

Matti Vanhala: Challenges for Finnish economic policy in an unstable international environment

Abstract of a speech by Mr Matti Vanhala, Governor of the Bank of Finland, at the conference "Monetary policy in 2004", Helsinki, 9 October 2003.

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Global economy

It would appear that global economic recovery is under way at last. The latest economic data from the United States is more convincing, and economic activity in Asia is relatively brisk. Economic developments in Russia also deserve a mention, and there is a sense of improved optimism both in Europe and the euro area as a whole. It therefore seems likely that we will obtain robust growth figures on a global level in the near future. Why, then, do I then refer to an "unstable international environment" in the title of my speech?

The reason is that despite the favourable short-term outlook, sustainable recovery is being affected by a number of uncertainties. Global economic expansion is starting to gather speed in exceptionally unstable circumstances. Extremely strong expansionary fiscal and monetary policies are the lifeline of industrial countries. Although such strong expansionary measures can set recovery in motion, they alone do not create sustainable growth.

Euro area monetary policy

Confidence indicators show that euro area companies' expectations on economic activity have improved significantly. Concerns over deflation have receded, and inflation expectations have stabilised. In light of this, the stance taken by the ECB's monetary policy is lax. Euro area central banks are now offering money at the lowest rate ever in the history of open financial markets. Furthermore, banks' real lending rates are also extremely low. There is no evidence, nor are there any indications, to suggest that the price of financing would prevent investments in any of the euro area countries.

Expansionary fiscal policy measures are not the answer to euro area problems

The failure of one or several euro area countries to pursue sustained fiscal policies that have been accommodated to given cyclical conditions is a very serious matter. Although adverse effects will be felt throughout the monetary union, the most severe consequences arising from a strong deterioration of public finances will be caused to the countries themselves.

Public finances, within the problematic countries, should be stabilised within a reasonable time span by introducing a fiscal policy geared to restrict the growth of public spending. Where this can be achieved, the Stability and Growth Pact has worked the way it was intended.

However, it has also been suggested that the present uncertain economic situation requires fiscal policy measures in euro area countries that are expansionary in nature. References have been made to the United States and the question has been asked as to why Europe is unable to effect as strong expansionary measures. Many reasons exist that make comparisons with the United States infeasible. Firstly, the expansion of the US public deficit is largely due to an increase in military expenses, which can hardly be regarded as counter-cyclical expansionary economic policy. Furthermore, there was, and still is, substantially more genuine room for manoeuvre in the US economy in this respect. Contrary to the euro area, US public finances were clearly in surplus when the country entered into recession. For demographic reasons alone the outlook for US public finances clearly outweighs that for the euro area. Furthermore, the tax rate is markedly lower in the US in comparison to the euro area, which also gives the United States substantially latitude in taxation.

Finnish economy

If the expected recovery of the world economy begins, the Finnish economy will, without doubt, follow suit. However, forecasts suggest that the growth rate would only return to a 2–3% level.

One trend in which Finland has taken the lead in international comparisons is population ageing. The problem of ageing is not exclusive to Finland, but it has started to manifest itself here exceptionally early. In effect, the increase in labour growth in Finland has virtually come to a halt and is expected to make a downwards turn in the near future. This will inevitably be reflected in all sectors of the Finnish economic policy decision-making.

In the next few decades, population ageing will pressure Finland into increasing spending on its public sector, amounting altogether to some 6% of the GDP. The funds accumulated in the pension scheme cover only one third of these upward pressures. Can the remainder be met with increases in taxation? I doubt it. In fact, there is increased pressure to reduce taxes further in the future.

Another easily distinguishable future trend is tightening competition over the location of companies. Finnish companies are increasingly a part of a global business world with operations in Finland. In such a world the relocation of operations to places where costs can be kept to a minimum becomes the norm. A small, expensive, rapidly ageing and remote country is hardly in the best possible position when an international company is contemplating where to locate operations.

Labour mobility is gradually changing from a theoretical possibility into a reality that shapes economic policy. What kind of prospects does Finland have for succeeding in international competition? Political stability and security, a reliable legal system, a still solid infrastructure and well-educated population are some of the more obvious advantages. A highly educated labour force is able to attract high technology businesses to Finland. However, well-educated Finns may also be tempted to seek jobs outside Finland.

The logic underlying the development of a welfare state is changing. We can no longer presume that we first define the service goals and then adjust taxation accordingly to meet the resulting expenses. It is becoming increasingly clear that the logic is leading us in the opposite direction. The boundaries within which the services of a welfare state have to be accommodated are progressively more determined in two ways: externally on the basis of international competition among companies, and internally on the basis of employment, and through it, the financial base for public sector services. Within these constantly narrowing boundaries the expenses caused by population ageing account for an ever-increasing share.

Finland must be able to compensate for the adverse impact of ageing on the labour force by making more efficient use of labour reserves. According to forecasts, Finland's employment rate seems to be settling at 68% for a prolonged period. This is far from adequate. If employment remains at such a low rate, the entire financial base for the welfare state is certain to disintegrate. It is essential that the employment rate be raised significantly, and 75% can only be regarded as the minimum objective.

On the other hand, we need to take active measures to safeguard Finland's position in the competition over the location of companies. Delayed action in this matter is but a waste of both time and opportunities. We need to respond to the threats affecting the competitive situation of companies before these threats cause permanent damage to our economy. A number of measures have been put forward to achieve these goals, including reforms in taxation, labour markets, social security, education and entrepreneurship.

But, above all, what we also need is consensus on the implementation of these measures. Maybe, over time, that too can be found.