

From Financial Crisis to Monetary Union in Six Years Lessons from the Finnish Experience in Joining the Euro Area

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By the end of 1992 Finland had seen its GDP fall by around 14% in just two years. Unemployment rose from 4% in 1989 to a peak of over 20% and a shift into non-employment made the actual position even worse. A banking crisis meant that the government had to put funds amounting to over 17% of GDP into the banking system to keep it viable even after some drastic mergers. The current account was in deficit to the tune of 6% of GDP and the exchange rate link to the ERM had had to be broken and a depreciation of over 20% ensued. The size of the decline was worse than that endured in the Great Depression of 1929.

Yet Finland qualified for membership of Stage 3 of Economic and Monetary Union by mid-1998 and was one of the three countries with the best inflation performance to which the other aspirants had to converge. Finnish GDP has now regained the growth path of the years before 1989, which is itself faster than the Euro area average. Inflation is the Euro area average and the banking system is now well capitalised, profitable and prudently managed. There is a massive trade surplus, the government is running a surplus and the debt to GDP ratio, already well below the critical 60% level, is falling rapidly. The one serious blot on the landscape is that unemployment remains slightly above the Euro area average and even on optimistic forecasts employment and unemployment rates will not return to their pre-crisis levels until the last part of this decade.

This is an extraordinary turnaround in just six years. Indeed since the Maastricht convergence criteria required a period of two years' convergence prior to mid-1998, it is clear that the recovery in the nominal economy was even faster. Both the bad management and bad luck that led to the crisis and the good management and good luck that have helped Finland recover so well have been well documented and will not be reiterated here. In drawing lessons for the present applicant countries to the EU it is, however, important to bear in mind that before the crisis the Finnish economy had already built much of the infrastructure for the current performance, in terms of the built infrastructure, business services and above all the investment in human capital. Indeed had macroeconomic management been better and the process of financial deregulation been organised to what were even then the best international standards, the collapse of the former Soviet Union could probably have been weathered with only a limited recession. Trade with the FSU was 15% of the total and the industries involved with that trade needed major restructuring in order to be able to compete openly.

Such speculations, while entertaining, are not necessarily of great value. However, it is worth reflecting that it has been widely argued that without a crisis and severe problems the motivation for drastic restructuring would have been absent. While the unemployment and GDP costs could have been much smaller, there might have been much less stimulus for Nokia to restructure so that it could become the success story it has. The dynamism across the whole of the private and public sectors could have been much less and changes needed for successful entry to Stage 3 of EMU, such

as the breaking of Finland's traditional cycle of excess wage growth and subsequent devaluation, might have been deferred. The point of labouring this hypothetical debate is that a regime change was needed to get to the current position. Crises not only force regime changes but they also provide the willingness to accept the difficulties that are inherent in such a change. In order to get the general gain there will be some losers, particularly in the short run and that will be difficult both socially and politically. In the Finnish case it is socially difficult in the long run as well.

In my remarks I want to focus on just one part of the regime change, namely, that for monetary policy, although I shall make two supporting comments about fiscal policy and financial supervision as essential ingredients for the success of monetary policy.

The key issues for monetary policy in the context of this conference are threefold. First, trying to track the Exchange Rate Mechanism of the European Monetary System contributed to the crisis. Second, the adoption of inflation targeting was a key feature of the subsequent success. Lastly, the existence of the prospect of first EU membership and second Euro area membership were crucial. To put these three ingredients in their simplest terms:

- Early action to prevent the bubble economy expanding in the way it did would have involved a monetary tightening. That would have resulted in the exchange rate breaking through the top of its band with respect to the ERM. The Bank of Finland was well aware of this dilemma and was advocating action publicly a year before it was actually able to act. Note of course that the Bank of Finland was not independent in that period and could not deviate from the government's exchange rate targeting strategy, although it could and did point out the problems that entailed.
- Once the exchange rate anchor was removed, something credible had to replace it. Re-establishing the exchange rate anchor at the new lower level would not have been a plausible as a longer-term strategy. The Bank needed to focus directly on the primary task of maintaining price stability. The low exchange rate was needed to improve the competitiveness of Finnish industry and generate the growth necessary for restructuring in the private sector. In order to establish that the mistakes of the past were definitely in the past the Bank needed to adopt a regime, which was not just clearly capable of succeeding, but where there would be a lot to lose from reneging. Inflation targeting offers that, with its need to have a clear target, a fully spelt out forward-looking strategy of how to achieve it and transparent decision-making along the way to show that the policy is indeed being followed. As a result price expectations were rapidly refocused on inflation of 2% (or less) and the target achieved.
- Finland's strong and obvious commitment first to EU and then EMU membership meant that the risk premium to which it would otherwise have been subjected as a small open economy was rapidly diminished. Finland was able to converge rapidly to German nominal interest rates once the recovery was well under way. Thus simultaneously there was the advantage in inflation terms as the exchange rate rose towards its longer-run equilibrium levels and the advantage for investment from lower interest rates so that the economy could keep growing at an average of 5% in real terms for a period of over six years.

There was thus a sequence of regimes. Holding to an exchange rate peg that becomes implausible will lead to the inevitable sharp and unpleasant adjustment.

Re-establishing credibility rapidly involves adopting a regime that imposes strong conditions on the central bank (and on the government). Being able to cope with rapid structural change without inflation requires very considerable flexibility in relative prices. Achieving that in the Finnish case with movements only in the real and not the nominal exchange rate would have been very difficult. The prospect of EU and EMU membership is itself a factor making convergence easier for smaller and hitherto inflation-prone countries, as credibility is acquired from the future regime. However, timing is crucial. It is fortunate that commencement of Stage 3 at the first date of 1997 was not really a prospect.

However, the appropriateness of the monetary regime and indeed the success of the outcome went hand in hand with the reaction of the fiscal authorities. As the government was committed to both EU and EMU membership, it ensured that the budget deficit was brought under control without breaching the 60% Maastricht debt ratio, despite having to make substantial cuts in the social protection system that is a cornerstone of the Finnish social balance. It also gave the Bank the necessary independence for credibility. As in so many examples, financial stability and price stability were interlinked. Regaining financial stability also entailed a regime change, bringing it within the ambit of the central bank, rather than the reverse move, which is becoming more common recently.