

Seppo Honkapohja: Bank of Finland's 200 years

Speech by Mr Seppo Honkapohja, Member of the Board of the Bank of Finland, at the CEPR-BoF Conference "Entrepreneurial finance, innovation and growth", Helsinki, 23 October 2014.

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The Bank of Finland had its 200 year anniversary three years ago. The charter of the bank was promulgated on December 12, 1811, and we are the fourth oldest central bank operating today. Only the Swedish Riksbank, the Bank of England, and Banque de France are older. The Bank of Finland is also more than 100 years older than Finland's political independence, which was achieved only in 1917.

Establishment of a national bank of issue in Finland came about after, in 1809, the Russian Empire had annexed Finland as an autonomous Grand Duchy, with the Russian Tsar as the Grand Duke. The Grand Duchy of Finland was given its own particular administrative structure, separate from the government of Russia. The new national bank of issue was part of this newly created national administration.

The first task of the Bank of Finland was to separate the Finnish financial system from Sweden by issuing (rouble- and kopeck-denominated) notes, and by granting credits to Finnish landowners and merchants. The Bank of Finland was originally established in the city of Turku, in the south-west of Finland, and moved to Helsinki, the new capital of the country, in 1819.

Despite the efforts of the Bank of Finland, Swedish money remained widely used in Finland until 1840, when Finland went on the silver standard (following Russia), and the remaining Swedish paper money was withdrawn from circulation. After this milestone, the notes issued by the Bank of Finland became the dominant means of payment in the country and the circulation was effectively controlled by the Bank of Finland.

Finland obtained its own currency unit, the markka in 1860 – i.e. well before the country became independent. This happened in the aftermath of the Crimean war and the international financial crisis of 1857–58, when the rouble was seriously destabilized and went off the silver standard.

At first, the new currency unit, the markka, was defined simply as a quarter of the paper rouble. In 1865, however, the head of the financial department of the Finnish senate, J.V. Snellman, obtained from Tsar Alexander II the permission to link the markka to the silver standard independently of the rouble. As the Russian rouble remained inconvertible to silver, Finland's monetary system was thus effectively separated from Russia's.

In 1868, the Bank of Finland was transferred under the control and ownership of the parliament. Until then, the bank had been subordinated to the Imperial Senate of Finland. The system in which the central bank belongs to the parliament was adopted following the Swedish example and has lasted to this day.

Most European countries moved to the gold standard in the 1870s, and Finland followed suit in 1878. At that point, the gold content of the Finnish markka was defined so that it was exactly equivalent to the French franc (as well as the Belgian and Swiss francs, and the Italian lira). Finland thus became, by a unilateral decision, an effective member of the European franc zone (the Latin Monetary Union), even if not a signatory to the monetary union agreement. The Bank of Finland managed to keep the exchange rate of the markka vis-à-vis the French franc constant for 36 years, from the start in 1878 until the outbreak of the First World War.

Finland declared her independence in December 1917, following the October revolution in Russia. The First World War and the Finnish Civil War of 1918 caused sharp inflation. In

1923 the Bank of Finland finally manages to stabilize the value of the currency, and the markka had lost almost 90 per cent of its prewar value in gold. At this lower parity, the markka was returned to gold as of the beginning of 1926, following the British pound sterling.

In the interwar years, the Bank of Finland became the undisputed leader of Finland's economic policy. This was largely due to the very strong governor of the bank, Risto Ryti, who acquired considerable prestige in Finland and also abroad.

Ever since Ryti's governorship, which lasted from 1924 until the outbreak of the Second World War, the governor of the Bank of Finland has been one of the most central figures in Finnish public life. This is illustrated by the fact that four members of the board of the Bank of Finland have become Presidents of the Republic: Kyösti Kallio, Risto Ryti, Urho Kekkonen, and Mauno Koivisto. Two of these, Mr Ryti and Dr Koivisto, had been governors of the bank.

The Great Depression forced the pound off gold in the autumn of 1931, and the Scandinavian currencies and Finland had to follow suit. The markka was floated and then depreciated vis-à-vis most foreign currencies. In the spring of 1933, the worst of the depression was over, and the Bank of Finland pegged the markka to pound sterling.

The Second World War caused in Finland severe inflation which was only brought under control by the early 1950's. This allowed the Finnish markka to enter the Bretton Woods system in 1952 – Finland had become member of the IMF already in 1948.

In the post-war decades, Finnish monetary policy was subordinated to a vigorous, government-led growth policy which sought to promote investment and industrialization, and used interest rate controls, capital controls and government-sponsored lending as its instruments. Under this regime, the Bank of Finland's operational tasks multiplied, including the operation of an extensive system of capital import policies and selective credit guidelines.

This financial repression policy lasted until the end of the 1970's and achieved very high investment rates and growth rates for the economy, but at the price of a relatively high inflation rate and recurrent balance-of-payments problems. The markka was devalued on several occasions. This financial and monetary policy regime changed only in the aftermath of the first oil crisis.

In the 1980s the Bank of Finland, following international trends, gradually lifted the controls on capital movements and also liberalized domestic credit markets. After the deregulation, a very strong credit cycle developed which also produced a sizable current account deficit. This credit cycle ended in 1991 with a severe banking crisis. At the same time, Finland lost some of her traditional export markets when the Soviet Union collapsed.

In the course of the ensuing economic crisis, Finland's GDP fell by some 14 per cent. The Finnish markka was first devalued (November 1991) and the floated (September 1992), depreciating all in all by about 30 per cent against the European currency unit (ECU).

In February 1993, with the markka now a floating currency, the Bank of Finland committed to an inflation target of "less than two per cent" as the primary objective of its monetary policy. Under this regime, the confidence was gradually restored in financial markets, interest rates returned to normal levels, and the exchange rate recovered. A period of strong economic recovery also took place.

When Finland joined the EU from the beginning of 1995, she accepted all obligations of the Maastricht Treaty, including the plan for the Economic and Monetary Union. The painful financial instability of the late 1980s and early 1990s was probably one main reason why the euro enjoyed relatively strong appeal among Finnish politicians and the population at large as well.

After the banking crisis of the early 1990s, financial supervision was reorganized in Finland in 1993. Financial supervision was made a part of the Bank of Finland, but as an independent institution with its own decision-making bodies. Later, also insurance supervision was merged to this supervision authority which operates in connection to the Bank of Finland.

The newly re-established financial stability of the mid-1990's allowed Finland to join the European Exchange Rate Mechanism (ERM) in October 1996. Finland was then among the first group of countries to adopt the euro in 1999. The governor of the Bank of Finland, Dr Sirkka Hämäläinen, became one of the members of the ECB's first executive board, and actually its first female member.

Now a part of the Eurosystem, the Bank of Finland continues in its role as the monetary authority and the bankers' bank in Finland. Nevertheless, it has streamlined its operational functions, while investing in more than previously in its economic research and communications activities. The Bank now has 390 employees (at mid-2014) and 580 when the Financial Supervision Authority is included.

The Bank of Finland has traditionally invested a significant amount of resources in economic research. This continues today. As part of its profile within the Eurosystem, the Bank of Finland has also developed a research concentration on the economic and financial developments in Russia, which is again a very important trading partner for Finland.

According to recent polls, the Bank of Finland is now among the top three most trusted institutions in the country. The current Governor of the bank, since 2004, is Mr. Erkki Liikanen, who has previously served as Finland's finance minister and a member of the European Commission.