The euro era has internationalised the Finnish economy – the recession is weakening its external stability

28 April 2009

Finland’s foreign trade, capital flows and positions in foreign assets and liabilities have undergone dramatic change since the turn of the millennium, reflecting the globalisation of the Finnish economy. The sustained current account surplus, lasting more than ten years but gradually declining in the past few years (Chart 1), has seen net foreign debt giving way to net foreign assets (Chart 2). This development diverges sharply from the past. The net international investment position (NIIP) is affected considerably by the value of Finnish shares in foreign ownership.

The subprime crisis in the United States escalated in 2008 into international financial turmoil, leading to worldwide recession with obvious, unavoidable consequences for Finland as well. In this new situation, both traditional industrial economies and emerging economies are plagued by recession. More than ever before, global financial markets are the vehicle of contagion in an integrated world economy.

The crisis has already led to major structural changes in financial markets around the world. Stock market prices, along with other asset prices, nosedived, and there was a subsequent slowdown in world trade and economic activity.

In Finland, there has been a loss of foreign agents operating in the MFI sector. The stock market price crash is reflected in foreign portfolio asset values and the value of foreign ownership of Finnish securities, with implications for Finland’s IIP.

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1 This article is based on Jorma Hilpinen (ed.), Suomen talouden kansainvälistyminen 2000-luvulla rahoitus- ja maksutasetilastojen valossa (‘Internationalisation of the Finnish economy since the turn of the millennium as seen through financial and balance of payments statistics’), Bank of Finland A:112, Helsinki 2008 (in Finnish, with abstract, summary and conclusions in English), a compendium of articles on the subject published in December 2008 (see http://www.suomenpankki.fi/ fi/ulkakustut/selvitykset_ja_raportit/leistajuiset_selvitykset/2008_k_112.htm).

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Chart 1. Finland’s current account

![Chart 1](chart1.png)

Sources: Bank of Finland and Statistics Finland.

Chart 2. Finland’s net international investment position (NIIP) and net foreign assets

![Chart 2](chart2.png)

Sources: Bank of Finland and Statistics Finland.
structures. The current account surplus shrank substantially during the last months of 2008, and this weakening has continued into 2009.

Changes in foreign trade
Export-led growth and favourable export performance require competitive production conditions. The ICT-driven Finnish export growth following the severe recession of the early 1990s and during the 2000s cannot be explained by the traditional comparative advantage offered by factors of production. Several studies have yielded evidence that knowledge and research factors have contributed most to this success. A competitive economic environment and functional and equitable social structure also emerge as success factors. The recession of the 1990s redirected the financial sector to be more market-oriented so that the risks are better reflected in credit pricing.

Price competitiveness encompasses the movements of the euro exchange rate vis-à-vis other currencies. The euro exchange rate movements are exogenous to the Finnish economy so that flexibility is needed to adjust to these movements. It is often argued that the 1990 recession rendered the Finnish economy more flexible. However, in a fully integrated global economy, Finland cannot compete with the new and emerging economies in price competitiveness.

Finland is an open economy in which foreign trade in goods and services comprised more than 40% of GDP in the boom years of 2006 and 2007. This openness nearly equals that of the other Nordic countries, but falls well below that of the small and medium-sized countries of continental Europe. The GDP share of foreign trade always declines during a recession.

On average, Finnish export growth has stayed in line with market growth, due in part to the strong demand from Russia. In addition to the Russian trade, the most rapid export growth has occurred elsewhere than in traditional markets. Foreign trade with Far East countries has developed vigorously during the present decade. China has grown in importance in both Finnish imports and exports. Trade with India, Korea and Taiwan has also expanded (Table 1). However, Germany, Sweden and Russia remain Finland’s most important trading partners.

Real changes in foreign trade commodity and partner structures take time. Turns in world market prices may, however, cause sudden shifts in trade values. Raw material and energy prices fell steeply during the final quarter of 2008, when the price of crude oil more than halved. The Russian share of Finnish exports fell accordingly, and Finland’s export prospects will most likely deteriorate further over the long term if the
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Decline in Russian oil revenues is sustained.

The recession has hit all export industries in Finland and will speed up structural change. The significance of the forest industry as a major exporter is declining. The industrial life cycle of this traditional industry is considerably longer than that of information and electronics product manufacturing. Emerging in the 1990s, major parts of this latter industry have since relocated to the Far East to be nearer a rapidly growing market. Correspondingly, imports from the Far East are expanding as more investment and consumer goods are being acquired from that area. These developments will no doubt lead to shrinking surpluses or deficits in Finnish foreign trade. The deepening recession has reduced both exports and imports. The decline in exports has been radical, resulting in a deficit in the current account as early as January 2009.

Growth in foreign trade in services is an essential aspect of globalisation. The growth apparent in Finland consists mainly of intra-group services in a few multinational enterprises. The statistical evidence available so far does not support the anticipated large-scale offshoring across enterprises.

Foreign direct investment as a globalisation indicator

Foreign direct investment (FDI) statistics measure equity and other capital relationships and their changes between a parent company and its subsidiaries and associates located in different economies. Nowadays, FDI flows from a country more weakly reflect international fixed investment by resident enterprises than in the past, since the direct investment enterprises abroad increasingly acquire finance directly from international markets. Equity inputs by parent companies may remain minor if investment is targeted to emerging, low-cost economies.

Towards the end of the 1990s and around the turn of the millennium, Finnish FDI was dominated by a few large mergers and acquisitions, raising FDI stocks to new levels and bringing the stock of outward FDI up to 40% of GDP, a large figure by international standards.

### Table 1.

<table>
<thead>
<tr>
<th>Country of destination</th>
<th>Exports 2008</th>
<th>Imports 2008</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>198</td>
<td>215</td>
</tr>
<tr>
<td>Sweden</td>
<td>169</td>
<td>185</td>
</tr>
<tr>
<td>Germany</td>
<td>128</td>
<td>192</td>
</tr>
<tr>
<td>EU15</td>
<td>134</td>
<td>170</td>
</tr>
<tr>
<td>Euro area (12)</td>
<td>135</td>
<td>176</td>
</tr>
<tr>
<td>South Korea and Taiwan</td>
<td>142</td>
<td>383</td>
</tr>
<tr>
<td>India</td>
<td>335</td>
<td>332</td>
</tr>
<tr>
<td>China</td>
<td>210</td>
<td>634</td>
</tr>
<tr>
<td>Russia</td>
<td>474</td>
<td>473</td>
</tr>
</tbody>
</table>

Source: National Board of Customs.
comparison, at which it then levelled off.

The stock of inward FDI in Finland approached 30% of GDP in 2005 and continued to rise until 2007. Non-financial corporations account for almost all FDI abroad (Chart 3), while there has been substantial inward direct investment in financial sector companies.

Direct investment may be based on either intrinsic factors at enterprise level or on the macroeconomic conditions in the country of residence of the investor and/or the country in which the potential direct investment enterprise is located. As enterprises grow in relation to local markets, the threshold to expand abroad is lowered. Competition factors often lie behind FDI decisions. There is also evidence that research intensity leads to internationalisation. According to recent studies, microeconomic enterprise motives and benefits serve as the primary explanatory factors for FDI, but high domestic costs also remain an important reason to move abroad.

Since the turn of the millennium, FDI has increasingly consisted of international capital flows and subsequent stocks between the financial centres of multinational enterprises and their parent companies, subsidiaries or associates, and of the sophisticated financial arrangements for mergers and acquisitions. Traditional equity investment makes up only a part of these arrangements. Some back and forth flows cancel each other out when investments are classified as outward or inward according to controlling ownership. Multinational enterprise structures are complicated and diverse, so that bookings in statistics become a multitude of individual cases. Intra-group finance as well as bond issues gained ground in international corporate finance before the advent of the financial turmoil, while foreign bank loans faded in significance.

Net income from foreign direct investment has become a growing receipt item in the current account, amounting to slightly over 1.5% of GDP. Dividends paid to the holders of Finnish shares (Nokia shares held by foreigners) have overrun this figure, however.

Foreign affiliates trade statistics (FATS) describe the activities of foreign subsidiaries in their host
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countries using a few real economic variables. According to this data, the number of employees of affiliates and branches in Finnish ownership abroad has grown 50% during the present decade, and most rapidly in China, by nearly 600%. This growth has moved China to fourth position after Sweden, the United States and Germany.

A majority of banks are now in foreign ownership

Nordic banking integration has spurred the profound structural change in Finnish credit institutions that has been underway since the banking crisis of the 1990s. The limited domestic growth potential of each country helped trigger this integration, which has seen the Finnish MFI sector come largely under foreign ownership (Chart 4). In 2008, foreign bank subsidiaries and branches' share of the balance sheet total of banks resident in Finland rose to 70%. However, the impact of the financial market crisis was also reflected in the foreign-owned component of the Finnish MFI sector. After the collapse of Icelandic banking, the MFIs in Icelandic ownership returned to Finnish ownership or terminated their operations in Finland.

The large foreign ownership in banking in Finland resembles the situation in the new EU member states rather than the other Nordic countries. However, untypically for Europe, the parent banks of foreign-owned bank subsidiaries and branches in Finland are close by, as they are resident in another Nordic country. Nordic banks also play a significant role in the Baltic states, denoting a deep integration of the Nordic and Baltic markets.

The major foreign-owned banks in Finland are in the form of subsidiaries. The numerous foreign bank branches operating in Finland specialise in specific lines of business and do not aim at full-service banking. The number of credit institutions in Finland has held steady over the last decade, and the entry of foreign subsidiaries and branches has been offset by mergers of small local banks.

Retail banking by MFIs resident in Finland remains nearly 100% domestic. This mirrors European developments. No pan-European retail bank exists. In contrast, European interbank markets have become thoroughly integrated since

Chart 4.

Foreign direct investment in Finnish financial institutions: stock

Sources: Bank of Finland and Statistics Finland.
the introduction of the euro. In Finland, some 70% of loans and deposits between MFIs were of foreign origin in 2007, and this figure fell only slightly in 2008. The ownership structure of banks suggests that foreign intra-group flows have expanded to replace genuine foreign wholesale banking flows. During most of the present decade, the interbank loan receivables of Finnish banks have exceeded the respective liabilities. These foreign assets have declined sharply since last autumn, while the liabilities have continued to mount.

The gap between bank loans and deposits has widened during the new millennium boom years, and Finnish MFIs have increasingly resorted to the capital markets in foreign funding. This has been facilitated by the disappearance of exchange-rate risks with the adoption of the euro and low interest rates. The recent financial market turbulence and subsequent crisis have affected bond and money market paper issues, and the outstanding stock held by foreign residents has remained practically unchanged at 15% of GDP in 2007 and 2008.

The balance sheets of the subsidiaries of Nordic banking groups may contain large intra-group items where the group figures have been booked in the subsidiary. In addition, a few branches serve as a bank representative and their loans granted might appear only in the foreign headquarters’ books. Moreover, European company status and related booking practices, if they become popular among multinational MFIs present both inside and outside the euro area, will certainly detract from the information value of euro area and national banking statistics.

**Rapid growth in foreign portfolio investment is halted by the financial crisis**

Foreign portfolio assets and liabilities became the largest items in Finland’s international investment position during the bullish years since the turn of the millennium, indicating the significant internationalisation of finance and investments in the form of securities (Table 2). Foreign portfolio asset and liability stocks peaked in autumn 2007, assets approaching the value of annual GDP, and liabilities, ie mainly Nokia shares in foreign ownership, actually exceeding this. Due to the financial crisis and particularly the crash in share prices, the foreign portfolio asset stock fell 25% during 2008, while the value of Finnish securities held by foreign residents fell even more, by 33%.

### Table 2.

<table>
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</thead>
<tbody>
<tr>
<td><strong>Shares</strong></td>
<td>0.3</td>
<td>4.5</td>
<td>83.1</td>
<td>43.5</td>
</tr>
<tr>
<td><strong>Bonds</strong></td>
<td>0.9</td>
<td>9.4</td>
<td>88.3</td>
<td>80.9</td>
</tr>
<tr>
<td><strong>Money market instruments</strong></td>
<td>1.5</td>
<td>0.5</td>
<td>5.5</td>
<td>4.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>2.7</td>
<td>14.4</td>
<td>173.9</td>
<td>130.8</td>
</tr>
</tbody>
</table>

Source: Bank of Finland.
The recovery from the recession of the 1990s only gradually improved the positions of financial institutions. The cross-border portfolio investment potential made possible by EU integration was scarcely exploited until the introduction of the euro in 1999. This facilitated investment in the majority of European securities without exchange-rate risk and has been the largest single factor boosting cross-border portfolio investment.

Large institutional investors are regulated by the authorities, and employment pension funds cannot exceed prescribed risk levels. The portfolio risks of the Finnish employment pension funds are regulated by legally defined solvency rules. The social partners are involved in the process of assessing and amending this legislation. The solvency rules for employment pension funds were altered in 1997 to ease foreign portfolio investment, which led to the growth in foreign bonds in fund portfolios. A similar decision was taken in 2006, allowing a greater proportion of shares in portfolios to provide the better yields necessary to cover growing pension outlays for an ageing population. As a result, Finnish institutional investors surrendered Finnish government bonds in the early 2000s.

The shift in investor policies led to a turnaround in central government foreign funding. In contrast to total debt, foreign funding grew rapidly. Practically all central government debt outstanding has been held by foreign investors since 2005. The highly internationalised primary dealer system has brought government benchmark bond markets closer to the foreign investor. Today, nearly all primary dealers of Finnish government bonds are foreign banks.

Marketplace interaction and mergers between the enterprises running stock exchanges have worked to promote efficiency. The autonomy of national markets has faded during the present decade with the development of the international financial system. The integration of marketplaces led to the merger of the Helsinki Stock Exchange with other Nordic and international trading grounds. The advance in technology and electronic trading systems brought about economies of scale and reduced dependence on the physical location of systems.

The number and size of investment funds have grown continuously since the mid-1990s, and most rapidly since the turn of the millennium. Funds initially attracted resources from households and later increasingly from institutions. Fund portfolio structure has evolved in step with that of institutional investors. Following Finland’s membership of the European Union and EMU, the bulk of investment in securities has shifted abroad. Supply has grown fastest amongst funds investing globally and in emerging markets, while the number of funds investing...
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