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The Finnish Economy: Achievements and Challenges

Briefing Note

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The Finnish Economy:
Achievements and Challenges

Table of Contents

1. Executive Summary

Achievements:

- Growth performance in Finland has been strong
- Inflation has remained among the lowest in the EU.
- Finland is world-leader in competitiveness, absence of corruption, and among the best-performers in the world in ICT-innovation and education levels
- Productivity remains high in the private sector (excluding services)
- After three years of stagnation following buoyant growth in the second half of the 90s, employment has picked up and unemployment rates fell in 2005/2006

Challenges

- The unemployment rate is still high at 8.4%
- Productivity in the sheltered services sector is low, and public sector productivity has also been stagnating
- The ageing shock threatens to hit Finland 10 years in advance of the rest of the EU due to an earlier baby-boom generation
- An important task is to raise employment levels, especially for older workers (50+)

Finland (2005)[1]	
GDP p.c.:	29.420 Eur
GDP growth:	2.1%
Inflation:	0.8%
Unemployment:	8.4%
Population:	5.3 million

The following table places Finland in the context of EU-25 in selected statistics (2004):

Table 1[2]

	EU-25 (2004)	Finland (2004)
GDP per capita in PPP	100	112.8
Labour productivity per person employed	100	108.5
Comparative price levels	100	122.9
Employment rate	63.3	67.6
Employment of older workers	41	50.9
Gross domestic expenditure on R & D (% GDP)	1.9	3.51

[1] Statistics Finland, 2006
[2] European Commission, 2006

The following can be noted:

- In GDP levels, Finland is well above average in EU-25 with 113% of EU-25 GDP. However, in EU-GDP level performance remains mediocre.
- Labour productivity, employment rates and employment of older workers remains above EU-25 average, although these are considered major challenges in Finland.
- Finland is on average more expensive than EU-25 countries

2. The Finnish Economy from a historical perspective

"Finland, Finland, Finland, the country where I want to be..." is the first line of a rather ironic song by British comedian group Monty Python from 1980. Back then, Finland was considered to be a rather special case in European political geography; not really West-European, albeit not really a Soviet satellite state either, despite cooperation agreements with the Soviet Union. The German term of "Finlandisierung" entered political terminology to describe the Finnish situation. In addition to its rather remote location, strange language and Nordic climate, Finland was not really considered the place to be in Europe. Monty Python's song further states that Finland is "a poor second to Belgium, when going abroad". Behind the irony, there is a story worth telling, not least because it may contain important economic lessons.

Strong post-war growth process

- Having never enjoyed any considerable riches, the Finnish economy was particularly strangled by the World War II.
- In 1948, Finland signed an Agreement on Friendship, Cooperation and Mutual Assistance with the Soviet Union and was allowed to remain a "capitalist" market economy. Consequently, the Finnish economy enjoyed many trade privileges with its eastern neighbour.
- A Nordic welfare state was established. Certainly facilitated by the preferential trade agreements with the Soviet Union, the Finnish economy benefited from a tremendous growth process, bringing about a flourishing social welfare state with GDP p.c. at the same level as in other Nordic countries, by the end of the 1980s.

Overheating of the economy in the 1980s

- The 1980s and a long period of growth also saw a deferral from sound economic policies. The liberalisation of financial markets in the same decade led to strong growth in credit supply, consumption and investment. This in turn led to excessive debts in the private sector and prices of stocks, houses and land increased.
- The Bank of Finland, not independent in its mandate, had to hold on to the fixed exchange rate regime with an overvalued currency. Inflation accelerated, imports grew and the trade balance fell into large deficit.
- The result was a serious overheating of the economy. Given fixed exchange rates and free capital movements, the growing current account deficit led to depreciation expectations of the Finnish Markka, raising interest rates and restricting investment and consumption.

The Collapse of the Soviet Union hit Finland especially hard...

- According to text-book economics, overheating should have been rebalanced by a standard adjustment process through higher interest rates and subsequently lower investment. Before this process could however substantially proceed, the Finnish economy was hit by an external shock, which was to affect the country much more than others , namely the collapse of the Soviet Union.
- With the collapse of the Soviet Union, Finland lost about 20% percent of its external trade overnight.
- Coupled with the "home-made" overheating of the economy, the 1990s thus began with a forced depreciation and resulted in radical debt-deflation, culminating in probably the worst recession in post-war OECD cross-country comparison.[3]

The Finnish depression from 1990 to 1994

- The ensuing "domino-effect" across all sectors of the Finnish economy revealed grave inefficiencies in the economy, above all in the banking sector. Consequently, at the peak of the crisis, about 9% of bank loans were non-performing. The banking sector was bailed-out by the government inducing a radical surge in government debt levels.
- House prices plummeted by 50% between 1990 and 1993.[4]
- As most non-performing loans were taken by firms that went bankrupt as their trade opportunities diminished or debt-deflation made their loans unbearable, the resulting lay-offs laid the foundations for an unprecedented surge in unemployment. Unemployment rocketed from 3.3% in 1990 to 16.6% in 1994.[5]
- In the beginning of the 1990s, one of the richest economies of the world (in 1989 de facto equal to Denmark and Sweden in p.c. GDP levels) saw unforeseen numbers of citizens queuing up for bread and soup at the Salvation Army.
- The immediate costs of the crisis are estimated at 8-10% of GDP. In fact, between 1990 and 1991 alone Finnish GDP shrank by approx. 7%. Sweden, also in grave difficulties at the same time for similar reasons, only saw its GDP shrink by a mere 2%, probably as it did not suffer the Soviet Union trade shock to the same extent.

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[3] See Kiander and Vartia (1998) "The Great Depression - the Finnish Crisis of the 90's and Economic Policy DIscussion":, the Research Institute of Finnish Economy, B143, (in Finnish) , for an excellent review of the recession.

[4] OECD Economic Surveys (2006), Finland, March 2006, Paris, p. 113

[5] The figures are from the International Labour Organization, and therefore internationally standardized. According to some Finnish data, e.g. Holm/Somervuori (1997), "Structural Unemplyment in Finland" OECD Working Paper No. 177, the peak of the unemployment rate in1994 drew much closer to 20%.

Recovery and following boom

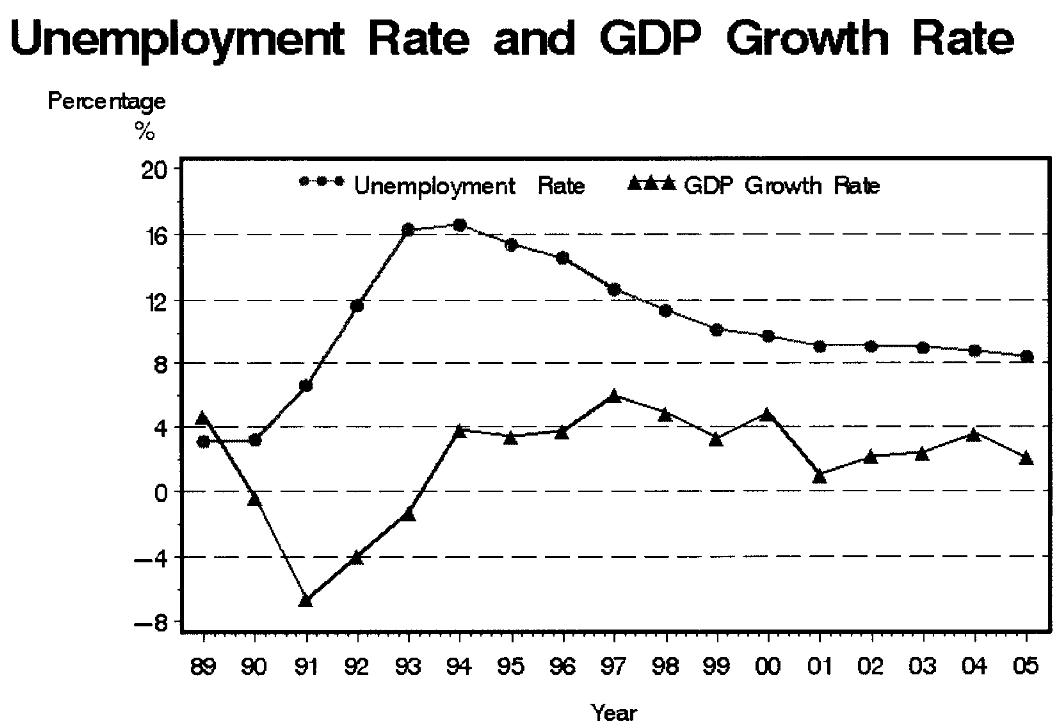
- Struggling in the depths of a stagflation, with high unemployment, negative growth and high inflation, Finnish society made huge efforts to recover. The Finnish economy improved. New industries in the form of ICT-technology boom (headed by Nokia) joined and overtook the traditional paper and pulp industry to become the second major pillar of production specialisation in Finland.
- Together with the technology and innovation boom it was the result of a common national action effort, embraced by the government, industry and trade unions alike, to return to a sustainable growth path.
- At the price of considerable cuts in real wages and painful efficiency improvements (read: numerous branch shut downs and personnel lay-offs), particularly in the banking sector.

3. General Economic Outlook

Pheonix from the ashes?

The following graph highlights Finnish performance between the eve of the depression in 1989 and 2005 on two representative indicators, the unemployment rate and the growth rate of GDP:

Graph 1:



Source: OECD

- **Unemployment:** Following the radical surge of unemployment from 3.3% to 16.6% between 1990 and 1994, the situation has greatly improved. Structural rigidities, however, have caused the unemployment level to stagnate at 8-9% for the last 5 years.

- **Growth:** Following negative growth in the first half-of the 90s with -6.6% of GDP in 1991 at the lowest, growth has averaged 3.4 after 1995. The slight downturn in 2001 relates to the bursting IT-bubble.

The achievements of the 1990s

As of 1996, the Finnish recovery began to gather momentum: growth averaged 3.4% and the government has been running a surplus since 1998, peaking at 7% of GDP in 2000. The success of the ICT-industry, largely geared by the mobile-phone giant Nokia, has contributed to establishing Finland as the leading knowledge-based and innovation-led economy in the world. Today, Finland tops various global indicators, among which it is world leader in:

- Competitiveness: the World Economic Forum ranking has seen Finland at the top of the list since 2004
- Corruption-free environment. For the last few years, Finland has also been the least corrupt country in the world, according to the Transparency International Corruption Perception Index (CPI)
- Education: Finland has been the best performing EU-country in the PISA tests of educational attainment carried out by the OECD.
- R&D expenditure is the second highest in the EU with 3.5% of GDP, slightly lower than Sweden

Research and innovation as main drivers of growth

R&D expenditure in Finland was 3.5% in 2004. This is well above the Lisbon goal for the EU of 3% by 2010. The remarkable point in Finland is that this expenditure comes largely from the business sector, the government only having a 1% share. The role of Nokia is crucial here. The global multinational Nokia does not publish R&D expenditure by country breakdown, but it is estimated that it accounts for approx. 50% of all business R&D investment.

Patents: Other relevant indicators in this respect are high-tech and ICT patents. Finland has by far the highest number of high-tech and ICT-patent applications. Finland has by far the highest national share of patent applications to the European Patent Office (EPO) in high tech and in information and communication technology (ICT), with 44.1% and 51.6% respectively of the total (2002).

Growth performance after 2000 has not been as remarkable

Following strong growth in the second half of the 90s and around the millennium turn, growth performance after 2001 has not been as remarkable as in the second half of the 1990s, mainly because the contribution to growth from the ICT-sector slowed down following the burst of the IT-bubble.

Growth was especially weak in 2005 at merely 2.2%. This was largely due to a labour dispute in a crucial sector for the Finnish economy - the paper industry - lasting two months in the summer of 2005. In the same year, the global electronics market experienced a downturn, further dampening growth. As both reasons seem to have been of temporary nature, however, growth is expected to bounce back at 3.4% in 2006.

The dispute in the paper industry alone is estimated responsible for a 1%-point slowdown in growth in 2005. This demonstrates one central shortcoming of the Finnish economy: a high degree of specialisation in production patterns (paper, electronics) is a cause of high volatility in growth rates and therefore high vulnerability of the economy in general.

Challenges ahead

Current challenges in Finland include:[6]

- **Ensuring the sustainability of public finances**: the extra spending pressure comes from ageing, especially considering that the ageing boom will hit Finland approx. 10 years in advance of the rest of Europe. Taking the simultaneous downward pressure on high taxes on labour, sustainability is a challenging undertaking.

[6] Challenges compiled from OECD, IMF, European Commission together with authors own contributions.

- **Raising the employment rate:** Currently at 68%, there is a long-term objective to raise this to 75% by 2011. Both figures are high compared with other European countries. There will presumably be no way to avoid the further lowering of taxation on labour to achieve this.
- **Broadening and enhancing growth potential in the service sector**. Growth potential from ICT and high-tech sectors is now stagnating. Further growth potential lies in the service sector, which is currently among the most sheltered and most expensive in the EU-25.

4. Analysis of Selected Policy Areas

The following reviews some selected topics from the Finnish economy of potential interest to the ECON delegation in June 2006.

4.1 Government Finances (and Pension System)

Budgetary surplus and declining debt levels

Surplus: The general government budget in 2005 was in surplus with 2.6% of GDP. This surplus is easily the largest in the Euro area. It has to be noted however, that the size of the surplus is mainly due to the contribution from the pension funds, which are included in general government statistics in Finland. The pension funds have been running considerable surpluses in the last years to account for future expenditure.

Following huge deficits due to the crisis in the first half-of the 1990s, the general government budget has been in surplus since 1998. In 2000, the surplus peaked at 7.1% of GDP. (See Graph 2 in Annex) Compared to the average of other EU countries, the period from 1995-1999 in Finland is very much in line with the rest of Europe. As of 2000 however, the Finnish surplus has clearly been an outstanding achievement in EU perspective.

Debt: During the depression in the first half of the 90s the government ran high deficits, but above all took over the non-performing loans of the banks. This and other depression related expenditure resulted in a radical surge of the government debt level as % of GDP from about 15% in 1990 to just under 60% in 1994 (see Graph 3). The budget surpluses since 1998 have largely served the purpose of repaying this debt. As Graph 3 shows, the declining debt levels (as % of GDP) since 1995 prove that this policy has succeeded.

Pressure to lower high taxes on income and reduce ageing related spending growth

Revenue: Taxes on labour are especially high. OECD estimates that the tax wedge in Finland for a single person is higher still than in other Nordic countries.

For many EU countries, several studies have shown a negative correlation link between taxation and employment. Although this is certainly also true in the Finnish case considering the low employment especially in the services sector, this correlation may be weaker in Finland because of the link between taxation and public employment.

Nevertheless the high tax on labour remains a legitimate concern. **The government budget proposal for 2006** includes a reduction of taxation of earned income by 820 mill. Euros or 0.5% of GDP.

Also, the wealth tax is to be abolished, at a cost of 70 Mill. Euros (0.05% GDP)

In order to encourage employment in the services sector, the maximum tax credit for domestic household and care work will be doubled to 2300 Euros.

Finally, to tackle the problem of low employment of older people, temporary low wage support will be targeted at this age group.

Expenditure: Despite strict spending rules from the government, cost developments have tended to push up the share of government spending in GDP. The share of general government consumption in GDP has risen by 2%-points since 2000. This is partly due to a surge in municipal spending (rising 6% annually since 2000). Indeed, increasing productivity in municipalities is one of the major challenges.[7]

Fiscal pressures from ageing suggest that public finances are not sustainable in the long-run. As of 2010 a large bulk of the population will be retiring, leaving the financial burden to subsequent cohorts. Also, increased longevity implies a higher share of older age groups. The government scenarios suggest that current fiscal policy is therefore not sustainable in the long-run, an observation confirmed by the OECD.

Pension System was reformed in 2005

While there is a trend in many countries towards privatisation of various insurance mechanisms, Finland still maintains a system where all social security from health, education and pensions is centred in one institution, KELA (The Social Insurance Institution of Finland). Treating all mechanisms in detail would be beyond the scope of this briefing. Therefore, the focus is on the pension system, not least due to its relevancy as regards the Lisbon targets.

The pension system in Finland remains public, and mainly earnings-related. It is essentially a combination of a very small national pension and an earnings-related employee pension (see also "Insurance sector", p. 11).

The ageing shock will hit Finland approx. 10 years before the rest of the EU, therefore timely savings accumulation for this expenditure rise is very critical in the Finnish case.

[7] However it has to be noted that low efficiency in the municipal sector is to a large extent due to peripheral locations and low urbanization. While a challenge for many other countries, prdoductivity gains from ICT-usage in the municpal sector is relatively advanced in European comparison. This makes the Finnish case different from many other countries.

A wide ranging pension reform introduced in 2005 was considered a success and received a lot of international recognition.[8] Pension benefits are now calculated on income earned annually over the whole working life. Essentially, the reform attempts to extend working lives by 2-3 years.

In a nut-shell, this reform contains three elements:

- It abolished two early retirement schemes
- There will be an automatic cut in pensions according to the increase in life expectancy
- Benefits will be calculated on the basis of the whole lifetime income and not the last working years

Success of this system will depend largely on whether early retirement pathways can be further curtailed.

Also, under the current regime the unemployed can retire at age 57. The OECD calls for activation measures to be implemented and the "unemployment pipeline" to be abolished.

Finally, a relatively large share of the population retires on a disability pension. Through early intervention combining medical and vocational rehabilitation this pension gateway may also be alleviated.

4.2 Labour Market

The Finnish government's employment objective

The Finnish government's main economic policy priority has been to boost employment. In 2003, it set a target of creating 100,000 extra jobs until the end of the legislative term in 2007. This translates into an increase in the labour market participation rate from 68% in 2005 to 70% (the Lisbon target) in 2007 with the long-term objective of reaching 75% in 2011.
To reach this objective, the government will introduce measures:

- to reduce early retirement,
- to encourage low-paid workers to enter the market,
- to lower the age at which students finish their studies and enter the labour market.

The year-on-year rate of employment growth has been about 2% in recent months. If this rate is maintained during 2006, the government will be close to achieving its objective.

[8] See e.g. Börsch-Supan, Axel (2005), The Finnish Pension Reform 2005, Finnish Centre for Pensions Working P.

A seemingly contradictory picture of the labour market

Large corporations are continuing to lay off highly-paid Finnish workers. Finnish companies are moving work abroad (often to Asia) or downsizing, or foreign companies taking over Finnish firms and then moving the labour away. The continuing redundancies from large Finnish corporations are of serious concern for the government and the Finnish president, Tarja Halonen, recently called on large corporations to take greater social responsibility.

Media reports on planned redundancies in the near future have also led to a fall in consumer confidence in recent months as the sentiment regarding the outlook for unemployment has deteriorated although this is at odds with recent figures for actual unemployment which have been improving.

In fact, stronger economic growth is now feeding through into faster increases in employment and a decline in the unemployment rate and many indicators suggest that remaining unemployment is now predominantly of a structural nature. The biggest increases in employment were registered in the public sector, the industrial sector and transport businesses. There are also significant increases in the number of self-employed and in agriculture.

While these developments towards more employment are encouraging, **problems** remain on the labour market.

- The wide-spread use of early retirement pathways[9] needs to be restricted in order to raise the employment of older people.
- The number of vacancies has increased sharply reflecting skill and geographic mismatches on the market.
- Ageing could dampen growth prospects, especially if public sector employment continues to grow rapidly. The government has set guidelines to only fill every other vacancy at central government level until 2011.
- Youth unemployment has remained persistently high. The government is trying to tackle this by reducing course length, simplifying admission procedures for universities and making 3-year Bachelor degrees more attractive. Furthermore, the 2006 budget contains subsidies to encourage employers to take on older workers and the under 25s.
- Long-term unemployment is on the increase again and the government wants to respond with a rise in the activation rate of active labour market programmes to 30% by the end of 2007 and an expansion of the Public Employment Service.

Finland lifted restrictions on labour from new EU Members States

Finland lifted restrictions for labour from the new EU Members States on 1 May 2006. This move will, however, be accompanied by tighter requirements on Finnish companies to meet Finnish standards of pay and working conditions. In particular, they will have to monitor subcontracted labour and temporary agency workers more closely .

[9] The possibility to practically retire early, even if early retirement in the narrow sense of the word is not available, predominantly through unemployment and disability.

Therefore, a system of compulsory registration of all foreign employees will be introduced. Furthermore, to complement these moves, the bill for a new law on the regulation of subcontracted work is expected before the end of 2006.

The Centralised Wage Bargaining System

Finland has a strong tradition of wage bargaining at a central level based on solidarity. This system sets national agreements that then act as a framework for negotiations at sectoral and company level. Since 1995, the government has taken a more active stance in the negotiations and the social partners have since concluded a series of comprehensive income settlements with the government often rewarding the partners in the settlement with lower taxes and social security contributions.

The latest agreement was reached in November 2004 and covers around 90% of all employees until after the next general election in 2007. It includes pay increases of a mixed nature for the first year and a percentage-based increase in the second year resulting in a proportionally higher increase for the lower-paid. The current agreement furthermore includes an indexation clause allowing for additional increases depending on consumer price index inflation exceeding 2.6%.

The coverage of the central agreements varies as the number of local trade unions accepting the agreement varies from year to year. In general, however, coverage is high.

By securing moderate increases in wages and salaries, the centralised agreements have undoubtedly helped to contain inflation. However, the system comes at a cost:

- Centralised bargaining compresses the wage distribution and may fail to allow for the reflection of productivity differentials.
- Centralised agreements can contribute to real wage rigidities.
- Wage floors through agreements can result in higher minimum wages which can reduce employment.
- Regional differences may be perpetuated by a reduced supply of low-skilled service jobs.
- Regional wage flexibility is low.

In view of these problems, international organisations such as the IMF and the OECD have repeatedly called for increasing wage flexibility in Finland. The IMF considers the widening of the compressed wage structure and a shift to a more decentralised wage-setting system desirable, while the OECD recommends - among other things - to promote the use of "opt-out" clauses. Indeed, recently there have been some changes to the system aiming to allow for more local bargaining.

However, there are also substantial arguments against the widening of the compressed wage structure. Much of the Finnish social capital underlying the fabric of the economy builds on a high public preference on equity. From a public choice perspective, a compressed wage structure can thus also be seen as a considerable asset contributing to competitiveness and social peace. In the same vein, high taxes and high redistribution levels are therefore a legitimate means to maintain a national compromise.

4.3 Monetary Policy and Inflation: Finland in the EMU

Low levels of inflation

In 2005, Finland had the lowest inflation rate in the EU with 0.8% (together with Sweden).[10]

The low level of inflation is attributable to wage moderation on the one hand, but also (to a presumably lesser extent) by rapidly falling communication charges (mobile telephone, internet etc.) on the other. Wage moderation is facilitated by solid productivity gains which help to keep unit labour costs low.

In the first quarter of 2006 however, the inflation rate increased to an estimated 1.6%, driven mainly by high import costs which peaked in the first quarter of 2006, mainly attributable to oil and metal prices. However, the pass-through to producer prices has been limited.

It could be expected that higher nominal wage growth combined with strong consumer demand and rising house prices push up inflation in the following two years, to approx. 2% in 2007 (OECD estimate). However, even these increases in inflation will keep inflation in Finland below EU average.

Possibly too easy monetary conditions

In January 2006, the IMF warned that monetary conditions may be excessively easy from a Finnish perspective. [11] Indeed, the Finnish financial supervisory authority (Rata) expressed some concern that growth in disposable incomes - boosted by tax cuts - would not persist. Many households may be basing their borrowing decisions on overly optimistic expectations of income growth. Although house-prices do not seem too far from fundamentals, there are also signs of overheating in the housing-market.

Credit expansion for housing is high. As demand for mortgages remains high, lenders compete for customers, which reduces margins. Mortgages are characterised as "loss-leaders" that attempt to capture customers for other banking services. In addition, as there is a trend towards long maturities, which pose the danger of locking in low profit margins for an extended period of time.

Overall, from a relative European perspective, Finland seems to be an example for an economy combining sustainable high-growth levels with moderate inflation, despite some persisting dangers and possibly slightly too easy monetary conditions.

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[10] Eurostat. Annual Average Rate of Change in Harmonized Price Indices (HICP)
[11] IMF Article IV consultation, Finland, January 2006

4.4 Financial Markets

Banking Sector enjoys good profitability

Banking groups realised a strong performance in 2005 (total operations profit of Finnish banking groups rose by 16.4%). This was mainly due to an increase in cost efficiency on the one hand and a growth in income mainly through lending especially in the retail sector on the other. Bank assets have grown 20% since 2004. Finnish households have continued to increase consuming in mortgages, mostly for longer maturities of 17 years and lower interest rates, and 1/3 of the total volume on renegotiating mortgages. The total amount of mortgages increased by 16.7%, during 2005.

Market share in overall lending is dominated by the OP Bank with 30.5%, Nordea with 31% and Sampo with 14.3%. Bank deposits have increased by 7% in 2004, with retail deposits no less than 70% of the total, whilst the corporate sector accounts for only 19% and the public sector 11%. The increase in loans outstrips deposits and so banks have a deposit deficit. This deficit has been filled by banks increasingly turning to the international capital markets for financing.

The number of banks operating in Finland has been stable over the last few years. At the end of 2005, there was a total of 345 banks split as follows: 12 commercial banks; 238 co-operative banks belonging to the OP group; 42 local co-operatives; 40 saving banks; 13 branches of foreign credit instruments.

The number of branches operating in Finland remains stable at 1,616 branches due to an increase in E-banking. Most payment services are affected through the internet (only 3% of bank customers pay at a branch). In total 66% of bank customers pay their bills on the Internet. This has also decreased the use of ATM terminals, which were reduced in 2005.

In 2005, for the first time, banks have prepared their financial statements in line with IFRS. First reactions suggest that the effects of the IFRS return are minimal with little changes in capital adequacy. Return on equity is currently an average nearly 20%.

Funds. Favourable stock markets have given rise to increased mutual fund investing by retail investors as an alternative to deposits. The mutual fund market in Finland is with 45 billion Euro at the end of 2005, up by 41% from 2004 (out of which more than 50% from new fund investments!). The share of equity funds increased by 37% and money market funds decreased by 24%.

Finland to join SEPA in 2008. Finnish Banks published a SEPA implementation and migration plan on 15 March 2006. The SEPA electronic Credit Transfer Scheme developed by EPC is deemed to be a good model despite some shortcomings, according to Finnish banks. However Finnish banks are more sceptical about the suitability for Finland of the SEPA electronic direct debit scheme, which cannot be adopted as it currently stands.

Insurance Sector is also advanced, especially on solvency tests

Finland is a country with only 5 million inhabitants and covers only 2% of the EU insurance market.

However the Finnish insurance industry is advanced and well used as the volume of premiums written account for 9% of Finland's GDP and insurers' investments account for nearly 59% of GDP. These high rates are explained by the obligatory employee pension insurance which accounts for a major part of the total.[12]

Insurance companies in Finland (67 in total of which 21 branches of foreign insurers) are either mutual or limited companies. More than 50% are limited companies, although it is possible for a group to have both mutual and limited companies.

The market is fairly concentrated with the 4 largest groups owning 80% of the market.

Different distribution channels are used depending on the product. Banks for example, in view of the boom in the mortgage market, have become a big distribution channel of life insurance. Internet and brokers are also increasingly used.

Authorised employee pension companies (under private ownership) provide compulsory pension insurance to most private sector companies in Finland. Group life insurance covers all employees.

Due to the wide coverage of earnings-related benefits, the need for personal pension insurance was not so urgent in Finland is in other countries. However an ageing population in Finland also led to public social services cuts. Consequently the use of private insurance pension, health, compensation and motor liability is increasing.

Foreign insurance companies are free to set up authorised employee pension insurance companies and are governed by the same conditions.

The Finnish employee pension scheme is a partly-funded defined benefits scheme. Current pay-outs take up ¾ of pension insurer's premiums and investment income and the remaining ¼ is funded to cover future benefits.

Asset Portfolios. Finnish insurance companies manage asset portfolios which are large compared to the premiums collected. This is partly explained by the partly-funded employee pension scheme. Another feature is that benefits due under liabilities and motor liability insurance are paid in annuities instead of lump sums. This allows for long-term provisions in balance sheets making investment in long term maturities possible.

[12] Finnish Insurance Today; Federation of Finnish Insurance companies

At current value, the Finnish insurer's investment portfolio is 89 bn Euro at the end 2004 or 6x the volume collected in gross premium or 59% of Finland's GDP. A major change in the asset portfolio is an increasing tendency to diversify out of Finland; at the end of 2004 43% of investments were in the euro zone and 16.8% in other countries. Most foreign assets are bonds, equities and funds.

Supervision. Finnish insurers' solvency has been supervised from 1952 onwards by means of a solvency test, which incorporates an early warning system. The solvency test evaluates the nature of the insurance business and the underlying risks as well as the risk content of the assets held. The Finnish concept of solvency is wider than the EU concept of the solvency margin. Solvency capital includes assets valued at current value and a prudential margin on the liabilities" side, such as an equalisation provision.

For authorised pension insurers, solvency requirements include a provision for future bonuses which serves as a buffer against fluctuation in the invested assets. Furthermore their solvency is monitored by supervisory limits set individually for each insurer on the basis of the risk content of assets.

Securities Sector - deeper integration of Nordic securities systems

The Helsinki SE forms part of the Nordic Exchange, which is operated by OMX - the world's first privately owned, electronic, profit-driven exchange. The Nordic Exchange is Europe's 5th largest stock exchange.

In October 2006, the current separate exchange structures for Sweden, Denmark and Finland will be merged within one Nordic list to be organised in 3 segments: large cap, mid cap and d small cap.

One of the issues for the Nordic Exchange is the heavy dominance of Nokia shares, in a total of 27.686 mio SEK as daily turnover for the Nordic Exchange, Nokia shares' volume represents 4.700 mio SEK, followed by Ericsson as second with 2937 mio SEK![13]

OMX however does not only run and operate the Nordic Exchange, but is the world's leading provider of exchange systems and system services.

OMX has seen at first hand through the integration of the Nordic Exchange the importance of harmonising system platforms and of having an efficient transaction technology. Tougher market conditions and increased competition will lead to lower production costs, however, slow integration in national rules still give rise to fragmentation in the last part of the transaction chain, namely clearing and settlement.

As a leading expert, OMX follows the implementation of Mifid with closed interest and sees the sizeable IT investments required to comply with Mifid as well as the tight deadline to be an issue.

[13] OMX annual report 2005, 1 EUR = 9.2 SEK

Planning will be key, as will cooperation between exchanges - possibly in the form of partnerships. Ultimately according to the OMX legal Counsel, Mifid will certainly open up possibilities and more options to trade in new venues.

All OMX Exchange members can access all OMX's markets through a single point (Including Oslo and Iceland as they use OMX' trading system).

OMX is also developing a Pan-Nordic organisation for CCP (Central Counterparty) for equities, bonds and derivatives, thus creating lower transaction costs and a higher liquidity.

4.5 Competition

The Finnish market is relatively small. Its remote location and low population density on a fairly large geographical area have direct and undeniable consequences for the market structure. To give one example applicable to the retail sector: as for company size, the choice basically exists between two "evils": either one "chooses" large companies and a low degree of competition, or small companies and relatively higher competition. The latter in turn reduces the possibilities of exploiting economies of scale. At the end of the day, both choices lead to higher prices for the consumer. Against this background, it is not surprising that e.g. foodstuff prices are on average 10% higher in Finland than in the rest of the EU.[14]

These are only some reasons why an effective competition policy is especially important for small economies like Finland. There is a strong case in Finland to make *competition* policy an integral part of a larger-based *competitivity* policy. For the achievement of this goal, the role of effective competition legislation and supervision is key.

Finnish competition legislation

The Finnish Competition Authority (FCA) is the agency in charge of monitoring competition. It was founded in 1988 (whereas the first competition legislation came into force in 1958). With a staff of 70, divided into 6 units[15], it reviews roughly 900-1000 cases per year and has a budget of approximately 5 million euros. Of these cases, just over half are purely domestic cases and the remainder EU cases.

The main Finnish Competition Act draws back to 1992, when horizontal cartels and the abuse of dominant positions were prohibited. Since then, there have been two major amendments in 1998 and 2004, the latter aiming at further harmonising legislation on competition restraints with EC Articles 81 and 82. As a result, the relevant articles in Finnish competition legislation fully correspond to their counterparts in EC Art. 81/82. While the FCA is the competition authority, the court responsible for competition matters is the Market Court. [16]

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[14] According to a study by the Kuluttajatutkimuskeskus (the Finnish Centre for Consumer Research), Yearbook 2005

[15] Monopoly, Cartel, Advocacy, International Affairs, Communications and Personnel Units.

[16] The FCA can decide that a competition restraint shall be terminated, impose a delivery obligation and order that a company shall implement the commitments supplied by it to the FCA. The FCA can also issue temporary injunctions to cease a restraint. To enforce the application of an injunction, prohibition or an obligation, the FCA may impose a conditional fine. The Market Court, an independent court of law, decides, upon the proposal of the FCA, on imposing

International comparison

In international OECD comparison, the FCA is a fairly slim organisation with respect to its resources. Despite its small size, it is however very effective. In 2003, the OECD described the FCA as "fair and responsive" which means that it is both effective and just.[17]

Due to its small markets, because of its remote location, large distances and small population size, Finland has sometimes been quoted as the Promised Land of cartels. The FCA disagrees with this, stating that despite fairly concentrated markets -in terms of players - the authorities are quite effective in curtailing illegal practices.

Current cases in Finland include proceedings against an asphalt cartel and raw wood cartel. The pulp and paper industry often seems to come under scrutiny by the authorities, because of its especially concentrated market structure. Also, the food retail sector used to be very concentrated. However, with the recent entry of German giant Lidl in this sector, competition has achieved positive outcomes in prices for the consumer.

These sectoral observations represent selected examples. Considering the number of cases, no sectoral concentration of proceedings can be detected.

5. Conclusions - Achievements and Challenges Ahead

Are there any secrets to the Finnish (and Nordic) model?

Recent debate in various countries in central Europe has centred on whether the "Nordic Model" - among which Finland is often quoted - is one which should be adapted by the rest of Europe.

While many aspects of the Nordic model are specific to Nordic culture and institutions, some lessons may be relevant:

- Nordic countries have high levels of "social capital". Social capital implies trust, respect, transparency and predictability of public sector actions.
- "Flexicurity": relatively low job protection (compared to some central European economies) combined with high unemployment benefits and proper incentives to (re)find employment can in certain conditions be socially just and economically efficient at the same time.
- For geographic and historical reasons, Nordic populations are small and homogeneous. Among other things, this means that public services can more easily be tailored to the "median voter", meaning that public service supply can be more efficiently organised. E.g. Finland only has 2% of foreigners in its population, the lowest share in the EU.

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competition infringement fines for breaches of the competition restraints. In addition to imposing fines, the Market Court is the first instance decision-maker on prohibiting mergers and acquisitions. However, it is within the FCA's powers to impose conditions set as condition of approval for mergers and acquisitions.

[17] OECD (2003), Regulatory Reform in Finland. Survey

- High employment levels are achieved by particularly high female employment, facilitated through working and affordable day-care arrangements for children.
- The educational level of the whole workforce is relatively high in Finland as in other Nordic countries. E.g. in 2000, 32% of total workforce in Finland had achieved tertiary education, while the EU15-average was 24%. Education is indeed key. Finland's biggest corporation, Nokia, has also benefited from the Finnish education system. The supply of high-skilled engineers has been high, and consequently, their wages have also remained moderate. Free education may also have contributed to wage moderation.

Despite their benefits, the challenges to the Nordic model are also increasing. E.g. it is not clear how productivity in the large public sector will develop in the future and how long the high levels of taxation can effectively be maintained in the era of globalization.

Summing up, the positive achievements in Finland include:

- government surpluses have been run since 1998
- pension funds surpluses today are critical for future spending

- the national labour market coalition has been functioning well due to a high degree of consensus in industrial relations
- wage moderation has led to very favourable inflation level

- the quality of health and education is high
- private R&D expenditures are well above Lisbon targets
- innovation and competitiveness have progressed despite, or perhaps partly due to, the most compressed wage structure in the world

- public sector efficiency is relatively good in European comparison, despite low population density and Finland's rather remote location. Still improvements in this area remains an internal Finnish challenge.

Main challenges ahead include:

Population ageing is the main demographic fact. Finland faces the ageing peak approx. 10 years before the rest of the EU (and the OECD) countries.

- Ensuring the sustainability of public finances in view of rapid ageing and pressure to decrease taxes on labour.
- Raising the employment rate even further, especially for people over 50 years old .

- Broadening and enhancing growth potential in the service sector. Productivity is poor in the sheltered service sector.
- A central structural shortcoming of the Finnish economy is its high degree of specialisation in production patterns (mainly paper&pulp and ICT). This is a cause of high volatility in growth rates and financial markets leading to high vulnerability of the economy in general. It is also due to this risk that Finnish membership in the (stabilising) Euro is especially beneficial.

Finland is in many ways a role model in Europe. However, it cannot and should not afford to rest on its achievements. An OECD Economic Survey in 2006 comparing all member states interestingly noted that a country's position in the competitiveness rankings of the World Economic Forum in 1995 was actually negatively correlated with growth in GDP over the subsequent decade. This means countries with high rankings grew slower in the coming decade. Although this might not apply to the Finnish case and statistical artefacts always exist, Finland still needs to act now. Even though many other European economies face much greater challenges at this time, past experiences suggest that it is especially difficult to remain vigilant in good times.

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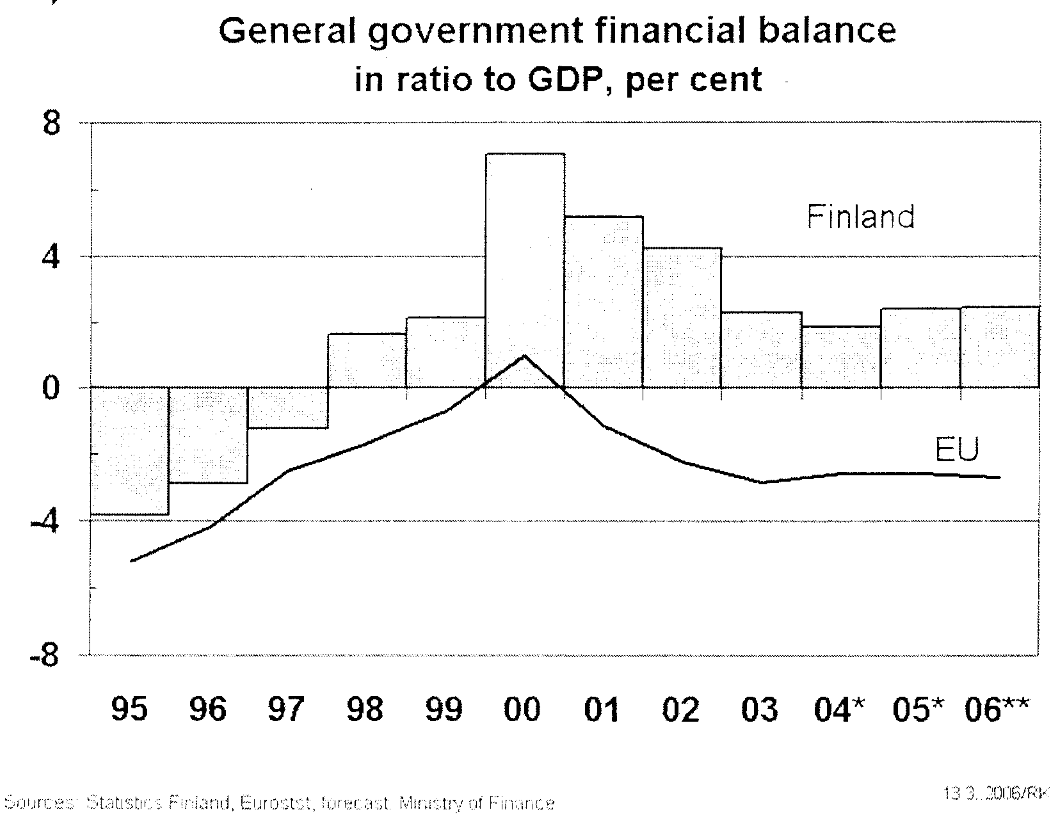
ANNEX

MINISTRY OF FINANCE
FINLAND

GRAPH 2



MINISTRY OF FINANCE
FINLAND

GRAPH 3