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Finland: 2005 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for Finland

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2005 Article IV consultation with Finland, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on October 25, 2005, with the officials of Finland on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 30, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January 30, 2006 discussion of the staff report that concluded the Article IV consultation.

- statement by the Executive Director for Finland.

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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FINLAND

Staff Report for the 2005 Article IV Consultation

Prepared by Staff Representatives for the 2005 Consultation with Finland

Approved by Poul Thomsen and Adnan Mazarei

December 30, 2005

- A staff team comprising Messrs. Thakur (Head), Lutz, and Miyajima (EP, all EUR), visited Helsinki during October 18–25, and met Mr. Liikanen, Governor of the Bank of Finland, Mr. Hetemäki, Permanent Under Secretary of State at the Ministry of Finance, other senior officials of the economic ministries and the Financial Supervisory Authorities. Mr. Saarenheimo, the newly elected Executive Director for the Nordic-Baltic region, and Ms. Kivinen, Advisor in the Nordic-Baltic Executive Director's Office, participated in the discussions.

- The mission consulted with many members of the Finnish policy community. Meetings were held with the Finance Committee of the Parliament, representatives of the Finnish Trade Unions (SAK), the Confederation of Industries (EK), the Association of Local Authorities (Kuntalitto), and members of the business, academic and private financial communities. The mission's Concluding Statement and press conference received coverage in the Finnish media. The authorities intend to publish this staff report.

- Finland will be assuming the rotating presidency of the European Union in the second half of 2006.

- The three-party coalition government, led by Prime Minister Matti Vanhanen, faces general elections in Spring 2007.

- Finland has accepted the obligations of Article VIII, Sections 2, 3, and 4, and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, and subscribes to the Special Data Dissemination Standard. A Data ROSC was concluded in October 2005.

- In light of favorable economic conditions and broadly unchanged policy requirements prevailing in Finland, this report is kept brief, focusing on key issues. The staff team size and mission length were accordingly also reduced.

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I. Economic Background and The Policy Setting

1. **Finnish economic performance continues to be remarkable on several counts.** Growth is outpacing the euro area average despite the temporary setback of a production shutdown in the key paper industry, inflation remains low, employment has started to pick up, and the fiscal surplus remains among the largest in the European Union (EU). Growth has been underpinned in recent years by productivity gains in the electronics sector led by Nokia, Finland's flagship technology company. The longer-term outlook, however, is clouded by imminent aging of the population, with old-age dependency set to rise most rapidly in the EU.

2. **The authorities and the staff generally agree on the broad agenda of reforms needed to face the demographic shock and globalization.** The Fund's assessment that large fiscal surpluses are needed over the coming decade to ensure sustainability is shared by the authorities.[1] The recently initiated pension reforms are consistent with the thrust of past Fund advice. The multi-year program of tax cuts aimed at promoting employment is supported by the staff although, without the recommended offsetting restraint on public spending, it has led to declining structural fiscal surpluses. A widening of the compressed wage structure and a shift to a more decentralized wage-setting system are desirable, but the authorities see these as goals that can only be achieved gradually, given the tradition of solidaristic wage bargaining.

3. **Following buoyant growth in 2004, a lengthy shutdown in the paper industry dealt a major but temporary setback to growth in 2005.** Although its role is gradually declining, the sector remains a mainstay of the Finnish economy, accounting for 20 percent of merchandise exports. The seven–week disruption in the second quarter, stemming from a labor dispute, cut annual GDP growth by almost 1 percentage point in 2005. The resolution of the dispute, however, is expected to lead to an offsetting rebound in activity in 2006 (Figure 1).

GDP and Demand
(percent change)

	2003	2004	2005 est.	2006 proj.
Real GDP	2.4	3.6	1.9	3.5
Domestic demand	2.4	3.6	1.0	2.8
Consumption	3.5	2.8	2.9	2.3
Private	4.4	3.2	3.4	2.7
Gross fixed capital formation	-1.5	5.0	0.3	2.5
Residental investment	8.9	7.4	2.7	3.4
Net exports 1/	-0.4	0.4	0.9	1.0

Sources: Statistics Finland; and staff projections.
1/ Contribution to growth.

[1] The staff's extensive assessment of fiscal sustainability during the last consultation (IMF Country Report No. 05/36, February 2005) underscored that the pace and magnitude of the demographic transition in Finland and the implied earlier expected rise in age-related spending than elsewhere call for ambitious fiscal surpluses.

4. **After three years of stagnation, employment picked up and unemployment fell.** The gains in employment since late 2004 are driven by public and private services (health, construction, and especially part-time retail trade), and aided by the moderate multi-year collective wage accord through September 2007, covering around 90 percent of the labor force. The unemployment rate, stuck at 9 percent since 2000, has begun to edge down slowly toward the estimated NAIRU of 8 percent (Figure 2). However, vacancies have risen markedly of late, suggesting continued skill mismatching. The authorities' goal of raising the employment rate from the present 68 percent to 70 percent by the end of the current electoral cycle in 2007 remains elusive.

Inflation, Labor Market and Output Gap Indicators
(percent change)

	2003	2004	2005	2006
			est.	proj.
Harmonized CPI	1.3	0.1	0.9	1.5
GDP deflator	-0.3	0.5	0.3	1.3
Employment	-0.3	0.0	1.3	0.6
Unemployment rate 1/	9.0	8.8	8.3	7.9
Labor compensation 2/	3.4	4.5	3.5	3.5
Unit labor costs 2/	0.6	0.8	2.9	0.6
Output gap 3/	-0.6	0.0	-0.9	-0.2

Sources: Statistics Finland; and staff projections.
1/ Percent of labor force.
2/ Economy-wide.
3/ In percent of potential ouput.

5. **Productivity gains and wage moderation have kept inflation unusually subdued, despite the rise in energy prices.**[2] HICP inflation fell to 0.1 percent in 2004—the lowest in the euro area—reflecting reduced excise taxation, low non-energy import prices, and rising competition in services such as retailing and telecoms. Inflation has gradually picked up during 2005, in part due to the higher oil prices, but is estimated to reach only about 1 percent for the year as a whole.

6. **The extended period of low interest rates has boosted credit growth, especially that for housing.** Mortgage lending has grown by more than 15 percent in 2005, and now exceeds 40 percent of bank lending (Table 4). In addition to low interest rates, intensified competition lowering lending margins, strong disposable income growth and buoyant income expectations have underpinned household borrowing. The debt-income ratio has risen to levels last seen in the early 1990s. However, much lower interest rates have kept debt servicing burdens significantly lower than in the earlier period. House prices have risen moderately, by about 6-7 percent annually over the past three years.

7. **The central government finances have moved into a deficit of about ½ percent of GDP in 2005.** The general government surplus is more than accounted for by the surplus of the social security funds, with both the central and local governments now in deficit. The dwindling of the surplus from over 5 percent of GDP in 2001 is largely the consequence of a sharp discretionary policy shift in recent years (Figure 3).

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[2] The productivity gains are especially high in a few sectors such as the Nokia-centered technology cluster. The low spillover effects to the rest of the economy are at least in part a reflection of the relative inflexibility of Finland's labor and product markets (see Box 1, IMF Country Report No. 05/35, February 2005).

8. **The budget for 2006 continues the authorities' recent efforts to alleviate the high tax burden.** The cuts in income taxation (of almost ½ percent of GDP) and increased employment subsidies are aimed especially at workers at the lower end of the income scale. In recent years, personal income taxes have been reduced, a number of excises have been cut sizably in response to EU tax harmonization, and the corporate income tax was reduced by two percentage points to 26 percent in 2005. Taxes on labor are to be reduced further in 2007 as part of the wage accord.

General Government Overall Balances
(percent of GDP)

	2003	2004	2005 est.	2006 proj.
Central and local governments	-0.2	-0.4	-1.0	-0.9
Social security	2.5	2.3	2.8	2.6
General government	2.3	1.9	1.8	1.8
General government (structural)	2.6	1.9	2.2	1.8

Sources: Statistics Finland; Ministry of Finance; and staff projections.

II. Short-Term Prospects

9. **Economic growth is projected to rebound strongly in 2006.** Exports are expected to lead the recovery, aided by a bounce-back in exports of paper as the industry shakes off the effects of the shutdown, and by improved prospects for the global technology sector. Private consumption will continue to sustain demand, stimulated by tax cuts, employment gains, low interest rates and robust confidence. The recent slight tightening of monetary conditions is not expected to hamper the recovery (Figure 4). Staff's forecast is for GDP to grow by 3½ percent in 2006 and around 2¾ percent in 2007.

10. **Inflation is projected to rise in 2006–07 toward but remain below the euro area average.** As the impact of higher energy prices is transmitted through the economy and output begins to exceed potential toward the latter half of 2006, inflation is likely to rise from recent exceptionally low levels. Solid productivity gains are expected to keep unit labor costs in check. A further fall in the terms of trade, in line with a secular decline in the prices of Finland's exports (notably paper and cellphones) is likely.

11. **The risks to the forecast for growth are tilted to the downside.** Prolonged high energy prices could dampen confidence at home and growth in export markets. Weaker growth in the euro area than currently projected would be a drag on exports, although Russia's re-emergence as a major export market, and the important role of Sweden, the United Kingdom and China as trading partners, will serve to cushion any adverse impact. While Finland's external competitive position remains comfortable, a sharp appreciation of the euro could pose risks to growth. The main domestic uncertainty stems from the tentativeness of the recovery in employment.

III. The Policy Discussions

12. **Against the backdrop of the favorable near-term outlook, the discussions focused on policies in three main areas that would help ensure fiscal sustainability and promote long-term growth.**

- **Reforms of public and social services:** How to raise efficiency in the provision of public services, provided largely at the local government level, in the face of rising demand as rapid aging sets in;

- **Policies to improve the functioning of the labor market:** How to boost employment among younger and older workers, reduce labor market mismatches, and raise the demand for low-skilled labor;

- **Broadening productivity gains:** How to raise the diffusion of productivity gains, especially in sheltered sectors (utilities, transport and retail services, and agriculture), including through improved training and strengthened competition.

A. Fiscal Policy and Reform of Public Services

13. **The near-term task for policy is to restore balance in the finances of the central and local governments.** Officials acknowledged that the objective of balancing central government finances by 2007 was not expected to be achieved. Indeed, the latest Stability Program projections (November 2005) envisage a deficit of ½ percent of GDP persisting into 2009. The new system of expenditure ceilings, in place since 2004, has worked well so far, but would come under strain in 2007. In the authorities' view, the moderate stimulus implied in the budget for 2006 (by 0.4 percent of GDP) was considered acceptable, since it stemmed from the tax cuts that were deemed desirable from a structural standpoint. The staff, however, noted that the stimulus was not needed, especially in the light of the easy monetary conditions. Moreover, the sobering fiscal outlook underlined the need for further expenditure restraint.

14. **As demographic pressures on the demand for public services escalate, how to raise efficiency in their provision has emerged as a major challenge.** Despite recent efforts, the tax burden remains well above the average in the advanced economies, and with an imminent dwindling of labor supply, officials noted that economic growth and the revenue base for public services would rely increasingly on productivity gains. Even allowing for the difficulties in measuring productivity in public services, there was evidence of declining productivity in the provision of education and social services since the late 1990s (Figure 5). In addition to the reforms in the structure of municipalities currently under debate, the authorities are also pursuing plans to raise productivity in

central government services, intending to replace only one of every two expected retirees through 2011.[3]

15. **The task of restructuring municipalities and the scope and financing of their services are beset with political and social sensitivities.** Reflecting historical reasons and an emphasis on local autonomy and regional equity, Finland has a large number (432) of small municipalities, with an average size of about 11,000 people, much smaller than in Denmark and Sweden. A commission, set up to determine responsibilities for service provision and its financing over at least the next decade, is expected to submit its recommendations by May 2006, with legislative changes to take effect from January 2007. The options being debated include mergers of smaller municipalities and creation of 20 to 25 new regional entities to whom taxes and transfers would accrue, with services provided by existing municipalities on contractual bases. The mission, while welcoming these initiatives as essential, pointed to the need to also consider rebalancing the public and private provision and financing of social services. Consolidation of activities may be useful in some localities to capture scale economies, while public-private partnerships may induce increased efficiency in more urban areas. User charges, levied for some services, should be reassessed, and could also be considered for less essential services. Concurrent efforts to reform municipal structures in Denmark may hold useful lessons for Finland.

16. **A reform of the fiscal framework governing municipal finances is essential to changing incentives.** The rapid rise in municipal employment in recent years, if continued, could seriously undermine the fiscal strategy—as well as prospects for growth (see para 20)—since rising transfers would put a heavy strain on central government expenditure ceilings and/or force municipalities to raise income tax rates, frustrating the authorities' efforts to reduce taxation. Limited reforms to municipal finances, including abolition of the automatic adjustment of state grants when local spending exceeds plans, will come into effect at the beginning of 2006. A more far-reaching change such as a shift from relatively cyclical tax bases to property taxes, while desirable from an economic standpoint, was seen as politically infeasible in the near term.

17. **Looking ahead, the fiscal room for maneuver will be increasingly constrained by the timing and magnitude of the aging shock.** Despite starting from a net asset position, with aging occurring a decade earlier than most other European countries and its stronger fiscal impact due to the relatively comprehensive character of public welfare provision in Finland, substantial adjustment would be needed to assure fiscal sustainability,

[3] A Bank of Finland study (Kinnunen, Helvi, "Expenditure Pressures on Public Finances: How Much Can We Afford?" Bank of Finland Bulletin, 2004:3) suggests that even modest productivity growth in aging-related public services (especially health) would make a significant contribution to fiscal sustainability.

as acknowledged by the authorities in their latest *Stability Program*.[4] With this in view, a significant reform of the public pension system was initiated in early 2005. Key elements, to be phased in over an extended period, include the replacement of the standard retirement age of 65 with a flexible retirement age ranging from 63 to 68, and an increased accrual rate for older workers. The goal is to raise substantially the current effective retirement age of about 59. Officials noted that tentative, early evidence suggests that older workers may be staying in the labor force longer. Nevertheless, there was agreement that mutually reinforcing labor and product market reforms would reduce substantially the need for fiscal adjustment.[5]

B. The Labor Market and Bargaining Framework

18. **The recent accord ensures wage moderation, but represents only modest progress towards more flexible wage-setting.** The accord is expected to maintain competitiveness. However, the centralized bargaining model, by solidifying wage rigidities that are unfavorable to the young and unskilled workers, hinders employment growth in the less productive sheltered sectors (Figure 6). The authorities concurred with the mission that the wage-setting mechanism needed to evolve to accommodate greater productivity differentials. In response to this concern, the 2006 budget includes a temporary wage subsidy targeted towards low-paid older workers, designed to reestablish work patterns that would, with on-the-job gains in productivity, result in continued employment after the subsidy expires. Moreover, officials conceded that in the coming years, the limited fiscal room will make it increasingly difficult to "buy" wage moderation through tax cuts, as has been the case in recent years.

19. **While the recent pick-up in employment is encouraging, increasing signs of labor market mismatches are a cause for concern**. Vacancies have increased sharply, notwithstanding continued high unemployment, reflecting skill and geographic mismatches. Active labor market policies are attempting to address retraining needs of older workers, and the authorities are trying to make available more land for residential development to ease housing shortages in urban centers. Officials noted that continued

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[4] With estimated general government net financial assets of about 70 percent of GDP at end-2005, sustainability over the medium term is not in question.

[5] Staff analysis suggests that additional measures to permanently raise the general government surplus by some two percentage points of GDP would be needed to ensure sustainability. However, as also underlined by similar recent work by Finnish officials, raising labor and product market efficiency could boost growth prospects and significantly reduce the degree of required fiscal adjustment (Box 2, IMF Country Report No. 05/35, February 2005, and Kilponen and Ripatti, "Labor and Product Market Reforms in General Equilibrium—Simulation Results Using a DGE Model of the Finnish Economy", preliminary draft manuscript, May 2005).

mismatches pose a risk of emerging upward wage pressures in some sectors (e.g., construction) in coming years.

20. **Over the longer run, demographics could dampen growth prospects, especially if public sector employment continues to grow rapidly.** Finland's working-age population is anticipated to begin declining at the end of the decade. In addition, municipal authorities are not immune to population aging, with an expected sharp uptick in retirements. Officials noted that simply replacing retiring municipal workers would imply clear risks of upward wage pressures, and attendant adverse implications for private sector growth.[6] In response to these trends, the authorities, as a part of the pension reforms, extended by two years (to 57) the age at which the long-term unemployed can enter the "unemployment pipeline" to early retirement. In addition, the unemployment pension (available at an earlier-than-standard age) is to be phased out in 2009.

C. Long-Term Prospects for Growth

21. **The discussions also explored the outlook for long-term growth in light of the demographic transition, an issue facing most advanced economies, but with an imminence and special resonance for Finland.** Growth in living standards will increasingly depend on the extent to which the productivity performance of the information technology and financial services sectors could be replicated throughout the economy. In addition, investment in equipment and machinery, generally a vehicle for introducing new technologies, has been lagging. Moreover, officials noted that recent research confirmed the suspicion that an older society is likely to face ageing related stagnation in human capital productivity, especially with rapidly transforming technologies.[7] Were recent trends in hours worked and labor productivity to persist, under a pessimistic scenario, annual GDP growth could well fall to barely 1 percent in the second half of the decade. The serious implications of this possibility for the viability of the welfare state were yet to be grasped by the general public.

22. **The absence of more widespread productivity gains despite many favorable preconditions remained somewhat puzzling.** Causes for the low investment rates were not well understood. Indicators such as research and development, levels of skill, cost of capital, and external competitiveness were roughly on par with those in Sweden and the United States (Figure 7). Although Finnish financial markets were generally less deep and sophisticated, especially regarding availability of later-stage venture capital, officials did

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[6] OECD staff recently estimated that with unchanged productivity, replacing retiring municipal workers would by itself more than double the share of new labor market entrants pre-empted by municipalities from 20 to over 40 percent.

[7] Daveri, Francesco, and Mika Maliranta "Aging, Technology and Productivity," preliminary draft manuscript, September 2005.

not think that legal or regulatory impediments could account for Finland's productivity lag. Some believed that cultural factors, such as the social stigma attached to bankruptcy, may explain the relatively weak entrepreneurial climate.

23. **It was clear, however, that continued emphasis on labor and product market liberalization was the appropriate policy response.** Some recent progress was evident in the telecoms and retail sectors. Nevertheless, a faster pace of deregulation would promote a smoother reallocation of resources and assist in the introduction of new products and adoption of new technologies. Officials noted their efforts to encourage partnerships between business and academia, including greater emphasis on life-long learning and retraining to improve labor market matching.

D. Financial Sector Issues

24. **Monetary conditions were excessively easy from a Finnish perspective, posing potential financial sector and macroeconomic risks.** The financial supervisory authorities expressed some concern that the robust growth in disposable incomes, boosted also by tax cuts, was unlikely to persist. As a result, some, especially younger, households may be basing their borrowing decisions on overly optimistic expectations of income growth. Moreover, this trend may be abetted by increased competition among lenders, reflected in lowered lending margins, especially for mortgages, which were characterized as something of "loss leaders," attempting to capture customers for other banking services. Supervisors expressed concerns that lengthening mortgage maturities posed a threat to banks by locking in low profit margins for an extended period. As a result, supervisors had recently sounded a public note of caution about growing risks to the banking system.

25. **Changes in domestic financial market structure and growing international financial integration were also expected to pose additional supervisory challenges.** The authorities noted that current indicators suggested that financial institutions on average were in a strong position. Stress tests recently conducted by the central bank implied that a supply shock such as a further rise in oil prices would increase loan loss reserves and weaken, but not eliminate bank profits. Nevertheless, the authorities and staff concurred on the need for vigilant banking supervision in light of emerging risks from rapid credit growth.[8] The recent acquisition of a domestic insurance company by a bank also pointed to the need for close cooperation between the respective supervisors.

IV. Staff Appraisal

26. **Finland's recent economic performance and near-term outlook are favorable, but difficult challenges remain over the longer run.** Solid growth, sizeable fiscal surpluses and a skilled labor force provide a strong platform to prepare for the demographic

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[8] The exposure of Finland's financial parent institutions to risks from rapidly growing balance sheets in their Baltic offspring remains minimal at present.

transition ahead. The authorities have taken some welcome steps in this direction, such as the recent initiation of pension reform. However, further steps to put the public finances on a sustainable footing and enhance growth prospects are required.

27. **Although the current state of the public finances is satisfactory, recent trends are of concern.** The focus on raising employment has come at the cost of a worsening fiscal position. Cuts in personal income taxes, targeted especially toward lower income brackets, are desirable and welcome. However, without commensurate expenditure restraint, these cuts have already shifted the central government finances into deficit, and entail risks to public finances in the longer run. Further steps to restrain spending are required to respect the medium-term spending rule and meet the authorities' goal of a central government balance.

28. **Raising the efficiency of public services is key to meeting the coming demographic challenge.** The efficiency of local governments, which provide the bulk of the aging-related services, has declined significantly in recent years. In this context, the authorities' efforts to reorganize responsibilities for the provision and financing of public services are timely and welcome. However, the difficulties in capturing efficiency gains should not be underestimated, and will call for resolve among all social partners. Greater use of benchmarking municipal services, including publishing the results, may spur local authorities to adopt best practices.

29. **Efforts to raise efficiency will need to be complemented by measures to limit the burgeoning demand for public services.** Mechanisms that would bring demand in line with the costs of providing less essential services, including through a shift to private providers, also deserve consideration. User charges should be reviewed to reflect changing costs. Given the long gestation periods needed for implementing such reforms, an early start would be highly desirable.

30. **While these steps will go far in strengthening the fiscal position, ensuring sustainability will require further measures, including revisiting pension system parameters.** The substantial pension reforms in train go some way toward alleviating fiscal pressures by encouraging longer working lives and limiting the growth in pension outlays. However, these steps are insufficient to assure fiscal sustainability. Therefore, it will be important to assess the ongoing impact of recent measures on sustainability, and be prepared to undertake additional revisions to the pension regime. Moreover, efforts should be made to limit early exits from the labor force, including accelerating the phasing-out of unemployment pensions.

31. **The wage bargaining system needs to allow for greater flexibility in wage-setting across the economy.** The latest accord has locked in moderate wage increases over an extended period, promising a continued favorable competitive position, but, at the costs of tax concessions which may not be available in the future. Moreover, while partially stemming the process of growing compression of the wage structure, it failed to allow for a fuller reflection of productivity differentials. The "solidaristic" bargaining model also risks

leaving a substantial portion of the workforce outside the system, hindering the economy's ability to address the demographic challenge by preventing the fullest use of labor resources.

32. **Measures are also called for to ease growing labor market mismatches and reduce structural unemployment.** The authorities' efforts to "price in" labor through subsidies for lower-skilled older workers are welcome if they are well targeted. Temporary active labor market programs can help promote employment opportunities for underutilized segments of the labor force. In addition, other supporting structural measures would be essential to achieve the authorities' ambitious employment goals.

33. **Finland's high ranking in competitiveness may mask shortcomings in institutions and attitudes.** Despite a skilled labor force, the paucity of investment and lack of strong economy-wide productivity gains raise questions about long-term growth prospects. Despite some recent progress in telecoms and retail trade, Finland would benefit from enhanced competition, as suggested by its high price level. As aging reduces effective labor supply, it would be all the more important to remove impediments to realizing a fuller return on the nation's human capital wealth.

34. **The financial system is sound and well–supervised, as shown by the FSAP and recent indicators, but faces some challenges.** Heightened competition for market shares has increased the risk that credit standards could suffer, especially for housing loans. The current low lending margins may also constrain future profitability. Growing financial integration in the Nordic-Baltic region also underscores the need for closer cooperation between national supervisory authorities.

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

Table 1. Finland: Main Economic Indicators, 2002-2009 1/

	2002	2003	2004	Est. 2005		Proj. 2006	2007	2008	2009
	(Percentage change, unless otherwise indicated)								
Output and demand (volumes)									
GDP	2.2	2.4	3.6	1.9		3.5	2.7	2.5	2.4
Domestic demand	1.5	2.4	3.6	1.0		2.8	2.3	2.2	2.2
Consumption	2.3	3.5	2.8	2.9		2.3	2.2	2.1	2.1
Private consumption	1.5	4.4	3.2	3.4		2.7	2.6	2.4	2.4
Public consumption	4.3	1.5	1.6	1.7		1.2	1.2	1.3	1.3
Gross fixed capital formation	-3.1	-1.5	5.0	0.3		2.5	2.5	2.6	2.5
Private investment	-4.6	-3.0	5.6	0.9		2.9	2.7	2.6	2.5
Public investment	6.6	6.7	2.1	-2.7		0.4	1.4	2.5	2.5
Export of goods and services	5.0	1.4	5.6	7.7		6.1	5.6	5.0	3.6
Import of goods and services	1.8	2.9	6.0	7.2		5.0	5.3	5.0	3.5
Foreign contribution to growth (in percent of GDP)	1.5	-0.4	0.4	0.9		1.0	0.7	0.5	0.4
Prices, costs, and income									
Consumer price inflation (harmonized)	2.0	1.3	0.1	0.9		1.5	1.6	1.6	1.6
Core inflation (excluding energy and seasonal food)	1.9	1.2	0.0	0.9		1.5	1.5	1.5	1.5
GDP deflator	1.0	-0.3	0.5	0.3		1.3	0.7	1.3	1.4
Terms of trade	-0.9	-3.0	-3.0	-3.5		-0.3	-0.9	-0.9	-0.9
Unit labor cost, manufacturing	0.3	-0.4	-0.1	1.9		-0.4	0.2	0.3	0.1
Labor market									
Labor force	0.2	-0.3	-0.2	0.7		0.2	0.1	0.1	0.0
Employment	0.2	-0.3	0.0	1.3		0.6	0.4	0.3	0.0
Unemployment rate (in percent)	9.1	9.0	8.8	8.3		7.9	7.6	7.5	7.5
Potential output and NAIRU									
Output gap (in percent of potential output) 2/	-0.2	-0.6	0.0	-0.9		-0.2	0.0	0.0	0.0
Growth in potential output	2.9	2.9	3.0	2.8		2.7	2.6	2.5	2.4
NAIRU (in percent)	9.6	9.0	8.6	7.9		7.7	7.5	7.5	7.5
	(In percent)								
Money and interest rates									
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	6.6	11.0	6.3	9.4	3/	...	...	...	...
Domestic credit (growth rate, e.o.p.)	5.1	7.7	8.8	14.5	3/	...	...	...	...
3-month money market rate	3.3	2.3	2.1	2.1	4/	...	...	...	...
10-year government bonds yield	5.0	4.1	4.1	3.4	5/	...	...	...	...
Monetary condition index 6/	91.6	92.1	95.1	94.8	3/	...	...	...	...
	(In percent of GDP, unless otherwise indicated)								
National saving, investment, and income									
Gross national saving	26.0	22.8	23.3	21.3		21.9	21.9	21.7	21.4
Gross domestic investment	19.3	18.8	19.4	18.5		18.7	18.7	18.7	18.6
Private saving	18.9	17.5	18.5	16.6		17.3	17.3	16.9	16.5
Household saving as percent of disposable income	-1.3	-0.2	0.7	1.7		2.8	2.8	2.7	2.6
Private investment	16.4	15.9	16.4	15.7		15.9	16.0	15.9	15.9
Government savings surplus	4.2	2.3	1.9	1.8		1.8	1.9	2.1	2.2
Household's real disposable income (increase in percent)	2.3	5.5	5.2	3.9		2.6	2.4	2.3	2.0
	(In percent of GDP, unless otherwise indicated)								
Balance of payments									
Current account balance	6.7	4.0	4.0	2.8		3.2	3.2	3.1	2.8
Trade balance	9.7	7.9	6.9	7.6		8.0	8.3	8.3	8.1
Net external debt (excluding equity FDI and shares)	2.2	-11.7	-8.1	-10.6		-13.3	-16.1	-18.5	-20.7
Net international investment position	-40.8	-23.9	-12.2	-0.8		3.3	7.5	11.4	15.1
Exchange rates (period average)									
Euro per US$ (post-1999; FIM per US$ before)	1.06	0.89	0.81	0.8	5/	...	...	...	...
Nominal effective rate (INS, increase in percent)	1.3	4.4	-0.5	-0.2	4/	...	...	...	...
Real effective rate (increase in percent) 7/	-0.9	2.0	1.5	-1.2	4/	...	...	...	...

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

1/ Projections are staff estimates based on the authorities' current policy indications.
2/ A negative value indicates a level of potential output that is larger than actual GDP.
3/ October.
4/ September.
5/ November.
6/ Using weights for real short- and long-term interest rates and the real effective exchange rate (ULC) of 1/3 each.
7/ Based on relative normalized unit labor costs.

Table 2. General and Central Government Financial Accounts, 2002-2009 1/

				Est.	Proj.			
	2002	2003	2004	2005	2006	2007	2008	2009
	(In percent of GDP)							
General government 1/								
Revenues 2/	51.7	50.6	50.4	50.7	49.8	49.9	49.9	49.9
Expenditure	47.5	48.3	48.5	48.9	48.1	48.0	47.8	47.7
General Government balance	4.2	2.3	1.9	1.8	1.8	1.9	2.1	2.2
of which: net interest on public debt	0.1	0.0	0.2	0.1	0.0	-0.2	-0.3	-0.5
Primary balance 3/	4.3	2.4	2.1	1.9	1.7	1.7	1.7	1.7
Structural balance (in percent of potential GDP) 4	4.4	2.6	1.9	2.2	1.8	2.0	2.1	2.2
Structural primary balance (in percent of potentia	4.5	2.7	2.1	2.3	1.7	1.8	1.7	1.7
…corrected for one-off factors 5/	3.9	2.7	2.1	2.3	1.7	1.8	1.7	1.7
One-off factors 5/	0.6	…	…	…	…	…	…	…
Debt (EMU definition) 6/	42.2	45.0	44.9	43.7	39.9	36.7	33.3	29.9
Central government 1/								
Revenues	27.1	26.6	26.5	26.1	25.3	25.3	25.3	25.3
Expenditure	25.7	26.2	26.2	26.6	25.8	25.7	25.6	25.4
Central Government balance	1.4	0.4	0.2	-0.5	-0.5	-0.5	-0.4	-0.2
Debt	42.1	44.0	42.6	40.3	39.0	38.3	37.2	36.1

Sources: Ministry of Finance; and staff projections.

1/ On ESA95 basis.
2/ The fall in revenues in 2003 reflects, in part, planned cuts in some indirect taxes as well as the fading out of one-off factors related to exceptional tax revenues due to income from stock options in earlier years.
3/ Defined as noninterest (structural) revenue minus noninterest (structural) expenditure.
4/ Corrected for the influence of the business cycle as measured by the output gap.
5/ One-off factors include exceptional tax revenues due to income from stock options.
6/ Includes stock-flow adjustements reflecting changes in the portfolio allocation of Finnish pension funds.

Table 3. Finland: Balance of Payments, 1999-2009
(in billions of euros)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
							Est.		Proj.		
Current account	7.3	10.0	9.6	9.5	5.7	5.9	4.2	5.1	5.3	5.3	5.0
as a percentage of GDP	6.0	7.6	7.0	6.7	4.0	4.0	2.8	3.2	3.2	3.1	2.8
Goods and services	10.2	11.7	11.1	11.2	8.9	8.1	7.2	8.1	8.3	8.1	7.9
Exports of goods and services	45.4	55.9	54.2	54.0	53.1	56.6	62.1	66.3	70.5	74.3	77.3
Goods	39.4	49.7	48.0	47.5	46.6	49.1	52.1	55.7	59.2	62.5	65.0
Services	5.99	6.19	6.21	6.55	6.52	7.55	10.04	10.63	11.30	11.83	12.26
Imports of goods and services	-35.2	-44.2	-43.1	-42.8	-44.2	-48.5	-54.9	-58.2	-62.2	-66.2	-69.4
Goods	-28.0	-34.8	-33.9	-33.9	-35.2	-38.8	-40.4	-42.9	-45.4	-48.2	-50.6
Services	-7.19	-9.37	-9.26	-8.91	-8.97	-9.71	-14.46	-15.32	-16.86	-17.94	-18.81
Income	-1.9	-1.9	-1.2	-0.7	-2.9	-1.2	-0.6	0.3	0.5	0.8	0.9
Compensation of employees	0.3	0.4	0.4	0.4	0.3	0.3	0.4	0.4	0.4	0.4	0.4
Investment income	-2.2	-2.3	-1.6	-1.1	-3.2	-1.6	-0.9	-0.1	0.2	0.4	0.5
Current transfers	-1.1	0.1	-0.3	-1.1	-0.4	0.6	-2.5	-3.4	-3.5	-3.6	-3.8
Official	-1.6	-1.5	-1.7	-0.7	0.1	1.0	-2.0	-3.0	-3.1	-3.2	-3.4
Capital and financial account	-6.0	-9.8	-12.4	-8.7	-10.4	-5.9	-4.2	-5.1	-5.3	-6.3	-6.0
Capital account	0.1	0.1	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-6.1	-9.9	-12.5	-8.8	-10.5	-6.1	-4.4	-5.3	-5.5	-6.5	-6.2
Direct investment	-1.9	-16.5	-5.2	0.3	5.2	6.4	-1.1	-1.1	-1.1	-1.1	-1.0
In Finland	4.3	9.6	4.2	8.4	2.9	4.1	5.4	6.1	6.8	7.6	8.5
Abroad	-6.2	-26.1	-9.4	-8.1	2.3	2.2	-6.5	-7.2	-7.9	-8.7	-9.5
Portfolio investment excl. fin. derivatives	-2.2	-2.5	-6.2	-5.1	-0.8	-1.8	-1.4	-1.7	-1.6	-1.8	-1.8
Other investment	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8	-1.8
Assets	-3.3	-5.9	-11.3	-2.1	-13.7	-7.9	-10.8	-9.3	-10.1	-9.7	-9.9
Liabilities	1.5	15.4	10.8	-2.2	-1.8	-2.9	8.8	6.9	7.3	6.1	6.5
Official	-0.6	-1.5	-0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.2
Private	-1.2	-0.3	-1.3	-2.3	-2.2	-2.2	-2.2	-2.1	-2.1	-2.1	-2.1
Reserve assets	-0.2	-0.4	-0.5	0.2	0.5	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-1.2	-0.2	2.8	-1.9	4.8	0.0	0.0	0.0	0.0	1.0	1.0
Memorandum items											
GDP at current prices	121.0	130.9	136.5	140.9	143.8	149.7	152.9	160.3	165.8	172.2	178.7

Sources: Bank of Finland; and staff projections.

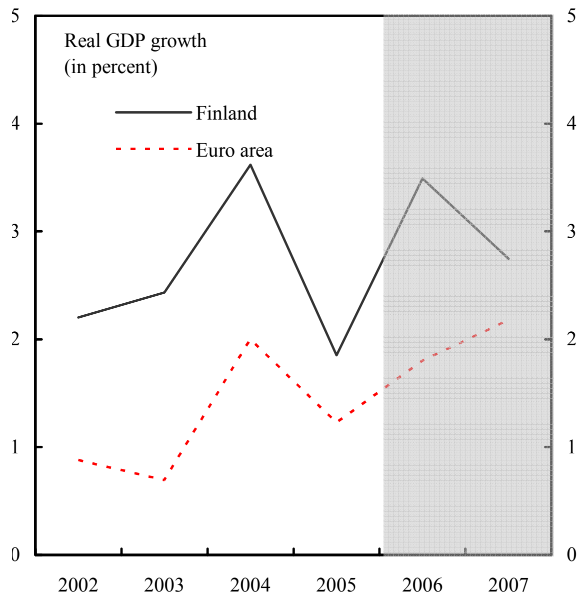
Table 4. Finland: Indicators of Financial Vulnerability, 2000-2005

	2000	2001	2002	2003	2004	June/2005
Households						
Total household debt (in percent of GDP)	30.2	31.8	33.7	37.1	40.2	...
Debt-to-income ratio	63.7	65.3	70.7	71.4	79.1	...
Non-financial corporations						
Gross debt (in percent of GDP)	52.8	53.0	51.1	51.0	50.9	...
Debt-to-equity ratio	...	...	...	...	...	...
Government						
General government debt (EMU definition, in percent of GDP)	44.6	43.9	42.6	45.5	45.1	...
Central government debt (in percent of GDP)	49.3	45.9	42.9	45.0	42.6	...
Banking sector						
Outstanding credit to nonfinancial private sector (percent change, e.o.p.) 1/	6.4	6.9	7.8	11.2	11.5	12.4
Of which housing loans (percent change, e.o.p.)	10.6	11.5	12.9	15.4	15.3	16.0
Housing loans in percent of total lending to nonfinancial private sector	38.5	40.1	42.0	41.6	43.0	43.5
Asset Quality						
Non-performing loans/total loans (in percent) 2/	0.6	0.6	0.5	0.5	0.3	0.3
Capital Adequacy						
Capital adequacy ratio	11.6	10.5	11.7	18.9	19.6	17.3
Equity / total assets (in percent)	6.0	5.9	5.6	9.7	8.7	8.8
Profitability						
Interest rate spread 3/	4.3	3.5	3.2	2.6	2.4	2.4
Net interest income (in percent of total income) 4/	46.8	61.4	65.3	63.1	60.3	60.9
Return on equity (in percent) 4/	22.4	13.5	10.7	11.3	8.6	10.0
Return on assets (in percent) 4/	1.2	0.7	0.6	0.7	0.8	0.9
Liquid assets/total assets (in percent) 5/	15.2	14.0	10.7	12.0	12.9	11.2
Off-balance sheet liabilities/total assets (in percent)	18.7	20.4	19.6	20.2	15.9	16.2
Stock market						
Change in stock market index (in percent, e.o.p.)	-10.6	-32.4	-34.4	4.4	3.3	24.5
Change in housing price index (in percent, e.o.p.)	-0.2	1.4	8.8	7.4	5.8	4.7

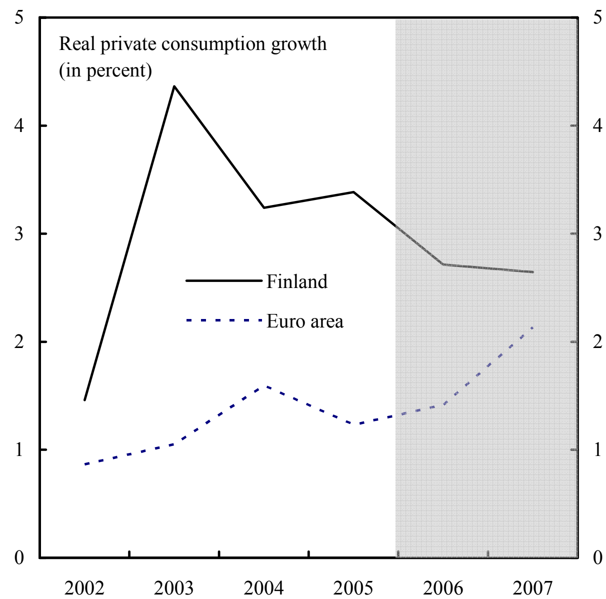
Sources: Bank of Finland; The Finnish Bankers' Association; Financial Supervision Authority; Statistics Finland; and Fund staff estimates.
1/ Euro-denominated lending only, which accounted for about 98 percent of total lending in 1999 and 2000.
2/ Loans are defined as the sum of claims on: credit institutions, the public, and public sector entities.
3/ Average lending rate minus average deposit rate.
4/ 2001 adjusted for large intra financial conglomerate transactions.
5/ Liquid assets are defined as the sum of bills discounted by the central bank, debt securities, and the balance sheet item "liquid assets".

Figure 1. Finland: Growth, Demand and Employment, 2002-07

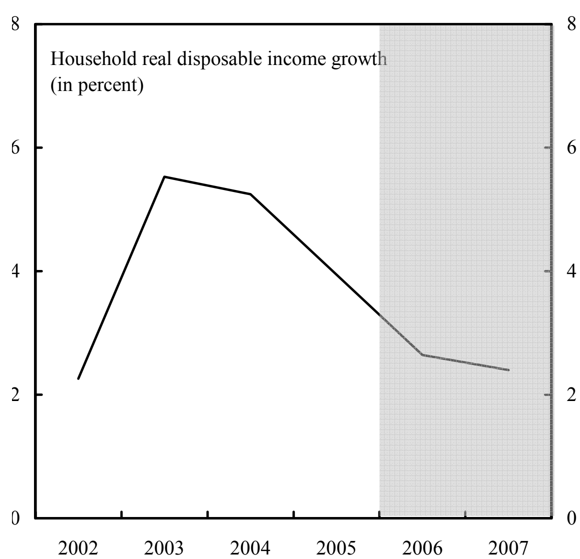
Despite the strike-affected 2005, growth has outpaced the euro area average...



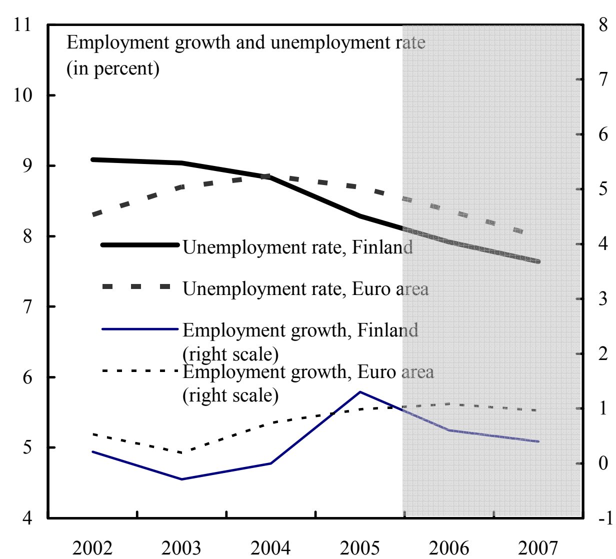
...reflecting buoyant private consumption...



...although the growth of household real disposable income is slowing...

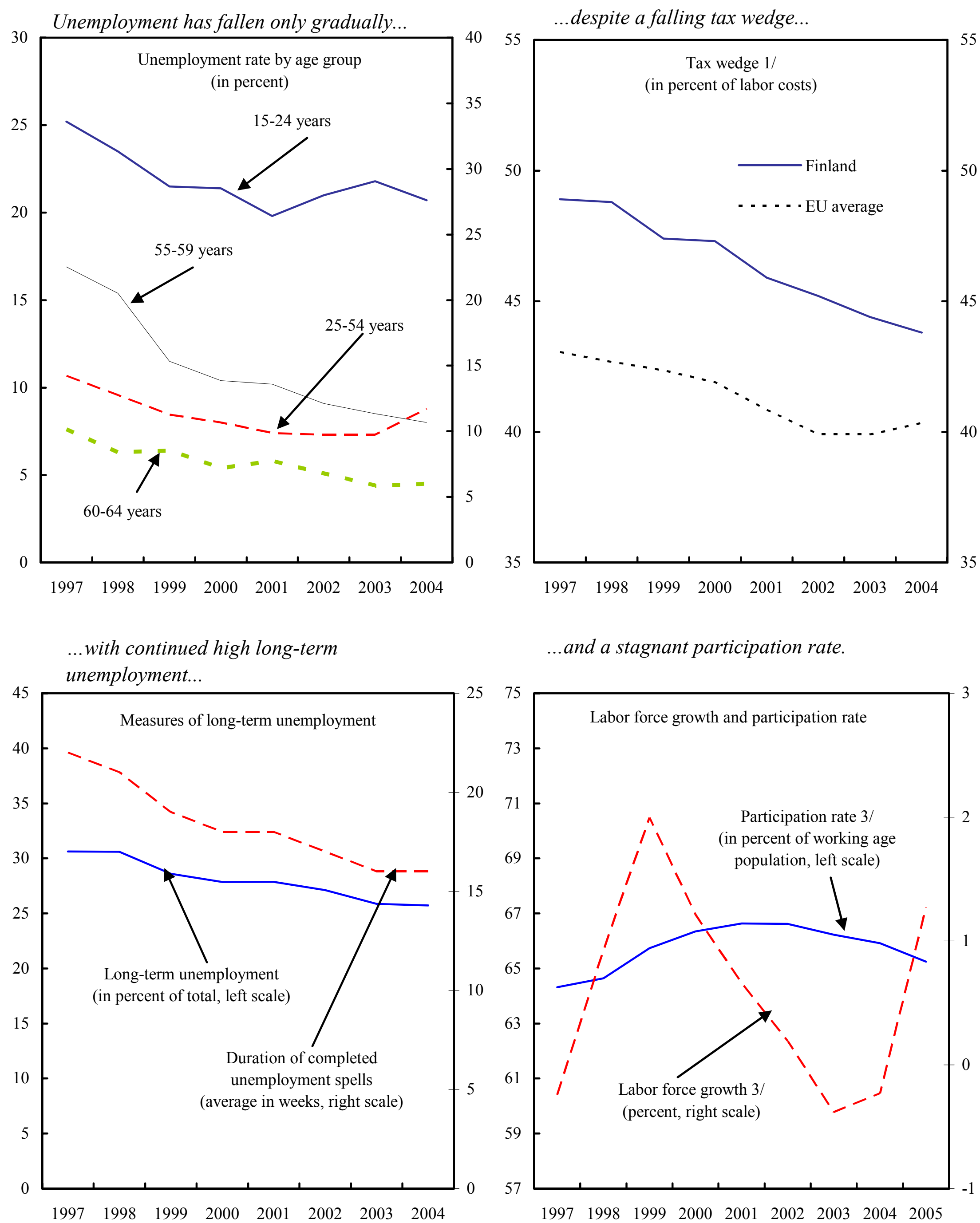


...offset in part because of improving employment prospects.



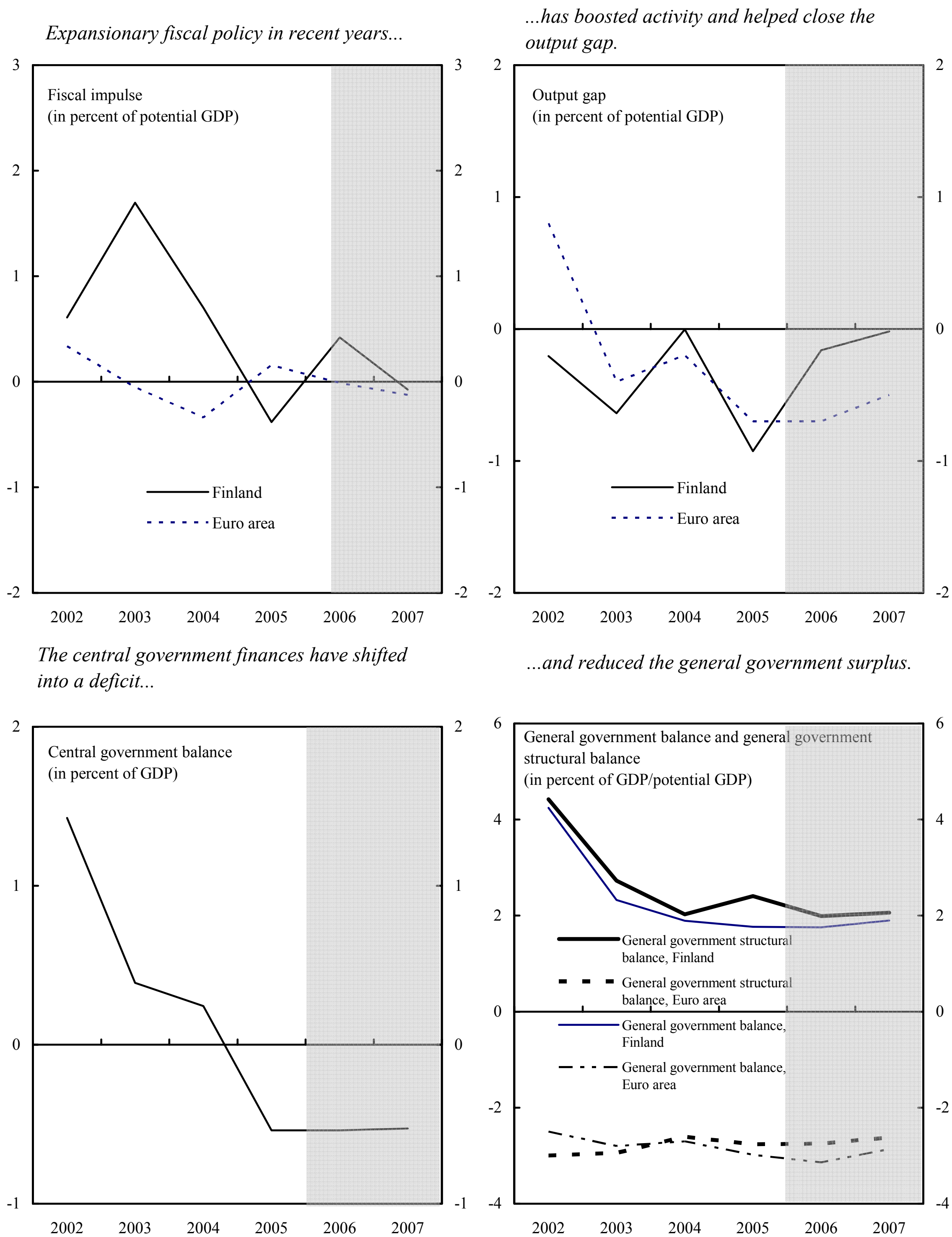
Sources: Statistics Finland; ETLA; WEO; and Fund staff calculations.

Figure 2. Finland: Labor Market Characteristics, 1997-2005



Sources: Finnish Labor Review; OECD Employment Outlook 2004; and Fund staff calculations.
1/Income tax plus employee and employer contributions (as a percentage of labor costs); single person without children.
2/ Defined as the unemployment rate of persons with less than upper secondary education.
3/ 2005 data are for first two quarters only.

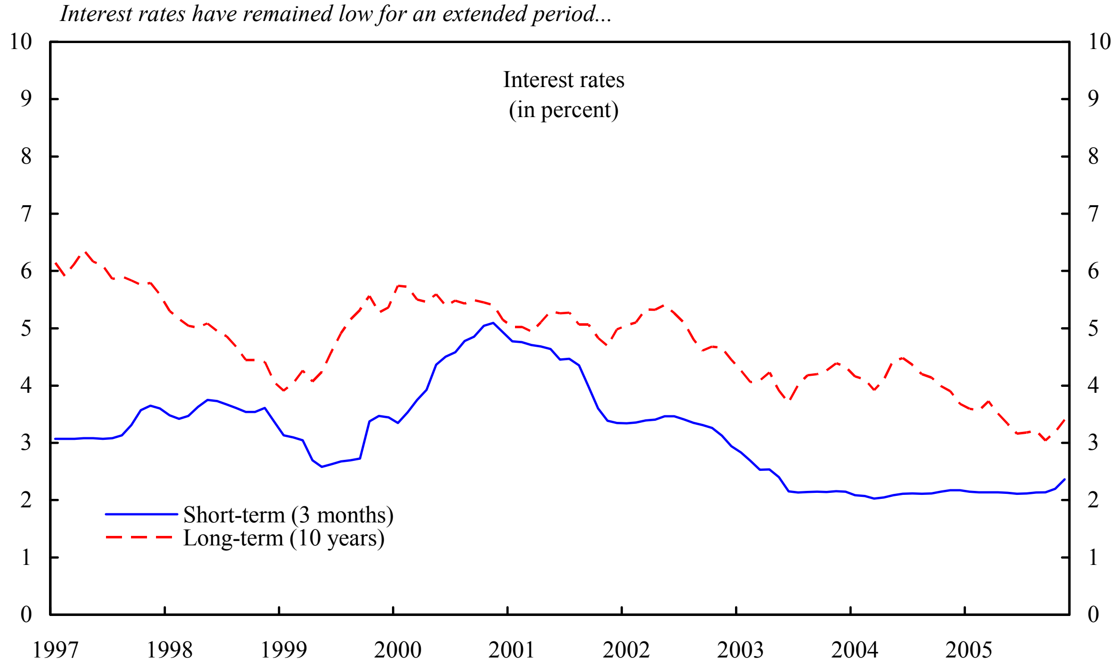
Figure 3. Finland: Selected Indicators, 2002-07



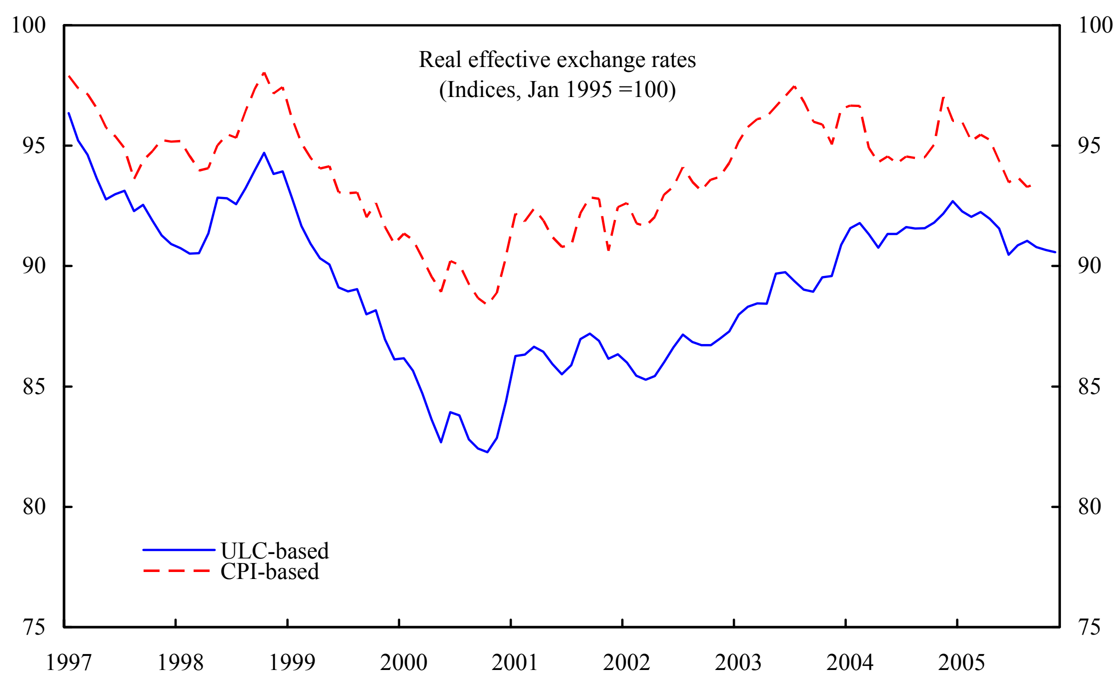
Sources: Statistics Finland; WEO; and Fund staff calculations.

Figure 4. Finland: Interest Rates and the Real Effective Exchange Rates, 1997-2005

Interest rates have remained low for an extended period...



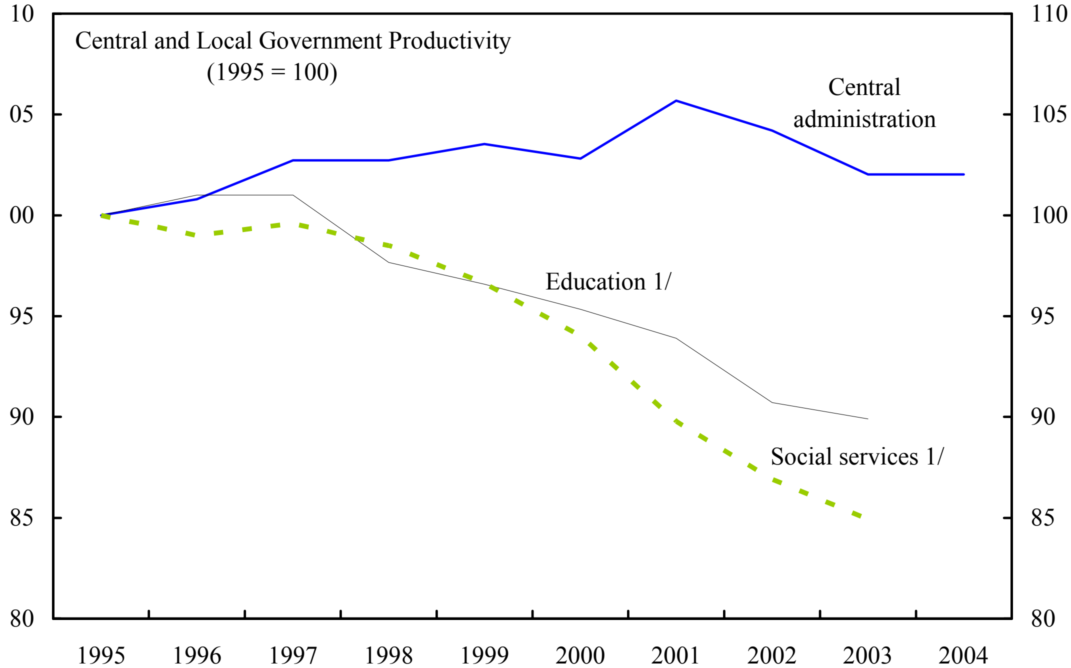
... and the real exchange rate has been steady.



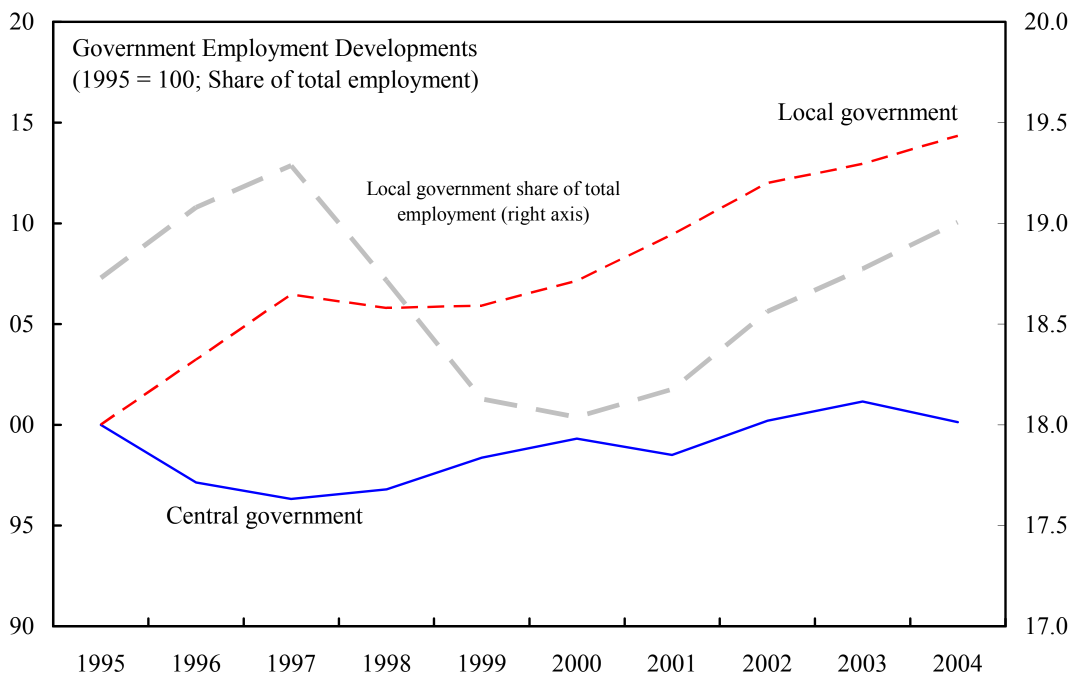
Sources: IFS; Bank of Finland; and Fund staff calculations.

Figure 5. Finland: Government Productivity and Employment

Local government productivity has been falling...



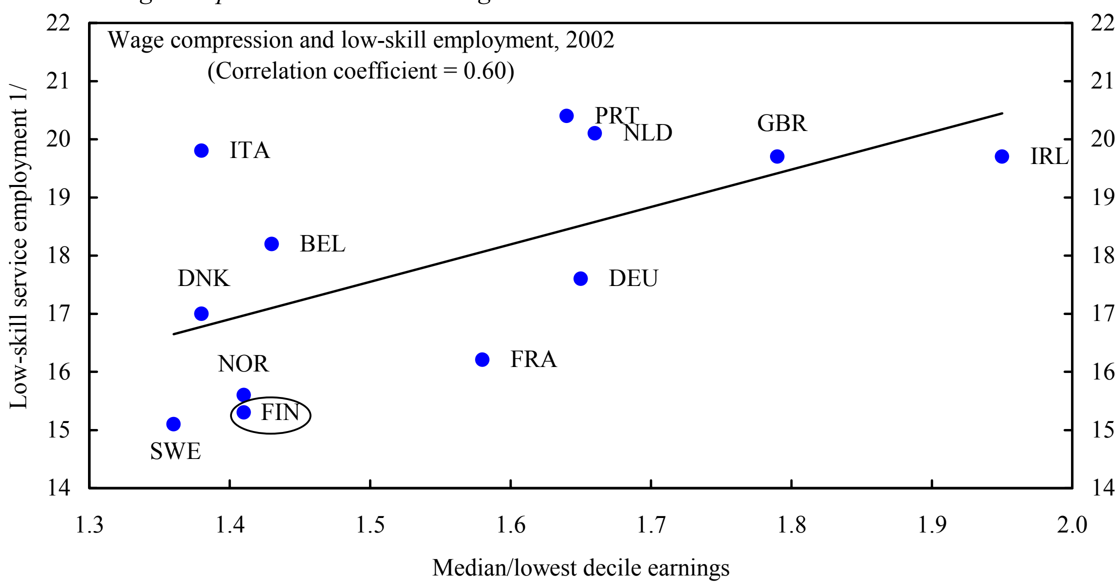
..with a steady rise in local government employment.



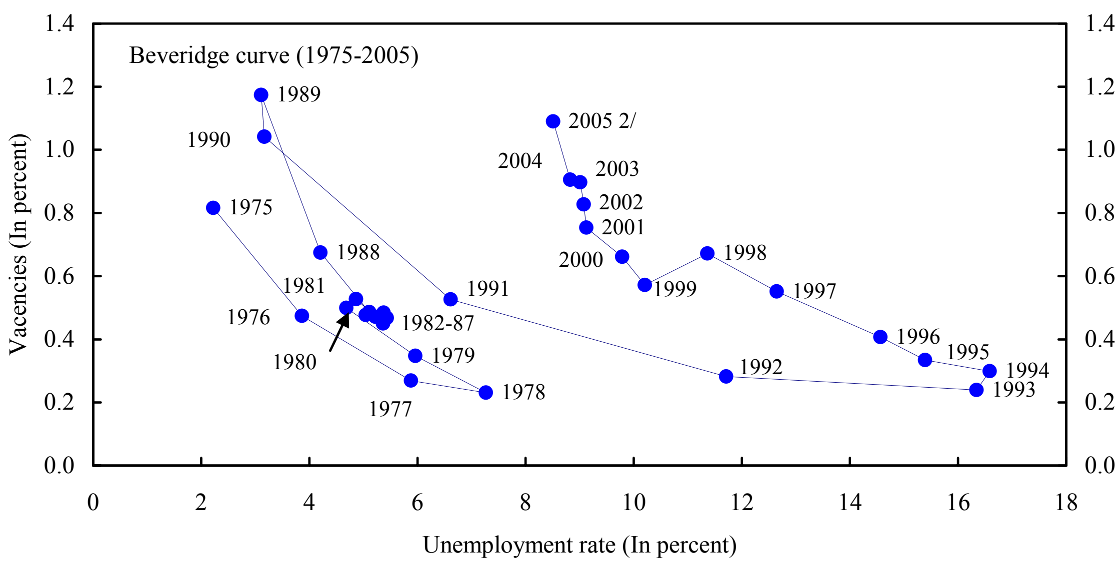
Source: Statistics Finland.
1/ Provided by municipalities.

Figure 6. Finland: Labor Market

Wage compression has been among the most severe...

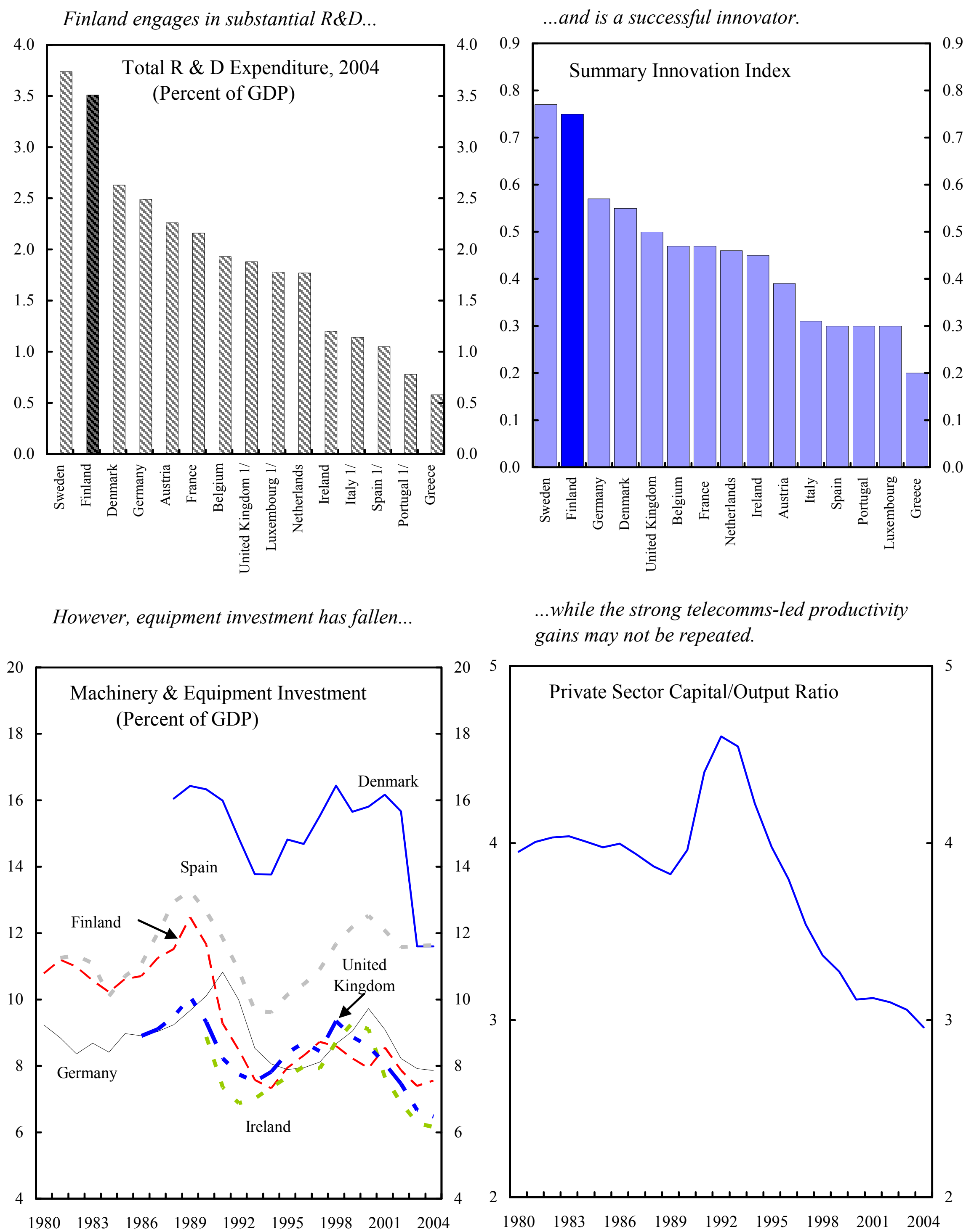


...while labor market mismatches have increased.



Sources: OECD; Bank of Finland.
1/ In percent of total employment. Low-skill services are defined as wholesale and retail trade, hotels and restaurants, expressed as a percentage of total employment.
2/ First half of 2005.

Figure 7. Finland: Research, Innovation and Investment Indicators



Sources: Eurostat; WEO; Bank of Finland.
1/ 2003.

FINLAND: FUND RELATIONS[9]
(As of November 30, 2005)

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

General Resources Account:	**SDR Million**	**Percent of Quota**
Quota	1,263.80	100.00
Fund holdings of currency	972.92	76.98
Reserve Position	290.95	23.02

SDR Department:	**SDR Million**	**Percent of Allocation**
Net cumulative allocation	142.69	100.00
Holdings	94.57	66.28

Outstanding Purchases and Loans: None

Latest Financial Arrangements: None

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

	Forthcoming				
	2005	2006	2007	2008	2009
Principal					
Charges/Interest		1.45	1.45	1.46	1.45
Total		1.45	1.45	1.46	1.45

VII. **Exchange Arrangements:**

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 (Sections 2, 3, and 4) and maintains an exchange system that is free of restrictions on the making of payments and transfers for current international transactions, apart from those in accordance with:(i)IMF Executive Board Decision No. 144-(52/51) and the relevant UN Security Council resolutions—measures have been taken to freeze the accounts of the Taliban and of listed individuals and organizations associated with terrorism; (ii) EU regulations and the relevant UN Security Council resolutions—certain restrictions are maintained on the making of payments and transfers for current international transactions with respect to Myanmar, certain individuals associated with the previous governments of Iraq and the former Republic

[9] Updated information relating to members positions in the Fund can be found on the IMF web site (http://www.imf.org/external/np/tre/tad/index.htm).

of Yugoslavia, and Zimbabwe; (iii) EU Regulation No. 147/2003, effective January 27, 2003—financing of and financial assistance related to military activities in Somalia are prohibited. Restrictions also apply on transfers with respect to members of Al-Qaida and the Taliban, and individuals and organizations associated with terrorism.

VIII. **Article IV Consultation:**

Discussions for the 2004 Article IV consultation were held in Helsinki during October 19-28, 2004 and the Executive Board concluded the consultation on January 28, 2005. Country Report No. 05/25 summarizing the views of the Executive Board, was published.

Finland: Table of Common Indicators Required for Surveillance
(as of December 23, 2005)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Dec. 2005	12/23/05	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Nov. 2005	12/05	M	M	M
Reserve/Base Money	Nov. 2005	12/05	M	M	M
Broad Money	Oct 2005	12/05	M	M	M
Central Bank Balance Sheet	Nov 2005	12/05	M	M	M
Consolidated Balance Sheet of the Banking System	Oct 2005	12//05	M	M	M
Interest Rates[2]	Dec. 2005	12/23/05	D	D	D
Consumer Price Index	Nov 2005	12/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2004	7/05	A	A	A
Revenue, Expenditure, Balance and Composition of Financing[3] – Central Government	Nov. 2004	12/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Nov.	12/05	M	M	M
External Current Account Balance	Oct. 2005	12//05	M	M	M
Exports and Imports of Goods and Services	Oct. 2005	12/05	M	M	M
GDP/GNP	Q3 2005	12/05	Q	Q	Q
Gross External Debt	Q3 2005	12/05	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank financing.
[4] The general government consists of the central government (including central government extrabudgetary funds), local governments, and social security funds.
[5] Including currency and maturity composition.
[6] Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 06/10
FOR IMMEDIATE RELEASE
February 1, 2006

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

IMF Executive Board Concludes 2005 Article IV Consultation with Finland

On January 30, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the 2005 Article IV consultation with Finland.[1]

Background

Economic performance in recent years continued to be favorable. Growth has outpaced that in the euro area and is expected to pick up to over 3 percent in 2006. The external current account has remained comfortably in surplus, and inflation has remained below the euro area average. Although the public finances remain in surplus, there has been a weakening in recent years, with the central government accounts shifting into a deficit. Moreover, the imminent rise in old-age dependency—more rapid than elsewhere in Europe—is clouding the long-term outlook for growth and fiscal sustainability.

Economy activity weakened in 2005, primarily due to a major but temporary setback to output as a the result of a labor dispute in the key paper sector. Activity has been underpinned by domestic demand, especially strong private consumption, supported by low interest rates, reductions in income taxation, and buoyant consumer confidence. Growth is projected to rebound strongly in 2006, with a bounce-back in paper exports helping to boost net exports. A decline in private consumption growth is anticipated to be more than offset by a pickup in investment.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On eturn 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.

Inflation has been very low in the past two years, aided by strong productivity growth and wage moderation. Cuts in some excises, increased competition in some domestic sectors, and low non-fuel import prices have also contributed to keeping inflation in check. Although inflation is expected to rise in 2006 toward the euro area average, the multi-year wage accord, combined with continued productivity growth is expected to maintain external competitiveness. Employment growth has picked up in 2005 after three years of stagnation, driven by public and private services. However, job mismatches are also increasing, and risks of some labor shortages in particular sectors are emerging. Monetary conditions have been very easy, and credit growth has risen markedly, with mortgage lending increasing by about 15 percent in 2005.

Although the general government surplus is estimated at about 1¾ percent of GDP in 2005, its magnitude has declined markedly in recent years, largely the result of cuts in personal income taxation at the central level designed to boost employment, and growing local government expenditures. The central and local governments are now both in deficit, with the general government surplus more than accounted for by pension fund surpluses. The budget for 2006 includes further cuts in income taxes of about ½ percent of GDP and increased employment subsidies aimed at workers at the lower end of the income scale.

The authorities are taking some steps to address the long-term fiscal pressures. Measures to raise central government efficiency are in train. Proposals are also being debated to reform the financing of local governments and restructure their activities to raise efficiency in the provision of public services. Significant pension reforms were initiated in 2005, to be phased in over a number of years.

Executive Board Assessment

The Executive Directors commended the authorities for their consistent implementation of policies that had underpinned Finland's strong economic performance in recent years. Directors noted the record of solid growth and low inflation and expected the short-term outlook to remain favorable, despite some downside risks. They considered that the most pressing task in the period ahead would be to strengthen the fiscal position and continue to implement reforms to cope effectively with the challenges of an aging population. Directors were reassured by the authorities' recognition of the need for adaptation and transformation of the Finnish economy.

Although Finland's overall fiscal position is relatively comfortable, Directors expressed concern about its recent deterioration. Efforts to boost employment through cuts in labor taxation without offsetting reductions in public spending had shifted the central government balance into deficit. While welcoming the tax cuts, Directors called for further steps to restrain expenditure in order to respect the authorities' medium-term spending rule and meet their goal of balanced central government finances.

Directors viewed an increase in efficiency of public services as critical to addressing the imminent demographic challenge. They welcomed the authorities' efforts to reorganize the provision and financing of such services, and suggested that these would need to be complemented by measures to limit demand for public services, including more effective employment of user charges. While Directors welcomed the pension reforms being phased-in, they called for further measures in this area to enhance long-term sustainability.

Directors considered that the centralized wage bargaining mechanism needed a greater degree of flexibility to allow the wage structure to more fully reflect productivity differentials and promote the employment of low-skilled labor. Continued efforts are essential to address growing labor market mismatches and make the fullest use of labor resources, including through active and well-targeted labor market policies such as employment training. Directors also called for further progress on product market liberalization.

Directors welcomed the assessment that Finland's financial system is sound and well supervised. Nonetheless, continued vigilance will be needed in light of the rapid growth in credit and heightened competition among lenders, especially in the mortgage segment, which could pose increased risks for credit quality and future bank profitability. Directors also underscored the importance of close cooperation among supervisory authorities in the rapidly integrating Nordic-Baltic region.

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

Finland: Selected Economic Indicators

	2003	2004	2005 1/	2006 1/
Real economy				
GDP (change in percent)	2.4	3.6	1.9	3.5
Domestic Demand (change in percent)	2.4	3.6	1.0	2.8
Harmonized CPI (change in percent) 2/	1.3	0.1	0.9	1.5
Unemployment rate (in percent) 2/	9.0	8.8	8.3	7.9
Gross national saving (in percent of GDP)	22.8	23.3	21.3	21.9
Gross domestic investment (in percent of GDP)	18.8	19.4	18.5	18.7
Public finances (general government, in percent of GDP)				
Overall balance	2.3	1.9	1.8	1.8
Primary balance 3/	2.4	2.1	1.9	1.7
Gross debt (Maastricht definition)	45.0	44.9	43.7	39.9
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area) 4/	11.0	6.3	9.4	...
Total domestic credit 4/	7.7	8.8	14.5	...
Interest rates (year average)				
Three-month money market 5/	2.3	2.1	2.1	...
Ten-year government bonds 5/	4.1	4.1	3.4	...
Balance of payments (in percent of GDP)				
Trade balance	7.9	6.9	7.6	8.0
Current account	4.0	4.0	2.8	3.2
Fund position (as of end-November, 2005)				
Fund holding of currency (in percent of quota)		76.98		
Holdings of SDRs (in percent of allocation)		66.28		
Quota (in millions of SDRs)		1,263.80		
Exchange rate				
Exchange rate regime		Euro		
Present rate (December 23, 2005)		US$ 1.1849 per euro		
Nominal effective exchange rate (increase in percent) 6/	4.4	-0.5	-0.2	...
Real effective exchange rate (increase in percent) 7/	2.0	1.5	-1.2	...

Sources: Finnish authorities, International Financial Statistics; and IMF Staff estimates.

1/ IMF staff estimates and projections, unless otherwise indicated.

2/ Consistent with Eurostat methodology.

3/ Defined as non-interest revenue minus non-interest expenditure.

4/ For 2005, 12-month increase to October.

5/ For 2005, monthly average for September.

6/ For 2005, average 12-month increase to September.

7/ Based on unit labor costs. For 2005, average 12-month increase to September.

Statement by Tuomas Saarenheimo, Executive Director for Finland
January 30, 2006

The economic performance in Finland remains remarkable. In terms of growth, inflation and the public sector financial situation, Finland's performance stands out favorably in comparison with most of the other EU countries. Also on the employment front, the tide has turned. Favorable economic conditions and broadly unchanged policy requirements have allowed staff to produce a brief and focused report. Notwithstanding its brevity, my authorities find the report to be of high standard providing a well focused overview of the economic situation and policies, as well as a useful reminder of challenges that lay ahead.

I wish to convey the Finnish authorities' appreciation to Mr. Thakur and his team for their input in the discussions held in Helsinki and for the well written report. I look forward to a fruitful Board discussion.

1. Recent Economic Developments and Short-Term Prospects

Recent data related to employment, sales and foreign trade indicate that after a temporary setback, the GDP growth has picked up again towards the end of the year. Staff's forecast of 1.9 percent for last year was likely met. Consumption has remained the main engine of economic growth. According to the latest surveys, household confidence remains high, and employment prospects are perceived strong.

The export growth has been supported by a strong demand for metal industry products. The share of imported intermediate products in both output and exports has continued to rise and is now notably high. There are no official statistics on re-exports, but in certain branches such as telecommunication, automobiles and home appliances the share of re-exports is likely quite high. This, together with issues related to transfer pricing, complicates the evaluation of the GDP/output/exports relations.

In the labor market, jobs have been created especially in private services and construction, but also the industry is hiring again with new vigor. According to the latest figures from December, employment is expanding by 2.7 percent year-to-year. The labor supply has increased, especially among age groups over 55. The unemployment rate continues to fall and the full-year unemployment rate will most likely reach staff's forecast of 8.3 percent. At the same time, vacancies have risen lately, especially in domestic trade and services, suggesting that skill mismatches remain a problem.

The inflation remains low. The rise in consumer prices in 2005 was 0.9 percent, less than half of what is generally forecasted for the Euro area. In 2006, consumer price inflation is expected to accelerate only slightly.

The trend in general government finances has turned out to be slightly better than expected in the fall and the central government's revenue estimates have been adjusted upwards.

Preliminary estimates, based on tax accruals until November, suggest a somewhat smaller central government deficit/GDP for 2005 than the 0.5 percent forecast of last September.

The economic growth is projected to rebound strongly this year. While inflation is slightly edging up, price competitiveness vis-à-vis the euro area continues to improve. This together with the perceived pick up of the economic activity in the euro area and in Finland's neighboring key markets, Sweden and Russia, means that the growth forecasts for this year and the next, 3.5 percent and 2.7 percent, respectively, are quite attainable.

2. Fiscal Policy

Reducing unemployment is a top priority of the Government's economic policy. Staff correctly points out that the multi-year program of tax cuts aimed at promoting employment has come at the cost of a deteriorating fiscal position. Specifically, staff argues that the fiscal stimulus from 2006 tax cuts was not needed, especially in light of the easy monetary conditions. My Finnish authorities emphasize that these tax cuts were motivated by structural considerations and aimed at improving incentives for labor market participation. The cyclical risks entailed by the tax cuts were deemed small, as Finland enjoys the lowest inflation rate in the Euro-area and even the Staff report recognizes risks to growth being tilted to the downside. Furthermore, according to the latest assessment by the authorities, the fiscal policy stance is turning out to be neutral in 2006.

My authorities agree with staff that the near-term task for policy is to restore balance in the finances of the central and local governments. The recently updated Stability Program suggests that expenditure pressures arising from population ageing are likely stronger than previously estimated. This underscores the need not only to curb public expenditures, but also the importance of efficient markets and structural measures aimed at reinforcing the general government.

Staff correctly emphasizes the importance of efficiency in public services. As regards the central government, the Government has set a guideline of filling only every other new vacancy within on-budget entities until 2011. If attained, this means an average annual reduction of over 2 percent in personnel and - with an assumption that output remains unchanged - a corresponding growth in productivity. With respect to local governments, where the majority of public personal services are provided, the Government has started "a local government and service structure project" to increase the efficiency of service production. This project involves administrative changes, which should improve efficiency in several aspects. The goal is to improve structures, operating principles, organizations and working procedures.

Staff proposes rebalancing public and private provision of social services and reassessing the role of user charges. Both issues have been under a lively debate. The private provision of services has already been used for instance in local public transportation services and in pre-school kindergartens, and it is being introduced in other areas. User charges are in active use

in most public services, especially in local recreational services, but also e.g. in health services. However, in public education user charges remain mainly absent.
I fully share staff's concern regarding the fiscal impact of ageing. The incentives built in the pension reform that entered into force in 2005 will encourage older workers to stay longer in the workforce and thereby alleviate fiscal burden and labor shortage in the near future. It is estimated that the average working career will increase by some 2 to 3 years. The sustainability of the general government's finances will, however, still require a substantial increase in contribution rates which, in turn, will incur additional distortionary effects and efficiency losses to the economy. This underlines the importance of further efforts to curb the public expenditure growth.

It is worth emphasizing that the urgency in tackling the challenge of ageing in Finland does not arise so much due to the anticipated demographic challenges being particularly large. In fact, long-term population projections for Finland compare rather favorably with most other developed countries. Rather, the issue is urgent because our baby-boom started early and ended early, and consequently, the high tide of population aging sets on about a decade earlier than in most countries. Finland will have to deal with its aging challenge quickly, but the magnitude of this challenge remains reasonable. And by the time most other countries face their demographic problems, we are already over the worst. Finland will provide those countries an opportunity to observe and learn – hopefully from our successes rather than from our mistakes.

3. Labor Market Policies

Staff points out that the recent wage accord ensures wage moderation, but at the same time, represents only a modest progress towards a more flexible wage-setting. Wage moderation has been an important precondition to Finland's economic performance since the recession of early 1990s. On the other hand, it is clear that centralized agreements have left little room for differentiating wages according to productivity or labor market conditions. Higher flexibility in relative wages would help to allocate resources more productively and would also alleviate problems of skill mismatch. There have been some recent changes to the system, aiming to increase the scope for local bargaining. As such, these changes are modest, but looking further back in time, one can see that wage-setting in general has, indeed, become more flexible. At the same time, possibilities for local bargaining continue to vary a lot from branch to branch. All in all, we agree with staff that this is an area where further progress can be made.

On the role of fiscal policy in wage moderation, it may be slightly misleading to characterize the multi-year program of tax reductions under the present and the previous government as "buying" wage moderation. Although the specifics of the tax cuts were often revealed in the context of the centralized wage negotiations, the overall magnitudes of tax reductions were decided on structural grounds in the government programs without the input of labor market parties. In the end, it is unclear to what extent the tax cuts actually facilitated wage moderation and, therefore, the depletion of fiscal room for further tax cuts does not necessarily entail increased wage pressures.

4. Financial Sector Issues

Staff correctly observes that the current low lending margins may constrain the future profitability of the banking sector. Low margins, as a sign of competition, are as such welcome and not a direct cause for worry. The situation becomes problematic only once competition leads to excesses and starts to undermine financial sector stability. As of this moment, the situation appears reassuring. The Finnish banking and insurance companies experienced robust performance in 2005, and stress tests, conducted by the Bank of Finland as well as jointly by the Central Bank and the two supervisory authorities, suggest that the financial system remains sound.

On the loan demand side, my authorities share staff's concern that the strong increase for housing loans may be underpinned, in part, by overly optimistic income expectations and perhaps some loosening of lending criteria, which could lead to loan servicing problems in the future. However, it should be noted that the household sector's level of indebtedness still remains reasonable, both in light of historical comparisons and relative to other developed countries. Also, history suggests that even in times of extreme economic stress, loan losses from mortgages have been negligible. All in all, households do not appear to pose a significant risk to the stability of the Finnish financial system in the near future.

Longer-term risks include the ongoing structural change within the financial sector as well as the practicalities of the supervisory and regulatory functions in an increasingly global operating environment. The authorities agree with staff's assessment that these structural developments underscore the need for closer cooperation between national supervisory authorities, particularly in the Nordic-Baltic region. This also holds true for national central banks in respect of their financial stability functions.

5. Long-Term Challenges

The investment rate in Finland has declined, and particularly so for investment in tools and machinery. This is partly explained by the shift in production structure from machine-intensive paper industry towards knowledge-intensive electronics industry. Also, until early 1990s, the Finnish corporate tax system strongly favored fixed investment, which may have led to overinvestment. Finally, Finnish companies have substantially increased their R&D activity, which enters national accounts as current spending and not as investment, as it arguably should.

Still, the falling trend in investment is clearly a matter of concern. To a large extent, it is a reflection of the ongoing process of globalization. Finland is a relatively small market, and its enterprises must seek growth outside. Despite its tangible advantages, Finland is often not perceived even by domestic enterprises as a sufficiently attractive base to serve the global markets.

The dichotomy between Finland's high ranking in international competitiveness comparisons and the paucity of investment in Finland is not easy to explain. Credit for the high competitiveness ranking belongs to a well-educated population, close co-operation between enterprises and universities, a well-functioning infrastructure, and a society that is safe and stable. Staff suggests that Finland's ranking in competitiveness may mask shortcomings in institutions and attitudes, and the authorities do not disagree. The incentive system built into the Finnish welfare state may have over decades encouraged a culture of complacency and risk aversion that hinders entrepreneurial activity. If this is so, then it is clearly a challenge that will take time and determination to tackle.

Staff points out that ageing of the Finnish work force risks reducing human capital productivity development, especially with rapidly transforming technologies. This is a relevant point, and one that applies to most developed countries. I would argue, however, that Finland is fairly well positioned to respond to this challenge. Finland excels in education internationally. The key challenge is how to adapt the methods used successfully in schools to training of older workers in companies.

Unemployment, although halved since the depression in early 1990s, still persists at a high level. Many indicators, as consumers' generally positive perception of their employment prospects and relatively high levels of vacancies, suggest that unemployment is now predominantly structural and, to a large extent, touches a relatively stable pool of the weakest part of the labor force. A series of macro and micro policies have been implemented to tackle the situation. Recent reforms to Public Employment Services add to these efforts and aim specifically to produce an appropriate mix of counseling, training and other active labor market measures. The problem will likely be somewhat alleviated when cohorts most affected by unemployment leave the labor force. Yet, skill mismatch is not limited to older workers. The structural problem is likely to be stubborn, and policies must be geared towards preventing the renewal of the "hard core" of unemployment. Employment and growth policies will remain at the top of the political agenda.

Overall, my Finnish authorities recognize that, while the Finnish economic and social model has generally served the country well, it will need to be adapted to the challenges posed by ageing and the rapid change in global economic structures. Finland has a history of far-reaching reforms, implemented often in times of economic distress. Today, in a generally favorable economic environment, a gradual transformation towards a more flexible form of the economic model is under way. Much remains to be done, but the starting point is favorable, momentum is building up, and there are grounds to be optimistic that the Finnish economy continues to perform well in the years to come.