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Monetary Policy in Finland: The Last Ten Years

By Mauno Koivisto, Helsinki

I. The Policy Strategy

During the past ten years an attempt has been made to break away from the spiral of continuing inflation and devaluation which has plagued the Finnish economy throughout the post-war period. The policy designed to achieve this goal has rested on three main pillars: (1) a large devaluation in 1967 coupled with a comprehensive stabilization programme and growth-promoting measures intended to restore competitiveness and promote further diversification of production, (2) the development and utilization of active counter-cyclical policy weapons to reduce fluctuations in demand, and (3) the use of monetary and exchange rate policy to undercut the expectational basis of the inflation-devaluation spiral.

The fundamental causes of Finland's inflation and recurrent balance-of-payments problems can be seen to be concentration of exports and production in a fairly narrow range of goods whose prices are unusually volatile, and general resistance to changes in relative prices, relative wages and relative incomes. Given this diagnosis, it is natural that monetary restraint has not been the sole measure used in the attempt to eliminate these difficulties but that it has been part and parcel of a larger strategy designed both to achieve structural stability by promoting diversification and to reduce cyclical fluctuations by evening out variations in demand.

1. Causes and Consequences

This strategy can best be understood if the course of a typical inflation-devaluation cycle in Finland is examined. Buoyancy in demand for forest industry products leads to growing income in Finland's main export industries and in turn to increased forestry income and corporate profits. Subsequently, wage claims swell in part because of the desire of workers to share in the success of the export industries and in part

because of higher import prices, which often accompany an upswing in demand in foreign markets. Employers' resistance to demands for wage increases is often at a nadir in this phase of the cycle because capacity utilization and profits are high, factors which in turn produce growing investment demand.

Workers in sectors where the export upswing has had no direct impact on output also increase their wage claims in order to maintain differentials, which adds to inflation. Eventually both cost and demand pressures cause the current account deficit to grow. At first this poses no problem because the high expected return on investment makes it feasible to borrow abroad, but after some time rising costs reduce export competitiveness, cut profits and raise unemployment. To deal with these problems supply-promoting, demand-reducing or demand-switching policies are frequently adopted, with the latter generally being treated as a last resort.

The reasons why it is desirable to escape the syndrome of inflation, balance-of-payments difficulties and devaluation are common to all countries. Their weight, however, varies from one country to the next. For example, unlike many other countries, Finland does not experience a large shift in sectoral income when a rise in the rate of inflation causes the real rate of interest to turn negative.

The "cost" of inflation to the public sector, which traditionally has run a financial surplus, is offset by the progressivity of direct taxes which constitute an important source of government revenue, and the "cost" to the household sector, another traditional surplus sector, is offset in part by the fact that the pensions and other social transfers are either index-linked or adjusted regularly. The "benefit" to the corporate sector, the main deficit sector, is offset in part by the fact that inflation reduces corporate profitability in an open country where a stable exchange rate policy is pursued and where many important export prices are given exogenously either because of cartel pricing or because of long-term contracts.

It is of course true that the absence of large inflation-induced changes in the sectoral distribution of income does not preclude the existence of important inter-personal and intra-sectoral effects (e. g., large firms tend to borrow more extensively and thus to benefit more than small ones), but on the whole the income distribution effects are probably rather modest in Finland. The various compensatory mechanisms tend

to aggravate inflation and at the same time may explain why resistance to rising prices is not greater.

A rise in the long-term expected rate of increase of wages in conditions where profit expectations are still strong causes entrepreneurs to substitute capital for labour. While this may have the advantage of ensuring that the most up-to-date technology is employed, it is not at all certain whether such a shift, occurring as it does for reasons unrelated to the scarcity of real resources, will produce a pattern of relative prices in keeping with the long-term scarcity of labour and capital. However, the fact that the bulk of the financial flows go through oligopolistically-competing financial institutions which operate in a setting where the nominal rate is rigid means that many factors other than the simple interest rate return affect the allocation of finance and thus, indirectly and partially, the allocation of physical capital.

The third consequence of the inflation-devaluation spiral is reduced efficiency resulting from the large swings in economic activity which lead to step-like increases in capacity and large fluctuations in utilization. The major swings in activity are due to both the fluctuations in output occurring because of the one-sided structure of exports and attempts to reduce balance-of-payments deficits by restraining domestic demand. If the swings in capacity creation and capacity utilization could be evened out, the overall capacity utilization rate could be increased substantially. Even a fairly small improvement in this sphere could lead to quite substantial increases in the social and private rate of return on capital.

2. Policy Alternatives

When the rate of inflation is faster than in competitor countries, policy-makers are confronted with a difficult set of choices, all related to the balance of payments. First, they can attempt to maintain competitiveness, output and employment by attempting to switch demand from non-tradeables to tradeables by altering the actual or effective exchange rate. This entails the risk of a further acceleration in the rate of inflation and exacerbation of the problems outlined above unless a viable stabilization policy can be worked out. Secondly, they can attempt to restore competitiveness by encouraging investment designed to increase productivity, a strategy which generally requires temporary and often substantial reliance on foreign borrowing. Thirdly, they can

attempt to restore competitiveness through a combination of domestic demand restraint and comprehensive incomes policy. This, however, may lead to foregone output, higher unemployment and lower investment.

Even in the era of more flexible exchange rates, Finland has felt little temptation to opt for the first alternative because of the conviction that accelerating inflation would entail substantial real costs. Instead, combinations of the second and third alternatives have constituted the backbone of economic policy over the past ten years, though some fairly small exchange rate adjustments have been made, especially in the recent past, in response to exchange rate changes in Finland's major competitor countries.

There is much to recommend the second approach since it entails few of the costs of inflation or of foregone output and unemployment which the first and third bring in their wake. However, there is the danger that the cost of foreign finance will rise excessively before competitiveness can be restored, a fact which would severely limit a country's room to manoeuvre.

II. The Institutional Setting and the Role of Monetary Policy

Central bank policy has naturally played a role in the implementation of this strategy, though its relative importance has changed as emphasis in policy formulation has shifted from one target to another. To understand the Bank of Finland's policy actions it is useful to sketch briefly the institutional setting, the most important features of which are the absence of a highly developed financial market and the corresponding relative importance of the deposit banking institutions.

In common with many other small countries, the market in financial claims, and in particular the secondary market in such claims, is not highly developed. As a result, one standard weapon of monetary policy — open market operations — cannot be used on an extensive scale. Since the banks are not required to hold reserves at the central bank, they tend to be net debtors to this institution, and one of the Bank of Finland's main policy instruments is the modulation of the cost and availability of the credit which it extends to the commercial banks. The Bank of course co-ordinates this lending with its other lending because it is the Bank's total position vis-à-vis the domestic sector which is important for economic activity.

Moreover, since foreign capital markets are an important potential source of finance for Finnish firms, the Bank also regulates foreign capital flows. Apart from occasional restrictions and general regulations governing maturities and other credit terms, short-term foreign commercial transactions are unrestricted. Control centres on long-term capital flows, with the main aim being to even out the fluctuations in the investment that these funds are used to finance.

The absence of a developed secondary market also means that in Finland wealth and interest rate effects do not work through portfolio substitution in the way they are seen to do in countries with developed secondary markets. Moreover, the interest rate is not very flexible so that credit tends to be rationed by the financial institutions when demand for capital is great. In these conditions the central bank can affect the growth of the economy by altering the rate of investment through the modulation of the cost and availability of central bank and foreign finance. However, when investment demand is weak, there is little that Finland's traditional monetary policy can do to stimulate the economy, especially as the Bank of Finland traditionally does not lend to the Government.

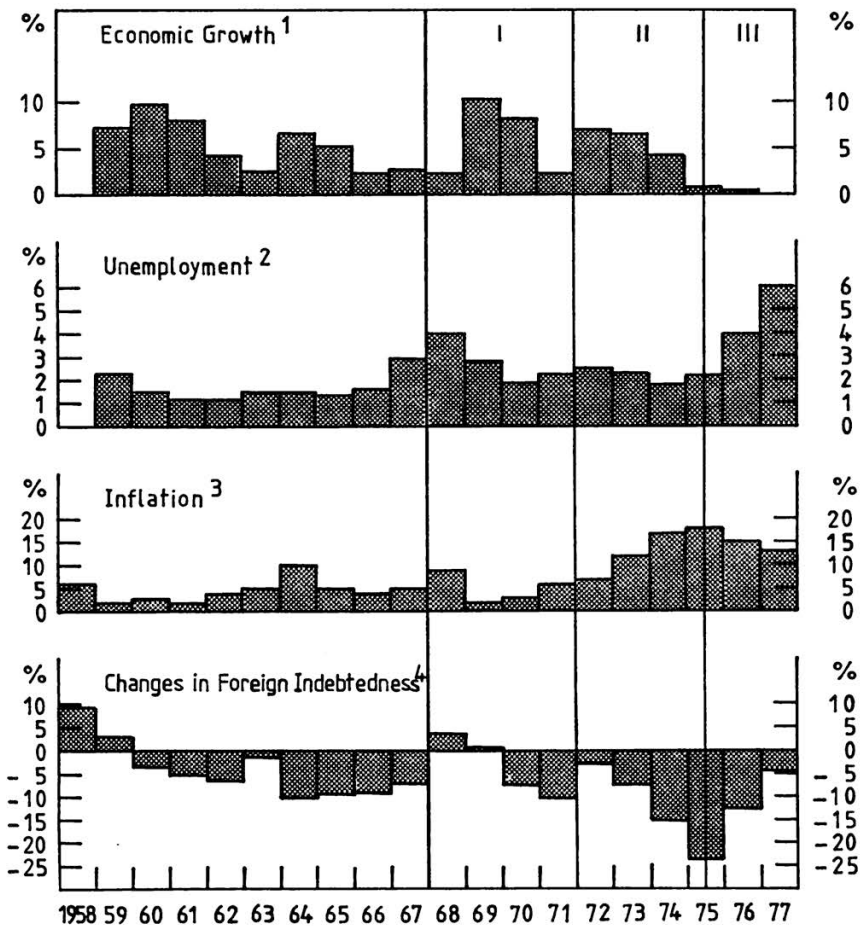
The fact that the central bank is not banker to the Government is partly a result of the fact that the Bank of Finland operates directly under the supervision and guarantee of Parliament and not under the Government. The relative importance of the central bank in the formulation and conduct of economic policy may be larger than in some other countries because the existence of fairly short-lived coalition Governments mean that discretionary counter-cyclical fiscal policy is rarely sharp or incisive. On the other hand, the relatively large share of progressive direct taxes in total public sector revenue and extensive unemployment assistance schemes endow automatic stabilizers with a greater role than in many other countries. Moreover, a monetary policy which is seen to work primarily through one component of demand — investment — is inevitably one-sided and can affect aggregates such as total employment only after quite a long lag.

III. A Policy Overview

In the following overview the past ten years are divided somewhat arbitrarily into three sub-periods on the basis of the emphasis of economic policy. The first period, running from the end of 1967 to 1971,

was characterized by devaluation and stabilization. The next period, extending from 1972 to 1974, was a time of strong expansion based on foreign borrowing. This was a period when problems both in the world at large and at home began to cumulate. Finally, the third period, running from 1975 to 1977, saw a change from expansionary to restrictive economic policy in order to check the growth of foreign debt and to dampen inflation.

Chart: Major Economic Indicators 1958 - 1977



1 Volume of GDP, % Δ.
 2 Unemployment/labor force, % (comparable unemployment statistics are not available for 1958).
 3 Cost-of-living index, % Δ.
 4 Current account balance/current account expenditure, %.

The chart shows the development of some important macroeconomic aggregates in the past ten years and, for purposes of comparison, in the preceding ten years. As can be seen, the three-period division does not coincide with cyclical developments. This is natural in the sense that the aims of economic policy are often different from what counter-cyclical policy alone might dictate.

1. The 1967 Devaluation and the Stabilization Period

The Finnmark was devalued by 24 per cent in October 1967. This, together with a revival of economic activity abroad and a subsequent recovery of domestic consumption and investment demand, led to a sizeable upturn in 1969 - 1970 that was followed by a modest slowdown in 1971. The major policy problem after the devaluation was to stabilize domestic prices and costs. At the same time it was felt that investment should be stimulated in order to promote diversification, growth and employment.

Economic performance in 1968 - 1971 was quite impressive (chart). After a year of slow growth in 1968, real GDP grew rapidly for two years. The inflation rate was very low once the effects of the devaluation had been contained. In fact, Finland had one of the lowest rates of price increase in the OECD-area in 1969 - 1971. Unemployment also fell, but this was partly due to substantial emigration to Sweden in 1969 - 1970. A current account surplus was recorded in 1968 - 1969, but a deficit emerged thereafter, causing some policy concern in 1970 - 1971.

At the time of the devaluation it was clear that the stabilization of prices and costs required more than ordinary fiscal and monetary policy could offer. A large index linkage system based on agreements and legislation had been built up gradually, and it would have been almost impossible to avoid further inflation if it had not been dismantled. For these reasons a comprehensive incomes policy agreement was worked out and the index linkage system largely abolished. This agreement was based on the principle that wage increases should be in line with the average rise in productivity. The agreement was supplemented with legislation needed to give the Government powers to safeguard the development of the economy, and marked the beginning of a period of successful incomes policy.

After the devaluation and the following stabilization measures, fiscal and monetary policies were designed to bring about a rapid revival in

economic activity and to shift resources into the tradeables sectors. New selective measures were taken to encourage investment held to be important for structural change. After the devaluation, the Bank of Finland established a domestic suppliers' credit financing scheme, and in 1968 and 1969 granted special credit for housing investment as well as for investment in manufacturing. The proceeds of the export levy which was imposed on exports immediately after the devaluation were used to promote diversification and to improve the infra-structure.

In this period government measures had a substantial impact on financial conditions. After the devaluation, the export levy was instituted and collected until 1969. In the autumn of 1969 a restrictive stance was adopted and counter-cyclical and investment funds were accumulated at the Bank of Finland.

In late 1970 a retroactive export tax was levied on wood-processing products. In addition to the counter-cyclical measures affecting the private sector, the Government also built up counter-cyclical reserves of its own. In 1971 the funds collected under these counter-cyclical arrangements were released, but were used primarily in 1972.

These counter-cyclical arrangements of the Government were supported by central bank measures. In this period the Bank of Finland relied on modulation of the cost and availability of central bank credit granted to the commercial banks to regulate the financial market, though ceilings on bank lending were used for a short period. Some restrictions were also put on the commercial banks' right to import foreign capital. The general interest rate level, which had been unchanged from 1962, was raised by 1 percentage point in 1971 and lowered by $\frac{3}{4}$ of a percentage point from the beginning of 1972.

2. The Expansionary Period 1972 - 74: Growing Pains

The international economic climate was expansive in the first part of the period and plagued by a number of disruptions towards the end. In Finland an attempt was made to increase productive capacity in order to promote rapid economic growth. As a result, both the rate of investment and imports rose significantly, with investment reaching nearly 40 per cent of GDP in 1974. This development was made possible by a high domestic savings ratio, rapidly growing foreign debt (chart), and the strength of export demand.

At the beginning of the period, monetary policy was easy because growth was expected to be much slower than it turned out to be. Subsequently domestic demand pressures increased the current account deficit, led to bottlenecks in production and fed inflation (chart). Rapid growth also meant that employment was strong, and labour began to move back from Sweden. In addition, there was further need to increase productive capacity once Finland concluded a free-trade agreement with the EEC.

The energy crisis changed conditions substantially. As economic growth was expected to slow down, various international organizations such as the OECD and the IMF urged countries to stimulate demand, particularly investment demand. Finland took these recommendations seriously and, unlike most other Western countries, attempted to increase supply rather than to restrict demand. Another reason for choosing this strategy was that Finland imports the bulk of her oil from the Soviet Union on a bilateral basis and thus knew that her higher import bill could be paid by increased export deliveries. It turned out, however, that prices of wood-based export products rose rapidly so that Finland's terms of trade did not deteriorate as had been forecast.

Monetary policy was framed in keeping with this strategy. As a result of rapidly growing revenue, the Government was able to accumulate counter-cyclical reserves in the Bank of Finland, which tightened the financial market. To make sure that investment projects already under way could be completed, the Bank of Finland raised the central bank credit quotas on several occasions. However, because balance-of-payments and inflationary problems were envisaged, restrictive measures were gradually implemented. The cost of central bank finance was raised to restrain credit expansion. In addition the general interest rates level was raised by 1½ percentage points and the Bank of Finland cut its share in the financing of domestic suppliers' credit. Drawings of short-term import credits were restricted by a cash payment system, and the liquidity effects of long-term borrowing were modulated with the aid of a special capital import deposit scheme which obliged borrowers to place all or part of a loan drawn abroad on temporary deposit at the Bank of Finland.

Towards the end of the period, growth slowed down gradually because of a deficiency of foreign demand, inflation accelerated still further and foreign indebtedness increased markedly (chart). This required a shift towards a more restrictive policy.

3. The Restrictive Period 1975 - 1977: The Struggle with Foreign Indebtedness and Inflation

A small country with a fixed exchange rate cannot long pursue an economic policy that differs essentially from that pursued by its trading partners. Finland felt the force of this dictum in a tangible way in 1975 when its policy designed to support domestic production and to make up for the cyclical deficiency in foreign demand ran into difficulty in the shape of weakness in the recovery of demand abroad which led to a sharp deterioration in the current account and accelerating inflation. Since foreign exchange reserves have traditionally been rather small in Finland, the growing gap between import expenditures and export earnings was primarily covered by importing capital (chart), and in a few years total foreign debt rose from less than 10 per cent to rather more than 20 per cent of GDP. The need to correct these trends became the dominant feature of economic policy in this period. The policy centred on strict management of financial conditions combined with efforts to undercut the expectational basis of inflation. Recently, however, concern has focussed on the country's rising unemployment.

This period saw a drastic improvement in balance of payments and a notable deceleration in inflation; the current account was more or less in balance in 1977, and inflation was approaching the OECD- Europe average (chart). On the other hand total production rose only marginally from the level of 1974. This resulted in a sharp deterioration in employment and capacity utilization, a deterioration which was aggravated by disappointed expectations of a quick and sustainable revival in foreign demand.

Fiscal policy was strongly expansionary in 1975 and, on the whole, rather neutral in the rest of the period. On the other hand monetary policy was restrictive, having been formulated so as to be compatible with the current account targets set for 1976 and 1977. Imports of long-term capital were scrutinized closely, and the increase in the central bank's net domestic lending slowed down. In order to mitigate the adverse effects of overall stringency on growth and employment, more emphasis was placed on selective central bank policy measures.

The commercial banks' credit quotas at the central bank were reduced in the autumn of 1975 and further reductions were implemented in 1976 and 1977. The rate of increase in the banks' actual use of central bank finance slowed down considerably towards the end of the period.

The total cost to the banks of central bank financing was high in this period. The call money rate, which is the rate at which commercial banks can obtain marginal funds in the call money market, remained between 15 and 20 per cent during most of the period.

The reduction in commercial banks' borrowing from the Bank of Finland in the first half of 1977 was facilitated by the running down of Government funds deposited at the central bank. The decumulation of Government surpluses proper took place in 1975, but the impact on the financial market was largely offset by a scheme requiring importers to place funds on deposit in the Bank of Finland for six months. The tendency for the financial market to ease was felt only one and a half years later when the scheme was gradually dismantled and the deposits withdrawn, but was offset by quota reductions.

In the course of this period, the Bank of Finland altered its special financing arrangements in order to ensure sufficient credit for exporting and import-substituting enterprises. The Bank also participated in the financing of increased export stocks and of raw timber transactions. An indication of this strategy of combining overall stringency with selective measures is the fact that the ratio between selective and general central bank finance rose from one fifth in 1975 to nearly one half in 1977

IV. Lessons

There is much to be learned about the formulation and conduct of monetary and economic policy from the events of the past ten years. First and foremost is the importance of eliminating basic disequilibria and working towards structural stability. The 1967 devaluation and follow-up measures met with success in the short-run, thanks in part to a fortuitously-timed upswing in demand abroad. However, the seeds for the overheating which ensued were laid in these years as the industrial profitability of this period led to both demand pressure in the form of substantial investment and cost pressures in the form of rising labour costs. Success with the second pillar of the strategy — utilization of active counter-cyclical policy — was more modest, largely because of the need for accurate forecasts, the importance of events abroad which, even when they can be accurately predicted, are not subject to influence and the difficulty of achieving consensus about the appropriate measures to be implemented. For these reasons, it would seem desirable to supplement general attempts at the modulation of demand with ef-

forts to create a stable economic environment free of tendencies either to stagnate or to go through flurries of excessively rapid expansion.

Another clear difficulty, but one which is not easily resolved, is resistance to changes in relative prices, wages and incomes, irrespective of their origin. A change in relative prices — either shadow or effective — may be the only feasible way to achieve changes in the allocation of resources, but since any change in relative prices has implications for income differentials and since there is generally an attempt to seek compensation for changes in such differentials, it may often be possible to change relative prices only through a process of *tâtonnement* which generates inflation since those on the losing end attempt, ultimately without success, to keep their income in its traditional relation to the income of scarce factors of production. Evidence in support of this is found in the history of the relative wages of highly trained labour and, more recently, in attempts to raise the price of oil. The fact that inflation tends to be rapid in economies which are undergoing substantial structural change may not be accidental.

A third lesson of the past decade is the importance of expectations for the stability and flexibility of an economy, and the high costs which sometimes have to be incurred if they are to be changed. The costs often seem unreasonably burdensome since expectations are basically psychological and social rather than economic. In Finland, efforts to reduce expectations of a continuing inflation-devaluation spiral have met with mixed success. In the years immediately after the devaluation, the efforts were rewarded, but in the first half of the 1970s Finland, like many other countries, found it difficult to reduce the rate of price increase when an in-phase upswing affected almost all countries simultaneously, when raw material prices shot upwards and when major exchange rate changes and monetary accommodation fuelled the already substantial inflationary fires. In the past couple of years inflationary expectations have been stifled somewhat, but the costs in terms of unemployment and foregone output have been high.

Many of the above general economic lessons apply with equal force to monetary policy, though the difficulty of making accurate cyclical forecasts over the relevant horizon and the importance of expectations are even greater if, as seems to be the case in Finland, monetary policy principally affects real variables by influencing the rate of investment.

Zusammenfassung

Die Geldpolitik in Finnland während des letzten Jahrzehnts

Während des letzten Jahrzehnts bemühte sich Finnland aus dem Kreislauf von Abwertung und Inflation auszubrechen, die die finnische Wirtschaft in der Nachkriegszeit plagte. Die globale Strategie ruhte auf drei Hauptsäulen: (1) eine beträchtliche Abwertung zu Beginn dieses Zeitraums, gekoppelt mit einem umfassenden Stabilisierungsprogramm und wachstumsfördernden Maßnahmen, um die Wettbewerbsfähigkeit wieder herzustellen und eine weitere Diversifikation in der Volkswirtschaft zu fördern; (2) Entwicklung und Anwendung von aktiven antizyklischen wirtschaftspolitischen Waffen, um die Nachfrageschwankungen zu reduzieren und (3) Anwendung der Geld- und Währungspolitik, um die Erwartungsbasis der Inflations-Abwertungsspirale zu brechen.

Nach einer kurzen Schilderung des wirtschaftlichen und institutionellen Rahmens, in welchem die Wirtschaftspolitik durchgeführt wurde, wird die Durchführung dieser Strategie in drei zeitlichen Unterabschnitten betrachtet: Der Zeitabschnitt von 1967 bis 1971 war durch Abwertung und Stabilisierung gekennzeichnet. Der zweite Abschnitt von 1972 bis 1974 war eine Zeit starker Expansion. Im dritten Zeitabschnitt von 1975 bis 1977 war ein Übergang zu einer restriktiven Geldpolitik zu beobachten, um den Anstieg der Auslandsverschuldung einzudämmen und die Inflation zu dämpfen.

Abschließend wird versucht, aus den Erfahrungen des letzten Jahrzehnts für die finnische Geldpolitik Lehren zu ziehen. Dabei werden besonders die Schwierigkeit, eine aktive antizyklische Politik zu verfolgen, sowie die Bedeutung einer strukturellen Stabilität zu erreichen, hervorgehoben. Die Probleme, die sich aus der Starrheit der relativen Preise, relativen Einkommen und relativen Löhne ergeben, werden dabei ebenso berücksichtigt wie die Bedeutung der Erwartungen.

Summary

Monetary Policy in Finland: The Last Ten Years

During the past ten years Finland has attempted to break away from the spiral of devaluation and inflation which has plagued the Finnish economy throughout the post-war period. The overall policy strategy has been rested on three main pillars: (1) a large devaluation at the beginning of the period coupled with a comprehensive stabilization programme and growth-promoting measures to restore competitiveness and to promote further diversification of the economy, (2) the development and use of active counter-cyclical policy weapons to reduce fluctuations in demand and (3) the use of monetary and exchange rate policy to break the expectational basis of the inflation-devaluation spiral.

After sketching the economic and institutional setting in which economic policy is conducted, the implementation of this strategy in three sub-

periods is reviewed. The first sub-period, running from 1967 to 1971, was characterized by devaluation and stabilization. The second, extending from 1972 to 1974, was a time of strong expansion. The third sub-period, running from 1975 to 1977, saw the adoption of a restrictive policy in order to check the growth of foreign debt and to dampen inflation.

An attempt is made to draw lessons from the experience of the past decade. The difficulty of pursuing an active counter-cyclical policy and the importance of achieving structural stability are stressed. The problems created by the rigidity of relative prices, relative incomes and relative wages are also considered as is the importance of expectations.

Résumé

La politique monétaire en Finlande pendant la dernière décennie

Pendant la dernière décennie la Finlande tenta de s'arracher au cercle vicieux de la dévaluation et de l'inflation, plaie de l'économie finlandaise de l'après-guerre. La stratégie globale s'appuyait sur trois piliers principaux: (1) une forte dévaluation au début de cette période, accompagnée d'un large programme de stabilisation et de mesures favorisant la croissance, afin de rétablir la compétitivité et une diversification plus poussée de l'économie nationale; (2) développement et application d'armes de politique économique anticycliques actives, afin de réduire les fluctuations de la demande, et (3) application de la politique monétaire et de devises, afin de briser la base d'attente de la spirale inflation-dévaluation.

Après une courte description du cadre économique et institutionnel, dans lequel la politique économique fut conduite, la réalisation de cette stratégie est considérée dans trois périodes: celle de 1967 à 1971, caractérisée par la dévaluation et la stabilisation; celle de 1972 à 1974, caractérisée par une forte expansion; et celle de 1975 à 1977, témoin d'une transition vers une politique monétaire restrictive dans le but d'endiguer la croissance de l'endettement extérieur et de tempérer l'inflation.

On essaye en conclusion de tirer des leçons de l'expérience de cette décennie pour la politique monétaire finlandaise. A cette occasion on souligne en particulier la difficulté de poursuivre une politique anticyclique active et la portée d'arriver à une stabilité structurelle. Les problèmes résultant de l'immobilisme des prix relatifs, des revenus relatifs et des salaires relatifs sont autant pris en considération à cette occasion que la portée des résultats escomptés.