

Erkki Liikanen: Finland, EMU and the euro

Remarks by Mr Erkki Liikanen, Governor of the Bank of Finland, at Norges Bank (Central Bank of Norway), Oslo, 8 May 2009.

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Introduction

A few years ago, the Nobel laureate, economist **George Akerlof** heard that his distant relative had bought a house in **Trondheim** for more than USD 1 million. To him, it was a lot of money anywhere, but particularly a sign of high property values in Scandinavia.

He later told this story to **Robert Shiller**, another well-known economist. Perhaps this was not only a Scandinavian story. They decided to look at it at greater length for the insight it offers into the patterns of booms and busts and notably the twin crises of confidence and crisis that are currently everywhere in the world.

These reflections were recently published as a book by Akerlof and Shiller, "The Animal Spirits". The distant Norwegian relative was the inspiration for a very interesting analysis. This was the first time I have seen a Nordic experience presented as the first sign of the excesses that lead to the boom and bust cycle we are going through today.

In contrast, the Nordic banking crises of the late 1980s and early 1990s and their resolution have, for some time, been part of most major analyses that have aimed at putting the present financial crisis in an historical context. That time, Finland, Norway and Sweden had similar institutional arrangements and shared qualitatively similar experiences. In today's crisis, things are different. Finland is the only Nordic country that has joined the Euro area. It may be interesting to have a brief discussion on how this situation came about and how we in Finland feel about it in the current situation.

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Finland applied for membership of the European Union in March 1992 while the country was experiencing a prolonged bust; in fact, a depression. We concluded negotiations early March in 1994, a few days before **Norway**.

Finland did not ask for any derogation in the Treaty of Maastricht. We joined the EU in 1995 and became part of ERM in 1996. And consequently, in 1999, Finland joined the euro area as one of the founding group of eleven countries.

To pool our currency with 10 others was no small decision. On the political side, it marked a major step towards deeper integration within the EU. On the economic side, it established a whole new framework for the Finnish economy and economic policies.

We have today more than a decade of experience of life as a small member of a large currency union. This decade has spanned a diverse set of economic circumstances. It started with the dotcom boom that soon turned into a bust. Finland was a part of it, due to a significance of her ICT industries.

It continued with the deflation scare, gradual recovery, through the long-rate conundrum, and into the commodities boom. And finally, it turned into the second decade amidst a spectacular, vertigo-inducing collapse of some global financial and trade structures that we started to take for granted.

Even though Finland had not asked for any derogation when joining the EU, the decision to adopt the euro was not without challenges. Initially, there was a lot of scepticism. In 1996 opinion polls put support for the euro below 30 per cent.

But that scepticism soon started to dissipate. Strong political leadership certainly played an important role. Today three quarters of the population consider the euro beneficial to the

Finnish economy, on the whole. Among economists, there are hardly any voices questioning the wisdom of our decision to join the euro.

In this speech I shall try explain how an unpopular currency became popular. I will illuminate our experience from three angles, each of which was present in the debate leading to our eventual decision to join.

The first angle is one of business cycle management. Finland was not really seen as a part of an optimal currency area with the rest of the eleven countries. We had our own, rather idiosyncratic business cycle. Would the common monetary policy exacerbate cyclical volatility in Finland?

The second angle is one of crisis management. At the time when the decision to join was made, Finland's deep depression of the early 1990's was fresh in our memories. At that time, our recovery was aided by a substantial depreciation of the Finnish markka. How would the loss of exchange rate policy affect our ability to survive truly adverse economic circumstances?

The third, and final, angle deals with politics and decision making; to what extent would we have a say on our own fate? Apart from the obvious aspect of shared monetary policy, our membership in the euro area also meant closer cooperation and coordination of fiscal and financial policies and in international fora. Would we be able to find ourselves an active role in the Eurosystem, or become a passive bystander while the bigger players take decisions?

Let me start with business cycle management.

Euro and the business cycle

Before we joined the EMU, there was a lively debate about its pros and cons. It was generally acknowledged that EMU would reduce certain sources of uncertainty. In particular, there would be less exchange rate uncertainty, and also interest rates were expected to be more stable – and, on average, lower. EMU would also bring about microeconomic efficiency benefits such as lower costs of currency exchange, more price comparability and greater competition, as well as deeper, more competitive and more efficient money and other financial markets.

On the other hand, a great deal of attention was devoted to the asymmetry of economic structures in Finland vis-à-vis the rest of the euro area. While macroeconomic trends in the core EU countries such as **Germany**, **France** and the **Benelux** countries usually were broadly similar, economic fluctuations in Finland had historically diverged a lot from the core. Our cycles had had different timing and greater amplitude than other members.

This was due to the specialised structure of the Finnish economy. Production and foreign trade were dominated by a narrow group of industries. A traditional major player was the paper and pulp industry, which had a history of large fluctuations in both prices and quantities.

An increasingly important contribution was also made by the ICT (Information and Communication Technology) industry, the growth of which was largely driven by the success of one company, **Nokia**. The Finnish economy was becoming sensitive to developments in the telecom sector, although this was not yet fully understood at the time of the "asymmetry debate".

Finland stood apart from the euro area also with respect to its geographical trade specialisation. Only one third of our exports went to the euro area, which made Finland particularly vulnerable to disturbances outside the currency union.

Exchange rates were seen as a particular risk: fluctuations in the external value of the euro could have a disproportionately strong effect on Finnish production. This concern was magnified by concerns that **Sweden** and the **UK**, our most important trading partners, might

stay outside the currency union – or even the exchange rate mechanism – as in fact happened.

So, in economic terms, there were cons as well as pros, to joining the currency union, and it was not clear which were more important. The final decision was driven by political considerations at least as much as by economic ones. Membership in the currency union guaranteed Finland a seat at all the tables where decisions were to be made. If an “inner circle” were to emerge inside the EU, Finland would be part of it.

So, Finland joined the ERM in October 1996, and introduced the euro in 1999. What has our experience been over the ten years? To what extent have the fears or the benefits materialised?

Interestingly, many of the asymmetric shocks feared by the opponents to Finland's adoption of the euro have already materialised 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 Helsinki index was about 75% below its peak, compared to about 60% for the DJ Euro Stoxx.

Also Finland saw *large fluctuations in its exchange rates*. The exchange rate of the euro vis-à-vis the dollar first depreciated nearly 30% and then appreciated by 50%.

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 later on, the Finnish economy was also able to weather the recession of the ICT industry and the appreciation of the euro relatively painlessly.

The Finnish inflation rate, which was brought under control during the inflation-targeting regime before joining the EMU, has remained modest. On average, since 2000, Finnish inflation has been within the range of the ECB's definition for price stability and below the euro area average. The GDP growth in Finland has fluctuated more or less in tandem with the euro area, but the average rate of growth has been about one percentage point higher in Finland than in the euro area. Throughout these years, and until very recently, unemployment continued along a steadily declining path.

Why have the asymmetries manifested themselves in such a subdued manner? No doubt part of it was luck. The effects of these asymmetric shocks were, to some extent, mitigated by other coincident factors, such as the success of Finnish exporters on the growing Chinese market.

But I believe structural factors have also been significant, and the euro has been an important factor in bringing about structural change. The single currency, and the commitment to succeed within its constraints, has contributed to a process of transformation, which in turn has changed the Finnish economy in a profound fashion. This change started already before the single currency, but the euro has brought further discipline and helped to sustain the momentum. I will list *a few such structural factors*.

First, wage setting. With no exchange rate policy available to correct mistakes, wage setting must be done responsibly. By and large, and notwithstanding some slippages, this has been the case. At the aggregate level, wage setting has been anchored by low and stable inflation expectations and guided by long-term competitiveness rather than short-term cyclical developments. (The one important exception took place in the wage negotiations of 2007). At the same time, wage flexibility at the microeconomic level is now acknowledged as an important part of a well-functioning market economy.

Second, public finances. Single currency, and the stability and growth pact, has supported the resolve for fiscal consolidation in Finland. Since the turn of the millennium, and until this year, the Finnish public sector has stayed in surplus, all the while bringing tax rates gradually down. This has been an important factor underpinning confidence in the Finnish economy throughout economic fluctuations. Strong emphasis on fiscal discipline is important now, amidst the crisis, and will be even more important in the years to come, given the demographic transformation Finland is entering.

Third, the euro has supported Finland's commitment to making itself into an open and competitive economy. Openness to trade has been recognised as a prerequisite for growth, particularly for a small country. A small country can only exploit economies of scale by specialising, becoming a world player in a few fields, and importing most of the rest. Finland's economic strategy has been geared to this aim. Governments of various political coalitions have sought to keep the business climate favourable. Research and development has been a priority – Finnish R&D expenditure as a share of GDP ranks at the top of Europe, alongside with Sweden. And of course, high-quality education is a crucial part of an innovation-driven society.

Of course the euro alone has not made this happen. But the euro sealed a clear break with the past. It gave us truly independent central banking institutions with an assured orientation to price stability. It sealed our transition from an economy where past mistakes could always be corrected and unprofitable industries propped up by devaluing the currency, to an economy where decisions had to be made for the long term and competitiveness was more about quality and know-how than price.

All in all, the experience so far, in terms of our ability to withstand asymmetric shocks, has been overwhelmingly positive. Instead of accentuating the economic cycle, the euro has in fact proved to be a stabilising factor – an anchor that has helped to make the whole economy more long-term oriented and less prone to cyclical fluctuations.

Let me next move on to the second broad angle, namely crisis management in a currency union.

Euro and crisis management

The world economy is today going through an unprecedented crisis. The crisis is remarkably symmetric: For the large majority of countries, it cuts 5-8 percentage points off their growth rate this year.

*Finland will take a hit comparable to that experienced by other open economies whose production is weighted towards investment goods, such as **Germany, Sweden and Japan.*** Visibility remains very poor but, at this point, we anticipate that the Finnish economy will contract by some 5 per cent this year.

Clearly, the symmetric nature of the crisis has consequences for the role of the exchange rate as a policy tool. An asymmetric shock may change a country's equilibrium exchange rate so that its market exchange rate needs to adapt to restore equilibrium. A symmetric shock, on the other hand, does not change the equilibrium exchange rate. An attempt to compensate for its effects by changing the exchange rate would be merely beggar-thy-neighbour policy and a recipe for trouble on the international front. So, the active use of exchange rate policies would be out of the question.

Norway and Finland are both part of the **Nordic-Baltic Constituency of the IMF and the World Bank.** In this Constituency we have a broad range of different monetary policy regimes as well as floating and fixed exchange rate regimes. Some countries have done well; others have been under considerable stress. For some, independent exchange rate has been unproblematic, for others it has been a source of vulnerability. Right or wrong, for those

experiencing the greatest difficulties, membership in the euro area has become a centrepiece of their strategy out of the crisis.

So, does the euro form a shelter or a straitjacket in this crisis? Put another way, how would the Finnish markka do today, if it still existed? This is a difficult question, not least because this kind of counterfactual analysis is inherently impossible, and I will not pretend to know the answer. But let me just say that we have been happy to sit out the storm within the euro area rather than outside it.

The exchange rate is not a straightforward policy instrument. Although in principle, it may support faster adjustment of real imbalances, experience has shown that it becomes difficult to control precisely when the challenges are greatest. In times of crisis, the exchange rate tends to respond to financial disturbances rather than to real imbalances and, more often than not, it becomes a constraint on policies rather than a useful adjustment channel.

Membership in the euro area eliminates one potential adjustment channel, but above all, it eliminates a major source of uncertainty at times when uncertainty is already high. We are glad to accept that trade-off.

The final viewpoint to euro membership relates to the role of a small national central bank in the decision making process of a large currency union.

Decision making in the Eurosystem: Getting your voice heard

This is one aspect of the single currency that is often misunderstood; what actually is the role of national central banks in the ECB and in the Eurosystem? Over the past ten years we at the Bank of Finland have been asked often why the Bank of Finland still matters. Isn't everything decided in Frankfurt? What is the role of National Central Banks?

How do the ECB and Eurosystem operate? As a result of the Maastricht Treaty and practices established over these ten years, the institutional structure of the Eurosystem is carefully balanced. The hub remains relatively small in comparison to the spokes. In important ways, the Eurosystem remains highly decentralised.

All important decisions are *taken by the Governing Council, which usually meets* in Frankfurt. A large majority of the Council (all but six members of the Executive Board) are governors from National Central Banks.

They sit around the table making decisions in their personal capacity as members of the Governing Council, not as representatives of their countries. They are fully independent in this role as are the members of the European Commission or the European Court of Justice.

But when each of them is also a head of a National Central Bank, it is clear that their staff is deeply involved in preparing all issues on the agenda of the Governing Council meetings. So when the governor takes off to Frankfurt, he is thoroughly prepared and carrying loads of papers and briefing notes in his briefcase.

The single currency has delivered many important benefits, but higher productivity in the making of monetary policy is not one of them. All important decisions are prepared at the ECB *and* in the 16 National Central Banks in parallel.

There is a certain degree of division of labour, but much of that work is done at the same time by all. This is important. It serves as a mechanism of checks and balances. It helps to avoid the pitfalls of "groupthink" – a sort of consensual corporate culture that stifles creativity and critical thinking – and it ensures that relevant viewpoints seldom get neglected. This is a way to guarantee that decision-making is "wisdom-based" as a senior central banker once said.

The ECB always produces its own analysis, and in a way has preferential access to the Council agenda, but the ECB analysis is tested against the analysis prepared in each of the national central banks and the judgment of the members from the Governing Council.

One must also remember that the implementation of monetary policy is decentralised. The National Central Banks are responsible for liquidity operations with their counterparties, which can be any financial institution from an EEA country which has a counterparty status in the country of the NCB. This means that National Central Banks are active in the market every banking day.

Decision making by the Governing Council is supported by a web of ECB expert committees, working groups and task forces where a governor nominates a member. These bodies have no decision making power, but they serve as fora in which some differences can be ironed out and the groundwork laid for the Council. Roughly 80s Bank of Finland officials travel regularly to meetings of such groupings.

Finland is one of the smaller shareholders in the Eurosystem. The Bank of Finland holds less than 1½ per cent of the ECB's subscribed capital. But when it comes to monetary policy decisions, everyone has one voice and one vote around the table. It would be naïve to claim that the size of the country has no effect on the weight of one's voice, but in reality size matter less than one might think. By and large, it is the weight of one's arguments, not the size of the country that is key to influence in the Eurosystem.

What is clear, though, is that a small central bank has fewer resources to devote to preparatory work than a larger central bank. This is why a small central bank must make efficient use of its limited resources. Small size can sometimes be turned into an advantage. Communication is easier in a small organisation, and excess bureaucracy is less of a risk.

A small central bank also must prioritise – it cannot be a jack-of-all-trades. It must decide early on which issues and processes to invest in, pick those issues that matter the most and try to master them thoroughly.

Being influential means following research closely and, if necessary, investing in research of one's own. But it also requires the right attitude, being forward looking and mentally prepared to take an active role. And, of course, it requires constant networking and the ability to listen, not only to lecture.

After ten years of experience as part of the euro area, we at the Bank of Finland do not feel that giving up our own currency has diminished our ability to influence our own fate. On the contrary, we feel that we have managed to establish a role as a decision maker in tables that would be far beyond our reach if we were still managing our own currency. Not all decisions coming out of those tables are to our liking, but this, again, is a trade-off that we are happy to accept.

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I have presented you with three viewpoints to life as a small country with a larger currency area. And from each of these viewpoints, our experience has been a positive one. In terms of cyclical stabilisation, Finland has been able to absorb and adapt to sizeable asymmetric shocks without substantial macroeconomic difficulties. At the same time, leaving exchange rate policies behind has helped Finland develop a structurally stronger economy.

In terms of crisis management, the experience has been equally reassuring. In a financial storm, a big ship with a strong anchor is the place we prefer to be. We do not miss our small, old, boat, even though in that boat, we held the rudder and could, in theory, steer ourselves.

And finally, in terms of decision making, we feel as much in charge of our fate as we ever did before. We have lost one potential policy instrument or adjustment channel, but we have gained a say on issues and at tables in which The Bank of Finland is still very much an organisation with a mission.

All in all, membership in the euro area has served Finland very well so far. This view is widely shared, by the general public as much as by economists. Ten years is still a short time to make a final judgment, so perhaps this should be seen as an interim report. But, given the quite varying challenges thrown at us by this decade, our ride could have been a good deal bumpier. So, at least, I think this qualifies as a good start.