International Monetary Fund

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IMF Executive Board Concludes 2014 Article IV Consultation with Finland

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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.

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 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	...
					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.

[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.

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