

Erkki Liikanen: Finland, the EMU and the introduction of the euro

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Economic Forum of Hospodarske Noviny Club, Bratislava, 20 October 2006.

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Introduction

Finland joined the euro area among the first eleven countries on 1 January 1999. The EMU and the introduction of the euro marked a major step towards deeper integration within the EU, and viewed from the Finnish perspective, have affected our economy and economic policies in many respects.

In the debate before the introduction of the euro, it was recognised that while the EMU and the euro would bring with them many benefits in terms of economic efficiency, their impact on economic stability was open to dispute.

Finland was different from other potential EMU countries and the question was: Could the single monetary policy be suitable for the Finnish economy?

Firstly, I will walk you through this "asymmetry discussion", which at the time received a great deal of attention, both among economists and a broader audience.

Secondly, I will tell you about the changeover process, including the information campaigns organised by the Bank of Finland and others, as well as about the lessons we learnt from the changeover. Special focus is placed on attitudes and expectations, as measured by various opinion polls.

And finally, I shall conclude by discussing the performance of the Finnish economy during the eight years we have now been in the EMU.

Doubts before the start of the monetary union: macroeconomic stability

Asymmetric shocks

Before we joined the EMU, there was a lively and intensive debate about its pros and cons. It was recognised that the monetary union would bring about many benefits in terms of economic efficiency, such as less uncertainty over exchange rates, lower costs of currency exchange, more price comparability and greater competition, as well as more efficient money and other financial markets.

But opinions were sharply divided as to the impact of the monetary union on economic stability.

Much attention was devoted to the so-called asymmetry of the Finnish economy. While macroeconomic trends in EU countries such as Germany, France and the Benelux countries usually were broadly similar, economic developments in Finland diverged a lot.

There were differences in the both the timing of the fluctuations and the amplitude of the fluctuations, which was much greater in Finland than elsewhere. As the single monetary policy was to be tuned according to the economic situation of the whole euro area, it was feared that the single monetary policy could be inappropriate or even grossly inappropriate for the Finnish economy.

The following reasons were put forward for the asymmetry of the Finnish economy vis-à-vis the other euro countries:

The structure of our production and foreign trade was one-sided. The share of the forest industry in production and exports, although declining, was much larger in Finland than in other European countries. In the 1990s our industry became very technology-intensive, largely as a result of the growth of the mobile phone and network industry. This made the Finnish industry vulnerable to negative developments in the telecom sector.

Only a third of our exports went to the euro area, so Finland was also more vulnerable to disturbances from outside the euro area than the others. There was a particular concern about exchange rate movements: it was feared that the movements of the Swedish krona, the pound sterling and the US dollar vis-à-vis the euro would undermine the competitiveness of the Finnish economy.

A specific asymmetric feature in the Finnish economy was the bilateral trade with the Soviet Union. It enabled Finland to pay its higher oil bill by increasing exports to the Soviet Union. Even after the collapse of the Soviet Union, trade between Finland and Russia has correlated positively with the price of oil.

Deregulation after mid-1980s resulted in a large credit boom and in a rapid increase in asset prices, investment and consumption. The interest costs were deductible in taxation. This together with inflation contributed to low real interest rates.

Monetary policy was tied to defending the exchange rate and while fiscal policy was tightened, it could not prevent the economy from overheating. High inflation and high cost pressures undermined competitiveness and the credibility of the fixed exchange rates.

When monetary policy in Germany was tightened following the reunification of East and West Germany, high real interest rates spread within Europe and the economic climate started to deteriorate. The situation intensified and speculation against the Finnish markka contributed to Finland allowing the markka to float in the autumn of 1992, after protracted resistance.

The rising real interest rates, partly due to the defence of the exchange rate, aggravated the domestic situation. Asset prices and GDP fell strongly while unemployment and the budget deficit increased rapidly. In consequence, Finland suffered a severe banking crisis. Other EMU countries were also in recession in the early 1990s, but the depth of Finland's recession was exceptional.

To summarise, before Finland's entry to the monetary union it was feared that in monetary union our economy would be vulnerable to external shocks and neither the single monetary nor the exchange rate of the euro would respond to these 'asymmetric' country-specific shocks.

The traditional tool used to deal with unfavourable shocks and competitiveness problems, namely the devaluation of the markka, was no longer available in the monetary union. To the opponents of the monetary union, this was the key argument, in particular if our important trading partners Sweden and the UK remained outside the currency union – or at the very least the exchange rate mechanism ERM II – as it in fact happened.

Process of preparing for the euro

Two-phased introduction of the euro to Finland

After this lively debate Finland joined ERM 1996 and introduced the euro with 10 other member states in 1999.

Slovakia and the other new EU countries have also committed themselves to joining the euro area. They all plan to introduce the euro in a "Big Bang", with the changeover to the euro happening overnight.

This was not the case with the first group. The euro was introduced as an account currency in 1999, when the conversion rates of the participating member states' currencies were irrevocably fixed and the euro was substituted for these currencies. Euro banknotes and coins were put into circulation in 2002. The three years between 1999 and 2002 were a transition period, during which euro banknotes and coins were produced and other necessary preparations made.

Finland started practical preparations for the euro almost three years before the first changeover – by establishing an EMU project to draw up a national plan for the euro adoption. The EMU project was led by a committee, which was chaired by the Ministry of Finance. The Bank of Finland and all the other competent authorities participated in the committee. The final changeover plan was published in December 1997. After the changeover in 1999 the EMU project focused on the introduction of the euro notes and coins in 2002.

Opinions and expectations

Ten years ago, in autumn 1996, and two years before the changeover, a half of the EU citizens (51%) supported for the euro and one third (33%) was against. In Finland the situation was much worse: 62% were against the euro, only 29 % supported.

By spring 1998, support in the euro area countries grew to 2/3 of the populations (66%) in the euro countries. Little by little knowledge about the euro rose in Finland as did its acceptance. By August 2001 it was as high as 72%. The euro was more accepted by men and young people than by women and senior citizens.

One reply pattern in the surveys is especially worth mentioning. As late as in December 2001 a third of Finns (34%) had not yet started to study euro prices at all. And an equal share of the Finns considered that learning euro prices was the hardest thing about the changeover.

Today, almost five years later, we can observe that these citizens were right. Learning euro prices was indeed the hardest thing and continues to be so.

Preparing the citizens for the euro

Three major campaigns

When the euro was introduced as an account currency in 1999, a rather limited national campaign was run in Finland. It was managed by the Ministry of Finance and co-financed by the EU.

At the end of 1999, the Ministry of Finance started planning for the cash changeover. It chaired a group of authorities that ran the national campaign. The campaign was financed by the Finnish government and the EU. (1996 to 2002 the campaign budget was seven million euro.)

In the end of 1999, the Bank of Finland initiated information efforts for the cash-changeover and started regular cooperation with the national campaign. (The Bank of Finland spent about two million euro on its own euro information efforts. All in all, the financial resources allocated to the campaigns were quite modest.)

In most of the euro countries a special changeover board was established. It managed and/or supervised all preparations, including a single information campaign for the general public.

In Finland we took a more decentralised approach. There were three separate campaigns – each conducted by authorities with a special emphasis on their field of expertise.

- 1) A national campaign conducted by government authorities and the European Commission.
- 2) A euro area-wide campaign conducted by the European Central Bank and the national central banks of the Eurosystem.
- 3) The Bank of Finland's own campaign.

The joint campaign of the ECB and the NCBs (called Euro 2002 Campaign) concentrated on the banknotes and coins themselves. The Bank of Finland complemented it with a Finnish emphasis, providing training and details of the cash changeover.

The national campaign informed the general public on the changeover process as a whole. It gave general information on the changes in shopping, banking transactions and other everyday-life activities. The national campaign also focused on the most vulnerable groups, such as the elderly, handicapped and immigrants.

The approach of three campaigns had several advantages.

Firstly, the target groups were different. The national campaign aimed at both ordinary citizens and the most vulnerable groups. The European campaign focused on the young and urban people in, whereas the Bank of Finland was most concerned about the elderly and those living in rural communities. Focusing on different target groups also led to a variation in the visual appearance of the campaign material.

Secondly, the tone of the campaigns varied. The European campaign celebrated the euro and welcomed it. The Finnish authorities – knowing the many doubts that the Finns had – decided to choose a neutral approach. The Bank of Finland, for example, advised its advertising agency to give only factual information. The fundamental idea was to reassure Finland's citizens that the introduction of the euro might not necessarily be fun, but it would not be painful either. The key to survival or even success was to know the facts.

Thirdly, keeping the campaigns small and simple meant there was a lot of room for manoeuvre up to the last minute. For example the Bank of Finland received continuous feedback from the public via telephone and adjusted the main focus accordingly. Therefore we were able to address even the most recent questions posed by the public.

Lessons from the campaigns

It is our experience that the general public is more prone to learn from a campaign, if information is presented with familiar words and in a familiar environment, even with some nostalgia. Another key is coordination. All efforts must be carefully coordinated and adjusted. Even if there are several campaigns, they must communicate with a single voice.

Last but not least, the authorities need partners from the private sector. Cash handlers in Finland were trained by the partners of the Bank of Finland. And their trainers were first trained by the Bank. Many companies had a direct stake in the process and they were an excellent information channel. Through them leaflets, posters, videos etc. were delivered exactly to those who most needed them.

Of course we must remember that different nationalities prefer different information channels. For example, Italians watch a lot of TV. Finns also watch television, but they want to learn by reading. Therefore, reaching these people by sending them euro leaflets and brochures proved very effective. According to our survey, the readership level of the brochure we had delivered to every household was an impressive 80%.

Changeover – a success story in Finland and all euro area

Finland's cash changeover was successful

The changeover to euro as an account currency in 1999 went smoothly. Also the introduction of euro banknotes and coins in 2002 proceeded extremely smoothly in Finland, as it did in the rest of the euro area. The speed of the cash changeover was such that Finland was one of the first in the euro area to reach completion.

Essential to the successful introduction was the fact that the various parties involved in maintaining currency supply and the key enterprises had prepared themselves effectively and had trained their staff properly. And there was also a lot of good will from the side of the staff. This was a "once in a lifetime" exercise.

All of the country's ATMs were fully converted to dispense euros within four days. Within a week three quarters of all cash transactions were being carried out in euro. Two weeks after the changeover, the European Commission reported that the changeover was practically complete in five countries: Finland, Germany, Luxembourg, Ireland and the Netherlands. In those countries 95% or more of payments were already made in euro. Finland functioned completely in euro within one month.

According to a survey commissioned by the Bank of Finland at the end of January 2002, 75% of respondents felt that the euro changeover had been simple and easy. Only 15% considered it difficult.

Today – almost five years after the cash changeover

Many Finns were uncertain before the changeover, but most of the citizens now support the euro. According to the Eurobarometer, conducted by the European Commission a year ago, 2/3 (67%) of Finns think that the adoption of the euro was beneficial to them and to the country. Finland was the fourth most positive country in the euro area after Luxembourg, Ireland and Belgium. Finns are more critical to the EU.

Euro – higher prices?

In many euro area countries, citizens say that prices went up with the introduction of the euro. This is a major concern for the countries currently planning the introduction of the euro.

What about Finland, did prices actually rise in our country? Statistics show that there was no notable change in Finnish inflation with the changeover to euro cash. In fact, the rate of increase in consumer prices in 2002 was slightly lower than in 2001. While it is true that many product prices were rounded upward at the time of the changeover, the impact on overall inflation was modest and short-lived.

Statistics Finland estimated the changeover effect on Finnish inflation in January 2002 as small and noticeable mainly in a few services. According to Eurostat, the price-rise effect of the changeover for the whole euro area in 2002 was about 0.1–0.3 percentage points.

Consumers' perceived inflation and CPI inflation in Finland

However, survey results suggest that the consumers' perceived inflation has been considerably higher after the introduction of the Euro. There are similar differences between perceived and actual inflation in many other countries that moved to the Euro.

In a recent report by the Bank of Finland, several possibilities for explanations are proposed for the gap between real and perceived inflation. Firstly, it seems that consumers form their price perception on the basis of much smaller composites of goods and services than those included in the consumer price index.

Secondly, the changeover to euro cash has obscured the comparison of prices, and consumers are now apparently less precise when they follow price developments than before. Sellers' pricing practices have also changed: 'psychological prices', eg those ending in the digits 5–9, now account for a smaller portion of nominal prices as a result of the euro-cash changeover.

Finally, the fact that consumers have generally used an even six and not the exact figure (5.95) as the euro-to-markka conversion coefficient has resulted in a slight (0.9%) overestimation of prices.

The Finnish Consumer Research Centre has also studied the price awareness of the public. The results indicate that consumers' price awareness has diminished with the changeover. Perhaps the most surprising was that price awareness had not essentially improved by 2005, more than three years after the cash changeover.

Finland's experience of the monetary union: evidence and conclusions

We now have almost eight years' experience of the monetary union. Interestingly, many of the asymmetric shocks feared by the opponents to Finland's adoption of the euro have already been realised over this relatively short period.

The telecom industry, which is important for Finland's economy, experienced a strong boom-bust cycle around the turn of the century, and the exchange rate of the euro vis-à-vis the dollar, which is important for Finland's exports, first depreciated nearly 30% and then appreciated 50%.

Moreover, the price of oil has multiplied during the existence of the euro. However, contrary to the opponents' expectations, neither the positive external shock experienced at the turn of the century nor the increase in the price of oil served to push Finland's economy into an inflationary spiral, and the Finnish economy was also able to weather the recession of the telecom industry and the appreciation of the euro rather painlessly.

Eight years is too short a period for a definitive assessment of the pros and cons of a monetary union, but let me draw some tentative conclusions from our experiences thus far.

In spite of these asymmetric shocks, it can be said that the single monetary policy has suited Finland's economy rather well. This is indicated among other things by the fact that, except for the initial period, Finland's inflation has remained for the most time within the range of the ECB's definition for price stability and in fact in recent years has been among the lowest ones in the EU.

At the same time employment and output have grown well in comparison to most of the other euro area countries. On top of which, the profitability of Finland's industry has been at a good level. Our experience seems to indicate that even in a small and 'asymmetric' country the ECB's credible monetary policy and stability orientation can offer a large majority of the citizens and enterprises a sound monetary environment.