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FINLAND

January 2020

2019 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

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 2019 Article IV consultation with Finland, the following documents have been released and are included in this package:

- A **Press Release** on 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 a lapse of time basis, following discussions that ended on November 18, 2019, with the officials of Finland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 18, 2019.
- An **Informational Annex** prepared by the IMF staff.

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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January 16, 2020

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IMF Executive Board Concludes 2019 Article IV Consultation with Finland

On January 9, 2020, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Finland.[1]

Finland's economic performance in recent years has been solid, after a long recession: yearly growth has averaged around 2½ percent, employment has continued to increase, and unemployment is now close to historical lows. But growth has slowed in 2019, and household debt and productivity weaknesses persist. Growth is expected to be only around 1½ percent this year and the next, before converging to a potential growth rate of about 1¼ percent. Risks are mainly to the downside: the recent improvement in employment could yet prove to be mostly cyclical, and the economy is exposed to further deterioration in external demand.

The new government has committed to spending more on education, employment, infrastructure, and climate policies. A cornerstone of the new medium-term economic program is for employment to reach a rate of 75 percent by 2023, from 72.6 percent currently—an additional 60,000 jobs from current levels. The government has indicated that it favors wage subsidies and more spending on assistance for job seekers. There are also spending increases on education to address labor market mismatches. The government plans to achieve carbon neutrality by 2035, by reducing emissions and strengthening carbon sinks through increased taxes, subsidies for renewables, and expenditures.

The 2019 budget implies an easing of fiscal policy: based on currently-allocated spending, the headline government balance would decrease to around -1¼ percent of GDP over the next two years, before returning to around -1 percent of GDP in the medium term. This would mean

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

missing the government's own medium-term target of a minimum structural balance of -0.5 percent of GDP. Debt would slightly increase, approaching 60 percent of GDP by 2024, but *net* financial worth would drop more substantially as a consequence of asset sales.

The banking system is well capitalized and profitable. However, some borrowers look vulnerable, especially from the rapid increases in housing company loans and consumer credit.

Executive Board Assessment[2]

The slowing economy highlights underlying challenges. The economy has performed well over the past three years, with unemployment falling and real earnings increasing. But growth has slowed more quickly than anticipated in 2019. Trend growth is constrained by adverse demographics, while productivity growth remains weak. There are some vulnerabilities in household finances. The external position remains moderately weaker than implied by fundamentals—the estimated current account gap would imply a real exchange rate overvaluation in the range of 5 to 10 percent, with similar estimates from real exchange rate models.

The new government's program is challenging. It has committed to spending more on education, employment, infrastructure, and climate policies—and balancing the budget. In the short run, fiscal stimulus will support demand—but even so, growth is only expected to reach 1½ percent this year and the next. Given likely growth and employment over the medium term, the government would still have a fiscal deficit of about 1 percent of GDP in 2023, about ½ percentage point away from its medium-term fiscal target.

There are many options to meet the medium-term fiscal target. Assuming it proceeds with the planned expenditure increases, offsetting measures would be required. The government could eliminate tax expenditures and subsidies on environmentally-harmful policies. Otherwise, the government will have to find other savings. Cost control has to be part of the debate about health and social services reform.

Improved tax and benefit incentives could boost employment. The government could look at leave and homecare benefits, which generate incentives for women to stay at home, and tax and benefit schedules that mean that some face a financial penalty to work, rather than stay unemployed or out of the workforce. Still more could be done to increase participation and employment of older workers. Employment of older workers could be increased by further limiting early retirement. But relying on job subsidies, which are expensive and have had mixed effects in other countries, seems likely to disappoint.

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[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

The financial system is sound, but extra measures are needed to address vulnerabilities of borrowers. While Finnish banks are highly exposed to real estate, residential and commercial real estate markets are not obviously overvalued. But household debt has been increasing, especially from housing company loans and consumer lending. The recent recommendation to limit the ratio of household debt to income is both sensible and in line with steps taken in many other countries. But it is important to address the tax code, which creates a clear incentive for investors to favor housing company loans, and to improve data collection.

Finland: Selected Economic Indicators, 2017–25

	2017	2018	2019	2020	2021	2022	2023	2024	2025
			Proj.						
			(Percentage change, unless otherwise indicated)						
Output and demand (volumes)									
GDP	3.1	1.7	1.5	1.6	1.5	1.3	1.3	1.3	1.3
Domestic demand	1.5	2.6	1.1	1.7	1.5	1.3	1.4	1.3	1.3
Private consumption	1.0	1.8	1.5	1.4	1.3	1.3	1.3	1.3	1.3
Public consumption	0.2	1.5	1.5	2.1	1.6	1.3	1.2	1.2	1.1
Gross fixed capital formation	4.0	3.3	1.5	1.8	1.7	1.7	1.7	1.7	1.6
Change in stocks (contribution to growth in percent of GDP)	0.1	0.6	-0.4	0.0	0.0	0.0	0.0	0.0	0.0
Exports of goods and services	8.8	2.2	3.9	2.0	2.0	2.0	2.0	2.0	2.0
Imports of goods and services	4.1	5.0	3.2	2.2	2.0	2.0	2.0	2.0	2.0
Net exports (contribution to growth in percent of GDP)	1.6	-1.1	0.5	-0.1	0.0	0.0	0.0	0.0	0.0
Prices, costs, and income									
Consumer price inflation (harmonized, average)	0.8	1.2	1.2	1.5	1.5	1.6	1.6	1.8	1.9
Consumer price inflation (harmonized, end-year)	0.5	1.3	1.3	1.5	1.4	1.6	1.6	1.8	1.9
GDP deflator	0.7	2.1	1.9	2.0	2.0	2.0	1.9	1.9	1.9
Unit labor cost, manufacturing	-8.4	2.9	0.6	0.9	0.3	0.3	0.2	0.1	0.0
Labor market									
Labor force	0.8	1.4	0.1	0.3	0.3	0.3	0.2	0.1	0.0
Employment	1.0	2.7	1.0	0.5	0.4	0.2	0.1	0.1	0.0
Unemployment rate (in percent)	8.6	7.4	6.5	6.4	6.3	6.4	6.5	6.5	6.5
Potential output and NAIRU									
Output gap (in percent of potential output)[1]	-0.7	-0.4	-0.3	-0.2	-0.1	0.0	0.1	0.2	0.1
Growth in potential output	1.4	1.4	1.4	1.4	1.3	1.3	1.3	1.3	1.3
			(Percent of GDP)						
General government finances[2]									
Overall balance	-0.7	-0.8	-0.8	-1.1	-1.2	-1.2	-0.9	-0.9	-0.9
Primary balance[3]	0.3	0.1	0.0	-0.4	-0.6	-0.5	-0.2	-0.2	-0.3
Structural balance (in percent of potential GDP)	-0.6	-0.7	-0.9	-1.3	-1.4	-1.4	-1.1	-1.1	-1.0
Structural primary balance (in percent of potential GDP)[3]	0.4	0.2	-0.1	-0.6	-0.8	-0.7	-0.4	-0.4	-0.4
Gross debt	60.8	58.9	58.5	57.9	58.2	58.6	58.8	59.1	59.4
Net debt[4]	-57.7	-51.5	-49.0	-46.2	-43.4	-40.8	-38.7	-36.6	-34.5
			(Percent)						
Money and interest rates									
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	6.7	6.1	...	...	...	...	...	...	...
Finnish MFI euro area loans (growth rate, e.o.p.)	3.2	4.8	...	...	...	...	...	...	...
Domestic nonfinancial private sector credit growth (e.o.p.)	2.4	2.2	2.9	4.1	4.5	4.4	4.0	3.8	3.7
3-month Euribor rate (percent)	-0.3	-0.3	...	...	...	...	...	...	...
10-year government bonds yield	0.5	0.7	...	...	...	...	...	...	...
			(Percent of GDP)						
National saving and investment									
Gross national saving	23.1	23.5	24.1	24.4	24.6	24.8	25.0	25.2	25.7
Gross domestic investment	23.9	24.9	24.8	25.0	25.1	25.0	24.9	25.0	25.4
Balance of payments									
Current account balance	-0.8	-1.4	-0.7	-0.6	-0.5	-0.1	0.1	0.2	0.3
Goods and services balance	0.1	-0.7	0.0	0.0	0.0	0.1	0.2	0.3	0.3
Net international investment position	0.0	-2.2	-2.8	-3.2	-1.9	-1.9	-1.7	-0.6	0.4
Gross external debt	181.1	210.5	210.6	209.4	207.6	205.5	203.6	201.0	198.7
Exchange rates (period average)									
Euro per US$	0.89	0.85	...	...	...	...	...	...	...
Nominal effective rate (appreciation in percent)	0.7	3.2	...	...	...	...	...	...	...
Real effective rate (appreciation in percent)[5]	-0.6	2.0	...	...	...	...	...	...	...
Memorandum items									
Nominal GDP (in Euro billions)	225.8	234.5	...	...	...	...	...	...	...
Nominal GDP (in U.S. dollar billions at market exch. rates)	255.0	277.0	...	...	...	...	...	...	...

Sources: Bank of Finland, BIS, 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.

INTERNATIONAL MONETARY FUND

FINLAND

STAFF REPORT FOR THE 2019 ARTICLE IV CONSULTATION

December 18, 2019

KEY ISSUES

Context: The economy has performed well over the past three years but has slowed in 2019. There are some vulnerabilities in household finances, and productivity growth remains weak, with trend growth also constrained by adverse demographics. A new coalition government targets greater social support and inclusion, higher employment, carbon neutrality by 2035, and a balanced budget by 2023.

Fiscal policy: A key challenge is to balance plans to increase spending with the need to maintain fiscal buffers. The fiscal expansion will provide useful cyclical support in the short run, but offsetting measures will be required to ensure the structural balance reaches the government's medium-term target. These should include containing age-related spending and removing tax expenditures and other environmentally-harmful subsidies.

Structural policies: The government aims for a substantial increase in employment, but the effectiveness of the proposed wage subsidies is unclear. Alternatively, incentives from tax and benefit schedules could be improved, especially for younger women, older workers, and those out of the workforce.

Macroprudential and financial policies: Risks in the banking system remain low overall, but some types of lending (notably, housing company loans and consumer loans) are increasing household vulnerabilities. The recent recommendation to limit the ratio of household debt to income is both sensible and in line with steps taken in many other countries. But it is important to address the tax code, which creates a clear incentive for investors to favor housing company loans.

Approved By
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Discussions took place in Helsinki November 6–November 18, 2019. The team comprised Florian Misch, Vladimir Pillonca, Alasdair Scott (head), and Philippe Wingender (all EUR), with inputs from Parisa Kamali (FIN). Piotr Kopyrski, Tamari Mitaishvili, Natalia Romanova and Tan Wang (all EUR) assisted. Ms. Karjanlahti (OED) joined the discussions. The mission met with Mr. Lintilä, Minister of Finance; Mr. Rehn, Governor of the Bank of Finland; Mr. Hetemäki, Permanent Secretary of the Ministry of Finance; Ms. Tuominen, head of the FIN-FSA; other senior officials; the ECB; social partners; and representatives of the financial sector and academic communities.

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