Erkki Liikanen: The country that paid its debt, became an early member of the IMF, and joined the EU

Speech by Mr Erkki Liikanen, Governor of the Bank of Finland, at the 15th Maple Leaf and Eagle Conference, University of Helsinki, Helsinki, 13 May 2014.

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Ladies and gentlemen,

It is a great honor for me to be here today at the 15th Maple Leaf and Eagle Conference at the University of Helsinki.

As Governor of the Bank of Finland I have the good fortune to meet a lot of interesting colleagues from other central banks, both from Europe and other continents. Transatlantic contacts are also close. When the Bank of Finland, an old institution, organized its 200th Anniversary Conference in 2011, we had many prominent speakers.

Let me name just two of them, who both recently have taken up new duties. Janet Yellen, then vice-chair and now chair of the US Federal Reserve, while Mark Carney has moved from being Governor of Bank of Canada to Governor of the Bank of England.

Conferences are however not the most typical forum for central bankers to convene. Normally we meet bimonthly at the regular meetings of the Bank for International Settlements in Basel, Switzerland, and twice a year under the auspices of the International Monetary Fund, Washington DC.

Personal contacts are in my opinion of utmost importance, especially since the beginning of the global financial crisis in 2007 / 2008. While the crisis has brought many disappointments, international cooperation among central bankers has been vital and has worked beyond expectations. One lesson we have learned is that a financial crisis spreads rapidly from one continent to another. We are all interconnected and even more interdependent than we understood before the crisis. In this sense the theme for you conference, North America in the World, and the World in North America, is more than appropriate.

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Today’s speech I will raise three central themes that have to do with Finland’s transatlantic relations, in a historic perspective.

Firstly, Finland was the only country to fully serve its debt to the United States after World War I. It gave our country a good reputation that is remembered still today. But what was it all about? And what can we and other countries learn from this experience?

Secondly, Finland became a member of the International Monetary Fund and the World Bank as early as in January 1948. How was that possible, when Finland’s international position was so weak in the Cold War environment that we could not join the Marshall Plan and could not even join the U.N. until 1955. And even when Sweden became a member of the IMF as late as 1951?

Thirdly, the North American contribution was strong when European integration was promoted after World War II. The traditional rivalry between France and Germany had to be contained, and the West had to stand united in the ideological battle with the Eastern bloc. Finland very much stood at the sidelines when the Coal and Steel Community and later the European Economic Community, the EEC, was founded. Our economic relations with Western Europe were handled though the European Free Trade Association, EFTA. In the 1970s relations were deepened via a free trade agreement with the EEC, but it took until 1995 before Finland could join the European Union as a full member.

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In the inter-war period international economic relations were complicated. Almost every European country was in debt to the United States for loans used to finance World War I and subsequent reconstruction. The newly independent Finland for its part had received a food loan from the US in 1919. Germany, on the other hand, owed reparation debts to the winning countries according to the Versailles Peace Treaty.

Several international conferences were held in the 1920s in order to resolve these international debt relations, and several plans were agreed, and institutions established, for example, the Bank for International Settlements. However, the debt situation was not progressing well.

In 1931, US President Herbert Hoover granted the European debtor countries a year-long moratorium as part of an arrangement of international economic relations related to the Great Depression. The intention of the moratorium was to postpone repayment of the debt by one year. The Moratorium did not mean the pardoning of debts, only their postponement. Payments to the US were to start again in December 1932.

Meanwhile, the European states decided to radically cut down the amount of reparations debts that Germany had to pay. Britain and France did this in the interest of world economic recovery – remember that we were in the middle of deep international depression – and the leadership in London and Paris were also aware of the totalitarian threat in Europe, especially in Germany. The Americans, however, were not willing at that point to write off their loans to Europe.

The outcome was that every other country except Finland took the Hoover moratorium to mean a pardon and left their debt to the US unpaid from 1933 onwards. Thereby, Finland became the United States' only debtor country that continued to pay its debt until the end – and this is why Finland got its reputation as an uniquely reliable debtor.

But why did Finland continue to serve its debt? It was not a mistake, but a conscious means to improve Finland's reputation. In the 1920s, Finland had, indeed, the reputation of a bad debt payer. That was the result of a law issued in 1921 providing for the loan taken from France at the beginning of the 1920s to be paid back in Finnish markka.

Since the markka was suffering from a strong inflation at the time, France ended up losing a significant amount of money – at least in terms of gold. This pleased neither France nor the international financial markets. Officers in our Foreign Ministry were aware of the problems regarding reputation, and tried to find a way to mend it.

Their hopes were fully satisfied when the US press paid a great deal of attention to Finland's being one of only a few nations (and finally the only one) to continue its repayments.

Between 1933 and 1936, almost 3,000 stories were published in American newspapers on Finland and the debt. Finland was portrayed as a small northern country that gives the shirt off its back, while its richer neighbors leave their debts unpaid.

The Governor of the Bank of Finland, Mr Risto Ryti, visited the US in December 1934 and gave a widely quoted interview to the Associated Press, in which he said that Finland could do nothing less: "It is only natural that we should. We signed the contract. We promised to pay. It is the only honest thing to do."

Indeed paying back the debt was maybe the best promotion campaign ever for Finland – and furthermore it was not expensive. The size of the debt as a percentage of Finland's GDP was small, and its share of the US total receivables from Europe was actually negligible.

The huge attention paid to the matter in the American media was perhaps a bit out of proportion. But there was a principle at stake. The reason for the US media's strong reaction was the Great Depression and the rage felt by American taxpayers against countries not paying their debts.

Finland continued to meet regular instalments until the 1940s, when a few years' moratorium was called because of World War II. At that time, Finnish and US authorities also discussed whether it would be possible to invest the money repaid by Finland into something that would benefit Finland. This aim was met through the ASLA grant fund and Fulbright Centre established at the beginning of the 1950s. The last payment on the debt was made in accordance with a renewed, faster schedule in 1976.

There is a lesson to be learned from the episode with "The country that paid its debt". The lesson is that it is worthwhile for a small country to uphold its good reputation. The credit worthiness of a nation, however, is only partly based on history. Fundamentals matter at least as much. Finland's high international credit rating (AAA) is based on us having our own house in order, having a sound economy, and public finances in good health. These are objectives worth pursuing also for their own sake. The kite mark of a good credit rating is important, but not the only reason to behave responsibly.

History might help, but it is the decisions of today that determine our financing costs of tomorrow.

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Creditworthiness was also an important consideration when Finland became a member of the International Monetary Fund and the World Bank in January 1948.

Finland's international position was extremely difficult in the first years after World War II, not only economically but also politically. Our relations with the allied countries were prescribed by the interim peace treaty signed on 19 September 1944.

The government was overseen by an Allied Control Commission dominated by the Soviet Union and relations with the Great Powers were still unsettled. This also had economic implications. The subject of Finnish creditworthiness was dominated by doubts about whether Finland could manage the reparations demanded by the Soviet Union and there were also fears for Finland's internal political stability.

There was a severe lack of capital in Finland. In 1946 the Americans did not want to lend money to Finland as long as peace negotiations had not been concluded and, in particular, that the size of war reparations to be paid by Finland to the Soviet Union was unknown.

Understandably, Washington did not want to lend money to Finland that eventually would go to Moscow. When a Finnish mission wanted to travel to the US to obtain credit for the purchase of American goods, it was met by a telegram from the State Department saying: "The visit of the proposed delegation most undesirable. Should be postponed indefinitely."

The difficulty – if not outright impossibility – of obtaining a loan directly from the US administration moved the focus of debate towards joining the International Monetary Fund and the World Bank.

President J.K. Paasikivi met the US ambassador Maxwell Hamilton in Helsinki in September 1946 to discuss the situation after the US refusal to consider more loans. Hamilton proposed that Finland should seek credit at the World Bank. Paasikivi replied that Finland would indeed apply for membership in the IMF and the World Bank as soon as the peace treaty had been concluded.

Paasikivi anticipated that, after signing the peace treaty, Finland would first enter the United Nations and only then apply for membership of the "International Bank" as the World Bank was called at the time.

The marching order that Paasikivi proposed to Hamilton – first the peace treaty, then the UN, finally the IMF – became quickly obsolete, as it was decided that Italy could be accepted as a member of the organizations although its peace treaty had not been signed. Finland was then able to follow the precedence sat by Italy.

Joining the IMF and the World Bank were economically appealing to Finland but fraught with political consequences. The dominant economic motivation at the time was to obtain dollar loans. Opting out of Marshall aid in the summer of 1947 intensified Finland's need for foreign currency in the form of credit. Politically the IMF and the World Bank also offered a way to bolster Finland's international standing.

However, as the end of the 1940s approached, the Soviet Union grew ever more suspicious of the western orientation of these organizations and the United States' de facto leadership of them.

Finland became the 46th member of the IMF in early 1948, after the parliament in Helsinki had approved the agreements on 13 December 1947. At the time the Soviet Union still had not completely turned against the Bretton Woods sisters, and Poland and Czechoslovakia were members of the organizations.

Finland was put together with these two countries in an East European constituency. Only a couple of years later this group of countries broke up when first Poland and then Czechoslovakia left the IMF amid the worsening Cold War. Finland however remained in the IMF and later, when Sweden finally joined, a Nordic constituency was formed.

Membership of the Bretton Woods system can be regarded as one of the most far-reaching decisions that Finland took in trade and the entire field of foreign policy in the decades after World War II. Membership of the IMF was one great step on the path the country chose in its international economic relations.

The most tangible consequence of the IMF was the commitment to a process that made the Finnish markka externally convertible. Another part of the same package was membership of GATT (General Agreement on Tariffs and Trade), which meant a reduction in tariff barriers and a commitment to implementing the principles of free trade.

The impact of membership of these global economic organizations was not restricted to foreign trade alone but had a deep influence on the whole of Finnish society. A convertible currency and diminishing customs barriers gradually brought Finnish prices in line with international markets.

The gradual deregulation of foreign trade initiated a major restructuring of Finnish industry and focused the nation's efforts on improving national productivity and competitiveness. Together with later steps towards free trade, they transformed Finland into a modern industrialized country, and made it possible to raise Finnish living standards to the western European level.

In view of Finland's position as a country defeated in the war, its membership of the IMF came at a relatively early time. Neutral Sweden delayed its application for a long time and joined the Bretton Woods institutions a full three years after Finland. But they could afford being out better than Finland could.

Finland joined the IMF while the fund still had relations with the Soviet bloc. The relations broke off by the end of the 1940's. Whether Soviet objections would have prevented Finland's membership if its application had been delayed is hypothetical, but cannot be ruled out.

From the perspective of Finland's reputation in the world, and very much in the eyes of our Northern American friends, it was a definitive plus to be a member of club of market economies. Part of a country's reputation is based on your reference group, and for Finland, it was the IMF and the Nordic constituency.

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Let me now turn to my third and final theme, the European integration project. Again for reasons of foreign policy, Finland had to remain outside the Organization for European Economic Cooperation, which was founded to channel Marshall aid to the participating states in Europe. It was only 1in 1969 that Finland joined the OECD, the successor organization of the OEEC.

Not receiving Marshall aid constituted a heavy economic loss for Finland. While for example Norway and Denmark received, in various forms 255 and 273 million dollars respectively, Finland had to pay even higher war reparations to the Soviet Union.

It is important to remember that the American administration explicitly wanted to promote cooperation between the former enemies in Europe. One should not underestimate the stimulus given by the US to the project of European integration. There were even secret funds from the American intelligence community that were channeled to different form of organizations working for European unity.

In the late 1940s there really was a lot of integration projects that started without Finland taking part; for instance the projected European Customs Union, the Nordic Customs Union and the European Payments Union, to name but some examples.

The official Finland did not react at all to the emergence of the Council of Europe. In the early 1950s the other Nordic countries established permanent delegations at the European Coal and Steel Community – the forerunner to the EEC – but for Finland this option was unthinkable.

For the general position of Finland, Stalin’s death in 1953 and the more responsive attitude of the regimes that followed, gave Finland more room for maneuver in our Western relations. In 1955 Finland became a member both of the Nordic Council and of the United Nations.

The absence of Finland from the early phases of the economic and political integration in Europe made it even more important that the country had managed to become a member of the IMF and the World Bank, as well as of the GATT agreement.

For Finland it was extremely important when it came to foreign trade policy that the export markets in the West remained open. Finnish industry competed with among other – and foremost – Swedish companies. During the whole period of the Cold War Finland was able to gain more or less the same benefits as the Swedes when it came to opening up of export markets.

Finland also stayed on the same footing with Sweden through the EEC free trade agreement in the early 70s.

The 1975 Helsinki summit of the Conference on Security and Co-operation in Europe – with both Canada and the US taking part – had in the long run the somehow unintended consequence that it helped to undermine the legitimacy of the Eastern bloc.

In 1989 the new dynamic president of the European Commission, Jacques Delors, proposed that the EC relationship with European states like Austria and Sweden should be managed through an agreement called the European Economic Area. The Berlin wall came down the same year. For Finland it was important to safeguard its commercial interests. Finland joined the EEA negotiations, but the train was moving rapidly. First Austria and then also Sweden applied for full membership in the European community.

In the Maastricht EC summit of December 1991 European leaders contemplated the possibility of opening membership negotiations with Austria and Sweden, leaving Finland (and also Norway) behind. This was a possibility that president Mauno Koivisto and others in Helsinki very much wanted to avoid. The Soviet Union collapsed in the end of 1991 and in March 1992 Finland was ready to apply for membership in the EC.

Finland joined the EU together with Sweden and Austria 1 January 1995.

By next year end Finland has been a member of the EU for 20 years. One of the most significant achievements in European integration over these years has been the single currency. Finland was in the first group of countries to join the monetary union. In my assessment, the decision was a good one. Finland has enjoyed unprecedented price and financial stability during its participation in the single currency.

Even though the monetary union has been under severe strain due to the imbalances in some of the member countries, as we know, the Finnish money markets have been calm. Thanks to that, the negative impact of the “Great Recession” of the last years hit Finland mainly through export markets, and the financial conditions have remained supportive to growth. Finland has a serious structural challenge in our industry, but it not related to the financial crisis or economic and monetary union.

The next step in Finland’s participation in transatlantic economic integration is already under preparation. I am referring to the negotiations on a trade agreement between the EU and the US, under the rubric of Transatlantic Trade and Investment Partnership. As you will know, the negotiations were begun last summer. The agreement, if successfully completed, holds a great promise for boosting growth in an area which covers roughly a half of global economic output.

For Finland, the key issues include enhanced market access in goods, services and public procurement; facilitation of customs procedures; and reduction of technical barriers to trade. There are several high tech industries in Finland which could benefit from lowering of transatlantic trade barriers.

A central banker will pay special attention to banks and the rest of the financial services industry. It is not yet fully clear to what extent the Transatlantic Trade and Investment Partnership will cover the financial services sector. It has been argued that the negotiations provide an opportunity for promoting regulatory convergence. That is an important goal. On the other hand, both the EU and the US are reluctant to surrender their autonomy in the area of prudential regulation. Also, effective regulatory coordination at the global level is already taking place at a less binding level at the BIS.

The large economies of the world have all worked extremely hard over the last years to reform their banking regulation. One even speaks of a “Regulatory Tsunami.” I have myself been part of that effort by chairing the working group that proposed a reform of banking structures in the EU.

Thinking about all the work that has been done in order to reform banking regulation on both sides of the Atlantic, it would be unfortunate if the regulations would turn out to be ineffective due to international loopholes of regulatory arbitrage. Therefore, regulatory convergence should definitely remain on the agenda. It is perhaps less important what forms and forums are used to advance it.

Thank you very much for your attention!