INTERNATIONAL MONETARY FUND

IMF Country Report No. 12/253

FINLAND

2012 ARTICLE IV CONSULTATION

August 2012

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2012 Article IV consultation with Finland, the following documents have been released and are included in this package:

- **Staff Report** for the 2012 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on June 11, 2012, with the officials of Finland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on August 3, 2012. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- **Staff Statement** of August 27, 2012 updating information on recent developments.
- **Informational Annex** prepared by the IMF.
- **Public Information Notice** (PIN) summarizing the views of the Executive Board as expressed during its August 27, 2012 discussion of the staff report that concluded the Article IV consultation.
- **Statement by the Executive Director** for Finland.

The document listed below has been or will be separately released.

Selected Issues Paper and Analytical Notes

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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INTERNATIONAL MONETARY FUND

FINLAND

August 3, 2012

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION

KEY ISSUES

Context: After a robust rebound following the 2008–09 crisis, economic activity in Finland has slowed markedly, owing to gyrations in euro area (EA) financial markets, which have dragged down external demand and impaired domestic confidence. Risks to the outlook are tilted to the downside with the main risk being an intensification of the EA sovereign debt crisis that could spill over to Finland. A slowdown of world growth or an adverse oil price shock could also negatively impact the economy. While competitiveness remains broadly satisfactory, margins have been eroded and it may become a concern should current trends continue.

Further strengthening the financial sector: While the banking sector is well capitalized, risks emanating from the crisis as well as heightened requirements envisaged under Basel III warrant higher capital and liquidity buffers, which should be accomplished in moderate steps to prevent deleveraging. With a majority of assets controlled by subsidiaries of foreign banks, the sector is vulnerable to a short-term funding shortfall and spillovers from a worsening of the EA crisis. Given the heavy concentration of the banking sector, nationally systemic banks should be subject to closer supervision and more stringent prudential requirements. At the same time, strengthening macro-prudential tools would help mitigate risks in the housing market.

Balancing near- and longer-term fiscal objectives: The near-term fiscal stance is appropriately neutral as it avoids pro-cyclical withdrawal of support when growth is set to weaken while not endangering long-term sustainability. As the recovery strengthens, the structural fiscal position should be gradually tightened to close the sustainability gap. Budget retrenchment should be implemented flexibly, allowing automatic stabilizers to operate if macro conditions are less favorable than anticipated.

Raising potential growth: With a rapidly aging population, structural policies to enhance potential growth should focus on lengthening working careers. In addition, further competition in the service and health care sectors as well as municipal reform could spur productivity and help close the sustainability gap.

Approved By
Mahmood Pradhan (EUR) and Tamim Bayoumi (SPR)

Discussions for the 2012 Article IV consultations were held in Helsinki during May 31–June 11, 2012. The mission comprised Mr. L. Figliuoli (head), Ms. L. Christiansen, Mr. D. Kanda, Ms. M. Hassine, Mr. A. Aslam (all EUR) and Mr. M. Kortelainen (RES). Mr. H. Berger (EUR) joined for part of the mission. The mission met with Mr. E. Liikanen, Governor of the Bank of Finland; Ms. J. Urpilainen, Minister of Finance; other senior officials; social partners; representatives of the financial sector; and research communities.

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INTRODUCTION

1. **Despite strong fundamentals and a track record of good policies, Finland's near-term outlook is threatened by intensifying external strains**. Activity in the EA is set to contract in 2012 on the back of the protracted sovereign debt crisis, financial sector deleveraging, and additional fiscal consolidation in several European countries. Spillovers to Finland already have been significant, given its highly open economy and trade and financial linkages with Europe, and, as a result, growth decelerated at the end of 2011. Though activity in the first quarter was slightly stronger than expected, growth is projected to slow significantly in 2012. Thus, the key immediate policy concern is to cushion the downturn, while mitigating financial, fiscal, and structural vulnerabilities.

2. **Downside risks prevail**. A further deterioration of financial market conditions could have severe negative spillovers for Finland. Increased concern about fiscal sustainability in the EA, forcing additional front-loaded fiscal tightening, would dampen further the prospects for near-term recovery. In case of a strong intensification of the EA crisis, leading to heightened financial stress and associated deleveraging, a sharp recession would be inevitable.

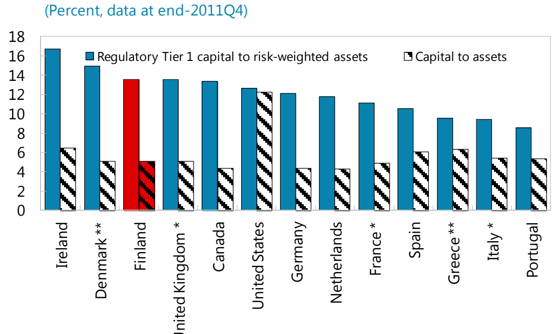
3. **The Finnish economy also faces important longer-run challenges**. Rapid aging and slowing productivity, coupled with recent cost pressures that have eroded competitiveness, threaten longer-term growth and fiscal sustainability. Growing financial integration in Europe and complexity create new risks and test supervisory abilities.

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Developments

4. **The Finnish economy rebounded robustly in 2010, but stalled at the end of 2011.** Following the steep (almost 8½ percent) real GDP decline of 2009, domestic demand surged strongly in 2010, propelled by rising consumer confidence and renewed wage growth, leading to a rapid recovery in activity. However, exports, which had collapsed more than 20 percent in 2009, never regained their previous vigor. As the sovereign debt turmoil in the EA intensified in the second half of 2011, dwindling demand from trading partners dragged the economy to a standstill in late 2011. For the year as a whole, domestic demand prevented a sharper weakening of growth, which reached almost 3 percent.

Capital Ratios
(Percent, data at end-2011Q4)

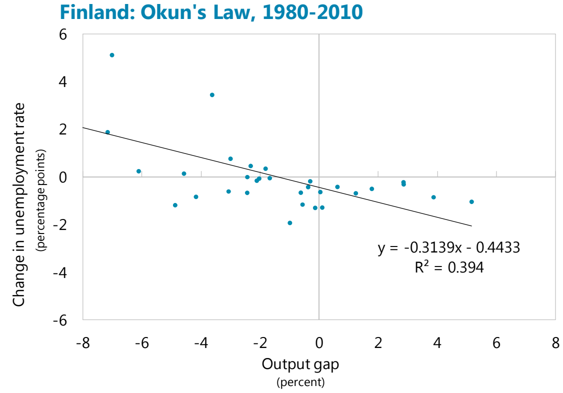


* Data at end-2011Q2; ** Data at end-2011Q3.
Sources: IMF Financial Soundness Indicators and Fund staff calculations.

(Table 1, Figure 1). Though activity in the first quarter of 2012 turned out slightly stronger than expected, weak investment continued to point to a deteriorating growth outlook.

5. The labor market slowly improved, while inflation decelerated. The unemployment rate rose about 2½ percentage points during 2008–09 to an 8¾ percent high, but well below Okun's law predictions thanks largely to labor hoarding. It then declined modestly during the subsequent recovery, ending the first quarter of 2012 at around 7½ percent, with subdued growth prospects constraining firms' willingness to hire. Harmonized consumer price inflation, which had exceeded that of the EA since late 2010 reflecting cost pressures and a value-added tax (VAT) increase, started to come down in the second half of 2011, reaching just above 2½ percent at year-end, in line with EA inflation (Figure 2).

Finland: Okun's Law, 1980-2010



Sources: IMF World Economic Outlook and Fund staff calculations.

6. The banking system has remained generally sound despite mounting EA turbulence, but vulnerabilities persist. (Table 2; Figures 3–4).

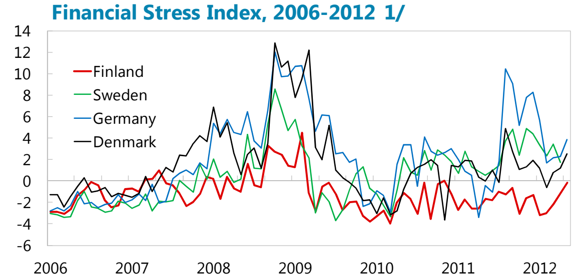
- The capital adequacy ratio (CAR) stood at 14¼ percent at end-2011, well above regulatory standards. At 13½ percent at end-2011, the core Tier 1 capital ratio was unchanged from a year earlier, though it remains higher than in European peers.

- The non-performing loan (NPL) rate, at ½ percent in March 2012, remains low. However, the NPL to capital ratio, at 5½ percent in Q411, increased slightly relative to one year earlier due mainly to an uptick in troubled loans to households and, to a lesser extent, to corporations.

- Profitability has deteriorated amid weakening interest income and increased competition for retail business. Return on assets dropped further during 2011, to ½ percent in Q112.

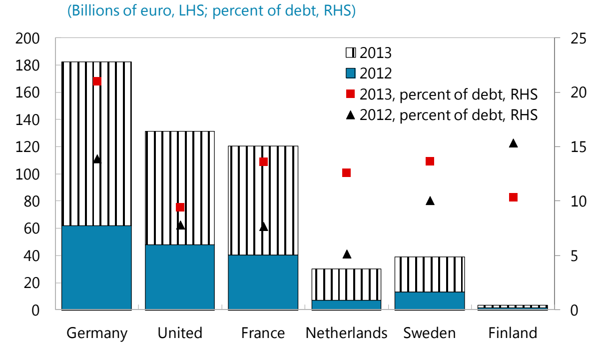
- Large foreign exposures subject Finnish banks to spillover and deleveraging risks owing to the financial sector strains in the EA (Box 1). In

Financial Stress Index, 2006-2012 1/



Sources: Cardarelli, R., S. Elekdag, and S. Lall (2009), "*Financial Stress, Downturns, and Recoveries,*" IMF Working Paper, WP/09/100 and Fund staff calculations.
1/ The financial stress index is a composite of the spread between commercial papers and sovereign bonds, the beta of the banking sector (from a CAPM), the term structure of interest rates, and volatilities in stock returns and in the exchange rate. Large values imply higher distress. A value of zero indicates neutral financial conditions.

Bank Rollover Requirement, 2012-13
(Billions of euro, LHS; percent of debt, RHS)



Sources: Dealogic and Fund staff calculations.

addition, the Finnish banking sector is highly concentrated, with a majority of assets controlled by subsidiaries of foreign Nordic banks, and heavily dependent on wholesale funding. This heightens the vulnerability to a short-term funding shortfall and spillovers from a possible worsening of the EA crisis (AN[1] 1). Moreover, the net external position of Finnish banks has deteriorated over the past year, reflecting both higher foreign exposure and greater dependence on foreign funds.

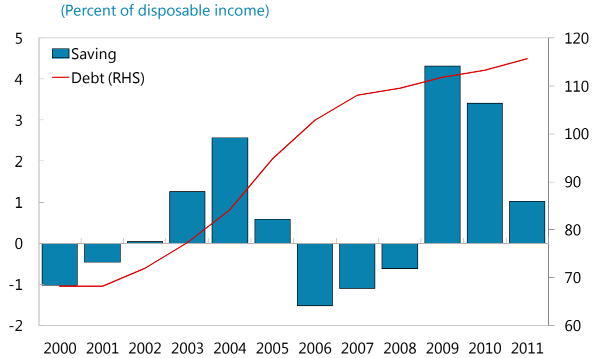
7. The insurance and pension fund sectors are weathering well the ongoing crisis, but not without suffering losses.

- The deep economic downturn combined with the low level of interest rates and highly volatile equity and bond markets led to reduced solvency margins for insurers in 2010–11. However, at 3¾ and 4 times the regulatory requirement for nonlife and life insurance respectively, such margins remain high relative to European peers. Investments of Finnish insurers returned a loss just shy of 2 percent at end-2011.

- Compared to other European countries, Finnish pension funds have given preference to equity over debt instruments in their portfolios. Hence, tumbling share prices during the height of the crisis caused deeper losses, from which pension funds are still healing.

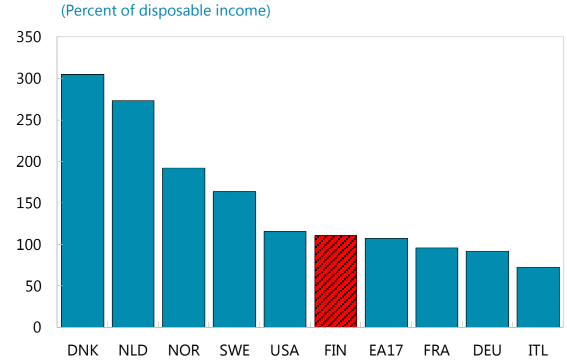
8. Household indebtedness has surged. Household debt as a share of disposable income increased sharply during the past decade, rendering household balance sheets riskier. With mortgages overwhelmingly of the floating-rate variety, decline in interest rates and longer repayment terms have lowered borrowing costs. In addition, banks have first charge at default and full recourse against borrowers. Thus, default rates have remained low. Unlike other EA countries, mortgage growth in Finland has been stable throughout 2011, exceeding the EA average by about 4 percentage points. The share of highly indebted households, likely to face heightened repayment problems in 2012 as unemployment increases again, is rising.

Household Saving and Debt, 2000-11
(Percent of disposable income)



Sources: Statistics Finland and Fund staff calculations.

Selected Countries: Household Debt, 2010
(Percent of disposable income)



Sources: Haver Analytics and Fund staff calculations.

[1] Analytical Note. See Finland: Selected Issues and Analytical Notes, International Monetary Fund, 2012.

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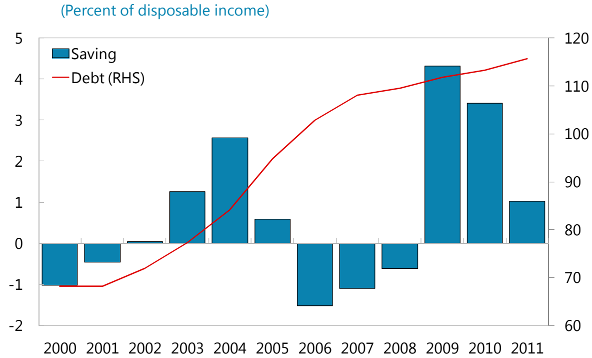
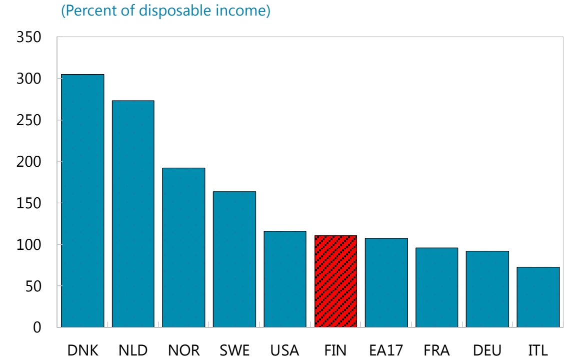


Sources: Statistics Finland and Fund staff calculations.

Selected Countries: Household Debt, 2010
(Percent of disposable income)



Sources: Haver Analytics and Fund staff calculations.

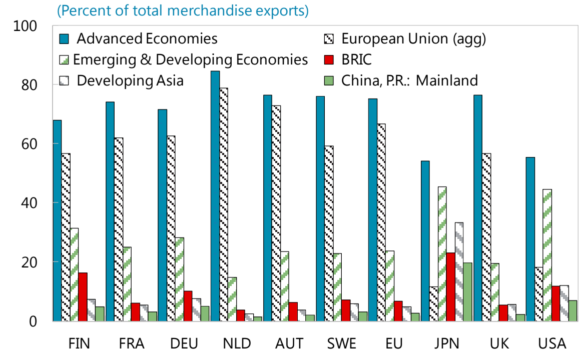
[1] Analytical Note (AN). See Finland: Selected Issues and Analytical Notes, International Monetary Fund, 2012.

Box 1. Finland: Cross-Border Spillovers[1]

Finland's financial and trade linkages to the other Nordics make it sensitive to growth slowdowns in the region. Although Finland's trade pattern across countries is relatively diversified, its financial linkages are more concentrated in the Nordics. Foreign direct investment in Finland is dominated by Sweden with close to 60 percent of the total for Finland. Similarly, cross-border banking flows are dominated by Sweden and other Nordic countries.

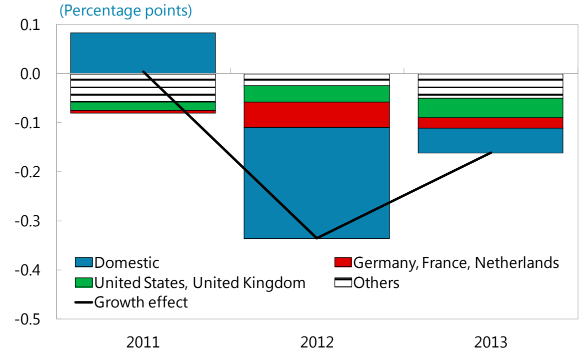
A diversified trade pattern and limited exposure to countries with large consolidation plans help limit spillovers from fiscal consolidation in the euro area. Despite notable consolidation plans in some of its trading partners, the impact on Finland's growth in 2012 and 2013 from worldwide consolidation will likely be low. Simulation results imply that domestic consolidation plans are likely to generate a more significant drag on GDP with a likely reduction in 2012 of ¼ percentage point, while foreign consolidation will reduce output growth by around 0.1 percentage points in 2012 and 2013.

Comparison - Export Market Destinations, 2011
(Percent of total merchandise exports)



Sources: IMF Direction of Trade Statistics and Fund staff calculations.

Contribution to Growth from Global Fiscal Consolidation, 2011–13
(Percentage points)



Sources: Direction of Trade Statistics, World Economic Outlook and Fund staff calculations.

While bank exposure to high spread countries is very limited, significant linkages with banks in Sweden and Denmark make Finland susceptible to shocks in these countries. The claims of Finnish banks on the three program countries Greece, Ireland, and Portugal are very limited so that the direct impact from a default on 50 percent of the outstanding sovereign claims would entail no notable losses to Finnish banks. Further, losses would remain small even if Finnish banks lose 30 percent of their asset value in the three program countries. Claims on Sweden and Germany are more relevant and a 10 percent haircut on these assets reveals a more severe loss of around 2 and ½ percent of GDP, respectively.

[1] See AN 1.

Box 1. Finland: Cross-Border Spillovers (concluded)

Spillovers to Finland from International Banks' Exposures

(As of September 2011)

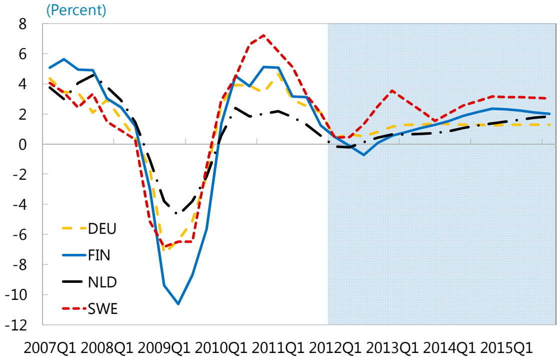
Shock originating from	Magnitude 1/	Deleveraging need 2/	Finnish banks' losses (percent of GDP)	Impact on credit availability (percent of GDP) 3/
Greece	30	0.0	0.0	-0.1
Greece, Ireland and Portugal	30	0.0	0.1	-0.7
Italy	10	0.0	0.1	-0.4
Spain	10	0.0	0.1	-0.9
France	10	0.0	0.2	-3.3
Germany	10	0.0	0.6	-5.1
Sweden	10	0.0	1.9	-56.5
UK	10	0.0	0.4	-2.6
Selected European Countries 4/	10	55.8	3.6	-71.6
US	10	0.0	0.3	-4.4

Sources: RES/MFU Bank Contagion Module based on BIS, ECB, and IFS data.
1/ Magnitude denotes the percent of on-balance sheet claims (all borrowing sectors) that default.
2/ Deleveraging need is the amount (in percent of Tier I capital) that needs to be raised through asset sales in response to the shock in order to meet a domestic banking sector Tier I capital asset ratio of 10 percent, expressed in percent of total assets and asuming no recapitalizations.
3/ Reduction in foreign banks' credit to Finland due to the impact of the analyzed shock on their balance sheet, assuming a uniform deleveraging across domestic and external claims.
4/ Greece, Ireland, Portugal, Italy, Spain, France, Germany, Sweden, and the United Kingdom.

Considerable risk stems from a growth slowdown in Sweden or a simultaneous growth slowdown in the rest of the euro area. Multi-country VAR analysis suggests that a negative growth shock in Sweden of ½ standard deviation in 2012 alone could lower GDP growth in Finland by about 0.1 percentage point in 2012 and above ½ percentage point in 2013 compared with the current baseline. A shock to all euro area members (excluding Finland) could lower Finnish GDP growth by more than ½ percentage point in 2013.

Output Growth Comparison: Sweden 2012 Shock

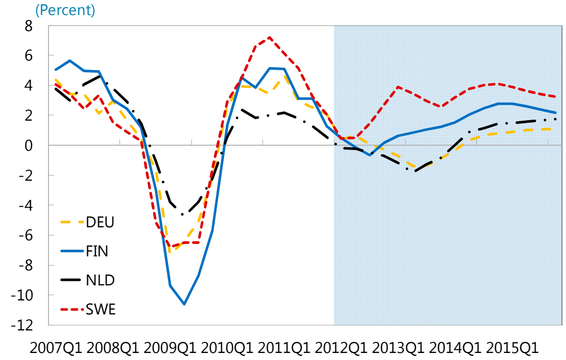
(Percent)



Sources: OECD, Poirson and Weber (2011), World Economic Outlook, and Fund staff calculations.

Output Growth Comparison: Euro Area Wide 2012 Shock

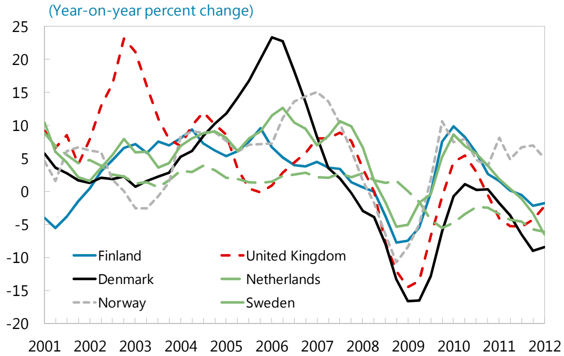
(Percent)



Sources: OECD, Poirson and Weber (2011), World Economic Outlook, and Fund staff calculations.

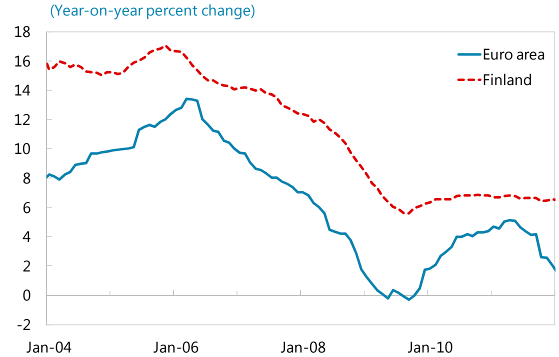
9. Real estate prices are at historically high levels but broadly in line with fundamentals. After moderate retrenchment in 2009, house prices recovered the pre-crisis growth path and according to some indicators real house prices and credit are above their long-run trend (Box 2). Nevertheless, the increase in housing prices exceeded income growth only marginally in recent years, suggesting the absence of major real estate bubbles (AN 2). The fall in rental rates for office space in 2011 is likely the harbinger of a modest price correction for commercial real estate, particularly with banks tightening lending policies.

Real House Price Growth, 2001–12
(Year-on-year percent change)



Sources: OECD and Fund staff calculations.

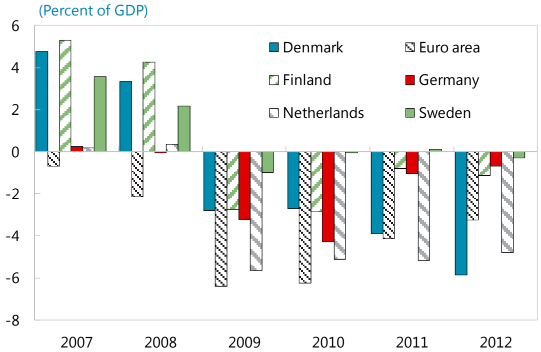
Growth of Mortgage Loans, 1999–2012
(Year-on-year percent change)



Sources: European Central Bank, Haver Analytics, and Fund staff calculations.

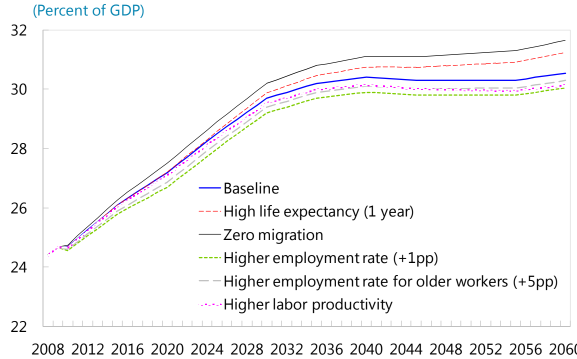
10. The fiscal position deteriorated sharply during the acute 2009 recession, and, while consolidation has begun, the costs of population aging loom large. Reflecting both automatic stabilizers and discretionary stimulus, the general government (GG) headline balance deteriorated by 7 percent of GDP in 2009, spawning a deficit of about 2¾ percent of GDP in 2009–10 (Tables 3–4, Figure 5). In 2011, the budgetary stance tightened by about 1 percent of GDP in structural terms. This followed from a hike in energy taxes and the full-year impact of a 1 percentage point raise in the standard rate of VAT to 23 percent in mid-2010, while, on the expenditure side, the stimulus measures started to be phased out. Nonetheless, with weaker-than-projected growth, the headline deficit stood at around ¾ percent of GDP and gross debt continued to increase, ending 2011 at close to 49 percent of GDP. Meanwhile, population aging remains a challenge for long-term fiscal sustainability, with associated GG costs estimated at 6½ percent of GDP per annum by 2016 (AN 6 and ¶31). Related to below-the-line operations, Finland has secured collateral for its financial assistance to some debtor countries through the EFSF.

General Government Balances, 2007–12
(Percent of GDP)



Sources: World Economic Outlook and Fund staff calculations.

Aging-Related Expenditure: Different Scenarios, 2008–60
(Percent of GDP)



Sources: DG ECFIN: The 2009 Ageing Report and Fund staff calculations.

Box 2. Finland: Macro-Financial Linkages[1]

Financial variables have strengthened the economic recovery but support is fading. The low interest rate environment and the improvement in the situation in the banking sector in 2010 have stimulated demand for mortgage loans and housing prices. This in turn strengthened household asset positions, which underpinned robust private consumption growth. The recovery lost steam as asset markets started to deteriorate and the outlook clouded over, slowing investment in residential property and consumption growth.

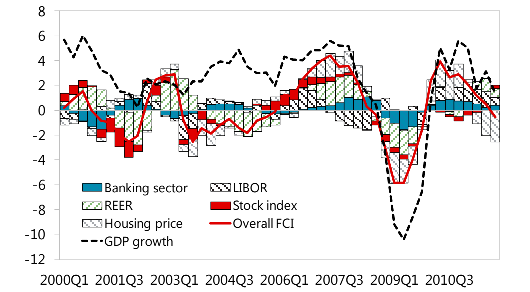
The historic relationship between credit, housing, and output growth is strong in Finland, making output susceptible to negative shocks in real estate and credit markets. Vector Autoregressions (VARs) suggest that a negative shock to credit availability of 5 percent could be associated with a reduction in output by ¼ to ½ percent after one year and 1 to 1¾ percent after 2 years. Housing prices would be lower by ¼ to 2½ percent in the first year and 2¼ to 2¾ percent in the second year. At the current level of output, housing prices and credit are above their long-run trend.

The credit market is broadly in equilibrium and major disruptions from the credit market to economic growth are less likely. Credit demand declined with economic prospects. With the relative resilience of the banking sector to the woes in the euro area, the impact on credit provision has been limited. Thus, there has been little misalignment in the credit market throughout the earlier phases of the crisis and the recovery phase.

[1] See AN 2.

Financial Conditions Index, 2000Q1-2011Q4

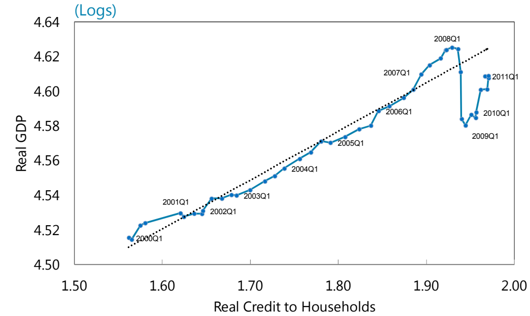
(Percentage points of y/y real GDP growth)



Sources: Cardarelli, R., S. Elekdag, and S. Lall (2009), "*Financial Stress, Downturns, and Recoveries*," IMF Working Paper, WP/09/100 and IMF staff calculations.

Finland: Credit to Households and Output Developments, 1990-2011Q1

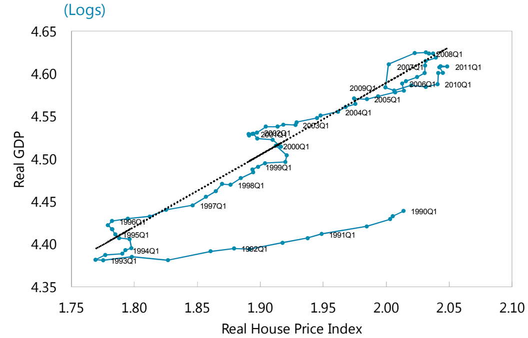
(Logs)



Sources: National authorities and Fund staff calculations.

Finland: House Prices and Output Developments, 1990-2011Q1

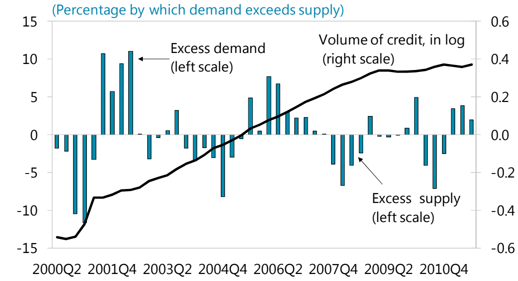
(Logs)



Sources: National authorities, OECD, and Fund staff calculations.

Finland: Excess Supply/Demand for Credit, 2000Q2-2011Q3

(Percentage by which demand exceeds supply)



Source: Fund staff calculations.

11. Previous large current account surpluses have waned, suggesting that competitiveness, while still adequate, has eroded. With the collapse in exports of 2009 and a renewed slowdown in trading partner growth at end-2011, the current account turned from a 2½ percent of GDP surplus in 2008 to a ¾ percent of GDP deficit in 2011. Exports, which in 2008 accounted for more than 45 percent of GDP, have now fallen below the 40 percent mark (Tables 5–7, Figures 6–7). Additionally, Finland has continued to lose export market share (Box 3). Nonetheless, econometric estimates do not suggest misalignment. On balance, in staff's view, competitiveness remains broadly satisfactory, though margins have been eroded and it may become a concern should current trends continue. While the authorities share this assessment, they highlight that most of the structural export decline (from outsourcing by the ICT and paper industries) already has taken place, limiting the risks of further deterioration. The relatively robust external position limits vulnerabilities from capital flows, with the net international investment position improving steadily since 2007 and expected to remain comfortable. Both assets and liabilities have been rising at a strong pace with considerable direct investment net assets, while portfolio and other investment are in net liability.

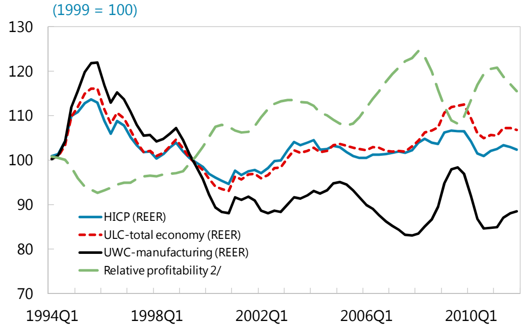
Box 3. Finland: External Competitiveness

Various price and quantity indicators imply some deterioration in competitiveness. Real effective exchange rates (REERs) based on various cost and price indices have, on average, moved broadly sideways. Meanwhile, the current account has continued its downward trend, reaching a deficit (of 0.7 percent of GDP) in 2011—the first time in nearly two decades.

Real effective exchange rates hint at a worsening of relative profitability in manufacturing. Using the ratio of the REERs based on HICP and on unit wage cost in manufacturing as a proxy for relative profitability points to deteriorating conditions. After trending upward for more than a decade, albeit with temporary interruptions, including during the 2008–09 crisis, this measure now again is showing a decline in relative profitability.

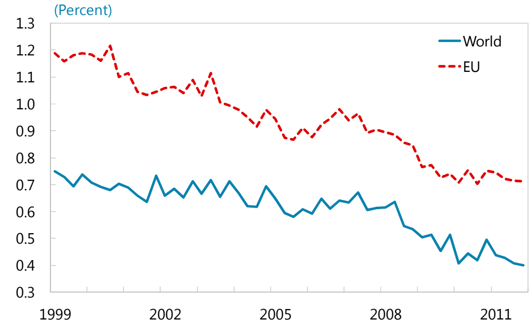
Finland has continued to lose export market share. Finland's export market share in the world has been on a declining trend for more than a decade. Since 2008, the decline in export share in the EU market has also intensified, not least on the back of declining exports of electronics due to both outsourcing of production and a downsizing of the ICT industry.

Finland: Real Effective Exchange Rates, 1994-2011 1/
(1999 = 100)



Sources: European Commission and Fund staff calculations.
1/ Based on data for 36 industrial countries.
2/ Computed as the ratio of the HICP REER to the UWC-manufacturing REER.

Finland: Export Shares, 1999-2011 1/
(Percent)



Sources: International Financial Statistics and Fund staff calculations.
1/ Computed as Finland's exports to the World and the EU in percent of total World and EU imports from the World, respectively.

Box 3. Finland: External Competitiveness (concluded)

The IMF's multilaterally-consistent methodologies suggest the real exchange rate is broadly in balance. Recent external balance assessment (EBA) estimates support the view that the real exchange rate, or more generally the external position, is broadly in line with fundamentals. Specifically, while the EBA real exchange rate approach continues to flag mild real undervaluation, the macroeconomic balance approach points to the opposite. In the external sustainability approach, the current account is exactly aligned with fundamentals. However, CGER methodologies indicate the real exchange rate is moderately weaker than implied by fundamentals. In particular, the three different approaches produce a deviation from fundamentals-based values in the range of 2 to–18 percent depending on the CGER method used, averaging a -6 percent deviation, suggesting moderate real undervaluation.

Estimates of Competitiveness Using EBA Methodologies 1/
(Deviation from norms)

Methodology	
CA gaps (percent of GDP)	
Macroeconomic balance (MB) approach	-2.5
External sustainability (ES) approach	0.0
Equilibrium real exchange rate approach (percent deviation)	-7.0
Memorandum items:	
Current account balance (percent of GDP)	
Current account norm (MB approach)	1.8
Current account norm (ES approach)	-0.1

Source: IMF staff estimates.

1/ EBA (External Balance Assessment). CA gaps: minus indicates overvaluation. REER gaps: minus indicates undervaluation. REER deviations between -10 and +10 mean the real exchange rate (RER) is close to balance. EBA estimates are based on data available in spring 2012.

Estimates of Competitiveness Using CGER Methodologies 1/
(Percent deviation from levels implied by medium-term fundamentals)

Methodology	
Macroeconomic balance (MB) approach	2
External sustainability (ES) approach	-2
Equilibrium real exchange rate approach	-18

Source: IMF staff estimates.

1/ CGER (Consultative Group on Exchange Rate Issues). Values between -10 and +10 mean the real exchange rate (RER) is close to balance. Minus indicates undervaluation. International Monetary Fund, 2008, "Exchange Rate Assessments: CGER Methodologies" (available at www.imf.org). CGER estimates are based on data available in spring 2012.

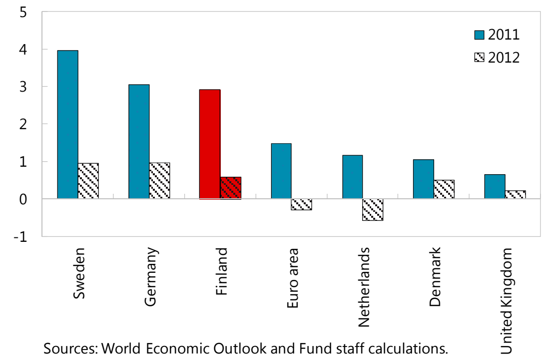
On balance, staff estimates that the real exchange rate and the external balance are broadly in line with fundamentals. As discussed above, developments in non-econometric indicators suggest competitiveness has deteriorated, thereby eroding the moderate margins of competitiveness estimated in the past, but without resulting in real overvaluation. Moreover, IMF econometric methodologies do not show significant deviations from fundamentals-based values overall.

B. Macro Outlook

Prospects for 2012 and 2013

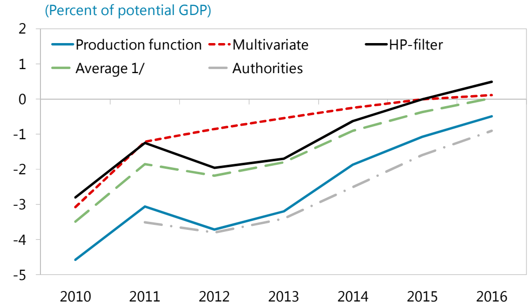
12. Following the slowdown at the end of 2011, growth is projected to weaken further before picking up at the end of 2012 and in 2013. Staff forecasts real GDP to expand by around ½ percent in 2012, driven by weak consumption and investment marred also by sluggish exports, with negative growth in the middle of the year. Assuming financial market conditions in the EA normalize gradually, activity should start to recover at end-2012, leading to about 1½ percent GDP growth in 2013. Consequently, output will fall further below potential in 2012, with the output gap closing only slowly over the medium term, even though trend growth remains below pre-crisis rates. As the economy slows in 2012, inflation will decline to below 3 percent, though monetary indicators point to persistent expansionary conditions through the end of 2012 and tax hikes will continue to put upward pressure on prices. The unemployment rate will rise again to nearly 8 percent by end-2012, decreasing slowly thereafter. The Ministry of Finance's growth projections are slightly higher for 2012 and lower for 2013 than staff's, while the Bank of Finland is somewhat more sanguine for 2012.

Real GDP Growth, 2011–12
(Percent)



Sources: World Economic Outlook and Fund staff calculations.

Finland: Output Gap, 2010–16
(Percent of potential GDP)



Sources: Stability Programme for Finland 2012 and Fund staff calculations.
1/ Average of output gap estimates from staff's production function, multivariate, and HP-filter approaches.

Medium- and Long-Term Prospects

13. The renewed deceleration is likely to exacerbate the permanent output loss, and aging will weigh further on potential growth. The latter will remain below pre-crisis values as weak investment in 2008–09 and again in 2012 is taking its toll (Table 1). A potential output loss of as much as 8 percent by 2017 is estimated relative to the pre-crisis trend (AN 3). At the same time, the rapidly aging population will constrain growth of working-age cohorts. With manufacturing productivity set to expand below 2 percent, growth prospects are lackluster in the absence of increases in the participation rate or reforms to boost productivity.

Risks to the Outlook

14. The authorities agreed that risks to the outlook are tilted to the downside, with heightened uncertainties. Downside risks primarily relate to uncertainty about financial market gyrations in the EA and spillovers from a deeper and more protracted EA recession than currently projected (AN 1 and Risk Assessment Matrix). On the positive side, financial market reactions to EA crisis resolution actions could surprise on the upside, leading to a faster return to normalcy than currently expected. Further depreciation of the euro could have a similar effect. Over the longer run, persistent expansionary monetary conditions and safe-haven capital inflows could be conducive to overheating and asset-price bubbles. More specifically:

- The baseline scenario includes a gradual easing of European financial market tensions. However, heavier deleveraging and a credit crunch are a possibility.

- Persistence of negative investor sentiment could lead to widening spreads also for Finland, prompting further domestic fiscal retrenchment to avoid losing the coveted AAA rating.

- More fiscal tightening abroad than anticipated or stronger-than-expected adverse effects of the budget retrenchment assumed in the baseline could hit Finnish exports hard (AN 1), given the very open nature of the economy. In general, though, the authorities are more optimistic on the impact of fiscal consolidation.

- Negative growth impacts could also derive from a significant reduction in Finnish real estate prices, an adverse oil supply shock, or a slowdown of world growth.

In principle, each of these factors could drive deviations from the baseline in either direction and impact staff’s central projection for activity accordingly. Nevertheless, the probability of downside outcomes is deemed prevalent—with unusually pronounced dispersion—as reflected in the discussion above.

15. A strong intensification of the EA crisis, leading to more acute financial stress, would generate severe negative spillovers. The Finnish banking system, with its close integration with its Nordic neighbors, could suffer a strong adverse impact. This would likely take the form of liquidity withdrawal by parent banks, amid difficulties in wholesale funding, forcing a strong deleveraging of Finnish banks and likely an associated credit crunch. As a consequence, real activity would also be impaired and contract severely. Staff simulations suggest that, amid sharp increases in sovereign and corporate risk premia, accompanied by further fiscal consolidation, Finnish GDP could shrink by 4 percent below the baseline in 2012–13 (AN 4).

Finland: Risk Assessment Matrix[1/]

(Scale—high, medium, or low)

Source of Risks	Overall Level of Concern	
	Relative Likelihood[2/]	**Impact if Realized**
1. Strong intensification of the EA crisis.	**Medium** • Heightened financial stress could worsen the EA outlook. • Fiscal tightening in major EA countries could have stronger-than-expected adverse effects on growth.	**High** • Effects through lower export demand and inward financial spillovers, resulting in deleveraging and increased uncertainty.
2. Slowdown of world growth.	**Medium** • Slowing demand from emerging Asia and the U.S.	**High** • Finland is highly sensitive to external trade shocks. In 2009, the collapse in exports contributed to a close to 8½ percent reduction in GDP. • A shock could have a more severe impact now, as fiscal buffers have been drawn down, while the room for further monetary relaxation is also scant.
3. "Drying up" of financial markets.	**Medium** • Contagion arising from an intensification of financial stress in the EA.	**High** • Finland has little direct exposure to the most vulnerable euro-zone countries, but the banking sector is dominated by subsidiaries of foreign banks and highly concentrated. The banking system's funding gap is around 50 billion euros, closed through foreign sources. • Adverse shocks could reduce banking sector liquidity, forcing deleveraging and possibly an associated credit crunch.
4. Adverse oil price shock.	**Medium** • Geo-political risks could lead to a sharp increase in oil prices.	**Medium** • Higher energy prices could depress demand and raise inflation.
5. Mispricing of assets.	**Low** • Persistence of expansionary monetary conditions could fuel excessive asset price increases.	**Medium** • A downward correction in real estate prices could cause a marked decline in output (AN 2).

[1/] The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path discussed in this report (which is the scenario most likely to materialize in the view of the staff). The RAM reflects staff's views on the source of risks and overall level of concerns as of the time of discussions with the authorities. The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding this baseline.

[2/] In case the baseline does not materialize.

POLICY DISCUSSIONS

16. Against this background, Finland must address existing vulnerabilities and long-term sustainability issues, while paying due attention to short-term growth.

- In the financial sector, proactive efforts should be undertaken to lift capital to the levels envisaged under Basel III. More emphasis should be given to liquidity provisioning as heightened stress in the wholesale market is a key risk and new regulation under Basel III will require further adjustment efforts by banks. In light of squeezed profit margins, supervision should ensure that the prudential business model is maintained and no excessive move to higher risk-return portfolios is undertaken. Cross-border supervision should be further intensified because financial flows have increased, in particular across the Nordic region.
- Fiscal policy must strike a delicate balance between supporting short-term economic activity, mitigating recessionary forces, and addressing the sustainability gap. Given the deteriorated outlook, this argues for allowing automatic stabilizers to work fully in the near term and planning a gradual pace of consolidation over the medium term.
- Further structural policies to spur potential growth should be implemented. This includes raising the effective retirement age and boosting labor supply. Moreover, strengthening competition in the service and health care sectors could enhance productivity, while, in the public sector, merging municipalities could realize economies of scale.

C. Maintaining Financial Stability

Bank Capitalization and Liquidity

17. The consensus was that, while the banking sector is sound, individual institutions may need to strengthen capital and liquidity, especially the latter. Banks already meet the minimum capital and conservation buffer requirements envisaged under Basel III, though the authorities acknowledged that not all credit institutions satisfy the leverage ratio requirement. Furthermore, compliance with Basel III liquidity requirements will entail some additional effort as regards the asset composition of the liquidity buffer and the size of long-term stable funding (AN 5). As the banking system is substantially funded through foreign sources and wholesale markets, staff argued that banks ought to be encouraged to build up capital and above all liquidity buffers gradually. The authorities concurred, emphasizing that these objectives should be accomplished in measured but steady steps over the medium term to avoid fostering pressures for deleveraging.

18. Supervisors confirmed that, according to stress tests, capital buffers are sufficient, while liquidity provision should be improved (AN 5). Under a prolonged recession scenario for 2012–15, banks overall remain above the current minimum capital requirement. Nevertheless, profitability would suffer gravely and the Tier 1 ratio decline by more than 4 percentage points, with one of the seven largest banks falling below minimum requirements. Further, the liquidity coverage ratio would be insufficient in the transition to Basel III, raising the risk that banks may have to rely on emergency liquidity assistance. Moreover, the net stable funding ratio would not meet the corresponding requirement for some banks. The increase in unemployment and simultaneous drop in real estate prices assumed in the stress scenario would also significantly impact NPL ratios.

Finland: Breakdown of Tier 1 Capital Change Under Adverse Scenario, 2011-15

(In percent of risk-weighted assets)

	2011	2013	2015
Tier 1 capital ratio	13.6	12.0	9.5
Change in Tier 1 capital ratio from 2011		-1.5	-4.0
Of which:			
Change in capital 1/		-0.2	-1.8
Change in assets 1/		-4.0	-4.5
Change in risks 1/		2.6	2.3

Sources: Finnish authorities and Fund staff calculations.
1/ Increase(+)/decrease(-).

Finland: Aggregate Stress Test Results, 2011-15

	Baseline			Adverse scenario					
	2011	2012	2013	2011	2012	2013	2014	2015	Change (2011-15)
Total income (percent change from previous year) 1/	3.0	4.0	6.0	3.0	-17.5	-3.5	-21.6	-5.1	-47.9
Profitability (operating profit after taxes, percent of own funds, RoE)	8.4	8.2	8.8	8.4	1.4	-1.7	-9.1	-8.5	-16.9
Tier 1 capital (percent of risk-weighted assets)	13.6	12.7	12.8	13.6	12.6	12.0	10.7	9.5	-4.0
Tier 1+2 capital (percent of risk-weighted assets)	14.2	13.7	13.8	14.2	13.1	12.4	10.9	9.6	-4.6
Memorandum item:									
Risk-weighted assets (billion euros) 2/	147.8	162.3	167.3	147.8	159.3	164.1	169.0	174.1	17.8

Sources: Bank of Finland, FIN-FSA, and Fund staff calculations.
1/ Change (2011-15) computed as the sum of the 2012-15 growth rates.
2/ Change (2011-15) denotes the percentage change over the period.

19. The authorities concurred on the need for preemptive action to mitigate the considerable risk posed by potential interruptions of bank funding from abroad. A renewed worsening of the EA crisis could hamper long-term wholesale funding and exacerbate vulnerabilities posed by large international groups. Hence, the mission argued that stepped-up efforts are needed to ensure preparedness to prevent or alleviate potential disruptions in cross-border flows, by designing contingency plans (encompassing burden-sharing agreements) with home authorities, the European Banking Authority, and the European Central Bank, including clear delineation of responsibilities of each institution.

Other Micro Supervision and Regulation of Financial Institutions

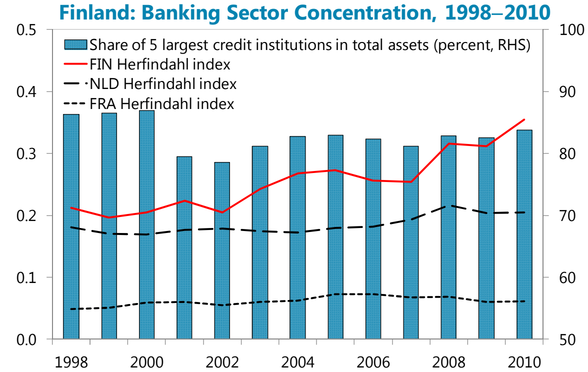
20. Though cross-border banking activities have received increased attention, supervisors recognized that additional steps would be useful. Several memoranda of understanding (MoUs)—in line with best international practice—have been signed with foreign (mainly Nordic and Baltic) supervisors and supervisory colleges have been active. Nevertheless, the authorities noted that MoUs are not binding, which hampers enforcement actions. It would be helpful to strengthen their legal status. At any rate, closer harmonization in application of international standards as well as common reporting systems and supervisory approaches would buttress effectiveness of cross-border supervision. Similarly, it was agreed that enhancing cross-border sharing of supervisory information could facilitate preparedness in host and home countries. This would require appropriate legal changes and would pave the way for the application of a more holistic toolkit for assessing risks from cross-border exposures. Finally, advances in cross-border crisis-handling and bank resolution would be crucial (¶25).

21. Supervision of the insurance sector conforms to international standards but staff counseled speedier enactment of the new regulatory framework. The 2010 Financial Sector Assessment Program (FSAP) update recommended strengthening the analysis of the (consolidated) risk profile of complex financial groups by integrating procedures and practices of banking and insurance supervision (Table 8). This has been partly implemented and further work is ongoing. The new supervisory framework should be complemented by prompt introduction of supporting regulations, clarifying inter alia requirements on the level and structure of capital as well as eligible instruments for bank-insurers, a key step given the prevalence of the *banc-assurance* model in Finland.

Macro-Prudential Supervision

22. Heavy concentration in the banking sector implies high contagion risk from systemic banks and requires enhanced supervision. The mission reported that, according to bank contagion maps based on balance sheet inter-linkages, a few institutions act as liquidity hubs, thus, rendering them systemically crucial in the event of a crisis. The authorities also informed that Finnish subsidiaries have substantially increased short-term financing to parent banks in 2011 and derivative operations are increasingly being located within Finnish subsidiaries. Thus, officials accepted that nationally systemic banks should be subject to closer supervision and possibly more stringent prudential requirements, such as additional capital buffers, greater reliance on loss-absorbing capital instruments, higher liquidity provisions and topped-up contributions to the Deposit Guarantee Fund.

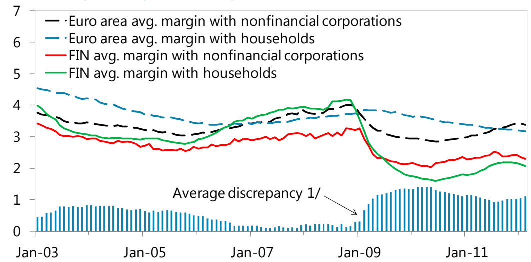
Finland: Banking Sector Concentration, 1998–2010



Sources: Bank of Finland, DataInsight, ECB Data Warehouse, Haver, IMF Financial Soundness Indicators database, and Fund staff calculations.

23. There was agreement that close monitoring of banks' risk taking behavior is warranted, particularly in the current low interest rate environment. The mission noted that the high degree of variable-rate loans combined with low rates have made the private sector more vulnerable to a rapid rise in the interest rate. Further, the authorities were concerned that very low rates over a prolonged period may encourage more risk taking by banks to increase short-term profitability, including by accelerating credit expansion, ultimately with an adverse impact on financial sector health. The mission also advised that protracted accommodative monetary conditions could in the long run fuel excessive credit growth and asset bubbles. In this connection, it noted that the estimated adverse impact of potential housing price shocks on household consumption and economic activity is sizable.

Credit Institutions' Interest Rate Margins, 2003–12
(Average lending minus average deposit rate)



Sources: ECB and Fund staff calculations.
1/ Average discrepancy is a simple average of the difference in margins between the euro area and Finland for long-term loans to nonfinancial corporations and households.

24. Discussions concluded that macro-prudential management would benefit from strengthening limits to loan-to-value (LTV) ratios and other tools. Officials reported and staff welcomed: (i) plans to define national competencies for macro-prudential supervision; (ii) the in-depth survey of vulnerabilities related to the housing and credit markets; (iii) publication of standard definitions to calculate the LTV ratio; and (iv) the prospective introduction of countercyclical capital buffers. While the authorities currently recommend a maximum LTV ratio of 90 percent, staff endorsed giving the Financial Supervisory Authority (FIN-FSA) authority to set binding LTV ceilings and recommended formulation of a plan to reduce gradually LTV ratios. Further, staff would support introduction of a national loan registry (NLR). Though the authorities generally agreed, they explained that large banks may resist the NLR as it could dent their oligopolistic position. In addition, the mission reiterated the desirability to limit further interest rate deductibility on mortgage loans.

Crisis Resolution

25. Officials concurred that crisis and bank resolution frameworks should also be reinforced. Supervisors noted that the Deposit Guarantee Scheme has increased available resources, with earlier and faster payouts in crisis conditions. Staff argued that contingency planning should be developed in cooperation with home country supervisors, to ensure coordination of interventions in parent banks and their subsidiaries in case of crisis, in particular with ex-ante burden-sharing guidelines to limit the scope for contagion from abroad. Regarding bank resolution, staff shared the authorities' preference for a common bank-resolution framework at the EU level. The authorities concurred that, if progress at the EU-level lags, it would be beneficial to formulate proactively national or regional resolution frameworks.

D. Fiscal Policy

Short-Term Fiscal Policy

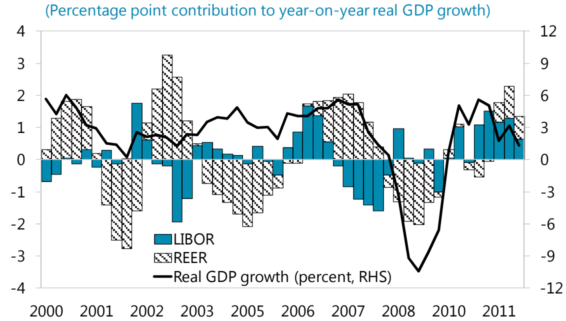
26. The short-term fiscal stance is neutral. The general government (GG) structural primary surplus is expected to stay virtually unchanged in 2012, consistent with a worsening of the headline GG deficit by slightly more the ¼ percent of GDP (to around 1 percent of GDP). With pension funds exhibiting a 2¾ percent of GDP surplus and local governments in a slight deficit, the central government (CG) headline deficit is estimated to weaken by a similar amount.

27. Staff supported the authorities' 2012 fiscal stance.

- The authorities' budget for 2012 provides for virtually full operation of automatic stabilizers, leading to an increase in the headline deficit, thereby supporting domestic demand. This is desirable, because the outlook for near-term growth is weak and the output gap is still sizable (at least based on the production function approach, used also by the European Commission and the authorities). On the other hand, the long-term fiscal sustainability gap is also considerable (¶31), owing to the impact of population aging on public expenditures. This remains true even though gross public debt, at below 50 percent of GDP in 2011, is comparatively low and GG net financial assets are positive. Thus, staff concurred that a broadly neutral 2012 fiscal policy is appropriate, avoiding pro-cyclical withdrawal of support to the economy while preventing damage to long-term sustainability prospects.

Finland: Monetary Conditions Index, 2000–11 1/

(Percentage point contribution to year-on-year real GDP growth)

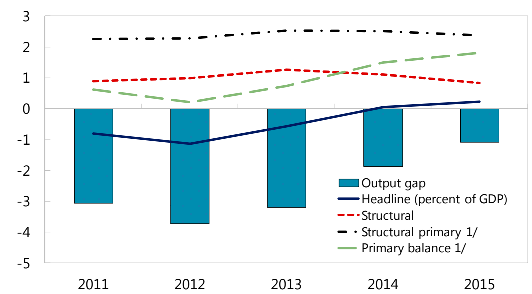


Source: Fund staff calculations.

1/ The Monetary Conditions Index is based on two subcomponents of the Financial Conditions Index (see AN 2).

Finland: General Government Balances, 2011–15

(Percent of potential GDP)



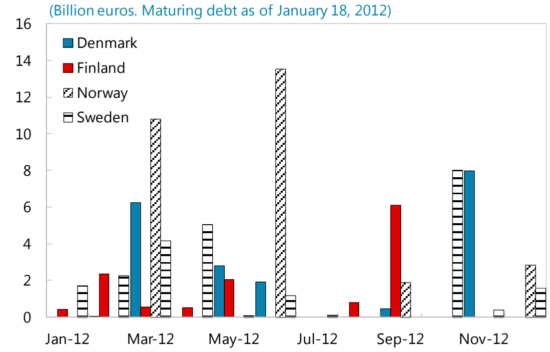
Sources: DataInsight, Finnish Ministry of Finance, Statistics Finland, and Fund staff calculations.

1/ Adjusted for interest expenditure.

- At the same time, it was not disputed that structural fiscal relaxation in 2012 ex ante may be excessive. First, considerable uncertainty surrounds estimates of potential output, with the multivariate approach, for example, suggesting a very small output gap, if any. Hence, on balance, the evidence from the output gap appears sufficient to justify allowing automatic stabilizers to operate but not enough to support initiating discretionary stimulus. Second, monetary conditions in Finland appear to be quite expansionary, thus, also providing considerable support to economic activity. Third, Finland is a small, very open economy; hence fiscal stimulus tends to dissipate abroad.

Selected Countries: Maturing Debt, 2012

(Billion euros. Maturing debt as of January 18, 2012)



Sources: Bloomberg LP and Fund staff calculations.

Finland: Evolution of Fiscal Position
(Percent of GDP, unless otherwise indicated)

	2010	2011	2012		2013		2014		2015	
			Staff 1/	Auth.	Staff 1/	Auth.	Staff 1/	Auth.	Staff 1/	Auth.
General government revenue	52.7	53.2	53.3	53.3	53.9	53.9	54.1	54.1	54.2	54.2
General government expenditure	55.5	54.0	54.4	54.4	54.5	54.4	54.1	54.2	54.0	54.2
General government balance	-2.8	-0.8	-1.1	-1.1	-0.6	-0.5	0.1	-0.1	0.2	0.0
Central government balance (baseline)	-5.6	-3.1	-3.4	-3.4	-2.6	-2.5	-1.9	-2.0	-1.7	-1.9
Central government balance (government program target scenario)	-5.6	-3.1	-3.4	…	-2.6	…	-1.6	…	-1.0	…
General government primary balance 3/	-1.5	0.6	0.2	0.2	0.7	0.8	1.5	1.3	1.8	1.6
GG structural balance 2/	-0.1	0.9	1.0	…	1.3	…	1.1	…	0.8	…
GG structural primary balance 2/ 3/	1.2	2.3	2.3	…	2.5	…	2.5	…	2.4	…
Discretionary measures 2/ 4/	…	…	0.0	…	0.9	…	1.6	…	2.2	…
GG structural primary balance, excluding discretionary measures 2/ 3/	…	…	2.3	…	1.6	…	0.9	…	0.2	…
GG structural balance (government program target scenario) 2/	-0.1	0.9	1.0	…	1.3	…	1.4	…	1.6	…
GG structural primary balance (government program target scenario) 2/	1.2	2.3	2.3	…	2.5	…	2.8	…	3.1	…
Memorandum items:										
Nominal GDP growth (in percent)	4.2	6.6	2.5	3.6	4.0	4.0	4.9	4.4	4.2	4.1
Authorities' structural balance	…	0.6	…	0.4	…	0.8	…	0.9	…	0.7
Authorities' structural primary balance	…	2.0	…	1.7	…	2.1	…	2.3	…	2.2

Sources: Ministry of Finance, 2012 Stability Program, and Fund staff calculations.
1/ Staff projections are based on the authorities' announced measures, but staff's growth and output gap assumptions. The government program target scenario includes additional measures, as deemed necessary by staff, to reach the 2015 central government 1 percent of GDP deficit target.
2/ Percent of potential GDP.
3/ Excluding interest expenditure.
4/ 5 billion (2015 level, about 2.2 percent of GDP) in adjustment measures during the program period. Distributed as 40 percent taking effect by 2013, 70 percent by 2014, and 100 percent by 2015.

Medium-Term Fiscal Policy

28. The authorities pursue substantial fiscal adjustment through 2015, but measures specified so far fall short of the target. The government program aims at setting the CG debt-to-GDP ratio on a declining path and reducing the CG deficit from around 3 to 1 percent of GDP between 2011 and 2015 (the end of the government's term).[2] However, under current policies and macroeconomic assumptions, staff expects the CG deficit to stay above 1½ percent of GDP in 2015, broadly in line with the Ministry of Finance projections. At the same time, as lower growth has permanent effects on potential output and aging costs mount, the GG structural primary balance fails to improve markedly over the medium term. Gross public debt is projected at slightly more than 50 percent of GDP in 2015, hence rollover risks are limited. The retrenchment is equally divided between revenue and expenditure, though some measures are still to be properly defined. For example, the government program also includes generic steps such as shrinking the grey economy. The authorities agreed that current measures may prove insufficient and will review annually progress toward meeting the deficit and debt targets, identifying additional measures if needed.

[2] The government program target scenario.

Finland: Central Government Consolidation Measures, Net Cumulative Effect by 2015

Expenditure		EUR billion 1/
(-)	Cut central government transfers to local governments.	-1.1
(-)	Cut defence spending and materials procurement.	-0.2
(-)	Public administration ICT reform.	-0.1
(-)	Freeze University Index adjustment.	-0.1
(-)	Cut expenditure for reimbursement of prescription-only medicines under statutory health insurance.	-0.1
(-)	Cut business subsidies.	-0.1
(-)	Other expenditure cuts, net.	-0.5
	TOTAL, net	**-2.2**
Revenue		
(+)	Increase excise duties on alcohol, tobacco, sweets, soft drinks, and energy.	0.5
(+)	Increase all VAT rates by 1 percentage point (standard rate to increase to 24 percent).	0.9
(+)	Vehicle taxation.	0.2
(-)	Reduce corporate income tax rate from 26 percent to 24.5 percent.	-0.5
(+)	Freeze thresholds for earned income and investment income taxes.	0.8
(+)	Other revenue measures, net.	0.6
	TOTAL, net	**2.5**

Sources: Ministry of Finance; *Programme of the Finnish Government*, Prime Minister's Office, Finland; *Stability Programme for Finland 2012*, Ministry of Finance; *Revised Central Government Spending Limits 2012-15*, Ministry of Finance; *Central Government Spending Limits 2013-16*, Ministry of Finance; *Framework Agreement* (October, 2011), Central Labour Market Organisations of Finland.

1/ Ministry of Finance estimates.

29. The authorities' consolidation plan is apt, given long-term fiscal sustainability challenges. Fiscal policy in the medium-run must balance the conflicting objectives of supporting growth and making progress toward closing the sustainability gap (AN 6). Staff argued that a gradual structural adjustment, about ½ percent of GDP per annum, would strike an appropriate balance between output stabilization and fiscal sustainability. It would close the sustainability gap in 10 years with growth sufficient to eliminate the output gap over the medium term. The authorities' plans through 2015 are broadly in line with such an adjustment path (though, as noted earlier, in the absence of additional measures, actual tightening will be lower). Nevertheless, some officials expressed concern that adjustment fatigue and the political cycle could jeopardize fiscal tightening, were it smoothed over 10 years.

30. But discussions highlighted that it should be implemented flexibly to avoid harming growth.

- With the renewed slowdown in economic activity, the mission stressed that the planned adjustment should be delayed if growth were to falter significantly below potential. At least automatic stabilizers should be allowed to operate fully, and further structural consolidation postponed until a recovery has taken firm hold. Indeed, negative effects on demand from budget consolidation are likely to be higher when monetary policy has very limited ability to accommodate budget tightening as is currently the case. In addition, simultaneous fiscal consolidation in several European countries could have a larger-than-expected contractionary impact.

- The need for immediate fiscal consolidation is lessened by the fact that Finnish authorities have a strong track record in fiscal discipline. As noted, rollover risks are marginal. Despite the sustainability gap, financial markets still regard Finland as low risk. Moreover, the GG structural balance is expected to remain above the limit agreed at the European level over the medium-term without measures beyond those already identified.

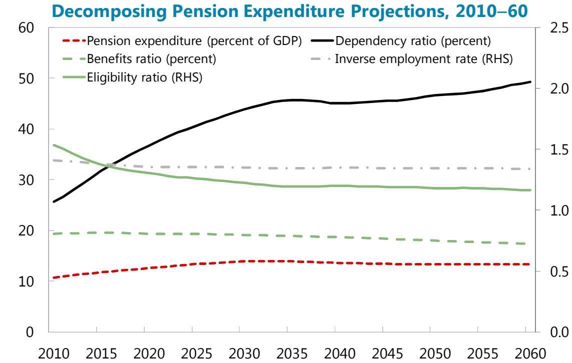
- These considerations suggest that flexibility in the implementation of the planned fiscal adjustment is both possible and desirable. The authorities generally agreed, but noted that, to warrant relaxation of their plan, the shock to the recovery would have to be considerable.

- The authorities and staff also considered that it might be preferable to substitute part of the headline tightening with structural measures that improve significantly fiscal sustainability, but only modestly impact the government balance and domestic demand in the short run. These include increasing the retirement age and boosting productivity in the public service system—the average effective retirement age was around 60 in 2007[3], and productivity in local governments has been on a declining trend for several years.

Long-Term Fiscal Sustainability

31. The long-term GG position is not yet fully sustainable, reflecting a rapidly aging population and the impact of the crisis. Specifically, staff estimates a sustainability gap of about 4¼ percent of GDP. This is lower than the assessment at the time of the last consultation (6 percent of GDP) because of stronger-than-anticipated fiscal performance in 2010 and adjustment in 2011 (AN 6). Nonetheless, with the onset of aging and the associated increase in health-care and long-term care costs, closing the gap requires action. Absent corrective measures, public debt is projected to rise to over 220 percent of GDP by 2060. Spreading uniformly the adjustment over a 10-year period, sustainability requires structural measures totaling 4½ percent of GDP. On balance, as noted above, this would therefore imply an adjustment of about ½ percent per annum, consistent with previous recommendations (Table 9, Figures 8–9).

Decomposing Pension Expenditure Projections, 2010–60



Sources: DG ECFIN: The 2009 Ageing Report and Fund staff calculations.

Measures to Achieve Sustainability

32. With an already high revenue ratio, it was accepted that there is little scope for further increases in the tax burden. Revenue measures should therefore focus on a broadening of the tax base and a shift from labor taxation to consumption and property-based taxation. Consumption and

[3] OECD Economic Surveys: Finland, 2010, Volume 2010/4, April.

property taxes are generally less distortionary than income taxes. In this connection, the one percentage point increase in the standard VAT rate and the energy tax hike are steps in the right direction; but more should be done, including by reducing the number of items on reduced VAT rates. Property tax rates are low by international comparison and the authorities agreed that higher rates would provide municipalities with a more stable source of income, creating scope for reducing municipalities' reliance on highly cyclical corporate taxes. Staff endorsed the authorities' plans to lower mortgage interest deductibility, which subsidizes home ownership and promotes indebtedness by households, potentially heightening vulnerabilities of the financial system.

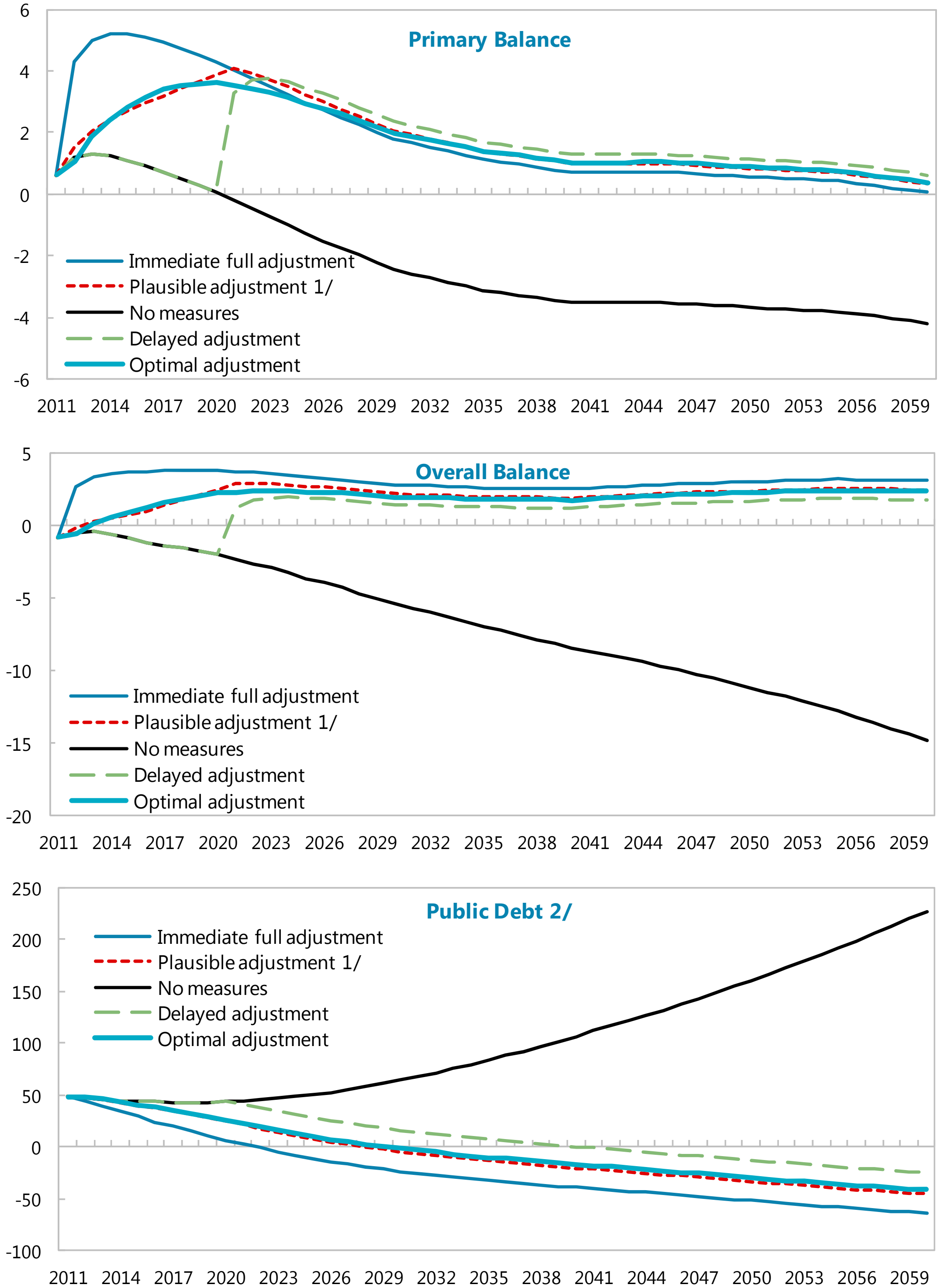
33. Therefore, expenditure measures will need to account for the majority of adjustment. With a rapidly aging population and associated increasing health care costs, priority should be given to measures that help restrain growth in demand for health- and long-term care, while improving efficiency in the provision of such services, as advocated by the OECD[4] and contain local government spending growth. The generosity of the social and unemployment benefits system could also be moderated. For example, unemployment and disability pipelines to early retirement should be further restricted (Table 10). Tuition fees and more loans in lieu of student grants for tertiary education could also help generate some expenditure savings, but also, and more importantly, encourage faster graduation and entry into the work force.

34. There was agreement that reform of the fiscal framework, especially for local governments (LG), could facilitate reaching sustainability. The authorities acknowledged that increased attention should be given to contain rapid expenditure growth in LG. This aim could be supported by moving toward expenditure ceilings for municipalities and by smoothing their revenue stream to avoid pro-cyclical spending peaks and troughs, thus strengthening long-term budget planning. Moreover, additional mergers of municipalities would pave the way for efficiency improvements. Nevertheless, officials remarked that constitutionally protected autonomy of LG complicated implementation of these steps, which required steady consensus-building among municipalities. As a result, LG reform has been postponed until at least 2013. Separately, staff argued that an independent fiscal council could analyze the macroeconomic framework to assess the realism of budgetary projections, together with a greater focus on risk analysis and the effects of potential downside scenarios (AN 7).

[4] OECD Economic Surveys: Finland, 2012, February. Notably, substantial efficiencies could be gained by merging municipalities—which provide the bulk of health care services—into sufficiently large units, and rationalizing the inefficient parallel funding system for health care. Long-term home care should also be encouraged.

Finland: Fiscal Sustainability, 2011–60

(Percent of GDP)



Sources: ECFIN: The 2009 Ageing Report and Fund staff calculations.

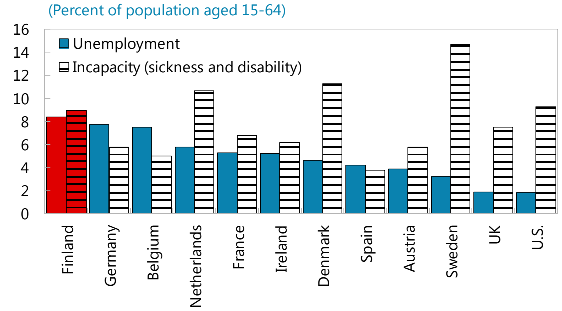
1/ The plausible adjustment scenario is that of uniform adjustment over a 10-year period.

2/ Negative public debt reflects the accumulation of assets.

E. Structural Reforms

35. With population aging and an imminent decline of working age cohorts, there was consensus that actions are needed to increase labor supply. Studies, including by the OECD and IMF[5], find a significant positive long-term effect of labor and product market reforms on total factor productivity, growth, and employment. The authorities noted that they have raised the effective retirement age in recent years and the latest agreement with social partners increases it by four months, while further measures are to be implemented by 2017. Also, labor market policies and benefits have been adjusted to hasten activation of the unemployed, while a tax deduction is planned to encourage work training programs. Staff welcomed such actions, while stressing that these efforts to boost employment could also be supported by further lowering the taxation of labor.

Income-Replacement Benefit Recipiency Rates 1/
(Percent of population aged 15-64)



Sources: Duell, N., D. Grubb, and S. Singh (2009), "Activation Policies in Finland," OECD Social, Employment and Migration Working Papers, No. 98, OECD Publishing and Fund staff calculations.
1/ Data are from 2004 and should be considered approximate.

36. Similarly, re-orienting R&D expenditures and strengthening competition in the service sector would enhance productivity, and thus growth. The authorities acknowledged the results of a recent review by the OECD[6] whereby R&D expenditure should be refocused on basic research with incentives adjusted to reward academic quality and are studying options in this area. Staff also observed that tuition fees and more reliance on loans rather than grants for students would improve the cost effectiveness of higher education. Additionally, the large productivity differential between manufacturing and services should be reduced by opening the service sector to more competition, particularly in wholesale and retail trade, not least by relaxing excessive municipal zoning restrictions. These efforts should be supported by strengthening resources and powers of the competition authority to enforce the new competition law of 2011. Opening the health care sector competition could also improve efficiency and help contain the buildup of aging pressures.

Model-Based Average Impacts of Structural Reforms on Growth in the OECD 1/

Policy	Definition of shock	Effect
Statutory retirement age	+ 1 year	+ 0.3 percent GDP per capita
Unemployment benefits, replacement rate	- 10 percentage points	+ 3 percent GDP per capita
Business R&D	+ 1 percent	+ 0.13 percent TFP growth
Public R&D	+ 1 percent	+ 0.17 percent TFP growth

Source: OECD.
1/ Assessment of the impact of structural reforms on growth or GDP should be taken with great caution.

[5] OECD Economic Surveys: Euro Area, 2012, and Barkbu, Rahman, Valdes, and staff team, "Fostering Growth in Europe Now," IMF Staff Discussion Note No. 12/07.

[6] OECD Economic Surveys: Finland, 2012, February.

37. Further municipality reform would also enhance public sector efficiency. Staff noted that such reform (¶34), together with more systematic benchmarking, could generate productivity gains at the LG level. This would be particularly important for the health-care sector, which is primarily within the purview of municipalities.

STAFF APPRAISAL

38. Despite strong foundations and policies, Finland's near-term outlook is threatened by intensifying external strains. As a result of adverse spillovers from the marked slowdown of activity in the EA, GDP growth is to decelerate markedly in 2012. Accordingly, output will fall further below potential in 2012 and inflation will moderate. Though activity should start to recover late in 2012, volatile financial market conditions and to a lesser extent structural fiscal consolidation (also in trading partners) will remain a hindrance. Competitiveness, albeit still adequate, has worsened significantly in recent years. Risks to the outlook—primarily from external sources—are tilted to the downside, with heightened uncertainties. The supply potential of the economy may have been significantly curbed by the crisis and the recent deterioration in competitiveness, aggravating the problems posed by aging, not least to fiscal sustainability.

39. Bank capital and, above all, liquidity buffers should be gradually enhanced. Though the Finnish system is well capitalized and liquid, progress is needed in some institutions with respect to the leverage ratio and liquidity to meet the prospective Basel III requirements. Moreover, volatile financial market conditions suggest that strengthening both capital and liquidity buffers would be prudent. To ease concerns posed by marked reliance on wholesale funding, high concentration, and dependence on foreign parent banks, upping liquidity cushions is particularly important. These aims should be pursued in stages over the medium term to prevent deleveraging.

40. Further steps toward strengthening supervision of nationally systemic banks and reinforcement of macro-prudential tools would be desirable. Contagion risk from systemic banks acting as liquidity hubs is exacerbated by heavy concentration in the Finnish banking system. Hence closer supervision and possibly more stringent prudential requirements for nationally systemic banks, such as additional capital buffers, higher liquidity provisions, and topped-up contributions to the Deposit Guarantee Fund would be appropriate. Supervisors should scrutinize carefully bank risk-taking behavior, in light of incentives to seek higher short-term profits, not least by pushing on credit growth, in an environment of low interest margins, given that most loans are based on floating rates and tied to Euribor rates, currently at historical lows. Allocation of the macro-prudential responsibility to the FIN-FSA in cooperation with other authorities as well as publication of standard definitions to calculate the loan-to-value ratio (LTV) and the planned introduction of countercyclical capital buffers are welcome. These steps should be complemented by granting the FIN-FSA authority to make LTV ceilings binding and implementing a national loan registry to guard against excessive borrowing.

41. There is scope to buttress further the effectiveness of cross-country supervision and crisis resolution mechanisms. MoUs are not binding and consideration should be given to strengthen their legal status. Mutual sharing of supervisory information could facilitate preparedness in host and home countries and should be enhanced. Joint contingency planning with other national authorities for cross-border resolution should be advanced with ex-ante burden-sharing guidelines defined to limit contagion. A common bank-resolution framework at the EU level would be preferable, but national or regional plans are advisable in the interim.

42. The fiscal stance planned through 2015 is appropriate, but should be implemented flexibly. Fiscal policy must balance the conflicting objectives of supporting growth and making progress toward closing the sustainability gap, arising from the impact of population aging on public expenditures. Thus, the broadly neutral fiscal policy for 2012 and the gradual structural tightening envisaged for 2013–2015 are appropriate, avoiding pro-cyclical withdrawal of support to the economy while beginning progress toward long-term sustainability. Specifically, this adjustment path eliminates the sustainability gap in 10 years, and allows for a steady reduction and eventual disappearance of the output gap by 2017. Given the unusual downside risks surrounding the recovery, the authorities should nevertheless stand ready to loosen budget policy if growth underperforms considerably, in particular letting automatic stabilizers operate fully and delaying further structural consolidation until a recovery has taken firm hold.

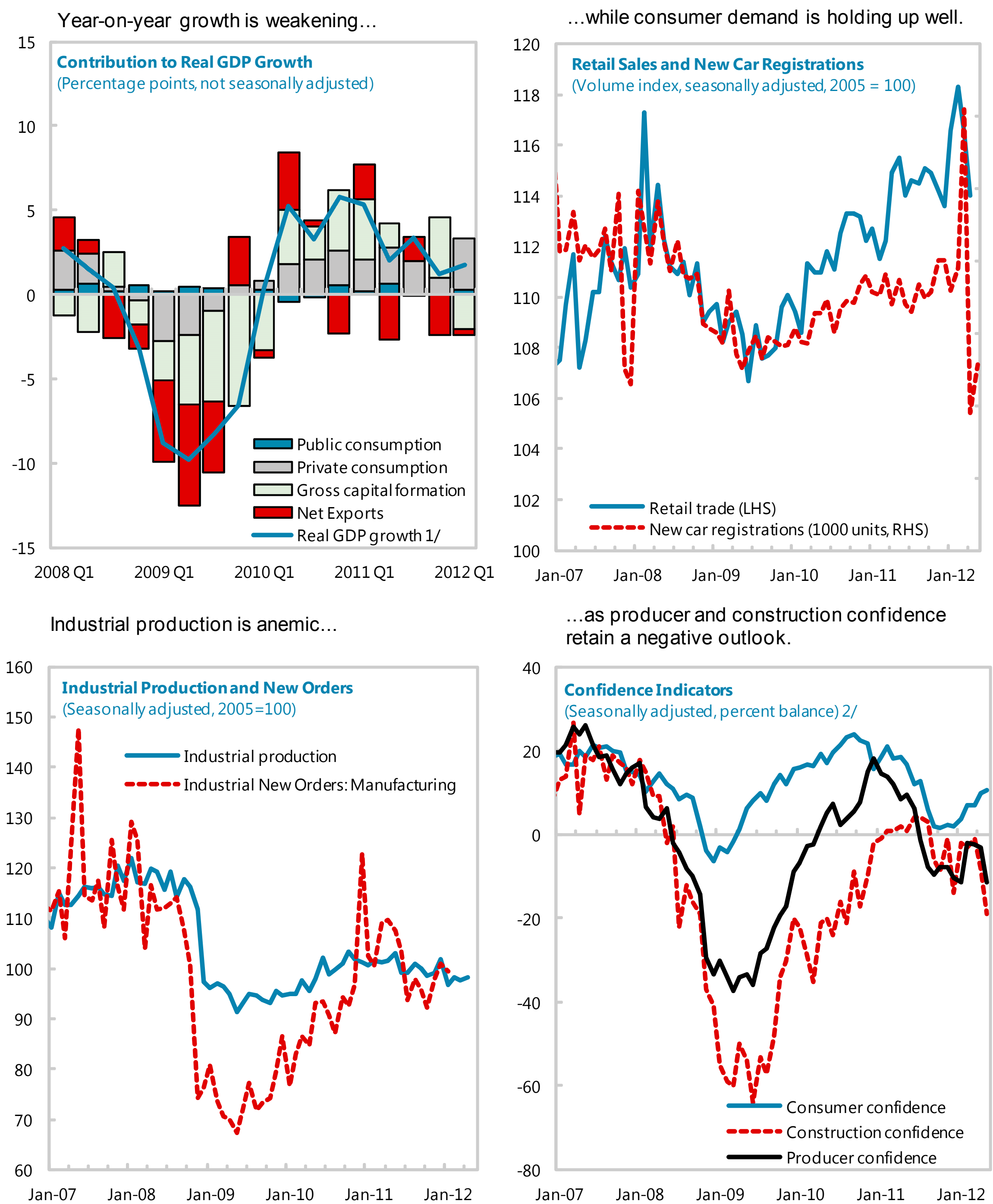
43. Measures that directly reduce the impact of aging on public expenditures or broaden the tax base should form a key plank of medium-term adjustment efforts. These include steps to mitigate the expected rise in health- and long-term care costs and further tighten unemployment and disability pipelines to early retirement as well as increases in the statutory minimum and maximum retirement ages. With an already high revenue ratio, there is little scope for further increases in the tax burden. Hence, revenue measures should focus on broadening the tax base, and shifting from labor taxation to less distortionary consumption- and property-based taxation, especially for LG, not least by reducing special treatments under the VAT and mortgage interest deductibility.

44. Improvements to the fiscal framework, notably for LG, would help achieve sustainability. Expenditure ceilings for municipalities could contribute to slow down increases in spending in LG. Reduced dependence on highly cyclical revenue sources would buttress long-term budget planning. Additional mergers of municipalities would pave the way for economies of scale.

45. To maintain potential growth amid the looming decline of working age cohorts and aging, policies should encourage greater labor force participation and productivity. Apart from raising statutory retirement ages, overhaul of tax and benefit systems ought to curtail disincentives to enter or stay in the labor market. Moreover, public R&D expenditures should be refocused on basic research rather than direct support to business R&D. Tuition fees and more reliance on loans rather than grants for students would likely improve higher education efficiency. Additionally, the large productivity differential between manufacturing and services should be reduced by opening the service sector to more competition. Similarly, opening the health care sector to competition could improve efficiency and help contain the buildup of aging pressures.

46. It is recommended that the next Article IV consultation be held on the current 24-month cycle.

Figure 1. Finland: Real Sector Developments, 2007–12

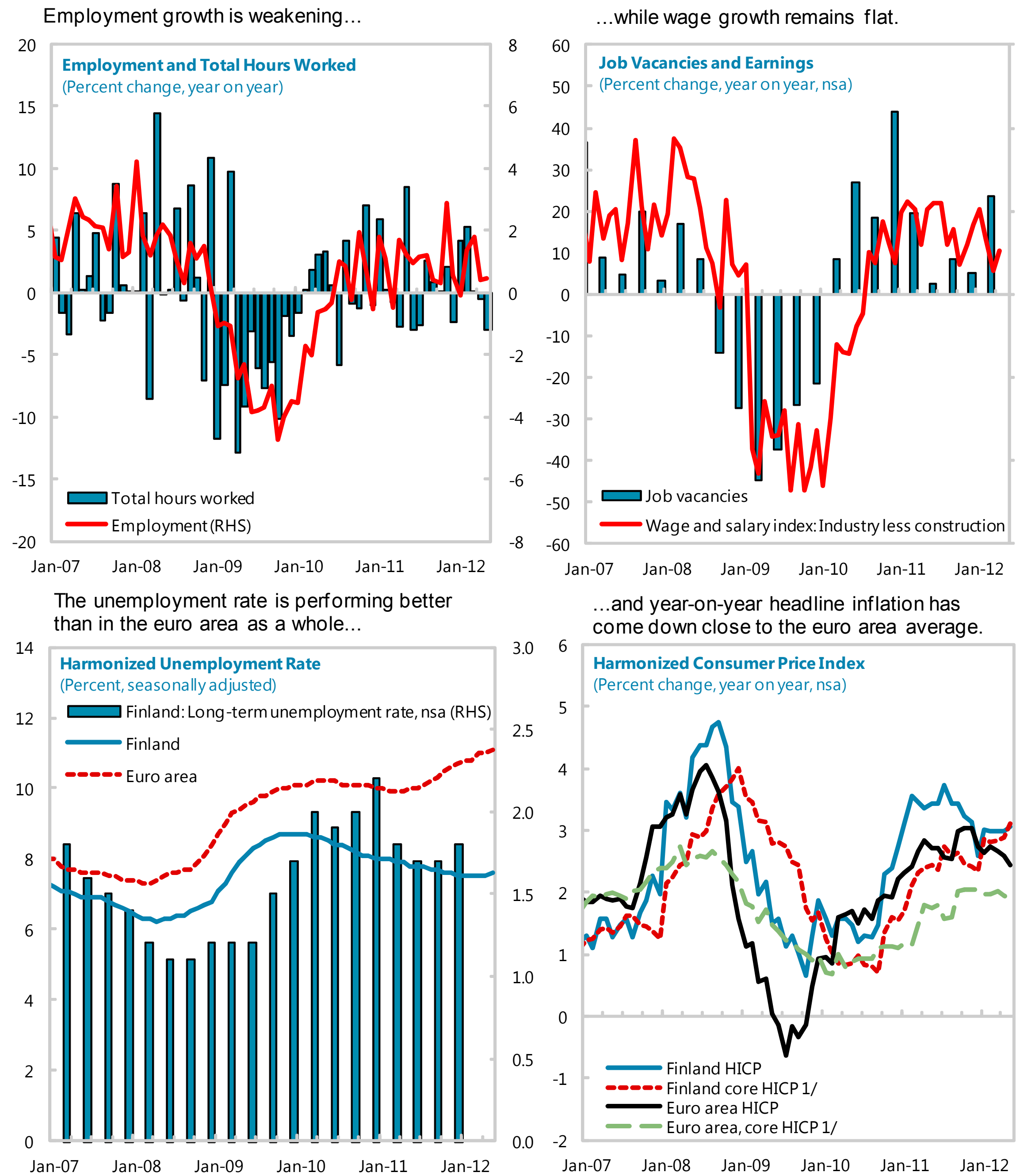


Sources: Eurostat, Finnish Authorities, Haver Analytics, and Fund staff calculations.

1/ Percent.

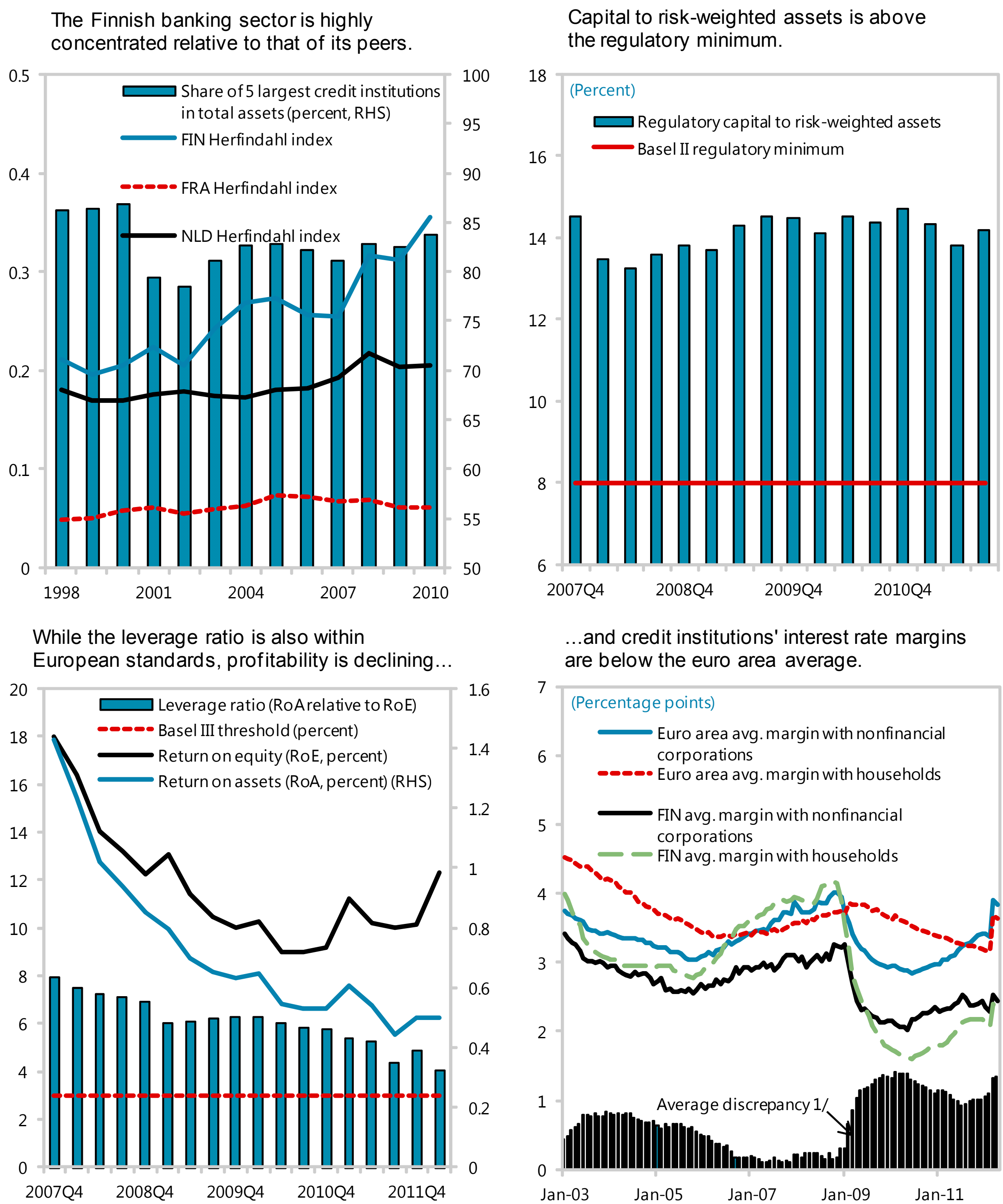
2/ Percent balance indicates the percentage of respondents reporting an increase minus the percentage of respondents reporting a decrease.

Figure 2. Finland: Labor Market and Inflation, 2007–12



Sources: Eurostat, Finnish Authorities, and Fund staff calculations.
1/ Core inflation is defined as headline inflation excluding energy and seasonal food.

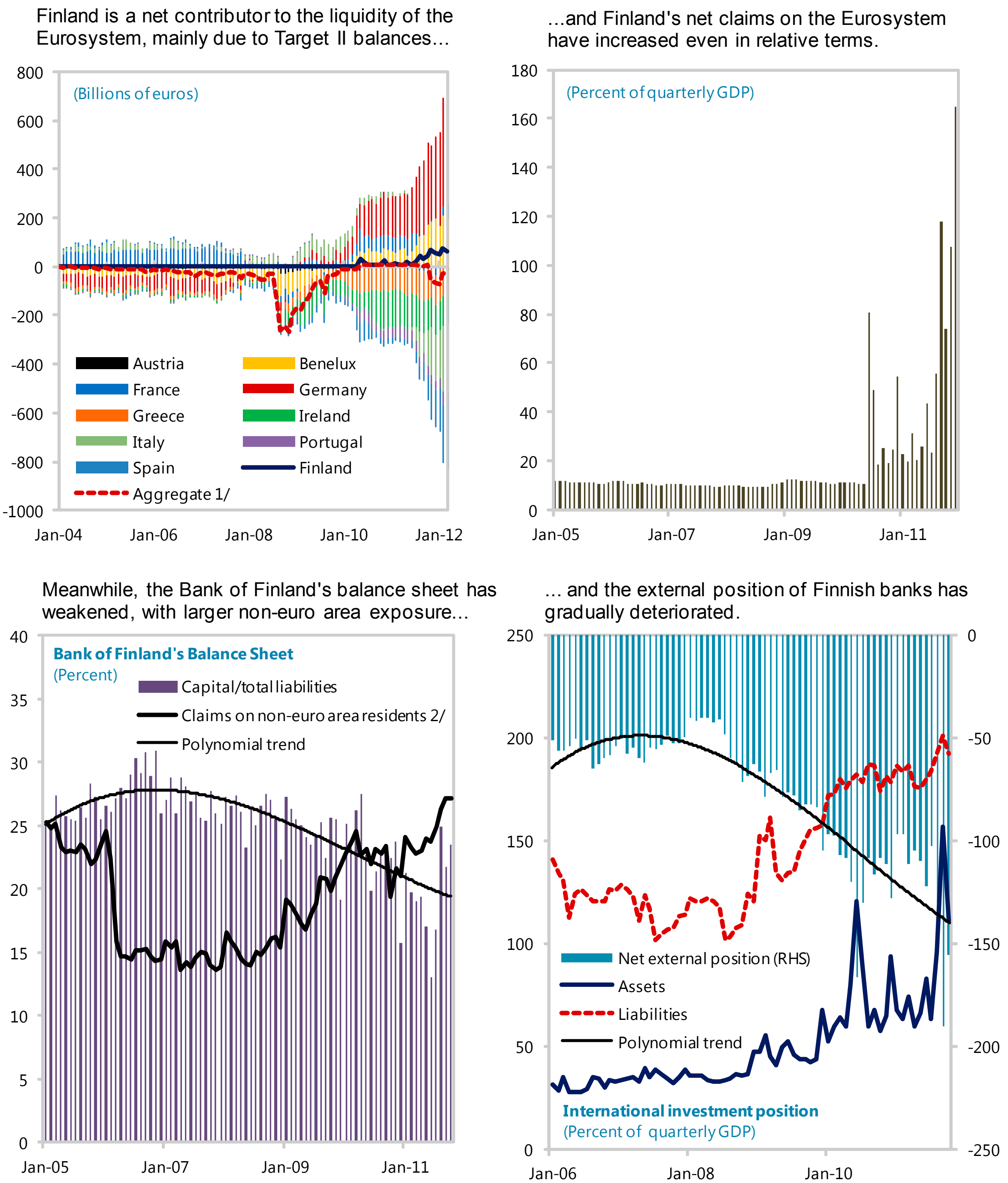
Figure 3. Finland: Financial Sector, 1998–2011



Sources: Bank of Finland, DataInsight, ECB Data Warehouse, FSI database, Haver Analytics, and Fund staff calculations.

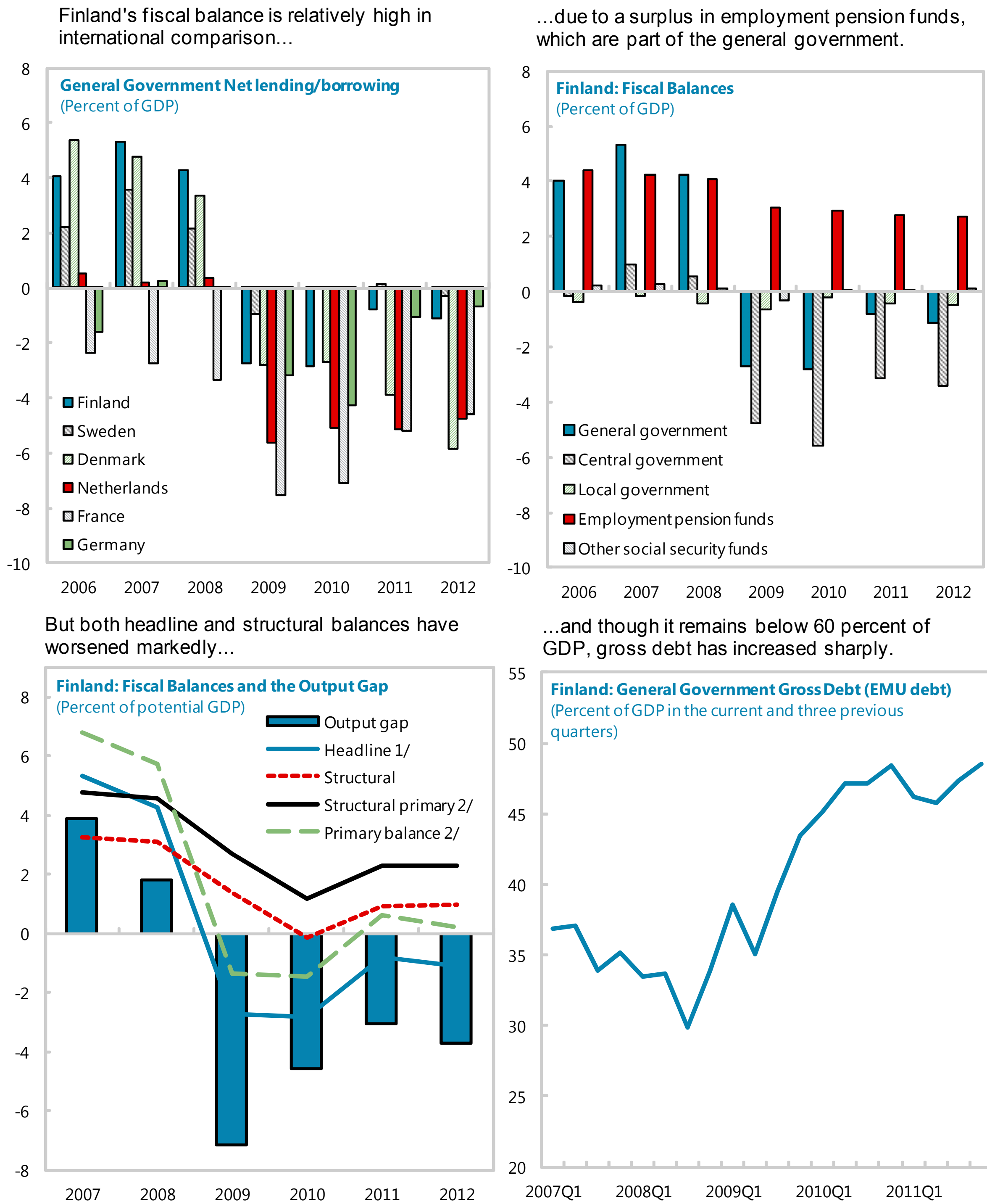
1/ The average discrepancy is a simple average of the difference in margins in the euro area and Finland for long-term loans to nonfinancial corporations and households.

Figure 4. Finland and Selected Countries: Financial Position, 2004–11



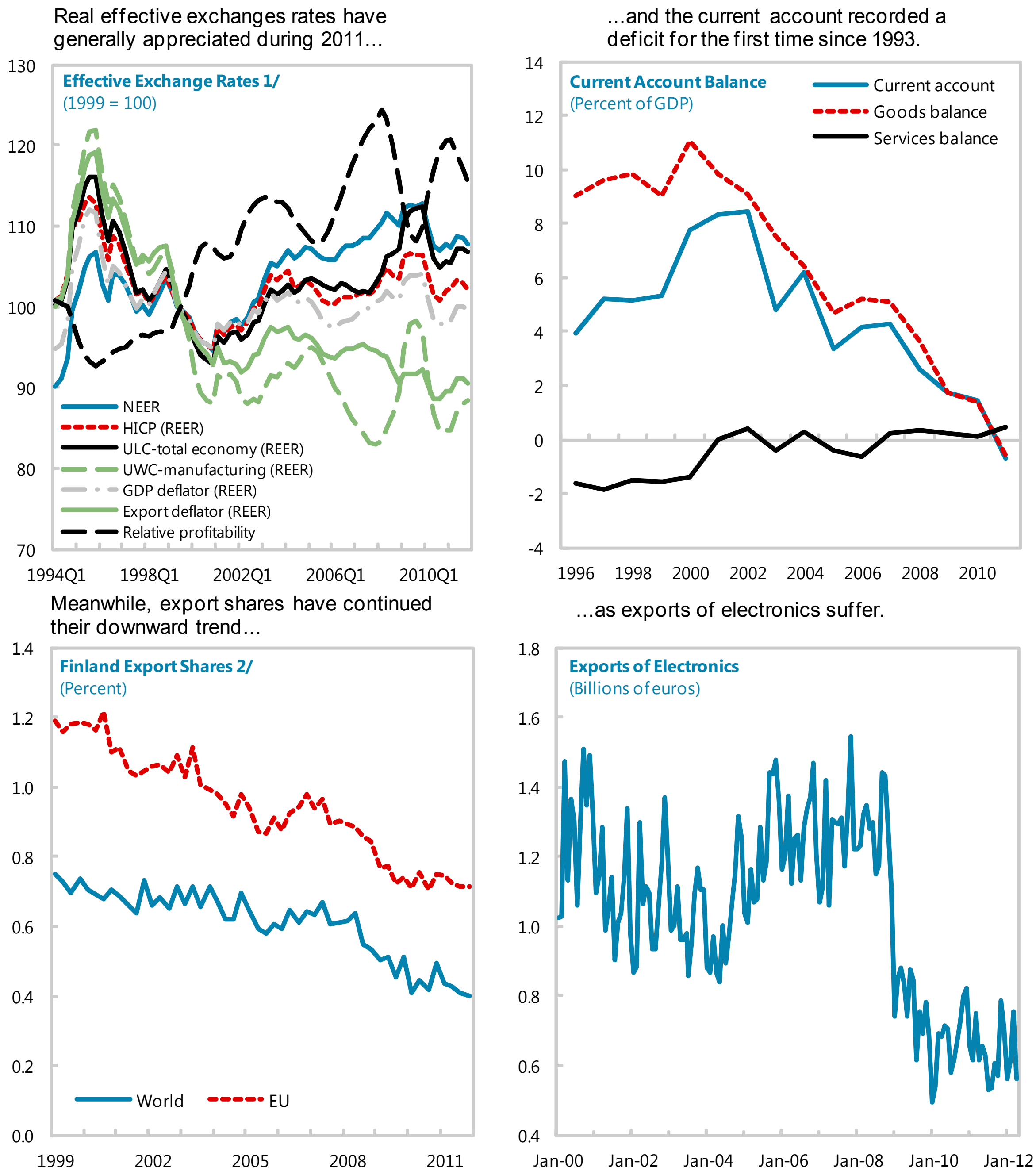
Sources: Bank of Finland, European Central Bank, and Fund staff calculations.
1/ Non-weighted net position of the eurosystem.
2/ Percent of quarterly GDP.

Figure 5. Finland and Selected Countries: Fiscal Sector, 2006–12



Sources: DataInsight, Finnish Ministry of Finance, Statistics Finland, and Fund staff calculations.
1/ Percent of GDP.
2/ Adjusted for interest expenditure.

Figure 6. Finland: External Developments, 2007–11



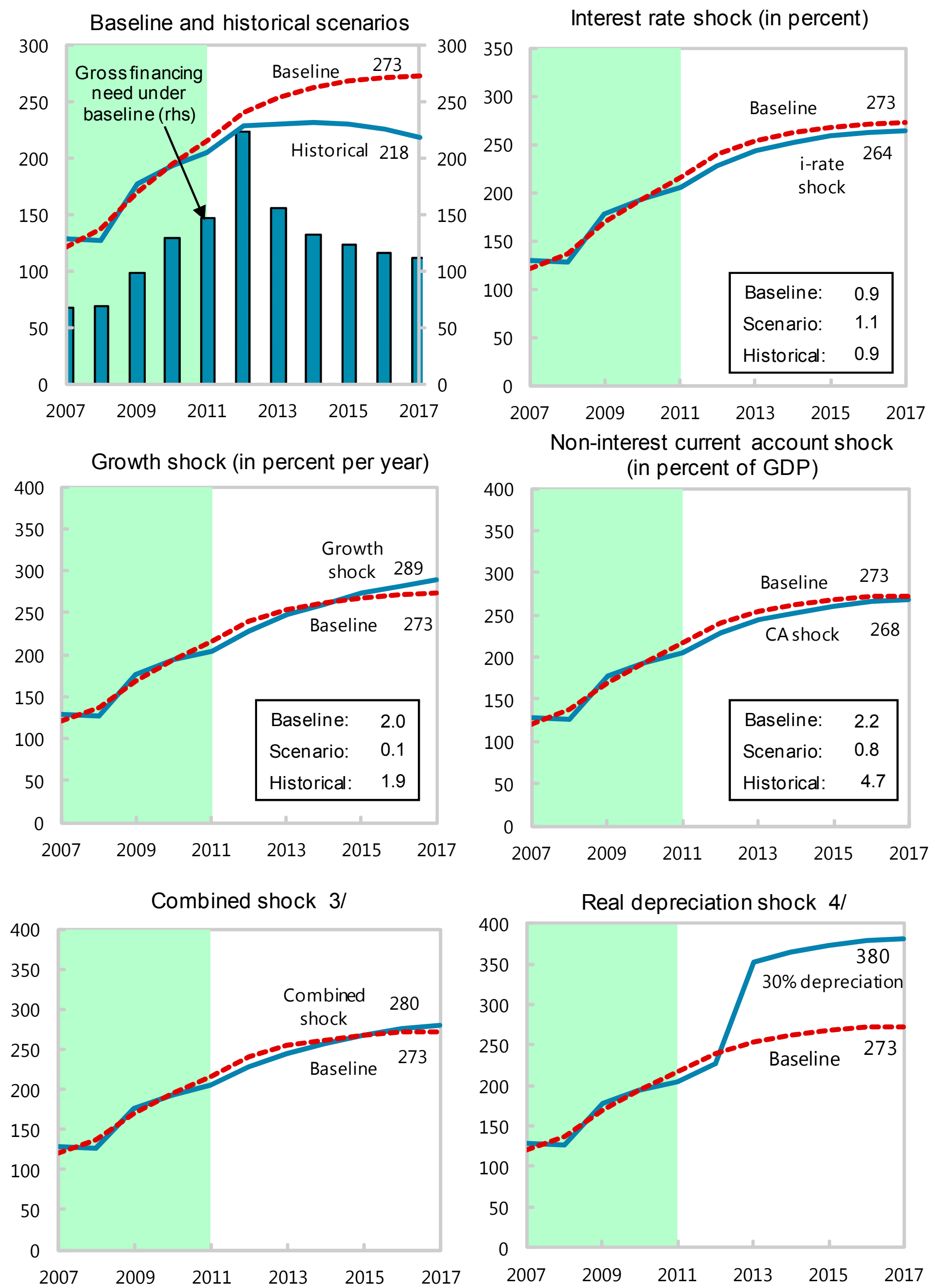
Sources: European Commission, DataInsight, Haver Analytics, International Financial Statistics, and Fund staff calculations.

1/ Based on data for 36 industrial countries.

2/ Computed as Finland's exports to the World and the EU in percent of total World and EU imports from the World, respectively.

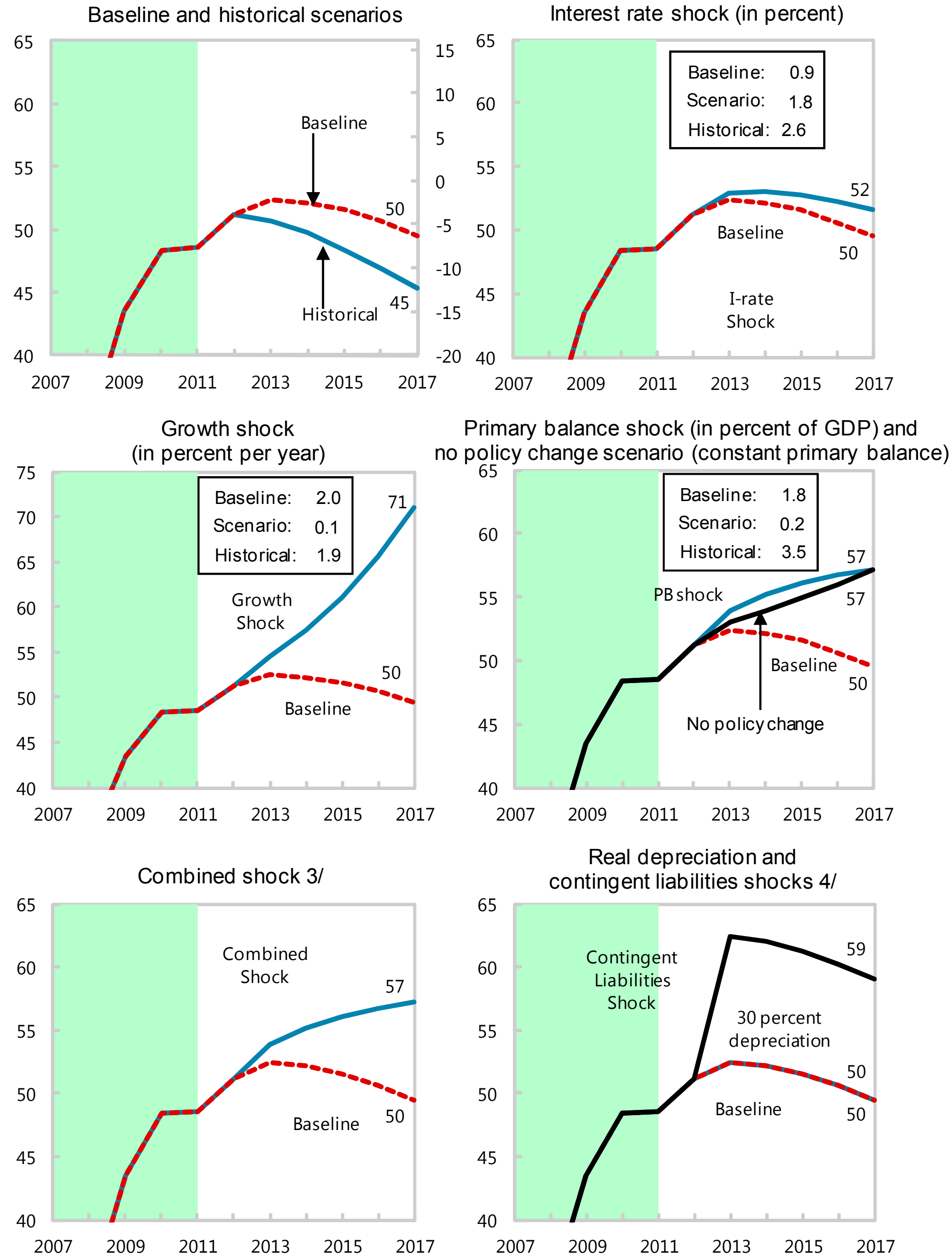
Figure 7. Finland: External Debt Sustainability: Bound Tests 1/ 2/

(External debt in percent of GDP)



Sources: International Monetary Fund: Country desk data, and Fund staff calculations.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2013.

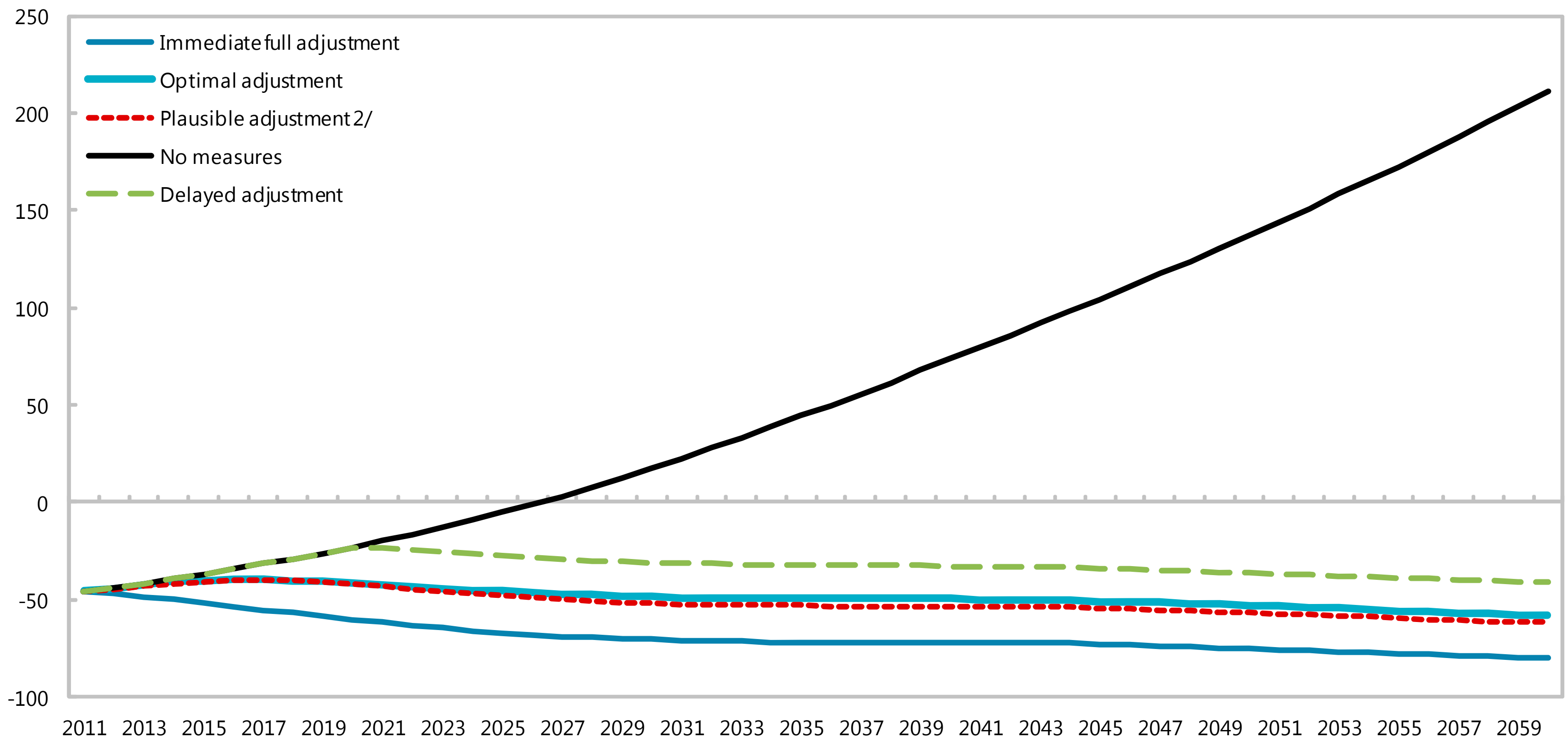
Figure 8. Finland: Public Debt Sustainability: Bound Tests 1/ 2/
(Public debt in percent of GDP)



Sources: International Monetary Fund country desk data, and Fund staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
4/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2012, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 9. Finland: Sustainability Analysis: Public Net Debt, 2011–60 1/

(In percent of GDP)



Sources: ECFIN: The 2009 Ageing Report, and Fund staff calculations.

1/ Net debt is defined as gross debt minus liquid financial assets.

2/ The plausible adjustment scenario is that of uniform adjustment over a 10-year period.

Table 1. Finland: Macroeconomic Framework, 2009–17

	2009	2010	2011	2012	2013	2014	2015	2016	2017
						Proj.			
				(Percentage change, unless otherwise indicated)					
Output and demand (volumes)									
GDP	-8.4	3.7	2.9	0.6	1.6	2.5	2.1	1.9	1.9
Domestic demand	-6.1	3.1	4.1	0.6	1.4	2.3	2.0	1.9	1.9
Private consumption	-2.7	3.0	3.1	3.3	1.8	2.6	2.3	2.1	2.0
Public consumption	1.1	0.2	0.8	0.6	0.5	0.8	0.8	0.8	0.8
Gross fixed capital formation	-13.3	2.6	4.3	-0.9	1.2	3.1	2.7	2.7	2.7
Change in stocks (contribution to growth in percent of GDP)	-2.0	0.8	1.8	-1.1	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	-21.5	7.8	-1.1	1.6	3.8	5.9	5.3	5.3	5.3
Imports of goods and services	-16.4	7.7	0.2	1.6	3.1	5.3	5.2	5.3	5.3
Net exports (contribution to growth in percent of GDP)	-3.0	0.1	-0.5	0.0	0.2	0.2	0.0	0.0	0.0
Prices, costs, and income									
Consumer price inflation (harmonized, average)	1.6	1.7	3.3	2.8	2.3	2.2	2.0	2.0	2.0
Consumer price inflation (harmonized, end-year)	1.8	2.8	2.6	2.5	2.3	2.2	2.0	2.0	2.0
GDP deflator	1.4	0.4	3.6	1.9	2.4	2.3	2.1	2.1	2.0
Unit labor cost, manufacturing	18.0	-10.0	-2.6	2.8	0.2	0.7	0.5	0.2	0.2
Labor market									
Labor force	-0.9	-0.2	0.4	0.3	0.0	0.0	0.0	0.1	0.1
Employment	-2.9	-0.4	1.1	0.4	-0.1	0.0	0.2	0.2	0.2
Unemployment rate (in percent)	8.2	8.4	7.8	7.7	7.8	7.7	7.6	7.5	7.4
Potential output and NAIRU									
Output gap (in percent of potential output) 1/	-7.2	-4.6	-3.1	-3.7	-3.2	-1.9	-1.1	-0.5	0.0
Growth in potential output	0.5	0.9	1.3	1.3	1.1	1.1	1.3	1.3	1.4
NAIRU (in percent)	7.7	7.6	7.6	7.5	7.5	7.5	7.5	7.4	7.4
					(In percent of GDP)				
General gvernment finances 2/									
Overall balance	-2.7	-2.8	-0.8	-1.1	-0.6	0.1	0.2	0.6	0.8
Primary balance 3/	-1.3	-1.5	0.6	0.2	0.7	1.5	1.8	2.3	2.5
Structural balance (in percent of potential GDP)	1.4	-0.1	0.9	1.0	1.3	1.1	0.8	0.9	0.8
Structural primary balance (in percent of potential GDP) 3/	2.7	1.2	2.3	2.3	2.5	2.5	2.4	2.5	2.5
Gross debt	43.5	48.4	48.5	51.2	52.4	52.2	51.6	50.6	49.5
Net debt (negative of net financial worth)	-62.8	-64.7	-59.8	-57.2	-54.5	-52.0	-50.1	-48.8	-47.7
					(In percent)				
Money and interest rates									
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	-1.7	4.8	6.9	…	…	…	…	…	…
Finnish MFI euro area loans (growth rate, e.o.p.)	1.4	6.3	6.2	…	…	…	…	…	…
3-month money market rate 4/	1.2	0.8	1.4	0.7	…	…	…	…	…
10-year government bonds yield 4/	3.7	3.0	3.0	2.0	…	…	…	…	…
					(In percent of GDP)				
National saving and investment									
Gross national saving	20.4	20.9	21.2	19.0	19.2	19.5	19.7	19.8	19.9
Gross domestic investment	18.6	19.5	21.9	19.7	19.5	19.6	19.7	19.8	19.9
					(In percent of GDP)				
Balance of payments									
Current account balance	1.8	1.4	-0.7	-0.7	-0.4	-0.1	0.0	0.0	0.0
Trade balance	1.8	1.4	-0.6	-0.1	0.0	0.2	0.3	0.3	0.3
Net international investment position	0.0	10.6	14.0	15.4	16.2	17.2	18.2	19.2	20.2
Gross external debt	169.0	194.1	216.0	240.2	254.1	262.0	268.1	271.4	272.5
Exchange rates (period average)									
Euro per US$	0.72	0.76	0.72	…	…	…	…	…	…
Nominal effective rate (appreciation in percent)	1.9	-4.5	0.0	…	…	…	…	…	…
Real effective rate (appreciation in percent) 5/	1.1	-5.4	0.0	…	…	…	…	…	…

Sources: Bank of Finland, International Financial Statistics, Information Notice System, Ministry of Finance, Statistics Finland, and Fund staff calculations.
1/ A negative value indicates a level of actual GDP that is below potential output.
2/ Fiscal projections include measures as specified in the Government Program.
3/ Adjusted for interest expenditure.
4/ 2012 data are from June 29.
5/ CPI-based real effective exchange rate.

Table 2. Finland: Indicators of Financial Vulnerability, 2005–12

	2005	2006	2007	2008	2009	2010	2011	2012	
Households									
Total household debt (in percent of GDP)	51.5	56.1	57.3	60.0	66.6	63.1	59.7	…	
Total household debt (in percent of disposable income)	91.9	101.2	105.4	107.5	107.6	113.4	114.4	…	
Financial assets/GDP	113.1	117.9	112.1	99.9	119.9	123.9	112.7	…	
Non-financial corporations									
Gross debt (in percent of GDP)	84.5	87.7	90.4	104.8	107.0	104.8	100.3	…	
Government									
General government debt (EMU definition, in percent of GDP)	41.7	39.6	35.2	33.9	43.5	48.4	48.6	…	
Central government debt (in percent of GDP)	37.2	34.9	30.6	29.4	37.8	42.7	42.7	…	
Banking sector									
Outstanding credit to nonfinancial corporations (annual percent change, e.o.p.)	7.8	8.4	12.9	18.8	-4.8	4.8	6.9	7.9	1/
Credit to households (percent change, e.o.p.)	15.1	13.0	11.2	8.0	5.5	6.2	5.2	5.4	1/
Housing loans in percent of total lending	…	42.1	42.0	40.9	43.3	43.0	38.4	38.7	1/
Asset quality									
Non-performing loans/total loans (in percent) 4/	0.40	0.39	0.38	0.48	0.51	0.47	0.53	0.60	1/
Capital adequacy									
Regulatory capital as percent of risk-weighted assets	17.2	15.1	15.1	13.6	14.6	14.4	15.4	…	2/
Regulatory tier 1 capital to risk-weighted assets	15.0	12.8	13.5	12.5	13.8	13.6	14.5	…	2/
Equity/total assets (in percent)	9.2	9.4	7.9	6.2	6.4	5.5	4.4	4.4	1/
Profitability									
Interest rate margin (percentage points, e.o.p.) 5/	2.3	2.6	2.6	2.4	1.6	1.5	1.8	1.7	1/
Net interest income (in percent of total income)	60.6	53.7	50.5	67.8	52.3	45.7	53.6	47.4	1/
Return on equity (in percent)	11.8	14.4	18.0	12.2	10.0	9.2	10.1	12.3	1/
Return on assets (in percent)	0.9	1.2	1.4	0.9	0.6	0.5	0.5	0.5	1/
Liquid assets/total assets (in percent) 6/	6.0	6.4	5.0	4.8	7.5	6.8	6.8	6.2	1/
Deposits as percent of assets	40.7	39.8	37.8	34.1	34.1	29.9	24.8	25.5	1/
Off-balance sheet liabilities/total assets (in percent)	16.4	18.4	18.7	13.8	15.6	13.6	10.8	11.1	1/
Asset prices									
Change in stock market index (in percent, e.o.p.)	31.1	17.9	20.5	-53.4	19.5	18.7	-30.1	-24.9	3/
Change in housing price index (in percent, year average)	8.0	7.8	6.0	0.9	-2.3	8.1	2.8	…	

Sources: Bank of Finland, Financial Supervision Authority, Finnish Bankers' Association, Haver Analytics, Statistics Finland, and Fund staff calculations.

1/ As of March 2012.

2/ As of December 2011.

3/ As of April, 2012, change since April, 2011.

4/ Loans are defined as the sum of claims on credit institutions, the public, and public sector entities.

5/ Average of margins (average lending rate minus average deposit rate) on loans to non-financial corporations and households for deposit, commercial, cooperative, and savings banks, and foreign branches.

6/ Liquid assets are defined as the sum of bills discounted by the central bank, debt securities, and the balance sheet item "liquid assets."

Table 3. Finland: General Government Statement of Operations, 2007–13

(In percent of GDP, unless otherwise indicated)

	2007	2008	2009	2010	2011	2012	2013
						Proj.	
Revenue	52.7	53.6	53.4	52.7	53.2	53.3	53.9
Tax revenues	30.8	30.6	29.8	29.5	30.4	30.4	30.9
Taxes on production and imports	13.0	12.9	13.4	13.3	14.0	14.3	14.7
Current taxes on income, wealth, etc.	17.5	17.4	16.1	15.9	16.1	16.0	16.0
Capital taxes	0.3	0.4	0.3	0.2	0.2	0.2	0.2
Social contributions	12.0	12.2	12.9	12.7	12.4	12.5	12.5
Grants	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Other revenue	9.7	10.6	10.4	10.3	10.2	10.1	10.3
Expenditure	47.4	49.3	56.1	55.5	54.0	54.4	54.5
Expense	47.1	48.9	55.5	55.2	53.6	54.0	54.0
Compensation of employees	12.9	13.3	14.7	14.4	13.9	13.9	13.7
Use of goods and services	9.3	10.0	11.3	11.4	11.1	10.8	10.9
Consumption of fixed capital (CFC)	2.1	2.1	2.2	2.1	2.1	2.1	2.1
Interest	1.5	1.5	1.4	1.4	1.4	1.3	1.3
Subsidies	1.3	1.3	1.4	1.5	1.4	1.4	1.4
Grants	1.0	1.1	1.3	1.2	1.2	1.2	1.2
Social benefits	17.2	17.7	20.8	20.9	20.3	21.0	21.1
Other expense	1.8	2.0	2.3	2.2	2.2	2.2	2.3
Net acquisition of nonfinancial assets	0.3	0.4	0.6	0.4	0.4	0.4	0.4
Net acquisition of nonfinancial assets excl. CFC	2.4	2.5	2.9	2.5	2.5	2.5	2.5
Consumption of fixed capital (CFC)	-2.1	-2.1	-2.2	-2.1	-2.1	-2.1	-2.1
Net operating balance	5.6	4.6	-2.1	-2.5	-0.4	-0.7	-0.1
Net lending/borrowing	5.3	4.2	-2.7	-2.8	-0.8	-1.1	-0.6
Net acquisition of financial assets	4.8	4.5	5.6	3.5	2.3	…	…
Currency and deposits	0.4	0.4	-0.9	2.7	1.2	…	…
Securities other than shares	-0.6	1.9	2.0	-4.1	1.1	…	…
Loans	0.0	1.9	1.6	0.4	-0.3	…	…
Shares and other equity	4.5	0.2	3.5	3.8	0.0	…	…
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	…	…
Financial derivatives	0.0	0.0	0.0	0.0	0.0	…	…
Other accounts receivable	0.5	0.0	-0.6	0.7	0.3	…	…
Net incurrence of liabilities	-0.4	0.2	8.3	6.5	3.2	…	…
Special Drawing Rights (SDRs)	0.0	0.0	0.0	0.0	0.0	…	…
Currency and deposits	0.0	0.0	0.0	0.0	0.0	…	…
Securities other than shares	-1.4	-0.7	6.4	6.7	2.1	…	…
Loans	0.4	0.6	0.6	0.3	1.3	…	…
Shares and other equity	0.0	0.0	0.0	0.0	0.0	…	…
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	…	…
Financial derivatives	-0.1	0.4	-0.2	-0.4	0.0	…	…
Other accounts payable	0.7	0.0	1.4	-0.1	-0.2	…	…
Memorandum items:							
Primary balance (excl. interest expense)	6.8	5.7	-1.3	-1.5	0.6	0.2	0.7
Structural balance (in percent of potential GDP)	3.2	3.1	1.4	-0.1	0.9	1.0	1.3
Structural primary balance (in percent of potential GDP) 1/	4.8	4.6	2.7	1.2	2.3	2.3	2.5
Robust balance (in percent of potential GDP)	-1.1	-1.8	-2.6	-3.7	-2.8	-2.9	-2.8
Central government net lending/borrowing	1.0	0.5	-4.8	-5.6	-3.1	-3.4	-2.6
General government gross debt	35.2	33.9	43.5	48.4	48.5	51.2	52.4
General government net debt 2/	-72.5	-52.2	-62.8	-64.7	-59.8	-57.2	-54.5
Central government gross debt	32.5	31.1	39.3	44.0	44.8	47.8	49.4
Output gap (percent of potential output)	3.9	1.8	-7.2	-4.6	-3.1	-3.7	-3.2
Nominal GDP (Euro bill.)	179.8	185.7	172.5	179.7	191.7	196.5	204.3

Sources: International Financial Statistics, Government Finance Statistics, Eurostat, Ministry of Finance, and IMF staff estimates.
1/ Adjusted for interest expenditure.
2/ Defined as the negative of net financial worth.

Table 4. Finland: General Government Integrated Balance Sheet, 2005–10
(In percent of GDP)

	2005	2006	2007	2008	2009	2010
Net worth	…	…	…	…	…	…
Nonfinancial assets	…	…	…	…	…	…
Net financial worth	58.6	69.4	72.5	52.2	62.8	64.7
Financial assets	107.0	115.0	113.9	92.5	114.5	122.5
Currency and deposits	5.9	6.3	6.2	6.5	6.0	8.5
Securities other than shares	28.3	26.3	23.1	22.9	27.2	21.8
Loans	12.4	12.2	11.3	12.8	15.4	15.2
Shares and other equity	55.5	64.5	66.8	44.7	60.9	70.8
Insurance technical reserves	0.0	0.0	0.1	0.1	0.1	0.1
Financial derivatives	0.1	1.3	1.8	1.1	0.6	1.2
Other accounts receivable/payable	4.6	4.4	4.6	4.5	4.3	4.8
Liabilities	48.4	45.6	41.4	40.4	51.8	57.8
Currency and deposits	0.2	0.2	0.2	0.2	0.3	0.3
Securities other than shares	36.7	33.9	29.3	28.6	37.3	43.0
Loans	7.1	6.3	6.1	7.2	7.7	7.7
Shares and other equity	0.1	0.0	0.0	0.0	0.0	0.3
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0
Financial derivatives	-0.2	0.9	1.0	-0.2	0.3	0.6
Other accounts receivable/payable	4.4	4.3	4.7	4.5	6.2	6.0

Sources: Global Insight, Government Finance Statistics, and Fund staff calculations.

Table 5. Finland: Balance of Payments, 2009–17

(In billions of euro, unless otherwise indicated)

	2009	2010	2011	2012	2013	2014	2015	2016	2017
				Proj.					
Current account	3.1	2.6	-1.3	-1.4	-0.8	-0.1	0.0	0.0	0.0
(percent of GDP)	1.8	1.4	-0.7	-0.7	-0.4	-0.1	0.0	0.0	0.0
Goods and services	3.5	2.8	-0.2	-0.3	0.4	1.1	1.2	1.3	1.3
(percent of GDP)	2.0	1.5	-0.1	-0.1	0.2	0.5	0.5	0.6	0.5
Exports of goods and services	65.1	72.8	75.8	78.7	81.9	86.6	91.2	96.2	101.6
Goods	45.1	52.5	56.7	58.4	60.7	64.2	67.4	70.9	74.7
Services	20.0	20.3	19.1	20.3	21.2	22.4	23.8	25.3	26.9
Imports of goods and services	-61.6	-70.0	-75.9	-79.0	-81.5	-85.6	-90.1	-94.9	-100.2
Goods	-42.1	-49.9	-57.8	-58.5	-60.8	-63.7	-66.8	-70.3	-74.0
Services	-19.6	-20.1	-18.2	-20.5	-20.7	-21.9	-23.2	-24.7	-26.2
Income	1.3	1.5	0.6	0.5	0.6	0.6	0.7	0.7	0.8
Compensation of employees	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Investment income	1.0	1.2	0.3	0.3	0.3	0.3	0.4	0.4	0.4
Current transfers	-1.7	-1.7	-1.6	-1.7	-1.7	-1.8	-1.9	-2.0	-2.1
(of which, official)	-2.1	-2.0	-2.0	-2.1	-2.1	-2.2	-2.3	-2.4	-2.5
Capital and financial account	5.2	-2.9	9.7	1.4	0.8	0.1	0.0	0.0	0.0
Capital account	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	5.0	-3.1	9.5	1.2	0.6	0.0	-0.1	-0.2	-0.2
Direct investment	-3.3	-2.8	-3.9	-2.0	-2.1	-2.2	-2.1	-1.9	-2.4
In Finland	0.3	5.1	0.0	3.0	3.1	3.3	3.1	2.9	2.6
Abroad	-3.5	-7.9	-3.9	-5.0	-5.2	-5.5	-5.2	-4.8	-5.0
Portfolio investment	-5.9	-7.6	9.6	9.7	9.7	9.8	9.8	9.9	9.9
Financial derivatives	2.2	-0.4	0.6	0.0	0.0	0.0	0.0	0.0	0.0
Other investment	12.6	6.1	3.4	-6.4	-7.0	-7.6	-7.9	-8.1	-7.7
Assets	-8.8	-29.6	-81.4	-55.5	-40.0	-35.0	-30.0	-25.0	-20.0
Liabilities	21.4	35.6	84.9	49.1	33.0	27.4	22.1	16.9	12.3
Official	-4.4	-15.2	-9.1	-6.4	-5.1	-4.6	-4.1	-3.7	-3.3
Private	17.0	21.2	12.6	0.0	-1.9	-3.0	-3.7	-4.4	-4.4
Reserve assets	-0.6	1.7	-0.3	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-8.3	0.3	-8.4	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:									
GDP at current prices	172.5	179.7	191.7	196.5	204.3	214.3	223.3	232.4	241.6

Sources: Bank of Finland, Statistics Finland, and Fund staff calculations.

Table 6. Finland: Net International Investment Position, 2003–11
(In percent of GDP, unless otherwise indicated)

	2003	2004	2005	2006	2007	2008	2009	2010	2011
Assets	156.2	178.1	195.5	209.8	212.9	221.3	266.9	315.8	364.1
Direct investment abroad	41.4	41.0	44.1	44.1	44.0	44.2	52.0	57.1	56.0
Portfolio investment abroad	58.2	70.6	83.1	98.0	96.7	69.6	101.4	118.0	108.5
Other investment abroad	50.5	60.3	62.2	64.3	69.0	104.3	108.9	136.8	195.4
Loans and deposits	31.2	35.0	37.3	42.0	42.9	44.3	55.6	67.4	90.9
Trade credits	3.5	4.3	3.8	3.5	4.1	3.3	3.2	3.2	3.2
Other debt liabilities	1.6	2.3	2.3	2.0	1.9	6.4	3.1	5.9	5.1
Financial derivatives	14.2	18.7	18.8	16.8	20.2	50.2	47.0	60.3	96.3
Reserve assets	6.1	6.2	6.1	3.4	3.2	3.2	4.6	4.0	4.2
Liabilities	182.6	188.1	210.7	223.6	240.8	231.0	266.8	305.2	350.1
Direct investment in Finland	27.3	27.7	29.5	32.3	34.6	32.3	34.1	35.6	33.5
Portfolio investment in Finland	108.2	107.0	124.0	132.6	143.4	95.6	117.8	125.3	113.8
Other investment abroad	47.1	53.5	57.2	58.7	62.8	103.1	114.9	144.2	202.9
Loans and deposits	29.2	30.9	33.8	37.0	38.2	46.9	60.9	75.1	101.8
Trade credits	2.4	2.5	3.1	2.8	2.9	3.3	3.0	3.4	3.3
Other debt liabilities	1.3	2.0	2.0	2.6	2.4	2.8	5.2	8.2	5.6
Financial derivatives	14.2	18.1	18.3	16.3	19.3	50.1	45.7	57.5	92.2
Net international investment position	-26.4	-10.0	-15.3	-13.8	-27.9	-9.7	0.0	10.6	14.0
Direct investment	14.0	13.3	14.6	11.7	9.4	11.8	17.9	21.4	22.5
Portfolio investment	-50.0	-36.4	-40.9	-34.6	-46.7	-26.0	-16.5	-7.4	-5.3
Other investment abroad	3.4	6.8	5.0	5.6	6.2	1.2	-6.0	-7.4	-7.5
Loans and deposits	1.9	4.2	3.5	5.1	4.7	-2.6	-5.3	-7.7	-10.8
Trade credits	1.1	1.8	0.7	0.7	1.2	0.1	0.2	-0.2	-0.1
Other debt liabilities	0.3	0.3	0.3	-0.7	-0.5	3.6	-2.1	-2.3	-0.6
Financial derivatives	0.1	0.6	0.5	0.5	0.9	0.1	1.3	2.8	4.1
Reserve assets	6.1	6.2	6.1	3.4	3.2	3.2	4.6	4.0	4.2
Memorandum item:									
GDP at current prices (in billions of euros)	145.5	152.3	157.4	165.8	179.8	185.7	172.5	179.7	191.7

Sources: Bank of Finland, Statistics Finland, and Fund staff calculations.

Table 7. Finland: External Debt Sustainability Framework, 2007–17

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	2007	2008	2009	2010	2011			2012	2013	2014	2015	2016	2017	Debt-stabilizing non-interest current account 6/
1 **Baseline: External debt**	121.1	137.2	169.0	194.1	216.0			**240.2**	**254.1**	**262.0**	**268.1**	**271.4**	**272.5**	**-7.6**
2 Change in external debt	-1.0	16.1	31.8	25.1	21.9			24.3	13.9	7.9	6.1	3.3	1.1	
3 Identified external debt-creating flows (4+8+9)	-17.5	-4.4	19.1	3.6	-19.4			-1.3	-4.2	-6.9	-6.2	-6.2	-5.9	
4 Current account deficit, excluding interest payments	-5.6	-4.2	-2.5	-1.9	0.0			-0.9	-1.7	-2.2	-2.3	-2.4	-2.3	
5 Deficit in balance of goods and services	-5.3	-4.0	-2.0	-1.5	0.1			0.1	-0.2	-0.5	-0.5	-0.6	-0.5	
6 Exports	45.9	47.2	37.7	40.5	39.5			40.1	40.1	40.4	40.9	41.4	42.0	
7 Imports	40.6	43.1	35.7	38.9	39.6			40.2	39.9	39.9	40.3	40.8	41.5	
8 Net non-debt creating capital inflows (negative)	5.9	10.2	2.0	3.8	0.5			-0.8	-0.8	-0.9	-1.0	-1.1	-0.9	
9 Automatic debt dynamics 1/	-17.7	-10.4	19.6	1.7	-19.9			0.4	-1.7	-3.8	-2.9	-2.6	-2.6	
10 Contribution from nominal interest rate	1.3	1.5	0.8	0.5	0.7			1.7	2.1	2.2	2.3	2.4	2.3	
11 Contribution from real GDP growth	-5.5	-0.3	13.0	-6.4	-5.1			-1.3	-3.8	-6.0	-5.2	-5.0	-5.0	
12 Contribution from price and exchange rate changes 2/	-13.5	-11.5	5.8	7.6	-15.5			...	...	...	...	...	...	
13 Residual, incl. change in gross foreign assets (2-3) 3/	16.4	20.5	12.7	21.5	41.2			25.6	18.1	14.8	12.2	9.5	6.9	
External debt-to-exports ratio (in percent)	263.7	290.9	447.8	479.4	546.4			599.5	634.0	648.2	656.2	655.7	648.2	
Gross external financing need (in billions of US dollars) 4/	162.9	185.8	233.8	305.8	388.4			562.9	399.7	352.7	342.5	333.8	333.4	
in percent of GDP	66.1	68.0	97.3	128.2	145.6	10-Year	10-Year	223.3	155.0	130.9	122.5	115.2	111.3	
Scenario with key variables at their historical averages 5/								**228.1**	**230.4**	**232.1**	**230.0**	**225.2**	**217.9**	**-10.9**
Key Macroeconomic Assumptions Underlying Baseline						Historical Average	Standard Deviation							
Real GDP growth (in percent)	5.3	0.3	-8.4	3.7	2.9	1.9	3.9	0.6	1.6	2.5	2.1	1.9	1.9	
GDP deflator in US dollars (change in percent)	12.4	10.5	-4.0	-4.3	8.7	6.2	7.5	-6.1	0.7	2.0	1.7	1.6	1.5	
Nominal external interest rate (in percent)	1.3	1.4	0.5	0.3	0.4	0.9	0.4	0.7	0.9	0.9	0.9	0.9	0.9	
Growth of exports (US dollar terms, in percent)	19.8	13.8	-29.6	6.5	9.2	8.3	14.2	-4.2	2.3	5.5	4.9	5.0	5.0	
Growth of imports (US dollar terms, in percent)	17.8	17.8	-27.2	8.2	13.8	11.3	14.5	-4.1	1.5	4.7	4.8	4.9	5.1	
Current account balance, excluding interest payments	5.6	4.2	2.5	1.9	0.0	4.7	2.8	0.9	1.7	2.2	2.3	2.4	2.3	
Net non-debt creating capital inflows	-5.9	-10.2	-2.0	-3.8	-0.5	-3.8	3.7	0.8	0.8	0.9	1.0	1.1	0.9	

1/ Derived as $[r - g - \rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock, with r = nominal effective interest rate on external debt; ρ = change in domestic GDP deflator in US dollar terms, g = real GDP growth rate, ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as $[-\rho(1+g) + \varepsilon\alpha(1+r)]/(1+g+\rho+g\rho)$ times previous period debt stock. ρ increases with an appreciating domestic currency ($\varepsilon > 0$) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Table 8. Finland: FSAP Update Recommendations, 2010

Recommendation	Status
Financial Stability Analysis	
Monitor bank mortgage pricing practices and household debt service capacity closely. Increase efforts to compile information on banks' mortgage portfolio, including loan-to-value (LTV) ratios. Frequency: annually.	Broadly implemented: Survey on pricing practices conducted in 2010; unified standard methodology on LTV calculation from July 2012.
Enhance the top-down stress testing framework by (i) modeling macro-financial linkages on a bank-by-bank basis; (ii) further integrating bank and sectoral data; (iii) incorporating financial conglomerate dimension; and (iv) improving the synergies between the Bank of Finland's (BOF) Research and Financial Stability Divisions and the FIN-FSA. Exercise can be conducted quarterly.	Mostly completed with macro-financial modeling linkages, annual top-down stress testing exercises, and close cooperation between the FIN-FSA and the BoF. Under way: improvement of existing models including liquidity stress tests.
Make available quarterly core financial soundness indicators using the data dissemination system already in place.	Implemented.
Enhance the current framework to assess systemic risk by: (i) using more detailed information on cross-border exposures; (ii) including all nonbank elements of the financial sector and cross-border linkages; (iii) establishing cross-border cooperation on systemic risk assessment with other authorities; and (iv) integrating the framework in the set of supervisory tools, to better feed into policy action.	Implemented: Regional MoU (2010); supervisory colleges set up that use detailed quarterly liquidity reports and closely monitor cross-border financial institutions.
Safety Net	
Set up a bank-specific resolution regime to enhance cost-effectiveness and speed of bank resolution.	Not implemented: To be implemented with the EU27 Resolution Regime.
Use Core Principles for Effective Deposit Insurance Systems to evaluate and assure operational resources of the Deposit Insurance Scheme commensurate with needs.	Largely implemented on governance, protection of depositors, funding, coverage, and cooperation with other safety net participants, including central banks and supervisors.
Supervision and Regulation	
Improve FIN-FSA's supervisory powers to impose administrative fines and/or penalty payments beyond the current securities markets related scope; increase the maximum amount of such fines and penalties.	Partly implemented: Securities: Higher penalties and stronger authority of FIN-FSA; insurance: FIN-FSA lacking sanctioning power except for reporting issues; banks: enhanced supervisory powers only with Basel III.
Increase the effectiveness of cross-border supervision, including information sharing with home supervisors with respect to the activity of foreign branches.	Largely implemented: Nordic/Baltic countries MoU (08/2010) on exchange of information, enhanced cooperation framework, and management and resolution of cross-border systemic crises.
Increase the focus on liquidity risk, using the forthcoming liquidity standard of FIN-FSA as a catalyst for detailed analysis of supervised institutions' funding profiles.	Implemented: BoF and FIN-FSA quarterly monitor banks' liquidity and are in the process of developing liquidity stress tests. Collateral availability and quality is reviewed weekly bank by bank.
Further integrate procedures and practices of banking and insurance supervision, with a view to enhancing FIN-FSA's analysis of the (consolidated) risk profile of complex financial groups active in Finland.	Mostly implemented: Unified on-site inspection and supervisory processes; cross-utilization of expertise in supervising market risks and in model validation.

Table 9. Finland: Public Sector Debt Sustainability Framework, 2007–17

(In percent of GDP, unless otherwise indicated)

		Actual					Projections						
		2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	Debt-stabilizing primary balance 9/
1	**Baseline: Public sector debt 1/**	35.2	33.9	43.5	48.4	48.5	**51.2**	**52.4**	**52.2**	**51.6**	**50.6**	**49.5**	**-0.2**
	o/w foreign-currency denominated	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
2	Change in public sector debt	-4.5	-1.2	9.5	4.9	0.1	2.6	1.2	-0.3	-0.6	-1.0	-1.1	
3	Identified debt-creating flows (4+7+12)	-8.4	-5.3	5.3	1.1	-2.2	-0.1	-1.4	-2.5	-2.3	-2.6	-2.7	
4	Primary deficit	-6.8	-5.7	1.3	1.5	-0.6	-0.2	-0.7	-1.5	-1.8	-2.3	-2.5	
5	Revenue and grants	52.7	53.6	53.4	52.7	53.2	53.3	53.9	54.1	54.2	54.4	54.5	
6	Primary (noninterest) expenditure	46.0	47.9	54.7	54.2	52.6	53.1	53.2	52.6	52.4	52.1	52.0	
7	Automatic debt dynamics 2/	-1.6	0.4	4.0	-0.4	-1.6	0.1	-0.7	-1.0	-0.5	-0.4	-0.2	
8	Contribution from interest rate/growth differential 3/	-1.6	0.4	4.0	-0.4	-1.6	0.1	-0.7	-1.0	-0.5	-0.4	-0.2	
9	Of which contribution from real interest rate	0.3	0.5	0.9	1.2	-0.3	0.4	0.1	0.2	0.5	0.6	0.7	
10	Of which contribution from real GDP growth	-1.9	-0.1	3.1	-1.6	-1.3	-0.3	-0.8	-1.2	-1.0	-1.0	-0.9	
11	Contribution from exchange rate depreciation 4/	0.0	0.0	0.0	0.0	0.0	...	...	...	...	...	...	
12	Other identified debt-creating flows	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
13	Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
14	Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
15	Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
16	Residual, including asset changes (2-3) 5/	3.9	4.1	4.2	3.8	2.4	2.7	2.6	2.2	1.8	1.6	1.6	
	Public sector debt-to-revenue ratio 1/	66.7	63.4	81.5	91.8	91.2	96.1	97.3	96.4	95.1	93.1	90.8	
	Gross financing need 6/	-1.2	-0.1	7.9	10.9	8.4	7.3	7.0	6.4	6.3	5.8	5.5	
	in billions of U.S. dollars	-3.0	-0.2	18.9	26.0	22.3	18.3	18.0	17.3	17.5	16.9	16.5	
	Scenario with key variables at their historical averages 7/						**51.2**	**50.7**	**49.8**	**48.4**	**46.9**	**45.3**	**0.3**
	Scenario with no policy change (constant primary balance) in 2012-2017						**51.2**	**53.0**	**54.0**	**55.0**	**56.0**	**57.2**	**-0.2**
	Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
	Real GDP growth (in percent)	5.3	0.3	-8.4	3.7	2.9	0.6	1.6	2.5	2.1	1.9	1.9	
	Average nominal interest rate on public debt (in percent) 8/	4.0	4.3	3.8	3.3	3.1	2.8	2.7	2.9	3.1	3.4	3.5	
	Average real interest rate (nominal rate minus change in GDP deflator, in percent)	1.0	1.3	2.4	2.9	-0.5	0.9	0.3	0.5	1.0	1.3	1.5	
	Nominal appreciation (increase in US dollar value of local currency, in percent)	10.3	-6.6	7.2	-9.5	-0.3	...	...	...	...	...	...	
	Inflation rate (GDP deflator, in percent)	3.0	2.9	1.4	0.4	3.6	1.9	2.4	2.3	2.1	2.1	2.0	
	Growth of real primary spending (deflated by GDP deflator, in percent)	1.5	4.4	4.8	2.7	-0.1	1.5	1.8	1.5	1.7	1.3	1.6	
	Primary deficit	-6.8	-5.7	1.3	1.5	-0.6	-0.2	-0.7	-1.5	-1.8	-2.3	-2.5	

Sources: GlobalInsight, IMF World Economic Outlook, Statistics Finland, and Fund staff calculations and projections.

1/ Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

3/ The real interest rate contribution is derived from the denominator in footnote 2/ as r - π (1+g) and the real growth contribution as -g.

4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.

5/ For projections, this line includes exchange rate changes.

6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.

7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.

8/ Derived as nominal interest expenditure divided by previous period debt stock.

9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 10. Finland: Proposed Structural Fiscal Measures

Measure	Rationale	Authorities' View
Further pension reform: • Raising retirement age. • Lowering accrual rate for pension benefits. • Tightening early retirement.	The average effective retirement age was around 60 in 2007, and the OECD estimates that raising it to 67 would suffice to close the sustainability gap. Even partial movement would greatly facilitate adjustment efforts. Sizable savings could be accrued by lowering the accrual rate for pension benefits—particularly for periods of parental leave, unemployment, and education—and tightening early retirement via disability or unemployment (disability pension recipients total about 8½ percent of the working age population, well above the OECD average of 5¾ percent).	The authorities do not dispute the need for such measures. Steps already taken are expected to raise the effective retirement age by close to two years, and additional measures are to be introduced by 2017. Also, since 2010 new pensions are adjusted downward as life expectancy rises.
Savings in health and long-term care: • Increase in user fees. • Tightening entitlements to long-term care. • Productivity increases. • Benchmarking.	Health-care and long-term care expenditure are projected by the EC to rise to around 3¼ percent of GDP by 2060 with population aging, due to expensive advances in medical technology and real income growth, given high income elasticity of health-services demand. Thus, an increase in user fees could moderate demand growth, although care should be taken to prevent overburdening the chronically ill. Tightening entitlements in long-term care could spawn savings in an area where aging pressures will be strong. Productivity increases in health- and long-term care of ½ percent a year (which has been achieved in some OECD countries) would significantly lower upward projections for spending. Domestic and international benchmarking to identify best practices would also be beneficial.	The authorities agree on the need to contain costs and increase productivity and have made some progress in these areas. But they also emphasize the need to keep extensive availability of social services given societal preferences.

Table 10. Finland: Proposed Structural Fiscal Measures (concluded)		
Measure	**Rationale**	**Authorities' view**
• Reform of local government (LG): • Reduce reliance on corporate taxes and enhance reliance on property taxes. • Ceiling on municipal income tax rates. • Broader competitive bidding. • Merger of municipalities.	Spending at the municipal level has grown faster than in the rest of the general government (GG) and municipality productivity has declined by about 10 percent over 2000–08. Reliance on corporate taxes at the municipal level—which have funded strong expenditure increases in good times due to their high cyclicality—ought to be reduced, offset by higher property taxation or, possibly, central government (CG) transfers. A ceiling on municipal income tax rates, expenditure ceilings at the municipal or local government level, and restraint in the growth of CG transfers would strengthen incentives for LG spending consolidation. Also, competitive bidding in the provision of services to LGs should be broadened to generate cost savings. Finally, there is scope for efficiency gains through mergers of municipalities.	The authorities support the measures in principle but stress that the Finnish constitution gives local authorities broad autonomy. Thus, the consensus of the local government must be sought prior to introducing the reforms, which is not easy. The authorities have put forward a proposal for mergers of municipalities but any potential reform has been postponed until after the local elections in the autumn of 2012.
Improved rate of return on government financial assets.	General government financial assets exceeded 100 percent of GDP in 2010 and substantial portions of these assets are low-yielding, reflecting a cautious investment approach. Given the large stock, an asset management strategy that generates a modest increase in returns could make a significant contribution to close the sustainability gap.	The authorities are considering options to do so while limiting any significant increase in risks.

INTERNATIONAL MONETARY FUND

FINLAND

STAFF REPORT FOR THE 2012 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

August 3, 2012

Prepared By | European Department (in consultation with other departments)

CONTENTS

I. FUND RELATIONS

(As of June 30, 2012)

Mission: May 31 to June 11, 2012 in Helsinki. The concluding statement of the mission is available at http://www.imf.org/external/np/ms/2012/061112.htm.

Staff team: Mr. L. Figliuoli (Head), Ms. L. Christiansen, Mr. D. Kanda, Ms. M. Hassine, Mr. A. Aslam (all EUR), and Mr. M. Kortelainen (RES). Mr. H. Berger (EUR) joined for part of the mission.

Country interlocutors: Mr. E. Liikanen, Governor of the Bank of Finland; Ms. J. Urpilainen, Minister of Finance; other senior officials of the central bank, the ministry of finance, the ministry of employment and economy, the Financial Supervisory Authorities, Local and Regional Authorities; Parliamentary authority; social partners; and members of the business, financial sector, and research communities.

Fund relations: The previous Article IV consultation discussions were held in Helsinki during May 27 to June 7, 2010 and the staff report was discussed by the Executive Board on August 25, 2010. The Executive Board's assessment and staff report (IMF country Report No. 10/273, September 2010) are available at http://www.imf.org/external/pubs/cat/longres.aspx?sk=24180.0. The Article IV discussions with Finland are on the 24-month consultation cycle.

I. **Membership Status:** Joined January 14, 1948; Article VIII.

II. **General Resources Account:**	**SDR Million**	**Percent of Quota**
Quota	1,263.80	100.00
Fund holdings of currency	841.54	66.59
Reserve Tranche Position	422.27	33.41
Lending to the Fund		
New Arrangements to Borrow	227.70	

III. **SDR Department:**	**SDR Million**	**Percent of Quota**
Net cumulative allocation	1,189.51	100.00
Holdings	1,120.71	94.22

IV. **Outstanding Purchases and Loans:** None

V. **Latest Financial Arrangements:** None

VI. Projected Payments to Fund:

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2012	2013	2014	2015	2016
Principal					
Charges/Interest	0.04	0.10	0.10	0.10	0.10
Total	0.04	0.10	0.10	0.10	0.10

VII. Exchange Rate Arrangements:

Finland's currency is the euro, which floats freely and independently against other currencies.

Finland has accepted the obligations under Article VIII, Sections 2(a), 3, and 4 of the Fund's Articles of Agreement. It maintains an exchange system free of restrictions on the making of payments and transfers for current international transactions, except for those measures imposed for security reasons in accordance with Regulations of the Council of the European Union, as notified to the Executive Board in accordance with Decision No. 144-(52/51).

II. STAFF ANALYTICAL WORK ON FINLAND, 2001–12

Fiscal Policy

- *From Short-term Vulnerabilities to Long-term Sustainability, Analytical Note 6, Selected Issues and Analytical Notes, August 2012* www.imf.org.

  Fiscal Rules in Perspective, Analytical Note 7, Selected Issues and Analytical Notes, August 2012 www.imf.org.

- *Long Run Fiscal Sustainability in Finland, Analytical Note 5, September 2010, IMF Country Report No. 10/273.*

- *Fiscal Sustainability in Finland: The Role of Population Aging and Structural Reforms, Selected Issues, February 2005, IMF Country Report No. 05/36.*

- *The Impact of Fiscal Policy in Finland, Selected Issues, October 2003, IMF Country Report No. 03/326.*

Financial Sector

- *Basel III and the Finnish Financial System, Analytical Note 5, Selected Issues and Analytical Notes, August 2012* www.imf.org.

- *Macro-financial Linkages, Analytical Note 2, Selected Issues and Analytical Notes, August 2012* www.imf.org.

- *Macroeconomic Deleverage Scenarios, Analytical Note 4, Selected Issues and Analytical Notes, August 2012* www.imf.org.

- *Macro-Financial Linkages, Analytical Note 1, September 2010, IMF Country Report No. 10/273.*

- *International Trade and Financial Spillovers, Analytical Note 2, September 2010, IMF Country Report No. 10/273.*

- *Financial-Real Sector Linkages in Finland, Appendix I, February 2009, IMF Country Report No. 09/39.*

Labor Markets

- *Enhancing Employment Rates in Finland: The Role of Activation Strategies, Selected Issues, August 2007, IMF Country Report No. 07/278.*

Growth, Productivity, and Related Cyclical Issues

- *International Spillovers, Analytical Note 1, Selected Issues and Analytical Notes, August 2012 www.imf.org.*
- *Potential Output Estimates, Analytical Note 3, Selected Issues and Analytical Notes, August 2012 www.imf.org.*
- *The Crisis and Potential Output in Finland, Analytical Note 3, September 2010, IMF Country Report No. 10/273.*
- *External Competitiveness, Analytical Note 4, September 2010, IMF Country Report No. 10/273.*
- *Estimating the Output Gap in Finland, October 2003, IMF Country Report No. 03/326.*
- *A Note on Finland's "New Economy", Selected Issues, November 2001, IMF Country Report No. 01/215.*

III. PAST FUND STAFF RECOMMENDATIONS AND IMPLEMENTATION

Past Staff Recommendations	Implementation
Fiscal Policy	
Although the general government deficit is manageable, the overall fiscal position under current policies remains unsustainable. While the large fiscal impulse in 2009 was warranted from a cyclical perspective, the composition of fiscal measures raised concerns as not all would be automatically reversed once growth resumed. A strong and credible commitment to a measured budget consolidation is required to restore sustainability. Stronger consolidation would be possible only if growth turns out to be more robust than expected. The twin objectives of reducing output and fiscal sustainability gaps must be balanced. Fiscal adjustment efforts should focus on expenditure restraint, notably at the local level and via pension, old age and healthcare reforms, as well as tax base broadening, although scope remains for raising indirect and property taxes. The efficiency of public services needs to be increased.	Local government reform is being discussed with the aim of reducing the number of municipalities to a smaller total, which can provide basic public services more cost effectively and efficiently. However, the decision has been postponed. The standard VAT rate was increased by one percentage point to 23 percent and energy taxes were increased on average by 150 percent. Excise duties were raised while the corporate income tax rate was cut. Municipalities were given a greater share of revenues, and also raised municipal tax rates. Significant reforms in the pension system were adopted in 2005 with little action subsequently, though on January 1, 2011 the age limit for the part-time pension was increased to 60 years for individuals born after 1952. Further plans include increasing pension contributions by 0.4 percentage points in both 2015 and 2016.
Labor Market Policy	
The wage bargaining system needs to allow for greater flexibility in wage setting. Measures are needed to ease labor market mismatches, reduce structural unemployment, and induce early entry into the labor force. Reforms of tertiary educational financing could also promote earlier employment among the youth. At the other end of the age spectrum, the unemployment pipelines ought to be further restricted or eliminated.	The government has undertaken to expand labor participation through reforms of the tax and benefits system and intensified training. The Finnish central-level labor market organizations concluded a broad-based framework agreement in October 2011. The new agreement sets the framework for pay and cost increases in branch-level collective agreements for a period of 25 months. Wage increases were moderated in exchange for a 0.5 percent cut in the corporate income tax. On education, in 2011 there was a minor tightening of annual minimum requirements for progress in study to qualify for financial support, while university funding rules remain unchanged. A social guarantee, coming

	into force in 2012, will offer youth, within 3 months of becoming unemployed, a job, on-the-job training, a study place, or a period in a workshop or retraining.
Competition Policy	
Increase competition in services (for example, liberalizing shop operating hours) and product markets, especially in 'sheltered' sectors, to boost productivity growth.	Finland has raised R&D investment to 4 percent of GDP in 2010 in line with its target. The government will review the use of R&D tax incentives over direct subsidies for businesses and start-ups. The 2011 Competition Act brought regulation in line with recommendations from the European Commission. It allows for stricter merger control, enhanced damage compensation, whistle-blowing instruments, and expanded investigative powers for the Finnish Competition Authority.
Financial Sector Policy	
Actions in support of the financial system have been appropriate but bank cost efficiency should be improved, while excessive risk-taking avoided. Supervision and crisis management frameworks for large cross-border institutions must also be strengthened. A bank-specific resolution regime would render the process faster and more cost-effective. Vigilance on liquidity risk and banks' funding and risk profiles should be stepped up. There is also scope to further strengthen the analytical frameworks for stress testing and systemic risk assessment. Intense competition has reduced banks' net interest margins. Further cost reductions will be important as funding stresses, associated with the euro area sovereign debt crisis, could persist.	A Memorandum of Understanding (MoU) on financial stability, crisis management and crisis resolution was signed by the ministries of finance, central banks, and financial supervisory authorities in Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway, and Sweden. The supervisory authorities of the participating countries also set up a cross-border stability group. A uniform financial sector stress test was conducted between March and May 2012 by the FIN-FSA in cooperation with supervised entities. Supervision exercises were more risk-based throughout 2011 and on-site inspection activity increased.

IV. STATISTICAL ISSUES

(As of June 20, 2012)

Assessment of Data Adequacy for Surveillance:

General: Data provision is adequate for surveillance.

Data Standards and Quality

Subscriber to the Fund's Special Data Dissemination Standard (SDDS) since June 3, 1996. Uses SDDS flexibility options for timeliness on data for central government operations.

A data ROSC was electronically published on October 31, 2005 (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18675.0).

Finland: Table of Common Indicators Required for Surveillance

(As of July 18, 2012)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items:	
						Data Quality–Methodological soundness[8]	Data Quality–Accuracy and reliability[9]
Exchange Rates	06/12	07/02/12	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	05/12	07/12	M	M	M		
Reserve/Base Money	05/12	07/12	M	M	M		
Broad Money	04/10	06/10	M	M	M		
Central Bank Balance Sheet	05/10	06/10	M	M	M		
Consolidated Balance Sheet of the Banking System	05/10	06/10	M	M	M		
Interest Rates[2]	06/12	07/02/12	D	D	D		
Consumer Price Index	05/12	06/12	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Q4 2011	04/12	A	A	A	LO, LO, LNO, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	11/11	01/12	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	05/10	06/10	M	M	M		
External Current Account Balance	Q4 2011	04/12	M	M	M	O, O, O, LO	LO, O, LO, O, O
Exports and Imports of Goods and Services	Q4 2011	04/12	M	M	M		
GDP/GNP	Q4 2011	03/12	Q	Q	Q	O, O, O, O	LO, O, LO, O, O
Gross External Debt	04/08	06/08	M	M	M		
International Investment Position[6]	Q4 2011	03/12	M	M	M		

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes, and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government, including National Insurance Scheme, and local governments.

[5] Including currency and instrument composition.

[6] Includes external gross financial asset and liability positions vis-a-vis nonresidents.

[7] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

[8] Reflects the assessment provided in the data ROSC (published in October 2005, and based on the findings of the mission that took place during May 10–25, 2005) for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O); largely observed (LO); largely not observed (LNO); or not observed (NO).

[9] Same as footnote 8, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative on Finland
August 27, 2012

1. **This statement summarizes developments in Finland since the issuance of the staff report** (www.imf.org). The additional information does not change the thrust of the staff appraisal.

2. **Economic developments in 2011 have proven somewhat weaker than indicated in the staff report, while staff now also projects lower growth in 2013.**

- Recent revisions to the official data reveal that real GDP growth in 2011 reached 2.7 percent, down from the 2.9 percent previously estimated. In addition, revisions to the current account statistics now put the corresponding 2011 deficit at 1.2 percent of GDP, compared to 0.7 percent of GDP before.

- Real GDP growth for 2013 is now expected at 1.4 percent (compared to 1.6 percent in the staff report), reflecting up-to-date information pointing to a longer-lasting period of weak growth than anticipated in the staff report, owing to continuation of the weakness in the euro area. In particular, new orders in manufacturing continued their worsening trend in June and consumer confidence has deteriorated.

3. **Staff projects the 2012 headline fiscal balance to be also slightly weaker.** The deficit for 2012 is now expected at 1.3 percent of GDP (compared to 1.1 percent before), partly owing to lower-than-expected tax collections, which has prompted a downward revision of general government revenue.

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FOR IMMEDIATE RELEASE
August 31, 2012

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2012 Article IV Consultation with Finland

On August 27, 2012 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.[1]

Background

While Finland has strong fundamentals and a track record of good policies, the near-term economic outlook is highly vulnerable to external developments. This owes in particular to the high export dependence and financial sector interlinkages with other Nordic countries. Spillovers to Finland have already been significant with growth decelerating at end-2011 as the euro area sovereign debt crisis intensified. Although Finland has benefited from safe-haven status during the European sovereign debt turmoil so far, risks to the outlook are tilted to the downside.

After the deep recession of 2008–09, the Finnish economy rebounded robustly in 2010 but the sovereign debt turmoil in the euro area dragged it to a standstill in late 2011. Though activity in the first quarter of 2012 turned out slightly stronger than expected, weak investment continued to point to a deteriorating growth outlook, consistent with a deterioration in construction and producer confidence indicators. The unemployment rate came down gradually in 2011, after a

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

moderate increase during the 2008–09 crisis partly due to labor hoarding, but it ceased to improve in the second quarter of 2012. Meanwhile, inflation started to moderate in the second half of 2011 after the effects of indirect tax increases waned. While competitiveness remains adequate it has deteriorated markedly as Finland continued to lose export market shares during the past decade, and for the first time in nearly two decades recorded a small current account deficit in 2011.

The banking system has remained generally sound despite the increasing strains in the euro area financial markets. Capital comfortably exceeds regulatory requirements and the non-performing loan rate remains low, though it increased somewhat during 2011. However, banks' operating profits have declined amid weakening interest income and increased competition for retail business. In addition, the Finnish banking sector is highly concentrated with a majority of assets controlled by subsidiaries of foreign Nordic banks, exposing it to the risk of short-term funding shortfall and financial-sector spillovers from a potential intensification of the euro area crisis. The insurance and pension fund sectors have weathered the ongoing crisis well, though the insurance sector has suffered a reduction in solvency margins during 2010–11. Nonetheless, these still remain high and well above regulatory minima. Household debt has risen rapidly during the past decade and now accounts for more than 110 percent of disposable income, while house prices appear broadly in line with fundamentals.

The fiscal position improved markedly in 2011 after a sharp deterioration in 2009. As fiscal policy turned to support growth through automatic stabilizers and discretionary budget stimulus, the general government budget position worsened by about 7 percentage points of GDP in 2009 but remained below the Maastricht deficit limit in 2009–10. With some policy tightening and continued economic recovery into 2011, the headline deficit of the general government improved markedly to less than 1 percent of GDP, and gross debt, while continuing to increase, ended 2011 at below 50 percent of GDP. Nonetheless, projected weak growth in 2012 will likely result in a renewed worsening of the headline deficit and population aging remains a challenge for long-term fiscal sustainability.

Executive Board Assessment

Executive Directors commended Finland's strong economic fundamentals and continued sound policy management. Directors noted, however, that as a small open economy, with deep trade and financial linkages, the country is sensitive to adverse spillovers from the turmoil in the euro area. Economic activity has slowed and risks to the outlook are tilted to the downside. The economy also faces longer-term challenges arising from an aging population and slowing productivity, which could impact competitiveness and growth. Against this backdrop, Directors welcomed the authorities' commitment to prudent policies aimed at improving internal and external imbalances, safeguarding financial sector stability, and ensuring long-term fiscal sustainability.

Directors welcomed that the banking sector is sound and well capitalized. In light of the high dependence on wholesale funding and foreign parent banks, they emphasized the importance of gradually building up bank capital and liquidity buffers. This will also be important with regard to the transition to Basel III and the additional efforts needed for some individual institutions to satisfy leverage ratio and liquidity requirements.

Directors welcomed the authorities' plans to strengthen macroprudential supervision and underscored the need to strengthen limits to loan-to-value ratios and to introduce a national loan registry to guard against excessive borrowing. They also recommended close monitoring of banks' risk-taking behavior given the vulnerability of households to a rapid rise in the interest rate owing to the large share of variable-rate loans.

Directors highlighted the need to enhance cross-country supervision and crisis resolution frameworks in response to increased cross-border banking activities and the prominent role of large international groups. While a common bank-resolution framework-along with a common enforcement mechanism—at the EU level is preferable, most Directors noted that national or regional plans should be designed in the interim.

Directors supported the current broadly neutral fiscal stance and the authorities' adjustment plan aimed at addressing long-term fiscal challenges and closing the sustainability gap. They agreed that automatic stabilizers should be allowed to operate if downside risks materialize, and many Directors saw merit in a flexible approach to implementing medium-term consolidation plans, in particular if growth underperforms significantly.

Directors observed that fiscal efforts should focus on mitigating the expected rise in health and long-term care costs and further tightening unemployment and disability pipelines to early retirement as well as increasing the statutory minimum and maximum retirement age. On the revenue side, they recommended broadening the tax base and a shift from labor taxation to consumption and property-based taxation. Improvements to the fiscal framework to slow down increases in local government spending could also help achieve sustainability.

To boost potential growth and competitiveness, Directors emphasized the need for reforming the labor market and improving productivity. They welcomed the recent steps to increase the effective retirement age and adjust pension entitlements, but highlighted the need for further efforts towards greater labor force participation. They also recommended refocusing public R&D expenditures toward basic research, further competition in the service sector, and increased flexibility in wage setting.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2012 Article IV Consultation with Finland is also available.

Finland: Selected Economic Indicators, 2010–13

	2010	2011	2012 1/	2013 1/
Real economy				
GDP (change in percent)	3.3	2.7	0.6	1.4
Consumer price inflation (harmonized, average) 2/	1.7	3.3	2.8	2.3
Unemployment rate (in percent) 2/	8.4	7.8	7.6	7.7
Gross national saving (in percent of GDP)	19.9	19.6	18.3	18.5
Gross domestic investment (in percent of GDP)	18.5	20.8	19.9	19.8
Public finances (general government, in percent of GDP)				
Overall balance	-2.9	-0.8	-1.3	-0.9
Primary balance 3/	-1.5	0.6	0.0	0.4
Gross debt (Maastricht definition)	48.6	49.1	52.5	53.8
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area, growth rate, e.o.p.)	4.8	6.9	…	…
Finnish MFI euro area loans (growth rate, e.o.p.)	6.3	6.2	…	…
Interest rates (year average, percent)				
3-month money market rate 4/	0.8	1.4	0.7	…
10-year government bonds yield 4/	3.0	3.0	2.0	…
Balance of payments (in percent of GDP)				
Trade balance	1.4	-0.6	-0.2	-0.3
Current account	1.4	-1.2	-1.6	-1.3
Exchange rate				
Exchange rate regime		Euro		
Present rate (July 18, 2012)		USD1.22 per euro		
Nominal effective rate (appreciation in percent)	-4.5	0.0	…	…
Real effective rate (appreciation in percent) 5/	-5.4	0.1	…	…

Sources: Finnish authorities, International Financial Statistics, and IMF staff estimates.

1/ Fund staff estimates and projections, unless otherwise indicated.

2/ Consistent with Eurostat methodology.

3/ Adjusted for interest expenditure.

4/ 2012 data are from June 29.

5/ CPI-based real effective exchange rate.

Statement by Benny Andersen, Executive Director for Finland
and Kari Korhonen, Senior Advisor to the Executive Director
August 27, 2012

The Finnish authorities once again welcome the candid dialogue with the mission and agree on balance with the findings presented in the staff report.

Recent Economic Developments and Outlook

The authorities share the staff's views on recent developments and outlook. Following the onset of the global financial crisis Finland's economy plummeted in 2009, but recovered well during 2010, driven by external demand and strong residential building construction, and has weathered the euro area (EA) crisis relatively well until the end of 2011, supported by robust private consumption and investment. This is largely due to the fact that at the outbreak of the crisis there were no major imbalances in the Finnish economy.

However, the outlook has recently deteriorated due to the deepening and prolonging of the EA sovereign debt crisis. GDP declined by 0.3 percent in Q2 of 2012 from the same period of last year. Growth is expected to come almost entirely from private consumption in 2012. The latest forecast by the Ministry of Finance as of June sees an annual rate of growth of 1.2 percent in 2013.

Last year, exports declined in volume terms by close to 1 percent and the trade balance moved into a deficit. This year, exports are forecast to grow only slowly owing to weak demand in our main export markets in Europe. Finland's international competitiveness has deteriorated since 2010 and this is reflected in some loss of market share. Consumer price inflation peaked at 3.7 percent in July 2011, but has since decelerated to 2.9 percent this past July. The Ministry of Finance forecasts the harmonized inflation rate to moderate from 3.0 percent in 2012 to 2.4 percent in 2013.

In line with the deceleration of economic activity, the increase in employment came to a standstill by the end of 2011. The risk of higher than forecast unemployment rate is warranted, in particular, if the uncertain situation and weaker confidence were to continue both in Finland and in the rest of Europe. The recent announcement by Nokia of a substantial cut of jobs in Finland along with other companies' layoff news is reflected in the latest confidence surveys that show increased pessimism. Employment in the public sector increased during the past two years. There is pressure to increase staffing in the social services sector, in particular in health and old age care. Hence, it is expected that public sector employment will continue to increase in spite of the tight fiscal situation in municipalities.

In spite of the EA crisis, the state of the financial system has remained stable in Finland. The low ECB policy rates have had a positive impact on the economy. Moreover, Finland has been able to afford expansionary fiscal policies when needed in order to support employment and growth. Households have clearly benefited from the low interest rate environment and have not been forced to deleverage. The authorities have, however, repeatedly cautioned banks/households about the risks of excessive lending/borrowing for housing and consumption.

Risks to the Outlook

The authorities agree with staff on the risks to the outlook presented in the staff report. The current account has turned from a sizeable surplus in the past decade into a small deficit. There are several explanations for this outcome such as sector-specific problems in the forestry and electronics industries, adverse commodity price developments and weakened international competitiveness since 2010. Given the low interest rates since 2009, household consumption and housing investments have been boosted by debt-financing. This development has contributed to the rebalancing of the current account. While the current account deficit is still small, and its financing does not pose a problem, it nevertheless points to a risk of emerging external imbalance should the deficit continue to grow.

Regarding the stability of the financial system, spillovers due to the EA crisis pose potentially serious risks for Finland as well. As pointed out by staff, the risks from domestic sources emanate mainly from mortgage financing, which is mostly linked to very short-term interest rates. The authorities agree with staff that the household debt could burden the risk-bearing capacity of Finland's financial system and the economy in the longer term if it continues to increase as it has in the past few years.

In view of the weakened economic outlook in Finland and in her main trading partners, the risk of higher unemployment has become more evident over the summer. The authorities do share staff's concern about the risks facing the economy in the short and longer term and are committed to implementing policies that aim for a better internal and external balance and maintenance of financial sector stability.

Financial stability

The authorities concur with staff's view that the main risks to Finland's financial stability originate currently from the EA crisis. A mitigating factor for the banking sector is the fact that the Nordic banks operating in Finland are only moderately exposed to the EA crisis countries.

Staff and the authorities agree that while the banking sector is currently sound and meets the minimum capital and conservation buffer requirements envisaged under Basel III, some institutions would benefit from stronger capital and especially liquidity buffers in order to better withstand adverse market conditions. The authorities will encourage the financial sector to build up capital and liquidity buffers gradually in order not to induce deleveraging.

With regard to staff's recommendation on an extra capital charge for SIFIs, a high level working group is analyzing whether such a charge should be implemented through the Finnish legislation.

On the bank funding situation, staff and authorities agree that a worsening of the EA crisis has the potential to put wholesale funding at risk, because the Finnish banking sector is highly concentrated and largely dependent of wholesale funding.

The increase of cross-border banking activities requires commensurate strengthening of the supervision and regulation framework for the maintenance of financial stability at all times. Accordingly the authorities envisage a continued enhancement of cross-border cooperation bringing benefits to all parties involved. While they appreciate the current cross-border cooperation agreed in the Memoranda of Understanding, they see merit in making them more effective. The recent initiative to move towards a Banking Union at EU/EA level in a relatively short timeframe is a major step forward in strengthening cross-border supervision.

The recovery and resolution framework for banks should be developed. This issue was discussed also during the 2010 and 2011 consultations and the authorities voiced their preference for a common EU-level framework. For the authorities, the latest (June 2012) proposal by the EU Commission for an EU recovery and resolution directive provides a good basis to move forward in this area. Similarly, the pending FSAP recommendation on the supervisory framework for bank-assurance will be accomplished when implementing the new EU regulations (CRD4 and Financial Conglomerates Directive).

House prices and household debt increased strongly in Finland before the financial crisis, as in most other developed economies, but the level of household debt remained relatively low in international comparison. There are no clear indications of real overvaluation in Finnish house prices; rather they are in line with fundamentals.

Nevertheless, the authorities are well aware of the potential risks emanating in the housing market in view of the uncertain economic outlook and rising unemployment. The authorities have cautioned households of being perhaps overly optimistic about their future income growth and the continuation of the very low level of interest rates as more or less permanent. Likewise, the authorities have reminded the mortgage lenders of requiring adequate down payments from borrowers and calculations of mortgage servicing capacity at significantly higher interest rates than at the current historically low rates. It seems that the authorities' advice is working, because the latest data on individual mortgages shows that interest margins are on the rise and that borrowers are motivated to lower the interest margin by increasing their down payments, which reduces Loan-to-Value ratios (LTV).

Staff's advice to policymakers for mitigating risks of household debt is to design policy tools which could be implemented quickly in order to moderate debt growth in case that is deemed necessary. For instance, setting binding LTV ratios would be one such potential tool, and the authorities welcome the plan to legislate such powers for the FIN-FSA. Banks would also start to report standardized LTV ratios to the supervisor in the future. Staff suggested the establishment of national loan registry, whose implementation – and effectiveness as a macro-prudential tool – in Finland will be explored. Traditionally, Finnish homeowners are reliable mortgage borrowers, firstly, because the homeownership is the most common form for building equity and, secondly, affordable rental housing for family needs is scarce.

Fiscal policy

The authorities share the staff's view on the fiscal position and fiscal policy stance. The government's fiscal strategy is focused on the achievement of long-term sustainability. The government is committed to a substantial reduction in the central government debt-to-GDP ratio by 2015 as well as to cutting central government deficit to below 1 percent of GDP.

In view of the weakened economic outlook, the government is looking into new measures to revive economic activity and to build up consumer and industry confidence. Continuation of structural reforms plays an important role in this respect. In spite of the formidable challenge the government now faces, it is determined to continue fiscal consolidation within the Government Program for 2012-2015. The closing of the fiscal sustainability gap as planned does not allow slippages.

The plan ahead is as follows: during spring of 2013, after the government has made an assessment of the progress in the Program targets, additional revenue and expenditure measures will be determined, if needed, to keep the Program on track.

Even though the Finnish general government deficits and debt are relatively low compared to those of many other countries, bringing the debt ratio on a declining path is a must and will enable Finland to maintain the AAA rating. Demographic ageing reduces potential growth, increases age-related spending and poses a tough challenge on the sustainability of public finances. This challenge has been aggravated by the deterioration of the public finances in the wake of the financial crisis. Tax revenue has dropped, while public expenditure has continued to grow. In relation to GDP, public expenditure is expected to remain at an elevated level in the next few years despite recent consolidation measures.

Closing the sustainability gap of 4¼ percent over 10 years implies now an adjustment of ½ percent of GDP per annum. The authorities agree with staff on the suggested measures to achieve sustainability. These measures are in line with the ones already discussed during the 2010 consultation and the 2011 staff visit. They are included in the government's program.

There is full agreement between staff and the authorities on the fact that the scope for increasing income taxation is limited and that the tax base should be broadened to taxing consumption, energy and property. Staff's suggestion to eliminate items on reduced VAT deserves merit, but the authorities have faced opposition, for instance, on the grounds that raising VAT on food items would mainly hurt persons on fixed incomes, low income earners and families with dependent children. The lower VAT rates were earlier introduced on some services in order to raise demand for them and thus generate employment in the service sector, which is the fastest growing sector in terms of employment.

On the expenditure side, the government is currently working on measures to limit the growth of fiscal expenditures related to old age care and thus preparing in advance for the future aging related costs. In this vein, the ongoing project of municipal mergers is expected to have a significant impact on containing costs when the baby boom generation reaches the age of 75 and over in about 10 years.

The issue of tuition fees appears regularly in the consultation discussions concerning saving in the tertiary education, which up to now has been free in Finland. There is a strong consensus in the Finnish society that education should be provided free of charge to those who qualify, and reforms should not lead to less equal opportunities and limit upward mobility. In fact, measures have been already taken to speed up the graduation from tertiary education by limiting the number of years of obtaining educational grants. This financial incentive has already had an impact by shortening the average time spent toward graduation with Master's degrees.

Structural reforms to promote growth

Upon observations of the structural reforms recommended by Fund staff during the Article IV consultations of the past decade, one finds that there has been significant progress on most of them such as the pension reform, lengthening of working life on both ends and municipal consolidation. It takes time to garner political support for major structural reforms, but the prevailing negotiation process involving the authorities at the central and local level, and employee and employer organizations has turned out to be a workable model.

In the social services sector, the authorities see room for more private-public partnership in order to provide diversification of services and to enhance cost efficiency. There is also room for improvement to find a better balance between unemployment benefits and incentives to work such that accepting employment would become clearly preferable to living on benefits and transfers.

Also, promoting competition in various sectors of the economy would increase potential output. International cost-competitiveness of Finnish production must be enhanced such that further weakening of the external balance is to be avoided. At the same time, increased flexibility in wage setting at the firm and industry level is needed. This would promote cost-competitiveness and the ability of the economy to adapt to changes.