1.6 percent; real growth was 1.3 percent on a year-on-year basis in the first half of 2003.
- The Bank of Finland has lowered its forecast for year-average real growth to 1.3 percent for 2003 as a whole (from 1.6 percent in May 2003) and to 2.9 percent for 2004 (from 3.0 percent). This aligns the Bank's projection with that of the staff for 2003, but remains somewhat above the staff's forecast for 2004. As noted in the staff report, the Ministry of Finance had already revised its growth forecast subsequent to the Article IV consultation discussions to 1.2 percent for 2003 and 2.4 percent for 2004. Thus, the projections for real growth are now more similar to each other.

3. **On fiscal policy**, the 2004 budget proposal submitted to parliament in September indicates a general government surplus of 1.7 percent of GDP. The Ministry of Finance had envisaged a surplus of 1.3 percent of GDP at the time of its budget preparation in May 2003. While all the necessary details are not yet available, the change mostly reflects an upward revision to projected central government revenues from previously conservative estimates (as suggested in paragraph 14 of the staff report), in addition to a downward revision to interest expenditure. These effects, which raise the central government balance by about 0.7 percent of GDP, are partially offset by a narrowing of the surplus of other parts of the general government by about 0.3 percent of GDP. Staff would also revise its projection of the general government surplus in 2004 to about the same level as the Ministry of Finance, provided parliament does not introduce any additional changes, and taking into account that the Finance Ministry's projection for GDP is now very similar to that of the staff.

4. With reference to **official development assistance (ODA)**, Finland increased its contribution from 0.32 percent of gross national income in 2001 to 0.35 percent in 2002, and ODA is officially estimated at 0.35 percent in 2003, rising to 0.37 percent in the 2004 budget proposal.

5. In **other economic developments**, recent indicators are consistent with a moderate expansion, while inflation has remained subdued. Industrial production in August 2003 was 1.7 percent higher than a year earlier; the seasonally-adjusted unemployment rate, though rising somewhat earlier in the year, declined modestly to 9 percent in August; and consumer

confidence remained strong in that month. Year-on-year inflation (HICP) continued at a lower-than-expected rate in August, standing at 1.2 percent. Staff has revised its year-average inflation forecast to 1.5 percent for 2003 (from 1.8 percent) and to 1.1 percent for 2004 (from 1.7 percent), reflecting recent developments, a larger impact from the reduction in vehicle taxation, and a more appreciated euro and lower oil prices than previously assumed.



INTERNATIONAL MONETARY FUND

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October 17, 2003

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

IMF Concludes 2003 Article IV Consultation with Finland

On October 8, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.¹

Background

Finland has made remarkable strides since the severe recession and banking crisis of the early 1990s. The economic restructuring and expansion after the crisis reflected private sector initiative, solid macroeconomic management—including the shift from large deficits to significant surpluses of the general government—and structural reforms. These successes allowed Finland to converge successfully to the euro, and to outperform euro-area partners in the recent past in terms of economic growth and the public finances. Based on prudent policy choices, increased external competitiveness, and favorable export performance, including both traditional industries and the dynamic information and communications technologies (ICT) sector, real GDP growth averaged almost 5 percent during 1994–2000. Inflation was 1–3 percent. The economy, in the face of a weak external environment, also performed reasonably well during 2001–02—though the pace of activity slowed considerably and remains subject to volatility.

With the external environment still fragile in 2003, real growth is likely to be moderate, but it should gather pace in 2004. Staff forecasts growth of 1.3 percent in 2003, driven mainly by

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.

private consumption. Gradually rising investment and accelerating export growth lie behind staff's forecast of 2.6 percent growth in 2004. Downside risks to the projection stem mainly from the external environment and the possibility of continued business investment weakness; but upside surprises, in particular from the ICT sector, are also possible. Partly reflecting that output is expected to stay below its potential, projected inflation is under 2 percent in both years.

Fiscal discipline has slipped in recent years. In 2002, the general government surplus was still high at 4.6 percent, compared with 7 percent in 2000. However, one-off factors, largely reflecting (lagged) exceptional tax revenues related to income on stock options, were an important but fading contributor. Moreover, while the public finances are in considerably better shape than in many other euro-area countries, slippages have been evident: spending has been ratcheting up to above the stability program targets set in 2000–01, with real central government expenditures in 2002 an estimated 4 percent above the original target. Based on Finance Ministry estimates for the 2003 supplementary budget, staff expects that the general government surplus will decline further, to about 2 percent of GDP, as the central government balance swings to a small deficit of 0.3 percent of GDP. In 2004, and possibly later years, the general government surplus may fall even more: the government's new expenditure ceilings are frontloaded and looser than those set earlier, while preliminary budgetary plans for 2004 envisage significant tax cuts.

Rapid population aging and high unemployment pose key policy challenges. The official unemployment rate (seasonally adjusted) has hovered above 9 percent so far this year and broader measures put the unemployment rate over 16 percent. High labor taxes and the lack of wage differentiation are among the factors that have made much of the unemployment structural. At the same time, Finland's population is aging faster than in euro-area countries while the effective retirement age is low. This depresses the supply of labor and, in conjunction with high structural unemployment, hampers economic growth with negative consequences for the public finances. Combined with the inevitable rise in age-related spending, preparing for the demographic shock has important implications for fiscal policy now and in the medium term to avoid jeopardizing the public finances after the shock works its way through. Policies to increase the employment rate—related to pensions, and labor and product markets—would help to raise potential output and support fiscal sustainability.

Executive Board Assessment

Executive Directors noted that Finland's recovery from the severe difficulties of the early 1990s exemplified the benefits of sound economic policies. The impressive consolidation of the public finances and structural measures that fostered increased openness, competitiveness, and flexibility were at the heart of Finland's successes, and helped Finland weather the current slowdown in the world economy. Directors emphasized that the strong economic performance needs to be safeguarded, by maintaining fiscal discipline and by implementing further structural reforms to address high unemployment and the challenges related to rapid population aging.

Directors concurred that economic growth is likely to remain subdued in the short term, but should gather pace in 2004. In this context, many Directors considered it appropriate for the authorities to make use of some of the room created by past fiscal surpluses to try to boost economic growth and employment, noting that the authorities intend to at least partially reverse the reduction in general government surplus during 2005-06. However, a number of Directors advised against resort to fiscal stimulus by tax cuts and frontloaded expenditure increases, whose impact would likely be limited in a small and open economy. These Directors considered that fiscal stimulus would run counter to the need to prepare for rapid population aging by building sufficient fiscal surpluses.

In the view of Directors, the main medium-term challenges are to support economic growth and reduce unemployment, while securing fiscal sustainability in light of the spending pressures associated with population aging. They noted that raising the employment rate would be key and would involve increasing work incentives, further pension reform, and labor tax cuts. Such tax cuts would be an important component of raising employment and safeguarding competitiveness in circumstances in which tax rates are already high by international standards and tax competition is increasing. Assuring a sound fiscal position in the context of such tax cuts would require that the authorities establish and maintain a record of expenditure discipline, particularly in light of Finland's mixed record on spending discipline in recent years. Directors stressed that without confidence in the underlying fiscal position, tax cuts would be less credible and effective.

Against this background, many Directors viewed a general government surplus of 4 percent of GDP as a useful medium-term norm. To secure such a surplus while leaving room for credible tax cuts, these Directors felt that expenditure would need to be much more tightly contained than now planned under the government's spending ceilings. Some Directors, however, questioned the economic necessity of a medium-term budget surplus target of 4 percent, noting that even with a somewhat lower target the Finnish public finances would be in better shape than those of most other industrial countries.

Nevertheless, Directors judged that there would be room to reduce government spending to below the expenditure ceilings. In particular, social protection, education, and health were seen as areas for savings, including by achieving greater economies of scale through enhanced cooperation at the local level. At the same time, Directors noted that the operations of the most efficient municipalities suggested that more general cost savings could be achieved. Directors also emphasized that any revenues above projections should be used to strengthen the fiscal position. In this context, most felt that introducing new user fees and raising property taxes from their low levels could be a way to enhance revenue.

Directors noted that another important aspect of securing expenditure discipline would be a strengthening of the expenditure framework. In this context, Directors recommended the inclusion of expenditure ceilings as part of the regular budgetary process. In addition, switching to nominal from real spending ceilings would help improve the transparency and monitoring of public spending—and thereby the discipline associated with the ceilings.

Directors underscored that additional pension reforms would support efforts to raise the employment rate and reduce social security spending. They welcomed recent reforms as a significant step in the right direction, but encouraged additional efforts to: eliminate the subsidized component of part-time pensions and disincentives to hiring older workers; tighten eligibility criteria and enforcement for disability pensions; and shorten the transition periods for so-called baby-boomers. Directors also supported the authorities intention to reform the public sector pension scheme. They observed that further reforms of the existing pension benefits may ultimately be needed to avoid longer-term increases in taxes or debt.

Directors, in noting the authorities' job creation target, stressed that its achievement would require ambitious and early labor market reforms. In addition to reducing the labor tax wedge and incentive traps that make work unattractive, they saw greater wage differentiation and improvements in the efficiency of re-training programs as essential. Encouraging job search by tapering off unemployment benefits over time, and tighter enforcement of job acceptance requirements were also seen as measures to raise the employment rate. In addition, Directors emphasized that encouraging greater development of the private market for services would further help enhance the working opportunities for lower-skilled workers, and welcomed efforts to increase privatization.

Directors observed that the financial system remains basically sound and welcomed the strengthening of supervisory arrangements, particularly by increasing the independence and prompt corrective action powers of the financial supervisory authority. Directors welcomed measures aimed at developing more fully a regional crisis management framework across the Nordic countries and in the euro area too. Directors encouraged the authorities to continue their efforts to promote the stability of the financial sector. With a view to ensuring comprehensive and coordinated oversight of financial markets, some Directors also saw merit in considering unifying the supervisory authority across the banking and insurance sectors. Directors commended the authorities for their continued efforts to combat money laundering and the financing of terrorism.

Directors praised the authorities for their ambitious overseas development assistance goals, their contribution to the financing of the Africa Regional Technical Assistance Center Initiative, and their support for measures to improve market access for the exports of developing countries. They encouraged the authorities to adopt a more supportive stance within the EU in favor of trade liberalization, particularly with respect to the Common Agricultural Policy.

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 2003 Article IV Consultation with Finland is also available.

Finland: Selected Economic Indicators

	2000	2001	2002	2003 1/
Real economy				
GDP (change in percent)	5.6	0.7	1.6	1.3
Domestic Demand (change in percent)	3.6	0.7	1.3	0.9
Harmonized CPI (change in percent) 2/	3.0	2.7	2.0	1.8
Unemployment rate (in percent) 2/	9.8	9.1	9.1	9.3
Gross national saving (in percent of GDP)	28.2	27.1	26.9	25.8
Gross domestic investment (in percent of GDP)	20.6	20.0	20.0	19.7
Public finances (general government, in percent of GDP)				
Overall balance	7.0	5.0	4.6	2.0
Primary balance 3/	8.1	5.6	4.7	2.0
Gross debt (Maastricht definition) 4/	44.5	43.8	42.7	44.9
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area) 5/	-3.7	4.8	5.4	2.9
Total domestic credit 5/	6.4	6.9	7.8	9.6
Interest rates (year average)				
Three-month money market 6/	4.5	4.2	3.3	2.1
Ten-year government bonds 6/	5.4	5.0	5.0	3.6
Balance of payments (in percent of GDP)				
Trade balance	11.4	10.5	9.2	8.3
Current account	7.6	7.1	6.9	6.1
Fund position (as of end-May, 2003)				
Fund holding of currency (in percent of quota)		59.9		
Holdings of SDRs (in percent of allocation)		104.78		
Quota (in millions of SDRs)		1,263.80		
Exchange rate				
Exchange rate regime		Euro		
Present rate (August 21, 2003)		US\$ 1.0941 per euro		
Nominal effective exchange rate (increase in percent) 7/	-5.2	1.9	1.3	1.5
Real effective exchange rate (increase in percent) 8/	-4.8	0.7	-0.8	0.8

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 non-interest revenue minus non-interest expenditure.

4/ Projection for 2003 is based on the assumption of unchanged government assets.

5/ For 2003, annualized increase to April.

6/ For 2003, monthly average for July.

7/ For 2003, average 12-month increase to May.

8/ Based on unit labor costs. For 2003, average 12-month increase to May.

**Statement by Benny Andersen, Alternate Executive Director for Finland
and Minna Lotta Nikitin, Advisor to Executive Director
October 8, 2003**

Our Finnish authorities wish to express their appreciation to Mr. Feldman and his team for constructive discussions in Helsinki and for a well-written and interesting set of reports prepared for the 2003 Article IV consultation. The authorities are in broad agreement with staff's assessment of economic developments and prospects for Finland.

Recent Economic Developments and Short-Term Prospects

The Finnish economy has performed relatively well in recent years, and output growth was revised upwards recently for both 2001 and 2002. With real growth estimated at 1.2 percent in 2001 and at 2.2 percent in 2002, Finland was one of a few euro area countries showing an increase in the growth rate in 2002.

This year, however, effects of the global slowdown have been more pronounced. In the first quarter of this year, total output was markedly smaller than in the previous quarter. Growth nevertheless appears to have picked up over the spring and summer. The recent tax cuts together with the expected upswing in the international economy towards the end of the year should bolster growth. The 1.2 percent GDP growth that is forecast for this year will come by and large from the service sector. Both industrial and construction production are forecast to stay at the same level as last year. Driven by exports and a recovery of investments, growth is projected to accelerate to 2.4 percent in 2004. There are, however, downside risks related mainly to external developments. Furthermore, a rise in unemployment might begin to erode households' confidence.

The short-term outlook depends to a large extent on a pickup in export growth. As staff point out, the export-oriented ICT sector remains important for Finland's economic performance. In this regard, performance of ICT exports will have a crucial role for the outlook. The ICT sector has weathered the industry-wide downturn relatively well, and the volume of ICT exports is projected to increase around 5 percent this year and around 10 percent next year.

The prolonged period of growth below potential has also begun to show up in demand for labor, and the unemployment rate is rising somewhat this year. While the consumer confidence has remained high in Finland, large number of layoffs in recent months could erode confidence and dampen consumption growth.

After remaining above the euro area average in recent years, the pace of the rise in consumer prices has slowed down. The inflation forecast for this year is 1.2 percent, well below the euro area average. The appreciation of the euro, moderate increase in import prices, and one-off factors (e.g. a reduction in vehicle taxation) have all contributed to the lowering of inflation. The current account surplus is expected to be 6.5 percent of GDP this year.

Policy Discussions

The authorities and staff agree on long-term goals...

The discussions centered on long-term fiscal sustainability amid persistently high unemployment and rapidly aging population. The authorities share staff's view on the necessity of accumulating large general government surpluses to meet the needs arising from population aging. There is also agreement on the goal of streamlining public expenditures in exchange for tax cuts, which are necessary for raising employment.

...but have different views on the way forward.

While the authorities and staff agree on the need to lower taxes and curb expenditures, the differences relate to an appropriate strategy going forward. Staff put emphasis on the expenditure restraint first and tax cuts second, whereas the authorities consider the current phase of the business cycle suitable for tax cuts. Moreover, increasing tax competition within the EU leaves Finland no choice but to lower taxes sooner rather than later. The authorities see also merit in income tax cuts in order to support domestic demand and employment. The authorities emphasize the importance to maintain consumer confidence high, because strong domestic demand would compensate for the weaker external demand.

While Finland easily meets the fiscal targets of the Stability and Growth Pact, it has recently slipped against its own more ambitious surplus objectives, although this has largely been due to cyclical weakness and the loss of asset-related revenues.

Staff suggest that a general government surplus of at least 4 percent of GDP should be targeted in the medium term. This was also the official target of the government prior to the slowdown of economic growth after the year 2000. The year 2000 was exceptional for the public finances, as tax revenues from stock options contributed to the record high general government surplus of 7 percent of GDP. According to Eurostat, Finland still recorded the largest general government surplus (4.2 percent of GDP) among the EU countries in 2002.

However, slower growth and lower tax receipts have forced the policy makers to reconsider the slope of targeted decline of the indebtedness of the central government. In 2003, the general government surplus will be just under 2.5 percent. The surplus in central government finances is projected to erode completely and the municipal sector will be in deficit. Thus, the general government surplus will be entirely attributable to the employment pension schemes. Current estimates (the baseline scenario assumes average annual growth of 2.5 percent) suggest that the surplus would be about 2.5 percent in 2007.

Revenue measures concentrate on lowering labor taxes...

In order to increase households' purchasing power, reinforce consumer confidence and support the longer term foundation for economic growth, the government's budget proposal for 2004 envisages a reduction in labor taxes by lowering all the marginal tax rates in state income tax scale by one percentage point and increasing the scale's income brackets by one percent. The tax cuts amount to 0.8 billion euros or 0.5 percent of GDP next year. In addition

to labor tax cuts, alcohol taxation will be lowered on average by 33 percent next year. The excise duty on alcoholic beverages is expected to decline by about 300 million euros.

...while expenditure ceilings provide a binding constraint for the electoral period.

The government has agreed on expenditure ceilings for the 2004 – 2007 electoral period. The reformed expenditure ceilings are expressed in the price and cost level of 2004, and they include increase in expenditures of about one billion euros, which was decided upon in the government program. The main differences compared to the previous expenditure ceilings are that the binding ceilings now extend over the electoral period, supplementary budget proposals are included in the ceilings, and the ceilings exclude cyclical components and interest payments.

The authorities endorse staff's opinion that expenditure savings are needed in many areas of public services and transfers. After a long period of tight fiscal policy and expenditure cuts, the authorities see, however, that this road is not as productive as it was in the mid-1990s. The main priority now should be in structural changes in the service production and local government as a whole. The authorities are already putting into force staff's overall recommendation to improve the efficiency of the public sector.

The authorities are focusing on the employment situation...

A primary objective of the government's policy is to create 100 000 new jobs by 2007, as at over 9 percent the high official unemployment rate remains a key concern for Finland. Furthermore, the employment rate is currently about 67.5 percent, thus falling short of the Lisbon target of 70 percent. The authorities are aiming at raising the employment rate to 75 percent during the next electoral period. The authorities agree with staff on various policy actions to meet the unemployment challenge such as lowering of labor taxes, increasing work incentives and reforming product markets. In addition, the government is currently considering ways to promote job creation in the service sector by reducing payroll taxes.

Finland has an extensive system of retraining programs for the unemployed, but there remains a substantial mismatch between the job vacancies and the unemployed. The authorities endorse staff's view that enhancing the efficiency of the retraining programs should be given a priority. According to a recent report by the Ministry of Labor, structural unemployment amounts to about 60 percent of all registered unemployed jobseekers. The report also concluded that two thirds of the structurally unemployed would still be employable, if suitable jobs were on offer and appropriate supporting measures were provided.

The authorities recognize the problems connected with the lack of wage differentiation across skill levels. However, recent wage agreements have created a significant room for wage setting at the firm level, and there are signs that the measures already taken are having a desired effect.

The authorities and staff agree that one of the ways to increase employment is to reduce the duration of studies. While the problems associated with a long duration of studies are well

understood, tuition fees are perhaps a less relevant issue than reforming the grant system that currently tends to prolong the completion of university studies. The government intends to reform the grant system in November. On the same occasion, various other options to speed the completion of studies will be considered. Moreover, the Finnish growth strategy has been, and will continue to be, based on high quality education.

...and continuing with pension reforms.

Finland's population will age the fastest in Europe up to 2030, and the working age population (20 to 64 year-olds) will head into decline already in 2010. An integral part of the government's reform agenda is to maintain the sustainability of pension financing once the baby-boom generation enters retirement. To this end, the social partners reached an agreement about a major overhaul of the private pension system last year, and all the legislation enabling the private sector pension reforms were approved by Parliament in early 2003. The aims of the reform were to postpone the average effective retirement age by 2-3 years from the current 58 years, to adapt the pension scheme to an increased average life expectancy, and to make possible a unification and simplification of the private-sector earnings-related pension acts. The pension reform measures include an accelerated accrual rate between the ages of 63 and 68, and an increase in the age limit for part-time pension from 56 years to 58 years. In addition, the accrual of pension was extended to lifetime earnings as opposed to a selected number of years near retirement.

The pension reform in the public sector is also under way. The reform measures follow similar principles that apply to the private sector reform. Legislative measures for completion of the public sector pension reform are expected to be approved by Parliament by the end of 2003.

Other Issues

The authorities agree with staff's assessment that the Finnish financial system has weathered the slowdown in economic growth and decline in equity prices fairly well. Bank balance sheets remain healthy, and even though the decline in equity prices has had a stronger impact on the insurance sector, insurance companies' risk-carrying capacity is quite high in general. There has been a tendency towards larger units and increased cross-border activities within the financial sector in many European countries, including the Nordic region. This has already been reflected in formalized supervisory arrangements between the Nordic supervisory authorities for some years. In June 2003, also the Nordic central banks signed a Memorandum of Understanding on the management of a financial crisis in banks with cross-border establishments.

Finally, Finland's development assistance is geared toward the fulfillment of the Millennium Development Goals. Finland is also contributing to the AFRITAC initiative. In addition, Finland is supportive of measures improving market access for developing country exports in the global markets. The government intends to raise the ODA from 0.35 percent of GNI in this year's budget to 0.7 percent by 2010 provided that the general economic situation is favorable.