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IMF Executive Board Concludes 2008 Article IV Consultation with Finland

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

Background

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

While growth was robust in 2007, with activity significantly above potential, expansion slowed sharply in the first three quarters of 2008. Growth is projected to decelerate to about 1 1/2 percent in 2008 and further to -1 percent in 2009. Amid a flagging external environment, sluggish employment growth, the erosion of real disposable income by higher inflation and debt servicing, squeezed profit margins, and rising financing costs will restrain both consumption and investment. The cumulative direct impact of financial tightening on 2008-09 growth is estimated at ¾ percentage points.

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

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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

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

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

Executive Board Assessment

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

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

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

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

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

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

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

Finland: Selected Economic Indicators

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

Sources: Finnish authorities; International Financial Statistics; and IMF staff estimates.
1/ IMF staff estimates and projections, unless otherwise indicated.
2/ Consistent with Eurostat methodology.
3/ Defined as non-interest revenue minus non-interest expenditure.
4/ For 2008, annual change through November.
5/ For 2008, data re for first 11 months.
6/ Based on unit labor costs.