Statement by Olli-Pekka Lehmussaari, Alternate Executive Director for Finland October 8, 1999

My Finnish authorities wish to express their sincere appreciation for the fruitful exchange of views they had with Mr. Watson and his team during the mission's visit to Finland and for the team's candid assessment of the Finnish economy. My authorities agree with the staff's assessment of the main challenges of economic policies in Finland. The following comments are only intended to underline some issues, where my authorities wish to point out some nuances of the discussions.

The Fund mission's preliminary findings from June 7, 1999 were, for the first time, released to the public. They were very well received in the domestic news media, where the message clearly came through that structural reforms were an essential complement to further fiscal consolidation, to maintain sustainable economic growth in the longer term. Finland participates in the IMF's pilot project for the voluntary release of Article IV staff reports.

Economic performance

Finland joined the EMU with 10 other countries at the beginning of 1999 well aware of the challenges the new monetary framework would entail. Membership in the EMU will, as also pointed out in the staff's observations, require continued improvements in the flexibility of the economy, together with a strong resolve among policy makers and social partners. In this new environment, more weight is put on fiscal and structural policies, and also responsible wage setting, for maintaining the economy on a sustainable growth and employment path.

Given the somewhat asynchronized cyclical conditions of Finland with the rest of the euro area, a discussion of the looming risks of overheating in the economy has already been going on for some time. However, despite the robust growth in recent years no significant imbalances have yet emerged in the Finnish economy. Moreover, the evolution of domestic costs has remained in line with the rest of the euro area. The high unemployment originating from the recession period has declined markedly. These favorable developments can be attributed to appropriate and successful economic policies. Adaptations and shifts in the production structure and the strong performance of the electronics industry in particular have also contributed to the good performance.

Near-term economic prospects

Growth is expected to continue strong at near 4 percent in both 1999 and 2000. The most recent figures are for the second quarter of 1999, when GDP grew 3.4 percent compared to the same period a year ago. The preconditions for growth remain favorable, although the period of fastest growth now appears to be over. The growth rate is expected to decelerate from the average of 5 percent between 1994-1999 to around 3 percent between 2000-2003, which corresponds to the estimated growth potential.

The risks appear to be on the upside, i.e., weighted more towards stronger-than-forecast rather than weaker-than-forecast growth. There does not appear to be any immediate danger of a general overheating in the economy, and inflationary pressures continue to be absent. However, some sectoral and regional pressures have emerged. Sectoral pressures are evident in the construction and electronics sectors, where the availability of skilled labor has weakened markedly. In addition, regional pressures have emerged in 4–5 growth centers, and, as a result, housing prices, especially in the Helsinki region, have risen relatively rapidly.

The government aims to increase the employment rate from the current 65 percent towards 70 percent, the target laid down in the EU’s employment guidelines. Employment is currently growing rapidly while young people of age 15–24 are coming to the labor market in large numbers. Thus, the unemployment rate is likely to decline only gradually, in particular as it is to some extent of a structural nature. The current wage agreement expires at the end of next January. This agreement is the second centralized agreement in a row. The government has expressed its preference for a new centralized agreement and has declared itself ready to cut income taxation within the limits set by the Government Program in order to facilitate a moderate wage agreement.

It is likely that there will not be a centralized agreement this time, after a number of unions expressed their views in favor of wage negotiations at the union (sectoral) level. The Central Labor Organization will not strive for a centralized solution. As a result, some media commentators have expressed a disappointment with the turn of events by stating that the labor unions clearly fail to see that membership in the euro area has created new responsibilities for the unions. Other remarks are more neutral because the form of wage negotiations does not need to be decisive in reaching moderate wage agreements.

Inflation in Finland has remained modest, with a 12 month change in the HICP (harmonized) by 1.3 percent in August. However, there has been a slight upward trend in prices from the beginning of the year, and a moderate acceleration in inflation cannot be ruled out in the second half of the year.

The stock of bank lending is growing strongly. The rate of increase in the total lending stock accelerated to over 13 percent in August, fuelled by demand for housing and business loans. The continuing decline in lending rates contributed to the strong demand for loans in the first half of the year. Currently, the average interest rate on new loans is roughly 4%. Although the strong growth of credit is partly explained by the recovery from the severe recession in the early 1990s, it could give cause for concern if it continues.

Public finances

The Stability and Growth Pact, together with Maastricht Treaty, sets binding standards for fiscal policies. Currently Finland meets these criteria easily. Finland's medium term fiscal targets are more ambitious than those of the EU's Stability and Growth Pact. The central government aims at a structural surplus which, together with roughly balanced local government finances and a clear surplus in the social security funds, indicates a surplus in general government finances at around 4-5 percent in relation to GDP during 2000-2003. The general government debt ratio continues to decrease rapidly. While at its highest in 1994, debt to GDP ratio was almost 60 percent; the estimate for the end of year 2000 is 43 percent.

The government is committed to reduce the income tax and social security contributions by 1.5 percent of GDP over the election period. This reduction will partly be compensated by higher energy, capital and corporate taxation. Should the budgetary developments in the government balance prove weaker than estimated in the stability program, the government has committed itself to take necessary consolidation measures.

To establish a structural surplus in the central government finances the government has set medium term expenditure ceilings for each ministry, which aim to keep total expenditure roughly constant in real terms. The budget proposal for year 2000 was given to parliament in September. In this proposal, real expenditure of the central government only marginally exceeds 1999 level, and the targeted structural surplus in central government finances will be achieved, while the central government debt will decline correspondingly. It is the first time since 1990 that central government finances are predicted to show a surplus. This surplus is estimated to be 0.7 percent of GDP in 2000 (national accounts basis).

The fiscal impulse is estimated to be slightly restrictive next year, but not as much as it has been this year. Moreover, the fiscal policy stance in Finland continues to be more restrictive than on average in the euro area. Given the somewhat different cyclical phase, this is important for balanced and sustainable economic growth in Finland.

Structural challenges

In the Government Program and budget proposal, special emphasis is given to structural policies. Reducing payroll taxation is clearly targeted, but its implementation is conditional on moderate wage agreements. The large tax wedge has been identified as one of the obstacles to a well-functioning labor market. The staff report rightly focuses on the negative incentives of unemployment and other social security benefits and suggests further cuts and reductions in the benefits and their duration. The interplay of benefits and high, progressive labor taxation has clearly contributed to high unemployment. Some steps have been taken to solve this problem, both through taxation and through social benefits. A very clear guiding principle is that taking a job must always pay more than being unemployed, and the benefit systems are being developed toward this end.

Internal migration reveals regional imbalances and adds in the short run to pressures on the housing and the municipal infrastructure in the main growth centers, even if migration is much needed to balance the labor market in a somewhat longer perspective. Some disincentives still exist in the labor market, affecting labor supply and also labor demand, and these problems need to be alleviated. The functioning of the product markets should also be further enhanced, with the aim to improve conditions for small enterprises and self-employment.

In the long perspective, the aging of the population is a major challenge for the Finnish economy. The staff report deals at length with the aging population problem and the incentives of the pension system, and rightly so. The points raised in the staff report have all, at least partly, been dealt with in the Government Program. Part of this problem is connected to early retirement. Currently the effective retirement age is 59 years on average, compared to the statutory retirement age of 65 years. Average life expectancy has been growing and is expected to grow further, which implies that the proportion of active population in relation to the total population will decrease.

At the moment, only 45 percent of those aged between 55-64 are at work. The government aims to rise the effective retirement age by 2-3 years in the somewhat longer term and to increase the employment rate towards 70 percent in medium term. In the future, labor market policies should focus more on improving the employability of older unemployed persons. Until now, those already on the “unemployment-to-retirement path” in the age group 55-59 have in practice been considered outside the labor markets.

Since the beginning of the 1990s, several reforms have been introduced in Finland in order to reduce pension expenditure growth. It has been estimated that these reforms will decrease pension expenditure as a share of GDP by 2½ percentage points in the long run.

The representatives of labor market organizations and pension institutions reached an agreement in July, 1999 on additional measures to postpone retirement and to promote the continued active participation in working life. The unemployment pension will be made less attractive for both employers and employees. Also the funding rules regarding disability pensions will be changed to avoid the shedding of aging workers. These changes are designed to come into force at the beginning of 2000.

Over time, changes should also be made in the design of earnings-related pensions so that these are clearly perceived as a form of saving rather than a tax. This implies moving progressively in the direction of defined contributions away from currently prevalent defined benefits schemes. These changes, by tightening the link between individual contributions and benefits and making pension entitlements more transparent, should improve the incentives to work, as the staff report states.