Finland—Summary of the Staff Concluding Statement of the 2016 Article IV Mission

The Finnish economy is emerging from a protracted recession, but the recovery will be slow. The mission projects growth to increase to 0.9 percent in 2016 and 1.1 percent in 2017, before reaching about 1½ percent over the medium term. Private consumption and investment are the main drivers of growth, even as consumption is weighed down in the short run by slower real wage growth, reflecting rising inflation and the Competitiveness Pact. Downside risks include weaker global growth, uncertainty over post-Brexit arrangements, potential financial shocks in Nordic neighbors, and larger-than-expected short-run growth effects from domestic fiscal consolidation and labor market reforms.

Reviving growth remains Finland's preeminent challenge. This requires deep structural reform to raise productivity and labor participation.

Recent progress on structural reforms is welcome but requires close follow up. The Competitiveness Pact will reduce relative labor costs in the short term. It could also make the wage bargaining process more flexible at the firm level and help better align wages with productivity. However, this outcome is not assured and the government should closely monitor the Pact's implementation. The cut in the duration of unemployment benefits should help raise labor supply, and the mission encourages social partners to agree soon on additional activation measures. The draft bills on the health and social services reform constitute major progress, but key elements of the new system remain to be further developed.

Reform efforts are also needed in other priority areas. Product market reforms—particularly in the retail sector and in state-dominated sectors such as rail and postal services—could increase competition and yield productivity gains, including through downstream effects on the wider economy. Reversing cuts to public R&D spending and creating stronger incentives for private R&D—e.g., via well-designed and permanent tax credits—would promote innovation. Strengthening Active Labor Market Policies (ALMPs) and further measures to increase affordable housing in urban areas would facilitate labor mobility.

Fiscal policy should strike a balance between long-run sustainability and protecting the recovery. Structural fiscal adjustment is needed to contain aging-related spending pressures. This makes the health and social services reform also crucial from a fiscal perspective. However, fiscal adjustment efforts should seek to minimize potential adverse growth effects. The envisaged easing of fiscal consolidation in 2016-17 is appropriate but more can be done to support the economy in the short run, including by bringing forward the remaining *growth package* spending. Also, the composition of fiscal policy would be made more growth-friendly by reallocating resources toward R&D spending, ALMPs, and public investment, and away from poorly-targeted transfers and tax expenditures.

The review under the Financial Sector Assessment Program (FSAP) found that the financial system is broadly sound. It also made recommendations to address structural vulnerabilities and potential risks. While profitable and well capitalized, the Finnish banking system is large, highly concentrated, closely interlinked with other Nordic countries, and relatively reliant on wholesale funding. The implementation of European legislation, participation in the banking union, and the macroprudential policy framework represent substantial progress. The mission also welcomes the plans to introduce a systemic risk buffer and a floor on mortgage risk weights. Instruments based on borrower and loan characteristics should also be considered. Banking supervision should be further strengthened, including on banks' internal risk models and liquidity positions. To mitigate risks from regional linkages and Nordea's conversion of its subsidiary into a branch, regional cooperation should be deepened, including through agreement on robust data sharing and supervisory cooperation.