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January 24, 2022

Statement by Mr. Moreno and Mr. Lopez on Finland
(Preliminary)
Executive Board Meeting
January 26, 2022

We thank staff for their insightful report and Mr. Pösö and Mr. Kraavik for their useful Buff statement. We mainly share staff's appraisal and policy recommendations. From the outset, we want to commend the authorities and the Finish people for the successful vaccination campaign and for their contribution to the international efforts in vaccine supply. We associate ourselves with Mr. Buisse's statement and would like to offer some additional comments.

Economic recovery is well underway, helped by the ample fiscal support deployed during the pandemic, although uncertainty remains high and risks are tilted to the downside. A decisive and broad policy response, along with potent automatic stabilizers and a low weight of contact intensive sectors, cushioned the social and economic impact of the COVID-19 shock in Finland, one of the mildest in Europe. The policy strategy has rightly adapted to epidemic developments, which combined with widespread vaccination has prompted a rapid recovery, with economic activity already recovering pre-pandemic levels in 2021. Prospects for consumption and investment are positive on the back of strong employment recovery, unreleased pent-up savings and the high rate of capacity utilization in manufacturing. Inflation has increased due to base effects and temporary supply-side factors, but it remains in relatively moderate levels. This positive picture, which is projected to persist in 2022, is clouded by the uncertainty related to pandemic developments. Risks are biased to the downside, dominated by a potential deterioration of the external demand, a tightening of international financial conditions, or a persistence of inflationary pressures. *Given the output gap is projected to be positive in 2022 and some shortages of skilled labor have been lately reported, we ask staff to provide comments on potential demand-side and wage-side inflationary pressures going forward.*

The fiscal stance should ensure a careful balance between supporting the recovery and ensuring sustainability in the medium term. The policy response to the pandemic prompted a sharp increase in public debt, although it remains in relatively comfortable levels —staff project debt to reach 74½ percent of GDP by 2027. As the economy returns to its potential growth, the authorities should gradually unwind policy support and prepare the public finances to face the structural challenges related to population aging. In this respect, we welcome the authorities' strategy to boost the employment rate, including measures to tackle early retirement, to revamp the employment services model, to enhance education and training of low-skilled workers and to facilitate integration of migrants. In line with the government plans, this strategy should be complemented by measures to reduce the overall level of public spending and increase its efficiency, especially in the health system and social services. *Regarding the pension system, we would appreciate staff's comments on possible improvements to reinforce its sustainability.*

While short term economic prospects are positive, long-term growth is constraint by pre-pandemic structural forces related to demographics and low productivity. Despite the growth in employment, we note that the unemployment rate has been reduced more slowly while labor shortages in some sectors are increasing. We concur with staff that comprehensive reforms in the labor market, the education system, the social benefits and the migration polices will the instrumental to alleviate labor mismatches, increase labor market flexibility and enhance labor productivity. Although the centralized wage bargaining system has traditionally worked well, some improvements to provide higher flexibility at firm level could help reduce wage-productivity misalignments. In the context of the NG EU funds, we welcome the Finland's medium-term Sustainable Growth Program aim to tackling many of those structural challenges with a wide range of reforms and investments in the areas of the green and digital transitions, R&D incentives, the labor market, and the education and health systems. We commend the authorities for their ambitious commitments to climate change and carbon neutrality by 2035; the strategy should be flexible to adapt policies as needed to reach this important goal.

The financial sector weathered the pandemic well, although the macroprudential policy should be strengthened to mitigate risks in the housing sector. We agree with staff that the banking system has remained sound during the pandemic —helped by their low exposure to contact-intensive sectors— while other structural vulnerabilities remain, namely high concentration, regional interlinkages, and reliance on wholesale funding. Additionally, the increase and changing composition of households' mortgage borrowing could pose a risk on financial stability. The authorities are taken steps to strengthen their macroprudential toolkit, although we agree with staff that additional income-based measures or sectoral buffers could be introduced to improve the framework, along with a revision of the tax code to mitigate incentives for housing company loans.