

Finland: 2008 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 2008 Article IV consultation with Finland, the following documents have been released and are included in this package:

- The staff report for the 2008 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on November 3, 2008, 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 December 16, 2008. 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 January 30, 2009, updating information on recent developments.
- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 30, 2009 discussion of the staff report that concluded the Article IV consultation.
- A statement by the Executive Director for Finland.

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FINLAND

Staff Report for the 2008 Article IV Consultation

Prepared by Staff Representatives for the 2008 Consultation with Finland

Approved by Ajai Chopra and Tessa van der Willigen

December 16, 2008

Executive Summary

Although among the best EU performers, Finland's economy faces important challenges. Spillovers from the global turmoil are adversely affecting activity and may weaken the financial system. In the longer term, rapid population aging and slowing productivity weigh down on growth and fiscal sustainability, while expanding financial integration tests supervision.

From a cyclical perspective, a fiscal structural loosening is warranted. However, its effectiveness in Finland's small, open economy would be limited, in the absence of an EU-wide fiscal package. The authorities were confident that an EU-coordinated budget expansion is in the cards. There was agreement that loosening should be designed to minimize damage to long-term fiscal sustainability.

Medium-term policies still fall short of ensuring long-term fiscal sustainability. A permanent improvement in the structural primary balance after 2011 of at least 1½ percent of GDP is required. This gap should be filled soon once the economy recovers for intergenerational equity and to reduce the needed adjustment, as the authorities recognize. The authorities concurred that, with comparatively high spending, adjustment should rely mainly on expenditure restraint and improved efficiency. Tax reform and higher pension fund yields can help too. Government's plans to lower labor taxation are appropriate, but staff advised against cutting the food VAT rate.

Though banks have been largely sheltered from the turmoil so far, the impact of a weakening economy on bank profitability and non-performing loans must be monitored closely.

The authorities also noted that rising household debt, softer house prices, and developments in funding markets may become a concern. Staff supported authorities' steps to guarantee bank debt renewal and recapitalize banks, if needed, as well as their efforts to improve European coordination and harmonization in deposit insurance and cross-border financial supervision. Both insurance and pension companies have suffered significantly negative returns this year, and supervisors underscored the need to step up vigilance of financial conglomerates.

Structural reforms are essential to raise long-term growth and secure fiscal sustainability. With the working-age population set to decline, the participation rate should be increased, and measures to increase competition, especially in the "sheltered" sectors of the economy, are required to stimulate productivity. The authorities were receptive to these suggestions, but emphasized the need to move cautiously in socially sensitive areas.

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I. ECONOMIC SITUATION

1. **Though among the best EU performers, the Finnish economy faces important challenges.** Spillovers from the global turmoil are adversely affecting economic activity (Figure 1, Table 1). High wage increases have raised the risk of cost pressures that could maintain inflation above the EU average and erode competitiveness. Looking forward, rapid aging and slowing productivity threaten longer-term growth, competitiveness, and fiscal sustainability. Improved pension fund management could help cope with aging, while growing financial integration and complexity create new risks and supervisory challenges.

2. **Growth was robust in 2007, but is decelerating fast.** It attained a strong 4½ percent in 2007, with activity significantly above potential, although the pace slackened in the second half of the year. Exports were vigorous early in the year. Private consumption was buoyed by high employment growth and sizable wage awards. Vibrant corporate investment offset slackening residential construction. Expansion slowed sharply in the first three quarters of 2008, amid declining consumer and business confidence.

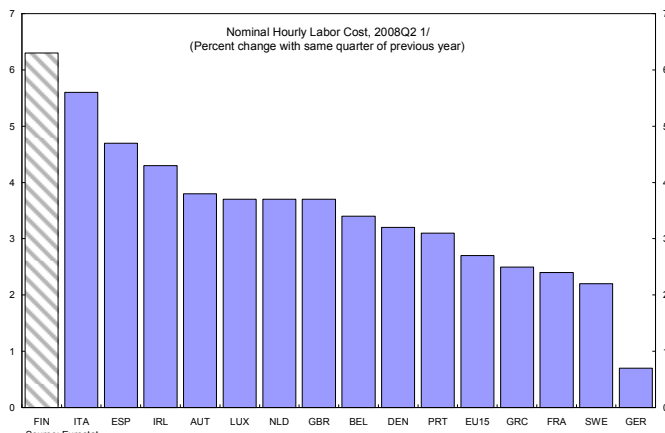
	2005	2006	2007	2008	2009
				proj.	proj.
Real GDP	2.8	4.9	4.5	2.1	0.6
Consumption	2.9	3.1	2.7	2.6	0.9
Private	3.3	4.1	3.2	3.0	0.9
Gross fixed capital formation	3.5	4.7	8.5	0.0	-4.5
Net exports 2/	-1.1	2.0	1.1	1.4	-0.1

Sources: Statistics Finland; and staff projections.

1/ A paper sector labor dispute is estimated to have reduced growth by about 1 percentage point in 2005 (most of which was accounted for by a worse contribution of net exports to growth), with offsetting changes in 2006.

2/ Contribution to growth.

3. **The disappointing outcome of decentralized wage negotiations and a tight labor market pose inflation risks.** With cyclically brisk labor demand, long-called-for decentralized wage accords in the second half of 2007 provided some firm-level flexibility, but paid little heed to productivity gains and differentials, including most worryingly in the public sector. Employment growth has recently slowed, with the unemployment rate increasing to 6.5 percent in September, but sectoral labor shortages and mismatches persist.



1/ Data for Austria, Belgium, Ireland, Italy and the Netherlands are for 2008Q1; for Greece are for 2007Q3.

Inflation, Labor Market, and Output Gap Indicators
(Percent change)

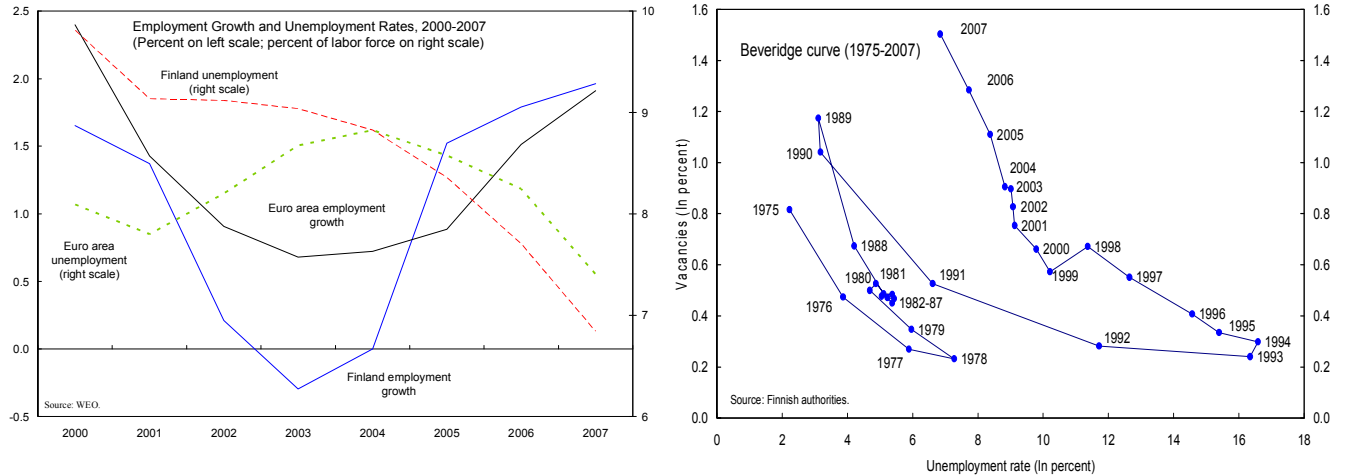
	2005	2006	2007	2008	2009
				proj.	proj.
Harmonized CPI	0.8	1.3	1.6	4.0	2.5
GDP deflator	0.4	1.3	2.9	3.3	2.0
Employment	1.5	1.8	2.0	1.3	-0.5
Unemployment rate 1/	8.4	7.7	6.8	6.4	6.8
Labor compensation 2/	3.8	2.9	3.5	5.5	4.8
Unit labor costs 2/	2.4	-0.3	1.2	4.6	3.6
Output gap	-1.5	0.0	1.3	0.4	-1.6

Sources: Statistics Finland; and staff projections.

1/ Percent of labor force.

2/ Economy-wide.

Inflation surged to 4.7 percent in September, greatly exceeding the euro area average. While this reflects in part excise increases and the energy and food price shocks earlier in the year, rising unit labor costs and “core” inflation risk fueling persistence of inflation above the euro area average.



4. **External competitiveness is adequate.** In 2006–07, the current account surplus hovered around a sizable 4–4½ percent of GDP, and is projected to remain broadly unchanged this year, as decelerating import demand offsets slowing growth among trading partners, higher average oil prices, and continuing decline in terms of trade (Figure 2, Table 2). Various measures point to a comfortable competitiveness margin for Finland (Box 1).

5. **The fiscal position stays enviable, although the surplus is set to drop.** The general government (GG) surplus surged to 5¼ percent of GDP in 2007, buoyed by economic expansion, strong property revenues (partly a statistical revision), and spending moderation. GG debt fell to 35 percent of GDP, with pension fund assets almost twice as large (Table 4). The surplus is projected to contract to some 4¾ percent of GDP in 2008, the result of slowing growth, tax cuts, and higher expenditures, especially following the recently agreed sizable wage raises, implying a marginal decline in the structural balance.

General Government Overall Balances
(Percent of GDP)

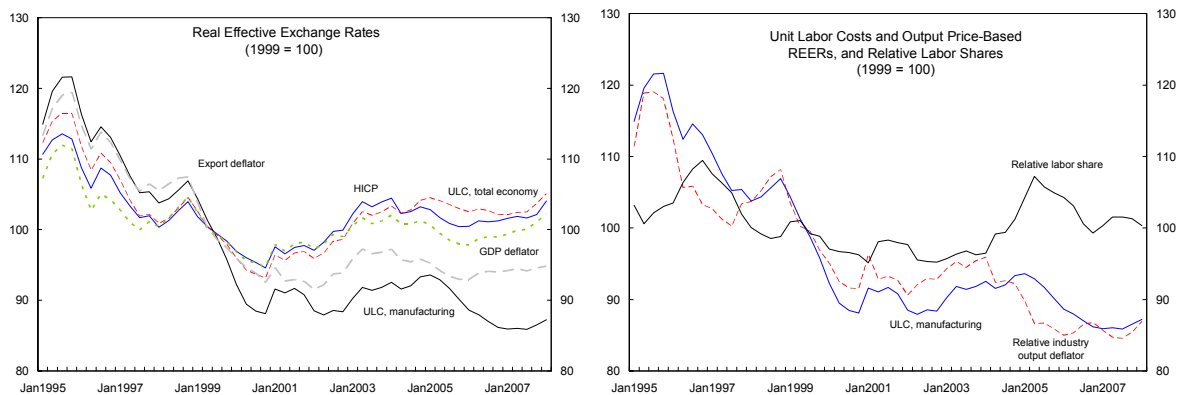
	2005	2006	2007	2008	2009
				proj.	proj.
Central and local governments	-0.2	0.6	2.0	1.7	0.2
Social security	2.9	3.4	3.3	3.0	2.5
General government	2.7	4.0	5.3	4.7	2.7
General government (structural) 1/	2.8	4.0	4.8	4.5	3.4

Sources: Statistics Finland; Ministry of Finance; and staff projections.
1/ Adjusted in 2005 for a paper sector dispute.

6. **Population aging still jeopardizes long-term fiscal sustainability.** Its fiscal impact is large (5½ percent of GDP of additional annual expenditures by 2050, mostly on account of healthcare and pensions). Finland is well placed to deal with this problem. Indeed, its benign initial (2007) fiscal position would already be sustainable, were it not for discretionary

Box 1. Finland's External Competitiveness

External competitiveness is adequate according to most indicators. The current account surplus, though declining, remains substantial. Standard real effective exchange rate (REER) measures based on different price or cost indices, after depreciating substantially in the 1990s, have been broadly stable since 2000. The manufacturing unit-labor-cost-based measure has dropped the most, reflecting relatively high productivity growth in Finland's tradable sector. However, the price of Finnish industrial goods relative to that of trading partners has also been falling. Nevertheless, relative export profitability (the inverse of the relative labor share) has stayed broadly stable over the last decade. And the net international investment position (especially when abstracting from the large share of foreign holdings of domestic equities) has shown a trend improvement (Table 3).



Applying the multilaterally-consistent CGER methodology to Finland suggests moderate real undervaluation. The three approaches assess an average competitiveness margin of 7 percent. The margins are smaller than those

estimated last year (17 percent mid-point), reflecting: (i) a sizable downward statistical revision in the current account surplus (about 1 percent of GDP); (ii) worse terms-of-trade prospects (mainly from higher energy and commodity prices); and (iii) a slightly higher negative effect of anticipated population aging on domestic saving.

Estimates of Competitiveness Margin Using CGER Methodologies
(In percent)

Methodology	
Macroeconomic balance approach	-7.3
External sustainability approach	-4.0
Equilibrium real exchange rate approach	-9.3

Source: Fund staff estimates.

Risks to the external position appear manageable. Recent large wage awards may result in higher relative unit labor costs and erode competitiveness. Finland's export base remains narrow, with the important forest and paper industry under pressure from Russian roundwood export tariffs. The terms of trade continue their trend decline, with much of domestic productivity gains distributed abroad through lower export prices. Relatively rapid population aging is expected to reduce domestic saving. Nonetheless, existing medium-term competitiveness margins appear sufficient to handle these concerns and prevent significant REER appreciation above its equilibrium value.

measures recently adopted or anticipated through 2011 (end of the government's term) that imply a sizable reduction of the surplus. Taking these into account, the impending burden of aging would lead to an unsustainable deterioration of public finances, if not offset by reduction of aging-related entitlements, cuts in other spending, or revenue increases.

Overall Risk Classification for Fiscal Sustainability

High: Cyprus, Czech Republic, Greece, Hungary, Slovenia

Medium: Belgium, France, Germany, Ireland, Italy, Luxembourg, Malta, Netherlands, Portugal, Slovakia, Spain, UK

Low: Austria, Denmark, Estonia, *Finland*, Latvia, Lithuania, Poland, Sweden.

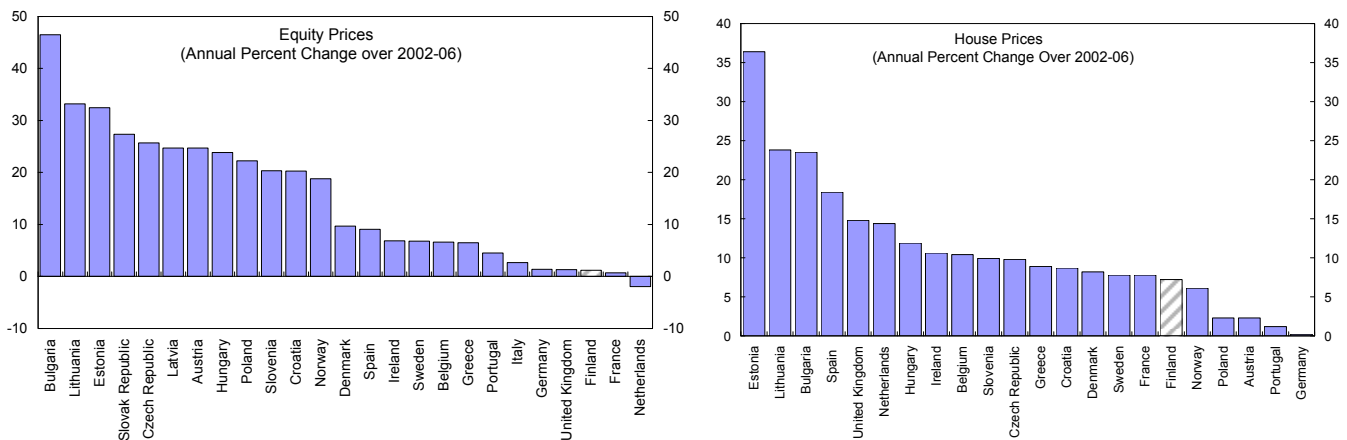
Source: European Commission, *Public Finances in EMU - 2008*.

7. Banks have been largely sheltered from the turmoil, but profitability, cross-country supervision, mortgage lending, and links to insurance companies and foreign affiliates require attention.

- Exposure to U.S. subprime assets, U.S. GSEs, and Lehman is minimal. The main problems related to two Icelandic banks' small local operations, which have been resolved. The CDS spreads for the biggest banks (both foreign owned) have widened and remain volatile, but stayed consistently below those of European peers.
- Despite some variation across banks, key financial stability indicators remain quite healthy (Table 5 and Figures 3–4). Returns on equity and capital-adequacy ratios are high, while loan-loss and cost ratios low. However, lending margins face pressures from increased competition, although recently banks have moved to increase them. Softer economic growth, reduced non-operating and fee income, and rising funding costs herald lower profitability and higher loan losses, albeit from very healthy levels.
- Banks have exhibited limited risk appetite and prudent underwriting policies. The decline in the share of customer deposits in recent years has been offset by bonds and CDs as funding sources, and Finnish banks have maintained good access to interbank markets. While liquidity has tightened, the domestic interbank market did not freeze in 2008 and banks even gained some deposits from mutual funds in a flight to safety. Credit growth held up in the first half of 2008, but declined in the third quarter.
- Some 60 percent of banking assets are foreign-owned, posing challenges for cross-border supervision.
- Helsinki stock prices are about 55 percent off their late-2007 peak, comparable to other European indices, although, with some 60 percent of total capitalization held by nonresidents, the impact on domestic activity is relatively limited.
- Housing prices have risen much more moderately in Finland than in many other European economies. They have slightly declined in real terms in 2008, amid rising

mortgage rates earlier in the year and margins more recently. Consumption is unlikely to be much affected as consumer loans backed by real estate collateral are limited. In general, mortgage credit standards are prudent, though rising rates, reliance on floating rates, and relatively high concentration of debt among young borrowers with low net worth are concerns. Nonetheless, prevalence of fixed monthly payments with variable maturity and frequent interest rate caps contribute to very low default rates.

- Household and nonfinancial corporation balance sheets remain strong, although household debt has risen sizably and enterprise profitability is squeezed by rising labor costs and energy and commodity prices (Figure 5). Given the uncertainties and costs of bond market access, corporate reliance on bank funding has increased.
- Insurance and pension companies have suffered significant losses owing to the plummeting capital markets. While minimum solvency ratios are met, margins have declined considerably¹, underscoring the need to step up vigilance over financial conglomerates. Life premia are stagnating, though the share of unit-linked life products is increasing, which could over time lower insurance sector risks.



8. **Structural progress continues, but at slower pace.** Reforms led to sizable employment gains in recent years, with the unemployment rate now below the EU average. Nevertheless, employment rates for the elderly and—especially—youth lag behind those in other Nordic economies, amid growing labor mismatches and still high structural unemployment (Figure 6). Productivity growth has been sluggish in the sheltered sectors (agriculture, utilities, and trade), and even declining in local government (LG) social services. Steps to ease such constraints—to activate the labor force and stimulate competition in product markets—have been largely confined in 2007–08 to implementation of previously adopted measures.

¹ Finnish statutory pension funds are buffer funds within the PAYG system. A lower buffer increases the probability of future rises in contribution rates, but does not mean insolvency of a pension provider.

II. OUTLOOK

9. **The economy is slowing in 2008–09 amid dwindling domestic demand and a flagging external environment.** Growth is projected to decelerate to about 2 percent in 2008 and further to ½ percent in 2009, owing mainly to lingering effects of the global turbulence.² Lower activity in a number of major trading partners will reduce export expansion, hit also by Russian export tariffs on roundwood. Sluggish employment growth, the erosion of real disposable income by higher inflation, higher debt servicing, and falling consumer confidence will constrain consumption. Capital formation is projected to brake for cyclical reasons, tightening profit margins, worsening expectations, and rising financing costs. Staff estimates a cumulative direct impact of financial tightening on 2008–09 growth at ¾ percentage points.³ Inflation is expected to peak at about 4 percent in 2008, before falling back in 2009, as the pass-through of earlier food and fuel price surges (and excise hikes) fades, aided by a late-2009 cut in food VAT.

10. **Uncertainties regarding the outlook are high, with risks broadly balanced.** Main risks include deviations from the baseline in: (i) lending conditions or housing and equity prices, that could affect domestic demand; (ii) oil prices; (iii) external demand spillovers; (iv) the value of the euro; and (v) labor market situation (the sharp acceleration of inflation may trigger cost pressures and erode competitiveness, but poorer employment prospects could dampen this concern). Upside and downside outcomes for these risk factors are deemed equally probable, but their dispersion is unusually pronounced, in light of uncertainties concerning the impact of the global financial distress on real activity.

Impact of Spillovers (or Risks to the Outlook) on Baseline GDP Projections
(Deviation from baseline projections in percentage points, full year effects)

	2009	2010
Baseline GDP growth	0.6	1.6
A 1 percentage point increase in lending risk premia	-0.9	-0.5
A 1 percentage point fall in external demand	-0.4	-0.2
A 10 percentage point rise in oil prices	-0.2	-0.1
A 1 percentage point appreciation of the euro	-0.2	-0.2

Source: Bank of Finland.



The chart includes the following risks to the projections of growth (2.1 percent in 2008 and 0.6 percent in 2009):

- changes in tightness of financial conditions;
- changes in foreign demand;
- variations in oil prices;
- changes in the value of the euro;
- changes in the labor market situation.

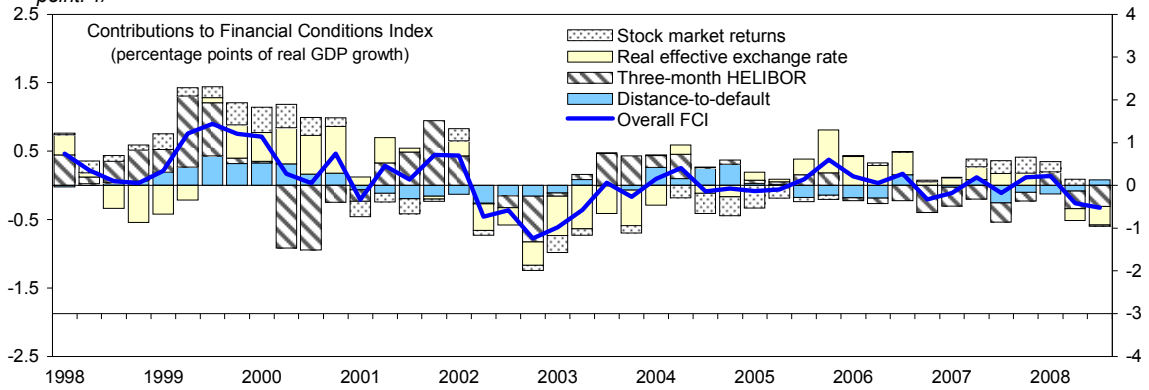
These risks are weighted by the staff's subjective probability assessment of their occurrence.

² Accordingly, the output gap turns negative in 2009.

³ Appendix I.

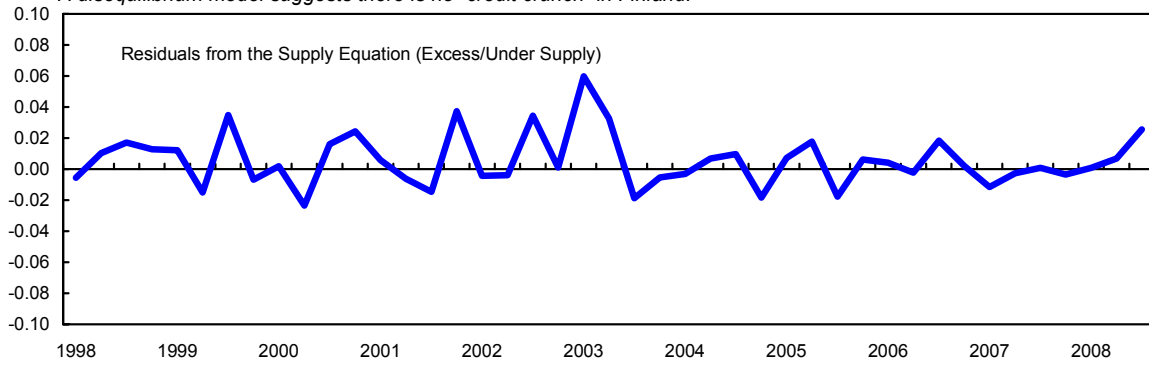
Finland: Financial - Real Sector Linkages Financial Conditions

The financial cycle seems to have turned, which is estimated to reduce GDP growth in 2008-09 by about 3/4 percentage point. 1/

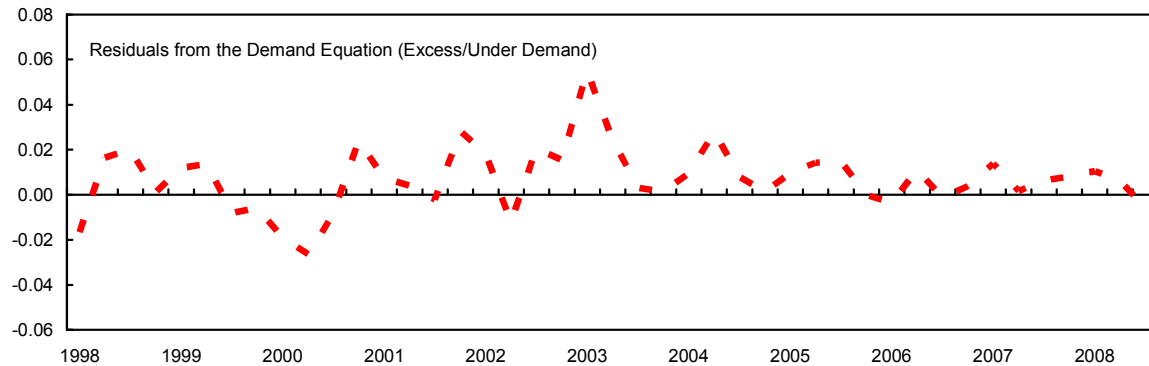


Excess Loan Demand and Supply

A disequilibrium model suggests there is no "credit crunch" in Finland.



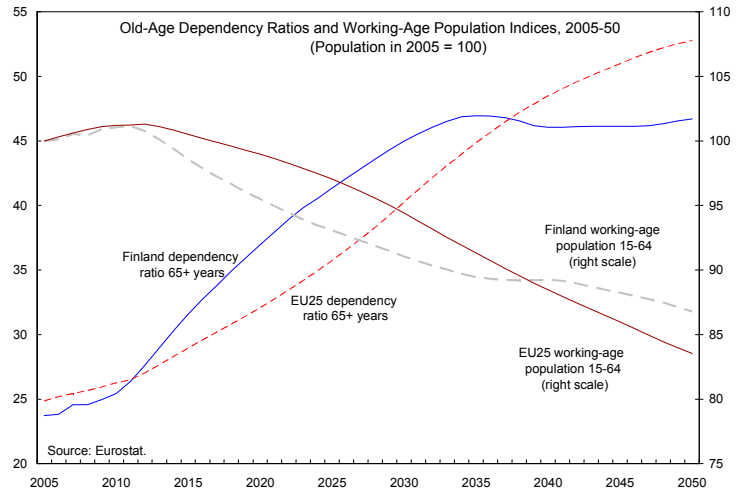
There was excess demand for loans until recently, but this has disappeared.



Source: Finnish authorities; and IMF staff estimates.

1/ Both the level of the FCI and the direction of recent changes have implications for economic activity. For example, a value of 1 means that the total impulse of financial conditions to GDP is one percentage point, annualized. A decline in the FCI from 1 to 1/2 would be expected to reduce GDP growth by 1/2 percentage point, but the contribution still would be positive. See Appendix I for more details.

11. **In the longer term, rapid aging and sluggish productivity are important risks for potential growth and competitiveness.** Trend productivity growth is declining in Finland, while imminent population aging will shrink working-age cohorts. Therefore, raising the employment rate and stimulating productivity—especially in the service sector with a lackluster productivity record—are key for long-run growth and competitiveness.



Prospects for labor force participation/employment and productivity growth imply a significant drop in income per capita growth.

Long-Term Scenario

	1995-2000	2001-05	2006-10	2011-20	2021-30
Productivity growth 1/	2.6	2.0	1.8	2.1	1.9
Demographic contribution 2/	0.0	-0.1	0.0	-0.8	-0.5
Employment rate contribution 3/	1.8	0.4	0.7	0.2	0.0
GDP per capita growth	4.5	2.3	2.5	1.4	1.4

Sources: WEO; Finnish Stability Program 2007.

1/ GDP per employed.

2/ Change in the share of population 15-64 years.

3/ Employed as a share of population 15-64 years.

III. POLICY DISCUSSIONS

12. **Against this background, discussions focused on fiscal policy, financial sector issues, and structural reform.** Specifically:

- the appropriate short-term budget policy;
- ensuring fiscal sustainability through growth-friendly tax and expenditure policies;
- maintaining stability and raising efficiency of the financial sector—in a context of global market tensions and rising volatility;
- reforming labor and product markets to enhance competition and utilization of soon-to-be shrinking labor force.

A. Fiscal Policy

13. **With fading economic expansion, policy makers have shifted priority to support growth through fiscal policy.** Following a substantial improvement in the GG structural balances during 2004–07, the 2009 budget and accompanying medium-term plan envisage a

decline in the structural primary surplus of 2 percent of GDP from 2008 to 2011. A fiscal impulse equivalent to about 1 percent of GDP is estimated for 2009 alone, with further cuts on labor taxes at the beginning of next year (brought forward for cyclical reasons), and a reduction in the VAT rate on food from 17 to 12 percent in October 2009.

14. **Staff saw merit in the relaxation envisaged by the authorities as part of an EU-wide fiscal stimulus package.** It recognized that, from a cyclical perspective, given negative output gaps envisaged for 2009–12, there is scope for a discretionary budgetary impulse. Nevertheless, staff noted that, especially with a tight labor market, the effectiveness of demand-enhancing measures in Finland’s small, open economy would be limited if done in isolation. It also cautioned that:

- available potential output estimates are based on time-series methods which do not allow for structural breaks, such as the recent run-up in energy prices or the repeated financial shocks. Thus, potential output may be overestimated (given also Finland’s high energy intensity) and the room for fiscal stimulus exaggerated.

	2007	2008	2009	2010	2011
		proj.	proj.	proj.	proj.
Staff Projection					
Overall balance	5.3	4.7	2.7	2.4	2.0
Primary balance	4.8	4.1	2.0	1.6	1.1
Overall structural balance	4.8	4.5	3.4	3.4	2.7
Primary structural balance	4.3	3.9	2.7	2.6	1.9
Staff Recommendation					
Overall balance	5.3	4.7	2.7	2.6	3.2
Primary balance	4.8	4.1	2.0	1.8	2.3
Overall structural balance	4.8	4.5	3.4	3.6	3.9
Primary structural balance	4.3	3.9	2.7	2.8	3.1

Sources: Statistics Finland; Ministry of Finance; and staff projections.

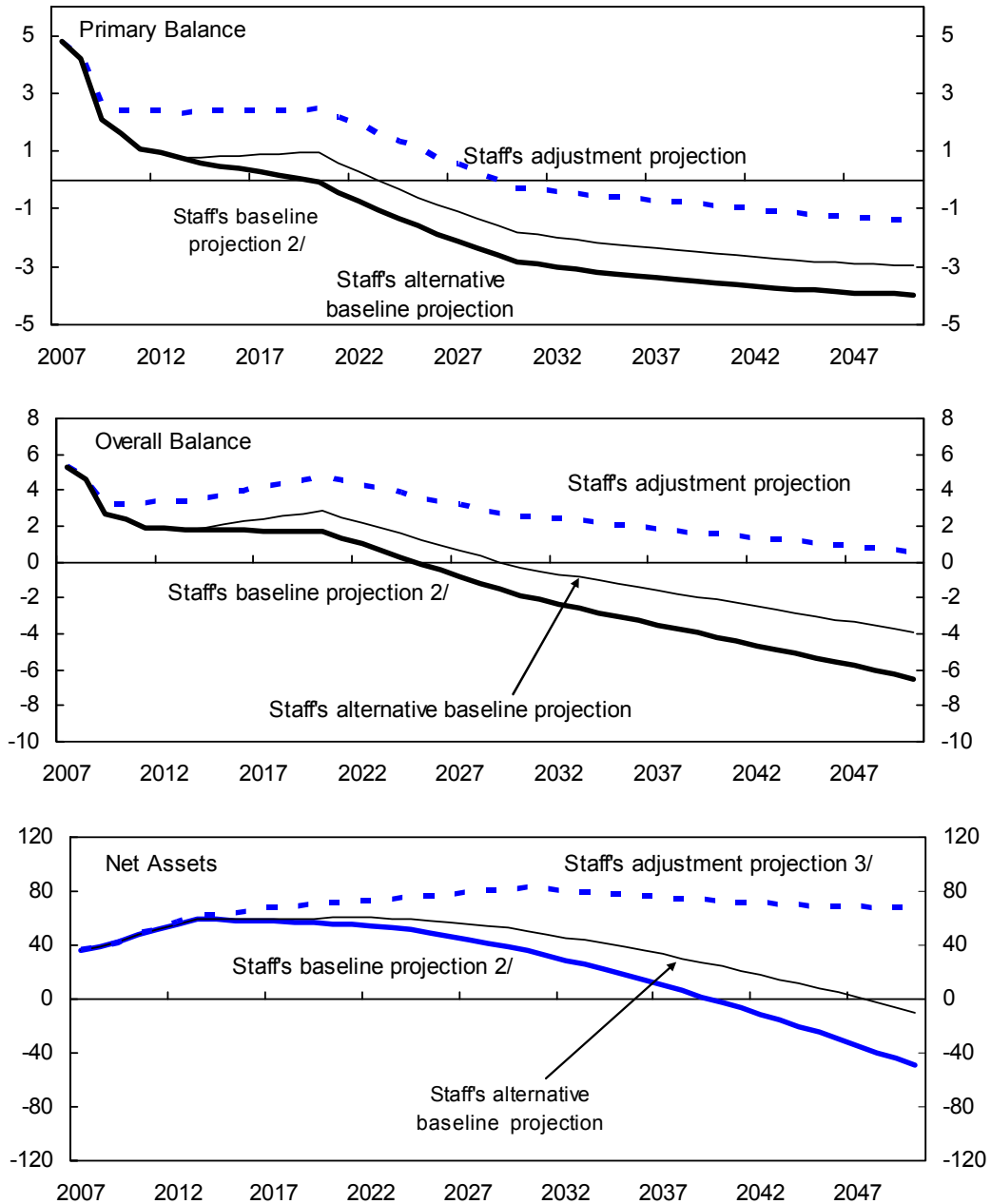
- some budgetary margins must be preserved, should the acute global crisis require fiscal interventions by Finland to recapitalize distressed financial institutions.

On balance, staff thought that the structural loosening planned by the government was appropriate, in the context of a harmonized EU fiscal package. The authorities were confident that a coordinated budget expansion at the EU level was in the cards and its size may be similar to that envisaged for Finland, while bank recapitalization will not be needed.

15. **There was agreement that the fiscal stimulus should be designed to minimize the negative impact on the long-term budget position.** This required the stimulus to rely on actions that reduce economic distortions or can be implemented swiftly and clawed back quickly once growth prospects improve. Specifically, rapidly implementable infrastructure projects—e.g. through public support of social housing construction projects halted by emergence of liquidity constraints for contractors—and earned-income tax cuts to promote labor force participation (¶22) were preferable.

16. **The authorities concurred that medium-term budget policies still fall significantly short of ensuring long-term sustainability.** Given the expected increase in aging-related spending (¶6), to ensure sustainability, the GG structural primary balance after

Long-Term Fiscal Projections, 2007-50 1/
(Percent of GDP)



Sources: Ministry of Finance; and IMF staff estimates.

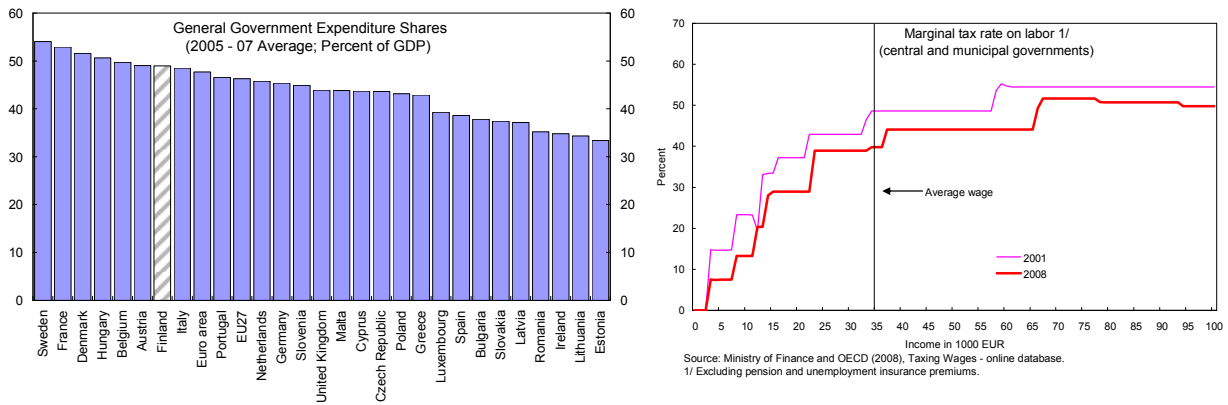
1/ Projections differ from those in the previous staff report reflecting latest developments in the fiscal position of the government, changes in the medium-term policy plans and their estimated impact, and a revision in demographic projections.

2/ Based on IMF staff projections for 2008-13, and influenced by Stability Program projections thereafter. Other assumptions include: average real GDP growth at 2 percent till 2020, and 1.4 percent thereafter; real interest rate at 3 percent; employment rate increasing to 74 percent by 2030 (from about 69 percent in 2006); labor productivity growing by 2 percent up to 2020, and by 1.8 percent thereafter. The baseline and alternate baseline projections correspond to sustainability gaps of 2½ percent and 1½ percent of GDP, respectively.

3/ The level of net assets in the staff adjustment scenario is endogenous and results from the requirement that the structural primary balance in 2013 be set to maintain a net debt (or assets) ratio that is eventually constant despite the increase in aging costs.

2011 should be permanently higher than in the current policies path by 1½–2½ percent of GDP—the fiscal sustainability gap. The gap would be even larger if structural relaxation is more than now anticipated. Staff recommended filling the gap as early as possible once the economy recovers, because front-loaded fiscal retrenchment is desirable for intergenerational equity and to contain the size of the required tightening, as accepted also by the authorities.

17. **Officials stressed that expenditure restraint is the lynchpin of adjustment, but tax reform and improved management of pension assets can support it.** The expenditure-to-GDP ratio in Finland is already comparatively high and will rise further due to aging, thus containment of government spending is a priority (¶18–21). Taxation of earned income is quite heavy with the marginal rate for the average wage exceeding 40 percent, which discourages employment and labor force participation. Thus, lowering labor taxation would promote growth—and possibly help fiscal sustainability, if accompanied by a broadening of the bases of less distortionary levies (¶22). Higher returns on pension assets could also limit the sustainability gap (¶23).



18. **The authorities regard efficiency enhancements as key to reduce government expenditure without jeopardizing public service provision.** Productivity increases in health and long-term care of ½ percent a year (which has been achieved in some OECD countries) would lower significantly projected rises in spending. However, officials recognized that public productivity has declined since the late 1990s, especially in education, health, and social

Selected Health Resource Indicators 1/

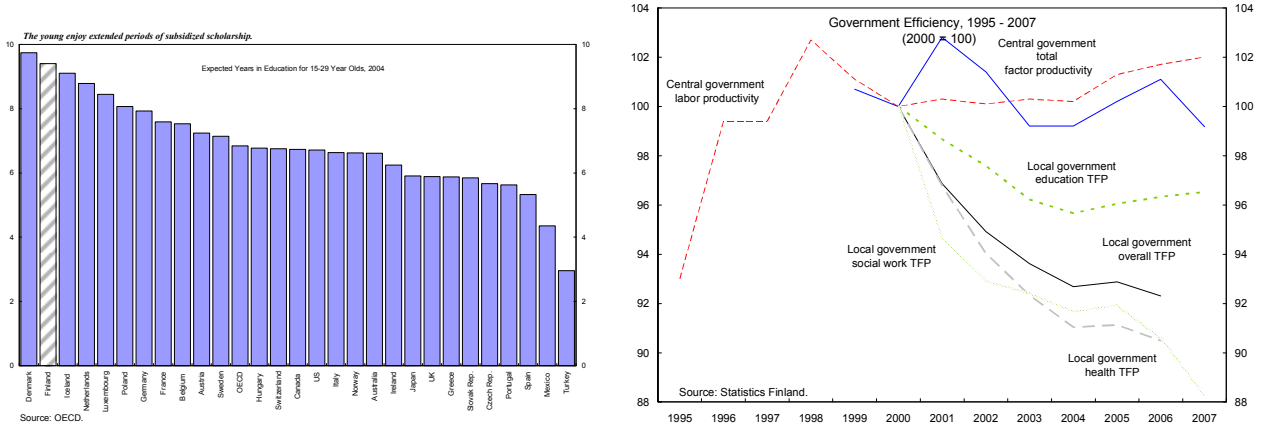
Available data suggest that there is room for improvements in the efficiency of health spending.

	Health worker density index (as defined by the WHO)	Pharmacists per 100,000 people	In-patient care admissions per 100 people	Average length of stay (in days), all hospitals
Austria	9.3	61.7	31.2	8.0
Belgium	15.6	...	16.4	8.7
Denmark	13.6	66.0	22.1	5.0
France	10.2	111.6	18.9	11.7
Germany	13.2	58.1	22.6	10.2
Greece	7.5	...	...	8.0
Ireland	19.0	88.2	14.2	7.6
Italy	10.5	86.1	15.3	7.5
Luxembourg	...	82.7	...	...
the Netherlands	16.7	16.8	9.3	...
Portugal	7.0	98.3	11.6	8.6
Spain	6.8	...	11.8	8.7
Sweden	13.5	...	15.6	6.3
the United Kingdom	...	...	...	...
Finland	25.6	155.1	25.8	10.0
EU-14 Average (excludes Finland)	11.9	74.4	17.2	8.2
Nordic countries	17.3	63.9	19.1	6.3
OECD Average	12.5	74.4	18.6	8.4

Sources: WHO and the World Bank's World Development Indicators database.

1/ Data are from latest year available.

services, all provided by LGs. There was support for domestic and international benchmarking to identify best practices. Staff cautioned that, if efficiency-improving measures are not successful, tougher actions may be required.



19. **Measures to contain demand for public services and increase competition in their provision were identified.** Competition can kindle response to customer preferences and improve efficiency by raising cost awareness. Accordingly, in line with staff recommendations, the authorities will continue to:

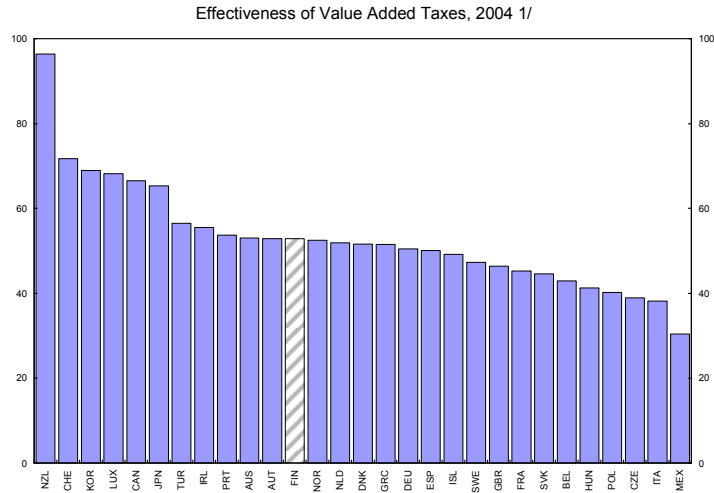
- increase recourse to user charges for public services, thus relying more on price mechanisms to regulate demand, provide signals to suppliers to improve service delivery, and facilitate competition among providers;
- encourage contracting out, outsourcing, and well-designed public-private partnerships, especially in areas like institutional and home-care for the elderly and day-care for children, where the private sector may have a comparative advantage relative to local entities.

20. **In addition, it was not disputed that it would be useful to improve the budgetary discipline of LGs.** Specifically, staff counseled to adopt CPI-based rather than cost-based indexation for CG transfers to LGs and to strengthen the agreement with the association of LGs so as to extend expenditure ceilings to LGs. The authorities were skeptical about the LGs willingness to accept those changes.

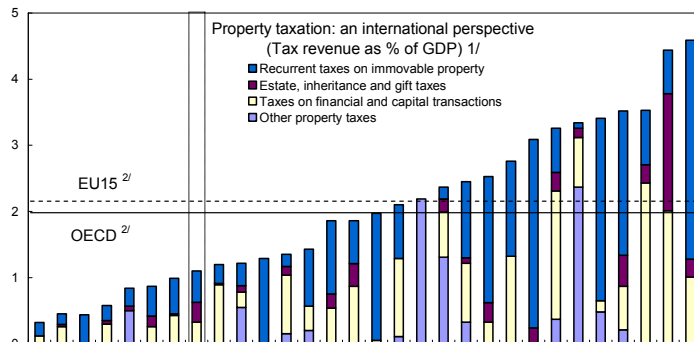
21. **The authorities are considering further social security reform to increase the still low effective retirement age.** Early versions of the proposals by a working committee, which must be submitted to the government by early 2009, are broadly in line with past Fund advice. Specifically, they aim to: (i) restrict use of the unemployment pipeline (which in practice provides early retirement from age 57), stepping up activation measures for the older

unemployed; (ii) tighten control on access to disability pensions; and (iii) strengthen early medical and vocational rehabilitation.

22. **Tax reform should contribute to fiscal sustainability also.** The government is committed to lowering taxes on labor and the VAT rate on food. Staff concurred that moderating labor taxes should boost labor participation and growth, and therefore can benefit long-term fiscal sustainability. However, it advised against the VAT cut—because the VAT is among the least distortionary taxes and revenue losses must be minimized for sustainability’s sake. Indeed, staff argued that the base of the Finnish VAT should be broadened, considering that its effectiveness is barely at the OECD average with special treatments for a relatively large share of goods and services. Finally, it noted that property taxation—which is comparatively low—should be increased. Officials acknowledged this, but explained that sizable rises in property taxation would be unpopular and require the agreement of local governments that are unlikely to implement them.



Source: OECD (2006), *Consumption Tax Trends*.
 1/ Effectiveness of VAT is measured as the effective VAT rate as a percent of the standard statutory rate, where the effective rate is VAT revenues divided by the potential VAT base (i.e., consumption minus VAT). The effectiveness of the VAT reflects the broadness of the VAT base and the level of compliance.



Source: OECD (2007), *Revenue Statistics 1965-2006*.
 1/ 2004 for Portugal; 2005 for Australia, Greece, Iceland, Mexico and Poland.
 2/ Total property taxes; unweighted average.

23. **The authorities target an increase of the long-term real return on pension fund assets.** Raising it to 4 percent a year (from the 3 percent assumed in the baseline sustainability scenario) would reduce the GG deficit in 2050 by 3 percentage points of GDP. To facilitate this objective, in 2007, the investment guidelines for pension funds were eased. Staff proposed additional steps (¶31).

B. Financial Sector

24. **While confirming the resilience of Finnish banks to market turmoil so far, the authorities pointed out several concerns.** Risks relating to toxic assets, derivatives, liquidity, or off-balance-sheet exposure appear moderate. However, the ongoing turbulence

does affect banks indirectly through lower growth, and thus less profitability and higher non performing loans. Though reliance on covered bonds and securitization is limited, bonds and CDs are increasingly important funding sources for major Finnish banks and may become more expensive. Also, losses on group insurance and asset management activities and the banks' global operations (especially in the Nordic-Baltic region) could be sources of unexpected contagion and need to be watched carefully. Accordingly, officials saw the need to monitor insurance capital and cover ratios closely and ensuring proactive recapitalization where necessary.

25. Officials are vigilant about mortgages and consumer lending in light of the run-up in household debt. House price rise has been less worrisome than in other countries, households' net worth is robust, and debt servicing is historically low. Thus, the slowing economy and higher unemployment may be a bigger concern than current weaknesses in household balance sheets. In this context, supervisors stressed the need for alert scrutiny of weakening home prices and credit risks in specific sectors such as high loan-to-value loans to young borrowers.

26. Diversification of banks' wholesale funding was seen as a positive development. Despite a sound mortgage portfolio, both covered bonds or securitization remain rare. Mortgage-covered bonds can be issued only by dedicated mortgage banks, and only two banks have so far set up such special vehicles. Staff argued that this provision could be relaxed. The authorities observed that securitization is small in part due to excessive product customization. The larger banks are now considering to develop securitization as a strategic funding source to preserve capital and boost return on equity. Staff encouraged officials to support the process through voluntary industry-led standardization and facilitating a dialogue between banks and potential investors. There was agreement that these steps were useful, but gradualism was of the essence, given unfavorable market conditions and the need for market participants to acquaint themselves with the new instruments.

27. Staff supported the authorities' measures to buttress the financial sector. In keeping with euro area agreements, Finland raised its deposit insurance to €50,000, announced a €50 billion fund to guarantee the rollover of term debt issued by banks (subject to compensation on commercial terms and with maximum maturity of five years), and proposed a bank recapitalization fund of €4 billion. Staff urged prompt passage of the related legislation and regulations. It also endorsed the authorities' intention to implement these measures without distorting competition among Finnish banks.

28. Central bank stress tests indicate that banks can withstand fairly adverse

shocks. According to the 2008 exercise, a severe economic and financial downturn would cause bank profitability to decline significantly, owing to loan losses and write-downs on shares, real property, or bonds. Nonetheless, no bank would impair its capital adequacy.

2008 Main Stress Test Assumptions

- a severe decline in GDP growth for 2008-10
 - a jump in unemployment rate to above 10 percent by 2010
 - a rise in 3-month Euribor to 5.7-5.8 percent over 2008-10
 - declines in home prices in 2008-10 ranging between 6-10 percent annually
 - a 32 percent decline in stock prices in 2008, modest recovery only in 2010
-

29. The authorities have made good progress in expanding the scope of stress tests, but further improvements were identified. Supervisors concurred that future tests should aim to: (i) cover more thoroughly market risks, such as valuation losses, counterparty risks, risk concentration, and strategic risks relating to liquidity and new capital issuance; (ii) integrate more completely the insurance sector; and (iii) explore procyclicality implicit in capital adequacy measures under Basle II.

30. Supervisors acknowledged that, while financially sound, the insurance sector is facing the impact of the global crisis and stagnation in some lines. Solvency levels for insurance companies were strong and improving until mid-June 2007, but have dropped significantly after the steep market declines in 2008. Finnish insurers' premium growth leveled off in 2007, with falling premia in the life segment in recent years. Accordingly, the authorities noted concerns relating to: (i) the impact of insurers' potential problems on related groups; and (ii) possible saturation of the life market.

31. Pension funds appear in good financial health, but officials may evaluate further reforms to cope with changing demographics. The 2005 reforms have significantly improved the system's long-term stability, but have resulted in linking benefits to life expectancy and other considerable risk-sharing by the employees.⁴ Thus, with high and uncapped contribution rates, officials expressed interest in exploring the merits of gradually raising funding levels and introducing a defined-contribution (DC) component option—while preserving an adequate minimum means-tested pension and defined-benefit (DB) component up to a replacement rate target determined by societal preferences on intergenerational risk sharing. A DC component could help raise long-term returns, thereby easing adjustment to future demographic or investment return shocks and aiding fiscal sustainability. The authorities were broadly receptive of suggestions to: (i) integrate administration and investment functions across funds, notably those of local and central governments; and (ii) fine-tune solvency regulations to reflect better the PAYG nature of the pension system.

⁴ Any increases in contributions in private sector plans will be borne by employers and employees equally.

32. **The authorities are committed to strengthen cross-border supervision.** Already well regarded, Finnish financial market supervision should further improve efficiency and effectiveness with the merger of the Financial Supervisory Authority and the Insurance Supervisor. The authorities are satisfied with their cooperation with Swedish and Danish counterparts. Nonetheless, the still evolving harmonization of EU regulations and supervision for large multinational institutions remains an important concern, as underscored by recent Icelandic and Benelux cases. Officials concurred that further clarification of supervisory and fiscal responsibility of home-host authorities in crisis resolution was a priority. Similarly, supervisors deemed helpful to: (i) use supervisory colleges for both subsidiaries and significant branches; (ii) improve harmonization and clarity about operation of deposit insurance schemes, especially in the wake of its significant recent expansion; and (iii) develop common criteria for intervention in troubled institutions. While these measures should be pursued at the EU level, it was agreed that an eventual move towards a more integrated European supervisory structure, at least for the major cross-border institutions, would be opportune.

33. **The authorities reiterated their interest in an FSAP update for early 2010.**

C. Structural Policies

34. **There was consensus that labor and product market reforms are needed to stimulate growth.** In particular, with the working-age population set to decline after 2010, boosting potential growth (and achieving fiscal sustainability) will require further labor force activation measures.⁵ Measures to enhance competition in product markets could raise productivity growth. With respect to Fund recommendations (Table 7), progress continued although largely restricted to realizing past legislative or regulatory reforms. To address the lack of wage differentiation in the recent decentralized agreements, social partners are considering improvements to stress the linkage with productivity increases, including changing the order in which categories embark in negotiations. The government will also apply moral suasion on social partners to seek more moderate outcomes from the next wage bargaining round and some agreements may be reopened.

IV. STAFF APPRAISAL

35. **While a strong performer recently, the Finnish economy faces the headwind of the international crisis and important structural challenges.** Banks and other financial institutions have been resilient to the global turmoil so far, but spillovers from the persistent upheaval will take a severe toll on growth and may exacerbate weaknesses in the financial system. Inflation has picked up, with high wage increases raising the risk of cost pressures that keep inflation above the EU average. Uncertainties about the outlook are unusually high owing to

⁵ Thoroughly analyzed in IMF Country Report 07/278.

the global crisis. Looking forward, rapid population aging and slowing productivity threaten longer-term growth and fiscal sustainability. Deepening financial integration and complexity create new risks and test supervision.

36. **External competitiveness is comfortable at present.** Competitiveness margins have declined since the previous consultation—reflecting also higher energy and commodity prices. Nevertheless, they appear sufficient to handle pressures from aging and the secular decline in terms-of-trade, although risks are exacerbated by the recent high wage awards.

37. **From a cyclical perspective a fiscal structural loosening is warranted, but it should avoid damaging the long-term budget position.** With a tight labor market, the effectiveness of demand-enhancing measures in Finland's small, open economy is limited. Thus, the relaxation contemplated in the 2009 budget is suitable, in the context of joint action at the EU level. The impulse should rely on measures that reduce distortions—such as the proposed labor-income tax cuts that promote labor force participation—or can be implemented swiftly and reversed rapidly once growth prospects improve. In addition, budgetary margins must be preserved, in case the global crisis requires fiscal interventions to recapitalize distressed financial institutions.

38. **Long-term fiscal sustainability is still elusive.** Relative to the authorities' medium-term policies, a permanent improvement in the structural primary balance after 2011 of at least 1½ percent of GDP is needed to stabilize net public debt in light of the budgetary costs of aging. This gap should be filled as soon as the economy recovers to contain the size of the fiscal correction and distribute the burden more equitably across generations.

39. **The main pillar of fiscal sustainability is expenditure restraint, but tax reform and higher pension fund yields can help.**

- The bulk of the needed adjustment should rely on containment of spending since the public-expenditure-to-GDP ratio in Finland remains comparatively high. More efficient government programs could lower markedly expenditure rises from aging without harming service provision. To improve productivity, further enhancements to benchmarking could help identify best practices. Increasing resort to user charges and greater recourse to contracting out, outsourcing, and well-designed public-private partnerships could make an important contribution as well.
- Lower earned income taxes can promote higher labor force participation—and possibly aid fiscal sustainability, if accompanied by broadening the base of less distortionary levies, especially the VAT. In this context, cutting the VAT rate on food is not advisable. It would be useful to increase property taxation, low in international comparison. To lift the real long-term return on pension assets, a defined contribution pension option and a greater degree of funding could be considered.

40. The brunt of continuing capital market turbulence on bank profits and financial conglomerates bears watching.

- Lending growth and profitability have declined, and liquidity has become tighter, though loan losses and capital adequacy remain at healthy levels. Rising household debt, softer house prices, mortgage concentration in weak borrower segments, developments in funding markets, and the impact of a weakening economy on bank profitability and non-performing loans must be monitored closely.
- Both insurance and pension companies have been hit particularly hard by the global crisis. While minimum solvency ratios are met, margins have declined considerably, underscoring the need to step up vigilance over possible contagion to banks in financial conglomerates.
- The authorities' actions to guarantee bank debt renewal and recapitalize banks, if needed, are appropriate and related legislation and regulations should be passed promptly. Their intention to implement these measures without distorting competition among Finnish banks is commendable.

41. Strengthened cooperation with supervisors abroad is crucial in a majority foreign-owned banking system. The authorities' efforts toward further clarification of supervisory and fiscal responsibility of home-host authorities in crisis resolution deserve strong support. Progress is also important towards broader use of supervisory colleges and better harmonization of deposit insurance and criteria for intervention in distressed banks, and the eventual creation of a more integrated European supervisory structure for major cross-border institutions.

42. With fast population aging, raising labor utilization and productivity is essential to boost living standards and support fiscal sustainability. Steps to strengthen activation of the unemployed and partially disabled, shorten time spent in tertiary education, improve training and reduce labor market mismatches, and lessen poverty traps will continue to be crucial. The next round of wage bargaining ought to reflect productivity increases and differentials to stem rising unit labor costs. Measures to raise competition, above all in "sheltered" sectors of the economy, are required to enhance productivity growth.

43. The next Article IV consultation will be held on a 24-month cycle. Finland is a non-systemic country, with stable economic and financial conditions, and without outstanding Fund credit or pressing policy issues of broad interest to the Fund membership. Hence, the authorities agreed to move consultations to a 24-month cycle, with an interim staff visit.

Table 1. Finland: Main Economic Indicators, 2004–11

	2004	2005	2006	2007	Proj.			
					2008	2009	2010	2011
(Percentage change, unless otherwise indicated)								
Output and demand (volumes)								
GDP	3.7	2.8	4.9	4.5	2.1	0.6	1.6	2.7
Consumption	2.6	2.9	3.1	2.7	2.6	0.9	1.4	2.2
Private consumption	3.0	3.3	4.1	3.2	3.0	0.9	1.5	2.4
Public consumption	1.8	1.9	0.6	1.3	1.0	1.1	1.3	1.5
Gross fixed capital formation	3.6	3.5	4.7	8.5	0.0	-4.5	1.5	2.7
Private investment	3.6	6.3	6.5	8.3	0.3	-5.7	1.0	2.7
Public investment	3.7	-11.0	-6.4	9.4	-0.4	3.5	3.5	2.5
Exports of goods and services	8.6	7.0	11.8	8.2	4.0	-0.6	4.6	4.5
Imports of goods and services	7.2	11.8	7.8	6.6	1.2	-0.6	4.5	3.6
Foreign contribution to growth (in percent of GDP)	1.0	-1.1	2.0	1.1	1.4	-0.1	0.2	0.5
Prices, costs, and income								
Consumer price inflation (harmonized)	0.1	0.8	1.3	1.6	4.0	2.5	2.0	2.0
Core inflation (excluding energy and seasonal food)	0.7	0.5	0.9	1.3	...	...	...	...
GDP deflator	0.6	0.4	1.3	2.9	3.3	2.0	0.9	1.4
Terms of trade	1.3	-0.7	-3.1	-1.4	-2.5	-1.4	-1.5	-1.3
Unit labor cost, economy-wide	0.3	2.4	-0.3	1.2	4.6	3.6	2.5	1.5
Labor market								
Labor force	-0.2	1.0	1.1	1.0	0.8	0.0	0.0	0.0
Employment	0.0	1.5	1.8	2.0	1.3	-0.5	0.1	0.2
Unemployment rate (in percent)	8.8	8.4	7.7	6.8	6.4	6.8	6.8	6.6
Potential output and NAIRU								
Output gap (in percent of potential output) 1/	-1.1	-1.5	0.0	1.3	0.4	-1.6	-2.3	-1.6
Growth in potential output	3.3	3.2	3.3	3.2	3.0	2.7	2.3	2.0
NAIRU (in percent)	8.5	7.9	7.8	7.2	6.6	6.4	6.4	6.4
(In percent)								
Money and interest rates								
M3 (Finnish contribution to euro area , growth rate, e.o.p.) 2/	6.3	8.2	8.1	19.7	8.2	...	...	...
Finnish MFI euro area loans (growth rate, e.o.p.) 2/	10.6	12.2	11.5	11.7	13.1	...	...	...
3-month money market rate 3/	2.1	2.2	3.1	4.3	4.8	...	...	...
10-year government bonds yield 3/	4.1	3.4	3.8	4.3	4.2	...	...	...
(In percent of GDP, unless otherwise indicated)								
National saving, investment, and income								
Gross national saving	26.4	25.4	26.3	27.3	26.2	25.1	24.2	23.9
Gross domestic investment	19.9	21.8	21.8	23.3	22.2	21.5	21.7	21.5
Private saving	21.4	20.2	20.1	19.7	19.2	20.0	19.4	19.5
Household saving as percent of disposable income	2.2	0.0	-1.5	-3.8	-3.7	-2.8	-1.7	-1.8
Private investment	17.0	19.3	19.6	21.0	19.9	19.2	19.2	19.1
Government savings surplus	2.2	2.7	4.0	5.3	4.7	2.7	2.4	2.0
Households' real disposable income (increase in percent)	2.8	3.3	4.1	3.1	2.9	2.0	1.8	1.9
(In percent of GDP, unless otherwise indicated)								
Balance of payments								
Current account balance	6.5	3.6	4.5	4.1	4.0	3.5	2.5	2.4
Trade balance	6.7	4.9	5.5	4.9	4.7	4.1	3.2	2.8
Net external debt (excluding equity FDI and shares)	-8.2	-5.5	-5.5	-6.8	-10.5	-13.7	-15.9	-17.7
Net international investment position	-10.9	-14.7	-13.4	-28.1	-19.7	-14.8	-10.9	-6.8
Exchange rates (period average)								
Euro per US\$ 4/	0.81	0.80	0.80	0.73	0.67	...	...	...
Nominal effective rate (increase in percent) 4/	2.2	-0.5	0.0	2.2	0.3	...	...	...
Real effective rate (increase in percent) 4/5/	1.2	0.3	-1.1	1.3	1.8	...	...	...

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

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

2/ For 2008, annual change through September.

3/ For 2008, data are for end-October.

4/ For 2008, data are for first ten months.

5/ Based on relative normalized unit labor costs.

Table 2. Finland: Balance of Payments, 2004-2013
(In billions of euros)

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
	Proj.									
Current account	10.0	5.7	7.5	7.3	7.5	6.8	5.0	5.1	5.1	5.2
As a percentage of GDP	6.5	3.6	4.5	4.1	4.0	3.5	2.5	2.4	2.4	2.3
Goods and services	10.6	6.9	8.3	9.1	9.8	8.6	6.6	6.7	6.6	6.6
Exports of goods and services	60.9	65.7	75.5	82.2	86.7	86.2	89.3	94.0	98.8	103.9
Goods	49.1	52.7	61.7	65.8	69.0	68.5	70.9	74.0	77.1	80.3
Services	11.7	13.1	13.8	16.4	17.7	17.7	18.4	20.0	21.7	23.6
Imports of goods and services	-48.6	-58.8	-67.2	-73.1	-76.9	-77.6	-82.7	-87.4	-92.2	-97.3
Goods	-38.9	-45.0	-52.5	-57.0	-60.1	-60.6	-64.6	-68.2	-72.0	-76.0
Services	-9.7	-13.9	-14.7	-16.1	-16.8	-17.0	-18.1	-19.1	-20.2	-21.3
Income	0.1	-0.2	0.6	-0.8	-1.2	-0.7	-0.5	-0.4	-0.3	-0.2
Compensation of employees	0.4	0.4	0.2	-1.6	-1.7	-1.7	-1.8	-1.9	-1.9	-2.0
Investment income	-0.2	-0.6	0.4	0.8	0.5	1.1	1.3	1.5	1.6	1.9
Current transfers	-0.7	-1.0	-1.4	-1.0	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3
Official	-1.3	-1.5	-1.9	-1.6	-1.6	-1.7	-1.7	-1.7	-1.8	-1.8
Capital and financial account	-8.2	-2.5	-8.8	-5.3	-7.5	-6.8	-5.0	-5.1	-5.1	-5.2
Capital account	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-8.3	-2.8	-8.9	-5.5	-7.7	-7.0	-5.2	-5.3	-5.3	-5.3
Direct investment	3.1	0.4	2.0	3.1	-0.8	-0.7	-0.6	-0.5	-0.3	-0.1
In Finland	2.3	3.8	4.5	8.3	7.5	8.4	9.4	10.5	11.8	13.2
Abroad	0.9	-3.4	-2.5	-5.2	-8.3	-9.1	-10.0	-11.0	-12.1	-13.3
Portfolio investment excl. fin. derivatives	-8.8	-3.7	-11.5	-9.1	-8.7	-9.0	-9.3	-9.5	-9.8	-10.1
Other investment	-2.0	0.4	-3.1	0.7	1.8	2.7	4.7	4.8	4.9	4.9
Assets	-10.1	-1.8	-12.5	-7.7	-10.1	-8.9	-9.5	-9.2	-9.4	-9.3
Liabilities	8.0	2.3	9.5	8.5	12.0	11.6	14.2	14.0	14.3	14.2
Official	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.1	0.1
Private	-2.4	0.1	-3.3	0.5	1.6	2.5	4.5	4.6	4.7	4.8
Reserve assets	-0.6	0.1	3.6	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-1.8	-3.2	1.2	-2.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:										
GDP at current prices	152.3	157.3	167.0	179.7	189.6	194.5	199.4	207.6	216.4	225.6

Sources: Bank of Finland; and staff projections.

Table 3. Finland: Net International Investment Position, 2001-07
(In percent of GDP)

	2001	2002	2003	2004	2005	2006	2007
Assets	130.7	133.0	157.4	178.0	194.4	206.9	208.7
Direct investment abroad	42.4	42.3	41.3	41.0	44.0	43.0	42.7
Portfolio investment abroad	45.4	50.4	58.1	70.6	83.2	97.3	95.8
Other investment abroad (incl. financial derivatives)	36.1	33.8	52.0	60.3	61.1	63.2	67.0
Reserve assets	6.8	6.5	6.1	6.2	6.1	3.4	3.2
Liabilities	212.5	169.6	182.0	188.0	209.9	219.7	234.8
Direct investment into Finland	19.5	22.5	27.3	27.7	29.4	30.9	32.2
Portfolio investment into Finland	144.5	105.7	107.9	106.9	124.1	131.6	143.2
Other investment into Finland (incl. financial derivatives)	48.5	41.4	46.8	53.4	56.4	57.1	59.4
Net investment position	-81.8	-36.6	-24.6	-10.0	-15.5	-12.8	-26.1
Direct investment	22.8	19.8	14.0	13.3	14.6	12.1	10.5
Portfolio investment	-99.1	-55.3	-49.8	-36.3	-40.9	-34.3	-47.4
Other investment (incl. financial derivatives)	-12.4	-7.6	5.1	6.8	4.8	6.1	7.6
Reserve assets	6.8	6.5	6.1	6.2	6.1	3.4	3.2

Sources: Bank of Finland; Statistics Finland; and staff calculations.

Table 4. General and Central Government Financial Accounts, 2004–11

	2004	2005	2006	2007	Proj.			
					2008	2009	2010	2011
(In percent of GDP)								
General government 1/								
Revenues	47.0	47.5	47.3	47.3	46.7	45.7	45.4	45.2
Expenditure	44.9	44.8	43.3	41.9	42.0	43.0	43.0	43.2
General government balance	2.2	2.7	4.0	5.3	4.7	2.7	2.4	2.0
<i>Of which: net interest on public debt</i>	0.0	-0.1	-0.3	-0.5	-0.6	-0.7	-0.8	-0.9
Primary balance 2/	2.2	2.6	3.7	4.8	4.1	2.0	1.6	1.1
Structural balance (in percent of potential GDP) 3/	2.7	2.8	4.0	4.8	4.5	3.4	3.4	2.7
Structural primary balance (in percent of potential GDP) 2/ 3/	2.6	2.7	3.7	4.3	3.9	2.7	2.6	1.9
Gross debt (EMU definition) 4/	44.1	41.3	39.2	35.2	32.4	31.2	29.2	27.8
Central government 1/								
Revenues	24.8	24.8	24.3	24.4	24.3	23.3	22.9	22.7
Expenditure	24.4	24.4	23.5	22.3	22.7	23.0	22.9	23.2
Central government balance	0.4	0.4	0.9	2.1	1.6	0.3	0.0	-0.4
Gross debt	40.3	36.8	34.6	30.7	27.5	26.5	25.9	25.3

Sources: Ministry of Finance; and staff projections.

1/ On ESA95 basis.

2/ Excludes net interest on government debt and financial assets

3/ Corrected for the influence of the business cycle as measured by the output gap, adjusted in 2005 for a paper sector dispute that was to have reduced output by about 1 percentage point.

4/ Includes stock-flow adjustments reflecting changes in the portfolio allocation of Finnish pension funds.

Table 5. Finland: Indicators of Financial Vulnerability, 2003–08

	2003	2004	2005	2006	2007	2008
Households						
Total household debt (in percent of GDP)	37.6	40.6	45.1	46.7	48.1	...
Debt-to-income ratio	73.5	79.2	89.6	97.2	102.7	...
Financial assets/GDP	81.5	84.6	93.4	87.3	85.4	...
Non-financial corporations						
Gross debt (in percent of GDP)	51.0	50.9	50.9	50.4	50.4	...
Government						
General government debt (EMU definition, in percent of GDP)	44.3	44.1	38.2	35.3	31.2	...
Central government debt (in percent of GDP)	43.9	42.6	41.9	38.2	35.3	...
Banking sector						
Outstanding credit to nonfinancial corporations (percent change, e.o.p.) 1/	...	8.9	7.8	8.4	12.9	15.7 2/
Credit to households (percent change, e.o.p.)	...	13.2	15.1	13.0	11.2	7.2 2/
Housing loans in percent of total lending	57.9	59.2	60.8	61.5	61.2	59.7 2/
<i>Asset quality</i>						
Non-performing loans/total loans (in percent) 3/	0.48	0.37	0.27	0.26	0.28	0.35 4/
<i>Capital adequacy</i>						
Regulatory capital as percent of risk-weighted assets	18.7	19.1	17.2	15.1	15.4	13.5 4/
Regulatory tier 1 capital to risk-weighted assets	9.7	16.5	15.0	12.8	11.5	12.2 4/
Equity/total assets (in percent)	10.9	9.6	9.9	9.8	8.3	7.4 2/
<i>Profitability</i>						
Interest rate spread 5/	2.8	2.7	2.5	2.6	2.6	2.8 2/
Net interest income (in percent of total income)	63.3	60.8	64.5	56.6	50.8	64.4 4/
Return on equity (in percent)	11.3	12.4	10.1	11.1	14.3	10.9 4/
Return on assets (in percent)	0.7	0.8	0.9	1.0	1.2	0.8 4/
Liquid assets/total assets (in percent) 6/	12.0	12.9	11.2	12.8	10.2	...
Deposits as percent of assets		40.1	38.3	36.3	36.9	...
Off-balance sheet liabilities/total assets (in percent)	20.2	15.9	16.2	13.4	18.1	...
Stock market						
Change in stock market index (in percent, e.o.p.)	4.4	3.3	31.1	17.9	20.5	-50.7 7/
Change in housing price index, Helsinki region (in percent, e.o.p.)	7.5	6.5	10.1	7.9	5.6	...
Change in housing price index, rest of Finland (in percent, e.o.p.)	4.2	6.9	8.4	5.5	4.9	...

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

1/ Euro-denominated lending only.

2/ As of September 2008.

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

4/ As of June 2008.

5/ Average lending rate minus average deposit rate.

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/ As of November 18, 2008.

Table 6. Investment Limits for Pension Funds (concluded)
(Percent of Total Assets)

Country	Equity	Real Estate	Bonds	Retail Investment Funds	Private Investment Funds	Loans	Bank deposits	Foreign Assets
Norway	35%	No limit.	30% (corporate)	30%		1% (unsecured loans)	No limit	No limit
Portugal	55% (listed)- 15% (non-listed)	50%	No limit (listed)-15% (non-listed)	No limit	No limit	50%	No limit	No limit for OECD countries
Spain	No limit (listed)-30% (non-listed)	20%	No limit (listed)-30% (non-listed)	No limit	30%	20%	No limit	No limit
United Kingdom	No limit	No limit	No limit	No limit	No limit	No limit	No limit	No limit
United States	No general limits	No general limits	No general limits	No limit	No limit	No limit	No limit	No limit
B. Other OECD Countries								
Czech Republic	No limit	10%	No limit	No limit	No limit	0%	10%	No limit for OECD countries
Hungary	No limit (listed), 10% (non-listed).	5%-10%	Federal Government Bonds: No limit, Corporate Bonds: 10%-25%	Mandatory: 50%, Voluntary: No limit	5%	Mandatory: 0%, Voluntary: 30%	No limit	No limit (20% limit of total foreign assets from non-OECD countries)
Mexico	15% (Basic Fund), 30% (voluntary funds)	0%	Federal Government: No limit; Corporate AAA: No limit, AA: 35%, A: 5%	0%	0%	0%	Quantitative limit	20%
Poland: OPF	40% (listed)- 7.5% (non-listed)	0%	40% (listed)- 15% (non-listed)	10%-15%	0%		20%	5%
Poland: EPF	5%	0%	10%	No limit	0%		No limit	5%
Slovak Republic	80%	0%	No limit	50%	0%	0%	No limit	70%

Source: OECD (2007), Survey of Investment Regulations of Pension Funds, July.

Note: Some details about the exact definition of the limit have been omitted for space reasons. Please refer to the original source for such details.

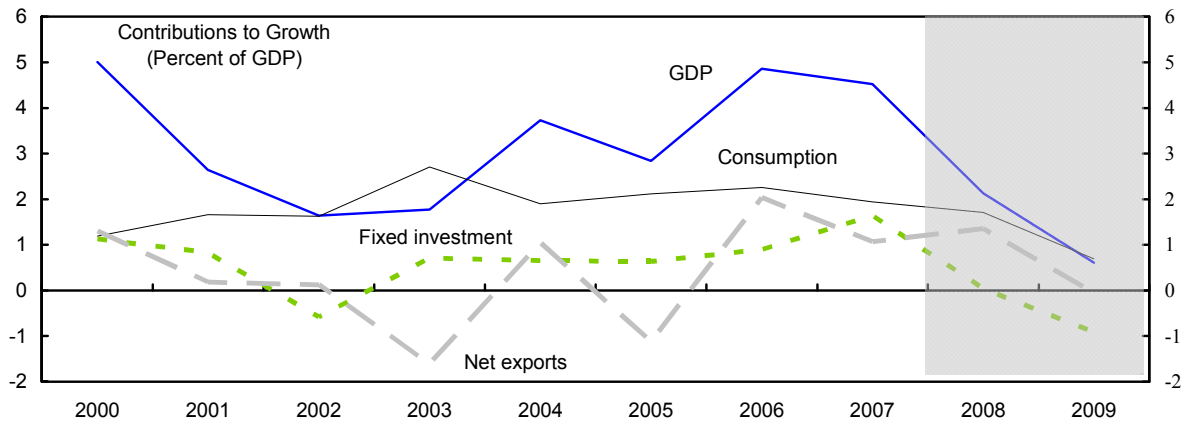
Table 7. Finland: Recent Fund Staff Recommendations and Implementation 1/

Past Staff Recommendations	Implementation
<p>Fiscal Policy</p> <p>Although the general government surplus has been sizable in recent years, the overall fiscal position under current policies remains unsustainable. Efforts should focus on expenditure restraint, especially at the local level, in light of high tax rates. The efficiency of public services needs to be raised. It may be necessary to further revisit the pension system's parameters.</p>	<p>Significant reforms in the pension system were adopted in 2005, with a life expectancy coefficient to be applied from 2009. The multi-year expenditure rule was reformed to increase its effectiveness. Efforts to improve expenditure efficiency are being implemented, with greater success to date at the central government level. Intergovernmental financing rules are being revised and measures to encourage municipal mergers have been adopted.</p>
<p>Labor Market Policy</p> <p>The wage bargaining system needs to allow for greater flexibility in wage setting. Measures are needed to ease labor market mismatches, reduce structural unemployment, and induce earlier entry into the labor force. Various "pipelines" to early labor force departure need to be further curtailed.</p>	<p>Employment gains under previous government exceeded its target, and Lisbon strategy employment targets (overall, women and older workers) are already met. Centralized bargaining was not in force in the current wage negotiations. Labor tax rates have been cut generally, with additional specific reductions targeted for older, less productive workers. These cuts are to be extended notably to young labor market entrants. Tax incentives and subsidies have been created for labor-intensive services, home care and service work and to promote occupational and regional labor mobility. New Ministry of Employment and the Economy formed to ensure more effective cooperation of economic, industrial and labor policies. Labor force service centers have been established for the hard-to-employ. The unemployment pension is to be phased out from 2009, and the "unemployment pipeline" was tightened to begin from age 57. A tripartite working group has been established to recalibrate the balance between flexibility and security ("flexicurity"). Another group was established to initiate a comprehensive social security reform to promote work incentives, reduce poverty and ensure adequate basic security.</p>
<p>Competition Policy</p> <p>Strengthen competition in product markets, especially in "sheltered" sectors, to boost productivity growth.</p>	<p>Competition Authority's powers have been enhanced to more directly address anti-competitive behavior, and the new government has formed a working group to review existing competition legislation. Research has been launched to assess developments in competition, specifically in the service sector. Companies and Auditing Acts amended to make it easier to set up new companies and reduce administrative burdens, and a national action plan is to be introduced for better regulation. Government goal adopted to increase R&D to 4 percent of GDP and make better use of ICT, and promote innovation. Implementation of the EU services directive began in 2007.</p>
<p>Financial Sector Policy</p> <p>Strengthen financial sector stability, especially regarding cross-country supervision, and improve stress testing techniques.</p>	<p>Good progress has been made in expanding the scope of stress tests. Cooperation has been enhanced with foreign supervisors regarding foreign-owned Finnish financial institutions. Supervisors are also working closely with market participants and foreign supervisors to improve supervision of an increasingly cross-border "infrastructure." Merger of Financial Supervisory Authority and Insurance Supervisory Authority to take effect in 2009.</p>

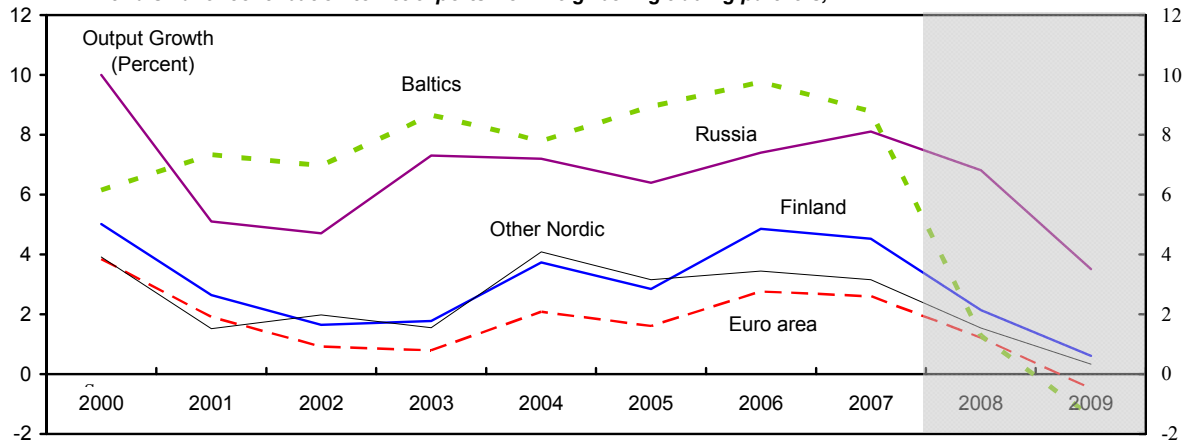
1/ See the Country Reports for 2005 and 2007 (<http://www.imf.org/external/pubs/cat/longres.cfm?sk=18857.0>, <http://www.imf.org/external/pubs/cat/longres.cfm?sk=21258.0>).

Figure 1. Finland: Growth and Inflation, 2000-09

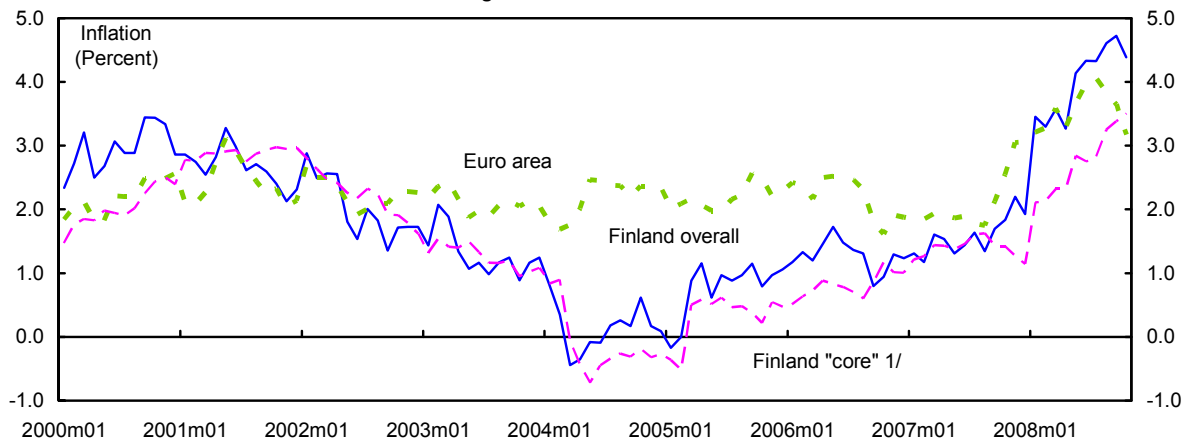
Growth is expected to slow to some 2 percent this year, and to only 1/2 percent next year,...



...with a smaller contribution to net exports from neighboring trading partners,...

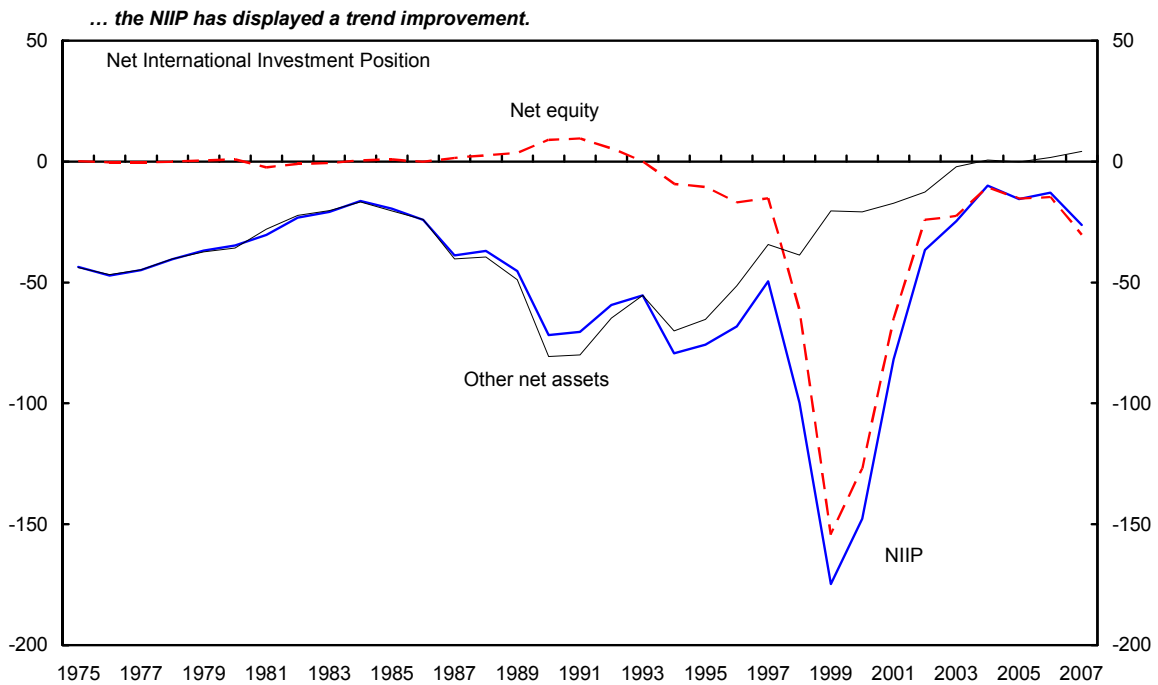
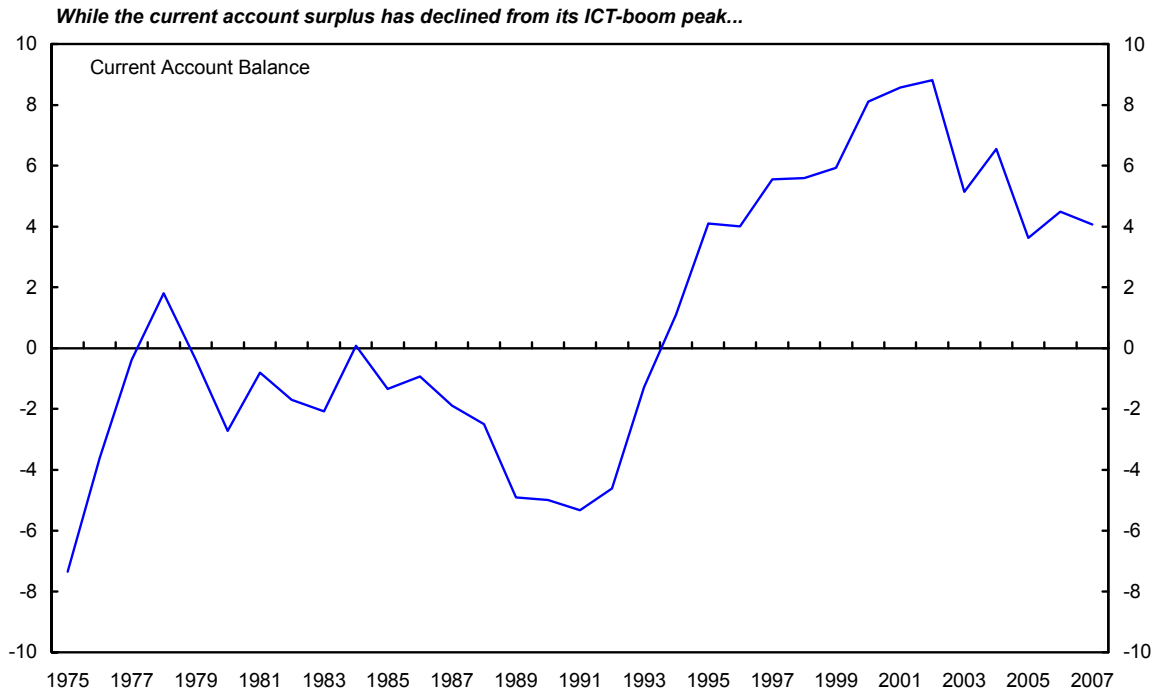


...while inflation exceeds the euro area average for the first time since 2002.



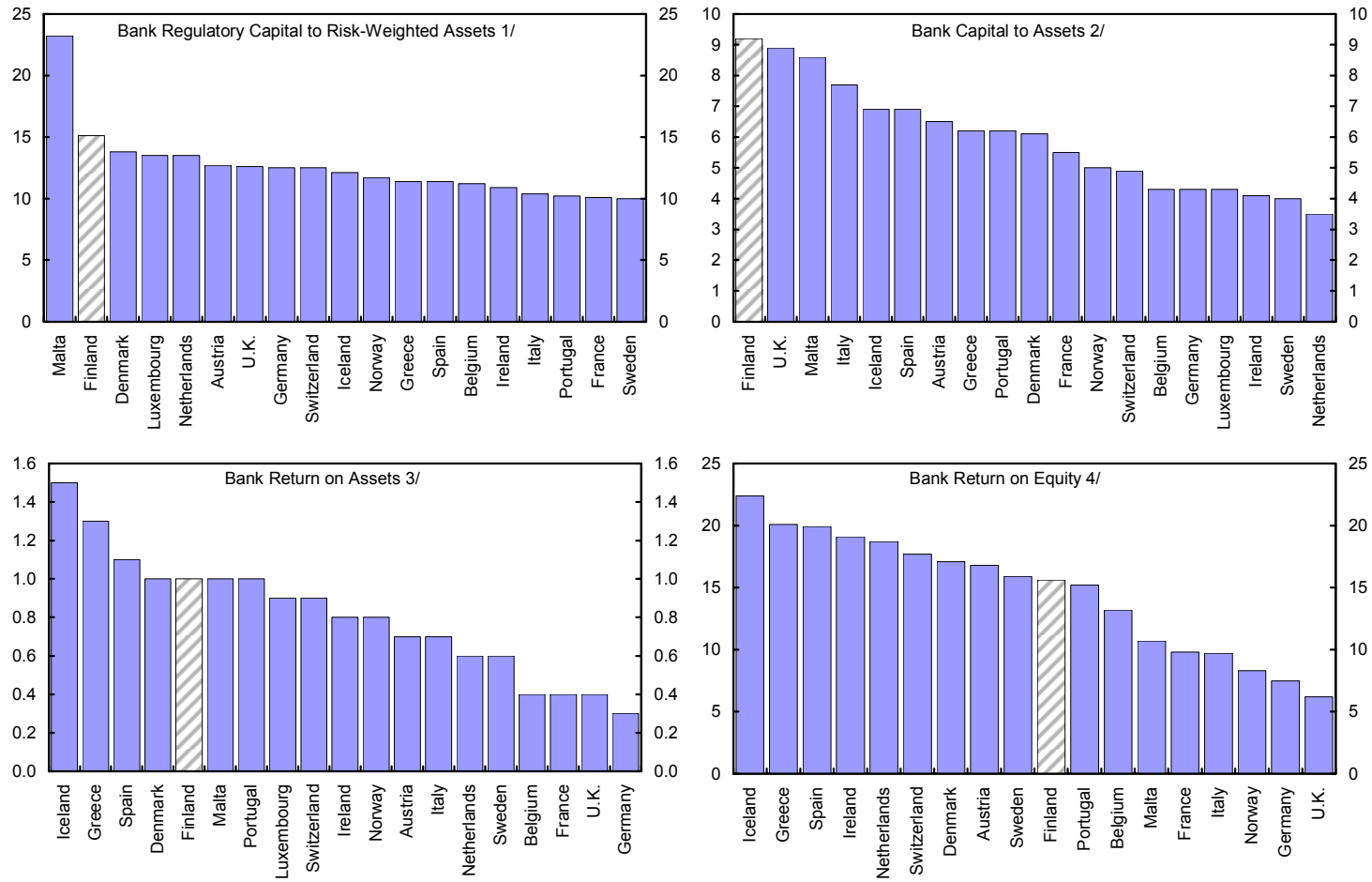
Sources: Statistics Finland Eurostat; and IMF staff estimates.
 1/ Overall excluding energy and unprocessed food.

Figure 2. Finland: Current Account and Net International Investment Position, 1975-2007
(Percent of GDP)



Sources: IFS; WEO.

Figure 3. Finland: Selected Banking Ratios, 2007



Source:IMF Draft Fall 2008 GFSR.

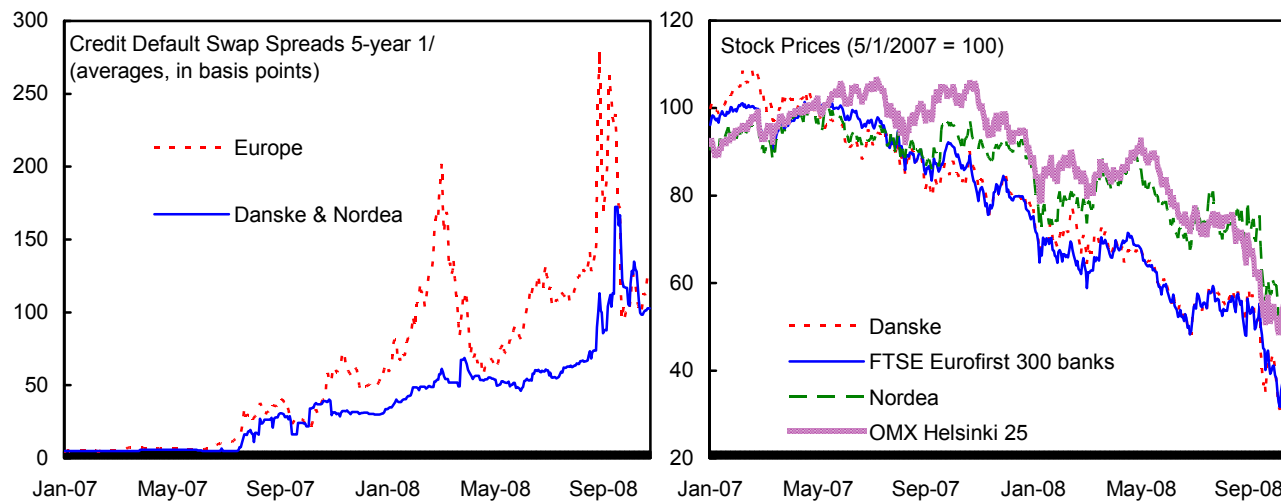
1/ Data for Denmark, Germany and Iceland are for 2006; data for the Netherlands and Sweden are for 2008Q1.

2/ Data for Finland, the U.K., Malta, Norway, Switzerland and Germany are for 2006; data for Spain, France, Luxembourg, Ireland and Sweden are for early 2008.

3/ Data for Denmark, Switzerland, Finland, Ireland, Norway and Germany are for 2006; data for Sweden are for 2008Q1.

4/ Data for Ireland, Switzerland, Denmark and Germany are for 2006; data for Sweden and Norway are for 2008Q1.

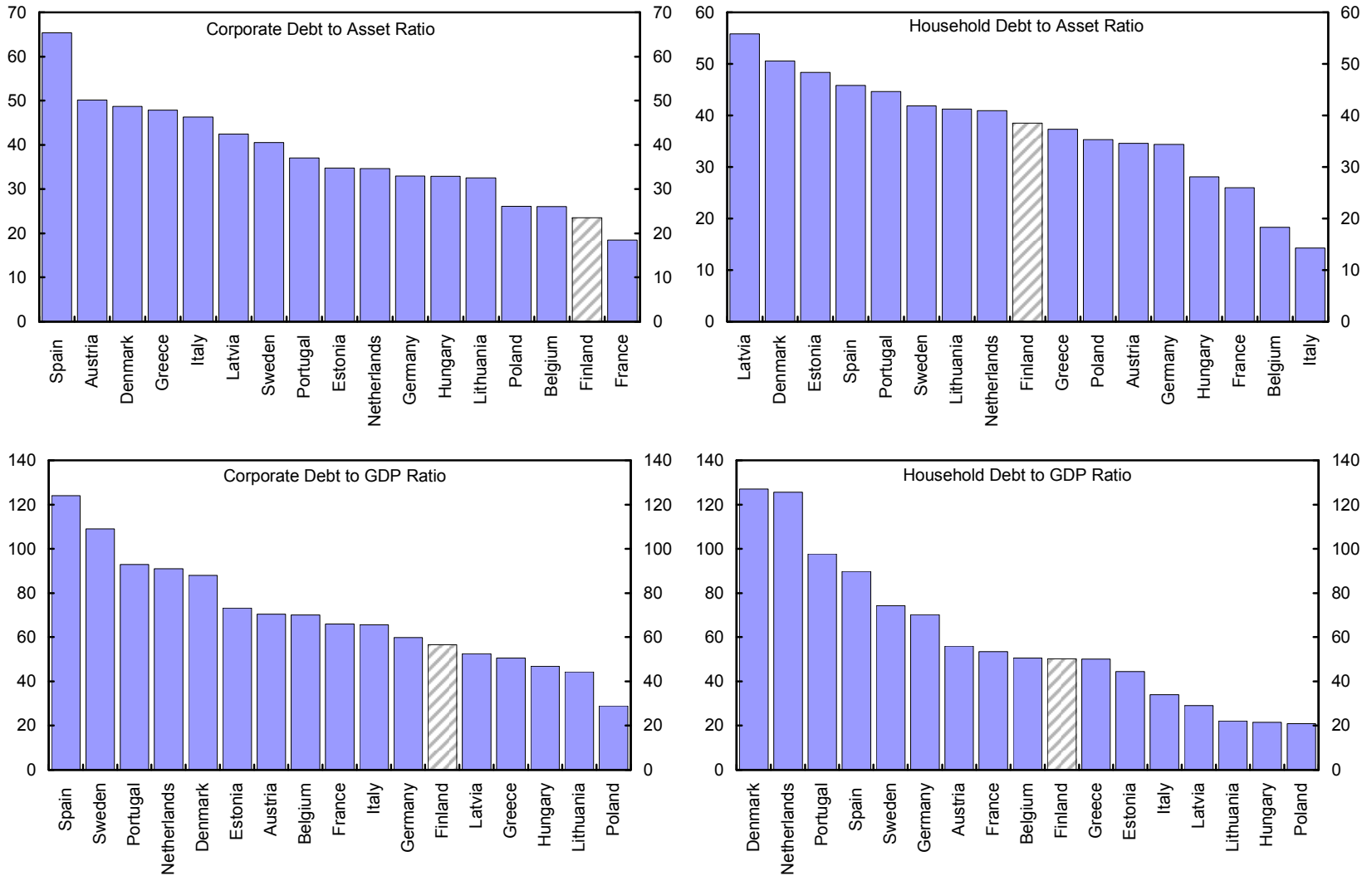
Figure 4. Finland: Developments in the Financial Sector, 2007-08



Source: Bloomberg.

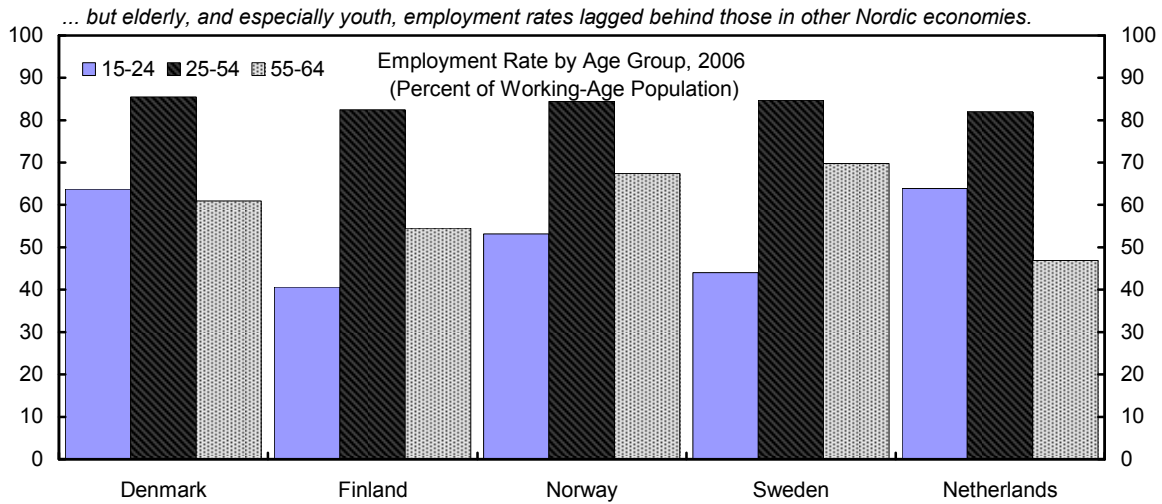
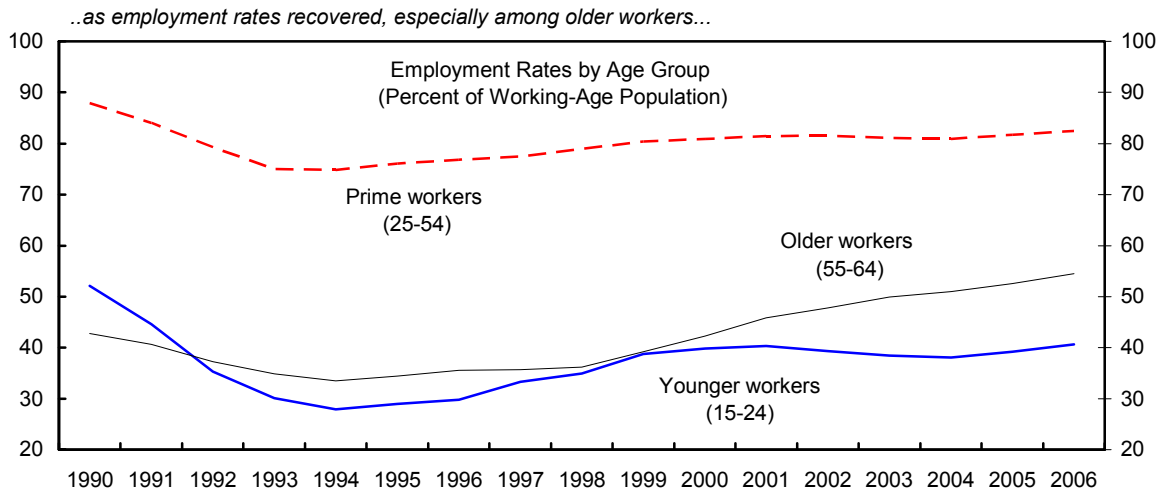
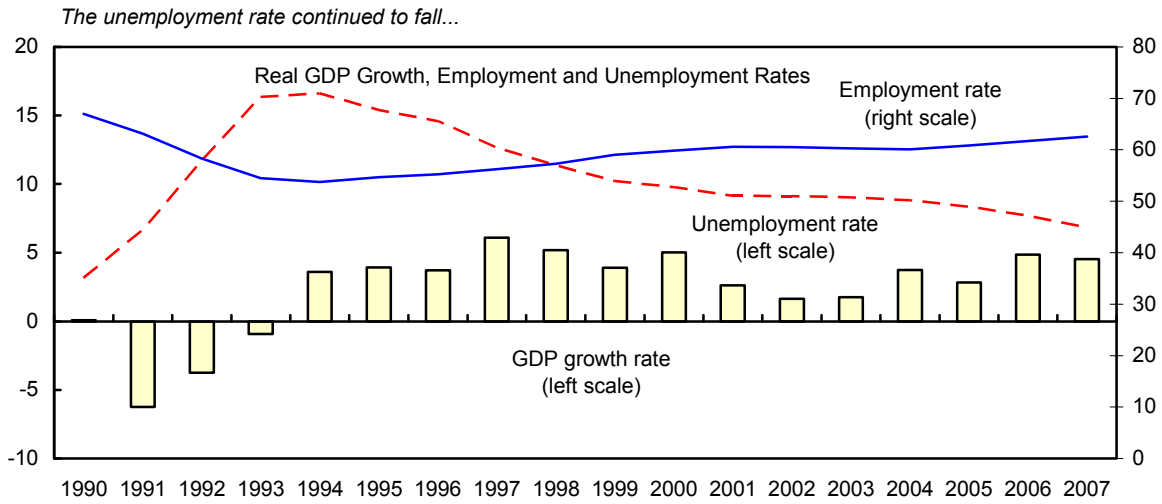
1/ Europe is an average of RBS, HBOS, HSBC, UBS, and Barclays.

Figure 5. Finland: Corporate and Household Debt Ratios, 2002-06 Averages



Source: IMF European Department Regional Economic Outlook, Fall 2008.

Figure 6. Finland: Labor Market Developments, 1990-2007

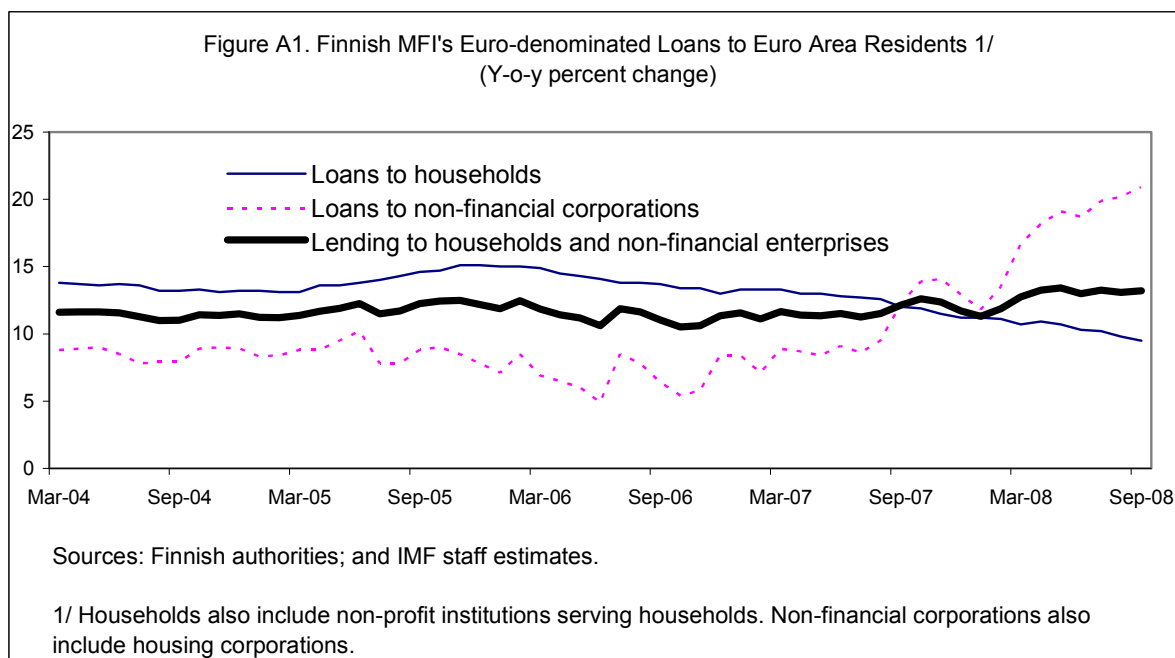


Sources: Statistics Finland; OECD.

Appendix I. Financial-Real Sector Linkages in Finland⁶

1. **As discussed in the main text of this report, the impact of the global financial turmoil on the Finnish banking sector's performance has so far been limited.**

Furthermore, credit growth has remained robust. Indeed, lending to non-financial enterprises accelerated to about 21 percent at end-September 2008, from about 8 percent at end-2006, in part reflecting the uncertainties and increased costs of enterprises' bond market access (Figure A1).⁷



2. **To assess the (direct) impact of the expected slowdown and ongoing global financial turmoil on credit availability and GDP growth, we use a three-pronged approach.** First, we build a financial conditions index (FCI), using vector autoregressions (VAR) and impulse-response functions (IRF). Second, we estimate a disequilibrium model of a system of equations for the supply of and demand for credits. Third, we estimate the impact of credit growth on GDP growth, using simple correlations and VAR.⁸

⁶ Prepared by Etibar Jafarov (EUR).

⁷ Data on corporate lending should be interpreted with caution. Anecdotal evidence suggests that these data are distorted by enterprises continuing to draw on pre-crisis credit lines.

⁸ The first analysis follows the methodology used by Swiston, Bayoumi, and Mathai (2008). The main advantage of a VAR-based FCI with respect to other methodologies is that it accounts for both direct and indirect impact of shocks to financial variables on economic activity. The second and third analyses are similar to those in Pazarbaşıoğlu (1997) and Čihák and Koeva Brooks (2008), accordingly.

3. **The results indicate that the financial cycle has turned, but there was no “credit crunch” in Finland as of September 2008.** Tightening in financial conditions so far in 2007–08 is expected to reduce real GDP growth in 2008–09 by about $\frac{3}{4}$ percentage point, but this seems to be mainly related to demand factors such as weak economic activity, rather than supply factors such as capital destruction, balance sheet constraints, lack of access to market liquidity, and banks’ unwillingness to provide credits (as observed in some other developed economies). Indeed, the estimation of the equations for the supply of and demand for credits in Section B of this appendix suggests that (1) credit supply in 2008 was above the levels predicted by the model and (2) demand for loans has weakened. In addition, the estimations in Section C suggest that loan supply alone had limited impact on growth in Finland. One implication of these findings for policy-making could be that, in the absence of further shocks, Finland may not need a big package of bank recapitalization and that the fiscal stimulus to support growth is good also for the financial sector.

4. **Nevertheless, the outlook for credit quality bears watching, as activity is expected to further weaken.** While interest rates have increased globally, growth in both exports and domestic demand are expected to slow down significantly. Gross household debt has risen above disposable income, which, together with floating rates, suggests that vulnerability to adverse shocks has increased over the past few years, even though debt-servicing costs remain low.

A. VAR-Based FCI

5. **The FCI aggregates the impulse responses of GDP to a number of financial variables in a VAR model.**

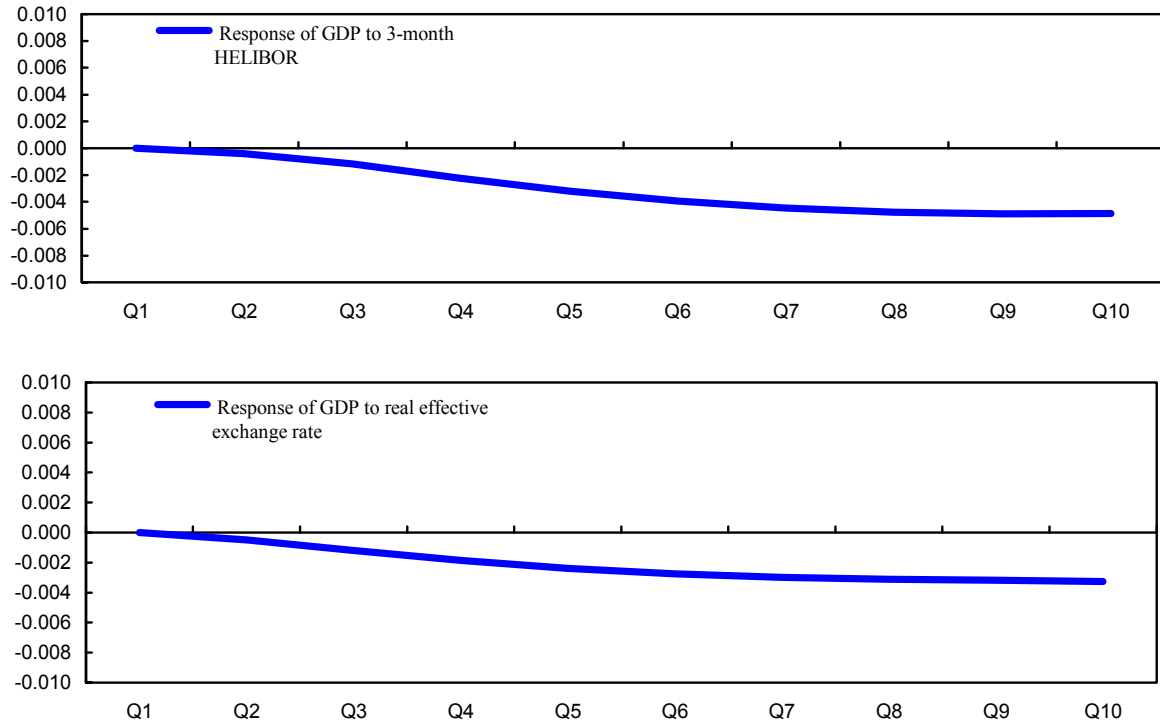
- First, to identify shocks, we use the Cholesky decomposition of the residuals and the following variables (in levels): real GDP (y_t); GDP deflator (def_t); distance-to-default (dtd_t); three-month HELIBOR (R_t); real effective exchange rate ($reer_t$); and real equity return (er_t). The choice of variables is determined by economic and statistical significance of variables and data availability.⁹ In addition, we took into account the results of other studies of financial conditions, including Gauthier, Graham, and Liu (2004), Goodhart and Hoffman (2002), and Swiston, Bayoumi, and Mathai (2008). Thus, the VAR model we estimate can be written as follows:

$$A(L)z_t = \alpha + e_t \tag{1}$$

⁹ Future studies on this subject will significantly benefit from including data on bank lending surveys in Finland, which were not available to us at the time of writing this appendix.

Where $z_t = (y_t, def_t, dtd_t, R_t, reer_t, er_t)'$, α is a vector of constants, and e_t is a vector of error terms.¹⁰ The estimated responses of variables to the shocks are mostly as expected. For example, increases in interest rates and real effective exchange rate appreciation reduce real GDP (Figure A2).

Figure A2. Response of GDP to Interest Rates and REER



Source: IMF staff estimates.

- Then, the FCI is estimated as in the following equation:

$$FCI_t = \sum_{j=1}^n \left[r_{t,j_{t-1}} + \sum_{i=2}^m (r_{t,j_{t-1}} - r_{t-1,j_{t-1}}) \right] \quad (2)$$

where r 's are the responses of GDP to each variable in the VAR, the j 's index the variables, and the i 's index the time period. The term in brackets measures the impact on GDP in quarter t of a financial shock occurring in the previous period. Since the variables in the system are expressed in levels, the marginal impact of a shock that occurred before the previous quarter is measured by subtracting the shock's effect on

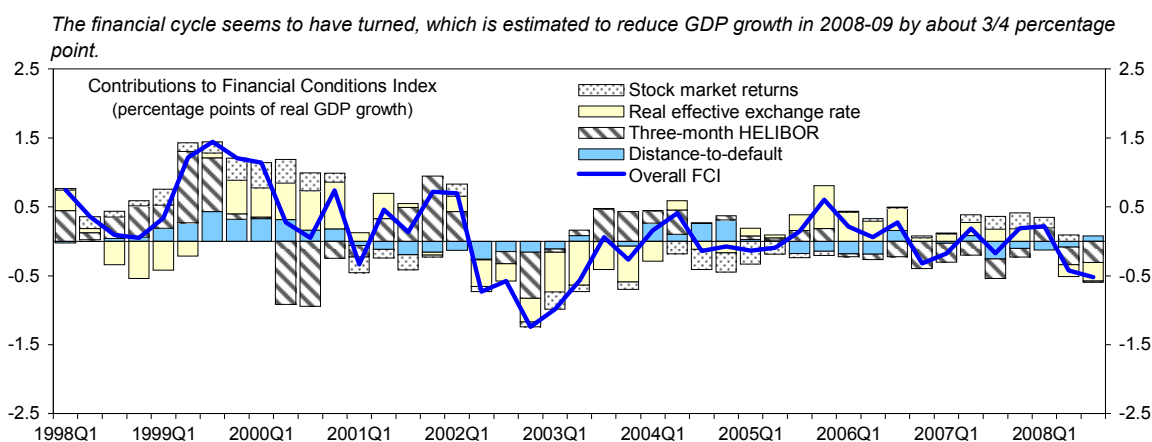
¹⁰ A different order of the elements in vector z was also used, but the main conclusions do not change.

the level of GDP in the previous period from its effect on the level of GDP in the current period.

- It is worth noting that both the level of the FCI and the direction of recent changes have implications for economic activity. For example, a value of 1 means that the total impulse of financial conditions to GDP is 1 percentage point, annualized. A decline in the FCI from 1 to $\frac{1}{2}$ would be expected to reduce GDP growth by $\frac{1}{2}$ percentage point, but the contribution still would be positive.

6. **The estimated FCI suggests that the financial cycle has turned (Figure A3).** The FCI was in negative territory in 2002–03, due to lingering effects of real exchange appreciation, increases in the interbank market rates, and stock market declines in 2000–02, meaning that it dragged GDP growth down in that period. It was generally in positive territory from early 2004 to late 2007, due mainly to declines in interbank market rates, contributing to GDP growth, and re-entered negative territory in 2008, owing to higher interest rates, lagged effects of real exchange appreciation, and the reversal of earlier stock price gains. Compared with 2007, the financial conditions are expected to reduce growth by about $\frac{3}{4}$ percent in 2008–09 (in the absence of further shocks). The analysis also suggests that changes in interest rates and the real effective exchange rate account for most of the changes in the FCI. On the other hand, the contribution of distance-to-default, used to approximate banks' willingness to provide credits, to the FCI is small.

Figure A3. Financial Conditions Index



Sources: Finnish authorities; and IMF staff estimates.

B. Disequilibrium Model of a System of Equations for the Supply of and Demand for Credits

7. **A disequilibrium model is estimated to identify the factors determining credit growth as well as excessive demand and supply of credits.** The model consists of a system

of equations for the supply and demand of credit. A general-to-specific approach yields the following equations.

$$\begin{aligned} \Delta l_t^s = & -0.004 + 0.57 \Delta l_{t-2}^s + 0.29 \Delta m3_{t-2} \\ & + 0.05 \left[\Delta \left(\frac{sp_b}{sp} \right) \right]_{t-2} + 0.06 \Delta dtd_t \\ & + 0.67 \Delta y_t + 0.05 \Delta mar_{t-2} + u_{1t} \end{aligned} \quad (3)$$

$$\begin{aligned} \Delta l_t^d = & -0.007 + 0.51 \Delta l_{t-2}^d - 0.04 \Delta i_t \\ & + 0.92 \Delta y_t + u_{2t} \end{aligned} \quad (4)$$

where, l^s stands for loan supply in real terms; $m3$ for broad money in real terms; sp_b/sp for the banking sector share price relative to the market average; dtd for distance-to-default; y for real GDP; mar for margin; l^d for demand for loans in real terms; i for lending rate in real terms; and u_t for shocks.¹¹

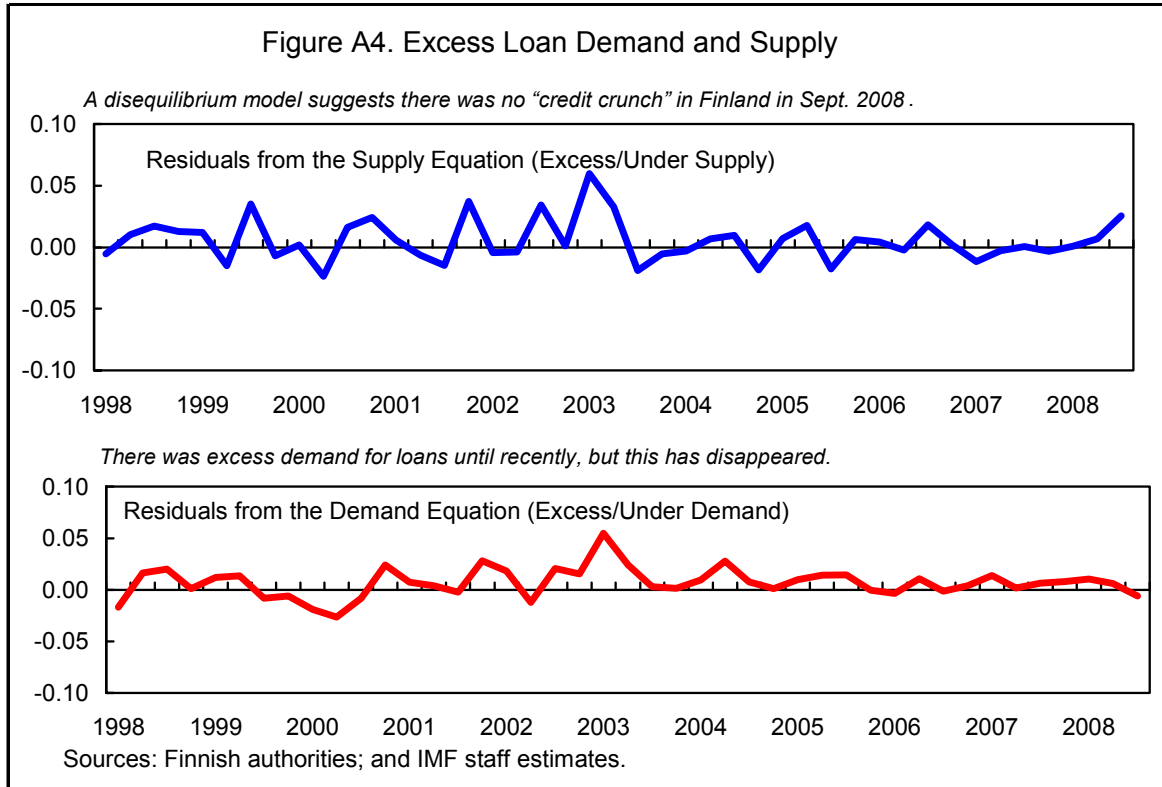
8. **The results portend that there was no generalized “credit crunch” in Finland in September 2008.** Specifically, growth in credit supply was above the levels predicted by the model. On the other hand, there was some excess growth in demand for loans in 2002–05, but that largely disappeared in 2008 (Figure A4). These results should be interpreted with caution since this analysis does not take into account other credit channels such as the bond market (Figure A5). Furthermore, we estimate supply of and demand for loans in aggregate terms. It is quite possible that some enterprises and households that would qualify for credits before the financial turmoil have had difficulty to obtain loans after the turmoil began.

C. Impact of Credit on GDP Growth

9. **Bank loans seem to have a limited impact on GDP growth in Finland.** We estimated the impact of loan growth on output, using both simple and instrumental variable regression, as well as the VAR technique. The coefficients on loan supply growth are

¹¹ Variables are in first differences since some variables appear to have unit roots. We found two cointegrating relationships between loans, GDP, lending rates, and distance-to-default, but these relationships were not statistically significant and were dropped out of equations 3 and 4. Also, we separately estimated similar equations for supply of and demand for loans to enterprises and households, but the results were not significantly different from those reported here.

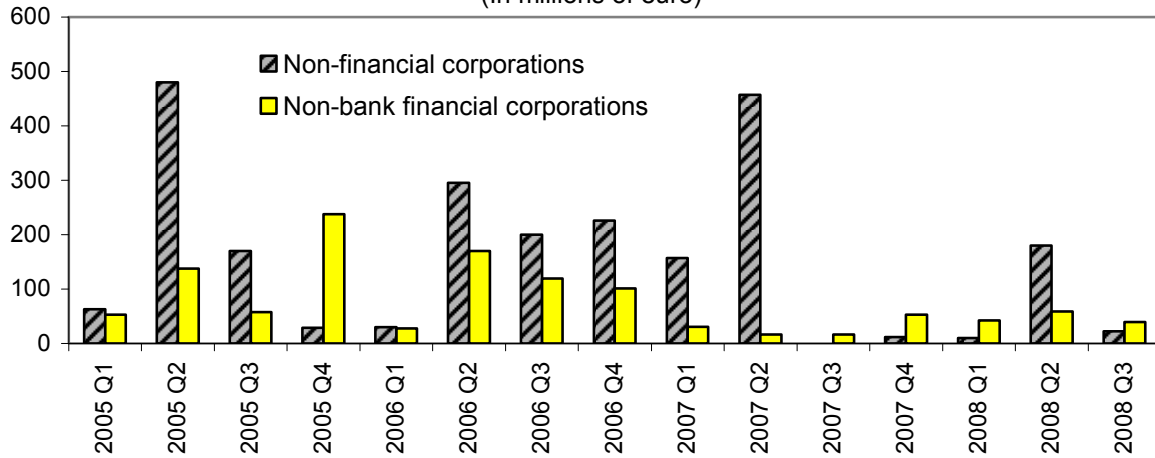
consistently small, and the variable is not statistically significant (Tables A1, A2, and A3), hinting that, in the recent past, loan growth has been of relatively little importance in explaining growth in Finland.^{12 13}



¹² The finding that bank loans have a limited impact on GDP growth does not contradict the conclusion in the previous section that the increases in interbank lending rates would contribute to the reduction in GDP growth in 2008-09. First, higher interbank rates account for less than half of the estimated impact of tighter financial conditions on GDP growth. In other words, the higher interbank lending rates would reduce GDP growth by only $\frac{1}{4}$ percent. Second, bank borrowing is not the only channel for enterprises (especially for large enterprises) to borrow funds. Third, lending rates may affect investment and consumption decisions even in the absence of borrowing. For example, lending rates are taken into account in the calculation of the cost of capital even when enterprises use their own funds to invest (in Finland, the corporate sector has been a net lender in the last five years). Finally, a cumulative impact of financial conditions of growth of $\frac{3}{4}$ percent of GDP over two years doesn't appear large.

¹³ Driscoll (2004) finds that loans have "small, often negative and statistically insignificant" effects on output in the USA. On the other hand, Čihák and Koeva Brooks (2008) find that a 10 percent increase in loan supply raises GDP growth by about 1 percentage point in the euro area.

Figure A5. Bond Issuance in Finland
(In millions of euro)



Source: Finnish authorities.

Table A1. Regression of Output on Loans

OLS Regression of Output on Loans			
	Coefficient	Std.Error	t-value
Δy_{t-1}	-0.03	0.13	-0.20
Δy_{t-2}	0.30	0.11	2.70
Δl_t	-0.07	0.04	-1.82
Δl_{t-1}	0.07	0.03	2.07
Δl_{t-2}	0.00	0.03	0.05
Constant	0.01	0.00	3.89
Obs.	63		
R-squared	0.17		

Sources: Finnish authorities; and IMF staff estimates.

Table A2. IV Regression of Output on Loans 1/

	Coefficient	Std.Error	t-value
Δl_t	0.00	0.05	0.08
Δy_{t-1}	-0.01	0.13	-0.07
Δy_{t-2}	0.24	0.12	1.96
Constant	0.01	0.00	4.14
Obs.	63		

Sources: Finnish authorities; and IMF staff estimates.

1/ Past values of loans are used as instruments.

Table A3. Vector Autoregression Estimates
 Included observations: 63 after adjustments
 Standard errors in () & t-statistics in []

	Δy	ΔI
Δy_{t-1}	0.28 (0.11) [2.45]	0.02 (0.39) [0.06]
Δy_{t-2}	0.39 (0.11) [3.44]	0.72 (0.39) [1.86]
ΔI_{t-1}	0.02 (0.02) [0.78]	0.09 (0.12) [1.66]
ΔI_{t-2}	-0.02 (0.03) [-0.68]	0.45 (0.11) [4.23]
C	0.00 (0.00) [1.81]	0.00 (0.00) [-0.96]
Adj. R-squared	0.33	0.39
F-statistic	9.65	11.97
Log likelihood	243.66	156.91

Sources: Finnish authorities; and IMF staff estimates.

D. Conclusions

10. **We conclude that financial conditions in Finland have tightened, but this outcome was not related to supply-side problems as in some other developed economies.** On the one hand, the analysis in Section A of this appendix suggests that financial conditions have stiffened, which is expected to reduce real GDP growth in 2008–09 by about $\frac{3}{4}$ percentage points. However, this is mainly related to the increases in interbank market rates since mid-2007 and lingering effects of real exchange appreciation, with no significant contribution from the distance-to-default (used here as a proxy for banks' willingness to provide credits). On the other hand, the estimate of the disequilibrium model of a system of equations for the supply of and demand for loans in Section B suggest that (1) credit supply in September 2008 was above the levels predicted by the model and (2) there was excess demand for loans in 2003–07, but that excess demand has disappeared since then. These findings are consistent with the facts that Finnish banks are well capitalized, have largely maintained their access to interbank market, and have a strong deposit base. Indeed, both deposits and corporate lending of Finnish banks surged in the first three quarters of 2008. Moreover, the analysis in Section C suggests that bank lending has had so far limited impact on GDP growth in Finland. These conclusions imply that, in the absence of further shocks,

Finland may not need a big bank recapitalization package, as some other developed economies, and that the adopted fiscal stimulus to support growth is good also for the financial sector.

11. Our findings also suggest that the outlook for credit quality remains uncertain, since both external and domestic demand are expected to decelerate further.

Widespread recourse to floating rates has increased vulnerability to adverse shocks over the past few years, even though debt-servicing costs remain low, and this risk may be exacerbated by weaker economic activity.

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ANNEX I. FINLAND: FUND RELATIONS
(As of November 30, 2008)

- A staff team comprising Messrs. Figliuoli (head), Lutz, Jafarov (all EUR), and Shah (MCM) visited Helsinki during October 23–November 3. They met Mr. Liikanen, Governor of the Bank of Finland, Mr. Katainen, Minister of Finance, other senior officials of the central bank, economic ministries, and the Financial and Insurance Supervisory Authorities. Mr. Hukka, an Advisor to Executive Director for the Nordic-Baltic region, participated in the discussions.
- The mission consulted with many members of the Finnish policy community. Meetings were held with the Chairman of the Parliamentary Finance Committee, representatives of the Finnish Trade Unions (SAK), the Confederation of Industries (EK), the Association of Local Authorities (Kuntaliitto), and members of the business, and private financial communities.
- The mission's concluding statement and press conference received wide coverage in the Finnish media. The authorities intend to publish the staff report.

I. **Membership Status:** Joined January 14, 1948; Article VIII.

II. General Resources Account:	SDR Million	Percent of Quota
Quota	1,263.80	100.00
Fund holdings of currency	1,102.79	87.26
Reserve Position	161.05	12.74

III. SDR Department:	SDR Million	Percent of Allocation
Net cumulative allocation	142.69	100.00
Holdings	155.19	108.76

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

V. **Latest Financial Arrangements:** None

VI. **Projected Payments to Fund:**
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming			
	2009	2010	2011	2012
Principal				
Charges/Interest	<u>0.01</u>	<u>0.01</u>	<u>0.01</u>	<u>0.01</u>
Total	0.01	0.01	0.01	0.01

VII. Exchange Arrangements:

Finland's currency is the euro, which floats freely and independently against other currencies.

Finland has accepted the obligations under Article VIII, Sections 2(a), 3 and 4 of the Fund's Articles of Agreement, and maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those measures imposed for security reasons in accordance with Regulations of the Council of the European Union, as notified to the Executive Board in accordance with Decision No. 144-(52/51). An updated and comprehensive list of all EU restrictions can be found at:

http://ec.europa.eu/external_relations/cfsp/sanctions/measures.htm

VIII. Article IV Consultation:

Discussions for the 2007 Article IV consultation were held in Helsinki during May 22–31, 2007 and the Executive Board concluded the consultation on August 1, 2007. Country Report No. 07/279, summarizing the views of the Executive Board, was published.

ANNEX II. FINLAND: STATISTICAL ISSUES
(As of December 5, 2008)

E. Assessment of Data Adequacy for Surveillance

General: Data provision is adequate for surveillance.

F. Data Standards and Quality

Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since June 3, 1996. Uses SDDS flexibility option on the timeliness of data on both general and central government operations.

A data ROSC was electronically published on October 31, 2005 (<http://www.imf.org/external/pubs/cat/longres.cfm?sk=18675.0>). The Finnish authorities have worked to satisfy the data ROSC mission team's recommendations in the area of government finance statistics. More specifically, they have increased the detail on revenue and expense classifications, which are now consistent with both ESA 95 and requirements of Eurostat's quarterly GFS database, as well as the recommendations of the IMF's Government Finance Statistical Manual, 2001.

Finland: Table of Common Indicators Required for Surveillance
(As of December 5, 2008)

	Date of latest observation	Date received	Frequency of Data ⁷	Frequency of Reporting ⁷	Frequency of publication ⁷	Memo Items:	
						Data Quality – Methodological soundness ⁸	Data Quality – Accuracy and reliability ⁹
Exchange Rates	Nov. 19, 2008	Nov. 19, 2008	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities ¹	Oct. 2008	Nov. 2008	M	M	M		
Reserve/Base Money	Oct. 2008	Nov. 2008	M	M	M		
Broad Money	Sept. 2008	Oct. 2008	M	M	M		
Central Bank Balance Sheet	Oct. 2008	Nov. 2008	M	M	M		
Consolidated Balance Sheet of the Banking System	Sept. 2008	Oct. 2008	M	M	M		
Interest Rates ²	Nov. 19, 2008	Nov. 19, 2008	D	D	D		
Consumer Price Index	Oct. 2008	Nov. 2008	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – General Government ⁴	2007	Mar. 2008	A	A	A	LO, LO, LNO, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing ³ – Central Government	2007	Mar. 2008	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt ⁵	Oct. 2008	Nov. 2008	M	M	M		
External Current Account Balance	Sept. 2008	Nov. 2008	M	M	M		
Exports and Imports of Goods and Services	Q2. 2008	Sept. 2008	M	M	M	O, O, O, LO	LO, O, LO, O, O
GDP/GNP	Q2. 2008	Sept. 2008	Q	Q	Q	O, O, O, O	LO, O, LO, O, O
Gross External Debt	Sept. 2008	Nov. 2008	M	M	M		
International Investment Position ⁶	Sept. 2008	Nov. 2008	M	M	M		

¹Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

²Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

³Foreign, domestic bank, and domestic nonbank financing.

⁴The general government consists of the central government, including National Insurance Scheme, and local governments.

⁵Including currency and instrument composition.

⁶Includes external gross financial asset and liability positions vis-à-vis nonresidents.

⁷Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).

⁸Reflects the assessment provided in the data ROSC published in October 2005, and based on the findings of the mission that took place during May 10–25, 2005 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).

⁹Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

**Statement by the IMF Staff Representative
January 30, 2009**

1. **This statement summarizes economic developments in Finland since issuance of the staff report.** The additional information does not change the thrust of the staff appraisal.
2. **Economic growth contracted sharply at the end of 2008, while inflation is decelerating more slowly than in other euro area economies.**
 - Seasonally adjusted output fell by 1.6 percent year-on-year in October 2008. Industrial production plunged by about 10 percent year-on-year in November, with a near-collapse in the wood and paper industry. New orders for manufacturing were off by one-third. Consumer confidence in December dropped to its lowest level since the early 1990s. Accordingly, staff has pared down the estimate of 2008 GDP growth to 1½ percent.
 - The harmonized (HICP) inflation rate declined to 3.4 percent in December. Nevertheless, it remains well above the 1.6 percent euro area average, a gap that has widened throughout the fall. Nominal hourly wages accelerated further to 6.7 percent in the third quarter, well above the 4 percent euro area average.
3. **Staff has further lowered its growth projections for 2009 and 2010, to -1 and 1¼ percent respectively.** The revision reflects lower activity among trading partners as well as reduced domestic demand. It is in line with revisions to the euro area projections in the context of the January interim WEO update. With worse-than-envisaged terms of trade and exports decelerating faster than imports, the external current account surplus in 2009 and the medium term is expected to shrink more than anticipated by the staff report.
4. **Amid a deteriorating economic environment, the Finnish authorities have adopted a number of budgetary measures to support activity.** In addition to the tax cuts already included in the draft 2009 budget and noted in the staff report, the government has decided to raise spending, including for building construction and renovation, and for infrastructure projects in transport and energy. The overall package of discretionary loosening is estimated at about 1¼ percent of GDP. Owing also to the worsened growth outlook, the headline surplus is now projected to decrease to 1¼ percent of GDP in 2009.
5. **The financial sector remains under stress, but appears to be comparatively resilient.** Banks' capital adequacy remains well above minimum levels. Banks have not needed to make use of government guarantees for debt issuance, nor has any government-funded recapitalization been necessary. Lending conditions are reported to have tightened, but credit growth remained robust through October, although this may be partly due to a sluggish corporate bond market.

Finland: Selected Economic Indicators

	Staff Report 2008 1/	Revised 2008 1/	Staff Report 2009 1/	Revised 2009 1/	Staff Report 2010 1/	Revised 2010 1/
Real economy						
GDP (change in percent)	2.1	1.5	0.6	-1.0	1.6	1.2
Harmonized CPI (change in percent) 2/	4.0	3.9	2.5	1.8	2.0	1.9
Gross national savings (in percent of GDP)	26.2	26.4	25.1	24.5	24.2	23.0
Gross domestic investment (in percent of GDP)	22.2	22.7	21.5	22.3	21.7	22.0
Public finances (general government, percent of GDP)						
Overall balance	4.7	4.2	2.7	1.3	2.4	0.9
Primary balance 3/	4.1	3.6	2.0	0.7	1.6	0.0
Gross debt (Maastricht definition)	32.4	32.6	31.2	32.0	29.2	30.0
Money and credit (end of year, percentage change)						
M3 (Finnish contribution to euro area) 4/	8.2	6.6	...	...	...	...
Finnish MFI euro area loans 4/	13.1	12.7	...	...	...	...
Interest rates (year average)						
Three-month money market 5/	4.8	4.6	...	...	...	...
Ten-year government bonds 5/	4.2	4.3	...	...	...	...
Balance of payments (in percent of GDP)						
Trade balance	4.7	4.5	4.1	3.1	3.2	2.0
Current account	4.0	3.6	3.5	2.3	2.5	1.0
Exchange rate						
Nominal effective exch. rate (increase in percent) 6/	0.3	-0.8	...	...	...	...
Real effective exchange rate (increase in percent) 6/ 7/	1.8	0.6	...	...	...	...

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

1/ IMF staff estimates and projections.

2/ Consistent with Eurostat methodology.

3/ Defined as non-interest revenue minus non-interest expenditure.

4/ 2008 data for staff report are annual change through September, while revised 2008 data are through November.

5/ 2008 data for staff report are for end-October, while revised 2008 data are year averages.

6/ 2008 data for staff report are for first 10 months, while revised 2008 data are for first 11 months.

7/ Based on unit labor costs.



INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
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Public Information Notice (PIN) No. 09/13
FOR IMMEDIATE RELEASE
February 4, 2009

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

IMF Executive Board Concludes 2008 Article IV Consultation with Finland

On January 30, 2009, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.¹

Background

Although among the best EU performers, the Finnish economy faces important challenges. Spillovers from the global turmoil are adversely affecting activity and may weaken the financial system. High wage increases have raised the risk of a wage-price spiral that could maintain inflation above the EU average and erode competitiveness. Looking forward, rapid aging and slowing productivity threaten longer-term growth, competitiveness, and fiscal sustainability. Improved pension fund management could help cope with aging, while growing financial integration and complexity create new risks and supervisory challenges.

While growth was robust in 2007, with activity significantly above potential, expansion slowed sharply in the first three quarters of 2008. Growth is projected to decelerate to about 2 percent in 2008 and further to ½ percent in 2009. Amid a flagging external environment, sluggish employment growth, the erosion of real disposable income by higher inflation and debt servicing, squeezed profit margins, and rising financing costs will restrain both consumption and investment. The cumulative direct impact of financial tightening on 2008–09 growth is estimated at ¾ percentage points.

A tight labor market and the disappointing outcome of decentralized wage negotiations, with little heed paid to productivity gains and differentials, contributed to boost inflation in

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.

late 2008 to 4¾ percent, well above the euro zone average. Rising unit labor costs and “core inflation” risk swelling inflationary expectations, fueling second-round effects from the price hike, although worsening job prospects may temper this concern. With lower fuel prices, inflation is anticipated to recede slowly. Various estimates suggest that external competitiveness is adequate. The current account surplus has hovered around a sizable 4–4½ percent of GDP in recent years.

The fiscal position stays enviable, although the general government surplus is set to drop. It surged to 5¼ percent of GDP in 2007, buoyed by economic expansion and spending moderation. Indeed, despite a large expected increase in aging-related expenditures, the fiscal position would already be sustainable from a long-term perspective. However, recently adopted or anticipated discretionary measures imply a substantial reduction of the surplus, inconsistent with eventual stability of the public-debt-to-GDP ratio.

Banks have been largely sheltered from the turmoil, but profitability, cross-country supervision, mortgage lending, and links to insurance companies and foreign affiliates require attention. Key financial stability indicators remain quite healthy, and exposure to “toxic assets” is minimal. However, the ongoing turbulence does affect banks indirectly through lower growth, and thus less profitability. House prices have risen comparatively moderately, while household and nonfinancial enterprise balance sheets remain strong, although household borrowing has increased sizably in recent years. With some 60 percent of banking assets foreign-owned, strengthened cross-country supervision is key. Insurance and pension companies have suffered significant losses owing to plummeting capital markets, although minimum solvency ratios continue to be met.

Executive Board Assessment

Executive Directors commended the Finnish authorities’ pursuit of prudent and stability-oriented policies, which have underpinned Finland’s strong economic performance and fundamentals in recent years. High per capita GDP growth until recently, fiscal and current account surpluses, a low ratio of public debt to GDP, and a sound financial system provide the authorities with substantial room for maneuver during the current global economic crisis.

Directors noted that spillovers from the global turmoil have adversely affected economic growth. Moreover, while Finnish financial institutions have proven resilient to the ongoing turbulence so far and stability indicators are relatively healthy, the downturn poses risks to the financial system. Looking further forward, Directors underscored that rapid population aging, slowing productivity growth, and labor and product market rigidities pose challenges to longer-term growth and fiscal sustainability.

In light of Finland’s sizable general government surplus, Directors agreed that a structural fiscal relaxation is warranted in the present circumstances, as part of a coordinated EU-wide fiscal stimulus consistent with European Council guidelines. Directors cautioned that this short-term budgetary easing should not adversely affect long-term fiscal sustainability, and supported the use of measures that can be implemented rapidly and scaled back once activity rebounds. They emphasized that,

once growth resumes, early action should be taken to address the long-term fiscal sustainability issue.

Directors acknowledged that expenditure restraint should be the lynchpin of efforts to achieve fiscal sustainability. In this regard, improved expenditure efficiency supplemented by user fees to moderate demand for public services will be important. Directors supported a shift from labor income to less distortionary taxation, especially as it would also help increase labor force participation. However, most Directors considered the planned cut in the value added tax rate on food to be undesirable on efficiency grounds, while a few Directors saw merit in the measure from an equity perspective and as a short-term tax stimulus. Directors believed that the recent easing of pension fund investment guidelines could lead to higher long-term returns and thus also buttress the long-term fiscal position.

Directors noted the staff's assessment that the real exchange rate maintains a moderate margin of external competitiveness. They concurred that Finland's competitiveness is adequate, but could be undermined if high wage awards in excess of productivity gains continue.

Executive Directors commended the authorities for their effective supervision of the Finnish financial system. They noted stress tests results indicating that banks could withstand fairly severe shocks. Nevertheless, Directors urged the authorities to remain vigilant to financial sector risks. In particular, they cautioned that the economic downturn could worsen bank profitability and liquidity, especially through contagion from parent banks given the large share of foreign-owned banks in the banking system. They welcomed the steps that have been taken to guarantee bank debt renewal and to recapitalize banks, if needed, and urged further enhancements in cooperation with home supervisors of foreign-owned banks.

Directors underscored the importance of raising labor utilization and productivity growth to support economic growth and fiscal sustainability. They welcomed the authorities' intention to raise the still-low effective retirement age. They considered that a shift to less centralized wage bargaining could increase labor market flexibility while differentiated wage increases should better reflect productivity differentials. This could stimulate labor force participation while preserving competitiveness. Directors also urged that additional measures be taken to enhance competition and productivity in product markets, especially in the "sheltered" sectors.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The [staff report](#) (use the free [Adobe Acrobat Reader](#) to view this pdf file) for the 2009 Article IV Consultation with Finland is also available.

Finland: Selected Economic Indicators

	2006	2007	2008 1/	2009 1/
Real economy				
GDP (change in percent)	4.9	4.5	1.5	-1.0
Harmonized CPI (change in percent) 2/	1.3	1.6	3.9	1.8
Unemployment rate (in percent) 2/	7.7	6.8	6.4	7.2
Gross national saving (in percent of GDP)	26.3	27.3	26.4	24.5
Gross domestic investment (in percent of GDP)	21.8	23.3	22.7	22.3
Public finances (general government, in percent of GDP)				
Overall balance	4.0	5.3	4.2	1.3
Primary balance 3/	3.7	4.8	3.6	0.7
Gross debt (Maastricht definition)	39.2	35.2	32.6	32.0
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area) 4/	8.1	19.7	6.6	...
Finnish MFI euro area loans 4/	11.5	11.7	12.7	...
Interest rates (year average)				
Three-month money market	3.1	4.3	4.6	...
Ten-year government bonds	3.8	4.3	4.3	...
Balance of payments (in percent of GDP)				
Trade balance	5.5	4.9	4.5	3.1
Current account	4.5	4.1	3.6	2.3
Fund position (as of end-December 2008)				
Fund holding of currency (in percent of quota)		87.3		
Holdings of SDRs (in percent of allocation)		108.8		
Quota (in millions of SDRs)		1,263.80		
Exchange rate				
Exchange rate regime		Euro		
Present rate (February 3, 2009)		US\$1.29 per euro		
Nominal effective exchange rate (increase in percent) 5/	0.0	2.2	-0.8	...
Real effective exchange rate (increase in percent) 5/ 6/	0.9	1.0	0.6	...

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

1/ IMF staff estimates and projections, unless otherwise indicated.

2/ Consistent with Eurostat methodology.

3/ Defined as non-interest revenue minus non-interest expenditure.

4/ For 2008, annual change through November.

5/ For 2008, data re for first 11 months.

6/ Based on unit labor costs.

**Statement by Jen Henriksson, Executive Director for Finland
and Janne Hukka, Advisor to Executive Director
January 28, 2009**

1. Finland's outlook as a small open economy is intimately connected with the state of the international business cycle. Hence, the recent sharp deterioration in the external environment has led to a more rapid than expected turnaround in economic activity. The close-to-potential GDP growth in the first half of 2008 was followed by a significant slowdown particularly towards the end of the year. A slump in new orders and cancellations of existing orders, coupled with tighter financing conditions, have turned prospects in industry bleak. A rapid fall in investments, a wave of lay-offs and weakening consumer confidence have followed. Also the construction sector has been hard-hit by the subdued state of the housing market.
2. That said, Finland enters the crisis from a relative position of strength. The recent years of growth did not create significant imbalances in the economy. Notwithstanding the medium term demographic challenges, the prudent policies prior to the crisis have created comparatively comfortable fiscal space for counter-cyclical stimulus. Moreover, the collective memory of the previous crisis at the turn of the 1990s, combined with stabilizing effects of Finland's euro area membership, have prevented a build-up of large-scale financial sector vulnerabilities.

Recent Economic Developments and Outlook

3. Reflecting the most recent indicators of rapidly slowing economic activity, the authorities' expectations for the current year have become considerably more cautious than staff's revised projection. Just a week ago, the authorities indicated that they expect the Finnish GDP to contract by more than 2 percent in 2009. A gradual recovery will likely follow the bottoming out of the global downturn.
4. The contraction in growth will inevitably take its toll on employment. The rapid employment gains of recent years stabilized toward the end of 2008 and the unemployment rate is now set to rise for the first time in 15 years. As employers are forced to shed the labour reserves accumulated against the backdrop of expected labour shortages prior to the crisis, the impact on employment figures will also be steeper than usual. The authorities envisage that the unemployment rate will climb up to 8 – 9 percent by the end of 2009, compared to just over 6 percent last year.
5. The downturn has left growth in public demand as the main driving force in national output. Lower global demand, a rise in labour costs from the 2007 wage negotiations and the scaling down of forest industry production capacity have led to a discouraging outlook for Finnish exporters. Tighter financing conditions and the decline in construction have further weighed down investment plans. The cuts in industrial output and rising unemployment have also eroded consumer confidence and

the projected increases in real disposable incomes over 2009-2010 do not fully translate into higher consumption.

6. After having been suppressed for a number of years, inflation accelerated considerably early last year and exceeded the euro area average for the first time in six years by mid-2008, reflecting higher labour costs and delayed hikes of food prices. With the reversal of energy prices and the rapid cooling of demand conditions, the pace of increase in consumer prices should fall close to or below 2 percent in 2009 and 2010.

Financial Sector Developments

7. The authorities share staff's view that the overall situation in the Finnish financial markets is still relatively unproblematic. Banks' short-term liquidity position is healthy and capital adequacy ratios are on solid levels. However, the cost of longer-term funding has increased markedly. Also, banks' profitability is weakening in line with the rapidly slowing growth, falling interest rates and reduced demand for housing loans and financial services in general.
8. Although no immediate need for public support is foreseen, the authorities are implementing measures in line with the EU principles agreed in October 2008 to support the functioning of the financial markets:
 - In December 2008, the Parliament approved a proposal for a state guarantee scheme for Finnish banks. The scheme allows adequately capitalised banks to apply for a state guarantee on their new short- or medium-term funding of up to 50 billion euros. The scheme is in place until the end of April with an option to extend it to the end of the year. The pricing of guarantees will follow the recommendations of the ECB.
 - In early February, the Government will present a proposal to the Parliament for a law on precautionary recapitalization of Finnish deposit banks. Under the scheme, capital is provided through subordinated loans and access is limited to solvent banks. The total amount of the scheme is limited to 4 billion euros. The interest on the loans is the sum of the state's five-year funding cost and a 600 basis point overall premium. Interest payments take seniority over dividends. The loan conditions include reporting requirements on the bank's lending behaviour. Both the state guarantee and the recapitalization schemes entail restrictions to executive pay.
9. Due to worsening financial situation in the corporate sector, banks are under growing pressure to increase funding especially for large Finnish companies that are suffering from steeply rising costs and reduced access to other sources of financing. Consequently, the authorities are planning additional actions to alleviate companies' increasing financing difficulties. The state pension fund was this week granted the

right to purchase limited amounts of domestic corporate commercial paper. Further measures will be decided upon in the coming weeks.

10. Despite the strongly negative returns in 2008, the longer term outlook for the Finnish pension funds remains broadly favourable. The 2007 reform of the investment guidelines aimed at a gradual 2 percent per annum rise in the pension funds' portfolio share of equities, which could result in the long-term real return rising to 4 percent a year. The temporary relaxation of the funds' solvency rules at the end of last year has also improved their financial health.
11. Starting from 2009, the Financial Supervision Authority and the Insurance Supervisory Authority merged into the Financial Supervisory Authority with a mandate over both sectors. The merger enables a more efficient utilisation of the best expertise and available resources in an environment of increasingly complex risks and regulation.

Fiscal Policy

12. The 2009 budget proposal and the subsequent amendments in November 2008 introduced various stimulative measures against the cyclical downturn, including tax-cuts on labour and pensions, measures designed to boost infrastructure investment, housing construction and renovation as well as measures to perk business operating potential and financing options. The budget also includes a cut in food VAT that is mainly motivated by equity considerations, but may also boost private consumption.
13. The discretionary stimulus introduced so far amounts to 1.2 percent of GDP, and it is in line with the amount agreed under the European Economy Recovery Plan by the European Council in December 2008. The total budgetary impact of the measures, automatic stabilizers included, is roughly 2 ½ percent of GDP. The authorities intend to introduce additional fiscal measures in a supplementary budget proposal in early February 2009.
14. Finland's healthy fiscal surpluses ease the burden of the cyclical downturn on public finances. The 2008 general government surplus is estimated to have remained above 4 percent of GDP. However, this year will already see an erosion of the general government surplus because of the rapid fall in cyclically sensitive tax revenues, rise in unemployment related expenditure and the expansionary budget. The central government balance will slip into deficit in 2009 for the first time this decade. Local government finances are also expected to slide from a near-balance to a slight deficit, which is to widen further in 2010. Hence, the near-term general government surplus hinges entirely on the employment pension funds. The debt-to-GDP ratio will increase substantially from its 2008 level of 33 percent.
15. The authorities concur that the near-term state of public finances is inconsistent with long-term fiscal sustainability – estimated to require a general government surplus of around 4 percent in the medium term – but remain committed to pursuing sound

spending and tax policies. The Government will assess in late February whether sufficient provision has been made for the ageing population so that any necessary reforms can be launched by 2011 while it is still in office. Meanwhile, growth in public spending will be curbed by structural measures and enhancements in public sector efficiency. The main instruments in this context are the Government productivity programme and the ongoing restructuring of municipalities, where following numerous local government mergers the emphasis has started to shift to a reform of service structures. The authorities have also set up a working group examining possible reforms to the tax system, due to complete its efforts by the end of 2010. The prospect of rising long-term real return on pension fund assets may also improve the general government balance in the long run.

Structural Policies

16. The authorities concur with staff over the need for further labour and product market reforms:

- Following the establishment of two working groups focusing on labour market mismatches and “flexicurity”, the Government has launched a comprehensive review of the whole social security legislation. The Committee presented its mid-term report in January 2009. The main elements under consideration are the unemployment pipeline, disability pensions and rehabilitation of workers outside the labour force. The sizeable income tax cuts and targeted increases in appropriations are expected to further improve labour market dynamics.
- Two working groups have also been established to examine further product market reforms. The “Competition Law 2010” analyzes the needs to reform the current competition law. The “Level playing field” looks into the role of regulations, including tax laws, that are not neutral with respect to private and public sector players in product markets. Both working groups are to reach conclusions this winter. The Government has also launched a new innovation strategy seeking to enhance the economy’s innovation capacity and identify areas where reforms are necessary.

17. After meagre results from the decentralized 2007 round of wage negotiations, the authorities are considering a new structure to improve the provision of information on wage and price developments and mitigate leap-frogging between different employee groups. Partially owing to the current downturn, the wage increases from the next round of negotiations in 2010 are anticipated to be modest.