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Finland – and Her Economy – in the Euro Area

It is a great pleasure to give this presentation to you today. The topic is very current since there are discussions in Europe on how different members of the Eurosystem have carried out their economic policies.

I would like to put before you some of the impacts, benefits and perhaps some restrictions Finland faced and still faces, due to membership of the EMU, the Economic and Monetary Union. The membership for its part has shaped the environment and formed conditions for all agents of the economy.

It is important to point out that when Finland joined the euro, the country had just recovered from a very severe economic and financial crisis. This means that the effects of our membership are intrinsically mixed with the effects of the crisis, such as the significant depreciation of the currency, a sudden increase in government debt, a rise in the number of mergers and acquisitions as well as privatisations in both banking and industry.

The Finnish experience in the early 1990s stood out from similar experiences of its neighbouring Nordic countries; not least because of the coinciding sudden collapse of the Soviet Union and its export markets which strongly intensified the crisis. During a period of only a few years, our GDP decreased by an unprecedented 10% and the unemployment rate increased from below 4% close to a staggering 18%.

While another factor – and one that makes it difficult to isolate the positive effects of the EMU – is the remarkable impact of the so-called new economy. From late 1990s onwards Finland's economic performance has been dominated by the exceptional growth of our high tech industry, led by the success of Nokia. The information and communications sector as a whole contributed to so strong a boom that the effects of the new monetary regime are hard to distinguish from the technology- related changes in the economy.

Now we have to ask how Finland and her economy have done during the time of EMU membership. That can be assessed logically through firstly highlighting some of the deliberation that went on behind the decision to enter the EMU. One should bear in mind that the effects of the EMU started to materialise even before formal entry. It is crucial to extend our observations to also cover several years before the point of time of official membership acceptance. Then we can look at some relevant macroeconomic indicators. Private individuals form a very important group of agents in all economies and it is worth studying how households and private individuals have perceived the common currency. Finally we can draw conclusions.

Deliberations around the EU/EMU

Political motives played an important role when the decision to join the monetary union was made. It was seen as means of being part of the inner circle of the European Union and enhancing the country's influence in future European development.

In all respects, economic considerations were also crucial. Finnish monetary policy had traditionally suffered from a lack of credibility where devaluation was repeatedly used as a means of restoring competitiveness and was directly reflected in interest rates. Critics blamed this for many of the country's structural problems, such as large investment rates relative to growth and chronic weakness of the current account. It was anticipated that monetary policy would be strengthened, that interest rates would be lower and more stable if the country were to join the monetary union. This should in turn enhance investment and economic growth.

Biggest benefits were expected in the form of better credibility of monetary policy which would in turn result in lower interest rates and thus enhancing economic growth. It was also seen that an external lever was needed to create the right mindset, in order to have moderate wage increases, a reduction of costs and an improvement in the country's competitiveness in a bigger global market.

However, there were also some concerns expressed regarding losing our current independent monetary policy and the possibility of devaluating our currency in case of unforeseen economic adverse shocks. Generally speaking when there are shocks affecting different countries differently, i.e. so called asymmetric shocks, each country can use its monetary policy or exchange rate movements to adjust accordingly. It should be pointed out that most of the studies made before the EMU showed that Finland's economic structure deviated clearly from the rest of the EU. Therefore the expected difficulty of adjusting to asymmetric economic shocks without national money was considered to be one of the main objections to Finland's membership. In addition to the potential threat in the form of asymmetric shock, inflexibility of labour markets and whether the country's public finances were strong enough and possessed sufficient buffers to adjust to a difficult economic cycles were also mentioned.

Balancing positive expectations with some negative expectations was highlighted in quite heated and not in all cases very rational debates. Also issues such as the loss of our symbol of independence, our own currency, were taken up. There was undeniably a lot of tension in the discussions of that time.

Finland and Sweden have about the same structures in their economies, especially when you compare a breakdown of their exports by countries and products. It is interesting to analyse reasons for the opposite conclusions of the monetary union. Different decisions concerning membership were due to a major difference in approach. In Sweden it was thought that first one should improve the economic position and then contemplate entry into the EMU, only when everything is strong enough. In Finland, economists shared the same worries as in Sweden; however there was the assumption of a more flexible labour market and potentially more responsive fiscal policy in Finland than in Sweden. Also it was seen that membership, as such, forces changes in public policy and private sector behaviour and thus would take care of critical success factors inside the monetary union.

Economic environment

Looking at GDP growth since the mid 1990s, one can see that the growth expectations have already materialised, to quite a large extent. Finnish economic development has clearly exceeded the average of the other Eurosystem members. This is partly due to a powerful but favourable asymmetric shock in the form of an IT boom. The boom was much stronger in Finland than in other euro area countries, on average. In Sweden there was a similar shock and its overall economic development has been equally strong. What is noteworthy is the fact that even with strong growth the Finnish currency could not appreciate - because of its commitment under the ERM – whereas a clear strengthening of the Finnish markka would have been likely, if Finland still had the free hands of its own monetary policy.

The expectation of better credibility of the monetary policy has materialised. Both long-term and short-term interest rates have not only been at a lower level than previously but also been more stable. There have not been fluctuations despite the write-downs in the ICT sector and difficulties of the neighbouring Russian economy, and shocks such as corporate scandals in the international financial markets.

Not only interest rate levels have lowered but also risk spreads have narrowed. Finland used to pay risk premium in the form of higher interest rates on its debts compared with government debts of more credit worthy countries. As public finances in Finland have been balanced, we have seen a narrowing of spread e.g. over the ten year German bond rate.

Observations on competitiveness

A country's competitiveness can be measured by the real effective currency value. That is not the only measurement which is valid. There are different assessments of a country's competitiveness, striving towards a comprehensive observation, and including several other criteria than just economic ones. When comparing the competitiveness of various countries, the best known institutions are the Swiss business management institute IMD and the World Economic Forum (WEF). According to the IMD's competitiveness comparisons Finland ranks in 6th place. And the first place is given to the United States of America. And WEF ranks Finland as the first, with the USA being the second. Both institutes measure, in principle, the same thing i.e. the country's real and structural competitiveness and the state of its economy. Because of different criteria the results are also not entirely comparable. One could note that if in the comparisons all so-called soft criteria were to be left out and the assessment is only economic, the position of Finland would drop substantially.

According to the IMD report, the main weaknesses Finland has, in the comparison, are among other things the high wage costs of industrial production, a heavy overall tax burden and slow growth of the work force. Also the welfare system as a whole does not currently provide adequate incentives to search for employment.

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Unemployment

Unemployment is perhaps the worst problem in the Finnish economy. During severe economic crises in the early 1990s unemployment rocketed to unprecedented levels. Despite quite rapid economic growth in the recent years, it seems that unemployment remains stuck at quite a high level, indicating a mismatch between those who are seeking for a job and the number of vacancies.

Productivity

In the Finnish economy we have seen very rapid productivity increases in several sectors. The highest increase has been seen in banking services and telecom sector. As an illustration one could note that the outcome of the recovery of the banking crises in the early 1990s led to a radical reduction of the number of bank branches and a rapid increase in the use of state-of-the-art technology. Over a period of five years the work force in the banking sector decreased by more than half. Today roughly 90% of all banking transactions are made electronically. In corporate banking services this development has been even stronger, showing that 99.9% of corporate banking transactions are made in electronic form.

Openness of businesses

Without doubt one essential development has been the increasing level of openness in the economy. This has taken place at several levels as the share of exports in the country's GDP has increased. But the change has also been substantial in the financial markets through use of euro which is recognised globally.

Exports have increased steadily since 1990. The breakdown by countries which are the main trading partners of Finnish exports have remained close to the proportion they were 15 years ago. This breakdown illustrates well how dispersed the Finnish export business is and how, for its part, it is contributing to better economic growth than on average in the EU. Finland and her economy benefited from fast growing economies outside the European Union.

During the period we have also seen the emergence of Finnish multinational companies on an unprecedented scale. This development was led by Nokia, the mobile phone manufacturer, but there has been also strong internationalisation of more traditional companies. Much of the internationalisation and expanded activities abroad has been done in the form of acquisitions and takeovers.

More international financial markets

Since 1990 capital markets have internationalised as well. This development can not be directly related to EMU membership. However disappearing currency risks have facilitated both investments to Finland and Finnish investments abroad. Pension funds and companies in particular have been active in diversifying their portfolios and investing abroad.

The internationalisation of the capital market has also been seen in the foreign ownership of the Finnish shares. In the Helsinki Stock Exchange the foreign ownership peaked at over 70% of the market capitalisation of the stock exchange at the beginning of 2000. Foreign ownership is still today over 50% and Helsinki Stock Exchange is one of the most international stock exchanges in the world. This, for its part, has been contributing to the possibilities for raising equity capital. It is very difficult to distinguish unambiguous and concrete impacts of EMU membership in the stock market. Nonetheless it is obvious that the common currency has facilitated equity offerings for Finnish companies.

All in all a huge change has taken place in capital markets, in the debt market in particular. In international markets the euro has overtaken the US dollar as the most used currency of bond issues. Partly that may be due to the fact that the European actors have been more active in launching bonds than US issuers in the last three years. Among all European issuers, perhaps naturally, the euro has been clearly favoured and by far more than other currencies.

Trends in the international market have also been reflected in Nordic issuance. The euro has been by far the most important currency in bond issues by Nordic issuers as well. This is noteworthy since only Finland is a member of the euro area and Swedish issuers rely on the common currency euro in the bond markets.

Financial management

There are also some effects at the company level that can be studied by looking at the concrete implications of the common currency in financial management through specific company example. Otherwise it is very difficult to see what benefits or disadvantages the euro has brought with it for running businesses. As an example, and a case study, we can take a Finnish industrial company which has activities in more than 30 countries around the world. Roughly 90% of its EUR 7 billion turnover is generated outside Finland. This means that it has substantial flows of currencies in and out. Perhaps a word of caution is necessary however. The case study shows only a specific impact on the company, and may not be applicable to all enterprises and may therefore be wise not to generalise too much.

In the long term financing an increasing number of companies in Finland have been gaining from broader bond and loan markets. Not only bond issuance but also other borrowings in the form of syndicated loans as well as normal bank loans are done in international financial markets. Number of lenders has increased due to the common currency. This means that companies such as this case study company have had more financing sources at their disposal. As an important fact facilitating debt raising is of course the fact that now Finnish companies can use their own currency. The euro has a very liquid market and is widely used in global international financing.

In Europe we have seen an increase and improvement of the medium-term note market which is in use for Finnish companies as well. All companies having a decent rating have been able to tap the MTN market which is deep and liquid to cover medium term financial needs.

Companies also seem to have benefited in the area of cash management. Now it is possible to integrate electronic banking services with accounting and main client ledger systems together using a single currency. In the case study, one person can take care of European wide cash management systems. All banking transactions are made in electronic form, which generates automatically entries into the company's accounting system.

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Management of financial risks

In the area of risk management the common currency makes market conditions more stable. In particular interest rate risk management is easier today than before, since more predictable and more stable interest rates help to hold bigger open interest rate risk exposures. One could even argue in these more stable times, that interest rate risk exposure as a concept has diminished. The case study company can have most of its loans on a floating rate basis and needs not to match all maturities of its assets and liabilities, as in the era of more fluctuating interest rate.

Another area of financial risk management where companies can reach substantial savings, is foreign exchange management. This is due to the fact that when both in and outflows are more often in euros, i.e. the accounting base currency, the natural currency risk exposure, and the need to hedge this, is clearly smaller than in the case of having bigger revenues and costs in several currencies. In the case study the need to make foreign exchange deals has decreased almost by 40% based on the common currency. Additional savings in foreign exchange management can be reached through narrower spreads i.e. more competitive prices between different currencies, when the other one of the currency pairing is the very liquid euro instead of the Finnish markka, as was the case earlier. Through both the diminished currency exposure and very narrow spreads, annual costs on FX dealing have gone down from EUR 4.4 million, to EUR 1 million.

Private individuals

Let me then turn to private individuals and the household sector. Again it is difficult to distinguish the impacts of the euro as such on the behaviour of households. However based on more stable interest rates, which have dropped to very low levels, it is obvious that households are willing to raise loans for both housing and other purposes. A remarkable increase has been seen in household indebtedness since the late 1990s, when the amount of household debt in Finland increased from the EUR 30 billion level up to about EUR 70 billion. Despite the rise in absolute terms, household borrowing is still relatively low in relation to GDP, compared with most European countries.

After the very gloomy period of low private consumption at the beginning of the 1990s, consumer demand has risen to quite a stable level and has now maintained a growth rate of 2% annually. Bearing in mind our continuing high levels of unemployment this remarkable development may be seen as unconventional. In Finland consumer confidence has also been clearly stronger than in most EU countries. Confidence was not eroded by either Asian crises, difficulties in the Russian economy, or the bursting of the IT bubble.

The man in the street in Finland sees the euro as being beneficial to the country. According to the latest Euro barometers assessing how people in different countries perceive the euro and its advantages, Finland ranked as one of the most satisfied euro countries. More than two thirds of all individuals perceive the euro as a good thing.

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Conclusions and future challenges

It may still be too early days to say to what extent if any, membership of the EMU has benefited Finland and her economy. Positive development and success regarding the economy itself and enterprises in it are obvious; however one has to point out that the effects of the membership, as such, are intrinsically mixed with the effects of other measures taken to recover from the crises of the 1990s. Having seen the economic development in Finland today, it is even more difficult to argue that Finland would have had to stay outside the EMU. It could be easier to name some threats and potential adverse effects resulting from the decision to stay outside than find plausible explanations that argue for the benefits of not joining the monetary union.

A very practical reason for the popularity of the euro, to the man in the street in Finland, is that there is no need to exchange money when travelling around Europe. The typical Finn feels proud that it is Finland's own money that is valid and accepted extensively around the world.

In the coming years and not far in the future, the aging of the population, a heavy tax burden and persistently high unemployment levels challenge the sustainability of the economy and force actions that must result in overcoming these foreseeable challenges.
These actions must be taken; independent of whether Finland is inside or outside the monetary union and membership provides us with the environment where we can face these more confidently.

(Please also see the slides of the presentation)