

FINLAND – FROM A CRISIS TO A SUCCESSFUL MEMBER OF THE EU AND EMU

***Remarks by Ms Sinikka Salo, Member of the Board,
in the seminar at Narodowy Bank Polski, Warsaw, 21 April 2006***

I am very pleased to be here and present my assessment of the past years of Finland's membership in the EU and EMU. Thank you for the invitation! For dealing with this topic, I also need to take a look back to economic developments before the EU to be able to give a better understanding for this assessment.

Indeed, Finland's economic performance in the decades following the Second World War has been relatively favourable. Historically and as a consequence of the losses suffered during the war, post-war Finland was clearly the poorest of the Nordic countries. From this starting point, Finland has been able to raise its standard of living close to that of the other Nordic countries and more than equal the current European average.

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 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 on the Finnish economy already before it materialized. I think this is a phenomenon seen in all countries with the prospect of joining the EMU. This is the observation that I would like to highlight right from the start of my presentation. 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 membership in the monetary union became a reality.

As mentioned, the emphasis of my lecture is in the time covering Finland's EU membership. In the light of 11 years of EU membership and 7 years of euro there are already some grounds to do this kind of review. Before that, however, some highlights from the time before the EU membership.

The Finnish economy before the EU membership – highlights

In the post-war decades Finland was a western market economy, but the economy was perhaps somewhat more regulated than other economies in Western Europe were on average. Finland participated in West European economic integration more cautiously and more slowly than other countries due to the moderate stance of its foreign policy. In any case, business activity in Finland was mostly in private hands. The share of state-owned companies was considerable in basic industries, but companies operated mainly on market terms and were largely open to foreign competition. Foreign trade was for the most part deregulated as early as the 1950s.

Until the end of the 1980s, the Finnish investment-to-GDP ratio was very high, usually 25 to 30 % of GDP. This helped to achieve growth rates slightly higher than the European average. However, in retrospect, one can see that investment efficiency was relatively weak. Financial market regulation, high rate of inflation, taxation and partly political steering were all factors that acted as a constraint on the effective allocation of resources.

Regulation of foreign capital movements and domestic interest rates was widespread, even if the tightness of regulation varied according to changing economic policy requirements. The aim was to keep the exchange rate of the Finnish markka fixed, first in relation to the US dollar and then, from the 1970s, in relation to a trade-weighted basket of currencies. Even so, a fairly high rate of inflation made it necessary for Finland to devalue the markka from time to time.

Finnish inflation was close to the level seen in the other Nordic countries, higher than in Germany and its neighbouring countries, but lower than in Southern Europe. Inflation was curbed by means of comprehensive incomes policy agreements between employer and employee organisations; these agreements sometimes proved too loose, however. They were often tied to taxation and other government measures; even interest rate policy had occasionally to be taken into account.

For the most part, the economy was liberalised in the 1980s, as in many other West European countries. Partial price regulation was gradually dismantled, and the money market, especially interest rates, was deregulated over a few years in the middle of the decade. Foreign financing and the foreign exchange market were freed from regulation in several phases over the course of the decade.

Although companies and banks across the board demanded deregulation, it became evident at the end of the 1980s and the beginning of the 1990s that they were otherwise unprepared to face free market conditions. In some cases, the deregulation of the markets led to irresponsible borrowing, most notably in relation to real estate, for instance. Costs generally slipped out of control at the end of the 1980s, and the fixed exchange rate placed constraints on the possibility to tighten monetary policy.

As a consequence, in the early years of the 1990s, Finland drifted into the worst economic crisis seen in any western market economy. The sources of the crisis were, however, also external. With the collapse and disintegration of the Soviet Union, Finnish exports to Russia dropped rapidly. Meanwhile, the global forest industry was in recession and the level of international interest rates high.

The markka's exchange rate underwent a strong depreciation, and the markka started to float in 1992. Finnish GDP declined by more than 10 % in the early years of the 1990s and unemployment rose to close to 20 %. The recession led to a banking crisis, and the largest banking group, the savings banks, failed. Banks' chances of finding foreign financing almost dried up. Getting through the crisis was largely aided by the state's decision to provide guarantees for all banks. The deficit in central government finances expanded strongly in response to the handling of the economic crisis and bank losses, and government foreign borrowing was threatened with temporary difficulties.

The economic and human losses caused by the crisis were extensive. A considerable number of essentially sound companies went bankrupt, partly for the reason that companies were unable to service their foreign currency debts that had swollen along with the weakening of the markka. On the other hand, the crisis prompted basic improvements in the structures of the economy. These improvements have been of vital importance for Finland's fairly favourable performance over the last ten years, essentially facilitating the adjustment of the Finnish economy to the European Union and monetary union.

Restrictions on foreign ownership in Finnish companies were not entirely abolished until 1993. Later, foreigners in fact bought considerable quantities of Finnish shares, for instance, about 85 to 90% of the leading mobile phone producer, Nokia. In the final stages of the crisis, these purchases provided a substantial contribution to the stabilisation of the markka's exchange rate. Even though Nokia was sold for a knock-down price, foreign ownership has undoubtedly provided a major support to Nokia's international image and growth. With the ongoing development of the stock market, the state has also sold a considerable proportion of its corporate assets, even though the majority of shares in many key companies are still held by the state.

By the early 1990s, cost developments moderated noticeably, and price stability became a reality. The 2 % inflation target set by the Bank of Finland was able to be achieved fairly easily. The financial structures of the economy strengthened, and the previous, almost chronic current account deficit turned into a surplus. This mainly stemmed from more effective corporate investment and better earnings performance in companies. It was also possible for public finances to be restored to balance or even to surplus, by freezing public expenditure. Banking business was conducted with greater efficiency, and bank personnel actually halved. However, domestic demand remained very subdued for a number of years, and strong economic growth was driven by rapidly recovering exports.

Finnish economy in the EU and EMU

When Finland joined the EU in 1995, the Finnish economy was already in relatively good shape, except for persistent unemployment. As I mentioned, with the early commitment on fulfilling the Maastricht criteria, expectations of joining in the common currency were already fairly firmly established in 1995. Public finances had improved at a fast pace. Monetary policy rates declined as early as 1993, coming close to the levels seen in Germany, with the ten-year government bond yield following suit a couple of years later. This commitment certainly had positive impact on credibility of monetary policy and private behaviour, but of course it is very difficult to disentangle these effects from other factors. The recovery of the economic and financial crisis had certainly in itself changed the structure in several ways, as I highlighted before. Nevertheless, by 1995, price stability had been achieved even in conditions of relatively accommodative monetary policy. The EMU interest rate criterion was met almost automatically upon fulfilment of the other Maastricht convergence criteria.

Of the EMU criteria, exchange rate requirements were the most demanding to meet, as the markka had been subject to sharp volatility. At the beginning of the decade, the markka had weakened by more than 30 %, but after stabilisation of the economy the exchange rate was able to regain half of the loss and then gradually stabilised. Yet, there were both upward and downward pressures on the markka's exchange rate, often originating from shocks in the other Nordic foreign exchange markets.

The Finnish markka was pegged to the exchange rate mechanism (ERM) of the European Monetary System in October 1996. It was pegged at a rate approximately at the average level of the previous few years, but the choice of the exchange rate level gave rise to considerable debate. In view of long-term trends, the rate was seen as being relatively weak, and it was feared that it would lead to inflationary pressures. On the other hand, the Finnish economy was still heavily indebted externally – with foreign debt accounting for about 50 % of GDP. Under these circumstances, we wanted to secure a competitive exchange rate in relative terms. At the time, inflationary pressures, even globally, remained surprisingly limited, which has helped to ensure Finland's continued growth in monetary union, thanks to fairly good competitiveness.

In the latter part of the 1990s, the Finnish economy grew at a fast annual rate of as much as 4 to 6 %. The share of exports in the economy expanded strongly, but domestic demand also recovered towards the end of the decade. Even so, the investment ratio has remained relatively low at below 20 % of GDP. Initially, the current account surplus was large, but subsequently it has gradually contracted, largely because of adverse developments in Finnish export prices for electronics and forest industry products in particular. Despite that, the success of the electronics industry, mainly thanks to Nokia, has been vital to development in Finland.

(Nokia is the world's leading producer of mobile phones. At the peak of the last ICT cycle in 2000, Nokia is estimated to have accounted for 2.8 % of Finnish GDP and over 1.6 percentage points of GDP growth. However, following the subsequent slump in ICT, the contribution to GDP growth was only 0.04 % in 2004, with Nokia's share of Finnish GDP little changed at around 3 %. Nokia has announced that it will expand mobile device production in China and India. The share of Nokia's exports in total Finnish exports was about 20 % in 2004. Nokia paid around 3 % of total taxes received by the general government. While Nokia accounts for a large share of GDP, exports and R&D, its direct impact on employment is much smaller.)

Finland was one of the first countries to participate in monetary union at the beginning of 1999. Before that, the Bank of Finland took part in technical preparations for monetary union, and the Bank of Finland's monetary policy instruments were gradually adapted to the system designed for the ECB. The Finnish markka enjoyed great credibility in the market, which was reflected in the markka's forward rate; it remained very close to the expected rate at which the markka was pegged. This was partly related to the need to adjust the interest rate level only moderately, contrary to the case in some south European countries. The markka's exchange rate was not changed in connection with the entry in monetary union, which proceeded by and large without problems. The euro cash changeover a couple of years later also came off with ease, partly because the number of banknotes in Finland was the smallest (2 to 3 % of GDP) among the countries participating in monetary union.

In recent years, Finnish economic growth has decelerated to about 2 to 3 %, despite which the growth rate is still one of the strongest within the euro area as a whole. The economic balance has been relatively good – with the exception of unemployment, which remains at about the 8 % level.

As a member of the monetary union, whose monetary policy is tailored for the euro area on average, the focus of Finnish economic policy is centred on fiscal and incomes policies. As far as incomes policy is concerned, comprehensive incomes policy agreements have been continued, with duly moderate wage hikes; on the other hand, the Finnish cost level has risen faster than the euro area average. Upon Finland's accession to the EU, it was decided, at the behest of employee organisations and trade unions, to establish two buffer funds for incomes policy purposes. These funds serve to stabilise development of unemployment-related expenditures. However, the importance of these funds has remained only marginal.

Since Finland's adoption of the euro, fiscal policy has been marked by fiscal discipline. Finnish general government finances have been in surplus all the time, even if this is largely due to accrued income in employment pension funds. Central government finances have remained close to balance, despite sizeable tax cuts. The local government deficit is small. The share of public expenditures of GDP has been falling gradually, and their level is clearly lower than in Sweden and Denmark. As corporate finances have also remained robust, Finland has shown an important, albeit gradually shrinking current account surplus.

Prior to joining the EU, Finland's consumer price level relative to the income level was as much as 40 % higher than in Central and Southern Europe. This derived from the relatively closed markets, high agricultural prices and consumption taxes. Since joining the European Union and becoming part of the euro area, the impact of these factors has diminished notably. With the opening of the economy, competition in retail trade increased sharply and, as a consequence, Finland saw the market entry, for instance, of a German discount store. Also the prices of agricultural products decreased upon Finland's entry into the EU, and both tax competition and EU regulations compelled us to markedly lower taxes on alcoholic beverages and cars in particular. Since Finland's adoption of the euro, consumer price increases have been the smallest, besides Germany, among the euro area countries, and the price differential to the EU average is only about a fifth. Due to Finland's Nordic location and sparse population, it is probably impossible to ever reach the same level of low prices prevailing in the main EU countries.

When it comes to internationalisation and globalisation, Finland has adopted a liberal approach. Within the EU, Finland has been opposed to various attempts at building internal and external barriers to trade. Finland has started from the conviction that globalisation is an inevitable challenge and that the countries quickest to adapt to it will also, in the long run, reap the greatest benefits from it. A case in point is Nokia, which has benefited decisively from domestic and global liberalisation.

Finnish companies have been widely sold to foreign investors; yet Finnish companies have invested even more abroad. Especially integration between the Nordic countries has been strong, which has been particularly reflected in the energy and banking sectors, for example. The largest Finnish bank is an integrated part of a pan-Nordic bank (Nordea), and smaller banks have also been sold to Sweden. Consequently, banks registered in Sweden currently control about a half of the Finnish banking market.

The Bank of Finland participates in euro area monetary policy preparation and decision-making. However, monitoring of domestic financial and foreign exchange markets remains a priority for euro area central banks. The exchange rate of the euro has experienced considerable volatility, but has so far posed no major problems for the Finnish economy or companies. The euro's exchange rate may be of greater significance for Finland than for any other euro area country, as the share of the euro area in Finnish foreign trade is one of the smallest, at only about a third. The three countries, Sweden, the UK and Denmark, which are almost comparable to the euro area for Finnish foreign trade, are still outside the euro area. Compared with the other euro area countries, Finnish foreign trade is also more extensive than on average with Russia and the Asian countries.

Since the euro change over, Finnish financial markets have developed at a fast pace. Maturities of housing loans have been extended from the previous loan periods of about 10 years to 20, 30 years, or to even longer periods. The increase in lending has therefore been very rapid, but apparently for the most part well-founded and sound. Despite this, the very low level of interest rates in the euro area could, if protracted, pose problems. In any case, banks operating in Finland are now in good shape.

Strengths and weaknesses of the Finnish economy

The Finnish economy exhibits a number of strengths but also faces a number of threats. The strengths include a stable society, a strong tradition for the rule of law and a well-educated population. With the smallest foreign population in relation to the other euro area countries, Finland is partly at an advantage, partly at a disadvantage. The homogeneity of the population is reflected in, for instance, the high

average level of education. On the other hand, the imminent weakening age structure of the population might call for somewhat higher immigration numbers of young labour than at present.

The age structure of the Finnish population is the weakest in the euro area in that the post-war baby boomer generation, now at the retirement age, is rapidly adding to the pension burden in the coming years. But the birth rate has remained higher than the European average, so that Finland's position in the long term is probably not particularly weak.

Finland's problems are mainly related to its northern, isolated location and small population base. Although Finland generally ranks among the top countries in international comparisons for competitiveness, very few greenfield direct investments have been directed to Finland. It is primarily only the Finns themselves who make new real investments in Finland, and they too have invested little in recent years, which gives some cause for concern. Finnish output is still relatively one-sided, with the emphasis on the forest industry and Nokia. Certainly, some metal industry sectors are traditionally strong (lifts, ship engines and equipment). One area of concern is that exports of services from Finland remain rather modest.

Forecasts point to the continuation of fairly stable and balanced growth in the Finnish economy. Output growth figures would appear to remain close to a flat rate of 3 %. Consumer prices are likely to continue rising slowly, the unemployment situation is expected to improve gradually and the current account surplus is set to decline. Problems in public finances are relatively small.

Concluding remarks – review of hopes and expectations, unrealised risks

It is, of course, difficult to say to what extent the positive developments in the Finnish economy over the recent decade are the consequence of the EU and monetary union. Nevertheless, I dare join the widely shared view that the overall outcome of Finland's EU-membership has been very successful.

I shall sum up briefly major effects of EMU that, according to the widely shared view at the time of joining the union, were considered as relevant for Finland:

- *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 euro area monetary policy would imply lower interest rates, in particular lower and more stable long-term interest rates.

It was also predicted that 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, as I described. 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.

- *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 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 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 (As I mentioned, 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 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.

- *Protection during international crises*

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.

- *No particular challenges for fiscal policy*

The EMU has not posed any particular challenges for 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 non-EMU countries. The 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

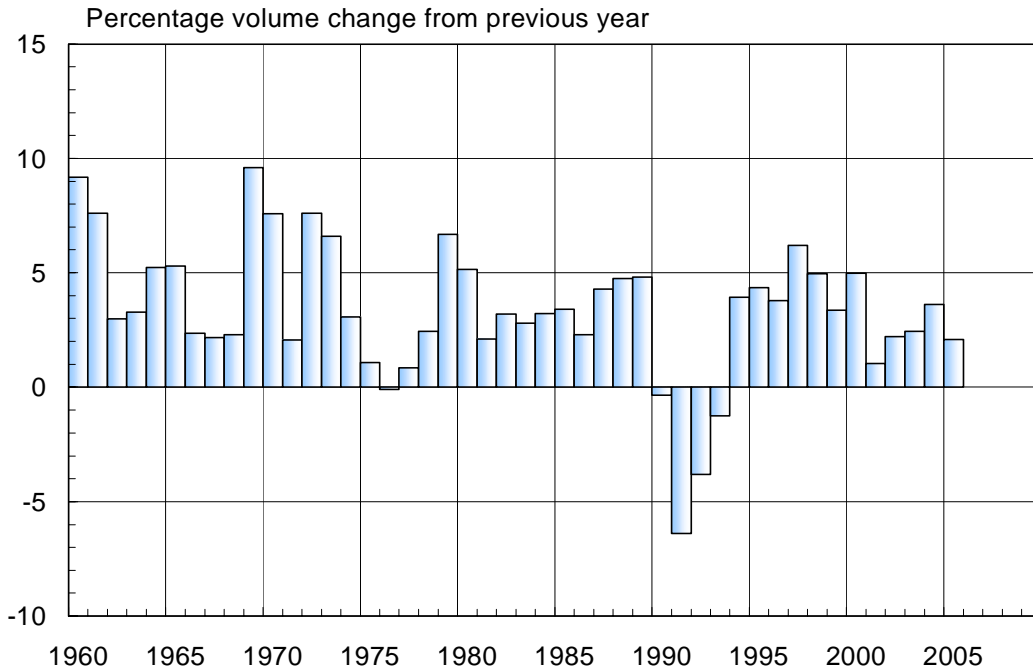
continue to constitute a hindrance for deeper integration of Finnish trade with other euro area countries. This is not a Finnish phenomenon, of course, but a general European state of affairs.

Indeed, it was expected when Finland joined the EU that trade with euro area and EU countries would have increased, but this has not happened. On the contrary, the share of 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 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.

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 favourable trends and 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. Finland's EU experience is widely seen as a highly positive process.

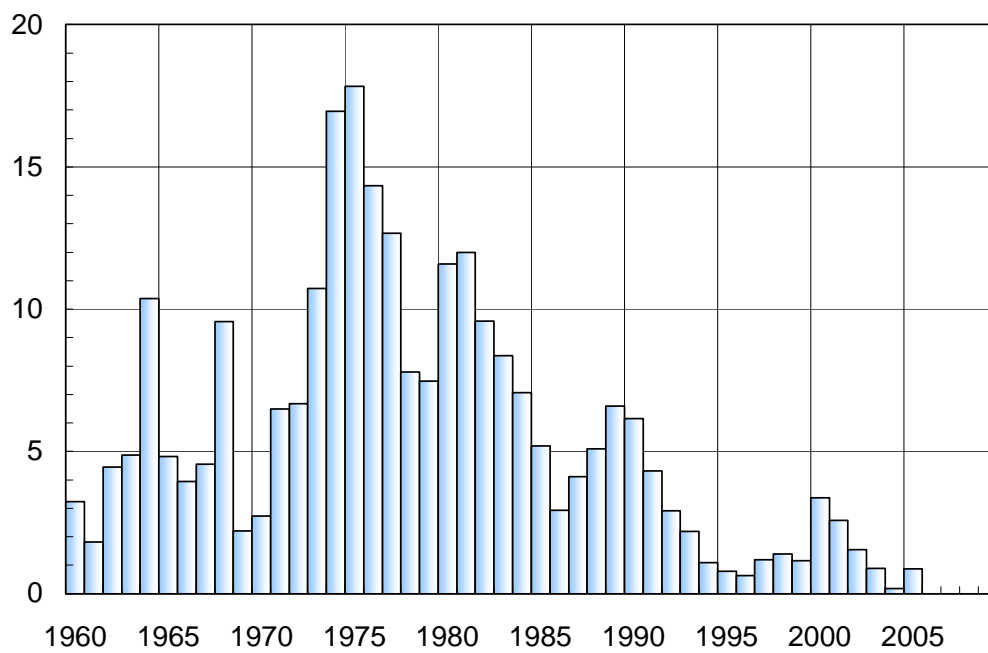
Gross domestic product in Finland



Sources: Bank of Finland and Statistics Finland.

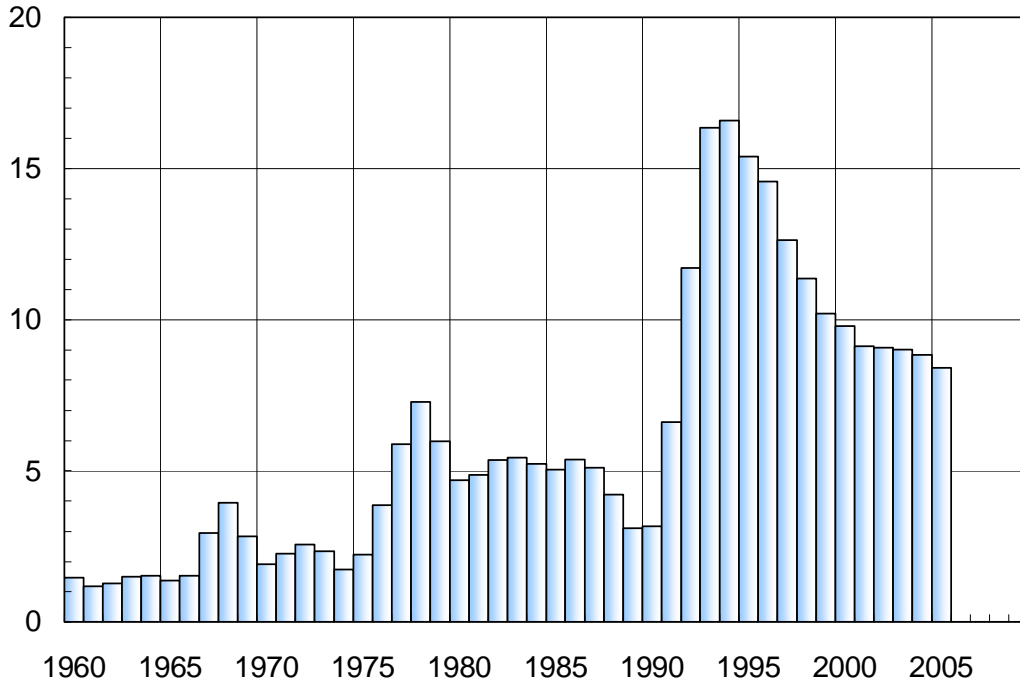
Consumer prices in Finland

Percentage volume change from previous year



Source: Statistics Finland.

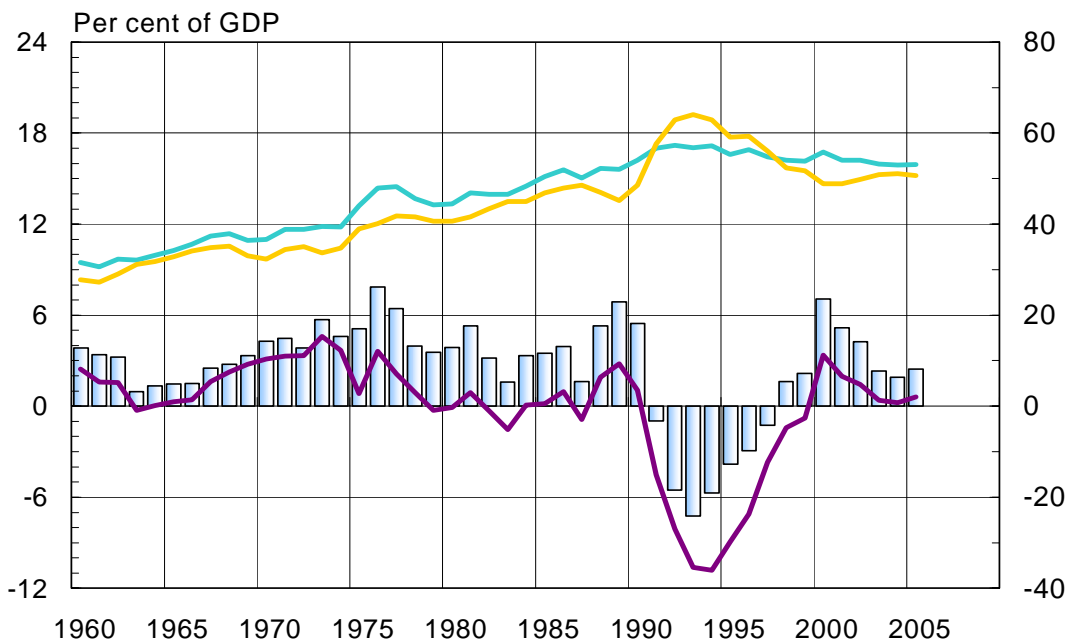
Unemployment rate in Finland



Source: Statistics Finland.

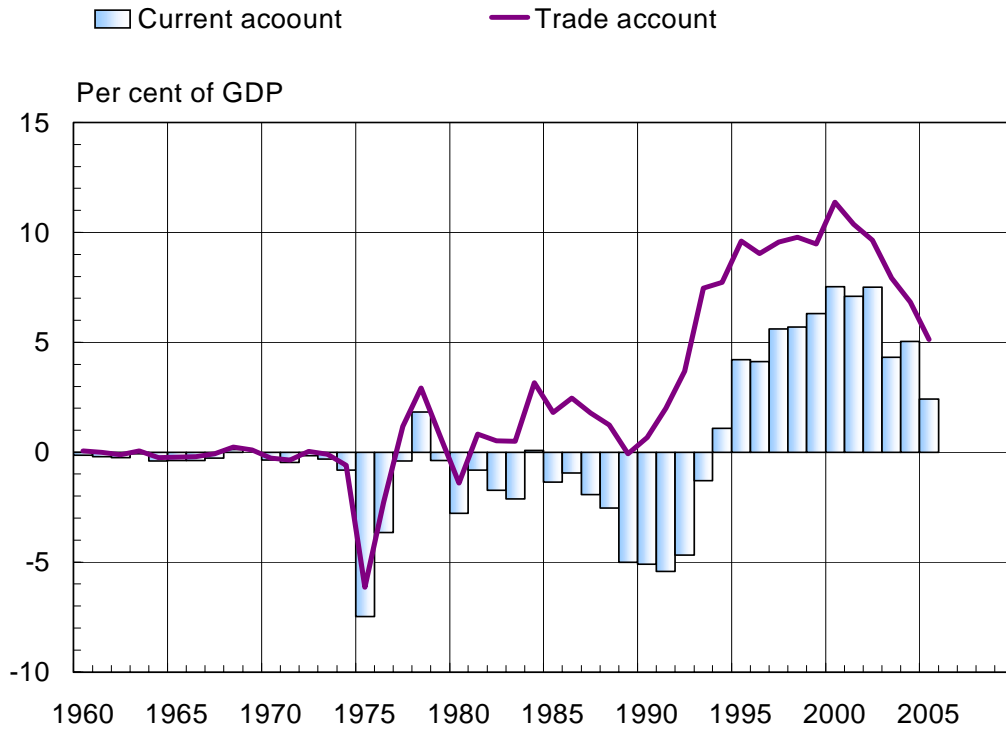
General government balances in Finland

- General government financial position (left scale)
- General government surplus (left scale)
- General government expenditure (right scale)
- General government revenue (right scale)



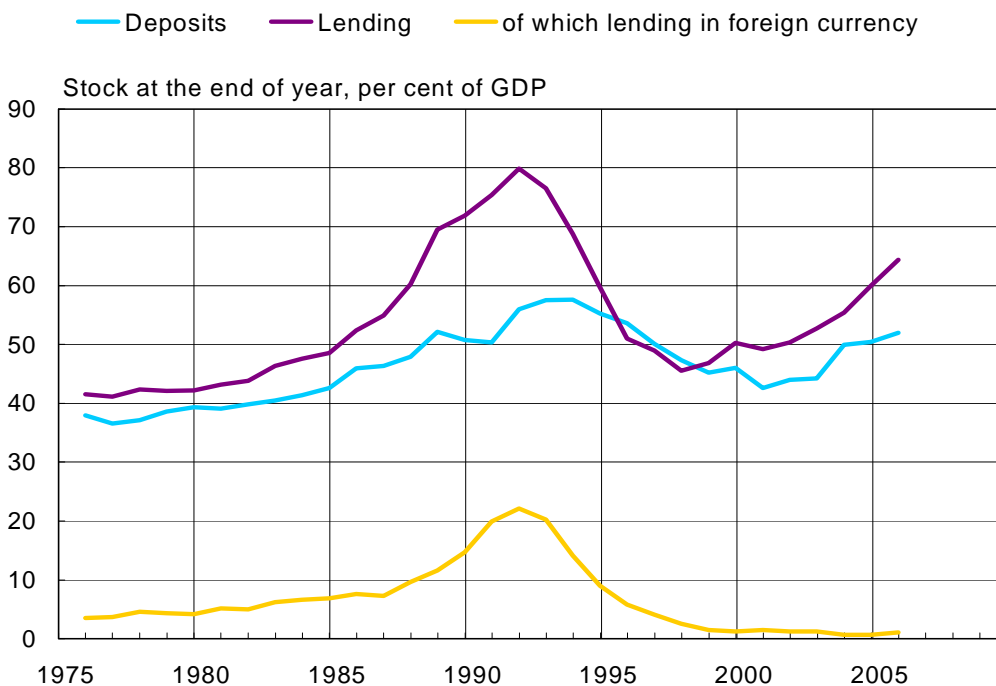
Source: Statistics Finland.

Current account and trade account in Finland



Source: Bank of Finland.

Stock of bank lending and deposits in Finland

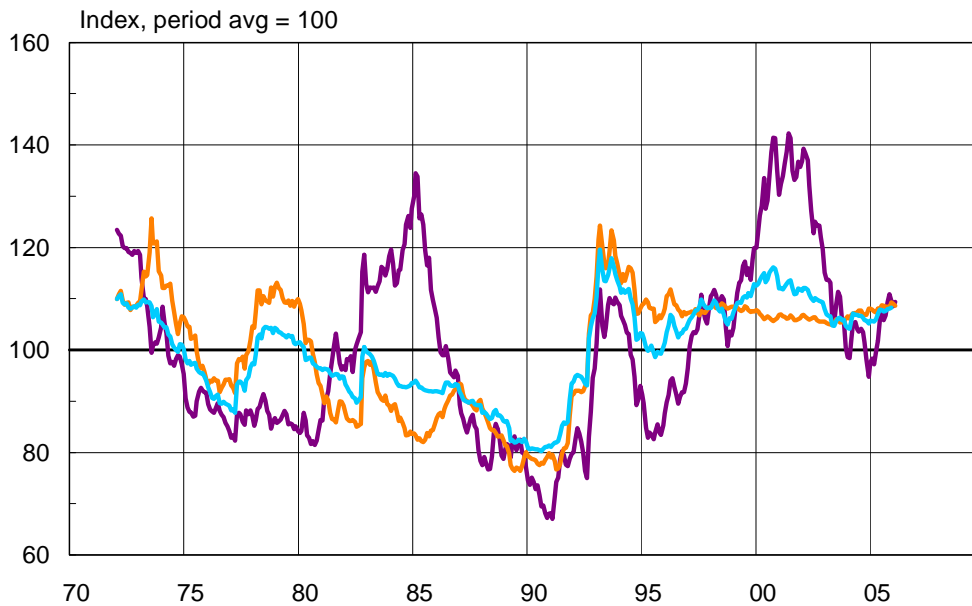


Source: Bank of Finland.

Finland's real exchange rates

Rising curve indicates markka "euro" depreciation

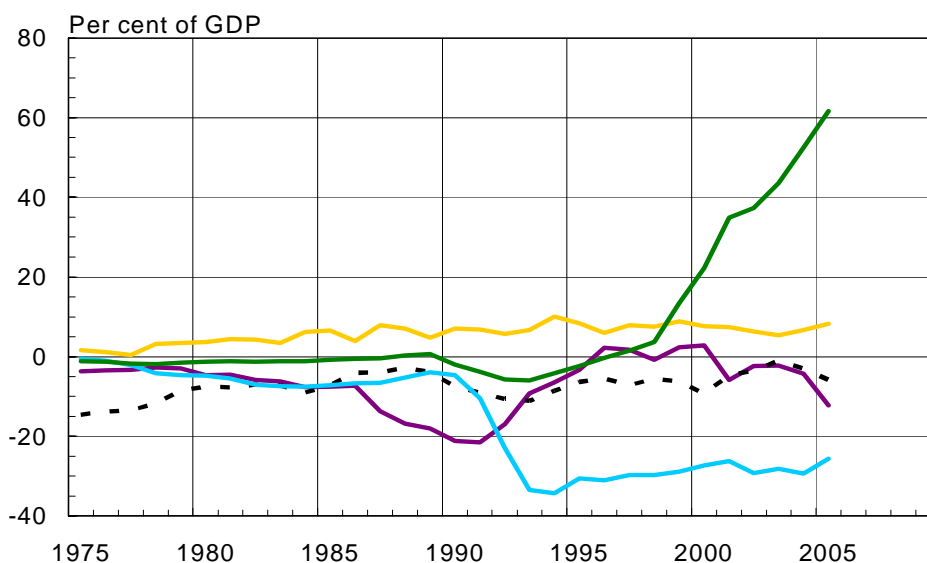
- Real FIM/USD-rate (CPI-adjusted)
- Real FIM/DEM-rate (CPI-adjusted)
- Finland's real exchange rate (narrow plus euro area competitiveness indicator)



Source: Bank of Finland.

Finland's net international investment position

- Monetary financial institutions
- - - Enterprises excl. shares and other equity items
- Bank of Finland
- Central government
- Employment pension institutions and other financial institutions



Source: Bank of Finland.