CONCLUDING STATEMENT

Finland: Staff Concluding Statement of the 2023 Article IV Mission

FOR IMMEDIATE RELEASE

A Concluding Statement describes the preliminary findings of IMF staff at the end of an official staff visit (or 'mission'), in most cases to a member country. Missions are undertaken as part of regular (usually annual) consultations under Article IV of the IMF's Articles of Agreement, in the context of a request to use IMF resources (borrow from the IMF), as part of discussions of staff monitored programs, or as part of other staff monitoring of economic developments.

The authorities have consented to the publication of this statement. The views expressed in this statement are those of the IMF staff and do not necessarily represent the views of the IMF's Executive Board. Based on the preliminary findings of this mission, staff will prepare a report that, subject to management approval, will be presented to the IMF Executive Board for discussion and decision.

A staff team from the International Monetary Fund (IMF), led by Mr. Alex Pienkowski, held discussions during January 8-22 for the 2023 Article IV Consultation. The team met with Finance Minister Riikka Purra, Acting Governor Marja Nykänen, other senior officials, representatives from the private sector, banks, labor unions, and other stakeholders.

Helsinki, Finland – January 23, 2024: The Finnish economy recovered swiftly from the pandemic, but Russia's invasion of Ukraine worsened the outlook, with high inflation and rising interest rates weighing on household purchasing power and investment. Recent estimates indicate that the economy contracted in 2023 (-0.5 percent), and modest growth is anticipated in 2024, with risks to the downside.

- Fiscal policy should focus on putting debt on a declining path through a gradual but sustained fiscal adjustment.
- Structural reforms should center on labor markets: reducing skills mismatches, encouraging employment, and boosting productivity.
- Despite large buffers, large cross-border exposures, a weakening housing market, and high household debt pose risks to the financial system. This necessitates tightening liquidity regulation and enhancing the macro-prudential toolkit.

Stalled Growth, Receding Inflation, and a Widening Fiscal Deficit

Economic growth has stalled, but employment remains relatively robust. Finland is likely in recession, with high interest rates, weak trading-partner growth, and a downturn in the housing market all weighing on activity. A recovery in household purchasing power, along with easing financial conditions, is expected to support a modest recovery in 2024, with growth projected to be ½ percent. The labor market remains relatively strong, but unemployment is likely to increase modestly, as the construction sector continues to shed jobs. In the medium term, growth is expected to improve to around 1½ percent due to an anticipated increase in investment and employment resulting from the labor market reforms.

Inflationary pressures are diminishing. Twelve-month headline inflation, which peaked at 9.1 percent in November 2022, has receded to 1.3 percent in December 2023, primarily driven by declining energy prices. Core inflation, although more persistent, has also shown deceleration, particularly in non-energy goods and non-housing services. Supported by modest wage growth, negative base effects, and a growing output gap, headline inflation is anticipated to remain below 2 percent in 2024, gradually recovering over the medium-term.

The fiscal deficit has widened. The deficit is expected to have increased to 2.5 percent of GDP in 2023, primarily due to higher discretionary spending, notably energy-related compensation, defense spending, humanitarian aid, high index-linked increases in social benefits, and support for wellbeing services counties. Gross public debt is expected to have reached 75 percent, further exceeding Nordic peers. Deficits are projected to remain substantial over the medium-term.

Finland's economic outlook is subject to downside risks. Finland faces several significant external risks, including from greater geo-economic fragmentation and a rebound in international energy prices. But domestic risks are also elevated. The combination of high household debt, falling house prices, higher unemployment, and rising interest rates could tip the economy into a deeper "balance sheet recession". Large-planned investments from the green transition represent an upside risk over the medium term.

Gradual Consolidation Needed to Reduce Debt

The government's ambition to reduce the fiscal deficit is welcome, but stronger policies are needed to achieve this. The government program targets a medium-term fiscal adjustment of about 2 percent of GDP over the next 4 years through spending cuts and fiscal gains from higher employment. This ambition is welcome. However, current policy measures fall well short of achieving this, with the fiscal deficit projected to increase in 2024 and debt to continue to rise. Additional measures are needed to close this gap.

A gradual and moderate fiscal tightening would put debt on a declining path. The current consolidation plan will slow the upward debt trajectory but will fall short of reversing it. A fiscal consolidation of around ¼ percent of GDP should begin in 2024, growing to ½ percent per year over time, with a target of achieving overall fiscal balance by 2028. Such a stance would begin to reduce public debt, helping to place public financing on a more sustainable footing and build buffers to support the expected increase in age-related spending. The recent reforms to social benefits are welcome, but further expenditure reduction is required, including through efficiency gains from the wellbeing services counties. Higher revenues—including through indexation of excise taxes, the expansion of carbon taxation, greater standardization of VAT rates, and reforming the taxation of dividends from non-listed firms—should be considered.

Addressing Long-Standing Structural Challenges to Achieve Sustainable Growth

Boosting employment and productivity remain key for growth. The mission welcomes the authorities' reform agenda to raise employment by reforming social benefits, increasing labor market flexibility, and reducing the labor tax wedge. Such reforms would facilitate adjustment to economic shocks and contribute to a more dynamic labor market. Policy should also focus on reducing skill mismatches, strengthening tertiary education, and attracting and better integrating talent from abroad. The government's commitment to increase research and

development investment is welcome, but more consideration should be given to how it can catalyze private funding.

Further measures are needed to achieve the ambitious and commendable carbon emissions objectives. New climate policies include expanding the production of low-emission energy, including the recent opening of a new nuclear power plant and an expansion in wind-turbine capacity. These will help to further reduce emissions but would not be sufficient to achieve the ambitious 2035 carbon neutral target. Additional policies could include strengthening carbon pricing and increasing the role of carbon-sinks in the land use sector, particularly in forestry.

Strengthening the Financial Sector

The financial system is resilient, but there are sources of vulnerability that require vigilant monitoring. Banks have ample capital buffers to withstand severe macroeconomic shocks, involving deglobalization and significant weakening of profits and capital ratios. However, under a severe but plausible macro-financial shock, banks are vulnerable to liquidity risks due to a high reliance on short-term wholesale funding. In response, and consistent with the recent FSAP report, liquidity regulations should be tightened, and buffers increased. In addition, falling house prices, large cross-border exposure, and high household debt pose risks to the financial system. These developments warrant vigilant risk monitoring.

Staff welcomes the recent tightening of macroprudential policies, but more could be done. The systemic risk buffer will soon be reinstated at 1 percent, raising required capital to pre-pandemic levels. However, the reduction in this buffer during the pandemic highlighted the merit of a *positive* neutral rate on the countercyclical capital buffer, implementation of which would allow the authorities to release capital in periods of extreme stress. In addition, to prevent excessive household indebtedness and to enhance borrowers’ repayment capacity over the medium term, a complete set of borrower-based measures (BBMs) should be introduced into the policy toolkit. These measures could be activated only when concerns about adverse impacts on house prices and demand abate.

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