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The economic dimension of the single currency: the Finnish perspective

Remarks in the conference "Economic and Monetary Union: Challenges and Risks", organised by the EuroCollege, University of Tartu and Eesti Bank, Tartu May 11-12, 2001.

Talking about the economic impact of the monetary union, with its common monetary policy and the broad co-ordination of other aspects of economic policy, I must begin by mentioning a couple of caveats. First, I will talk from a particularly Finnish perspective, and from Finnish experience. I believe that the effects of EMU membership can well be different for different countries, depending on their particular starting points and the problems or strengths they have to begin with. So, experiences of one member cannot be always generalized to others, and the impact of the union on some new member could be different from its effects on older members.

Another caveat is that one cannot really judge the impact of the EMU on its members just by looking at the statistics, by checking what happened to a country's economic situation after joining the monetary union. For one thing, EMU is still very young. It has been in operation for less than three years, and we do not have experience of its operation over a full economic cycle. On the other hand, many of the effects of EMU started to work their way already before membership.

Let us take Finland as an example. When Finland joined the EU in 1995, it was stated that the aim was to participate also in the monetary union in the first group of countries joining it. From that point on at least, the Maastricht criteria and the foreseeable policy regime of the EMU served as clear orientation points for the Finnish economic policy strategy, and for Finnish firms as well. In fact, because of this advance adjustment, the start of the monetary union on the first day of 1999 was by no means a "big bang" in any practical terms. Rather, it was just a seal on the developments which had occurred over several years already.

Despite this, I think that we can learn from each others' experience, and the accession countries should try to look at the experience of the "old" EMU countries. This must not be mechanical, however. It must be done with great caution and applying a high degree of judgement in the process, considering the experience of other countries against the particular situation and background in each new member country.

I think that the conference organizers' idea of using Gordon Brown's five tests for the EMU membership as a basic framework for this conference is an excellent one and I shall structure my presentation accordingly. I'll try to explain how I see each of the five tests in the case of the Finnish EMU membership - these five being: effects on the business environment, on financial services, the challenges caused by cyclical asymmetry, flexibility requirements for member states, and last but not least, the effect of the monetary union on the general macroeconomic performance of the country.

I'll start from the last point in Gordon Brown's list, namely the effect on overall economic performance.

Has joining the EMU helped to promote higher growth, stability, and a lasting increase in jobs?

As you know, the latter half of the 1990's, i.e. the period after Finland joined the EU, has been a period of unprecedented growth and transformation in the Finnish economy. Even though the unemployment rate still remains far too high, as in most of Europe, it is fair to say that there is now a very broad consensus among Finnish economists and policymakers that the stability of the economy is now much better than is used to be, and the policy trade-offs are much more favourable.

To fully appreciate the change which seems to have happened, one should understand the frustrating instability of the Finnish economy in the previous decades. The economy used to be very inflation-prone, its structural current account deficits led to recurrent balance-of-payments crises and devaluations, and the corporate sector was notorious for its weak capital structure. Growth was relatively fast, it is true, but instability was a major problem. Another problem, for most economists, was the relative inefficiency of investment, in the sense that very high investment rates were required to generate the growth we had.

Among the most important changes which have taken place since are the following (see the charts and tables attached):

- Productivity growth has accelerated significantly, compared to the experience of the previous 20 years or so. This has enabled the economy to grow much faster than used to be thought possible;

- The growth-vs.-inflation trade-off has improved significantly, judging from the fact that the recent rapid growth in the economy has been realized with less acceleration in inflation than one would have anticipated based on our historical experience;

- The growth-vs.-current account trade-off has also improved markedly. Despite several years of high growth, the persistent tendency of the current account to be in deficit, which used to be thought as structural, has disappeared. Instead, there is now a very large and apparently still growing surplus in the current account;

- The capital structure of firms has strengthened dramatically. In a sample of 500 largest companies in Finland, the average debt-equity ratio has decreased from about 1,9 in 1994 to 1.2 in 1999;

Now, it is very difficult to say with certainty to what extent these significant changes which have occurred are in fact results from the Finnish membership in the EMU. Some alternative explanations can be found as well: for example, the so-called "new economy" has been credited for the moderation of inflationary pressures and the lower investment requirements for growth (this could in turn explain the improvement on the current account). Moreover, broadly similar and parallel improvements in price stability and the balance of payments have been experienced also in Sweden although it has not yet joined the EMU.

However, it seems to me that the changes I just listed have a common denominator, so to speak: there is an underlying factor which can (in theory at least) explain them all. Since this factor is also connected with the monetary union, it seems a quite reasonable hypothesis that the improvement of the Finnish economic performance has in fact been partly improved by the monetary union. This common underlying factor is an improvement in the credibility of monetary policy.

Let me explain. First, better credibility can explain the improvement in the output-inflation tradeoff, as wage inflation does not take off as easily as before. Second, as monetary policy is not seen as prone as before to bail out export industries in the event of problems, firms now act more prudently and invest with more caution than before. This may explain the decrease in the investment intensity of growth and hence the improvement in the structural current account. A more credible monetary policy has also made capital markets work more efficiently, which may explain the improved solvency of firms and perhaps the acceleration in productivity growth as well.

Of course, the improvement in the credibility of monetary policy, which seems to have occurred in Finland in the course of the 1990's, is not quite the same thing as monetary union. Improvement in credibility just requires the adoption of stability oriented policy and strong, independent institutions to implement it. But it seems that monetary union has helped a great deal in achieving this. Perhaps it was indispensable: there is no way to tell whether the political and economic conditions for a credible monetary policy could have been cemented in Finland without EMU. In the 1960's, 70's and 80's, they were not.

Having said this, it is already clear how I assess the first item on Gordon Brown's list - namely

<u>Has adopting the common currency created better conditions for firms in the long-term perspective?</u>

What we know is that after the EU and EMU memberships became a reality, Finnish firms have become much more international than before, in terms of ownership and operations. Also, the economy has become even more export oriented than before. At the same time, the industry structure has changed so that the share of the electronics and IT sectors have grown enormously. In the Finnish case this has meant an increased diversity in the structure of exports, as the electronics exports (such as mobile phones) have emerged as the third major export category alongside the more traditional paper and heavy engineering products.

It would be simplistic to attribute the success of this internationalization and diversification of industry mainly to the currency arrangement Finland has chosen. Causes for the Finnish IT miracle - if there is a miracle - must be sought elsewhere. But as I said, there is reason to believe that the stabilization of expectations and the consequent improvement in the functioning of labour and capital markets has to do with the monetary union, and so part of the positive business environment which we have had recently must be attributed to EMU membership. It is also the case that the broad economic policy co-ordination in the EFC and Ecofin, has helped policy makers to focus on medium to long run stretegic programming and hence the policy co-ordination processes have made business environment more stable and predictable than they otherwise might have been.

Turning from industry to finance and banking, one can take up the next question, namely

How have the country's financial services been affected?

As you would know, the Finnish financial sector has been almost completely transformed after the financial crisis of early 1990's. Banks have become more cost efficient and profitable, there is now a strong if not dominant multinational player in the market, and the stock market has grown and internationalized beyond all expectations.

However, regarding this change in our financial services industry, it is again not easy to distinguish the effect of the monetary union from other powerful forces of internationalization which have swept the country in general. Certainly, the Finnish financial system has been completely transformed in the run-up to the EMU. But it is not at all clear that joining the EMU has been a decisive force here. We know that actually the Nordic bank mergers have not paid too much attention on the ins/outs question. Geographical location seems to have been a much more significant factor in selecting merger partners than the local currency arrangement, be it EMU, ERM or floating. So, perhaps EMU has been only a minor factor in the banking development so far and other strategic and technological factors have been more influential.

In the money and capital markets, the effects of EMU have been more clear. National benchmark instruments and national benchmark rates have virtually disappeared in all of the small EMU countries, as they have been replaced by the Euribor and Bund markets. This unification of money and capital markets may have hurt some traders who lost their business, but on balance the effect for the member economies is clearly positive. This is essentially because of the elimination of unnecessary exchange rate risk. For example, Finnish pension funds are now able to diversify their rapidly growing asset portfolios internationally, something which was previously prevented by exchange rate risk. These diversification possibilities are also utilized on a rather large scale.

In the future, as the monetary union develops its financial regulation activity, the Finnish membership in the EMU may well have even more easily identifiable effects on our banks and financial markets. This could result from a more international approach to regulation within the union. For example, if the ECB and the Eurosystem develop their roles in banking supervision further, as I hope they will, then membership in the "inner circle" of EMU countries may be extremely useful to supervisory authorities and central bankers for understanding what is going on for developing joint action if necessary. This kind of development is likely to follow soon if international banking mergers become more common in the euro area.

The next point has to do with the cost of abandoning national monetary policy. The question is,

Are business cycles compatible so that we can live comfortably with common, euro interest rates?

Before joining the EMU, the problem of asymmetric business cycles was discussed to some extent in Finland. In particular, it was pointed out that the Finnish business cycle had usually been very different from the "core" European countries. The worry was that common monetary policy, geared to "average" European needs, would be sometimes too lax and sometimes too tight for Finland. The former situation would cause inflation to get out of control; in the latter case, policy would curtail aggregate demand too much and could cause an unnecessary recession.

I do not want to sound imprudent, but I think that the limited experience which we have so far suggests that these fears were probably exaggerated. It is true that during the Finnish EMU membership, until now at last, economic growth has been very fast and inflation has been higher than in the Euro area on average. Some time ago the Bank of Finland, OECD, IMF and some government officials all expressed worries about the possibility of overheating in Finland. However, now it appears that the acceleration of inflation has been small in relation to the scale of the economic upswing, and the situation remained under control.

Why have things worked out better than originally expected? It seems that membership in a large monetary union has removed two destabilizing factors which used to be important to the traditional Finnish business cycle. First, the “balance-of-payments constraint” and its monetary consequences have almost disappeared in its traditional sense. It used to be the case that whenever the current account was seriously in deficit, the money market reacted to that by tightening and interest differentials vis-a-vis the rest of the world would start to rise. (Correspondingly, balance-of-payments surpluses used to create excess liquidity and absorption problems which were difficult to manage.) Now, for a small member in a monetary union, international liquidity is not nearly as vulnerable as before. Hence this monetary channel in business cycle transmission is no longer there and this has probably made the dynamics of the Finnish business cycle much smoother and less extreme than before.

The other factor which has probably changed the Finnish business cycle dynamics for the better is the increased stability of inflation expectations which I have already mentioned. This is basically because the suspicion that monetary policy would, in the end, accommodate excessive cost increases has now disappeared. With a more stable “anchor” for price expectations, the labour and real estate markets in particular will be now calmer than before, meaning that they are less prone to overheat in economic booms. This means that the likelihood of generating an unsustainable increase in domestic costs should be less than it used to be when we had a national currency.

I am not as frivolous as to claim that the Finnish economy no longer is capable of ending up in an unpleasant disequilibrium. Even if the dynamics of the economy now appear to be more favourable than before, shocks do occur from time to time which require adjustment. Therefore, it is reasonable to raise the last point on the test list, namely:

<u>If problems emerge, is there sufficient flexibility to deal with them? (test 4)</u>

The flexibility discussion contained by this criterion for membership has been actually very much in the forefront in the Finnish discussion on the effects of the EMU. This discussion has revolved around three main themes:

- the role of fiscal policy in facilitating business cycle adjustment in the new policy environment;
- the role of incomes policy in avoiding irreversible erosion of competitiveness of the economy;
- the need for microeconomic reform of labour markets to make the labour market more flexible.

Turning to fiscal policy first, the last decade has been dominated by a consistent effort to improve the government budget balance. This has also been very successful, and the Finnish budgetary position is now very strong by European standards. This effort to pay back debt fast has been motivated by two different reasons, one of which has to do with stabilization policy. This reason is that a solid fiscal position is desirable to generate leeway for fiscal policy which could be used to "buy time" in the event of an unexpected recession. This does not imply the view that future recessions could be “cured” by fiscal expansion; I don't think there are many who trust in that kind of strategy these days. But it means understanding that re-balancing the budget after some negative shock can happen in a more gradual and less disruptive way if the government debt level is initially small. This has been an important point in the Finnish policy.

The other reason – quite unrelated to EMU – why strengthening of public finances has had a high priority is the fact that the population of Finland is ageing fairly rapidly and the government wants to accumulate pension funds and reduce debt in anticipation of the coming increase in the pensions expenditure.

I want to emphasize that even the first of these two reasons for pursuing a very prudent fiscal policy is related to the EMU only indirectly. More specifically, I do not think that the fiscal criteria of the Maastricht treaty or the Growth and Stability Pact have been significant constraints of incentives to Finnish fiscal policy. The genuinely economic motives for prudence have been so much more demanding, that the policy has been satisfying the external, formal criteria voluntarily, and by a clear "safety margin" at that.

Regarding the role of incomes policy next, you probably know that Finland is one of the few countries where the position of centralized incomes policy has been very strong, and even continued to strengthen. The unions do not only strike centrally co-ordinated wage bargains: the actual scope of incomes policy is larger than that. Much of labour market policy, taxation, and social security policy is in fact negotiated in a tripartite fashion between the labour unions, employer organizations, and the government.

Experience shows that this incomes-policy oriented way of formulating economic and social policy has actually become even more dominant after it became clear that Finland joins the EMU in the first wave of countries and there are no clear signs that this development would be reversed in the near term at least.

One may speculate why the EMU membership seems to have increased the bargaining power of labour unions in general economic policy. One plausible explanation is that because of their traumatic historical experience, Finnish policy makers are extremely keen to avoid getting into an irreversible cost crisis, which would result from wages rising too much for a prolonged period. In the past, that kind of situations used to lead to forced devaluations of the currency, When Finland joined the EMU, it was immediately obvious to everybody that the kind of situations which used to be solved by devaluations must never emerge again. The very high priority of cost control for the government has then given the unions quite a lot of leverage on other aspects of policy. Similar developments may have occurred in some other small EMU countries (Ireland, Austria, the Netherlands to some degree), but I think Finland is actually a bit special in this regard.

Finally, there is the question of labour market flexibility. How much more should we have? This issue has been politicized quite a bit in Finland, and is connected to the status of incomes policy in the society. I think that one way to look at the Finnish situation is to distinguish between micro and macro flexibility.

Macro flexiblility of labour markets has to do with the ability of the labour markets to weather general, macroeconomic shocks. It is the kind of macro flexibility which may be needed in the event of unpleasant shocks, when national monetary and exchange rate policy are lacking. For that purpose, wage moderation of the kind sometimes achieved by incomes policy may be an instrumental form of flexibility. Many labour market organizations (especially in manufacturing industries) have also taken a positive attitude towards developing more innovative models of wage determination, for example profit sharing systems and the so-called “buffer funds” where excess unemployment insurance contributions are collected to insurance funds when the economy is growing fast, for the purpose of reducing indirect labour costs when economic activity is weak. The effect of the EMU membership in Finland has been that developing and using these forms of flexibility are now actively discussed among the labour market partners and the government,

Micro flexiblility, on the other hand, relates more to the ability of labour markets to match jobs with people and their skills, and to equilibrate individual wage demands with the individual productivities of individuals. Here the performance of the Finnish economy is disappointingly weak as the unemployment rate is high, hovering still around 10 per cent (and much more if you include people on “measures”). It may be that this problem has less to do with the monetary union membership than with taxation and other “structural” factors. However, it needs to be noted that the existence of high and persistent long-term unemployment has also some bearing on the cyclical adjustment of the economy: it casts doubt on the ability of the labour market to deal with adverse shocks and structural change. Moreover, high unemployment costs are a burden to the government budget and hence limit the ability of the budget to absorb negative shocks in the short run. At the time when joining the monetary union was first discussed, some people thought that the EMU membership would in due course “force” the labour market to change so that it would become more flexible even in the micro sense. So far, there is no evidence of that kind of development.

At this point, I would like to emphasize the positive role of the Broad Economic Policy Guidelines and other “processes” of economic policy co-ordination within the EU. It is clear that these co-ordination processes produce only recommendations and initiatives. However, their importance in helping governments to develop their economies should not be overlooked. I am not speaking only about peer pressure for reform; I think that national policy makers do genuinely benefit from the benchmarking of policies and institutions which take place within these policy co-ordination processes. The processes also “force” countries to analyze their respective situations in certain ways which might otherwise not happen. All this creates focus and incentive for policy development which must not be underestimated. In view of the unemployment problems of Europe, it is clear that the tasks are especially large in the field of developing the functioning of labour markets.

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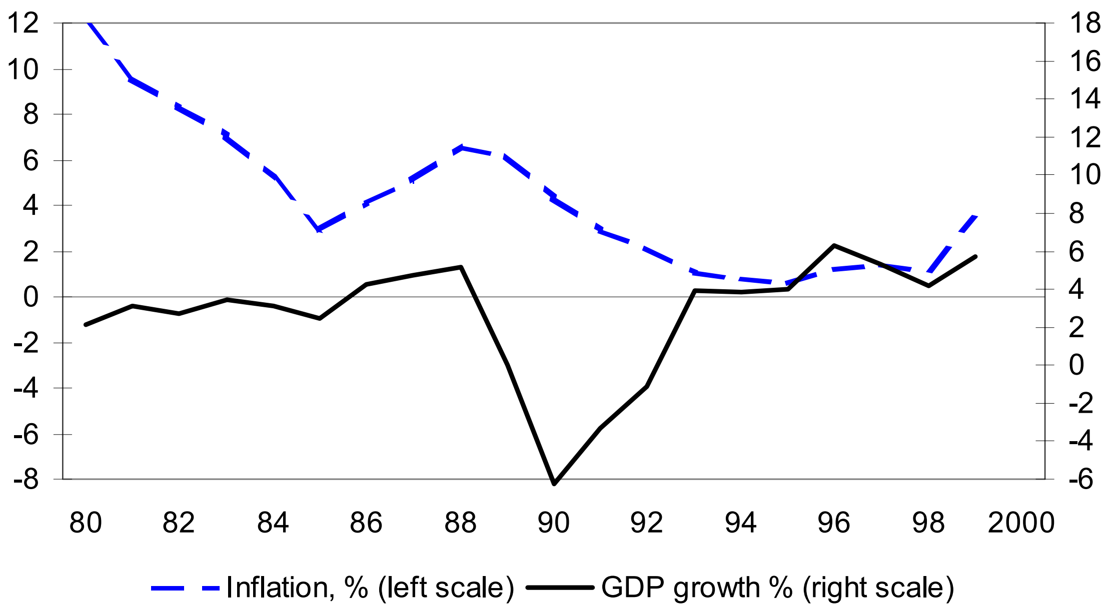
To sum up, I think I have given a rather positive picture of the effects of EMU on the Finnish economy, and on balance, I indeed see the effects as overwhelmingly positive. I hope I have also succeeded in describing some of the effects of EMU in their relation to the Finnish historical and political background. On the basis of this analysis, it seems to me that a very large part of the economic benefits of joining the EMU are in fact due to increased credibility of monetary and fiscal institutions - better trust on the value of money and the medium-term balance of the budget. As a result of this better credibility, inflationary expectations have been much lower and more stable than before, and asset and labour markets have been able to work without the macro problems which waves of inflationary fear would otherwise cause.

It is clear that, to join the monetary union in a smooth and not disruptive way, countries must adapt well in advance both in terms of the macroeconomic aggregates and in terms of the microeconomic maturity of their markets. At the same time, the recent improvements in the performance of the Finnish economy demonstrate that EMU membership, and even the prospect of it, greatly facilitates overcoming some of the most difficult problems of economic policy, especially if these problems have to do with less than perfect credibility of policy strategies and institutions.

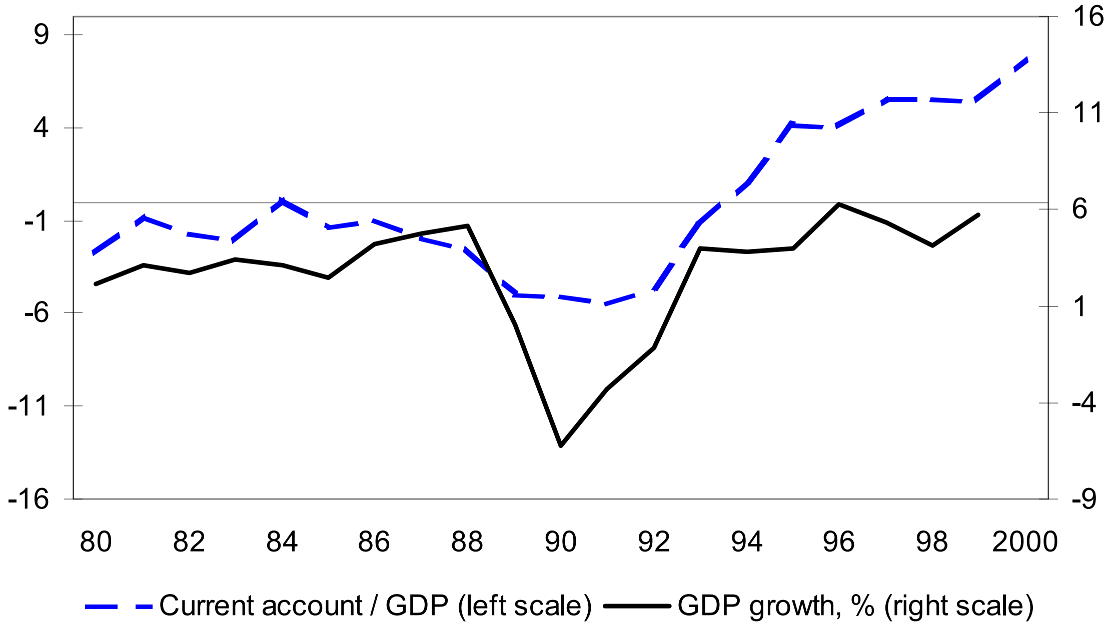
Productivity improvement in Finland

Rates of growth, p.a.	1975–1990	1990–1993	1993–1999
Labour productivity	2,9	3,1	3,2
Capital intensity	3,6	8,6	0,5
Total productivity	1,3	–0,6	3

GDP growth vs. inflation in Finland



GDP growth vs. current account in Finland



Debt - Equity Ratio of large Finnish firms, %