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2014 ARTICLE IV CONSULTATION—STAFF REPORT; PRESS RELEASE; 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 2014 Article IV consultation with Finland, the following documents have been released and are included in this package:

- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 21, 2014, following discussions that ended on March 14, 2014, 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 April 30, 2014.
- An **Informational Annex** prepared by the IMF.
- A **Press Release** summarizing the views of the Executive Board as expressed during its May 21, 2014 consideration of the staff report that concluded the Article IV consultation with Finland.
- A **Statement by the Executive Director** for Finland.

The following document has been or will be separately released.

Selected Issues Paper

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

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INTERNATIONAL MONETARY FUND

FINLAND

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION

April 30, 2014

KEY ISSUES

Finland's record of strong economic growth has stalled with the economy in recession for three out of the last five years, largely because of domestic structural weaknesses and a challenging external environment. Weak productivity and high wage growth have eroded competitiveness, amplifying the effects of the declining ICT and paper sectors. This has led to high unemployment and added to longer-term aging-related fiscal pressures. Household debt continues to rise, adding to the highly concentrated banking system's vulnerability to regional shocks. Absent reforms, the outlook remains for a slow and fragile recovery.

The priorities are reforms for growth, credible, but gradual, fiscal consolidation, and measures to address lingering financial stability concerns.

- **Bold and rapidly implemented structural reforms would improve labor market performance and boost productivity, while facilitating structural adjustment.** The government reform program is making progress, but the full agenda has yet to be implemented.
- **Credible fiscal adjustment phased-in over the medium-term would support fiscal sustainability while protecting the fragile recovery.** A frontloaded fiscal adjustment, as is envisaged in the government's recent spending limits decision, could weaken the recovery. A better alternative would be to increase the pace of consolidation only as the economy strengthens, along with structural reforms to raise medium-term growth.
- **Strengthening the macroprudential framework is critical.** This would help guard against underlying vulnerabilities and promote regulatory harmonization within the Nordic region. The full scope and flexibility of CRD IV/CRR instruments should be deployed, including establishing a systemic risk buffer and making LTV caps effective.

Approved By
Mahmood Pradhan (EUR) and Peter Allum (SPR)

Discussions for the 2014 Article IV consultation were held in Helsinki during March 3-14, 2014. The mission comprised Mr. H. Berger (head), Mr. N. Arnold, Ms. B. Mircheva, Mr. A. Al-Eyd, and was assisted at HQ by T. Dowling and J. Colon (all EUR). The mission met with Mr. E. Liikanen, Governor of the Bank of Finland; Ms. J. Urpilainen, Minister of Finance; other senior officials; social partners; representatives of the financial sector; and research communities.

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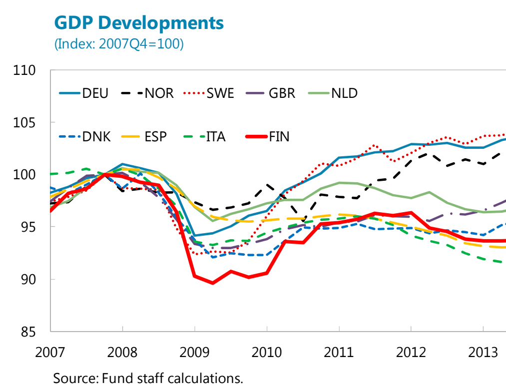
RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent developments

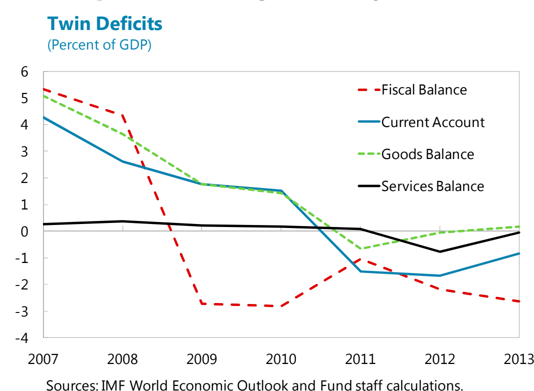
1. **Finland's strong recovery from the global crisis was short-lived**. After rapid growth in 2010–11, GDP declined by 1 percent in 2012 and by an estimated 1.4 percent in 2013 (Table 1). Unemployment is elevated, at more than 8 percent as more people went without work for longer, and the output gap is sizable, estimated at around 3 percent of potential GDP. Moderating, but still positive, wage growth and higher indirect taxes explain why inflation (2.2 percent in 2013) remained above the euro area average (Figure 2).



Source: Fund staff calculations.

2. **Behind the slowdown is a combination of cyclical and structural factors**. The effects from weak domestic and external demand in the wake of the crisis have been exacerbated by the decline in the information and communications technology (ICT) industry and the continuing fall in global demand for traditional exports such as paper and pulp (Figure 1). Longer-term structural factors are also playing a role, including a rapidly aging workforce and declining total factor productivity (TFP) growth. At the same time, the persistently weak growth outlook has affected the confidence of investors, with private sector investment falling from over 20 percent of GDP in 2007 to under 16 percent in 2013. Highly leveraged households (mostly in the form of mounting real estate credit) are contributing little to overall consumption growth.

3. **The fiscal deficit has widened and current account surpluses have given way to deficits**. Increased social spending and the weaker economy have raised the general government deficit to an estimated 2.4 percent of GDP in 2013 (Table 4). At the same time, the debt-to-GDP ratio is approaching the 60 percent benchmark in 2014 (under the pre-ESA2010 GDP accounting standard). Along with the reduced importance of the ICT sector, the current account surpluses of the late 1990s and early 2000s have disappeared (Table 2). The real effective exchange rate (REER), though somewhat on the strong side, is broadly in line with fundamentals (see Box 1).

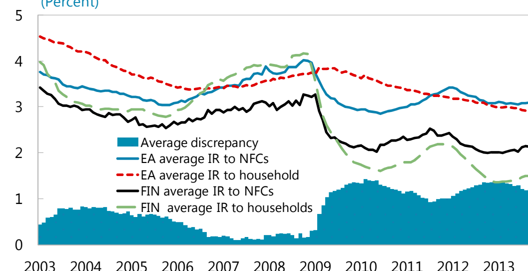


Sources: IMF World Economic Outlook and Fund staff calculations.

4. **The slowdown has come despite unusually favorable financial conditions, increasing risks to banks.** The banking sector, dominated by large Nordic institutions, has been operating in a low interest rate environment, partially linked to Finland's appeal as a "safe haven." This has weighed on banks' margins and increased their exposure to riskier borrowers, especially through housing-

related loans. Overall credit has declined with the weak economy, but household debt has continued to grow, reaching 118 percent of disposable income in 2013, more than double the level in the late 1990s (Figure 4). Standard metrics suggest that real house prices are 8.5 percent above fundamentals.[1]

Credit Institutions' Interest Rate Margins in the Euro Area and Finland
(Percent)



Sources: European Central Bank and Fund staff calculations.
Notes: The average discrepancy is a simple average of the difference in margins in the euro area (EA) and Finland for long-term loans to non-financial corporations and households.

5. **Structural issues are playing a significant role in the slowdown**. In addition to the weakening of traditional industries, falling export shares also reflect a loss in competitiveness linked to high pre-crisis wage growth at a time when labor productivity was deteriorating (Figure 2). The slowdown in productivity predominantly stems from weaker TFP growth caused, in large part, by the fading importance of the ICT sector and the associated decline in patent and innovation activity.[2] As a result of this and an aging workforce, potential output growth is estimated to have declined from about 3 percent on average in 1997–2007 to less than ½ percent in 2013.[3]

6. **Policymakers have begun to address these challenges.** The government is pursuing an ambitious reform agenda to improve the public finances and strengthen conditions for economic growth, with some measures already in train. Also, long-needed progress is being made towards putting in place a macroprudential policy framework in line with the evolving framework at the European Union (EU) and euro area levels.

B. Outlook and Risks

7. **The recovery will be slow**. Growth is projected to improve modestly, driven largely by the expected improvement in euro area exports and gradually strengthening investment helped by still low interest rates and building confidence in the recovery. However, in light of the expected slowdown in Russia and the planned fiscal consolidation, the pick-up in growth will be moderate—about 0.3 percent in 2014 and 1.1 percent in 2015. As a result, unemployment will remain high and the output gap will shrink only gradually, with inflation decelerating to about 1.5 percent in 2015.

8. **A number of downside risks could further lower growth.** Slower-than-expected exports linked to a cooling of global trade, rising geopolitical tensions, or a protracted period of slow European growth could easily derail the recovery. Domestically, high household debt could cause consumers to cut back if interest rates normalized more quickly than expected, for example because of changing global financial conditions. Rapid fiscal consolidation or a less growth-friendly budget composition could further weaken demand. Finally, a financial shock, such as a funding difficulty

[1] IMF, 2013, "*Nordic Regional Report*," describes the underlying methodology.

[2] See Chapter III of the Selected Issues for further details.

[3] See Chapter I of the Selected Issues for a discussion of potential output estimates under a variety of approaches, including the importance of smoothing parameter assumptions for the volatility of potential output growth.

hitting the large Swedish or Danish banks operating in Finland, could impact financing conditions, with potentially significant consequences for investment and consumption, especially if amplified by a fall in house prices (see also Table 7 with the Risk Assessment Matrix).

The Authorities' Views

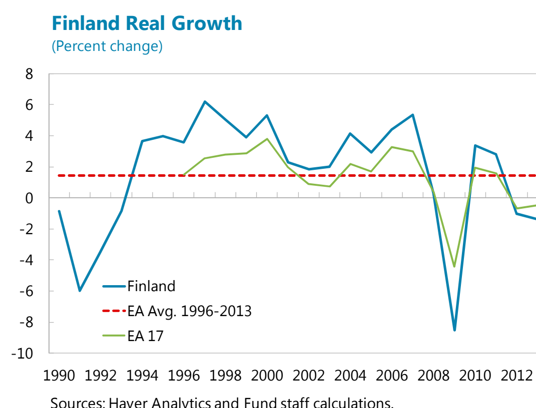
9. **The authorities broadly agreed that the pace of recovery would be moderate and initially fragile.** They recognized that the growth path would be very dependent on the external environment, especially the pace of recovery in Europe. Relatedly, the authorities acknowledged the risks to growth from developments in Eastern Europe, as Russia is an important export market and the source of all Finnish gas imports. However, they noted that the planned "growth package" (see below) should mitigate short-term risks while structural reforms should boost medium-term growth and facilitate adjustment, which could lead to export market diversification. Although household debt is still rising as a share of disposable income, the authorities did not think this represented a significant risk to financial stability in the near term. They also felt that the macroprudential policy tools provided in recent draft legislation would help them address future risks in this area.

POLICY DISCUSSION

10. **Finland remains a high-capacity economy, but raising growth requires reforms**. The labor force is highly skilled and firms operate in a reliably favorable business climate. However, a number of well-known obstacles—linked to the shrinking workforce, weakening productivity, and the capacity for structural adjustment—are holding back growth and need to be addressed quickly by structural reforms. In the short- to medium-term, the pace and composition of fiscal consolidation should be designed to protect the fragile recovery. And completing and deploying the full macroprudential toolkit would help guard against domestic and regional financial stability risks.

A. Structural Policies: Restarting the Growth Engine

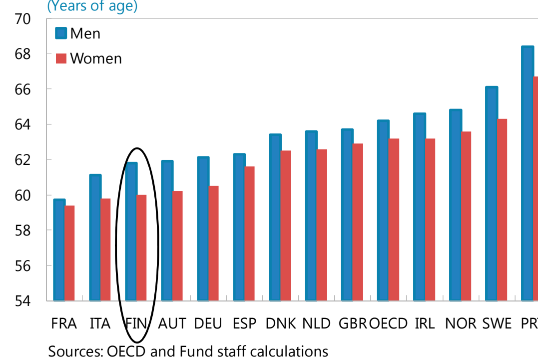
11. **Reforms were at the heart of Finland's resurgence after the crisis in the early 1990s**. The dynamic ICT sector prospered in an environment of strong policies aimed at improving competitiveness through private sector innovation. Reforms linked to EU accession in 1995 added further momentum and opened important export markets. As a result, between 1991 and 2008, Finland closed the labor productivity gap with the best performing OECD countries, mirroring strong TFP developments and a shift in investment from physical capital towards R&D. However, export market shares had already declined prior to the global crisis, along with the fading fortunes of Nokia's mobile handset business and the global shift from paper to electronic media.



Sources: Haver Analytics and Fund staff calculations.

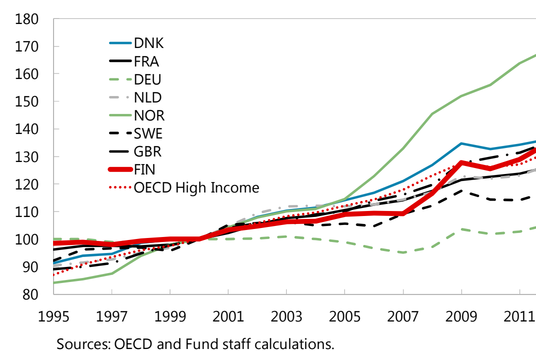
12. **A number of new structural issues demand attention, particularly in the labor market**.

- *Short work careers reduce labor supply*. The pension reform of 2005 has created incentives for a longer working life. However the majority of workers retire as soon as they are legally eligible, shrinking the labor force as the population ages. At around 61 in 2013, the average effective retirement age remains considerably lower than in peer economies, despite increases in life expectancy. Projections by the United Nations suggest that life expectancy at birth in advanced economies will improve by 6 years between 2005-10 and 2045-50, lifting the expected retirement duration by 3 years for men and nearly 4 years for women.[4] This contrasts with the government's current plan to increase the effective retirement age by 1.5 years by 2025, suggesting further increases will be needed after 2025.

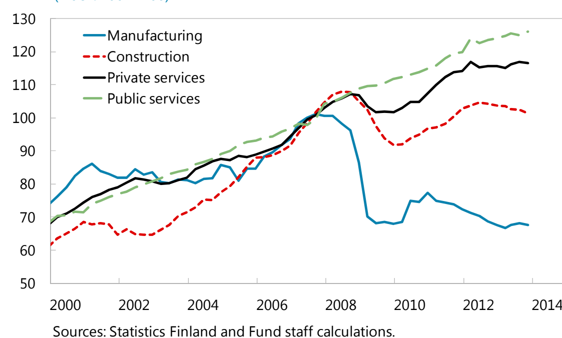


- *Study times are lengthy*. Finnish students take a relatively long time to enter the labor force. This is partly due to cumbersome entrance processes that can delay entering university, followed by long tertiary study times—with less than half of the students completing their degrees in the targeted time. Even though universities rank high against the average of OECD countries, their performance lags behind Nordic neighbors and European top performers.[5]

- *Wage levels are high relative to productivity*. Unit Labor Costs (ULC) are elevated and have risen markedly since the onset of the crisis, reflecting, among other factors, strong wage growth against a background of generous unemployment benefit replacement rates and duration (currently at 500 days) relative to many other OECD economies (Figure 2).



13. **Low productivity growth points to weaknesses at the sectoral level**. To some degree, the secular decline in TFP growth is a consequence of structural change, with manufacturing's contribution to value added and employment falling, largely due to the reduced importance of Nokia. Although the services sector



[4] Estimation by OECD in "Economic Survey: Finland 2014."

[5] See OECD, "Economic Survey: Finland 2012."

(e.g., private healthcare, rental/leasing) is growing, its productivity tends to be lower. This is particularly true for Finland's retail sector, which still faces among the highest regulatory barriers in the EU—for example, from planning restrictions that limit economies of scale and market entry. Despite the introduction of the 2011 Competition Act, retail market concentration remains high. The productivity of Finland's large public sector has also been declining, notably in the provision of local public healthcare and social services.

14. **In response, policymakers have set ambitious goals for reform**. In November 2013, the government agreed on a reform program that—in addition to fiscal reforms (see next section)—includes measures to lengthen working careers, reduce structural unemployment, and boost the economy's growth potential.

- Social partners, in coordination with the government, are discussing a pension reform that aims to gradually increase the effective retirement by 1.5 years (to a still low 62.4) by 2025. The discussions are to be concluded by end-2014, with implementation starting in 2017.

- There are plans to streamline university entrance requirements and shorten study times to accelerate the transition into the labor market. The government has already shortened the duration of financial assistance to students (while increasing the level).

- To encourage labor participation, active job seekers are allowed to earn up to €300 per month without a reduction in unemployment benefits, while employment plans will be monitored more closely. To improve the functioning of the labor market, policies are being developed to encourage job seekers to consider offers across regions, employment services for immigrants, the disabled, and long-term unemployed are being improved, and the child home care subsidy and job alteration leave policies are being amended.

- At the local government level, some mergers of municipalities have taken place and personnel cuts in 2013 are estimated to have achieved €400 million in annual savings. The plan to consolidate the administration of healthcare and social services under five regional joint municipal authorities has the potential to improve economies of scale in these areas. Detailed measures are to be formulated by summer 2014 and considered by Parliament in the fall, with the operation of the new regional organizations to start in 2017.

15. **A rapid and comprehensive implementation of reforms would improve labor market performance.** In particular, the pension reform should become effective as soon as possible, preferably even before early 2017. The reform's impact on actual retirement decisions will require close monitoring, including ensuring that the incentives linking life expectancy and the effective retirement age are working. Reducing unemployment benefits' duration and replacement rate could add to ongoing initiatives to boost labor market activation by increasing job search incentives.

16. **There is scope for additional measures to boost productivity**. The efficiency of the provision of public healthcare and social services should be improved. Consolidating administration of these services at the regional level, as recently agreed by the government and other stakeholders,

and standardizing data and information systems can be powerful tools in this regard. It is also important to rejuvenate efforts to deregulate Finland's retail sector, which would improve private sector productivity overall. In addition, steps are required to adjust R&D policies to the post-Nokia era, where innovation and growth might be found in firms outside the existing ICT cluster. In this context, while R&D investment (3½ percent of GDP in 2013) remains high by international standards, it could be better focused to support innovation, especially by young firms (e.g., through well-designed tax credits). Moreover, better aligning research grants with performance, and improving the design of pre-seed and seed stage support schemes may also help.

17. **Facilitating adjustment will further support growth**. The transition from ICT to other sources of growth will be facilitated by wage agreements that steer average wages in line with productivity, while also offering sufficient flexibility to take into account developments at the sectoral and firm level. Furthermore, reducing the reliance of the economy on the ICT sector by stimulating innovation in other sectors would help improve productivity.

18. **Removing obstacles to labor mobility is crucial**. Employment protection should not become an impediment to adjustment—for example, in the context of local government reform. In addition, increasing the quantity of affordable housing in urban areas where employment is available will reduce obstacles to job seekers across the country. This requires reducing planning restrictions and increasing competition in the construction sector. Tax incentives can help here as well—for example, by raising property taxes on unused land zoned for development or improving the treatment of income from investment in residential rental property. Finally, the supply of affordable housing can be increased by higher government investment.

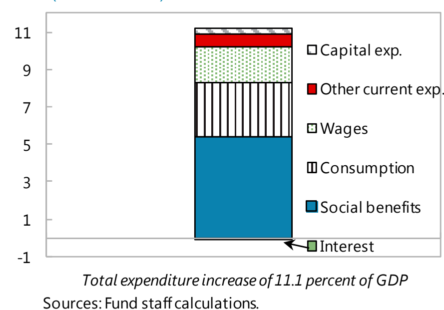
The Authorities' Views

19. **The authorities agreed with staff's assessment of the structural challenges facing the Finnish economy and acknowledged the urgency of structural reforms**. They pointed out the measures already introduced as part of the structural reform program announced in the fall of 2013 (see above) that aim to tackle key issues such as labor market participation, retail sector competition, and public sector productivity. While recognizing that further steps will likely be necessary, the authorities also stressed the Finnish tradition of consensus-based decision making as a factor in the speed at which some reforms can be introduced (e.g., pension reform). They noted that one benefit of consensus-based decisions is that they are less likely to be unwound over time. They acknowledged the advantages of broadening the focus of R&D support while pointing out the challenge of determining the appropriate tools to achieve this. The authorities considered the advantages of further labor market reforms, but pointed to the difficulties of implementing measures at the early stage of a recovery while the social partners were engaged in pension reform.

B. Fiscal Policy: Finding the Right Balance

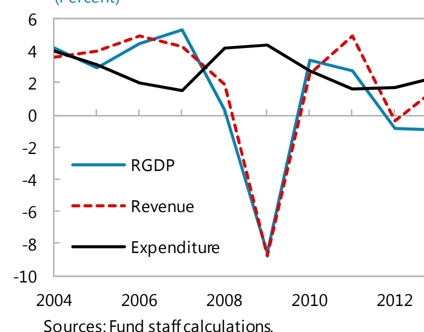
20. **Finland's fiscal position has deteriorated since before the global crisis, largely due to rapid spending growth.** Between 2007 and 2013, total expenditure increased by 11.1 percent of GDP, with higher spending on social benefits, public consumption excluding wages (i.e.

"intermediate consumption"), and the wage bill accounting for 90 percent of the increase. Spending accelerated even before the crisis, largely due to generous public sector wage increases and rising aging-related spending (e.g., on healthcare), then continued to rise rapidly when the crisis struck (Figure 3). Overall, around 60 percent of the observed spending growth can be associated with structural factors, with the remainder due to the weak economy (e.g., unemployment benefits).



Sources: Fund staff calculations.

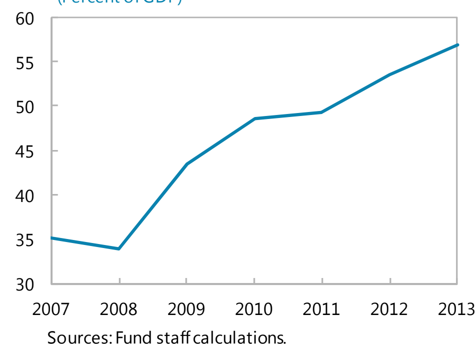
21. **Slow GDP growth has depressed revenues, exacerbating deficits and prompting the authorities to increase taxes.** When the crisis struck in 2009, Finnish real GDP fell by 8.5 percent and revenue declined correspondingly. Despite sizable tax increases—including a VAT rate hike from 23 to 24 percent, increases in energy and excise taxes, and higher local income taxes—which raised the revenue-to-GDP ratio from 53 percent in 2007 to nearly 56 percent in 2013, revenues have fallen behind expenditures. This has caused the fiscal balance to deteriorate (both in headline and structural terms), shifting from consistent surpluses to persistent deficits.



Sources: Fund staff calculations.

22. **Local governments have been the driving force behind many of these developments.** Local governments accounted for approximately 70 percent of the increase in public consumption (excluding wages) and wage spending over 2007–13. As a result, over the same period the aggregate local government deficit grew by 0.5 percent of GDP, despite local government tax revenues and central government transfers rising by 1.5 percent and 1.4 percent of GDP, respectively. Local government spending accounts for more than one-third of general government total expenditure, reflecting their large role in the provision of public services (e.g., healthcare), and two-thirds of public investment.

23. **General government debt has risen considerably**. The public debt ratio grew from 35 percent to 57 percent of GDP between 2008 and 2013 and is close to breaching 60 percent of GDP this year (see the DSA in Annex I). While still well below the average euro area public debt ratio, which exceeds 90 percent of GDP, the higher debt level has reduced buffers to absorb short-term shocks and to smooth aging-related fiscal pressures over the longer term. Population aging and lower trend growth have given rise to a longer-term fiscal sustainability gap, estimated at around 4.7 percent of GDP,

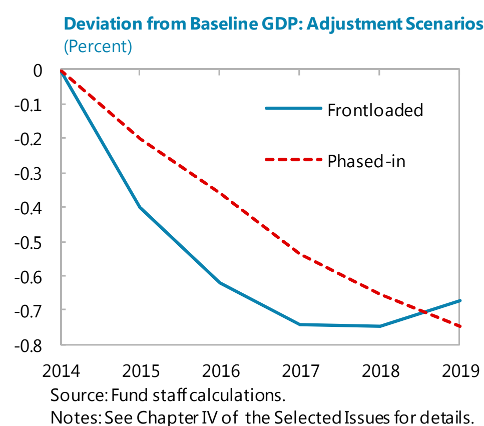


Sources: Fund staff calculations.

mostly driven by higher projected spending on pensions, healthcare, and long-term care.[6]

24. **Ultimately, it will take both growth and fiscal consolidation to ensure the long-run sustainability of the public finances.** Historical experience suggests that growth and fiscal consolidation are the main drivers of successful sovereign debt reductions in advanced economies. However, while fiscal consolidation directly contributes to lower debt, it typically has a negative short-run impact on GDP, thereby (temporarily) directly raising the debt ratio as the denominator falls. Indirectly, lower GDP would also be a drag on revenue, so the improvement in the headline primary balance—and correspondingly in the numerator of the debt ratio—due to the consolidation would be smaller than otherwise. Furthermore, recent research shows that the fiscal multiplier tends to be larger when the output gap is large, as in Finland currently.[7]

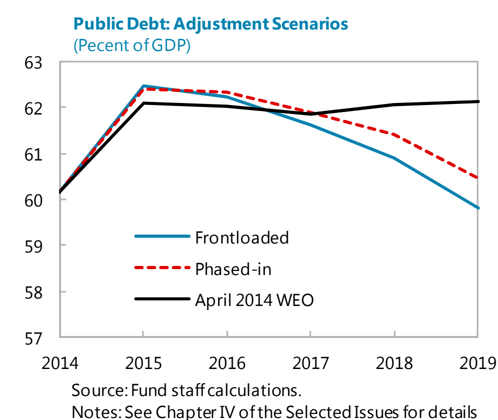
Deviation from Baseline GDP: Adjustment Scenarios
(Percent)



Source: Fund staff calculations.
Notes: See Chapter IV of the Selected Issues for details.

25. **This suggests a gradual approach to consolidation to protect the fragile recovery.** Illustrative simulations show that for the same total adjustment over the 2015–19 period, depending on the multiplier assumptions used, the cumulative output loss would be around 0.5 to 1 percentage points of GDP greater for a frontloaded adjustment than for a phased-in approach.[8] Both frontloaded and phased-in adjustments would cause debt to begin falling after 2015, even though by 2019 the debt ratio would be slightly lower under the frontloaded approach due to higher primary surpluses early in the consolidation. In principle, the central government's well-established spending limits framework—reinforced by the proposed new steering system for local government finances—provides an effective mechanism with which to implement such a phased-in medium-term adjustment plan, while allowing automatic stabilizers to operate should growth underperform. Securing broad-based political support for the plan would further enhance its credibility.

Public Debt: Adjustment Scenarios
(Pecent of GDP)



Source: Fund staff calculations.
Notes: See Chapter IV of the Selected Issues for details

26. **Instead, the government's recent spending limits decision points to a frontloaded adjustment—mitigated by off-budget measures to support growth.** The fiscal stance in 2014 is broadly neutral. But the decision on central government spending limits envisages a consolidation effort of 1.1 percent of (2015) GDP over the 2015–18 period, of which 0.8 percentage points of GDP

[6] See Chapter IV of the Selected Issues and "*The 2012 Aging Report*" from the European Commission for details.

[7] See Abbas and others, 2013, "*Dealing with High Debt in an Era of Low Growth*," for an analysis of past episodes of sovereign debt reductions in advanced economies. Chapter IV of the Selected Issues discusses the multiplier issue and the mechanics of how a consolidation's negative GDP impact can cause the debt ratio to rise in the short-run.

[8] See Chapter IV of the Selected Issues for details.

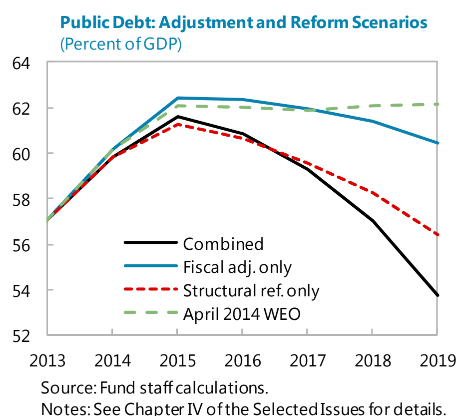
would fall in 2015. If implemented in the 2015 budget to be submitted to parliament in late-2014, as is assumed in staff's baseline projection, this would amount to a structural adjustment of about

0.6 percent of potential GDP in 2015. At the same time, the government has announced a "growth package"—worth about around 0.3 percent of GDP—and additional measures that are projected to effectively offset part of the consolidation in 2015, so the net impact on output would be lower than otherwise. The "growth package" aims to use asset sales and higher transfers from state-owned firms to finance additional spending, mostly off-budget, in 2014 and 2015, including for R&D support and one-off public investments, with much of the spending likely to occur in 2015. Among the additional measures are plans to allow pension funds to finance new public housing construction in urban areas starting in 2014, which could boost growth and labor mobility in 2015 and beyond.

27. **While difficult to gauge, the overall effect of these measures constitutes a drag on growth in 2015.** There is a downside risk that the proceeds from asset sales to finance the "growth package" are lower than expected, which would result in lower spending and less mitigation of the output impact of budgetary tightening. For example, simulations suggest that if none of the mitigating factors discussed above were to materialize, growth in 2015 may be as much as 0.2–0.4 percentage points lower than in the baseline, depending on the size of the fiscal multiplier.[9] However, there are also upside risks. The central government's 2015 budget might entail less tightening than implied by the spending limits decision and local governments' spending might be reduced by less than currently planned. Finally, even if the size of the overall adjustment is as currently expected under staff's baseline, the composition of the adjustment measures overall could differ, which would change the growth impact.

28. **In the medium term, the right budget composition would support growth.** The already relatively high level of taxation—Finland ranks third in the OECD in terms of the general government revenue-to-GDP ratio—would suggest the consolidation should focus on expenditure cuts. However, on current plans, higher taxes would contribute almost half of the envisaged consolidation effort, through a mix of direct and indirect tax increases. This runs contrary to recent efforts by the central government to make Finland's tax structure more growth friendly. For example, the corporate income tax rate was cut in 2014 from 24.5 to 20 percent—with compensating reforms to dividend taxes that broadened the tax base, as well as increases in energy and excise taxes—which should encourage higher investment over the medium-term. Recent local government tax increases have also mainly been through income taxes instead of property taxes, which tend to have less detrimental growth effects and vary less with the business cycle. Recent estimates suggest that raising the property taxes to the OECD average could generate revenue of about 1 percent of GDP.

Public Debt: Adjustment and Reform Scenarios
(Percent of GDP)



Source: Fund staff calculations.
Notes: See Chapter IV of the Selected Issues for details.

29. **Successful structural reforms will be important to offset the drag from fiscal consolidation in the medium**

[9] See Chapter IV of the Selected Issues for details.

term. Simulations of the impact of structural reforms on output—based on OECD measures of structural indicators and the gap between Finland and the OECD "frontier" and DSGE model results—suggest that reforms could raise output by between 1 and 3 percent relative to the baseline in 2019.[10] This would be sufficient to put debt on a downward path over the medium-term. And the simulations suggest that combining structural reforms with fiscal adjustment would lead to an even faster decline in the debt ratio.

30. **In this context, measures that combine growth-enhancing effects with fiscal savings are particularly effective.** Pension reform is a central pillar of the government's structural reform program agreed in 2013. If executed as planned, it is expected to significantly reduce the sustainability gap over the long term through direct fiscal savings (from the later retirement of public employees) and higher revenues (by increasing labor supply and potential growth). The proposed steering system for local governments' finances—conceptually similar to the central government's spending limits framework—should help to contain spending growth over the medium-term. Additionally, local government reforms to improve public sector productivity, such as the consolidation of health and social services administration, should deliver further savings over the medium- to long-run.

The Authorities' Views

31. **The authorities recognize the risks to growth from rapid fiscal adjustment, but ultimately view a potential loss of credibility as more important.** They pointed to the difficulty of securing broad-based support for a more gradual consolidation path extending beyond the elections in 2015. They emphasized that their approach would help maintain Finland's reputation for responsible fiscal management in line with an earlier commitment to put government debt on a downward path. The authorities also stressed the growth-enhancing nature of certain measures in the "growth package" introduced in conjunction with the spending limits decision, which they believe will reduce risks to growth next year. They defended the roughly 50-50 split in spending cuts and tax increases as a key plank in the governing coalition's agreement. Generally, the idea of substantive property tax reform was not considered politically feasible in the near-term.

C. Financial Policy: Ensuring Stability

32. **The Finnish banking system has proven resilient during the crisis, but the low interest rate environment has left its mark on profitability.** Banks' capital ratios declined somewhat in 2013, but remain comfortably above regulatory norms and high relative to many European peers (Table 6). However, with interest rates still at very low levels, the bulk of banks' income stems from non-interest earnings, including equity investments. At the same time, banks remain highly dependent on wholesale funding, as reflected in a high and rising loan-to-deposit ratio (119 percent at the end of 2013, up from 111 percent in 2012). Nevertheless, the Financial Supervisory Authority (FIN-FSA) considers liquidity buffers adequate and in line with Basel III requirements, at least among the large banks that are active in wholesale funding markets.

[10] See Chapter IV of the Selected Issues for details.

33. **Domestic asset quality is an area of concern.** Nonperforming loans (NPLs) remain low, rising slightly to 0.6 percent of total loans in 2013. But the aggregate measure masks a notable rise in corporate NPLs, which grew by 10.8 percent year-on-year in 2013, while a decline in external assets, primarily reflecting deleveraging within Nordea Bank Finland's Baltic operations, has helped reduce NPLs overall. Lending to SMEs remains subdued and larger corporates increasingly issue debt amid still favorable capital market conditions.

34. **At the same time, household indebtedness continues to rise, helping to boost house prices in certain regions.** Household debt as a share of disposable income is around 120 percent, up from just over 100 percent prior to the crisis, with both the level of housing-related credit rising and disposable income declining in the wake of the crisis. The high level of housing-related credit, including that incurred by housing associations, is reflected in elevated house prices, though the level of overvaluation is lower than in other Nordic countries. However, the national average conceals rapid growth in prices in large metropolitan areas (see Box 2).

35. **Risks to the Finnish banking system predominately stem from spillover risks due to strong regional interconnections and the dominant role of foreign-owned banks.** Nordea Bank Finland and Danske Bank Finland are the largest banks operating in Finland. Although this can provide a degree of stability (e.g., through supportive group level liquidity or capital management), it also means that economic or financial shocks in Sweden and Denmark could cause significant negative spillovers to lending activity in Finland. Moreover, group level policies—such as Nordea's consolidation of its derivatives business in Finland—complicate the signals from aggregate financial soundness indicators and can result in an undue concentration of risk. While higher interest rates would raise banks' funding costs and could pose a risk to banks' net interest income, the impact would likely be limited for income from lending to households, as the bulk of this is via mortgages with adjustable interest rates (see Box 2).

36. **The advancing EU regulatory agenda is an opportunity to strengthen Finland's macroprudential framework.** Long-needed progress is underway as some CRD IV/CRR recommendations are being transposed into national legislation under the draft Act on Credit Institutions. The proposed empowerment of the independent Board of the FIN-FSA will create a macroprudential authority effective from mid-2014, with decision-making powers over all adopted instruments. The Board is comprised of representatives from the Bank of Finland, Ministry of Finance, and Ministry of Social Affairs and Health, as well as two independent candidates, all of whom are nominated by the parliament's Supervisory Board. The represented institutions and independent positions will have permanent voting rights. Importantly, the policy-making process will be supported through surveillance and analysis, provided primarily by the Bank of Finland.

37. **Ensuring the full scope and flexibility of macroprudential tools identified by the ESRB are available will be critical to the Board's effectiveness.** Finland lags behind its Nordic peers in legislating a comprehensive set of macroprudential instruments. The current draft legislation incorporates mandatory macroprudential instruments set out in CRD IV/CRR, but only at the minimum standards for each tool and with very limited recourse to others. This unduly restrains the authorities' capacity to contain mounting risks, respond to shocks, or to fully harmonize regulations

with their regional peers and, thus, deter regulatory arbitrage. In this regard, the macroprudential framework can be strengthened in two specific areas:

- A *systemic risk buffer* (SRB) should be incorporated into national legislation. Allowing for mandatory additional capital holdings, including in a targeted manner, under the SRB is particularly important given the banking sector's large size, degree of concentration, extent of cross-border activities, and dependence on wholesale funding.

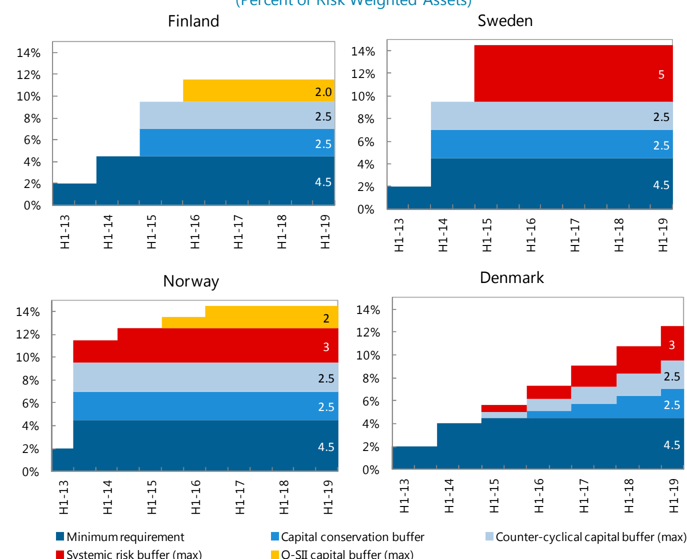
- The *countercyclical capital buffer* (CCB) should not be limited to the minimum mandatory reciprocity threshold of 2.5 percent. Current draft legislation excludes the possibility of requiring additional capital should it be justified by underlying risks. Allowing the full scope of the CCB would empower the Board to guard against large swings in credit, and better ensure regulatory consistency across the region.

Finland: Proposed Adoption of CRD IV and CRR Instruments

	Mandatory	Optional	Finland to Adopt
CRD Instruments:			
Countercyclical Capital Buffer	■		■
Systemically Important Institution Buffer	■		■
Systemic Risk Buffer		■	
Liquidity Requirements under Pillar II		■	
Other Pillar II		■	
CRR Instruments:			
Higher Requirements (capital, liqudity, large exposures, risk weights)		■	
Higher Real Estate Risk Weights (or stricter lending criteria)		■	
Higher Average LGDs (exposure-weighted)		■	
Other:			
LTV		■	■
LTI, DSTI, LTD limits, and Leverage Ratio		■	

Sources: ESRB, FIN-FSA, and Fund staff.
Notes: Loan-to-Income (LTI); Debt-Service-to-Income (DSTI); Loan-to-Deposit (LTD).

Nordic Four: Transition to Common Equity Tier 1 Capital Buffer[1]
(Percent of Risk Weighted Assets)



Sources: FIN-FSA and Fund staff calculations.
[1] These data are only representative as they have been compiled from known draft capitalization plans of respective supervisory authorities.

38. **To reduce risks from elevated house prices, regulators must have the full capacity of tools to contain mortgage lending.** Plans to introduce Loan-to-Value (LTV) caps for new mortgages—set at 90 percent for current mortgage holders and 95 percent for first time buyers—should directly reduce demand for a limited portion of loans and help ensure credit quality throughout the cycle. Nevertheless, the provision of collateral—including financial assets, deposits, property, and insurance instruments or state guarantees—against the LTV caps effectively raises the amount of leverage that can be achieved. This practice should be limited to avoid reducing the effectiveness of LTVs and also to maintain the spirit of ESRB recommendations on their use.[11]

[11] The ESRB recommends LTVs as a means to restrict the quantity of credit relative to the value of the collateral. See "*The ESRB Handbook on Operationalising Macroprudential Policy in the Banking Sector*" at www.esrb.europa.eu.

39. **A more targeted approach to LTVs, along with more stringent capital measures, could prove highly effective in addressing localized housing pressures.** Given the dispersion in regional house prices, the Board should consider enforcing more binding LTVs (e.g., set at 80 percent for current holders and 85 percent for first time buyers) in certain metropolitan areas. This could be achieved by tightening the collateral ceiling, as allowed for in the draft legislation. As a complementary measure, higher mortgage risk weights for banks should also be considered. This would help to limit the supply of housing-related credit when financial stability concerns arise and ensure greater regulatory coherence at the regional level. Finally, the introduction of a national loan registry would facilitate macroprudential monitoring of credit developments.

40. **The advancement of the Banking Union should enhance regional supervisory cooperation.** It is important to ensure that large regional banks are assessed at the group level during the upcoming Balance Sheet Assessment, including by using like methodologies and independent third party reviews. In support, binding regional agreements on resolution and burden sharing, particularly in the Nordea Crisis Management Group, should be reached without delay. The principles of these agreements should be in line with the Single Resolution Mechanism (SRM) and Bank Recovery and Resolution Directive objectives to facilitate harmonization between Finland and other Nordic countries when the SRM comes into operation. Similarly, once liquidity and funding requirements are fully developed at the EU level, they should be harmonized across the Nordic region to ensure group-level liquidity is adequately defined in branches and subsidiaries.

The Authorities' Views

41. **The authorities acknowledged the importance of more fully implementing CRD IV/CRR, including as a means to harmonize regional frameworks.** However, they viewed the outcome of the current draft legislation as pragmatic given the strong capitalization of Finnish banks and lack of consensus on key issues at the European level. They did not exclude further enhancing the macroprudential toolkit in line with European-level progress. The authorities also recognized staff concerns over elevated house prices, but viewed the proposed LTV caps as adequate, particularly given the recent moderation in mortgage lending and overall house prices. The authorities saw some merit in future consideration of more binding LTVs, but noted that this would significantly change the current structure of loan provision. They also broadly agreed with staff on the possibility of using LTVs on a targeted basis to address regional house price pressures, but thought it was necessary to first carefully consider any potential implications.

42. **The authorities welcomed progress toward banking union, seeing it as an opportunity to further strengthen regional supervisory coordination.** The authorities noted the potential challenges of joint supervision of large banks operating across countries currently outside and inside of the banking union framework. But they also pointed to the tradition of supervisory cooperation in the Nordic region and stressed the role for the existing supervisory colleges, which could help enhance coordination and promote a smooth transition to evolving European regulations.

STAFF APPRAISAL

43. **Finland's recovery from the global crisis was brief.** Real GDP dropped by almost 2½ percent during 2012–13, and unemployment has risen above 8 percent. The shortfall in growth, coming at a time when peer economies saw GDP improve and unemployment decline, points to deeper structural problems. Exports suffered from the continued decline of the ICT and paper and pulp industries, but also because Finnish wage costs increased just as labor productivity growth fell. Longer-term factors, such as a rapidly aging workforce, added to the headwinds.

44. **The outlook is for slow growth.** With the gradually improving outlook for the euro area, external demand is expected to increase over the course of 2014. This should eventually support a rebound in investment, especially if interest rates remain low. However, GDP growth is likely to pick-up more gradually than previously forecast, reflecting recent weak data and trade exposure to Russia, as well as the planned fiscal consolidation. With a still sizable negative output gap, unemployment will decline slowly, while inflation is projected to decelerate to 1.5 percent by 2015.

45. **The economic upturn will also likely be fragile**. Weaker external demand could easily derail the recovery—for example, because of negative effects from an escalation of geopolitical tensions, or slower euro area growth. Domestically, high, and still rising, levels of household debt could make consumers more cautious to spend if interest rates normalize faster than expected. Finally, the growth outcome could also change with the timing and composition of fiscal adjustment.

46. **Bold and rapidly implemented structural reforms are needed to achieve higher medium-term growth.** Pension reform to lift the effective retirement age is crucial to avoid declining labor market participation, as is encouraging younger workers to enter the labor market sooner. Plans to improve the productivity of public sector healthcare should be specified and implemented quickly. Boosting retail competition would improve overall productivity in the private sector, while R&D investment can be better focused to support innovation, especially by young firms. In addition, it is important that wage bargaining supports adjustment by steering real wages in line with overall productivity growth, while ensuring sufficient flexibility to accommodate variation at the firm and sectoral levels. Measures to increase the quantity of affordable housing would facilitate labor mobility and matching.

47. **Fiscal policy should seek to balance growth and sustainability concerns.** The deterioration of the public finances has both cyclical and structural roots. Credible fiscal adjustment over the medium-term—backed by continued broad-based political support—would ensure sustainability and help protect the fragile recovery. The broadly neutral fiscal stance in 2014 is appropriate, and staff simulations suggest that gradually increasing fiscal adjustment in line with the expected strengthening of the economy would minimize the risks to growth. If growth underperforms, automatic stabilizers should be allowed to operate.

48. **In contrast, the planned frontloaded adjustment risks slowing the recovery.** The recent decision on medium-term spending limits for the central government suggests that the bulk of the fiscal consolidation could come in 2015, when the upturn will still be gathering speed. To reduce the

risks to growth, it will be important to steer the discussion of the 2015 budget towards making the composition as growth-friendly as possible—for example, by increasing the contribution from expenditure cuts, while preserving public investment, and shifting the revenue component of the adjustment away from direct taxes towards property taxes. Full and rapid implementation of the government's "growth package" and measures to enhance housing investment are also crucial.

49. **A robust macroprudential framework is crucial to containing financial stability risks.** Despite relatively high levels of capitalization, banks remain vulnerable to risks stemming from elevated house prices, high levels of household indebtedness, regional interconnections, and dependence on wholesale funding. Thus, the planned legislation should maintain the full scope and flexibility of the European framework (CRD IV/CRR). This would ensure that the independent Board of the FSA has the capacity to respond to financial stability risks and to work toward full harmonization of macroprudential tools across the Nordic region. The Bank of Finland is well placed to support the new macroprudential policy-making process through surveillance and analysis.

50. **It is proposed that the next Article IV consultation with Finland occur on the standard 12-month cycle.**

Box 1. Exchange Rate and Current Account[1]

After widening as Finland lost export market share after the crisis, the current account deficit is now shrinking as external demand improves and domestic demand remains subdued. The current account (CA) deficit improved from 1.4 percent of GDP in 2012 to 1.1 percent in 2013. The move from a pre-crisis CA surplus to recent deficits was driven primarily by a drop in export demand, reflecting the break-up of Nokia, the structural decline in global demand for paper and pulp, and declining competiveness. The recent improvement in the CA deficit stems from slightly better external demand, as well as weak domestic demand due to the persistently low confidence of investors and consumers alike.

Finland's net international investment position (NIIP) remains positive, at 17 percent of GDP (Table 3). Portfolio debt liabilities have come to dominate capital inflows since 2007. As a result, gross external debt liabilities have doubled relative to GDP (to 240 percent of GDP in 2013), driving up the share of external debt in total external liabilities to 80 percent (from 52 percent in 2007). This is largely due to Swedish and Danish banks funding much of their broader euro area activities through their Finnish operations, as well as "safe haven" flows during the crisis. Comparatively, net external debt is low (26 percent of GDP). The composition of Finland's external assets has remained remarkably stable over time, with external equity and debt assets accounting for roughly 1/3 and 2/3, respectively, of total external assets.

The IMF's multilaterally-consistent methodologies suggest the real exchange rate remains broadly in line with fundamentals. Recent External Balance Assessment (EBA) estimates are mixed, but, overall, support the view that the real exchange rate is broadly in line with fundamentals and desirable policies. While the Equilibrium Real Exchange Rate approach concludes that the real exchange rate is neither over- nor undervalued, the Macroeconomic Balance approach suggests mild overvaluation and the External Sustainability approach points to the opposite. CGER methodologies also produce a mixed picture, even though the models suggesting overvaluation come out somewhat stronger than the relevant EBA approaches.

Estimates of Competitiveness Using EBA Methodologies[1]

Methodology	CA gap (percent of GDP)	REER gap (Percent)
Macroeconomic balance (MB) approach	-1.2	5.0
External sustainability (ES) approach	1.9	-7.0
Equilibrium real exchange rate approach	-	0.0

Source: IMF staff estimates.

[1] EBA (External Balance Assessment). CA gaps: minus indicates overvaluation. REER gaps: minus indicates undervaluation. REER deviations between -10 and +10 mean the real exchange rate (RER) is close to balance. EBA estimates are based on data available in April 2014.

Estimates of Competitiveness Using CGER Methodologies[1]

(Percent deviation from levels implied by medium-term fundamentals)

Methodology	
Macroeconomic balance (MB) approach	9.4
External sustainability (ES) approach	8.8
Equilibrium real exchange rate (REER) approach	-3.7

Source: IMF staff estimates.

[1] CGER (Consultative Group on Exchange Rate Issues). A positive current account gap and a negative real effective exchange rate gap indicate undervaluation. International Monetary Fund, 2008, "Exchange Rate Assessments: CGER Methodologies" (available at www.imf.org). CGER estimates are based on data available in November 2013.

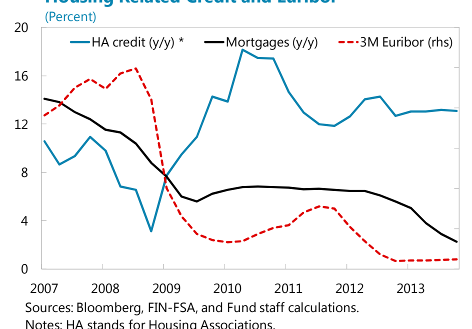
[1] All results are based on the October 2013 World Economic Outlook, and real effective exchange rate estimates for February 2014.

Box 2. Household Debt and Interest Rate Risk

Retail borrowing rates in Finland are at historic lows. The real average prime bank rate across key lenders is slightly negative, down from around 2.7 percent prior to the crisis. This has cushioned the impact of the economic downturn on households, but it has also facilitated higher household debt, boosted house prices in certain regions, and challenged banks' profitability. In the context of weak overall growth, this mix raises the risks to both household and bank balance sheets from higher interest rates.

Household indebtedness has increased. A substantial portion of household debt is comprised of variable rate mortgages (largely tied to Euribor), but additional debt is incurred through housing associations. Borrowing by housing associations increased notably early in the crisis with the decline in interest rates, and currently amounts to around €10 billion (or 9-10 percent of total household borrowing). Although mortgage borrowing has cooled over the past year, borrowing through housing associations remains elevated, and whether amortized or pre-paid through personal loans, adds to household debt.

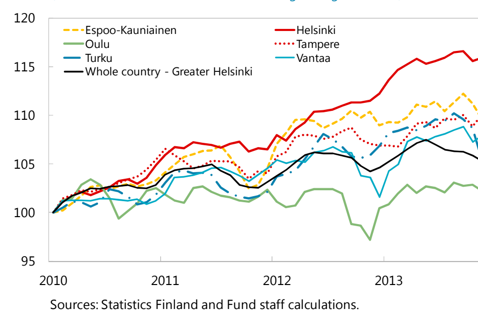
Housing Related Credit and Euribor
(Percent)



Sources: Bloomberg, FIN-FSA, and Fund staff calculations.
Notes: HA stands for Housing Associations.

House prices have risen the fastest in metropolitan areas. The pace of house price growth has been pronounced in Helsinki and other highly developed areas despite the crisis, but less so in other regions, especially where there have been declines in manufacturing and industry. Similar dynamics are evident in the relative prices of smaller dwellings compared to larger properties or detached homes, underscoring the upward pressures on house prices in highly populated areas.

Housing Prices by Region
(Index: March 2010=100, 3-month moving average, old flats)



Sources: Statistics Finland and Fund staff calculations.

Still-growing household indebtedness and concentrated house price pressures underscore risks from a rise in domestic interest rates. Higer interest rates could be driven by a normalization of global monetary policy and/or risks in global funding markets, and would impact the economy through several channels:

- *Mortgage payments* by households would rise over time. But the cushion provided by variable mortgage amortization schedules and the prohibition of banks to unilaterally revise lending margins on existing mortgages would limit immediate risks. FIN-FSA stress tests indicate only modest impacts on mortgage serviceability from interest rates rising to as high as 6 percent.
- *SMEs* would be affected by rising rates, particularly given already higher relative impariment levels on bank loans, having negative knock-on effects to employment and household income.
- *Private consumption* would be weakened by higher debt servicing costs, amplifying the effects through lower household incomes.
- *House prices* would be exposed to a downward correction. Estimates suggest that a 10 percentage point decline in property prices in Nordic countries could reduce GDP by as much as 2½ percent, and private consumption and residential investment by as much as 3½ and 28½ percent, respectively.[1]
- *Household net wealth* would fall with declining house prices, reducing household borrowing capacity through lower collateral valuations and confidence effects.[2] Finnish household wealth is high (on par, for example, with Germany), but with a lower share of liquid financial assets. This suggests limited positive income effects from higher interest income streams.

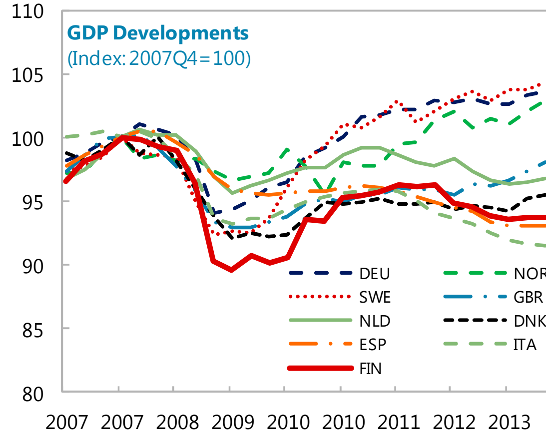
Strong regional bank interconnections underscore potential risks from other Nordic countries. Similar interest rate, or other, shocks in Sweden or Denmark could cause marked revisions in the domestic lending capacity of Noredea Bank Finland and Danske Bank Finland. Given the systemic importance of these banks, the negative effects would be similar to those emanating from within Finland. As an example, the correction in house prices elsewhere in the Nordic region has prompted local affiliates to reduce high loan-to-value lending in Finland.

[1] See the IMF working paper by Igan and Loungani, 2012, "*Global Housing Cycles*."

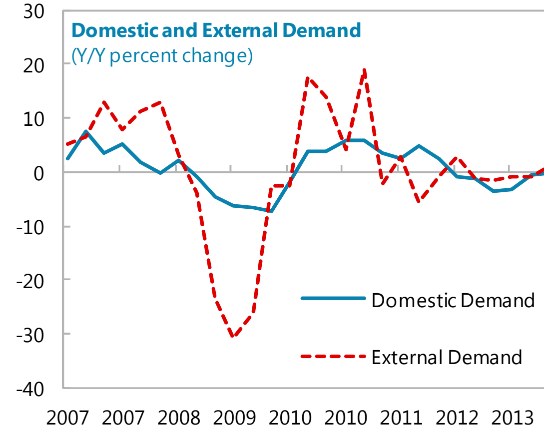
[2] See IMF, 2013, "*Nordic Regional Report*."

Figure 1. Recent Developments

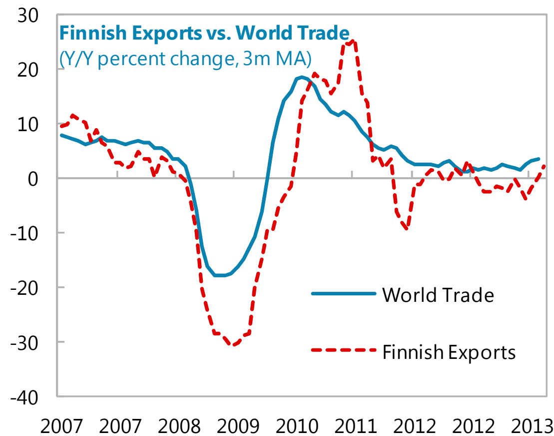
Finland's economy is lagging behind its peers...



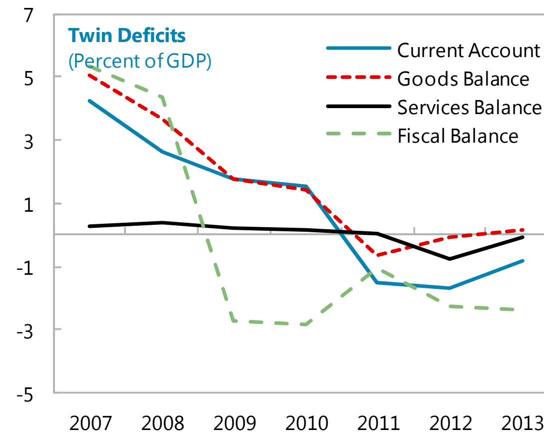
...driven by a sluggish domestic and external demand.



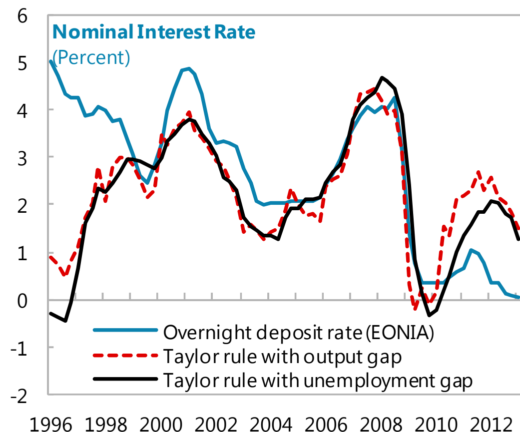
Finnish exports have lost momentum...



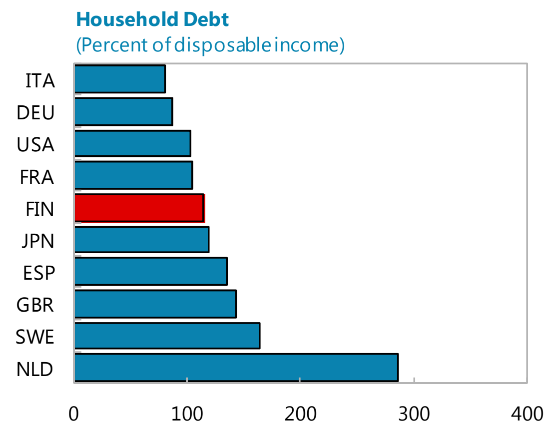
...and twin deficits have emerged.



Lending terms remain favorable...



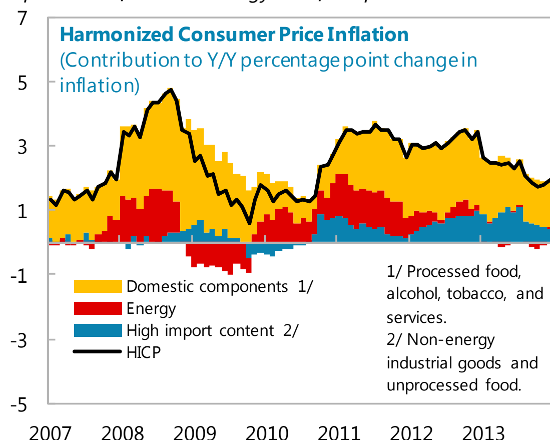
...contributing to high household debt, though debt remains below regional comparators.



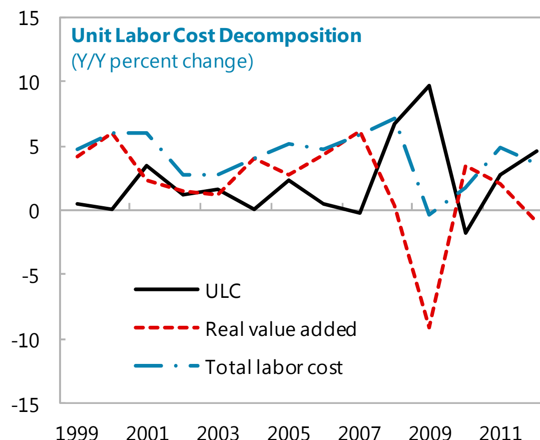
Sources: Bank of Finland, CPB World Trade Monitor, Datastream, Haver Analytics, IMF World Economic Outlook, and Fund staff calculations.

Figure 2. Structural Indicators

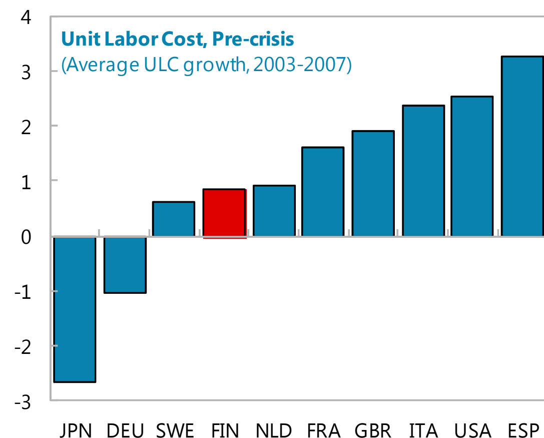
Inflation in Finland is higher than the Euro Area average despite low inflation in energy and food prices...



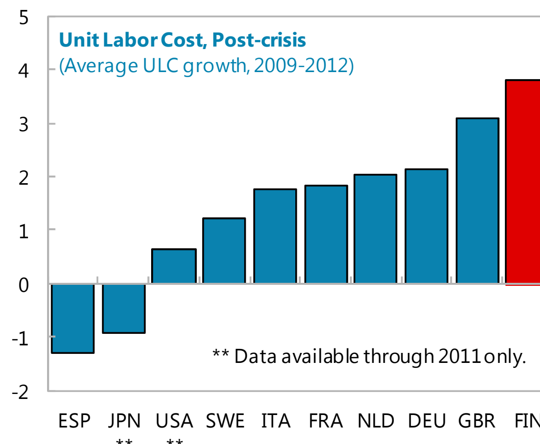
...due in part to the legacy of rapid growth in unit labor costs.



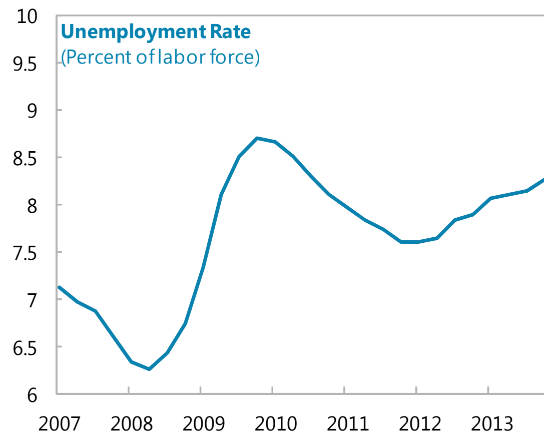
ULC growth was not exceptionally high before the crisis...



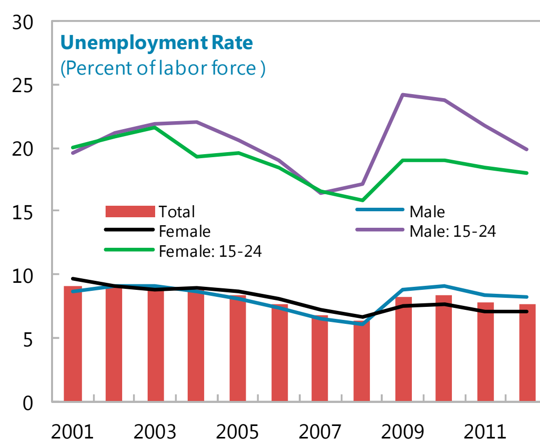
...but has risen sharply since...



...despite unemployment hovering around 8 percent...



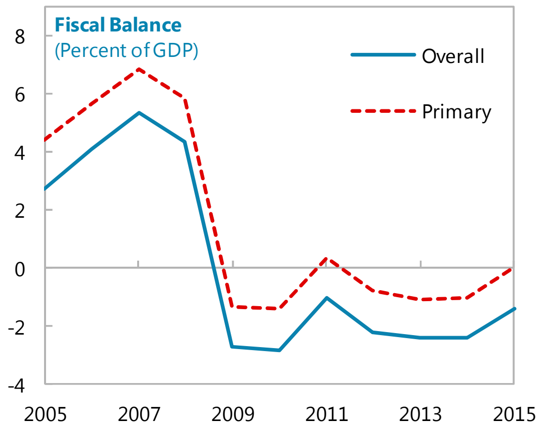
....and remaining elevated for the young



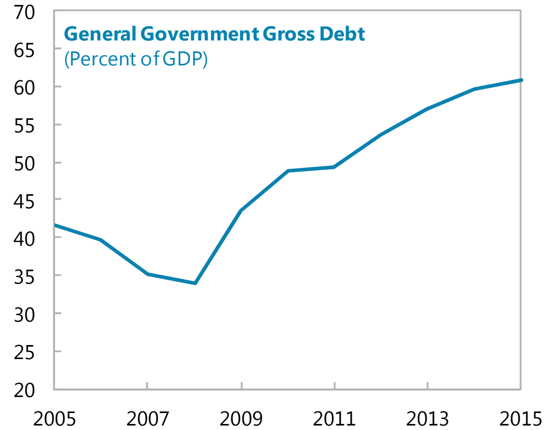
Sources: Eurostat, Haver Analytics, IMF World Economic Outlook, OECD, Statistics Finland, and Fund staff calculations.

Figure 3. Fiscal Indicators

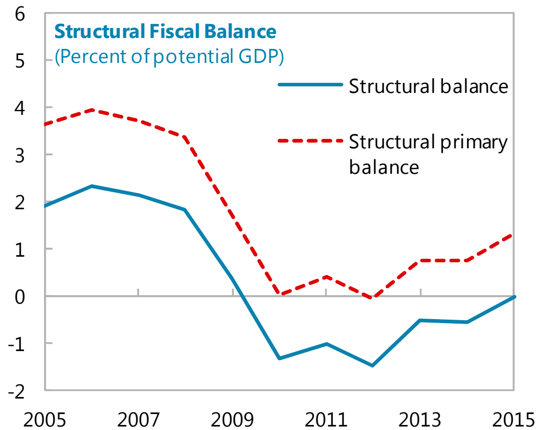
The headline fiscal balance has deteriorated markedly…



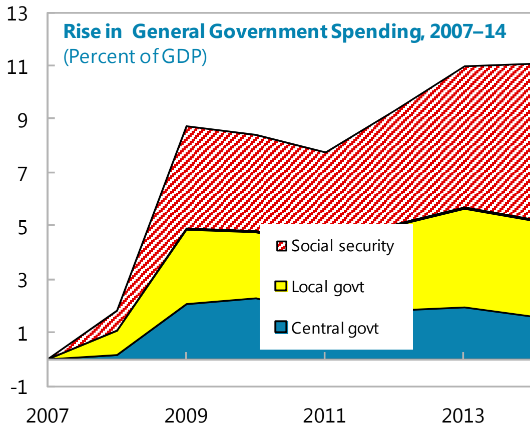
…leading to a substantial rise in debt since 2008.



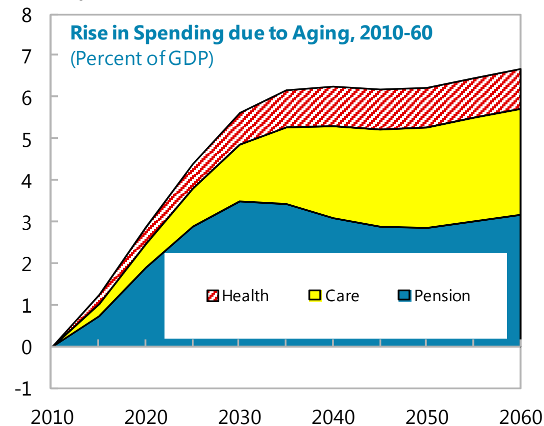
While the drop in the fiscal balance is partly cyclical, the structural fiscal position has also eroded…



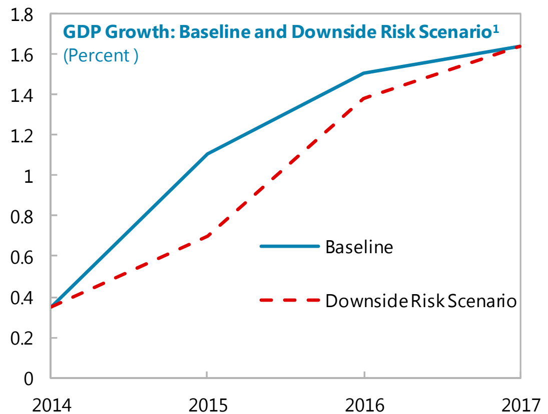
…largely due to sustained increases in social security and local government spending.



Aging-related spending pressures are set to rise sharply, so fiscal adjustment is needed…



….but a frontloaded adjustment risks slowing the recovery.[1]

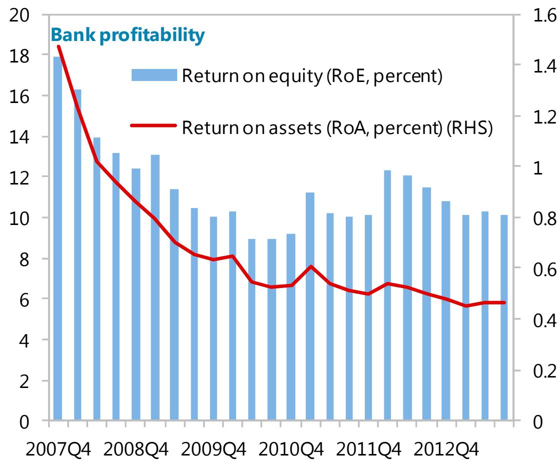


Sources: EC AMECO Database, DG ECFIN The 2012 Ageing Report, IMF World Economic Outlook, and Fund staff calculations.

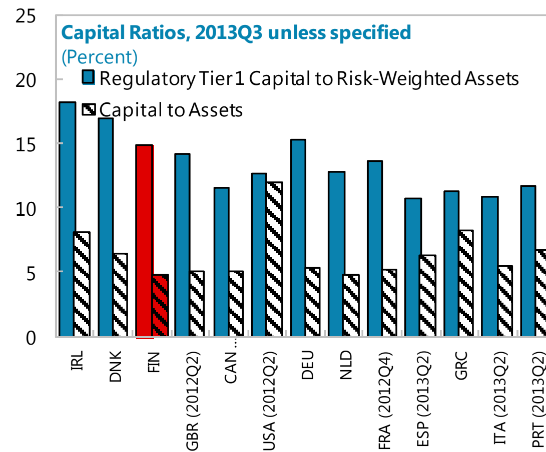
[1] The downside risk scenario is an illustrative simulation of the possible growth impact of a frontloaded fiscal consolidation, broadly along the lines of the government's spending limits decision, but omitting any mitigating factors. A fiscal multiplier of 1 is assumed in the simulation. See Chapter IV of the Selected Issues for details.

Figure 4. Financial Indicators

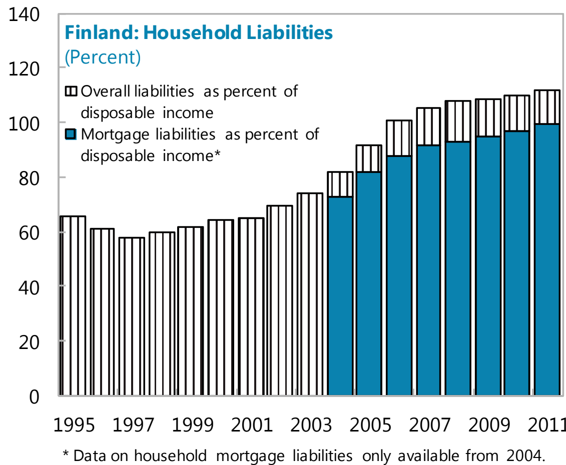
Finnish bank profitability has declined in the low interest rate environment...



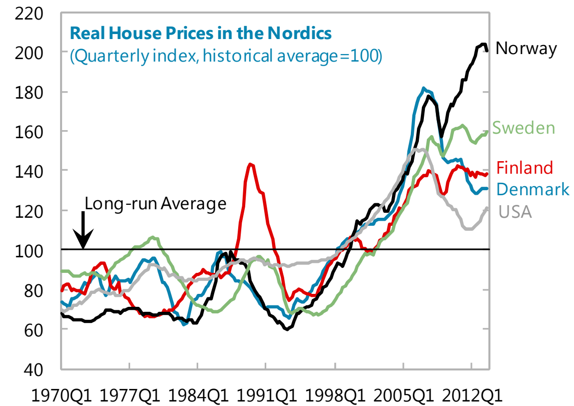
...but overall measures of capitalization remain adequate.



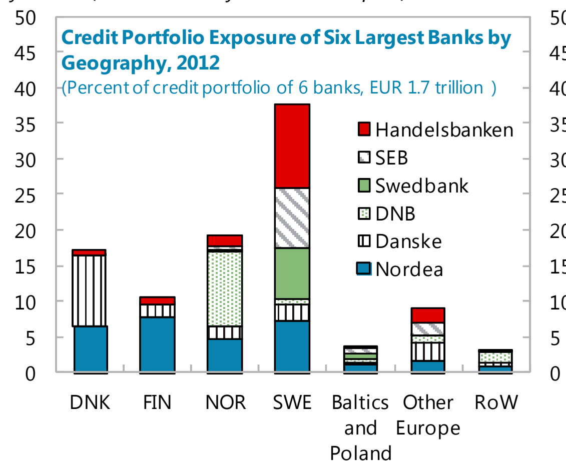
Nevertheless, there are mounting risks to banks from rising household indebtedness, particularly related to mortgages...



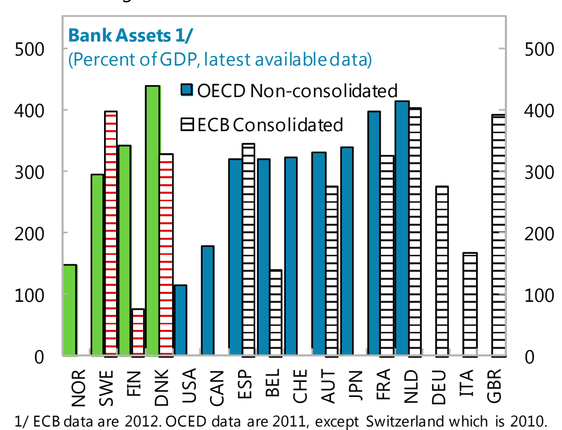
...a well as from overvalued house prices.



At the same time, these banks are part of a regional banking system, reflected in heavy cross-border portfolios.



This leaves these large banking systems vulnerable to both domestic and global shocks.



Sources: European Central Bank, Haver Analytics, IMF Financial Soundness Indicators, OECD, and Fund staff calculations.

Table 1. Selected Economic Indicators, 2010–19

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
					Proj.					
					(Percentage change unless otherwise indicated)					
Output and demand (volumes)										
GDP	3.4	2.8	-1.0	-1.4	0.3	1.1	1.5	1.6	1.8	1.8
Domestic demand	2.9	4.2	-0.8	-1.4	0.2	0.8	1.5	1.7	1.8	1.8
Private consumption	3.3	2.5	0.3	-0.8	0.2	1.4	1.9	2.0	2.0	2.0
Public consumption	-0.4	0.5	0.5	0.8	0.5	-1.0	0.5	0.5	1.0	1.0
Gross fixed capital formation	1.7	5.8	-0.8	-4.6	-1.2	1.3	2.0	2.3	2.3	2.3
Change in stocks (contribution to growth in percent of GDP)	0.9	1.5	-0.9	-0.4	0.2	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	7.9	2.8	-0.2	0.3	0.5	2.6	2.7	2.7	2.7	2.7
Imports of goods and services	6.8	6.2	-0.7	-1.8	0.1	1.7	2.9	2.9	2.9	2.9
Net exports (contribution to growth in percent of GDP)	0.5	-1.3	0.2	0.9	0.2	0.3	0.0	0.0	0.0	0.0
Prices, costs, and income										
Consumer price inflation (harmonized, average)	1.7	3.3	3.2	2.2	1.7	1.5	1.7	1.9	2.0	2.0
Consumer price inflation (harmonized, end-year)	2.8	2.6	3.5	1.9	1.4	1.5	1.7	1.9	2.0	2.0
GDP deflator	0.3	2.7	2.9	2.0	2.0	1.5	1.8	1.9	1.9	1.9
Unit labor cost, manufacturing	-9.7	4.8	6.0	-0.2	0.8	1.2	0.2	0.2	0.2	0.2
Labor market										
Labor force	-0.2	0.4	0.3	-0.6	-0.3	0.0	0.0	0.1	0.1	0.1
Employment	-0.4	1.1	0.4	-1.1	-0.3	0.3	0.2	0.2	0.2	0.2
Unemployment rate (in percent)	8.4	7.8	7.7	8.1	8.1	7.9	7.7	7.6	7.5	7.4
Potential output and NAIRU										
Output gap (in percent of potential output)[1]	-2.4	0.0	-1.3	-2.9	-2.9	-2.6	-2.0	-1.5	-0.9	-0.4
Growth in potential output	0.3	0.4	0.3	0.3	0.3	0.8	0.9	1.1	1.2	1.2
NAIRU (in percent)	7.7	7.7	7.6	7.6	7.6	7.6	7.6	7.5	7.5	7.4
					(Percent of GDP)					
General government finances[2]										
Overall balance	-2.8	-1.0	-2.2	-2.4	-2.4	-1.4	-0.9	-0.4	-0.1	0.1
Primary balance[3]	-1.4	0.4	-0.8	-1.1	-1.0	0.0	0.6	1.3	1.6	1.9
Structural balance (in percent of potential GDP)	-1.3	-1.0	-1.5	-0.5	-0.6	0.0	0.2	0.4	0.4	0.4
Structural primary balance (in percent of potential GDP)[3]	0.0	0.4	-0.1	0.7	0.8	1.3	1.7	2.1	2.2	2.1
Gross debt	48.8	49.3	53.6	57.0	59.6	60.9	61.4	61.2	61.0	60.1
Net debt (negative of net financial worth)	-65.6	-54.3	-55.4	-52.7	-49.2	-46.6	-44.1	-42.3	-40.6	-39.3
					(Percent)					
Money and interest rates										
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	5.2	6.0	0.5	4.1	...	...	...	...	...	...
Finnish MFI euro area loans (growth rate, e.o.p.)	6.6	6.4	7.1	7.7	...	...	...	...	...	...
3-month Euribor rate (percent)[4]	0.8	1.4	0.6	0.2	0.3	...	...	...	...	...
10-year government bonds yield[4]	3.0	3.0	1.9	1.9	2.0	...	...	...	...	...
					(Percent of GDP)					
National saving and investment										
Gross national saving	20.0	19.0	17.8	17.0	18.1	18.6	18.9	19.1	19.1	19.1
Gross domestic investment	18.4	20.5	19.8	18.7	18.4	18.4	18.5	18.6	18.6	18.6
Balance of payments										
Current account balance	1.5	-1.5	-1.4	-1.1	-0.2	0.4	0.5	0.7	0.7	0.6
Goods and services balance	1.6	-0.6	-0.8	0.1	0.0	0.3	0.3	0.2	0.2	0.1
Net international investment position	10.7	16.2	17.7	19.3	20.9	22.9	24.8	26.7	28.3	29.9
Gross external debt	189.6	216.1	231.3	240.8	245.4	248.7	249.8	250.0	249.5	248.8
Exchange rates (period average)										
Euro per US$	0.75	0.72	0.78	0.75	...	...	...	...	...	...
Nominal effective rate (appreciation in percent)	-4.5	0.0	-3.3	2.6	...	...	...	...	...	...
Real effective rate (appreciation in percent)[5]	-5.4	0.0	-2.9	2.1	...	...	...	...	...	...

Sources: Bank of Finland, International Financial Statistics, IMF Institute, Ministry of Finance, Statistics Finland, and Fund staff calculations.

[1] A negative value indicates a level of actual GDP that is below potential output.

[2] Fiscal projections include measures as specified in the Government Program.

[3] Adjusted for interest expenditure.

[4] 2014 data are latest available.

[5] CPI-based real effective exchange rate.

Table 2. Balance of Payments, 2010–19
(In billions of euros, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
							Proj.			
Current account	2.7	-2.8	-2.7	-2.1	-0.4	0.7	1.1	1.5	1.5	1.4
(percent of GDP)	1.5	-1.5	-1.4	-1.1	-0.2	0.4	0.5	0.7	0.7	0.6
Goods and services	2.8	-1.1	-1.1	0.5	0.2	0.9	0.8	0.7	0.6	0.5
(percent of GDP)	1.6	-0.6	-0.6	0.3	0.1	0.4	0.4	0.3	0.3	0.2
Exports of goods and services	72.9	77.8	79.9	79.4	79.2	81.2	83.5	85.7	88.1	90.5
Goods	52.5	56.9	57.2	56.2	56.0	57.4	59.0	60.7	62.4	64.1
Services	20.4	20.9	22.7	23.1	23.2	23.8	24.4	25.0	25.7	26.4
Imports of goods and services	-70.0	-78.9	-81.0	-78.8	-79.0	-80.3	-82.6	-85.0	-87.5	-90.0
Goods	-49.9	-58.1	-57.3	-56.1	-55.1	-55.9	-57.4	-58.9	-60.4	-62.0
Services	-20.1	-20.8	-23.8	-22.8	-23.9	-24.4	-25.3	-26.2	-27.1	-28.0
Income	1.5	-0.1	-0.3	-1.2	0.4	0.4	0.5	0.5	0.6	0.7
Compensation of employees	0.3	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Investment income	1.3	-0.3	-0.3	0.3	0.3	0.4	0.4	0.5	0.5	0.6
Current transfers	-1.7	-1.6	-1.3	-1.3	-1.0	-0.6	-0.2	0.2	0.2	0.2
(of which, official)	-2.0	-2.3	-1.2	-1.2	-0.9	-0.5	-0.1	0.4	0.4	0.4
Capital and financial account	-3.5	8.5	17.2	2.1	0.4	-0.7	-1.1	-1.5	-1.5	-1.4
Capital account	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-3.7	8.4	16.9	1.9	0.2	-0.9	-1.3	-1.7	-1.7	-1.6
Direct investment	-2.1	-1.8	-2.6	-3.1	-2.8	-2.6	-2.6	-2.5	-2.3	-2.4
In Finland	5.6	1.8	3.2	0.4	0.7	0.8	0.9	1.1	1.4	1.4
Abroad	-7.7	-3.6	-5.9	-3.4	-3.5	-3.4	-3.5	-3.6	-3.7	-3.8
Portfolio investment	-9.9	8.0	9.3	9.3	9.4	9.4	9.5	9.5	9.6	9.6
Financial derivatives	-0.1	1.1	1.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	6.7	1.4	9.7	-4.4	-6.4	-7.7	-8.2	-8.7	-8.9	-8.9
Assets	-29.8	-83.5	-1.9	-4.0	-4.0	-4.4	-4.5	-4.8	-4.8	-4.8
Liabilities	36.6	84.9	11.6	-0.4	-2.4	-3.3	-3.7	-3.9	-4.1	-4.1
Official	-15.2	-7.6	-5.3	-4.3	-3.8	-3.4	-3.1	-2.8	-2.5	-2.3
Private	21.9	8.9	15.0	-0.1	-2.6	-4.3	-5.1	-6.0	-6.4	-6.6
Reserve assets	1.7	-0.3	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	0.8	-5.7	-14.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:										
GDP at current prices	178.7	188.7	192.4	193.4	197.9	203.0	209.8	217.2	225.3	233.7

Sources: Bank of Finland, Statistics Finland, and Fund staff calculations.

Table 3. Net International Investment Position, 2005–12
(Percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012
Assets	197.9	231.9	243.7	230.8	298.2	343.3	359.8	386.2
Direct investment	54.2	57.8	61.8	61.6	73.9	79.1	66.0	77.6
Equity & investment fund shares	29.2	35.6	39.0	39.9	52.5	55.6	47.1	55.6
Debt instruments	25.0	22.1	22.8	21.6	21.4	23.6	18.9	21.9
Portfolio investment	78.9	103.0	104.1	67.0	106.3	121.3	103.9	128.0
Equity & investment fund shares	33.0	46.3	49.7	23.3	43.1	55.7	43.3	56.5
Debt securities	45.9	56.6	54.4	43.7	63.2	65.6	60.6	71.5
Fin. deriv. (other than reserves)	17.9	17.7	21.7	47.7	48.8	61.2	91.1	72.4
Other investment	41.2	49.9	52.6	51.4	64.3	77.7	94.9	103.8
Reserve assets	5.8	3.6	3.4	3.1	4.8	4.0	3.9	4.5
Liabilities	212.5	246.5	273.8	233.5	292.0	322.5	342.1	368.1
Direct investment	40.3	45.4	51.7	50.3	55.1	57.6	49.0	55.4
Equity & investment fund shares	21.1	26.5	29.1	24.7	28.7	30.8	27.4	30.9
Debt instruments	19.3	18.9	22.7	25.7	26.4	26.8	21.6	24.5
Portfolio investment	117.7	139.3	154.4	85.0	116.4	117.2	100.3	126.1
Equity & investment fund shares	61.3	74.5	93.5	35.7	43.5	41.2	25.5	31.2
Debt securities	56.4	64.8	60.9	49.4	72.9	76.0	74.8	94.9
Fin. deriv. (other than reserves)	17.4	17.2	20.8	47.6	47.5	58.3	87.2	67.9
Other investment	37.0	44.6	46.9	50.5	73.0	89.4	105.6	118.7
Net International Investment Position	-14.6	-14.6	-30.1	-2.6	6.2	20.8	17.6	18.1
Direct Investment	13.8	12.3	10.1	11.3	18.8	21.5	17.0	22.1
Portfolio Investment	-38.8	-36.4	-50.3	-18.0	-10.1	4.1	3.6	1.9
Fin. deriv. (other than reserves)	0.5	0.5	0.9	0.1	1.3	2.9	3.8	4.5
Other Investment	4.1	5.3	5.7	0.9	-8.7	-11.7	-10.8	-14.9

Sources: International Financial Statistics and Fund staff calculations.

Table 4. General Government Statement of Operations, 2010–19

(In percent of GDP, unless otherwise indicated)

	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
				Est.			Proj.			
Revenue	53.0	54.1	54.5	56.0	56.1	56.6	56.8	57.1	57.0	57.1
Tax revenues	29.6	30.8	30.8	32.1	31.9	32.1	32.3	32.4	32.3	32.4
Taxes on production and imports	13.4	14.2	14.4	14.8	15.0	15.2	15.0	14.9	14.7	14.7
Current taxes on income, wealth, etc.	16.0	16.4	16.0	16.9	16.5	16.7	16.9	17.1	17.3	17.4
Capital taxes	0.2	0.2	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.4
Social contributions	12.8	12.7	13.3	13.4	13.6	13.6	13.7	13.6	13.5	13.5
Grants	0.2	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue										
Expenditure	55.8	55.1	56.7	58.4	58.5	58.0	57.7	57.5	57.1	56.9
Expense	55.5	54.8	56.3	57.8	57.9	57.5	57.4	57.2	56.9	56.7
Compensation of employees	14.5	14.2	14.5	14.7	14.5	14.1	13.8	13.6	13.3	13.2
Use of goods and services	11.5	11.5	11.8	12.2	11.9	11.9	11.9	12.0	11.9	11.9
Consumption of fixed capital (CFC)	2.2	2.2	2.2	2.3	2.3	2.3	2.3	2.3	2.3	2.3
Interest	1.4	1.4	1.4	1.3	1.4	1.4	1.5	1.7	1.8	1.8
Subsidies	1.5	1.4	1.4	1.4	1.5	1.4	1.3	1.2	1.2	1.2
Grants	1.2	1.3	1.3	1.4	1.4	1.4	1.4	1.4	1.4	1.4
Social benefits	21.0	20.6	21.5	22.6	23.1	23.1	23.2	23.3	23.4	23.4
Other expense	2.2	2.1	2.0	2.1	2.0	1.9	1.9	1.7	1.7	1.6
Net acquisition of nonfinancial assets	0.3	0.4	0.4	0.5	0.5	0.4	0.3	0.3	0.2	0.2
Net acquisition of nonfinancial assets excl. CFC										
Consumption of fixed capital (CFC)										
Net operating balance	-2.5	-0.7	-1.8	-1.8	-1.9	-1.0	-0.6	-0.1	0.1	0.3
Net lending/borrowing	-2.8	-1.0	-2.2	-2.4	-2.4	-1.4	-0.9	-0.4	-0.1	0.1
Net acquisition of financial assets	3.6	2.2	3.7							
Currency and deposits	2.7	1.3	-1.1	...						
Securities other than shares	-4.1	0.9	-0.5	...						
Loans	0.5	-0.3	1.9	...						
Shares and other equity	3.8	0.1	3.4	...						
Insurance technical reserves	0.0	0.0	0.0	...						
Financial derivatives	0.0	0.0	0.0	...						
Other accounts receivable	0.7	0.1	0.1	...						
Net incurrence of liabilities	6.7	3.3	5.9	...						
Special Drawing Rights (SDRs)	0.0	0.0	0.0	...						
Currency and deposits	0.0	0.0	0.0	...						
Securities other than shares	6.8	2.0	3.4	...						
Loans	0.3	1.2	2.0	...						
Shares and other equity	0.0	0.0	0.0	...						
Insurance technical reserves	0.0	0.0	0.0	...						
Financial derivatives	-0.4	0.0	0.2	...						
Other accounts payable	-0.1	0.0	0.3	...						
Memorandum items:										
Primary balance[1]	-1.4	0.4	-0.8	-1.1	-1.0	0.0	0.6	1.3	1.6	1.9
Structural balance (in percent of potential GDP)	-1.3	-1.0	-1.5	-0.5	-0.6	0.0	0.2	0.4	0.4	0.4
Structural primary balance (in percent of potentia	0.0	0.4	-0.1	0.7	0.8	1.3	1.7	2.1	2.2	2.1
Central government net lending/borrowing	-5.6	-3.4	-3.8	-3.7	-3.5	-2.4	-2.1	-1.5	-1.2	-1.0
General government gross debt	48.8	49.3	53.6	57.0	59.6	60.9	61.4	61.2	61.0	60.1
General government net debt[2]	65.6	54.3	55.4	52.7	49.2	46.6	44.1	42.3	40.6	39.3
Central government gross debt	44.3	45.5	48.8	50.9	52.2	52.3	51.7	50.7	49.6	48.1
Output gap (percent of potential GDP)	-2.4	0.0	-1.3	-2.9	-2.9	-2.6	-2.0	-1.5	-0.9	-0.4
Nominal GDP (billions of euros)	178.7	188.7	192.4	193.4	197.9	203.0	209.8	217.2	225.3	233.7

Sources: Eurostat, Government Finance Statistics, International Financial Statistics, Ministry of Finance, and Fund staff calculations.

[1] Adjusted for interest expenditure.

[2] Defined as the negative of net financial worth.

Table 5. General Government Balance Sheet, 2005–12
(In percent of GDP)

	2005	2006	2007	2008	2009	2010	2011	2012
Net worth	...	...	...	...	...	...	...	...
Nonfinancial assets	...	...	...	...	...	...	...	...
Net financial worth	58.6	69.4	72.5	52.3	62.8	65.6	54.3	55.4
Financial assets	107.0	115.0	113.9	92.6	114.6	123.4	112.4	119.4
Currency and deposits	5.9	6.3	6.2	6.5	6.1	8.6	9.5	8.4
Securities other than shares	28.3	26.3	23.1	22.8	27.3	22.0	21.7	21.9
Loans	12.4	12.2	11.3	12.8	15.4	15.3	14.0	15.8
Shares and other equity	55.5	64.5	66.8	44.7	61.0	71.3	61.3	67.3
Insurance technical reserves	0.0	0.0	0.1	0.1	0.1	0.1	0.0	0.0
Financial derivatives	0.1	1.3	1.8	1.1	0.6	1.2	1.0	1.2
Other accounts receivable/payable	4.6	4.4	4.6	4.6	4.3	4.9	4.9	4.8
Liabilities	48.4	45.6	41.4	40.3	51.8	57.9	58.1	64.0
Currency and deposits	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3
Securities other than shares	36.7	33.9	29.3	28.6	37.4	43.2	44.3	48.2
Loans	7.1	6.3	6.1	6.5	7.7	7.6	8.4	10.2
Shares and other equity	0.1	0.0	0.0	0.0	0.0	0.3	0.3	0.3
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.2	0.9	1.0	0.5	0.3	0.6	-0.7	-0.8
Other accounts receivable/payable	4.4	4.3	4.7	4.4	6.2	5.9	5.6	5.8

Sources: Global Insight, Government Finance Statistics, and Fund staff calculations.

Table 6. Financial Soundness Indicators for the Banking Sector, 2008–13

	2008	2009	2010	2011	2012	2013
Households						
Total household debt (in percent of GDP)	53.4	60.6	62.1	62.2	64.1	64.1
Total household debt (in percent of disposable income)	109.3	111.4	113.1	115.0	117.3	117.6
Financial assets/GDP	99.9	120.0	125.9	115.4	120.8	121.2
Non-financial corporations						
Gross debt (in percent of GDP)	55.5	60.1	60.0	59.8	60.8	63.7
Government						
General government debt (EMU definition, in percent of GDP)	33.9	43.6	48.8	49.3	53.6	57.0
Central government debt (in percent of GDP)	31.1	39.4	44.3	45.5	48.8	50.9
Banking sector						
Total assets (in billions of euro)	347.1	349.1	418.2	542.4	496.2	445.4
in percent of GDP	186.9	202.6	234.0	287.4	257.9	226.5
Total deposits (in billions of euro)	109.4	110.4	119.2	130.5	136.3	131.6
in percent of GDP	58.9	64.1	66.7	69.1	70.9	66.9
Credit to nonfinancial and housing corporations (annual percent change, e.o.p.)	18.1	-5.9	4.6	9.1	4.8	6.1
Credit to nonfinancial corporations (annual percent change, e.o.p.)	21.6	-9.6	1.7	8.3	2.5	3.4
Credit to households (percent change, e.o.p.)	8.0	5.5	6.1	5.2	4.9	2.2
Housing loans in percent of total lending	45.0	47.8	47.4	42.1	42.7	40.3
Asset quality						
Non-performing loans (in billions of euro)	0.8	1.2	1.2	1.3	1.3	1.4
Non-performing loans/total loans (in percent)[1]	0.4	0.7	0.6	0.6	0.5	0.6
Povisions to non-performing loans (in percent)	*N/A*	*N/A*	*N/A*	*N/A*	*N/A*	*N/A*
Household non-performing loans/total household loans (in percent)[1]	0.5	0.6	0.5	0.6	0.6	0.7
Household non-performing loans/total non-performing loans (in percent)[1]	57.8	44.2	43.5	47.5	51.9	54.5
Capital adequacy						
Regulatory capital as percent of risk-weighted assets	13.6	14.5	14.4	14.2	17.0	15.6
Regulatory tier 1 capital to risk-weighted assets	12.5	13.7	13.6	13.6	16.1	14.8
Equity/total assets (in percent)	6.2	6.4	5.5	4.4	4.4	4.9
Profitability						
Interest rate margin (percentage points, e.o.p.)[2]	2.6	1.7	1.7	1.9	1.3	1.4
Net interest income (in percent of total income)	60.3	46.7	44.7	48.1	43.8	40.3
Return on equity (in percent)	12.4	10.0	9.2	10.1	10.9	10.1
Return on assets (in percent)	0.9	0.6	0.5	0.5	0.5	0.5
Liquid assets/total assets (in percent)[3]	4.8	7.5	6.8	6.8	14.6	12.3
Liquid assets/short-term liabilities	*N/A*	*N/A*	*N/A*	*N/A*	*N/A*	*N/A*
Deposits as percent of assets	31.6	31.6	28.5	24.1	27.5	29.6
Off-balance sheet liabilities/total assets (in percent)	13.8	15.6	13.6	10.8	11.1	11.8
Use of ECB refinancing (billions of euro)[4]	0.2	2.7	0.1	2.3	3.7	2.5
in percent of banks total assets	0.1	0.8	0.0	0.4	0.7	0.6
in percent of total ECB refinancing operations	0.0	0.4	0.0	0.3	0.3	0.4
Asset prices						
Change in stock market index (in percent, e.o.p.)[5]	-53.4	19.5	18.7	-30.1	8.3	15.9
Change in housing price index (in percent, year average)	0.6	-0.3	8.7	2.7	1.6	1.6

Sources: Bank of Finland, Financial Supervision Authority, Finnish Bankers' Association, Haver Analytics, Statistics Finland, and Fund staff calculations.

[1] Denominator also includes guarantees.

[2] Average of margins (average lending rate minus average deposit rate) on loans to non-MFIs.

[3] Liquid assets are defined as the sum of cash, claims on central bank payable on demand and debt securities eligible for refinancing with central bank.

[4] Sum of main and long-term refinancing operations and marginal facility.

[5] For 2013, the observation is as of January 2014 (change since January 2013).

Table 7. Risk Assessment Matrix
(Scale—high, medium, or low)

Source of Risks	Overall Level of Concern	
	Relative Likelihood	**Impact if Realized**
1. Side Effects from global financial conditions.	**High** • Surges in global financial market volatility, especially in wholesale funding, leading to economic and fiscal stress, and constraints on country policy settings, including in Finland, a small open economy that is financially integrated with the large Nordic banking system.	**Medium** • Bank losses and funding stress could translate into curtailed lending, with negative effects for investment, consumption, and growth. • **Policy Response**: Reduce vulnerabilities of the financial sector by fully implementing the macroprudential toolkit
2. Protracted period of slow European growth.	**High** • Drop in export demand as Finland's exports are tightly linked to EA markets.	**High** • With domestic demand already anemic, external demand will wane further, pushing Finland into a period of economic stagnation. • **Policy Response**: Maintain gradual pace of fiscal consolidation
3. Risks to financial stability from incomplete regulatory reforms.	**Medium** • Financial instabilities linked to the remaining uncertainties about the design of future regulatory landscape and slow progress in reaching global agreements on effective crisis resolution mechanisms.	**Low** • Bank's willingness to lend may be affected as well as their cross-border operations and exposure. • **Policy Response**: Move ahead with financial sector reform, including at the EU, euro area, and Nordic level.
4. Adverse house price shock in Finland (or an interconnected neighboring Nordic country).	**Medium** • Given high levels of household debt, a drop in house prices would reduce household liquidity and net wealth. • The impact of a house price shock would be elevated if it occurred in conjunction with stress in global funding markets (see point 1).	**Medium** • The effect to consumption and employment will lower growth. • Rising NPLs and bank funding costs could translate into curtailed lending, with negative effects on investment. • **Policy Response**: Full adoption of the macroprudential toolkit.
5. Increasing geopolitical tensions surrounding Ukraine lead to disruptions in financial, trade, and commodity markets.	**Medium** • Doubts about whether Ukraine will consistently make timely commercial and financial payments. • An increase in geopolitical tensions, including the imposition of additional sanctions. • Drop in global and regional trade and financial instability. • A slowdown in Russia.	**Low** • Exports to Russia may be affected, with a negative growth impact. • Finland is almost entirely reliant on Russian gas, but a supply disruption would be limited in the short-run. • Financial linkages with Russia and Ukraine are limited. • **Policy Response**: Proactively seek to diversify export markets and energy sources.

Appendix I. Debt Sustainability Analysis

Finland Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

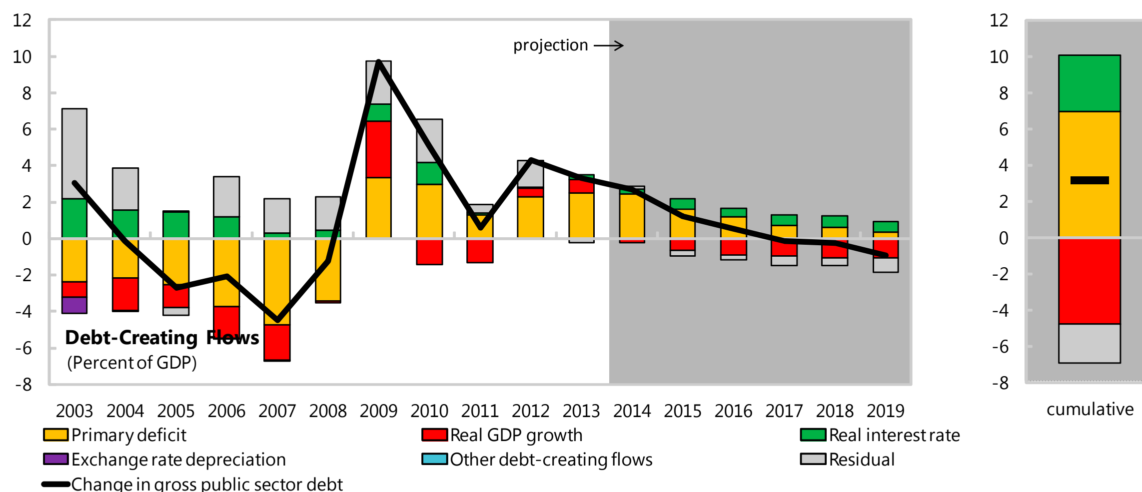
Debt, Economic and Market Indicators [1/]

	Actual			Projections					
	2003-2011 [2/]	2012	2013	2014	2015	2016	2017	2018	2019
Nominal gross public debt	42.3	53.6	57.0	59.6	60.9	61.4	61.3	61.0	60.1
Public gross financing needs	6.6	8.3	8.0	8.9	8.8	9.0	10.1	6.4	4.5
Real GDP growth (in percent)	1.9	-1.0	-1.4	0.3	1.1	1.5	1.6	1.8	1.8
Inflation (GDP deflator, in percent)	1.3	2.9	2.0	2.0	1.5	1.8	1.9	1.9	1.9
Nominal GDP growth (in percent)	3.2	1.9	0.6	2.3	2.6	3.3	3.5	3.7	3.7
Effective interest rate (in percent) [4/]	3.9	3.0	2.4	2.4	2.4	2.7	2.9	3.0	2.9

As of February 10, 2014		
Sovereign Spreads		
Spread (bp) 3/		30
CDS (bp)		19
Ratings	Foreign	Local
Moody's	Aaa	Aaa
S&Ps	AAA	AAA
Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2003-2011	2012	2013	2014	2015	2016	2017	2018	2019	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	0.9	4.30	3.32	2.7	1.2	0.5	-0.1	-0.2	-0.9	3.2	
Identified debt-creating flows	-1.1	2.80	3.51	2.5	1.5	0.8	0.4	0.2	-0.1	5.3	
Primary deficit	-1.3	2.3	2.5	2.5	1.6	1.2	0.7	0.6	0.4	7.0	-0.5
Primary (noninterest) revenue and gra	51.2	53.0	54.5	54.6	54.9	55.0	55.0	54.7	54.8	329.1	
Primary (noninterest) expenditure	50.0	55.3	57.1	57.1	56.6	56.2	55.7	55.3	55.2	336.1	
Automatic debt dynamics [5/]	0.1	0.5	1.0	0.1	-0.1	-0.4	-0.4	-0.4	-0.5	-1.7	
Interest rate/growth differential [6/]	0.2	0.5	1.0	0.1	-0.1	-0.4	-0.4	-0.4	-0.5	-1.7	
Of which: real interest rate	1.1	0.0	0.3	0.3	0.5	0.5	0.6	0.6	0.6	3.1	
Of which: real GDP growth	-0.8	0.5	0.7	-0.2	-0.6	-0.9	-1.0	-1.0	-1.0	-4.8	
Exchange rate depreciation [7/]	-0.1	0.0	0.0	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other debt-creating flows (specify)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes [8/]	2.0	1.5	-0.2	0.2	-0.3	-0.3	-0.5	-0.4	-0.8	-2.1	



Source: Fund staff calculations. 1/ Public sector is defined as general government. 2/ Based on available data. 3/ Bond Spread over German Bonds.

4/ Defined as interest payments divided by debt stock at the end of previous year.

5/ Derived as [(r - p(1+g) - g + ae(1+r)]/(1+g+p+gp)) times previous period debt ratio, with r = interest rate; p = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the denominator in footnote 4 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 2/ as ae(1+r).

8/ For projections, this line includes exchange rate changes during the projection period.

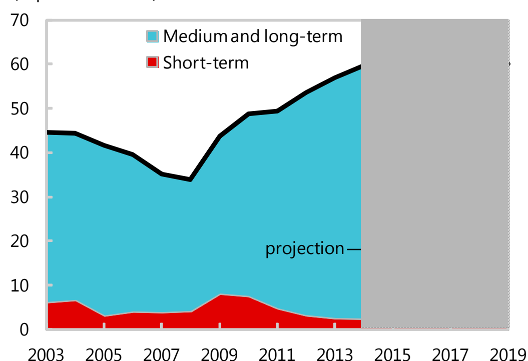
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Finland Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

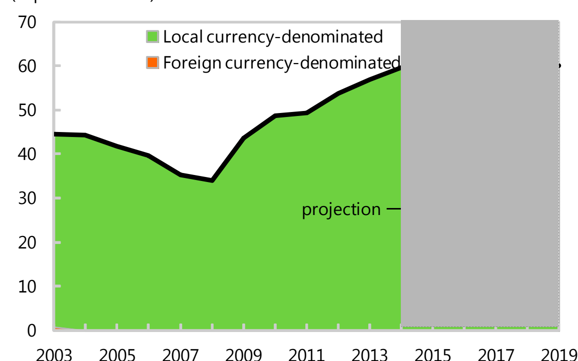
By Maturity

(in percent of GDP)



By Currency

(in percent of GDP)

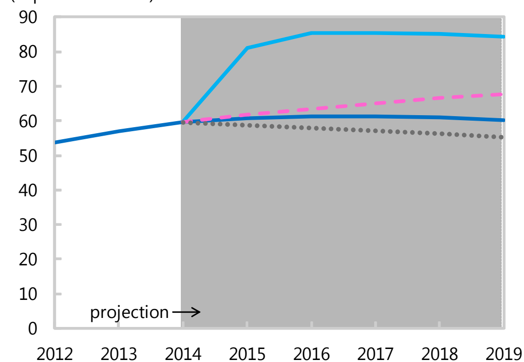


Alternative Scenarios 1/

Baseline
Contingent Liability Shock
Historical
Constant Primary Balance

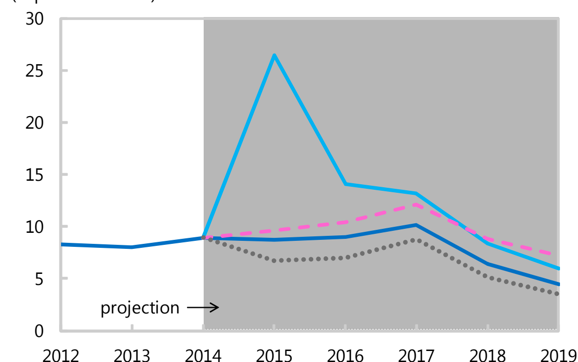
Gross Nominal Public Debt

(in percent of GDP)



Public Gross Financing Needs

(in percent of GDP)



Underlying Assumptions

(in percent)

Baseline Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	0.3	1.1	1.5	1.6	1.8	1.8
Inflation	2.0	1.5	1.8	1.9	1.9	1.9
Primary Balance	-2.5	-1.6	-1.2	-0.7	-0.6	-0.4
Effective interest rate	2.4	2.4	2.7	2.9	3.0	2.9
Constant Primary Balance Scenario						
Real GDP growth	0.3	1.1	1.5	1.6	1.8	1.8
Inflation	2.0	1.5	1.8	1.9	1.9	1.9
Primary Balance	-2.5	-2.5	-2.5	-2.5	-2.5	-2.5
Effective interest rate	2.4	2.4	2.6	2.9	3.0	2.9

Historical Scenario	2014	2015	2016	2017	2018	2019
Real GDP growth	0.3	1.2	1.2	1.2	1.2	1.2
Inflation	2.0	1.5	1.8	1.9	1.9	1.9
Primary Balance	-2.5	0.4	0.4	0.4	0.4	0.4
Effective interest rate	2.4	2.4	2.8	3.2	3.4	3.4
Contingent Liability Shock						
Real GDP growth	0.3	-3.0	-2.6	1.6	1.8	1.8
Inflation	2.0	1.0	1.4	1.9	1.9	1.9
Primary Balance	-2.5	-18.9	-1.2	-0.7	-0.6	-0.4
Effective interest rate	2.4	2.6	3.1	3.2	3.3	3.2

Source: Eurostat, , Finnish State Treasury, Ministry of Finance, Statistics Finland, and Fund staff calculations.

1/ The Baseline is constructed from historical data on debt maturity, currency denomination of debt, and other characteristics of outstanding government debt. Projections are based on financing needs and other related variables from reports of the Swedish National Debt Office and the Ministry of Finance. In the Historical scenario, real GDP growth, the real interest rate, and the primary balance are set to historical averages. In the Constant Primary Balance scenario, the primary balance projection is kept constant at the 2013 Baseline proejction level. The Contingent Liability Shock scenario considers a one-time increase in non-interest expenditures equivalent to 10 percent of banking sector assets. In turn, this results in adverse effects on real GDP growth, which is reduced by 2 standard deviations for 2 consecutive years. The revenue-to-GDP ratio remains unchanged relative to the baseline; the deterioration in the primary balance leads to an increase in the interst rate; and the decline in growth results in lower inflation.

INTERNATIONAL MONETARY FUND

FINLAND

STAFF REPORT FOR THE 2014 ARTICLE IV CONSULTATION – INFORMATIONAL ANNEX

April 30, 2014

Prepared By European Department

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FUND RELATIONS

(As of April 30, 2014)

Mission: March 3 to March 14, 2014 in Helsinki. The concluding statement of the mission is available.

Staff team: Mr. H. Berger (Head), Mr. N. Arnold, Ms. B. Mircheva, Mr. A. Al-Eyd (all EUR).

Interlocutors and outreach: The team met with Mr. E. Liikanen, Governor of the Bank of Finland, Ms. J. Urpilainen, Minister of Finance, and other senior officials of the central bank, the Ministry of Finance, the Ministry of Employment and Economy, the Financial Supervisory Authorities, local and regional authorities; Members of Parliament; social partners; and members of the business, financial sector, and research communities. The mission held a press conference at the Bank of Finland after the concluding meeting.

Fund relations: The previous Article IV consultation discussions were held in Helsinki during March 3 to 14, 2014 and the staff report was discussed by the Executive Board on May 21, 2014. The Executive Board's assessment and staff report (IMF country Report No. 14/XXX, May 2014) are available at [Link to 2014 SR here]. The next Article IV discussions with Finland will be based on the 12-month consultation cycle.

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

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	1,263.80	100.00
Fund holdings of currency	847.54	67.06
Reserve Tranche Position	416.27	32.94
Lending to the Fund		
New Arrangements to Borrow	227.70	

SDR Department:	**SDR Million**	**Percent of Quota**
Net cumulative allocation	1,189.51	100.00
Holdings	1,120.71	94.22

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund:

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2014	2015	2016	2017	2018
Principal					
Charges/Interest	0.10	0.10	0.10	0.10	0.10
Total	0.10	0.10	0.10	0.10	0.10

Exchange Rate 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. It 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).

STATISTICAL ISSUES

(As of April 30, 2014)

Assessment of Data Adequacy for Surveillance:

General: Data provision is adequate for surveillance.

Data Standards and Quality

Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since June 3, 1996. Uses SDDS flexibility options for timeliness on data for 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).

Finland: Table of Common Indicators Required for Surveillance
(As of April 14, 2014)

	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	04/14/14	04/14/14	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	02/2014	04/2014	M	M	M		
Reserve/Base Money	02/2014	04/2014	M	M	M		
Broad Money	02/2014	04/2014	M	M	M		
Central Bank Balance Sheet	02/2014	04/2014	M	M	M		
Consolidated Balance Sheet of the Banking System	02/2014	04/2014	M	M	M		
Interest Rates[2]	04/14/14	04/14/14	D	D	D		
Consumer Price Index	03/14	04/14	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2013	03/14	A	A	A	LO, LO, LNO, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2013	03/14	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	03/14	04/14	M	M	M		
External Current Account Balance	02/14	03/14	M	M	M	O, O, O, LO	LO, O, LO, O, O
Exports and Imports of Goods and Services	02/14	03/14	M	M	M		
GDP/GNP	Q4 2013	03/14	Q	Q	Q	O, O, O, O	LO, O, LO, O, O
Gross External Debt	Q4 2013	04/2014	Q	Q	Q		
International Investment Position[6]	Q4 2013	04/2014	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government, including National Insurance Scheme, and local governments.
[5] Including currency and instrument composition.
[6] Includes external gross financial asset and liability positions vis-a-vis nonresidents.
[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).
[8] Reflects 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).
[9] Same 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.

PAST FUND STAFF RECOMMENDATIONS AND IMPLEMENTATION

Past Staff Recommendations	Implementation
Fiscal Policy	
Strong and credible commitment to a measured budget consolidation, balancing output and fiscal sustainability gaps. Fiscal adjustment efforts should focus on expenditure restraint, notably at the local level and via pension, old age and healthcare reforms, as well as tax base broadening. The efficiency of public services needs to be increased.	Fiscal adjustment measures have been implemented since 2012—including the most recent measures decided in March 2014—but two years of negative growth have weakened the headline fiscal position. Since 2011 the Government has in various contexts decided on measures designed to reduce public expenditure and to increase revenue. Measured in 2018 nominal terms the net effect of these measures comes to around 3.1% of GDP. The standard VAT rate was increased by one percentage point to 24 percent, with energy and excise taxes also raised to allow for a broadly revenue neutral cut in the corporate income tax rate from 24.5 to 20 percent. Pension reforms since 2012 have increased contribution rates. The average effective retirement age has risen to around 60.9 at end-2013 (from 59.4 in 2008).
Labor Market Policy	
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 early entry into the labor force. Reforms of tertiary educational financing could also promote earlier employment among the youth. At the other end of the age spectrum, the unemployment pipelines ought to be further restricted or eliminated.	The government has undertaken to reduce structural unemployment through reforms of the tax and benefits system and intensified active labor market policy. The Finnish central-level labor market organizations concluded a broad-based framework agreement in 2013. The new agreement sets the framework for pay and cost increases in branch-level collective agreements for a period of 2 years, with an option to potentially extend the agreement by one year. Agreed wage increases are moderate. On education, the duration of financial support for tertiary students has been reduced, the financing of tertiary education has been reformed to encourage faster graduation, and university entrance procedures have been streamlined. Since 2013, a "Youth Guarantee," offers youth, within 3 months of becoming unemployed, a

	job, on-the-job training, a study place, or a period in a workshop or retraining.
Competition Policy	
Increase competition in services and product markets, especially in 'sheltered' sectors, to boost productivity growth.	The 2011 Competition Act brought regulation in line with recommendations from the European Commission. It allows for stricter merger control, enhanced damage compensation, whistle-blowing instruments, and expanded investigative powers for the Finnish Competition Authority. Recent reform proposals aim to build on this, including measures to increase retail and construction sector competition.
Financial Sector Policy	
Bank capital and liquidity buffers should be gradually enhanced. Supervision and crisis management frameworks for large cross-border institutions must be strengthened, with ex-ante burden-sharing guidelines defined to limit contagion. Vigilance on liquidity risk and banks' funding and risk profiles should be stepped up. An independent Macroprudential Policy council should be established and macroprudential policy tools reinforced, including binding LTV ratio and countercyclical capital buffers (CCBs). A national loan registry should be developed to assist systemic risk monitoring.	A Memorandum of Understanding (MoU) on financial stability, crisis management, and crisis resolution has been signed among the Nordic and Baltic authorities in 2012. Legislation to establish the independent FIN-FSA board as macroprudential policy authority has been drafted. A government bill to designate the independent FIN-FSA board as macroprudential policy authority has been submitted to Parliament. The draft legislation includes the option for the FIN-FSA Board to apply macroprudential policy tools, including CCBs and an adjustable and binding LTV-ratio. In February 2014, a Government working group proposed new legislation on the resolution of financial market crises, a new crisis resolution structure for authorities, and the establishment of a new Deposit Guarantee and Resolution Fund.

Press Release No.14/247
FOR IMMEDIATE RELEASE
May 28, 2014

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

IMF Executive Board Concludes 2014 Article IV Consultation with Finland

On May 21, 2014 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.[1]

Finland's strong economic record has stalled. The economy has been in recession for three of the last five years, and unemployment is now more than 8 percent, with more people without work for longer. The shortfall in growth, coming at a time when peer economies saw GDP improve and unemployment fall, points to deeper, structural problems. Exports suffered from the continued decline of the information and communications technology industry and falling demand for paper and pulp, but also because Finnish wage costs increased when labor productivity deteriorated. Longer-term factors such as a rapidly aging workforce added to the headwinds. Inflation, while above the euro area average, has recently been decelerating. Against this background, government debt has been rising toward 60 percent of GDP.

The outlook is for a slow and fragile recovery. Weaker external demand could easily derail the upswing—for example, because of negative effects from an escalation of geopolitical tensions. Domestically, the growth outcome could change with the timing and composition of fiscal adjustment. While the Finnish banking system remains strong, it is highly concentrated with a majority of assets controlled by subsidiaries of foreign Nordic banks, exposing it to the risk of short-term funding shortfalls and financial-sector spillovers. And still rising levels of household debt could make consumers more cautious to spend if interest rates normalize faster than expected.

[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. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Reforms are under way to support growth and address risks. Finland remains a high-capacity economy with a skilled labor force and favorable business climate, and there are plans to boost public sector productivity by consolidating the local administration of health and social services and lengthen working careers. However, there is ample scope for reforms to address obstacles to longer-term growth, such as the shrinking workforce and the slowdown in private sector productivity growth. In the short- to medium-term, the newly set expenditure ceilings will help strengthen the public finances, but the path of the recovery depends critically on the implementation. Additionally, draft legislation to strengthen macroprudential policy, and reform of financial regulation at the European level promise to help guard against domestic and regional financial stability risks.

Executive Board Assessment[2]

Executive Directors noted that Finland remains a high-capacity economy and commended the Finnish authorities for their strong economic record and well-deserved reputation for implementation of sound policies. Noting the challenges posed by domestic and external factors and that significant downside risks remain, Directors recommended bold corrective actions to help reorient the economy, enhance competitiveness, and lift long-term growth and employment prospects. They called for a three-pronged strategy encompassing growth-friendly fiscal adjustment, productivity-enhancing structural reforms, and strengthened financial sector oversight and macroprudential regulation.

Directors noted that fiscal policy should strike an appropriate balance between supporting growth and securing sustainability, and recommended full implementation of the authorities' growth package. Many Directors recommended a front-loaded fiscal adjustment to help stabilize the public debt and maintain credibility, while a number of Directors supported a more gradual consolidation to better underpin the nascent recovery. Directors encouraged the authorities to make the composition of the 2015 budget as growth-friendly as possible, by increasing the contribution from expenditure cuts; shifting some of the tax burden from direct to property taxes; and allowing automatic stabilizers to operate. Over the medium term, fiscal efforts should aim to better manage the growth of local government spending and mitigate health and long-term care costs.

Directors called for a strengthened macroprudential framework to help guard against financial vulnerabilities and promote stability. Notwithstanding relatively high levels of capitalization, banks remain vulnerable to risks stemming from the low interest rate

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[2] At the conclusion of the discussion, the Managing Director, as a Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

environment, elevated house prices and household indebtedness, regional interconnections, and dependence on wholesale funding. Directors welcomed the authorities' plans to appoint the independent Board of the Finnish Financial Supervisory Authority (FIN-FSA) as the macroprudential authority. They also underscored that the macroprudential toolkit of the FIN-FSA Board should be harmonized with the European framework, in order to enhance its effectiveness and ensure consistency throughout the Nordic region. Relatedly, Directors called for further efforts to strengthen cross-country supervision and crisis resolution frameworks.

Directors emphasized the need for productivity-enhancing labor market and regulatory reforms in a number of areas. Such measures included: refocusing public Research and development (R&D) expenditures toward basic research and young firms, addressing retail sector regulatory barriers, boosting service sector competition, aligning wage growth with labor productivity, and increasing the supply of affordable housing to improve labor mobility. They welcomed the steps towards increasing the effective retirement age and encouraged further pension reform designed to raise labor force participation.

Finland: Selected Economic Indicators, 2010–15

	2010	2011	2012	2013	2014	2015
					Proj.	
	(Percentage change unless otherwise indicated)					
Output and demand (volumes)						
GDP	3.4	2.8	-1.0	-1.4	0.3	1.1
Domestic demand	2.9	4.2	-0.8	-1.4	0.2	0.8
Private consumption	3.3	2.5	0.3	-0.8	0.2	1.4
Public consumption	-0.4	0.5	0.5	0.8	0.5	-1.0
Gross fixed capital formation	1.7	5.8	-0.8	-4.6	-1.2	1.3
Change in stocks (contribution to growth in percent of GDP)	0.9	1.5	-0.9	-0.4	0.2	0.0
Exports of goods and services	7.9	2.8	-0.2	0.3	0.5	2.6
Imports of goods and services	6.8	6.2	-0.7	-1.8	0.1	1.7
Net exports (contribution to growth in percent of GDP)	0.5	-1.3	0.2	0.9	0.2	0.3
Prices, costs, and income						
Consumer price inflation (harmonized, average)	1.7	3.3	3.2	2.2	1.7	1.5
Consumer price inflation (harmonized, end-year)	2.8	2.6	3.5	1.9	1.4	1.5
GDP deflator	0.3	2.7	2.9	2.0	2.0	1.5
Unit labor cost, manufacturing	-9.7	4.8	6.0	-0.2	0.8	1.2
Labor market						
Labor force	-0.2	0.4	0.3	-0.6	-0.3	0.0
Employment	-0.4	1.1	0.4	-1.1	-0.3	0.3
Unemployment rate (in percent)	8.4	7.8	7.7	8.1	8.1	7.9
Potential output and NAIRU						
Output gap (in percent of potential output)[1]	-2.4	0.0	-1.3	-2.9	-2.9	-2.6
Growth in potential output	0.3	0.4	0.3	0.3	0.3	0.8
NAIRU (in percent)	7.7	7.7	7.6	7.6	7.6	7.6
	(Percent of GDP)					
General government finances[2]						
Overall balance	-2.8	-1.0	-2.2	-2.4	-2.4	-1.4
Primary balance[3]	-1.4	0.4	-0.8	-1.1	-1.0	0.0
Structural balance (in percent of potential GDP)	-1.3	-1.0	-1.5	-0.5	-0.6	0.0
Structural primary balance (in percent of potential GDP)[3]	0.0	0.4	-0.1	0.7	0.8	1.3
Gross debt	48.8	49.3	53.6	57.0	59.6	60.9
Net debt (negative of net financial worth)	-65.6	-54.3	-55.4	-52.7	-49.2	-46.6
	(Percent)					
Money and interest rates						
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	5.2	6.0	0.5	4.1	...	...
Finnish MFI euro area loans (growth rate, e.o.p.)	6.6	6.4	7.1	7.7	...	...
3-month Euribor rate (percent)[4]	0.8	1.4	0.6	0.2	0.3	...
10-year government bonds yield[4]	3.0	3.0	1.9	1.9	2.0	...

Finland: Selected Economic Indicators, 2010–15 (continued)

	2010	2011	2012	2013	2014	2015
					Proj	
			(Percent of GDP)			
National saving and investment						
Gross national saving	20.0	19.0	17.8	17.0	18.1	18.6
Gross domestic investment	18.4	20.5	19.8	18.7	18.4	18.4
Balance of payments						
Current account balance	1.5	-1.5	-1.4	-1.1	-0.2	0.4
Goods and services balance	1.6	-0.6	-0.8	0.1	0.0	0.3
Net international investment position	10.7	16.2	17.7	19.3	20.9	22.9
Gross external debt	189.6	216.1	231.3	240.8	245.4	248.7
Exchange rates (period average)						
Euro per US$	0.75	0.72	0.78	0.75	...	...
Nominal effective rate (appreciation in percent)	-4.5	0.0	-3.3	2.6	...	...
Real effective rate (appreciation in percent)[5]	-5.4	0.0	-2.9	2.1	...	...

[1] A negative value indicates a level of actual GDP that is below potential output.

[2] Fiscal projections include measures as specified in the Government Program.

[3] Adjusted for interest expenditure.

[4] 2014 data are latest available.

[5] CPI-based real effective exchange rate.

Statement by Ms. Meyersson, Executive Director for Finland and Mr. Miettinen, Advisor to Executive Director

May 21, 2014

We would like to start by conveying our authorities' gratitude to staff for the detailed discussions during the Article IV consultations and for the thorough analysis of the Finnish economy. An independent analysis of our economic policies and challenging economic situation is particularly welcome at the current juncture. The Finnish authorities agree on balance with the findings presented in the staff reports. While there are some differences about the timing and composition of fiscal measures aimed at securing fiscal sustainability in the long run, many of staff's recommendations are in line with the policies that are being implemented.

Recent Economic Developments and Outlook

Finland's economic performance was strong from 2000 until 2008, but the financial crisis hit the country hard. Finland's economy plummeted in 2009 by 8.5 percent, but recovered well during 2010 and 2011. The Finnish economy contracted again in 2012 and 2013 due to weak demand and the prolonging of the euro area sovereign debt crisis. The latest decline has pushed unemployment in Finland above 8 percent. After falling two years in succession, GDP is expected to gradually return to growth. According to the Ministry of Finance's latest forecast, Finnish GDP is expected to post growth of 0.5 percent in 2014. In 2015, GDP growth will pick up to 1.4 percent, and be increasingly broadly-based.

The factors underlying the weaknesses of the Finnish economy are well captured in the staff report and some of them are of fundamental nature. As pointed out by staff, labor productivity has been poor since the financial crisis. Part of the reason for this lies in the declined contribution of high-productivity sectors to total output. Return to sustainable growth and elimination of a significant sustainability gap, estimated by the Ministry of Finance to be 3 percent of GDP, requires timely implementation of major structural reforms.

The outlook in Europe, Finland's principal export market, is now brighter than in the past few years, which will boost Finnish companies' export demand. The last round of wage negotiations produced a moderate wage increases that marks the first step towards regaining lost competitiveness. Maintaining moderation in wage agreements is an essential part of restoring Finnish competitiveness also in the longer term. As a result of the agreed wage developments,

real earnings are projected to decline. This results in weak domestic demand which is expected to pick-up only in 2016 in the Ministry's latest forecast.

Despite the recent positive trend in the global economy and the improved outlook in the domestic economy, the risks in the outlook are still predominantly to the downside. The authorities agree with staff that delays in the recovery of the Finnish trading partners pose a risk to export-led growth projections. In particular, spillover effects from the crisis in Ukraine and recession in Russia will exert downside risks to Finland's expected recovery.

One of the most significant domestic challenges is to improve the efficiency of the labor market. Population ageing coupled with the mismatch problems in the labor market may become a real obstacle to growth.

Macroeconomic policies and the reform agenda

The long-run challenges of the Finnish economy and public finances are clear, and the policies to tackle these challenges mutually acknowledged: bold and rapidly implemented structural reforms are needed to achieve higher growth in the medium to long term.

Regarding the short run, the policy recommendation is not as straightforward. Here the key question is how to sustain economic recovery and promote growth without risking confidence in fiscal stability and sustainability in the long run. The appropriate policy orientation depends on how the risks and benefits of the alternative options are emphasized. Staff's report emphasizes the short-run risks of fiscal consolidation on recovery. The analysis and recommendation rest, among other things, on staff's estimates of the size of the output gap and fiscal multipliers which are inherently uncertain. In its recent decisions, the Government has recognised these elements but also taken into account the risks of sharply climbing public debt on fiscal stability.

The Government's fiscal and economic policy is geared to bridging the sustainability gap in public finances. In the autumn of 2013, the Government announced a new structural policy programme aimed at improving the conditions for economic growth and to close the sustainability gap.

Most of the favourable effects of the reforms on growth and fiscal sustainability will only materialise in the long run. Since this route is considered very slow and if deficits remain significant, there is a risk that state debt will spiral out of control once interest rates return to normal. Reducing central government deficit in a credible way is important to preserving confidence and to preventing a vicious circle of escalating debt in the medium term, before the structural reforms have the chance to make an impact.

The Government decisions in March 2014 on new consolidation measures and their timing take into account these concerns. The growth package, which supports seed financing for innovations and important infrastructure investments, mitigates the negative impact of the consolidation on the economy to some extent in 2015-2016.
The staff report correctly points to structural weaknesses in the Finnish economy. The Government's structural reform program tackles these weaknesses in five areas: i) improving productivity in the public sector; ii) lengthening working careers; iii) lowering structural unemployment; iv) improving the economy's growth potential; and v) strengthening local government finances.

Labor market

The social partners are negotiating on the pension reform that aims at increasing the effective age of retirement by a minimum of 1.5 years. The consensus-based decision making regarding this issue has taken some time, and the expectation is to finalize discussions in fall of 2014 to deliver the changes as soon as possible. The government has undertaken measures to reduce unemployment through reforms of the tax and benefit system and intensified active labor market policy. From the beginning of this year, it has been possible to receive some earnings without losing the unemployment benefit or housing allowance. Employment will be actively offered to unemployed by employment offices, and sanctions for persons that do not accept employment will be enacted. As pension reforms are prioritized, some other labor market reforms which staff points to, have received less attention.

The government has already introduced legislation to provide incentives for earlier completion of studies. In addition, more weight is placed on the matriculation examination at the entry into higher education and intakes have been increased to expedite the eventual entry to working life. With the announcement of the latest fiscal policies the government also announced reforms to support new housing investment in the capital region.

Healthcare

A significant part of the public expenditure is spent on healthcare and social services in Finland. In March 2014 the government and the opposition parties agreed on the implementation of a comprehensive reform of social welfare and healthcare services in Finland. The reform will consolidate social welfare and healthcare services into five regions that are large enough to deliver economies of scale. In particular, this reform allows for closing efficiency gaps between specialized care units, more efficient exploitation of new technologies and division of labor

between and inside the regions and more efficient control at the national level. The plan is to have this reform in place by 2017.

Local governments

The reform agenda includes measures to strengthen local government finances. A new steering system will be implemented in 2015 that enables better safeguards for the sustainability of municipality finances. The new steering system should ensure that the municipalities' obligations are consistent with balanced budgets. In addition, the agenda includes measures that improve public service productivity. Municipalities have already embarked on cutting costs and increasing municipality taxes. Some municipal mergers have also taken place.

The extensive reform plan notwithstanding, more work is needed to implement these reforms.

Financial sector policies

The Finnish authorities have drafted a national legislation for implementing the Capital Requirements Directive (CRD IV) in compliance with the Capital Regulations Regulation (CRR). The legislation was sent to parliament in April this year. The draft legislation proposes to fulfill the mandatory requirements of the CRD IV. Staff draws attention to the possibility of regulatory arbitrage and to the current design of the legislation. The authorities are well aware of these concerns and are ready to adjust the legislation if warranted.

In addition to the mandatory criteria, the legislation introduces an adjustable LTV cap to the mortgage markets. There is a provision to use collateral in the calculation of the LTV cap, and this provision, along with the LTV cap itself, can be changed by the Finnish FSA board to be more stringent. The authorities are well aware of the risks related to the mortgage market, and households and banks have been prompted to make stress calculations with higher interest rates. On average, Finnish mortgage LTVs are not alarmingly high, as was also shown in the Nordic Regional Report, but the average masks a concentration of debt to more indebted households. The proposal endows the FIN-FSA board with the necessary tools to address risks in the mortgage market if necessary.