

Nordic tiger measures new challenges

Finland confronts the 'dilemmas of success,' weighs policy coordination options

Finland's economy has rebounded impressively from a deep crisis in the early 1990s, and its public finances have been rebuilt. On this sound foundation, the authorities face new challenges in the coming decade, including the impact of a rapidly aging population, risks of overheating in the real economy and asset markets, and high structural unemployment.

From crisis to sustained expansion

Finland's recovery from the recession of the early 1990s is one of Europe's success stories. Its recent economic growth has been well above the European Union (EU) average, and unemployment has fallen from over 16 percent to below 10 percent. Finland's story of crisis and recovery has elements in common with a number of other strong performers.

- An external shock—the impact of collapsing trade with the former Soviet Union—triggered the crisis, but deep-rooted problems, such as an overvaluation of the markka, a terms of trade deterioration, and the bursting of an asset price bubble, sharply deepened the severity of the crisis.

- A comprehensive policy package fostered a recovery of confidence. The authorities devalued the currency and exercised firm restraint over public spending. In fact, public spending fell by some 10 percentage points of GDP in six years—one of the strongest performances in the European Union. The public finances shifted from a deficit of 7 percent of GDP in 1993 to a small surplus in 1998. Together with a firm monetary policy, this cleared the way for Finland to

become, in 1999, a founding member of European Economic and Monetary Union (EMU).

- Exports of goods and services drove the economic upswing. Exports rose from less than 25 percent of GDP at the start of the 1990s to some 40 percent of GDP in 1997. The current account shifted from a deficit of over 5 percent of GDP to a surplus of the same size—by far the largest adjustment among advanced economies. Telecommunications, with Nokia the flagship, expanded particularly strongly. As recovery spread to other sectors, growth accelerated to an average of almost 5 percent over the past three years.

- The labor unions responded to the crisis and its aftermath with a policy of wage moderation, achieved through a centralized bargaining system. This helped foster the steep fall in unemployment and was consistent with a decline of inflation to very low levels.

New challenges

As Finland gains experience in managing its policies under monetary union, the authorities have cautioned that success must not breed complacency. Three challenges dominate the horizon. First, population aging over the coming decade and a half threatens to jeopardize the longer-run soundness of the public finances or trigger a further increase in Finland's already high tax burden. Second, while fiscal policy has been adapted to allow a fuller operation of stabilizers, the risk of overheating remains. Finland's economy con-

Camdessus pays tribute to former department head Manuel Guitián

On February 8, IMF Managing Director Michel Camdessus noted the death of Manuel Guitián on February 7 in Madrid at the age of 61. The full text of News Brief No. 00/9 is available on the IMF's website (www.imf.org).

"Manuel Guitián served the IMF with great distinction for 29 years until his retirement in late 1998 as the Director of the Monetary and Exchange Affairs Department," Camdessus said. "Manuel made notable contributions to the work of the IMF in many areas. In the 1970s and 1980s, he was one of the main architects of the design of macroeconomic adjustment programs, and he wrote extensively on this subject. In more recent years, he played major roles in coordinating technical assistance for monetary authorities in a number of countries, notably in Asia following the Asian crisis, and in the IMF's work related to capital

account liberalization. He was an early advocate of the code of good practices on transparency in monetary and financial policies. Manuel strongly held the view that the IMF was entrusted with an important and distinctive role. Drawing on his legal as well as economics background, he developed this argument with characteristic clarity and persuasiveness in *The Unique Nature of the Responsibilities of the International Monetary Fund* (1992), a pamphlet that deepened understanding of the role of the IMF.

"Manuel left a distinguished legacy of work at the IMF, but we who had the privilege to work with him here recall not only his impressive intellectual contribution and wise counsel but also his reliable collegiality and gentle friendship. He will be sorely missed," Camdessus said.



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tinues to grow rapidly, while euro-area monetary conditions are tuned to the less cyclically advanced core economies. Third, the labor market is not functioning efficiently. It continues to be characterized by high structural unemployment on average and large disparities between regions. The IMF's most recent Article IV consultation with Finland and the subsequent IMF Executive Board discussion of the staff report focused on these issues.

Implications of the demographic shock

The IMF consultation underscored that the issues confronting Finland are closely linked, and the approach to population aging will be of central importance. Finland can use various policy instruments to deal with the fiscal impact of this demographic shock. It can tighten the medium-term stance of fiscal policy (to reduce debt levels and interest costs), and it can strengthen a range of structural policies, including the design of social benefits. The balance between these responses will have implications for labor market performance and the economy's resilience during cyclical fluctuations.

The authorities are convinced that fiscal consolidation must be the cornerstone of their approach to the demographic shock, and they are committed to achieving a significant fiscal surplus over the medium term. This will sharply reduce the public debt ratio—to 35 percent from some 50 percent of GDP over the next four years—unlocking interest savings that will partly offset the fiscal impact of population aging. But this is part of a broader overall strategy. A key aim is to cut taxes on labor income by some 1½ percent of GDP through 2003. To achieve these fiscal goals, the government program freezes real central government spending over the medium term and seeks to raise employment levels to near 70 percent of the working-age population. The program will attempt to boost employment through a mix of measures, including addressing tax traps, better targeting active labor market programs, and increasing the effectiveness of vocational training.

To help the authorities evaluate how different components of their strategy could come together most effectively, the IMF staff contrasted two medium- and long-run economic strategies (see chart, page 64). The first scenario featured modest structural reforms and large general government surpluses over the medium term. Even with surpluses of 5 to 6 percent of GDP over the next few years, however, it would be difficult to meet the costs of population aging without raising the burden of social contributions on labor income in the coming decades. This would increase employment-related taxes just when it would be crucial to increase labor market participation and employment to mitigate the demographic shock.

The IMF staff's second scenario would incorporate deeper reforms in the labor market, benefit programs, and pensions to raise employment—allowing somewhat lower fiscal surpluses in the medium term, and a larger cut, over time, in taxes on labor income. This could foster a virtuous circle, strengthening output and employment and thus the long-term position of the public finances. But these initiatives must be implemented on an urgent basis if a premature exit of the baby-boom generation from the labor force is to be avoided.

Addressing cyclical tensions

With the economic cycle in Finland well ahead of the euro-area average, the authorities are confronted with the dilemmas of success. Surveys confirm that corporations expect robust export growth, and consumer sentiment remains buoyant. Strong domestic demand continues to fuel a virtuous circle of employment growth and rising output, with the service sector expanding strongly. Overall, GDP growth should be at least 4 percent in 2000, and consumption and residential investment may be stronger than projected, given robust job creation, wealth effects from rising asset prices, and relatively low real interest rates.

With its broad and robust expansion intact, and monetary and financial conditions guided by other developments in the euro area as a whole, the Finnish authorities must seek nonmonetary means to counteract the risks of overheating. They have at their disposal fiscal and structural policies and official influence over wage setting. The authorities are particularly concerned to avoid a longer-run cost cycle that could damage employment or an asset price cycle that could jeopardize financial stability and sustained economic expansion.

An important focus of the IMF consultation was to assess when, and through which instruments, policy-makers should respond to price pressures (see box, page 63). On balance, the conclusions were that overheating in the real economy was probably not imminent, though it was an important watchpoint for the medium term. Currently, strong competitiveness and high productivity growth in the manufacturing industry help cushion the economy to some extent against these risks; and these factors also mean that Finland can tolerate a somewhat higher rate of CPI inflation than the euro-area average. Moreover, internal migration and rising participation should continue to ease isolated labor market bottlenecks, while the discipline of monetary union should encourage continuing wage moderation.

Asset price inflation, equally, does not appear to pose immediate dangers, although vigilance is called for. Corporate and household balance sheets have been rebuilt in recent years, and memories of the

early 1990s crisis remain fresh—with some institutions still working out property lending problems. And a sizable part of the rise in house prices thus far appears to represent a recovery from depressed levels. Nonetheless, there is a clear risk that residential and commercial real estate markets in the south—given continued internal migration—will remain under strong pressure and that asset prices will continue to be fueled by low interest rates.

While overheating may not be imminent, the authorities and the IMF staff discussed the need to move preemptively in various ways, conscious that some relevant reforms are hard to implement and will take time to have effect. In the fiscal field, first, the continued economic expansion provides an opportunity to press on with planned medium-term consolidation, which will help forestall risks of overheating. In 1999, the fiscal impulse was contractionary to the tune of 1¼ percent of GDP, and the overall stance of macroeconomic policies was probably broadly neutral. For 2000, projections suggest a further fiscal withdrawal of at least ½ of 1 percent of GDP. To enhance fiscal stabilizers, the authorities are building up “EMU buffer funds” to finance unemployment benefits in periods of cyclical downturn, which will avoid repeating the past experience of procyclical rises in unemployment contributions.

But the IMF consultation stressed that a key route to avoiding problematic labor cost or asset price cycles under monetary union is to enhance the flexibility of the real economy, notably through labor market reforms. This would help forestall domesti-

cally generated cost pressures and improve the economy’s resilience to shocks. As regards asset markets, the staff suggested that it would be advisable to remove distortions favoring owner-occupied housing (such as mortgage interest deductibility) and review the functioning of the land market, including municipalities’ approach to development.

A common theme thus emerged in evaluating the options to address both cyclical and longer-run demographic issues. Continuing structural reforms can play a key role in meeting the problems of population aging in an efficient manner, and they can also improve the economy’s resilience to cyclical stresses. In both areas, the trade-off between purely fiscal approaches and a blend of fiscal and structural reforms clearly favors the latter. And measures to improve the functioning of the labor market figure large in both these contexts.

Labor market issues

During discussions with the IMF, the authorities and the social partners noted that Finland’s generous social benefit system and the various routes to early retirement helped cushion one of the deepest recessions experienced in an advanced economy in recent decades. There is a growing recognition, however, that a different challenge must be met today: how to integrate more of the unemployed into the workforce. Indeed, broader employment would both help cushion the economy against the future shock of population aging and help alleviate other potential stresses under economic and monetary union.

When and how should cost and price pressures be resisted?

European Central Bank policy aims for low inflation in the euro area. Cost/price developments for a small, open economy such as Finland may well differ from those in the core economies. In deciding on the right policy response for Finland, it is important to distinguish between several phenomena:

- The competitiveness of the economy suggests a significant margin for real appreciation—via nominal appreciation of the euro and/or higher inflation in Finland’s trading partners.
- Productivity growth in manufacturing exceeds that in the service sector by more than is typical for the euro area, and the consumer price index (CPI) can thus rise slightly faster than the area average without endangering Finland’s competitiveness in traded goods.
- Generalized cost pressures could emerge in the labor market and depress employment, but recent trends in labor costs and aggregate employment do not indicate this as yet.
- Insufficiently differentiated wages can foster cost pressures through excessive wage increases at the low-skill level, where unemployment is already high.

- Bubbles may occur in asset markets—but the rise in property prices thus far largely represents a recovery from depressed levels; and while stock prices are high, the domestic impact is limited by nonresident ownership.

The first two influences cited above would justify slightly higher CPI inflation than the euro-area average. By contrast, it is important for policy to address risks of cost pressures, damage to low-skill employment, or asset price inflation. In the present setting, both fiscal and structural policies have a role to play. With the cycle ahead of the euro-area average and monetary conditions easy, fiscal withdrawal can help avoid a destabilizing cycle in costs and prices, and this coincides with the need for structural fiscal consolidation. More fundamentally, forestalling such problems requires structural reforms to raise potential output—for example, improving incentives for employment creation, job search, and better skill matching, and addressing distortions in the real estate market. Near-term fiscal tightening, by muting demand pressures, helps to buy time for such adjustments but is not sufficient to tackle supply-side constraints.



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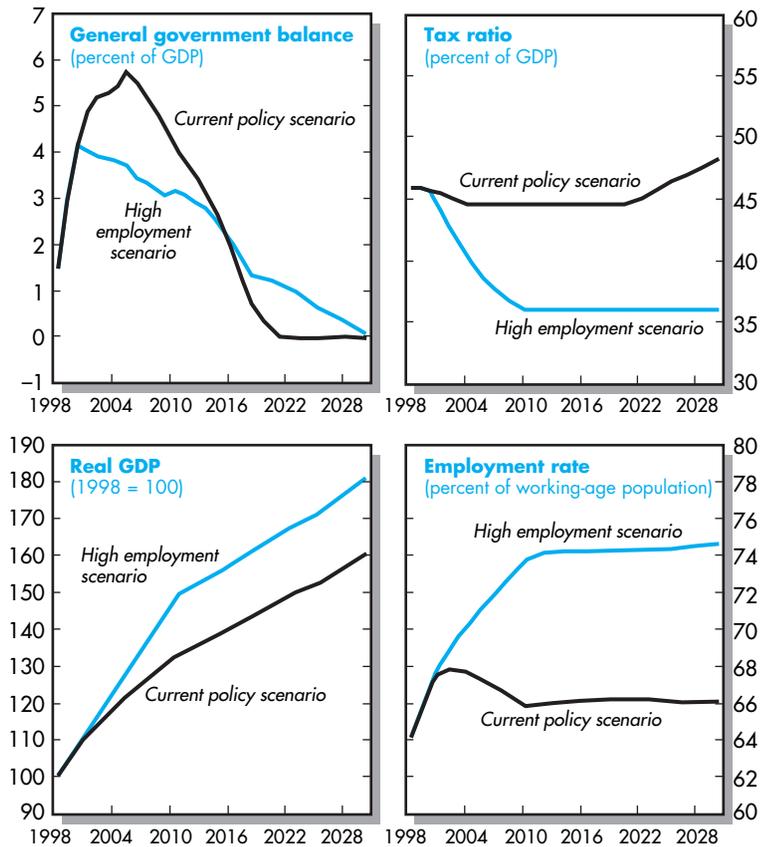
Over the past few years, Finland has taken steps to tighten unemployment benefit eligibility somewhat; enhance training programs; and permit greater flexibility in work-time arrangements, especially for small and medium-sized enterprises. It has also suspended inflation indexation for unemployment benefits and lowered personal income taxes. Together, these reforms improved the balance of incentives between seeking work or training, as against remaining on social benefits for an extended period.

Nonetheless, while unemployment has declined sharply, it remains high among the low skilled and in the northern and eastern regions. And Finland's employment ratio is unimpressive by international standards. The percentage of part-time and self-employed workers is low, reflecting taxes and regulations, and social benefits are still not strongly linked to readiness to seek work or training. Unemployment benefits, after taxes and transfers such as child and housing allowances, remain high over an extended period. And while strong centralized bargaining has favored wage moderation, wage differentiation remains limited.

A crucial priority now is to condition benefits much more directly on job search and job training efforts and to support job search efforts effectively through active labor market policies and improved training. This would be reinforced by a faster tapering down of unemployment benefits. In wage formation, it will be important not only to avoid excessive general settlements but also to increase the scope for differentiation among firms and sectors and in regions where productivity is low and job creation slow.

It is also vital to avoid a premature withdrawal of the baby-boom generation from the workforce—a key component in an effective strategy to handle the demographic shock. Current incentives tend to encourage employees approaching 55 years of age to drop out of the labor force and to discourage firms from hiring them. Ending this situation will require reforms in unemployment benefits and disability pensions. Moreover, pension entitlements will need to be linked to lifetime contributions, and the management of pension fund assets should be strengthened. This strategy would slow the fiscal impact of population aging and minimize perceptions that pension contributions are part of a heavy tax burden on labor income.

Finland: long-term fiscal scenarios



Data: IMF staff estimates

Fostering broad support for reforms

The authorities welcomed the emphasis on deeper structural reforms featured in the IMF staff's fiscal scenarios as a helpful input to the domestic policy debate. But the task of developing support for such reforms remains a demanding one, and the authorities stressed the importance of proceeding with fiscal consolidation—both to balance the central government budget and to ensure policy credibility until such structural reforms are in place. Success in achieving structural reforms will depend in no small measure on the authorities' skill in conveying the message that these reforms will serve the goal of equity (including intergenerational equity), will continue to protect those most in need, and will foster social cohesion by reintegrating the unemployed. The question remains whether a critical mass of measures to improve labor market performance can be put into place while cyclical pressures are still well contained and the demographic window of opportunity is still ajar. ■

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Note: Finland's authorities, convinced that transparency would enhance the quality of domestic debate on policy issues, published the IMF mission's conclusions for the first time as well as the staff report and documents related to the IMF Executive Board discussion. These and related documents can be accessed via the IMF's external website (www.imf.org).