INTERNATIONAL MONETARY FUND

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FINLAND

November 2015

2015 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; INFORMATIONAL ANNEX; 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 2015 Article IV consultation with Finland, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its November 11, 2015 consideration of the staff report that concluded the Article IV consultation with Finland.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on November 11, 2015, following discussions that ended on September 15, 2015, 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 October 26, 2015.
- An **Informational Annex** prepared by the IMF staff.
- A **Statement by the Executive Director** for Finland.

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

Selected Issues

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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FOR IMMEDIATE RELEASE
November 17, 2015

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

IMF Executive Board Concludes 2015 Article IV Consultation with Finland

On November 11, 2015 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Finland.

The Finnish economy has been in recession for three years. It has experienced a unique confluence of structural and cyclical shocks since 2007. Exports have suffered due to the declines of Nokia and the paper industry, compounded by weak external demand, especially from the euro area and Russia. Wage hikes in 2008–10 and weak productivity growth have hurt competitiveness. Rapid population aging is a further drag on growth. As a result, the current account and fiscal balances have deteriorated, with the 2014 fiscal deficit breaching the Stability and Growth Pact's (SGP) 3 percent of GDP criterion.

A modest recovery is projected to begin this year and gradually strengthen in 2016. However, absent further reforms, growth is likely to remain much lower than pre-crisis. Downside risks heighten the fragility of the recovery. Weaker-than-expected growth in key trade partners would be a drag on exports and spillovers from an external financial shock would create tighter financial conditions, with negative effects on output. Domestically, procyclical fiscal tightening could weaken the recovery more than already anticipated.

The new government has announced a broad structural reform program, including labor market and benefits reforms to reduce unit labor costs and improve competitiveness. Pension reforms to lengthen working careers were recently introduced to Parliament and should help mitigate the impact of population aging on labor force growth. Reforms to improve public sector productivity and contain aging related fiscal pressures, especially in health and social services, are being developed. The government's medium-term fiscal plan envisages substantial consolidation that aims to bring the deficit back in line with the SGP criterion next year and begin closing the long-

[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.

run fiscal sustainability gap. Legislation passed last year introduced a number of improvements in financial sector policy, including a new macroprudential policy framework.

Executive Board Assessment[2]

Executive Directors noted that a confluence of adverse cyclical and structural shocks has sharply weakened Finland's economic performance in recent years. While welcoming recent signs of a modest recovery, Directors underscored that reviving economic growth remains Finland's central policy challenge. In this context, they called for strong measures to facilitate the reallocation of resources between sectors, boost productivity, and raise labor supply. They acknowledged that Finland's strengths in different areas can help it tackle these challenges.

Directors welcomed the authorities' comprehensive structural reform agenda. They highlighted the recent progress on pension reforms and liberalizing shop opening hours. They noted, however, that other elements still need to be further developed and implemented. They emphasized the need to increase the flexibility of the wage bargaining system and curtail the long duration of unemployment benefits. They noted that this should be done in conjunction with a strengthening of active labor market programs and urged the authorities to reconsider plans to reduce funding for these programs. They also cautioned that intended cuts in R&D spending could weaken medium-term productivity growth. Directors welcomed plans to reform the delivery of health and social services, but noted that outcomes should be closely monitored to avoid deterioration in the quality of services.

Directors concurred that fiscal adjustment is needed to close the sustainability gap and comply with the Stability and Growth Pact. They stressed, however, that this should be balanced with the need to protect the fragile recovery. In this regard, they agreed that consolidation efforts should prioritize measures that address aging-related spending pressures, such as health, social services, and pension reforms. In the short run, they suggested making the composition of fiscal adjustment more growth-friendly, including by shifting cuts from public investment to consumption. Many Directors considered that consolidation could be further smoothed by frontloading some spending from the growth package. A number of Directors, however, viewed the planned pace of adjustment to be appropriate and cautioned against slowing it. Directors underscored that automatic stabilizers should be allowed to operate if growth disappoints and that fiscal costs from a significant surge in refugees should be accommodated.

Directors commended the authorities for introducing a new macroprudential policy framework and implementing the EU's Bank Recovery and Resolution Directive. They noted that there is scope to strengthen the macroprudential framework further, including through the introduction of

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

a systemic risk buffer. They also highlighted the importance of enhancing regional cooperation on financial stability, supervisory, and bank resolution issues. Directors looked forward to the coordinated FSAPs for Finland and Sweden in 2016.

Finland: Selected Economic Indicators 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Proj.			
				(Percentage change, unless otherwise indicated)					
Output and demand (volumes)									
GDP	-1.4	-1.1	-0.4	0.4	0.9	1.2	1.3	1.4	1.6
Domestic demand	-1.2	-1.1	0.0	-0.2	0.7	1.0	1.2	1.4	1.5
Private consumption	0.3	-0.3	0.5	0.7	0.5	0.6	0.9	1.2	1.4
Public consumption	0.5	0.8	-0.2	-0.1	-0.8	-0.3	-0.1	0.1	0.3
Gross fixed capital formation	-2.2	-5.2	-3.3	-2.1	2.6	3.6	3.4	3.0	2.9
Change in stocks (contribution to growth in percent of GDP)	-1.0	0.0	0.5	-0.1	0.1	0.1	0.0	0.0	0.0
Exports of goods and services	1.2	1.1	-0.7	0.7	2.1	2.7	2.8	2.8	2.9
Imports of goods and services	1.6	0.0	0.0	-0.8	1.7	2.4	2.6	2.7	2.8
Net exports (contribution to growth in percent of GDP)	-0.2	0.4	-0.3	0.6	0.1	0.1	0.1	0.1	0.1
Prices, costs, and income									
Consumer price inflation (harmonized, average)	3.2	2.2	1.2	0.0	1.3	1.6	1.8	2.0	2.0
Consumer price inflation (harmonized, end-year)	3.5	1.9	0.6	0.4	1.3	1.6	1.8	2.0	2.0
GDP deflator	3.0	2.6	1.6	0.7	1.4	1.6	1.8	1.9	2.1
Unit labor cost, manufacturing	10.7	-4.4	-2.1	1.3	-1.5	0.2	0.5	0.5	0.5
Labor market									
Labor force	0.3	-0.6	0.2	0.0	-0.1	-0.2	-0.3	-0.4	-0.4
Employment	0.4	-1.1	-0.4	-0.8	-0.1	0.2	0.2	0.2	0.2
Unemployment rate (in percent)	7.7	8.1	8.7	9.4	9.4	9.0	8.5	8.0	7.4
Potential output and NAIRU									
Output gap (in percent of potential output)[1]	-1.9	-2.7	-3.3	-3.2	-2.7	-2.1	-1.7	-1.2	-0.5
Growth in potential output	0.3	-0.3	0.2	0.2	0.4	0.6	0.9	0.9	0.9
NAIRU (in percent)	7.8	7.8	7.9	7.8	7.8	7.7	7.6	7.5	7.4
					(Percent of GDP)				
General government finances[2]									
Overall balance	-2.1	-2.5	-3.3	-3.4	-2.8	-2.6	-2.2	-1.7	-1.3
Primary balance[3]	-0.7	-1.3	-2.1	-2.2	-1.7	-1.5	-1.1	-0.5	0.0
Structural balance (in percent of potential GDP)	-1.1	-0.9	-1.1	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8
Structural primary balance (in percent of potential GDP)[3]	0.3	0.3	0.1	0.1	0.2	0.1	0.2	0.4	0.5
Gross debt	52.9	55.6	59.3	62.3	64.1	65.9	66.8	67.0	66.4
Net debt[4]	-50.3	-54.0	-50.1	-46.2	-42.3	-38.5	-35.2	-32.3	-29.8
					(Percent)				
Money and interest rates									
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	0.5	4.1	1.3	...	...	...	...	...	...
Finnish MFI euro area loans (growth rate, e.o.p.)	7.1	7.7	3.8	...	...	...	...	...	...
3-month Euribor rate (percent)	0.6	0.2	0.3	...	...	...	...	...	...
10-year government bonds yield	1.9	1.9	1.4	...	...	...	...	...	...
					(Percent of GDP)				
National saving and investment									
Gross national saving	20.5	19.4	19.7	19.5	20.0	20.7	21.2	21.7	22.1
Gross domestic investment	22.4	21.3	21.0	20.3	20.7	21.2	21.7	22.1	22.4
Balance of payments									
Current account balance	-1.9	-1.7	-0.9	-0.7	-0.7	-0.6	-0.5	-0.4	-0.2
Goods and services balance	-1.1	-0.6	-0.2	0.4	0.6	0.7	0.7	0.7	0.8
Net international investment position	11.7	5.4	-0.7	-3.1	-5.3	-7.3	-9.1	-10.6	-12.0
Gross external debt	227.5	206.4	217.2	222.9	225.4	226.8	227.2	226.1	224.7
Exchange rates (period average)									
Euro per US$	0.78	0.75	0.75	...	...	...	...	...	...
Nominal effective rate (appreciation in percent)	-3.3	2.6	1.9	...	...	...	...	...	...
Real effective rate (appreciation in percent)[5]	-2.9	2.2	1.3	...	...	...	...	...	...

Sources: Bank of Finland, International Financial Statistics, IMF Institute, Ministry of Finance, Statistics Finland, and IMF staff calculations.

[1] A negative value indicates a level of actual GDP that is below potential output.

[2] Fiscal projections include measures as specified in the General Government Fiscal Plan.

[3] Adjusted for interest expenditure.

[4] Defined as the negative of net financial worth (i.e., debt minus assets).

[5] CPI-based real effective exchange rate.

INTERNATIONAL MONETARY FUND

FINLAND

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION

October 26, 2015

KEY ISSUES

Finland has suffered a unique confluence of structural and cyclical shocks. This has driven the economy into recession for the past three years. The impact on growth and exports of the parallel structural declines of Nokia and the paper industry has been exacerbated by weak external demand, including from Russia and the euro area. Wage hikes in 2008–10 and weak productivity growth have hurt competitiveness. Rapid population aging is a further drag on growth. Pre-crisis current account surpluses have become deficits and the fiscal position has deteriorated. The nascent recovery is fragile and, absent reforms, medium-term growth will be much slower than before the crisis.

Reviving growth is Finland's central challenge. Policy imperatives include:

- **Structural reforms.** Robust implementation of structural reforms—including in the areas of wage bargaining, unemployment insurance, ALMPs, and the delivery of health care—would help facilitate reallocation of labor between sectors, boost productivity, and raise labor supply growth. The government's reform program covers the key issues but needs to be fully developed and vigorously implemented.
- **Fiscal policy.** Fiscal consolidation is needed to address long-term spending pressures and respect the SGP, but poses risks to growth. The composition of the consolidation should be made as growth friendly as possible, including by protecting public investment and delaying hikes in unemployment insurance contributions. The government's *growth package* of one-off investments could partially mitigate the consolidation's growth impact, especially if it is made more frontloaded.
- **Financial sector and macroprudential policies.** The new macroprudential framework should be fully implemented. Further measures, particularly a systemic risk buffer, would strengthen the framework. Greater coordination between financial sector supervisors in the region is critical to contain cross-border spillover risks. The 2016 FSAP will provide an opportunity for detailed recommendations.

Approved By
James Gordon (EUR) and Steven Barnett (SPR)

Discussions for the 2015 Article IV consultation were held in Helsinki during September 3–15, 2015. The mission comprised Messrs. Hofman (head), Arnold, Deb, and Ms. Geng, and was assisted at HQ by Ms. Mircheva, Mr. Dowling, and Ms. Rojas (all EUR). Mr. Miettinen (OED) joined the discussions. The mission met with Mr. Liikanen, Governor of the Bank of Finland; Mr. Stubb, Minister of Finance; Mr. Rehn, Minister of Economic Affairs; Ms. Tuominen, head of the FIN-FSA; other senior officials; social partners; and representatives of the financial sector, key industries, and research communities.

CONTENTS

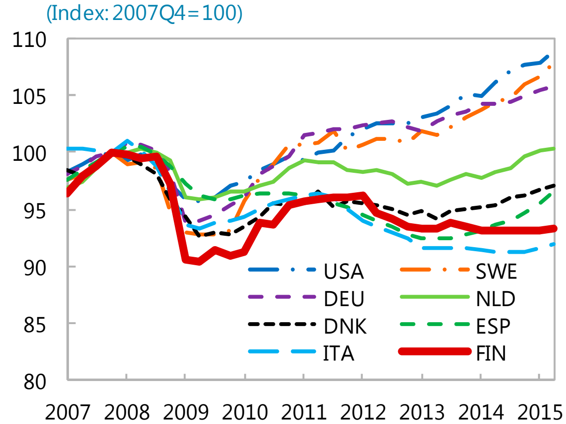
APPENDICES

RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

A. Recent Developments

1. Finland has suffered three years of recession. Though Finland initially bounced back from the global financial crisis in 2010–11, GDP declined by a cumulative 3 percent in 2012–14 (Table 1). Both domestic and external demand have been weak in the wake of the crisis (Figure 1). Rising unemployment, which increased to 8.7 percent in 2014, modest wage increases, and already indebted households contributed to a slowdown in private consumption in 2013–14. Weak growth, both at home and in key trade partners (euro area, Russia), has dampened firms' "animal spirits", causing private sector investment to decline from 20 percent of GDP in 2007 to 16 percent in 2014. Inflation has slowed, as in the rest of the euro area, from 2.2 percent on average in 2013 to 1.2 percent in 2014, with end-of-period inflation at 0.6 percent. The decline is due largely to falling oil and food prices. The same factors are expected to lower average headline inflation further to 0.0 percent in 2015, while average core inflation is forecast at around 0.6 percent.

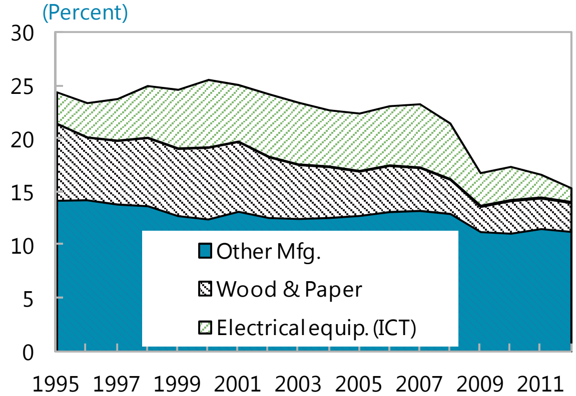
Real GDP Developments
(Index: 2007Q4=100)



Sources: Eurostat and Fund staff calculations.

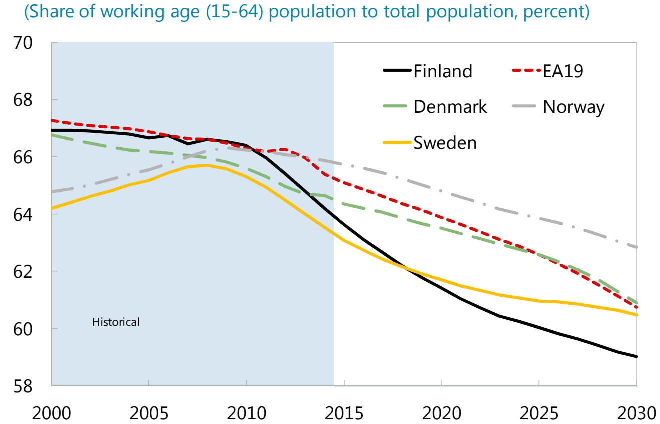
2. The cyclical headwinds buffeting Finland have coincided with large structural shocks. The most important shock has been the sharp decline in the ICT sector since 2007, due largely to the abrupt decline of Nokia's handset business, which it sold to Microsoft in 2013 (Figure 2). The steep drop in demand during the crisis also accelerated the secular decline in the paper industry. The shrinkage of these high productivity industries explains a substantial fraction of the decline in aggregate productivity growth since 2007. Longer-term structural factors also contribute to Finland's growth challenges, especially the rapidly aging workforce and slow labor supply growth.

Manufacturing Industries' Shares of Total Value Added
(Percent)



Sources: EU KLEMS and Fund staff calculations.

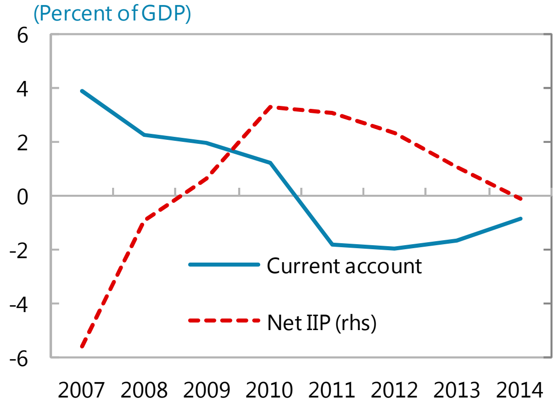
Population Projections
(Share of working age (15-64) population to total population, percent)



Sources: Eurostat and Fund staff calculations.

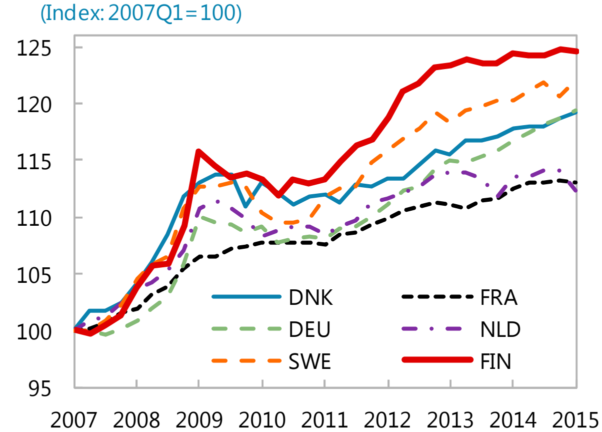
3. The current account has shifted to persistent deficits since the crisis. With the export-oriented electronics and wood and paper industries declining, nominal exports have fallen more than 10 percent from their peak in 2008. With imports only falling 1 percent over the same period, the trade balance has deteriorated (Figure 3). A wage agreement in 2007 that generated rapid wage increases in 2008–10 also contributed to a loss of competitiveness just as the crisis struck. As a result of the wage increases and falling productivity, unit labor costs (ULCs) have risen 25 percent since 2007. Pre-crisis current account surpluses have given way to persistent deficits, causing the net international investment position to deteriorate (Tables 2 and 3). However, the real effective exchange rate appears broadly in line with fundamentals (Box 1).

Current Account Balance and Net International Investment Position
(Percent of GDP)



Sources: Statistics Finland and Fund staff calculations.

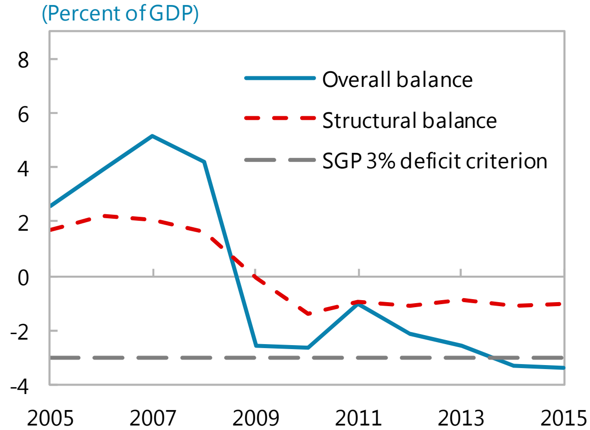
Unit Labor Costs
(Index: 2007Q1=100)



Sources: OECD and Fund staff calculations.

4. The fiscal position has also slipped from surpluses to deficits and the constraints of the SGP have begun to bind. Despite slowing public consumption and investment growth, the general government deficit widened to 3.3 percent of GDP in 2014 (Figure 4, Tables 4 and 5). This breach of the Stability and Growth Pact's (SGP) 3 percent of GDP deficit threshold was primarily due to the weak economy and higher than expected unemployment. The gross debt-to-GDP ratio was just short of the SGP's 60 percent threshold, but is forecast by staff to breach it in 2015. Despite the breach of the SGP limits, the European Commission decided not to recommend that Finland enter the Excessive Deficit Procedure (EDP) in June based on the consolidation plans announced by the new government.

Fiscal Balances
(Percent of GDP)



Sources: IMF World Economic Outlook, and Fund staff

5. The new government recognizes the challenges facing Finland and is planning action. The coalition government, which took office in May, has announced a broad structural reform program, including labor market and benefits reforms to reduce unit labor costs and improve competitiveness. The medium-term fiscal plan envisages a consolidation worth around 2 percent of GDP over 2016–19. It aims to bring the deficit back in line with the SGP criterion next year and begin closing the long-run fiscal sustainability gap. A number of financial sector policy reforms legislated last year, including a new macroprudential policy framework, are now being implemented.

B. Outlook and Risks

6. **The economy's return to growth will likely be slow.** The outlook is for growth of 0.4 percent in 2015 and 0.9 percent in 2016 (down from April 2015 WEO projections of 0.8 and 1.4 percent, respectively). Despite modest nominal wage increases, growth in 2015 is partly driven by a projected pick-up in private consumption. Consumption growth is supported by lower inflation, which boosts households' real purchasing power, and one-off mortgage amortization holidays offered by major banks (worth about 0.3 percent of GDP in total), which increased discretionary income in the first half of 2015. Private investment is expected to start contributing positively to growth in 2016, partly driven by sizable investments in new technology in the paper industry. The recovery will also be supported by the bottoming out of Nokia's decline and the revival of its network equipment business (Nokia announced it will buy Alcatel-Lucent, giving it economies of scale that should improve its competitive position). Absent further structural reforms, however, medium-term growth will remain much slower than before the crisis, rising to only 1.6 percent in 2020. By then the output gap (-3.2 percent of potential GDP in 2015) will still be slightly negative. Unemployment is forecast to rise to 9.5 percent in 2015–16 and begin gradually declining in 2017. Headline inflation is projected to pick-up again in 2016 to 1.3 percent as the effects of falling commodity prices abate. While a protracted bout of deflation is therefore unlikely, in the short run low inflation could hamper relative price adjustments and contribute to households' debt burdens.

Nokia's Market Capitalization
(Billions of euros, quarterly average)

Sources: Bloomberg and Fund staff calculations.

7. **Spillovers from weaker-than-expected external demand, a financial shock, and the growth impact of fiscal tightening are the main sources of risk (Table 6).** Slower growth in key export partners, including Russia, the rest of the Nordic region, or the euro area, would be a drag on export growth and likely retard the recovery. Spillovers from a financial shock, whether originating in the region (e.g., severe housing market decline in one of the other Nordics) or elsewhere in the euro area (e.g., deeper and more protracted turbulence related to Greece), could be channeled through Swedish or Danish banks. Such a shock could cause a tightening of financial conditions in Finland, with a potentially significant impact on investment, consumption, and the housing market. Domestically, the main risk is that the procyclical fiscal consolidation would weaken the recovery more than has been accounted for in the baseline (e.g., if fiscal multipliers are higher than expected).

Recent migrant inflows—while thus far small compared to the most affected European countries—could be positive for labor force growth, but will have short-run fiscal costs.

Authorities' Views

8. The authorities saw weaker external demand or financial shocks as the main risks. They agreed with staff that such shocks had the potential to impair the fragile recovery. They noted, however, that the drop in exports to Russia last year was sharper than expected and that, given the scale of the realized decline, any further weakening should have a smaller impact. The authorities acknowledged that fiscal consolidation will have a negative impact on growth. However, they thought the likelihood of this being large was low, arguing that most of the conditions that could increase fiscal multipliers are not significant for Finland. In particular, they noted fiscal multipliers in small open economies are typically small and that the share of liquidity constrained consumers is smaller in Finland than in most other euro area countries. Also, interest rates at the zero lower bound are unlikely to affect multipliers in Finland since, as a small member of a monetary union, monetary policy does not respond to fiscal policy changes in Finland even in normal times.

POLICY DISCUSSION

9. Finland's primary challenge is to revive growth. Tackling this challenge will require bold and comprehensive structural reforms, including in the labor market, to address low productivity and labor supply growth. Fiscal policy should balance consolidation needs against growth objectives to avoid derailing the fragile recovery. The macroprudential policy toolkit and regional cooperation on financial stability issues should be further strengthened to guard against future risks.

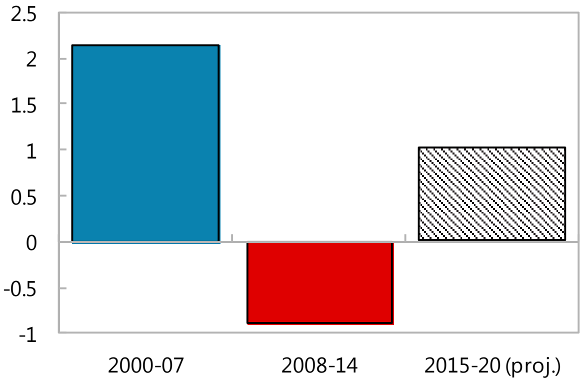
A. Structural Policies: Raising Finland's Growth Potential

10. Structural reforms are needed to facilitate resource reallocation between sectors, boost productivity, and raise labor supply growth. The precipitous decline of once rapidly growing high-productivity sectors has negatively impacted aggregate labor productivity and total factor productivity (TFP) growth, with the latter forecast to be only half its pre-crisis average over the medium-term.[1] Reallocating resources from declining industries to growing ones is critical to restoring growth and raising TFP. Impediments to labor mobility—such as too little affordable housing in Helsinki and limited retraining opportunities—can hamper this reallocation. Also, the centralized wage setting system compresses the wage distribution. This constrains firms' ability to adjust wages in line with firm-specific productivity developments and effectively causes a relatively high minimum wage that may make it more difficult for low-skilled workers to find jobs, reducing participation and raising structural unemployment. Coupled with generous unemployment benefits (500 days duration), wage compression may have also discouraged skill development that can facilitate inter-sectoral labor mobility. Meanwhile, labor force growth has fallen sharply as the impact

[1] See first chapter of Selected Issues Paper.

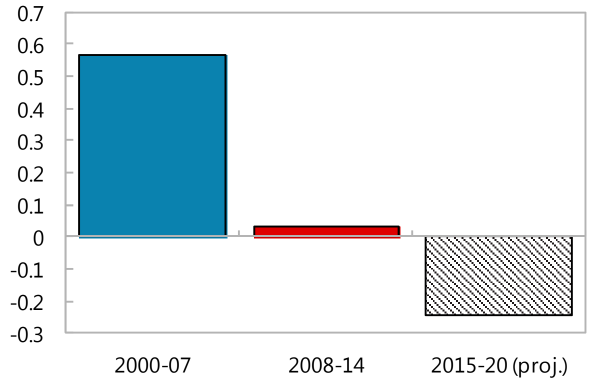
of population aging has been compounded by a decline in the participation rate of 25–54 year olds (by 4 percentage points since 2008) and a relatively low participation rate for 65–69 year olds (13 percent versus 25 percent OECD average).[2]

TFP Growth
(Percent, annual average)



Sources: Statistics Finland and Fund staff calculations.

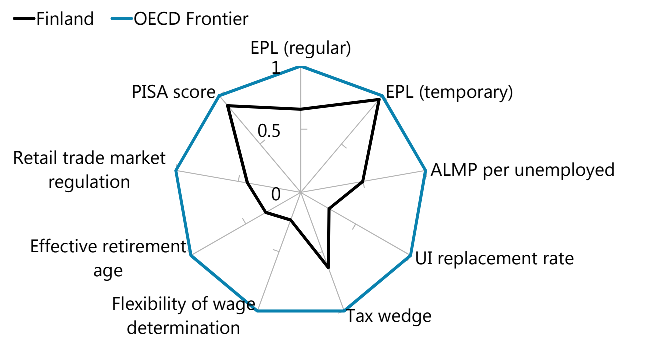
Labor Force Growth
(Percent, annual average)



Sources: Statistics Finland and Fund staff calculations.

11. The new government's structural reform program seeks to address several policy gaps. It aims to improve competitiveness and raise growth through both product and labor market reforms. Additionally, the authorities seek to improve public sector productivity and contain aging related fiscal pressures. Several of the most important labor market and public sector reforms will either need to be negotiated with social partners or will take several years to fully develop and implement.

Structural Policy Gap: Finland vs. OECD Frontier
(Index: 1=OECD frontier)



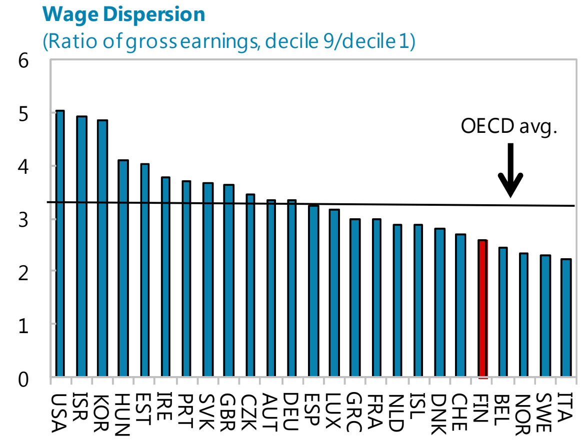
Sources: OECD and Fund staff calculations.

Note: For each indicator, OECD Frontier is set equal to 1, while the worst OECD performer is set equal to zero. OECD Frontiers for the indicators included in the table are defined as follows: the Danish level is used for ALMP per unemployed, OECD average for UI replacement rate and tax wedge, the average level of the three best-performing OECD countries for effective retirement age, the Swedish level for product market regula in retail trade, the Korean level for PISA score, and the average levels of the three best-performing OECD countries in terms of unemployment ra plus the USA for the rest of the indicators.

12. Labor market reforms focus on reducing unit labor costs and raising the labor supply. Pension reforms, agreed last year, aim to increase the average effective retirement age to 62.4 by 2025 (from 61 years currently). The reforms should slow the decline in labor supply growth and help address the long-run sustainability gap in public finances. Plans to tighten requirements on student aid should help reduce very long tertiary study duration and increase labor force participation by younger people. The government also seeks to reduce unit labor costs, including via a reduction of employers' social security contributions and via unremunerated increases in working hours (the

[2] See second chapter of Selected Issues Paper.

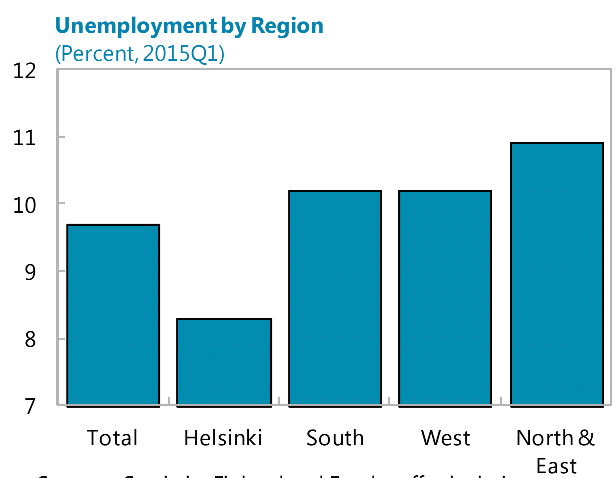
modalities of how the latter is to be achieved are subject of ongoing discussions with the social partners). The government has indicated its intention to increase the flexibility of the wage bargaining system at the firm-level and appointed an internal government expert to make specific proposals to achieve this. Reforms to unemployment benefits that would trim their generosity and duration are also planned, but will not be implemented before 2017.



Sources: OECD and Fund staff calculations.

13. The reform program also aims to improve public sector productivity, especially in the provision of health and social services. Measures aimed at reducing bureaucratic requirements and increasing local governments' flexibility in service delivery—easing the minimum staff-to-children ratio in day cares, for example—should increase productivity in the near-term. The planned reform of the provision of health and social services, however, will be a more complex, medium-term endeavor. This reform aims to shift responsibility for delivering health and social services from municipalities to regional bodies to streamline administration, reap economies of scale, and facilitate the dissemination of best practices.

14. Measures are also planned to support private sector productivity growth and increase the availability of housing. A recent proposal to Parliament to liberalize shop opening hours should help increase competition and have an immediate positive effect on retail sector output and employment. Other initiatives aim to reduce various administrative and regulatory burdens on business, including streamlining permitting processes, but many details remain to be specified. Plans to improve financial incentives for collaboration on R&D between universities and firms could potentially have a beneficial impact on private sector productivity over the medium-term, though the planned cuts to public R&D spending overall are a concern. Separately, measures in the reform program to stimulate housing construction should help ease constraints on regional labor mobility. Planned measures include easing requirements for state-subsidized housing construction, reducing restrictions on land use, and streamlining aspects of the permitting and development process.



Sources: Statistics Finland and Fund staff calculations.

15. The government's reform program is promising, but needs to be further developed and implemented. Staff welcomed the reform intentions, but noted that the effects of key reforms, including of the wage bargaining system, unemployment insurance, and health and social services, would depend on their precise modalities and implementation. Thus, the authorities should quickly flesh out the details of their reform agenda. The outcomes of reforms to increase the local governments' flexibility in the delivery of services should be closely monitored to ensure they do not result in lower quality of services. The impact of the pension reform should also be assessed over time to ensure it is achieving its aims.

16. The reform program could also be strengthened in some areas. With unemployment high and rising, active labor market programs (ALMP) should be expanded to increase retraining and skill development opportunities. Strengthening ALMPs can also help ensure that reforms that increase labor supply do not lead to higher structural unemployment. The government's plan to cut ALMP funding therefore raises concern and should be reconsidered. Direct investment in affordable housing and related infrastructure in the main urban areas would also support labor mobility between regions. Similarly, overall public investment in R&D and innovation could be increased (and should at least be maintained at current levels), as evidence suggests such spending is associated with faster private sector TFP growth over the medium-term. There is also scope for further product market reforms, including reducing planning restrictions on real estate developments for retail locations that can limit market entry and economies of scale.

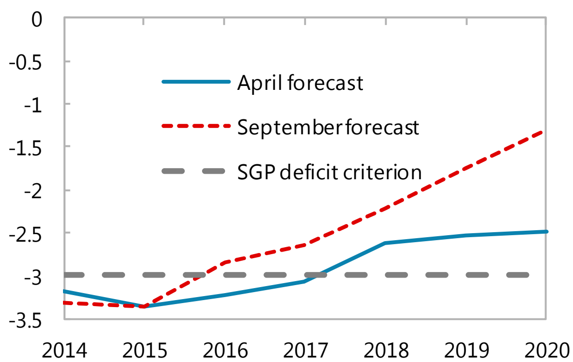
Authorities' Views

17. The authorities agreed with staff on the structural challenges and were determined to move ahead with planned reforms. The authorities wanted to proceed quickly with reforms but cautioned that implementing too many measures simultaneously could create resistance and be counterproductive. In line with Finnish tradition, taking decisions based on broad consensus with social partners was the government's strongly preferred option. The authorities were adamant, however, that they would take required measures even if consensus could not be secured. For example, after recent efforts to reach a "social contract" with employers and trade unions on a reduction of unit labor costs had failed, the authorities had introduced proposals to amend legislation governing collective agreements and bypass trade unions. The authorities fully agreed with staff on the need for more flexibility in collective wage setting, but believed that radical changes to the system could prove costly and disruptive. Hence, they are exploring options to increase firm-level flexibility in wage formation within the broad contours of the existing system, such as by adding opt-out clauses to collective agreements. The authorities considered the pension reform that comes into force in 2017 sufficient to put pension expenditure on a sustainable path. However, they assured staff they will monitor developments and reassess the need for further reforms at five-year intervals. On ALMP and R&D spending cuts, the authorities indicated that there was scope to cut less effective programs to help satisfy fiscal consolidation needs.

B. Fiscal Policy: A Difficult Balance

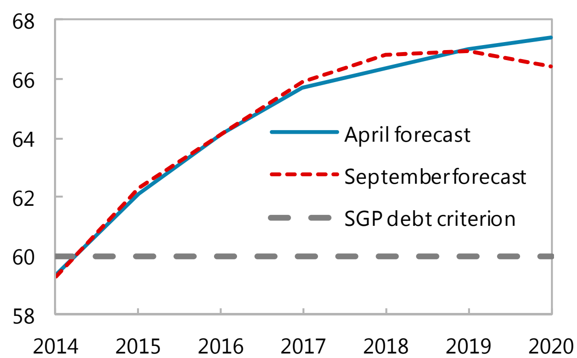
18. Fiscal consolidation is needed to ensure long-run sustainability and respect SGP rules. The long-run fiscal sustainability gap is sizable (estimated at around 5 percent of GDP) and is primarily due to projected aging related spending pressures. Partly due to such pressures, public expenditure has already increased 12 percentage points of GDP since 2007, suggesting a need to begin addressing the sustainability gap now. Also, after breaching of the SGP's deficit criterion in 2014, fiscal consolidation is needed to ensure the deficit is brought back below the 3 percent threshold next year and that the public debt-to-GDP ratio is on a downward path by 2020 (see Appendix I). To address these issues, the new government is planning fiscal adjustment of nearly 2 percent of GDP over 2016–19. While this consolidation generates only a small improvement in the structural fiscal balance, it prevents a further deterioration of the structural balance (e.g., from rising aging related spending) that would have occurred without the measures. The consolidation path is slightly frontloaded, with more than three fifths of the consolidation occurring in the first two years. The proposed 2016 budget envisages consolidation measures worth about 0.6 percent of GDP.

Overall Fiscal Balance Projections
(Percent of GDP)



Sources: IMF World Economic Outlook and Fund staff calculations.
Note: *April forecast* is before consolidation measures were announced. *September forecast* reflects consolidation plans.

Public Debt Ratio Projections
(Percent of GDP)



Sources: IMF World Economic Outlook and Fund staff calculations.

19. **However, in the short term the consolidation poses a risk to the recovery.** Staff's projections include the estimated growth impact of consolidation. Assuming a fiscal multiplier of 0.6—the estimated average over the cycle—the consolidation in 2016 is expected to reduce growth by about 0.3 percentage points relative to the April 2015 WEO projection. However, there is significant uncertainty around multiplier estimates and the growth impact of the consolidation could be larger. The impact on growth will also depend on the composition of fiscal adjustment.

20. **The authorities' consolidation plan is heavily weighted towards spending cuts.** Spending reductions are more than ¾ of the planned consolidation measures over 2016–19. Education, foreign aid, and social benefits are targeted for some of the most substantial cuts, though how some of these savings will be achieved remains to be determined. Despite high and rising unemployment, spending on ALMP will be reduced, while plans to reform unemployment benefits, generating savings of 0.1 percent of GDP per year, will be delayed to 2017. Public investment in new projects, such as the City Rail Loop in Helsinki, will be reduced, though these cuts will be partially offset by increased maintenance of existing infrastructure (see below).

21. **Local governments will be responsible for about 20 percent of the savings.** This will be achieved in part by the central government reducing their responsibilities and allowing them greater flexibility in the delivery of services. In addition, a General Government Fiscal Plan has been

introduced that sets out medium-term spending and deficit limits on both the central and local governments. However, municipalities have substantial fiscal autonomy under the constitution, and it is unclear if spending limits at the municipal level can be fully enforced.

22. On the revenue side, the net impact of envisaged tax policy measures will be small. The budget proposal includes a hike in unemployment insurance (UI) taxes to generate 0.1 percent of GDP per year in 2016–17. Other revenue raising measures for 2016–19 include phasing out the tax deductibility of mortgage interest and excise tax increases. These measures will be largely offset, however, by lower income, capital, and corporate taxes, including an earned income tax credit increase worth about 0.2 percent of GDP.

23. A "growth package" is planned to mitigate the adverse impact of consolidation. Similar to a comparable package that was introduced in 2014, the growth package consists of one-off investments in infrastructure maintenance (0.3 percent of 2016 GDP) and other key projects, including investments in innovation and digitization of government services. In total, the growth package is worth about 0.7 percent of GDP, with about 0.15 percent of GDP spent in 2016 and 0.3 percent of GDP spent 2017 and 2018 each. Financing for the package comes from a combination of asset sales, increased dividends from public enterprises, and cuts to new infrastructure projects (the latter reduce the net impact of the package's infrastructure component by about half).

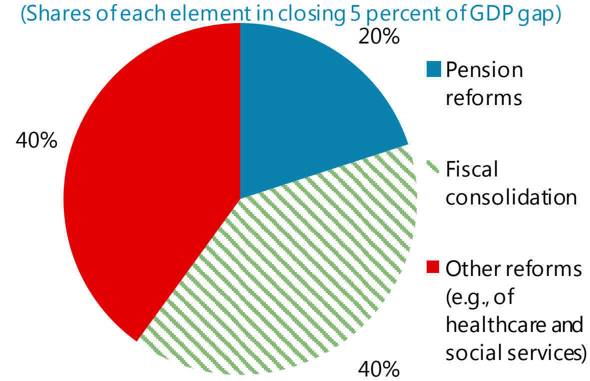
24. Staff supported measures to curb long-term spending pressures, but suggested that the pace of consolidation could be smoothed to reduce growth risks. For instance, there would seem to be some scope for a more even consolidation path within the constraints posed by the SGP. Moreover, frontloading some of the spending from the currently backloaded growth package would also help reduce the effective fiscal consolidation and ameliorate the growth impact. In particular, it should be feasible to bring forward some of the planned infrastructure maintenance spending. Additionally, if growth is weaker than expected, automatic stabilizers should be allowed to operate and fiscal costs from a significant surge in refugees should be accommodated.

25. The composition of consolidation should also be made as growth friendly as possible. In the government's current plan most of the measures on the revenue side shift the tax composition away from direct (income) taxes towards indirect (consumption) taxes. This should be beneficial for growth in the medium- to long-run. However, the planned increase in the UI contribution tax—which is driven by the rules governing the UI fund—increases labor costs at a time when labor demand is already weak. It would be better to delay this tax increase until unemployment is closer to normal levels. On the expenditure side, spending on ALMP should be increased rather than cut, to help reduce high unemployment. Also, planned cuts to productive public investment and R&D should be avoided, as they are most damaging to growth. Staff's analysis suggests that for a given amount of consolidation, shifting cuts from public investment and targeted transfers to public consumption and untargeted transfers could reduce the negative short-run effects on output by about one third.[3]

[3] See third chapter of Selected Issues Paper.

26. In the longer-run, structural reforms are essential to contain aging related spending pressures and ensure fiscal sustainability. The pension reforms that will be legislated this year are projected to reduce the fiscal sustainability gap by around 1 percentage point of GDP. Taking into account the government's nearly 2 percent of GDP consolidation effort, this suggests that closing the remaining 2 percentage points of the gap will depend on the impact of various planned structural reforms. In particular, reforms to improve the cost efficiency of health and social services, including by consolidating services provision at the regional level, will be critical to containing aging related spending pressures.

Contribution to Closing the Fiscal Sustainability Gap
(Shares of each element in closing 5 percent of GDP gap)



Sources: National authorities and Fund staff calculations.

Authorities' Views

27. The authorities acknowledged that consolidation posed risks to growth, but felt it was important to have sufficient buffers to ensure compliance with the SGP. They argued that savings needed to be locked-in early to make sure the public debt-to-GDP ratio is on a downward path by 2020. They indicated that the timing of the growth package spending will partly depend on the availability of financing from planned sources and saw limited scope for frontloading of investments. The authorities believed that the negative growth impact from cuts to public investment and R&D in Finland would not be as high as the literature suggests, as the country's infrastructure levels and R&D spending were near the frontier. The authorities agreed that reforms to improve public sector productivity, especially in health and social services, were critical, but noted that the careful design and implementation of such reforms would take time.

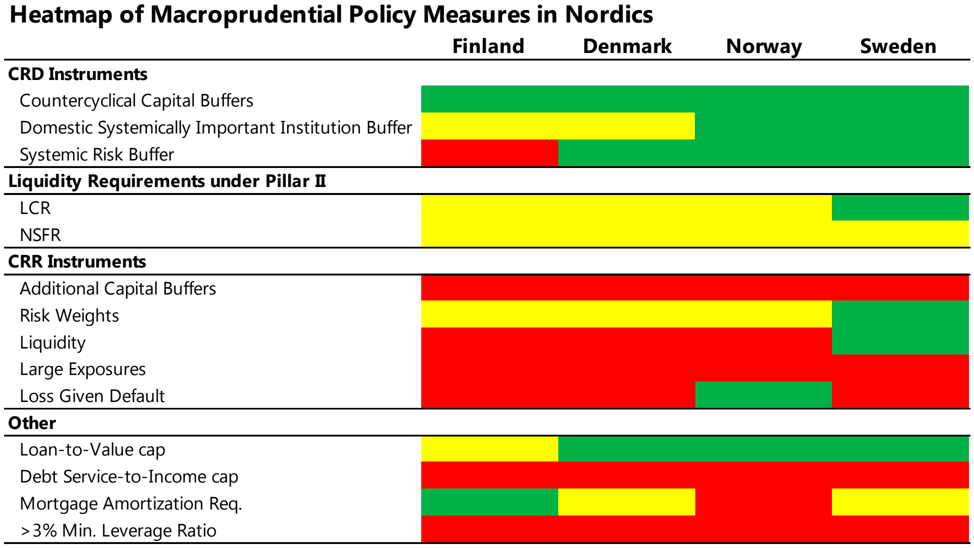
C. Financial Sector Policies: Safeguarding Sustained Stability

28. There are few indications of imminent domestic financial stability risks. Even after an extended period of very low interest rates, the banking system remains profitable and appears relatively well capitalized (Table 7). Also, despite the weak economy, non-performing loans (NPLs) remain low at 1.5 percent of total loans, having fallen from 1.8 percent at end-2014. Credit to non-financial and housing corporations has been growing fairly steadily at around 5 percent in 2014 and the first half of 2015, while household credit growth has been around 2 percent. The household debt ratio has risen to about 120 percent of disposable income, which is moderate relative to comparator countries (Figure 5). Meanwhile, the housing market has cooled and standard metrics suggest that average house prices are broadly in line with fundamentals.

29. However, ensuring adequate frameworks to deal with future shocks is key. While currently healthy, banks' could still be weakened if very low interest rates continue much longer or if the projected recovery fails to materialize. Prolonged stagnation and higher unemployment could also conceivably cause house prices to decline and prompt deleveraging by the most highly indebted households. Moreover, with the economy in a weakened state, financial shocks (including external ones) could cause particularly severe damage. Conversely, it is also important that the authorities have an adequate toolset to contain risks once the recovery gathers steam. Important structural vulnerabilities also remain in the financial sector, including the banking system's concentration, regional interconnectedness, and heavy reliance on wholesale funding.

30. A new macroprudential policy framework was introduced, but there is scope for further measures. The implementation of the Bank Recovery and Resolution Directive (BRRD) in national legislation, including establishing a resolution authority and a new deposit guarantee and resolution fund is a positive step. In addition, the Act on Credit Institutions passed last year introduced the macroprudential policy tools required by CRR/CRD-IV, as well as a loan-to-value (LTV) ratio cap for new mortgages to apply from mid-2016. It also established the independent Board of the Finnish Financial Supervisory Authority (FIN-FSA) as the macroprudential authority. There is scope to further strengthen the macroprudential toolkit, including adding a systemic risk buffer (SRB), as recommended by an internal study group. Adding this optional CRD instrument would better align Finland with the regulatory standards that its large foreign banks face in their home jurisdictions. In view of banks' increasing reliance on wholesale funding, which creates potential funding and liquidity risks, the authorities should implement the Basel III net stable funding ratio and liquidity coverage ratio requirements as soon as is feasible.

Heatmap of Macroprudential Policy Measures in Nordics



Source: Fund staff.

Note: Green indicates implemented; yellow indicates legislated or planned, but not yet implemented; red indicates no measure currently planned.

31. Further enhancing regional cooperation on financial stability issues is also important. The Single Supervisory Mechanism (SSM) became the competent microprudential regulator for the three largest Finnish banks last year. However, as two of these—Nordea and Danske Bank—are subsidiaries of parent institutions outside of the banking union, the need for close cooperation on financial stability issues and cross-border resolution frameworks remains. The issue is accentuated by Nordea's plans to convert its Finnish subsidiary into a branch. If this materializes, it will be important that the Finnish authorities retain the capacity to closely monitor this systemically important bank (which accounts for about 30 percent of loans and deposits in the Finnish banking system) for the purposes of financial stability risk analysis and macroprudential policy formulation. Moreover, it would be critical that robust cross-border supervisory cooperation, such as on information sharing, depositor protection, and resolution arrangements, is agreed between the relevant Finnish, Swedish, and European authorities.

32. The 2016 FSAP will provide an opportunity to delve deeper into financial sector issues. The upcoming Finland FSAP—which will be closely coordinated with the Sweden FSAP—will include a thorough examination of the financial sector and financial stability risks, as well as an integral assessment of the regulatory environment.

Authorities' Views

33. The authorities agreed that there is scope to strengthen the policy framework. The authorities supported the working group's recommendation to introduce a SRB but expected that this proposal will probably not be taken up before next year owing to the priority of other legislative proposals. While noting that a framework for regional cooperation on financial sector issues was in place, the authorities agreed that a deepening of cooperation was useful in view of Nordea's plans to convert its subsidiary into a branch. On the latter issue, the authorities voiced concerns about the potential detrimental consequences on macroprudential policies and microprudential level playing field, and on resolvability, considering the systemic importance of the Nordea subsidiary in the Finnish banking sector. The authorities were broadly positive on their experience with the SSM assuming supervision of the three largest banks, while noting that there had been a learning curve and that the workload of the FIN-FSA had somewhat increased.

STAFF APPRAISAL

34. The Finnish economy has been in recession for three years. It has experienced a unique confluence of structural and cyclical shocks since 2007. Exports have suffered due to the declines of Nokia and the paper industry, as well as weak external demand, especially from the euro area and Russia. Wage hikes in 2008–10 and weak productivity growth have hurt competitiveness. Rapid population aging is a further drag on growth. As a result, the current account and fiscal balances have deteriorated, with the 2014 fiscal deficit breaching the SGP's 3 percent of GDP criterion.

35. The recovery will likely be slow and is subject to significant downside risks. A moderate recovery is projected to start in 2015 and to gradually strengthen in 2016. However, absent further reforms, growth is likely to remain much lower than before the crisis. Moreover, downside risks heighten the fragility of the recovery. Weaker-than-expected growth in key trade partners would be a drag on exports and spillovers from an external financial shock could cause financial conditions to tighten, with negative effects on output. Domestically, the procyclical fiscal tightening could weaken the recovery more than already anticipated. While the recent surge in refugees creates short-run fiscal risks, over the medium-term it should support labor supply growth.

36. The main challenge is to revive growth. Productivity growth has fallen sharply, including because of changes in the economy's sectoral composition, and labor supply growth has slowed owing to population aging. Addressing these issues will require structural reforms to boost productivity growth, facilitate the reallocation of resources from declining industries to growing ones, and raise labor participation rates.

37. The government's structural reform program is promising, but needs to be further developed and implemented. The initiative to liberalize shop opening hours is a welcome step that should have immediate positive impact on output and employment. Proposals to reduce unit labor costs have the potential to increase competitiveness. The government's intention to increase the flexibility of the wage bargaining system and curb the long duration of unemployment benefits are also welcome and developing concrete proposals in these areas should be a priority. Such reforms should be paired with a strengthening of ALMP, so current plans to cut ALMP spending seem ill-advised. Giving municipalities greater flexibility in delivering services could improve public sector productivity, but outcomes should be carefully monitored. Increasing spending on R&D, if well-targeted, could raise medium-term growth and plans to cut such spending should be reconsidered.

38. Fiscal policy should balance consolidation needs against growth objectives. Fiscal adjustment is needed to close the sustainability gap and to ensure compliance with the SGP, but poses risks to growth. Consolidation efforts should focus on items that address long-term aging-related spending pressures, such as health and social services reforms. The pace of the consolidation could be smoothed to reduce negative growth effects and still respect the SGP. Growth package spending should be frontloaded. The composition of fiscal adjustment could also be made more growth friendly by shifting cuts from public investment to consumption. UI contribution increases raise labor costs at a time when labor demand is already weak and should be delayed until unemployment is lower. Automatic stabilizers should be allowed to operate if growth disappoints and fiscal costs from a significant surge in refugees should be accommodated.

39. Financial sector risks appear contained for the moment, but ensuring robust policy frameworks to deal with future risks is key. With the economy in a fragile state, financial shocks (including external ones) could be particularly damaging. It is also important that the authorities have an adequate toolset to contain risks once the recovery gathers steam. The development of a macroprudential policy framework last year has been a major positive step, but there remains scope to strengthen the policy toolkit, particularly by adding a SRB. Also, regional cooperation on financial sector issues should be further enhanced, including to address issues raised by Nordea's plans to convert it Finnish subsidiary into a branch.

40. It is proposed that the next Article IV consultation with Finland occur on the standard 12-month cycle.

Box 1. External Sector Assessment

Sizable pre-crisis current account (CA) surpluses have turned into persistent deficits. In the decade up to 2007, Finland's annual CA surplus averaged 5½ percent of GDP. Since 2011, however, the CA has shown a deficit of about 2 percent of GDP. The shift to CA deficits has eroded the net international investment position (NIIP). The deficit in the current account is balanced by a surplus in the financial account. From 2009–12, positive portfolio debt investments due to Finland's status as a "safe haven" contributed substantially to the financial account surplus. In 2014, foreign direct investment became more important as Microsoft purchased Nokia's handset business. Portfolio inflows will continue to be an important component of the financial account, averaging about 6 percent of GDP per year out to 2020.

The CA deterioration is mainly driven by the decline of Nokia and wood and paper exports. Exports of electrical and optical equipment have fallen from their pre-crisis peak of 8½ percent of GDP to 3 percent in 2014. Wood and paper exports have declined more steadily, by about 2½ percentage points of GDP since 2002 to 5½ percent in 2014. These declines have only been partially mitigated by rising exports from other industries, such as chemicals, so Finland's share of global exports has declined (see Figure 3, lower left panel). This has been exacerbated by ULCs rising nearly 25 percent since 2007, due to a mix of rapid wage increases during 2008–10 and falling productivity as result of the sectoral changes in the economy.

However, exports appear to be stabilizing and the trade balance is expected to move back into surplus. As a result, the CA balance is expected to improve by a cumulative ½ percent of GDP to -0.2 percent in 2020. Given continued CA deficits, the NIIP is forecast to continue deteriorating, from -0.8 percent of GDP in 2014 to -12 percent in 2020. The change in the NIIP can mostly be attributed to *net foreign direct investment*, which falls by 9½ percentage points of GDP from 2014 to 2020. *Net portfolio investment* also deteriorates slightly, by about ½ percentage points of GDP over the same period. *Net other investments* (e.g., loans, deposits, and trade credit), though negative, offset some of this decline. Projected valuation effects from exchange rate changes also play a role. Gross external debt is expected to remain around 220–230 percent of GDP, while net external debt will average around 50 percent of GDP through 2020.

Staff views the external position as broadly in line with fundamentals. This is supported by the External Balance Assessment (EBA). The EBA's CA, REER (Index and Level), and External Sustainability (ES) analyses all suggest the REER was slightly overvalued in 2014. Given the substantial uncertainty surrounding such estimates, the staff continues to assess the REER as broadly in line with fundamentals. This is consistent with the fact that the deterioration in the CA was mainly driven by identifiable structural shocks—specifically, the declines of Nokia and the paper industry—which are not well captured in the EBA CA norm estimate of 0.9 percent of GDP. However, based on past estimates of REER gaps from Article IV Staff Reports, using different CGER and EBA approaches over time, the REER appears to have gone from undervalued to roughly in line with fundamentals (see Figure 3, lower right panel chart). This correction in the estimated REER gap is also likely a contributing factor in the deterioration of the CA balance.

External Balance Assessment (EBA) Methodologies 1/

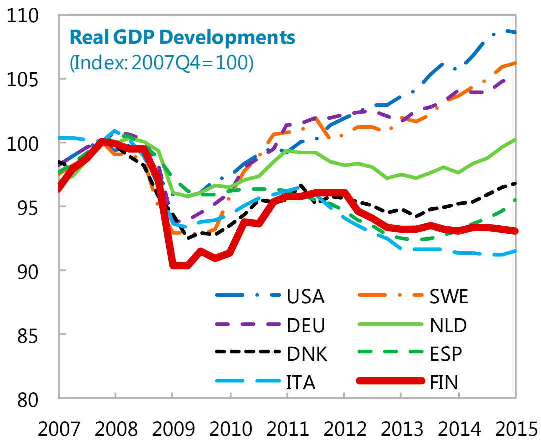
Methodology	CA gap *(Percent of GDP)*	REER gap *(Percent)*
EBA CA Analysis	-2.1	4.9
EBA REER (Index) Analysis	--	2.0
EBA REER (Level) Analysis	--	4.7
EBA External Sustainability (ES) Approach	-0.5	1.7

Source: Fund staff calculations.

1/ CA gaps: minus indicates overvaluation. REER gaps: minus indicates undervaluation. REER gaps between -5 and +5 percent are considered to indicate the REER is broadly in line with fundamentals. EBA estimates are based on data available in March 2015.

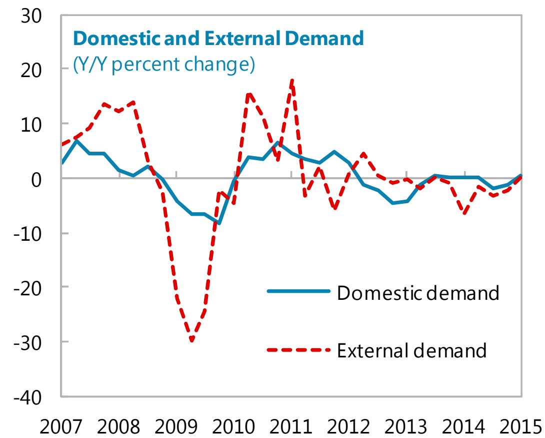
Figure 1. Recent Developments

Finland has been in a slump or 3 years…



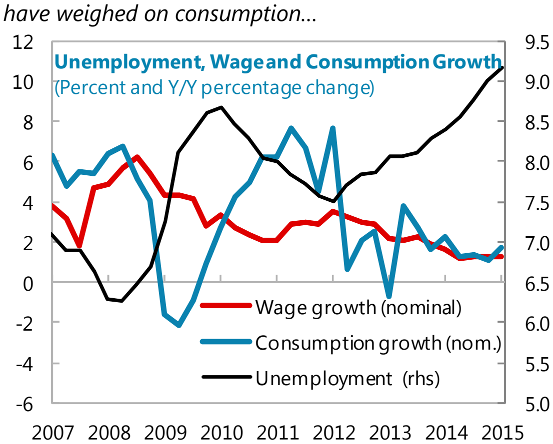
Sources: Eurostat and Fund staff calculations.

…partly due to weak domestic and external demand.



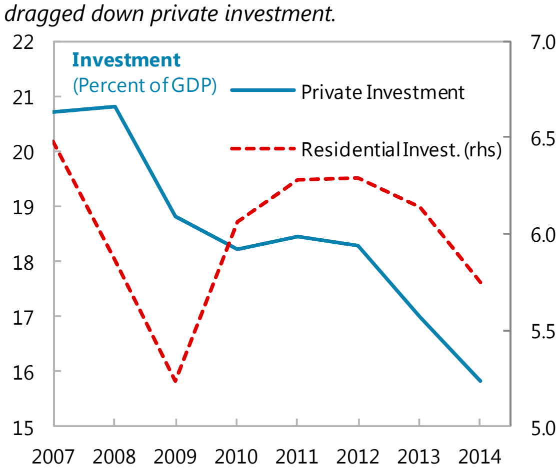
Sources: IMF World Economic Outlook and Fund staff

Slowing nominal wage growth and rising unemployment have weighed on consumption…



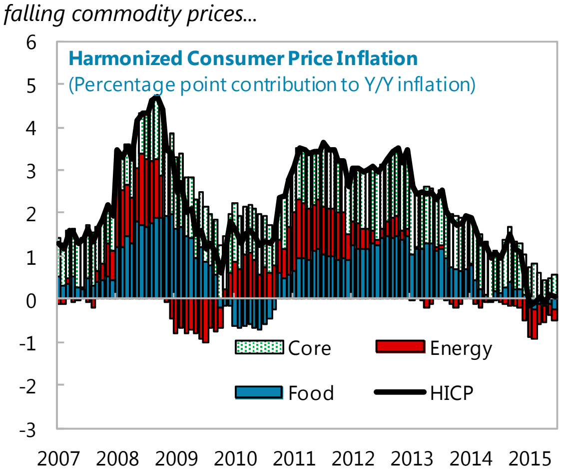
Sources: IMF World Economic Outlook, Statistics Finland, and

…while uncertain demand and income prospects have dragged down private investment.



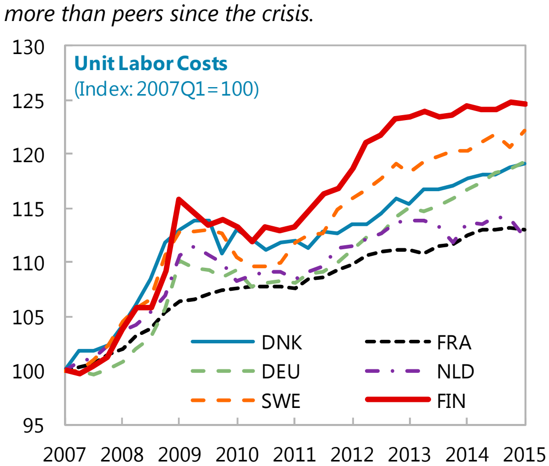
Sources: Statistics Finland and Fund staff calculations.

Inflation has fallen, as in the rest of Europe, in part due to falling commodity prices…



Sources: Eurostat, Statistics Finland, and Fund staff

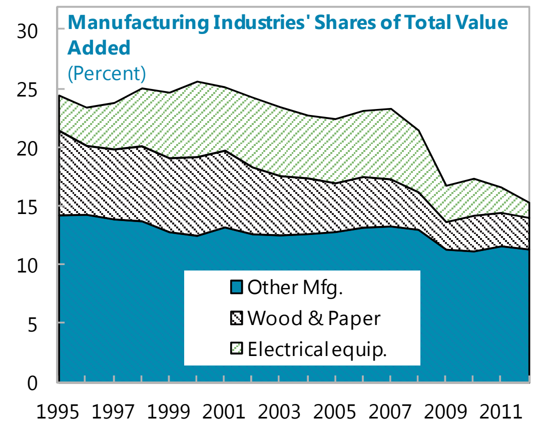
…and despite rising unit labor costs, which have increased more than peers since the crisis.



Sources: OECD and Fund staff calculations.

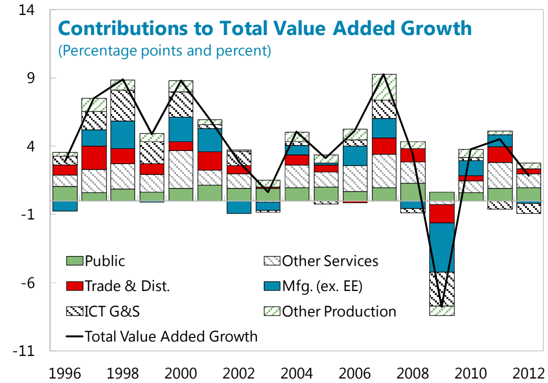
Figure 2. Structural and Labor Market Indicators

Finland has suffered structural shocks with the collapse of Nokia and decline of the wood and paper industry.



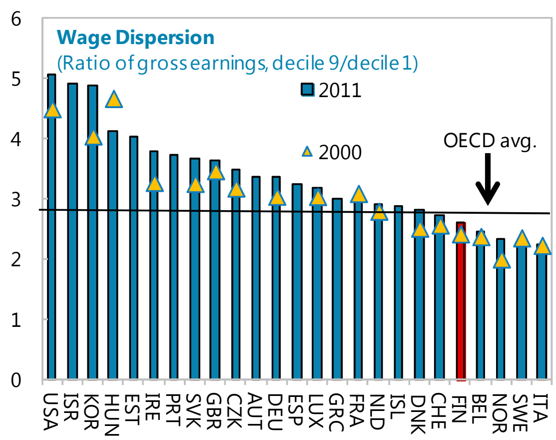
Sources: EU KLEMS and Fund staff calculations.

The impact of the secular decline of the wood and paper industry was offset by ICT growth until the crisis.



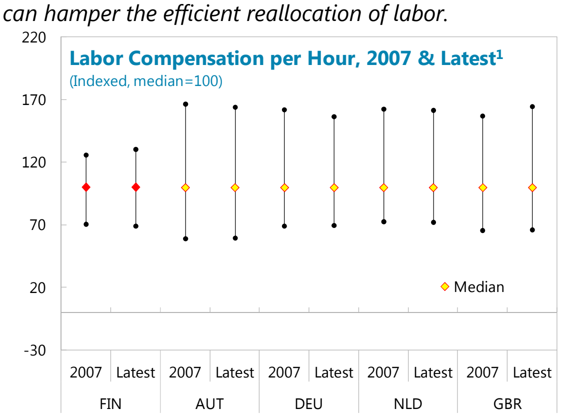
Sources: EU KLEMS and Fund staff calculations.

Wage dispersion is relatively low…



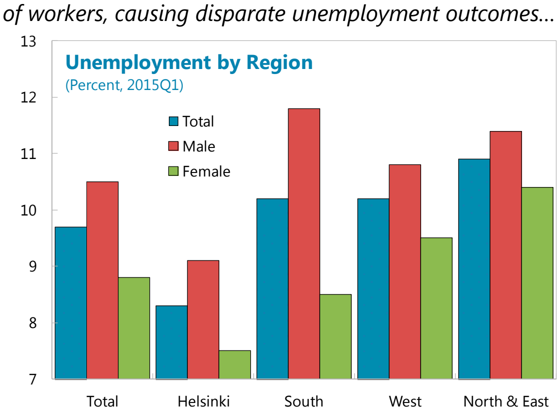
Sources: OECD and Fund staff calculations.

…and the wages across industries are compressed, which can hamper the efficient reallocation of labor.



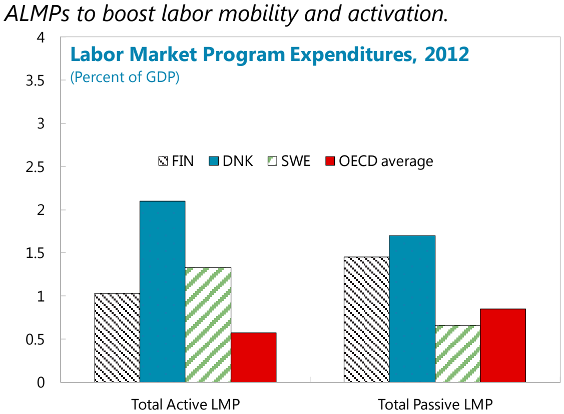
Sources: EU Klems and Fund staff calculations.
[1]/Distribution of labor compensation per hour

Industries can be concentrated by region and gender share of workers, causing disparate unemployment outcomes…



Sources: Statistics Finland and Fund staff calculations.

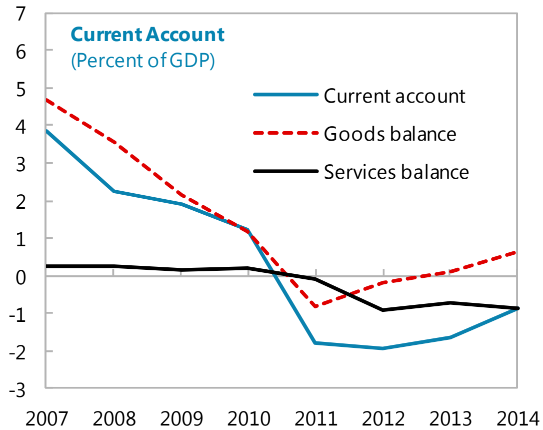
…suggesting a role for increasing and better targeting ALMPs to boost labor mobility and activation.



Sources: OECD and Fund staff calculations.

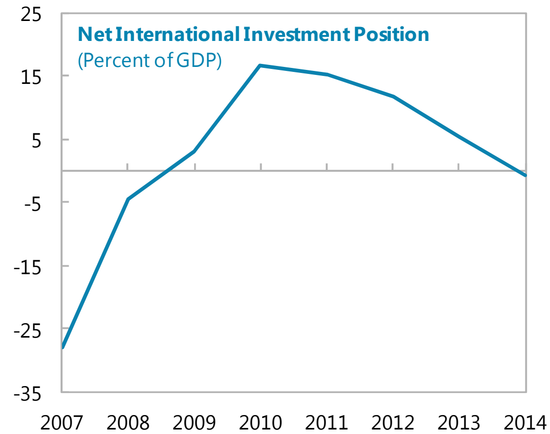
Figure 3. External Sector

The current account has fallen into persistent deficits…



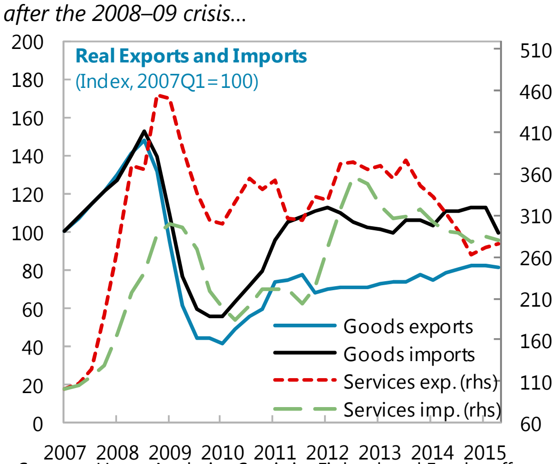
Sources: IMF World Economic Outlook and Fund staff

…causing the NIIP to deteriorate.



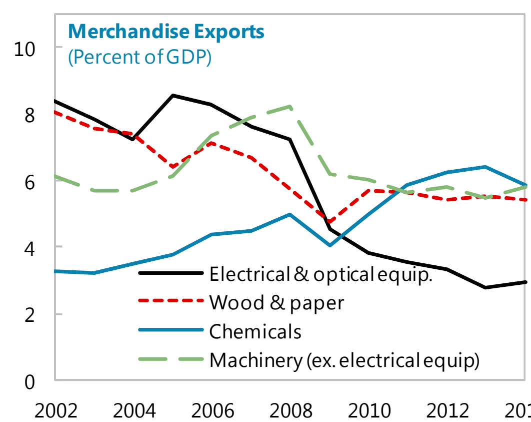
Sources: Statistics Finland and Fund staff calculations.

This is largely due to the failure of exports to fully recover after the 2008–09 crisis…



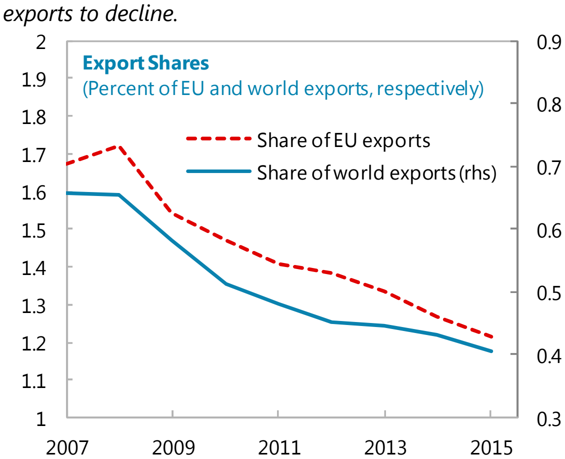
Sources: Haver Analytics, Statistics Finland, and Fund staff

…driven primarily by the massive decline in ICT and wood and paper industries' exports.



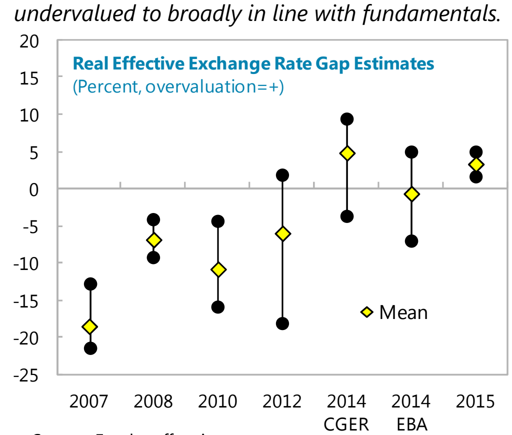
Sources: Finnish Customs, Statistics Finland, and Fund staff calculations.

This has caused Finland's share of both EU and world exports to decline.



Sources: IMF WEO and Fund staff calculations.

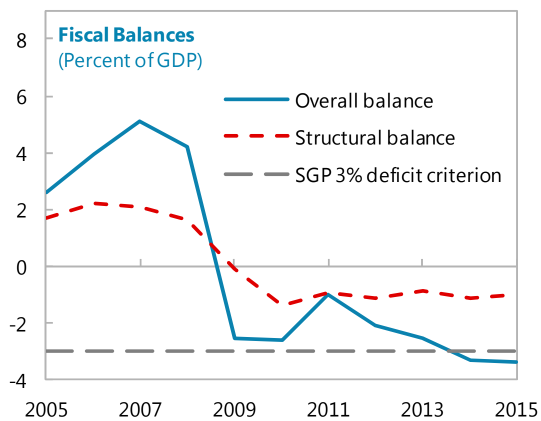
Meanwhile, its REER is assessed to have moved from undervalued to broadly in line with fundamentals.



Source: Fund staff estimates.
Note: Bars show the minimum and maximum estimates of REER gaps for different CGER (2007-14) and EBA (2014-15) estimation approaches.

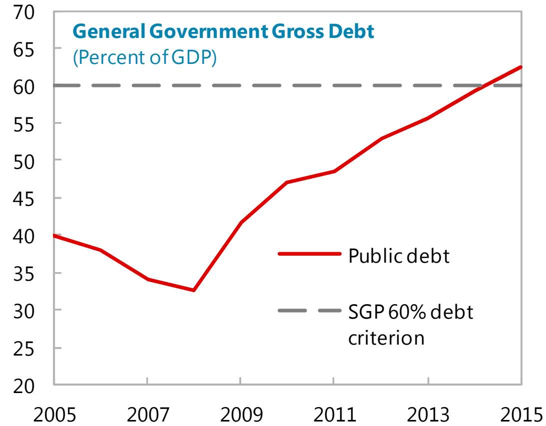
Figure 4. Fiscal Indicators

The fiscal position has also slipped into persistent deficit, breaching the SGP 3 percent deficit criterion…



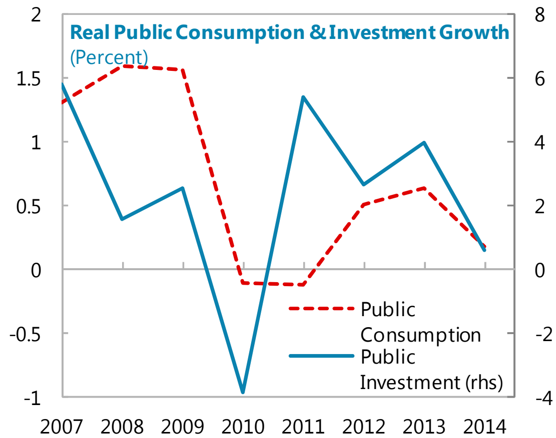
Sources: IMF World Economic Outlook, and Fund staff

…causing a steady rise in the debt ratio, which is expected to breach the 60 percent of GDP SGP criterion this year.



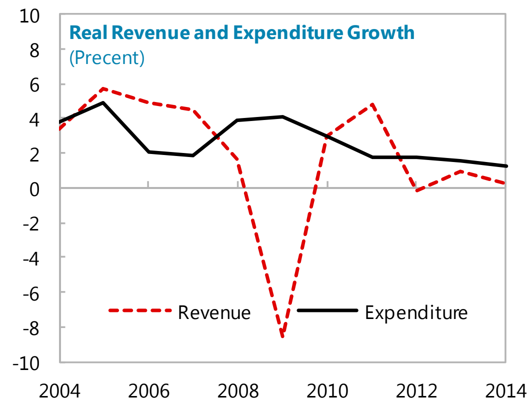
Sources: IMF World Economic Outlook and Fund staff

This deterioration has come despite efforts to cut the growth of public consumption and investment…



Sources: Statistics Finland and Fund staff calculations.

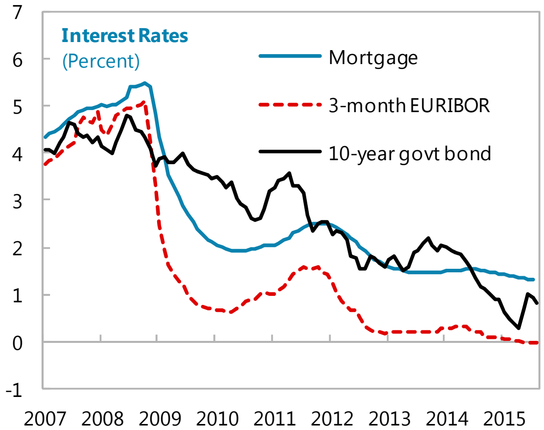
…as the weak economy has driven real revenue growth even lower than that of spending.



Sources: IMF World Economic Outlook and Fund staff calculations.

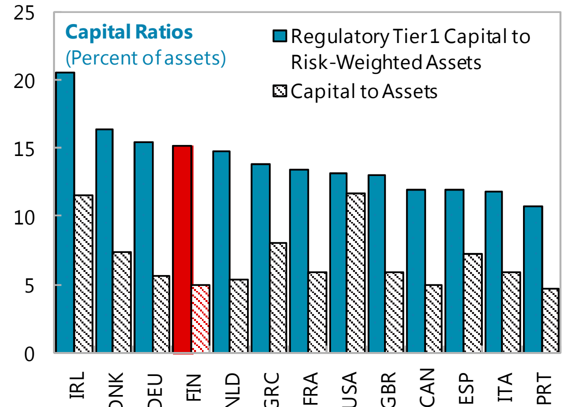
Figure 5. Financial Sector

The extended period of falling interest rates has generated relatively easy financial conditions…



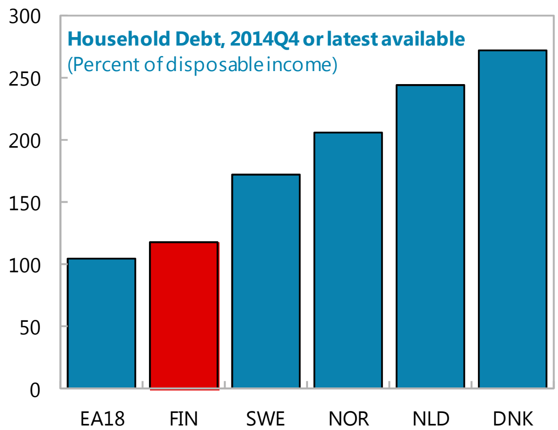
Sources: Eurostat, Bank of Finland, and Fund staff calculations.

…as banks are not constrained by the need to boost regulatory capital to meet new requirements.



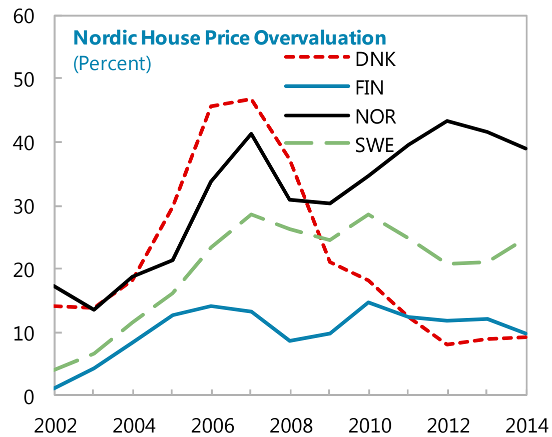
Sources: IMF Financial Soundness Indicators and Fund staff calculations.

Nonetheless, the household debt ratio remains well below the levels in comparator countries…



Sources: Haver Analytics and Fund staff calculations.

…and credit growth has recently slowed, while the housing market has begun to cool off.



Sources: OECD and Fund staff calculations.

Table 1. Finland: Selected Economic Indicators, 2012–20

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Proj.					
				(Percentage change, unless otherwise indicated)					
Output and demand (volumes)									
GDP	-1.4	-1.1	-0.4	0.4	0.9	1.2	1.3	1.4	1.6
Domestic demand	-1.2	-1.1	0.0	-0.2	0.7	1.0	1.2	1.4	1.5
Private consumption	0.3	-0.3	0.5	0.7	0.5	0.6	0.9	1.2	1.4
Public consumption	0.5	0.8	-0.2	-0.1	-0.8	-0.3	-0.1	0.1	0.3
Gross fixed capital formation	-2.2	-5.2	-3.3	-2.1	2.6	3.6	3.4	3.0	2.9
Change in stocks (contribution to growth in percent of GDP)	-1.0	0.0	0.5	-0.1	0.1	0.1	0.0	0.0	0.0
Exports of goods and services	1.2	1.1	-0.7	0.7	2.1	2.7	2.8	2.8	2.9
Imports of goods and services	1.6	0.0	0.0	-0.8	1.7	2.4	2.6	2.7	2.8
Net exports (contribution to growth in percent of GDP)	-0.2	0.4	-0.3	0.6	0.1	0.1	0.1	0.1	0.1
Prices, costs, and income									
Consumer price inflation (harmonized, average)	3.2	2.2	1.2	0.0	1.3	1.6	1.8	2.0	2.0
Consumer price inflation (harmonized, end-year)	3.5	1.9	0.6	0.4	1.3	1.6	1.8	2.0	2.0
GDP deflator	3.0	2.6	1.6	0.7	1.4	1.6	1.8	1.9	2.1
Unit labor cost, manufacturing	10.7	-4.4	-2.1	1.3	-1.5	0.2	0.5	0.5	0.5
Labor market									
Labor force	0.3	-0.6	0.2	0.0	-0.1	-0.2	-0.3	-0.4	-0.4
Employment	0.4	-1.1	-0.4	-0.8	-0.1	0.2	0.2	0.2	0.2
Unemployment rate (in percent)	7.7	8.1	8.7	9.4	9.4	9.0	8.5	8.0	7.4
Potential output and NAIRU									
Output gap (in percent of potential output)[1]	-1.9	-2.7	-3.3	-3.2	-2.7	-2.1	-1.7	-1.2	-0.5
Growth in potential output	0.3	-0.3	0.2	0.2	0.4	0.6	0.9	0.9	0.9
NAIRU (in percent)	7.8	7.8	7.9	7.8	7.8	7.7	7.6	7.5	7.4
				(Percent of GDP)					
General government finances[2]									
Overall balance	-2.1	-2.5	-3.3	-3.4	-2.8	-2.6	-2.2	-1.7	-1.3
Primary balance[3]	-0.7	-1.3	-2.1	-2.2	-1.7	-1.5	-1.1	-0.5	0.0
Structural balance (in percent of potential GDP)	-1.1	-0.9	-1.1	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8
Structural primary balance (in percent of potential GDP)[3]	0.3	0.3	0.1	0.1	0.2	0.1	0.2	0.4	0.5
Gross debt	52.9	55.6	59.3	62.3	64.1	65.9	66.8	67.0	66.4
Net debt[4]	-50.3	-54.0	-50.1	-46.2	-42.3	-38.5	-35.2	-32.3	-29.8
				(Percent)					
Money and interest rates									
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	0.5	4.1	1.3	...	...	...	...	...	...
Finnish MFI euro area loans (growth rate, e.o.p.)	7.1	7.7	3.8	...	...	...	...	...	...
3-month Euribor rate (percent)	0.6	0.2	0.3	...	...	...	...	...	...
10-year government bonds yield	1.9	1.9	1.4	...	...	...	...	...	...
				(Percent of GDP)					
National saving and investment									
Gross national saving	20.5	19.4	19.7	19.5	20.0	20.7	21.2	21.7	22.1
Gross domestic investment	22.4	21.3	21.0	20.3	20.7	21.2	21.7	22.1	22.4
Balance of payments									
Current account balance	-1.9	-1.7	-0.9	-0.7	-0.7	-0.6	-0.5	-0.4	-0.2
Goods and services balance	-1.1	-0.6	-0.2	0.4	0.6	0.7	0.7	0.7	0.8
Net international investment position	11.7	5.4	-0.7	-3.1	-5.3	-7.3	-9.1	-10.6	-12.0
Gross external debt	227.5	206.4	217.2	222.9	225.4	226.8	227.2	226.1	224.7
Exchange rates (period average)									
Euro per US$	0.78	0.75	0.75	...	...	...	...	...	...
Nominal effective rate (appreciation in percent)	-3.3	2.6	1.9	...	...	...	...	...	...
Real effective rate (appreciation in percent)[5]	-2.9	2.2	1.3	...	...	...	...	...	...

Sources: Bank of Finland, International Financial Statistics, IMF Institute, Ministry of Finance, Statistics Finland, and Fund staff calculations.

[1] A negative value indicates a level of actual GDP that is below potential output.

[2] Fiscal projections include measures as specified in the General Government Fiscal Plan.

[3] Adjusted for interest expenditure.

[4] Defined as the negative of net financial worth (i.e., debt minus assets).

[5] CPI-based real effective exchange rate.

Table 2. Finland: Balance of Payments, 2012–20

(In billions of euros, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
				Proj.					
Current account	-3.9	-3.4	-1.8	-1.5	-1.5	-1.3	-1.0	-0.9	-0.6
(percent of GDP)	-1.9	-1.7	-0.9	-0.7	-0.7	-0.6	-0.5	-0.4	-0.2
Goods and services	-2.2	-1.2	-0.5	0.8	1.3	1.5	1.6	1.7	2.0
(percent of GDP)	-1.1	-0.6	-0.2	0.4	0.6	0.7	0.7	0.7	0.8
Exports of goods and services	79.2	79.1	78.4	78.2	79.7	82.2	84.9	87.4	89.7
Goods	56.9	56.8	57.2	57.0	58.0	59.8	61.7	63.5	65.2
Services	22.4	22.3	21.2	21.2	21.7	22.4	23.2	23.8	24.5
Imports of goods and services	81.5	80.3	78.9	77.4	78.4	80.8	83.3	85.7	87.7
Goods	57.3	56.5	55.9	54.7	55.3	57.0	58.7	60.4	61.8
Services	24.2	23.7	23.0	22.7	23.1	23.8	24.6	25.3	25.9
Income	-1.7	-2.2	-1.3	-2.3	-2.8	-2.8	-2.6	-2.6	-2.5
Investment income	-1.7	-2.2	-1.3	-2.3	-2.8	-2.8	-2.6	-2.6	-2.5
Capital and financial account	-16.7	-7.0	-8.2	-1.1	-1.1	-0.8	-0.6	-0.5	-0.1
Capital account	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-16.9	-7.2	-8.4	-1.3	-1.3	-1.1	-0.8	-0.7	-0.3
Direct investment	2.6	-1.7	-12.6	-2.8	-3.1	-3.4	-3.2	-2.9	-3.9
In Finland	3.9	-3.8	11.2	0.4	0.9	1.2	1.0	0.7	1.7
Abroad	6.5	-5.5	-1.4	-2.4	-2.2	-2.2	-2.2	-2.2	-2.2
Portfolio investment	-9.3	-3.8	4.6	0.0	-1.1	-0.1	-0.3	-0.1	0.5
Financial derivatives	-1.1	-2.0							
Other investment	-9.7	-0.5	0.3	-2.1	-0.5	-1.2	-1.1	-1.3	-0.7
Assets	1.7	-28.4	-2.4	2.4	3.7	3.3	3.3	3.4	3.9
Liabilities	11.3	-28.0	-2.7	4.5	4.2	4.5	4.4	4.7	4.6
Official									
Private									
Reserve assets	0.5	0.8	-0.2	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-13.3	-4.1	-6.8	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:									
GDP at current prices	199.8	202.7	205.2	207.3	212.1	218.0	224.7	232.3	240.8

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

Table 3. Finland: Net International Investment Position, 2006–14

(Percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013	2014
Assets	203.9	207.3	254.0	263.2	327.7	392.6	356.2	309.8	377.6
Direct investment	50.5	52.4	67.4	64.9	75.4	71.9	71.3	64.7	67.0
Portfolio investment	89.4	87.6	73.0	93.0	115.2	112.9	117.7	120.3	150.3
Equity & investment fund shares	40.2	41.9	25.4	37.7	52.9	47.0	51.9	57.1	73.7
Debt securities	49.2	45.8	47.6	55.3	62.4	65.9	65.7	63.2	76.5
Fin. deriv. (other than reserves)	15.3	18.3	52.0	42.7	58.1	99.0	66.5	40.8	67.8
Other investment	45.6	46.2	58.3	58.4	75.2	104.6	96.6	80.1	87.9
Reserve assets	3.1	2.9	3.3	4.2	3.8	4.3	4.1	3.9	4.6
Liabilities	217.4	233.5	259.0	260.2	311.1	376.6	344.8	304.6	378.4
Direct investment	39.5	43.6	55.0	48.4	54.9	53.5	50.9	45.5	56.9
Portfolio investment	120.4	129.3	92.6	101.9	111.3	109.0	118.3	124.3	149.7
Equity & investment fund shares	64.7	78.7	38.9	38.1	39.1	27.7	31.0	39.3	47.8
Debt securities	55.7	50.6	53.7	63.8	72.2	81.3	87.2	85.0	101.9
Fin. deriv. (other than reserves)	14.9	17.5	51.9	41.6	55.4	94.8	62.4	38.4	63.9
Other investment	42.6	43.1	59.5	68.3	89.5	119.4	113.2	96.4	107.9
Net International Investment Position	-13.5	-26.2	-5.0	3.0	16.6	15.9	11.5	5.2	-0.8
Direct Investment	10.9	8.7	12.4	16.5	20.4	18.4	20.4	19.3	10.1
Portfolio Investment	-30.9	-41.6	-19.6	-8.8	3.9	3.9	-0.6	-4.0	0.6
Fin. deriv. (other than reserves)	0.4	0.8	0.1	1.2	2.7	4.2	4.1	2.4	3.9
Other Investment	2.9	3.1	-1.3	-10.0	-14.3	-14.8	-16.6	-16.3	-20.0

Sources: Statistics Finland and Fund staff calculations.

Note: Changes to the NIIP since the 2014 Article IV are mainly due to the switch to the BPM6 statistical standard.

Table 4. Finland: General Government Statement of Operations, 2012–20

(In percent of GDP, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018	2019	2020
						Proj.			
Revenue	54.0	55.1	54.9	55.1	55.0	54.7	54.6	54.8	55.0
Tax revenues	29.9	31.0	31.1	31.3	30.9	30.5	30.2	30.4	30.5
Taxes on production and imports	14.1	14.5	14.4	14.2	14.2	14.0	13.7	13.8	13.9
Current taxes on income, wealth, etc.	15.6	16.2	16.5	16.8	16.3	16.1	16.2	16.3	16.3
Capital taxes	0.3	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Social contributions	12.8	12.8	12.8	12.9	13.1	13.0	12.9	13.0	13.0
Grants	0.3	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3
Other revenue									
Expenditure	56.1	57.6	58.3	58.5	57.9	57.3	56.8	56.6	56.4
Expense	55.6	57.1	57.6	57.9	57.3	56.8	56.4	56.2	56.0
Compensation of employees	14.3	14.4	14.2	14.1	13.9	13.6	13.4	13.4	13.4
Use of goods and services	11.3	11.6	11.6	11.4	11.5	11.6	11.6	11.6	11.6
Consumption of fixed capital (CFC)	3.4	3.5	3.5	3.5	3.6	3.6	3.7	3.7	3.7
Interest	1.4	1.3	1.2	1.2	1.1	1.1	1.1	1.2	1.3
Subsidies	1.4	1.3	1.4	1.3	1.2	1.2	1.1	1.1	1.1
Grants	1.2	1.2	1.3	1.3	1.3	1.3	1.4	1.4	1.3
Social benefits	20.7	21.7	22.4	23.2	23.0	22.9	22.8	22.5	22.3
Other expense	1.9	2.1	2.0	1.9	1.7	1.4	1.3	1.3	1.3
Net acquisition of nonfinancial assets	0.5	0.5	0.6	0.6	0.6	0.6	0.4	0.4	0.3
Net operating balance	-1.6	-2.0	-2.7	-2.8	-2.3	-2.1	-1.8	-1.4	-1.0
Net lending/borrowing	-2.1	-2.5	-3.3	-3.4	-2.8	-2.6	-2.2	-1.7	-1.3
Net acquisition of financial assets	3.6	2.5	-0.21						
Currency and deposits	-1.1	-0.8	-0.8						
Securities other than shares	-0.5	1.3	-0.5						
Loans	1.9	0.5	-0.6						
Shares and other equity	3.3	2.4	1.0						
Insurance technical reserves	0.0	0.0	0.0						
Financial derivatives	0.0	0.0	0.0						
Other accounts receivable	0.1	-0.9	0.6						
Net incurrence of liabilities	5.7	4.9	3.0						
Special Drawing Rights (SDRs)	0.0	0.0	0.0						
Currency and deposits	-0.1	0.0	0.1						
Securities other than shares	3.3	2.8	3.3						
Loans	1.9	0.6	0.9						
Shares and other equity	0.0	0.0	0.0						
Insurance technical reserves	0.0	0.0	0.0						
Financial derivatives	0.2	0.8	-0.7						
Other accounts payable	0.4	0.6	-0.7						
Memorandum items:									
Primary balance[1]	-0.7	-1.3	-2.1	-2.2	-1.7	-1.5	-1.1	-0.5	0.0
Structural balance (in percent of potential GDP)	-1.1	-0.9	-1.1	-1.0	-0.9	-0.9	-0.9	-0.8	-0.8
Structural primary balance (in percent of potentia	0.3	0.3	0.1	0.1	0.2	0.1	0.2	0.4	0.5
Central government net lending/borrowing	-3.6	-3.6	-3.8	-3.1	-2.9	-2.8	-2.3	-1.9	-1.4
General government gross debt	52.9	55.6	59.3	62.3	64.1	65.9	66.8	67.0	66.4
General government net debt[2]	-50.3	-54.0	-50.1	-46.2	-42.3	-38.5	-35.2	-32.3	-29.8
Central government gross debt	48.0	49.8	51.5	51.7	51.3	51.0	50.1	48.6	46.6
Output gap (percent of potential GDP)	-1.9	-2.7	-3.3	-3.2	-2.7	-2.1	-1.7	-1.2	-0.5
Nominal GDP (billions of euros)	199.8	202.7	205.2	207.3	212.1	218.0	224.7	232.3	240.8

Sources: Eurostat, Government Finance Statistics, International Financial Statistics, Ministry of Finance, and Fund staff.

[1] Adjusted for interest expenditure.

[2] Defined as the negative of net financial worth (i.e., debt minus assets).

Table 5. Finland: General Government Balance Sheet, 2006–13

(In percent of GDP)

	2006	2007	2008	2009	2010	2011	2012	2013
Net worth	...	...	...	...	...	...	...	...
Nonfinancial assets	...	...	...	...	...	...	...	...
Net financial worth	66.5	69.7	50.0	59.6	61.8	48.8	50.3	54.0
Financial assets	110.4	109.8	88.7	109.1	117.9	107.8	115.0	
Currency and deposits	6.0	6.0	6.2	5.8	8.2	9.1	8.1	
Securities other than shares	25.2	22.3	21.9	26.0	21.0	20.8	21.1	
Loans	11.7	10.9	12.3	14.6	14.6	13.5	15.2	
Shares and other equity	61.9	64.4	42.9	58.1	68.2	58.7	64.8	
Insurance technical reserves	0.0	0.0	0.0	0.1	0.1	0.0	0.0	
Financial derivatives	1.2	1.7	1.0	0.6	1.2	0.9	1.2	
Other accounts receivable/payable	4.2	4.4	4.4	4.1	4.7	4.7	4.6	
Liabilities	43.8	39.9	38.6	49.3	55.3	55.7	61.6	
Currency and deposits	0.2	0.2	0.2	0.3	0.3	0.3	0.3	
Securities other than shares	32.5	28.3	27.4	35.6	41.3	42.5	46.4	
Loans	6.0	5.9	6.2	7.3	7.3	8.1	9.8	
Shares and other equity	0.0	0.0	0.0	0.0	0.3	0.3	0.3	
Insurance technical reserves	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Financial derivatives	0.8	1.0	0.5	0.3	0.6	-0.7	-0.8	
Other accounts receivable/payable	4.1	4.5	4.2	5.9	5.6	5.4	5.6	

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

Table 6. Finland: Risk Assessment Matrix[1/]

(Scale—high, medium, or low)

Source of Risks	Overall Level of Concern: Relative Likelihood[2/]	Overall Level of Concern: Impact if Realized
1. Euro area bond market contagion.	**Medium** • As a euro area member, Finland could be affected if sovereign and financial sector stress re-emerges across the Euro area due to protracted policy uncertainty and/or events related to Greece.	**Medium** • Finland is a core euro area member and its sovereign yields generally track German yields. Severe financial market stress could cause bank losses and funding difficulties, which could lead to curtailed lending, with negative effects on growth.
Policy response:	Full implementation of the macroprudential policy toolkit will help reduce vulnerabilities in the medium-run. Banks with potentially significant credit and funding risks should be pushed to improve buffers in the short-run. If financial market stress materializes, the ECB should provide ample liquidity.	
2. Structurally weak growth in the euro area.	**High** • Finland's exports are tightly linked to Euro area markets.	**High** • With domestic demand already anemic, external demand will wane further, pushing Finland into a period of economic stagnation.
Policy response:	Ease the pace of fiscal consolidation; if growth prospects continue to deteriorate, allow automatic stabilizers to function; focus on structural reforms to improve competitiveness.	
3. Political fragmentation erodes the globalization process and fosters inefficiency.	**Medium** • Russia is Finland's fifth largest export market. Negative effects from a renewed increase in geopolitical tensions could spillover through further reductions in trade.	**Low** • Depending on the severity of a downturn in Russia and exchange rate depreciation, the reduction in trade in goods and services could shave as much as a couple tenths of a percent off GDP growth.
Policy response:	Short-run: allow fiscal policy and automatic stabilizers to act a shock absorber. Medium-run: Promote diversification in export markets, including through support for firms trying to enter new markets.	
4. Adverse house price shock in an interconnected neighboring Nordic country.	**Medium** • Household debt is high in the Nordics due to easy access to credit, low interest rates, and tax incentives for housing. • Property prices remain elevated. • The two largest banks in Finland are Swedish and Danish.	**Medium** • Declining in demand from other Nordics would lower growth. • Rising non-performing loans and funding costs for Swedish or Danish banks could translate into curtailed lending in Finland, with negative effects on investment and housing.
Policy response:	Full adoption of the macroprudential toolkit and introduction of the systemic risk buffer to bolster the largest banks' ability to absorb losses.	

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

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

Table 7. Finland: Financial Soundness Indicators for the Banking Sector, 2008–14

	2008	2009	2010	2011	2012	2013	2014
Households							
Total household debt (in percent of GDP)	51.7	58.2	59.9	60.1	62.3	63.0	64.5
Total household debt (in percent of disposable income)	109.4	111.8	113.8	115.1	118.1	118.5	122.5
Financial assets/GDP	96.1	112.1	120.0	110.4	116.8	125.5	127.5
Non-financial corporations							
Gross debt (in percent of GDP)	58.4	64.5	67.2	65.9	65.8	66.7	65.6
Government							
General government debt (EMU definition, in percent of GDP)	32.7	41.7	47.1	48.5	52.9	55.8	59.3
Central government debt (in percent of GDP)	29.8	37.6	42.7	44.7	48.0	49.8	52.4
Banking sector							
Total assets (in billions of euro)	347.1	349.1	418.2	542.4	496.2	455.3	505.9
in percent of GDP	179.2	192.8	223.5	275.5	248.3	224.6	246.6
Total deposits (in billions of euro)	109.3	110.3	119.1	130.3	135.7	139.4	140.5
in percent of GDP	58.9	64.1	66.7	69.1	70.9	68.8	68.5
Credit to nonfinancial and housing corporations (annual percent change, e.o.p.)	18.2	-5.9	5.4	9.1	4.8	6.1	5.1
Credit to nonfinancial corporations (annual percent change, e.o.p.)	21.5	-9.4	2.4	8.3	2.5	3.9	2.1
Credit to households (percent change, e.o.p.)	8.0	5.6	5.8	5.6	4.9	2.2	1.9
Housing loans in percent of total lending	45.0	47.8	47.4	42.1	42.7	40.3	39.3
Asset quality							
Non-performing loans (in billions of euro)	0.8	1.2	1.2	1.3	1.3	1.4	4.4
Non-performing loans/total loans (in percent)[1]	0.4	0.7	0.6	0.6	0.5	0.6	1.8
Povisions to non-performing loans (in percent)	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*70.50*
Household non-performing loans/total household loans (in percent)[1]	0.5	0.6	0.5	0.6	0.6	0.7	1.7
Household non-performing loans/total non-performing loans (in percent)[1]	57.8	44.2	43.5	47.5	51.9	54.5	45.2
Capital adequacy							
Regulatory capital as percent of risk-weighted assets	13.6	14.6	14.4	14.2	17.0	16.0	17.3
Regulatory tier 1 capital to risk-weighted assets	12.5	13.8	13.6	13.6	16.1	15.2	16.4
Equity/total assets (in percent)	6.2	6.4	5.5	4.4	4.4	5.0	4.3
Profitability							
Interest rate margin (percentage points, e.o.p.)[2]	2.6	1.7	1.7	1.9	1.4	1.5	1.5
Net interest income (in percent of total income)	60.3	46.7	44.7	48.1	43.8	40.0	51.7
Return on equity (in percent)	8.4	6.9	6.9	7.6	8.5	8.1	8.2
Return on assets (in percent)	0.6	0.4	0.4	0.4	0.4	0.4	0.4
Liquid assets/total assets (in percent)[3]	4.8	7.5	6.8	6.8	14.6	12.3	...
Liquid assets/short-term liabilities	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*	*N.A.*
Deposits as percent of assets	31.6	31.6	28.5	24.1	27.5	30.6	27.0
Off-balance sheet liabilities/total assets (in percent)	13.8	15.6	13.6	10.8	11.1	11.6	12.6
Use of ECB refinancing (billions of euro)[4]	2.5	2.7	0.1	2.3	3.7	2.5	0.7
in percent of banks total assets	0.7	0.8	0.0	0.4	0.7	0.6	0.1
in percent of total ECB refinancing operations	0.3	0.4	0.0	0.3	0.3	0.3	0.1
Asset prices							
Change in stock market index (in percent, e.o.p.)	-53.4	19.5	18.7	-30.1	8.3	26.5	5.7
Change in housing price index (in percent, year average)	0.6	-0.3	8.7	2.6	1.6	1.3	-0.7

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

[1] Denominator also includes guarantees. The definition of NPLs changed in 2014, explaining most of the increase in NPLs from 2013 to 2014.

[2] Average of margins (average lending rate minus average deposit rate) on loans to non-MFIs.

[3] Before 2014, liquid assets are defined as the sum of cash, claims on central bank payable on demand and debt securities eligible for central bank refinancing. From 2014, the definition will be expanded to include all liquid assets eligible for the LCR (data will come from LCR reports).

[4] Sum of main and long-term refinancing operations and marginal facility.

Appendix I. Debt Sustainability Analysis

Public debt rose in 2014, driven by a higher than expected fiscal deficit, and is forecast to exceed 60 percent of GDP in 2015. Under the baseline debt to GDP is expected to peak in 2019 and to gradually decline thereafter. A contingent liability shock is the stress scenario with the greatest impact on the public debt-to-GDP ratio. Under the assumptions of this scenario, the debt ratio would rise to nearly 94 percent of GDP by 2020.

A. Baseline Scenario

1. Macroeconomic assumptions. Real GDP growth is expected to gradually pick-up, from 0.4 percent in 2015 to 1.6 percent in 2020. While GDP deflator inflation declines to a low of 0.7 percent in 2015, due largely to the effects of energy and food price declines since mid-2014, it is expected to rebound relatively quickly to 1.4 percent in 2016 and rise to 2.1 percent by 2020. Interest rates are expected to remain subdued due to QE and the likely gradual pace of rates rises once monetary policy begins to normalize.

2. Finland's debt level is expected to breach 60 percent of GDP in 2015, which calls for using the higher scrutiny framework. Though this is the first year debt is breaching the 60 percent of GDP threshold, it is projected to continue rising until 2019 and remain above 60 percent over the forecast horizon. The Finnish government has announced fiscal consolidation plans to stabilize and begin reducing the debt. The impact of these efforts on the debt ratio is partially undermined by the expected negative growth impact of the measures, which is already incorporated in the baseline. However, given the relatively long average maturity of Finnish public debt, the gross financing needs remain below 15 percent of GDP every year in the baseline scenario. Moreover, the net debt ratio remains negative due to the large stock of pension assets, though the net debt deteriorates more than gross debt rises over time as pension assets are used to pay benefits.

3. Realism of baseline assumptions. The median forecast error for real GDP growth is relatively large at -1.27 percent (18^{th} percentile). This is mostly driven by the large negative shock Finland suffered in 2009 and the initial rapid rebound from the crisis. Median forecast errors for the primary balance (-0.03 percent of GDP) and inflation (0.2 percent) are modest.

4. The forecast fiscal adjustment is not large in either absolute terms or by comparison to other countries' experiences. The 3-year average change in the cyclically adjusted primary balance (CAPB) is around 0.5 percent of potential output. This places it firmly in the middle of the distribution of CAPB adjustments across countries.

B. Stress Testing

5. Finland's debt ratio would remain under 100 percent of GDP even in the worst shock scenario examined. For the standard macro-fiscal stress scenarios, the debt ratio stays below

70 percent of GDP, except in the real GDP shock scenario. The contingent liability shock scenario causes the largest debt ratio increase, to a peak of around 94 percent of GDP in 2019.

6. The shock scenarios include:

- **Real GDP growth shock.** Under this scenario, growth is one-standard deviation lower than the baseline in 2016 and 2017 (i.e., 3.9 percentage points lower). This also causes inflation to be 25 basis points (bps) lower in these years and interest rates to be higher, by 71 bps in 2016 and by 143 bps in 2017. The debt ratio peaks at 82 percent of GDP in 2019 and the gross financing need (GFN) exceeds 20 percent of GDP in 2017.

- **Primary balance shock.** In this scenario, the primary balance (PB) is 1.6 percentage points of GDP lower than in the baseline in 2016 and 2017. The debt ratio almost reaches 70 percent of GDP in 2019, while the GFN peaks at 15 percent of GDP in 2017.

- **Real interest rate and real exchange rate shocks.** Under the real interest rate shock scenario, the real interest rate is 274 bps higher than the baseline over 2016-20. Despite this, debt only reaches 68 percent of GDP by 2020 and the GFN remains below 15 percent of GDP. The impact of the real exchange rate shock is even smaller, with the debt ratio only 1 percent of GDP higher than in the baseline at its peak in 2019 and the GFN remains almost identical to the GFN in the baseline scenario.

- **Combined macro-fiscal shock.** This scenario is a combination of the effects of the macro-fiscal scenarios above. In this scenario, growth and inflation fall, the primary balance deteriorates, the exchange rate depreciates, and interest rates rise relative to the baseline. The debt ratio rises above 85 percent of GDP by 2020, while the GFN hits an apex of 21 percent of GDP in 2017.

- **Contingent liability shock.** In this scenario, the contingent liability shock in 2016 equals about 17 percent of GDP. Additionally, growth falls as in the real GDP shock scenario and the real interest rate spikes 441 bps in 2016. As a result, the debt ratio jumps more than 20 percentage points of GDP between 2015 and 2016 and the GFN peaks at around 30 percent of GDP in 2016. The debt ratio peaks near 94 percent of GDP in 2019.

Finland Public Sector Debt Sustainability Analysis (DSA) - Baseline Scenario

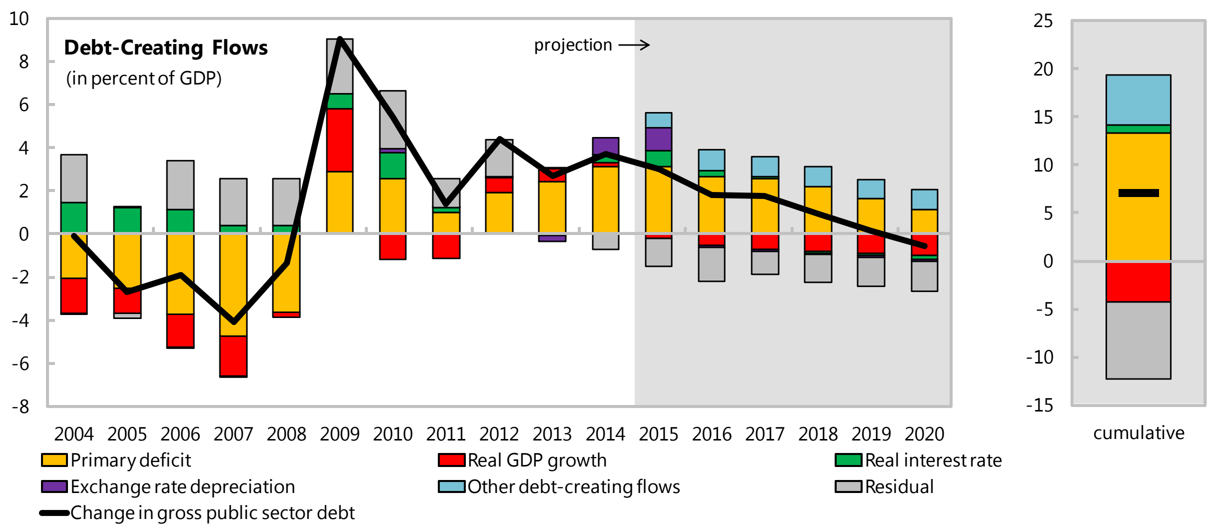
(in percent of GDP unless otherwise indicated)

Debt, Economic and Market Indicators [1/]

	Actual			Projections						As of July 08, 2015		
	2004-2012 [2/]	2013	2014	2015	2016	2017	2018	2019	2020	Sovereign Spreads		
Nominal gross public debt	41.9	55.6	59.3	62.3	64.1	65.9	66.8	66.9	66.4	EMBIG (bp) 3/	16	
Public gross financing needs	7.3	8.5	9.8	11.4	11.3	13.0	10.3	8.1	8.4	5Y CDS (bp)	230	
Real GDP growth (in percent)	1.4	-1.1	-0.4	0.4	0.9	1.2	1.3	1.4	1.6	Ratings	Foreign	Local
Inflation (GDP deflator, in percent)	1.8	2.6	1.6	0.7	1.4	1.6	1.8	1.9	2.1	Moody's	Aaa	Aaa
Nominal GDP growth (in percent)	3.2	1.5	1.2	1.1	2.3	2.8	3.1	3.4	3.7	S&Ps	AA+	AA+
Effective interest rate (in percent) [4/]	3.7	2.4	2.3	2.0	1.9	1.8	1.7	1.8	1.8	Fitch	AAA	AAA

Contribution to Changes in Public Debt

	Actual			Projections							
	2004-2012	2013	2014	2015	2016	2017	2018	2019	2020	cumulative	debt-stabilizing primary balance [9/]
Change in gross public sector debt	1.1	2.7	3.7	3.0	1.8	1.8	0.9	0.1	-0.5	7.1	
Identified debt-creating flows	-0.7	2.6	4.5	4.3	3.4	2.8	2.2	1.5	0.9	15.1	
Primary deficit	-0.9	2.4	3.1	3.1	2.7	2.6	2.2	1.6	1.1	13.3	-0.3
Primary (noninterest) revenue and gra	50.7	53.9	53.9	54.2	54.1	53.7	53.5	53.7	53.9	323.1	
Primary (noninterest) expenditure	49.8	56.3	57.0	57.3	56.7	56.2	55.7	55.3	55.1	336.4	
Automatic debt dynamics [5/]	0.2	0.2	1.4	0.5	-0.3	-0.6	-0.9	-1.0	-1.2	-3.4	
Interest rate/growth differential [6/]	0.2	0.5	0.6	0.5	-0.3	-0.6	-0.9	-1.0	-1.2	-3.4	
Of which: real interest rate	0.7	-0.1	0.4	0.8	0.3	0.1	-0.1	-0.1	-0.2	0.8	
Of which: real GDP growth	-0.6	0.6	0.2	-0.2	-0.5	-0.7	-0.8	-0.9	-1.0	-4.2	
Exchange rate depreciation [7/]	0.0	-0.3	0.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.0	0.0	0.0	0.7	1.0	0.9	0.9	0.9	0.9	5.2	
Please specify (1) (e.g., drawdown of	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Please specify (2) (e.g., ESM and Euro	0.0	0.0	0.0	0.7	1.0	0.9	0.9	0.9	0.9	5.2	
Residual, including asset changes [8/]	1.9	0.1	-0.7	-1.3	-1.6	-1.1	-1.3	-1.4	-1.4	-8.0	



Source: IMF staff.

1/ Public sector is defined as general government.

2/ Based on available data.

3/ Long-term bond spread over German bonds.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

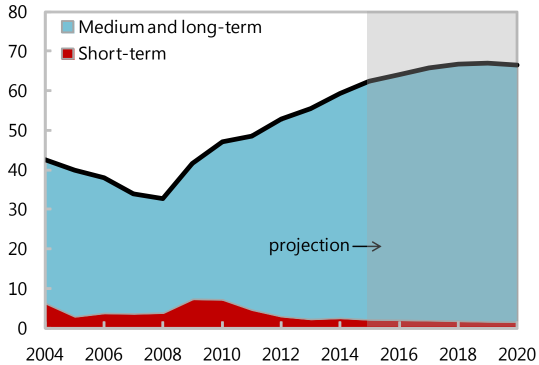
8/ Includes asset changes and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

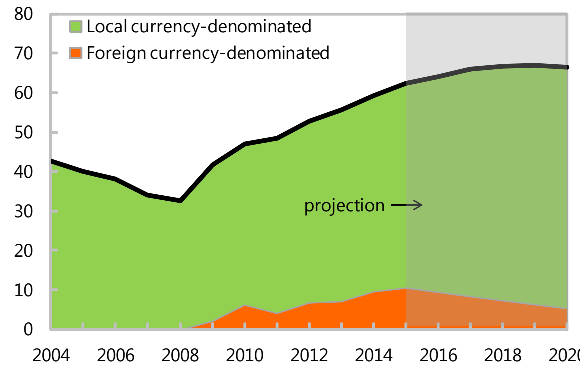
Finland Public DSA - Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



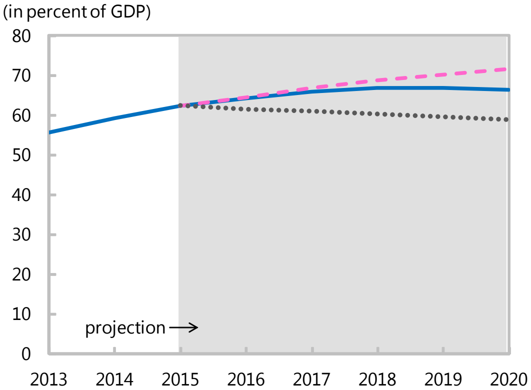
By Currency
(in percent of GDP)



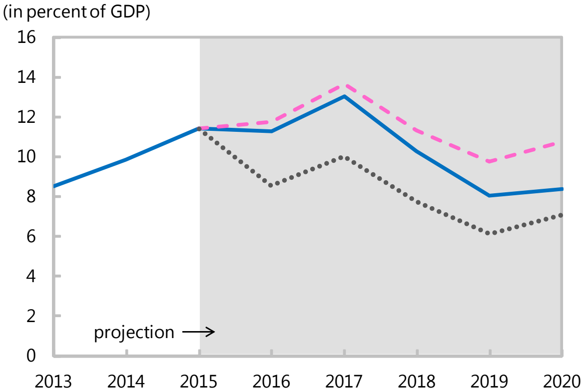
Alternative Scenarios

Baseline Historical Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



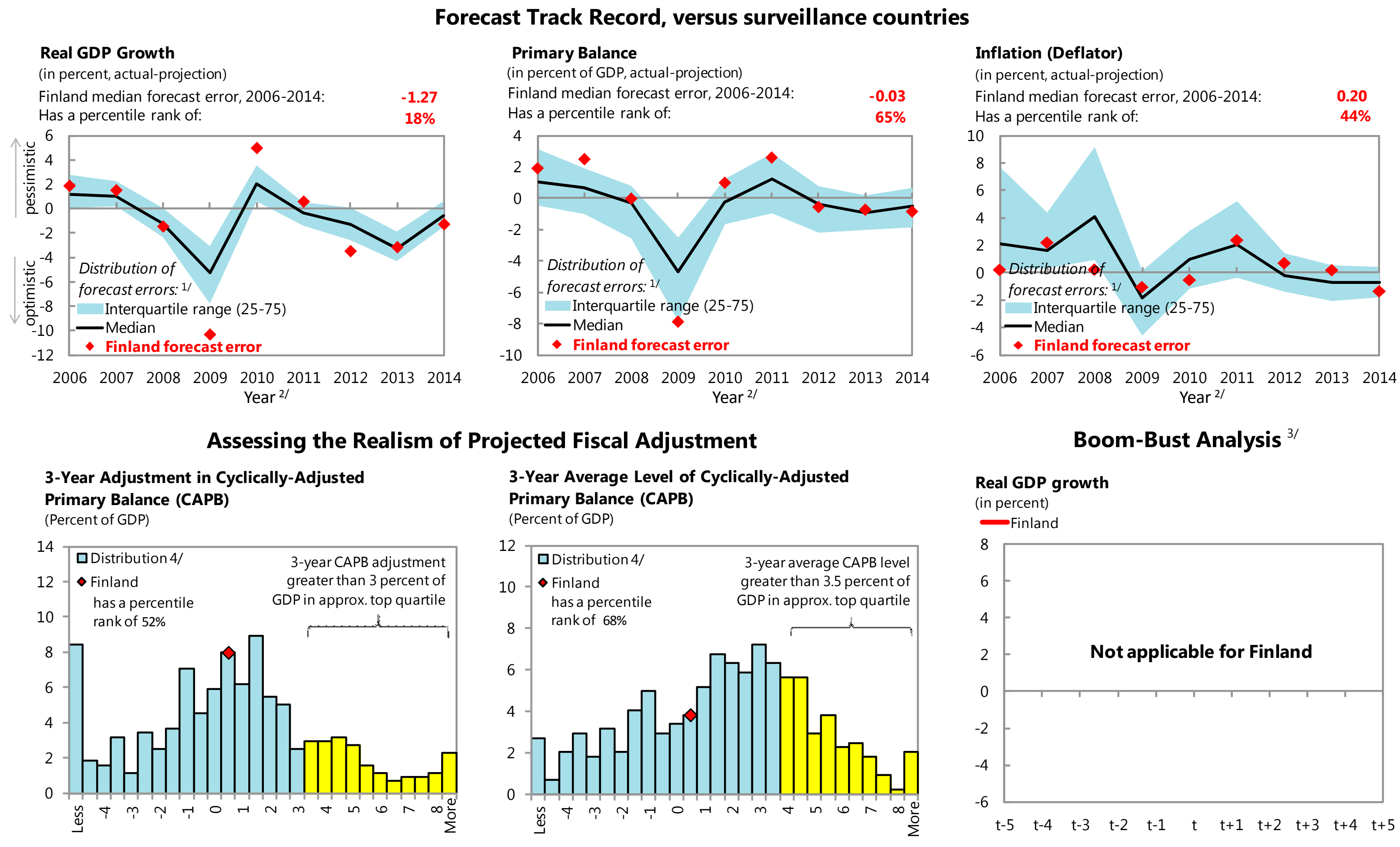
Underlying Assumptions
(in percent)

Baseline Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.4	0.9	1.2	1.3	1.4	1.6
Inflation	0.7	1.4	1.6	1.8	1.9	2.1
Primary Balance	-3.1	-2.7	-2.6	-2.2	-1.6	-1.1
Effective interest rate	2.0	1.9	1.8	1.7	1.8	1.8
Constant Primary Balance Scenario						
Real GDP growth	0.4	0.9	1.2	1.3	1.4	1.6
Inflation	0.7	1.4	1.6	1.8	1.9	2.1
Primary Balance	-3.1	-3.1	-3.1	-3.1	-3.1	-3.1
Effective interest rate	2.0	1.9	1.8	1.7	1.8	1.8

Historical Scenario	2015	2016	2017	2018	2019	2020
Real GDP growth	0.4	0.7	0.7	0.7	0.7	0.7
Inflation	0.7	1.4	1.6	1.8	1.9	2.1
Primary Balance	-3.1	0.1	0.1	0.1	0.1	0.1
Effective interest rate	2.0	1.9	2.0	2.1	2.4	2.5

Source: IMF staff.

Finland Public DSA - Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes surveillance countries, percentile rank refers to all countries.

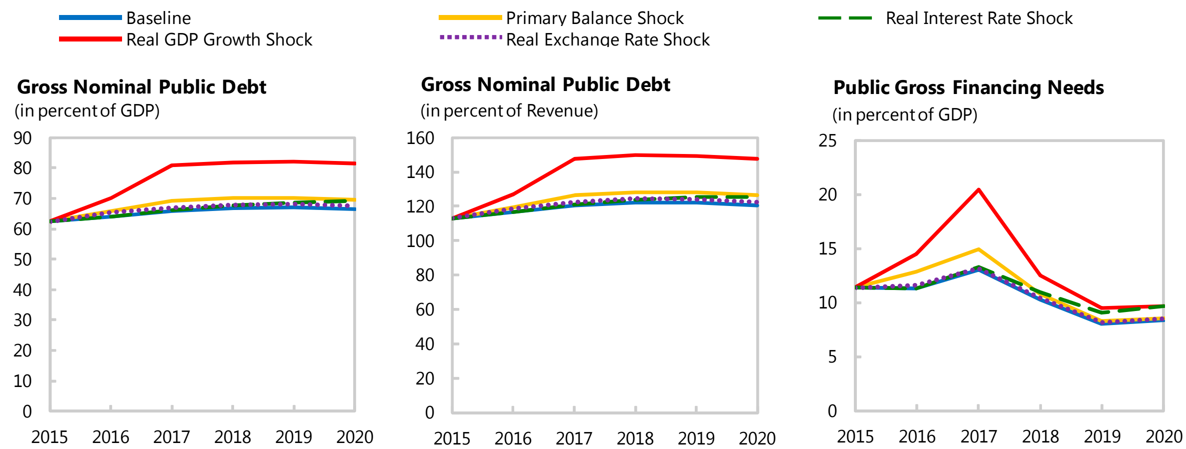
2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Finland, as it meets neither the positive output gap criterion nor the private credit growth criterion.

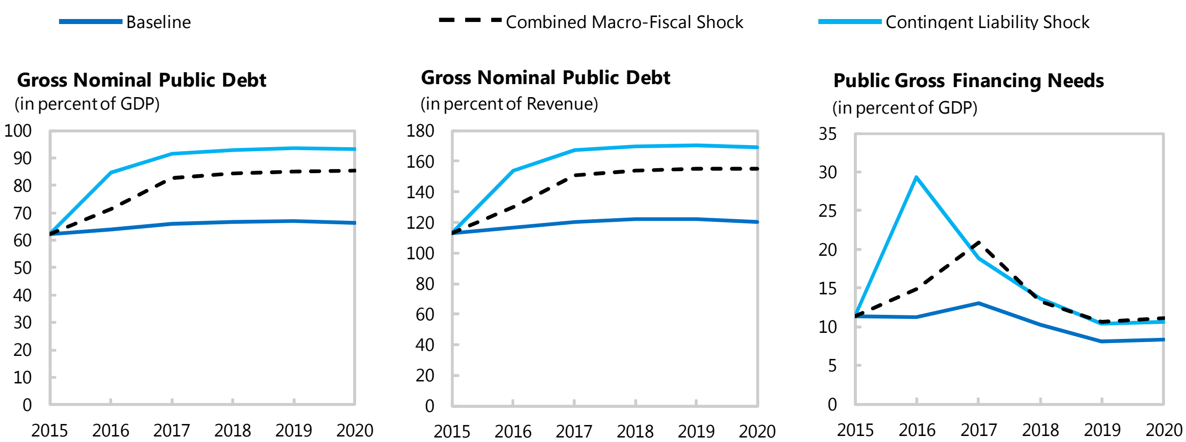
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Finland Public DSA - Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	0.4	0.9	1.2	1.3	1.4	1.6
Inflation	0.7	1.4	1.6	1.8	1.9	2.1
Primary balance	-3.1	-4.2	-4.2	-2.2	-1.6	-1.1
Effective interest rate	2.0	1.9	1.8	1.8	1.9	1.9
Real Interest Rate Shock						
Real GDP growth	0.4	0.9	1.2	1.3	1.4	1.6
Inflation	0.7	1.4	1.6	1.8	1.9	2.1
Primary balance	-3.1	-2.7	-2.6	-2.2	-1.6	-1.1
Effective interest rate	2.0	1.9	2.3	2.7	3.1	3.4
Combined Shock						
Real GDP growth	0.4	-3.0	-2.7	1.3	1.4	1.6
Inflation	0.7	0.5	0.6	1.8	1.9	2.1
Primary balance	-3.1	-5.5	-8.3	-2.2	-1.6	-1.1
Effective interest rate	2.0	1.9	2.3	2.7	3.1	3.4

Real GDP Growth Shock	2015	2016	2017	2018	2019	2020
Real GDP growth	0.4	-3.0	-2.7	1.3	1.4	1.6
Inflation	0.7	0.5	0.6	1.8	1.9	2.1
Primary balance	-3.1	-5.5	-8.3	-2.2	-1.6	-1.1
Effective interest rate	2.0	1.9	1.9	2.1	2.1	2.2
Real Exchange Rate Shock						
Real GDP growth	0.4	0.9	1.2	1.3	1.4	1.6
Inflation	0.7	1.8	1.6	1.8	1.9	2.1
Primary balance	-3.1	-2.7	-2.6	-2.2	-1.6	-1.1
Effective interest rate	2.0	1.9	1.8	1.7	1.8	1.8
Contingent Liability Shock						
Real GDP growth	0.4	-3.0	-2.7	1.3	1.4	1.6
Inflation	0.7	0.5	0.6	1.8	1.9	2.1
Primary balance	-3.1	-20.2	-2.6	-2.2	-1.6	-1.1
Effective interest rate	2.0	2.0	3.1	2.7	2.7	2.7

Source: IMF staff.

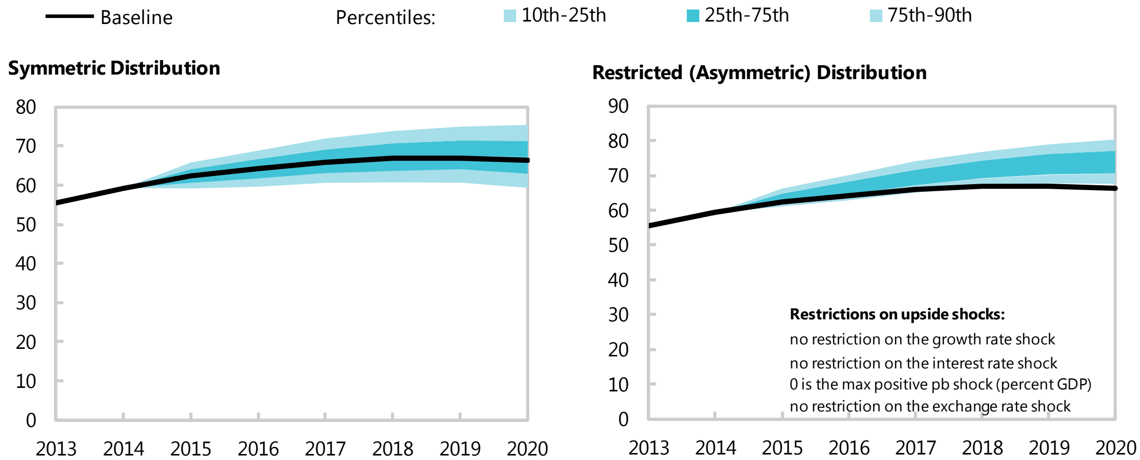
Finland Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

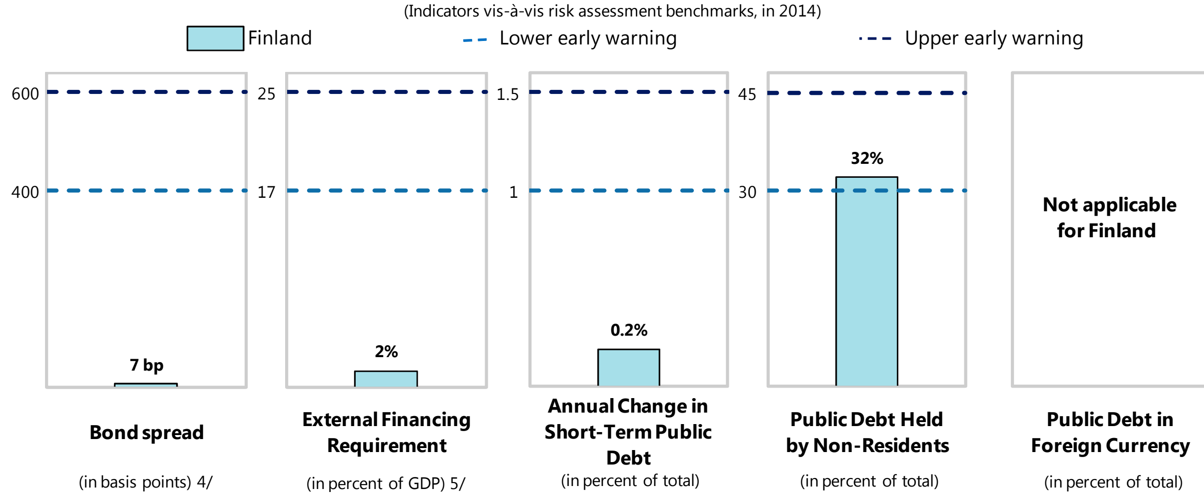
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2014)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 85% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 20% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

400 and 600 basis points for bond spreads; 17 and 25 percent of GDP for external financing requirement; 1 and 1.5 percent for change in the share of short-term debt; 30 and 45 percent for the public debt held by non-residents.

4/ Long-term bond spread over German bonds, an average over the last 3 months, 09-Apr-15 through 08-Jul-15.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

INTERNATIONAL MONETARY FUND

FINLAND

October 22, 2015

STAFF REPORT FOR THE 2015 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By | European Department

CONTENTS

FUND RELATIONS

(As of September 30, 2015)

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

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	1,263.80	100.00
Fund holdings of currency	1,121.00	88.70
Reserve Tranche Position	142.80	11.30
Lending to the Fund		
New Arrangements to Borrow	217.98	

SDR Department:	**SDR Million**	**Percent of Quota**
Net cumulative allocation	1,189.51	100.00
Holdings	1,123.38	94.44

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

Projected Payments to Fund:

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

	Forthcoming				
	2015	2016	2017	2018	2019
Principal					
Charges/Interest	0.01	0.05	0.05	0.05	0.05
Total	0.01	0.05	0.05	0.05	0.05

Exchange Rate Arrangements:

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

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

Article IV Consultation:
Finland is on the 12-month consultation cycle.

FSAP Participation:
Finland will have a review under the Financial Sector Assessment Program (FSAP) in 2016.

STATISTICAL ISSUES

(As of October 22, 2015)

Assessment of Data Adequacy for Surveillance:

General: Data provision is adequate for surveillance.

Data Standards and Quality

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

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

Finland: Table of Common Indicators Required for Surveillance
(As of October 22, 2015)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of Publication[7]	Memo Items: Data Quality–Methodological soundness[8]	Memo Items: Data Quality–Accuracy and reliability[9]
Exchange Rates	10/07/15	10/07/15	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	08/2015	10/2015	M	M	M		
Reserve/Base Money	08/2015	10/2015	M	M	M		
Broad Money	08/2015	10/2015	M	M	M		
Central Bank Balance Sheet	08/2015	10/2015	M	M	M		
Consolidated Balance Sheet of the Banking System	08/2015	10/2015	M	M	M		
Interest Rates[2]	10/13/15	10/13/15	D	D	D		
Consumer Price Index	09/2015	10/2015	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2014	03/2015	A	A	A	LO, LO, LNO, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	2014	03/2015	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	09/2015	10/2015	M	M	M		
External Current Account Balance	08/2015	09/2015	M	M	M	O, O, O, LO	LO, O, LO, O, O
Exports and Imports of Goods and Services	08/2015	09/2015	M	M	M		
GDP/GNP	Q2 2015	09/2015	Q	Q	Q	O, O, O, O	LO, O, LO, O, O
Gross External Debt	Q2 2015	09/2015	Q	Q	Q		
International Investment Position[6]	Q4 2014	09/2015	Q	Q	Q		

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.

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

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

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

[5] Including currency and instrument composition.

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

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

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

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

PAST FUND STAFF RECOMMENDATIONS AND IMPLEMENTATION

Past Staff Recommendations	Implementation
Fiscal Policy	
Gradual fiscal adjustment in line with the strength of the economy, focused on medium-term reforms to close the sustainability gap.	Since 2011 the government has implemented fiscal consolidation measures worth about 3 percent of GDP in nominal terms. Pension reforms should reduce the fiscal sustainability gap by 1 percentage point of GDP.
Make the composition of adjustment as growth friendly as possible.	The standard VAT rate, energy and excise taxes were raised to allow for a broadly revenue neutral corporate income tax rate cut in 2014.
Allow automatic stabilizers to operate if growth is weaker than expected.	Unemployment benefit spending was allowed to rise in 2014 as growth disappointed.
Labor Market Policy	
Pension reforms to lift the effective retirement age would support labor force growth.	Pension reforms currently being legislated will raise the average effective retirement age to 62.4 years old by 2025.
Reforms of tertiary education and student aid could promote longer working lives.	Measures to reform tertiary education financing, including reducing the duration of student aid are being implemented.
Increasing the quantity of affordable housing in Helsinki would facilitate labor mobility.	An agreement was reached between the central government and municipalities in the Helsinki area to increase land available for development.
Competition Policy	
Measures to increase competition in services and product markets can boost productivity growth.	Proposals to liberalize shop opening hours should increase retail sector competition.
Financial Sector Policy	
Implement the European macroprudential policy framework (CRD-IV/CRR), including a systemic risk buffer and binding loan-to-value (LTV) ratio.	The 2014 Act on Credit Institutions introduced the required CRD IV/CRR instruments, as well as a maximum LTV ratio.
Designate the independent Board of the FIN-FSA as the macroprudential policy authority.	The Act established the FIN-FSA as the designated macroprudential authority and the FIN-FSA board as the decision making body for macroprudential decisions.

Implement the Bank Recovery and Resolution Directive (BRRD) and reach regional agreements on bank resolution with other Nordic countries.	The legislation implementing the BRRD has been in effect since January 2015. This addresses the resolution of financial market crises, creates a new crisis resolution structure for domestic authorities, and establishes a new Deposit Guarantee and Resolution Fund.

Statement by Mr. Audun Groenn, Executive Director for Finland and Mr. Paavo Miettinen, Advisor to the Executive Director November 11, 2015

Our Finnish authorities would like to thank staff for comprehensive and candid discussions during the consultations and for an in-depth analysis of the state of economy, reform programs and the policy framework. The authorities' views have been accurately documented, and the authorities would like to only make comments on economic developments and the new government's program for reviving growth and consolidating public finances. The Finnish authorities broadly concur with staff's appraisal and the overall policy recommendations and analysis. The appraisal lends support to the government's goal to reverse the deterioration in competitiveness and to strengthen the Finnish economy.

Recent Economic Developments and Outlook

Finland is undergoing an extended period of slow economic growth that is among the weakest on record. GDP in 2015 is projected to be more than five percentage points below the 2008 level, and unemployment figures have risen close to double digits. It is of particular concern that lately the long term and structural unemployment rates have increased rapidly. Finland has experienced several asymmetric shocks that include the decline in two important export industries, deterioration in productivity, rapid rise in unit labor costs, weakness in the main trading partners' economies and a quickly aging population. These developments are well described in the staff report and the selected issues papers.

The economic projections for Finland envisage only a slow recovery and a continuation of low growth. The risks for the near term are also on the downside. The Ministry of Finance projects close to zero growth for this year and a tepid strengthening of the recovery to an annual 1.3 percent GDP growth in 2016. While domestic consumption will remain weak due to a moderate pick-up in inflation and the fiscal consolidation measures, investment activity should be accelerating due to some large investments that are already under way or in the pipeline in the forestry industry, as well as and in chemical and construction industries. Moreover, the external environment will support growth as many of Finland's main trading partners are growing reasonably well supported by accommodative monetary policies and low oil prices. The contribution of net exports to growth in Finland will remain weak in 2016, as imports pick up due to investment growth. Also weakness in many emerging markets and continued volatility in financial markets pose risks to the external environment. Recently the wave of refugees to Europe is having its impact on public finances in Finland as well.

Fiscal policy: a balancing act geared to consolidation of public finances and reviving growth

Finland, being a small open economy, is very dependent on exports of both goods and increasingly also of services, and hence the key priority is to maintain competitiveness in global markets. This is also a prerequisite for the sustainability of the Nordic welfare model. The new government is committed to an ambitious reform agenda aimed at raising the employment rate, promoting entrepreneurship, and the long term growth potential. That said, the authorities are fully aware of the urgent need to implement structural reforms in order to revive economic growth and consolidate public finances to a sustainable level. However, most structural reforms will start to have impact only in the medium term, but their implementation is long overdue.

The government is committed to making decisions to cover the entire sustainability gap of 10 billion Euros. The consolidation of public finances will firstly halt by the end of the Government term and then reverse the increase in the debt-to-GDP ratio in 2021. In the short run, the authorities are pursuing a balancing act with necessary consolidation efforts while trying to induce economic recovery. The authorities are determined to preserve the confidence in fiscal stability in Finland and to comply with fiscal rules of the EU. The consolidation measures include mainly expenditure reductions, but will also raise revenue by excise tax increases, and an accelerated removal of mortgage interest rate deductions. At the same time, the income taxes for the low and middle income earners are somewhat reduced in order to promote work incentives. As noted in the staff report, the magnitude of the negative effects from consolidation measures depend on the size of the fiscal multipliers that are highly uncertain. The impact of asylum seekers and refugees is taken into account and the government has already proposed an addendum to the budget to account for the fiscal costs related to the rapid inflow of asylum seekers.

The government's reform program is supported with a one-off investment package worth 1.6 billion euros that will also off-set some of the negative effects from the consolidation measures. About a third of the package is directed to reducing the infrastructure repair debt and the remainder is devoted to the advancement of the Government's key projects and reforms.

Structural reforms to be implemented without delay

Closing the competitiveness gap. For a small open economy like Finland, the more rapid increase in unit labor costs in comparison to peers and the persistent current account deficits in the past few years that is forecast to last until 2020 illustrate a deeper structural problem of the economy. Due to the loss of the ICT-intensive export base there was a shift from high labor productivity output to lower labor productivity production that resulted in a loss of competitiveness in the exports sector.

The government's goal is to reverse the deterioration in the Finnish competitiveness. While the negotiations for a social contract with labor unions and employers' federations broke down, the government is proceeding with legislative measures to reduce unit labor costs. To regain competitiveness, these measures need to be complemented with a sustained period of very moderate pay increases, and companies and communities need to make individual efforts to improve their efficiency.

The government has prepared a set of measures to reduce the unit labor costs by 5 percentage points while also strengthening the employees' redundancy security. The proposed measures include a removal of two public holidays, reductions in paid sick-leave and in holiday allowance, and a cut in the public sector annual leave to 6 weeks. The employees' redundancy security is improved by forcing medium and large companies to provide health benefits for six months, and an option to receive re-employment coaching that is worth the company's average one-month pay in a layoff situation. These measures would enter into force as mandatory ceilings by the time of the next collective wage bargaining agreement in 2016, if enacted, and they would remain in force for three years. In the meantime, the labor unions and the employer federations continue discussions to find alternative ways to achieve the targeted reduction in unit labor costs.

Labor market reforms. The Ministry of Employment and the Economy is considering proposals that would pave the way for wider use of localized wage agreements and a more flexible use of working-time. The proposals also underline that the employees should have representation in the firm's decision-making bodies to improve information sharing, transparency and to build trust for the local level wage bargaining. The proposal received mixed reviews by the labor market representatives, but the Ministry will continue to finalize the proposal, which is part of the government's program to reform the wage bargaining process.

The government has also proposed to reduce the earnings-related unemployment benefits to 400 days from the current 500 days starting from 2017, as part of the fiscal consolidation package and to increase labor supply. On ALMP, the government´s program introduces a project to increase the efficiency of the public employment services (PES). The priorities of the reform are to make full use of digitalization in the PES, to create closer contacts with the employers and to respond to their recruitment needs and to enhance the role of the private employment services. In order to decrease income trap due to a high participation tax rate, from 2014 on, an income of 300 Euros per month is allowed without reduction of unemployment benefits or housing subsidy.

The government program also supports the increase of housing supply in the Helsinki metropolitan area that would promote labor mobility.

Education reform to increase working life/labor force participation. The government has introduced cuts in education and R & D. The latter is not supported by staff, but the authorities see room for a more efficient use of the remaining funding. According to the authorities, the reform program envisages a better cooperation between institutions of tertiary education and business life as well as accelerating graduation and transition to working life, and this would result in savings.

Innovation and deregulation. The reform program gives also special emphasis to development of bio-economy and clean technologies for achieving climate goals and improving export performance. In addition, the program envisages increased use of digitalization and dismantling of unnecessary regulation and zoning restrictions. The changes also aim to promote complementary construction and to significantly increase the supply of both housing and building sites. A proposal to liberalize shop opening hours has already been tabled in the parliament.

Finalizing key reforms in health care and municipalities

The government has indicated that it will reduce municipalities' responsibilities that would

achieve about one billion euros in savings by 2019. The Government's fiscal plan for 2016-2019 contains a maximum limit of expenditures for the local governments and it includes a number of measures aimed at strengthening local government finances.
The government's social welfare and health care reform work is underway. A draft Government proposal will be circulated for comment in April 2016. The Government proposal will be submitted to parliament in October 2016.

The objective of the reform of social welfare and health care services is to narrow health disparities and manage costs (so called SOTE reform). The current system is fragmented, disintegrated and inefficient. Hence, the reform will be implemented with a complete horizontal and vertical integration of services, and by strengthening the capacity of service providers. The integration is expected to have a significant impact on the sustainability in public finances. With SOTE reform, the Government seeks to reduce the cost of social welfare and health care services by 3 billion euros by 2029 (at 2019 prices). The estimated impact to sustainability gap would be -1.25 percent of GDP.

The new structure for social welfare and health care services will be based on autonomous regions. The service provision is consolidated from municipalities to these larger regions that may also use the private sector in service production. In order to control for the expenditure on social and health care services and enhance efficiency, the possibility of opening up the market (for more) private competition will be explored. Additionally, the details regarding a freedom of choice model will be explored, as well as the legislative amendments required by EU directive on Patient Mobility.

Financial sector stability
The Capital Requirements Directive (CRD IV) was adopted in the Finnish legislation in 2014. The FIN-FSA was appointed as the designated macro prudential authority and the FINFSA Board was given the responsibility for macroprudential policy decisions. The Finnish authorities support the establishment of a systemic risk buffer, but the legislation process would most likely be postponed until next year due to the existing legislation backlog. The authorities see a deepened regional cooperation on financial sector issues of utmost importance between the Nordic and Baltic countries. Finally, the authorities appreciate the plan to conduct FSAPs for Finland and Sweden back-to-back in 2016, as these assessments will provide a thorough review of the Finnish financial sector performance and a framework to identify systemic vulnerabilities. The combination of these exercises offers also an assessment of the Nordic financial and insurance institutions and their operating environment.