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Finland: 2007 Article IV Consultation—Staff Report; Staff Statement and Supplement; 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 2007 Article IV consultation with Finland, the following documents have been released and are included in this package:

- The staff report for the 2007 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on May 31, 2007, 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 July 11, 2007. 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 staff statement of August 1, 2007 updating information on recent developments.

- A Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its August 1, 2007 discussion of the staff report that concluded the Article IV consultation.

- A statement by the Executive Director for Finland.

The document listed below has been or will be separately released.

Selected Issues Paper

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FINLAND

Staff Report for the 2007 Article IV Consultation

Prepared by the Staff Representatives for the 2007 Consultation with Finland

Approved by Alessandro Leipold and Adnan Mazarei

July 11, 2007

EXECUTIVE SUMMARY

Though one of the best performing EU economies, Finland faces rapid population aging, sluggish productivity in sheltered sectors, and supervisory problems associated with deepening international financial integration. Thus, discussions focused on: (i) fiscal policies capable of ensuring sustainability; (ii) labor and product market reforms to enhance human resource utilization and stimulate productivity gains; and (iii) the maintenance of financial sector stability.

On current projections, the budget framework for 2008–11 implies a sizable fiscal deterioration. Reflecting this and the costs of population aging, long-term fiscal sustainability requires improving the primary balance. Fiscal restraint would be appropriate also from a cyclical perspective. The authorities were confident that higher-than-expected actual and potential growth, sustained by not yet identified structural reforms, could reduce greatly the fiscal loosening. Staff counseled greater prudence.

Given already high taxation, fiscal restraint should focus on spending retrenchment, facilitated by efficiency gains. Staff recommended greater recourse to user charges and outsourcing as well as more stringent spending ceilings which could be extended to local governments. The authorities stressed that consensual policymaking and strong local autonomies made changes difficult.

There was agreement that improved labor utilization, especially of older workers and the young, was needed to ensure future growth. This might require more wage differentiation, reforming student allowances, and tightening early retirement through disability or unemployment, with broader recourse to activation. While broadly agreeing, the authorities emphasized the need to move cautiously in these socially sensitive areas.

Financial system supervisors concurred that cooperation with market participants and foreign supervisors must be enhanced to minimize systemic risks from cross-country activities.

Finland's external competitiveness is strong, but imminent aging with a fast-rising dependency ratio, declining terms of trade, and pressures on exporters' profitability indicate that the current account surplus is likely to shrink.

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I. Introduction

1. **The economic situation remains enviable.** Growth has outpaced that in the euro area since the early 1990s, inflation has remained among the lowest in the EU, and the government budget and external current account are both comfortably in surplus. Finland is also near the top of rankings for research and development, innovation, and competitiveness.

2. **Nevertheless, significant challenges loom.** Exports are growing strongly, having rebounded from a labor dispute-induced fall in 2005, but they remain comparatively concentrated in two sectors: telecommunications and paper products. Demographic pressures are soon to be felt, with the old-age dependency ratio set to rise the most rapidly in the EU. Despite recent pension reforms, the authorities acknowledge in their latest Stability Program that without additional steps the fiscal position is unsustainable. Fast-paced change and increasing international integration in the financial sector open opportunities, but create risks and test supervisory capabilities.

II. Recent Economic Developments

3. **The economy surged in 2006, the result of underlying strength and one-off factors.** Although the rebound following the 2005 labor dispute in the paper sector is estimated to have added 1 percentage point to growth, underlying activity still expanded by some 4½ percent—about 1 percent above potential (Table 1 and Figure 1). The components of domestic demand made more balanced contributions to growth, with strengthening business fixed investment joining vibrant residential construction in offsetting somewhat the reduced contribution of consumption. Nonetheless, private consumption growth remained solid, as employment gains, income tax reductions, and improving consumer confidence offset the dampening effects of higher interest rates and mounting debt loads. Net exports contributed 2½ percentage points to growth, reflecting buoyant activity in the "neighborhood" (Sweden, Russia, and the Baltics), a rallying German economy, and the paper sector bounceback.

GDP and Demand 1/
(Percent change)

	2004	2005	2006	2007 proj.
Real GDP	3.7	2.9	5.5	4.0
Domestic demand	3.0	4.3	3.1	3.6
Consumption	2.6	3.2	2.3	2.9
Private	3.0	3.8	3.0	3.4
Gross fixed capital formation	3.6	3.7	5.1	5.5
Residential investment	8.8	6.1	5.9	1.8
Net exports 2/	1.0	-1.1	2.5	0.7

Sources: Statistics Finland; and staff projections.
1/ A paper sector labor dispute is estimated to have reduced growth by about 1 percentage point in 2005 (most of which was accounted for by a worse contribution of net exports to growth), with offsetting changes in 2006.
2/ Contribution to growth.

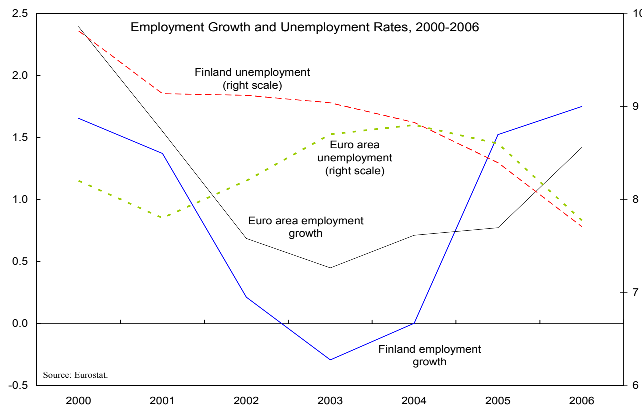
4. **The labor market is finally benefiting from the cyclical upswing, amid, however, signs of mismatches and related tightening.** After some delay, rising employer confidence has boosted job growth, with over 125,000 net new jobs created in the last three years. The unemployment rate mirrors the euro area level, but signs of labor shortages are appearing

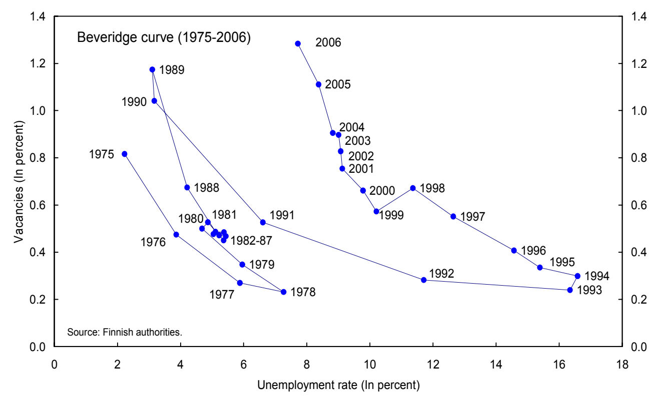
(e.g., in construction), especially in the booming Helsinki area. Impediments to territorial mobility, worsening skills mismatches, and social insurance features (see below) are hindering further employment gains, and threaten to spur wage pressures, as unemployment is falling below the structural rate (estimated at 7½–8 percent).

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

	2004	2005	2006	2007 proj.
Harmonized CPI	0.1	0.8	1.3	1.5
GDP deflator	0.6	0.2	1.3	1.0
Employment	0.0	1.5	1.8	1.8
Unemployment rate 1/	8.8	8.4	7.7	6.7
Labor compensation 2/	4.0	5.0	4.5	3.5
Unit labor costs 2/	1.7	2.3	0.8	1.3
Output gap	-1.1	-1.4	0.6	1.2

Sources: Statistics Finland; and staff projections.
1/ Percent of labor force.
2/ Economy-wide.





5. **Inflation has remained muted, aided by exceptional factors now on the wane.** Relatively low inflation has been supported by wage moderation in the face of fast productivity growth, as demonstrated by the latest tripartite agreement (for 2005–07) between unions, employers, and the government—struck in part thanks to income tax cuts offered by the government. Furthermore, the 4 percent decline in 2005–06 in the terms of trade has lowered the equilibrium real exchange rate, which, in the absence of nominal depreciation, exerts downward pressure on inflation. However, a number of one-off factors have also contributed, including lower telecommunications tariffs and food prices—the latter associated with increased competition from new foreign-owned retailers. With these effects fading, HICP inflation is creeping up to 1½ percent.

6. **Finland's external competitiveness is solid, but its export base is narrow.** With a current account surplus of about 6 percent of GDP and a barely negative net international investment position (accounted entirely for by foreign holdings of volatile ICT shares—mainly Nokia), standard indicators of external competitiveness are comforting (Table 2 and Figure 2), with various real effective exchange rate (REER) estimates broadly unchanged over the past decade (Figure 3 panel 1). The manufacturing unit-labor-cost-based measure has shown the largest improvement. However, capital's share in this sector in Finland vis-à-vis its trading partners is under greater pressure because of a relatively weaker export deflator (Figure 3 panel 2). This is largely because Finland's export composition is rather

heavily biased towards sectors whose prices are rapidly declining (ICT) or comparatively stagnant (paper products) (Figure 4).

7. **The fiscal position improved significantly last year, underpinned by expenditure restraint.** The general government surplus of 3¾ percent of GDP—mostly in the pension funds—is the second highest in the EU. With the output gap close to zero, the surplus is almost entirely accounted for by structural factors (Table 3). It benefited from a determined implementation of multi-year central government spending limits, which has permitted income tax reductions without weakening the fiscal position. As a result, the gross debt ratio declined over 2003–06 by over 5 percentage points to below 40 percent of GDP, while assets of the public pension system now approach 70 percent of GDP.

General Government Overall Balances
(Percent of GDP)

	2004	2005	2006	2007 proj.
Central and local governments	-0.4	-0.2	0.6	1.2
Social security	2.5	2.8	3.2	2.8
General government	2.1	2.5	3.8	4.0
General government (structural) 1/	2.6	2.7	3.5	3.5

Sources: Statistics Finland; Ministry of Finance; and staff projections.
1/ Adjusted in 2005 for a paper sector dispute.

III. Outlook

8. **Economic expansion will continue in the near term, albeit at a slower pace.** During the mission, authorities and staff anticipated growth at about 3 percent in 2007 and 2¾ percent in 2008. However, data for the first quarter of 2007 and revised quarterly data for 2006 recently released suggest that the momentum of growth in 2007 is significantly higher than expected. Accordingly, staff has raised its growth projection to 4 percent in 2007, still less than in 2006. The bulk of the deceleration is due to the ebbing of an unusually strong contribution from net exports in 2006 (including the rebound from the labor dispute). The contribution of domestic demand is projected to increase by about ½ percent of GDP, with private consumption boosted by strong consumer confidence and employment growth, despite rising interest rates and household debt levels (the latter approaching 100 percent of disposable income). Continuing fast employment growth is likely to tighten the labor market. As the economy is expected to continue to operate somewhat above potential, inflation should creep upwards, although rising interest rates and recent euro strength may have cooling effects.

9. **Risks appear balanced for growth but risks that inflation may exceed its projected level prevail.** The "neighborhood effect" may not decline as projected, which could sustain a larger contribution to growth from trading partners. Higher-than-anticipated labor force participation rates could emerge and immigration—stimulated by a tightening

labor market—might accelerate,[1] which would allow for greater growth without engendering wage pressures. On the downside, excessive salary increases could harm external competitiveness and stoke inflationary pressures (the latest authorities' projection has raised wage growth in 2008 from 3½ to 5 percent) . More important, if Russia—as recent reports hint—were to impose a 10-fold increase over the next two years in export tariffs on unprocessed wood, Finland's paper sector (which accounts for one-fourth of all exports) would suffer.

10. **For the medium term, the authorities' official projections envisaged a further slowdown in growth.** The deceleration (to 2¾ percent on average) in 2008–11 would result from lower employment expansion and a resumption of the modest trend decline in productivity growth during 2000–04. Staff concurred with this assessment.

11. **Officials, however, thought that GDP could rise much faster if the government implemented bold structural measures.** In particular, reforms of labor and product markets could substantially lift potential growth of the economy. While agreeing on the need to deepen reforms, staff cautioned that time and size of any boost to growth from structural measures were uncertain.

12. **The authorities regarded competitiveness of the economy as broadly adequate.** While wage growth in Finland has exceeded that in the euro area, so has productivity growth, especially in the export-intensive electronics sector. However, the bulk of these gains are shifted to foreign consumers through lower prices, limiting domestic income gains. The terms of trade were anticipated to temporarily improve this year, before resuming their trend worsening thereafter, and strengthening euro area growth was expected also to contribute to a one-off improvement in the external accounts. However, capacity constraints and continued shifting of production abroad were expected to limit export growth below that in foreign markets.

13. **Staff concurred, while noting that some measures suggested a significant undervaluation of the real exchange rate.** As explained above, standard indicators of external competitiveness are benign. Estimates based on methodologies elaborated by the Consultative Group on Exchange Rate Issues (CGER)—point to a sizable competitiveness margin,

Estimates of Competitiveness Margin Using CGER Methodologies
(In percent)

Methodology	
Macroeconomic balance approach	-12.7
External sustainability approach	-20.4
Equilibrium real exchange rate approach	-21.5

Source: Fund staff estimates.

[1] Finland liberalized immigration from the new EU member states more than a year ago.

with a mid-point of 17 percent[2]. These estimates should be taken with a larger than usual dose of caution. In light of rapid population aging, Finland needs to build up substantial assets in a short time to pre-fund the associated costs, requiring temporarily large fiscal and current account surpluses. As aging unfolds, the domestic savings rate is expected to decline and these surpluses are anticipated to diminish. The trend worsening of Finland's terms of trade is also expected to reduce the external surplus. Indeed, these forces may, to some extent, already make their presence felt, as attested by pressures on exporter's profitability. On balance, therefore, staff felt that the real exchange rate was not significantly undervalued.

IV. Policy Discussions

14. **The overarching concern is the risk posed to longer-term growth by rapid aging and the anticipated productivity slowdown.** With the fastest population aging in the EU and attendant fiscal costs, discussions focused mainly on medium-term and structural issues. As working-age cohorts are expected to shrink from the end of this decade, increasing the employment rate and supporting faster gains in productivity throughout the economy will be key for future growth prospects. Above all, this requires improving the lackluster productivity record of the sheltered sectors (agriculture, utilities, and trade), as the contribution from high technology industries—facing falling prices and stiffer competition in world markets—declines. The adaptation of the economy to the challenges of aging and diversification needs support from the rapidly evolving financial sector, which must cope with the spread of innovative technologies or products and deepening international integration, raising issues about internal risk management and cross-country supervision.

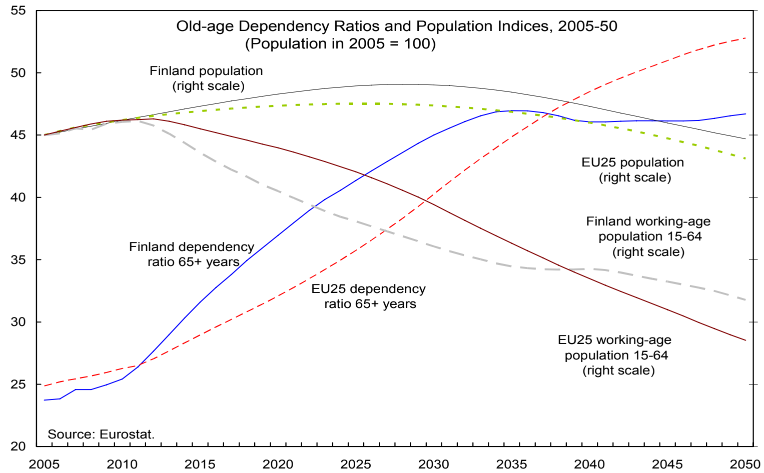
Prospects for labor force participation/employment and productivity growth imply a significant drop in income per cap growth.

Long-Term Scenario

	1995 - 2000	2000 - 05	2005 - 10	2010 - 20	2020 - 30
Productivity growth 1/	2.6	2.2	2.2	1.9	1.9
Demographic contribution 2/	0.0	-0.1	0.0	-0.8	-0.5
Employment rate contribution 3/	1.8	0.4	0.7	0.1	0.0
GDP per capita growth	4.5	2.5	2.9	1.2	1.3

Sources: WEO; Finnish Stability Program 2006.
1/ GDP per employed.
2/ Change in the share of population 15-64 years.
3/ Employed as a share of population 15-64 years.

[2] These analyses are discussed in *Methodology for CGER Exchange Rate Assessments*, IMF, 11/8/06, http://www.imf.org/external/np/pp/eng/2006/110806.pdf.



15. **Against this background, the discussions focused on three priorities:**

- craft tax and public expenditure policies that promote continued economic expansion while ensuring fiscal sustainability,
- reform the labor and product markets in order to enhance utilization of soon-to-be shrinking human resources and contribute to greater competition in sheltered sectors,
- maintain financial sector stability.

A. Fiscal Policy

16. **The authorities acknowledged that, based on official macro projections, the government's program for 2008–11 implies a sharp deterioration of the fiscal position.** Specifically, the general government surplus would decline by about 2 percent of GDP over 2008–11, owing mainly to a front-loaded rise in expenditure. Modest cuts—generally backloaded—in personal income taxes, VAT on food, and inheritance taxes are also envisaged, only partially compensated by increases in excises on energy, alcohol, and tobacco. The central government (CG) balance would worsen by 1½ percent of GDP and turn a deficit by 2010.

Finland: Government Financial Operations, 2006-11
(In percent of GDP)

	2006	2007	2008	2009	2010	2011	Diff. 2007-11
			Staff's Baseline Projection 1/				
Overall balance							
General government	3.8	4.0	3.5	3.2	2.4	1.8	-2.3
Central government	0.9	1.2	0.6	0.5	-0.1	-0.4	-1.6
Local governments	-0.3	0.0	0.1	0.1	0.0	-0.1	-0.1
Social security	3.2	2.8	2.8	2.6	2.5	2.3	-0.5
Primary balance							
General government	3.7	3.9	3.4	3.1	2.1	1.5	-2.5
			Staff's Adjustment Projection				
Overall balance							
General government	3.8	4.0	4.0	4.0	3.9	3.8	-0.2
Central government	0.9	1.2	1.1	1.3	1.4	1.6	0.4
Local governments	-0.3	0.0	0.1	0.1	0.0	-0.1	-0.1
Social security	3.2	2.8	2.8	2.6	2.5	2.3	-0.5
Primary balance							
General government	3.7	3.9	3.9	3.8	3.5	3.4	-0.5

Source: Ministry of Finance; and staff estimates and projections.

1/ Based on the authorities' medium-term scenario, including the Ministry's June economic projections, adjusted for the staff's macroeconomic projections.

17. **Officials did not dispute the staff's view that under current policies the long-term fiscal position is unsustainable** (Box 1). Taking into account the new government's plan reducing the overall surplus to about 2 percent of GDP by 2011, in an otherwise "passive" projection the additional public spending associated with population aging eventually generates ever-growing deficits and debt. Ministry of Finance officials recognized that the general government primary balance in 2011 and beyond should be uniformly higher by around 2 percent of GDP than in the passive-scenario path to maintain long-term fiscal sustainability, at least through 2050.

18. **The authorities, however, were confident that higher growth associated with structural reforms could avert the fiscal deterioration.** Notably, the CG surplus of about 1 percent of GDP achieved in 2006 could be maintained through 2011 with GDP growth of 3½ percent, almost 1 percentage point above the average rate currently projected. Staff warned against relying on optimistic revisions to growth projections to discount the fiscal loosening, as the reforms had yet to be identified and implemented and their impact on growth verified. The authorities vowed to implement flexibly planned spending hikes and tax reductions, so as to limit risks to inflation and the fiscal position, if higher sustainable growth were not achieved.

19. **Staff also saw a need for tighter fiscal policy for cyclical reasons**. Continuing strong growth—positive output gaps are expected in both 2007 and 2008 and labor markets are tightening—points to the advisability of withdrawing some fiscal stimulus. The authorities stated that the fiscal stance would be appropriately corrected should signs of overheating arise.

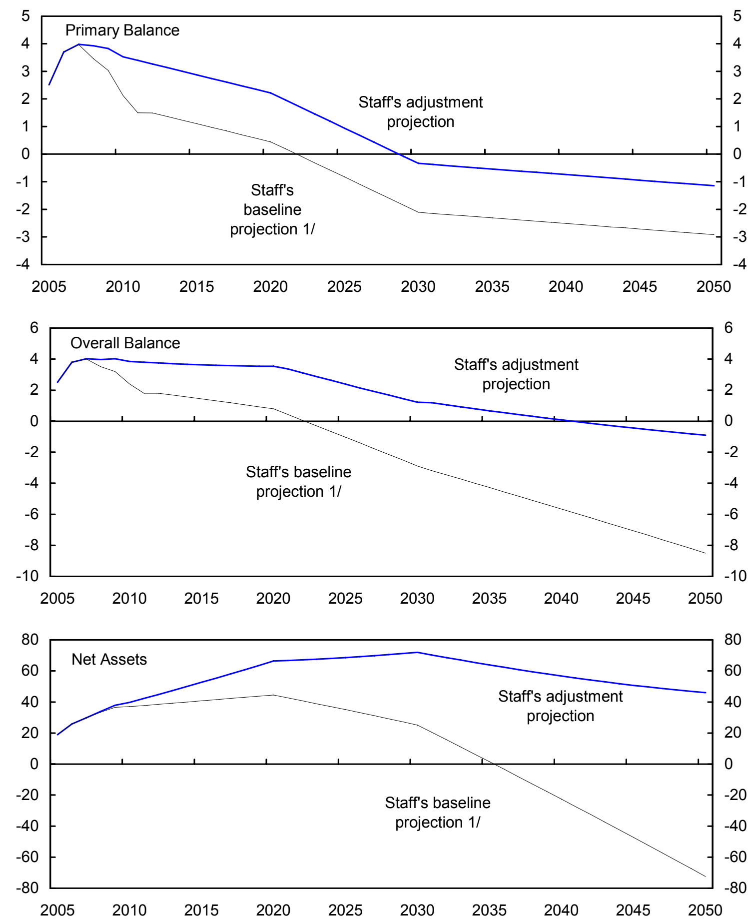
20. **The authorities noted that reducing Finland's relatively heavy tax burden could lessen economic distortions.** Taxation of earned income is particularly steep: the average and marginal rates for the average wage earner exceed 40 and 50 percent, respectively. Such large tax wedges introduce significant distortions in the labor market. Coupled with a high effective minimum wage, they discourage employment of low-skilled workers and lead to inefficient do-it-yourself practices. Thus, a lowering of income taxes was likely to boost employment and output. Staff concurred but stressed that tax cuts, albeit justified, demanded commensurate spending reductions not to undermine sustainability.

21. **It was acknowledged that adjustment efforts ought to concentrate on expenditure restraint.** The general government expenditure-to-GDP ratio is high—and projected to increase further owing to population aging. The authorities noted that the medium-term budget framework was already postponing several investment projects to limit

Box 1. Long-Term Fiscal Sustainability

"Passive" simulations of the general government (GG) position for 2007–50 raise sustainability concerns. The staff's baseline projection reflects stated policy intentions of the new government for 2008–11. After that, following the authorities' recent Stability Program, it assumes that the primary-revenue-to-GDP ratio remains constant throughout the period, with pension contributions increasing (by about 2 percent of GDP) but other taxes decreasing correspondingly. Age-related expenditure surges by about 6 percent of GDP, only in small part compensated by declines in education and unemployment spending. The GG balance slips into a deficit, reaching 8½ percent of GDP by 2050. And starting with net assets of about 20 percent of GDP, the GG ends with net liabilities. Although characterizing the risks to fiscal sustainability as "low," the European Commission also notes that a sustainability gap emerges based on the authorities' long-term projections.

Long-Term Fiscal Projections, 2005-50
(Percent of GDP)



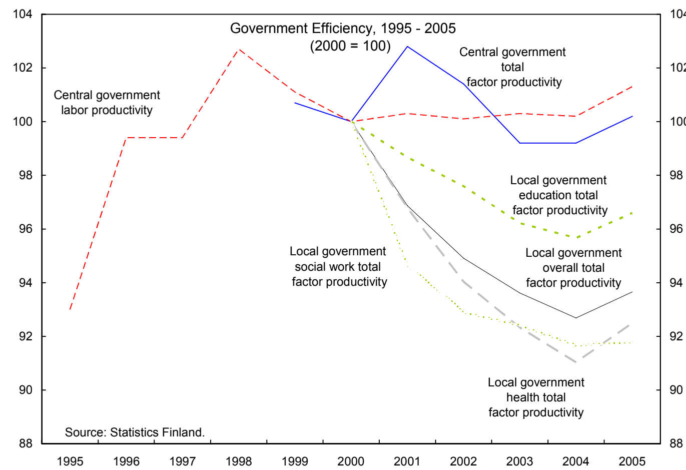
Sources: Ministry of Finance; and IMF staff estimates.
1/ Based on the new government's announced economic strategy's surplus target for 2008-11, and Stability Program projections thereafter. Other assumptions include: average real GDP growth at 1.9 percent till 2020, and 1.4 percent thereafter; real interest rate at 3 percent; employment rate increasing to 74 percent by 2030 (from about 69 percent in 2006); labor productivity growing by 2 percent up to 2020, and by 1.7 percent thereafter.

The sustainability gap is estimated at about 2 percent of GDP. This is the permanent adjustment of the GG primary balance, with respect to the "passive" scenario, needed to achieve the net assets targeted for 2050 by the authorities' stability program—46 percent of GDP. The staff's "active" scenario assumes that measures are taken to fill this gap.

Nevertheless, some further adjustment after 2050 is needed to stabilize debt fully. Staff projections indicate that improving the primary balance by approximately 1 percent of GDP more would be enough to stabilize net debt (alternatively the rate of return on gross assets could be raised by 1 percentage point). Otherwise, even in the "active" scenario, net assets (although still higher than now in 2050) would decline indefinitely.

spending growth. Nonetheless, they also deemed essential some increase in spending in the short term, including to honor electoral promises of sizable pay increases for health workers.

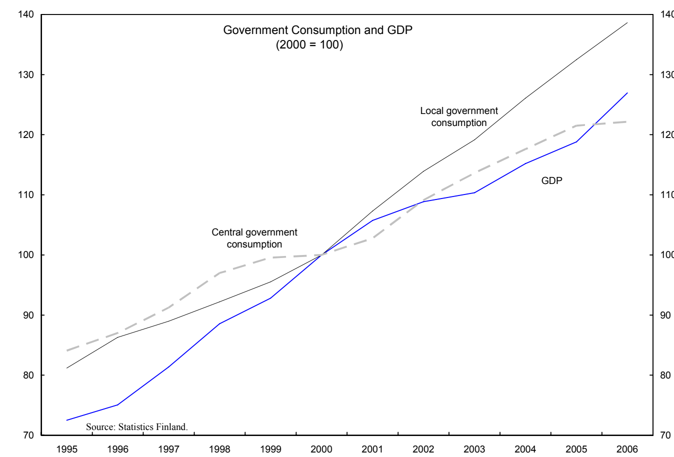
22. **The authorities viewed enhancing the efficiency of government as the best way to restrain spending**. Studies suggest that expenditure could be more efficient, particularly in higher education and health care—with some indicating that Finnish combined expenditure efficiency is somewhat below the OECD average (Figure 5). Thus, sizable spending savings would be feasible without jeopardizing the quality of services. The authorities concurred, but pointed out that the low population density limited economies of scale. They also agreed that recourse to domestic or international benchmarking could help identify best practices and stated that CG employment was already planned to be reduced through attrition. It was noted that greater use of contracting out, outsourcing, and well-designed public-private partnerships could stimulate efficiency and moderate cost inflation. More frequent resort to—and a rebalancing of—user charges for local services would also strengthen market incentives for consumers and suppliers.

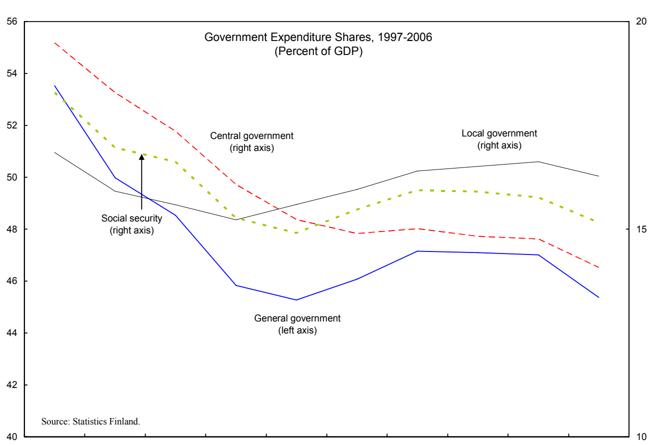


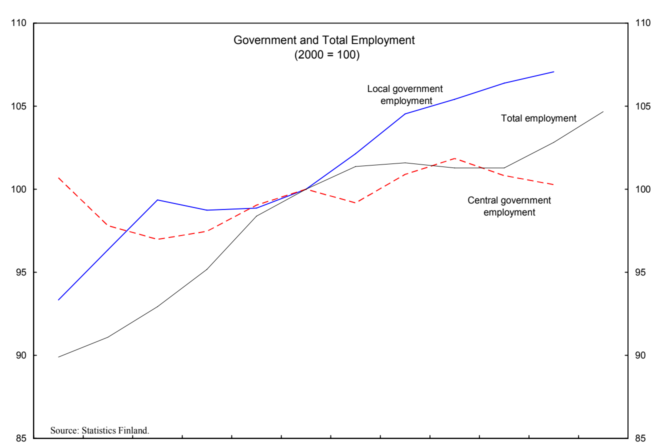
23. **Officials were open to improvements in the design of the multi-year spending ceilings in order to contain expenditure growth.** The government has committed to new expenditure ceilings until its term expires in 2011, based on the same principles as in the previous legislature, but with a larger contingency reserve and more flexible carry-over rules. Although broadly effective in curbing CG expenditure growth, the limits have not dented the high level of public spending. One problem lies in step increases in outlays decided by incoming governments when setting the new ceilings. Others arise from the generous cost deflator used in establishing the annual ceilings[3] and the incomplete coverage of the ceilings. Accordingly, staff recommended using the GDP deflator or the CPI, which would impose more stringent ceilings, thereby providing incentives to increase productivity and reduce costs. In addition, the spending rule could be extended to local governments (LGs) (see below). It was understood that these technical measures could help reduce expenditure growth, but a more substantive impact on spending trends required changes in underlying policies.

[3] The spending rule is defined in real terms, based on a public spending deflator, which tends to grow faster than the CPI or the GDP deflator and accommodates increases in wages and other government costs.

24. **The authorities agreed that instilling greater budgetary discipline at the local level was a key challenge.** Municipalities—the main providers of education, health care, old-age care, and other social services, with total outlays of about 17 percent of GDP and three-quarters of public employment—have experienced a rapid rise of recurrent spending and employment as well as worsening efficiency in recent years. These pressures are expected to mount with population aging. The authorities expect to generate savings from merging municipalities and coordinating provision of services. Staff recommended extending the expenditure ceilings to LGs, sanctioning their inclusion by a "domestic stability pact" with CG transfers used as enforcement mechanism. In addition, caps on LG income taxation (offset as needed by greater reliance on property taxation) might place limits on the growth of revenues which to some extent is fueling LG spending. The authorities explained that they were considering strengthening the existing agreement with the association of LGs to harden budget constraints, but interfering with the constitutionally protected autonomy of municipalities was politically difficult.







B. Structural Policies

Labor market

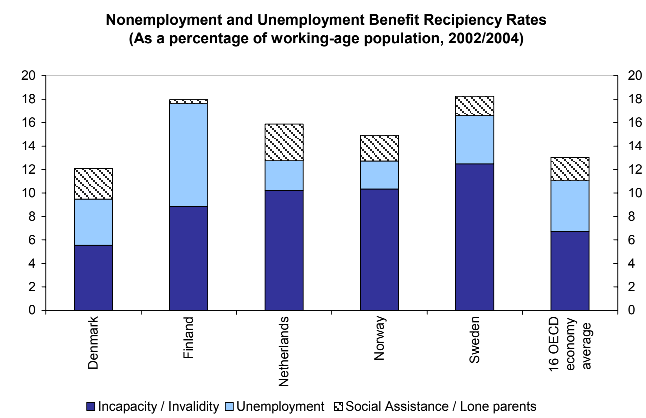
25. **There was consensus on the need to pursue several complementary strategies to raise activity and employment rates.** Specifically, the authorities:

- plan to increase substantially targeted wage subsidies, to boost employment at the low end of the labor market. They also noted that the decision to forgo centralized wage bargaining this year—which may presage its phasing out—could spur wage and regulatory flexibility.

- have recently created Labor Force Service Centers to reinforce activation of hard-to-place unemployment benefit recipients. To the same end, a 2006 reform made municipalities financially responsible for half of the cost of unemployment assistance and created obligations for beneficiaries. Furthermore, Public Employment Services intend to sign action plans with all young unemployed within the first three months of benefit recipiency to find active alternatives to passive entitlement. Finally, a profiling system for job seekers will be phased-in.

Box 2. Labor Market Issues

Finland lags behind its peers in labor-market performance. While unemployment has been more than halved since the recession of the early 1990s and the employment rate has risen to 68½ percent at end-2006, the latter is still below other Northern European countries (Figure 6). Furthermore, the shares of long-term unemployed and disabled are quite high.



Problems are particularly acute for young and elderly workers. Finland's generous welfare system, including highly subsidized education, delays the entry of younger workers into the labor force, and provides unwanted pathways to early exit for older workers (Figures 7–9). Even after the 2005 reform, unemployment benefits can be extended above the standard 500 days for those aged 57 and over. And the disability scheme now allows to consider also "social grounds" when claiming benefits. Thus the employment rate of older workers, at 53 percent, is below that of other Nordic countries. The employment rate for young workers, at less than 40 percent in 2005, compares unfavorably with rates above 60 percent in Denmark and the Netherlands, and is also below the OECD average (43 percent). Part of the explanation lies in prolonged entitlement to generous student allowances (up to €700 a month) supplemented by guaranteed loans and no tuition fees: with 9½ years of expected education for the 15-29 year old, Finland is an OECD outlier.

The wage-setting system, associated with generous benefits, has not helped price-in young and elderly workers, nor the low-skilled. While the economy-wide wage agreements have served to maintain overall wage moderation, they have also resulted in salary compression, with a high effective minimum wage. Furthermore, the high replacement ratio of unemployment and other social benefits often leads to high effective marginal tax rates which discourage work resumption.

Staff argued that, these valuable efforts notwithstanding, further scope for activation existed, notably of recipients of unemployment and disability benefits. Tightening access to early retirement, together with less generous student allowances, would also be useful (Box 2). The stressed that state enterprises were generally run as private entities and thus government ownership did not affect adversely efficiency. Nevertheless, it was not disputed that competition could be enhanced through further selective privatization, restraining local monopolies, and strengthening non-discriminatory third-party access to network industries. In addition, liberalizing shop opening hours and more flexible zoning laws could boost competition in wholesale and retail trade, while reforming agricultural support (which exceeds CAP-based levels) should increase efficiency and lower food prices. The authorities contended, though, that these measures were politically controversial and could only be implemented gradually.

C. Financial Sector

26. **The financial system appears sound and well supervised.** Banks are profitable and well capitalized. Returns on equity are generally high, with low cost ratios. Capital adequacy ratios are well in the double digits, with sizable financial "buffers," albeit slowly decreasing owing to the higher credit base. While lending margins have declined with increased competition, bank profits have risen with growing fee income and the expansion of lending portfolios—especially household mortgages. Bank of Finland (BoF) estimates of several stability indicators also point to the good position of the banking sector (Table 4).

27. **Supervisors closely monitor mortgage lending practices, but were confident that developments in the equity and housing markets were broadly benign.** Although household and corporate debt levels remain comparatively low, the authorities noted that household debt is relatively concentrated among younger borrowers, raising concerns about commercial banks' regard for repayment ability and undue reliance on collateral. Nevertheless, debt servicing expenses are historically low, as household net wealth and disposable income have improved strongly in recent years. House prices, while also rising rapidly, have grown less than in most advanced economies, with BoF analyses not detecting bubbles, except possibly in some Helsinki neighborhoods. Equity prices have increased by more than 50 percent since the beginning of 2003, creating some risk of reversal. However, BoF estimates suggest that stock market valuations do not deviate from fundamentals.

28. **Supervisors confirmed that the system can withstand considerable disruptions.** New stress tests undertaken jointly by the BoF and bank supervisors (FSA)—assuming a marked economic recession and a sizable drop in housing and equity prices—show that banks' profitability would be hard hit, but remain positive, and the impact on their capital position would also be manageable. While the authorities' stress tests are of high quality, staff recommended to improve them further by assessing the impact on the balance sheets of banks: (i) of the same shocks in different years; and (ii) of cross-border contagion, using extreme observations in market-based indicators.

29. **The authorities agreed that regulation and supervision of cross-border institutions pose considerable challenges.** The recent sale of Sampo's banking operations—the country's third largest—to the Danish Danske group has left Finland with the second highest share in the EU15 of foreign-owned banking system assets—70 percent compared to an average of 25 percent. In this connection, both BoF and FSA acknowledged that, while regional supervisory cooperation through memoranda of understanding (MoUs) is generally effective, it has not been tested under crisis conditions. Thus the authorities' efforts focus, at both the Nordic and European levels, on (i) harmonizing supervisory cooperation on major cross-border groups[4] (including the coordination of deposit guarantee schemes) and (ii) defining ex-ante rules and intervention procedures, in particular to minimize conflicting interests in case of financial crises (e.g., rules to determine when a subsidiary is of systemic importance and for burden-sharing for intervention in systemic institutions). Supervisors also confirmed their intention to work closely with market participants and foreign supervisors to improve supervision of an increasingly cross-border "infrastructure" (e.g., merged stock exchanges in the Nordic/Baltic area).

30. **Implementation of European directives is proceeding apace.** The capital requirements directive (based on Basel II) came into force in February 2007, but banks can delay its application to 2008. To limit temporarily the possible acceleration of lending from the capital "freed" by risk-based determination of capital, the FSA has required banks that choose the internal-ratings-based approach not to reduce for 2008 and 2009 their capital to less than 90 and 80 percent respectively of that prescribed under Basel I. The financial markets directive (MiFID) will be enacted in November 2007. Finland is planning to merge the FSA with the insurance supervisor in 2009, reflecting the growing bundling of activities by financial institutions.

V. Staff Appraisal

31. **Finland's recent economic performance is enviable.** Finland has consistently exhibited higher growth and lower inflation than most other EU countries, while the budget and external current account have attained sizable surpluses. Finland also excels in innovation and business environment rankings.

32. **Competitiveness of the Finnish economy is also broadly appropriate**. Though some measures suggest that the real effective exchange rate may be undervalued, the rising old-age dependency ratio and declining terms of trade, as well as pressures on exporters' profitability, probably mean that competitiveness margins are moderate. Moreover, the

[4] In particular, concerning other Nordic countries, supervision of Nordea is conducted according to the supervisory college model following an agreement with the Swedish authorities, which stipulates joint inspection and complete information sharing. An agreement is under discussion with Denmark to supervise jointly the activities of Sampo-Danske.

external current account surplus is expected to diminish over the medium to long term. The relatively strong external position at present is also the result of fiscal and structural policies that are generally desirable from a long-term perspective.

33. **The authorities nonetheless face considerable challenges.** A tightening labor market threatens a build-up of wage pressures. Owing to demographic pressures and sluggish productivity in sheltered sectors, growth is likely to decline, while—despite substantial reforms to the pension system in recent years—the fiscal position remains unsustainable from a longer-term perspective. Increasing international integration, together with technological and organizational changes in the financial sector, improve efficiency, but complicate supervision.

34. **Fiscal tightening is advisable both to ensure long-term sustainability and from a cyclical perspective.** To maintain an adequate net asset position of the general government at least through 2050, the noninterest balance must improve by about 2 percent of GDP relative to the authorities' projected path. Some withdrawal of fiscal stimulus is also called for because economic activity is somewhat above potential and the labor market is tight. Otherwise, excess demand could translate into inflationary pressures. A general government surplus of about 4 percent of GDP, only slightly above the 2006 level, would be an appropriate target in both 2007 and 2008.

35. **Therefore, the authorities' recently adopted budget framework for 2008–11 is insufficiently restrained.** Indeed, current projections imply a large fiscal loosening. The authorities are confident that stronger-than-projected growth, aided by as yet unspecified structural measures, could help maintain fiscal surpluses approximately at the current level. However, relying on the assumption of a sizable pick-up in growth is risky. Measures to boost productivity and employment should be implemented promptly and their effects on growth assessed before raising spending or cutting taxes.

36. **With taxes and expenditures high, fiscal adjustment should focus on spending restraint, facilitated by enhancing its efficiency, particularly at the local level.** Sizable savings would then be feasible while maintaining the quality of services. This calls for: benchmarking to identify best practices; redesigning the multi-year expenditure ceilings and extending them to local governments; greater recourse to outsourcing, public-private partnerships, and user charges; and reform of intergovernmental relations to tighten municipal budget constraints.

37. **Improved utilization of labor resources, especially older workers and the young, is fundamental for future growth.** Increased wage differentiation to help "price-in" those with low skills would be useful. Similarly, an increase in tertiary education fees (while maintaining financial aid to the truly needy), limits to the amount and duration of grants, and greater reliance on student loans could lower the time to graduation of students and accelerate their entry into the labor force. For the elderly, consideration should be given to

reduce the scope of early retirement, increase use of activation requirements, and tighten control on access to these benefits. Tax and benefit policies ought to be revised to increase the relative returns from employment, thereby alleviating "poverty-trap" effects.

38. **Strengthening competition in product markets to spur productivity would complement labor market reform.** Productivity can be enhanced, especially in the sheltered sectors, through further privatization, restraining local monopolies, and promoting non-discriminatory third-party access to network industries. In addition, more regulatory flexibility in the trade sector and reform of agricultural support should increase competition and efficiency.

39. **The financial system is sound and well supervised, but enhanced cross-border supervision of financial institutions and infrastructure is key to preserve stability.** Rising foreign ownership in the banking sector poses considerable challenges for regulation and supervision, highlighting the urgency to nurture cooperation between home and host supervisors, especially to prepare for financial crises. Moreover, supervisors have to step up their cooperation with market participants and foreign supervisors to control the systemic risks associated with the spread of new technologies or products and with cross-border financial infrastructure.

40. **Finland's data are adequate for surveillance.**

41. **It is proposed that the next Article IV consultation be held on the 12-month cycle.**

Table 1. Finland: Main Economic Indicators, 2002–09 1/

	2002	2003	2004	2005	2006	Proj. 2007	Proj. 2008	Proj. 2009
	(Percentage change, unless otherwise indicated)							
Output and demand (volumes)								
GDP	1.6	1.8	3.7	2.9	5.5	4.0	2.8	2.4
Domestic demand	1.4	3.8	3.0	4.3	3.1	3.6	3.0	2.5
Consumption	2.3	3.8	2.6	3.2	2.3	2.9	2.5	2.3
Private consumption	2.2	4.8	3.0	3.8	3.0	3.4	3.0	2.7
Public consumption	2.7	1.5	1.8	1.7	0.9	1.3	1.3	1.3
Gross fixed capital formation	-3.0	4.0	3.6	3.7	5.1	5.5	4.5	4.1
Private investment	-4.9	3.2	3.6	6.4	5.6	5.8	4.5	4.0
Public investment	9.8	8.4	3.7	-10.7	1.8	3.5	4.5	3.5
Export of goods and services	2.8	-1.7	8.6	7.1	10.7	6.0	4.8	4.8
Import of goods and services	2.5	3.3	7.8	12.2	5.4	5.3	5.7	5.5
Foreign contribution to growth (in percent of GDP)	0.4	-1.7	1.0	-1.1	2.5	0.7	0.0	0.0
Prices, costs, and income								
Consumer price inflation (harmonized)	2.0	1.3	0.1	0.8	1.3	1.5	1.8	1.8
Core inflation (excluding energy and seasonal food)	2.4	1.1	0.7	0.5	0.9	1.5	1.8	1.8
GDP deflator	1.3	-0.4	0.6	0.2	1.3	1.0	0.9	1.3
Terms of trade	2.2	1.1	1.3	-0.7	-3.3	0.5	-2.0	-1.4
Unit labor cost, manufacturing	-1.5	-4.8	-0.7	-1.0	-0.1	0.3	1.2	0.7
Labor market								
Labor force	0.2	-0.4	-0.2	1.0	1.1	0.7	0.3	0.1
Employment	0.2	-0.3	0.0	1.5	1.8	1.8	0.5	0.1
Unemployment rate (in percent)	9.1	9.0	8.8	8.4	7.7	6.7	6.5	6.5
Potential output and NAIRU								
Output gap (in percent of potential output) 2/	-0.6	-1.5	-1.1	-1.4	0.6	1.2	1.2	0.9
Growth in potential output	2.8	2.7	3.3	3.2	3.4	3.3	2.9	2.7
NAIRU (in percent)	8.4	8.8	8.5	7.9	7.8	7.2	6.9	6.6
	(In percent)							
Money and interest rates								
M3 (Finnish contribution to euro area , growth rate, e.o.p.)	6.6	11.0	6.3	8.2	8.5	...	...	...
Domestic credit (growth rate, e.o.p.)	5.1	7.7	8.8	15.2	12.0	...	...	...
3-month money market rate	3.3	2.3	2.1	2.2	3.1	...	...	...
10-year government bonds yield	5.0	4.1	4.1	3.4	3.8	...	...	...
	(In percent of GDP, unless otherwise indicated)							
National saving, investment, and income								
Gross national saving	28.5	24.9	26.5	25.7	26.6	27.5	27.4	27.0
Gross domestic investment	18.3	18.5	18.8	20.6	20.7	21.0	21.2	21.4
Private saving	21.7	19.8	21.6	20.6	20.4	21.1	21.5	21.4
Household saving as percent of disposable income	0.0	1.1	2.2	0.0	-1.5	-1.5	-1.6	-1.5
Private investment	15.6	15.7	15.9	18.1	18.3	18.5	18.8	19.0
Government savings surplus	4.1	2.4	2.1	2.5	3.8	4.0	3.5	3.2
Households' real disposable income (increase in percent)	2.8	5.9	4.0	1.4	1.5	3.8	3.5	2.6
	(In percent of GDP, unless otherwise indicated)							
Balance of payments								
Current account balance	10.1	6.4	7.7	5.1	5.8	6.6	6.1	5.6
Trade balance	9.4	7.8	6.6	4.9	5.7	6.1	4.2	3.7
Net external debt (excluding equity FDI and shares)	3.0	-9.4	-8.3	-5.9	-6.4	-12.6	-18.3	-23.2
Net international investment position	-40.7	-27.6	-10.9	-14.3	-12.5	-0.3	7.5	14.6
Exchange rates (period average)								
Euro per US$	1.06	0.89	0.81	0.80	0.80	...	...	...
Nominal effective rate (increase in percent)	2.1	6.2	2.2	-0.5	0.0	...	...	...
Real effective rate (increase in percent) 3/	0.1	3.6	2.4	0.2	0.2	...	...	...

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/ Based on relative normalized unit labor costs.

Table 2. Finland: Balance of Payments, 1999-2012
(In billions of euros)

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
											Proj.			
Current account	7.3	11.5	13.4	14.6	9.4	11.8	8.0	9.8	11.6	11.5	10.8	10.8	11.0	11.3
as a percentage of GDP	5.9	8.7	9.6	10.1	6.4	7.7	5.1	5.8	6.6	6.3	5.7	5.5	5.4	5.4
Goods and services	12.2	13.6	14.7	15.2	12.3	12.1	8.8	11.0	12.5	11.1	10.0	9.6	9.4	9.4
Exports of goods and services	47.5	57.6	57.8	58.0	56.4	60.8	65.8	74.7	79.8	83.4	87.5	91.6	95.5	99.7
Goods	39.4	49.6	48.0	47.4	46.6	49.1	52.6	61.5	65.9	67.0	70.5	73.9	77.2	80.6
Services	8.12	7.92	9.84	10.54	9.86	11.73	13.19	13.20	13.84	16.43	16.97	17.69	18.39	19.11
Imports of goods and services	-35.3	-43.9	-43.2	-42.7	-44.1	-48.7	-57.0	-63.6	-67.3	-72.4	-77.4	-82.0	-86.1	-90.3
Goods	-28.1	-34.6	-33.9	-33.9	-35.2	-39.0	-45.0	-51.9	-55.1	-59.3	-63.4	-67.1	-70.5	-73.9
Services	-7.21	-9.31	-9.30	-8.80	-8.97	-9.66	-11.99	-11.76	-12.18	-13.10	-14.01	-14.84	-15.58	-16.34
Income	-1.9	-1.9	-1.2	-0.7	-2.3	0.1	0.0	0.2	0.0	1.4	1.7	2.1	2.5	2.9
Compensation of employees	0.3	0.4	0.4	0.4	0.3	0.4	0.6	1.2	1.3	1.3	1.4	1.4	1.4	1.5
Investment income	-2.2	-2.3	-1.6	-1.1	-2.6	-0.2	-0.5	-1.0	-0.9	0.4	0.7	1.1	1.4	1.8
Current transfers	-3.1	-0.3	-0.1	0.1	-0.6	-0.5	-0.9	-1.4	-0.9	-0.9	-1.0	-1.0	-1.0	-1.0
Official	-1.6	-1.5	-1.7	-0.7	-1.3	-1.2	-1.6	-2.2	-1.6	-1.7	-1.7	-1.7	-1.7	-1.8
Capital and financial account	-6.0	-9.8	-12.7	-7.3	-9.8	-8.0	-3.5	-8.5	-11.6	-11.5	-10.8	-10.8	-11.0	-11.3
Capital account	0.1	0.1	0.1	0.1	0.1	0.2	0.3	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Financial account	-6.1	-9.9	-12.8	-7.5	-10.0	-8.2	-3.7	-8.7	-11.8	-11.7	-11.0	-11.0	-11.2	-11.5
Direct investment	-1.9	-16.5	-5.2	0.7	5.0	3.3	0.0	2.9	-1.5	-1.6	-1.6	-1.6	-1.6	-1.6
In Finland	4.3	9.6	4.2	8.5	2.9	2.4	3.6	3.0	5.6	6.3	7.0	7.9	8.8	9.9
Abroad	-6.2	-26.1	-9.4	-7.8	2.0	0.9	-3.6	0.0	-7.1	-7.8	-8.6	-9.5	-10.4	-11.5
Portfolio investment excl. fin. derivatives	-2.2	-2.5	-6.2	-5.0	-0.4	-8.8	-3.4	-13.1	-12.7	-13.5	-13.7	-14.2	-14.6	-15.1
Other investment	-1.8	9.5	-0.9	-3.4	-15.0	-2.0	-0.4	-2.1	2.4	3.3	4.3	4.9	5.1	5.2
Assets	-3.3	-5.9	-11.3	-0.7	-13.2	-10.1	-1.5	-13.0	-7.2	-10.1	-8.7	-9.4	-9.0	-9.2
Liabilities	1.5	15.4	10.5	-2.7	-1.8	8.0	1.1	10.8	9.6	13.4	13.0	14.3	14.1	14.4
Official	-0.6	-1.5	-0.6	0.4	0.4	0.3	0.3	0.3	0.3	0.2	0.2	0.2	0.2	0.1
Private	-1.2	11.0	-0.3	-3.9	-15.4	-2.4	-0.7	-2.4	2.1	3.1	4.1	4.7	4.9	5.0
Reserve assets	-0.2	-0.4	-0.5	0.2	0.5	-0.6	0.1	3.6	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	-1.2	-1.7	-0.8	-7.3	0.4	-3.8	-4.5	-1.3	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:														
GDP at current prices	122.7	132.3	139.9	144.0	145.9	152.3	157.2	167.9	176.3	183.0	189.8	196.3	203.1	210.4

Sources: Bank of Finland; and staff projections.

Table 3. General and Central Government Financial Accounts, 2002–09 1/

	2002	2003	2004	2005	2006	Proj. 2007	2008	2009
	(In percent of GDP)							
General government 1/								
Revenues 2/	50.2	49.5	49.2	49.6	49.1	49.0	49.2	49.0
Expenditure	46.1	47.2	47.1	47.0	45.4	45.0	45.7	45.8
General government balance	4.1	2.4	2.1	2.5	3.8	4.0	3.5	3.2
Of which: net interest on public debt	0.1	0.0	0.1	0.0	0.0	-0.1	-0.1	-0.1
Primary balance 3/	4.2	2.4	2.1	2.5	3.7	3.9	3.4	3.1
Structural balance (in percent of potential GDP) 4/	4.4	3.0	2.6	2.7	3.5	3.5	3.0	2.8
Structural primary balance (in percent of potential GDP) 3/ 4/	4.5	3.1	2.6	2.7	3.5	3.4	2.9	2.8
…corrected for one-off factors 5/	3.9	…	…	…	…	…	…	…
One-off factors 5/	0.6	…	…	…	…	…	…	…
Gross debt (EMU definition) 6/	41.3	44.3	44.1	41.4	39.1	36.1	34.2	32.4
Central government 1/								
Revenues	25.2	25.0	24.8	24.8	24.2	24.2	23.7	23.4
Expenditure	23.8	24.4	24.4	24.4	23.3	22.9	23.1	22.9
Central government balance	1.4	0.5	0.4	0.4	0.9	1.2	0.6	0.5
Gross debt	41.7	43.9	42.6	39.1	36.1	32.1	30.9	29.7

Sources: Ministry of Finance; and staff projections.

1/ On ESA95 basis.
2/ The fall in revenues in 2003 reflects, in part, cuts in some indirect taxes as well as the fading out of one-off factors related to exceptional tax revenues owing to income from stock options in earlier years.
3/ Excludes net interest on government debt and financial assets
4/ Corrected for the influence of the business cycle as measured by the output gap, adjusted in 2005 for a paper sector dispute that was estimated to have reduced output by about 1 percentage point.
5/ One-off factors include exceptional tax revenues owing to income from stock options.
6/ Includes stock-flow adjustments reflecting changes in the portfolio allocation of Finnish pension funds.

Table 4. Finland: Indicators of Financial Vulnerability, 2000–06

	2000	2001	2002	2003	2004	2005	2006
Households							
Total household debt (in percent of GDP)	29.9	30.8	32.8	36.5	39.6	44.0	45.0
Debt-to-income ratio	64.6	65.9	68.8	73.5	79.2	89.6	94.5
Non-financial corporations							
Gross debt (in percent of GDP)	52.8	53.0	51.1	51.0	50.9	50.9	...
Government							
General government debt (EMU definition, in percent of GDP)	43.8	42.3	41.3	44.3	44.1	41.4	39.1
Central government debt (in percent of GDP)	48.5	44.5	41.7	43.9	42.6	39.1	36.1
Banking sector							
Outstanding credit to nonfinancial private sector (percent change, e.o.p.) 1/	6.4	6.9	7.8	11.2	11.5	12.2	11.4
Of which: housing loans (percent change, e.o.p.)	10.6	11.5	12.9	14.7	15.2	16.7	14.1
Housing loans in percent of total lending to nonfinancial private sector	38.5	40.1	42.0	41.6	43.0	44.7	45.8
Asset Quality							
Non-performing loans/total loans (in percent) 2/ 3/	0.6	0.6	0.5	0.5	0.4	0.3	0.3
Capital Adequacy							
Capital adequacy ratio 3/	11.6	10.5	11.7	18.7	19.1	17.2	15.0
Equity/total assets (in percent)	6.0	5.9	5.6	9.7	8.7	8.8	9.2
Profitability							
Interest rate spread 4/	4.3	3.5	3.2	2.8	2.7	2.5	2.9
Net interest income (in percent of total income) 3/ 5/	46.8	61.4	65.4	63.3	60.8	59.1	52.4
Return on equity (in percent) 3/ 5/	22.4	13.5	10.7	11.3	12.4	10.5	10.6
Return on assets (in percent) 5/	1.2	0.7	0.6	0.7	0.8	0.9	1.0
Liquid assets/total assets (in percent) 6/	15.2	14.0	10.7	12.0	12.9	11.2	12.8
Off-balance sheet liabilities/total assets (in percent)	18.7	20.4	19.6	20.2	15.9	16.2	12.8
Stock market							
Change in stock market index (in percent, e.o.p.)	-10.6	-32.4	-34.4	4.4	3.3	31.1	17.9
Change in housing price index, Helsinki region (in percent, e.o.p.)	9.3	-1.2	10.8	5.9	6.1	5.9	9.9
Change in housing price index, rest of Finland (in percent, e.o.p.)	4.1	-1.5	6.0	6.3	8.2	6.4	6.8

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 2000.
2/ Loans are defined as the sum of claims on credit institutions, the public, and public sector entities.
3/ 2006 data are for June.
4/ Average lending rate minus average deposit rate.
5/ 2001 adjusted for large intrafinancial conglomerate transactions.
6/ Liquid assets are defined as the sum of bills discounted by the central bank, debt securities, and the balance sheet item "liquid assets."

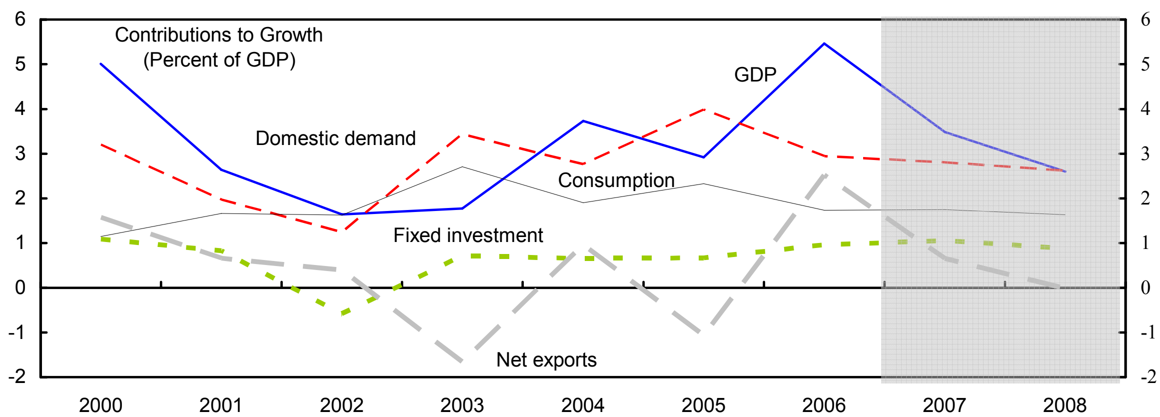
Table 5. Finland: Recent Fund Staff Recommendations and Implementation 1/

Past Staff Recommendations	Implementation
Fiscal policy	
Although the general government surplus has been sizable in recent years, the overall fiscal position under current policies remains unsustainable. Efforts should focus on expenditure restraint, especially at the local level, in light of high tax rates. The efficiency of public services needs to be raised. It may be necessary to further revisit the pension system's parameters.	Signicant reforms in the pension system were adopted in 2005. The multi-year expenditure rule was reformed to increase its effectiveness. Efforts to improve expenditure efficiency are being implemented, with greater success to date at the central government level. Intergovernmental financing rules are being revised and measures to encourage municipal mergers have been adopted.
Labor market policy	
The wage bargaining system needs to allow for greater flexibility in wage setting. Measures are needed to ease labor market mismatches, reduce structural unemployment, and induce earlier entry into the labor force. Various "pipelines" to early labor force departure need to be further curtailed.	Employment gains under previous government exceeded its target. Centralized bargaining will not be in force in the current wage negotiations. Labor tax rates have been cut generally, with additional specific reductions targeted for older, less productive workers. These cuts are to be extended notably to young labor market entrants. Labor force service centers have been established for the hard-to-employ. The unemployment pension is to be phased out from 2009, and the "unemployment pipeline" was tightened to begin from age 57. Employment rates among older workers have increased considerably in recent years.
Competition policy	
Strengthen competition in product markets, especially in "sheltered" sectors, to boost productivity growth.	Competition Authority's powers have been enhanced to more directly address anti-competitive behavior. Research has been launched to assess developments in competition, specifically in the service sector.

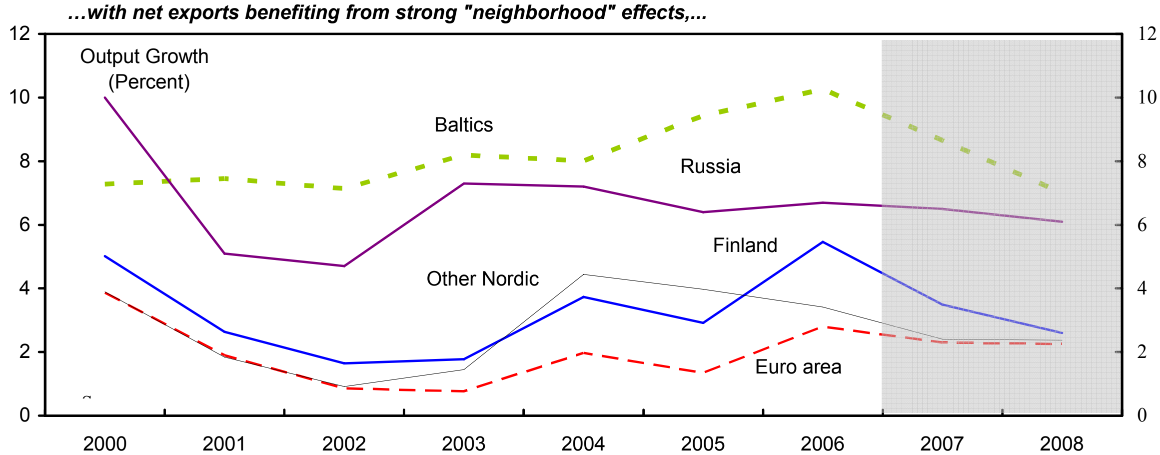
1/ See the Country Reports for 2004 and 2005 (http://www.imf.org/external/pubs/cat/longres.cfm?sk=18025.0; http://www.imf.org/external/pubs/cat/longres.cfm?sk=18857.0).

Figure 1. Finland: Growth and Inflation, 2000-08

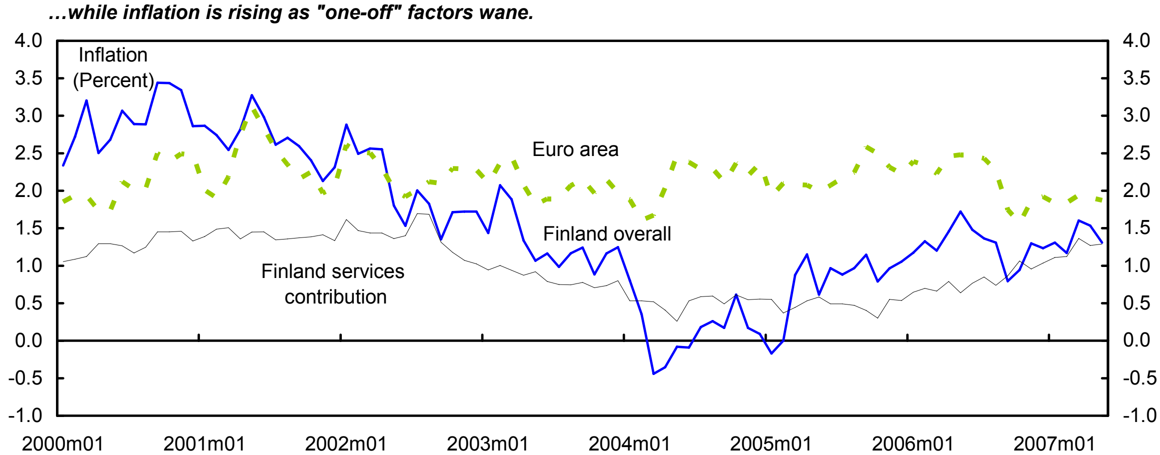
Growth surged to 5 1/2 percent in 2006, 1 percentage point of which from a labor dispute rebound,...



...with net exports benefiting from strong "neighborhood" effects,...



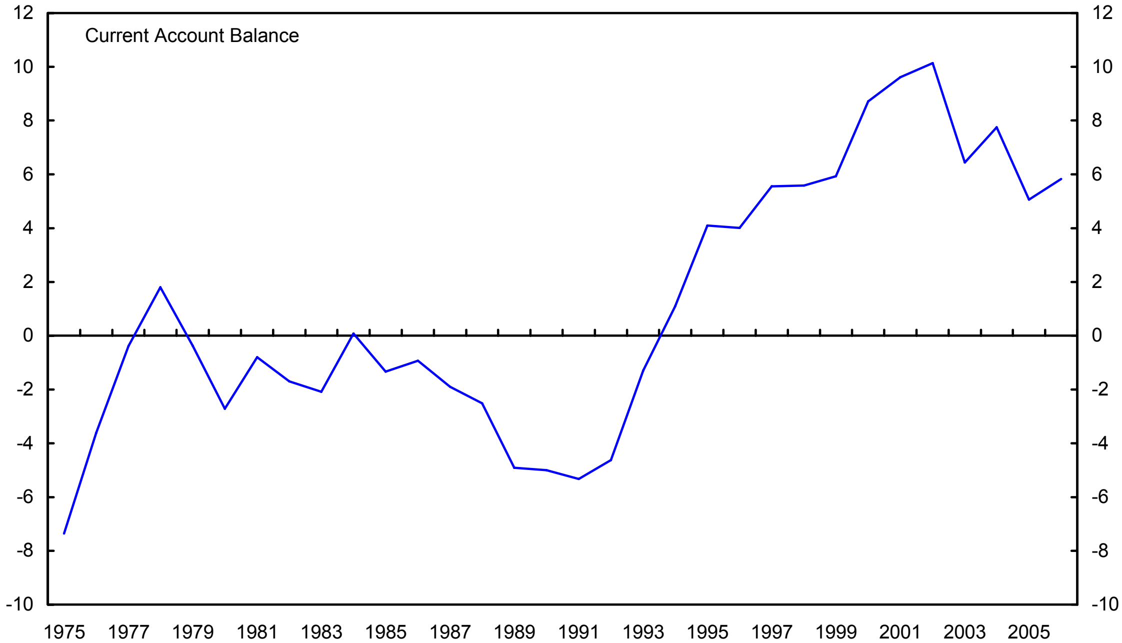
...while inflation is rising as "one-off" factors wane.



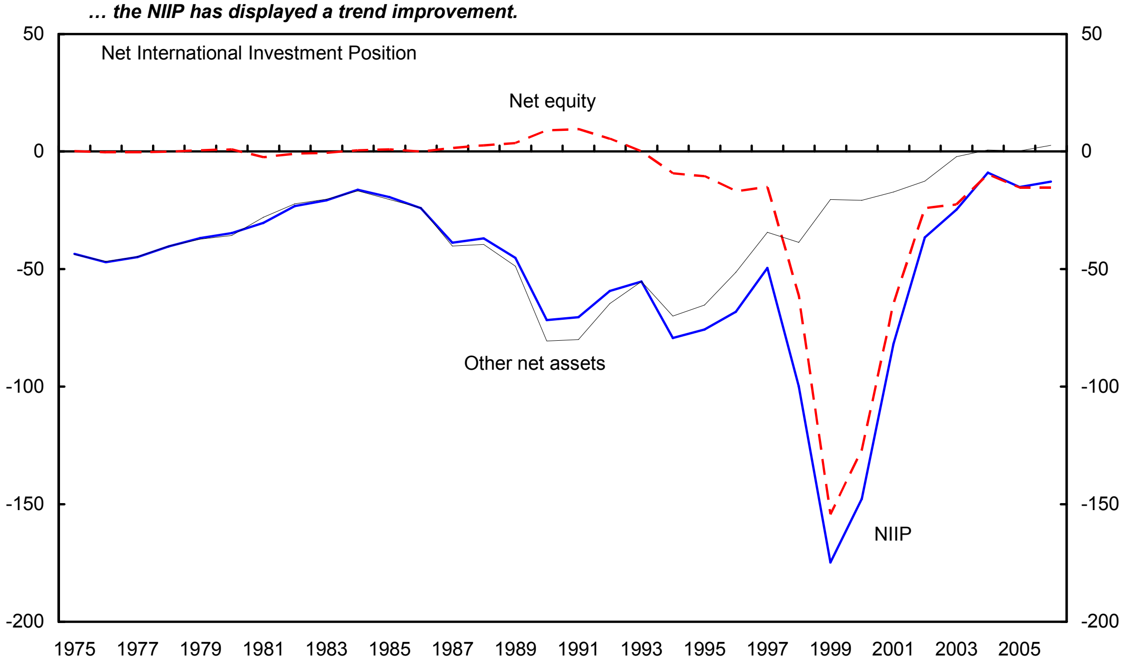
Sources: Statistics Finland Eurostat; and IMF staff estimates.

Figure 2. Finland: Current Account and Net International Investment Position, 1975-2006
(Percent of GDP)

While the current account surplus has declined from its ICT-boom peak...



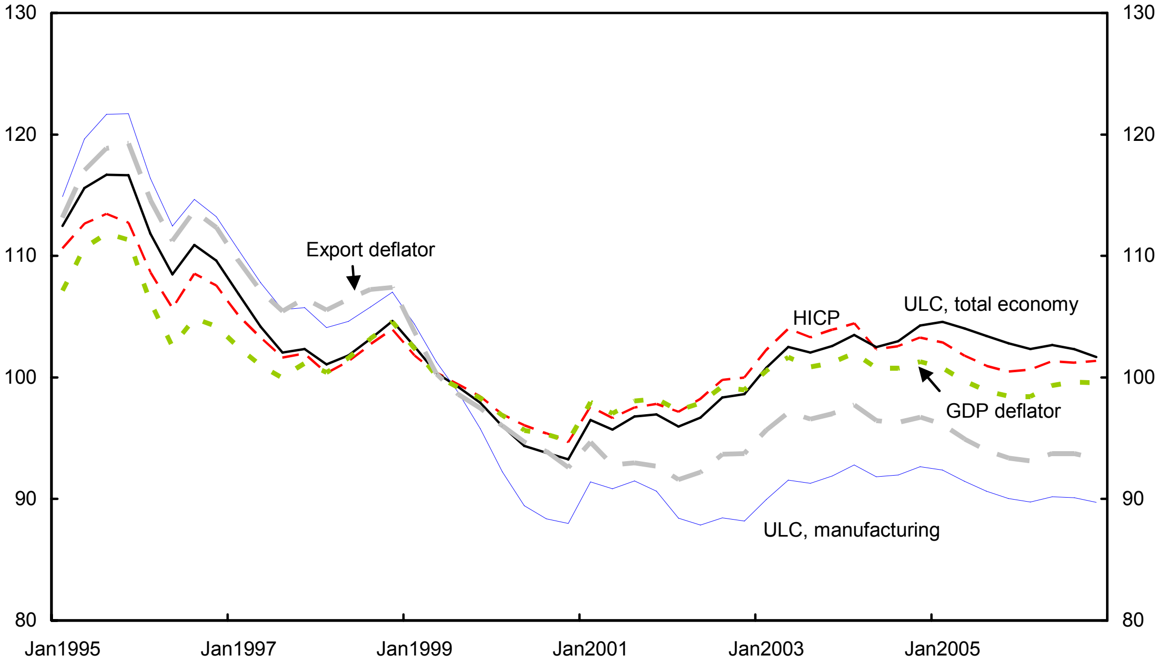
… the NIIP has displayed a trend improvement.



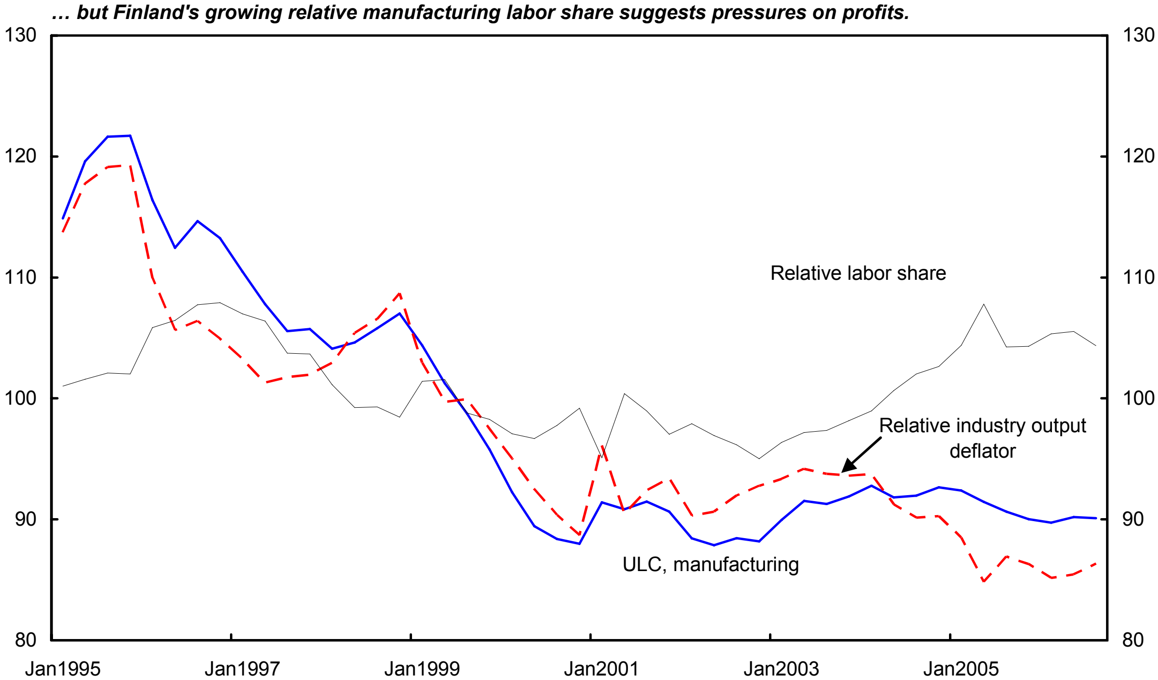
Sources: IFS; WEO.

Figure 3. Finland: Real Effective Exchange Rates, 1995-2006
(1999 = 100)

Most measures of external competitiveness are adequate,...



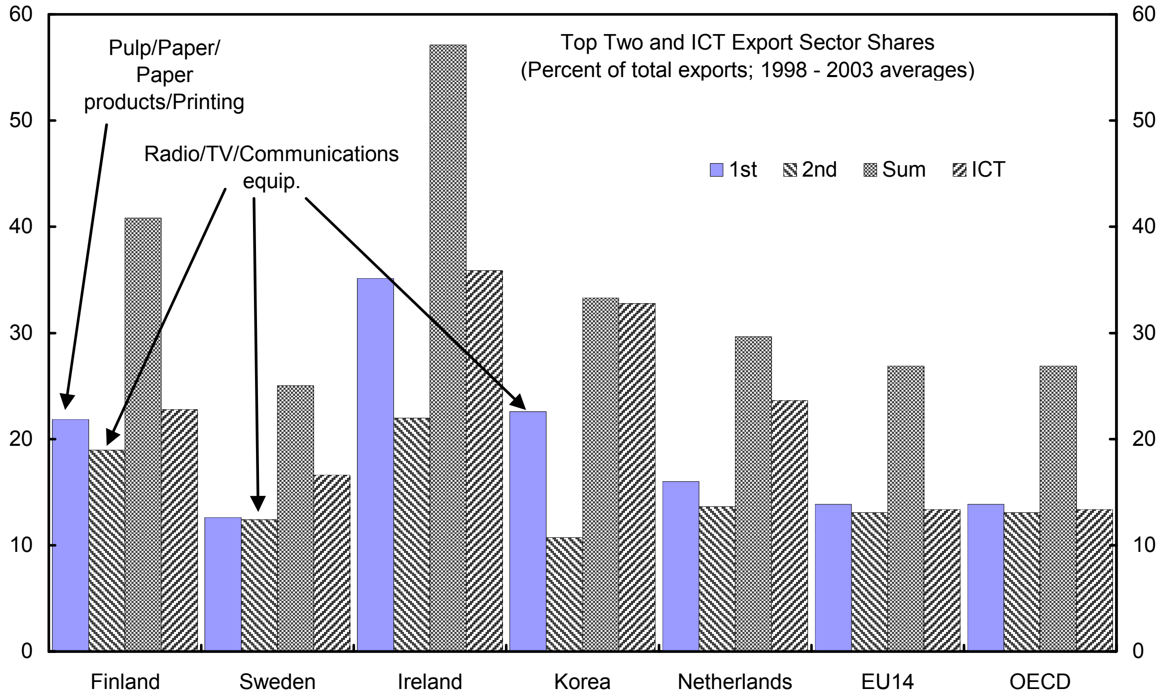
… but Finland's growing relative manufacturing labor share suggests pressures on profits.



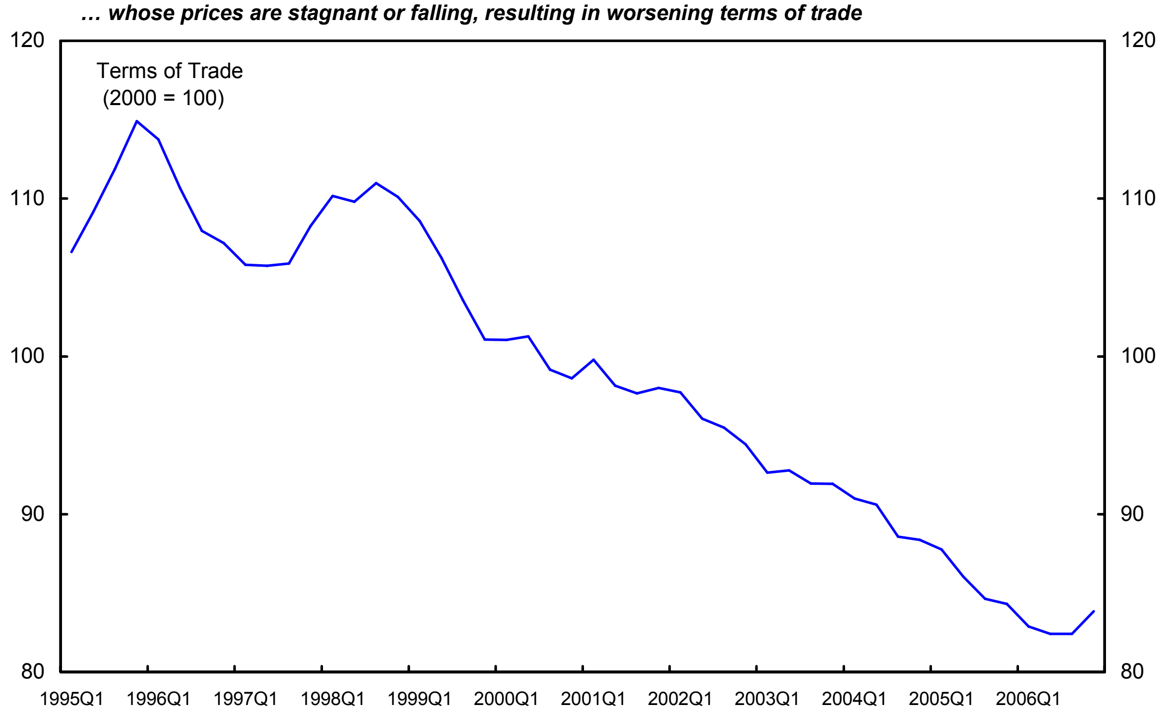
Sources: European Commission; and IMF staff estimates.

Figure 4. Finland: Export Shares and Terms of Trade

External risks stem from comparatively large reliance on a few export sectors...

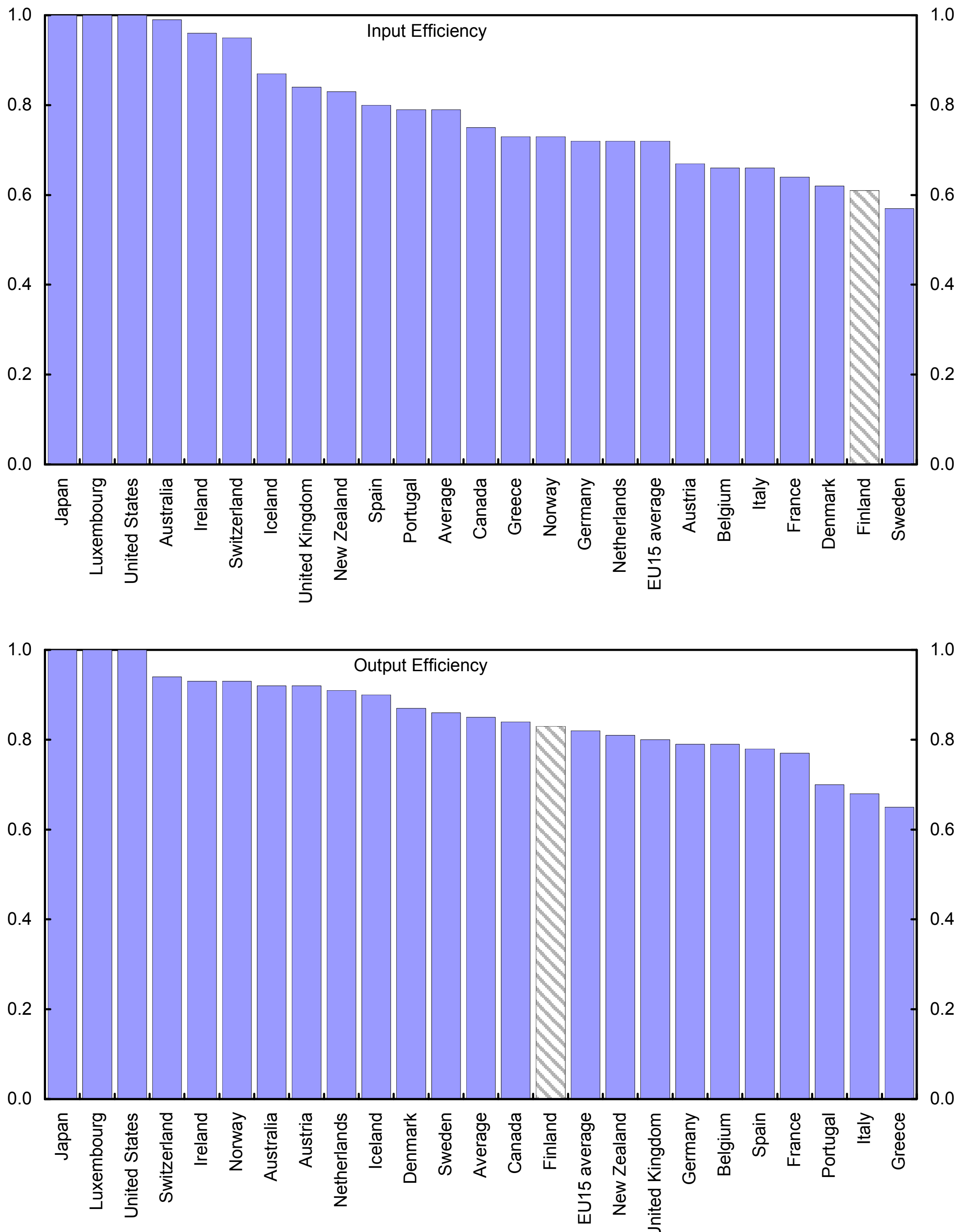


… whose prices are stagnant or falling, resulting in worsening terms of trade



Sources: OECD STAN database; IFS.

Figure 5. Finland: Public Sector Efficiency Measures, 2000 1/

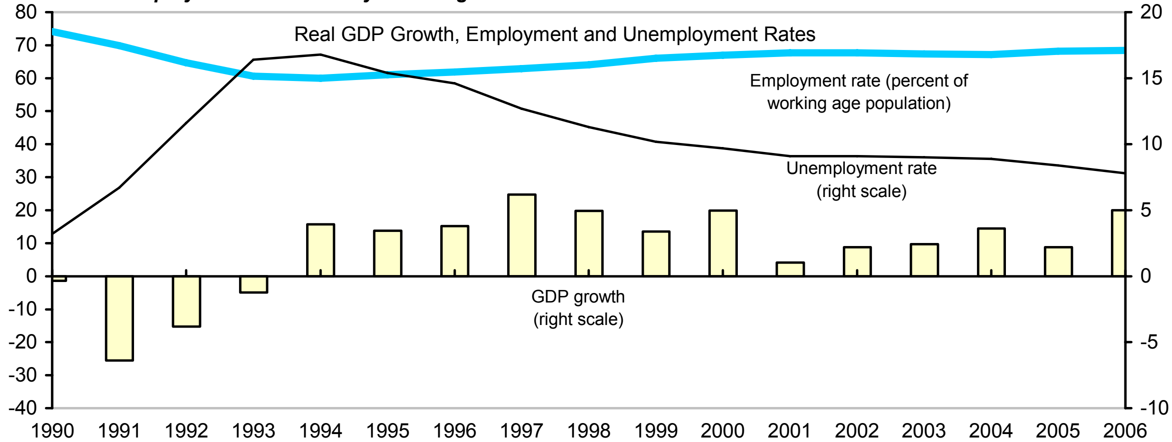


Source: Afonso, Schuknecht, and Tanzi (2005)

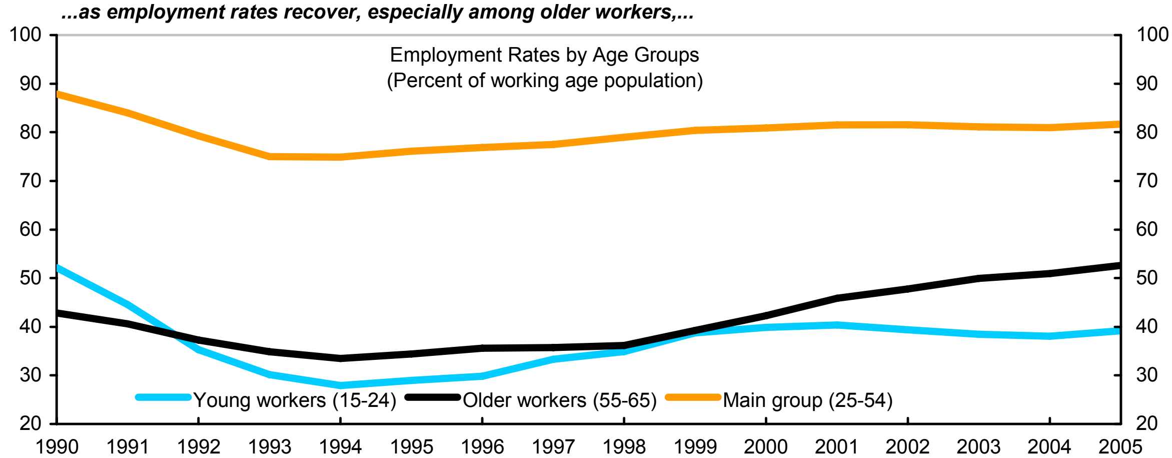
1/ / Production frontier analysis. Measured relative to the most efficient country (with a score of 1.0), the input efficiency indicates how much less input a country could use to achieve its current output (e.g., 0.6 indicates that it could achieve the same output with only 60 percent of current inputs); the output efficiency indicates how much less output a country is producing (e.g., 0.8 indicates that it is producing only 80 percent of output with the same input as the most efficient country). Input is public expenditure as a percent of GDP; output is a composite public sector performance indicator comprising seven public goods and services.

Figure 6. Finland: Labor Market Developments, 1990-2006

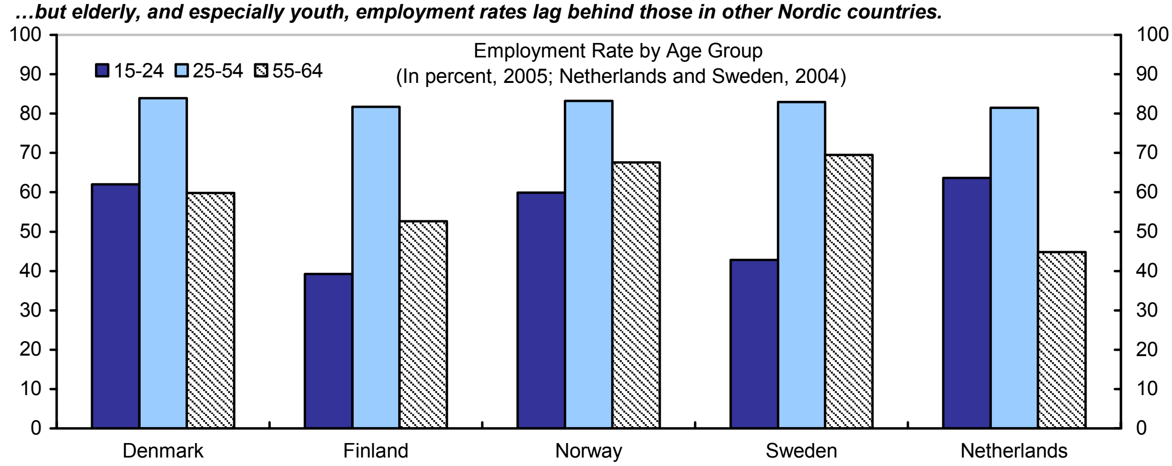
The unemployment rate is slowly declining...



...as employment rates recover, especially among older workers,...

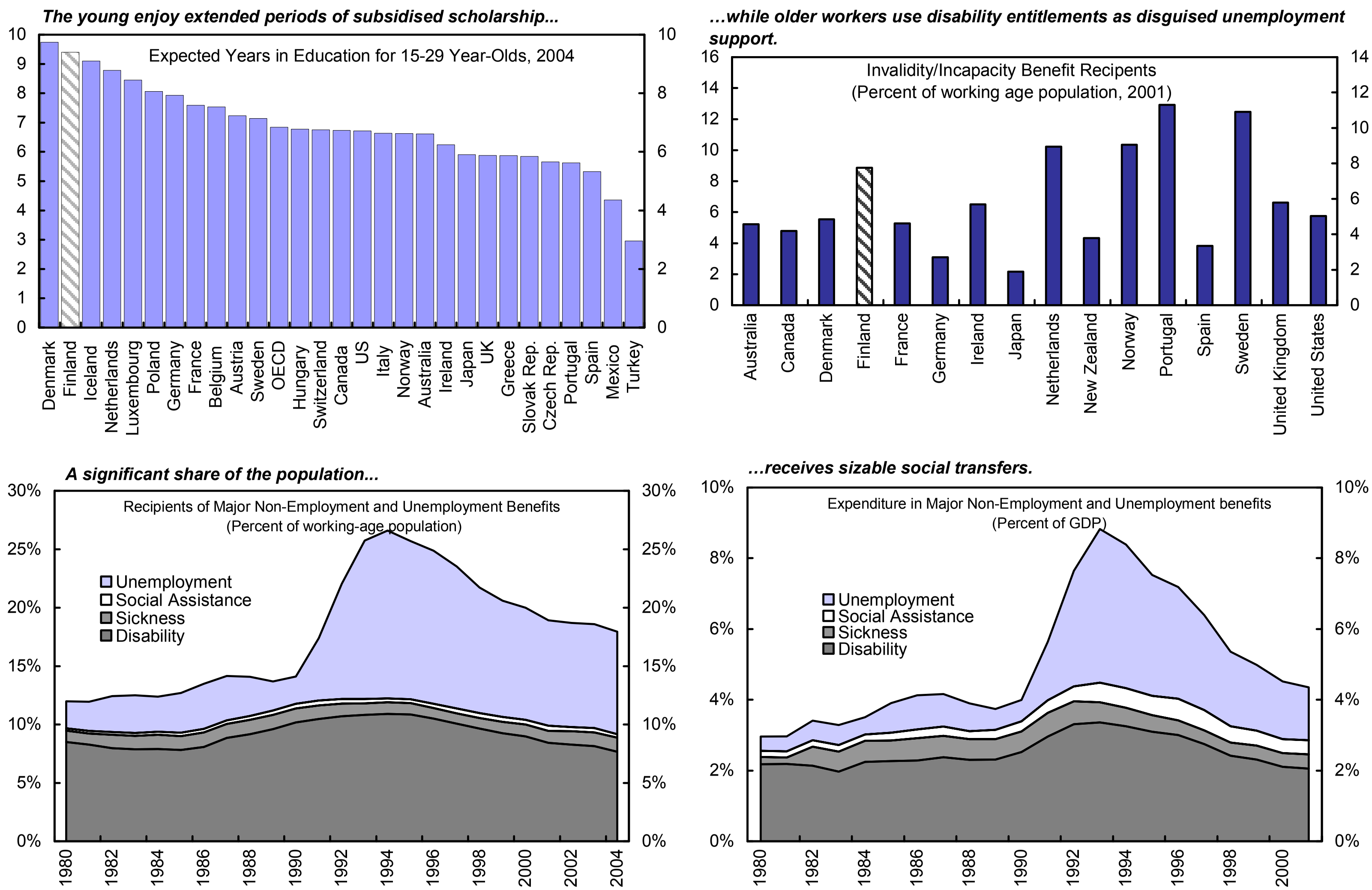


...but elderly, and especially youth, employment rates lag behind those in other Nordic countries.



Source: OECD.

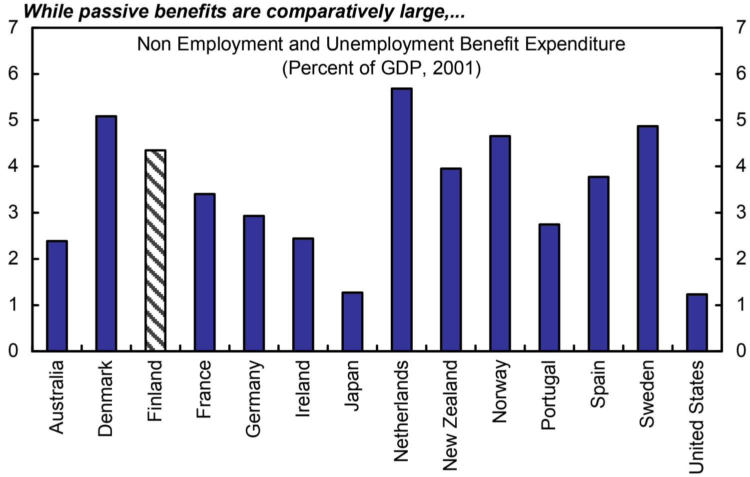
Figure 7. Finland: Selected Labor Market Characteristics, 1980-2004



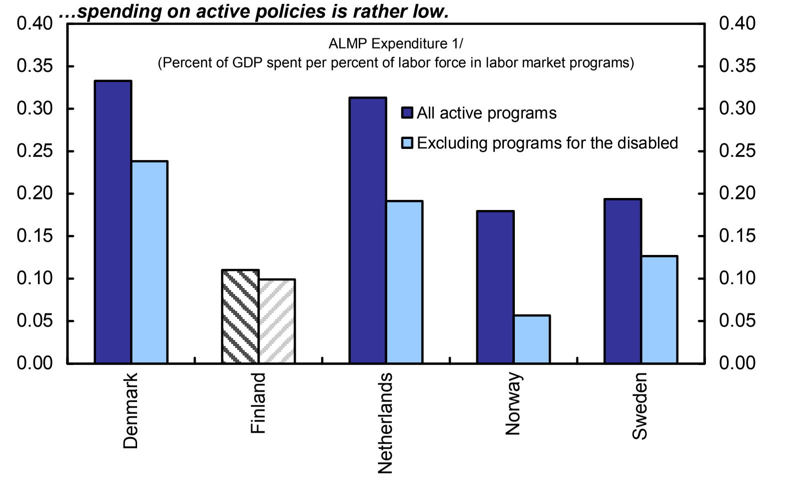
Source: OECD; and Carcillo and Grubb (2006).

Figure 8. Finland: Selected Labor Market Characteristics

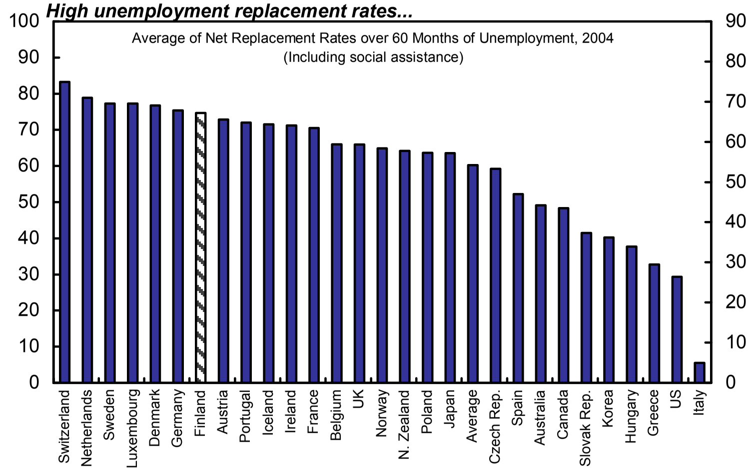
While passive benefits are comparatively large,...



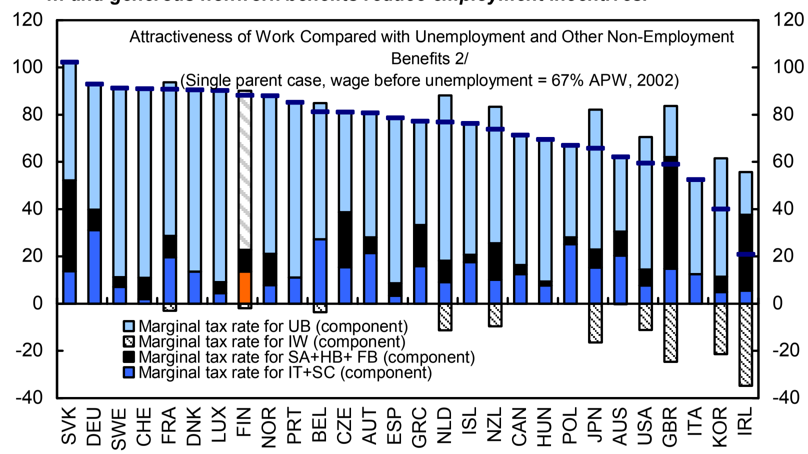
...spending on active policies is rather low.



High unemployment replacement rates...



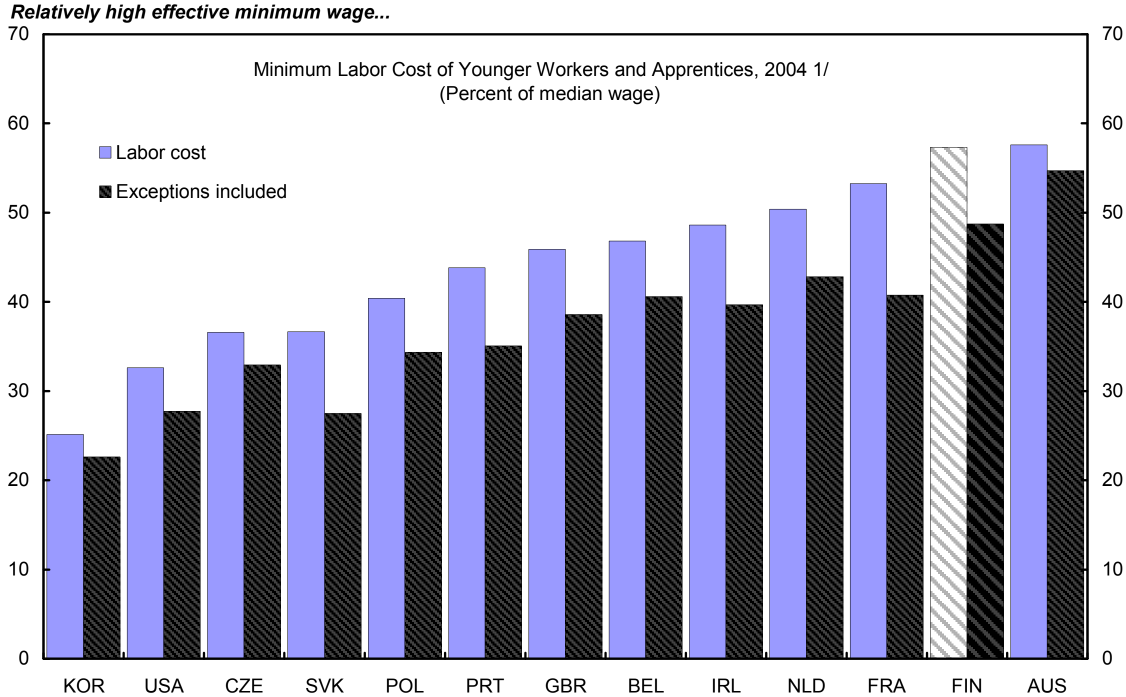
... and generous nonwork benefits reduce employment incentives.



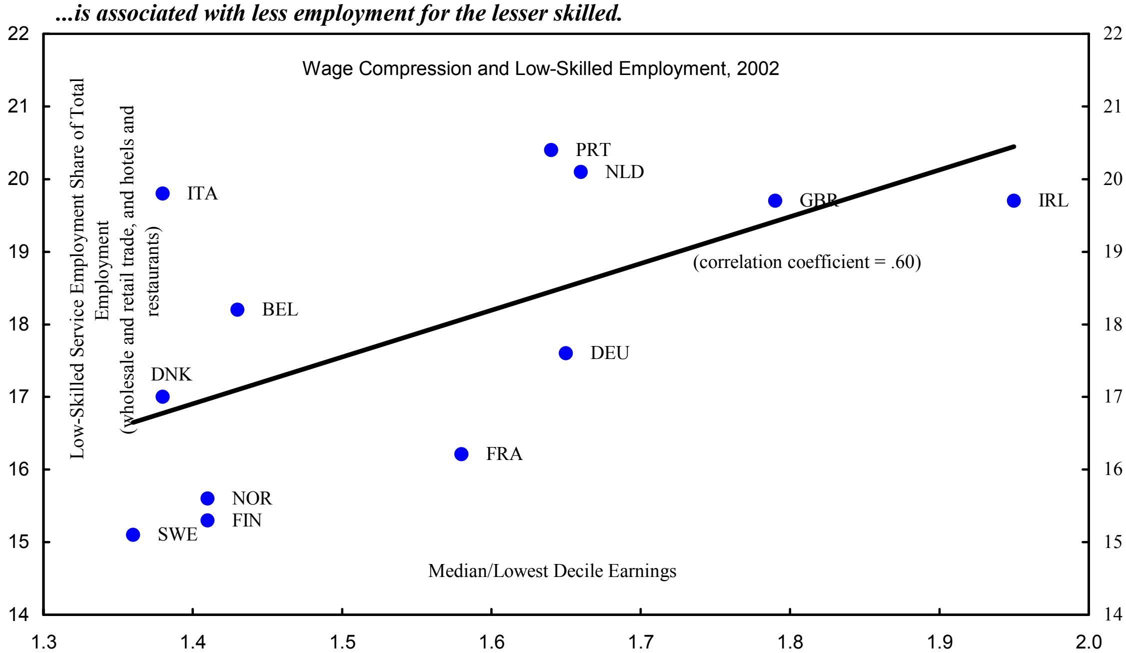
Source: OECD.
1/ ALMP: active labor market programs.
2/ APW: average production wage, UB: unemployment benefits, IW: in-work benefits, SA: social assistance, HB: housing benefits, FB: family benefits, IT: income tax (net of any tax benefits), SC: employees' social security contributions.

Figure 9. Finland: Wage Compression and Low-Skilled Employment

Relatively high effective minimum wage...



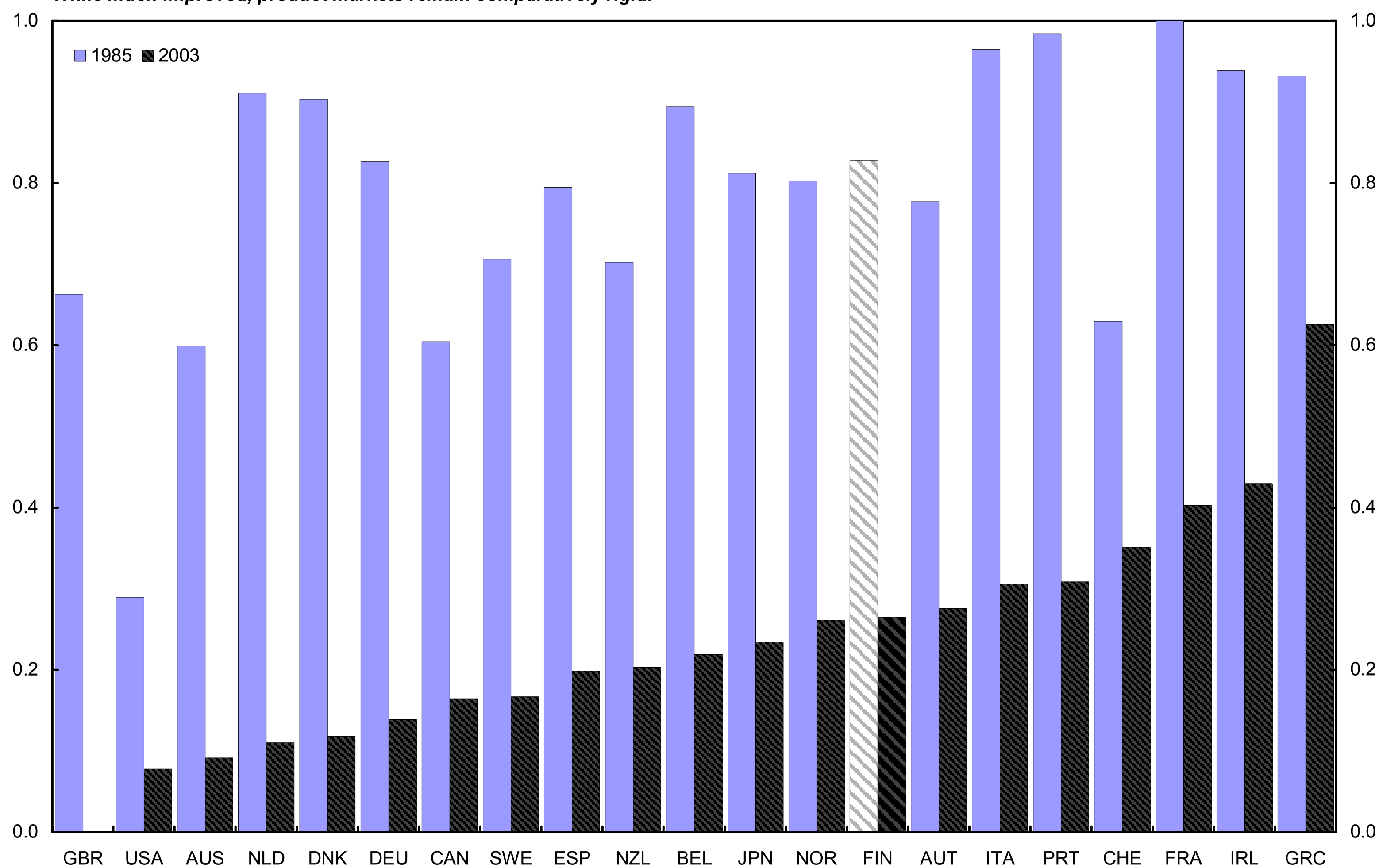
...is associated with less employment for the lesser skilled.



Sources: OECD, Miminum Wage and Taxing Wages database; OECD.
1/ The costs of labor is the sum of wage level and the corresponding social security contribution paid by employers for a single worker. The minimum cost for younger workers includes exceptions by age or by contract.

Figure 10. Finland: Product Market Rigidity 1/

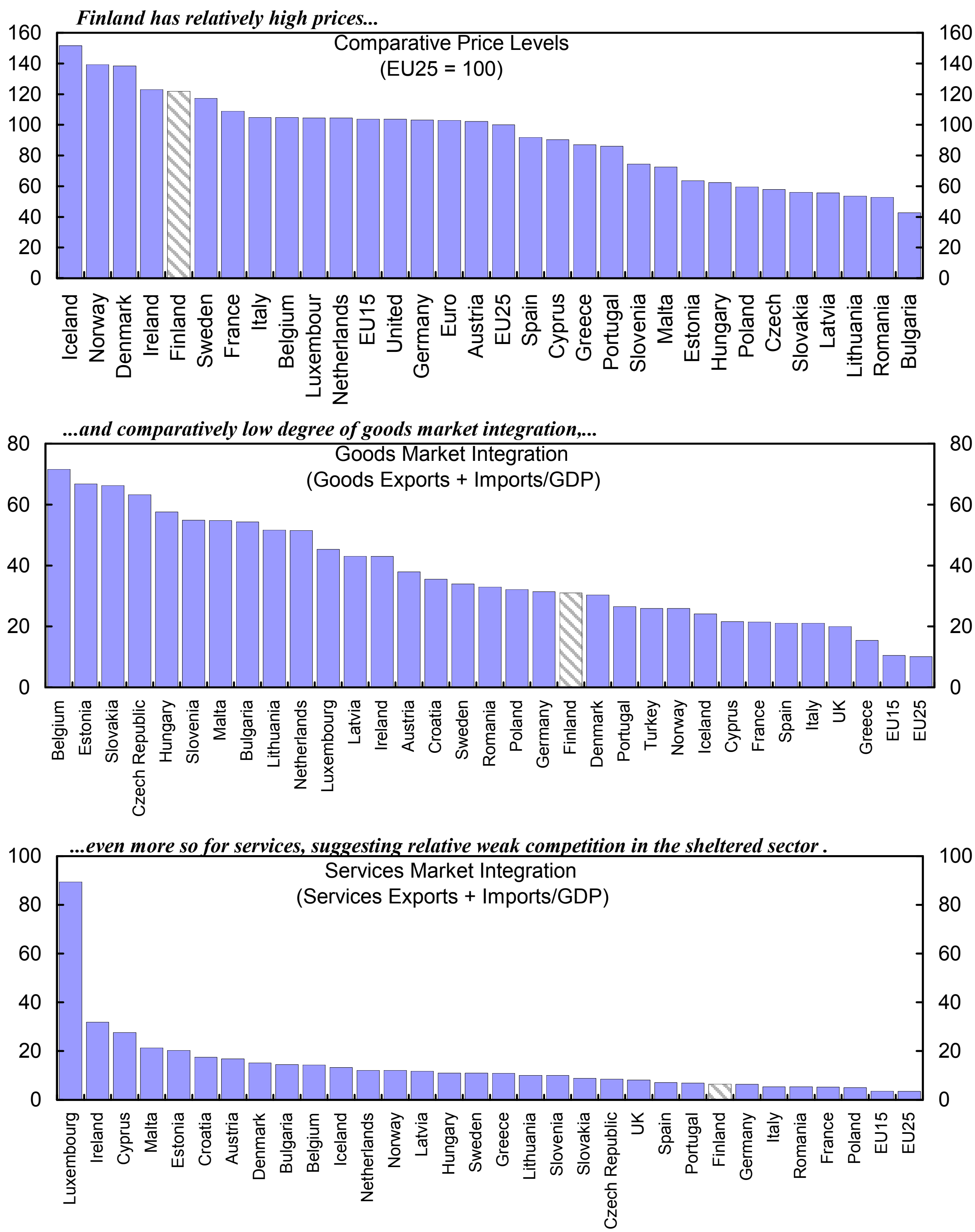
While much improved, product markets remain comparatively rigid.



Source: OECD *Going for Growth 2007*.

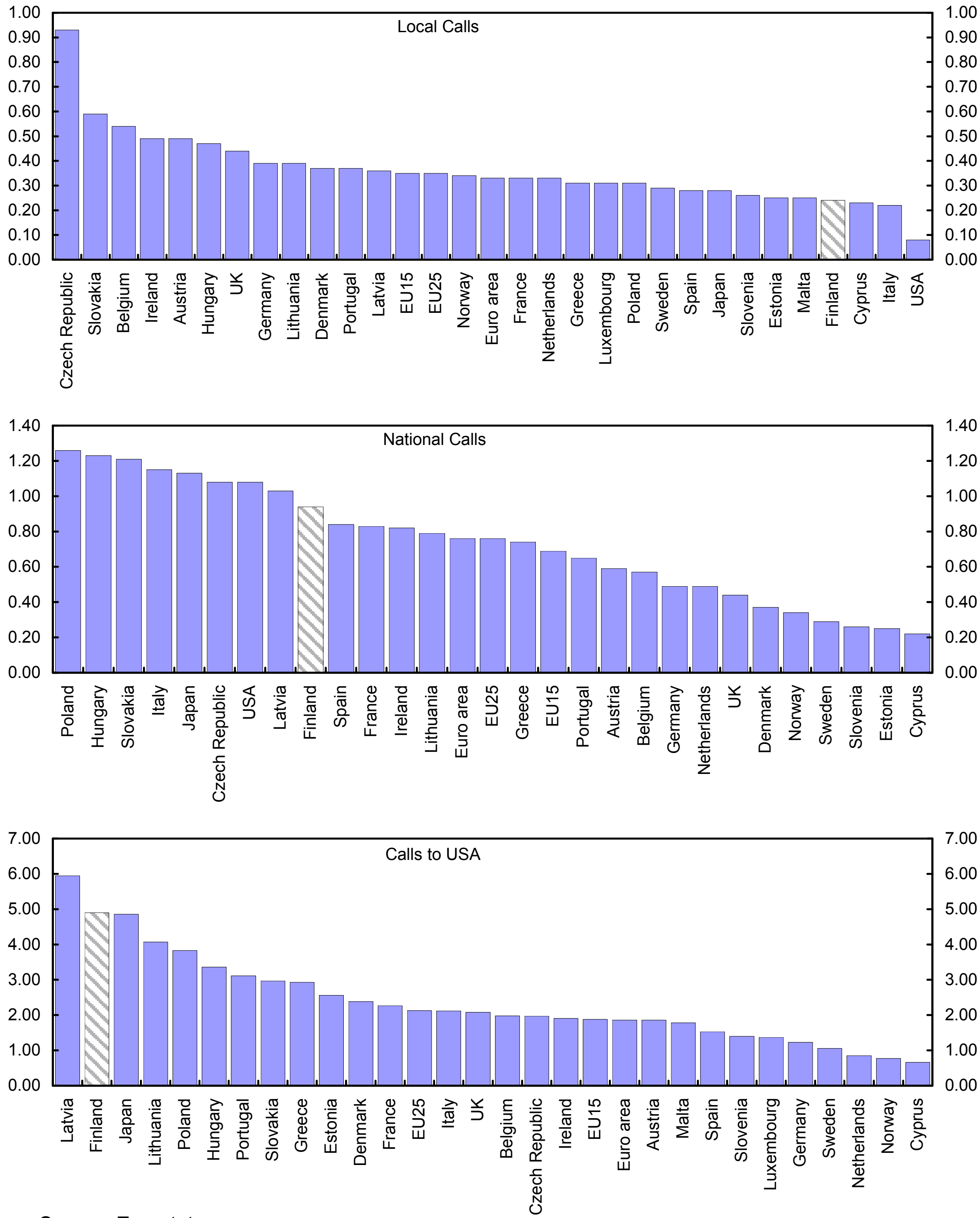
1/ Covers competition-restraining regulation in energy, transport and communications sectors, where 1 indicates the highest level of rigidity.

Figure 11. Finland: Selected Product Market Indicators, 2005



Source: Eurostat.

Figure 12. Finland: Telecommunication Charges, 2005
(10 minute calls)



Source: Eurostat.

INTERNATIONAL MONETARY FUND

FINLAND

Staff Report for the 2007 Article IV Consultation—Informational Annex

Prepared by the European Department

July 11, 2007

Contents Page

APPENDIX I. FINLAND: FUND RELATIONS

(As of April 30, 2007)

- A staff team comprising Messrs. Figliuoli (head), Lutz, Mottu (all EUR), and Carcillo (FAD) visited Helsinki during May 22–31. They met Mr. Liikanen, Governor of the Bank of Finland, Mr. Katainen newly appointed Minister of Finance, Mr. Hetemäki, permanent Under Secretary of State at the Ministry of Finance, other senior officials of the central bank, economic ministries, and the Financial Supervisory Authority. Mr. Saarenheimo, the Executive Director for the Nordic-Baltic region, 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 wide coverage in the Finnish media. The authorities intend to publish the staff report.

- Parliamentary elections were held on March 18, and a center-right coalition government took office, replacing a center-left coalition, both with the Centre Party as their pivot and Mr. Matti Vanhanen as Prime Minister.

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

II.	**General Resources Account:**	**SDR Million**	**Percent of Quota**
	Quota	1,263.80	100.00
	Fund holdings of currency	1,167.13	92.35
	Reserve Position	96.72	7.65
III.	**SDR Department:**	**SDR Million**	**Percent of Allocation**
	Net cumulative allocation	142.69	100.00
	Holdings	128.46	90.03
IV.	**Outstanding Purchases and Loans:**	None	
V.	**Latest Financial Arrangements:**	None	

VI. **Projected Payments to Fund**

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

	Forthcoming				
	2007	2008	2009	2010	2011
Principal					
Charges/Interest	0.45	0.61	0.61	0.61	0.61
Total	0.45	0.61	0.61	0.61	0.61

VII. **Exchange Arrangements:**

Finland's currency is the euro, which floats freely and independently against other currencies.

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. An updated and comprehensive list of all EU restrictions can be found at: http://ec.europa.eu/external_relations/cfsp/sanctions/measures.htm

VIII. **Article IV Consultation:**

Discussions for the 2005 Article IV consultation were held in Helsinki during October 18–25, 2005 and the Executive Board concluded the consultation on January 30, 2006. Country Report No. 06/36 summarizing the views of the Executive Board, was published.

APPENDIX II. FINLAND: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE

(As of June 12, 2007)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of publication[6]	Memo Items: Data Quality – Methodological soundness[7]	Memo Items: Data Quality – Accuracy and reliability[8]
Exchange Rates	June 12, 2007	June12, 2007	D	D	D		
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	May 2007	June 2007	M	M	M		
Reserve/Base Money	May 2007	June 2007	M	M	M		
Broad Money	Apr. 2007	June 2007	M	M	M		
Central Bank Balance Sheet	May 2007	June 2007	M	M	M		
Consolidated Balance Sheet of the Banking System	Apr. 2007	Apr. 2007	M	M	M		
Interest Rates[2]	June 12, 2007	June 12, 2007	D	D	D		
Consumer Price Index	Apr. 2007	May 2007	M	M	M	O, O, O, O	LO, O, LO, O, O
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	2006	Mar. 2007	A	A	A	LO, LO, LNO, O	LO, O, O, O, O
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	2006	Mar. 2007	A	A	A		
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4, 2006	Mar. 2007	Q	Q	Q		
External Current Account Balance	Mar. 2007	May 2007	M	M	M	O, O, O, LO	LO, O, LO, O, O
Exports and Imports of Goods and Services	Mar. 2006	May 2007	M	M	M		
GDP/GNP	Q4. 2006	Mar. 2007	Q	Q	Q	O, O, O, O	LO, O, LO, O, O
Gross External Debt	Q4. 2006	Mar. 2007	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 National Insurance Scheme, and local governments.
[5] Including currency and instrument composition.
[6] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A), Irregular (I); Not Available (NA).
[7] Reflects the assessment provided in the data ROSC published in October 2005, and based on the findings of the mission that took place during May 10–25, 2005 for the dataset corresponding to the variable in each row. The assessment indicates whether international standards concerning concepts and definitions, scope, classification/sectorization, and basis for recording are fully observed (O), largely observed (LO), largely not observed (LNO), or not observed (NO).
[8] Same as footnote 7, except referring to international standards concerning source data, statistical techniques, assessment and validation of source data, assessment and validation of intermediate data and statistical outputs, and revision studies.

Statement by the IMF Staff Representative
August 1, 2007

1. This statement provides an update on recent economic developments based on information received after the staff report was issued. The new information does not alter the thrust of the staff appraisal.

2. **There have been further revisions to the national accounts**. Estimates published in July indicate that annual growth in 2006 was lower than previously thought 5 rather than 5½ percent, as a result of more comprehensive data and the correction of a methodological error in the preliminary data. Private consumption and imports were revised up, while public investment is now thought to have shrunk. The contribution of net exports to growth has been halved to 1¼ percent of GDP. As mentioned in the staff report, data issued in June for the first quarter of 2007 and a revised quarterly pattern of GDP for 2006 suggested that the momentum of growth in 2007 is stronger than expected during the mission.

3. **In response to the June data revisions, the authorities have tentatively raised their GDP growth projections.** Specifically, the Ministry of Finance has increased its 2007 projection to 4.3 percent for 2007 and to 3.2 percent for 2008. The Ministry of Finance and the Bank of Finland will release their next official projections in September.

4. **The staff's GDP growth projections remain as stated in the report, despite the lower 2006 growth**. Based on the data issued in June, staff had already revised upwards its growth outlook for 2007 and 2008 in the report. The downward adjustment of 2006 GDP included in the July release of the national accounts was concentrated in the first quarter of the year, which does not impact negatively on growth prospects for 2007.

Selected Indicators

		Projected	
	2006	2007	2008
GDP growth	(Percent change)		
Authorities (March 2007)	5.5	3.1	2.7
Authorities (June 2007)	5.0	4.3	3.2
Staff (Staff Report)	5.5	4.0	2.8
Staff (revised)	5.0	4.0	2.8
Current account	(Percent of GDP)		
Staff (Staff Report)	5.8	6.6	6.1
Staff (revised)	4.7	5.3	4.8

5. **In light of the revisions to the national accounts, staff has lowered its estimate of the 2006 current account surplus to about 5 percent of GDP.** The downward revision by some 1 percentage point reflects higher imports of services and, to a lesser degree, goods. This has also led staff to reduce its projections of a current account surplus by broadly similar amounts in future years. Staff's estimates of the competitiveness margins are correspondingly somewhat smaller.

6. **Inflation in June was 1.4 percent, in line with the annual projection of 1.5 percent**.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 07/95
FOR IMMEDIATE RELEASE
August 3, 2007

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

IMF Executive Board Concludes 2007 Article IV Consultation with Finland

On August 1, 2007, the Executive Board of the International Monetary Fund (IMF) concluded the 2007 Article IV consultation with Finland.[1]

Background

Economic developments in recent years have been enviable. Growth has outpaced the euro area average, inflation is among the lowest in the European Union, and the external current account and general government budget are both comfortably in surplus. Nevertheless, the onset of population aging will be felt more rapidly in Finland than elsewhere in the EU (with the working age population projected to begin declining at the end of the decade). Without fiscal and structural reforms, this threatens long-term growth prospects and fiscal sustainability.

The economy is set to grow by about 4 percent in 2007, lower than the 5½ percent recorded in 2006, although the 2006 outcome was boosted by the rebound from a labor-dispute in the paper sector that shaved off about 1 percentage point from 2005 growth. The decline is almost entirely attributable to a smaller contribution from net exports (similarly influenced by the labor dispute), with the contribution of domestic demand growth projected to increase by about ½ percent of GDP. Consumption growth remains robust, despite rising interest rates and household debt loads, boosted by strong employment growth, income tax cuts, and strong consumer confidence. With the economy operating slightly above its potential, economic growth is expected to cool somewhat in 2008 to about 2½ percent, with declining contributions from all

[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.

components—consumption, investment, and net exports. Risks to the growth outlook are balanced.

The labor market has improved markedly since 2005, with rising participation rates and comparatively strong employment growth. The unemployment rate has dipped below the euro area average, and hovers near estimates of the structural unemployment rate. Labor shortages are increasing, especially in the construction sector and in the capital region.

Inflation has remained tamed, largely from comparatively high productivity gains that have limited unit labor cost growth, and a trend worsening in the terms of trade. However, other one-off effects that have also dampened price growth are waning, and inflation is slowly nearing the euro area average. Also, while the current multi-year, economy-wide wage compact (set to expire in the fall) has helped contain labor costs, a shift to sectoral agreements in the coming round may exacerbate wage and inflation pressures, though providing scope for useful pay differentiation.

Various estimates point to a benign external competitiveness position for Finland. The current account surplus has been in excess of 5 percent of GDP in recent years, contributing to a improved net international investment position.

The fiscal position strengthened markedly last year, with the general government surplus nearing 4 percent of GDP, a surplus expected to persist in 2007. The budget has benefited from higher-than-expected growth combined with a determined implementation of the authorities' multi-year spending limits on central government outlays. As a result, the debt ratio has fallen below 40 percent of GDP and the pension systems' assets now approach 70 percent of GDP. However, on the basis of official macro projections, the new government's program implies a sharp deterioration of the fiscal position, with the surplus declining to about 2 percent of GDP by the end of its mandate in 2011.

Executive Board Assessment

Executive Directors commended the authorities' stability-oriented macroeconomic policies that have underpinned a prolonged economic expansion. Growth and inflation developments have both outperformed euro area averages, and recent activity indicators suggest near-term growth prospects are favorable. The general government has recorded sizable surpluses, and is expected to do so again this year.

Directors concurred that the competitiveness of the Finnish economy is broadly appropriate. The external current account surplus is sizable at present, and some measures indicate comfortable competitiveness margins. However, rapid population aging, worsening terms of trade, and pressures on exporters' profitability suggest that the surplus is likely to decline over the medium to long term.

Despite this favorable background, Directors cautioned that Finland faces considerable challenges. They stressed that Finland's exceptionally rapid population aging and sluggish productivity in sheltered sectors raise concerns about long-term growth and soundness of its public finances. In addition, from a short-run perspective, the economy is estimated to be operating slightly above its growth potential, with rising geographic and skill-specific labor market shortages, which, with growing mismatches, could stoke wage and inflationary pressures. Indeed, the move from the traditional economy-wide wage agreement to sectoral, union-level wage negotiations for 2008 heightens inflationary risks, though holding promise of fostering much needed pay differentiation. Furthermore, the export base remains relatively narrow, posing risks to growth prospects.

In this light, and notwithstanding the already sizable general government surplus, Directors advised a somewhat tighter fiscal policy for both cyclical and sustainability reasons. They noted that, given positive output gaps expected in 2007–08 and tightening labor markets, some withdrawal of fiscal stimulus would be appropriate. Thus, Directors welcomed the authorities' intention to correct the fiscal stance envisaged for 2008–11, were signs of overheating to arise. In the period beyond 2011, Directors saw the need to target a uniform improvement in the primary surplus of about 2 percent of GDP, in order to prepare for the anticipated expenditure pressures from population aging.

Given already high revenue and expenditure levels, Directors stressed that fiscal adjustment efforts should concentrate on reducing the growth of public spending, preferably through increased efficiency, especially at the local level. To achieve this, they supported benchmarking to identify best practices, and redesigning and extending the system of expenditure ceilings. They also saw merit in greater recourse to outsourcing and well-designed public private partnerships, rebalancing user charges, and the reform of intergovernmental fiscal relations, to tighten municipal budget constraints.

Executive Directors noted that longer-term growth prospects and fiscal sustainability, would be bolstered by improvements in labor and product market performance. Greater utilization of human resources and strengthened competition in product markets were seen as vital components of boosting Finland's growth potential and placing its public finances on a sounder footing. Directors considered that efforts to increase employment rates by the young and older workers would be most useful. Increased wage differentiation was deemed to help "price-in" those with little labor market experience or low skills. Reducing the scope for early retirement and increasing activation requirements, along with the elimination of "poverty traps" through reform of tax and benefit schemes, could also foster greater employment, especially among older workers. Policies responding to these issues will need to take political economy considerations into account. Directors advocated measures to enhance competition, especially in sheltered sectors, to complement labor market reforms and boost productivity growth.

Directors welcomed the soundness and stability of the financial sector, as well as its diligent supervision. At the same time, they counseled vigilance, in light of rising international integration and rapidly evolving infrastructure. Enhanced cross-border cooperation among supervisors is crucial given the expanding foreign ownership of domestic banking operations. And heightened cooperation with both market participants and foreign supervisors was desirable to control the systemic risks arising from the adoption of new technologies or products.

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.

Finland: Selected Economic Indicators

	2004	2005	2006	2007 1/
Real economy				
GDP (change in percent)	3.7	2.9	5.5	4.0
Domestic Demand (change in percent)	3.0	4.3	3.1	3.6
Harmonized CPI (change in percent) 2/	0.1	0.8	1.3	1.5
Unemployment rate (in percent) 2/	8.8	8.4	7.7	6.7
Gross national saving (in percent of GDP)	26.5	25.7	26.6	27.5
Gross domestic investment (in percent of GDP)	18.8	20.6	20.7	21.0
Public finances (general government, in percent of GDP)				
Overall balance	2.1	2.5	3.8	4.0
Primary balance 3/	2.1	2.5	3.7	3.9
Gross debt (Maastricht definition)	44.1	41.4	39.1	36.1
Money and credit (end of year, percentage change)				
M3 (Finnish contribution to euro area) 4/	6.3	8.2	8.1	10.0
Total domestic credit 4/	10.5	12.9	12.1	12.0
Interest rates (year average)				
Three-month money market 5/	2.1	2.2	3.1	3.9
Ten-year government bonds 5/	4.1	3.4	4.0	4.0
Balance of payments (in percent of GDP)				
Trade balance	6.6	4.9	5.7	6.1
Current account	7.7	5.1	5.8	6.6
Fund position (as of end-April 2007)				
Fund holding of currency (in percent of quota)		92.4		
Holdings of SDRs (in percent of allocation)		90.0		
Quota (in millions of SDRs)		1,263.80		
Exchange rate				
Exchange rate regime		Euro		
Present rate (July 5, 2007)		US$ 1.36 per euro		
Nominal effective exchange rate (increase in percent) 6/	2.2	-0.5	0.0	1.7
Real effective exchange rate (increase in percent) 7/	2.4	0.2	0.2	1.8

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 2007, 12-month increase to March.

5/ For 2007, monthly average for March.

6/ For 2007, average 12-month increase to May.

7/ Based on unit labor costs. For 2007, average 12-month increase to May.

Statement by Tuomas Saarenheimo, Executive Director for Finland
August 1, 2007

Recent Economic Developments and Outlook

1. The upswing of the Finnish economy since the beginning of 2006 is proven to be stronger and longer lasting than anticipated. In the first quarter of this year, GDP growth continued at the brisk rate of 5 percent. As consumer confidence and domestic demand appear to be holding up well, the growth rate for the full year of 2007 is likely to come in at slightly above 4 percent, somewhat short of the 2006 rate which was inflated by the rebound from a major labor dispute a year earlier, but still above the potential rate of growth. In line with staff's projection, the authorities expect growth to decelerate further in the following years, mainly due to capacity constraints and especially the shortage of skilled labor in mechanical engineering industry and construction.

2. Supported by the cyclical upswing, the good employment trend of the past couple of years is continuing in 2007, with the employment rate approaching, or even surpassing, 70 percent. Labor demand remains high, as evidenced by the large number of vacancies. The seasonally adjusted unemployment rate has decreased steeply during the spring and stood at 6.7 percent in June, an improvement of 1.1 percentage points from a year earlier. The supply of labor is also increasing, as the average retirement age continues to increase and strong labor demand is attracting people from outside the labor market. Despite these positive developments in labor supply, labor markets are tightening, as reminded by staff, and the unemployment rate is now below its estimated structural level of 7.2 percent.

3. Although inflation remains modest, it is gradually moving closer to the euro area levels. The EU harmonized measure of consumer inflation, at around 1.4 percent, stands now half a percentage point below the euro area average. In the future, the authorities expect inflation to slightly accelerate further, consistent with staff's forecast. In addition to the high energy prices, this is partially due to accelerating wage dynamics caused by the tightening labor market conditions. While the annual average increase in the earnings is expected to remain unchanged at around 3 percent in 2007, the projection for 2008 is two percentage points higher, much due to the timing of the contractual pay increases at the end of the year. From the last quarter of the previous year to the last quarter of 2007, the earnings index is expected to increase by 4.5 percent, and the pace of rise seems to continue throughout 2008.

4. While wage growth remains above the EU average, continuing productivity growth has ensured that, in terms of external competitiveness, Finland's situation remains comfortable. In addition, Finland has greatly benefited – likely more than most other EU countries – from the ongoing global investment boom, particularly through the rising export prices in the metals industry, which has helped to offset the trend-like decline in the export

prices of telecommunication products. This pattern of export growth is expected to continue in the near future, and will help to broaden the Finnish export base. In the period from January to April 2007, the export share of the metals industry (16 percent) as well as the combined share for the rapidly growing mechanical and electric machinery industries (17 percent) exceeded the declining shares for the traditionally strong paper industry (14.7 percent) and telecommunication products (13.9 percent). However, looking further ahead, the authorities acknowledge a non-negligible risk of current account weakening, due to high and increasing labor costs and the deteriorating trend in terms of trade, as mentioned by staff.

5. Aided by the rise in economic activity and the strong growth in capital income, the financing position of the general government will strengthen this year, with an anticipated fiscal surplus of more than 4 percent of GDP. General government revenues will grow by 5.5 percent this year, while the growth in expenses will be 4.5 percent. Moreover, the recently updated figures suggest that general government expenditure as a share of GDP will decline by one percentage point to 44.6 percent this year.

Fiscal Policy

6. As noted by the staff report, the Government Program for the years 2008-2011 includes some essential and long-promised, short-term increases in public expenditures. The authorities acknowledge that this is likely to result in a deterioration of the fiscal position. They also share staff's view on the need to maintain tight fiscal policy in the current cyclical upswing. Recognizing the risk of weakening industrial competitiveness towards the end of the cyclical peak, due to growing cost and wage pressures, the central task of the government's economic policy is to safeguard economic stability. Accordingly, the envisaged tax cuts, mostly intended to enhance economic efficiency, are to take place at the end of the current term.

7. Nonetheless, the greatest challenge for fiscal policy comes from the rapidly proceeding population ageing, and the authorities fully share staff's concerns in this respect. The May 2007 update to the population forecast revises mortality projections downward and life expectancy upwards, with the result that in 2040, the number of population over 65 years is now expected to be some 120 000 larger than suggested by projections only three years ago. While the longevity correction included in the pension system will partly neutralize the effect of increases in life expectancy on pension expenditure, the consequences to health care and elderly care expenditure will be tangible. At the same time, due to a higher fertility ratio, the number of children will also exceed earlier estimates, resulting in an overall higher dependency ratio. The increasing expenditure pressures from pension and welfare services will coincide with declining growth in national income and the tax base, resulting in significant challenges for the sustainable funding of the general government.

8. The authorities agree that under current policies, the fiscal position of the general government is unsustainable over the long term. Nonetheless, they believe that once the envisaged reforms can contribute to a substantially faster growth rate than that underlying the present economic forecasts, a view also supported by Finland's outstanding track record in recent years. The Government Programme aims to achieve a structural surplus of one percent of GDP for the central government by the end of this parliamentary term. The Government Programme also commits the new government to achieve the goals stated in Finland's Stability Programme submitted by the previous government. The surplus objective will be supported by structural reforms, including an overhaul of the social security system, to improve the functioning of the labor markets. In addition, as noted by staff, the risks to inflation and the fiscal position can be alleviated by appropriate timing of the planned spending hikes and tax reductions.

9. The authorities recognize that adjustment of the fiscal situation to the challenges of population ageing must take place also on the expenditure side. As mentioned in the staff report, several investment projects have already been postponed in the medium-term budget framework to limit growth in government spending. It is also worth pointing out that envisaged cuts in income taxation will be postponed to cyclically more suitable times and will thus be back-loaded.. Moreover, the authorities concur with the assessment that there is a potential for savings from enhancing the efficiency of government service provision, without any deterioration in the quality of services. To this end, continued implementation of the Government productivity program and restructuring of public services remain key.

10. At the local government level, while tax revenues and central government transfers continue to rise rapidly, further savings can be gained from the government's ongoing municipalities and services reform. The aim of the reform is to improve productivity and curb local government expenditure growth. Service structures will be strengthened by consolidating individual services that require a population base larger than one municipality to be viable, and closer cooperation between municipalities will be promoted. Appropriate regrouping and merging of municipalities will further bolster the efficiency of local government. Some outright mergers have already taken place, and tens of further mergers are under preparation. The number of municipalities stands now at 416, down from 448 five years ago. As recognized by staff, however, the low population density does set some natural limits to the economies of scale from such development.

11. As the Government Programme states, the authorities are committed to secure the sustainability of public finances. According to the Government Programme, the government will assess whether sufficient provisions have been made to meet the impending challenges brought about by population ageing so that any necessary corrective actions can be undertaken while the present government is still in office.

Labor Market Policies

12. Despite the many positive developments in the Finnish labor market, staff correctly highlights the remaining structural problems. The recent gains in employment rates and the falling unemployment rate mask weaknesses in some parts of the labor market. Although the employment rate of older workers has improved rapidly in recent years, it remains below that of the Nordic peers, and the same applies to employment of the Finnish youth. These concerns need to be addressed, particularly in light of the demographic changes and the incipient downward turn in the overall labor force. The authorities, therefore, concur with staff's assessment on the need to improve labor market participation by shortening study times and encouraging ageing workers to stay longer in working life. In line with this, labor market issues are high on the government's agenda.

13. Changes are already taking place in the Finnish labor market. The recent decentralized wage agreements take better into account the economy-wide differences in productivity developments by enhancing the scope of local bargaining, thus providing more flexibility in the wage-setting system. The government plans include a substantial increase in wage subsidies for low-wage jobs, implementation of an action plan to activate young unemployed, as well as to phase in a profiling system for job seekers. In addition, the merger of the Ministry of Labor and the Ministry of Trade and Industry, once implemented in 2008, is expected to smooth the process of matching job seekers and vacancies by utilizing the public employment services more effectively.

14. To introduce more fundamental improvements to the functioning of the Finnish labor market, the government is planning to review the entire social security system and has set up a tripartite committee to consider different reform possibilities. The work of the committee covers the areas of (i) basic social security, (ii) earnings-related security, (iii) financing and incentives and (iv) governance and processes. The committee's work will commence this fall and is expected to be completed by the end of 2009, with the first legislative changes anticipated in the fall of 2008. The timetable is intentionally cautious, as the policies and benefit systems under scrutiny are socially sensitive, and rushing could endanger the success of the reform.

Financial Sector

15. Staff correctly observes that the Finnish financial system remains stable and sound. In 2006 the profitability and capital adequacy of the Finnish banks and most insurance companies was strong. Data from the first two quarters of 2007 indicate continued improvement of profitability. The risk-bearing capacity of the financial system remains very good.

16. Banks' good results have been boosted by rapid growth in net interest income, generated by an increase in the volume of financial intermediation and the widening margin between lending and deposit rates, as the pass-through of the increasing market interest rates is stronger to the former than to the latter. At the same time, tight competition has kept lending margins over the reference market interest rates narrow, which may pose a risk to banks' profitability in the long term. While intensifying competition has not so far been reflected in deposit rates, there are some incipient signs of a change on this front as well.

17. Household indebtedness remains relatively moderate in international comparison, and is not seen as a threat to financial stability or to sustained economic growth. This notwithstanding, as noted by staff, household debt is unevenly distributed within the household sector, which might give cause for some concern. The bulk of debt is, however, held by households with the highest levels of income, which also have greater assets than other households.

18. The corporate sector profitability is good and the level of debt reasonable. Banks' actual credit losses or nonperforming assets show no indication of increased difficulties in the corporate sector.

19. The most significant internal challenges to the stability of the financial system are structural and related to the consolidation and internalization of the financial sector. As also highlighted by staff, these structural changes also pose substantial challenges for regulation and supervision. In the future, the two major commercial banks may be transformed into branches of their foreign parent banks. Such a reorganization would lead to an entirely new situation for supervision, as the EU legislation so far does not give the host country supervisor much of a role. To the extent the host supervisor has a role, it comes largely from the option for the home country supervisor to outsource some tasks. Financial stability and consumer confidence might require creating a framework that allows active participation by the host country supervisor also in the case of branches.

20. The consolidation of the Finnish Financial Supervision Authority and the Insurance Supervision Authority, which is included in the Government Programme, is designed to improve the efficiency of financial and insurance market supervision by exploiting the synergies both in expertise and in terms of common supervised entities.

21. There are many ongoing large EU projects (e.g. the Single Euro Payments Area) in the area of financial market infrastructure that will bear fruit over the next few years. These initiatives will improve the efficiency of the Finnish financial system thanks to economies of scale, but they also include challenges from the viewpoint of maintaining the current high service levels, competition issues and crises management.