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Minutes of Executive Board Meeting 19/1-3

10:45 a.m., January 11, 2019

3. Finland—2018 Article IV Consultation

Documents: SM/18/287 and Correction 1; and Supplement 1; and Supplement 2 ; SM/18/289; and Correction 1

Staff: Scott, EUR; Sommer, SPR

Length: 26 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	J. Essuvi (AE), Temporary
	A. Olhaye (AF), Temporary
	C. Moreno (AG), Temporary
	G. Kim (AP), Temporary
	B. Saraiva (BR)
	P. Sun (CC)
	J. Montero (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	A. Castets (FF)
S. Meyer (GR)	
	H. Joshi (IN), Temporary
	I. Lopes (IT), Temporary
	Y. Saito (JA)
	G. Nadali (MD), Temporary
	M. Choueiri (MI), Temporary
	J. Hanson (NE), Temporary
T. Ostros (NO)	
A. Mozhin (RU)	
	R. Alkhareif (SA)
J. Agung (ST)	
	A. Urbanowska (SZ), Temporary
	D. Ronicle (UK)
	M. Svenstrup (US), Temporary

G. Tsibouris, Acting Secretary
K. Hviding, Summing Up Officer
E. Mannefred, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
European Central Bank: A. Meyler, R. Rueffer. European Department: K. Garcia, C. Scott, Casalderrey, V. Pillonca, T. Poghosyan, P. Wingender. Legal Department: H. Pham. Strategy, Policy, and Review Department: P. Deb, M. Sommer. Executive Director: T. Ostros (NO). Alternate Executive Director: P. Trabinski (SZ). Senior Advisors to Executive

Directors: M.Gilliot (FF), M. Sidi Bouna (AF). Advisors to Executive Directors: I. Fragin (GR), Z. Huang (CC), B. Parkanyi (NE).

3. FINLAND—2018 ARTICLE IV CONSULTATION

Mr. Virolainen submitted the following statement:

Recent Economic Developments, Outlook and Risks

Economic growth has continued for almost three years, fuelled in particular by the recovery in Finnish goods and services exports. Household consumption has also increased, as growth in disposable income and low interest rates have encouraged household spending. Employment growth has exceeded expectations.

The fundamentals for continued economic expansion remain in place. The Competitiveness Pact, which restricted the increase in labor costs, has contributed to improving Finnish companies' global competitiveness. The Finnish economy will continue to grow, although more moderately than in the past two years and at a considerably slower pace than prior to the financial crisis in 2008. The growth rate will gradually decelerate to its long-term potential rate.

The exceptionally rapid growth in employment witnessed in 2018 will slow down going forward, partly due to labor market mismatches. The number of unemployed is still high in Finland, despite an increase in job openings. Mismatches reflect differences in the supply and demand of labor both geographically and in terms of skills. Certain sectors, such as construction and services, have especially suffered from labor shortages. Job creation is also being constrained by a decline in the working-age population.

Uncertainty surrounding global economic development has increased, and risks to the Finnish economic growth are now clearly tilted to the downside. Exports will continue to grow at a reasonable pace in the baseline scenario, but a realization of the foreseeable risks could cut export growth significantly. This constitutes the greatest downside risk in the immediate years ahead.

Household consumption has exceeded household disposable income in recent years, leading to a rise in household debt levels. Even though household income will grow markedly faster in the forecast period than in the past few years, household indebtedness will likely rise further.

Overall, even though growth in output and employment will continue, the peak of the Finnish economic cycle has been passed. This is partly explained by the slowing down of the global upswing. Going forward, population aging and weak productivity developments will begin to put a further drag on the Finnish growth outlook.

Fiscal Policy

The economic upswing has continued to strengthen public finances. With higher tax revenues, lower unemployment-related expenditures, and some positive one-off factors, the 2018 budget deficit is expected to decrease to EUR 1.25 billion (0.5 percent of GDP). Due to the strong cyclical position, the fiscal stance in 2018 was slightly expansionary. However, the authorities are highly committed to the medium-term consolidation plan implying a contractionary fiscal stance again in 2019. Spending growth will be reined in by the adjustment measures outlined in the Government Program, the impacts of which will be felt gradually, and the fact that the Government's key projects will no longer boost expenditure in 2019.

The deficit will remain clearly under the EU Stability and Growth Pact's (SGP) 3 percent of GDP reference value limit throughout the forecast horizon. Public finances are expected to be in balance at the beginning of the 2020s. In addition, it appears that the Government will broadly achieve its own fiscal targets set for 2019 with projections of the general government net lending of -0.4 percent of GDP and the debt ratio of 58.4 percent of GDP.

The debt-to-GDP ratio turned to a downward path already in 2016, falling below the EU SGP's 60 percent reference value in 2018, and the growth momentum will keep reducing the ratio going forward. In 2018, aided by some positive one-off factors, the central government was able to reduce the outstanding stock of debt (by EUR 0.9 billion) for the first time in 10 years. However, in 2019, the central government debt is expected to grow again by EUR 1.6 billion.

The authorities are well aware of the structural weaknesses in the public finances and concur with staff's recommendation that the favorable cyclical situation presents an opportunity to rebuild fiscal buffers. Demographic headwinds and increasing age-related public expenditures make building fiscal buffers more challenging. Despite the recent strong economic growth and already implemented consolidation measures, fiscal buffers remain thin.

At the start of the current Government's term in 2015, it outlined a combination of measures to ensure sustainable growth and public finances.

The measures aim at cost savings of some EUR 10 billion and consist of consolidation measures (EUR 4 billion), structural reforms (EUR 4 billion), and measures boosting growth and employment (EUR 2 billion). The fiscal consolidation measures are specified and broadly confirmed, with some risks related to the measures to be implemented by the autonomous municipalities. The bulk of the cost savings from the structural reforms is expected to result from the social and healthcare reform in the long term. Growth and employment have been boosted by the Competitiveness Pact and will be further boosted by measures aimed at improving productivity growth, as well as by shifting taxation from labor to indirect taxation.

Structural Issues

Social and Healthcare Reform

A fundamental reform of the social and healthcare services (SOTE) is necessary due to the demographic headwinds and a lack of equal access to public health and social services. Currently, there are wide differences in the availability, quality, and costs of services between municipalities and regions.

The reform is estimated to bring cost savings. Costs will not be cut from what they are at present, but their future increase is estimated to be curbed by EUR 3 billion by 2029. For this to be possible, health and social service expenditure can only be allowed to grow by 0.9 percent per year, whereas at present they increase by 2.4 percent annually. The cost and efficiency gains are expected to be realized via better integration of both health and social services on one hand, and primary and specialized care on the other hand, as well as by allowing more freedom of choice for customers through increased competition. Moreover, digitalization and technology are expected to yield efficiency gains when effectively and systematically implemented in the counties.

With the help of the cost and efficiency gains, the reform aims to safeguard equal access to social and healthcare services. Another aim of the reform is to create a more harmonious regional administration than at present, which will provide multiple public services. It will clarify public administration by transferring the responsibility for organizing these services from nearly 400 different responsible authorities to 18 autonomous counties with directly elected decision makers.

According to the plan, the regional government, health, and social services reform is due to come into force on January 1, 2021, with the freedom of choice being implemented in stages in 2021-23. The laws will be put to a vote in the Parliament in early 2019 after the final constitutional assessment. The election of the county councils will be held in the fall 2019.

Labor Market Reforms and Competitiveness

The 2016 Competitiveness Pact between the social partners has been successful in lowering unit labor costs and restoring national competitiveness. Its main elements consisted of reductions in employers' social security contributions, extensions in working time, cuts in public sector holiday pay, and wage freezes in 2017. At the same time, the Government implemented tax concessions to compensate for purchasing power losses.

In addition, as agreed in the Competitiveness Pact, social partners have held discussions to reform the highly-centralized wage bargaining process but with limited success so far. While the outcome of the 2017-18 decentralized, but closely coordinated, wage bargaining round was satisfactory, further progress is needed going forward.

Several labor market reforms have been implemented in recent years, including the pension reform, reduction in the duration of earnings-related unemployment benefit, mandatory job search plans, and regular interviews for all unemployed jobseekers, and reforms to the unemployment insurance system incentivizing active job search and making short-term and part-time work financially more viable. Recently, the Parliament approved a legislative change making hiring and firing easier for smaller firms.

Due to demographic headwinds, a key goal of the current Government has been to raise the employment rate from 68 percent in 2015 to 72 percent by 2019. Aided by the stronger than expected economic rebound, this goal has now been reached as Finland's seasonally adjusted employment rate rose to 72 percent in November 2018.

The more pessimistic demographic outlook of the latest population forecast, however, strengthened the demographic pressures. The declining birth rate will reduce the working age population in the future, which contributes to the strain on public finances. This emphasizes the need for increasing the employment rate further and implementing structural reforms.

While a lot of progress has been made, further reforms to improve the functioning of the labor market are needed. The authorities continue to work on improving incentives to work by changes to the social benefits. In connection with the SOTE reform, public employment services will be reorganized into the 18 new regional governance structures. Several new measures have been piloted and initiated with the aim of addressing labor market matching problems and new forms of work, with a strong emphasis on digitalization and intelligent matching.

As regards labor mobility challenges, a major obstacle is the lack of affordable housing in growth centers. Housing construction in the Helsinki Metropolitan area has increased significantly in recent years but it will take time to meet the demand for affordable housing. The authorities continue to take measures to deal with the housing situation in growth centers by adjusting zoning rules and building regulations.

Financial Sector Stability

The Finnish financial system continues to be sound with a well-capitalized and profitable banking system. The authorities broadly concur with staff's conclusions about the key challenges for financial supervision and oversight, including financial sector size, high concentration, strong regional interconnections, and digitalization. Moreover, the low interest rate environment continues to pose challenges for both the banking and insurance sectors.

Nordea's relocation from Sweden to Finland significantly increased both the size of the Finnish banking sector, to about 375 percent of GDP, and the exposure of the Finnish financial system to other Nordic economies. The authorities have responded to the new challenges by strengthening domestic supervisory resources and making sure that Nordea's capital requirements are maintained at a sufficient level in the transition period and in the longer term, including a 3 percent systemic risk buffer effective from July 1, 2019. The Single Supervisory Mechanism (SSM) plays a key role in ensuring a consistent application of EU regulations and common supervisory practices across the euro area, while the Single Resolution Mechanism (SRM) works to ensure a consistent approach to banking resolutions. These are important elements in safeguarding the safety and soundness of the Finnish banking system. Moreover, the Nordic-Baltic regional supervisory cooperation, already at a good level in international comparison, continues to function with the ECB and the SRM having taken the lead in the joint supervisory and resolution colleges, respectively. The authorities are committed to continue the joint monitoring of financial stability risks and reciprocation of macroprudential measures.

The authorities share staff's desire to have further progress in completing the Banking Union, including a common European deposit insurance scheme. However, this is possible only if further progress is made in reducing the risks in the European banking sector.

Household indebtedness stands at historical heights at approximately 128 percent of disposable income. In 2018, loans to housing corporations and consumer loans increased rapidly. High indebtedness and an increased number of consumer payment default entries have prompted a review by the Ministry of Justice on establishing a comprehensive credit registry in Finland with a legislative proposal expected to be issued in 2019.

House price developments have continued to be moderate at the aggregate with increasing divergence across the country. Large regional differences are driven by urbanization and investor demand. Consumer confidence has remained relatively robust implying that household indebtedness may continue to increase adding to the elevated structural vulnerability.

The national macroprudential authority — the FIN-FSA — has taken several measures to safeguard against increasing system-wide risks in the credit market. An average risk weight floor of 15 percent on mortgage loans for IRB banks came into force on January 1, 2018. The loan-to-collateral cap on housing loans was reduced from 90 to 85 percent in July 2018. In June, the FIN-FSA imposed a systemic risk buffer on all Finnish credit institutions and re-examined the institution-specific additional capital requirements on larger credit institutions, which will be binding by July 1, 2019.

The authorities broadly agree with staff on the need to develop and broaden the macroprudential toolkit. They are currently analyzing whether to include additional borrower-based tools into the toolkit and a legislative proposal is likely expected in 2019. They also agree on the need to increase the coverage of data collection among non-bank providers of debt.

Mr. Mozhin and Mr. Palei submitted the following statement:

We thank staff for their concise Article IV report on Finland and an explanatory note on the Nordea's redomicile to Finland, as well as Mr. Virolainen for his comprehensive BUFF statement. The Finnish economy has strong fundamentals, due, to a large extent, to prudent fiscal policy framework and the authorities' close attention to maintaining competitiveness of the economy. At the same time, the Finnish authorities face major policy challenges related to unfavorable demographics against the background of rather anemic growth rates. These domestic challenges are exacerbated by the regional risks, especially high policy uncertainty in the European Union and the possibility of a “hard Brexit”. Global risks also call for continued vigilance.

Economic growth rebound over the past three years brought GDP back to the 2008 level. This slow growth for a prolonged period is somewhat puzzling to us, and we invite staff to comment on the main barriers to a more dynamic recovery in Finland after the Global Financial Crisis.

Under the current circumstances, with elevated risks of recession in the advanced economies, many policy-makers are concerned about the lack of demand management tools. Policy interest rates remain very low in nominal terms, while the application of negative interest rates has its limits. At the same time, reliance on fiscal policy as the primary response to a possible slowdown also has limits. Does the experience of Finland since 2008 provide any lessons with respect to the economic performance under the conditions of constrained demand management?

The chart on page 4 compares GDP growth in Finland with its Nordic peers. Could staff provide a similar chart comparing growth in GDP per capita terms? Is slow population growth in Finland due to limited immigration among the key explanatory factors of the differences? Do the authorities plan to adjust their immigration policy to facilitate GDP growth and alleviate looming fiscal pressures?

For many members of the euro area wage moderation policies seem to be an attractive tool of restoring competitiveness. The 2016 Competitiveness Pact in Finland aimed at a comprehensive set of labor market reforms, including the wage bargaining process. In his BUFF statement Mr. Virolainen referred to the adjustment in unit labor costs due to the 2017 wage freeze and reductions in employers’ social security contributions. Mr. Virolainen credited these policies for the increase in exports and faster GDP growth. We note that the staff report somehow left out any discussion of the external sector by simply pasting a table from the External Sector Report. We would like staff to reflect on the objectives, measures, and outcomes of the authorities’ policies aimed at restoring external competitiveness in the single currency area. The Finnish authorities’ approach resembles labor market reforms and wage moderation policies previously introduced in Germany and the Netherlands.

The role of the authorities in the redesigned wage bargaining process deserves special attention. While staff claim in paragraph 37 and footnote 28 that the government played no formal role and did not formally coordinate across sectors, Mr. Virolainen emphasized that the 2017-2018 wage bargaining round was closely coordinated by the authorities. We would appreciate additional clarifications on the role of the government. We also recall that in the report on the Netherlands staff referred to the leading role of the export sectors in driving wage moderation. Do we observe something similar in Finland, i.e. do the timing and sequencing of sectoral negotiations allow for a more prominent role of competitiveness considerations in the wage bargaining process?

Staff insist that relatively low labor mobility may be another candidate for explaining slow growth in Finland. In paragraph 6 of Annex III, staff proposed several policy measures aimed at further increasing regional labor mobility in Finland, and we agree with these recommendations. At the same time, the analysis of the barriers to labor mobility identified several challenges in the housing market. According to Figure 2 on page 24, Finland is a regional outlier in terms of house price dynamics, as prices in Sweden, Norway, and Denmark have increased much more. Should the authorities consider any additional policy measures aimed specifically at the changes in the housing market?

In the fiscal area, the Finnish authorities seem to be on track to achieve their medium-term consolidation plans, and staff broadly agree with this strategy. On the expenditure side, health and social security reforms are among the key contributors to maintaining fiscal accounts on a sound footing. We recall that, at the time of previous Article IV Consultations, Directors highlighted implementation risks in this area. We would appreciate an update on the pace of adoption and implementation of these reforms compared to the authorities' original plans.

One of the recommendations in the staff report dealt with the possibility of stronger emphasis on the development of infrastructure, especially near the urban centers. Could staff elaborate on the ways to finance additional infrastructure expenditures, including the possibility to leverage the public sector balance sheet, as the Finnish authorities successfully did in the case of export guarantees (Finnvera)? Did the authorities express any views on the costs and benefits of stronger emphasis on infrastructure development?

In the risk assessment matrix staff lumped together a broad range of risks, including those of growth slowdown in Europe, the U.K.'s exit from the

EU, possible tightening of international financial markets, and other factors. We would be interested in a more granular description of external risks to economic outlook in Finland than it was done in the RAM.

Finally, we felt that the draft press-release (pages 49-51) in its factual part ventures into policy recommendations to the Finnish authorities. We believe that this part of the press release could be streamlined with the policy issues moved to the part reporting on the Board discussion.

With these remarks, we wish the Finnish authorities success in facing challenges ahead.

Mr. Meyer submitted the following statement:

We thank staff for their insightful report and selected issues papers in the context of Finland’s Article IV consultation. We also thank Mr. Virolainen for his informative buff statement.

After major economic shocks, the economy has recovered in the past three years and now exhibits solid growth. However, economic challenges remain in boosting potential growth and competitiveness as evidenced by higher unemployment and lower productivity than in peer countries. The outlook for long-term growth in Finland is also affected by adverse demographics, which impact the long-term fiscal calculus as well. Against this background, there is a broad agreement that productivity, which is only slowly recovering, must be boosted through measures that increase labor market flexibility.

Macroeconomic Developments

Finland’s economy remained stronger than in euro area peers, yet a gradual slowdown to its potential rate is anticipated. During its three years of recovery, the country’s cost-competitiveness has improved and export market shares have increased. Moreover, the most recent quarterly figures for the third quarter of 2018 signal that the economic cycle might have peaked and the slowdown could come faster than currently expected. Headwinds to productivity growth include a skills-mismatch related to low internal labor mobility. At the same time, the authorities past efforts to reinvigorate the economy are showing results in declining unemployment, higher participation and a more balanced growth composition.

Fiscal Policies

The positive cyclical situation and ageing-related spending pressures justify the gradual fiscal consolidation and structural reforms. With the constant reduction of the nominal budget deficit in the past and coming years, government debt is expected to have dropped below 60 percent of GDP and continue declining further. Budget revenues are expected to continue increasing in 2019-2020, on the back of growing production, employment and wages; while expenditure growth should remain moderate. This should be sufficient to avoid a procyclical fiscal stance and to reduce the structural deficit to the vicinity of the medium-term objective (MTO), therefore being in compliance with the requirements of the EU's SGP. We share staff's view that such a gradual fiscal consolidation should be continued and that the implementation of the social services and health care reform remains crucial in addressing the demographic challenges. Finally, in light of the importance of the denominator in bringing down debt ratios and acknowledging the relatively low levels of potential growth, prioritizing growth enhancing investments could also be considered.

Financial Market Policies

As staff rightly point out, the redomicile of Nordea has changed the financial landscape in Finland to which the authorities (European and national) have swiftly responded. Following Nordea's move to Finland, the size of Finland's banking sector has multiplied and has become one of the largest in the EU (in terms of GDP). Finland's banking sector has also become more concentrated and interlinkages with and exposures to other Nordic countries have increased. Hence, we welcome the swift and adequate response by the relevant authorities in setting new capital requirements and increasing supervisory resources.

There are no signs of an immediate financial stability risks emanating from the housing market but households' rising indebtedness warrants attention. Residential real estate price dynamics have been muted recently, while mortgage lending growth is contained. However, risks stemming from the real estate sector are still present due to a high and increasing level of household indebtedness, relatively high debt service to income ratios despite low interest rates, compressed lending spreads and large bank exposures to the real estate sector. The high level of household indebtedness and its increasing trend are a main source of vulnerability, which might lead to negative repercussions between the macro-environment and the housing market. Importantly, housing corporation loans and non-bank credit have been growing rapidly. Therefore, as staff, we see potential benefits in enhancing the macroprudential toolkit with additional income-based instruments and the need for supervisory access to more granular data.

Structural Policies

Low labor mobility is the main challenge to better resource allocation and thus higher productivity growth. Major economic shocks and the financial crisis have induced sectoral shifts in the economy that both dislocated a significant portion of the labor force and prevented a swift recovery to previous productivity levels. The authorities are fully aware of these challenges and have enacted important reforms in the past to increase wage flexibility, fine tune incentives from social benefits and rules of dismissal. In agreement with the staff report, we see low labor mobility and inactivity traps as an obstacle to more extensive use of the labor force. However, we would put more emphasis on infrastructure investment (especially in transportation) to improve job mobility, than on wage differentiation. Finally, we would also highlight the importance of investment in R&D for improving non-cost competitiveness. A further specialization in lower tech goods and slower growth in productivity constitute an important medium-term risk for the economy.

Mr. Gokarn and Mr. Joshi submitted the following statement:

We thank staff for the informative reports and Mr. Virolainen for the insightful buff statement.

Three years of consistent growth performance has helped Finland to support employment growth and household consumption, although low productivity and shrinking workforce continue hamper the prospects of raising potential growth. Of importance are steps that enhance labor market dynamism, both through provision of flexible wages and incentivizing skill distribution across regions by way of enhancing the geographic mobility of jobs.

The macroeconomic fundamentals remain robust. Yet, policies to strengthen fiscal, financial and structural policies in areas of weakness are required to ensure strong and sustainable footing for future economic growth. The downside risks to the economy are essentially external -stemming from weaker global growth and trade disruptions including those from tightening of interest rates and risks related to large exposures of international banks to housing assets across the Nordic region and to wholesale funding. Although domestic risks are not yet pronounced, the less than expected gains from structural reforms in the labor market and social and health sectors could constrain savings and jeopardize fiscal sustainability. In addition, the decline in working age population could also hurt the growth outlook.

After an expansionary stance in 2018, fiscal policy is expected to become contractionary this year with the reduction of deficit by 0.7 percent of GDP despite the new revenue measures announced in the 2019 budget. We note that the fiscal policy is projected to stay contractionary beyond 2019, as consolidation takes hold and the economy is expected to converge to its potential and drive the trajectory of public debt downwards. We support staff views about the need to maintain the tempo of fiscal consolidation to ensure long-term sustainability in the light of likely pressures arising from age-related spending as well as elevated levels of contingent liabilities. Allocating unexpected savings for reducing debt and sustained reforms in social services and health sectors to enhance savings would bolster the health of the fiscal sector. We welcome the authorities' recognition of structural weaknesses in public finances and their commitment to rebuilding fiscal buffers including their resolve for reforms. Could staff comment on the main elements of their methodological approach for the assessment of savings projected from the reforms in the social and health care services?

While the credit market has dispensed loans moderately, those to housing corporations and consumers have expanded rapidly with commensurate expansion of household debt. We note that the increasing borrowings by highly indebted households as well as their exposure to floating rate loans could potentially exacerbate vulnerabilities to interest rate shocks. Although the recent tightening of credit is welcome, we support staff advice on further controlling mortgage credit by replacing the current cap on loans relative to collateral by cap relative to the value of the property and the use of debt-based macroprudential tools to thwart undue stretching of leverage. Similarly, enhanced regulation of consumer loans especially by non-banks including prudential requirements to assess creditworthiness and consumer protection rules would be needed to mitigate financial system risks. We appreciate the authorities' support for the application of appropriate caps on loans covering every lender and their positive approach towards setting up of a credit registry and welcome the steps taken by the FIN-FSA to safeguard against system-wide credit market risks.

Robust capital reserves underpin the soundness of the Finnish financial system. However, we note that the size of the banking sector has increased manifold with the relocation of the Nordea headquarters and bank lending remains highly concentrated in real estate. The financial system is also highly interconnected externally and faces rollover risks of covered bond funding, which plays a major role in bank funding. The authorities have stepped in to mitigate risks by prescribing new bank-specific systemic capital buffers, improving the supervision of Nordea and have taken efforts to mitigate cross-border risks. The importance placed on Single Supervisory Mechanism, Single Resolution Fund and the common deposit insurance scheme especially in the context of systemically important banks like Nordea is essential to enhance market confidence. But, beyond this, the management of prudential risks pertaining to the rapid expansion of digitalization of financial services is necessary. At the same time, sustained efforts are required to strengthen AML/CFT efforts, especially owing to concerns about the adequacy of supervision in the light of recent complaint about Nordea's Finnish operations. It would therefore be appropriate to strengthen synergy among various agencies responsible for AML/CFT supervision. We welcome Finland's assessment under the FATF standards and look forward to its report in 2019. We welcome the authorities' broad endorsement of staff assessment and are encouraged by the progress made in setting up of the Finnish deposit guarantee fund.

Among structural reforms, those related to improving social and health care services, regional mobility and productivity in the labor market across sectors are important for restoring economic dynamism. We note that the authorities have pursued several reforms such as adopting decentralized wage bargaining processes under the 2016 Competitiveness Pact and reforming social benefits to reduce inactivity. Further steps such as enhancing the ability to differentiate wages at the firm level to incentivize job-to-job transitions, enhancing social benefits and developing transport linkages around growth regions would help energize labor market activity and productivity. Could staff elaborate on the impact that the authorities' labor market reforms so far have had on reducing unemployment?

We wish the authorities the very best and every success in future endeavors.

Mr. Mojarrad and Mr. Nadali submitted the following statement:

We thank staff for a well-written set of papers and Mr. Virolainen for his helpful buff statement.

Having weathered two recessions since the global financial crisis, Finland has enjoyed three consecutive years of economic recovery. Growth in 2018 continued at a robust pace and on a broad base; inflation remained subdued despite a closing output gap; and unemployment dropped to its lowest level in seven years although it continued to vary widely across regions. The public finances have improved with the recovery; the external current account is in a small deficit; and the public debt has declined to the SGP threshold. The financial system is sound and stable; and recent reforms have boosted trade and employment. However, while the recovery is likely to continue, it is expected to moderate going forward. Given downside risks to the outlook, including population aging and weak productivity growth, the authorities are encouraged to consolidate public finances, strengthen the financial sector regulation and supervision, and advance growth-enhancing structural reforms. We concur with the thrust of the staff appraisal.

Gradual and steady fiscal retrenchment is necessary to rebuild fiscal buffers, given a relatively high level of contingent liabilities, the typical volatility of the economy, and the looming demographic headwinds and increasing age-related spending pressures. The 2019 budget appropriately implies a moderate tightening and reverses the 2018 fiscal stimulus. We welcome the authorities' commitment to closing the fiscal sustainability gap by continuing to implement their medium-term fiscal consolidation plan. Efforts should continue to strengthen tax administration and improve VAT collection as well as garner political consensus on social services and healthcare reform. If there are unexpected savings, we agree that they should be used to either retire debt or increase growth-enhancing expenditures on transportation and research and development. We note that potential savings from social services and healthcare reform are uncertain and will largely depend on implementation. Could staff indicate what other adjustments the authorities might consider to ensure savings are realized?

The banking sector is resilient and immediate financial stability risks appear limited. System-wide capital is comfortably above regulatory minima; returns are healthy; and NPLs are low. However, the oversized and complex financial sector, especially after the recent Nordea's redomicile, high real-estate loan concentration, strong interconnectedness with financial sectors of other Nordic countries, reliance on wholesale funding, and digitalization pose risks and require vigilance. We welcome the authorities' response to many of these challenges and underscore the importance of continued close regional cooperation and preparedness for crises. We also note that some issues require attention from European authorities, as reiterated by Mr. Virolainen. Could staff indicate if there are any plans to establish a common European deposit insurance scheme or for the Single Supervisory Mechanism to exercise supervisory powers over significant third-country bank branches operating in the euro area?

Steady increase in household indebtedness and the growing reliance on consumer credit provided by nonbanks and via digital platforms have raised additional concerns. We welcome the tightened credit policy and plans to expand macroprudential tools to debt-and-income-based measures and establish a comprehensive credit registry to better monitor and address household financial vulnerabilities. We also agree on the need for additional consumer protection measures through increased data collection on consumer lending provided through digital platforms.

Modest labor mobility and subdued labor productivity warrant deeper structural reforms to make the economy more dynamic. While good progress has been made in recent years to enhance the functioning of the labor market, more needs to be done to improve labor market dynamism and facilitate transfer of skills across regions, sectors, and firms. Work should therefore continue to increase wage flexibility at the local and firm level, revisit the generosity of the unemployment insurance system and social benefits, strengthen active labor market policies, expand housing supply in urban areas, improve transport infrastructure around growth regions, and reduce mortgage interest deductibility.

We wish the authorities continued success in their endeavors.

Mr. Lopetegui and Ms. Moreno submitted the following statement:

We thank staff for the reports and Mr. Virolainen for his informative buff statement.

Finland stands out as a strong performer in many dimensions, including solid institutions, sound fiscal finances, extensive social insurance mechanisms, and resilience to external shocks while having a high degree of openness. Nevertheless, the country faces challenges coming from demographic trends that would shrink the working-age population and put health and social security systems under pressure. Amid low productivity growth post-GFC, another challenge is the increasing indebtedness of households, a trend that has been observed during the past few years, and which has been accompanied recently by an increase in payment defaults. We encourage the authorities to work on staff recommendations to overcome these and other bottlenecks—like low labor market dynamic—that might hinder economic growth. As we broadly agree with staff´s appraisal, we will only make some comments for emphasis.

Despite good economic performance, there are downside risks to the outlook. The main risk is heightened protectionism, as escalating trade tensions could undermine Finnish exports. Also, disruptions to global value chains could harm production and supply of goods, and harm productivity. Staff mentions that should a scenario like this happen, automatic stabilizers should be allowed to operate. Could staff elaborate on what these stabilizers are and how they work? Wouldn't it also be important to increase labor/product market flexibility to face an external shock in the context of euro membership?

Labor market dynamism is being tackled but more needs to be done. Vacancies remain high relative to employment, particularly in construction and services. There appear to be various structural and policy reasons behind this outcome, but one reason mentioned in the buff statement for people not moving to places with higher vacancies is housing affordability. Are the authorities considering subsidies or other measures related to change the relative price of dwellings among regions to motivate migration towards a place that offers jobs? We welcome the increase in the employment ratio—from 68 percent to 72 percent in only four years—but wonder whether the increase is sustainable and whether other policies—on immigration, for instance—could play a role in achieving higher growth of the workforce. Staff's comments are welcome.

Risks are building up fast in the household sector. As household consumption has exceeded disposable income in recent years, the debt burden continues to increase, standing at 128 percent of disposable income. Apart from the observed accompanying increase in payment defaults, a worrisome development is the fact that more borrowers are vulnerable to higher interest rates. In a scenario in which global interest rates increase, given the integration of Finland to external markets, this is clearly a point of concern.

We commend the authorities for aiming at the establishment of a comprehensive credit registry, with legislative proposal expected in 2019. Also commendable are the macroprudential policies taken to safeguard against system-wide risks in the credit market, and the successful incorporation of Nordea bank, although this has significantly changed the configuration of the Finnish banking system, and nature of macro-financial risks. We welcome that the authorities are thinking of broadening the macroprudential toolkit and increasing the coverage of data collection among non-bank providers of credit.

With these comments, we wish Finland and its people the best in their endeavors.

Mr. Beblawi and Ms. Choueiri submitted the following statement:

We thank staff for the interesting reports and Mr. Virolainen for his helpful buff statement. We welcome the continued strength in Finland’s economic activity and the sharp pickup in the employment rate. Nonetheless, risks to the outlook, particularly those associated with the international trading environment, are on the downside. Since our last discussion, household debt continued to increase, and potential growth remained constrained by labor market rigidities and population aging. We welcome the agreement between the authorities and staff on the policies needed to address these challenges and rebuild fiscal buffers. We broadly concur with the staff appraisal and will turn in what follows to labor market reforms and financial sector policies.

Recent structural reforms have supported employment. The 2016 Competitiveness Pact promoted wage restraint and improved competitiveness. Moreover, changes to social benefits enhanced incentives to look for jobs, and new rules for temporary hires have the potential to boost employment and labor flexibility, as noted by staff. Nonetheless, further reforms are needed to increase labor market dynamism while maintaining a strong safety net. We see merit in staff’s call for more flexibility about setting wages at the firm level and changing unemployment benefits to increase job search soon after losing employment, as well as policies to aid regional labor mobility. Given the increasing demographic pressures facing Finland, can staff comment on the extent to which immigration could play a role in supporting the country’s labor force?

Household debt has been increasing steadily and it now stands at a historical high of about 128 percent of disposable income. The recent tightening of credit policies is therefore appropriate. Furthermore, the authorities agreed with staff to develop and broaden the macroprudential toolkit, including consideration of additional borrower-based tools as part of a legislative proposal in 2019. The authorities also agreed on the need to increase the coverage of data collection among non-bank providers of debt, as conveyed in the buff. We would welcome staff’s comments on the timeline that is envisaged for implementing this measure. Staff indicates that Finland’s household saving rates are lower than peers, although some of the difference is attributable to Finland’s public pension system. Can staff indicate the reason for these lower rates, particularly that households in other Nordic economies have increased saving rates as their economies have recovered?

Finland’s financial system remains sound. Staff also estimates that the authorities have responded to the challenges of Nordea’s redomicile within the bounds of their remits (Selected Issues Paper). We share staff’s view that the considerable increase in the size of Finland’s banking sector resulting from the recent redomiciliation of Nordea increases demands on supervision and heightens the importance of continued close regional cooperation and preparedness for crises.

We agree with Messrs. Mozhin and Palei that the Draft Press Release (Appendix I) contains policy recommendations that should be part of the Executive Board Assessment.

Mr. Fanizza and Ms. Lopes submitted the following statement:

We thank staff for the balanced set of reports and Mr. Virolainen for his helpful buff statement. We broadly share staff’s assessment and recommendations and associate ourselves with Mr. Meyer’s statement. At this stage, we would just like to focus on a couple of points.

The Finnish economy has been performing strongly, with robust broad-based growth, and decreasing unemployment. Going forward, growth is likely to moderate toward its potential level. Nevertheless, staff states that the economy is characterized by “typical volatility”. Could the staff explain what this concept means, how it is measured, and what are its underlying reasons.

One of the main challenges of the Finnish economy is to sustain productivity growth going forward. For that, the authorities should continue to press ahead with reforms to improve the functioning of the labor market, as well as to deal with the impact of an ageing society. At the same time, we believe investment remains a key element to achieve this goal. For example, investment in infrastructure (notably transports) could help address the problems related with low job mobility, or investment in enhancing skills and supporting innovation should improve non-cost competitiveness. In this context, we would ask staff further insights on the trade-offs between continued fiscal consolidation and increasing public investment. We also wonder whether these issues were discussed with the authorities in the context of the consultation.

Mr. Benk and Mr. Stradal submitted the following statement:

We thank staff for their informative set of reports and Mr. Virolainen for his helpful buff statement. Finland's economy has continued to grow above its potential for the third year which helped to largely close the output gap and surpass the pre-crisis level of GDP in real terms. However, signs of a maturing cycle are appearing and some structural weaknesses persist. Tackling the labor market rigidities and low productivity will be essential for the Finnish economy as it faces long-term demographic pressures. We broadly concur with staff's assessment and policy advice. We associate ourselves with Mr. Meyer's statement and provide the following comments for emphasis.

We take note of the fiscal consolidation continuing broadly as planned and commend the authorities for achieving a decrease in the debt-to-GDP ratio below the benchmark of 60 percent. We welcome the intention to further build fiscal buffers if economic growth continues as projected. The broad consensus across the political parties ahead of the elections on prudent fiscal policies is reassuring. We concur with staff that efforts to improve the cost-effectiveness of social services and health care should be accelerated.

The relocation of Nordea dramatically changed the Finnish banking sector landscape and we commend staff for the timely Selected Issues Paper on its implications. We welcome staff's assessment on the adequacy of the policy response. Approximately three quarters of Nordea's operations remain outside of the banking union, which puts a premium on maintaining cooperation between the euro area and non-euro area institutions to ensure adequate supervision and information sharing.

Staff supports the establishment of a common European Deposit Insurance Scheme (EDIS). We caution against making policy recommendations concerning the banking union in the context of one of its member country's Article IV consultation. Proposals with union-wide policy implications should rather be discussed in reports on the euro area or EU as a whole to capture all the dimensions and nuances. Completion of the banking union, including the potential establishment of an EDIS, is currently being negotiated within the EU and its outcome should not be prejudged as the discussion of the interplay between risk reduction and risk sharing is inconclusive as of now.

The continuing growth of household indebtedness is a cause for concern, especially as a large share of the loans has a floating interest rate. We welcome the recent measures aimed at tightening credit policies. We support the initiative to establish a comprehensive credit registry, which would enable complementary debt-based macroprudential regulatory measures.

Further progress in structural reforms is needed for sustaining Finland's cohesive economic model. Wage differentiation at the firm level is key to enhance the flexibility of the labor market and improve labor mobility. The role of property taxation in deterring mobility should be further explored. Reforms of the social benefits system should be prioritized to shape incentives in favor of more active labor market participation. We are encouraged by the authorities' full awareness of these weaknesses, as well as by the recent policy reforms incentivizing job search, facilitating dismissals in small companies, and enabling part-time work opportunities.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for its well-focused set of reports and Mr. Virolainen for his informative buff statement. We share the thrust of staff's appraisal and its focus on policies to increase resilience and boost productivity growth through enhanced resource reallocation. We associate ourselves with Mr. Meyer's statement and would like to add some comments for emphasis.

Recent growth has been healthy and widespread across sectors, while the labor market has improved significantly over the past year. At the same time, current macro-financial imbalances seem to be reasonably contained. Wage growth is modest, inflation remains subdued and overall credit growth is moderate, while public finances are in a relatively healthy position. We share staff's view about the two most relevant underlying weaknesses, namely, low labor market mobility—understood in a broad sense—and deteriorating household finances.

Regarding household finances, although not yet worrying, there are increasing signs of rising vulnerabilities. The savings rate continues to be extremely low. Loans to housing corporations and consumer credit through non-bank channels have been expanding rapidly, while the typical new borrower for housing purchases is taking on leverage of over 4 times income, and the share of variable rate loans remains high. We feel somewhat reassured by the measures adopted by the authorities over the last quarters, such as the floor on average risk weights for housing loans for banks using IRB models, or the cap for loan-to-collateral ratios for those loans. However, we share staff's view that macroprudential policies could be more effective if the toolkit were expanded with borrower-based tools, such as debt-to-income or debt-service-to-income caps, or with a more comprehensive credit registry.

These tools would ideally cover all lenders—including non-banks—and all types of debt.

We concur with staff's assessment that the Finnish financial system is sound and that the authorities have responded to the challenges of Nordea's redomicile within the bounds of their remits. However, Nordea is a large bank that now resides in a relatively small economy, which naturally raises the question of supervisory resources and backstops to protect depositors and Finnish taxpayers, as well as to prevent substantial spillovers to other euro area economies. In this regard, we would like to stress the importance of completing the banking union by providing a backstop to the Single Resolution Fund and by establishing a common European deposit insurance scheme in order to boost investors' confidence and to support resolution and liquidation where needed.

We also share staff's view on the importance of increasing labor market dynamism, while maintaining a strong safety net. However, we would like to stress the fact that the authorities have already implemented several deep reforms to improve the functioning of the labor market over recent years, such as tightening the conditions for receiving unemployment benefits, shortening their duration, increasing penalties to incentivize job search, introducing a mobility allowance, extending the trial period of new hires, etc. Thus, apart from persevering with the efforts to transition towards an organized decentralization system of collective bargaining, we wonder whether it is time for a pause to check if all these measures worked before attempting new ones. Staff's comments are welcome. Moreover, deep structural changes in the Finnish economy associated with the impact of the crisis and of Nokia's demise would suggest paying more attention to other relevant areas for productivity growth, such as private investment in R&D activities, which has fallen about 1/3 since its peak in 2009. What is staff's assessment regarding policies to support R&D investment in Finland?

Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for their candid set of reports and Mr. Virolainen for his insightful buff statement. We broadly share staff's assessment of the economic outlook and the balance of risks, and we would like to offer the following comments.

Finland's recovery is strong, but risks are tilted to the downside. The economic cycle is maturing, and growth is expected to revert to its potential over the medium term as global demand slows down. Moreover, tighter global financial conditions, increased trade tensions, and adverse demographics constitute major downside risks to the outlook. We concur with staff that the key challenge is to make the economy more dynamic. In the long term, an increase in productivity is critical to boost employment and potential growth, as the labor force is expected to shrink.

A tighter fiscal stance is warranted, as age-related pressures are looming. Stronger tax revenues and lower spending have improved fiscal balances. We nonetheless concur with staff that prudent fiscal policy is needed to rebuild fiscal buffers, given the high exposure to shocks and an elevated level of contingent liabilities. We welcome the authorities' strong commitment to a medium-term consolidation plan, as indicated by Mr. Virolainen in his statement. Further improvement in the effectiveness of public spending via a reduction of unemployment benefits and continued progress in implementing health care and social security reform will be instrumental to ensure fiscal sustainability.

Strengthening labor market reform is paramount to improving Finland's economic competitiveness while maintaining social cohesion. While we take note of the achievements of past reforms and the ongoing labor market recovery, prevalent job market inefficiencies and subdued productivity growth weigh on near-term prospects. In this regard, addressing skills mismatches, incentivizing job search efforts, and increasing regional mobility (via wage flexibility across regions) are steps in the right direction. In the long run, a new impetus is needed to enhance productivity growth, given the declining working age population. We welcome staff's analysis presented in Annex III, but would welcome a more detailed study of labor market mobility decomposed according to workers' age, sector of employment, type of contract (temporary vs permanent job), place of origin, etc. Staff's comments would be welcome.

The financial sector continues to be sound and well-capitalized; however, vulnerabilities remain. We note that the relocation of Nordea to Finland in 2018 has almost quadrupled the size of the Finnish banking sector, which prompted the authorities to set up new capital requirements and increase supervisory resources. We commend the authorities for their adequate and timely responses to these new challenges, but more work needs to be done. The highly concentrated and interconnected financial system, as well as the high level of digitalized services can pose significant risks for financial stability. In this context, we encourage the authorities to further expand the macroprudential toolkit and improve data collection. Moreover, the full implementation of a common deposit insurance scheme within the euro area banking union would be beneficial. In addition, further consumer protection measures in the mortgage market should be considered, also given the rising level of household indebtedness. We note that staff do not find any evidence of overvaluation in the residential real estate market, but risks are still present. Also, we encourage the authorities to closely monitor unsecured consumer lending, especially by non-banks, and to monitor the growth in household debt. The efforts to establish a comprehensive credit registry system are welcome in this regard.

Mr. Castets and Ms. Gilliot submitted the following statement:

We thank staff for their informative report and Mr. Virolainen for his insightful buff statement. For several years now, the revival of the economic activity in Finland has been encouraging. The economic expansion has been mainly fueled by a dynamic domestic demand, a hike in employment rate and a high investment growth in a context of favorable financial conditions, great consumer and business confidence and helpful global economic trends. After having reached 2,4 percent in 2018 (above the euro area GDP forecast), growth is expected to moderate in 2019 reflecting a slowdown in public and private consumption as well as a lesser contribution of net exports to GDP. Under the combined impact of a higher level of activity and an improvement in general government finances, public debt has been reduced through sound fiscal policy. Within this positive overview, we concur that facing growth trend deceleration and weak productivity growth stands for the main challenge in the medium term to maintain public finances sustainability. We adhere to the Fund's recommendations on fiscal policy and acknowledge from Mr. Virolainen's statement the willingness of the authorities to consider rebuilding fiscal buffer considering the looming prospect of higher age-related expenditure even if we feel that the impact of ageing and how to address this challenge would have deserved a broader treatment beyond fiscal considerations. Debt path will also depend on the ability of the authorities to promote growth-enhancing expenditures, notably in infrastructure, and reduce labor market's inefficiencies. We associate ourselves with Mr. Meyer's statement and would like to make two additional remarks.

Structural Reforms

We salute the efforts made by the authorities to foster job creation as well as their awareness of the difficulties the job market is and will soon face through high structural unemployment related to skill mismatches, lack of regional labor mobility and working-age population contraction. Given that the peak of the economic cycle has been passed and less favorable financial and trade conditions are likely going forward, new sources of productivity need to be found to help the economic activity reach a dynamic pace and boost wealth creation and employment. Labor productivity has been subdued for a long time in Finland and we welcome the success of the 2016 Competitiveness pact aimed at restoring national competitiveness while compensating for purchasing power losses. We concur with staff's recommendations on the need for greater decentralized wage bargaining and further improvements in the incentives measures to return to employment although we acknowledge that lot a work has been done as pinpointed in the buff statement. With regard to the latter issue, we see an interest in targeting the professional integration of youth, unskilled workers and long unemployed.

On social service and healthcare reform, we welcome the streamlining of social services providers from nearly 400 to 18 entities thus allowing great economies of scale. We agree that this reform should contribute to fiscal sustainability while enhancing and harmonizing the quality of social and healthcare services at a national level.

On ageing, as for several other European countries, we see the need for a more in-depth and consistent analysis of the different impacts of demographic shifts across Europe, as well as a broader set of recommendations. One could have expected a more detailed discussion of the impact of ageing on the labor market, the external balance and productivity going forward. Accordingly, staff's recommendations to tackle ageing appear very much focused on fiscal consolidation, while increasing labor participation, enhancing productivity and attracting foreign workers are part of the equation. We therefore encourage staff to cover more comprehensively this issue in upcoming reviews.

Financial System

We share the staff's concern over the financial system risk exposures to foreign funding and high sectorial concentration. An abrupt reversal in global financial conditions could indeed translated through interest rates into a reduction in domestic consumption and investment. Housing loans and consumer credit lending's rapid expansion have led to excessive debt growth of households regarding their real disposable income, increasing all the while the vulnerabilities to shocks of both the housing market and the economy. Tightening credit policies from the banking sector has been a wise step taken by the authorities to contain those risks, avoid heavily indebtedness situations of households and contagion across banks portfolio. Now, looking at the debtor side, we believe that widening the macroprudential toolkit to include debt-to-income-based measures could help mitigating credit default risks in a context where markets interest rates have already started to rise and will heighten debt-servicing costs. In line with staff's recommendations, we also fully support the authorities' willingness to launch a positive credit register including relevant information on households' credit records so that the supervisory body and the lending institutions may be able to better appraise the borrowers' profiles. Finally, we thank Staff for their Selected Issues paper on Nordea headquarters' relocation. In so far as capital requirements and supervision have been enhanced in cooperation with the SSM to cover risks arising from Nordea's recent incorporation, we do not contemplate this re-domicile as a major source of concern for financial stability.

Mr. Agung and Ms. Rauqeuqe submitted the following statement:

We thank staff for the informative reports and Mr. Virolainen for his insightful buff statement. It is laudable that broad-based growth, improved labor outcomes and buoyant consumption and investment have been achieved amid low income inequality and strong reform support. We acknowledge the broad agreement between the authorities and staff on the policy priorities for addressing structural headwinds and adverse demographics. These include rebuilding fiscal buffers, further tackling labor market rigidities and being vigilant about increasing household indebtedness. As we share the thrust of staff's assessment, the following comments are made for emphasis.

Growth-friendly fiscal consolidation is key to rebuilding buffers and safeguarding long-term fiscal sustainability. The cyclical upswing has bolstered Finland's fiscal position and supported the downward trajectory of the debt-to-GDP ratio. Nevertheless, fiscal buffers remain thin. Moving forward, the 2019 budget strikes the right balance between consolidating the fiscal position and supporting growth, innovation and productivity via preserving R&D and education spending. While we take positive note of the expected cost and efficiency gains from reorganizing and introducing technology in social services and health care administration, decisive implementation and continuous monitoring of these planned adjustments and reforms will be important for keeping the authorities' fiscal consolidation plans on track, rebuilding fiscal buffers and addressing age-related challenges.

Addressing persistent weak job market dynamism will support competitiveness and medium-term growth. We commend the authorities' 2016 Competitiveness Pact and reforms to pensions, unemployment benefits and hiring and firing practices that have helped lower labor costs and boost external competitiveness. However, Finland's more front-loaded aging profile presents a potentially sizeable strain on public finances and medium-term growth. As such, we see merit in staff's recommendations for increased firm-level flexibility around wage bargaining, strengthening employment incentives and improving regional job mobility. In this light, the authorities' recent measures and pilots on labor market matching and new forms of work constitute further steps in addressing these demographic headwinds.

Heightened household sector indebtedness requires increased vigilance and enhanced macro-prudential toolkit. Financial sector indicators point to a sound financial system, and the authorities have appropriately responded to challenges presented by Nordea's redomicile. While credit policies have been tightened with respect to housing loans, debt-based macroprudential tools may be needed if the build-up in household leverage were to continue unabated. We therefore welcome the authorities' position to improve non-bank lending data collection and introducing a positive credit registry to support financial sector monitoring and supervision.

Ms. Levonian, Ms. McKiernan and Mr. Feerick submitted the following statement:

We thank staff for their report and well-focused Selected Issues Paper. We also thank Mr. Virolainen for his excellent, and last, buff statement. The short-term economic outlook is relatively benign, while recent policy actions undertaken by the authorities appear broadly appropriate. However, longer-term structural issues continue to cloud the outlook and are reflected in the low estimates for potential growth. We note the agreement between staff and the authorities on practically all substantive issues and offer the following points for emphasis.

Fiscal consolidation remains appropriate given the need to build up buffers. Recalling the useful Selected Issues Paper from last year's Article IV, which estimated the static net worth of the public sector (-160 percent of GDP), coupled with high levels of volatility in the economy, the authorities' commitment to closing the fiscal sustainability gap will be crucial. In this regard, we welcome the assurance from the authorities to identify additional measures in the event that savings from health and social services reforms are not forthcoming. We also recognize that fiscal space, most notably from any overperformance of revenues, could be prioritized towards productive investments to enhance potential growth.

The redomiciling of Nordea has dramatically altered the financial landscape in Finland. We note that the banking sector is now more concentrated, with interlinkages and exposures to other Nordic countries increased. We are pleased to note the significant efforts of the authorities – well articulated in the buff - in cooperation with other stakeholders across the region, to ensure that financial stability risks are contained. As regards the housing market, we note that while overall debt and leverage are not high by international standards, there are pockets of vulnerability amongst certain cohorts. We welcome the shared assessment between staff and the authorities on the need to enhance the macroprudential toolkit.

A suite of structural reforms are required to boost potential growth levels. Given the unfavorable contribution from labor supply given the demographic outlook, long run growth is almost entirely driven by productivity. In this regard, it is noteworthy that economic shocks have driven sectoral shifts in the economy and prevented a return to previous high levels of productivity growth. Policy interventions that focus on enhancing human capital, including through investment in R&D, will be crucial. Separately, we welcome the fact that recent reforms, including notably, the competitiveness pact, have facilitated a recovery in exports and boosted employment. The staff report focuses to a large extent on labor mobility challenges as an impediment to growth. We would highlight the argument put forward in Mr. Virolainen's buff that policy measures to address, amongst other things, housing supply will take time to pay dividends and it is not necessary to rush into further policy measures without assessing progress on this front.

Mr. Mouminah, Mr. Alkhareif and Mr. Alhomaly submitted the following statement:

We thank staff for a set of comprehensive reports and Mr. Virolainen for his helpful buff statement. We broadly agree with the thrust of staff assessment and recommendations and would therefore focus our comments on the following few points for emphasis.

It is encouraging to note that economic recovery continues with declining unemployment, but the projected slowing rate of recovery and the remaining weaknesses require sustaining prudent macroeconomic policies as well as advancing structural reforms to boost potential growth.

We are comforted by staff assessment that the financial system remains sound, with well-capitalized banks and improved liquidity, but vigilance is needed to safeguard financial stability. The high exposure of banks to real estate and the growing supervisory challenges caused by digitalization, among others, pose important risks. In this context, we welcome the measures implemented by the authorities to address many of the challenges that the system faces, but we encourage them to closely monitor lending activities by non-banks and strengthen macroprudential policy to address the growing risk of household debt.

We welcome the agreement between staff and the authorities on the need to build fiscal buffers to better deal with the looming age-related spending. In this regard, we agree that the fiscal consolidation should focus on enhancing the efficiency of public spending, given the already-high revenue ratio. At the same time, we welcome the new growth-enhancing measures to boost employment growth and promote R&D. Nevertheless, efforts should be stepped up to accelerate reforms in the areas of health and social services to contain fiscal pressures caused by demographic headwinds.

Finally, we take note of the continued challenges in the labor market, contributing to high unemployment in some regions despite abundant job openings in others. Here, the authorities have made commendable progress in reforming the labor market, including by incentivizing active job search, but we note from staff analysis the relatively low regional labor mobility. Against this background, we concur that the focus of reforms going forward should be on increasing the dynamics of the labor market to address the mobility issue.

With these comments, we wish the authorities all the success.

Mr. Sun and Ms. Liu submitted the following statement:

We thank staff for the informative reports and Mr. Virolainen for his helpful buff statement. Finland's economy continues to grow in a healthy manner, with low inflation and unemployment declining to its lowest level since 2011. Nevertheless, the current cyclical upswing is expected to moderate, and some downside risks remain. We broadly agree with staff's assessment and limit our comments to the following for emphasis.

We welcome the authorities' renewed commitment to implementing the fiscal consolidation plan while pushing forward the reforms of health and social services to make good use of the current favorable cyclical opportunity to rebuild fiscal buffers. In order to ensure long-term fiscal sustainability, it is necessary to continue to strengthen fiscal buffers to address the looming fiscal pressures from age-related public expenditures and a relatively high level of contingent liabilities. Furthermore, the debt sustainability analysis shows that net financial worth is estimated to be negative when pension liabilities are taken into account. We encourage the authorities to closely monitor the long-term sustainability of the fiscal position, while reforming the current welfare system for cost savings in the long run.

We concur with the staff's recommendations on further steps to increase job market dynamism. We welcome the authorities' labor market reforms in recent years, including the pension reform, the reduction of unemployment benefits, and the reform of the unemployment insurance system. The Competitiveness Pact has also contributed to improving Finnish companies' global competitiveness. Nevertheless, unemployment rate in Finland remains relatively high compared to Nordic peers, regional labor mobility is lower relative to other advanced economies, and job creation is being constrained by declining working-age population. We see merit in further improving the functioning of the labor market with continued reform of social benefits to increase job market dynamism, while maintaining a strong social safety net. It is also important to increase wage flexibility at the firm level to enhance the economy's ability to adjust to future shocks. Moreover, targeted policies could help incentivize more regional labor mobility, including more wage flexibility. At the same time, we share staff's view that improving infrastructure and transportation could help regional labor mobility.

The Finnish financial system is sound, and the banking system is well-capitalized and profitable with low NPLs. However, some distinctive features of the financial system may pose challenges to supervision. In particular, with the relocation of the headquarters of Nordea, the size of Finland's banking sector has increased significantly. Meanwhile, bank lending is concentrated on the real estate sector, and the financial system is highly interconnected with other Nordic economies. We take positive note that the authorities have responded to these challenges, including by strengthening domestic supervisory resources to ensure banks' sufficient capital level. Closer cooperation among regional supervisory authorities is encouraged to safeguard the safety and soundness of the financial system. Moreover, as one of the most digitalized economies in the world, Finland's peer-to-peer (P2P) lending has expanded rapidly in recent years. While P2P lending could facilitate greater competition and financial inclusion, credit and regulatory risks could also increase. We therefore encourage the authorities to closely monitor new developments of the online platforms, strengthen data collection, and enhance consumer protection.

Mr. Saito, Mr. Johnston, Mr. Minoura, and Mr. Kim submitted the following statement:

We thank staff for their detailed reports and Mr. Virolainen for his informative buff statement. We are pleased to see that the Finnish economy continues its healthy recovery, boosted by private consumption and residential investment, while the unemployment rate has fallen to its lowest level since 2011. However, Finland still faces underlying weaknesses, including low labor market dynamism and stagnant labor productivity growth. In this regard, we encourage the authorities to continue their efforts to implement the necessary policies, such as fiscal consolidation and labor market reforms. We broadly concur with the thrust of the staff's appraisal and limit our comments to the following points:

Financial Sector and Macroprudential Policy

While credit has expanded moderately overall, we share staff's concern about the increase of loans to housing corporations and consumer credit. We welcome the authorities' recent tightening of credit policies, including a floor of 15 percent on the average risk weight for housing loans and cutting the maximum loan-to-collateral (LTC) ratio for housing loans. Further modifications, such as the introduction of debt-based macroprudential tools, could be beneficial to reduce financial risks. Regarding the staff's recommendation for replacement of the current cap on mortgage loans relative to collateral with a cap relative to the value of the property, could staff elaborate more on the comparison between LTC and LTV in terms of their efficiencies? Moreover, given the growing reliance on consumer credit, stronger supervision and additional consumer protection measures are also needed. We also encourage the authorities to strengthen data collection on consumers' debt and income levels, and concur with the recent Justice Ministry recommendation for the establishment of a "positive credit register" to obtain real-time information.

As the size of the banking sector has increased substantially with the recent redomicile of Nordea to Finland, financial supervision needs to be strengthened. We positively note that capital requirements for Nordea have not been weakened and the supervisory authority will increase its headcount. In addition, the ECB and Nordic authorities have reaffirmed their commitment to information exchange and cooperation, mitigating the risks of cross-border discrepancies. Nevertheless, the move has serious implications for the policy framework, including deposit insurance. Nordea's depositors would be covered by the Finnish deposit guarantee scheme in the event of insolvency.

As the amount of covered deposits within the Finnish deposit guarantee scheme has grown significantly with the redomicile, how does staff see the adequacy of the current target for the Finnish fund (about €1 billion)? In this vein, finalizing details of the backstop for the Single Resolution Fund and establishing a common European deposit insurance scheme are critical to increase the confidence of both market participants and retail depositors.

Fiscal Policy

With output projected to expand above its potential growth rate, and looming spending pressures from age-related costs, we support the authorities' moderate tightening of the fiscal stance. Could staff elaborate on the quantitative impact of age-related costs? Given the already-high revenue ratio, there is little scope for further increases in the tax burden, and continued efforts to uphold the consolidation commitments under the Competitiveness Pact are essential. In particular, the proposed reforms to social services and health care are important to address age-related challenges and ensure fiscal sustainability.

Structural Reform

Despite the recent substantial increase in employment, Finland has continued to experience low labor market mobility and stagnant labor productivity. We note that the relatively low variation in wages across regions due to centralized wage bargaining does not provide sufficient incentives to labor market mobility. We encourage the authorities to take further steps to increase job market dynamism. Tapering unemployment benefits, so they gradually fall with duration, could incentivize job search. Enhancing the ability to differentiate wages at the firm level is also critical to facilitate job-to-job transitions and foster regional labor mobility. At the same time, given a shrinking working age population, we underscore the importance of the authorities' continued efforts to boost labor participation. We would appreciate it if staff could elaborate on factors behind Finland's lower labor participation rate compared to its peers, recent progress made by the authorities and staff's recommendations on additional measures going forward.

Mr. De Lannoy and Mr. Hanson submitted the following statement:

We thank staff for their report and selected issues paper and Mr. Virolainen for his informative buff statement. Finland experiences a solid recovery after being hit by major economic shocks. Output is reaching its potential against the background of an ageing population. This puts a premium on enhancing labor participation and productivity. A closed output gap and expected ageing-related fiscal pressures are also reasons to build fiscal buffers. We associate ourselves with Mr. Meyer's statement and would like to add the following comments.

Building fiscal buffers and progressing on the social services and health care reform is desirable, given the expected ageing-related spending pressures. We welcome the commitment of the authorities to the medium-term consolidation plan. We agree with staff that the positive output gap justifies a tightening of the fiscal stance, and that contingent liabilities and expected age-related spending costs underscore the need to build fiscal buffers.

We would have welcomed a more detailed analysis of age-related spending pressures in the report. Staff's analysis in the October 2018 Fiscal Monitor and in the working paper by Brede and Henn (2018) illustrates the positive effect of (moderate) consolidation and the social service and health care reform on intertemporal net worth of the Finnish public sector. It would have been insightful to specify the contingent liabilities and show the implications of ageing-related fiscal pressures on the debt trajectory in the Article IV analysis. Did staff consider extending the horizon of the DSA beyond the standard 5-year projection horizon?

Measures to enhance labor mobility can improve labor market participation and productivity. Enhancing wage differentiation and investment in infrastructure improve labor mobility. We also welcome the authorities' efforts to increase the availability of affordable housing by adjusting zoning rules and building regulations. This would further increase labor mobility.

Rising household indebtedness warrants attention, in particular the growth of non-bank credit via digital platforms. We welcome the box on Fintech and consumer credit, which shows a marked increase in lending through electronic platforms, but also points to data limitations. We agree with staff on the potential benefits of enhancing the macroprudential toolkit with additional income-based instruments and the need for supervisory access to more granular data, especially on consumer lending provided through digital platforms.

Mr. Saraiva and Mr. Fuentes submitted the following statement:

We thank staff for the papers and Mr. Virolainen for the comprehensive statement. Economic activity in Finland remained robust for its third consecutive year on the back of a strong external demand. Private consumption and residential investment growth has been healthy, supported by accommodative fiscal and monetary policies. Sustained growth momentum is widespread across sectors, contributing to close the output gap, supporting the ongoing downward trend in unemployment, and raising business confidence. Nevertheless, important structural bottlenecks and demographic headwinds continue to challenge Finland’s macroeconomic performance and fiscal sustainability in the medium term.

Fiscal position is solid and the main challenges stem from medium term age-related pressures. After a temporary expenditure boost in 2018, the fiscal stance is expected to turn contractionary into the medium term, consistent with the EU Stability and Growth Pact and the government’s consolidation plan. Yet, the rapidly aging population is projected to strain public finances over time, with dampening effects on labor productivity. In this regard, we commend authorities’ proactive approach, and their commitment to rebuild fiscal buffers and push forward the reform of health and social services as age-related fiscal pressures loom closer.

While recent reforms have reduced rigidities in the labor market, supplementary measures may be warranted to increase dynamism and flexibility. Authorities have effectively addressed some structural aspects of the labor market encouraging a higher labor participation, especially among older groups, and facilitating a steady reduction in unemployment, while maintaining wage inequality low. This is an important accomplishment, and the authorities should be commended for that. However, exploring additional ways to strengthen incentives to work may be needed to reduce unemployment further, as vacancies remain high relative to employment, and the gap between the skills needed in new jobs and those possessed by job-seekers continue to grow. Furthermore, actions to realign incentives from social benefits and increase regional mobility may also be necessary to address lingering rigidities in the labor market.

The outlook for potential growth remains bleak, even as the output gap continues to close. The compound effects of major macro-financial shocks and protracted recessions severely weakened potential output in Finland. Furthermore, constraints stemming from an aging labor force and a subdued growth in productivity are expected to maintain medium term growth at a considerably lower rate than before the financial crisis. Fixed investment has recently served to support economic recovery, but its recent surge is expected to wane over the medium term. In response to these circumstances, authorities have undertaken significant actions to restore national competitiveness in the context of the 2016 Competitive Pact. Nonetheless, altering the lowering trend in the working age population and elevating private investment are key components to boost medium term output in Finland.

Household debt has been increasing steadily together with the economic recovery and should be closely monitored. While credit to the nonfinancial private sector has picked up in 2018, the pace of mortgages and consumer credit have been rising even more rapidly. Moreover, the proliferation of digital financial services, particularly by non-banks, has given Finnish households access to a growing number of credit instruments in an environment of low interest rate and reduced regulation. Against this background, we welcome recent macroprudential measures to tighten credit policies, including the proposal to establish a centralized database for positive credit information to allow financial authorities to enhance monitoring and control of the consumer credit market. In any case, we see room for further use of macroprudential tools to safeguard the financial system and reduce household's vulnerabilities to interest rates increases.

Mr. Razafindramanana, Mr. Obiora, Mr. Olhaye, and Mr. Essuvi submitted the following statement:

We thank staff for a comprehensive report and selected issues paper and Mr. Virolainen for his buff Statement.

The Finnish economy continues to demonstrate solid and broad-based economic growth, coupled with historically low unemployment rates. Over the last three years, growth has been driven by stronger private consumption and residential investment and has benefited from favorable fiscal and monetary policies. However, vulnerabilities in the labor market persist alongside rising levels of household debt. Given this context, we urge the authorities to accelerate their reform agenda, particularly, structural reforms with a focus on enhancing labor dynamism while not jeopardizing the country's strong safety net. Furthermore, we encourage the authorities to be mindful of external risks associated with weaker global growth, trade disruptions and potential exposure of the financial sector to Nordic housing sector. Hence, we broadly agree with staff's appraisal and recommendations and would like to provide the followings comments for emphasis.

We see merit in the authorities' decision to tighten the fiscal stance, with the aim to enhance fiscal buffers as age-related spending outlays will continue to add pressure to long-term fiscal sustainability. In this regard, we encourage the authorities to speed up the implementation of reforms that will result in social services and health care that will be best suited to cope with age-related challenges. The fiscal stance under consideration will help address the relatively high level of contingent liabilities as well as the volatility of the economy that can increase the demand on public finance.

Enhancing the dynamism of the labor market will be essential to increase productivity and boost potential growth. In this regard we take positive note of the fact that the unemployment rate has achieved its lowest levels since 2011 in part due to several reforms that were pursued by the authorities, in particular the Competitiveness Pact. However, some vulnerabilities remain, namely labor mobility and labor productivity and thus we encourage the authorities to step up structural reforms to unleash further dynamism in the job market, including increasing incentives to facilitate transitions between jobs, stimulating greater regional mobility and to refine dismissal and hiring procedures with the aim to maximize productivity and income gains.

While the Finnish financial sector remains sound, well diversified and profitable, we are concerned that risks are increasingly associated with interconnectedness and credit expansion. On the latter, we appreciate the authorities' recognition that high household debt and associated consumer lending and housing cooperation loans may pose some risks. In this context, we welcome the recent tightening of credit policies and the authorities' intent to put in place a credit registry. However, we concur with staff that the authorities should consider transitioning to debt-based macroprudential tools.

Finally, we commend the authorities for their adequate response to the challenges posed by the relocation of Nordea from Sweden to Finland, particularly as it concerns the deposit guarantee scheme. That said, we encourage them to continue to strengthen the supervisor authority and to also address issues related to increasing digitalization of services and platforms, particularly of non-bank entities. Moreover, while the AML/CFT framework remains sound, we encourage the authorities to remain vigilante and to expand supervisory activities in this area going forward.

Ms. Pollard and Ms. Svenstrup submitted the following statement:

The Finnish economy has emerged from a severe downturn and is experiencing solid growth, rising confidence, and improving labor market outcomes. On the back of strong growth, the fiscal deficit was lower than expected in 2018, though still expansionary, and public debt is on a downward trajectory. Yet, the authorities face challenges in improving competitiveness and labor market dynamism, responding to demographic shifts, and building buffers against future shocks. Further, the redomicile of Nordea has dramatically increased the size and interconnectedness of the financial sector, raising new supervisory and coordination challenges. We broadly concur with the thrust of staff's policy recommendations to mitigate risks and further increase growth and offer a few comments for emphasis.

The Finnish financial system is sound, although the rise in household credit warrants continued monitoring and consideration of strengthening macroprudential tools as staff highlight. We urge the authorities to make all efforts to enhance supervision of AML/CFT supervision and enforcement.

The redomicile of Nordea is clearly the most significant immediate challenge for the Finnish financial supervisors, and we appreciate staff's helpful Selected Issues Paper on the topic. The responsible authorities have promptly responded to this move, as indicated in Mr. Virolainen's buff statement, including in setting capital requirements and undergoing organizational changes to FIN-FSA. We fully agree with staff that prompt action is needed to complete the European banking union, finalize the details of the Single Resolution Fund backstop, and operationalize a common euro area deposit insurance. Continued international coordination will also be important as much of the bank's operations remains outside of the banking union.

Fiscal policy will become contractionary in 2019 with the authorities' expenditure consolidation plan, notwithstanding the inclusion of welcome growth-enhancing expenditure measures. The authorities' efforts to improve fiscal sustainability are warranted given Finland's demographics and cyclical position, and we urge the continued reallocation of expenditures toward more efficient, growth-enhancing measures. We note staff's recommendation that the authorities should use unexpected savings for either growth-enhancing expenditures or to reduce debt. On the face of it, we would prefer the former given Finland's debt is already on a comfortable downward trajectory. Could staff provide more context on the trade-off between debt reduction and further growth-enhancing measures, if savings do indeed materialize? Why were the measures specified – e.g., expenditures on transportation infrastructure to aid labor mobility and/or reversing recent R&D cuts – not critical enough for inclusion in the authorities' budget plans?

Finally, we commend the authorities progress in implementing its Competitiveness Pact to increase labor market dynamism and complement the fiscal strategy. We concur with staff on the need for further labor market reforms to reduce skills mismatches and encourage employment, although we are sympathetic to the structural challenges in improving labor market mobility highlighted by the authorities.

The representative from the European Central Bank submitted the following statement:

We would like to thank Staff for their report and Mr. Virolainen for his buff statement. We associate ourselves with the statement by Mr. Meyer.

The recent growth performance has been strong, but, as growth is expected to moderate towards potential, policies supporting long run growth are key. The economic recovery, initially driven by consumption and real estate, has become more broad-based, being also supported by exports and non-residential investment. Over the past two years, Finland grew faster than the euro area average and, although growth somewhat declined, it remained stronger relative to peers in 2018. Growth is, however, expected to slow further toward potential over the next few years. The outlook for long-term growth in Finland is affected by adverse demographics, which also impact the long-term fiscal calculus. As the authorities acknowledge, headwinds to productivity growth include a skills-mismatch related to low internal labour mobility which is exacerbated by Finnish geography and uneven growth of property prices. With regard to risks, in addition to external factors, high household debt has accompanied low savings rates and any tightening in the financial cycle may reveal pockets of vulnerability.

It is important to safeguard, and build upon, the successes of the Finnish authorities in recent years in improving the resilience and competitiveness of the economy. In this regard, Staff proposals to improve further labour market dynamism, while maintaining social protection, are useful. While the performance of the labour market over the past two years, and especially 2018, has been very strong, with a faster fall in unemployment than expected, the high degree of mismatches limit productivity growth and, by extension, wage gains for employees. At the same time, it should be noted that one of the positive surprises of the employment boom has been an increase in participation, which may indicate that improving prospects could draw discouraged workers back to the labour force. However, as Staff rightly point out, this is still not enough to compensate for the falling working-age population. Relevant recent reforms aimed at reducing inactivity and incentivising job-to-job transitions are important steps in the right direction and should be maintained.

In view of the need to build fiscal buffers, like Staff, we welcome the planned moderate fiscal consolidation. Staff emphasise that, in the context of population aging, contingent liabilities and macroeconomic volatilities in a small open economy, the opportunity afforded by the current favourable macroeconomic situation should be utilised to build fiscal buffers. In terms of composition of the fiscal adjustment, it should be stressed that Finland's public expenditure ratio is among the highest in the euro area. Therefore, also considering also the rapidly aging population, consolidation efforts should target items related to long-term spending pressures, such as health and pension expenditure.

As Staff rightly point out, the redomicile of Nordea has changed the financial landscape in Finland and the authorities (European and national) have responded by setting new capital requirements and increasing supervisory resources. We agree with Staff's assessment of the response of the national authorities to the challenges of Nordea's re-domiciliation. Following Nordea's move to Finland (on 1 October 2018), the size of Finland's banking sector in relation to its GDP has become one of the largest in the EU. Finland's banking sector has also become more concentrated and interlinkages with and exposures to other Nordic countries have increased. To address the increase in the structural systemic risks stemming from Nordea's re-domiciliation, the authorities have adopted a set of O-SII and Systemic Risk buffers, which will ensure the appropriate Pillar 1 capital requirements for Nordea and the rest of the Finnish financial sector.

We overall agree with Staff's assessment of risks and vulnerabilities in Finnish credit and real estate markets. Vulnerabilities stemming from the real estate sector are elevated due to a high and increasing level of household indebtedness, relatively high debt service to income ratios despite low interest rates, compressed lending spreads and large bank exposures to the real estate sector. While residential real estate price dynamics have been muted recently and mortgage lending growth is contained, housing corporation loans have been growing rapidly and account almost entirely for the increases in the household debt-to-income ratio over the past year. Despite its small share in the total stock of credit, the evolution of consumer credit also deserves close monitoring, particularly in view of potential circumvention of the loan-to-collateral limits on mortgages. Regarding the commercial real estate, a large share of foreign investors could amplify price corrections in case of adverse shocks.

With respect to the macroprudential toolkit, we share Staff's views on the potential benefits of modifying the macroprudential toolkit with additional

> income-based instruments and on the need for more granular data. The existing loan-to-collateral limit should be complemented with other borrower-based tools. For example, debt-service-to-income and maturity limits could be introduced in order to avoid circumvention and increase the effectiveness of the overall policy action. Against this backdrop, it is important that the legal framework for borrower-based measures is extended to cover a more comprehensive set of instruments. Furthermore, the regular collection and analysis of data needed for an effective design and use of borrower-based instruments should be implemented swiftly. Lastly, given the large share of variable-rate mortgages, the authorities could consider creating a legal basis for a conversion of the 2010 recommendation on affordability tests against an increase in interest rates into a binding requirement.

The Acting Chair (Mr. Zhang) noted that the recovery in Finland had continued after the country had faced a number of economic shocks. The recovery was in its late stages, and the outlook was constrained by a number of factors, including productivity and a shrinking workforce. The staff had argued for more flexibility in the labor market to boost productivity. The staff had also suggested a moderate fiscal tightening to try to rebuild fiscal buffers.

Mr. Meyer made the following statement:

> I thank the staff for a well-written report and Mr. Virolainen for his helpful buff statement. I would like to pick up on the points that the Acting Chair made in his initial remarks.
>
> After major economic shocks, we welcome the recovery of the Finnish economy, evidenced in the last three years. Cost competitiveness has improved, and the export market shares have increased. However, while growth performance remains stronger than the euro area average or its peers, a gradual slowdown to the potential growth rate is anticipated. Looking ahead, challenges remain in boosting potential growth—estimated by the staff at 1.4 percent—and with regard to competitiveness.
>
> I will make three further remarks for emphasis.
>
> First, given the current cyclical position and expected ageing-related spending pressures, we regard it to be crucial to continue the gradual fiscal consolidation and pursue the implementation of the social services and healthcare reforms.
>
> Second, regarding the financial sector, following Nordea's move to Finland, the size of Finland's banking sector has multiplied and has become

one of the largest in the EU in terms of GDP. Hence, we welcome the swift and adequate response by the relevant authorities in setting new capital requirements and increasing supervisory resources. Households' rising indebtedness warrants attention, although we see no signs of an immediate financial stability risk stemming from the housing market. Like the staff, we see potential benefits in enhancing the macroprudential toolkit with additional income-based instruments and the need for supervisory access to more granular data.

Third, we note that unemployment, at 7.6 percent in 2018, according to staff's projections, remains higher than in peer countries. In line with the staff, we see low labor mobility and inactivity traps as obstacles to a more extensive use of the labor force. At the same time, we would put more emphasis on infrastructure investment to improve job mobility, than on wage differentiation.

With this, let me wish all the best to the authorities.

Ms. Lopes made the following statement:

We thank Mr. Virolainen for his helpful statement and the staff for the report and the answers.

We have issued a gray statement, and we fully associate ourselves with Mr. Meyer's gray statement and intervention, so I can be brief and just focus on one point we raised in our gray statement. It is related with the typical volatility with which the staff characterized the Finnish economy.

We asked a question in our gray statement in order to better understand how staff defines this concept, its measurement, as well as the underlying reasons. We read the written answer, but we remain somewhat unconvinced. In that answer, the staff explains the reasons for the recessions, but that is not exactly an explanation for the volatility. In a way, stating that there is an inherent volatility to a certain economy would have to be based on more than three crisis episodes that do not have a common reason, so it would need to be based on the inherent characteristics of that economy. For example, one should not expect another collapse of one of the most important companies in the country, given that the collapse of Nokia is one of the explanations. Is there or is there not an inherent characteristic to the Finnish economy to justify this volatility? If the staff considers that there is something driving the more severe picture, further analysis to provide a deeper understanding of the behavior would be warranted so as to figure out the most appropriate policy responses.

Mr. Benk made the following statement:

We thank the staff for their good report and Mr. Virolainen for his very informative buff statement. We welcome the broad agreement between the authorities and the staff concerning virtually all relevant policy issues, so let me emphasize three points.

First, we welcome the authorities' commitment to the medium-term fiscal consolidation plan. A further strengthening of fiscal buffers is needed, in view of the demographic projections and related spending measures. Progress on improving the cost-effectiveness of social services and healthcare is central in this respect.

Second, we commend the authorities for implementing the competitiveness pact to increase labor market dynamism, which is a necessary complement to the fiscal consolidation. We encourage the authorities to proceed further in this direction by enhancing wage differentiation in line with productivity differentiation at the company level or to improve labor market outcomes.

Finally, like Mr. Meyer, we are also concerned by the relentless growth in household indebtedness. Consequently, upgrading the macroprudential toolkit with debt-to-income and debt-service-to-income measures would be advisable. We fully support the initiative to launch a comprehensive credit register to enable these new measures.

Mr. Saito made the following statement:

We thank the staff for the informative papers and Mr. Virolainen for his insightful statement. As we have issued a joint gray statement with Mr. Johnston, we would like to offer two comments for emphasis, focusing on financial sector policies.

First, on macroprudential policy, against the backdrop of the increasing household debt, we welcome the authorities' recent tightening of credit policies, including a risk weight floor of housing loans for banks using internal risk-based models, and the cap for maximum loan-to-collateral ratios. Going forward, to directly address the increasing household debt, like Mr. Benk, we believe the introduction of debt-based macroprudential policies, such as debt-to-income or debt-service-to-income caps, could be considered. We would like to hear the staff's view on the feasibility of introducing effective debt-based tools with the new database recommended by the Justice Ministry.

Second, on the recent relocation of Nordea to Finland, as the size of the banking sector has increased substantially with the relocation, financial supervision needs to be strengthened. While it is encouraging that the authorities will increase supervisory resources, international coordination and cooperation continues to be important, as much of Nordea's operations remain outside of the banking union. We would also emphasize that the relocation has serious implications for the policy framework, including resolution. In this regard, finalizing the backstop for the Single Resolution Fund is critical. At the same time, establishing a common European deposit insurance is also important to increase the confidence of retail depositors.

With these comments, we support the conclusion of Mr. Virolainen's last Article IV consultation with Finland and appreciate his outstanding contributions to the discussion.

Mr. Mozhin thanked the staff for its comprehensive written responses and noted that the number of questions asked by his chair reflected its interest in the developments in the Finnish economy.

Mr. Castets made the following statement:

We issued a gray statement, and we fully associate ourselves with Mr. Meyer's written statement and his intervention. I also thank Mr. Virolainen for the useful buff statement and the staff for the well-written report.

We commend the Finnish authorities for the progress made over the past years, since unemployment decreased and the public debt also decreased below the 60 percent threshold.

I would like to make a point for emphasis, a point we addressed already in our gray statement, but which is an important one, regarding ageing. This is a common feature of several advanced economies and even more so within the European Union and the euro area, where we have a shrinking workforce due to ageing and have also had a very low productivity level for a decade. This implies difficult tradeoffs. Probably, the difficulty is going to rise going forward.

This chair feels that there could be a tendency to address this issue mostly through the fiscal lens, a point we made repeatedly in the past. In this regard, we feel that there could be some need for further analytical work, work to address this issue more comprehensively.

The fiscal dimension is an important piece of the puzzle but certainly is not the only one. We encourage the European Department to keep working on this issue and Japan's G20 presidency, which has made demographic shifts its priority, will be a good opportunity for that.

The staff representative from the European Department (Mr. Scott), in response to questions and comments from Executive Directors, made the following statement:[1]

I thank Directors for the questions and follow-ups on gray statements. As I counted, there are two outstanding questions from the floor. I will address those in reverse order.

Mr. Saito raised a question on the feasibility of introducing new macroprudential tools. The debt-based measures require a comprehensive database. The speed at which this can be accomplished depends on a number of issues; in particular, whether the authorities would have access to existing databases that are being privately run, which would give them a head start, or whether they would have to start from scratch. If they have to start from scratch, it could take some time to get those databases in place. Even before that, my understanding is that there is a debate in Finland about privacy protections. Other countries have addressed these difficulties, but the question of privacy is a question of social preference that we have no comment on.

The second question I have is from Ms. Lopes: Is there an inherent reason for volatility? Aside from the specific descriptions of the causes of the severe recessions that Finland has experienced, I would simply point to the characteristic that Finland is an advanced economy but a very small economy. It has a population of 5.5 million. It has rightfully set as an objective to be open to get the benefits that come from openness to trade. But with those benefits also come exposure to external circumstances. Like many economies of a similar size, there is that inherent volatility and vulnerability to external circumstances. Associated with that is the fact that there is a significant amount of sectoral concentration, so the country is susceptible to the vagaries of the circumstances of the individual firms.

[1] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes

Mr. Virolainen made the following concluding statement:

Let me start by thanking the mission team, led by Mr. Scott, for the high-quality interaction with my authorities and for providing valuable analyses and recommendations, with which my authorities broadly concur. I would also like to thank Directors for their useful input in the gray statements and their interventions.

The long-awaited economic rebound in Finland turned out to be stronger than initially forecast. Growth has been broad-based. Improved competitiveness has boosted exports. Household consumption has been underpinned by improved purchasing power, higher employment, and low interest rates.

Despite the strong recovery, the Finnish economy cannot be considered to be in good health just yet. Public finances remain in deficit; employment levels are still too low, structural unemployment too high; and productivity growth remains subdued. The peak of the growth momentum has been passed, and forecasts are being revised downward.

Overall, there continues to be broad agreement on the main challenges. Despite some differences in emphasis with respect to the specific policy measures to address these challenges, the upcoming parliamentary elections in April are not expected to bring about major shifts in the Finnish authorities' long-term policy agenda.

Let me summarize the key issues highlighted in the staff report and Directors' gray statements. I will start with the financial sector, which has undergone big changes with the redomicile of Nordea Bank to Finland. As rightly highlighted by the staff and Directors, Nordea's relocation poses new challenges to financial supervision and crisis management. In my authorities' response, a key objective has been to make sure that Nordea's risk absorption capacity will not deteriorate during the transition period. Going forward, Nordea will be subject to direct supervision and regulation by the European Central Bank (ECB), on an equal footing with other significant euro area banks. This includes the setting of Nordea-specific capital requirements based on the upcoming supervisory review and evaluation process. There is no reason to expect any material loosening of Nordea's capital requirements as a result of this process.

The ECB and the Finnish Financial Supervision Authority will jointly make sure that the supervisory resources are commensurate with the risks posed by Nordea. In due course, completion of the banking union, in tandem with adequate risk reduction in the European banking sector, will further strengthen the union-wide financial stability safeguards.

The staff and Directors also highlight some macro-financial vulnerabilities that require continued vigilance, mainly related to household indebtedness, real estate markets, and banks' funding structure. My authorities monitor the developments closely and stand ready to take any necessary actions within their mandates. Work is underway to enhance their macroprudential toolkit to address these vulnerabilities.

Second, on fiscal policy, while economic growth and fiscal adjustment have strengthened the position of public finances, they will remain in deficit over the next few years. The Finnish authorities are firmly committed to the fiscal consolidation path through a set of policy measures, including savings, promoting efficiency in public administration, and steps to improve the growth potential.

This brings me to the third key issue for Finland, structural policies. The social and healthcare reform plays a critical role in addressing concerns related to a rapidly ageing population. It is a complex and challenging reform and calls for careful consideration from a constitutional, social, and economic viewpoint. Despite some delays, my authorities remain firmly committed to the effective implementation of the reform.

With regard to the labor market, a strong recovery and the already completed reforms have been successful in raising the employment rate. However, robust employment must be supported by growth in labor productivity to yield sufficient growth, as underlined by the staff and Directors. My authorities fully concur. Labor productivity growth in Finland has been subdued over the past decade. Therefore, successful policy measures to improve the functioning of the labor market, as well as in education results and product development, are needed to enhance the growth potential.

Let me conclude by, once again, thanking the staff and Directors for their constructive views and valuable recommendations, which I will convey to my authorities.

The Acting Chair (Mr. Zhang) noted that Finland is an Article VIII member, and no decision was proposed.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the continued good economic performance but noted that growth is likely to slow next year as global demand moderates and financial conditions tighten. Given relatively modest potential growth, Directors stressed the need for structural reform, particularly in the labor market, and cautious fiscal policy. While sound overall, the financial sector's increased size and regional inter-connectedness have increased the demands on supervision.

Directors welcomed recent reforms that have made Finnish exports more cost competitive and helped boost employment. They noted, however, that productivity growth remains below what was seen before the crisis. Therefore, Directors stressed the need for ongoing structural reforms and targeted infrastructure investment to bolster long-term productivity growth.

Directors agreed that the focus of structural reforms should be on increasing labor market dynamism while maintaining a strong safety net. This would call for increased wage flexibility at the firm level and further changes to unemployment benefits to foster increased job search. Directors also noted that efforts to increase regional labor mobility could help reduce regional disparities in unemployment rates.

Given looming age-related spending pressures and contingent liabilities, Directors underscored the need to continue to rebuild fiscal buffers. Thus, they supported the moderate tightening implied by the 2019 budget and noted that fiscal policy should concentrate on raising the effectiveness of public spending, such as those proposed in the social services and health care reform.

Directors noted that the size of the banking sector has increased substantially with the recent redomicile of the largest financial group in the Nordic countries to Finland, increasing the demands on supervision and regional cooperation as well as crisis preparedness. While housing price increases have been relatively moderate, risks from the real estate sector should be monitored closely due to the high level of household indebtedness.

Directors also noted that growing reliance on consumer credit calls for additional consumer protection measures, such as better information disclosure requirements and interest rate caps. Macroprudential policies could be improved by the use of debt-based tools and access to better data, such as from a comprehensive positive credit registry.

It is expected that the next Article IV consultation with Finland will be held on the standard 12-month cycle.

APPROVAL: April 22, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Outlook and Risks

1. ***Economic growth rebound over the past three years brought GDP back to the 2008 level. This slow growth for a prolonged period is somewhat puzzling to us, and we invite staff to comment on the main barriers to a more dynamic recovery in Finland after the Global Financial Crisis.***

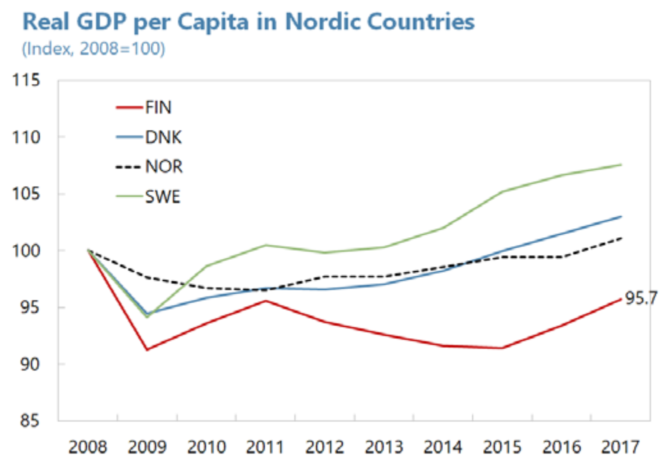
- Finland's weak recovery was associated with very weak exports. Analysis in the 2017 Staff Report and associated Selected Issues Paper shows that a large part can be accounted for by the fall in aggregate demand in the key export destinations of Russia and the euro area, and by shifts in export composition consistent with the restructuring of Nokia. But these factors do not explain all the shortfall. Finnish unit labor cost growth outpaced that of its peers in the period after the onset of the global financial crisis—the consequent deterioration in price competitiveness is able to explain bilateral trade patterns quite well for major trading partners. Since 2015, the economy has recovered but, as discussed in this year's Staff Report, has not been associated with a recovery in productivity, indicating that structural weaknesses—such as rigidities in the labor market—still remain, despite the reduction in unit labor costs as a result of the Competitiveness Pact.

2. ***Under the current circumstances, with elevated risks of recession in the advanced economies, many policy-makers are concerned about the lack of demand management tools. Policy interest rates remain very low in nominal terms, while the application of negative interest rates has its limits. At the same time, reliance on fiscal policy as the primary response to a possible slowdown also has limits. Does the experience of Finland since 2008 provide any lessons with respect to the economic performance under the conditions of constrained demand management?***

- Finland has been hit by many shocks: falls in export demand, reflecting the break-up of Nokia, the structural decline in global demand for paper and pulp, declining competitiveness, and the global financial crisis. It is difficult to construct a counterfactual scenario for what might have happened under different policy settings. As the Grey notes, nominal rates in almost all countries quickly hit the lower nominal bound; it is also instructive that Finland experienced another severe recession and slow recovery during the early 1990s despite having a floating exchange rate when the banking crisis hit.

3. ***The chart on page 4 compares GDP growth in Finland with its Nordic peers. Could staff provide a similar chart comparing growth in GDP per capita terms? Is slow population growth in Finland due to limited immigration among the key explanatory factors of the differences? Do the authorities plan to adjust their immigration policy to facilitate GDP growth and alleviate looming fiscal pressures?***

- Per capita growth is slightly weaker than actual growth—Finnish GDP per capita remains below its 2008 level—indicating that slow population growth does not explain the differences across countries.



Sources: Haver Analytics; and IMF staff calculations.

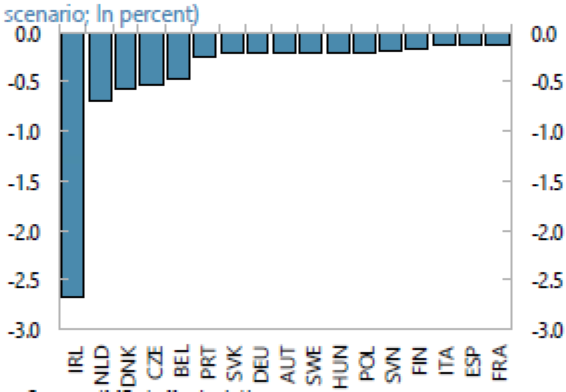
- The inward flow of migrants is currently around 0.6 percent of the population. Net immigration in Finland is proportionally higher than some other advanced economies (such as France and Italy), but lower than in Nordic peers. The government has stated that Finland needs migrants to increase labor supply, improve the weakening of the dependency ratio caused by ageing of the population, and attract more international talent and entrepreneurs to Finland. We are not aware of quantitative targets, however.

4. ***In the risk assessment matrix staff lumped together a broad range of risks, including those of growth slowdown in Europe, the U.K.'s exit from the EU, possible tightening of international financial markets, and other factors. We would be interested in a more granular description of external risks to economic outlook in Finland than it was done in the RAM.***

- Finland's integration within global value chains has trended upwards over the last two decades, with the foreign content of exports rising from less than one-quarter in 1995 to over one third in more recent years. In terms of gross exports, Finland's most important trading partners (in order) are Sweden, Germany, Russian, the US, and China. In terms of value added, the most important trading partners are the US, Russia, Sweden, Germany, and China. This accentuates the downside risks to Finland's economy, which are predominantly external, spanning weaker global growth, including in Europe, and trade disruptions, mainly related to US and China negotiations.

- The WEO analysis has shown that the effects of recent trade restrictions on Europe are currently limited, but notes that additional restrictions that have been mooted could have a much larger effect. A recent study by the independent Finnish economic institute ETLA finds that a large proportion of Finnish value added goes directly as intermediate or final goods and services to the US, which therefore remains an important export market for Finland. Under an adverse trade shock scenario, Finland would lose about 0.09 percent of Finnish GDP.
- The impact of Brexit on Finnish exports should not be large. Indeed, the 2018 UK Article IV Staff Report estimates that Finland would be among the economies least affected by Brexit (Figure). The estimate quantifies the long-term impact on each economy should the UK leave the block. The channels spanning the assessment include gains from trade, capital and labor mobility.

Long-Term Impact of Brexit: FTA scenario
(Decline in the level of output compared to a no-Brexit scenario; In percent)



Source: IMF staff calculations.

- Financial conditions could tighten more sharply than anticipated given the combined effect of rising interest rates and lower net asset purchases. Although the banking system appears resilient, there are macro financial risks related to large exposures of banks to housing-related assets across the Nordic region, and to wholesale funding conditions, which could mutually reinforce each other in an adverse scenario.

- Domestic risks are arguably more limited, but the gains from structural reforms in the labor market and social and health sectors could come short of expectations, harming fiscal sustainability. Labor market mismatches could remain significant, continuing to result in less than optimal allocation of labor across the economy and sectors, and ultimately weakening productivity.

5. ***The main risk is heightened protectionism, as escalating trade tensions could undermine Finnish exports. Also, disruptions to global value chains could harm production and supply of goods, and harm productivity. Staff mentions that should a scenario like this happen, automatic stabilizers should be allowed to operate. Could staff elaborate on what these stabilizers are and how they work? Wouldn't it also be important to increase labor/product market flexibility to face an external shock in the context of euro membership?***

- The reference to automatic stabilizers denotes the non-discretionary fiscal easing that would arise from e.g. increased expenditures on unemployment insurance. Finland has comparatively flexible product markets (see "Understanding Finland's Export Performance", 2017 Selected Issues Papers). This is why staff emphasizes increased labor market flexibility, especially to allow more flexibility at the firm level.

6. ***The Finnish economy has been performing strongly, with robust broad-based growth, and decreasing unemployment. Going forward, growth is likely to moderate toward its potential level. Nevertheless, staff states that the economy is characterized by "typical volatility". Could the staff explain what this concept means, how it is measured, and what are its underlying reasons.***

- During the past three decades, Finland has experienced three recessions, more than its neighbors. The downturns were also more severe, with peak-to-trough declines of 12, 10 and 4 percent of real GDP. The first recession was generated by a banking crisis that was associated with a collapse of private demand; the second and third by falls in export demand, reflecting the break-up of Nokia, the structural decline in global demand for paper and pulp, declining competitiveness, and the global financial crisis.

Fiscal Policy and Debt Sustainability

7. ***In the fiscal area, the Finnish authorities seem to be on track to achieve their medium-term consolidation plans, and staff broadly agree with this strategy. On the expenditure side, health and social security reforms are among the key contributors to maintaining fiscal accounts on a sound footing. We recall that, at the time of previous Article IV Consultations, Directors highlighted implementation risks in this area. We would appreciate an update on the pace of adoption and implementation of these reforms compared to the authorities' original plans.***

- Originally, the reform was planned to come into effect in 2020; however, it has been delayed for the second time, and now it is expected to become effective around 2021. The reform has been postponed because some parts of the bill governing health provider choice are considered as unconstitutional and is thus under revision by the government; the government is also allowing more time to build consensus and for necessary preparations for the implementation of the reform. At the time of the Article IV mission, a vote was hoped for before the end of the year; this was not possible and was once again delayed for early this year.

8. ***Could staff comment on the main elements of their methodological approach for the assessment of savings projected from the reforms in the social and health care services?***

- Staff's estimates of savings from the SOTE reforms are based on the authorities' own. The potential savings are based on the authorities' estimates of gains that could be achieved by cutting municipalities' cost for the provision of services. To achieve these targeted savings, the authorities aim to create structures that would trigger economies of scale in the provision of services, impose budgetary controls and better use of technological innovation. To derive these estimates, the authorities have looked at experiences from health care reforms in other countries.

9. ***We note that potential savings from social services and healthcare reform are uncertain and will largely depend on implementation. Could staff indicate what other adjustments the authorities might consider to ensure savings are realized?***

- Given the delays in enacting the reform, it would be difficult to ascertain at this moment what specific adjustments would be needed if implementation falls short of expectations. These would depend on the nature of the shortfalls as well as on the fiscal tools that would be appropriate at that time.

10. ***We would have welcomed a more detailed analysis of age-related spending pressures in the report. Staff's analysis in the October 2018 Fiscal Monitor and in the working paper by Brede and Henn (2018) illustrates the positive effect of (moderate) consolidation and the social service and health care reform on intertemporal net worth of the Finnish public sector. It would have been insightful to specify the contingent liabilities and show the implications of ageing-related fiscal pressures on the debt trajectory in the Article IV analysis. Did staff consider extending the horizon of the DSA beyond the standard 5-year projection horizon?***

11. ***With output projected to expand above its potential growth rate, and looming spending pressures from age-related costs, we support the authorities' moderate tightening of the fiscal stance. Could staff elaborate on the quantitative impact of age-related costs?***

- The 2017 Staff Report and associated Selected Issues Paper contains extensive discussion of age-related costs and its impact the government's long term fiscal sustainability and intertemporal net wealth. Staff analyzed the intertemporal balance sheet of the government, which is a more powerful analysis than what extending the DSA horizon would provide, as it expands the analysis to include government assets, public corporations, and pension liabilities. It also focuses on public sector net worth, rather than just public debt. The main findings of this exercise indicated that future fiscal balances will have to be sufficiently strong to compensate for upcoming spending pressures. This is achievable if long health and social services reform is successfully implemented and achieves the targeted savings during the next decade. The fiscal situation has not changed significantly since this exercise was conducted last year, and thus the assessment remains valid.

12. ***We note staff's recommendation that the authorities should use unexpected savings for either growth-enhancing expenditures or to reduce debt. On the face of it, we would prefer the former given Finland's debt is already on a comfortable downward trajectory. Could staff provide more context on the trade-off between debt reduction and further growth-enhancing measures, if savings do indeed materialize? Why were the measures specified – e.g., expenditures on transportation infrastructure to aid labor mobility and/or reversing recent R&D cuts – not critical enough for inclusion in the authorities' budget plans?***

- Staff's assessment (see also the discussion in the 2017 Staff Report and associated Selected Issues Paper) is that government debt is still high for a country exposed to large external shocks and demographic pressures and with substantial obligations for social insurance. Hence, staff's recommendation is to continue with the planned fiscal consolidation. Staff supports using unexpected positive fiscal surprises for growth-enhancing projects. The specific measures discussed with authorities include those to improve productivity, enhance labor mobility, and ultimately boost potential growth. Finland has a relatively high capital output ratios and public capital stock per capita, while also ranking relatively well on many metrics of the quality of infrastructure. But they lag some comparator countries such as Sweden, Denmark, and Germany in terms of transport infrastructure; a recent assessment of the condition of infrastructure indicate that the condition of the transport network has deteriorated in recent years, and thus there is a case for investing in the maintenance of the transportation sector, particularly those that can enhancing labor mobility.

Labor Market and Competitiveness

13. ***The role of the authorities in the redesigned wage bargaining process deserves special attention. While staff claim in paragraph 37 and footnote 28 that the government played no formal role and did not formally coordinate across sectors, Mr Virolainen emphasized that the 2017-2018 wage bargaining round was closely coordinated by the authorities. We would appreciate additional clarifications on the***

role of the government.

- The 2017-18 wage bargaining round was closely coordinated across sectors—that is, both employer and employee representatives considered agreements reached in other sectors. There was no role played by government.

14. ***We recall that in the report on the Netherlands staff referred to the leading role of the export sectors in driving wage moderation. Do we observe something similar in Finland, i.e. do the timing and sequencing of sectoral negotiations allow for a more prominent role of competitiveness considerations in the wage bargaining process?***

- There was no predetermined sectoral sequence of wage negotiations in the 2017-18 wage bargaining round. However, in practice, export sectors reached agreements earlier than others, setting precedents that other sectors followed. Both employer and employee representatives place considerable weight on national competitiveness, as also seen in, inter alia, the Netherlands and Sweden.

15. ***Staff insist that relatively low labor mobility may be another candidate for explaining slow growth in Finland. In paragraph 6 of Annex III, staff proposed several policy measures aimed at further increasing regional labor mobility in Finland, and we agree with these recommendations. At the same time, the analysis of the barriers to labor mobility identified several challenges in the housing market. According to Figure 2 on page 24, Finland is a regional outlier in terms of house price dynamics, as prices in Sweden, Norway, and Denmark have increased much more. Should the authorities consider any additional policy measures aimed specifically at the changes in the housing market?***

- Overall housing price growth in Finland has been subdued. However, there are substantial regional differences in price levels, which could be impeding labor mobility. In addition to the measures proposed by staff, addressing undersupply of housing in urban areas could help. Government support for social housing is a step in the right direction. Going forward, a review of zoning rules and easing planning processes could help responsiveness of housing supply to demand.

16. ***The 2016 Competitiveness Pact in Finland aimed at a comprehensive set of labor market reforms, including the wage bargaining process. In his BUFF statement Mr. Virolainen referred to the adjustment in unit labor costs due to the 2017 wage freeze and reductions in employers' social security contributions. Mr. Virolainen credited these policies for the increase in exports and faster GDP growth. We note that the staff report somehow left out any discussion of the external sector by simply pasting a table from the External Sector Report. We would like staff to reflect on the objectives, measures, and outcomes of the authorities' policies aimed at restoring***

external competitiveness in the single currency area.

- The terms of the Competitiveness Pact referred to in the buff have been extensively discussed in the 2016 Staff Report. The pact, which was agreed in June 2016 and covers over 90 percent of Finnish workers, includes (i) a wage freeze for 2017, (ii) an unremunerated increase in annual hours worked of 24 hours, (iii) a temporary 30 percent cut in holiday bonuses for public sector employees during 2017-19, and (iv) a 2 percentage point shift of social security contributions from employers to employees over 2017-19. In addition, the pact calls for modifications to the highly-centralized wage bargaining process aimed at increasing firm-level flexibility and better aligning wages with productivity. In return, starting in 2017 the government will provide income tax cuts that will more than offset the impact of the shift in social security contributions on workers' disposable income in the short run. The outcome, discussed in the 2017 Staff Report, has been to reduce labor costs and boost competitiveness. However, as discussed in this year's Report, productivity performance has been disappointing. This suggests that more wage flexibility is needed at the firm level.

17. ***Could staff elaborate on the impact that the authorities' labor market reforms so far have had on reducing unemployment?***

- Labor market reforms have helped to reduce structural rigidities and have contributed to higher employment. According to the independent Finnish economic institute ETLA, the Competitiveness Pact has increased employment by about 15 thousand people (0.6 percent of the labor force) in the short-run; the impact is estimated to be even larger in the long-run. However, the impact of reforms on structural unemployment is difficult to distinguish from effects of cyclical tailwinds. In particular, the decline in the average unemployment rate of EU28 countries from 2015 to 17 has been larger (1.8 ppt) than that of Finland (0.8 ppt). Moreover, some labor market rigidities still remain, exemplified by labor shortages in some sector, geographical mismatches, and no visible improvements in the labor dynamism (labor market churn, firm creation rates). Therefore, the focus of the report is on further reforms needed to address remaining rigidities.

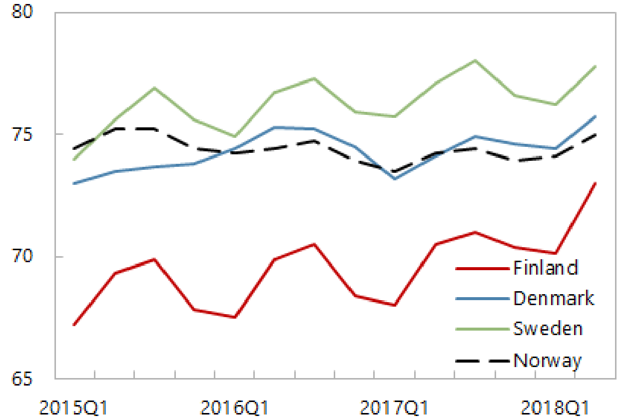
18. ***Labor market dynamism is being tackled but more needs to be done. Vacancies remain high relative to employment, particularly in construction and services. There appear to be various structural and policy reasons behind this outcome, but one reason mentioned in the buff statement for people not moving to places with higher vacancies is housing affordability. Are the authorities considering subsidies or other measures related to change the relative price of dwellings among regions to motivate migration towards a place that offers jobs?***

- Several policies are being considered to improve matching of workers and jobs. Unemployment benefits can now be used to pay for wage subsidies and mobility allowances. The scope of the mobility allowance was increased in 2018 and will be extended to part-time work and recruitment in 2019. Changes to the unemployment security penalty system are also being considered to further promote regional labor mobility. Other measures include making job offers available across wider areas and targeted information campaigns on allowances and tax deductions for commuting purposes. The government is also investing in regional transportation projects to boost the availability of skilled labor in urban centers, with financing commitments from local authorities and businesses in the region. It has also allocated funds for regional transport subsidies. These transport subsidies seek to maintain and improve operating conditions for small and medium-sized firms in sparsely populated areas by easing the cost burdens of long-haul product transportation.

19. ***We welcome the increase in the employment ratio—from 68 percent to 72 percent in only four years—but wonder whether the increase is sustainable and whether other policies—on immigration, for instance—could play a role in achieving higher growth of the workforce. Staff's comments are welcome.***

- There has been a substantial increase in Finland's employment rate, accompanied by a marked increase in the participation rate. The main reasons behind the improvement in employment include the strong economic recovery, the significant degree of wage restraint and consequent improvement in Finnish competitiveness in an environment of strong global growth. This improvement in labor market variables also reflects increased labor market participation of older cohorts. Because of increases to retirement age, a continued inward migration, and other policies (including some changes to unemployment benefits), we anticipate the employment rate to increase slightly further, and reach 72.7 percent by 2022.

Employment Rates in Nordic Countries
(Percent of active population)



Source: Eurostat.

20. ***Given the increasing demographic pressures facing Finland, can staff comment on the extent to which immigration could play a role in supporting the country's labor force?***

- The government has stated its support for inward migration to boost the labor force. The net inward flow of migrants is currently around 0.3 percent of the population. A significant issue is integration into the labor force. Performance of immigrants moving to Finland in the 1990s was very poor, with low employment rates and substantially less earnings than comparable natives. A recent study of Finnish immigration (Journal of Labor Economics, 2016) found that reform in 1999 that introduced "integration plans" for unemployed immigrants in Finland strongly increased participants' earnings and reduced their social benefits.

21. ***We welcome staff's analysis presented in Annex III, but would welcome a more detailed study of labor market mobility decomposed according to workers' age, sector of employment, type of contract (temporary vs permanent job), place of origin, etc. Staff's comments would be welcome.***

- The accompanying working paper (WP/18/252) analyzes the determinants of labor mobility for working age population and explores differences across gender (see Table 2 below). The results are qualitatively similar to those using the total population. Unfortunately, more detailed study of labor mobility by sector, contract, and place of origin is not possible due to data limitations.

Table 2. Determinants of Regional Labor Mobility: The Gravity Model

	Expected signs	(1) Total population	(2) Females	(3) Males	(4) Total working age population (15-64 years)	(5) Female working age population (15-64 years)	(6) Male working age population (15-64 years)
Log(Distance)	-	-1.45***	-1.46***	-1.45***	-1.46***	-1.46***	-1.46***
		(0.06)	(0.05)	(0.06)	(0.06)	(0.06)	(0.06)
Log(Population) (origin)	+	1.34***	1.38***	1.30***	1.40***	1.40***	1.30***
		(0.18)	(0.17)	(0.20)	(0.17)	(0.17)	(0.21)
Log(Population) (destination)	+	0.58***	0.68***	0.46**	0.48***	0.48***	0.29
		(0.16)	(0.16)	(0.19)	(0.16)	(0.16)	(0.20)
Log(Real GDP per capita) (origin)	-	-0.17*	-0.19*	-0.16	-0.19**	-0.19**	-0.17
		(0.09)	(0.10)	(0.11)	(0.09)	(0.09)	(0.12)
Log(Real GDP per capita) (destination)	+	0.28***	0.28***	0.29***	0.28***	0.28***	0.25***
		(0.07)	(0.08)	(0.08)	(0.07)	(0.07)	(0.09)
Unemployment rate (origin)	+	0.83***	0.71**	0.95***	0.78***	0.78***	1.00***
		(0.28)	(0.32)	(0.32)	(0.26)	(0.26)	(0.32)
Unemployment rate (destination)	-	-0.86***	-1.11***	-0.64**	-0.98***	-0.98***	-0.78**
		(0.25)	(0.29)	(0.31)	(0.22)	(0.22)	(0.32)
Log(Real wages) (origin)	-	0.11	0.14	0.09	0.07	0.07	0.04
		(0.17)	(0.18)	(0.20)	(0.16)	(0.16)	(0.20)
Log(Real wages) (destination)	+	0.10	-0.00	0.22	0.18	0.18	0.35**
		(0.14)	(0.16)	(0.17)	(0.14)	(0.14)	(0.18)
Log(Real house prices) (origin)	+	0.29***	0.38***	0.22**	0.30***	0.30***	0.23**
		(0.10)	(0.12)	(0.11)	(0.09)	(0.09)	(0.11)
Log(Real house prices) (destination)	-	-0.24***	-0.24***	-0.23**	-0.22***	-0.22***	-0.15
		(0.08)	(0.08)	(0.09)	(0.08)	(0.08)	(0.12)
Observations		5,491	5,491	5,491	5,491	5,491	5,491
R-squared		0.91	0.91	0.90	0.91	0.91	0.89
Year FE		Yes	Yes	Yes	Yes	Yes	Yes
Origin FE		Yes	Yes	Yes	Yes	Yes	Yes
Destination FE		Yes	Yes	Yes	Yes	Yes	Yes

Source: Statistics Finland and IMF Staff calculations.

Note: The dependent variable is the log migration between origin and destination regions. All variables are demeaned using national averages. The sample includes 19 NUTS 3 regions in Finland for the period 2000–2016. Estimations are performed using the OLS estimator with fixed effects. Standard errors clustered at the origin-destination regional pairs are in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.1$.

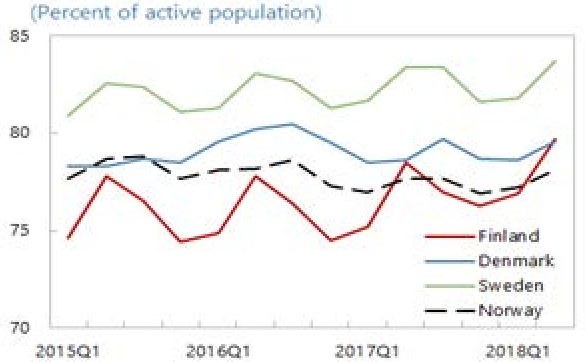
22. ***We share staff's view on the importance of increasing labor market dynamism, while maintaining a strong safety net. However, we would like to stress the fact that the authorities have already implemented several deep reforms to improve the functioning of the labor market over recent years, such as tightening the conditions for receiving unemployment benefits, shortening their duration, increasing penalties to incentivize job search, introducing a mobility allowance, extending the trial period of new hires, etc. Thus, apart from persevering with the efforts to transition towards an organized decentralization system of collective bargaining, we wonder whether it is time for a pause to check if all these measures worked before attempting new ones. Staff's comments are welcome.***

- Finland's wage bargaining framework was historically more centralized compared to the Nordic peers. This has resulted in widening discrepancies between wages and productivity across sectors and contributed to wide geographical divergence in regional unemployment rates. The 2016 Competitiveness Pact establishes a basis for addressing discrepancies across sectors. However, discrepancies across firms within sectors remain; indeed, productivity dispersion within sectors has been widening. This suggests that more flexibility is needed at the firm level. However, higher flexibility at the firm level requires developing institutions at the local level, including union representatives in firms. Sweden has followed this approach over an extended period of time, so incorporating these practices in Finland may require some time.

23. ***Given a shrinking working age population, we underscore the importance of the authorities' continued efforts to boost labor participation. We would appreciate it if staff could elaborate on factors behind Finland's lower labor participation rate compared to its peers, recent progress made by the authorities and staff's recommendations on additional measures going forward.***

- Finland's labor participation rate has historically been lower than in other Nordic countries, but it has been improving, and now exceed Norway's and is broadly in line with Denmark's (Figure). The participation rate has risen from 73 percent to nearly 80 percent. This improvement also reflects increased labor market participation of older cohorts, and policies to improve the functioning of the labor market.

Labor Participation Rates in Nordic Countries
(Percent of active population)



Source: Eurostat.

- Participation rates in Finland have remained persistently low in some parts of the country; the regional dispersion of labor participation has widened further in 2016. The Working Paper included in the AIV bundle (Poghosyan, 2018) explores some of the potential causes. The main policy recommendations are to improve labor market dynamism by increasing the flexibility of wage setting at firm level and changing employment benefits to increase job search soon after losing employment.

Financial sector

24. ***Could staff indicate if there are any plans to establish a common European deposit insurance scheme or for the Single Supervisory Mechanism to exercise supervisory powers over significant third-country bank branches operating in the euro area?***

- The EC proposal referred to in footnote 29 of the Selected Issues Paper is still current but no further progress has been made. There were some initiatives by the ECB to include large third-country branches under SSM supervision, but the ECB's proposal was not finally included in recent European Parliament proceedings.

25. ***The authorities also agreed on the need to increase the coverage of data collection among non-bank providers of debt, as conveyed in the buff. We would welcome staff's comments on the timeline that is envisaged for implementing this measure.***

- Our understanding is that there is no timeline yet for implementing a positive credit registry. Concerns have been raised about privacy, which would need to be addressed first.

26. ***Staff indicates that Finland's household saving rates are lower than peers, although some of the difference is attributable to Finland's public pension system. Can staff indicate the reason for these lower rates, particularly that households in other Nordic economies have increased saving rates as their economies have recovered?***

- Comparisons across countries need to be treated carefully: countries with PAYG-based pension systems such as Finland tend to have a lower recorded household saving rates than countries with a funded pension system. The reason for this is that changes in actuarial reserves of pension funds are considered as government saving in the former case, but not in the latter case. This can be important in countries with large pension funds. As noted by European Commission study on "Household saving rates in the EU—Why do they differ so much?" (Rocher, S. and M.H. Stierle 2015, EC Discussion Paper 005), adjusting for the different accounting treatment leads to lower household saving rates in countries with large pension fund assets like Sweden and Denmark.

- Other factors can also potentially explain Finland's lower household saving rate than other Nordic peers. Finnish households have weathered two recessions since 2008. The associated drop in income between 2011 and 2015 might has, as is typical, been with reductions in saving rates. House prices have also not increased has much, implying less need to save for substantial down payments to buy a house in Finland. Recent analysis by Fund staff finds that unlike Denmark, Norway and Sweden, Finland's household savings rate is broadly in line with savings behavior in peer economies in a broader group of countries, controlling for relevant macroeconomic factors (Papageorgiou and Zhang 2017 Selected Issues; IMF Country Report No. 17/351).

27. ***Regarding the staff's recommendation for replacement of the current cap on mortgage loans relative to collateral with a cap relative to the value of the property, could staff elaborate more on the comparison between LTC and LTV in terms of***

their efficiencies?

- How efficient a loan cap regulation is depends in part on how it is applied. In most countries, the loan cap limits the maximum size of a housing loan relative to the value of the house purchased and used as collateral for the loan. In Finland, the method for calculating the loan-to-value ratio of a borrower is exceptionally lenient: besides the house to be purchased, a wide range of other collateral offered by the borrower (and accepted by the lender) can also be taken into account in calculating the maximum loan amount (loan-to-collateral, LTC). Consequently, the LTV ratio (as typically calculated) may be fairly high in the case of some borrowers and exceed the value of the housing.

28. ***Nordea's depositors would be covered by the Finnish deposit guarantee scheme in the event of insolvency. As the amount of covered deposits within the Finnish deposit guarantee scheme has grown significantly with the redomicile, how does staff see the adequacy of the current target for the Finnish fund (about €1 billion)?***

- The target is 0.8 percent of covered deposits, so the nominal amount could change if nominal deposits are different from what is expected; the industry fees would be adjusted to meet those changes. (Note that the level of deposit protection in the EU is harmonized at €100,000 (or equivalent amount in the local currency), and this amount is guaranteed irrespective of the current level of available financial means of any Deposit Guarantee Scheme. All Member States extend this guarantee to their depositors. The amount of available financial means of a DGS has no impact on the level of this guarantee, and in any case, alternative means of financing the guarantee are available.) There are no firm guidelines on the resources of deposit guarantee funds, but the 0.8 percent target is about average The more important point for a bank of Nordea's size is proper resolution arrangements that would avoid insolvency (and hence demands on the deposit insurance fund)—see paragraphs 14, p9 and 16, pp11-12 of the Selected Issues Paper.

Structural reforms

29. ***One of the recommendations in the staff report dealt with the possibility of stronger emphasis on the development of infrastructure, especially near the urban centers. Could staff elaborate on the ways to finance additional infrastructure expenditures, including the possibility to leverage the public-sector balance sheet, as the Finnish authorities successfully did in the case of export guarantees (Finnvera)? Did the authorities express any views on the costs and benefits of stronger emphasis on infrastructure development?***

- The authorities' main fiscal priority is budget consolidation to achieve fiscal sustainability. They see the benefits from investing in improving existing infrastructure, in particular one that could enhance labor mobility, which could be accomplished if there are positive fiscal surprises. Finland has a relatively high capital output ratios and public capital stock per capita, while also ranking relatively well on many metrics of the quality of infrastructure. But they lag some comparator countries like Sweden, Denmark and Germany in terms of the conditions of transport infrastructure; a recent assessment of the condition of infrastructure indicate that the condition of the transport network has deteriorated in recent years, and thus there is a case for investing in the maintenance of the transportation sector, particularly those that can enhancing labor mobility. We therefore propose these measures as something to consider if the authorities achieve fiscal savings beyond what they estimate is necessary to achieve fiscal sustainability. Finnvera has a distinct business model. Its purpose is to provide guarantees to support firms that would be financially viable over a longer time frame but would not be able to get credit in the near term. Issuing guarantees for infrastructure investment carries different risks than that for promotion of exports, given that returns to infrastructure investment tend to be of much longer term and they are not necessarily backed by a liquid collateral, like export merchandise.

30. ***Deep structural changes in the Finnish economy associated with the impact of the crisis and of Nokia's demise would suggest paying more attention to other relevant areas for productivity growth, such as private investment in R&D activities, which has fallen about 1/3 since its peak in 2009. What is staff's assessment regarding policies to support R&D investment in Finland?***

- Finland's investment in R&D has been picking up recently [approaching 3 percent of GDP], but remains below the pre-crisis highs [of 3.5 percent of GDP]. The decline has been largely driven by a large drop in the private sector, especially Nokia and the electronics industry more generally. Public spending on R&D has also moderated as part of consolidation efforts, contributing to the decline. Going forward, productivity-enhancing structural reforms and deregulation efforts would help boost productivity and incentivize more R&D spending in the private sector.