Erkki Liikanen: The enlargement of the euro area 2011 – trust in the future

Introductory statement by Mr Erkki Liikanen, Governor of the Bank of Finland, at the Euro Conference, Tallinn, 20 September 2010.

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Estonia has made an impressive journey over the past two decades. This journey, from the rebirth of the country two decades ago, through rapid economic transition, and now into the heart of Europe, has always been followed keenly on the northern side of the Gulf of Finland.

In my short introductory statement, I would like to offer some observations on that journey and some wishes for the future.

I will try to draw some lessons for other prospective EMU members, but also for the Eurosystem and the EU as a whole.

I make these observations from the vantage point of a close neighbour and long-time friend of Estonia.

Timing

My first observation concerns the choice of timing.

At the same time as Estonia's EMU criteria were being assessed in Brussels and Frankfurt, European bond markets were under considerable strain. There were signs of panic in trading floors, and the financial press was predicting even the breakdown of the Monetary Union.

The reactions were proven, as usual, overblown, and the breakdown predictions badly informed fantasy, but it did all create a rather curious welcome for Estonia into the Monetary Union.

But, in a way, in those hectic weeks the EU showed many of its best qualities. It's institutions were able to take brave decisions when needed as is shown by the establishment of the European Financial Stability Facility (EFSF).

EU also showed the ability to concentrate on Estonia's case on its own merits, undisturbed by the ongoing instability on the financial markets.

Convergence criteria

My second observation is that, although we now have considerable experience in applying the convergence criteria, we still need to work on fine-tuning the way we interpret them.

Examination now puts more weight than before on sustainability – and rightly so. Convergence is not about hitting an admissible combination of economic indicators at one point in time.

But we may still be concentrating too much on the near term. Convergence is about a lasting commitment to sustainable economic policy. It includes commitment to price stability, to sustainable public finances, and to sustainable private sector development.

And, ultimately, it requires the capacity to take the appropriate political decisions when things go wrong.

I think it is this last aspect that in the end made Estonia's admittance relatively smooth. Estonia has shown a remarkable capacity to take difficult political decisions when they are needed.

This, I believe, was widely recognized and respected, and helped pave the way for Estonia to join the Monetary Union. It also bodes well for Estonia's future in EMU.

Boom and bust

My third observation regards another factor that also bodes well for Estonia as part of the euro area: the recent boom and bust episode in this country.

Estonia went through a very classical cycle of low interest rates, easy credit, and unrealistic expectations, which eventually built into a substantial overheating of the economy, and finally a spectacular bust in 2008–2009.

Some countries experienced this as part of the Monetary Union, while Estonia experienced it all by herself.

I am optimistic that the experience will prove to be a vaccination against future financial excesses.

The Finnish depression in the early 1990s resulted in suffering and economic hardship for many, but it also re-established a more cautious economic attitude that resulted in stronger balance sheets, and ultimately a stronger economy.

Finland received a vaccination against financial excesses that has lasted well over a decade. I am optimistic that Estonia will benefit from a similar vaccination, and will emerge from the recession as a stronger economy.

Only the beginning

My fourth observation is that this is only the beginning.

A lot is going on inside the euro area and the Eurosystem. Economic policy coordination is being given much greater traction than before.

In particular, the crisis has shown that a group of countries with a common currency and highly interconnected banking sectors have a great deal of interest in each others' public finances.

How each country chooses to allocate its public expenditure remains mostly its own business. But how a country finances its public expenditure must be a matter of common interest to a much greater degree than we were willing to acknowledge in the past.

Enhanced economic governance, including the European Semester, creates a framework for ensuring that budgetary policies take into account the common European interest. I trust Estonia will be a like-minded partner for all of us who will ensure that this framework will work as intended.

I am also looking forward to working with the Governor of Eesti Pank on the European Systemic Risk Board that will be established as of the beginning of next year.

We have high expectations for this new body. The financial crisis showed that there is a considerable gap between microprudential supervision and monetary policy.

We need stronger policy instruments to tackle fluctuations in the credit cycle, the pricing of risk and systemic risk.

I also believe that such policy instruments must be able to operate at the cross-border level since, in today's financial markets, systemic risk propagates very quickly across national boundaries.

The European Systemic Risk Board (ESRB) is well placed to take the primary responsibility for controlling systemic risk in Europe. It will have the expertise, access to relevant information and close cooperation with central banks and financial supervisors. What it may still need is more effective instruments to deal with systemic risk.

The first couple of years will be a critical in establishing the ESRB's precise institutional role and operational modalities.

The ESRB will no doubt face challenges, and the risk of institutional turf wars is real – particularly with strong national supervisors. But we need to be ambitious and provide the ESRB with sufficient powers to do its job.

Again, I hope we can work together with Estonia also on this issue.

Finland and the euro

Finally, a few remarks on our own experiences from being a member of the Economic and Monetary Union from the very beginning.

As in other countries, there was intensive debate in Finland on the pros and cons of the EMU membership before the final decisions were taken in May 1998. Not surprisingly, opinions at that time were widely divided.

Much attention was devoted to the possibility of "asymmetric shocks". The Finnish economy was judged to be structurally different from those of the so called core European countries, such as Germany, France and the Benelux countries.

The sceptics believed the economic stability of Finland was likely to suffer if economic development were too "asymmetric" vis-à-vis the core countries.

There were good historical reasons for this early scepticism. The structure of the Finnish economy had been one-sided. The share of forest-based industries in industrial production and exports, although declining, was much larger than in other European countries.

Only one-third of Finland's exports went to the prospective euro area countries, implying that the country was likely to be more vulnerable than others to shocks coming from outside the euro area.

There was also a particular concern about exchange rate movements. Especially, there were fears that the movements in the Swedish krona, the pound sterling and the US dollar vis-à-vis the euro would undermine the competitiveness of the Finnish economy.

After 12 years in EMU it should be possible to draw at least preliminary conclusions about whether these fears were justified or not.

Firstly, we did face an "asymmetric" shock at the very beginning of the Monetary Union. However, contrary to the pre-EMU fears, this shock turned out to be a positive shock, not a negative one. In 1998–2000, Finland was surfing on the wave of the ICT boom.

In normal circumstances this would have called for real appreciation of the currency, either in the form of nominal appreciation or accelerating inflation. Neither of these happened. In retrospect, it seems that membership of EMU, in fact, had a stabilising effect on the economy in the face of an "asymmetric" shock.

The current global crisis hit the Finnish economy more severely than other euro area countries. GDP dropped by 8% in 2009, the biggest decline since 1918.

In the course of two decades Finland had become increasingly specialized in the production of capital goods and ICT products. When global investment activity collapsed together with world trade, Finnish exports and industrial production dropped by one third.

Normally, a sharp decline in exports and industrial production would have been followed by a sizable decline in private consumption as disposable income diminished and the risk of unemployment increased. None of these developments occurred.

Consumer confidence was held up by low interest rates, the feared collapse in construction activity did not materialize, the rise in unemployment proved to be far less than forecast.

Three additional factors contributed to this relatively favourable outcome.

Firstly, government finances were initially in good shape. As a result, risk premia remained low, despite significant deterioration in the fiscal balance.

Secondly, the banking sector remained in a strong position throughout the cycle. It seems that the vaccination against extravagancies obtained during the banking crisis of the early 1990s was still effective 15 years later.

Thirdly, house price increases remained relatively moderate, at least compared with most other euro area countries and, indeed, most other OECD countries. The avoidance of a house price decline helped stabilize the economy during the downturn.

Please, do not misunderstand me. My intention is not to be complacent on the Finnish economy and economic policy in Finland. Membership of EMU and good policy explain only a part of the relatively good performance of the Finnish economy since the introduction of the euro.

Good luck explains an important part as well. Had the ICT boom lasted two more years at the beginning of the past decade, it is very likely that serious imbalances would have developed in the Finnish economy.

Had the global investment boom, which "asymmetrically" strongly favoured Finnish exporters, lasted two more years in the latter half of the decade, we would probably have seen wage inflation accelerate and a house price bubble emerge in Finland, too.

The bottom line

The bottom line of these remarks is that membership in the Monetary Union has had a stabilizing effect on the Finnish economy over the past 12 years. However, membership in itself does not guarantee stability and growth.

What economic policy could and should do, both inside and outside the Monetary Union, is to prevent the emergence of excessive indebtedness in both the public and the private sector, and the development of asset price bubbles.

On both sides of the Gulf of Finland, we know from experience that this is not an easy task.