

## **Erkki Liikanen: Finland, EMU and euro**

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the International Bankers' Club, Luxembourg, 1 December 2006.

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### **Introduction**

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

In the debate before the euro, it was recognised that the EMU and the euro would bring many benefits in terms of economic efficiency, but its impact on economic stability in Finland 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?

In this presentation, I will walk you through this "asymmetry discussion", which at the time received a great deal of attention in Finland, and then discuss 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**

Before we joined the EMU, there was a lively and intensive debate about its pros and cons. Economic efficiency, benefits, 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, were recognised.

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

On one hand, some believed that the EMU and the single monetary policy could improve the credibility of monetary policy. In so far as the traditional Finnish problem of inflationary pressure and eroding competitiveness was due to insufficient credibility of monetary policy, price stability and competitiveness could be better in EMU than before. It was also expected that interest rates would be more stable - and on average lower - in the monetary union than under autonomous monetary policy.

On the other hand, much attention was devoted to the so-called asymmetry of the Finnish economy. While macroeconomic trends in the core 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 timing of macroeconomic fluctuations, and the amplitude of fluctuations was 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 its stance 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 Finnish production and foreign trade were concentrated in a narrow group of industries. The share of the paper and pulp industries was still large. These industries are prone to cyclical fluctuations in both prices and quantities. In the 1990s the share of ICT industries grew rapidly, largely driven by the success of one company, Nokia. Thereby, the Finnish economy became sensitive to developments in the telecom sector, although this was not fully understood at the time of the "asymmetry debate".

Only one third of our exports went to the euro area, so Finland was also vulnerable to disturbances from other countries. There was a particular concern about exchange rate movements: it was feared that the movements of the US dollar and other currencies vis-à-vis the euro would have a strong effect on the competitiveness of Finnish production.

The traditional tool used to deal with competitiveness problems, 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 even outside the exchange rate mechanism ERM II – as it in fact happened.

The fears of asymmetric shocks were intensified by the still-fresh memory of the exceptionally deep economic and financial crisis suffered by Finland in the early 1990s. The crisis was preceded by an economic boom in the late 1980s driven partly by the liberalization of financial markets. The collapse of trade with the Soviet Union, an increase in interest rates in Europe, and problems of holding on to a fixed exchange rate regime set the scene for an economic depression and a banking crisis. Other EMU countries were also in recession in the early 1990s, but the depth of Finland's recession was exceptional.

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

The final choice to participate in the monetary union was motivated partly by economic, partly by political considerations. It was believed that the benefits of the monetary union in terms of economic efficiency and credible monetary policy would outweigh its costs, including the loss of independent monetary policy.

However, political motives were at least as important as economic motives. Finland wanted to sit around all the tables where decisions were to be made and be part of the 'inner circle', if that kind of club were to emerge inside the EU.

Politically, the decision to participate was not an easy one. Our Nordic neighbours had taken a different course. And originally the public opinion was clearly against participation. In autumn 1996 about half of all EU citizens supported the euro and only one third were against it. But in Finland a big majority, 62% were against the euro, only 29% supported it. As discussions advanced and the government took a clear position, acceptance of the euro started to increase. By 2001 it was as high as 72%.

### **Finland's experience of the monetary union**

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 ICT industry experienced a strong boom-bust cycle around the turn of the century. In Finland the downturn of the cycle was reflected more in growth expectations and asset prices than in production quantities. The Helsinki Stock Exchange price index, which is dominated by the ICT industry, tripled between early 1999 and early 2000, compared with an increase of DJ Euro Stoxx of about 50% over the same period. Thereafter, both indices fell. By early 2003 the decline was about 75% for the Helsinki index and about 60% for the DJ Euro Stoxx.

The exchange rate of the euro vis-à-vis the dollar first depreciated nearly 30% and then appreciated by 50%. Moreover, the price of oil has multiplied during the existence of the euro.

Contrary to the EMU opponents' expectations, neither the positive external shock experienced at the turn of the century nor the initial depreciation of the euro served to push Finland's economy into an inflationary spiral, and the Finnish economy was also able to weather the recession of the ICT industry and the appreciation of the euro rather painlessly.

The Finnish inflation rate, which was brought under control during the inflation targeting regime before EMU, has been broadly in line with the EMU average since 1999. After 2000 it has remained, for the most time, within the range of the ECB's definition for price stability. In recent years, the rate of inflation in Finland has in fact been among the lowest in the whole EU.

The GDP growth in Finland has fluctuated more or less in tandem with the GDP growth of the euro area, but the average rate of growth has been about one percentage point higher in Finland than in the euro area.

### **Factors explaining Finland's macroeconomic performance**

The performance of the Finnish economy reflects both cyclical and structural factors.

Economic growth has returned to normal rates after the crisis of the early 1990s, and the pick-up effect was still felt in output growth in the early years in EMU. Unfortunately, the rate of unemployment is still relatively high, although we are now far from the record levels seen in the early 1990s.

In recent years, demand has increased rapidly outside the euro area, and the Finnish export industry and the whole economy have benefited from the openness of the economy. At the same time, global competition and productivity increases have kept price increases of manufactured export and import goods in check, containing inflationary impulses from strong demand.

Inflation targeting and successful fiscal consolidation together with Finland's entry into the EU in 1995 all contributed to the fact that low inflation had become expected and accepted already before the beginning of EMU. Clear nominal anchor to inflation expectations and increased competition in product markets have contributed to a profound change in price and wage setting behaviour and made possible relatively rapid growth without inflation.

But perhaps I can mention three particular factors, which are related and explain an important part of the growth performance of the last 10 years.

First, there has been, since the 1980s, a consistent commitment by decision makers to foster innovation-driven economy. The successive governments have invested in research and development. The research and development expenditure in Finland is 3.5% of GDP, highest in Europe with Sweden and on the level of the United States. The government pays 1/3 and the private sector 2/3.

An important part of the research has focused on the ICT. Finland and the Finnish companies have also been active participants in EU research programs.

Second, free trade is a prerequisite for growth in a small country. You cannot have companies of important size without it. Competition in domestic markets is also critical. Only a competitive market makes innovation possible. As a small open economy Finland has adopted a pragmatic approach to economic policy issues and often been less resistant to economic reform and deregulation than some of the larger EU countries.

The economic crisis of the early 1990s contributed to the realisation that reforms were needed. Governments of various political coalitions have tried to keep the business climate favourable. The liberalisation of capital markets and the following rapid increase in risk financing gave stimulus to the growth, diversification and internationalisation of the ICT sector and the whole economy.

Third and related factor behind the developments in Finland is the rise of the ICT industry. It explains an important part Finland's rapid productivity growth since the 1990s.

An important milestone in the rise of the ICT cluster was the early liberalisation of the telecommunication sector in Finland, where heightened competition drove prices down and led to mass markets for wireless communication, providing a test laboratory for the equipment industry.

Standardisation among the Nordic countries and in particular the common Nordic NMT standard gave an early start for the internationalisation of the mobile telecommunication industry.

Later GSM standard was a result of a European research and standardisation effort and opening of the telecoms market in Europe gave access to new entrants in telecoms services. And new companies were able to take advantage of these opportunities. And mass market for wireless communications was created in Europe.

So telecom industries and telecom services accelerated the productivity growth.

Here, at the Bankers club, I also want to pay attention to changes in the banking sector. A major restructuring took place after the crisis in early 1990s. The number of the bank employees and branches was reduced to a half. Due to competitive pressure the banks had to change their business models. The earlier IT investments were put in efficient use, new IT and Internet-based services took off. The productivity of the banking sector accelerated and contributed essentially to the Finnish growth performance.

## **On education**

Entering a phase of innovation-driven development has presupposed the interplay of several fundamental factors, including efficient educational system, a consistent and predictable policy

environment, and a sound basic infrastructure. Most of these preconditions were in place before the 1990s.

In particular, the establishment of a comprehensive school system in 1972-75 has helped mobilise human resources effectively in the whole population.

The efficiency of the schooling system has been reflected in the OECD's Programme for International Student Assessments (PISA), which measures the knowledge and skills of 15-year-old students. In the last assessment in 2003, Finland kept its lead place in reading but was now in the top also in sciences and second after Hong Kong in mathematics. Finland's performance in the PISA ratings has often been referred to as an example which shows that it is possible to provide both high quality and equitable learning outcomes.

The share of working age population with higher education is higher in Finland than in other Member States, with the exception of Ireland, even though not as high as in the US. In 2000, 32%, of the total workforce in Finland had achieved tertiary education, while the EU15 average was 24%. Educated labour force has fostered innovation and increased the innovation absorption capacity. Supply of science and technology graduates has helped to maintain the salaries of researchers and engineers in the ITC-cluster moderate, in spite of strong demand.

### **Strong current account and international diversification of investment portfolios**

The growth of the ICT industry is reflected in the current account, which has been in surplus since 1994. The emergence of large current account surpluses is a marked difference with the past.

Besides competitive open sector and strong growth of exports, the current account surpluses reflect a rather subdued growth of domestic demand after the crisis of the early 1990s. The corporate sector adopted a more cautious investment policy line by reducing its debt exposure and increasing its buffer stocks. The general government sector has been in surplus for years.

As a consequence of international diversification of investors' portfolios, non-residents' holdings of shares in the Finnish Stock Exchange rose to over 70% of the total market capitalisation in 2000.

This greatly reduced the exposure of the Finnish economy to the ICT asset price bubble at the turn of the century, as the main ownership risks were born by foreign investors.

### **Prudent fiscal policy**

As to economic policies, after the crisis in the early 1990s there was a clear need to adopt policies which would be compatible with the free movement of capital across national borders. Broad support has developed for stability oriented fiscal policy as a basis for more long-term stable economic development. In line with this, public finances were consolidated. In recent years fiscal policy has been effectively based on explicit policy rules such as spending limits covering the whole electoral term.

As a result of prudent fiscal policies, the general government sector is in surplus. The surplus ratio is on the level of 2–3% and is expected to remain so.

### **Established social dialogue**

Established social dialogue has been helpful in the implementation of some reforms. Recently a major pension reform was agreed between employees, employers and the government. In the reform, which has already been implemented, two early-retirement schemes were abolished. There will be a longevity coefficient linking pensions to life expectancy, and benefits will be calculated on the basis of the whole lifetime income and not the last working years only, as earlier. This has improved the stability of the financing of the pensions, but challenges still remain.

Collective wage agreements play a relatively prominent role in shaping the relationship between employee and employer. The agreements have contributed to relatively moderate wage increases and low inflation while also compressing wage differentials. The challenge for the future is how to retain wage moderation and take into account the productivity differences between industries and firms.

## **Risks and policy challenges**

Needless to say, all is not that rosy and there are significant risks and policy challenges in the horizon.

I will mention just two of them.

First, one concern is the terms of trade, which, in recent years, have deteriorated and according to forecasts will continue to do so. The prices for ICT products are globally falling, due to technology developments and competition. Also the price developments in the forestry sector have been rather weak.

The challenge is to keep productivity growth high and also to add value into our exports.

Second, problems are also mounting on the horizon in public finances as the population is ageing earlier in Finland than in other industrialised countries. This is due to a high baby-boom in 1945-1950. Expenditure on pensions and other welfare services increases as the population ages, and at the same time, the room for financing extra expenditure by rising taxation is limited.

So we have a major challenge to improve the productivity of the public services.

## **Conclusion**

All in all, in its early years, Finnish EMU membership seems to have fulfilled most of its promises and avoided most of its risks. There have been benefits in terms of economic efficiency and monetary policy credibility, as predicted, and there is no evidence that the macroeconomic stability of the economy should have deteriorated, rather the opposite.

In spite of asymmetric shocks, Finland's rate of inflation has been among the lowest in the EU at the same time as its GDP has grown at above the euro area average growth rate. This favourable performance is due to the factors I described. Now it is important to avoid any complacency.