

Dr. Hämäläinen reviews developments in the Finnish economy in 1996

Review by the Governor of the Bank of Finland, Dr. Sirkka Hämäläinen, in connection with the Bank of Finland's Annual Accounts. PRESS RELEASE, 10/1/97.

Coherent economic policies and a stable international environment provided the appropriate conditions for steady growth and balanced performance of the Finnish economy in 1996. The rise in the price level was moderate and exchange rates remained fairly stable. For these reasons, it was possible to lower the instrumental interest rates of monetary policy to levels that were low by both historical and international standards. Long-term market rates followed the downward trend in short-term rates. Positive outcomes included a reduction in the central government deficit, the end of the banks' protracted series of financial losses and a noticeable improvement in the economy's external indebtedness. High unemployment continued to pose a serious problem.

The consumer price index rose by about 1 per cent in 1996, and the indicator of underlying inflation, which serves as a basis for monetary policy, was even more subdued. During the summer and autumn months, a lively public discussion ensued on the possibility of deflation. There were however no signs of a general decline in the price level, and the entire configuration of asset prices, for example trended upward.

Exports and investment provided less-than-expected stimulus to economic growth in 1996, but owing to a healthy rise in private consumption expenditure, total output is estimated to have grown by nearly 3 per cent. The market outlook for exports improved in the latter part of the year. Investment expenditure was buoyed mainly by previously started large-scale investment projects in the manufacturing sector, but construction activity picked up sharply in the latter part of the year. Because of a recovery in the service and construction sectors, the employment situation improved slightly, which had a salutary effect on expectations and demand in the household and corporate sectors.

The growth in domestic demand helped to constrain the general government deficit, i.e. the combined deficit of central and local governments and social security funds. Nonetheless, the central government deficit remained large by both historical and international standards. The indebtedness of households and firms again eased considerably and the external indebtedness of the total economy continued to improve.

The Bank of Finland continued to relax monetary policy in 1996. In the course of the year, the tender rate was lowered from 4.25 per cent to 3.0 per cent and the financial markets remained calm. The external value of the markka fluctuated to some extent but on the whole remained relatively stable. As the year progressed, the long-term interest rate moved considerably closer to the comparable German rate, and by the final months of the year the differential had stabilized at about ½ percentage point.

One significant development in 1996 was the continued strengthening of the banks and the termination of a period of several years of negative financial results. The aggregate result turned positive largely because of reduced loan losses and lower cost levels. Nonetheless, domestic banks' profitability and capital adequacy have still not reached levels that can be considered good by international standards.

Improved economic balance and steady economic policy enabled the Bank of Finland to make a proposal in October to the Government concerning the joining of the markka to the EU's Exchange Rate Mechanism (ERM). The proposal was approved and negotiations

with other EU countries led to an agreed ECU central rate for the markka of FIM 5.80661, corresponding to a central rate against the Deutschemark of FIM 3.04. The agreed markka exchange rate configuration vis-à-vis major ERM currencies corresponds to the average level of recent years. After Italy joined the ERM in November, the markka's ECU central rate became FIM 5.85424. Bilateral central rates against other ERM currencies were not affected.

Finland's purpose in joining the ERM was to ensure its eligibility to be among the first group of countries to move into Stage Three of EMU. According to the text of the Maastricht Treaty, the exchange rate convergence criterion requires exchange rate stability for two years prior to the examination and participation in the ERM. It now appears that the final decision on eligibility for Stage Three of EMU is slated for spring 1998.

As the Bank of Finland reaffirmed in connection with the ERM linkup, the monetary policy objective remains that of keeping the inflation rate at about 2 per cent, which accords with the major EU countries. Although the inflation objective is consistent with the stable exchange rate objective, in the event of a disturbance, ERM participation would imply precedence of the exchange rate objective. The ERM's wide (± 15 per cent) fluctuation margins provide a good buffer against speculative activity, but clearly the need to meet the EMU exchange rate criterion and to maintain economic balance requires a much more stable course for exchange rates. Continuing progress in balancing central government finances and maintenance of the moderate cost trend are key factors as regards exchange rate stability.

It is apparent that the easing of monetary policy and confidence in improving economic prospects will provide support for domestic demand over the future. With exports also picking up again, the growth of total output could reach 4 per cent in 1997. It appears that the rise in the price level will stay near the targeted level. The decline in unemployment should continue but again at a very sluggish pace. In order to accelerate the decline in the unemployment rate, the tax wedge should be narrowed further and the social security and tax systems should be made more work-friendly.

It appears that Finland will be able to meet all the economic convergence criteria for EMU, i.e. those pertaining to inflation, exchange rates, the long-term interest rate, and the public sector deficit and debt. The decision on which countries are to participate in Stage Three of EMU is to be made in spring 1998, only a little over a year from now, and before that time the Act on the Bank of Finland should be amended so that the EMU requirement regarding central bank independence can be fulfilled.

Practical preparations within the EU for Economic and Monetary Union have progressed according to plans. The Bank of Finland has participated in the work of creating the European System of Central Banks, in both the European Monetary Institute (EMI) and the EU's Monetary Committee. The preparatory work involves *inter alia* strategy and instruments for the conduct of a single monetary policy as well as detailed planning of the payment system. Progress has also been made in specifying the legal status of the single currency - the euro - as well as in the design of euro notes and coins. Much work has also been required in the development of an exchange rate system covering both EMU participants and other EU states.

The Bank of Finland's own preparations for Stage Three of EMU have intensified. The adoption of a single currency requires broad changes in the payment systems of the banks and the Bank of Finland. One major change will be the fusion of national payment systems into an EU-wide payment system. The Bank of Finland supports efficient and secure solutions, which will at the same time provide the best possible environment for Finnish banking and securities

markets. Cooperative efforts between the banks and the Bank of Finland have intensified in all areas of concern, and the Bank of Finland is participating in the national EMU project of the Ministry of Finance.

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The Bank of Finland's financial result for 1996 marked a significant improvement over the last several years, which had resulted in an erosion of the Bank's capital position. The primary reason for the improvement was the sale to the state of the Sponda group, which had fallen to the Bank in the wake of the banking crisis. In this connection, the Bank received repayment of a loan to Sponda and partial compensation for forgone interest income. Final losses in connection with the takeover of Skopbank were included in the Bank's balance sheet in 1996: the loss of equity capital amounted to about FIM 5 billion.

The Bank of Finland's result for 1996 after capitalization of prior years' losses not previously recorded in the balance sheet was FIM 3 754 million, which was added to the reserve fund in the balance sheet, thus strengthening the Bank's capital position.