Finland: Staff Concluding Statement of the 2022 Article IV Mission

FOR IMMEDIATE RELEASE

Washington, DC – November 17, 2022: *The government has successfully steered Finland through the pandemic and implemented structural reforms to boost employment and productivity, with an aim to strengthen the sustainability of the welfare state. But aftershocks from Russia's war in Ukraine have worsened the outlook and added fiscal pressures from measures strengthening security and partly shielding households from higher inflation. In the near term, the additional spending is a mildly stimulative fiscal impulse, adding to inflationary pressures. Over the medium term, this has put debt on a risker path. The mission recommends reversing the fiscal impulse next year, partly by better targeting energy support measures. This should be followed by a gradual, but well-defined and well-communicated medium-term consolidation plan based on measures identified in the comprehensive spending and tax reviews. Structural reforms to boost long-term growth remain a priority, including changes to the collective bargaining system that would facilitate adjustment to shocks and retain a sufficient degree of coordination to safeguard competitiveness. The tightening of global financial conditions will put pressure on Finland's large and interconnected financial system with high exposure to household indebtedness, which calls for further strengthening banks' liquidity buffers, improving the macro-prudential toolkit, and—when circumstances allow—reinstating capital buffers*.

Economic Outlook

Growth has been robust so far even as Russia's war in Ukraine is weighing on activity. The mission projects GDP growth in 2022 at around 2 percent. The economy has continued recovering from the Covid-19 pandemic in the first half this year, buoyed by household consumption. Unemployment has declined, and employment rate has reached the highest level in over a decade. The corporate sector has proven resilient to the immediate impact of the war, including reduced trade flows with Russia (partly re-oriented to other markets) and the ceasing of energy imports since May (cushioned by a low incidence of gas in the energy mix and access to alternative sources).

But growth is still projected to stall in the near term. The mission expects growth to be around zero next year, followed by a slow recovery and a return to a potential growth of slightly above 1 percent. Higher energy prices (feeding through to inflation) and higher interest rates have already dented households' purchasing power and confidence, but the full impact on consumption and the housing market is expected to be felt only in the first half of next year as mortgage rates are more fully reset, fixed-price energy contracts increasingly expired, and savings buffers slowly exhausted. The global slowdown and the tightening of financial conditions are expected to affect Finland through reduced trade and investments, but also with a lag given full order books in key industries. Risks to growth are tilted to the downside.

Inflation will remain elevated. Inflation will reach 7 percent this year and around 4¼ percent next year. While price increases have largely been driven by energy prices, the mission estimates the output gap this year to be slightly positive, contributing to inflation. The labor market has remained tight. While overall wage growth has remained moderate, the recent wage agreements in the public sector—breaking the tradition of following the export sector—point to growing pressures and risk undermining external competitiveness.

Securing Fiscal Sustainability Amid New Spending Pressures

Fiscal deficit will widen next year--providing a mild stimulus—and by even more in the medium term. The deficit will increase by about ½ percentage point of GDP in 2023 and by about 1 percentage point in the medium term compared to the pre-war path. The deterioration next year will reflect the slowdown in activity, and the impact of temporary measures to compensate for higher energy prices along with higher security-related spending. The latter will persist into the medium term, adding to pre-war allocations for new fighter jets. The new spending on energy compensation and security is on top of pre-war discretionary measures related to the government's reform program.

The worsened fiscal outlook has put public debt on a riskier path. Higher fiscal deficits make the projected debt path steeper relative to pre-war projections and the recent re-classification of guaranteed loans to social housing developers as public debt has produced a level shift (in 2021 by about 6 percent of GDP). Under unchanged policies, the debt ratio would increase from around 72 percent this year to close to 80 percent of GDP by 2027. It would also place the net worth of the public sector—a comprehensive indicator of fiscal sustainability incorporating aging-related costs—into negative territory. The authorities estimate that a consolidation of 3 percent of GDP would be needed to stabilize public finances in the long term. Finland thus needs to take further steps to cope with long-term challenges related to demographics.

For next year, fiscal policy should be supportive of monetary policy while prioritizing support to the vulnerable and security spending. A slightly tighter fiscal stance—by about ¼ percent of GDP relative to the fiscal position in 2022—would strike a balance between containing aggregate demand and inflation pressures and taking a step toward placing public financing on a more sustainable footing, while still accommodating support to the vulnerable and war-related spending. The needed savings could be found by better targeting energy-related compensation, as most measures are not targeted and/or impede price passthrough. To contribute to the fiscal effort, a one-time solidarity tax could be considered in lieu of windfall taxes on "excess" profits of energy companies, as the latter may undermine investment and energy supply. If near-term downsides risks materialize, automatic stabilizers should be allowed to operate, and a severe recession may warrant additional spending, but only if the slack is more sizable than anticipated and wage pressures are absent.

Over the medium term, a substantial fiscal consolidation is needed to put the debt ratio on a declining path and make room for aging-related spending. The mission recommends gradually improving the structural primary deficit by around ½ percentage point of GDP per year over the medium term to move towards closing the sustainability gap. Revisiting fiscal policy objectives and identifying specific measures would be critical for this effort. In this regard, the mission welcomes the ongoing work in the Ministry of Finance on spending and tax reviews. Regarding spending, the health and social services should be a key area of focus. The reform introducing larger administrative units ("wellbeing service counties") has a potential to produce efficiency gains from consolidation and new technologies, but financial incentives to deliver them are weak, and may need to be strengthened if the reform does not generate savings. Some revenue measures could also be considered: the tax base for the standard-rate VAT could be broadened and there is some scope to increase relatively low property tax revenues.

A more robust steering of general government finances would help maintain fiscal discipline and facilitate communication. The Ministry of Finance has recently proposed a new fiscal framework, wherein debt sustainability would underpin both fiscal balance and expenditure ceilings targets, guiding fiscal policy over a longer horizon. It also appropriately extends central government expenditure ceilings to cover well-being service counties and sets stricter conditions for breaching the limits while allowing an adequate room to maneuver. The mission welcomes the proposal, which is also broadly in line with the recently published European Commission Communication on that matter.

Strengthening Sustainability and Resilience to Shocks through Structural Reforms

Further boosting employment and productivity remains key to sustainability. Regarding employment, the mission recommends continuing to close routes to early retirement, and reforming in-work and out-of-work benefits to reduce work disincentives, including for women with care responsibilities. The government's proposal to increase R&D spending to 4 percent of GDP would help boost productivity, but the authorities should direct R&D tax incentives toward startups and SMEs where the impact of incentives will be the strongest. Addressing skill shortages would help better leverage the increased R&D spending. Improving access to tertiary education and attracting skilled foreign labor—important on its own—would help in this regard.

More flexibility within the coordinated wage bargaining framework should improve resilience to shocks and support labor market outcomes. Recent wage negotiations in the public sector have weakened the wage coordination mechanism in Finland, which is already less formal relative to peer countries. Also, wages in Finland are compressed and misaligned with productivity across sectors, adding to labor market rigidities and further weighing on productivity. To support employment and productivity, the mission recommends a system where high-level agreements set broad framework conditions, but with more flexibility in firm-level contracts, especially for firms that are currently subject to automatic extensions of the sectoral agreement. Wage flexibility is even more important in the conjuncture as energy shocks entail an asymmetric impact across firms and sectors.

Achieving authorities' climate goals requires further measures. The energy crisis has demonstrated the importance of shifting away from fossil fuels and Finland has made considerable progress in this direction. The National Climate and Energy Strategy projects a share of renewable energy above Finland's indicative minimum target in the EU's Fit for 55 Package by 2030. However, achieving Finland's carbon emissions targets will require further policy measures, especially in light of recent estimates suggesting that the land use sector has turned into a source of emissions instead of serving as a sink. Policies could include higher and better harmonized carbon prices (when energy prices subside from the current high levels) while addressing competitiveness and distributional concerns, and increased taxation of carbon-intensive peat production.

Financial Sector Policies

The banking system is generally resilient, but bank liquidity, and cross-border links are sources of vulnerability. The ongoing IMF Financial Sector Assessment Program has found that banks are well capitalized, profitable, and in terms of solvency, resilient to adverse macroeconomic shocks. However, a tightening of global financial conditions can put pressure on banks' liquidity given their over-reliance on short-term wholesale funding. Enhancing liquidity buffers, therefore, remains a priority. Furthermore, banks are exposed to risks emanating from the housing market given large household debt levels, and to systemic events in the Nordic region given their high cross-border exposures. Hence, resources across all financial oversight agencies should be increased to meet the existing and emerging risks.

Risks to financial stability can be mitigated by expanding the macroprudential toolkit and—as circumstances allow—tightening capital requirements. The authorities have taken steps in addressing borrower-side vulnerabilities, but macroprudential policy toolkit should be further strengthened, including by legislating caps on Debt-to-Income and Debt-Service-to-Income ratios to limit household vulnerabilities. Regarding systemic capital buffers, the mission welcomes the imminent increases in requirements for systemically important institutions, partially reverting easing measures taken during the COVID crisis. The authorities could usefully communicate their intention to fully reinstate systemic capital buffer requirements as circumstances allow. And in due time, strengthening the cyclical capital position and legislating a positive neutral rate for the Counter-Cyclical Capital Buffer can increase resilience in the banking system. Separately, the systemic risk monitoring framework should be enhanced by improving data analysis and covering corporate sector risks in greater detail, as well as the disclosure of the assessment of macroprudential risks in the non-bank financial intermediation sector. Finally, resolution and crisis management should be supported by stronger coordination of authorities' preparation and management of crises.

The mission thanks the authorities and other counterparts for constructive policy dialogue and productive collaboration.