EXECUTIVE BOARD MEETING

SM/18/287
Correction 1

January 9, 2019

To: Members of the Executive Board

From: The Secretary

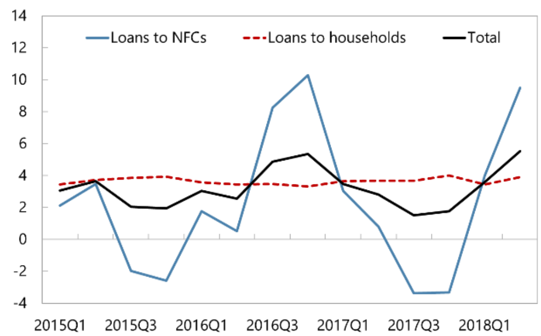
Subject: **Finland—Staff Report for the 2018 Article IV Consultation**

Board Action:	The attached corrections to SM/18/287 (12/17/18) have been provided by the staff:
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 9 and 14**
Typographical Errors	**Pages 16, 17, 20**
Questions:	Mr. Scott, EUR (ext. 38169) Mr. Wingender, EUR (ext. 39831) Mr. Pillonca, EUR (ext. 38474) Mr. Poghosyan, EUR (ext. 39684)

A. Credit Markets, Real Estate, Borrower Risks, and Macroprudential Policies

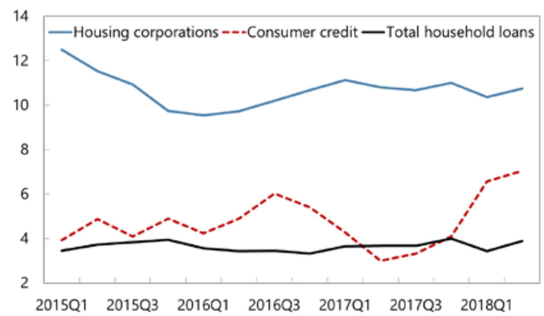
12. Credit has expanded moderately overall, but housing corporation loans and consumer credit have been rising more rapidly. Total loan growth to the private nonfinancial sector has remained broadly constant at around 3½ percent for the past five years. Most lending to households has been in the form of secured lending for housing, which has grown around 4 percent. Corporate loan growth has rebounded strongly in the second quarter of the year after a sharp contraction in the second half of 2017. Two lending categories stand out:

Credit to the Nonfinancial Private Sector
(Yoy growth, percent)



Source: Statistics Finland

Household Credit Growth, by Purpose
(Percent, yoy)



Sources: Statistics Finland; Bank of Finland; and IMF staff calculations.
Note: Consumer credit includes lending from non-bank financial institutions.

- Loans to housing corporations have been expanding rapidly—above 10 percent—for many years. The drivers—expansion of the housing stock and renovation of rental properties—are healthy. But ~~as~~ the shareholders of housing corporations ~~are~~ include homeowners, making these ~~are~~ de facto indirect loans to households, and households might thereby be tempted to take on more debt than can easily be repaid.[5]

- Consumer credit has been increasing steadily—above 7 percent y/y in the second quarter of 2018—and now accounts for 12 percent of aggregate household debt, driven by credit institutions easing lending standards and a rapid increase in non-bank lending. The expansion has been associated with an increase in payment defaults.

13. Household debt has been increasing steadily, despite the increase in real disposable incomes.[6] Saving rates are lower than peers, although some of the difference is attributable to Finland's public pension system.[7] Household debt remains lower than Nordic peers, but is expected to increase further. Highly-indebted households (i.e. those with debt greater than four times their

[5] Housing corporations effectively borrow on behalf of households. However, the terms and conditions of the loans and the pooling of credit risk among shareholders might not always be fully understood by households, who are ultimately liable for the debt.

[6] Saving from corporates and the government has increased, accounting for the increase in *national* saving (¶17).

[7] In PAYG-based pension systems, pension fund assets are considered part of general government savings, as opposed to household savings for funded pension systems. Adjusting gross saving rates for this reduces the difference between Finland's saving rate in 2017 and that of other Nordic countries by 60 percent. See also Rocher, S. and M.H. Stierle 2015, "Household saving rates in the EU—Why do they differ so much?", EC Discussion Paper 005.

important details still need to be finalized. Establishing a common European deposit insurance scheme would increase the confidence of retail depositors, and is important for cases where liquidation would be required.

- Third-country bank branches~~, such as Danske's in Finland,~~ are outside the perimeter of ECB banking supervision, creating scope for arbitrage and inconsistent supervisory treatment. The SSM should have supervisory powers over significant third-country branches operating in the euro area.[18]

23. Digitalization is a growing challenge for supervision and regulation, owing to the rapid changes in services and platforms and the lack of data on activities of non-bank service providers. Because products are morphing quickly and across lines of supervision, approaches that stress regulation of activities might be more successful at managing prudential risks than those that regulate entities.[19] Consumer protection—such as transparency about lending terms and conditions—is an important issue.

24. Sustained efforts are needed to ensure effective supervision and enforcement of AML/CFT.

- Recent developments have raised questions about the adequacy of AML/CFT supervision across the European Union. Most prominently, the activities of Danske's Estonian branch over the period 2007 to 2013 have prompted investigations by Danish and Estonian supervisors and the US Department of Justice. At the time of writing, there is no specifically Finnish investigation into the Danske affair, but Finland's National Bureau of Investigation has received a complaint about Nordea's Finnish operation (then a branch) over the same period; there is no decision as yet whether to open an investigation.

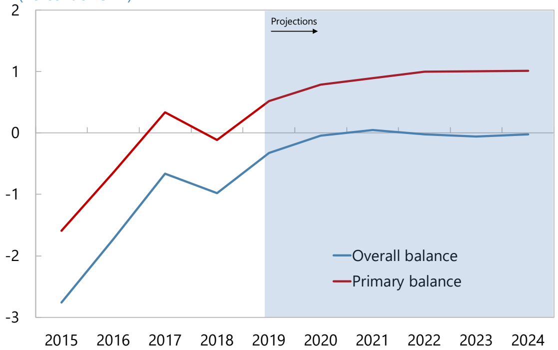
- Responsibility over AML issues in Finland relies on several institutions. The Ministry of Finance and the Ministry of the Interior are mainly responsible for legislation, and the FIN-FSA supervises financial institutions' compliance, including Know Your Customer requirements. The Regional State Administrative Agency for Southern Finland (RSAA), the Finnish Patent and Register Office, the National Police Board and the Finnish Bar Association are tasked with AML/CFT supervision for other entities such as real estate agencies, external accounting services, tax advisors, and gambling operators. The Financial Intelligence Unit is responsible for receiving and analyzing suspicious transaction reports.

- Following publication of the 2013 9th Follow-Up Report of Finland's Mutual Evaluation Report by the Financial Action Task Force (FATF), the government amended the AML Act in 2017 by adding requirements for national, and supervisory-specific risk assessments and risk assessments by obliged entities; creating a register for beneficial owners; and adding new obligations for businesses to maintain information concerning their beneficial owners. FATF is currently

[18] See Euro Area: Financial System Stability Assessment, IMF Country Report No. 18/226, p.20.

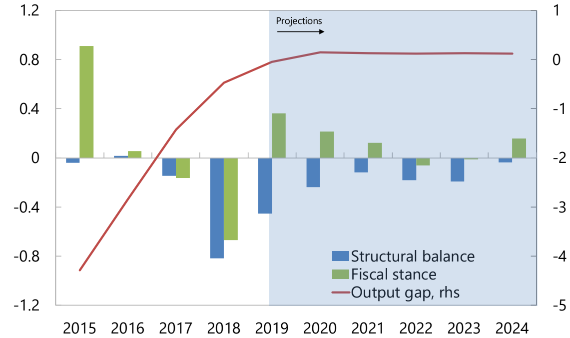
[19] See IMF Staff Discussion Note SDN/17/05 and "Financial Stability Implications from FinTech," Financial Stability Board, June 2017.

Fiscal Balances
(Percent of GDP)



Sources: IMF World Economic Outlook; and IMF staff calculations.

Fiscal Stance
(Percent of GDP)



Sources: IMF World Economic Outlook; and IMF staff calculations.

29. A moderate tightening of the fiscal stance is justified for both cyclical and structural reasons. With output projected to expand above its potential growth rate and no independent monetary policy, a continuation of 2018's procyclical fiscal stance should be avoided. Long-term sustainability considerations underscore the need to build fiscal buffers in light of looming spending pressures from age-related costs, a relatively high level of contingent liabilities,[20] and the typical volatility of the economy witnessed over the past 25 years that can rapidly increase demands on the public finances. With an already-high revenue ratio, there is little scope for further increases in the tax burden (although additional efforts to improve VAT collection would help). Continuing to uphold the consolidation commitments under the Competitiveness Pact is therefore important. Unexpected savings should be allocated to either reduce the debt or to growth-enhancing expenditures, such as on ~~of~~ infrastructure that might aid labor mobility (e.g. transportation) and measures to partially reverse recent cuts in R&D spending.

30. Progress on social services and health care reform has been slow, but should be pursued. The proposed reform to social services and health care is important to address the age-related challenges and is a crucial component of the fiscal consolidation plan. Currently, public health and social care is provided by 190 local agencies, making it difficult to exploit economies of scale. The plan is to make provision of services more cost effective by transferring responsibility for provision of services from almost 300 municipalities to 18 newly-formed counties, with an emphasis on competition and modernization. As yet, political consensus on the reform has not been achieved. Savings will largely depend on implementation—which has been delayed again to 2021. The project is ambitious, proposing major changes to regional administration and significant commitments to complex IT systems, but is susceptible to downside risks, including cost overruns. Nonetheless, if successfully implemented, the reform could make a major contribution to fiscal sustainability, potentially increasing public sector net worth by about 65 percent of GDP.[21]

[20] Government guarantees are above 20 percent of GDP.

[21] The authorities target fiscal savings of around 1.3 percentage points of GDP by 2030 through successful implementation of the reform. Given the current level of health and old-age expenditures of 11.4 percent of GDP and a projected increase from population aging of around 1.3 percent, the target would imply savings of approximately 10 percent of total health and old-age expenditures once the reform is completed. (See also Finland: Staff Report for the 2017 Article IV Consultation, IMF Country Report No. 17/370, Annex III; and Brede, Maren. and Christian Henn 2018, IMF Working Paper 18/78).

Authorities' Views

31. **The authorities considered that a tighter fiscal stance is warranted to build fiscal buffers as age-related fiscal pressures loom closer.** They felt that, from a "bottom-up" perspective that evaluates specific new measures, the fiscal stance in 2017 and 2018 was approximately neutral. They reiterated their commitment to closing the fiscal sustainability gap by, inter-alia, continuing the implementation of the fiscal consolidation plan and pushing forward the reform of health and social services. The potential savings from this reform are uncertain; the authorities would consider other adjustments to ensure savings are realized.

D. Structural Policies

32. **The sustainability of the social model puts emphasis on structural policies.** The model depends on high levels of employment and growth, implying a need for vibrant markets and efficient use of resources. Finland's product markets are comparatively liberalized; discussions focused mainly on areas in which labor market performance could be improved.

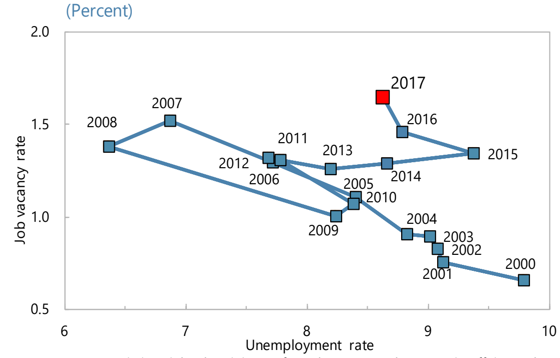
33. **The labor market has had to face considerable adjustment over the past decade.** Recessions have weakened employment and caused physical and human capital investment to be deferred. Major economic shocks and the financial crisis have seen substantial job losses in high-productivity manufacturing.[22] These compositional effects substantially weakened productivity. Some regions were more affected than others, contributing to regional labor market disparities.

34. **Notwithstanding recent growth, signs of underlying weaknesses remain…**

- **… with respect to labor mobility.** Most obviously, even with the recent substantial increase in employment, the unemployment rate remains notably above Nordic peers (Figure 4). The Beveridge curve, relating unemployment rates to vacancies, has shifted out during the past three years of recovery, indicating difficulties in matching workers to job opportunities; in some sectors—notably construction and services—labor shortages have continued despite overall unemployment remaining comparatively high. Staff analysis shows that regional labor mobility is ~~relative~~ low relative to other advanced economies (Figure 6; Annex III).

Beveridge Curve

(Percent)



Sources: Statistics Finland, Ministry of Employment and Economic Affairs and Fund staff calculations.

[22] Bank of Finland economists estimate that approximately 110,000 jobs were lost in manufacturing and trade since 2008. ICT's share of total output declined from 8 percent at the turn of the millennium to 3 percent currently. See Bank of Finland Bulletin 3/2018.

and facilitating the transfer of skills. Experience from other countries indicates that this is compatible with formal representation of labor and employers.[30] As it stands, about 25 percent of employees that work for non-organized employers, mostly SMEs, cannot bargain locally but are instead bound by sectoral agreements.

- There is room for further progress to improve incentives from social benefits. Job search intensity tends to increase sharply toward the end of benefit time limits; tapering benefits to gradually fall with duration could improve job search (Figure 4). A tripartite working group was setup to assess the effectiveness of recently introduced measures to incentivize job search of unemployed by Spring 2019.

- Other policies may need to be addressed to improve regional job mobility. Staff analysis finds a significant role for housing market variables. The authorities have already implemented measures to expand housing supply in urban areas, and the government provides mobility allowances to compensate for housing cost differentials across regions. But there is scope to improve transport infrastructure around growth regions to incentivize commuting and reduce demand pressures from centrally located properties. The gradual decline in mortgage interest deductibility to 25 percent in 2019 would mitigate debt-financed ownership incentives.

Authorities' Views

39. The authorities agreed on the need to continue structural reforms, but highlighted challenges associated with enhancing labor market dynamism. Past reforms have been bearing fruit: competitiveness has been restored and the labor market recovery has exceeded expectations. Nevertheless, labor productivity growth remains subdued and has not recovered as fast as in previous upswings. Modest labor mobility across regions can be explained by, inter alia, the geographical dispersion of the population, high home ownership rates, and less liquid real estate markets in rural areas. There is scope to reform social benefits to enhance labor incentives and labor market dynamism further, but social safety nets should be maintained. Regional governance reforms and greater reliance on outsourcing are expected to improve the effectiveness of active labor market policies.

STAFF APPRAISAL

40. Good economic performance continues, but growth is likely to slow. Finland is enjoying its third consecutive year of economic recovery, and the unemployment rate has declined to its lowest level since 2011. Growth in 2018 is expected to be 2.4 percent. But it is likely to slow next year as global demand slows and financial conditions tighten. There are downside risks to this outlook, such as from an increase in trade protectionism. And over the long term, growth is likely to be lower than what has been seen recently, unless productivity growth permanently increases.

[30] Framing the alternatives for the labor market as simply between organized and unorganized labor misses important distinctions. In a recent study, the OECD found that centralized bargaining systems are associated with lower productivity growth. "Organized decentralization"—in which sector-level agreements set broad targets while firm-level negotiations set detailed terms—are associated with higher employment, productivity, and wages. See "The role of collective bargaining systems for good labour market performance" in OECD Employment Outlook 2018.