

Meeting the Challenge of Monetary Union: Lessons from the Finnish Experience*

Sprostanie wyzwaniom Unii Monetarnej: wnioski płynące z doświadczeń Finlandii

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Abstract

We study lessons from the experience of Finland in meeting the challenges of joining the euro area at its outset and its subsequent economic success. Traditional optimum currency area theory is too limited a framework for judging the experience in qualifying and membership. Five main factors have an influence on the experience: asymmetric shocks in the country joining the area; the prior conditions, particularly the real exchange rate; structural flexibility of the country; degree of economic, institutional and regulatory integration; attractiveness of the outside option. The main lessons to be learned from the Finnish experience are: the importance of timing; the fact that targeting low inflation and prudent fiscal policy can deliver nominal convergence; the relative merits of prior convergence of economic structures, policies and institutions and favourable starting conditions, as opposed to imminent membership itself changing structural behaviour and providing the discipline for change.

Keywords: Finland, monetary union, convergence criteria, optimal currency area

JEL: F15, E52, O52

Streszczenie

Przedstawiamy wnioski płynące z doświadczeń Finlandii w stawianiu czoła wyzwaniom związanym z wejściem do strefy euro od samego początku, aż po ekonomiczny sukces tego procesu. Tradycyjna teoria optymalnego obszaru walutowego to zbyt wąskie ramy do oceny doświadczeń w zakresie kwalifikowania do strefy i uczestnictwa w niej. Na doświadczenia w tym zakresie wpływa pięć głównych elementów: szoki asymetryczne w kraju wchodzącym do strefy euro, warunki panujące przed wejściem (w szczególności faktyczny kurs wymiany), elastyczność strukturalna kraju, stopień integracji ekonomicznej, instytucjonalnej i regulacyjnej oraz atrakcyjność opcji zewnętrznej. Główne wnioski płynące z doświadczeń fińskich to: znaczenie, jakie ma wybranie odpowiedniego terminu, fakt, że niski cel inflacyjny i ostrożnościowa polityka fiskalna mogą skutkować nominalną konwergencją, relatywne zalety wcześniejszej konwergencji struktur ekonomicznych, prowadzona polityka i instytucje oraz sprzyjające warunki wyjściowe wobec bliskiego członkostwa, które zmieni zachowania strukturalne i zapewni dyscyplinę umożliwiającą zmianę.

Słowa kluczowe: Finlandia, unia monetarna, kryteria konwergencji, optymalny obszar walutowy

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1. Introduction

Meeting the criteria for membership of the euro area has turned out to be more difficult for the new member states than some countries expected. Thus far three countries have succeeded in joining, Slovenia on 1 January 2007 and Cyprus and Malta on 1 January 2008. Lithuania also applied, in 2006, but was rejected by a small margin on the inflation criterion. Moreover, Estonia, which has successfully run a currency board for 15 years, first with the Deutsche mark and, since its inception, with the euro, and hence to all intents and purposes has been a non-voting member of the euro area all along, decided not to proceed with its attempt to join in the face of certain rejection on the inflation criterion. There are thus two crucial economic considerations for membership. The first is the traditional assessment of whether membership is likely to be a net benefit in the present circumstances and the second is, when there does appear such a net benefit, how can compliance with the criteria laid down in the Maastricht Treaty be achieved without unacceptable costs in the period of qualification.

A key issue affecting the choice of when to try for membership is 'discipline'. One of the major reasons that Finland joined Stage Three of EMU at the outset was that it wanted to force itself away from the previous private and public sector behaviour that had seen relative rapid inflation followed by devaluation culminating in the severe financial crisis of the beginning of the 1990s. Similarly, Estonia chose to have a currency board backed by the Deutsche mark and later the euro as a means of anchoring inflation and ensuring fiscal discipline for the public sector and a strongly competitive approach for the private sector. While seeking such discipline may be successful, it can come at a heavy cost if either the public or private sectors do not respond to the threat, as illustrated by the case of Argentina in applying the currency board. Being a member of a currency union precludes the prudent use of monetary policy and thereby the exchange rate to respond to an unfavourable external shock. In this article, we consider the experience of Finland, which chose such a route of discipline, unlike its neighbour Sweden, which decided that it would prefer self-discipline and keeping the option of exchange rate adjustment. We argue that the Finnish experience lends support to other countries that see full membership of the euro area as a means of transformation.

The experience of Finland also sheds light on another facet that is of direct relevance to the new member states. Euro area countries that are growing faster than the area average may also experience faster inflation than is permissible during the period of qualification. If that is associated with fiscal discipline and faster productivity growth, then it is difficult to

see how, for a small catching-up country, this can be much other than a benefit both for the applicant and for the other members. However, the propensity for such inflation also depends on where the price level is compared to the rest of the euro area. In the Finnish case, however, the price level is above average and faster-than-average growth has come with lower-than-average inflation.¹

The standard Optimum Currency Area (OCA) criteria are helpful but insufficient for establishing the most suitable way forward, most straightforwardly because it is not until after the event that one can see how well the country meets the criteria. This is normally labelled as the endogenous approach to OCA criteria (Frankel, Rose 1998; Schelkle 2001). In other words, from an economic point of view it makes rather more sense to judge how well a country meets the OCA criteria after rather than before the event. From the point of view of making the decision over membership this is impossible. The judgement has to be made beforehand but on the hypothetical basis of how much the country is likely to change and what the costs of that change will be compared to those under the alternative plausible policies that could be applied.

Furthermore, in the EU, the member states have decided to apply a set of criteria for membership of the euro area that relate only implicitly to the OCA criteria and are mainly concerned with fiscal sustainability and the ability to manage inflation adequately under a nearly fixed exchange rate. They are concerned that for a one to two year judgement period the applicant state should be able to meet these nominal criteria in a sustainable manner. In practice, the ability to do that is influenced by the extent of real convergence. Nevertheless, the ability of the member state to exert the necessary discipline to qualify for the euro area during the two year period is not *prima facie* evidence of its ability to apply the same discipline once in the euro area. The Stability and Growth Pact is intended to provide a measure of fiscal discipline, while the revised Lisbon strategy provides a means of trying to achieve the necessary structural and institutional changes in the product and labour markets. However, since there is no matching discipline from a threat of exit as there was from the lure of entry, behaviour in the qualifying period is not necessarily a good guide to performance inside the euro area.

Thus, the ability and willingness to join full monetary union will depend not just on how similar the potential joiner is with the existing members in terms of economic structure and policies beforehand but also on how it expects these to converge. The considerations are not just about the real economy but also about the nominal economy as a considerable divergence in price

¹ Thus far 2000 is the only year when Finnish inflation was noticeably above the euro area average, perhaps not surprising with the real GDP growth of 6 per cent.

levels, reflecting a divergence in economic development, is likely to provide problems in convergence of inflation rates. Furthermore, these opportunities for membership are time dependent. Not only is the offer of membership on particular terms only available over specific time periods but the shocks that occur over those time periods may affect the outcome. Without the oil shocks of the previous two years both Lithuania and Estonia would probably have been accepted along with Slovenia for membership of the euro area in June 2006. If there had been a series of unfortunate shocks that had harmed Sweden, Denmark and the UK relative to the euro area over the periods when they were contemplating membership, their citizens might have voted to join.²

Lastly, the available alternative matters. Larger countries can hope to run a degree of independence in their monetary policy. At what level such largeness starts is difficult to assess (Artis, Rose 2002) as it is context dependent. Canada and the UK seem clearly large enough. The Netherlands and Belgium do not. The recent experience of Iceland and New Zealand provide a helpful reminder of the problem. If it is necessary for a small advanced country to run a very different monetary policy from much of the rest of the world, it can attract a major currency inflow driving its exchange rate to the levels that cause real harm to the economy – or the threat of that can cause it to fall short in tackling inflationary threats.

Therefore, taking these facets together, and illustrated by the case of Finland, we consider five main factors that may influence the experience and hence choices of a country contemplating joining Stage Three:

- the particular set of asymmetric shocks that influence the country during the period;
- the prior conditions, particularly the real exchange rate;
- the structural flexibility of the country;
- the degree of economic, institutional and regulatory integration;
- the attractiveness of the outside option.

2. Finland's road to EMU³

The analysis of economic integration in Europe is easily overrationalised with the benefit of hindsight. Andrew Schonfield's (1973) *Europe: Journey to an Unknown Destination*, is probably an apt rationalisation of the progress of Finland. In the early years of postwar

integration, Finland was concerned to maintain a careful balance between its economic interests in Western Europe and the political sensitivities of its eastern neighbour, the Soviet Union. Initial linkages, even with EFTA, which Finland joined with an Association Agreement in 1961, were cautious. After the event, Finland's steady progress from the 1973 Free Trade Agreement with the European Community (EC) to full membership of Economic and Monetary Union in the first wave over the course of 25 years might appear to be the outcome of following a well-planned and predicted strategy that was set out in advance. The practice was rather different and reflected external events and the choice of other closely related countries, particularly Sweden.

The initial step was that Finland, along with the other EFTA countries, participated in the negotiation of the European Economic Area (EEA). This process, agreed in March 1989, predated the collapse of the former Soviet Union and was very much a realisation that the Single Market Programme, implemented by the Single European Act of 1987, would entail a significant loss of competitiveness if the EFTA states were outside the process of harmonisation. Before those negotiations even started, the EU had embarked on the process towards Economic and Monetary Union, with the setting up of the Delors Committee in June 1988, which reported a year later in June 1989. The negotiations on the EEA proved rather one-sided and the EFTA countries in effect merely had to accept the EC's framework without any say in its development. This experience no doubt affected attitudes towards further steps (Brewin 1997).

While Austria applied for the membership of the European Community in July 1989, followed by Malta and Cyprus in 1990, the Finnish Government did not apply until March 18th 1992. The Finnish decision was prompted by a similar move by the Swedish Government nine months earlier. The Swiss and Norwegian applications followed Finland in 1992, although the Swiss application lapsed with the rejection of the EEA agreement in the referendum of December that year. The Swedish decision to apply for the membership came as a clear surprise to the Finnish authorities, who were not at the time pushing for a similar move. However, once the Swedish application had been made, any announcement by the Finnish government of not intending to apply for membership or postponing the decision to some indefinite date in the future would probably have hurt the economy, which was already in a critical condition. The enthusiasm for membership within the Government led by the Centre Party was scarcely overwhelming. The left-wing opposition was split, the majority being sceptical or at least undecided. It would thus have been easy at this stage to see the political outcome in Finland following either the Norwegian or Swiss routes and not resulting in eventual entry.

² The fact that referenda may be required for such a fundamental ceding of sovereignty further complicates the issue as they are not necessarily a good way of making the decision. For example, other factors, such as general confidence in the government's policies, may get bound up into the issue, although only a single vote is possible. See, for example, Miles, Lindh (2004) on the Swedish euro referendum. Similarly, monetary union may be part of a much larger package, whose benefits clearly outweigh any of the potential problems from monetary union. It would therefore not make much sense to vote on it alone.

³ This section draws on earlier work in Mayes, Suvanto (2002).

At the time of the application in spring 1992 the economy was almost in free fall.⁴ At the bottom of the recession in late 1993, GDP volume was down by more than 10 per cent from the 1990 level, the banking sector was faltering, the rate of unemployment had increased fivefold, the public debt ratio had increased fourfold, foreign indebtedness had doubled, the stock market had declined by 50 per cent, as had house prices, the currency had lost one third of its external value, and the foreign exchange reserves of the central bank were depleted. Despite the devaluation in November 1991, the tensions in the currency markets continued at the same time as GDP was falling and unemployment was rising sharply. Nevertheless, proceeding towards EU membership was coincident rather than offering the obvious way out of the problems.

However, Finland had already been shadowing the Exchange Rate Mechanism of the European Monetary System (ERM) by replacing the trade-weighted currency basket by the ECU in the pegged exchange rate regime in June 1991.⁵ Indeed, it has been argued that this exchange rate regime contributed to the crisis and its deepening, because the lack of credibility led to speculative attacks and to temporarily very high interest rates. The initial experience was hence far from conducive to entertaining ideas of EMU membership. As the speculative attacks against the currency continued, the markka was floated in September 1992. Five months later the Bank of Finland announced an inflation target of around 2 per cent a year to be achieved by 1995.⁶

The negotiations on the Finnish accession to the EC started in February 1993. The negotiation round was short, mainly because a lot of issues had already been settled during the negotiations on the EEA. The round was concluded in March 1994. Meanwhile, the 12 Member States had ratified the Maastricht Treaty.

Finland had made no reservations on the EMU provisions during the negotiations. Neither in the main had Sweden. Stage Two of EMU entered in force in the beginning of 1994. In July, the four accession countries started to participate as observers in all the work of the EU Council, the Committees and the European Monetary Institute (EMI). In the referendum, organised in October 1994, Finns lent support to the EU membership by a clear margin, 57 per cent voting in favour. While this was noticeably less than Austria's endorsement, with 66.4 per cent voting in favour in June, it was not like the marginal endorsement in Sweden in November with 52.2 per cent in favour and 46.9 per cent against. In Norway, the balance went the other way just a fortnight later with 52.2 per cent voting against – a margin of just 38,000 votes

in a population of 4.3 million. Timing and ordering were clearly important. Seeing a negative vote in Norway first could have altered the balance – just as the Norwegian vote could have swung the other way on just a small change in sentiment. The approach was thus relatively cautiously favourable, not a rapid enthusiastic rush into all current and impending aspects of integration.

EMU was not yet reality at the beginning of 1995, when Finland and Sweden entered the EU. It was not even fully certain that EMU would ever materialise. Although when the Maastricht Treaty was signed, the expectation was that Stage Three of EMU would go ahead at the first of its two planned dates in 1997, only some countries were expected to qualify. Indeed, most countries, including Finland, were still far from meeting the entry criteria in 1995. The discussion of whether Stage Three should go ahead at the first date turned out to be a formality, casting doubt both on whether even the second date of 1999 would be adhered to and offering even greater uncertainty about which countries will qualify among the first group of members. The fact that the probability of the birth of EMU was less than 100 per cent and the probability of Finland being among the first group of countries was even smaller, allowed many decision makers and opinion leaders to refrain from taking a clear position for or against EMU in the early years of Finland's EU membership. Although the economy had started to recover from the depression in 1994 and confidence was gradually improving, the fear of a new recession was a more urgent concern in late 1995 and early 1996 than the consequences of yet uncertain future of EMU. In Sweden, the debate on EMU was more active.

Of course, the Finnish authorities had started the legal and regulatory work to prepare the country for EMU, including the preparation of the change in the Act on the Bank of Finland in 1994 to make it compatible with the Treaty provisions. The technical preparations regarding the logistical and operational mechanisms of monetary policy started in 1994 and continued throughout the Stage Two years, on the basis of the decisions agreed upon jointly in the EMI framework. But this was technical work, which never reached any headlines until the reality began to approach in 1997.

The framework for Finnish macroeconomic policy that had been established to stabilise the economy after the crisis and set it rapidly back on the road to sustained growth began to cut in quite quickly and automatically helped achieve the Maastricht convergence criteria. Price stability had already been achieved in 1994, ahead of the 1995 target date, and was not threatened in subsequent years.

The interest rate criterion was met in 1995 as confidence in the sustainability of government finances had been restored. The consolidated general government debt was below the 60 per cent mark, thanks only to the fact that the pension institutions had invested large amounts of their assets in central government bonds.

⁴ For an analysis of the great recession in Finland in the early 1990s, see Honkapohja et al. (2007).

⁵ On the Finnish experience of the currency band, see Lehmussaari et al. (1992).

⁶ On monetary policy on the way towards EMU, see Pikkarainen et al. (1997) and Korhonen (2002).

Although privately owned, these institutions are treated in the statistics as being part of the public sector, because the assets they manage are collected from mandatory employment pension contributions. The nature of the change in the structure of public finance should not be underestimated. With the sharp decline in revenues and burgeoning social payments as unemployment soared, Finland had to cut back drastically on benefit rates and other aspects of public expenditure in order to return to a sustainable balance. In general, it was decided to try to make the adjustments to the shock rapidly and conclusively rather than to try to postpone much of the adjustment in the hope that the costs might be avoided. The arithmetic was sufficiently unfavourable even in the short term that harsh measures were required. Central government finances had deteriorated so sharply in 1991–1993 that the Government embarked on fiscal consolidation already in the midst of the recession. The consolidation was continued by the subsequent Government, which took office in 1995. It has been estimated that the two Governments made structural spending cuts amounting cumulatively to 9 percent of GDP over the years 1993–1999 (Lehtonen 1996).

The two remaining criteria were more difficult. In 1995, the general government deficit was not expected to reach 3 per cent very soon, and the markka was not linked to ERM, although it had been trading in a stable manner vis à vis the Deutschmark since autumn 1994.

Contrary to many other countries, the Maastricht criteria were never referred to as a justification for fiscal consolidation. The message was rather that fiscal consolidation is in the national interest because it is a precondition for lower interest rates and for longer-term financial stability. Although not clearly spelled out, the strategy can be interpreted to have been of mini-max type. It is good to maintain an option to join EMU by meeting the criteria, but meeting the criteria gives some protection also for a situation of monetary and financial instability which would follow if EMU does not materialise. The 1995–1999 programme of fiscal consolidation was heavily front-loaded but the actual outcomes were much more favourable than expected owing to the very rapid rate of economic growth at around 5 percent each year. The intentions of policy thus need to be seen against the plans rather than the outcomes. In practice, the pace of expenditure and deficit reduction was in advance of that planned and, as a consequence, tax relaxation was possible.

The remaining criterion, ERM membership, proved to be the most difficult. The difficulty was largely political. The decision to join was finally made in October 1996, when the likely date of examination of the criteria was less than two years ahead.⁷ There were at least two reasons for the hesitation. The floating exchange rate and inflation-targeting regime had functioned smoothly. The hardships

of the early 1990s with the pegged exchange rate were still clearly in people's memory, and nobody wanted to see it again. In any case, some of the arguments against the ERM were in fact expressions of scepticism about the whole EMU plan. It appeared that the domestic combination of policies was working and that there was no need to appeal to a further outside requirement to achieve that desired balance between stability and growth.

By 1997, industrial production and exports had recovered and confidence had improved despite the continuing high unemployment. In fact, GDP growth exceeded expectations and government finances improved faster than forecast. The currency market was stable most of the time with strong but short-lived pressure toward appreciation in January 1997. Suddenly, it seemed that EMU could be round the corner and that Finland would be likely to meet all the criteria easily. As the probability of non-EMU had withered away, taking a position on the desirability of Finland joining the EMU among the first group of countries could not be avoided.

3. Convergence first or convergence second?

One of the key issues in addressing membership of a monetary union is whether it is better from the point of view of economic welfare to wait until the economy is sufficiently convergent that the costs of membership are likely to be low or whether it is better to join at an early juncture so that membership forces the changes in economic structures and policies that are required to make the costs of membership tolerable. This is largely an empirical matter. Moreover, it is not one where there can ever be a clean natural experiment. It is not possible to take the same country and compare how it fares in both choices under similar circumstances. At any one time the only one choice can be made and the outcome of the other will remain necessarily hypothetical. If both are tried, the second will have only been attempted because the first failed and hence outcomes will be heavily coloured by that earlier failure (and the external circumstances will have changed). However, the case of Finland and Sweden provides as near an example of such a natural experiment as possible, with two relatively similar countries making opposite choices.

The debate over EMU membership in Finland intensified in 1996, in part, as a result of ERM membership. EMU was high also on the political agenda. The Prime Minister of the time had never hidden his strong support for Finland's participation in EMU. In autumn 1996, he commissioned an expert group consisting mainly of university professors to examine the pros and cons of EMU participation.⁸ The

⁷ There was some danger that by having less than two years' membership of the ERM Finland might be excluded from initial EMU but the actual decision was based on at least two years' stable behaviour inside the narrow ERM limits.

⁸ The phraseology in the English version of the text is 'to consider the significance of EMU for the Finnish economy...to pay special attention to the production structure, the labour market, public finances and economic policy.' (p. 6).

task and composition of the EMU Commission was similar to that of the Swedish EMU Commission, which had submitted its report already before the Finnish Commission started its work. It is therefore interesting to compare the analysis and conclusions of the two groups of experts.⁹

Not surprisingly, the "official" assessments of the likely consequences for both Finland and Sweden by the two Commissions were very similar in content. They both came to the conclusion that there was relatively little to choose on purely economic grounds between membership and non-membership, as there were both positive and negative factors and many imponderables about how behaviour might change after membership. There was general agreement that the efficiency gains will be positive but fairly small and that the problem area is the extent to which membership of Stage Three affects the costs of adjusting to existing economic imbalances and future shocks. Both reports put a lot of emphasis on the possibility of asymmetric shocks and on the functioning of the labour market.

However, when it comes to drawing conclusions, the two reports part company. The Finnish report did not take a firm stand one way or the other, although it gave a clear note of optimism about the balance of risks from membership. The Swedish report, on the other hand, came down clearly against. It judged the political considerations to be favourable and the economic considerations to be sufficiently unfavourable to outweigh them at least in the short run. While one might speculate what the conclusions could have been had, the balance of public opinion in the two countries been clearly the other way round, it is the detailed reasoning in the two reports that merits attention.

The Swedish Commission saw continuing risks to macroeconomic stability due to asymmetric shocks and thought that there would be much greater costs to the economy, particularly in the form of unemployment, in trying to adjust to them without the benefit of an independent monetary and exchange rate policy. They did not expect the ability of the labour market to adjust to shocks would change dramatically. The Commission stressed the need for a "broad and encompassing debate" on the issue otherwise the decision would not be viewed as *legitimate* by the electorate. In addition, it assumed that other countries, particularly the UK and Denmark would also stay out, so the political cost would be acceptable.

The Finnish report too singled out the worries about asymmetric shocks and economic stability as

being the key to the appropriate decision but their assessment was noticeably different. The authors of the report took it for granted that the labour market would have to be more flexible and suggested ways in which this might be achieved, by varying indirect costs over the cycle for example. They also felt that fiscal policy would be able to cope as the strong growth would enable debt to be run down and adequate stabilisation to be achieved largely through the automatic stabilisers. They expected that some of the asymmetries of the past would diminish with most of their trading partners being on the inside.

The Swedish report had assumed that non-membership would imply the continuation of a floating exchange rate and inflation targeting, which explains the emphasis given to monetary policy, rather than fiscal policy, as a means of stabilizing an economy facing asymmetric shocks. While not showing any enthusiasm for the pegged exchange rate, the Finnish report had to take the ERM2 as a starting point, because the country had already joined the exchange rate mechanism and legislation had been amended accordingly. This explains why the emphasis was on fiscal policy and on automatic stabilisers, in particular. In general, the Finnish report was less optimistic on stabilisation policy than the Swedish report. The Finnish experts thought that similar monetary and fiscal discipline and the sorts of changes that would be necessary inside EMU would be required anyway as the country would not be able to run particularly different economic policies from the participating countries.

Thus, there is a major difference in approach underlying the two reports' conclusions. In the Swedish case, the line of argument is that it is better to reduce unemployment problems first and let the Swedish and euro economies become more structurally convergent before entering Stage Three. In the Finnish case, however, the implication is that it is membership itself that will force the changes in public policy and private sector behaviour that are necessary both to solve the current unemployment problem and be able to react without unnecessary cost to future shocks. Thus, what we see is part of a long-standing and much wider European debate about whether one should only proceed with each step in closer integration at a legislative and institutional level after fairly considerable prior convergence or whether the legislative and institutional change should occur early on in the process and act as the driving force for change.

It is interesting to note that the Swedish central bank disagreed with the principal conclusion of the EMU Commission and advocated membership of Stage Three from the beginning in 1999 (Heikensten 1999). However, the disagreements were largely about the balance of risks. The bank argued for example that the chance of an adverse asymmetric shock was exaggerated

⁹ The Swedish EMU Commission submitted its report in November 1996. The main report covered a wide range of issues with the emphasis being on the economic impact of EMU, and a series of background studies were prepared by internationally well-known economists for the use of the Commission, see Calmfors et al. (1996). The same studies were helpful also for the Finnish EMU Commission, which submitted its report in April 1997, see Prime Minister's Office (1997).

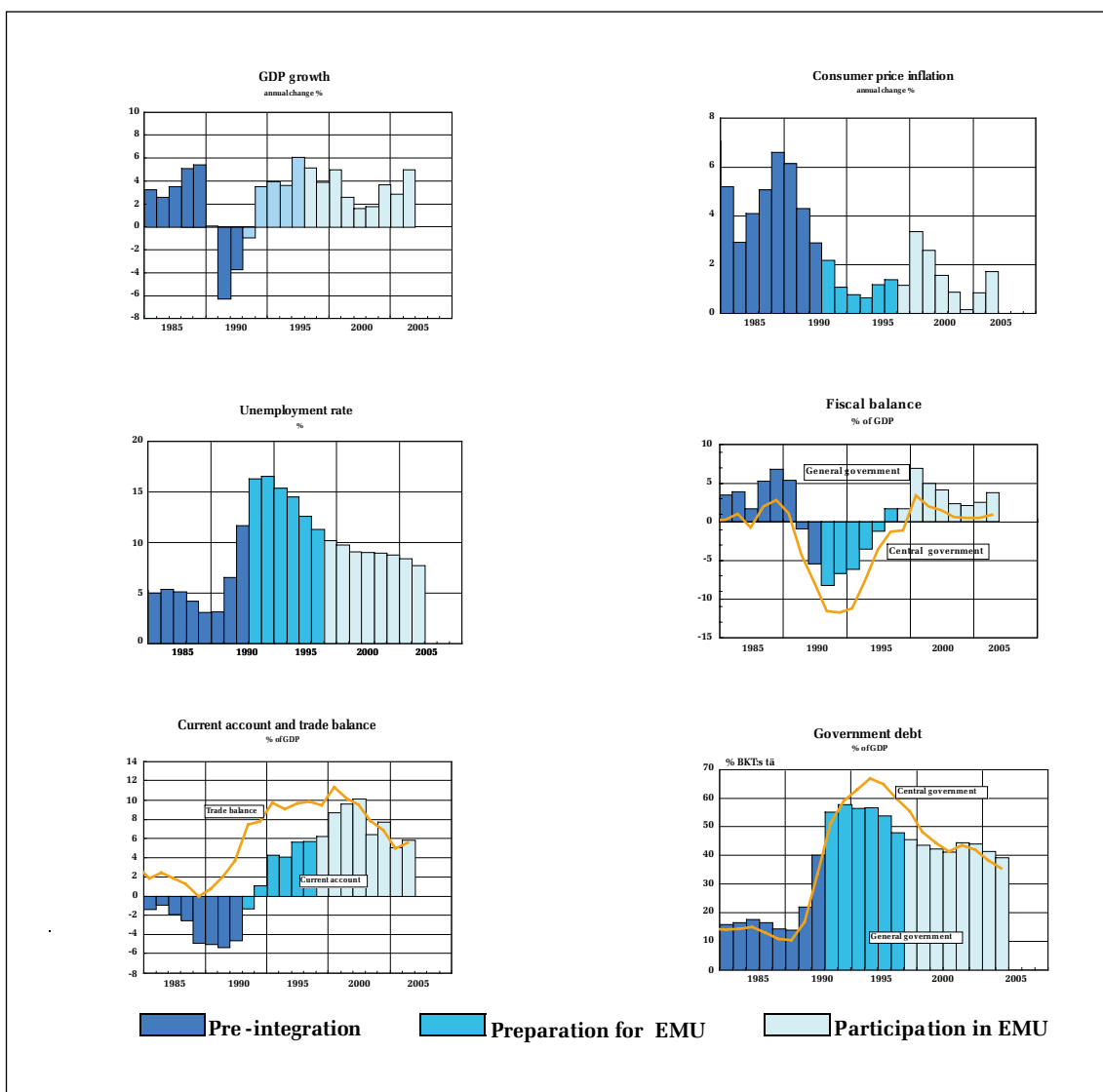
as was the ability of Sweden to run an independent policy to counteract it. Perhaps the most interesting ground for disagreement was that they felt that the necessary changes to improve the functioning of the labour market and wage formation (p. 2) required a credible 'economic policy' for sustainable growth and were independent of whether or not Sweden was participating in Stage Three. In Finland, the central bank avoided taking an official stance on the desirability or the probability of the monetary union. Internally, however, the bank organised technical preparations from 1994 as if Finland's participation in EMU as one of the first group of countries was a certainty and was active in informing the public about EMU and the preparations for it in its publications.

4. Overview of macroeconomic developments in Finland

Figure 1 depicts main features of the macroeconomic developments in Finland since mid-1980s. The phases of integration in the columns in the panels are shaded differently to distinguish them, running from darkest for the period beforehand, medium for the period when preparations for EMU were undertaken (including the entry to the European Union at the beginning of 1995) and finally lightest for the EMU era.

It is clear that the late 1980s were characterized by accelerating inflation, a deteriorating current account and very low unemployment. The economy was thus overheated by all standards, which was one of the

Figure 1. *Main macroeconomic indicators for Finland, 1985-2006*



Sources: Statistics Finland, Bank of Finland and State Treasury Office

causes of the subsequent crisis. Another related cause was excessive credit expansion and over-indebtedness which contributed to the emergence of the full-blown banking crisis. On top of that came the collapse of Finland's exports to the Soviet Union.

As mentioned above, the effects of the crisis in 1991–1993 were felt in the GDP level, which fell, along with sharply rising unemployment and rapidly deteriorating public finances. The trough of the recession is dated to mid-1993, when the preparations for EU membership and ultimately for the participation in EMU had already started. Thereafter, the recovery was rapid. Exports and industrial production, boosted by the weaker exchange rate, recovered first. They were followed by investment and private consumption, although it was not until the year 2000 that private consumption and retail trade volumes have reached their pre-recession levels. The comparatively high growth in 1994 to 1998 is mainly explicable by the recovery from the deepest peacetime recession of the country. In 1999 and 2000, the growth was boosted by the rapid increase of the ICT production with significant spillover effects to the rest of the economy. Thereafter, the growth has been maintained by robust private consumption, while in the most recent years it has been more broadly-based with strong contributions coming from both exports and reaccelerated private investment activity.

Unemployment declined rapidly during the recovery phase, but since around the year 2000 the improvement has been sluggish. It is partly due to the legacy of the recession which created a large amount of long-term unemployed with deteriorated human capital, but it certainly is an indication of prevailing structural rigidities in the labour market. All the more important, therefore, is the fact that during the past couple of years employment has been growing fast and the unemployment rate has declined below the euro area average for the first time since 1991.

While Finland had no difficulty in meeting the inflation criteria for EMU in 1998, inflation started to reaccelerate at the turn of the century, after six years of price stability. This was partly due to higher energy prices but a surprisingly large contribution came from the prices of services. Wage inflation was not a major factor. Thereafter, inflation has been low, in fact the lowest among the euro area countries now for more than four years.¹⁰ This time the increased price of energy (far more significant than in 2000) and rapid growth have not threatened price stability, at least not so far.

General government finances have traditionally been in surplus in Finland. The crisis of the early 1990s abruptly interrupted this tradition. As late as in early

1997, it was projected that Finland might not meet the 3 per cent deficit criterion. However, the underlying strength of the economy was underestimated at the time and at the time of the final review Finland had no difficulty in passing the entry tests on fiscal criteria.

Finland's current account has traditionally been in deficit. The crisis brought about an end to this tradition. The trade balance started to strengthen early, mainly as a result of declining imports during the crisis years. It took a few more years before the current account, burdened by sharply increased net interest payments to abroad, started to strengthen. In mid-1990s, it was already in surplus, and the trend surplus widened until 2002. Thereafter, the surplus has gradually diminished but still remains on the high side by comparison to other countries.

5. The Effects of EMU on the Finnish economy

Overall, the macroeconomic developments have been rather favourable since 1999 (Figure 1), i.e. the period when Finland has been participating in the monetary union. In practice, the monetary union started already in early 1998, at the latest, as it had become clear that Finland would be in the first group of countries to form the EMU. An interesting question, therefore, is: How much did Finland's participation in EMU contribute to this favourable development?

There is no obvious answer to this question, and it would be impossible to verify any answer empirically. There are at least two ways to approach the question posed above. The first is to compare the actual experience since 1998/1999 with the expectations that prevailed before the monetary unions was reality. The second is to compare Finland's experience with that of a comparable country which decided not to join. As mentioned above, a structurally similar country, Sweden, is an obvious choice.

Perhaps the main area where expectations have been fulfilled fully, or even exceeded, is monetary and price stability. This is understandable, given the frustrating experience of instability in the early 1990s. Interest rates have been low and stable, by historical standards. The rate of inflation, measured by the harmonised index of consumer prices, has been one of the lowest in the euro area since mid-2002. It seems that low inflation is both expected and accepted.¹¹ As inflation has been lower than in the rest of the euro area, the real short-term interest has been the highest. Apparently in no way did

¹⁰ In 2003 and 2004, the price index was affected by lowered excise taxes on alcoholic drinks, which brought the headline inflation to zero for a few months in 2004. Even adjusted for this, inflation in Finland was the lowest in the euro area at that time.

¹¹ The cash changeover at the beginning of 2002 raised perceived inflation (over the past 12 months) while at the same time expected inflation (over the forthcoming 12 months) declined (Kurri 2006). Expected inflation has been above the measured rise in the harmonised index of consumer prices, but more recently they have been more or less correct when inflation is measured by the national CPI which includes the effects of house prices and mortgage interest rates.

this affect consumer sentiment, as is evidenced by high consumer confidence and buoyant housing markets.

There were expectations at the beginning of 1990s that full integration into the EU, including the participation in the monetary union, would enhance competition with a favourable impact on productivity growth. There was, indeed, a step improvement in total factor productivity in the mid-1990s. This probably had much less to do with the European integration than which the recession which led to an intensified 'creative destruction' process in which the least profitable outlets were simply closed and the companies restructured by focusing on their core businesses. The ratio of business fixed investment to GDP fell sharply and has not returned to previous levels (which at 30% were high by European standards). Thus, we have the contrast of a more rapidly growing economy and lower investment levels. Capital is clearly more productive after the crisis than before.¹² The investment picture looks somewhat different if one takes into account the increased business spending on R&D. The share of R&D investment in Finland is the second highest in the world (3.5% of GDP, of which 70% is private spending). Again, it is almost impossible to attribute this change directly to Finland's participation in EMU. The main effect of EMU probably was anticipatory: once the option to devalue is taken away permanently, it is better to adjust early and pay more attention to productivity. There is ample anecdotal evidence that this, indeed, was the case. If this interpretation is valid, it would be an example of 'convergence second': one starts to adapt for a new regime once the probability of the new regime is sufficiently high.¹³

The second example of 'convergence second' is the fiscal discipline which has been respected by three successive governments since the beginning of 1999. The aim has been to reduce the tax burden while keeping the central government finances in surplus (with larger surplus in general government). Spending discipline has been maintained by multiannual spending ceilings covering the whole government term. It may, however, be misleading to claim that this fiscal orientation has been chosen because of Finland's participation in the monetary union. The main driver has been the preparation for the effects of ageing, but the side-product of

this strategy is to build some buffers to cope with adverse asymmetric shocks.¹⁴

The fears about adverse asymmetric shocks have not materialised. It is ironic that the first asymmetric shock turned out to be a positive one. The worldwide Information and Communications Technology (ICT) boom had a disproportionately large impact on the Finnish economy given the importance the sector had gained during the 1990s. This favourable asymmetric shock called for real appreciation of the currency. Outside the monetary union, the ICT boom would likely have led to nominal appreciation of the currency, thus hurting the competitiveness of more labour-intensive traditional industries. Inside the monetary union there was a pressure toward real appreciation. Indeed, inflation in Finland accelerated sharply and exceeded the euro area average by 1.5 percentage points for most of 1999 and 2000. Given the size of the shock, interest rates probably would have been higher and the exchange rate stronger in those years, had Finland stayed outside the monetary union. Once the ICT boom was over and exports and industrial production started to decline in 2001, there probably would have been some pressure on the central bank to relax monetary policy in order to weaken the currency.

Our impression is that Finland's participation in EMU has enhanced competition in product and service markets as well as reduced labour market rigidities. The structural change is most visible in financial markets. The Finnish banking system has been internationalised with two thirds of the banks being part of foreign groups. The stock market has similarly been merged – in both cases with Nordic and not with euro area partners. Competition in product markets has clearly increased, which has contributed to low inflation. Much less has happened in the labour markets, although increased competition inevitably makes the labour market more competitive as well. It seems that price stability is expected and accepted by wage setters. Nominal wage growth has exceeded the euro area average by 1 to 1.5 per cent, but thanks to higher productivity growth, unit labour costs have been rising in line with the euro area average. Part-time employment has increased considerably. There seems to be a general tendency toward more bargaining at the local level, not only on non-wage issues, such as working time, but increasingly also on wages.

¹² The work of Ripatti and Vilminen (2001), using CES production functions, shows clearly that the nature of the productive side of the Finnish economy shows a break around that time with the break being on the capital side of the economy. Maliranta (2003) uses establishment-level data and shows that much of the productivity increase took place as a result of closing down the least productive establishments.

¹³ It is easy to recall how the good performance of EC member states in the early years after the decision in 1987 to establish the Single Market was initially attributed to the formation of the Market by 1993 (Mayes, Burrige 1993). Yet, this form of analysis was rapidly abandoned as economic difficulties reappeared in the early 1990s.

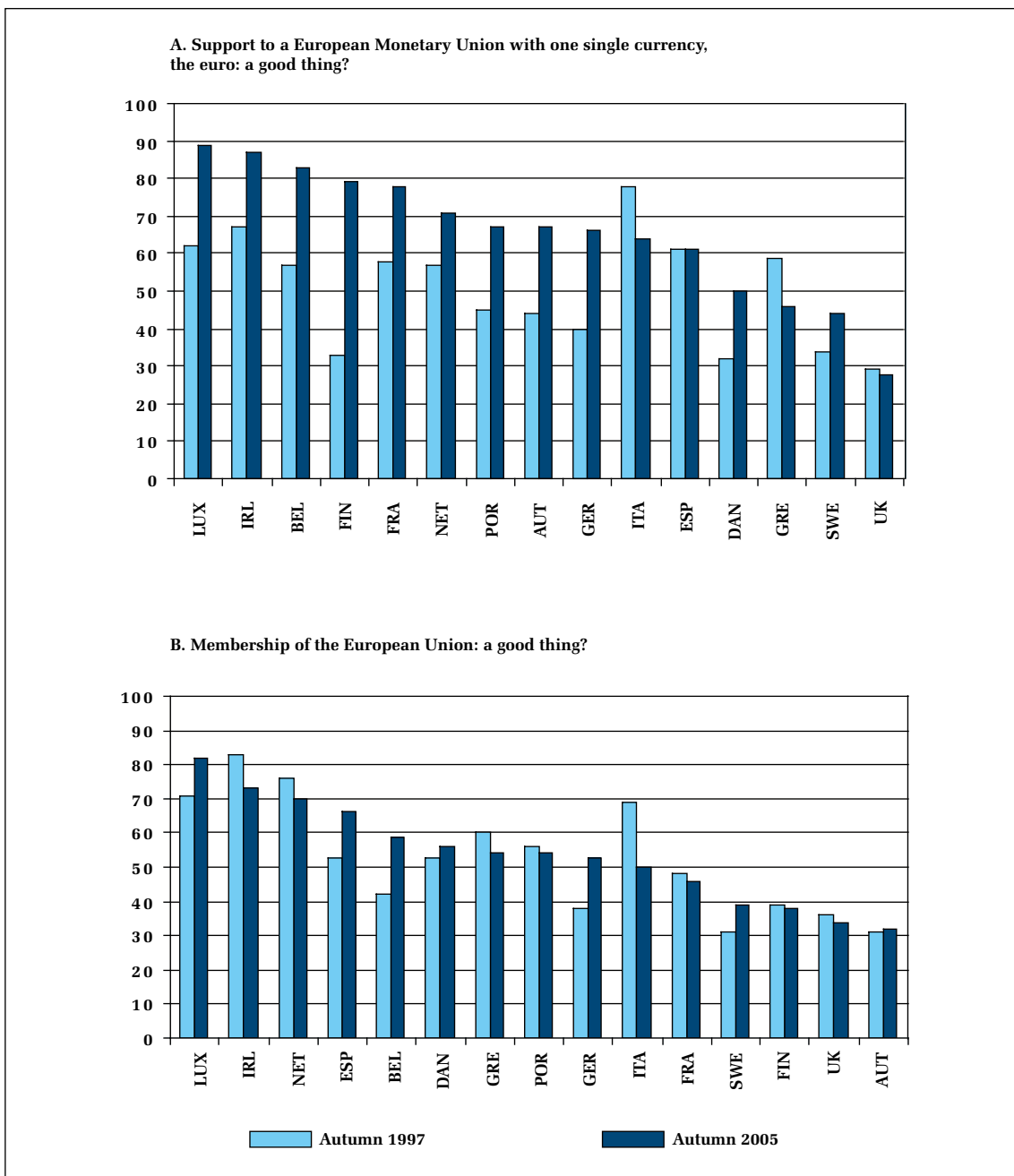
¹⁴ One of the most interesting developments in trying to establish a flexible basis on which to respond to shocks under EMU has been the establishment of the buffer funds. This scheme was created in the 1990s, mainly as a means to guarantee the trade union support for EMU participation. These funds complement the unemployment insurance funds that are administered by the social partners. They were previously required to be self-financing on a year-by-year basis, implying a pro-cyclical effect as in bad times fewer employed persons had to pay for more unemployed. But now they can run a surplus or deficit up to the cost of 3% unemployment. This means that contribution rates can be counter cyclical. This can be viewed as an aspect of how co-operative bargains by the social partners in a centralised system can actually improve the ability of the economy to react flexibly. It is also helpful as a pre-commitment. The buffer funds have not been used as the economy has not faced a serious downturn since their inception.

Economic development in Sweden since the start of euro area is comparable with that in Finland. Economic growth in 1998–2006 has been 3.2% per annum on average, compared with 3.3% in Finland. Inflation has been more or less the same in both countries, most of the time clearly below the euro area inflation. Neither is there any systematic difference in interest rates, short nor long, between the two countries. In times, the rates have been lower in Sweden. Indeed, it is practically

impossible to draw any conclusion about the economic costs or benefits of being inside or outside the monetary union on the basis of the experience of these two neighbouring countries.

Perceptions matter and as is clear from Figure 2 perceptions in Finland and Sweden have become very different. In 1997, support for the EU and EMU was very similar in the two countries; indeed support in Finland for EMU on this count was sufficiently low

Figure 2. *Popularity of the euro and the European Union*



Sources: Eurobarometer 48 (field work October–November 1997), Fig. 3.2 and Fig. 3.12, and Eurobarometer 64 (field work October–November 2005), Question A32.1 and Question A8a.

(the lowest among the countries that actually joined) that a referendum might have thrown the idea out – but none was held. In 2005, support for the EU was still relatively low and had fallen; support for EMU on the other hand had surged and was fourth highest in the EU. Thus, EMU was popularly regarded as a success and not bracketed with the whole EU project. Outside, Swedish perceptions changed much less but still favourably despite the rejection of membership in the referendum on 14 September 2003. If Sweden had joined EMU at the outset and economic performance had been similar, then there too enthusiasm might have changed more but this can only be speculation. Referenda, although on a single question, cannot prevent electors from conflating all sorts of issues not on the ballot paper when casting their vote.

So far Sweden has been saved from a major adverse asymmetric shock that would have required a prompt monetary policy action. In practice, this has therefore meant that Swedish monetary policy has tracked euro area policy quite closely (Giavazzi, Mishkin 2006). Although in the early years there was a 20% fluctuation in the euro/krona exchange rate, variations since 2002 have been small. The fears of Calmfors Commission (1997) have therefore not been realised and unemployment has now reached levels where the ‘convergence first’ requirements have largely been fulfilled. However, caution remains. A second Commission was appointed in Sweden – see Regeringskansliet (2002) for a summary of its report – to consider how stabilisation policy could be run inside EMU. It argues that Sweden should normally operate with a fiscal surplus 2.5 to 3% of GDP so as to allow much more extensive automatic and discretionary stabilisation in the event of a substantial shock. Finland too has been running such surpluses, mainly so as to accommodate both the consequences of unexpected shocks and known pressures such as those from an ageing population.

6. Concluding remarks

While one obvious conclusion is that there are some problems with the detailed nature of the convergence criteria laid down in the Maastricht Treaty that any other groups of countries considering forming or enlarging a monetary union would want to bear in mind when drawing up their own rules, the experience of Finland in the run up to the monetary union has a number of useful lessons.

- *Timing matters* in a number of senses. Political windows may only be open for limited periods of time. If economic convergence by whatever criteria does not occur during that window, the opportunity may be lost for a long period of time. The experience of Sweden illustrates this – by the time EMU membership was

put to the electorate the window of opportunity, as revealed by the opinion polls, had shut. Conversely, if meeting convergence criteria requires a temporary period of harsh policy there are only some times when that is politically possible. Because the opportunities tend to be discrete, the particular set of external shocks matters both for convergence and for electoral sympathy. Finland has prospered inside the euro area because of favourable asymmetric technological developments which monetary policy has accommodated. Estonia has suffered adverse energy price shocks in its period of assessment, probably resulting in a completely different profile of membership than if they had occurred earlier or later. Finland was lucky in the choice of time period for its own qualification – moving the window a year or so forward or backward could easily have resulted in breaching at least one of the criteria.

- *The viable alternative matters* also in a number of respects. If most of the advantages of monetary union can be reaped without full commitment, as in the case of Denmark, then it may not look economically worthwhile doing more. On the other hand, if there is a strong need for credibility as with the Baltic States in the early years of renewed independence, then the costs from the loss of an adjustment mechanism may be well worth paying. Similarly, if the alternative, such as inflation targeting appears to work well, as in the case of Sweden and the UK, it may be difficult to make a change.

- Except in obvious cases, *it is difficult to put together a convincing case for membership of a monetary union using ex ante Optimum Currency Area criteria*. Much of the point of joining a monetary union, as in the case of Finland, may be to force change away from previous welfare-reducing behaviour. It is extremely difficult to provide counterfactuals to any chosen policy regime. Thus, there is almost no evidence to suggest how different Finland would have been outside the euro area. Equally, it is difficult to suggest how different Sweden might have been on the inside. It is only in cases like Estonia, where the extended period under the currency board has mimicked membership of monetary union, that criteria estimated on ex ante behaviour can be a reasonable indicator of suitability as no regime change is expected.¹⁵

- *The Optimum Currency Area criteria do matter*. Structural similarity, policy and institutional similarity and most of all flexibility in other markets to cope with the loss of the exchange rate do matter. However, it is difficult to get enough evidence to argue convincingly whether one should adjust first to meet the criteria sufficiently ex ante as Sweden has wished or adjust

¹⁵ However, as the new member states are primarily transition economies, they are in the process of major regime change across the board, which means that it is very difficult to make long-run predictions. Rapid growth introduces tensions in the economy that are not always resolved smoothly as some of the Asian economies have demonstrated.

second to meet them sufficiently as Finland has been doing. Furthermore, it is difficult to assess the extent to which the criteria need to be met for the net effect to be beneficial. Finland's trade pattern is diverging from that of the euro area. Only a third of Finland's exports go to the euro area and the share of Asia and Russia has been rising.

- The most important conclusion that emerges from Finnish success inside and Swedish success

outside EMU is that membership per se is not likely to be the decisive factor. Prudent fiscal policies that have inbuilt rules that make it difficult for governments to threaten price stability and a monetary policy that credibly targets low inflation are ingredients of any success. Similarly, without a strong productive sector operating in open and flexible markets for goods and services and able to compete abroad, EMU as such will not offer a route to success.

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