February 2005
IMF Country Report No. 05/35

Finland: 2004 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Finland

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 2004 Article IV consultation with Finland, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 28, 2004, 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 December 29, 2004. 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.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 28, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Finland.

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

Selected Issues Paper

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

FINLAND

Staff Report for the 2004 Article IV Consultation

Prepared by Staff Representatives for the 2004 Consultation with Finland

Approved by Poul Thomsen and Martin Fetherston

December 29, 2004

- A staff team comprising Messrs. Thakur (Head), Luna, Lutz, and Stavrev (all EUR), visited Helsinki during October 19–28, 2004. The mission met Mr. Kalliomäki, Minister of Finance, Mr. Liikanen, Governor of the Bank of Finland, other senior officials, as well as representatives of the Finance Committee of the Parliament, Finnish Trade Unions (SAK), the Confederation of Industries (EK), Financial Supervisory Authorities, the Association of Local Authorities (Kuntalitto), and members of the business and academic communities. Mr. Farelius and Ms. Kivinen of the Nordic-Baltic Executive Director's Office participated in the discussions.

- The mission's Concluding Statement and the press conference at the end of the mission received wide coverage in the Finnish media. The authorities intend to publish this staff report.

- The three-party coalition government, led by Prime Minister Matti Vanhanen, is expected to remain in office until the next general elections in spring 2007.

- Finland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions (Appendix I) and subscribes to the Special Data Dissemination Standard (Appendix II). A Data ROSC is planned for May 2005.

- The last Article IV consultation was concluded on October 8, 2003 (SUR/03/102) with Executive Directors commending Finland's recent strong economic record. Stressing the long-term challenges facing Finland on account of the imminent aging of its population, Directors underlined the goal of raising employment, and called for enhancing incentives to work, reducing the taxation of labor, and pursuing further pension reform. In the absence of a wide-ranging set of structural reforms to raise employment and potential growth, Directors considered that a large fiscal surplus would be necessary to safeguard long-term fiscal sustainability.

Main Websites for Finnish Data

Data in this Staff Report reflects information received by December 9, 2004. In many cases, more recent data can be obtained directly from the following internet sources:

Statistics Finland.. http://tilastokeskus.fi/index_en.html

Bank of Finland... http://www.bof.fi/eng/index.htm

Ministry of Finance.............http://www.financeministry.fi/vm/liston/page.lsp?r=2622&l=en

Additional information and documentation on Finnish economic statistics can be found at the Fund's SDDS website http://dsbb.imf.org/Applications/web/sddscountrycategorylist/?strcode=FIN.

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Executive Summary

Background and Outlook: The economy weathered the global slowdown relatively well. Stimulated by **an expansionary fiscal policy**, domestic demand propelled growth well above the euro area average. With strengthening global activity, growth is expected to pick up to about 3 percent in 2004–05, with a closing of the small output gap. **Employment has stagnated,** however, and unemployment remains stuck at about 9 percent since 2001. **Inflation fell to the lowest level in the euro area** in 2004, reflecting large cuts in indirect taxation, but is expected to gradually revert to close to the euro area average. The recently concluded 2½ year wage accord is moderate, accompanied by sizable (about 1 percent of GDP) cuts in income taxation over 2005–07. While the fiscal surplus at about 2 percent of GDP appears comfortable in a comparative EU context, it is inadequate since the longer-term fiscal outlook is clouded by **rapid population aging which sets in earlier than any other EU country**.

Policy discussions centered on the following key issues:

- The **stance of short-term fiscal policy** in light of the need to **cut labor taxes to boost employment prospects**, and the coming aging-related fiscal pressures. Although no longer necessary from a cyclical perspective, the authorities viewed the income tax cuts as appropriate in the context of a moderate wage agreement and to achieve a critically needed increase in employment. The staff argued that the planned tax cuts **should be offset by cuts in spending** in order not to add to the long-term burden of fiscal adjustment.

- The staff and the authorities concurred on the benefits from **mutually reinforcing labor and product market reforms that would obviate the need for larger fiscal adjustment over the long-term**. In addition to the pension reforms currently being implemented, the mission urged the **adoption of measures to enhance employment at both ends of the age spectrum**, address labor market mismatches, and increase job search incentives. Productivity gains, relatively low outside the high technology sector, could be boosted through strengthened competition, especially in sheltered sectors, and through a smaller role for the state.

- The imminent aging of the population would lead to rising expenditure pressures. With a view to further **reducing the still high levels of labor taxation**, focus needs to be placed on expenditure restraint. This would require, inter alia, **raising efficiency in the delivery of social services**, especially at the local level. The mission noted that while the recent **pension reform is an important step in the right direction, it is, in itself, insufficient to ensure sustainability of the system**. In view of the worsening electoral arithmetic as the median age of the average voter rises rapidly, the mission called for early consideration of further measures.

I. Economic Background

1. **The Finnish economy has made impressive strides in recent years, but faces earlier than any other country in the EU the challenge of population aging**. Sustained economic growth over the past decade, among the highest in the industrialized world, has been underpinned by productivity gains led by the high technology electronics sector. A stable macroeconomic policy framework with low inflation and sizeable fiscal surpluses has supported investor confidence. However, employment has been stagnant since 2002 and unemployment has remained stubbornly high. The longer-term outlook is clouded by imminent aging of the population, with old-age dependency set to rise most rapidly among EU countries.

2. **Recent Fund advice has underlined the need for sizeable fiscal surpluses and further structural reforms to address the aging shock**. The authorities broadly share the Fund's assessment that large fiscal surpluses are needed over the coming decade and beyond to cope with the expected long-term fiscal pressures and ensure sustainability. The goals of the pension reforms recently initiated by the authorities are in line with Fund advice, although the authorities do not envisage further measures in the near future. The authorities share the Fund view that greater labor market flexibility and a shift to a more decentralized wage-setting system are desirable, but they regard these as medium-term goals that can only be achieved gradually, in view of the long tradition of solidaristic wage bargaining.

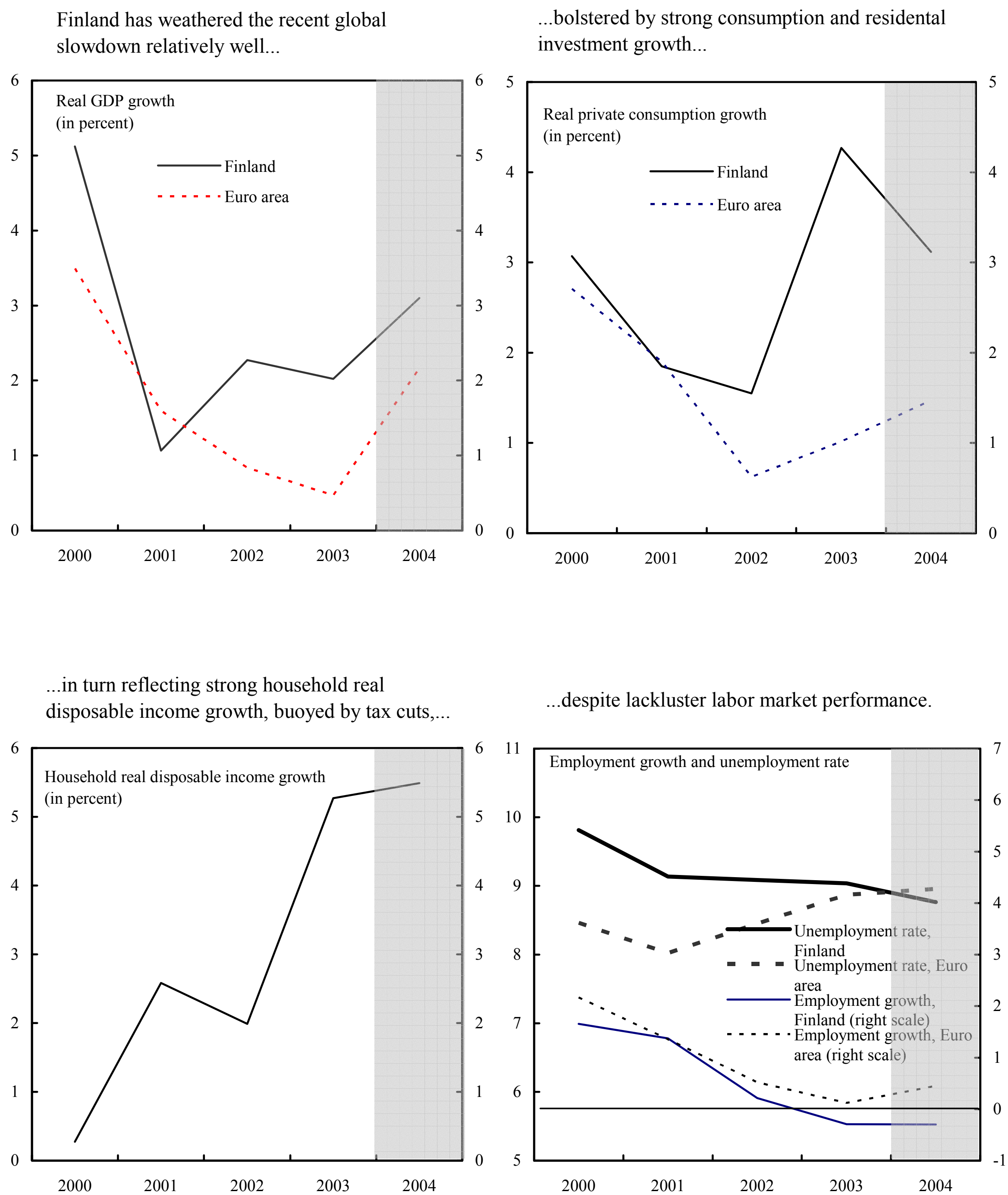
3. **The economy weathered the global slowdown relatively well**. The robust pace of domestic demand, stimulated by an expansionary fiscal policy, helped sustain GDP growth at 2 percent in 2003, well above the euro area average of ½ percent (Table 1). Domestic demand, especially private consumption, has continued to drive growth in 2004 as well, as disposable income was further boosted by exceptionally low inflation and sizeable tax cuts (Figure 1). While housing investment has been strong, business fixed investment has shown only tentative signs of a durable pick-up, after declining in 2002–03. Reflecting the initial slow pace of the global recovery and the loss of market share suffered by Nokia—Finland's flagship technology company—the contribution of the technology and export sectors to growth has been muted in comparison with the late 1990s.

GDP and Demand
(percent change)

	2002	2003	2004 est.	2005 proj.
Real GDP	2.3	2.0	3.1	2.9
Domestic demand	1.3	2.1	2.6	2.2
Consumption	2.2	3.5	2.6	2.0
Private	1.5	4.3	3.1	2.1
Gross fixed capital formation	-2.0	-2.9	2.3	3.1
Residental investment	2.1	9.0	7.5	2.1
Net exports 1/	2.0	-0.5	1.3	1.3

Sources: Statistics Finland; and staff projections.
1/ Contribution to growth.

Figure 1. Finland: Growth, Demand and Employment, 2000-04



Sources: Statistics Finland; ETLA; WEO; and Fund staff calculations.

4. **The cyclical recovery has failed to revive the labor market in the face of persistent structural rigidities**. The unemployment rate has remained at 9 percent since 2000, slightly above the estimated NAIRU of about 8½ percent (Figure 2).[1] A centralized wage-setting regime has fostered wage compression and led to growing mismatch in the labor market. At the same time, high taxes on labor and multiple possibilities for early exit from the labor force have tended to reduce labor supply. With recent employment gains confined largely to the financial services and local government sectors, the authorities' goal of raising the employment rate from the current 67 percent to 70 percent by the end of the current electoral cycle in 2007—and to 75 percent by 2011—appears increasingly beyond reach under present policies.

Inflation, Labor Market and Output Gap Indicators
(percent change)

	2002	2003	2004 proj.	2005 proj.
Harmonized CPI	2.0	1.3	0.2	1.5
GDP deflator	0.9	-0.1	0.2	1.0
Employment	0.2	-0.3	-0.3	0.5
Unemployment rate 1/	9.1	9.0	8.8	8.3
Labor compensation 2/	3.0	3.2	3.1	2.9
Unit labor costs 2/	0.9	0.6	0.5	1.1
Output gap 3/	-0.7	-1.2	-0.7	-0.1

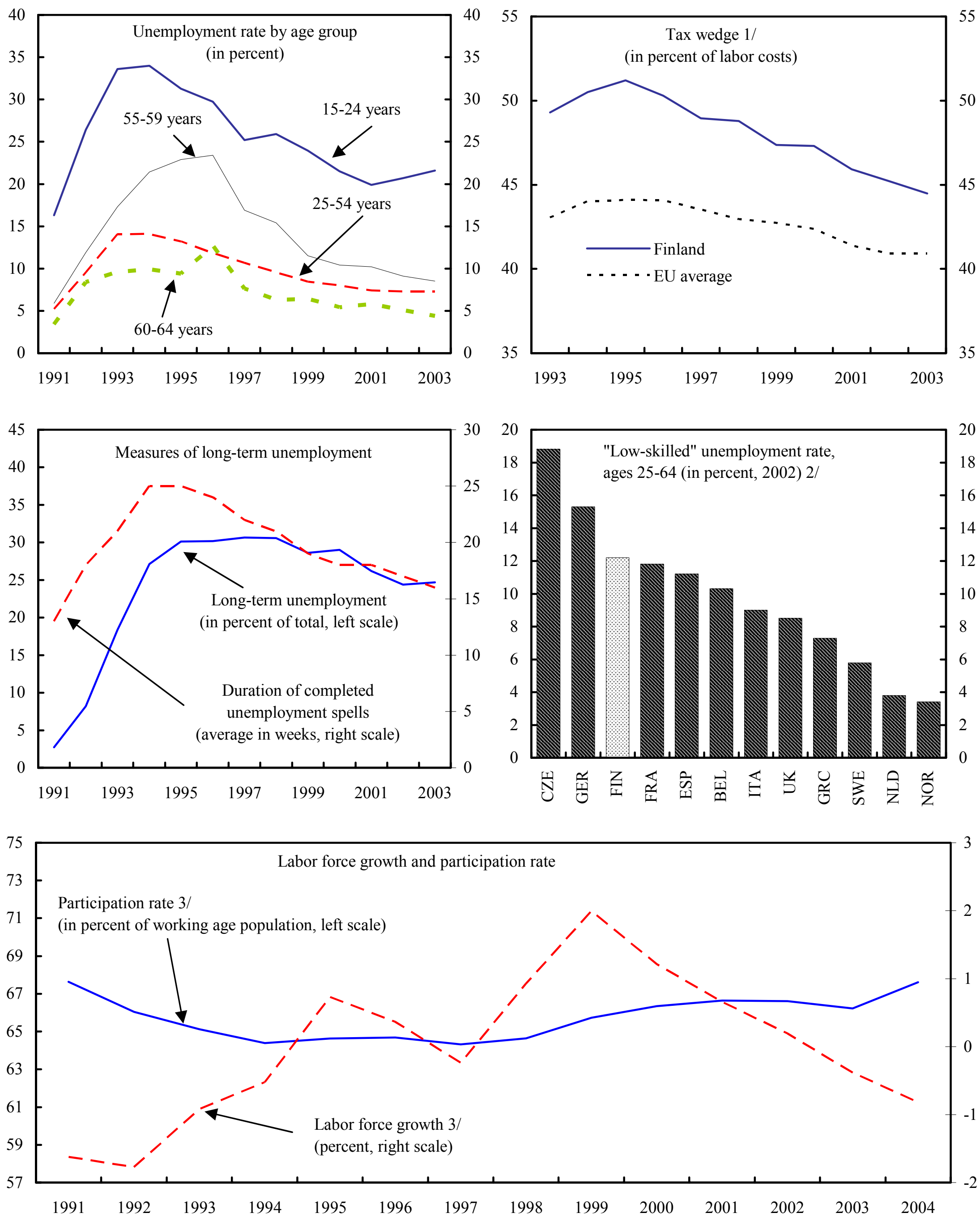
Sources: Statistics Finland; and staff projections.
1/ Percent of labor force.
2/ Economy-wide.
3/ In percent of potential ouput.

5. **Inflation has fallen to the lowest level in the euro area**. The HICP measure of inflation declined to 1.3 percent in 2003 and fell even further in 2004, reflecting large cuts in indirect taxation, especially on alcohol and cars, low import prices, the weak labor market and growing competition in services such as retailing, telecom, and air transport. As the impact of one-off factors such as the tax cuts recedes, inflation is gradually expected to revert close to the average prevailing in the euro area. The pace of house price inflation rose to 8 percent in 2003 from the recent annual average of 5 percent, mainly reflecting the rising cost of building land, especially in the Helsinki region.

6. **Strong productivity gains have helped contain unit labor costs despite a faster rise in wages than the EU average**. Recent high productivity growth has, however, been concentrated in a few sectors such as the Nokia-led electronics sector and financial services, without significant diffusion across the rest of the economy. The lack of large spillover effects may reflect the relative inflexibility of labor and product markets (Box 1).

[1] A broader measure of unemployment which tries to capture varieties of disguised unemployment, including participants in active labor market programs and those under unemployment pensions, is estimated to be as high as 16½ percent. "How Many People in Finland Are Unemployed?" by Samu Kurri, *Euro and Talous*, No. 4, 2003.

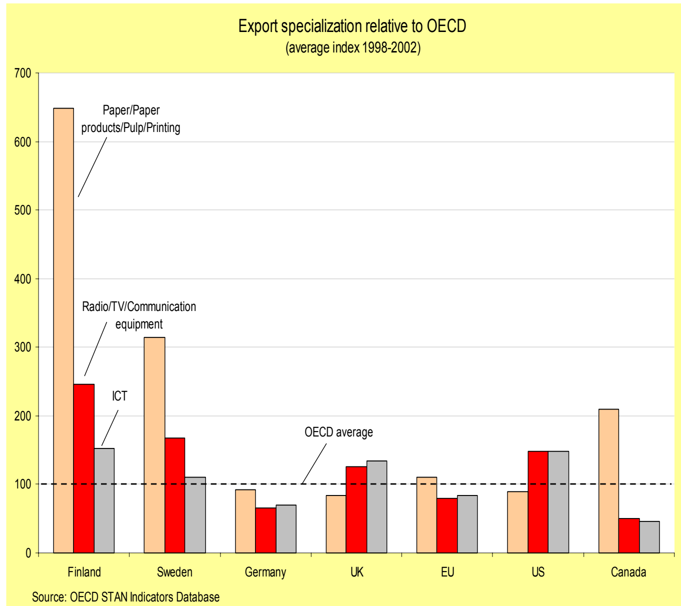
Figure 2. Finland: Labor Market Characteristics, 1991-2004



Sources: Finnish Labor Review; OECD Employment Outlook 2004; and Fund staff calculations.
1/Income tax plus employee and employer contributions (as a percentage of labor costs); single person without children.
2/ Defined as the unemployment rate of persons with less than upper secondary education.
3/ 2004 data are for second quarter.

Box 1. Finland—How Durable Is the Nokia Effect?

The emergence of the high-technology sector led by Nokia has played a key role in altering the structure of the Finnish economy over the past decade. The industrial structure and the profile of exports, traditionally dominated by forestry products—Finland is the world's leading exporter of paper—have become oriented towards the telecommunications industry. In 2002, information and communication technology (ICT) exports amounted to almost 22 percent of exports of goods—triple their share in the early 1990s and twice the EU average. Finland stands out as having the highest degree of specialization in exports among the advanced economies, making it more susceptible to sector-specific shocks such as the global downturn in the ICT industry.



The acceleration in productivity growth since the mid-1990s primarily reflects the productivity gains in the ICT sector, without significant diffusion across the rest of the economy. Nokia accounts for almost half of the Finnish ICT cluster's sales and its network includes a large number of suppliers and subcontractors (Paija, 2001).[1] However, productivity gains outside the Nokia cluster have been relatively small and temporary.[2] With weak inter-industry linkages between the Nokia cluster and the rest of the economy, the ICT diffusion and spillover effects in the form of research and development (R&D) and knowledge sharing appear to have been small, unlike in the United States and to a lesser extent in Sweden.

The relative inflexibility of the labor and product markets may have prevented stronger diffusion of productivity gains throughout the economy. A tentative conclusion from the Finnish experience seems to be that ICT diffusion can lead to economy-wide productivity gains only if accompanied by flexible labor and product markets. The period of Nokia's rise coincided with the global ICT sector boom and liberalization of telecom equipment and service markets. In the past two years, the global ICT downturn and increasingly stiffer competition have already had an adverse impact on Nokia's prospects. While Nokia's impact on Finland's exports, growth, and R&D spending continues to be substantial, steps to enhance the economy's competitiveness through deeper structural reforms would seem imperative to meet the coming challenges from globalization and demography.

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[1] Paija, L. (2001) The ICT Cluster in Finland—Can We Explain It? In Paija L. (ed.) Finnish ICT Cluster in the Digital Economy, ETLA, Helsinki: 11–70.

[2] Daveri, F., and O. Silva (2004) Not Only Nokia: What Finland Tells Us About *New Economy* Growth, *Economic Policy* 38: 117–163.

7. **The wage accord concluded in December 2004 represents a continuation of efforts to ensure wage moderation in return for cuts in income taxation**. The accord, to be ratified in union-level negotiations, covers a period of two and a half years to September 2007, and, including local-level increases and wage drift, is expected to result in a rise in annual wages of about 3½ percent over this period, broadly in line with recent years. In the context of the agreement, the government announced its intention to reduce income taxes by over 1 percent of GDP over the 2005–07 period. The accord retains the essentially centralized framework of Finland's wage bargaining regime, in contrast to the recent Nordic trend towards firm-level bargaining.

8. **The large current account surpluses partly reflect low domestic investment**. Finland has recorded surpluses in the range of 5 to 8 percent of GDP since the mid-1990s and is expected to sustain similar surpluses over the medium-term (Table 3). While in the late 1990s, they flowed partly from the thriving exports, more recently, they are largely a counterpart of the low level of corporate investment and higher net factor incomes. Finland's investment ratio has been below the euro area average for the past ten years. The net international investment position (excluding equities) has turned positive.

9. **The fiscal surplus has rapidly eroded in recent years**. Although the general government surplus, at around 2 percent of GDP in 2003, remained among the highest in the advanced world, it was more than accounted for by the surplus of the social security funds, with the central and local government sector in a small deficit. The dwindling of the surplus since its record level of 7 percent of GDP in 2000 is partly cyclical, reflecting the end of the technology-sector-driven boom; however, it is also a consequence of a sharp discretionary policy shift as the structural surplus fell by 3¼ percent of GDP over the period (Figure 3). The strong fiscal expansion—second only to that observed in the United States and the United Kingdom in the OECD area—was largely brought about by increased public spending in 2002 and tax cuts in 2003, the latter amounting to about 1½ percent of GDP.

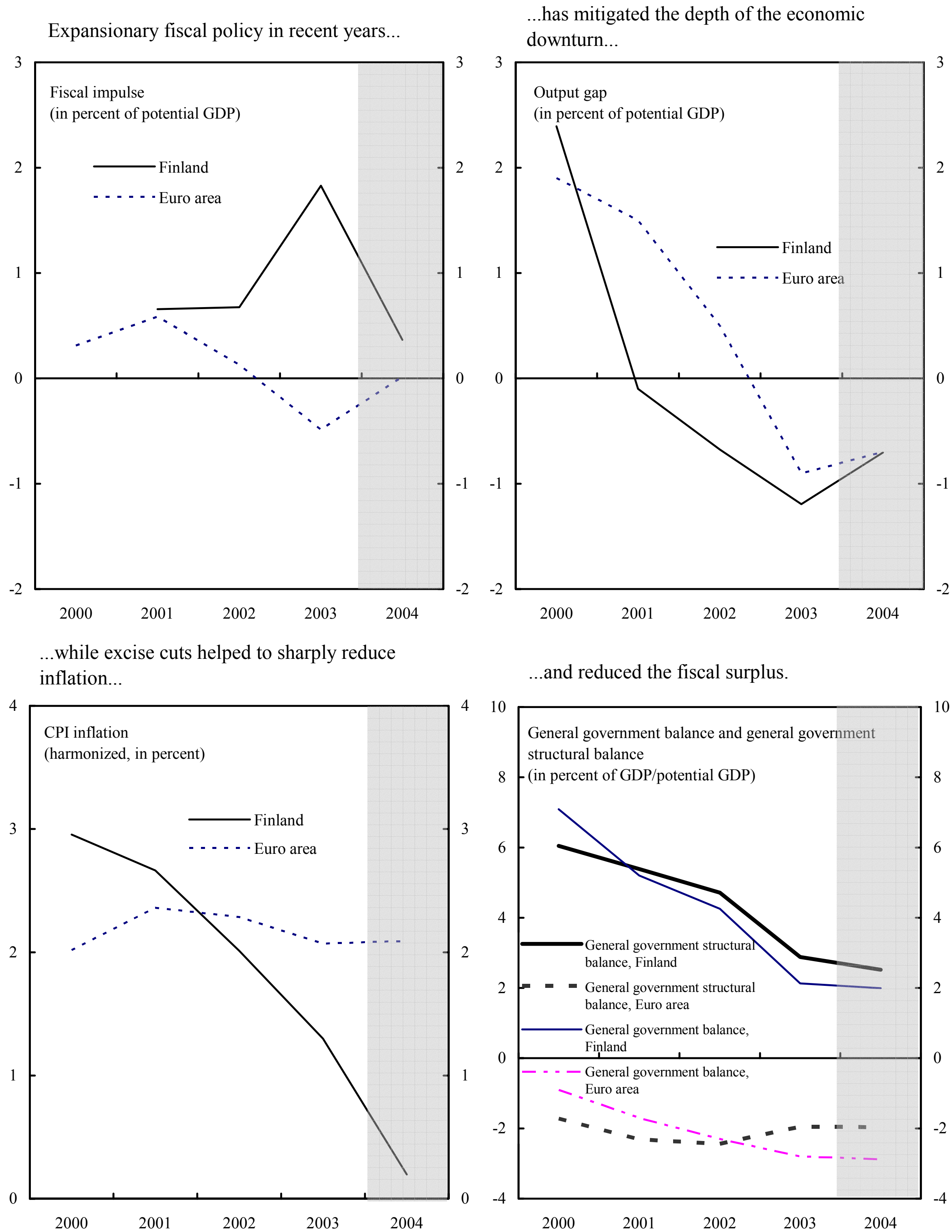
General Government Overall Balances
(percent of GDP)

	2002	2003	2004 est.	2005 proj.
Central and local governments	1.3	-0.3	-0.4	-0.9
Social security	3.0	2.4	2.4	2.7
General government	4.3	2.1	2.0	1.8
General government (structural)	4.5	2.8	2.4	2.0

Sources: Statistics Finland; Ministry of Finance; and staff projections.

10. **Strong growth helped maintain the fiscal surplus at 2 percent of GDP in 2004, although the structural balance weakened further**. With growth about ½ percent above that estimated in the budget, revenues were buoyant, despite cuts in income taxes and alcohol excises, totaling some 1 percent of GDP. The revised four-year expenditure rule with a 1-year legal and a 3-year indicative ceiling—covering about three-fourths of central government spending, but excluding cyclical, interest, and other volatile expenditures—was observed, although the margin remaining over the 2005–08 horizon is limited. The structural surplus is estimated to have worsened by about ½ percent of GDP.

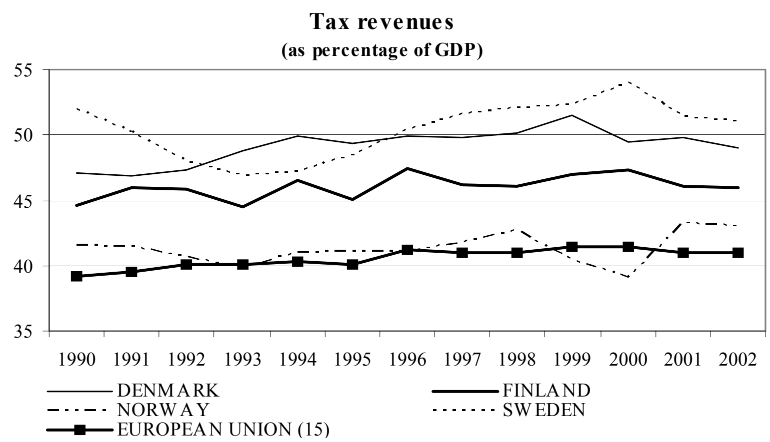
Figure 3. Finland: Selected Indicators, 2000-04



Sources: Statistics Finland; ETLA; WEO; and Fund staff calculations.

11. **The budget for 2005 is expansionary despite the projected economic rebound**. A cut in the corporate tax rate of 3 percentage points (to 26 percent) and in the personal capital income tax rate by 1 percentage point (to 28 percent) is designed to stimulate investment. In the context of the incomes policy accord, the authorities have also announced cuts in income taxes of 0.2 percent of GDP, aimed at stimulating employment. The general government surplus is projected to decline to about 1¾ percent of GDP, with the deficit of the central and local government sector likely to exceed ¾ percent of GDP.

12. **Despite recent tax cuts, the tax burden and tax wedges continue to be high**. Finland's tax burden is among the highest in the world, exceeded only by Sweden and Denmark, and is about 5 percentage points of GDP higher than the EU average. Moreover, marginal tax wedges on labor, despite a decline in recent years, remain well above the OECD average (Figure 2), and high marginal tax rates set in at comparatively low income levels.



13. **A significant reform of the public pension system is underway**. The reform, to be phased in over an extended period beginning 2005, aims to raise the effective retirement age, currently 59 years. A key element of the reform is the replacement of the standard retirement age of 65 with a flexible retirement age ranging from 62 to 68, and an accrual rate rising with age for older workers. The inactivity rates in Finland among males aged 50 and over from sickness and disability are among the highest in the industrialized world.

II. THE POLICY SETTING AND THE OUTLOOK

14. **The longer-term outlook is clouded by rapid population aging and the economy's vulnerability to shocks due to its relatively undiversified structure**. The lackluster productivity record of the sheltered sectors is likely to hold back growth as the contribution from the high technology sector, facing falling prices and stiffer competition in world markets, becomes less significant. The challenge for policy is to raise the utilization of labor in the face of low participation rates at both ends of the age spectrum. Labor resources are set to decline even more rapidly than in other European economies, constraining the fiscal room for maneuver. Indeed, the changing population age structure will begin to impact the labor market as early as 2006. The economy's greater vulnerability to shocks in light of its specialization in telecom and forestry products also argues for reforms to raise the flexibility of product and labor markets (Box 1).

15. **Despite Finland's top position in competitiveness rankings, there is fairly widespread anxiety about the economy's ability to compete in a rapidly globalizing world**. The unease stems from a perception that "a small, expensive, rapidly aging and remote country"[2] would be unattractive to global investors. A variety of trends—Finnish companies' rising propensity to invest abroad; shrinking net capital stock as the investment ratio remains below that of the euro area; the secular decline in the terms of trade as export prices fall; and persistence of high structural unemployment—all tend to feed a climate of pessimism about the economy's long-term prospects. The authorities have been trying to raise public awareness of the coming demographic transition and of the need to persevere with structural reforms if Finland is to capitalize on its strengths: a highly educated labor force, a culture of innovation, a consensual social climate, and strong macroeconomic fundamentals.[3]

16. **In the near-term, an improved domestic and external climate is set to strengthen growth**. Domestic demand is projected to accelerate to 2½ percent in 2004, as tax cuts stimulate consumption and investment stages a tentative recovery. Although monetary conditions have tightened, reflecting the euro appreciation, they are not expected to hold back the recovery of demand (Figure 4). Staff's forecast, based on assumptions underlying the ongoing WEO exercise, is for GDP to grow by around 3 percent in both 2004 and 2005 and for the small output gap to close. However, unemployment is expected to decline only slightly. The latest official projections, assuming an oil price of about US$45 in 2005 and US$40 in 2006, and an average euro exchange rate of $1.24, are broadly similar.

17. **The risks to the forecast are evenly balanced**. A faster pace of global recovery than assumed and a turnaround in Nokia's market share could strengthen exports further. The present projection assumes a continued loss in Finland's overall market share. Measures of competitiveness have remained broadly stable over the past two years despite the appreciation of the euro. However, high oil prices and further appreciation of the euro could worsen prospects in the euro area as a whole, while continued adverse employment trends could damage consumer confidence.

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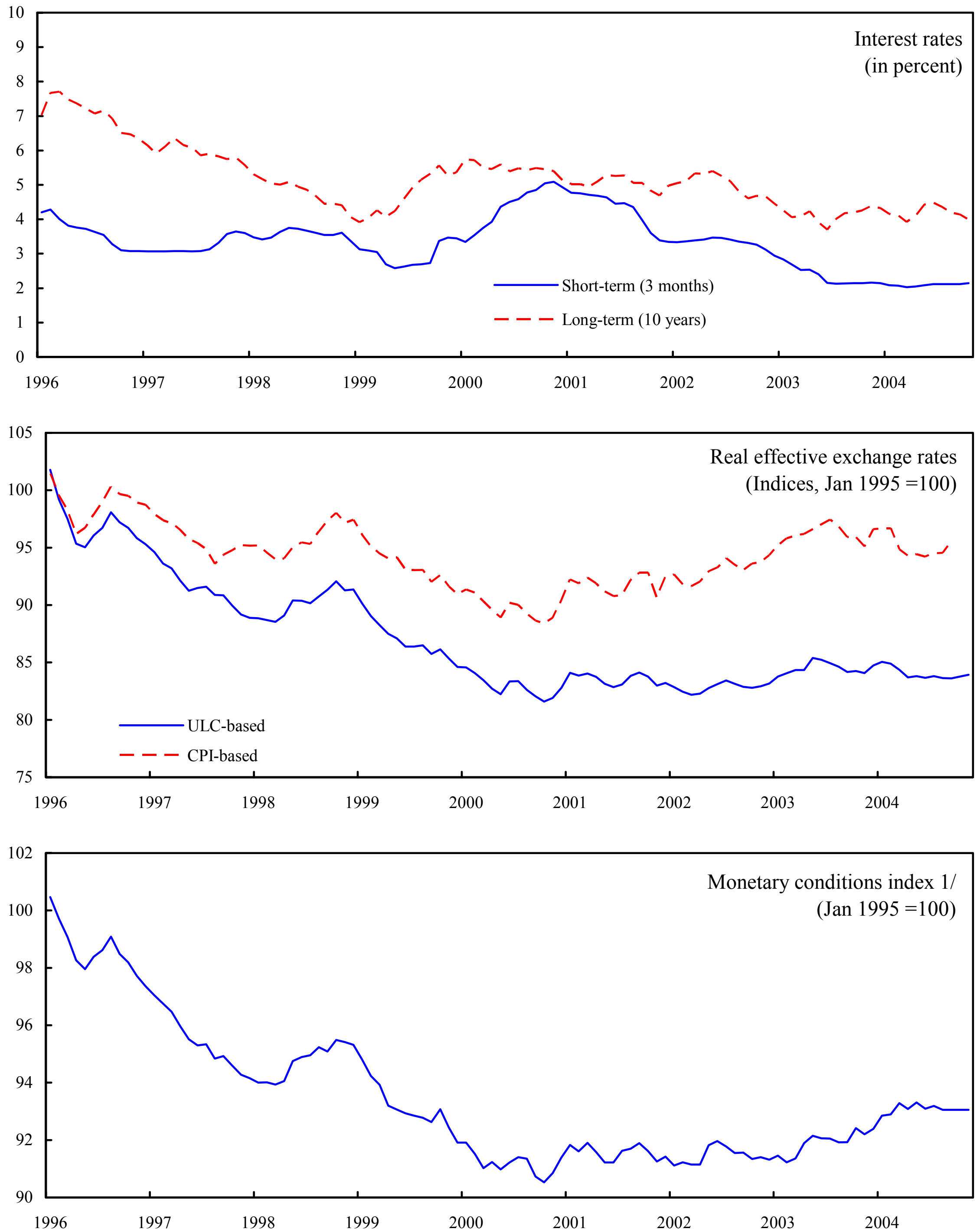
[2] Former Governor Mr. Vanhala's characterization in a speech delivered on October 9, 2003.

[3] Recent reports commissioned by the authorities include: "Strengthening Competence and Openness: Finland in the Global Economy," Prime Minister's Office, October 2004; and "Challenges For Growth in the 21st Century," Ministry of Finance, 2003.

Figure 4. Finland: Interest Rates and the Real Effective Exchange Rates, 1996-2004



Sources: ETLA; IFS; Bank of Finland; and Fund staff calculations.
1/ Using weights for real short-term and long-term interest rates and the real effective exchange rate (ULC based) of one-third each. An increase in the index represents a tightening of conditions.

III. The Policy Discussions

18. **Against the backdrop of a nascent recovery and the demographic transition, the discussions centered on three key issues**.

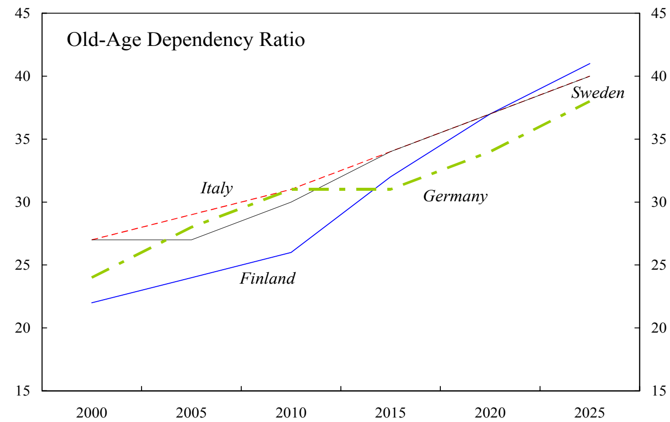
- **Ensuring fiscal sustainability**: With a recovery underway and rapidly approaching demographic pressures, how to place the fiscal position on a stronger footing through additional pension reforms and expenditure restraint, which would also allow for further reductions in the high taxation of labor;
- **Enhancing employment at both ends of the age spectrum**: How to calibrate policies to boost employment among the young and older workers, address labor market mismatches by reducing wage compression, boosting the demand for unskilled labor, and increasing incentives for job search;
- **Broadening productivity gains**: Strengthening competition, especially in sheltered sectors (utilities, transport and retail services, and agriculture), and reducing public ownership.

A. Fiscal Policy Issues

19. **The medium-term fiscal prospects are shaped by the strengthening recovery and the planned tax cuts**. The authorities noted that following the strong stimulus of 2001–03, fiscal policy had returned closer to a neutral stance in 2004. The stimulus implied in the budget for 2005, although no longer needed from a cyclical perspective, was considered appropriate since it flowed largely from the authorities' commitment to tax cuts in the context of the centralized wage accord and the critical importance of the objective of raising employment. Officials shared the mission's concern over the composition of the public sector surplus, with the central government balance expected to move into a sizeable deficit in 2005. The authorities were candid in acknowledging the difficulties in meeting the official objective of a balance in central government finances by 2007, but they remained committed to achieving it. The medium-term fiscal outlook is not regarded as a cause for concern, although longer-term prospects are less reassuring (Table 4).

20. **The authorities and the staff concur that mutually reinforcing labor and product market reforms would obviate the need for larger fiscal adjustment over the long-term** (Box 2). Absent such reforms, assessments of fiscal sustainability, employing broadly similar frameworks—those by the staff, the authorities, and the OECD—conclude that, despite starting from a net asset position, sizeable fiscal surpluses will be needed over the coming decade. The staff analysis suggests that, on present policies, the general government (excluding the social security surpluses of about 2½ percent of GDP) would need to sustain annual surpluses of 1½ percent of GDP through the end of the decade to ensure sustainability, compared with a present deficit of about ¾ percent of GDP. A more ambitious set of structural reforms, spanning the fiscal and pension fronts as well as labor and product

Box 2. Structural Reforms and Fiscal Sustainability



The long-term fiscal outlook is less comfortable than it appears at first glance. With the impact of aging occurring about a decade earlier than in many other European countries—between 2010 and 2025, the rise in the old-age dependency ratio is the steepest in the EU—and the stronger response of age-related spending, reflecting Finland's comprehensive public welfare provision, leaves it little fiscal leeway.

Staff analysis suggests that, in the absence of further structural reforms, sizeable fiscal surpluses would be required over the coming decade to meet the demographic shock. Staff's baseline projections suggest that, on present policies, a permanent fiscal adjustment of about 2 percent of GDP is required to ensure sustainability (Figure 5).[1] The conclusion of this scenario mirrors that of the authorities' own assessment, which suggests that the currently envisaged general government surpluses of about 2 percent of GDP for the rest of the decade will eventually result in accelerating public debt, as the fiscal costs of aging materialize. In the same vein, a recent OECD study suggests that—assuming no further pension reforms, potential output growth of 2¼ percent and even some increase in employment—a permanent fiscal adjustment of 1 percent of GDP would be needed to avoid a sharp deterioration of the government net asset position by 2050.[2] A significant fiscal tightening would be needed under the authorities' present program to achieve the required adjustment.

A more ambitious set of structural reforms would reduce the need for large fiscal surpluses, creating room for tax cuts. Staff's analysis on the basis of the Fund's GEM model, calibrated to the Finnish economy, shows that a combination of product and labor market reforms would help initiate a virtuous circle that would substantially reduce the required fiscal adjustment. In the "structural reforms" scenario, greater product and labor market efficiency leads to sizeable economic gains, resulting in higher employment and output—around 3 percentage points each (Figure 6). The need for fiscal adjustment is, accordingly, substantially lower than in the baseline scenario, by about 1 percent of GDP. These reforms, combined with additional pension or other expenditure measures, would make room for growth-enhancing tax cuts.

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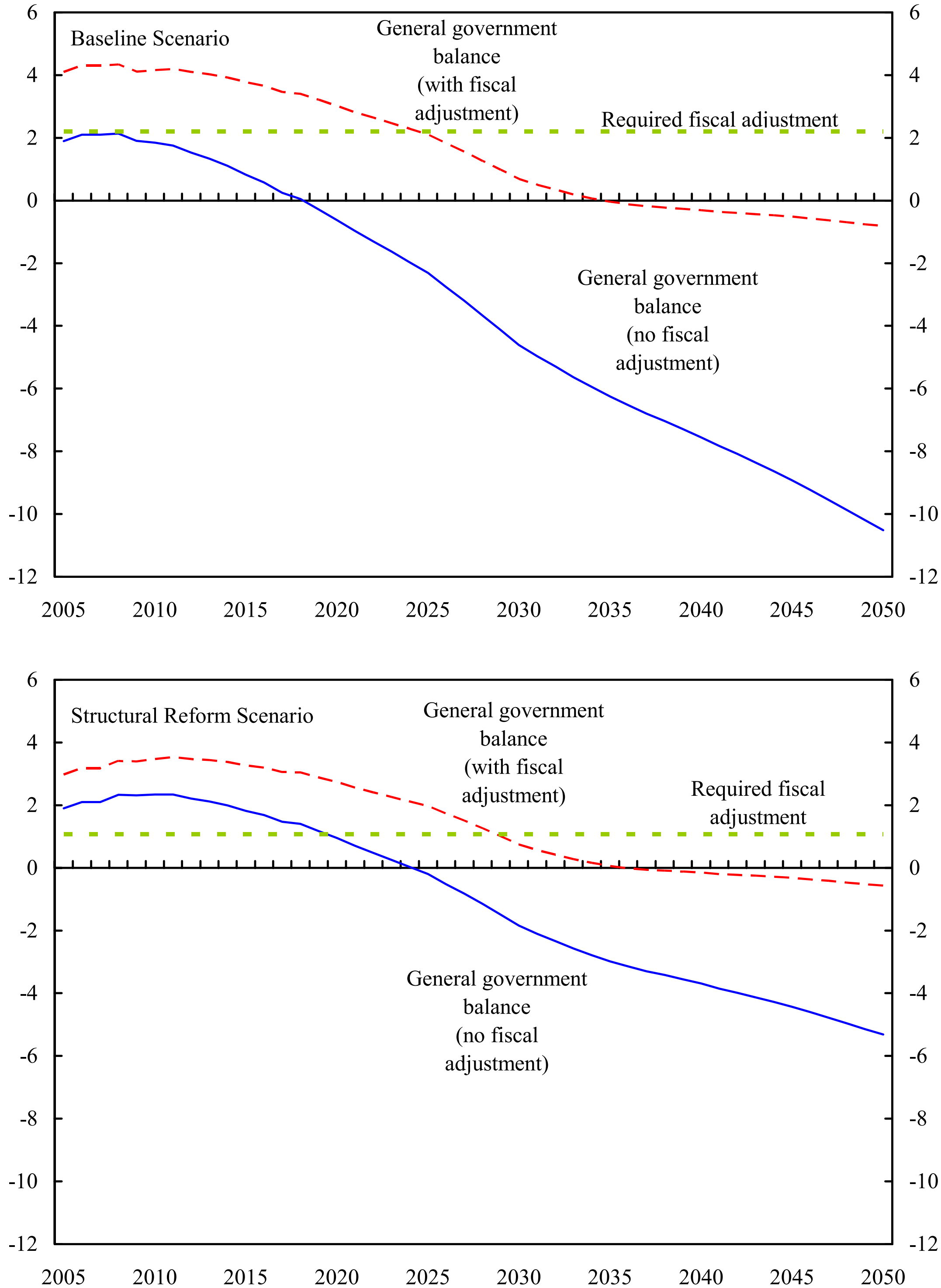
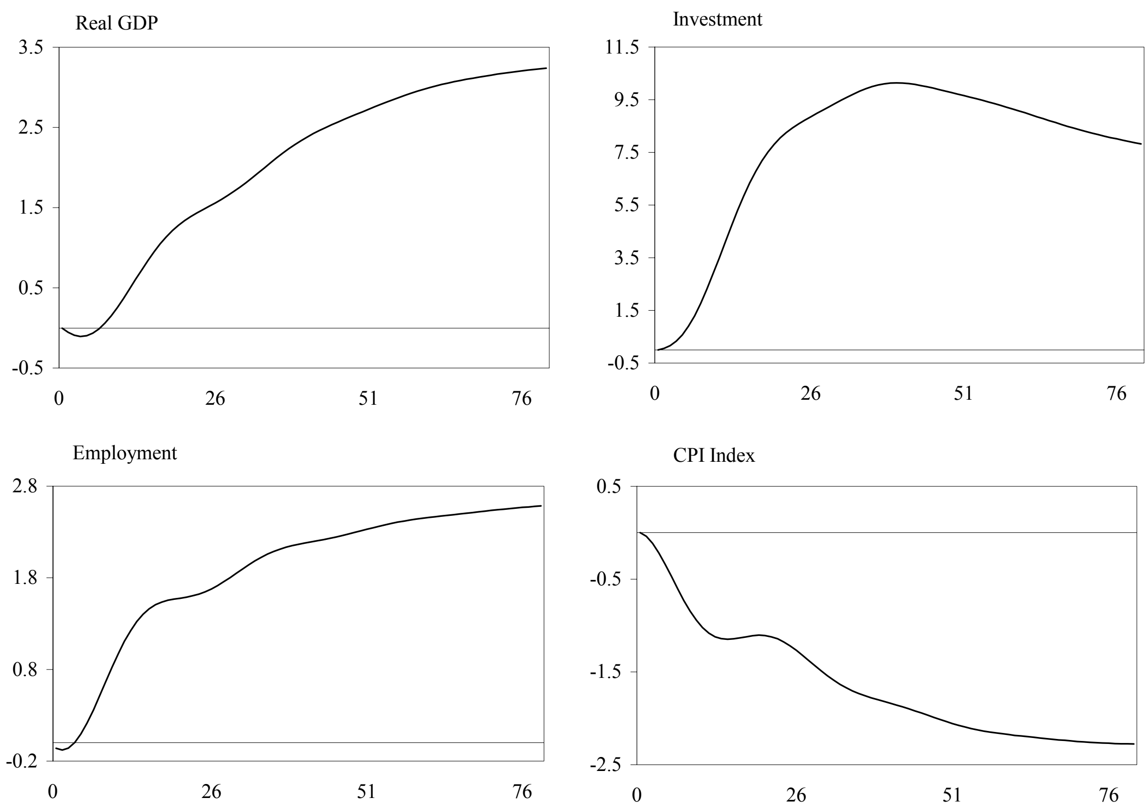
[1] See the Selected Issues Paper.
[2] See OECD, "2004 Economic Review—Finland."

Figure 5. Finland: Baseline and Structural Reform Scenarios, 2005-50
(Percent of GDP)



Sources: Finnish authorities; and staff projections.

Figure 6. Finland: Simulated Impact of Labor and Product Market Reforms 1/
(Percent deviation from baseline)

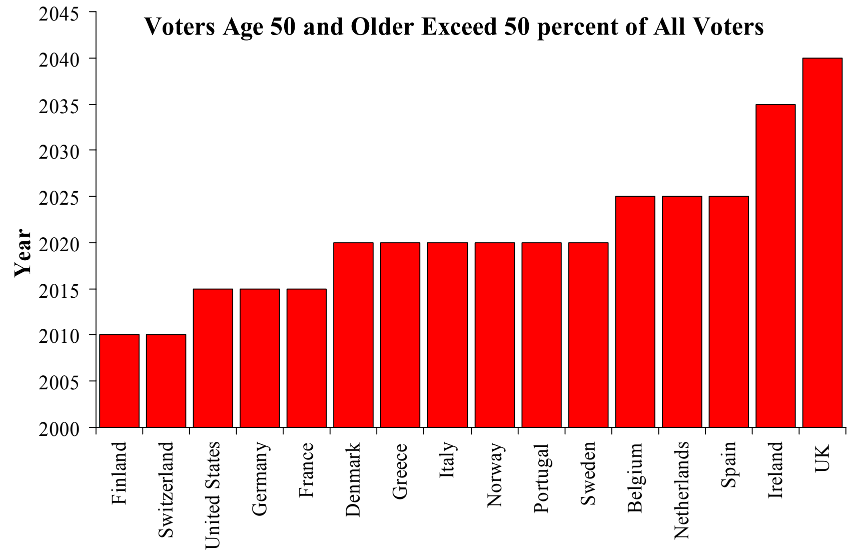


1/ Number of quarters on horizontal axis.

Source: Fund staff calculation based on the IMF's Global Economy Model.

markets, would reduce the need for fiscal adjustment, creating much-needed room for tax cuts (Figure 5). The staff and the officials agreed that these estimates were likely to understate the required fiscal adjustment since they did not allow for factors such as the likely rise in health care spending due to new expensive treatment methods, and a rise in wage and non-wage costs of local governments.

21. **The mood of popular complacency about the challenge of aging has complicated policymaking**. The Finnish ethos of consensus had in the past served to mobilize popular support behind difficult decisions at times of crises. However, with Finland's recent record of strong growth and fiscal surpluses, officials expressed frustration at the task of overcoming the public's "information deficit." They intended to continue their efforts to raise public awareness of the issues at stake. The mission underscored, especially in its public statements, that as aging accelerated, the electoral arithmetic would begin rapidly shifting against the constituency for structural reforms. Further reform of the pension system, combined with addressing labor and product market rigidities, would provide scope for tax cuts.



Source: United Nations, World Population Prospects: The 2002 Revision (2003).

22. **Pressures on public spending are unlikely to abate in the next few years**. Officials noted the narrowing margins under the expenditure ceilings and pointed to two main sources of pressure in the coming years. Demographically driven increases in spending were likely to result in rising transfers to local authorities. In addition, the decision to initiate new infrastructure investments without explicit allocations inside the spending ceiling was adding to spending pressures. Over the medium term, areas that offered scope for savings included education subsidies, public pensions and improved efficiency in the provision of public services—particularly those provided at the local level.

23. **The authorities agreed that local government finances are increasingly a cause for concern**. The local sector, providing a large share of the education and social services and accounting for the bulk of public employment, has experienced rapid growth in consumption in recent years. Declining efficiency of spending, combined with excessive reliance on volatile corporate profit tax bases, has obliged local governments to raise income tax rates, partially offsetting central government efforts to reduce taxation. The authorities planned limited reforms to municipal finances including abolition of the automatic adjustment of state grants when local spending exceeds plans. The mission argued that, over the longer term, a shift from relatively cyclical tax bases to property taxes may be needed. This option was, however, regarded as politically infeasible, in view of the widespread home ownership.

B. Labor Market Policies and Pension Reforms

24. **Reducing taxation of labor has been a key element of the authorities' efforts to promote employment**. In view of the particularly high tax wedge at the low end of the wage distribution, the authorities have tried to target tax reductions at the low-income earners. Considerable evidence suggested that targeted reductions in social insurance contributions by employers of the low skilled (and low paid) was a more effective policy to promote employment than across-the-board tax cuts.[4] While noting that tax cuts implemented in the context of incomes policy accords tended to be more of the latter variety, officials pointed to their efforts to tilt tax cuts towards the low-paid and the decision to reduce their payroll taxes in 2006. There was also a case to reduce high marginal tax rates at the upper end of the wage distribution to attract and retain skilled labor. The recent report of the Globalization Committee had recommended across-the board tax cuts to encourage work effort. The mission argued that, while a more substantial reduction in overall labor taxation was clearly desirable, it should occur only when offsetting expenditure cuts are secured.

25. **The authorities are mindful of the necessity for a broader structural agenda to achieve their ambitious employment target**. The expected further decline in the employment rate to 67 percent in 2004 underlined the demanding nature of the official objective of raising it to 70 percent. While reducing the tax wedge on labor would help stimulate employment,[5] officials agreed that incentives remained for workers to leave the labor force too early and enter it quite late, given the almost free education and generous subsidies. The authorities planned to shorten further the average time spent in tertiary education, by putting in place a two-tier university degree structure in 2005. The use of study loans rather than grants is also under consideration. However, since unemployment primarily afflicted the unskilled, both young and old, the authorities' approach focused on easing labor taxation, improving active labor market policies and securing a moderate wage accords that would gradually allow for greater flexibility in wage-setting.

26. **Finland has generally attracted lower immigration than the other Nordic or the larger EU countries**. For instance, the share of foreign-born population in Finland in 2002 was less than 3 percent, compared with 6–7 percent in Denmark and Norway and almost

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[4] Such targeted cuts have shown positive effects in Belgium, France, the Netherlands, and Spain, and are in line with the thinking of a study group set up in the Finnish Prime Minister's Office.

[5] While the Finnish approach is in line with the EU's Employment Guidelines of "making taxation employment friendly," the recent tax cuts have been relatively modest and, unless supported by policies to reduce labor and product market rigidities, may fail to have a major impact on employment. In this context, a recent survey of international experience is suggestive. See Nickell, S. (2003), "Employment and Taxes," *CESifo Conference Paper*, July 2003 www.bankofengland.co.uk/speeches/.

12 percent in Sweden. Officials noted that recent studies of migration from the Baltics suggested no significant actual or prospective rise in labor inflows into the Nordic countries. Nevertheless, Finland, along with most EU countries, has opted to introduce special transition rules governing the right of access to its labor market for citizens from the new EU member states.

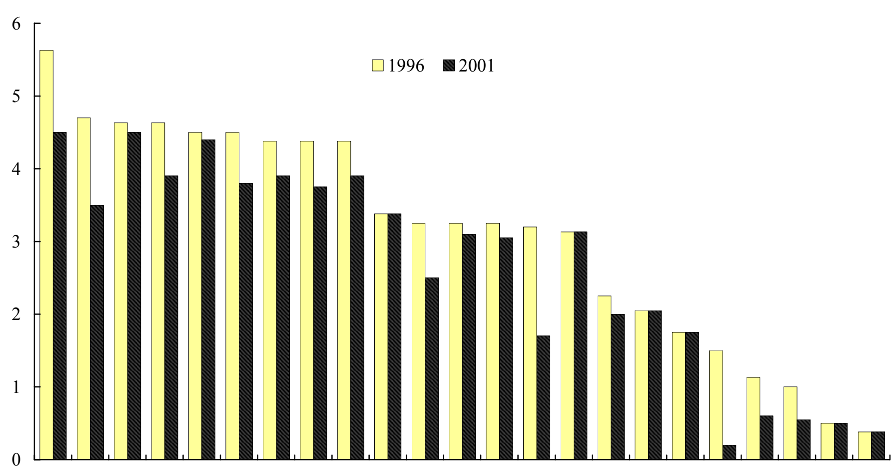
27. **The authorities recognize that changes in the institutional arrangements of the labor market are highly desirable**. While the centralized wage determination had served to moderate inflation, it had solidified wage rigidities that are unfavorable to the young and unskilled workers. Globalization, with the attendant greater competition in product and labor markets, had tended to alter the premises of centralized systems, as was evident in the trends in the rest of the Nordic world. The Finnish trade unions, wedded to the traditional "solidaristic" framework of wage bargaining, continued to place emphasis on job security and effective "job-to-job" training. Nevertheless, officials viewed the recent wage accord as marking a first step in the direction of more decentralized wage formation.

28. **The pension reform is expected to improve incentives for older workers to delay exit from the labor force**. The authorities believed that the tripartite agreement on the reform package was a major achievement and stressed the critical importance of three elements of the reforms in train: the automatic link of pensions to life expectancy; the nexus of benefits to lifetime earnings in place of the earlier "ten-year rule"; and introduction of a flexible retirement age. Officials argued that the impact of the changes already initiated needed to be assessed before contemplating further measures. Officials did not dispute that additional reforms such as further limiting the avenues to early retirement by closing the so-called "unemployment pipeline"—whereby the unemployed aged over 57 can continuously claim benefits to age 65—were needed, but stressed the political difficulty of "selling" any new reforms in the near term. The mission argued for early consideration of further reforms, given the long phase-in periods required.

C. Product Markets and Trade

29. **The authorities concurred that labor market reforms would yield positive synergies if they were complemented with product market reforms.** Lack of competition was evident in Finland's high price level in relation to the EU average. The relative size of the public enterprise sector remained larger than in most Nordic

Relative Size of the Public Enterprise Sector in OECD /1



Source: OECD

1/ Index 0-6 scale from the lowest to highest share of public enterprises; index based on the extent of state ownership and (gross) proceeds from privatizations.

countries. The sheltered sectors were characterized by relatively high market concentration, high prices, lagging productivity, and significant state ownership. Officials believed that privatization was likely to proceed only gradually. They agreed that despite Finland's high ranking in relatively "soft" measures of competitiveness (e.g., perceptions of corruption, supportive legal environment, good educational system), it lagged behind in "hard" measures (e.g., high tax rates, high compensation levels, high management remuneration). This divergence might explain comparatively low levels of inward foreign direct investment.

30. **The authorities noted that competitive pressures were gradually increasing**. Competition in the retail sector had risen somewhat since EU accession, and although still limited, had more recently led to a fall in food prices. Similarly, rising tax competition and the revived role of regulatory authorities in sheltered sectors, including network industries, also had a salutary impact. The Competition Authority's legislation had been brought into alignment with the EU competition law. The new legislation in place should allow the Competition Authority to deal effectively with cartels. The planned reform of shop opening hours is expected to enhance competition in the retail sector.

31. **Finland remains a strong supporter of the Doha Development Agenda, but retains its heavy farm subsidization**. Officials generally favored a multilateral trading framework as superior to a series of bilateral agreements. While agreeing that a reduction in Finland's farm subsidies—even higher than the EU average—would raise efficiency and consumer welfare, officials regretted that political difficulties would allow only a gradual progress in this area. Finland's official development assistance remained notable, budgeted to rise to almost 0.4 percent of GDP in 2005 from around 0.35 percent in recent years.

D. The EMU Experience and the Financial Sector

32. **The authorities looked back on the experience of over five years in the EMU with considerable satisfaction**. Expectations at the time of entry into the euro area at the beginning of 1999 had generally been met, while some of the concerns prevalent at the time of entry had been belied. As expected, Finland had benefited from monetary stability and lower interest rates. Officials noted that the effects of EMU entry were not easy to isolate from other influences, especially since the economy had just recovered from a period of severe recession and financial crisis at the time of entry. Despite initial concerns centered on the risk of unfavorable asymmetric shocks, growth had been more rapid than in the euro area, thanks to the boom in the high technology sector. The economy's openness had increased and, after several decades of deficits, large current account surpluses had emerged, even during periods of robust growth. Looking ahead, as EU enlargement intensified competition for placement of production and jobs, the challenge of adaptation for a country like Finland with high tax rates and a large welfare state was clear.

33. **The financial sector appears ready for greater European market integration**. Officials noted that bank profitability remained healthy, the proportion of non-performing loans extremely low, and stress tests suggested that banks could withstand extended economic stagnation and a significant fall in asset prices (Table 5). Although household debt

as a proportion of disposable income had risen, it was still low in an international perspective and there was little concern about the ability of households to service their debts. Increased cross-border financial activities by systemically important institutions and the merger of the Swedish and Finnish stock exchanges called for close cooperation among Nordic-Baltic supervisors and new coordinated supervisory mechanisms. The authorities noted that cross-border financial transactions raised important policy questions for the EU as a whole, not least regarding deposit insurance and the role of the lender of last resort.

IV. Staff Appraisal

34. **Finland's recent economic record has been impressive, but major challenges lie ahead**. The economy has weathered the global slowdown relatively well, with strong fiscal stimulus helping to support economic growth. Inflation is low, the external position is comfortable, and the public finances have recorded surpluses that remain among the largest in the European Union. However, structural unemployment remains high, and looking ahead, Finland faces a rapidly changing global and domestic environment that call for hard policy choices.

35. **The longer term outlook is clouded by imminent population aging, and rigidities in institutions that impede adaptation to change**. With the adverse effects of aging impacting Finland earlier than any other country in EU, the electoral arithmetic will begin to shift soon against the constituency for reforms. While Finland enjoys the advantage of a favorable initial position, with the public sector holding sizeable net assets and a significant pension reform under way, the window for an effective and politically feasible policy response is likely to close rapidly. An early pursuit of wide-ranging structural reforms would help set in train a virtuous circle of higher employment and growth and stronger public finances.

36. **Policy initiatives are needed to raise the employment rate—a precondition to achieving fiscal sustainability**. Given the incentives embedded in the current labor market and education arrangements for workers to enter the labor market rather late and leave it too early, achieving the authorities' ambitious employment target would call for major policy changes. Recent tax policy measures that reduce the burden of labor taxation will help promote employment, particularly of the low-skilled, but are unlikely to be effective on their own. Policies encompassing the tax-benefit system as well as product and labor market arrangements are required to raise utilization of labor at both ends of the age spectrum. A shift towards a more decentralized wage bargaining arrangement would ease the compressed wage structure, allowing a greater correspondence between wage and productivity differentials, and help reduce structural unemployment.

37. **In the absence of wide-ranging structural reforms, ensuring fiscal sustainability would require sizeable general government surpluses for the rest of the decade**. With the stronger expected rise in age-related spending than elsewhere, reflecting the rapidity of aging as well as Finland's comprehensive welfare state, fiscal surpluses would provide a cushion to

absorb the coming demographic shock. Staff's assessment suggests that the central and local governments would need to run a combined annual surplus of the order of 1½ percent of GDP, as compared with a projected deficit of over ¾ percent of GDP in 2005.

38. **With solid growth in prospect, the fiscal stimulus implied by the 2005 budget is no longer necessary**. The proposed cuts in taxation, including those announced in the context of the recent wage round, should be offset by cuts in spending as the full tax package is implemented. Over time, the beneficial effects on employment will be enhanced by tax cuts targeted at the lower end of the income scale. The government's intention to reduce employers' social security contributions for low-income workers in 2006 is an important step in this direction.

39. **The room for a durable reduction in the taxation of labor should be created by pruning public spending**. The authorities' objective to attain central government balance by 2007 will be feasible only if any new tax cuts or spending initiatives are offset by spending cuts elsewhere and ceilings on expenditures observed scrupulously. Social transfers that deter the effective utilization of labor could be reduced, with a focus on limiting incentives for early retirement. A key avenue to easing pressures on public spending is to raise the efficiency in the provision of social and welfare services. In order to place municipal finances on a sound footing, a reassessment of their revenue sources may be necessary, with consideration given to greater reliance on alternative sources such as property taxes.

40. **The pension reform to be phased in beginning next year is an important step towards ensuring fiscal sustainability, but is, by itself, insufficient**. The reform—with commendable features such as an automatic adjustment for rising life expectancy, link of benefits to life-time earnings, and sharply rising accrual rates at age 63—is expected to raise the effective retirement age by almost two years. While the reform goes some way towards promoting higher labor participation by limiting the avenues for leaving the labor market early, important avenues to early exit from the labor force remain. To maximize the beneficial impact of the reform on participation, the so-called "unemployment pipeline" should be closed.

41. **The prospective shrinking of labor supply underlines the importance of enhancing productivity**. The high-technology sector has propelled the recent strong productivity growth. Raising productivity in the sheltered sectors will require investment in equipment and technology, in turn calling for a supportive economic and policy environment. Reforms to promote greater flexibility in labor and product markets are likely to have a large pay-off in terms of durable productivity gains throughout the economy.

42. **Strengthening competition further in product markets would complement measures to improve the functioning of labor markets**. Despite notable progress achieved in recent years, especially in communications, air transport and retail trade, the price level remains significantly above the EU average and scope exists to enhance competition. Reducing rigidities that impair the functioning of product markets could have positive spillover effects on the labor market. Competition between private and public sectors in the

provision of services could also be encouraged. Last but not least, Finland's farm subsidies—high even by EU standards—should be reduced in the interest of greater efficiency and consumer welfare.

43. **The financial system is stable and is poised to benefit from increasing European financial integration**. However, growing cross-border financial activities by systemically important institutions and the recent merger of the Swedish and Finnish stock exchanges underline the importance of close cooperation among Nordic-Baltic supervisors and new coordinated supervisory mechanisms.

44. Finland's high level of official development assistance is commendable.

45. Finland's provision of economic statistics is adequate for the purposes of Fund surveillance.

46. It is recommended that the next Article IV consultation with Finland remain on the 12-month cycle.

Table 1. Finland: Main Economic Indicators, 2000–07 1/

					Proj.			
	2000	2001	2002	2003	2004	2005	2006	2007
	(Percentage change, unless otherwise indicated)							
Output and demand (volumes)								
GDP	5.1	1.1	2.3	2.0	3.1	2.9	2.4	2.2
Domestic demand	3.6	1.7	1.3	2.1	2.4	2.5	2.1	1.9
Consumption	2.2	2.0	2.2	3.5	2.1	1.9	2.0	1.8
Private consumption	3.1	1.8	1.5	4.3	2.5	2.2	2.3	2.0
Public consumption	0.0	2.4	3.8	1.6	1.0	1.4	1.5	1.5
Gross fixed capital formation	4.1	3.9	-3.1	-2.1	4.7	4.5	2.5	2.4
Private investment	5.7	3.3	-4.6	-3.0	6.1	4.7	2.5	2.5
Public investment	-5.7	8.1	6.6	2.7	-2.8	3.1	2.5	2.0
Export of goods and services	19.3	-0.8	5.1	1.1	3.1	3.2	3.6	3.5
Import of goods and services	16.9	0.2	1.9	2.6	1.2	1.8	3.3	3.5
Foreign contribution to growth (in percent of GDP)	2.7	-0.6	2.0	-0.5	1.3	1.1	0.7	0.6
Prices, costs, and income								
Consumer price inflation (harmonized)	3.0	2.7	2.0	1.3	0.2	1.5	1.8	1.8
Core inflation (excluding energy and seasonal food)	3.0	2.6	1.9	1.2	0.0	1.5	1.3	1.5
GDP deflator	3.2	3.0	0.9	-0.1	-0.2	1.0	1.1	1.1
Terms of trade	-4.6	2.3	-0.9	-3.7	-1.5	-1.3	-0.2	-0.4
Unit labor cost, manufacturing	-5.7	3.3	0.4	0.2	-0.8	0.1	0.4	0.5
Labor market								
Labor force	1.2	0.6	0.2	-0.3	-0.6	0.0	0.0	0.0
Employment	1.7	1.4	0.2	-0.3	-0.3	0.5	0.3	0.2
Unemployment rate (in percent)	9.8	9.1	9.1	9.0	8.8	8.3	8.0	7.8
Potential output and NAIRU								
Output gap (in percent of potential output) 3/	2.4	-0.1	-0.7	-1.2	-0.7	-0.1	0.0	0.0
Growth in potential output	6.6	3.6	2.9	2.6	2.6	2.3	2.3	2.2
NAIRU (in percent)	9.7	9.2	9.2	8.5	8.2	7.9	7.7	7.5
	(In percent)							
Money and interest rates								
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	-3.4	7.7	4.9	7.4	...	...	...	...
Domestic credit (growth rate, e.o.p.)	4.5	16.8	5.1	10.3	...	...	...	...
3-month money market rate	4.4	4.3	3.3	2.3	3.7	3.9	4.2	4.3
10-year government bonds yield	5.5	5.0	5.0	4.1	4.2	4.4	4.6	4.8
Monetary condition index 4/	91.9	91.3	91.6	92.1	...	...	...	...
	(In percent of GDP, unless otherwise indicated)							
National saving, investment, and income								
Gross national saving	28.2	27.7	25.8	24.2	24.3	24.8	25.1	25.2
Gross domestic investment	20.6	20.6	19.0	18.5	18.6	18.8	18.8	18.9
Private saving	18.6	19.6	18.7	19.1	19.4	20.1	20.1	20.2
Household saving as percent of disposable income	-1.3	-1.2	-1.3	-0.4	0.6	1.7	2.7	2.7
Private investment	18.0	17.8	16.2	15.5	15.7	16.0	16.0	16.0
Government saving surplus	7.1	5.2	4.3	2.1	2.1	1.9	2.1	2.1
Household's real disposable income (increase in percent)	0.3	2.6	2.0	5.3	5.5	2.5	2.5	2.2

Table 1. Finland: Main Economic Indicators, 2000–07 (concluded) 1/

	2000	2001	2002	2003	Proj. 2004	2005	2006	2007
	(In percent of GDP, unless otherwise indicated)							
Public finances								
General government 5/								
Revenues 6/	51.2	49.5	49.3	48.0	48.2	47.9	48.0	48.0
Expenditure	44.1	44.3	45.0	45.8	46.0	46.0	45.9	45.9
General Government balance	7.1	5.2	4.3	2.1	2.1	1.9	2.1	2.1
of which: net interest on public debt	1.1	0.7	0.2	0.3	0.0	-0.1	-0.2	-0.4
Primary balance 7/	8.1	5.9	4.5	2.4	2.1	1.8	1.9	1.8
Structural balance (in percent of potential GDP) 8/	6.0	5.2	4.5	2.8	2.6	2.1	2.2	2.2
Structural primary balance (in percent of potential GDP) 7/ 8/	7.1	5.9	4.7	3.1	2.6	1.9	1.9	1.8
…corrected for one-off factors 9/	5.1	4.8	4.1	3.1	2.6	1.9	1.9	1.8
One-off factors 9/	2.0	1.1	0.6	…	…	…	…	…
Debt (EMU definition) 10/	44.6	43.9	42.6	45.5	45.0	44.2	43.3	42.4
Central government 5/								
Revenues	27.6	25.6	25.9	25.3	25.5	23.9	23.4	23.0
Expenditure	24.2	23.6	24.4	25.0	25.4	24.4	23.9	23.4
of which: net interest on public debt	36.5	39.8	40.8	39.7	40.0	40.0	39.6	38.9
Central Government balance	3.4	2.0	1.4	0.3	0.1	-0.5	-0.5	-0.4
Debt 10/	49.3	45.9	42.9	45.0	43.7	42.8	41.8	40.9
Balance of payments								
Current account balance 11/	7.7	7.1	6.8	5.7	5.8	6.0	6.2	6.3
Trade balance	11.4	10.4	9.7	9.2	9.4	8.5	8.6	8.6
Net external debt (excluding equity FDI and shares)	13.8	5.5	2.2	-3.5	-9.2	-14.9	-20.6	-26.2
Exchange rates (period average)								
Euro per US$ (post-1999; FIM per US$ before)	1.09	1.12	1.06	0.89	...	...	...	...
Nominal effective rate (INS, increase in percent)	-5.2	1.9	1.3	4.4	...	...	...	...
Real effective rate (increase in percent) 12/	-4.6	0.8	-0.9	2.0	...	...	...	...

Sources: Ministry of Finance, Bank of Finland; and staff projections.

1/ Projections are staff estimates based on the authorities' current policy indications.
2/ Wages and salaries, plus employers' social security contributions, divided by working hours of employees.
3/ A negative value indicates a level of potential output that is larger than actual GDP.
4/ Using weights for real short- and long-term interest rates and the real effective exchange rate (ULC) of 1/3 each.
5/ On ESA95 basis.
6/ The fall in revenues in 2003 reflects, in part, planned cuts in some indirect taxes as well as the fading out of one-off factors related to exceptional tax revenues due to income from stock options in earlier years.
7/ Defined as noninterest (structural) revenue minus noninterest (structural) expenditure.
8/ Corrected for the influence of the business cycle as measured by the output gap.
9/ One-off factors include exceptional tax revenues due to income from stock options.
10/ Includes stock-flow adjustements reflecting changes in the portfolio allocation of Finnish pension funds.
11/ For 2004-06, staff expects a current account balance that stays above 7 percent of GDP.
12/ Based on relative normalized unit labor costs.

Table 2. Finland and Selected Countries: Expenditure Structure, 2002 1/
(In percent of GDP)

	Finland	Denmark	Sweden	EU15
Total	50.1	55.8	58.3	46.9
General public services	6.1	8.5	8.8	6.8
Defense	1.4	1.6	2.1	1.7
Public order	1.4	1.0	1.5	1.6
Economic affairs	5.0	3.7	4.8	4.2
Environmental protection	0.3	n.a.	0.3	n.a.
Housing and community amenities	0.5	0.9	0.9	0.9
Health	6.3	5.6	7.1	6.4
Recreation, culture and religion	1.2	1.7	1.1	0.8
Education	6.6	8.3	7.5	5.0
Social protection	21.3	24.5	24.1	18.7

Sources: Eurostat Chronos database.
1/ Definition differs slightly from Table 1. Data for the EU15 are for 2001.

Table 3. Finland: Balance of Payments, 1999-2009
(in billions of euros)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
								Proj.			
Current account	7.3	10.0	9.6	9.5	8.1	8.5	9.1	9.8	10.3	10.3	10.5
as a percentage of GDP	6.1	7.7	7.1	6.8	5.7	5.8	6.0	6.2	6.3	6.1	6.0
Goods and services	10.2	12.0	11.3	11.8	9.3	9.8	10.2	10.8	11.1	10.9	10.8
Exports of goods and services	45.3	55.9	54.1	54.1	53.1	55.0	57.1	59.9	62.8	65.3	68.0
Goods	39.4	49.7	48.0	47.5	44.6	46.4	46.7	49.0	51.4	53.4	55.7
Services	5.90	6.26	6.06	6.67	8.44	8.59	10.41	10.91	11.41	11.85	12.29
Imports of goods and services	-35.1	-43.9	-42.8	-42.4	-43.8	-45.2	-46.9	-49.2	-51.7	-54.4	-57.2
Goods	-28.0	-34.8	-33.9	-33.9	-31.6	-32.6	-33.8	-35.5	-37.3	-39.2	-41.2
Services	-7.12	-9.12	-8.92	-8.51	-12.19	-12.59	-13.07	-13.69	-14.40	-15.14	-15.92
Income	-1.9	-1.9	-1.2	-0.7	-1.0	-0.3	0.0	0.2	0.4	0.6	0.9
Compensation of employees	0.3	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Investment income	-2.2	-2.3	-1.6	-1.1	-0.5	-0.7	-0.4	-0.3	-0.1	0.2	0.4
Current transfers	-1.1	-0.2	-0.5	-1.6	-1.0	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3
Official	-1.6	-1.5	-1.7	-0.7	-0.1	-0.1	-0.2	-0.2	-0.2	-0.3	-0.3
Capital and financial account	-6.0	-9.8	-12.4	-8.7	-5.0	-8.5	-9.1	-9.8	-10.3	-11.3	-11.5
Capital account	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-6.1	-9.9	-12.5	-8.8	-5.1	-8.7	-9.3	-10.0	-10.5	-11.5	-11.7
Direct investment	-1.9	-16.5	-5.2	0.3	9.0	-1.2	-1.2	-1.2	-1.2	-1.1	-1.1
In Finland	4.3	9.6	4.2	8.4	2.5	4.9	5.5	6.2	6.9	7.8	8.7
Abroad	-6.2	-26.1	-9.4	-8.1	6.5	-6.1	-6.7	-7.4	-8.1	-8.9	-9.8
Portfolio investment excl. fin. derivatives	-2.2	-2.5	-6.2	-5.1	0.4	-0.6	-0.1	-0.4	-0.3	-0.4	-0.4
Other investment	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Assets	-3.3	-5.9	-11.3	-2.1	-13.9	-8.0	-10.9	-9.5	-10.2	-9.8	-10.0
Liabilities	1.5	15.4	10.8	-2.2	-1.1	1.0	2.9	1.0	1.2	-0.1	-0.1
Official	-0.6	-1.5	-0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.2
Private	-1.2	-0.3	-1.3	-2.3	-2.2	-2.2	-2.2	-2.1	-2.1	-2.1	-2.1
Reserve assets	-0.2	-0.4	-0.5	0.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-1.2	-0.2	2.8	-1.9	-3.1	0.0	0.0	0.0	0.0	1.0	1.0
Memorandum items											
GDP at current prices	120.0	130.1	135.5	139.8	142.5	146.6	152.4	157.8	163.0	169.1	175.4

Sources: Bank of Finland; and staff projections.

Table 4. Finland: Public Sector Debt Sustainability Framework, 1999-2009

(In percent of GDP, unless otherwise indicated)

	Actual							Projections						
	1999	2000	2001	2002	2003			2004	2005	2006	2007	2008	2009	
								I. Baseline Projections						**Debt-stabilizing primary balance 10/**
1 **Public sector debt 1/**	47.4	44.6	43.9	42.6	45.5			**45.0**	**44.2**	**43.3**	**42.4**	**41.3**	**40.1**	**-0.3**
o/w foreign-currency denominated	9.2	7.4	6.7	5.6	0.9			0.5	0.0	0.0	0.0	0.0	0.0	
2 Change in public sector debt	-1.2	-2.9	-0.7	-1.3	2.9			-0.5	-0.8	-0.9	-0.9	-1.1	-1.2	
3 Identified debt-creating flows (4+7+12)	-2.6	-9.4	-6.7	-6.0	-3.9			-3.3	-3.6	-3.6	-3.4	-3.6	-3.5	
4 Primary deficit	-5.3	-10.0	-7.9	-6.5	-4.2			-3.7	-3.4	-3.5	-3.5	-3.4	-3.3	
5 Revenue and grants	49.4	51.2	49.5	49.3	48.0			48.2	47.9	48.0	48.1	48.1	48.0	
6 Primary (noninterest) expenditure	44.1	41.3	41.6	42.8	43.8			44.5	44.5	44.4	44.6	44.7	44.8	
7 Automatic debt dynamics 2/	2.6	0.6	1.2	0.5	0.3			0.3	-0.1	0.0	0.0	-0.2	-0.3	
8 Contribution from interest rate/growth differential 3/	1.6	-0.8	1.0	0.8	1.2			0.4	-0.1	0.0	0.0	-0.2	-0.3	
9 Of which contribution from real interest rate	3.2	1.4	1.4	1.8	2.1			1.8	1.1	1.0	0.9	0.7	0.6	
10 Of which contribution from real GDP growth	-1.6	-2.2	-0.5	-1.0	-0.8			-1.4	-1.2	-1.0	-0.9	-0.9	-0.9	
11 Contribution from exchange rate depreciation 4/	1.0	1.4	0.2	-0.4	-0.9			-0.1	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)	1.4	6.5	6.0	4.7	6.8			2.8	2.7	2.6	2.5	2.4	2.4	
Public sector debt-to-revenue ratio 1/	96.0	87.1	88.6	86.5	94.9			93.5	92.3	90.2	88.1	85.9	83.5	
Gross financing need 5/	5.7	5.8	6.6	8.2	9.9			8.5	3.3	-2.0	-2.0	-2.0	-2.0	
in billions of U.S. dollars	7.3	7.0	8.0	10.9	16.0			15.3	6.2	-4.0	-4.1	-4.3	-4.4	
Key Macroeconomic and Fiscal Assumptions						10-Year Historical Average	10-Year Standard Deviation							Projected Average
Real GDP growth (in percent)	3.4	5.1	1.1	2.3	2.0	3.6	1.6	3.1	2.9	2.4	2.2	2.2	2.2	2.5
Average nominal interest rate on public debt (in percent) 6/	6.6	6.5	6.4	5.2	4.8	6.8	1.1	3.8	3.6	3.5	3.4	3.2	3.1	3.4
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	6.8	3.4	3.4	4.3	4.9	4.9	1.7	4.0	2.6	2.4	2.3	1.7	1.5	2.4
Nominal appreciation (increase in US dollar value of local currency, in percent)	-4.2	-13.4	-3.0	5.4	19.8	1.4	11.7	8.6	0.7	0.1	0.1	0.1	0.1	1.6
Inflation rate (GDP deflator, in percent)	-0.2	3.2	3.0	0.9	-0.1	1.9	1.8	-0.2	1.0	1.1	1.1	1.5	1.5	1.0
Growth of real primary spending (deflated by GDP deflator, in percent)	2.8	-1.8	1.8	5.3	4.4	1.5	2.6	4.6	2.9	2.3	2.6	2.3	2.3	2.8
Primary deficit	-5.3	-10.0	-7.9	-6.5	-4.2	-4.2	3.6	-3.7	-3.4	-3.5	-3.5	-3.4	-3.3	-3.5
								II. Stress Tests for Public Debt Ratio						**Debt-stabilizing primary balance 9/**
A. Alternative Scenarios														
A1. Key variables are at their historical averages in 2005-09 7/								**45.0**	**44.1**	**43.0**	**41.8**	**40.4**	**38.9**	**0.5**
A2. No policy change (constant primary balance) in 2005-09								**45.0**	**43.9**	**42.9**	**41.7**	**40.3**	**38.7**	**-0.3**
B. Bound Tests														
B1. Real interest rate is at historical average plus two standard deviations in 2005 and 2006								**45.0**	**46.7**	**48.5**	**47.7**	**46.5**	**45.3**	**-0.3**
B2. Real GDP growth is at historical average minus two standard deviations in 2005 and 2006								**45.0**	**46.4**	**48.3**	**49.5**	**50.4**	**51.2**	**-0.3**
B3. Primary balance is at historical average minus two standard deviations in 2005 and 2006								**45.0**	**50.5**	**56.0**	**55.2**	**54.0**	**52.7**	**-0.3**
B4. Combination of B1-B3 using one standard deviation shocks								**45.0**	**49.1**	**53.4**	**52.5**	**51.4**	**50.2**	**-0.3**
B5. One time 30 percent real depreciation in 2005 8/								**45.0**	**44.5**	**43.5**	**42.6**	**41.5**	**40.3**	**-0.3**
B6. 10 percent of GDP increase in other debt-creating flows in 2005								**45.0**	**54.2**	**53.3**	**52.4**	**51.2**	**50.0**	**-0.3**

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 $r - \pi$ (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/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
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 5. Finland: Indicators of Financial Vulnerability, 1998-2003

	1998	1999	2000	2001	2002	2003
Households						
Total household debt (in percent of GDP)	30.5	31.5	30.2	31.8	33.7	37.3
Debt-to-income ratio	58.5	61.2	63.7	65.3	70.7	74.6
Non-financial corporations						
Gross debt (in percent of GDP)	46.2	48.2	52.8	53.0	51.1	53.1
Debt to equity ratio	38.9	67.9	78.2	74.2	...	...
Debt to equity ratio 1/	57.9	60.2	...	...	...	...
Government						
General government debt (EMU definition, in percent of GDP)	48.8	47.4	44.6	43.9	42.6	45.5
Central government debt (in percent of GDP)	60.2	56.7	49.3	45.9	42.9	45.0
Banking sector 2/						
Outstanding credit to nonfinancial private sector (percent change, e.o.p.) 2/	12.1	14.2	6.4	6.9	8.6	11.2
Of which housing loans (percent change, e.o.p.)	13.1	15.8	10.6	11.5	13.3	15.6
Housing loans in percent of total lending to nonfinancial private sector	36.5	37.0	38.5	40.1	40.0	41.6
Asset Quality						
Non-performing loans/total loans (in percent) 3/	1.2	1.0	0.6	0.6	0.5	0.4
Capital Adequacy						
BIS capital asset ratio	11.5	11.9	11.6	10.5	11.7	19.3
Equity / total assets (in percent)	5.7	5.8	6.0	5.9	5.6	10.4
Profitability						
Interest rate margin 4/	4.0	3.5	4.3	3.5	3.2	2.5
Net interest income (in percent of total income) 5/	57.1	58.5	46.8	61.4	65.4	63.4
Return on equity (in percent) 5/	25.8	20.1	22.4	13.5	10.7	10.1
Return on assets (in percent) 5/	1.2	1.0	1.2	0.7	0.5	0.7
Liquid assets/total assets (in percent) 6/	19.3	19.6	15.2	14.0	10.7	12.0
Off-balance sheet liabilities/total assets (in percent)	16.0	15.9	18.7	20.4	19.6	20.2
Stock market						
Change in stock market index (in percent, e.o.p.)	68.5	162.0	-10.6	-32.4	-34.4	4.4
Change in housing price index (in percent, e.o.p.) 7/	9.6	10.5	-0.2	1.4	8.8	7.4

Sources: Bank of Finland; The Finnish Bankers' Association; Financial Supervision Authority; Statistics Finland; and Fund staff estimates.

1/ Defined as total debt as a percentage of common equity. Data source is Worldscope database. Estimates are based on accounting or book value of equity.
2/ Banking sector is defined here consists of all Finnish banks, including the Nordea Bank Finland Group (the Finnish subsidiary of Nordea Bank AB (Sweden); Merita Bank until 2000). Due to frequent restructurin within the Nordea group, the data are not directly comparable over time.
3/ Loans are defined as the sum of claims on: credit institutions, the public, and public sector entities.
4/ Average lending rate minus average deposit rate.
5/ Data for 2001 adjusted for large intra-financial conglomerate transactions.
6/ Liquid assets are defined as the sum of bills discounted by the central bank, debt securities, and the balance sheet item "liquid assets."
7/ Housing price index has been changed. The new index more accurately reflects the price development of all dwellings in the entire country.

FINLAND: FUND RELATIONS[1]
(As of November 30, 2004)

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	833.94	65.99
Reserve position in Fund	429.94	34.02

III. **SDR Department:**	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	142.69	100.00
Holdings	125.42	87.89

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				
	2004	2005	2006	2007	2008
Principal					
Charges/Interest		0.39	0.39	0.39	0.39
Total		0.39	0.39	0.39	0.39

VII. **Exchange Arrangements:**

Finland is a founding member of EMU, with a euro conversion rate of Finnish markka (Fmk) 5.94573. Finland has accepted the obligations of Article VIII (Sections 2, 3, and 4) and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, apart from those in accordance with: (i) IMF Executive Board Decision No. 144-(52/51) and the relevant UN Security Council resolutions—measures have been taken to freeze the accounts of the Taliban and of listed individuals and organizations associated with terrorism; (ii) EU regulations and the relevant UN Security Council resolutions—certain restrictions are maintained on the making of

[1] Updated information relating to members positions in the Fund can be found on the IMF web site (http://www.imf.org/external/np/tre/tad/index.htm).

payments and transfers for current international transactions with respect to Myanmar, certain individuals associated with the previous governments of Iraq and the former Republic of Yugoslavia, and Zimbabwe; (iii) EU Regulation No. 147/2003, effective January 27, 2003—financing of and financial assistance related to military activities in Somalia are prohibited. Restrictions also apply on transfers with respect to members of Al-Qaida and the Taliban, and individuals and organizations associated with terrorism.

VIII. **Article IV Consultation:**

Discussions for the 2003 Article IV consultation were held in Helsinki during June 9–18, 2003 and the Executive Board concluded the consultation on October 8, 2003. The Staff Report (IMF Country Report No. 03/325, 09/05/03), and a PIN (PIN/03/124) summarizing the views of the Executive Board, were published.

Finland: Core Statistical Indicators

(As of December 20, 2004)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money 1/	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP
Date of Latest Observation	9-Dec	October	November	November	October	9-Dec	October	September	September	2003	2004 Q3
Date Received	9-Dec	30-Nov	26-Nov	26-Nov	1-Dec	9-Dec	15-Nov	15-Nov	15-Nov	May	9-Dec
Frequency of Data	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly
Frequency of Reporting	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly
Source of Update	Bank of Finland	Bank of Finland	Bank of Finland	Bank of Finland	Bank of Finland	Bloomberg	Statistics Finland	Bank of Finland	Bank of Finland	ETLA 2/	ETLA
Mode of Reporting	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Monthly	Monthly	Monthly	Monthly	Daily	Monthly	Monthly	Monthly	Annual	Quarterly

1/ Finnish contribution to euro area M3.

2/ ETLA is the Research Institute of the Finnish Economy.

Statement by David Farelius, Alternate Executive Director for Finland and Satu Kivinen, Advisor to Executive Director January 28, 2005

Our Finnish authorities wish to express their appreciation to Mr. Thakur and his team for the constructive and candid exchange of views during the consultation visit and for the well-written reports. The authorities broadly agree with the staff assessment and view the reports as a fair and balanced analysis of the economy, policies and prospects.

1. Recent economic developments and short-term prospects

Finland's GDP growth has exceeded the euro area average rate of growth by a good margin in recent years, and according to the latest estimates, GDP growth was slightly above 3 percent in 2004. Last year, growth was sustained by stronger-than-expected domestic demand and an uptick in the pace of global economic growth. In 2005, consumption is projected to slow down, but the revival of exports coupled with strengthening corporate investment is expected to support growth. In the recently updated Stability Program, the growth projection for 2005 has been revised upwards to 2.8 percent. On balance, the economic outlook for 2005 is comparatively good, though the risks of a slowdown in growth have increased, particularly as regards raw material prices.

The current account surplus has amounted to 5 - 8 percent of GDP for a number of years reflecting relatively low investment activity. In fact, Finland's investment ratio has remained below the euro area average for a long time. In 2005, the current account is projected to remain at 8 percent of GDP. Over the medium term, the current account is projected to decline while still remaining in substantial surplus.

The pace of the rise in consumer prices has been clearly lower than was anticipated in the previous Stability Program, and in 2004 inflation stood at 0.2 percent. Inflation, which has been at very low levels partly because of exceptional factors (tax cuts of alcoholic beverages and automobiles), is expected to accelerate somewhat.

Unemployment has remained "stubbornly high" to quote the staff. The unemployment rate has stayed at near 9 percent, and the economy suffered substantial job losses in industry during 2004. The fall in the number of employed, however, has stabilized, and the most recent data show an increase in the number of employed. The employment rate, which has been approaching 68 percent, will likely remain below the 70 percent target that was set by the government in 2003 during this and next year.

Household real incomes have risen on average by 4 percent in 2004 and are forecast to grow by nearly 2 percent both in 2005 and 2006. At the same time, boosted by rapid mortgage borrowing, household indebtedness has also risen. The authorities do not see a real cause for concern yet, because loan maturities have become longer and mortgage rates are at historically low levels while housing prices continue to rise.

2. Fiscal policy

Finland's public finances, measured by the general government financial balance, are currently in a strong position. In the updated Stability Program, the projection for the general government surplus in 2004 has been revised upwards by 0.3 percent to 2 percent, but it will be somewhat weaker in 2005 (estimated at 1.8 percent before the recently agreed tax cuts). Central government finances will be in balance in 2004 showing a stronger fiscal position than was envisaged in the previous Stability Program. The general government debt levels have also been revised downwards to 44.8 percent of GDP in 2004 and to 43.5 percent in 2005.

The government's target is to balance central government finances by 2007. The government is committed to keeping central government expenditure within the spending limits for 2004-2007 that were approved in May 2003. The fiscal policy stance has shifted from a very expansionary phase in 2003 to a nearly neutral gear in 2004 and continues as neutral in 2005 and 2006.

The authorities and staff agree on the goal of streamlining public expenditures in exchange for further tax cuts, which are necessary for raising employment as targeted in the government program. The authorities believe that an important channel for increasing savings is to raise the efficiency in the provision of public services, particularly at the local level. Furthermore, it is important to keep increases in local taxes from offsetting government efforts to lower the overall level of taxation.

The discussions on fiscal policy centered on maintenance of fiscal sustainability in the long run in view of the diminishing labor input and rapidly aging population. The longer term outlook is of concern once the costs of aging start to materialize around 2010. The authorities share staff's view on the necessity of maintaining general government surpluses to meet the rising costs of pension and health care services for the elderly. However, the authorities consider that staff's suggestion to run a 4 percent general government surplus (including the social security funds) for the rest of the decade is unrealistic. Nevertheless, the government is well aware of the risks and challenges related to the goal of ensuring the long-term sustainability. In addition to rigorous budget discipline, the positive outcome will depend on an appropriate combination of reforms (labor market, pension and health care systems) and measures to speed up the growth of productivity and employment.

In this context, raising labor supply and the employment rate play an important role. Staff notes that labor supply is diminished at the young end due to late graduation from higher education and early departure into retirement at the other end. Reforms to raise labor supply at both ends of the age spectrum would be important for raising the employment rate. The authorities are aware of this situation and measures are being implemented to speed up graduation from universities. The enacted pension reform has already responded to the issue at the other end of the age spectrum, whereby the actual retirement can be phased between the ages from 63 until 68. Admittedly, it will take years before the effective retirement age would rise from the present age of 59 years to 62 years. Before assessing the need for further reforms, it is important to observe the effect of the current changes in the pension system.

3. Labor market policies

The wage negotiations were conducted at the centralized level and agreed at the union level late last year, and the government finalized its tax package with an elimination of the wealth tax to take effect in 2006. The income agreement that was signed by the Social Partners in November will run from March 1, 2005 until end September 2007. On an annual basis, negotiated wages will rise on average by 2.1 % in 2005 and 1.6 % in 2006. The estimated annual increases on earnings are 3.5 % in 2005 and 2.5 % in 2006. By now about 90 percent of employees are covered by the new accord.

Staff's assessment seems to lean toward a decentralized wage settlement that would have more accurately taken into consideration labor productivity differentials, with the likely effect of reducing wage compression which is a characteristic and widely recognized feature of the Finnish wage structure. However, it could be noted that the relative wage increases at various wage levels are much more even than during the last few years and thus support good employment development better than before.

While the Employment Contract Act and union-level agreements set rather tight limits to local bargaining, the new agreement includes an understanding on improving the local bargaining system to better meet the needs of both employers and the workforce. This kind of local bargaining package is a new feature in the Finnish incomes policy settlements. However, it does not necessarily mean a rapid passage from a centralized to a decentralized wage bargaining regime. In addition, possibilities on local bargaining vary very much from branch to branch. It is worth noting, however, that the present more centralized system has worked well in Finland during the difficult times in the 1990s and until now. Furthermore, the long wage accord together with cuts in income taxation will provide a stable and predictable environment to pursue further reforms, as suggested by staff.

Raising the employment rate is high on the government’s policy agenda. Reducing the taxation of labor has been a key element in pursuing this goal. The government will be cutting labor taxes by a total of EUR 1.7 billion in gross terms between 2005 and 2007 with the tax cuts weighted towards the lower end of the income scale. In addition to lowering labor taxation, the government has also focused on improving active labor market policies.

4. Long-term challenges

The authorities agree with staff’s assessment that major challenges lie ahead as Finland faces globalization, aging and structural unemployment remains high. Compared to many European countries, the economy is in a good position to face these challenges as fiscal stimulus has helped support growth during the global slowdown, inflation is low, the external position is comfortable and public finances are in surplus. Moreover, Finland is relatively well prepared for aging as pension liabilities have been partly pre-funded and the implementation of a major pension reform has now begun. In addition, tighter central government expenditure control, reduction of indebtness and fostering the growth potential of the economy are all ways to prepare for the financing pressures arising from aging.

The authorities believe that it will be important to raise productivity in the sheltered sectors of the economy, which has also been the advice by staff in earlier Article IV assessments. The authorities share staff's view that strengthening competition in product markets, promoting flexibility in labor markets, and diversifying the structure of the Finnish economy could lead to a virtuous circle of higher growth and stronger public finances.

The authorities have also recently made sustainability scenarios for public finances in the very long term, i.e. extending up to 2050. The scenarios use the national population estimates with higher life expectancy estimates (than the Eurostat 1999 population estimates) and naturally lead to higher estimates of public spending pressures. Notwithstanding the uncertainty related to any such long term projections, the authorities' baseline and alternative scenarios also usefully demonstrate the effect structural reforms can have. The calculations by the Ministry of Finance indicate that under the baseline scenario, the central and local governments will not be on a sustainable basis without adaptive measures. However, merely changing the assumption regarding the productivity of social and healthcare services (from assuming no increase in productivity to assuming an annual increase of 0.5 percent) leads to a substantial improvement in general government finances with the deficit at no stage exceeding the 3 percent limit.

Finally, Finland, in principle, favors easing the access of developing countries' agricultural products to industrial countries' markets and supports efforts to address this issue in the context of multilateral trade negotiations. The government will increase funds for development cooperation in accordance with its program so that based on the present estimation of national income growth the ODA will be at the level of about 0.44 % of GNI in 2007. In the 2005 budget, the ODA share is estimated to account for 0.39 percent of GNI.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL RELATIONS DEPARTMENT

Public Information Notice (PIN) No. 05/14
FOR IMMEDIATE RELEASE
February 7, 2005

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

IMF Executive Board Concludes 2004 Article IV Consultation with Finland

On January 28, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.[1]

Background

The Finnish economy has performed admirably in recent years, but must confront earlier than any other country in the EU the pressures of population aging. The momentum of growth was maintained, despite the receding role of the export-intensive high-technology electronics sector, aided by a strong fiscal stimulus, although unemployment, largely structural, remains high. Nevertheless, inflation is low and the fiscal and external current account surpluses are comfortable. However, longer-term prospects are clouded by the imminent rise in old-age dependency—the most rapid in Europe.

The economy weathered the global downturn relatively well, and in the near-term an improved external climate is expected to strengthen growth. Strong domestic demand, especially private consumption and residential investment, has buoyed the economy, reflecting strong disposable income growth and low interest rates. Increased external demand is expected to make a larger contribution in the near term, with growth averaging 3 percent in 2004-05. Inflation was largely absent in 2004, following sizable excise cuts, and an appreciating euro which tempered the increase in oil prices, but is expected to revert closer to that in the euro area average in 2005. Strong productivity gains have helped contain unit labor costs and maintain competitiveness.

[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.

A recent centralized wage accord covering a period of 2½ years is expected to ensure continued wage moderation. However, a compressed wage structure and increased labor market mismatches impede employment growth—despite significant cuts in labor taxation (which nevertheless remains comparatively high)—with relatively low labor contributions from both ends of the age spectrum, and from the less skilled. The unemployment rate has remained broadly at 9 percent since 2000.

The fiscal position has rapidly eroded in recent years, but is expected to remain in surplus over the medium term. While the decline in the surplus from 7 percent of GDP in 2000 is partly cyclical, it is also the consequence of a sharp discretionary policy shift, with the structural surplus declining by 3¼ percent of GDP by 2004. The 2005 budget is expansionary, with cuts in corporate and capital taxes, and the beginning of a three-year labor income tax cut following the wage agreement. Nevertheless, the general government fiscal balance is likely to remain at about 2 percent of GDP, as the output gap closes. The government's sizable net asset position, equivalent to some 15 percent of GDP at the end of 2004, is expected to increase further.

Despite the benign short-term outlook, Finland's long-term fiscal prospects are less comforting. Aging-related fiscal pressures are anticipated to occur earlier than in most other EU countries, and to be stronger, reflecting Finland's comprehensive public welfare system. A significant reform of the public pension system has been initiated, aiming to raise the effective retirement age by 3 years from its current level of 59 years. However, the reform, by itself, is insufficient to ensure fiscal sustainability.

Executive Board Assessment

Executive Directors commended the authorities for the impressive strides made by the Finnish economy in recent years, aided by strong productivity gains and a stable macroeconomic policy framework, with low inflation and sizeable fiscal surpluses. Directors noted, however, that employment has remained stagnant, and structural unemployment high. They also underlined that Finland will face the challenge of population aging earlier than any other country in the European Union.

Directors stressed that economic diversification will be important to reduce Finland's vulnerability to downturns in the information and technology sector. Nevertheless, they observed that the economy has weathered the global slowdown relatively well and that growth is set to remain robust in 2005. The recent tax cuts are expected to stimulate employment, and business investment is set to recover after a period of weakness. Although high oil prices and further appreciation of the euro could pose risks to growth, Directors considered these risks to be broadly offset by a likely faster pace of global recovery and strengthening export prospects. As the impact of cuts in indirect taxation and other one-off factors recedes, inflation is expected to revert to the average in the euro area.

Directors noted that while Finland's fiscal position remains comfortable from a comparative EU perspective, the general government surplus has eroded in recent years. They stressed that sizeable fiscal adjustment will be required in the coming years to ensure long-term fiscal sustainability, given the imminent demographic pressures on public finances. Directors therefore recommended that the planned cuts in income taxes over the period 2005–07 be offset by a reduction in public spending, preferably through improved efficiency in the provision of social and welfare services. Such efficiency gains rather than tax increases should be the preferred means of strengthening local government finances.

Directors argued that a holistic approach to structural reforms, setting in train a virtuous circle of stronger employment, growth, and public finances is necessary to address effectively the challenge of aging. Such comprehensive reforms would reduce the required fiscal adjustment. Absent such reforms, the general government would have to run sizable surpluses to ensure fiscal sustainability.

Directors called for policy initiatives to raise the employment rate, especially at both ends of the age spectrum where labor utilization is relatively low. The recent steps to reduce the burden of labor taxation will help promote employment, but may not be sufficient to attain the authorities' ambitious target for raising the employment rate. Welcoming the authorities' intention to reduce employers' social security contributions for low-income workers, Directors called for targeting tax cuts at the lower end of the income scale in order to maximize the beneficial effects on employment. A gradual shift to a more decentralized wage bargaining system would also help ease wage compression and reduce structural unemployment, as would improved training for low-skilled and older workers.

Directors welcomed the significant pension reform being phased in from the beginning of this year as an important step toward ensuring fiscal sustainability. The reform, with commendable features such as an automatic adjustment for rising life expectancy and sharply rising accrual rates, goes some way toward promoting higher labor participation. However, the reform will need to be followed up with further steps, such as closing the so-called "unemployment pipeline," whereby unemployed persons over 57 can claim benefits until age 65. Noting that a consensus for structural reform may become more difficult to achieve in future years, Directors called for early consideration of additional measures and for stepped-up efforts to raise public awareness of the need for faster reform.

In Directors' view, further strengthening competition in product markets would complement efforts to improve labor market efficiency and accelerate the diffusion of productivity gains from the technology sector to the rest of the economy. While commending the progress achieved in recent years in promoting greater competition in sheltered sectors such as communications and retail trade, Directors felt that considerable scope remains to enhance competition in the sheltered sectors, given that the price level is still significantly above the EU average. In this regard, a more proactive stance on foreign direct investment and privatization of public enterprises would be helpful. A reduction in Finland's farm subsidies, which are high by EU standards, would also contribute to raising competition and consumer welfare.

Directors viewed the financial system as sound and resilient to economic shocks, and considered that it is poised to gain from greater European market integration. They noted that growing cross-border financial activity would call for increasingly closer cooperation among Nordic-Baltic financial supervisors.

Directors expressed their appreciation for Finland's strong record of official development assistance (ODA) and the country's support for increased market access for developing countries' agricultural exports through multilateral trade initiatives. They welcomed the 2005 budgeted increase in ODA and the authorities' intention to continue to increase ODA as a percent of gross national income in the future.

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

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.

Finland: Selected Economic Indicators

	2001	2002	2003	2004 1/
Real economy				
GDP (change in percent)	1.1	2.3	2.0	3.1
Domestic Demand (change in percent)	1.7	1.3	2.1	2.4
Harmonized CPI (change in percent) 2/	2.7	2.0	1.3	0.2
Unemployment rate (in percent) 2/	9.1	9.1	9.0	8.8
Gross national saving (in percent of GDP)	27.7	25.8	24.2	24.3
Gross domestic investment (in percent of GDP)	20.6	19.0	18.5	18.6
Public finances (general government, in percent of GDP)				
Overall balance	5.2	4.3	2.1	2.1
Primary balance 3/	5.9	4.5	2.4	2.1
Gross debt (Maastricht definition)	43.9	42.6	45.5	45.0
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area) 4/	7.7	4.9	7.4	7.3
Total domestic credit 4/	6.5	9.1	11.2	11.7
Interest rates (year average)				
Three-month money market 5/	4.1	3.5	2.3	2.3
Ten-year government bonds 5/	5.0	4.9	4.2	4.0
Balance of payments (in percent of GDP)				
Trade balance	10.4	9.7	9.2	9.4
Current account	7.1	6.8	5.7	5.8
Fund position (as of end-November, 2004)				
Fund holding of currency (in percent of quota)		65.99		
Holdings of SDRs (in percent of allocation)		87.89		
Quota (in millions of SDRs)		1,263.80		
Exchange rate				
Exchange rate regime		Euro		
Present rate (December 29, 2004)		US$ 1.3608 per euro		
Nominal effective exchange rate (increase in percent) 6/	1.9	1.3	4.4	1.7
Real effective exchange rate (increase in percent) 7/	0.8	-0.9	2.0	-0.3

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

1/ IMF staff projections, unless otherwise indicated.

2/ Consistent with Eurostat methodology.

3/ Defined as non-interest revenue minus non-interest expenditure.

4/ For 2004, annualized increase to October.

5/ For 2004, monthly average for November.

6/ For 2004, average 12-month increase to October.

7/ Based on unit labor costs. For 2004, average 12-month increase to November.