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

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

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

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IMF Executive Board Concludes 2004 Article IV Consultation with Finland

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

Background

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

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

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies.
On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

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

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

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

Executive Board Assessment

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

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

Directors noted that while Finland's fiscal position remains comfortable from a comparative EU perspective, the general government surplus has eroded in recent years. They stressed that sizeable fiscal adjustment will be required in the coming years to ensure long-term fiscal

sustainability, given the imminent demographic pressures on public finances. Directors therefore recommended that the planned cuts in income taxes over the period 2005–07 be offset by a reduction in public spending, preferably through improved efficiency in the provision of social and welfare services. Such efficiency gains rather than tax increases should be the preferred means of strengthening local government finances.

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

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

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

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

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

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

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

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.