CONCLUDING STATEMENT

Finland: Staff Concluding Statement of the 2025 Article IV Mission

FOR IMMEDIATE RELEASE

A team from the International Monetary Fund (IMF), led by Mr. Alex Pienkowski, held discussions during October 29-November 8 for the 2025 Article IV Consultation. The team met with Governor Olli Rehn, Permanent Secretary Juha Majanen, other senior officials, and representatives from the private sector, banks, labor unions, and other stakeholders.

Helsinki, Finland – November 8, 2024: Following a hard landing in 2023, the Finnish economy has started to recover. Modest growth is projected in 2025 and in the medium term, but risks are tilted to the downside. To strengthen growth and build resilience, policy effort should focus on:

- Additional fiscal consolidation to reverse the debt trajectory.
- Measures to raise labor force participation and reduce skills mismatches, lower barriers for new, fast-growing firms to boost productivity and revive growth.
- Expanding the macro-prudential toolkit and undertaking a regional stress test to further enhance the resilience of the financial sector.

A Nascent Recovery, Low Inflation, but Continuing Fiscal Deficits

The economy has started to recover, but near-term growth will remain sluggish. After GDP fell by 1.2 percent in 2023, quarterly growth turned slightly positive in the first half of 2024, as falling inflation and wage growth provided support to real incomes, and helped to stabilize private consumption. But activity this year is expected to be weak, with annual growth projected at -0.3 percent, as private investment continues to contract. Despite a recent dip, employment since the pandemic has been robust, supported by weak real wages, higher immigration, greater public employment, and increased participation rates. Looking ahead, output is projected to grow by 1.6 percent in 2025 as private investment spending partially recovers and private consumption increases further, with interest rates falling and house prices stabilizing. Medium-term growth is projected to be slightly below 1½ percent.

Inflation declined to below 2 percent. Based on preliminary data, 12-month headline inflation reached 1.5 percent in October, driven by falling energy prices and moderating core inflation (2.3 percent) from weak domestic demand. Real wages are growing modestly, but moderating corporate profits prevented further inflationary pressure. Headline inflation is expected to stabilize around 2 percent by the end of 2025.

The fiscal deficit continued to widen. The fiscal deficit increased to 3.0 percent of GDP in 2023. While this partly reflects the deep recession, an increase in expenditures associated with defense and immigration-related needs, pressure from health and social services, and higher interest payments pushed the deficit higher. As a result, public debt, which is already higher than in Nordic peers, increased to 77 percent of GDP in 2023. The deficit is set to continue to increase in 2024 despite new fiscal consolidation measures announced in April 2024.

Finland's economic outlook is subject to downside risks. Downside risks are mostly external, and include: an escalation of Russia's war in Ukraine; adverse shocks in other Nordic countries, including in the commercial real estate markets; deepening geoeconomic fragmentation, or further tightening of global financial conditions. Conversely, domestic risks are more balanced, and upside risks include: higher investment and innovation from the green transition, a further expansion of the vibrant ICT sector, and stronger employment growth associated with the government's recent reforms.

Accelerate Fiscal Consolidation to Reduce Debt

New measures this year will help to reduce the deficit. On top of efforts in 2023, the Finnish government announced new fiscal consolidation measures in April 2024, amounting to €3 billion (1 percent of GDP). This included an increase in VAT rates from 24 to 25.5 percent in September, cost savings in central government operations, and scaling back obligations in health and social care. The bulk of these measures will be realized in 2025 and are an important first step in reducing the fiscal deficit. Despite remaining weaknesses in the economy, this fiscal consolidation is warranted by the need to credibly start reducing the fiscal deficit and build buffers against potential adverse shocks over the medium-term.

Greater medium-term fiscal adjustment is needed to reduce debt. Building on this positive initial fiscal adjustment, additional measures especially in 2026 and beyond are needed to put debt on a firm downward trajectory. To achieve this, the authorities should aim to balance the fiscal budget by 2029. This requires concrete measures on both expenditure and revenue. Productivity-enhancing spending—such as public investment, R&D support, and education—should be protected. This effort should be complemented by structural reforms that have the potential to accelerate the pace of the recovery.

Reviving Productivity and Growth

Further efforts to increase labor participation rates and reduce skill mismatches are needed. In recent years, welcome reforms aimed at boosting employment were deployed, including changes to unemployment benefits, social security and tax adjustments, and enhancements to employment services. These should support Finland's aspiration to increase participation rates closer to Nordic peers, and be complemented with policies to reduce skills mismatches and strengthen tertiary education. In this regard, the authorities' plan to increase the proportion of young adults attaining higher education degrees to approximately 50 percent by 2030 is welcome. Attention also needs to be given to the recent steeper-than-trend fall in average hours worked. While part of the decline is likely cyclical or associated with the changing preferences of a relatively rich and aging society, there may also be market and policy failures that require attention.

Building on strong foundations, further structural reforms are needed to strengthen business innovation and growth. Finland excels across many innovation metrics, especially in digitalization. Despite a multi-year decline, R&D expenditure relative to GDP is high by EU standards; and the authorities plan to support and raise it further. Finland also has a notable venture capital sector, supported by public-sector investment funds and a large domestic pension industry. However, weak productivity growth necessitates further structural reforms. While business entry and exit rates are similar to the EU average, the formation of *high-growth* young firms, so called "Gazelles", and productivity growth of the *frontier* firms in general has been slow relative to EU and Nordic peers. While there are no 'silver-bullet' solutions, attention should be given to the tax treatment of venture capital funding and rebates associated with investment spending by firms. Focus should also be on potential barriers to entry and excessive regulation in the service sector, which has experienced stagnant productivity in recent years.

Strengthening Financial Sector Resilience

While the banking system is resilient and systemic risks are contained, vulnerabilities remain. Banks' capital and liquidity buffers remain well above regulatory requirements, despite the hard economic landing and elevated interest rates, and stress tests indicate that banks can withstand a deep recession scenario. Nevertheless, vulnerabilities remain, including: large and highly interconnected banks that have significant direct lending, in particular to the real estate sector in other Nordic countries; liquidity risks due to a high reliance on short-term wholesale funding; and high household indebtedness and elevated debt service burdens. In this context, staff welcome Finland's initiative to lead discussions with its neighbors to undertake a joint Nordic-Baltic banking sector stress test to strengthen monitoring of cross-border macro-financial risks. Despite a steep increase in the intensity of cyber-attacks targeted at financial institutions, strong preparation and active counter-measures by the banks and relevant authorities have meant that the impact on financial stability has been contained.

Further measures are needed to target pockets of vulnerability. The reinstatement of the systemic risk buffer (SyRB) on credit institutions at 1 percent in 2024, following its suspension during the pandemic, has enhanced resilience. Additionally, the introduction of a *positive* neutral rate for the Counter-Cyclical Capital Buffer and a full set of borrower-based measures to the policy toolkit would allow the authorities to release capital in periods of extreme stress. Bank liquidity buffers should be enhanced to cover a predetermined threshold of wholesale funding outflows over a five-day horizon and they should hold a higher stock of high-quality liquid assets. Finally, the authorities should continue to make further progress in implementing the 2022 Financial Sector Assessment Program recommendations including in the areas of crisis management and non-bank financial institutions.

The IMF team is grateful to the authorities and private sector counterparts for their close collaboration and helpful and constructive discussions.