FINANCIAL REGULATION IN FINLAND FROM THE 1950S UNTIL THE 1980S
STABILITY AT WHAT PRICE?

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This paper provides an account of the origins and structure of the Finnish system of financial regulations which was prevalent in the post-war decades until the deregulation of the 1980s. Despite considerable macroeconomic volatility, the banking sector in Finland was remarkably stable. There were no significant bank failures over this period of more than 40 years, and credit losses were of no real importance either. It is conjectured that the stability of banks in the period was a product of the suppression of competition in the financial sector, instead of supervision or prudential regulation in the “modern” sense. Lending rates and capital movements were controlled. Cartel agreements between banks were actively supported by the authorities, e.g. by making the tax exemption of bank deposits conditional on the terms agreed by the banks’ deposit rate cartel. The Finnish prudential regulations gradually weakened in the course of the decades of regulation. The first capital adequacy regulations had been included in the banking law of 1933, where it had been stipulated that in commercial banks, capital and reserves should measure up to 10 per cent of the bank’s liabilities. In 1946, this was reduced to 6.7 per cent, and in 1969, to 4 per cent. Also in 1969, universal banking rights were granted to savings and cooperative banks, from which only 2 per cent of capital and reserves were required (also in relation to their liabilities). The banking practices, low capital ratios and high costs of banks, which became the norm in the decades of regulation, made the banks very vulnerable in the competitive and deregulated environment which they had to face after the deregulation that took place in the mid-1980s. It is concluded that the incompatibility of prudential regulation with the more competitive environment of the late 1980 was a reason for the fragility of the banks which was revealed in the Finnish banking crisis of the early 1990s.

JEL: N24, G28.

1. Introduction

This paper provides an account of the origins and structure of the Finnish system of financial regulations which was prevalent in the post-war decades until the deregulation of the 1980s. One of the interesting features of this period was that despite considerable macroeconomic volatility, the banking sector in Finland was remarkably stable. There were no significant bank failures over this period of more than 40 years, and credit losses were of no real importance either.

However, the review of banking regulation in place at the time suggests that the stability which was achieved was probably not due to efficient prudential regulation. In particular, it is apparent that banks’ risk taking was not much constrained and that capital requirements in particular were quite lax. If anything, prudential regulation and banking supervision in this period of financial stability was weaker than later, in the early 1990s, when a severe banking crisis developed and erupted in Finland.

On the other hand, apart from the weakness of prudential rules, the banking sector and the financial markets were subject to very extensive regulation of conduct. Much of domestic financial
intermediation took place at administratively fixed prices, because of interest rate controls and discrimination of securities markets in taxation. Foreign capital movements were also under rather comprehensive controls until the beginning of the 1980s. Moreover, as a large share of capital formation occurred as forced saving in the government budget and in the mandatory pensions system, the roles of competition and price mechanism in the financial system were limited.

It is conjectured in this paper that in the four post-war decades, it was the suppression of competition in banking which caused the stability of the sector, instead of supervision or prudential regulation in the “modern” sense. Not only was competition not promoted, but cartel agreements between banks were actively supported by the government and by the Bank of Finland, e.g. by making the tax exemption of bank deposits conditional on the terms agreed by the banks’ deposit rate cartel.

We show how the system of financial controls emerged as a result of the political difficulty of using standard monetary policy instruments to control inflationary pressures in the 1950s (and later), and how the system of regulated financial intermediation fitted in the general growth policy framework which prevailed in Finland from the early 1950s until the late 1970s, and how the attempt to reform the prudential rules at the time of general deregulation of financial markets in the 1980s ultimately failed. The analysis emphasizes interdependence of prudential regulation, conduct regulation (including competition policy) and the general economic policy regime of the country.

2. The Finnish financial system in 1930-1990

In order to understand the structure and development of financial regulation in Finland, it is necessary to begin with a brief overview of the financial system which was the object of regulation. The institutional structure of the Finnish financial system was remarkably stable from the years of the Great Depression until the severe Nordic banking crisis of the early 1990s. The financial sector was very bank-centred, with only a minor role (quantitatively, at least) left to the securities market. The domestic capital market consisted mainly of the stock exchange, with relatively small capitalization and turnover, and a small market for government bonds, which was mainly targeted to the household sector. Corporate bond issues were rare exceptions. An organized short-term money market did not really exist until the mid-1980’s (see e.g. Financial Markets in Finland, 1972 and 1986).

At the centre of the banking system the Bank of Finland, the central bank, was (and still is) subordinated to the parliament of the country. This model was adopted in 1867 following the Swedish example. The parliament appoints a supervisory council, which has almost exclusively consisted of senior members of parliament, representing all major parties – irrespective of the composition of government. Before Finland joined the EU, the parliamentary supervisory council had some important policy powers, including the setting of the interest rates applied by the Bank of Finland. Otherwise, the day-to-day management of the bank is the responsibility of the full-time board of management, chaired by the governor of the bank. In the period of interest for this study, an important part of the policy prerogatives of the board of management included most decisions pertaining to foreign exchange control and the influential guidelines and recommendations which the central bank issued to the commercial banks. The President of the Republic appoints the board members, and could, before Finland joined the EMU, also relieved them of their duties without notice “when public interest so requires” (Kuusterä 1994: 161-167).
The private banking sector included the commercial banks, two of which, Yhdyspankki (The Union Bank) and Kansallis-Osake-Pankki, dominated this segment. The commercial banks were, however, challenged especially in the household and SME markets by two strong networks of mutual, local banking groups: the savings banks network and the cooperative bank network. Both networks consisted of a large number of local institutions which cooperated extensively in marketing, technology, and the like. In the period from 1950s until the mid-1980s, there were more than 250 savings banks and more than 370 cooperative banks. Both mutual banking groups had a central institution (Skopbank for the savings banks, and OKO for the cooperative banks), which were organized as commercial banks. These central institutions acted as clearing centres for their respective networks, and also handled the financial relations of the savings bank and cooperative bank networks with the Bank of Finland, the central bank of the country.

In addition to the private banks, there was also a state-owned post office bank (Postisäästöpankki, from 1970 Postipankki), which was, however, transformed in 1988 into a commercial bank. Other financial institutions besides banks, such as mortgage institutions and insurance companies had only a relatively small share in financial intermediation. However, in 1961, a mandatory and partly funded occupational pensions system was established, the operation of which was delegated to a number of specialized private pension institutions (Kopra 1981). Gradually, these occupational pension institutions cumulated a considerable amount of funds, and obtained a significant market share as lenders and investors in the Finnish financial market.

The market shares of different categories of credit institutions in lending to the non-financial private sector during the decades of regulation in Finland are presented in the table 1.

<table>
<thead>
<tr>
<th>Source of Credit to the Nonfinancial Private Sector, % of total</th>
<th>1959</th>
<th>1969</th>
<th>1979</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial Banks</td>
<td>26</td>
<td>29</td>
<td>25</td>
</tr>
<tr>
<td>Savings banks</td>
<td>16</td>
<td>15</td>
<td>11</td>
</tr>
<tr>
<td>Cooperative banks</td>
<td>10</td>
<td>11</td>
<td>9</td>
</tr>
<tr>
<td>Post Office Bank</td>
<td>4</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td>Mortgage Banks</td>
<td>4</td>
<td>5</td>
<td>4</td>
</tr>
<tr>
<td>Insurance Companies</td>
<td>8</td>
<td>12</td>
<td>16</td>
</tr>
<tr>
<td>Bank of Finland</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>The State</td>
<td>30</td>
<td>17</td>
<td>16</td>
</tr>
<tr>
<td>Others</td>
<td>0</td>
<td>6</td>
<td>11</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

Source: Statistics Finland, Outstanding Credit (Luottokantatilasto).

Insurance companies include the occupational pension funds. National Pension fund is included in the State.

3. The development of prudential regulation in Finland

Prudential regulation of financial institutions, in the sense of norms whose main purpose is to ensure the stability of financial institutions, was quite weak in Finland until the Basel accord and the prospect of joining the EU forced a radical tightening of the rules – just before the banking crisis which erupted in 1991. Looking at the development of prudential regulation from the 1930s
until the banking crisis, one cannot escape the impression that prudential rules were not felt to be very important for the stability of the system, and when banking interests or the growth objectives of economic policy so required, prudential considerations increasingly had to yield.

The first capital adequacy regulations concerning Finnish commercial banks were given in the commercial bank law of 1933, which stipulated that in commercial banks, capital and reserves should measure up to 10 per cent of the bank’s liabilities. The bank law of 1933 was occasioned by the worldwide financial difficulties of the early 1930s, even though there was no general banking crisis in Finland during the Great Depression: only two very small banks failed, both in 1931, so that depositors lost some of their money, and the combined market share of these failed banks was less than 0.5 per cent of the total market. All other difficulties in the banking sector were handled by mergers without losses to depositors. Compared to many other countries, the banking problems were very moderate: the largest bank to get into difficulty in the crisis year of 1931 and which was forced to merge with a larger commercial bank had a market share of only about 5 per cent.

In the decades following World War II, the capital adequacy regulations were gradually relaxed. The first major step to this direction was taken in 1946, when the required capital/liabilities ratio of commercial banks was reduced to 6.7 per cent (temporary exceptions to the previous rule of 10 per cent had already been granted during the war). The change was made mostly in order to accommodate the erosion of the capital base of banks because of the rapid inflation of that time. In the 1950s and 1960s, the capital regulations of commercial banks were relaxed even further by giving the Banking Inspectorate the power to temporarily reduce the capital requirement of individual banks (down to 5 per cent of total liabilities).

Turning to the mutually owned institutions, which were very important in the Finnish market, the solvency of the cooperative and savings banks was not effectively regulated before 1970. The law on savings banks, which had been enacted in 1931, required that the savings banks had to maintain own funds corresponding to at least 10 per cent of exceptionally risky lending, meaning bills of exchange or loans against personal guarantee. However, no capital requirements at all had been set on saving banks’ other assets or lending, such as housing loans, etc. These lending categories without any capital charge whatsoever constituted an overwhelming share of savings banks’ assets. In practice, the reported amount of own funds (capital and reserves) of the savings banks varied around 2 - 3 per cent of their balance sheet. This almost non-existent capital regulation of the savings banks before 1970 was counterbalanced by some restrictions on their investment policy, however. In particular, investment in industrial or other shares was forbidden, as was all investment in real estate with the exception of bank buildings (Kuusterä 1995).

Cooperative banks, for their part, originally had no definite minimum capital requirement at all. In theory at least, there was a substitute to own capital, however: the law on cooperative societies stipulated that cooperative banks could only lend to their members, thus defining cooperative banks as associations of borrowers. This is significant, because until 1955, the ministry of finance required that the articles of incorporation of each cooperative bank should stipulate unlimited liability of the members. As a result, the borrowers were in effect ultimately jointly responsible for any losses incurred. This stringent rule was relaxed somewhat in 1955, when the ministry of finance started to approve articles of incorporation for cooperative banks which capped

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1 The two small banks which went bankrupt were Suomen Vienti-Pankki and Etelä-Pohjanmaan Pankki. In these bankruptcies, depositors lost 65.9% and 23.8%, respectively.

2 The shareholders of this bank (Maakuntain Pankki) lost 87.9% of their investment in the merger.
the joint obligation of members to pay additional capital up to 20 per cent of the total liabilities of the bank. Under such regulatory regime, the cooperative banks reported capital/asset ratios of about 1-2 per cent on average in the 1950s and the 1960s (OKL 1979).

The unequal conditions which these laws created for different types of credit institutions were subject to a lot of criticism, and in 1961 a government committee was set up to review and unify the banking laws. The committee work and the subsequent legislative process took a very long time, and new laws for all banking groups were promulgated only in 1969 and came into force in 1970. The new laws gave all banks practically equal rights to do universal banking business. In particular, the rights of all banks to own shares in industrial or commercial companies was set to 10 per cent of their own capital. This kind of investment had previously been forbidden to the savings banks. Another new extension was that savings banks were given the right to guarantee third parties’ obligations (Puntila 1970).

The bank law committee rationalized the extension of universal banking to savings and cooperative banks by appealing to the need to improve prerequisites for economic development (Pankkilakikomitea 1967: 9).

By investing funds in shares of new or expanding enterprises, financial institutions can take an active part in developing productive activities, for which widening markets and the restructuring of industries pose increasing challenges. At the same time, financial institutions can strengthen the capital structure of such enterprises, vital for economic growth, which in our country has been too much debt-based, because of the shortage of risk capital.

On these grounds, universal banking rights were granted to savings and cooperative banks. The capital requirements for these mutually owned institutions were now for the first time precisely defined, but set at quite low levels, at 2 per cent (in relation to total liabilities). The committee had proposed 3 per cent, but intensive lobbying by the cooperative and savings banks resulted in the lower requirement. To make the capital regulations even lighter, the banks were allowed to deduct from the liability base of the capital charges all claims on the central and local government, as well as claims on other banks. On the other hand, bank guarantees were now added to the liability base for 50 per cent of their value. It was also enacted that the Banking Inspectorate could, “taking into account the solvency of the bank”, reduce the capital requirement temporarily, but not below one per cent of total liabilities.

Although the capital requirements of the savings and cooperative banks were set at such low levels in the new law, the banks were allowed ten years’ transition period to adapt to the new regulations. Later, in 1978, the transition period was further extended to last until 1983.

While the bank law reform of 1969 gave mutual institutions an indisputable legal license to engage in universal banking, the commercial banks also got something, namely lighter capital requirements. The minimum capital requirement of commercial banks was reduced to 4 per cent of total liabilities (from the previous 6.7 per cent). The method of calculation of the capital charges was similar to the savings and cooperative banks, so that interbank borrowing, in particular, was not subject to capital charges. Moreover, the Bank Inspectorate could, upon application and taking into account the solvency of the commercial bank, allow a temporary reduction of the capital/liabilities ratio, but not below three per cent.

In retrospect at least, the bank law reform of 1969 must be seen as a dangerous weakening of capital regulations of commercial banks, and perpetuated the extremely weak capital ratios of the mutual institutions while giving official approval to increasing their risk-taking. This constituted no
doubt an extreme instance of regulatory capture, even though some of the easing of capital rules was made only in the legislative process, over and above the recommendations made by the committee which had prepared the draft law.

On the other hand, the case for stiffer capital requirements would have been hard to justify convincingly in the environment of the time, where credit losses were insignificantly small and no bank failures had occurred during the entire post-war period. The banking lobby could cite these facts in support of its demand for easier capital requirements. Moreover, the reasons mentioned by the committee, i.e. the need to accelerate economic development, and the shortage of risk capital, were seen as real and were not mere excuses. So, the high priority of growth helped override conservative banking principles when the law of 1969 was made.

The laxity of solvency rules gives rise to the question why the banking system was, nevertheless, very stable in the first four post-war decades. The reason cannot be found in general macroeconomic stability, since the volatility of the growth rate in Finland was quite high. The most likely reason for the (apparent) stability is in the lack of competition between banks, an anticompetitive system which was not only tolerated but actually upheld by the authorities. We now turn to an analysis of that system.

4. The system of financial controls emerges

In the decades following the Second World War, and until the mid-1980s, the Finnish financial system was characterized by extensive public intervention. The role of public sector saving and lending was significant. In the private sector, most of financial intermediation took place in markets where regulation prevented the price mechanism from playing any significant role. Free segments of the financial markets, like the securities market, remained almost insignificantly small. The term “simple financial markets” was coined by Finnish economists to distinguish the Finnish conditions from “developed” markets, operating on the basis of free price formation.

Finnish financial markets had developed mostly along liberalist principles from the latter half of the 19th century until the outbreak of the Second World War. However, the Great Depression of the 1930s and the war caused in most countries a transition towards more extensive financial regulations, and this happened in Finland as well. The first steps towards limiting the role of competition and the price mechanism in financial intermediation were taken in Finland already in 1931, when the Finnish banks made an official agreement on their deposit rates. The initiative to the formation of a general deposit rate cartel of all banks was made by the central bank with the purpose of lowering deposit rates and so to create the prerequisites for the simultaneous reduction of loan rates and improvement of bank profitability (Kalliala 1950).

The background for the interest rate agreement of 1931 was created by the debt problems created by the Great Depression. Especially the farming sector was heavily indebted, and when the prices of agricultural and forestry products collapsed at the start of the worldwide slump, and when nominal interest rates remained quite high, the debt service of the farming sector became increasingly difficult. Frequent bankruptcies and foreclosures led to the emergence of a populist anti-depression movement which demanded lower interest rates and easier credit.

The Bank of Finland’s monetary policy of the early 1930’s was sharply criticized also in the parliament, where “legislative action” was demanded to force lower interest rates. The interest rate agreement of banks, sponsored by the central bank, was a reaction to these political pressures, which did not entirely ebb, however, until about two years later when the money markets became
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clearly much easier. Still in 1932, the government of Prime Minister Sunila fell because of the interest rate question, when President Svinhufvud refused to submit to the parliament a legislative proposal on interest rate controls which Sunila’s government had drafted (Rossi 1951).

The Finnish interest rate agreement of 1931 was a formally voluntary deposit rate cartel. A special cartel committee, Rahalaitosten yhteislautakunta (literally “the joint committee of financial institutions”), was set up to supervise the compliance to the agreement and to decide on subsequent interest rate changes. In this body, the management of all major banking groups was represented. This body, in slightly different forms, existed until the 1980s to facilitate price cooperation between banks. The deposit rate agreement was formally terminated in 1938, probably because commercial banks were dissatisfied by the preferential conditions which the deposit rate agreement gave to savings banks. The end of the formal agreement did not cause any changes in actually applied deposit rates however (Autio 1996).

The next step towards setting up comprehensive financial controls was the introduction of exchange controls. Until the war, Finland was one of the most liberal countries with regard to the foreign exchange markets (with the exception of a short period of exchange controls in October-December 1931 after the collapse of the gold standard). In the 1930s, Finland, like Norway and Sweden, shadowed the sterling bloc in its foreign exchange policy, and abstained from any generic controls of foreign currency transactions (see League of Nations 1939).

The control of foreign capital movements was started in the summer of 1939 with a law limiting the share of foreign ownership in Finnish companies to 20 per cent unless special license from the government was given (this law would remain in force until the 1980s). After the war broke out in Europe, comprehensive capital controls were introduced and the Bank of Finland was entrusted with the responsibility of implementing the controls in practice. Buying and selling of foreign exchange was made subject to Bank of Finland licenses, and all foreign exchange assets and export revenues had to be repatriated and sold to the Bank of Finland. The objectives of the wartime currency controls are obvious. The government wanted to cope with the acute shortage of foreign exchange, and make sure that the scarce foreign exchange resources were used for the priority needs of the war effort, in conditions where the usual monetary and fiscal policy methods could not be used (Lehto-Sinisalo 1992).

Also the domestic credit markets were brought under administrative controls during the war years. In 1941, a formally voluntary agreement on freezing of lending rates was concluded between the different credit institutions, including insurance institutions as well as banks. The Bank of Finland started to issue (rather general) guidelines to banks and other credit institutions on the allocation of lending. Other measures taken during the war years included the regulation of private sector bond issues (1942), which gave the State a privileged position in the capital market, and tax exemptions on savings in bank deposits and government bonds (1943). Both the issue control of bonds and the tax exemptions of interest earned on bank deposits and government bonds were continued for decades after the war, and came to constitute important building blocks of the post-war anticompetitive system of regulations (Tarkka 1988).

5. Regulation is institutionalized after the War

After the war, there were at first some attempts to return to the more liberal pre-war conditions. Thus, during the late 1940s, when inflation accelerated to unprecedented levels, the Bank of Finland attempted to control it by modestly reactivating its interest rate policy, which had been completely passive since the 1934. Another step to the liberal direction was that the lending
guidelines, which the Bank of Finland had given banks in its circulars, were first streamlined and then mostly lifted by the circular sent in 1949. The detailed regulation of banks’ credit allocation decisions was thereby discontinued, even though the central bank also later occasionally sent banks some recommendations about which lending categories should be preferred or avoided, or how much the banks could expand their overall lending (Rossi 1951).

So, at the turn of the 1950s, it briefly seemed that monetary policy would start to be conducted by the conventional, market-based means. However, the Korean boom years of the early 1950s constituted a watershed after which extensive peacetime financial regulations increasingly replaced competition and market forces in Finnish monetary policy and financial intermediation.

The Korean boom started in the second half of 1950, as the prices of Finnish export products increased sharply: in 1951, export prices were, on average, 87 per cent higher than in the previous year, and that in dollar terms. Together with the two devaluations which had been carried out in 1949, this export price hike led to a sharp acceleration of inflation also in the domestic market.

In September 1950, banks agreed in their joint committee to a coordinated increase of loan rates by two percentage points. The Bank of Finland tried to follow suit: two weeks after the decision of the private banks, the Board of Management of the Bank of Finland proposed to the parliamentary supervisory council a similar increase in the discount rate, but this motion was shelved by the council with the explanation that “in the prevailing conditions of cost-push inflation”, a high interest rate would not reduce inflationary pressure, but would instead increase it. A month later, however, the council let itself to be persuaded and agreed to an increase of 2 percentage points in the Bank of Finland discount rate.

This episode is significant in two ways: it illustrates the private cartel-type nature of the interest rate regulation which prevailed after the war. The banks were not formally compelled to follow the Bank of Finland policy, and could also act on their own. The episode also shows how politicians took a negative attitude towards the efforts of the management of the Bank of Finland to pursue a more flexible and market-oriented interest rate policy.

The next year, 1951, marked the decisive politicization of the interest rate policy. In the spring months inflation (measured by wholesale prices) accelerated to more than 40 per cent (year-on-year) and real growth increased (later it turned out that the real GDP grew by about 8.5 per cent). In this situation, the government and the employers’ and labour organizations concluded a “truce” including a temporary price and wage freeze. The truce agreement also included the formation of a special committee, called “Economic Policy Planning Council” which included representatives from the government and various special interest groups. This committee was to prepare a stabilization programme to rebalance the economy.

In its report, the committee recommended the curbing of investment expenditure by various administrative means. It believed that this would make it possible to reduce interest rates (!). In its report, the committee stated: “The present disproportionately high interest rate tends to increase production costs. Especially it increases housing costs.” The Bank of Finland discount rate was 7.5 per cent and the most common rate applied by commercial banks on their lending was 10 per cent. The council proposed that interest rates should be cut by 2 percentage points, as well as introducing tight credit controls to curb investment (Vakauttamishjelma 1951: 19).

In December 1951, the Bank of Finland actually reduced its official rates by 2 percentage points according to the programme of the committee, and the cartel of the credit institutions followed suit. However, after only few weeks, in January 1952, commercial banks decided to break
the cartel and not implement the interest rate cut. A so-called “interest rate war” ensued, which only ended when the government proposed to the parliament a law on interest rate controls. Faced with the threat of government-controlled lending rates, the commercial banks backed down and the interest rate cartel was restored.

As normal interest rate policy had thus become very difficult politically, the Bank of Finland had to develop new instruments for its monetary policy. The main such instrument were quotas and penalty rates for banks’ refinancing at the central bank. The balance sheet structure of the Bank of Finland was such that the commercial banks usually had a sizable liquidity deficit, and consequently they had to resort to refinancing at the central bank. In 1951, bank-specific quotas were set for this borrowing, and penalty interest rates (over and above the official discount rate) were applied for any borrowing in excess of the quota. The adjustment of the refinancing quotas and the penalty rate schedules subsequently became the normal way for the Bank of Finland to implement its policy stance – under the conditions of low and almost frozen general interest rates (Oksanen 1977).

Under such system, the marginal cost of central bank credit could occasionally be very high, 5 percentage points higher than the official discount rate was not exceptional (Saarinen, 1986). To prevent the often high marginal cost of funds from being passed to lending rates, the Bank of Finland from 1953 implemented a ceiling on the lending rates of banks: the right to refinance at the central bank was made conditional on complying with the regulation that no bank should charge higher rate in their lending than the official rediscount rate of the Bank of Finland. Formal lending rate control was thereby instituted. It became standard practice for the central bank to intervene in the behaviour of the deposit rate cartel as well, by recommendations which asked the banks to pass any changes in the official discount rate policy of the Bank of Finland to their deposit rates, and generally to maintain stable interest rate margins between the lending and deposit rates.

6. **Financial implications of a State-financed growth policy**

In the beginning of the 1950s, the Finnish economic policy faced enormous structural problems. The country was still only half-industrialized, with a very high part of the labour force still employed in the primary sector (agriculture and forestry). In 1952, for example, the share of the primary sector in total employment was as high as 37 per cent. Productivity and living standards were much lower than in the neighbouring Nordic countries. In these circumstances, growth and industrialization had a very high priority in economic policy.

Thus, investment needs were enormous, but the controlled and artificially low interest rates which prevailed in Finland in the 1950s could by no means bring about equilibrium between saving and investment. The benefits to the industry of low and stable interest rates were felt to be greater and more certain than the additional saving which a high interest rate policy might have produced. Some loans from the World Bank were obtained, but the pressing question was how to finance the industrialization and structural transformation phase which lied ahead (Dahmén 1963; Tarkka 2006).

In this situation, economic policy resorted to forced saving in the public sector. In the 1950s, 1960s and even the 1970s, a large share of investment, even private investment was financed by public sector saving. This was part of a conscious growth and industrialization policy. Two important documents which illuminate the thinking behind this policy are the report of the Industrialization Committee (1951) and the 1952 book “Onko maallamme maltia vaurastua”
(literally “Does our country have the patience to get wealthy”) by Urho Kekkonen, then prime minister and later president of the republic.

The Industrialization Committee demanded that “industrialization should be included as an essential part in economic policy, and consequently taken into account in all decisions”. Regarding financing, the committee proposed that “saving and capital formation should be promoted by the means of general economic policy, and the resulting capital should be channelled to serve the industrialization effort”. The committee considered the Finnish interest rate level (of 1950) exceptionally high by international standards and “considered it important that the interest rate be significantly lowered and kept at a level where it does not hamper the progress of industrialization of our country” (Teollistamiskomitea 1951: 107 and 111).

In his book, Prime Minister Kekkonen agreed with the Industrialization Committee in that the economic growth “commensurate with the natural potentials of Finland” required an enormous increase in industrial investment. But “if we strive for the rapid expansion of industry (...) we cannot resort to the means by which our industries have survived so far”. He proposed that the financing of the investment programme should be realized by forced saving in the government budget: “briefly and heartlessly put, this means that the resources for the implementation of the industrialization programme must be acquired by the state by taxation”, and further, “we propose that our consumption should be reduced by 2 or 3 per cent from the level to which it would otherwise increase, and savings so generated should be used to expand productive activity.” The political occasion for such a proposal was created by the end of the large war reparations which Finland had had to pay to the Soviet Union in 1945-1952. Kekkonen’s idea was to use the resources freed by the end of reparations for investment purposes, instead of additional private consumption (Kekkonen 1952: 72 and 114).

The Finnish financial policy of especially the 1950s but also of the 1960s and the 1970s can be seen as fulfilling Kekkonen’s prescriptions. According to the national accounts, the share of the government sector saving in the gross capital formation of the entire economy fluctuated between 45 and 55 per cent in the decade of the 1950s, which is a very high share indeed. Later the share of public saving in the total decreased somewhat, but if we include the mandatory pensions system (which was started in 1961), the share of public saving remained around 30 to 35 per cent until the mid-1970s.

Finland did not become a socialist economy, however: part of the enormous amount of forced saving was used for government investment, part was used for investment in the equity capital of government-owned companies, but a very large part was lent to the private sector. For the purposes of the present study, the significance of the government as a lender is especially important. The share of the government sector in total credits to the private non-financial sector was over 39 per cent in 1953, reached 41 per cent in 1960, and was still in 1986, on the eve of deregulation, as high as 23 per cent (Tarkka 1988).

The high priority of growth policy, and the high investment rate which was mainly financed with debt and only a minimum of equity capital, are important explanations for the particular features of the Finnish financial controls and regulation in the post-war decades. The industrial enterprises (and the agricultural sector) were guaranteed low and stable interest rates on their debt in order to enable them to operate with very little equity. At the same time, banks were guaranteed stable interest margins and an environment without price competition – which made it possible for also them to operate with very low capital buffers.
From the point of view of this study, it is important to note that stability of the banks under competition was not the main rationale or the purpose of the Finnish system of banking regulation. Even though the banks were stabilized by the system, the primary concern was only to create stable prerequisites for the quantitative growth of industry, by sacrificing competition if needed. In the course of several decades, these predominantly macroeconomic objectives of Finnish financial policy (including the government surpluses and the comprehensive regulation of interest rates) obscured the connection of regulation with financial stability to policymakers and bankers alike.

7. Financial controls as a system of economic policy

After the tightening of the interest rate controls in the 1950s, a monetary policy system developed in which the whole interest rate structure of the banking system was administratively linked to the discount rate of the Bank of Finland. The discount rate was kept low and almost constant, and monetary policy resorted to regulation of banks’ refinancing from the central bank by rediscount quotas and penalty rates. Occasionally, in times of monetary tightening, the marginal cost of borrowing funds from the central banks was very high. Because of regulation of lending rates, banks could not pass their marginal cost of funds to their borrowers, and the availability of loans was restricted instead (Puntila 1972; Oksanen 1977).

Occasionally, the board of management of the Bank of Finland attempted to use “the interest rate weapon” as the changes in the general level of interest rates was called, but the changes were small and infrequent, thus emphasizing the role of the refinancing quotas and credit rationing. After the forced cut in 1951, the official discount rate was changed only 3 times in the 1950s; in the 1960s 3 times and in the 1970s 6 times. An episode in 1962 illustrates the circumstances. In March 1962, the board of management of the Bank of Finland proposed to the parliamentary supervisory council an increase in the discount rate from 6.75 to 8 per cent. This was at first granted by the council, but four weeks later, in their next meeting and after a change in government, the council revised the decision and the interest rate was returned to 7 per cent against the recommendation of the management of the Bank of Finland. After that, it took 9 years before the next discount rate increase was proposed.

A feature of the regulated financial system, in which banks’ refinancing at the central bank was subject to quotas, and which did not have interbank money market, was that banks could not easily compete for market shares in the loan market. Practically the only way to influence the market shares in those conditions was to succeed in the deposit market, but market shares in deposits could change only slowly in the absence of interest rate competition. Additional funding from an interbank money market became available only much later towards the end of the 1970’s – and, at that time, only at a very high price.

In the system of administratively set interest rates which emerged in Finland in the beginning of the 1950s, there might have been a danger that a free deposit/loan market would have grown outside the regulated sector. This possibility was checked by granting the official market (consisting of banks and government bonds) a preferential tax treatment. The first tax exemptions to bank deposits and government bonds had been granted already in 1943, but they were at first limited to a fixed quota per person. In 1956, however, interest income from bank deposits and government bonds was made entirely tax free in personal income taxation. The tax rules were very significant for the system of controlled interest rates, because it was stipulated that the tax exemption was granted only on deposits which complied with the banks’ interest rate cartel. This proviso was in effect from 1956 until the end of 1988, meaning that the tax laws effectively protected the price collusion of banks in the deposit market. At the same time, they effectively
prevented the development of any alternative to bank deposits as an outlet for household savings (Valvanne and Lassila 1965; Korkman 1986).

As a digression, we must note another way to encourage saving while keeping household funds within the regulated sector. From 1956, banks were allowed to take index-linked time deposits (and pass the costs of inflation compensation on these special deposit accounts to the borrowers). Two types of index-linked deposit accounts were allowed, one with full index compensation according to the increase in the cost of living index, and another account with 50-per cent compensation. Some index-linked government bonds were also issued. The popularity of the index-linked deposits varied, of course, with inflation. In some periods the index-linked deposit accounts constituted a significant share of the private sector bank deposits. The system of index account was discontinued in 1968 (Ranki 1981).

By the mid-1950s, then, at the latest, the Finnish financial controls constituted a more or less comprehensive system, a policy regime in which the various components supported each other and made the overall structure surprisingly enduring. All in all, the system was made up of the following components:

- an administrative interest rate system consisting of regulations and recommendations by the authorities, and government-sponsored agreements between banks;
- exchange control in the form of regulation of most international capital flows;
- control over the issue of private bonds;
- a tax system favouring the regulated segment of the financial markets;
- forced saving in the public sector and large-scale government lending to the private sector;
- a monetary policy which operated by rediscount quotas set to the refinancing of banks at the central bank, and which was transmitted to the private sector through the availability of credit.

The structure of the administrative interest rate system avoided almost all interest rate risk to the banks. Loan contracts allowed were variable rates, and whenever the Bank of Finland changed its discount rate (later renamed the base rate), it was accepted that this change was passed immediately to all loan rates. Moreover, in the event of a change in its discount rate, the Bank of Finland always let it be known that it “expected” the cartel of the banks to change all deposit rates by a corresponding amount. As a result, the interest margins of banks were very stable and predictable.

An important change to the control system of the lending rates was made by the Bank of Finland in 1960. The maximum interest rate which the banks were allowed to apply in their lending was significantly increased, but at the same time it was required that the banks should not increase their average lending rate. From 1960, the regulation of the average, not the maximum, lending rate became the effective form of interest rate regulation in the bank loan market.

Average interest regulation allowed the banks more leeway to differentiate their lending rates according to the riskiness of their customers. This was, indeed, the reason given by the Bank of Finland for adopting this new regime of lending rate regulation. Average interest rate regulation had other interesting properties as well, however: as long as there was excess demand for loans at the regulated rate of interest, it made the so-called evergreening of problem loans completely costless to the banks. If a client could not pay interest on his or her loan, the bank could simply convert the nonperforming loan to an interest-free one. Under the average interest regulation, this created leeway for the bank to increase the interest rates charged to other borrowers, who were ready to pay because of the prevailing excess demand for loans at the regulated interest rates. As a
result, the cost of giving a customer an interest-free loan was paid by other customers (Haavisto and Tarkka 1985).

The system of interest free loans which emerged under the average interest rate regulation in effect transferred the burden of any problem loans to other borrowers, without an effect on the profitability of the bank. This was of some significance in periods of recession. In the late 1977, for example, the share of interest free loans in the banks’ balance sheet was 2, and a significant share of loans were granted at low, clearly subsidized interest rates. In any case, recorded credit losses remained completely insignificant in Finland throughout the period of interest rate controls. This can be seen in Figure 1.

Figure 1

![Credit losses of commercial banks, per cent of lending](source: Statistics Finland, Commercial Bank Statistics (Liikepankkitilasto).

Among the most important challenges which the system had to face were the persistent balance of payments problems which followed the reinstitution of the external convertibility of the Finnish markka in 1958 (after almost 20 years) and the liberalization of imports. After this, monetary policy had to bear a bigger role in safeguarding the external equilibrium of the economy. On several occasions, the marginal cost of central bank credit to the commercial banks climbed to very high levels (over 19 per cent in 1966 and over 22 per cent in 1975). Despite the frequent tightening of monetary policy, several devaluations of the currency were required in 1967 and 1977-1978 and again in 1982 to restore the external equilibrium of the economy.

Another challenge was periods of high inflation, which made the controlled interest rates sometimes strongly negative. The most important such period was experienced in 1973-1977 following the first oil crisis (see Fig. 2). In order to make its monetary policy more effective, when the regulated interest rates had become patently unrealistic, the Bank of Finland in 1975 established an interbank call money market, in which it could intervene by supplying or withdrawing funds.
Gradually, the central bank operations on that call money market replaced the terms of the rediscount quotas as the most important instrument of monetary policy. This change, by introducing a new market price to the Finnish banking system, augured the coming changes to the regulated interest rate environment which had then prevailed for about three decades already.

Figure 2

Interest Rates and Inflation in Finland
Per cent, year-end values

Source: Bank of Finland.

8. The end of financial controls and the response in prudential rules

The possibilities for competition between banks were radically expanded by the financial deregulation which started in the beginning of the 1980s. As a result of this deregulation, new markets emerged which enabled the banks to compete for market shares by borrowing funds from an open money market. The process of deregulation also first undermined and finally scrapped the system of controlled lending and deposit rates which had protected Finnish banks from price competition for several decades. All these development led to higher risks for banks and thus tested the system of prudential regulation – a test which the prudential rules ultimately failed.

The deregulation of the Finnish financial markets started from short-term capital movements. In 1980, the commercial banks were allowed to borrow from abroad to cover their forward transactions with Finnish export companies. Before that, the Bank of Finland had acted as the
counterpart in all forward contracts, private banks acting only as intermediaries, but now the central bank wanted to withdraw from this market and allow banks to take care of it. The forward market and the associated foreign borrowing by the commercial banks effectively established a surrogate money market, in terms of covered foreign currency deposits, and soon banks’ short-term foreign borrowing constituted a very high share in their total funding (more than 30 per cent). Later, other capital import categories were gradually deregulated, until foreign borrowing was generally allowed to industrial companies in 1986 and finally to all firms in 1987 (Lehto-Sinisalo 1992).

The increased liquidity thus imported to the country eventually gave rise to a real domestic short term money market. For the first time, the larger Finnish companies had surplus liquidity, and a growing market of short-term “grey” deposits emerged at the beginning of the 1980s as banks started to compete for these funds (“grey” referring to wholesale deposits taken outside the banks’ traditional deposit rate cartel). The share of market-based funding in banks’ balance sheets, which had previously been negligible, grew rapidly, and the money market was finally organized in 1987, after the Bank of Finland had started to use market operations in bank CD’s as its main monetary policy instrument. After that, standardized CD’s and commercial paper rapidly replaced the informal short-term transactions which had previously dominated the new money market. Market interest rates (“Helibor” CD rates) were begun to be quoted daily (Alho et al. 1985; Financial Markets in Finland 1990, 1991).

The parallel existence of a wholesale market based on free interest rate determination and the regulated segment of financial intermediation was clearly not sustainable, and the authorities accepted the necessity of the general deregulation of interest rates applied by banks. This was implemented at the same time (in 1986) when long-term capital imports were also liberalized.

This triggered an extremely rapid expansion in bank lending, as banks tried to increase their market share and to expand their operations in order to justify the high cost structure they had developed in the period of suppressed competition. Eventually, the credit boom which ensued led to a collapse and a banking crisis in 1991, when the Finnish economy faced some important external shocks (such as the drop in exports due to the breakdown of the Soviet Union. See Vihriälä 1997; Tarkka 1994).

It was clear that the deregulation of banking and international capital movements had important implications for prudential rules. The prudential regulation of banks had to be modified, because the laws from 1969 did not fit the new more international and market-based conditions. In 1984, a committee was set up to unify and modernize the banking legislation, but again, the preparatory work and the legislative process after that took a very long time. In November 1987, just when the committee work was supposed to be close to completion, news arrived about the probable content of the capital accord which the Basel committee was preparing. It was clear that the Basel recommendations had to be taken into account, and the adaptation of the draft laws to this end caused an additional delay in the reform (Halme 1999).

The new laws were finally promulgated in 1990. For the first time, the same prudential rules were now imposed on all categories of banks (commercial, savings and cooperative banks). The new regulations mainly followed the Basel Committee recommendations, the main difference being that the definition of own capital was more generous. Despite that, the new law meant a significant tightening of capital requirements, especially for savings banks and cooperative banks. The banks with international activities were given time until the end of 1992 to satisfy the new law, others were given adjustment time until the end of 1995.
The law of 1990 turned out to be short-lived, however. The Cold War had ended in 1989 and in 1990 Finland entered negotiations about joining the European Economic area. In this situation, yet another working group was set up by the ministry of finance in December 1990 to prepare for a complete harmonization of the prudential rules with the European directives. The new law, which fully implemented the European Union directives, came into force from the beginning of 1994 on the day Finland joined the EEA. As a result of this harmonization, Finland’s accession into the EU exactly one year later required no further immediate changes in banking regulation.

In retrospect it must be concluded that the tightening of prudential rules for banks happened at least a decade too late. The authorities and the political system could not keep the prudential regulation of banks in step with the erosion and dismantling of the regulation of interest rates and capital movements, which had previously protected banks from competition and risks. This fatal delay was in part due to incompetence on the part of the authorities, but also to the tenacious resistance of the banking lobby to any tightening of regulation. The result was, anyway, that the Finnish banking sector faced the deregulation of foreign capital movements, the emergence of the money market, and the abolition of interest controls with too small a capital base and with weak and outdated supervision.

It would be outside the scope of this study to provide a detailed review of the course of the Finnish banking crisis which erupted in 1991, after several years of exceptionally rapid growth of bank lending and increasing foreign indebtedness of the economy. In the run-up to the crisis, banks (especially the savings bank network) engaged in sharp competition for market shares. The savings banks especially acquired significant stakes in industrial enterprises and real estate development projects, which the laws could not stop due to deficient regulations about consolidation of subsidiary investment companies of banks. The real estate and construction sectors clearly overheated and exposed banks and their debtors to very high risks. The situation finally came to an end when exports to the Soviet Union collapsed in 1991 (they had accounted for about 18 per cent of Finnish exports in 1986-1990). The crisis and its reasons have been discussed, e.g. in Bordes (1993) and Tarkka (1994).

The banking crisis which lasted until 1994, resulted in a complete overhaul of the Finnish banking system. Almost the entire savings bank network, starting with Skopbank, its central institution, fell into the hands of the government and was closed or sold to competitor banks. The bad assets were acquired by the government to an asset management company which gradually liquidated these assets in a very painful and expensive process. Other banks received capital injections and Government guarantees. The two largest commercial banks first merged with each other and then with a Swedish commercial bank. Depositors or creditors of banks did not lose, but the fiscal cost to the government of the crisis management process was very high. It is now estimated to have been about 6 billion euro in net terms, excluding interest. This is equivalent to about 7 per cent of the GDP of the year 1993. The total macroeconomic cost of the crisis is difficult even to define, but is certainly much higher. From its peak in 1990 to the trough in 1993, the real GDP contracted by about 11 per cent (Vihriälä and Nyberg 1994; Valtiovarain-ministeriö 1996).

9. Conclusions

The history of Finnish financial regulation after the Second World War and until the accession of Finland to the EU illustrates how prudential regulation of banks interacts with the regulation of competition and conduct of banks, and how both of these must be viewed in the context of the general economic policy of the country. In order to form a coherent and enduring whole, these three must be in some sort of conformity with each other. Each of them cannot be
changed without implications for the other components. In Finland, the stability of the financial system (in the sense of lack of bank failures or major credit losses) before the 1990s was more due to conduct regulation and limitation of competition (implemented for reasons of growth policy and of politics) than the kind of regulations which are expressly aimed at ensuring the solvency of banks and their ability to withstand risk.

The record of the Finnish regulated financial system is mixed. On the positive side, the system did support a high investment rate and a very high average growth rate from the 1950s and until the 1980s. In the four decades after the war, Finland caught up with its Nordic neighbours in terms of productivity, and, in the process, achieved a major transformation from an inefficient and largely rural society to an urbanized and industrialized economy.

On the other hand, there were recurrent balance of payments problems, and persistent inflation, which gave rise to a stop-go cycle in economic growth, and led to several large devaluations of the currency. This is evidence of the difficulty of demand management when interest rates are administratively frozen, as well as of the (probably inefficiently) high propensity to invest under the conditions created by the regulations.

It is also clear that the lack of price competition in banking led to various kinds of structural inefficiencies. Almost the only way banks could compete for funding was by expanding their branch networks, which resulted in a very high level of real resource costs in the sector. Also, the particular system of lending rate regulation, which set a ceiling on the average lending rate applied by each bank, made it possible, and even seemingly costless for banks to practice so-called evergreening of some inefficient industrial clients.

Finally, the banking practices, low capital ratios and high costs of banks which became the norm in the decades of regulation made the banks very vulnerable in the competitive and deregulated environment which they had to face after the deregulation which took place in the mid-1980’s. In that sense, the “hothouse” stability of the earlier period is one of the causes of the severe Finnish banking crisis of the early 1990s. It is impossible to escape the conclusion that the weakness of prudential regulation and the political difficulty of improving it are important reasons why the Finnish banking system could not withstand the combined effect of the deregulation of interest rates and capital movements, and the macroeconomic shock of 1991.
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