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Finland: Staff Report for the 1999 Article IV Consultation

This report was prepared by a staff team of the International Monetary Fund following discussions with the officials of Finland on economic developments and policies. The report was then considered by the IMF's Executive Board in the context of the IMF's periodic consultation with Finland, as required under Article IV of the IMF Articles of Agreement. The views expressed in the staff report itself are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF or of the authorities of Finland; a supplementary statement by IMF staff may also be included. The views of the Executive Board as expressed in the discussion of the Article IV consultation report and as summarized in a Public Information Notice (PIN) are also included. In addition, a statement by the member country authorities may be appended. Further background documentation prepared by IMF staff for the consultation may be published separately at a later date. The policy of publication of Article IV staff reports allows for the deletion of market sensitive information.

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FINLAND

Staff Report for the 1999 Article IV Consultation

Prepared by the Staff Representatives for the 1999 Consultation with Finland

Approved by Alessandro Leipold and G. Russell Kincaid

August 27, 1999

- A staff mission held discussions in Helsinki during May 28–June 7, 1999, with the Minister of Finance, the Governor of the Bank of Finland, and senior officials from the Bank of Finland, the Ministries of Finance, Interior, Labor, and Trade and Industry, and local authorities. The mission also met with representatives of research institutes, labor unions, the employers' organization, and a commercial bank. The authorities published the mission's concluding statement for the first time, and have indicated their intention to participate in the pilot project for the release of staff reports.

- The mission comprised Mr. Watson (Head), Mr. Beaumont, Ms. Daseking, and Ms. Stephens (Assistant) (all EU1). Mr. Lehmussaari, Alternate Executive Director, participated in the meetings.

- Finland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions (Appendix I). Finland has consented to its quota increase under the eleventh general review and has accepted the fourth amendment of the Articles of Agreement.

- Finland subscribes to the Special Data Dissemination Standard and provides high-frequency core indicators on a timely basis (Appendix II). Extensive data are published on the internet.

- General elections in March 1999 confirmed the five-party "rainbow coalition," led by Mr. Lipponen (Social Democrat). The political agenda is also marked by Finland's presidency of the European Union during the second half of 1999.

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EXECUTIVE SUMMARY

Background: A decade that began with the steepest recession among the advanced economies is ending with buoyant activity, low inflation, and founder membership of the euro zone. Initially export-led, growth has spread more broadly over the past year and a half. Macroeconomic policies have been impressive—with monetary policy firm, and primary public expenditure declining by some 10 percentage points of GDP in six years. But progress on structural problems has been slower. There have been reforms of unemployment benefits and pensions, but the tax wedge remains high; benefits are still not effectively conditioned on job-search; and the demographic shock is set to raise taxes and contributions on labor income over the coming decades. Centralized bargaining has secured wage moderation, but has not allowed sufficient dispersion to cut joblessness among the low-skilled. The unemployment rate has fallen substantially, but it is still some 10 percent—and twice that level in some regions. Selective labor shortages have started to emerge, raising questions about the risk of overheating during the next two years.

Policy Discussions: There was a consensus that real GDP growth was likely to be in the range of 3½ to 4 percent in 1999 and 2000, with risks evenly balanced. The staff agreed with a majority view that overheating was not imminent—given a margin of competitiveness, and likely some influence of EMU on wage bargaining—but stressed the urgency of further supply-side reforms. Such reforms would take time to work, and were crucial to raise the employment ratio in line with the authorities' goals. Euro zone monetary conditions were viewed as easy relative to Finland's cyclical position; but current projections suggested that they would be counterbalanced by fiscal withdrawal in 1999 and 2000. Staff welcomed the authorities' action to improve the working of automatic stabilizers, and advised aiming for their even fuller operation. The authorities' medium-term fiscal plans incorporate continuing spending restraint, sufficient to eliminate the central government deficit while allowing a 1½ percent of GDP income tax cut. The staff urged the authorities to accelerate measures to curtail early retirement, and other labor market reforms, thus increasing the scope for tax cuts over the medium term. There was significant support for the staff's advice to enhance the design and transparency of the employment pension funds.

Key Issues for Discussion:

- During 1999–2000, given the domestic economic situation and euro area monetary conditions, should the authorities maintain a somewhat contractionary fiscal stance, while allowing automatic stabilizers to operate freely?

- Would Directors endorse a strategy that aims at eliminating the central government deficit and building up a sizeable surplus in the pension funds, while improving their efficiency and transparency?

- How do Directors assess the scope and urgency for accelerating structural reforms, including a cut-back in early retirement, in order to increase the room for tax cuts and foster employment?

I. Background

1. ***Finland's economy has recovered strongly from the deep recession that began in the early 1990s, and over the past few years it has experienced growth well above the EU average.***[1] Spurred by a devaluation of the markka, exports of goods and services drove the recovery—rising from under 25 percent of GDP at the start of the decade to 40 percent of GDP currently. Economic growth averaged some 5 percent over the past three years, while inflation fell to a low level (Figure 1 and Appendix III). The external current account shifted from a deficit of over 5 percent of GDP in 1991 to a surplus of the same magnitude—by far the largest adjustment among advanced economies over that period.

2. ***Firm restraint over expenditure, in a setting of economic recovery, brought the public finances from a deficit of 7 percent of GDP in 1993 to a surplus in 1998, and reduced the public debt ratio to less than 50 percent of GDP.*** Primary spending fell by 10 percentage points of GDP between 1992 and 1998—the strongest performance in the European Union.[2] With the fruits of restraint dedicated to deficit reduction, taxes remained high. Together with a firm monetary policy, this cleared the way to membership in the euro area. Finland's impressive macroeconomic record was not matched in structural policies, though some labor market and pension reforms have been carried out since 1995. The unemployment rate is still some 10 percent, and in some regions is on the order of 20 percent.

3. ***The last Article IV consultation was concluded on August 28, 1998 (SUR/98/106).*** Directors commended the authorities' prudent macroeconomic policies, which had led to strong output growth in a setting of low inflation, a large external surplus, and a strengthened fiscal position. They advised that fiscal consolidation be continued, given the sizeable demographic shock ahead. To offset the loss of monetary independence under EMU, they urged increasing the flexibility of fiscal policy, and pursuing comprehensive structural reforms to improve the working of the labor market and reduce unemployment.

II. Recent Developments and Short-term Prospects

4. ***Since mid-1998, activity has been underpinned by robust domestic demand.*** Private consumption has expanded strongly, supported by rapid employment growth, while fixed investment has decelerated only slightly. The services and construction sectors have maintained a pace of strong expansion. In manufacturing, capacity utilization declined significantly in late 1998 from historically high levels (Figure 2). However, after slowing somewhat toward the end of 1998, industrial output accelerated in the first quarter of 1999,

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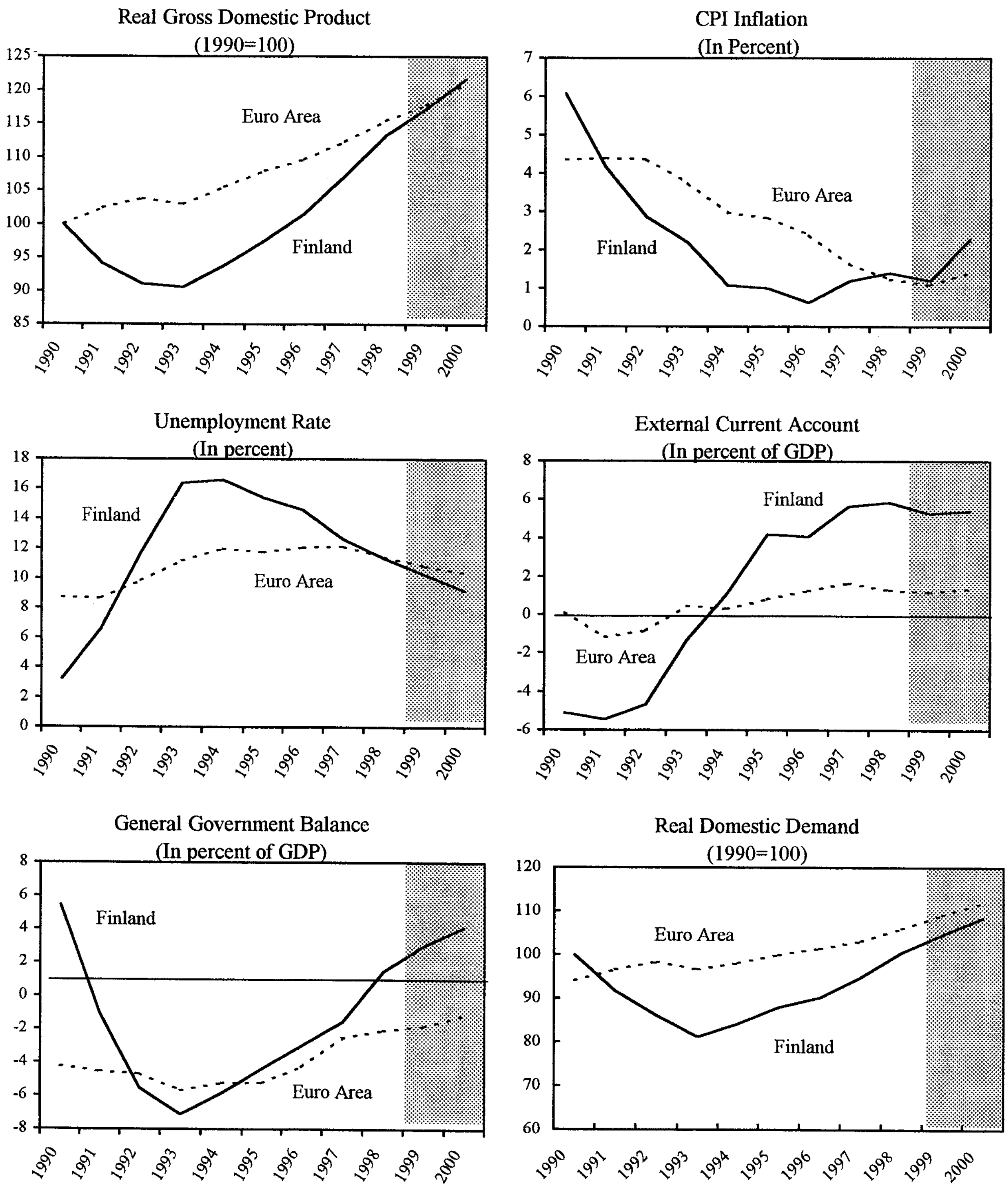
[1] The recession resulted from the effects of an overvalued currency, the collapse of trade with the former Soviet Union, a terms of trade shock, and the bursting of an asset price bubble.

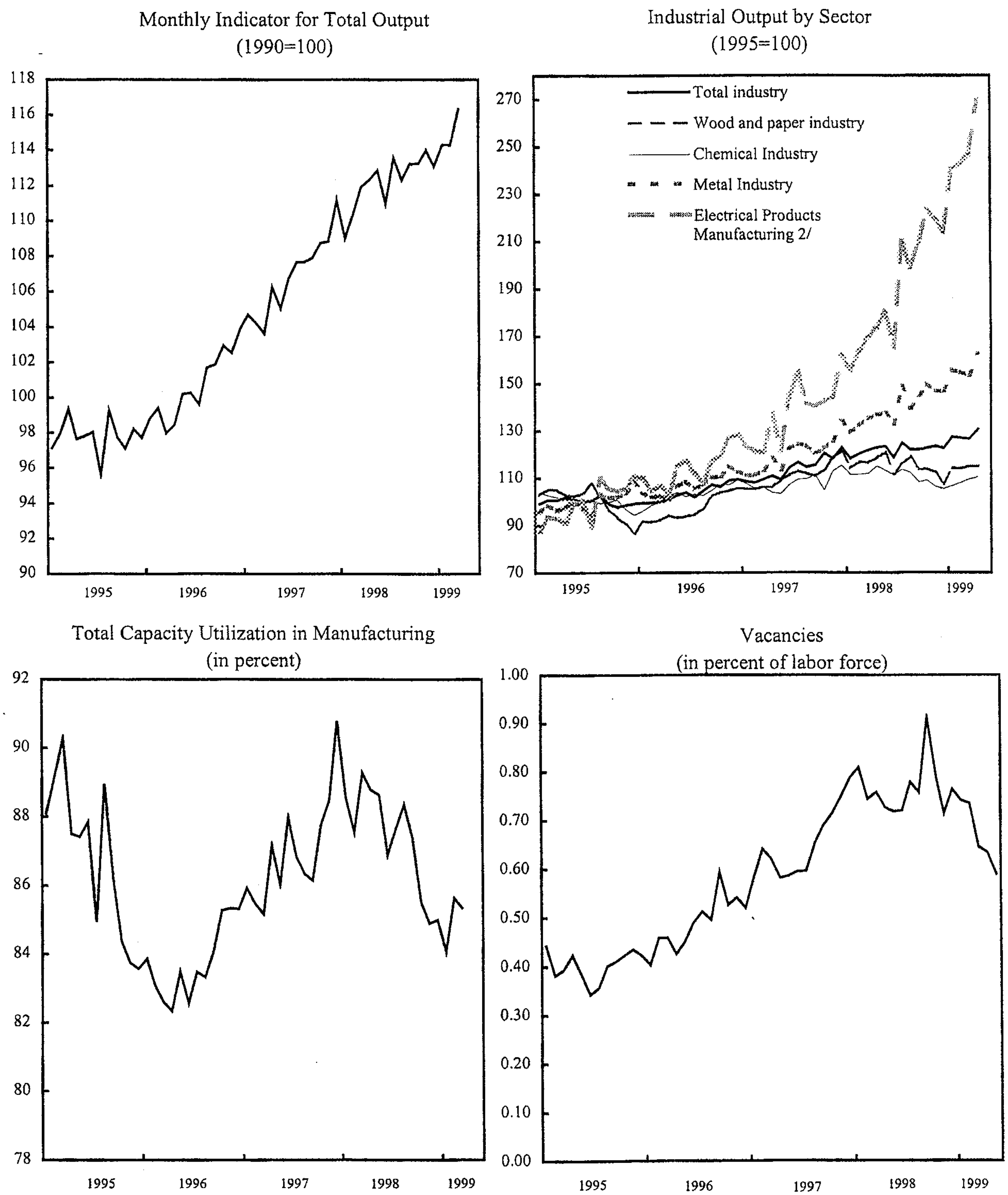
[2] The Selected Issues paper reviews experience and issues in the field of public expenditure.

Figure 1. Finland: Selected Economic Indicators, 1990-2000



Sources: World Economic Outlook, European Central Bank; and staff estimates.

Figure 2. Finland: Cyclical Indicators, 1995-99 1/



Sources: ETLA and staff estimates.

1/ Seasonally adjusted.

2/ Included in metal industry.

and was some 6 percent higher than a year earlier—spurred by the excellent performance of the electronics industry. Wage rates rose by an average of 3½ percent in 1998, broadly in line with an expected drift of 1 percent above the economy-wide pay increase agreed in the 1997 wage pact. The unemployment rate is currently about 10 percent. Twelve-month CPI inflation is running at 1¼ percent (after falling briefly to ½ percent at the beginning of the year).

5. ***Despite a weakening of exports toward the end of 1998—with the impact of the emerging market crisis being felt both directly and through weaker EU activity—the current account surplus remains above 5 percent of GDP.*** The high surplus reflects, in part, longer-run influences on saving and investment—namely, the prospective rapid aging of Finland's population, and a trend reduction of external indebtedness from the high levels accumulated by the private and public sectors in the late 1980s and early 1990s. In addition, competitiveness is currently strong—with some unwinding to be expected over the medium term, through a nominal appreciation of the euro and/or higher inflation in Finland than in its trading partners.[3]

6. ***Monetary and financial conditions are currently fairly accommodative (Figure 3).*** By mid-1999, nominal short-term interest rates were some 100 basis points lower than a year earlier. Adjusted for 12-month CPI inflation, bank lending rates touched new lows in recent months, and the volume of lending accelerated sharply over the past year. Long-term real rates extended their downward trend in 1998 and early 1999. Finland's real effective exchange rate appreciated somewhat in late 1998, but with the weakening of the euro in the first half of 1999 this has been reversed. Real estate prices continued to rise, with wealth effects supporting consumption and residential investment. Stock prices have more than tripled since 1996, although the related wealth effects may be less pronounced, given high non-resident ownership (equivalent to some 60 percent of total market capitalization).[4] Overall, monetary and financial conditions were supportive of activity in 1998, and have remained so in early 1999, with Finland's cyclical position being more advanced than the euro-area average.

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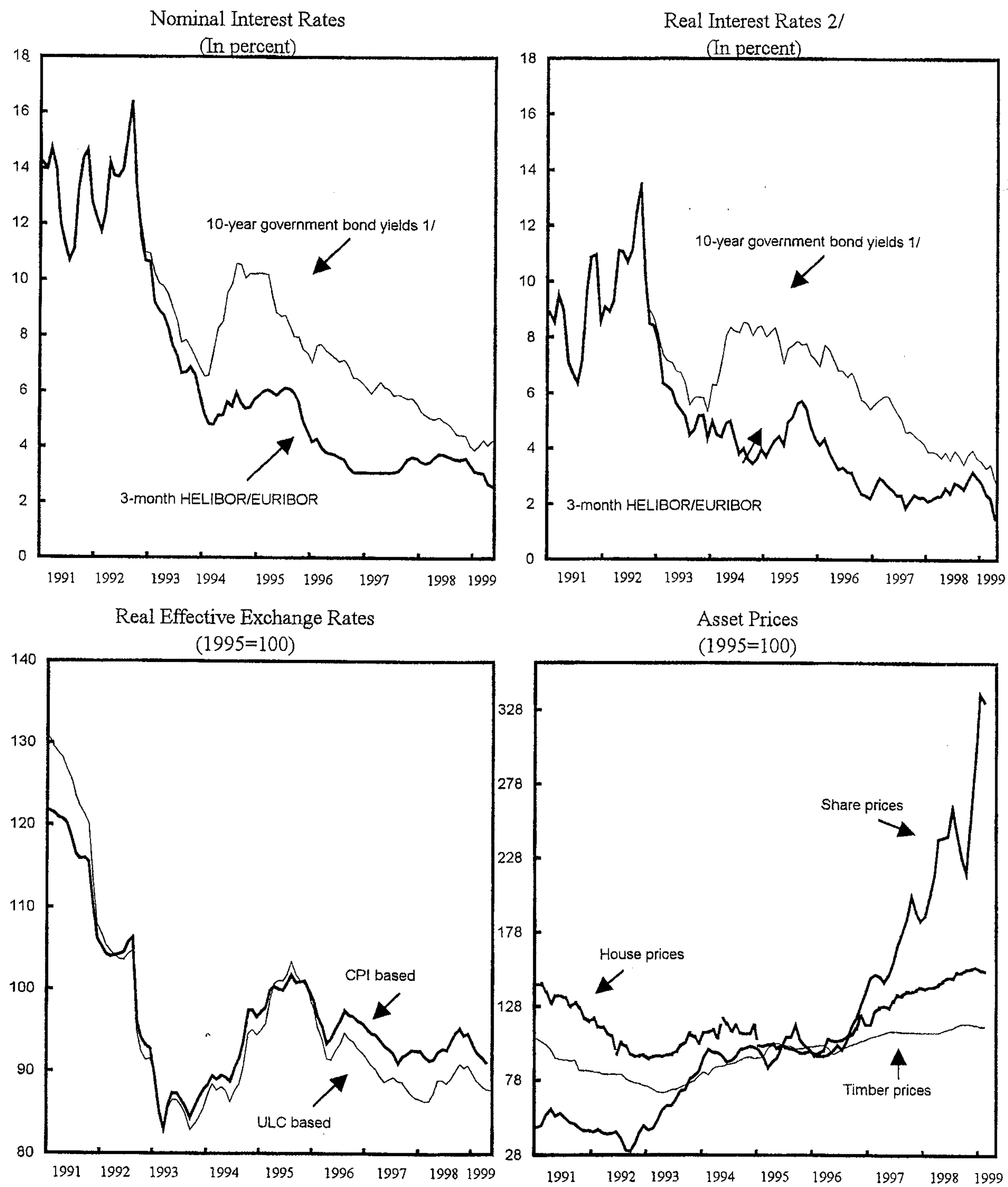
[3] Staff calculations based on the macroeconomic balance approach put the longer-run savings-investment surplus on the order of 3 to 4 percent of GDP; presently, the underlying current account, after allowing for the lagged effect of exchange rate changes and the closing of foreign and domestic output gaps, is estimated at over 6 percent of GDP (for a description of this approach, see IMF, Occasional Paper 167, 1998).

[4] Stock market performance since 1997 has been dominated by the electronics industry—and in particular, by Nokia, the world's largest supplier of mobile phones—with the industry-specific index rising more than four-fold over the two-year period. However, shares in a number of other sectors have also risen substantially. The sizeable market gains attributed to non-residents were reflected in a marked deterioration in Finland's net international investment position in 1998.

Figure 3. Finland: Monetary Indicators, 1991-99



Sources: ETLA, Bank of Finland; and staff estimates.

1/ Only available since November 1992.
2/ Derived on the basis of consumer price index through 1995 and core inflation (CPI net of the effects of indirect taxes, subsidies, and housing related capital costs) thereafter.

7. ***The 1999 budget extended the process of fiscal consolidation, while providing for some reduction in taxes on labor income.*** With activity stronger than projected, and profit taxes buoyant, the general government surplus appears set to reach some 3 percent of GDP. The fiscal impulse (measured as the change in the cyclically-adjusted primary balance) is estimated to be contractionary to the tune of 1 percent of GDP. With Finland's economy very open, and revenue performance boosted by electronics—where non-resident ownership is extensive—the domestic demand impact of fiscal withdrawal should not be overplayed. The regime shift implied by the adoption of the euro further complicates the assessment of the relative impact of fiscal and monetary policies. Nonetheless, weighing this fiscal withdrawal against the relative ease of monetary conditions, the overall stance of macroeconomic policies in 1999 appears broadly neutral. [5]

8. ***Structural reforms have been getting underway, and internal regional mobility has been relatively high, but serious problems remain in the labor market (Figure 4).*** In recent years, measures to strengthen incentives included some tightening of unemployment benefit eligibility, notably for the young; enhancement of training programs; and improvements in the flexibility of working-time arrangements, especially for small and medium-sized enterprises. Moreover, inflation indexation for unemployment benefits was suspended, and personal income taxes were lowered—reforms which together cut markedly the "threshold wage" (the gross wage equal to an unemployed person's replacement income), albeit from a high base.[6] Labor union density, at 80 percent, is among the highest in Europe: recently, centralized bargaining has favored moderate overall settlements, but wage differentiation remains limited. While economic recovery has cut the unemployment rate from 18 percent in early 1994 to some 10 percent now, there is high structural unemployment among the low-skilled, and in the northern and eastern regions. Broad unemployment (including participants in training programs, subsidized employment schemes, and early retirement) is estimated by the OECD at some 20 percent of the labor force. The employment ratio is not impressive by

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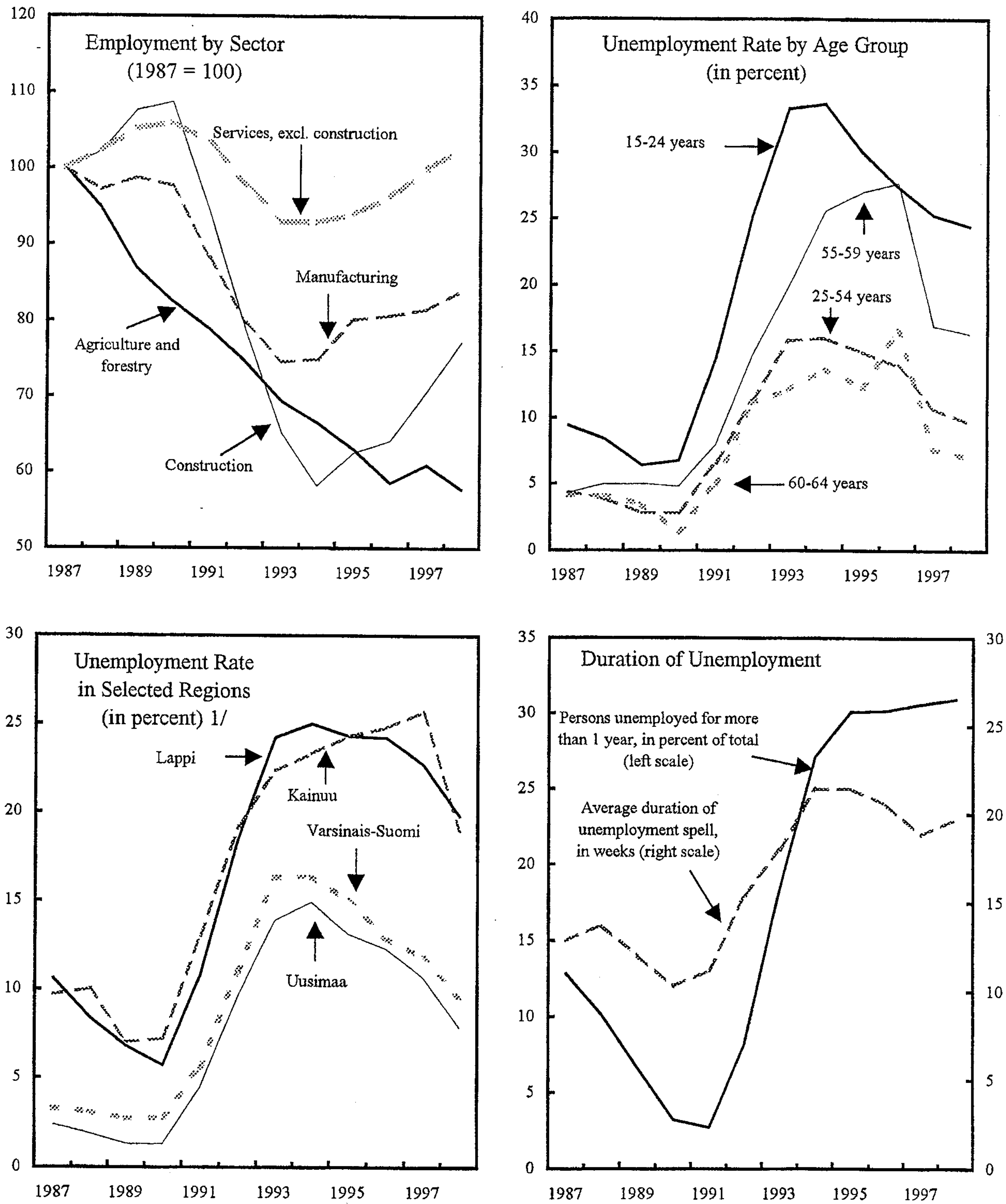
[5] It can be argued that Ricardian equivalence may offset part of the fiscal impulse (for an empirical analysis, which concludes that a high degree of Ricardian equivalence cannot be rejected in Finland, see *Bank of Finland Discussion Papers*, 28/96 and 6/97). On the other hand, with the advent of the euro, the impact of fiscal policy in Finland will not be weakened by country-specific interest and exchange rate responses. Based on past relationships, simulations by the Bank of Finland suggest that over a two year period, the impact on economic activity of a fiscal withdrawal of one percent of GDP is approximately equivalent to that of a one percentage point rise in real short-term interest rates, assuming rational expectations (see *Bank of Finland Discussion Papers, 10/98*).

[6] Since 1996, cuts in the threshold wage have been in a range of 12 percent (for married couples with one child) to 35 percent (for single persons without children); but replacement rates, after taxes and benefits—such as child and housing allowances—are high and remain so for an extended period of unemployment.

Figure 4. Finland: Labor Market Characteristics, 1987-98



Sources: Finnish Labor Market Review; and staff estimates.

1/ Lappi and Kainuu are regions in the Northern part of the country; Uusimaa and Varsinais-Suomi are in the South.

international standards (Figure 5). Part-time work and self-employment are notably low, reflecting fiscal and other regulations, and the fact that social benefits—despite reforms—are still not strongly conditioned on readiness to seek work or training.

9. ***With world trade projected to accelerate later this year, and the macroeconomic policy stance broadly neutral, solid economic growth should continue.*** The latest surveys confirm that corporations are now expecting somewhat stronger export growth, after the sluggish performance of the first quarter. Consumer sentiment has remained buoyant, and stronger domestic demand has continued to fuel a virtuous circle of employment growth and rising output, with the service sector expanding strongly. Overall, GDP growth should be in excess of 3½ percent in 1999, and close to 4 percent in 2000. The current account surplus is expected to fall somewhat below 5½ percent of GDP in 1999 and 2000.

10. ***The risks to output in 1999 and 2000 appear balanced.*** Downside risks remain in the global setting—but the most recent developments in Finland's export markets suggest these risks are diminishing. Domestically, risks are on the upside: consumption and residential investment may be stronger than projected, reflecting robust job creation, low interest rates, and wealth effects.

III. Policy Discussions

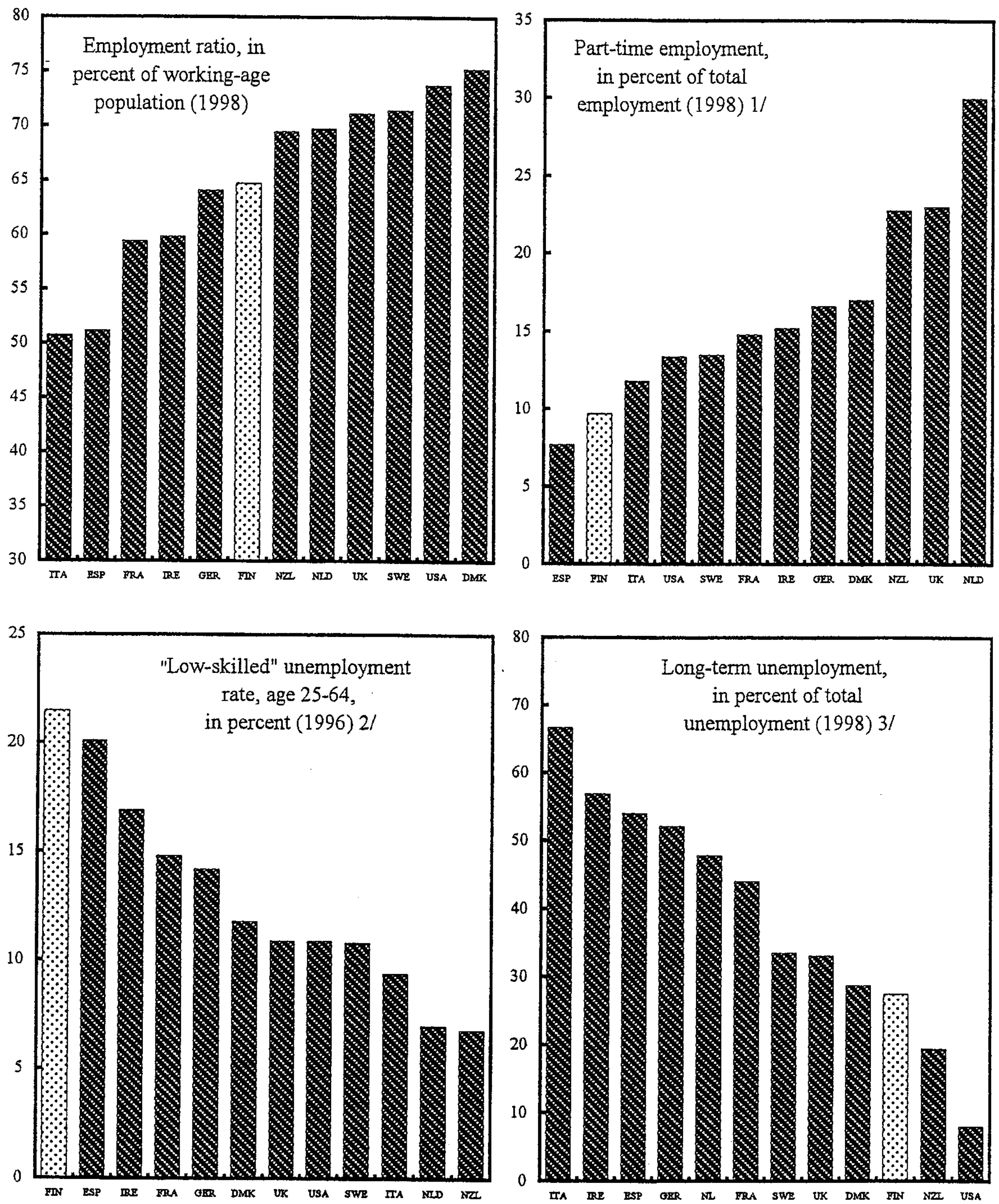
11. ***The discussions focused on two main issues: policy responses to the short-term outlook; and the authorities' medium- and long-term goals of raising employment and preparing for the impact of population aging.***

A. The Short-Term Outlook and Policy Stance

12. ***The authorities judged the economy to be operating quite close to capacity, though the degree of tightness in the labor market was uneven.*** At the time of the discussions, official and private forecasts for 1999 and 2000 were being revised upward. They now show an acceleration of growth from the dip in late 1998 toward an annual rate of some 4 percent over this period. The authorities confirmed that in the labor market, some pressures had emerged in the course of 1998 in the Helsinki area and a few other centers, but mainly in the high technology and construction sectors. These pressures were eased to some degree by internal migration and higher participation. While electronics was still expanding strongly through early 1999, recent months had seen a decline in vacancies economy-wide.

13. ***The centralized wage system had delivered moderation in recent years, but prospects for an accord for 2000-01 were uncertain, given wide sectoral variations in profitability and pressure on resources.*** The authorities saw a need for greater wage dispersion, to help spread job creation more broadly and ease bottlenecks. The dilemma was how to achieve this without triggering a generalized acceleration of wages (in 1993 a breakdown in central negotiations and pattern-bargaining across sectors led to inflationary increases at a time when unemployment was much higher than now).

Figure 5. Finland: Labor Market Indicators in Selected Countries



Source: OECD, Employment Outlook, June 1999.

1/ Data for Ireland refers to 1997; data for United States is estimate for wage and salary workers only.

2/ Defined as unemployment rate of people with less than upper secondary education. Data for New Zealand refers to 1997.

3/ Defined as 12 months and longer. Data for Ireland refers to 1997.

Countries are: DMK=Denmark, FIN=Finland, FRA=France, GER=Germany, IRE=Ireland, ITA=Italy, NLD=Netherlands, NZL=New Zealand, ESP=Spain, SWE=Sweden, and UK=United Kingdom.

14. ***The present uncertainty about wage trends led to some divergence in assessments of the NAIRU and the output gap, but within a fairly narrow range.***[7] Some policy-makers saw imminent risks of overheating, but most thought that a safety margin was still present in the labor market—with the discipline of monetary union helping tip the balance in favor of relatively moderate settlements. Wholesale prices had been falling through most of 1998 and early 1999, contributing to well-contained inflationary expectations for the remainder of the year. Overall, most officials considered that the cyclical position was more advanced than the euro area average; that growth prospects remained strong, with risks to activity balanced; and that concern about overheating was warranted, but probably over a two-year time horizon.

15. ***The authorities shared the staff's assessment that monetary conditions in the euro area were easy in relation to the domestic economic position.*** The situation, they noted, was not as novel as sometimes portrayed, however, since domestic monetary conditions had never matched perfectly with the economic position in all of Finland's varied regions. Also, the mismatch in Finland was considered to be smaller than in some euro-area economies that had been growing rapidly. The key to successful policy management was to take due account of monetary conditions in framing fiscal policy and, more fundamentally, to enhance the flexibility of the economy.

16. ***The near-term stance of fiscal policy was expected to be somewhat restrictive.*** The authorities anticipated some budgetary overperformance in 1999, and their latest projections confirmed that there was likely to be a significant withdrawal of fiscal stimulus. For 2000, the outlook depended on budgetary decisions still to be taken. Initial projections suggest a further withdrawal of perhaps ½ percent of GDP, provided expenditure levels are consistent with the agreed medium-term ceilings. On the other hand, the authorities have indicated that they would delay income tax cuts, if they were dissatisfied with the outcome of wage negotiations, in which case the fiscal withdrawal would be larger. Staff broadly supported the authorities' near-term fiscal plans, endorsing the case for continued fiscal withdrawal to help offset expansionary monetary conditions. Staff noted, however, that the fiscal stance should not be tightened indefinitely to address overheating, but that deeper labor and product market reforms were needed to improve the supply side of the economy (see Box 1 for a discussion of when and how to respond to potential cost and price pressures).

17. ***The authorities have further enhanced the scope for automatic stabilizers with the introduction of "EMU buffer funds", but the operation of stabilizers on the expenditure side is somewhat restricted by the comprehensive coverage of the medium-term expenditure ceilings.*** Staff welcomed the constitution of the buffer funds in the social security system, which should avoid repeating the past experience of pro-cyclical rises in

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[7] The NAIRU was estimated by a range of official sources at some 10 percent in 1998. OECD, EU, national, and staff estimates cluster around a negligible output gap in 1998. See Selected Issues paper for a discussion of different measures of the output gap.

Box 1. When and How should Cost Pressures be Resisted?

ECB policy aims for price stability in the euro area. For Finland, as an open and relatively small economy within the area, how far are there dangers of cost/price developments that could pose problems for policy makers? In interpreting cost and price developments, it is important to distinguish between several phenomena in the Finnish economy:

- The competitiveness of the economy (judged on relative unit labor costs, or the staff's macroeconomic balance approach) suggests a significant margin for real appreciation—via nominal appreciation of the euro, and/or higher inflation than in Finland's trading partners.

- Productivity growth in manufacturing, at 5½ percent annually, exceeds that in the non-traded sector by slightly more than in most other euro-area countries: Balassa-Samuelson effects are expected to cause CPI increases in Finland that are somewhat higher than the euro-area average (but to a lesser extent than competitiveness influences).

- Generalized cost-push 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.

- Low-skilled unemployment is already high, given compressed labor cost differentials, and this problem could become more serious as the median wage rises, if there is no increase in dispersion.

- Price bubbles or overshooting may occur in asset markets—but thus far the rise in real estate prices (particularly when assessed against household income) appears more consistent with a recovery from depressed levels; stock prices are high, but exposure to wealth effects and vulnerability to losses affect non-residents more than residents on present ownership patterns.

Price rises reflecting the first two factors above represent a move toward equilibrium, and over the medium term a modestly higher rate of CPI inflation in Finland, compared with the euro-area average, is to be expected on these grounds. By contrast policy needs to address risks of cost-push pressures, of damage to low-skill employment, or of asset price inflation:

- With the cyclical position more advanced than the euro-area average, and monetary conditions thus relatively expansionary, it is prudent for fiscal policy to withdraw stimulus, in order to lessen risks of a destabilizing cycle in prices; and this strategy coincides benignly with the need to complete structural fiscal consolidation.

- More fundamentally, forestalling such problems requires structural reforms—for example, addressing poorly designed social benefits, problems in wage formation, or distortions in the tax regime for housing finance. Near-term fiscal tightening, by mitigating excess demand pressures, at most helps to buy time for such adjustments.

unemployment contributions (see SM/98/190). However, on the expenditure side, cyclically-induced fluctuations in basic unemployment benefits and some other transfers do require offsets within the central government expenditure ceilings.[8] A full and balanced play of both revenue and expenditure stabilizers would be desirable, and the authorities are encouraged to explore ways to achieve this without undermining the spending ceilings.

18. ***In the present macroeconomic policy setting, with competitiveness favorable and some cushion in internal migration and rising participation, the staff did not see immediate risks of overheating.*** Staff stressed, however, the case for a wage agreement with scope for flexibility. While upward flexibility was increasingly prevalent through bonuses and profit-sharing arrangements, downward flexibility was needed to allow exceptional cost containment in firms and localities with low productivity and weak employment growth, fostering job creation both at the low-skill level and in regions with high unemployment. Without such reforms there were risks of further damaging low-skill employment and, over a longer time horizon, of eroding competitiveness to an undue degree. The staff suggested that the authorities' plan to condition tax relief on a moderate wage settlement should take into account also the need for such downward flexibility. Though overheating might not be imminent, policy measures to improve labor market incentives should be implemented without delay, because they would inevitably take time to bear fruit. Such measures might help to foster greater wage dispersion, and minimize the risks involved in any future shift to more decentralized bargaining (see section B for specific measures).

19. ***This cyclical setting prompted a discussion about asset market and financial sector risks—updating the broad review in the 1998 consultation.*** The staff questioned, in particular, whether asset price inflation might take root at a time, such as the present, when monetary conditions were easy relative to Finland's cyclical position; and whether the banks might not begin to engage in riskier lending under the pressure of European, and broader global, competition. Three main points emerged:

- ***The authorities did not see grounds for concern, as yet, about banks' risk exposure.*** Corporate and household balance sheets had been rebuilt in recent years; the average capital-adequacy ratio was 11½ percent in 1998; and direct exposure of Finnish banks to the Russian and Asian markets was low. Major progress had been made in enhancing the banking system's efficiency: banks' cost-earnings ratio was below 60 percent in 1997, compared with a euro-area average of 68 percent. Managements, generally, were prudent—quite well-prepared, for example, for Y2K, with the supervisory authority expected to complete a review of banks' contingency plans by the fall.

- ***The rise in house prices thus far was viewed by some officials, and the staff, as a recovery from depressed post-crisis levels, and banks' memories of the early 1990s***

[8] See Selected Issues paper.

real-estate crisis were fresh—with some institutions still working out property loans from that period. Nonetheless, the monetary authorities noted potential risks of a renewed real estate price cycle and overexposure by banks and households, if the increasing pressure on the residential and commercial real estate markets of the south—fueled by internal migration and low interest rates—persisted. There was already a considerable shortage of rental and lower income accommodation, contributing to rising prices. A number of reforms had been undertaken since 1993 to foster the development of the rental market by reducing the bias for owner-occupied housing, resulting from different tax treatments and regulations. Staff suggested continuing these reforms by eliminating the partial tax deductibility of mortgage interest payments, and reviewing the functioning of the land market—addressing any distortions that may reduce the availability of land for construction in municipalities with large inward migration.

- ***Domestic financial markets would face increasing competition from other euro zone banks and the securities markets, and further international consolidation appeared likely***. The mission welcomed the authorities' intention to discontinue the distortive tax-free status of low-interest deposit accounts, and the way in which supervisory practices in Finland had evolved.[9] Staff agreed with the authorities that the extent of future challenges, particularly in international coordination, should not be underestimated. More broadly, the health of the financial system would depend on a stable and balanced medium-term course for the economy.

B. Medium-Term Policy Issues

20. ***The authorities confirmed that their strategic priorities were to strengthen further the public finances—ahead of the impact of population aging—and to foster a higher level of employment.*** Discussions focused on broad approaches to achieving these complementary goals, and also on the design of specific measures.

Broad Policy Objectives

21. ***The authorities saw fiscal consolidation as the cornerstone of their approach to the demographic shock.*** With this shock occurring earlier in Finland than other EU economies, the authorities viewed the attainment of a significant general government surplus over the medium term as essential. This would facilitate a decisive decline in the public debt ratio, unlocking interest savings that would partially offset the impact of population aging. In line with this, the government program envisages a sharp drop in public debt—by more than

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[9] A lead supervisor arrangement was recently reached with Sweden, and the coordination between bank and non-bank supervisors had been enhanced by shifting insurance and pension supervision from the Ministry of Social Affairs to an independent agency, with cross-membership between its board and that of the banking and securities regulator.

10 percent of GDP, on a consolidated (EMU) basis, over the coming four years. To this end, the government's medium-term fiscal plans featured a continuing freeze on the real level of central government expenditure. This degree of spending restraint appears consistent with achieving a general government surplus of over 4 percent of GDP by 2000.

22. ***A key question in the discussions was the respective roles of high fiscal surpluses and structural reforms in efficiently addressing the demographic shock.*** The authorities stressed, first, that in dealing with population aging they followed a broad strategy—incorporating tax cuts, structural reforms, and fiscal consolidation; and second, that they traditionally viewed the pension component of the surpluses as more akin to private saving:

- ***One goal of the government's program was to cut taxes on labor income by some 1½ percent of GDP through 2003, combining across-the-board with targeted cuts benefiting low-income groups.*** Room for this would be created by a combination of spending restraint, a rise in corporation and capital gains taxes from 28 percent to 29 percent, and an increase in environmental—and possibly local property—taxes.

- ***Regarding structural reforms, a central objective of the government was to raise employment from currently some 65 percent of the working-age population to a level approaching 70 percent.*** In addition to tax cuts, there were commitments to enhance further the targeting of active labor market programs, and to improve vocational training.

- ***The authorities highlighted that sizeable fiscal surpluses would arise primarily within the employment pension funds, and were a key component in addressing the demographic shock, based on present entitlements and retirement projections.*** Such funds, which are partly funded and are managed by private firms, had traditionally been viewed by the authorities as vehicles for private savings and were classified outside the public sector until 1993. However, in line with OECD and Eurostat norms, they were now classified as part of the general government, largely reflecting their mandatory and comprehensive nature—and there is no plan to change these characteristics.[10]

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[10] Finland has two parallel statutory pension systems, classified as part of the general government: the national pension scheme, based on residency; and the employment pension scheme, based on employment, partly funded, and largely managed by private institutions. While the role of supplementary employer-financed and private pensions has remained limited—likely reflecting the relatively high pension level and coverage of the statutory pension schemes—private pensions have been growing quite rapidly over the past years, and the authorities confirmed that they would retain a tax treatment compatible with the continuing growth of such private schemes. For key features of the pension system, see the Selected Issues paper.

23. ***These medium- and longer-term fiscal priorities also conditioned the authorities' objectives under the EU Stability and Growth Pact.*** Finland's 1998 Stability and Growth program envisaged, as a separate constraint, balancing the *central government* budget. With local authorities traditionally maintaining a position of balance over time, this would ensure sufficient room for automatic stabilizers to operate without taking into account the pension fund surplus—which would be the authorities' strong preference in a medium-term perspective.[11] The EU Council of Ministers endorsed Finland's medium-term fiscal plans, urging the authorities to press ahead with fiscal consolidation at the central government level.

24. ***The staff welcomed the authorities' overall fiscal strategy—including notably the strong commitment to spending restraint—but laid added emphasis on the contribution that deeper structural reforms could make.*** Illustratively, the staff contrasted two longer-run economic strategies (Box 2 and Figure 6):

- ***The first strategy would be based on modest structural reforms, combined with large general government surpluses over the medium term.*** Under such a strategy, even with surpluses of 5 percent to 6 percent of GDP during the next few years, it would be difficult to meet the fiscal costs of population aging without some increase in the burden of taxes and social contributions on labor income over the coming decades. Such a rise in contributions would likely be perceived as an intergenerational transfer, driving up the labor market tax wedge at a time when it would be critically important to foster higher participation in order to mitigate the demographic shock. More generally, the opportunity costs of running high surpluses with a largely unchanged tax burden, in lieu of addressing pension and labor market reforms, would be high.

- ***The second strategy would incorporate deeper structural reforms to curtail early retirement and raise employment levels, allowing somewhat lower surpluses and a substantial reduction in tax rates on labor income over time.*** In addition, changes could be made in the employment pension scheme to render pension contributions less like a tax by making them more transparent and linking them more closely to benefits. This approach could help to set in motion a virtuous circle, enhancing output, employment, and the public finances. But, with large cohorts (the "baby-boom" generation) at risk of exiting prematurely from the labor force over the next five to ten years, prompt action to shift the incentives for early retirement was urgent for such a strategy to work.[12]

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[11] The burden of fiscal stabilization may fall quite heavily on the central government, if local authorities in future act counter-cyclically by seeking to correct deficits swiftly.

[12] A fuller exploration of these scenarios is presented in the Selected Issues paper.

Box 2. Medium- and Long-Term Fiscal Challenges and Policy Trade-Offs

In a nutshell, the Finnish authorities are faced with **three key medium- and long-term fiscal challenges**: (i) to prepare for anticipated expenditure pressures posed by a rapidly aging population; (ii) to maintain a fiscal position that can accommodate cyclical fluctuations within the 3 percent of GDP deficit limit of the EU Stability and Growth Pact; and (iii) to allow for indirect tax cuts, agreed in the context of EU tax harmonization, and to create scope for further cuts in the tax wedge on labor income.

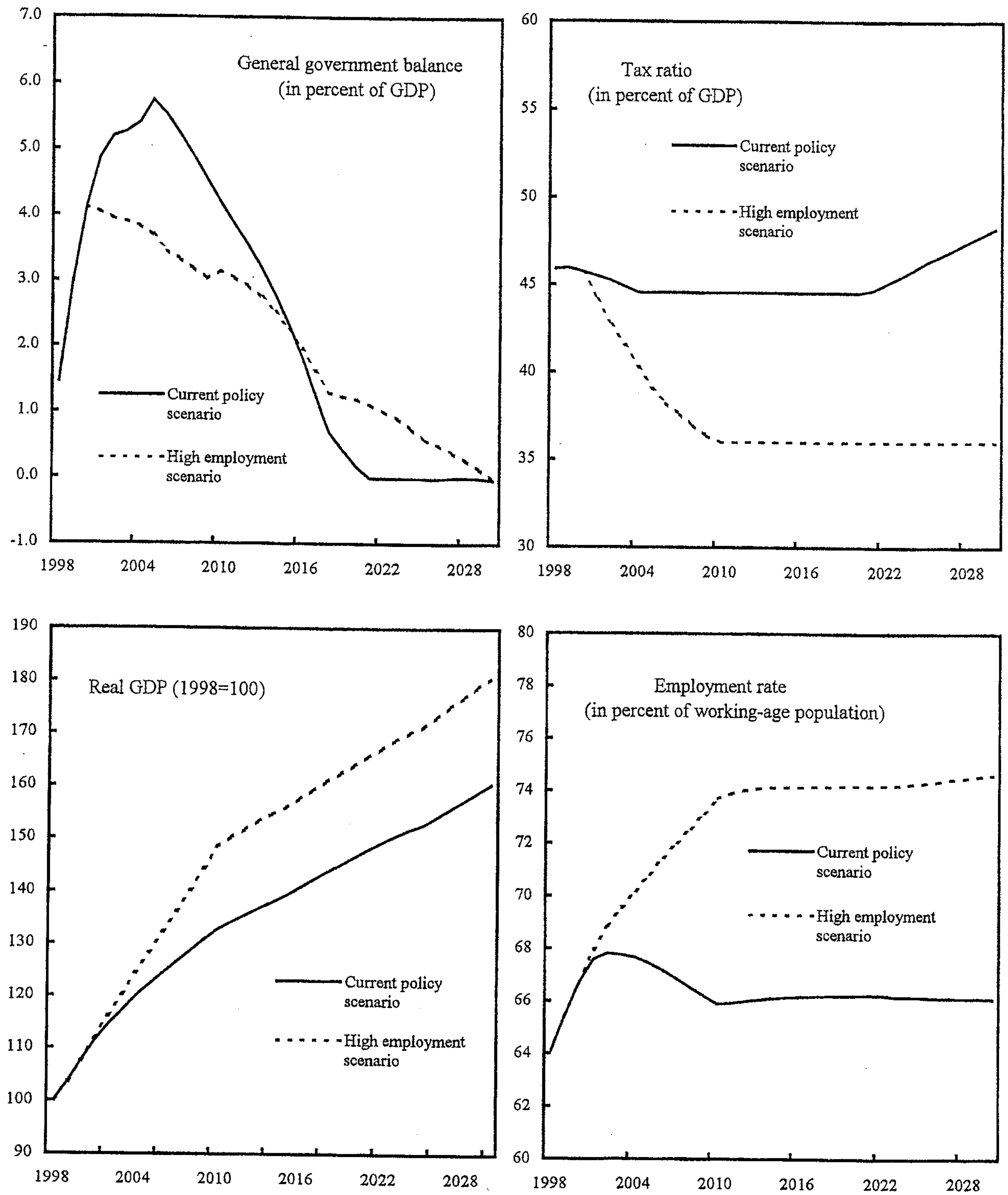
To illustrate the trade-offs between alternative policy strategies, the staff has developed two long-term scenarios:

The **current policy scenario** incorporates the government's projections of real expenditures for 1999/2000, and announced tax cuts on labor income, as well as reductions in indirect taxes in line with agreed EU policies. Subsequently, revenues are assumed to grow in line with GDP, and current expenditures are linked to demographic developments and labor productivity growth (as a gauge for real wage increases, developments in nonwage outlays, and the indexation of transfer payments). Capital expenditures, after increasing only moderately over the medium-term, grow in line with GDP over the long run. Importantly, it is further assumed that the effective retirement age remains at 59 years.

This policy strategy implies that (i) the unemployment rate falls just below 8 percent, and the employment rate peaks at under 68 percent, with both ratios deteriorating toward the end of the projection period, in response to a rise in the tax wedge; (ii) the surplus in the general government swells to 5¾ percent of GDP in 2005 and is gradually eliminated in the long run; and (iii) social security contributions and direct taxes have to be increased significantly by the end of the projection period to maintain fiscal balance.

The **high employment scenario**, in contrast, combines further moderate expenditure restraint with significant and front-loaded pension and labor market reforms, resulting in a gradual increase of the effective retirement age by three years. Under these assumptions, greater scope is opened up for tax cuts (with a lower peak in the general government surplus), and the combined effect of the reforms sets off a virtuous circle of strong employment generation, higher economic growth, and fiscal savings. As a result, the unemployment rate falls to 5½ percent and the employment ratio rises from about 65 percent to almost 75 percent of the working-age population—nearly 9 percentage points higher than in the current policy scenario. While not explicitly modeled, the removal of labor market rigidities, together with improved incentives, would also lower the risk of cyclical unemployment (in the event of economic downturns) becoming a long-term structural problem.

Figure 6. Finland: Long-Term Fiscal Scenarios, 1998-2030



Source: Staff estimates.

25. ***The authorities viewed this emphasis on the potential contribution of structural reforms as a helpful input to the domestic policy debate.*** But this should not detract, they stressed, from the priority of proceeding with fiscal consolidation at the present time—both to balance the central government budget and to ensure policy credibility until the scope and impact of such structural reforms could be evaluated. The staff agreed.

The Design of Measures to Support Medium-Term Policy Goals

26. ***Against this background, the discussions went on to explore specific reform measures relating to public expenditure as well as the labor and product markets:***

- Regarding the substance of their **public expenditure plans**, the authorities confirmed that medium-term ceilings—set by the cabinet, and covering spending by individual ministries, including transfers to local authorities and social security funds—had proved an effective control system in the past. Such ceilings were now agreed for 2000–2003. The discussions illustrated, though, the challenges for implementation that would arise as this strategy was pressed forward, if bottlenecks for growth were to be avoided. For example, with some municipalities experiencing heavy inward (and outward) migration, continuing restraint in transfers to municipalities would only work effectively if they achieved fuller cost recovery, raised property taxes, and were more selective in spending—while making their operations more efficient by enhancing cooperation with other municipalities through joint projects.[13] Another challenge was to assure adequate infrastructure spending, which had been pared back in recent years.[14] The staff suggested that there was some scope for additional savings, for example, by targeting more tightly transfers to households, which together with social security benefits account for some 20 percent of GDP; but politically this remains an uphill task.[15] In the field of official development assistance, the authorities confirmed that they would like to raise this above the current level of 0.34 percent of GDP once their situation permits.

[13] The staff had detailed discussions with representatives of municipalities, which confirmed that—provided structural reforms moved forward at this level—the planned restraint in transfers was indeed realistic. An important area where efficiency will need to be improved is the management of health care costs, which is essentially a local government responsibility.

[14] The authorities are exploring the scope for private financing of capital projects; the staff, citing other country experience, urged applying efficiency tests and avoiding risks of the state incurring contingent liabilities if project returns turned out to be lower than projected.

[15] Potential areas for expenditure cuts include family allowances, agricultural and housing subsidies, educational grants via improved means-testing, and public sector employment.

- The government has already set out the guiding principle for further **labor market** reforms: a focus on reducing disincentives to taking up a job. One measure planned to achieve this is further cuts in the taxation of earned income, to widen the gap between the net unemployment benefit and net labor income. There is also an intention to further retarget active labor market policies toward key groups, shifting civil service staff to assure effective interviewing and guidance of benefit recipients (800 staff were reassigned to these functions during the 1990s). The staff suggested shortening the comparatively long duration of the unemployment benefit, and tapering it off more strongly over time; a stricter enforcement of requalification requirements for this benefit; and action to address the disincentives to job-search and mobility that result from the way cash benefits such as housing and child care allowances are withdrawn. This would also foster continued mobility across Finnish regions.[16]

- The government agreed that a broad priority, affecting a range of public programs, was further action to reduce **early retirement**. They had already undertaken a number of reforms during 1993–97 to cut future pension expenditures and raise incentives for longer participation in the labor force. There was a range of views about the time-horizon for further reforms, and staff strongly stressed the case for taking measures urgently, so that members of the "baby-boom" generation no longer faced artificial incentives to withdraw from the labor force—and that firms no longer faced incentives against employing them (Box 3).[17] This was consistent with considerations of intergenerational equity as well as efficiency.

- The discussion further focused on specific reforms to strengthen the perception of **employment pensions as savings rather than taxes**, including enhanced competition and transparency (Box 3). A guiding principle, which officials thought deserved support, would be to move in the direction of making transparent the link between individual contributions, investment returns, and benefits. The authorities confirmed that a number of changes in the pension framework were under discussion with the social partners, but the scope of reforms remained to be seen.

- In the **product markets**, finally, further reforms are needed. Staff urged pressing ahead rapidly with privatizations mandated by parliament—which would make a significant contribution to reducing the public debt—and seeking a widening of this mandate in the case of commercial enterprises. There is also a case for simplifying tax and social security procedures, and cutting red tape, which may limit the growth of small enterprises and self-employment, including notably in personal services.

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[16] The authorities' approach to regional policy focuses on the development of a number of poles of growth across regions, with an emphasis on university towns.

[17] Staff projections in the Selected Issues paper illustrate the powerful interaction between Finland's unusually early demographic shock and the strong incentives for early retirement.

Box 3. How to Change Incentives in the Pension System [1]

In the field of pension policy, there was broad agreement on the priority of curtailing early retirement, and support for moving in the direction of making transparent the link between individual contributions, benefits, and investment returns. Based on these principles, staff highlighted a number of features it considered worth addressing:

A first operational priority should be to limit early retirement before the "baby-boom" generation reaches eligible ages. Some measures in this direction have already been taken. A number of complementary actions are called for now, including:

- closing the so-called "unemployment benefit pipeline" to early retirement, by removing the requalification exemption for the unemployed aged 55 and over;
- discontinuing the "unemployment-pension" for future claimants;
- alleviating firms' liability for disability pensions, to avoid encouraging the shedding of employees aged 55 and over;
- ensuring that new entrants to the disability pension scheme are, in fact, disabled according to reasonable criteria;
- increasing the after-tax penalty for early retirement;
- increasing the flexibility of the official retirement age;
- relating pension entitlements to contributions over an entire working life, ending distortions that discourage taking a new job late in an employee's career; and
- shifting ultimately to a system based on defined contributions rather than benefits.

The last two measures above should be part of a broader strategy to mitigate the "tax" aspects of employment pension contributions. Further changes in that direction could also be made on the investment side. Key reforms would be: to increase competition among pension management companies; to end direct lending by funds to corporations who pay contributions to them; and to raise minimum yields on pension fund portfolios before rebates of contributions are made. These changes, by making pension entitlements more transparent and credible, should both improve incentives to work and reduce the risk of the government and private sector saving for the same goal. Of course, greater competition would imply stronger supervision—and in this connection, the creation this year of a separate insurance and pension supervisory agency, with close links to the banking and securities supervisor, is very welcome. Finally, there is scope for an increased role of private pensions, which have been growing quite strongly over the past few years.

[1] For a further discussion of the Finnish pension system, see Selected Issues Paper.

Also, as part of a broad strengthening of the competitive environment, including in energy, domestic telecommunications, and other services, there is a case for reviewing possible distortions in wholesale distribution and in construction.

27. ***On the broad thrust of structural reforms, there was a fair measure of agreement between the authorities and the staff—but further changes in the social benefit system, in particular, will be difficult to press through.*** The question remains whether a critical mass of measures to improve labor market performance can be put in place while cyclical pressures are still well-contained, and the window of opportunity, demographically, is still ajar. Success in this will depend in no small measure on the authorities' skill in conveying the message that equity is well-served by such reforms; that they will focus protection on those most in need; and that they will avoid exclusion and foster social cohesion through reintegration in the work force, not just income support.

28. ***The authorities considered that greater transparency should enhance the quality of domestic debate on economic policy issues.*** They published the mission's concluding remarks for the first time, and are participating in the pilot project for staff report release. The authorities are also considering performing a self-assessment under the IMF's Code of Good Practices on Fiscal Transparency.

IV. Staff Appraisal

29. ***The conduct of macroeconomic policy in Finland since the early 1990s has been impressive.*** Firm monetary policy and public spending restraint, buttressed by wage moderation, have transformed the public finances and reduced inflation to a low level. Private sector balance sheets have been rebuilt; the external current account has swung from deficit to sizeable surplus; growth has become stronger than in neighboring countries; and unemployment has fallen markedly. In sum, a decade that began with the steepest recession among the advanced economies is ending with the public finances in surplus, activity strong, and founder membership of the euro zone.

30. ***This macroeconomic progress notwithstanding, important structural challenges remain in the public finances and the labor market, posing risks to economic performance in the medium to longer term.*** In the public finances, population aging will soon begin to exert major pressures, despite recent pension reforms. In the labor market, the employment ratio is still unsatisfactory, and pressures have appeared in some areas and sectors at a time when unemployment nationwide remains high. It is crucial to enhance the flexibility of the economy under monetary union—forestalling domestically-generated cost pressures, and improving resilience to shocks. But with the economy performing well, and memories of crisis receding, it will take continuing foresight and strong resolve among policy makers and the social partners to put these reforms in place in a timely fashion.

31. ***The near-term outlook for the economy is in most aspects ideal for reform.*** Business confidence is recovering; consumer sentiment is strong; and solid employment growth is providing a strong undertone to demand, which should also benefit from wealth effects as

real estate gains continue. Domestically, risks are on the upside, but they are counterbalanced by external downside risks. On balance, the economy is likely to operate at levels around potential—a cyclical position substantially ahead of the euro-zone average.

32. ***Accommodative monetary conditions relative to Finland's cyclical position call for some fiscal tightening***. Nominal and real interest rates are at record lows by the standards of recent decades; the real effective exchange rate is competitive; and asset markets are buoyant. Expanding money and credit aggregates, equally, portend high demand growth. Financial conditions are unduly accommodative for a country in an advanced cyclical position. Appropriately, the fiscal stance in 1999 is on the restrictive side, with a tightening of some 1 percent of GDP in prospect, thus providing a significant offset to monetary ease. In 2000, the government's spending plans should result in at least a modestly restrictive stance, even after allowing for tax cuts.

33. ***The major medium- and long-term challenge for policy lies in the demographic outlook.*** On present projections, population aging would raise public expenditure on pensions and health care substantially over the coming decades. Disturbingly, this could trigger a rise in taxes and social contributions on labor income in the future—just when broad labor force participation will be crucial to offset a shrinking of the working-age population.

34. ***To meet this challenge, a first priority is adequate fiscal consolidation.*** The fiscal position is already sufficiently strong to allow automatic stabilizers to operate freely within the Stability and Growth Pact limits, as would be appropriate in future in the event of downside as well as upside developments. The authorities are right to take the opportunity presented by the current cyclical situation to move promptly toward their longer-run goal of eliminating the central government deficit—implying a significant surplus at the general government level. The expenditure plans for 2000-2003 should achieve this goal. There is a case, nonetheless, for tightening these plans somewhat, by targeting transfers to households more effectively to those in need, without undercutting core social assistance.

35. ***The government's medium-term expenditure plans appropriately provide room for a cut in income taxes—of some 1½ percent of GDP through 2003—without undermining fiscal consolidation.*** The government has rightly emphasized a combination of across-the-board cuts and targeted reductions benefiting low-skilled and part-time employees. By widening the gap between the net unemployment benefit and net labor income, this should exert maximum leverage in raising employment. Provided additional structural reforms are undertaken to address the demographic shock directly, it should indeed be possible to step up the pace of tax cuts over the coming decade.

36. ***A key priority to buttress the long-run fiscal outlook is to avoid a premature withdrawal of the "baby-boom" generation from the labor force over the next 5 to 10 years.*** Currently, employees approaching the age of 55 face incentives to withdraw from the labor force, and firms are discouraged from employing them. Ending this situation will require a reform of unemployment and disability pensions. In addition, employment pension entitlements should relate clearly to life-time contributions, and the management of pension

fund assets should be further strengthened. Together with improved transparency, this should mitigate the tax-like aspects of employment pensions—enhancing incentives to work. This overall strategy would both slow the demographic shift, by delaying retirement, and minimize perceptions that pension contributions are part of a steep and potentially rising tax wedge on labor income.

37. ***In the labor market, more broadly, the government's emphasis on raising the employment ratio over the next four years is on the mark, as is the central message to reduce the disincentives to taking up a job.*** To this end, further efforts are needed to achieve a faster tapering of unemployment benefits, and a much stronger conditioning of benefits on efforts to find work or training—supported by enhanced active labor market policies and improved training. Generalized overheating is probably not imminent, but reforms to improve the flexibility of the labor market will take time to work, and should be initiated now. Finland's centralized wage system has successfully contained the level of wage settlements—but in future the scope for differentiation should be increased, especially in firms, sectors, and regions were productivity is low and job creation slow.

38. ***Product market reforms could contribute to fostering employment and mitigating inflationary pressures in asset markets.*** Priorities are to press ahead with, and seek a widening of, the privatization mandated by parliament; to enhance competition in the economy, including in energy, domestic telecommunications, wholesale distribution, and construction; to address regulations that may limit the growth of small enterprises and self-employment; and to improve the working of the market in land in rapidly developing areas.

39. ***In the financial sector, major progress has been made in enhancing the efficiency of the banking system, but globalized markets and monetary union will pose growing challenges for financial institutions and supervisors alike.*** The recent establishment of an insurance and pension regulator—operating in coordination with the banking and securities regulator—and the lead supervisor understandings with Sweden, are examples of significant progress in this area. The goal of ending tax free deposit accounts is commendable, and action should also be taken to eliminate the tax deductibility of mortgage interest payments. In the financial sector, as elsewhere, good progress has been made in addressing the Y2K issue; a priority economy-wide is to ensure that comprehensive contingency plans are well-advanced.

40. ***Finland's provision of high-quality data on a timely basis facilitates the conduct of effective surveillance.***

41. ***It is proposed that the next consultation take place on the standard 12-month cycle.***

Finland: Fund Relations
(As of July 31, 1999)

I. **Membership Status**: Joined 1/14/48; Article VIII.

II. **General Resources Account**:

	SDR Million	Percent Quota
Quota	1,263.80	100.0
Fund holdings of currency	755.69	59.8
Reserve position in Fund	508.12	40.2
Operational budget transfers (net)	-28.00	

III. **SDR Department**:

	SDR Million	Percent Allocation
Net cumulative allocation	142.69	100.0
Holdings	185.41	129.9

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements**: None

VI. **Projected Obligations to Fund** (SDR Million; based on existing use of resources and present holdings of SDRs): None

VII. **Exchange Rate Arrangements**

1. Finland is a founding member of EMU, with a euro conversion rate of Finnish markka (Fmk) 5.94573. Finland has accepted the obligations of Article VIII and maintains an exchange system that is free of restrictions on payments and transfers of current international transactions. In accordance with Executive Board Decision No. 144–(52/51), Finland notified the Fund on September 5, 1990 and July 6, 1992 of exchange restrictions pursuant to UN Security Council Resolutions against Iraq and the Federal Republic of Yugoslavia (Serbia/Montenegro), respectively. On July 27, 1995, Finland also notified the Fund of exchange restrictions imposed against Libya, and of changes in the exchange restrictions pursuant to UN Security Council Resolutions on Iraq and the Federal Republic of Yugoslavia (Serbia/Montenegro) as well as on certain areas in Bosnia and Herzegovina. Finland has since removed restrictions imposed against certain areas of the Republic of Croatia, Bosnia and Herzegovina, and the Federal Republic of Yugoslavia (except for the prohibition on the satisfying of certain claims). The UN Security Council Resolution on food for oil (Iraq) was implemented in December 1996.

Finland: Core Statistical Indicators

(As of July 31, 1999)

	Exchange Rates	International Reserves	Central Bank Balance Sheet	Reserve/ Base Money	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Central Government Balance	GDP
Date of Latest Observation	July 31	July 31	June 30	June 30	June	July 31	June	May	April	May 30	Q1, 1999
Date Received	July 31	July 31	June 30	June 30	July 31	July 31	July 15	July 18	June 18	June 30	June 29
Frequency of Data	Daily	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Frequency of Reporting	Daily	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly
Source of Update	Reuters	Bank of Finland	Bank of Finland	Bank of Finland	Bank of Finland	Reuters	ETLA	Bank of Finland	Bank of Finland	ETLA	ETLA
Mode of Reporting	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line	On-line
Confidentiality	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public	Public
Frequency of Publication	Daily	Weekly	Weekly	Weekly	Monthly	Daily	Monthly	Monthly	Monthly	Monthly	Quarterly

Finland: Basic Data

Demographic and other data:

Population (end-1997)	5.14 million
Population per sq. km	17
GNP per capita (1997)	US$24,790
Social indicators (1997)	
Life expectancy at birth	
Male	73
Female	81
Infant mortality rate	4 per 1,000 live births
Physicians per 1,000 people (1996)	2.8

	1990		1998	
	Billions of Fmk	Percent of GDP	Billions of Fmk	Percent of GDP
Private consumption	263.6	50.6	344.6	50.2
Public consumption	112.6	21.6	146.6	21.4
Gross fixed capital formation	148.2	28.4	126.5	18.4
Exports of goods and services	119.0	22.8	270.3	39.4
Imports of goods of services	127.8	24.5	208.9	30.5
GDP	521.0	100.0	686.0	100.0

Selected Economic Indicators, 1994-2000 1/

	1994	1995	1996	1997	1998 Prel.	1999 Proj.	2000 Proj.
	(Percentage change, unless otherwise indicated)						
Output and demand (volumes)							
GDP	3.7	3.9	4.1	5.6	5.6	3.6	3.8
Domestic demand	3.7	4.4	2.5	5.3	6.0	4.0	3.7
Consumption	1.8	3.6	3.2	2.9	4.3	3.5	3.3
Private consumption	2.5	4.3	3.5	2.9	5.5	4.2	3.9
Public consumption	0.3	2.0	2.5	2.9	1.4	2.0	2.0
Gross fixed capital formation	-2.3	10.8	8.4	11.7	9.0	6.0	5.1
Private investment	-3.0	14.2	8.0	11.5	11.0	8.0	6.5
Public investment	0.7	-3.3	10.6	12.6	-0.2	-4.5	-1.4
Export of goods and services	13.1	8.7	6.1	14.2	9.6	3.7	6.0
Import of goods and services	12.8	7.9	6.3	11.4	9.4	4.3	6.2
Foreign contribution to growth (in percent of GDP)	1.0	0.9	0.4	2.0	1.0	0.2	0.5
Prices, costs, and income							
Consumer price index	1.1	1.0	0.6	1.2	1.4	1.2	2.3
Harmonized CPI	...	...	1.1	1.2	1.3	1.3	2.3
GDP deflator	2.0	3.6	0.6	2.0	2.7	1.9	2.2
Terms of trade	1.7	5.5	0.8	-2.6	2.5	-1.0	-0.3
Unit labor cost, manufacturing	-4.7	4.3	0.0	-5.6	0.7	0.1	0.5
Productivity, manufacturing	9.7	3.7	2.8	8.1	4.9	4.1	3.5
Labor cost, manufacturing 2/	4.5	8.0	3.1	2.1	5.7	4.2	4.0
Unit labor cost, whole economy	-2.4	2.5	0.0	-0.8	2.6	2.1	1.6
Real disposable income	7.1	8.0	4.9	7.0	6.8	4.5	4.8
Labor market							
Labor force	-0.5	0.7	0.4	-0.2	0.9	0.2	0.1
Employment	-0.8	2.2	1.3	2.0	2.4	1.5	1.3
Unemployment rate (in percent)	16.6	15.4	14.6	12.6	11.4	10.3	9.2
Potential output and NAIRU							
Output gap (in percent of potential output) 3/	-5.9	-5.0	-4.3	-2.1	-0.1	0.1	0.4
Growth in potential output	2.4	3.0	3.3	3.3	3.4	3.5	3.5
NAIRU (in percent)	13.9	14.2	13.5	12.6	11.3	10.3	9.5

Finland: Selected Economic Indicators, 1994-2000 (continued) 1/

	1994	1995	1996	1997	1998 Prel.	1999 Proj.	2000 Proj.
Money and interest rates							
M3 (percentage change, end of period)	1.9	0.4	-1.3	8.8	2.4	...	...
Domestic credit (percentage change, end of period)	-8.3	0.4	-2.7	-3.2	9.7	...	...
3-month money market rate (in percent)	5.4	5.8	3.6	3.2	3.6	2.8	2.9
10-year government bonds yield (in percent)	9.1	8.8	7.1	6.0	4.8	4.1	4.5
	(In percent of GDP, unless otherwise indicated)						
National savings and investment							
Gross national saving (percent of GDP)	18.3	21.4	21.2	24.3	25.8	25.9	26.3
Gross domestic investment (percent of GDP)	17.2	17.2	17.2	18.7	20.0	20.6	20.9
Private saving	21.1	22.9	21.3	22.7	21.5	20.2	19.6
Household saving as percent of disposable income	2.6	6.2	2.8	4.7	4.7	4.5	4.5
Private investment	14.1	14.3	14.2	15.6	17.1	17.9	18.4
Private savings surplus	7.0	8.6	7.1	7.2	4.4	2.3	1.3
Government savings surplus	-5.8	-4.4	-3.0	-1.6	1.5	3.0	4.1
National savings surplus	1.1	4.2	4.1	5.6	5.8	5.3	5.4
Public finances							
General government 4/							
Revenues	52.5	51.7	52.8	51.4	51.0	50.7	50.5
Expenditure	58.3	56.1	55.8	52.9	49.5	47.7	46.3
of which: net interest on public debt	1.1	0.9	1.6	1.9	2.0	1.5	1.1
Fiscal balance	-5.8	-4.4	-3.0	-1.6	1.5	3.0	4.1
Structural balance	-1.7	-1.2	-0.3	-0.4	1.5	3.0	3.8
Structural primary balance 5/	-0.5	-0.3	1.3	1.5	3.4	4.4	4.9
Debt (EMU definition)	58.4	56.9	56.5	53.9	48.4	45.8	42.6
Central government 4/							
Revenues	24.2	24.2	25.3	25.6	25.9	25.8	25.7
Expenditure	35.2	33.6	32.4	29.7	27.5	26.0	25.0
of which: net interest on public debt	4.2	4.5	5.0	5.1	4.7	4.1	3.8
Fiscal balance	-11.0	-9.4	-7.1	-4.1	-1.6	-0.2	0.6
Structural balance	-8.7	-7.8	-5.6	-3.5	-1.5	-0.2	0.5
Structural primary balance 5/	-4.4	-3.3	-0.6	1.6	3.1	3.9	4.2
Debt	59.0	64.0	67.3	66.1	62.2	58.9	54.9
Balance of payments							
Current account balance 6/	1.1	4.2	4.1	5.6	5.8	5.3	5.4
Trade balance	7.8	9.7	8.9	9.5	9.7	8.8	8.9
Net international investment position	-50.7	-41.4	-41.8	-42.9	-68.9	-56.1	-49.1
Net external debt, excluding FDI and shares	44.7	35.6	31.5	27.6	24.0	17.5	11.1
Exchange rates (period average)							
Fmk per US$	5.2	4.4	4.6	5.2	5.3	...	...
Nominal effective rate (1995=100)	90.8	100.0	96.6	94.2	93.4	...	...
Real effective rate (1995 = 100) 7/	89.6	100.0	93.6	89.1	88.9	...	...

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

1/ Projections are staff estimates based on the authorities' current policy indications.
2/ Wages and salaries, plus employers' social security contributions, divided by working hours of employees.
3/ A negative value indicates a level of potential output that is larger than actual GDP.
4/ On a national accounts basis.
5/ Defined as noninterest revenue minus noninterest expenditure.
6/ Projections are based on real effective exchange rate assumptions of the World Economic Outlook.
7/ Based on relative normalized unit labor costs.

Finland: Medium-Term Macroeconomic Scenario, 1998-2004 1/

	1998 Prel.	1999 Proj.	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
	(Percentage change, unless otherwise indicated)						
Output and demand (volumes)							
GDP	5.6	3.6	3.8	3.5	2.7	2.4	2.3
Domestic demand	6.0	4.0	3.7	3.6	2.7	2.4	2.4
Consumption	4.3	3.5	3.3	3.1	2.4	2.1	2.0
Private consumption	5.5	4.2	3.9	3.4	2.3	1.9	1.9
Public consumption	1.4	2.0	2.0	2.4	2.5	2.4	2.4
Gross fixed capital formation	9.0	6.0	5.1	5.3	3.9	3.6	3.6
Private investment	11.0	8.0	6.5	6.3	4.5	4.1	4.0
Public investment	-0.2	-4.5	-1.4	1.5	1.5	1.7	2.0
Export of goods and services	9.6	3.7	6.0	5.6	5.7	5.6	5.5
Import of goods and services	9.4	4.3	6.2	6.4	6.5	6.4	6.4
Foreign contribution to growth (in percent of GDP)	1.0	0.2	0.5	0.3	0.3	0.3	0.2
Prices, costs, and income							
Consumer price index	1.4	1.2	2.3	2.6	2.7	2.6	2.4
Harmonized CPI	1.3	1.3	2.3	2.6	2.7	2.6	2.4
GDP deflator	2.7	1.9	2.2	2.4	2.4	2.3	2.2
Terms of trade	2.5	-1.0	-0.3	0.0	-0.1	-0.1	-0.1
Unit labor cost, manufacturing	0.7	0.1	0.5	2.3	2.2	2.2	1.6
Productivity, manufacturing	4.9	4.1	3.5	3.4	3.4	3.3	3.3
Labor cost, manufacturing 2/	5.7	4.2	4.0	5.8	5.7	5.5	4.9
Unit labor cost, whole economy	2.6	2.1	1.6	3.3	3.2	3.2	2.6
Real disposable income	6.8	4.5	4.8	4.5	3.5	3.1	3.0
Labor market							
Labor force	0.9	0.2	0.1	-0.1	0.0	0.1	0.0
Employment	2.4	1.5	1.3	1.1	0.3	0.1	0.0
Unemployment rate (in percent)	11.4	10.3	9.2	8.2	7.9	7.9	7.9
Potential output and NAIRU							
Output gap (in percent of potential output) 3/	-0.1	0.1	0.4	0.6	0.4	0.2	0.0
Growth in potential output	3.4	3.5	3.5	3.3	2.9	2.6	2.5
NAIRU (in percent)	11.3	10.3	9.5	8.6	8.2	8.1	7.9
	(In percent of GDP)						
National savings and investment							
Gross national saving (percent of GDP)	25.8	25.9	26.3	26.7	26.9	27.2	27.5
Gross domestic investment (percent of GDP)	20.0	20.6	20.9	21.2	21.4	21.6	21.8
Private saving	21.5	20.2	19.6	19.3	19.3	19.5	19.6
Household saving as percent of disposable income	4.7	4.5	4.5	4.5	4.5	4.5	4.5
Private investment	17.1	17.9	18.4	18.7	18.9	19.1	19.3
Private savings surplus	4.4	2.3	1.3	0.6	0.4	0.4	0.3
Government savings surplus	1.5	3.0	4.1	4.9	5.2	5.3	5.4
National savings surplus	5.8	5.3	5.4	5.5	5.6	5.7	5.7

Finland: Medium-Term Macroeconomic Scenario, 1998-2004 (continued) 1/

	1998 Prel.	1999 Proj.	2000 Proj.	2001 Proj.	2002 Proj.	2003 Proj.	2004 Proj.
	(In percent of GDP)						
Public finances							
General government 4/							
Revenues	51.0	50.7	50.5	50.2	50.0	49.7	49.5
Expenditure	49.5	47.7	46.3	45.3	44.8	44.4	44.1
of which: net interest on public debt	2.0	1.5	1.1	0.7	0.2	-0.3	-0.9
Fiscal balance	1.5	3.0	4.1	4.9	5.2	5.3	5.4
Structural balance	1.5	3.0	3.8	4.5	4.9	5.1	5.4
Structural primary balance 5/	3.4	4.4	4.9	5.2	5.1	4.8	4.5
Debt (EMU definition)	48.4	45.8	42.6	38.9	35.6	32.4	29.4
Central government 4/							
Revenues	25.9	25.8	25.7	25.5	25.3	24.9	24.6
Expenditure	27.5	26.0	25.0	24.1	23.5	23.1	22.6
of which: net interest on public debt	4.7	4.1	3.8	3.4	2.9	2.5	2.1
Fiscal balance	-1.6	-0.2	0.6	1.4	1.8	1.9	2.0
Structural balance	-1.5	-0.2	0.5	1.1	1.6	1.8	2.0
Structural primary balance 5/	3.1	3.9	4.2	4.5	4.6	4.3	4.1
Debt	62.2	58.9	54.9	50.4	46.1	42.2	38.4
Balance of payments							
Current account balance 6/	5.8	5.3	5.4	5.5	5.6	5.7	5.7
Trade balance	9.7	8.8	8.9	8.9	8.8	8.8	8.8
Net international investment position	-68.9	-56.1	-49.1	-42.4	-36.3	-30.5	-25.0
Net external debt, excluding FDI and shares	24.0	17.5	11.1	5.0	-0.8	-6.4	-11.9

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

1/ Projections are staff estimates based on the authorities' current policy indications.
2/ Wages and salaries, plus employers' social security contributions, divided by working hours of employees.
3/ A negative value indicates a level of potential output that is larger than actual GDP.
4/ On a national accounts basis.
5/ Defined as noninterest revenue minus noninterest expenditure.
6/ Projections are based on real effective exchange rate assumptions of the World Economic Outlook.

Statement by the IMF Staff Representative
October 8, 1999

1. This statement provides information on economic and policy developments in Finland that has become available since the staff report for the 1999 Article IV consultation (SM/99/215) was issued on August 31, 1999. This information does not change the thrust of the staff appraisal.

2. The main economic developments were as follows:

- Real GDP in the first half of 1999 grew by 3.4 percent over the same period a year earlier, with domestic demand rising by 3.8 percent. Industrial production in the first seven months was 5 percent higher than in 1998 and continued to be driven by the electronics industry, whereas performance in most other sectors remained sluggish. With a favorable external outlook, high consumer confidence, and upward trends in order books and business outlook indicators, staff continues to project GDP growth in 1999 slightly in excess of 3½ percent.

- The unemployment rate in August continued its downward trend to 9.8 percent (s.a.), against 11 percent a year earlier, and average employment during January-August was 3½ percent higher than in the previous year.

- The 12-month rate of consumer price inflation (harmonized) was 1.3 percent in August, slightly exceeding the average of 1.1 percent over the first eight months.

- According to recent announcements by the Central Organization of Finnish Trade Unions, wage negotiations will be conducted on a sectoral rather than an economy-wide level.

- The boom in the real estate market of certain growth centers has continued. To ease the shortage of housing, the government has decided to allow municipalities to raise the tax on vacant sites and has encouraged them to make more use of their options to purchase such land, but is not planning to eliminate the tax deductibility of mortgage interest payments.

3. The 2000 budget proposal, submitted to Parliament in early September, foresees a central government surplus (on a national accounts basis) of some ¾ percent of GDP—essentially in line with the government's earlier projections. The current proposal includes, for the time being, no income tax cuts in 2000, in line with the government's intention to await the outcome of wage negotiations in the fall. On this basis, it translates into a projected general government surplus of some 4¾ percent of GDP.

4. In September, the government has also updated its Stability Program, required for members of the euro area, covering projections for 2000-2003. Incorporating the impact of income tax cuts over the period 2001-2003, the general government surplus is projected to be in

- over -

the range of 4¼ - 4¾ percent of GDP. On the structural front, the program emphasizes the need to enhance the operation of the labor market, including measures to increase the effective retirement age. In this context, it notes that the government has agreed with the social partners on a number of actions, including a reduction in the level of "unemployment pensions" (which are available for unemployed aged 60 and over) and a higher age limit for the individual early retirement pension.

5. The authorities have recently completed a self-evaluation report on fiscal transparency, as foreshadowed at the time of the consultation discussions.

INTERNATIONAL MONETARY FUND
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October 18, 1999

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

IMF Concludes Article IV Consultation with Finland

On October 8, 1999, the Executive Board concluded the Article IV consultation with Finland.[1]

Background

Finland's economy has made a strong recovery from the deep recession that began in the early 1990s. Spurred by a devaluation of the markka, growth was predominantly export-driven, and the external current account shifted from a deficit of over 5 percent in the early 1990s to a surplus of the same magnitude in 1997/98. In this setting, prudent macroeconomic policies brought public finances from a deficit of 7 percent of GDP in 1993 to a surplus in 1998, and reduced the public debt ratio to less than 50 percent of GDP.

Since mid-1998, activity has been underpinned by robust domestic demand. Private consumption has grown firmly, supported by rapid employment growth. Fixed investment decelerated only slightly, with services and construction expanding strongly. After slowing somewhat toward the end of 1998, industrial output growth picked up in the first half of 1999, spurred by the excellent performance of the electronics industry. Wage rates rose moderately by an average of 3½ percent in 1998 and slightly less in the first half of 1999, and the unemployment rate has recently dropped below 10 percent. Twelve-month CPI inflation, after falling to ½ percent at the beginning of the year, is running at 1¼ percent. Despite a weakening of exports during the second half of 1998—with the impact of the emerging market crisis being felt both directly and through weaker EU activity—the current account surplus remained above 5 percent of GDP, with competitiveness currently strong.

[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. In this PIN, the main features of the Board's discussion are described.

Monetary and financial conditions are currently fairly accommodative relative to Finland's advanced cyclical position. By mid-1999, nominal short-term interest rates were some 100 basis points lower than a year earlier, and real rates, deflated by the 12-month CPI inflation, recently touched new lows. Bank lending accelerated sharply over the past year. Finland's real effective exchange rate appreciated somewhat in late 1998, but the weakening of the euro in the first half of 1999 reversed that trend. Real estate prices have continued to rise, with wealth effects supporting consumption and residential investment. Stock prices have risen more sharply, although the related wealth effects may be less pronounced given high foreign ownership.

The 1999 budget extended the process of fiscal consolidation, while providing for some reduction in taxes on labor income. With economic activity strong and tax revenue buoyant, the general government surplus is set to reach some 3 percent of GDP. The improvement in the cyclically-adjusted primary balance is estimated to be on the order of 1 percent of GDP, providing an offset to the relative ease of monetary conditions.

With recent reforms in the labor market and a significant rise in employment over the past few years, the unemployment rate has declined strongly—but it remains high. Recent measures to strengthen incentives in the labor market included some tightening of unemployment benefit eligibility; enhancement of training programs; and improvements in the flexibility of working-time arrangements, especially for small and medium-sized enterprises. A suspension of inflation indexation for unemployment benefits and a reduction in personal income taxes have increased the gap between net labor income and net benefits, but important incentive problems remain. The employment rate, at some 65 percent, is not impressive by international standards, and structural unemployment among the low-skilled and in the northern and eastern regions is very high, despite relatively strong regional mobility.

With world trade projected to accelerate later this year, and the macroeconomic policy stance broadly neutral, solid economic growth should continue. The latest surveys confirm that corporations are now expecting somewhat stronger export growth, after a sluggish performance in the first half of the year, while consumer confidence has remained buoyant. Overall, GDP growth is expected to be in excess of 3½ percent in 1999, and close to 4 percent in 2000.

Executive Board Assessment

Executive Directors commended the authorities for their impressive conduct of macroeconomic policies in recent years, notably their sustained success in restraining public expenditure. These policies had set the stage for Finland's strong economic growth, as well as its entry into the euro area as a founder member. Nevertheless, Directors noted that structural challenges remained in the public finances and the labor market. To raise the growth of output and employment, curb demographic pressures on the public finances, and improve the flexibility of the economy under monetary union, they urged the authorities to deepen structural reforms, particularly in the labor market.

Directors judged the current outlook for growth to be favorable. With the economy operating close to potential, Directors viewed euro area monetary conditions as accommodative in relation to Finland's cyclical position. While they did not see an immediate risk of overheating or threats to Finland's very satisfactory competitive position, Directors welcomed the authorities' plans to maintain their modestly restrictive fiscal policy stance through 1999 and 2000. This would also ensure progress toward the medium- and long-term objectives for the public finances. They commended the steps taken to enhance the operation of automatic fiscal stabilizers, and observed that if overheating does occur, fiscal policy should be tightened.

Directors strongly supported the authorities' plans to press forward with public expenditure restraint over the medium term. They believed, however, that additional savings could be achieved in the area of social spending without compromising core objectives—for example, through improved targeting of transfers to those most in need. This would create further scope for a reduction in the heavy tax burden, particularly on labor income, without undermining fiscal consolidation.

Directors considered that the major medium- and long-term policy challenge lay in the demographic outlook. In this connection, they welcomed the recent agreement on reforms that would reduce incentives for early retirement in order to improve employment and growth prospects as well as buttress the long-run fiscal position. Directors urged the authorities to keep under review the impact of these changes and to develop other reforms in the pension system that would encourage people to stay in the work force longer. They also advised strengthening the link between pension entitlements and lifetime contributions, so as to render contributions more like savings than taxes, and thereby enhance incentives to work.

Welcoming the authorities' emphasis on raising employment over the coming years and the recent labor market improvements, Directors emphasized that unemployment was nevertheless still high. They stressed that additional efforts were needed to improve the flexibility of labor and product markets. Further reforms to the unemployment benefits system—supported by active labor market policies—were viewed as a crucial complement to a lowering of taxes on labor income, so as to improve incentives for work and training. Several Directors considered that the emergence of a shortage of skilled labor in certain sectors also called for additional steps toward labor market flexibility. While noting that the centralized bargaining system had been very useful in bringing about rapid disinflation with moderate economic and social costs, Directors considered that greater wage differentiation across firms, sectors, and regions was called for to address persistently high unemployment rates among low-skilled workers and in certain regions. They urged the authorities to continue improving the functioning of product markets through accelerated privatization, deregulation, and a strengthening of the competitive environment.

Directors noted that these structural reforms in public expenditure, pensions, and the labor and product markets would not only enhance the resilience of the economy, but also foster a virtuous circle of higher output and employment, and greater scope to reduce tax rates. Such a broad-based reform strategy is essential to address the demographic shock effectively. As these measures would take some time to have their full effect, Directors urged prompt action in order to take advantage of the favorable near-term outlook for the economy.

In the financial sector, Directors welcomed the progress made in enhancing the efficiency of the banking system, while stressing that globalization and European integration posed growing challenges to institutions and supervisors alike. In light of the booming real estate market in certain growth centers, they advised the authorities to continue monitoring closely the effect of credit growth on the financial sector, and to explore ways to improve the functioning of the real estate market.

Directors noted that Finland's provision of high-quality data on a timely basis facilitated the conduct of effective surveillance.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.

Finland: Selected Economic Indicators

	1996	1997	1998	1999 1/
Real economy (change in percent)				
GDP	4.1	5.6	5.6	3.6
Domestic Demand	2.5	5.3	6.0	4.0
Harmonized CPI	1.1	1.2	1.3	1.3
Unemployment rate (in percent) 2/	14.6	12.6	11.4	10.3
Gross national saving (in percent of GDP)	21.2	24.3	25.8	25.9
Gross domestic investment (in percent of GDP)	17.2	18.7	20.0	20.6
Public finances (general government, in percent of GDP)				
Overall balance	-3.0	-1.6	1.5	3.0
Primary balance	-1.4	0.3	3.4	4.5
Gross debt (EMU-definition)	56.5	53.9	48.4	45.8
Money and credit (end of year, percentage change)				
M3 3/	-1.3	8.8	2.4	3.2
Total domestic credit	-2.7	-3.2	9.7	...
Interest rates (year average) 4/				
Three-month money market	3.6	3.2	3.6	2.8
Ten-year government bonds	7.1	6.0	4.8	4.4
Balance of payments (in percent of GDP)				
Trade balance	8.9	9.5	9.7	8.8
Current account	4.1	5.6	5.8	5.3
Fund position (as of end-September 1999)				
Holding of currency (in percent of quota)		62.6		
Holdings of SDRs (in percent of allocation)		79.1		
Quota (in millions of SDRs)		1,264		
Exchange rate				
Exchange rate regime		EMU Member		
Present rate (October 8, 1999) 5/		US$ 1.07 per euro		
Nominal effective exchange rate (increase in percent 6/	-2.9	-2.5	0.0	-0.6
Real effective exchange rate (increase in percent) 7/	-6.4	-4.8	-0.5	-0.2

Sources: Data provided by the Finnish authorities, *International Financial Statistics*; and IMF staff estimates.

1/ IMF staff projections.
2/ Consistent with Eurostat methodology.
3/ For 1999, 12-month increase to July.
4/ For 1999, average through August.
5/ The conversion rate of the Finnish markka is 5.94573 per euro.
6/ For 1999, average 12-month increase through July.
7/ Based on relative normalized unit labor cost. For 1999, average 12-month increase through August.

Statement by Olli-Pekka Lehmussaari, Alternate Executive Director for Finland
October 8, 1999

My Finnish authorities wish to express their sincere appreciation for the fruitful exchange of views they had with Mr. Watson and his team during the mission's visit to Finland and for the team's candid assessment of the Finnish economy. My authorities agree with the staff's assessment of the main challenges of economic policies in Finland. The following comments are only intended to underline some issues, where my authorities wish to point out some nuances of the discussions.

The Fund mission's preliminary findings from June 7, 1999 were, for the first time, released to the public. They were very well received in the domestic news media, where the message clearly came through that structural reforms were an essential complement to further fiscal consolidation, to maintain sustainable economic growth in the longer term. Finland participates in the IMF's pilot project for the voluntary release of Article IV staff reports.

Economic performance

Finland joined the EMU with 10 other countries at the beginning of 1999 well aware of the challenges the new monetary framework would entail. Membership in the EMU will, as also pointed out in the staff's observations, require continued improvements in the flexibility of the economy, together with a strong resolve among policy makers and social partners. In this new environment, more weight is put on fiscal and structural policies, and also responsible wage setting, for maintaining the economy on a sustainable growth and employment path.

Given the somewhat asynchronized cyclical conditions of Finland with the rest of the euro area, a discussion of the looming risks of overheating in the economy has already been going on for some time. However, despite the robust growth in recent years no significant imbalances have yet emerged in the Finnish economy. Moreover, the evolution of domestic costs has remained in line with the rest of the euro area. The high unemployment originating from the recession period has declined markedly. These favorable developments can be attributed to appropriate and successful economic policies. Adaptations and shifts in the production structure and the strong performance of the electronics industry in particular have also contributed to the good performance.

Near-term economic prospects

Growth is expected to continue strong at near 4 percent in both 1999 and 2000. The most recent figures are for the second quarter of 1999, when GDP grew 3.4 percent compared to the same period a year ago. The preconditions for growth remain favorable, although the period of fastest growth now appears to be over. The growth rate is expected to decelerate from the average of 5 percent between 1994-1999 to around 3 percent between 2000-2003, which corresponds to the estimated growth potential.

The risks appear to be on the upside, i.e., weighted more towards stronger-than-forecast rather than weaker-than-forecast growth. There does not appear to be any immediate danger of a general overheating in the economy, and inflationary pressures continue to be absent. However, some sectoral and regional pressures have emerged. Sectoral pressures are evident in the construction and electronics sectors, where the availability of skilled labor has weakened markedly. In addition, regional pressures have emerged in 4–5 growth centers, and, as a result, housing prices, especially in the Helsinki region, have risen relatively rapidly.

The government aims to increase the employment rate from the current 65 percent towards 70 percent, the target laid down in the EU's employment guidelines. Employment is currently growing rapidly while young people of age 15–24 are coming to the labor market in large numbers. Thus, the unemployment rate is likely to decline only gradually, in particular as it is to some extent of a structural nature. The current wage agreement expires at the end of next January. This agreement is the second centralized agreement in a row. The government has expressed its preference for a new centralized agreement and has declared itself ready to cut income taxation within the limits set by the Government Program in order to facilitate a moderate wage agreement.

It is likely that there will not be a centralized agreement this time, after a number of unions expressed their views in favor of wage negotiations at the union (sectoral) level. The Central Labor Organization will not strive for a centralized solution. As a result, some media commentators have expressed a disappointment with the turn of events by stating that the labor unions clearly fail to see that membership in the euro area has created new responsibilities for the unions. Other remarks are more neutral because the form of wage negotiations does not need to be decisive in reaching moderate wage agreements.

Inflation in Finland has remained modest, with a 12 month change in the HICP (harmonized) by 1.3 percent in August. However, there has been a slight upward trend in prices from the beginning of the year, and a moderate acceleration in inflation cannot be ruled out in the second half of the year.

The stock of bank lending is growing strongly. The rate of increase in the total lending stock accelerated to over 13 percent in August, fuelled by demand for housing and business loans. The continuing decline in lending rates contributed to the strong demand for loans in the first half of the year. Currently, the average interest rate on new loans is roughly 4%. Although the strong growth of credit is partly explained by the recovery from the severe recession in the early 1990s, it could give cause for concern if it continues.

Public finances

The Stability and Growth Pact, together with Maastricht Treaty, sets binding standards for fiscal policies. Currently Finland meets these criteria easily. Finland's medium term fiscal targets are more ambitious than those of the EU's Stability and Growth Pact. The central government aims at a structural surplus which, together with roughly balanced local government finances and a clear surplus in the social security funds, indicates a surplus in general government finances at around 4-5 percent in relation to GDP during 2000-2003. The general government debt ratio continues to decrease rapidly. While at its highest in 1994, debt to GDP ratio was almost 60 percent; the estimate for the end of year 2000 is 43 percent.

The government is committed to reduce the income tax and social security contributions by 1.5 percent of GDP over the election period. This reduction will partly be compensated by higher energy, capital and corporate taxation. Should the budgetary developments in the government balance prove weaker than estimated in the stability program, the government has committed itself to take necessary consolidation measures.

To establish a structural surplus in the central government finances the government has set medium term expenditure ceilings for each ministry, which aim to keep total expenditure roughly constant in real terms. The budget proposal for year 2000 was given to parliament in September. In this proposal, real expenditure of the central government only marginally exceeds 1999 level, and the targeted structural surplus in central government finances will be achieved, while the central government debt will decline correspondingly. It is the first time since 1990 that central government finances are predicted to show a surplus. This surplus is estimated to be 0.7 percent of GDP in 2000 (national accounts basis).

The fiscal impulse is estimated to be slightly restrictive next year, but not as much as it has been this year. Moreover, the fiscal policy stance in Finland continues to be more restrictive than on average in the euro area. Given the somewhat different cyclical phase, this is important for balanced and sustainable economic growth in Finland.

Structural challenges

In the Government Program and budget proposal, special emphasis is given to structural policies. Reducing payroll taxation is clearly targeted, but its implementation is conditional on moderate wage agreements. The large tax wedge has been identified as one of the obstacles to a well-functioning labor market. The staff report rightly focuses on the negative incentives of unemployment and other social security benefits and suggests further cuts and reductions in the benefits and their duration. The interplay of benefits and high, progressive labor taxation has clearly contributed to high unemployment. Some steps have been taken to solve this problem, both through taxation and through social benefits. A very clear guiding principle is that taking a job must always pay more than being unemployed, and the benefit systems are being developed toward this end.

Internal migration reveals regional imbalances and adds in the short run to pressures on the housing and the municipal infrastructure in the main growth centers, even if migration is much needed to balance the labor market in a somewhat longer perspective. Some disincentives still exist in the labor market, affecting labor supply and also labor demand, and these problems need to be alleviated. The functioning of the product markets should also be further enhanced, with the aim to improve conditions for small enterprises and self-employment.

In the long perspective, the aging of the population is a major challenge for the Finnish economy. The staff report deals at length with the aging population problem and the incentives of the pension system, and rightly so. The points raised in the staff report have all, at least partly, been dealt with in the Government Program. Part of this problem is connected to early retirement. Currently the effective retirement age is 59 years on average, compared to the statutory retirement age of 65 years. Average life expectancy has been growing and is expected to grow further, which implies that the proportion of active population in relation to the total population will decrease.

At the moment, only 45 percent of those aged between 55-64 are at work. The government aims to rise the effective retirement age by 2-3 years in the somewhat longer term and to increase the employment rate towards 70 percent in medium term. In the future, labor market policies should focus more on improving the employability of older unemployed persons. Until now, those already on the "unemployment-to-retirement path" in the age group 55-59 have in practice been considered outside the labor markets.

Since the beginning of the 1990s, several reforms have been introduced in Finland in order to reduce pension expenditure growth. It has been estimated that these reforms will decrease pension expenditure as a share of GDP by 2½ percentage points in the long run.

The representatives of labor market organizations and pension institutions reached an agreement in July, 1999 on additional measures to postpone retirement and to promote the continued active participation in working life. The unemployment pension will be made less attractive for both employers and employees. Also the funding rules regarding disability pensions will be changed to avoid the shedding of aging workers. These changes are designed to come into force at the beginning of 2000.

Over time, changes should also be made in the design of earnings-related pensions so that these are clearly perceived as a form of saving rather than a tax. This implies moving progressively in the direction of defined contributions away from currently prevalent defined benefits schemes. These changes, by tightening the link between individual contributions and benefits and making pension entitlements more transparent, should improve the incentives to work, as the staff report states.