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The first eleven years of Finland's EU-membership

Remarks by Ms Sinikka Salo in the Panel *"The Austrian and Finnish EU-Presidencies: Positive Experiences as a Driving Force"* in Brussels, organized by the Oesterreichische Nationalbank

Ladies and Gentlemen,

I am pleased and honoured to participate in this panel and present my assessment of the past years of Finland's membership in the EU and EMU before such a distinguished audience, and I would like to thank the organisers for this opportunity.

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Finland joined the EU, together with Austria and Sweden, from the beginning of 1995. In its accession negotiations Finland did not seek any opt-out from the third stage of the EMU, and the government, which was formed after the general elections in March 1995, proclaimed in its programme that its goal was to prepare Finland to join the first group of countries doing so.

Actually the EMU membership had important effects already before it materialized. I think this is a phenomenon seen in all countries with the prospect of joining the EMU. In the case of Finland, expectations of joining in the common currency were fairly firmly established in 1995 already, and it was very soon clear that these expectations influenced monetary policy and private behaviour already before the membership in the monetary union became a reality.

In the light of 11 years of EU membership and 7 years of euro there are already some grounds to review and assess the hopes and expectations as well as risks which were held about the membership in the EU, and in particular about the membership in the EMU. In my remarks my focus, indeed, is on the impact of the monetary union.

However, it should be kept in mind that many factors other than the monetary union have influenced the Finnish economy in the last decade and therefore it is very difficult to disentangle the effects of giving up national monetary policy and joining the EMU from these other factors. This is true in particular because, when Finland joined the EU and EMU, the country was just recovering from a severe economic and financial crisis which in itself had changed the structure of the economy in several ways.

According to the widely shared view at the time of joining the union, the following major effects of the EMU were considered as relevant for Finland, and I shall discuss each of them briefly.

Benefits resulting from improved credibility of monetary policy

The hope for improved credibility of monetary policy was clearly there, as Finnish monetary policy traditionally had suffered lack of credibility which caused recurrent balance of payment problems and large risk premiums in market interest rates. It was hoped and expected that high credibility of the euro area monetary policy would imply lower interest rates, in particular lower and more stable long-term interest rates.

It was also predicted that the monetary union would be conducive to wage moderation, because better credibility would lower inflation expectations and therefore imply smaller inflation premiums in wage contracts. In the monetary union the wage inflation does not take off as easily as before, as the monetary policy can no more bail out export industries in the event of problems like in the old days characterized by "inflation-devaluation cycles".

Both these hopes have been realized since. The decisive year for the monetary convergence of Finland with its future EMU partners was 1996. During that year monetary policy interest rates were brought very close to those of Germany and other "core" countries and since October 1996, when Finland joined the ERM, exchange rate fluctuations vis-à-vis the deutschmark diminished further to the extent that they became quite unimportant from the macroeconomic point of view. Because also long-term interest rate differentials vis-à-vis Germany declined strongly to only a slight margin, and because after 1997 no interventions by the Bank of Finland was needed to defend the prevailing parity vis-à-vis the deutschmark, Finnish monetary policy could be seen as having become harmonized already before *de jure* adoption of the euro. This was also reflected in the smooth adoption of the irrevocable fixed conversion rate for the markka in the run-up for the monetary union, in spite of the fact that Finland joined the ERM relatively late.

Finland has indeed been able to enjoy historically low interest rates, not only in absolute terms, as most countries these days, but also in relative terms, due to improved credibility of monetary policy. One may argue that significant improvement in the general government financial position that took place since 1994 could have worked to the same direction, but we should keep in mind that real interest rate differentials were high also in the 1980s when government debt was quite small and the budget was in surplus. This supports the conclusion that credibility of monetary policy through the membership in the monetary union was the crucial ingredient in the improvement. Also wage moderation has been good, in terms of the profitability and external competitiveness of the economy.

In conclusion: Finland in the days before the EU was suffering from stubborn inflation and, as a result, from higher interest rates and chronically eroding competitiveness. With the euro both of these problems have vanished.

Question of asymmetric shocks and of giving up independent monetary policy

A regime shift from national to common monetary policy invokes the well-known problem of asymmetric (meaning country-specific) shocks: if the member countries do not fulfil the criteria for an optimum currency area – which Finland and the rest of EU countries obviously do not do – common monetary policy cannot be expected to react to the asymmetric shocks the countries face as efficiently as national monetary policies could. To the extent that national monetary policies or exchange rate movements do in fact facilitate adjustment to asymmetric shocks, a country may have to face more severe economic fluctuations as a result of forsaking its national currency. This question was discussed extensively in Finland and was considered as the main risk for Finland in the EMU, although it was noted that a separate exchange policy is also a source of speculative disturbances – several times experienced in Finland – and that this source of shocks would be eliminated in the EMU.

Experiences so far are rather positive in this regard and common monetary policy has been reasonably appropriate for the Finnish economy. The problem of asymmetric shocks has not at all been at the forefront in the Finnish economic policy. Actually, it seems that economic cycle in Finland has recently become more synchronized with the other euro area countries although the amplitude of the cycle in Finland is larger. This is true, in particular, for industrial production. A test was also due in late 2000-early 2001 when Finland was hit by the burst in global ICT stock prices and stagnation of network markets. As you may know, Finland is more dependent on the ICT-sector than the euro area on average (in 2000 the share of Nokia alone was about 5.5% of the GDP volume). It is interesting to compare the recession that followed the ICT crash to the recession in the beginning of 1990s when Finland also was hit more severely by the sudden collapse of trade to the Soviet Union simultaneously with a downturn in other export markets. (The share of Soviet Union in Finnish total exports was in 1990, before the collapse, 13 %).

In the recession of early 1990s, the whole economy entered the recession in a situation when the credibility of monetary policy could not be maintained, not even with high real interest rates and real economic costs, as it turned out. By contrast, in the recession of early 2000s, due to the EMU membership, there was no impact on exchange rates and the ECB's rate cuts were supportive also to other sectors of economy. In particular, with low prevailing interest rates households could continue to be confident in maintaining their consumption and housing expenditure. Basically due to domestic demand remaining rather strong, GDP performance was reasonably good in Finland even after the ICT crash. In conclusion, in spite of the exceptionally strong dependence of the Finnish economy on the ICT sector, the ICT shock was not transmitted to other sectors of the economy through destabilizing exchange rate or interest rate reactions.

The EMU membership has been protecting the Finnish economy also during the international crisis, like the 11th September 2001 terrorist attacks. Even before we joined the monetary union, the prospect of membership provided some protection, as the exchange rate of the Finnish markka remained stable also during the Russian crisis in 1998, whereas Swedish krona and Norwegian krone were affected. The swings in the external value of the euro have not affected trade inside the euro area, and their impact on exports seems to be less dramatic. In general, inflation in Finland has been relatively close to the euro area average, and recently even lower than the average.

The EMU has not posed any particular challenges for the Finnish fiscal policy. The consolidation of the public finances after the banking crisis has been remarkable, and currently Finnish public finances are among the strongest in the euro area. The genuine economic motives (especially preparing to the ageing of the population and fear of erosion of the tax base) are so compelling that the policy has been satisfying the formal criteria of the Stability and Growth Pact voluntarily, and by a clear "safety margin". In general, 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.

Structural effects and efficiency benefits from a single currency

Adopting the euro was generally predicted to reduce transaction costs and increase competition, and thus make Finland better integrated to the European single market. It was predicted to give firms, households, and governments access to deeper and more efficient financial markets.

After the EU and EMU memberships became a reality, Finnish firms have become much more international than before, in terms of ownerships and operations. Competition has increased in many sectors, including trade, telecommunications and financial services, and this has led to decreasing consumer prices for instance in foodstuff, clothes, home electronics, phone calls etc. In this respect, an important role has been played by many foreign firms establishing their business in Finland and thereby intensifying competition which perhaps was too weak in our domestic markets before joining the EU.

Finland's EMU membership may also have made Finland a more attractive object for investors outside the euro area. A large part of the foreign ownership of Finnish shares is by investors who are not euro area residents; also foreign direct investments are to a large extent to the non-EMU countries. Rather surprising feature has been the large share of Sweden as well in inflows as in outflows of equity capital.

The participation in the euro area has also changed and is changing the structure of financial markets and their functioning. In particular, securities markets have grown from national to more European. This has been very important from the point of view of big investors and borrowers. For example, large Finnish pension funds have been able to diversify their assets outside Finnish markets in an unprecedented fashion. Actually, this is the way the bulk of the large current account surplus, that we now have, is invested.

Also in the area of retail banking more competition is emerging, and in the area of cross-border payments use of internet and lower expected costs of transfers are making internal markets of the EU more efficient. So far, European integration in this area has, however, been regrettably slow, and this may continue to constitute a hindrance for deeper integration of Finnish trade with other euro area countries. This is not a Finnish phenomenon, of course, but a general European state of affairs.

Indeed, it was expected when Finland joined the EU that the trade with euro area and EU countries would have increased, but this has not happened. On the contrary, the share of the EU countries in Finnish exports and imports has decreased during the EU membership. This development may be due to the period of sluggish growth in the major euro area countries, in particular in Germany – traditionally our most important trading partner – and thus it may be temporary. Also, there have been important structural changes at the global level which have redirected Finnish foreign trade during these 10 years: the rise of ICT sector, globalisation and the increased role of Asia in world economy.

Originally, one of the most often heard fears concerning the EU membership, and more recently, the enlargement of the EU, was related to the free labour mobility. Especially the trade unions were worried about the foreign workers coming to Finland and taking the jobs. Actually, if anything, the problem has been better the opposite: more qualified foreign help would have been welcome. Migration flows from the other EU countries to Finland have been very moderate. Only Estonia has been a relevant external source of labour for the Finnish labour market. Due to the ageing of the

Finnish population there is already now a shortage of able people in many sectors, and this will be a growing problem in the forthcoming years, especially in the public health care system.

To summarise:

All in all, the Finnish EU and EMU membership seems to have fulfilled most of its promises and most of the fears have not materialised. There is a very broad consensus among Finnish economists and policymakers that the stability of the economy is now much better than it used to be in the past, and that the policy trade-offs are much more favourable now. It is, of course, difficult to say, what exactly is due to the EU or EMU membership and what is due to other factors. The past eleven years have been good times for Finland. The economic development has been strong and also relatively stable despite the large swings in the global economy. In this sense EMU has improved the resilience of the Finnish economy. I dare say that the overall outcome of the whole EU-membership has been very positive for Finland.