BoF Online

2007 • No. 18

Finnish Balance of Payments: an overview of the past and future prospects

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The opinions expressed in this paper are those of the authors and do not necessarily reflect the views of the Bank of Finland.

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EUROSYSTEMET

Bank of Finland

Financial Markets and Statistics

12.12.2007

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1796-9123 (online)

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1 Introduction

This paper[1] treats Finnish Balance of Payments time series from the 1960's to the present. It also discusses future current account prospects. Comparable National Accounts and Balance of Payments time series with current major breakdowns are available[2] in the current account from 1950 on and in the financial account from 1975 on. The old financial account time series from 1950 on follow a previous classification system where loans and bonds were not distinguished between. In practise, financial flows and stocks other than long term bank loans and bonds were nonexistent due to the foreign exchange controls then in place. The sum of these two plus trade related flows and change in reserves equalled current account. The figures in the charts attached are expressed in relation to the nominal GDP, where relevant.

Foreign trade in goods was deregulated in Finland in 1957 and the first steps towards European integration were taken in the form of the 1961 EFTA agreement as signs of return to normalised economic conditions after the War. The 1990's recession represents a major milestone in Finnish economic history dividing a number of economic processes into before and after periods. Another watershed is the EU and the EMU membership in 1995 and in 1999, respectively[3].

Other major factors lie behind recent Finnish economic developments: The ICT revolution and phenomena like Nokia is one occurring in the 1990's after the recession, and the other is todays' integration and globalisation process, as seen in the China syndrome originating this millennium.

[1] This paper is based on a set of articles being prepared for 'Internationalisation of the Finnish economy in the 2000's in the light of financial and balance of payments statistics', forthcoming in Bank of Finland series A, in Finnish. Economists Airi Heikkilä, Kimmo Koskinen and Jaakko Suni are co-writers of those articles. Anne Pessi has assisted acquiring data and drawing charts.

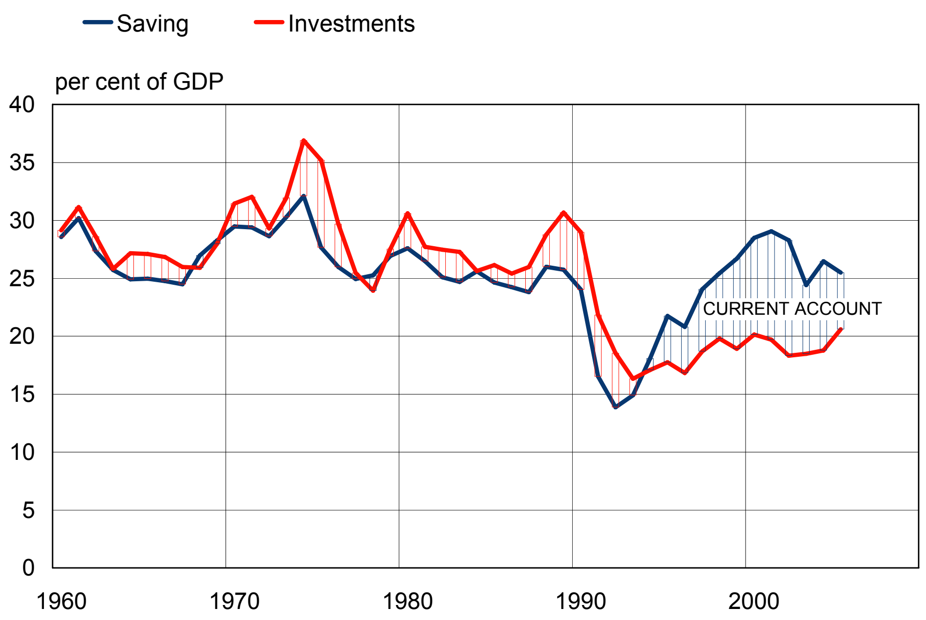
[2] Further information: www.bof.fi/statistics.

[3] Calendar of economic and policy events, see Bank of Finland Yearbooks, various issues.

2 Devaluation cycles and the descent into the 1990's recession

In the 60's, 70's and 80's Finland was a country which invested heavily to achieve economic growth. The investment ratio peaked in 1975 reaching 37 per cent of the GDP. Finland was then an investment-driven economy[4]. The country regularly faced current account deficits and ran up foreign debt in spite of a relatively high savings rate.

Chart 1. Investment and saving (gross) in the Finnish Economy



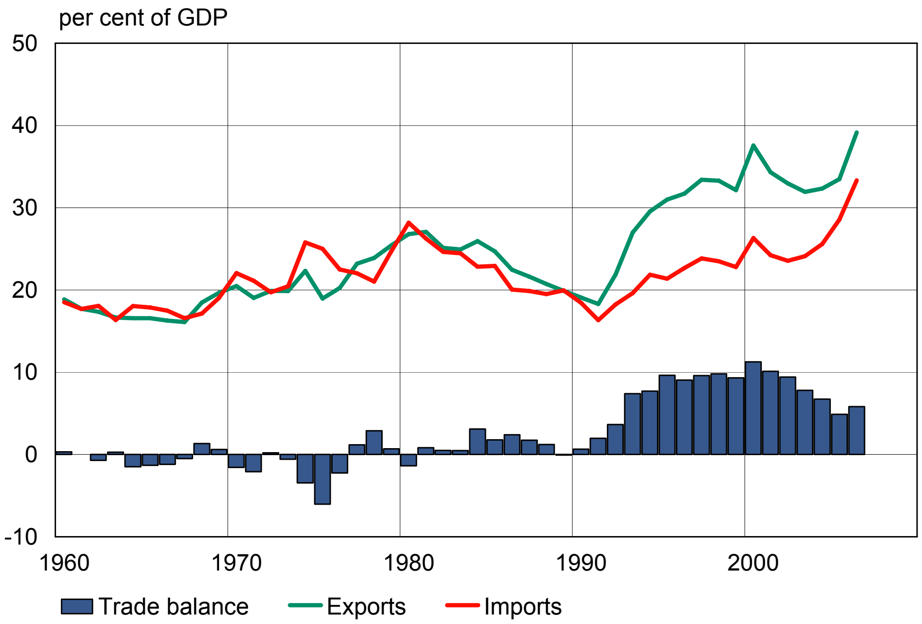
Source: Statistics Finland.

The Finnish current account was dominated by trade account movements. The goods made up some 75 per cent of total current receipts and expenditure in the early 80's. In addition to success in trade competition, trade in relation to the GDP serves as a measure of the openness of the economy. The share of goods exports and imports to the GDP declined during the 1980's, even when the internationalisation of the economy accelerated in terms of other indicators, such as foreign direct investments (FDI). This decline is partly due to the drop in

[4] See Carl J. Dahlman – Jorma Routti – Pekka Ylä-Anttila, (eds.): Finland as a Knowledge Economy, Elements of Success and Lessons Learned: Introduction by editors, page 6. World Bank Institute, Washington D.C. 2006.

oil price and imports from the Soviet Union in 1986, when exports to the Soviet Union also decreased as a result of the bilateral trade system. More diversified foreign trade leading to greater openness and smaller share of forest industry exports – could have alleviated the 1990's depression.

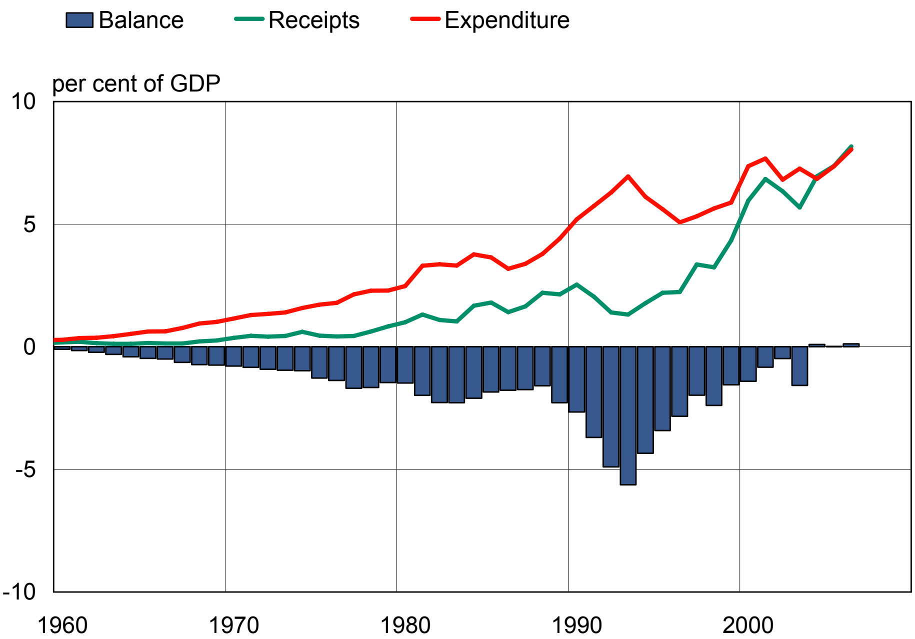
Chart 2. Exports and imports of goods and trade balance



Sources: Bank of Finland, Board of Customs and Statistics Finland.

Services have only had a minor role in current account and Finland has been regarded as an under-developed service provider. The widening deficit in income worsened external stability problems before the 1990's recession. Given this deficit it was not then credible that the current account could be balanced in a few years. Net income is a slowly moving item, and it improved only gradually over time.

Chart 3. Income

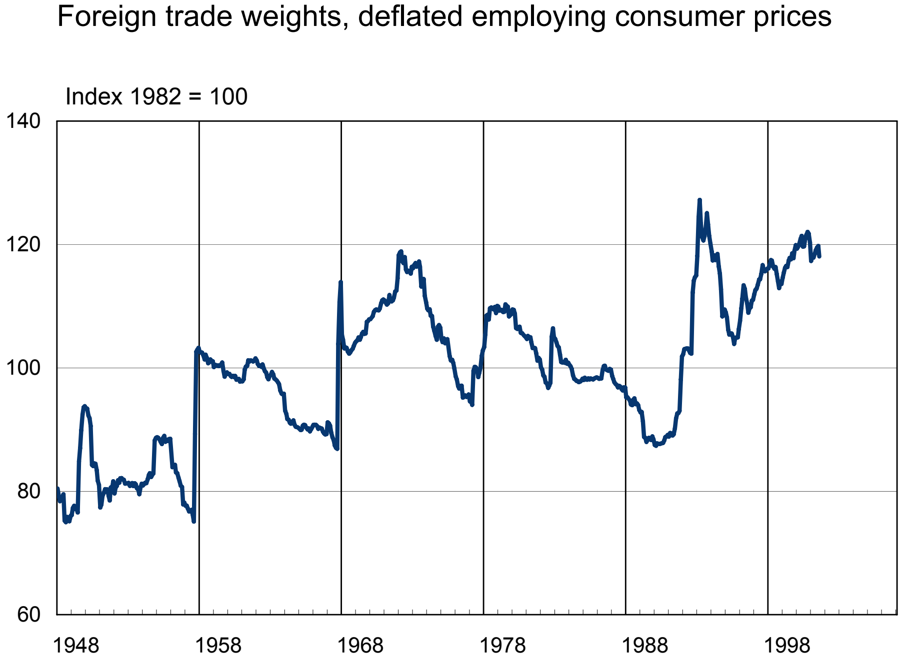


Sources: Bank of Finland and Statistics Finland.

Price competitiveness is a policy focus. During the markka era, when problems in the external stability worsened, the exchange rate of the markka was at stake. Export industries such as forest industry and metal and engineering industry had to maintain strong export performance to achieve overall economic growth. This required good price competitiveness. Domestic demand and price setting were inflation prone and competitiveness was no longer tenable. Moreover, Finnish exports were highly dependent on international fixed investment cycles adding to economic volatility in Finland. The Finnish economic performance in that era involved wider cyclical movements than in many other industrialised economies.

As a consequence, price competitiveness and brisk economic growth were to be regained again and again through exchange rate adjustments. Devaluations of the markka occurred in 1957, 1967, 1977, 1982 and finally in 1991 and while floating in 1992. Despite the desire to maintain a fixed exchange rate as in many other European countries, the markka exchange rate was in practise adjusted by major notchdowns.

Chart 4. Real exchange rate of markka



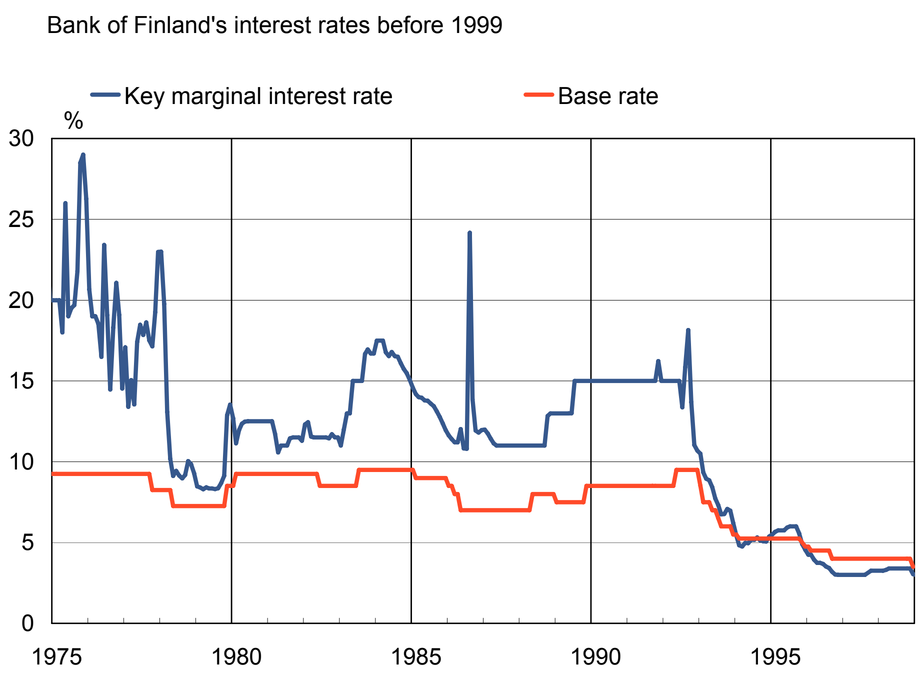
Source: Bank of Finland.

In addition to exchange rate movements, Balance of Payments developments were affected by monetary and foreign exchange controls. The Bank of Finland set guidelines for credit rationing implemented by banks. Interest rates were subject to a universal control by the Bank of Finland. The Central Bank set the so called base rate, and all other interest rates followed this base rate. The Central Bank financing of banks was based on credit quotas, and exceeding the quota was subject to penalty charges. The goal of monetary controls was to prevent excess demand that would lead to the growth of imports and a deteriorating current account. Similarly, foreign exchange controls kept the financing of the current account in check. All capital movements as well as current invisible transactions during the 60's and 70's were subject to licensing by the Bank of Finland. Banks were then authorised to conduct international business. Verification was required before the authorised bank could perform a foreign transaction for its client. All Central Bank instruments were employed to support external stability and managed economic growth. External stability and the current account in particular, was a primary constraint to growth.

The liberalisation of monetary and foreign exchange controls took place step by step from 1975 to the early 1990's following international trends and pressures opening channels to foreign finance. The Central Bank deposit and lending facility was introduced in 1975 and foreign financing in money markets a few years later. In the early 1980's, bank credit controls were also lifted and finally, market rates and open market operations were instituted in 1987. Liberalisation of foreign exchange controls was initiated in 1980 when private banks entered forward exchange markets. The sequence to liberalise Balance of Payments flows was begun by deregulating current transactions and capital imports. As late as 1985 the sale of markka denominated bonds abroad as means to evade foreign exchange and monetary controls was prohibited. However, a year later a major step was taken when long-term foreign financing was allowed for enterprises. Short term financing and financial outflows were deregulated in the final phase of liberalisation in 1990 and 1991.

Domestic interest rates hade to be kept high in order to maintain foreign currency reserves and liquidity, given the increasingly integrated financial and money markets with the regime of fixed exchange rate. Towards the end of the 1980's, the fixed exchange rate suffered credibility problems and from time to time speculative attacks were mounted against the markka leading to even higher interest rates.

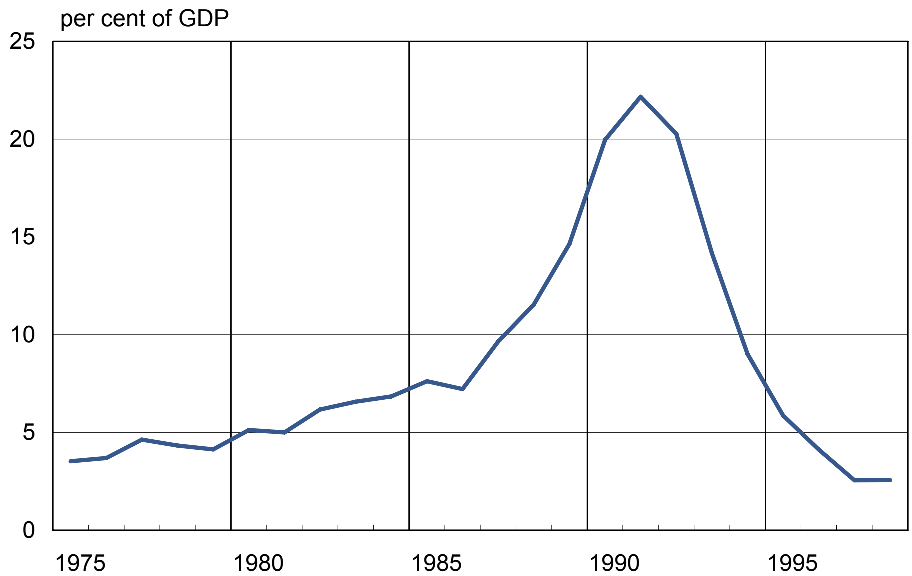
Chart 5. Key monetary policy interest rates



Source: Bank of Finland.

The Government and the Bank of Finland declared that prevailing exchange rate policy was on a firm footing. Banks' loan customers were keen to take cheaper credit in foreign currencies. To meet this demand, banks imported substantial foreign capital for domestic customers, even those without risk coverage. Domestic loans in foreign currencies became popularly widespread.

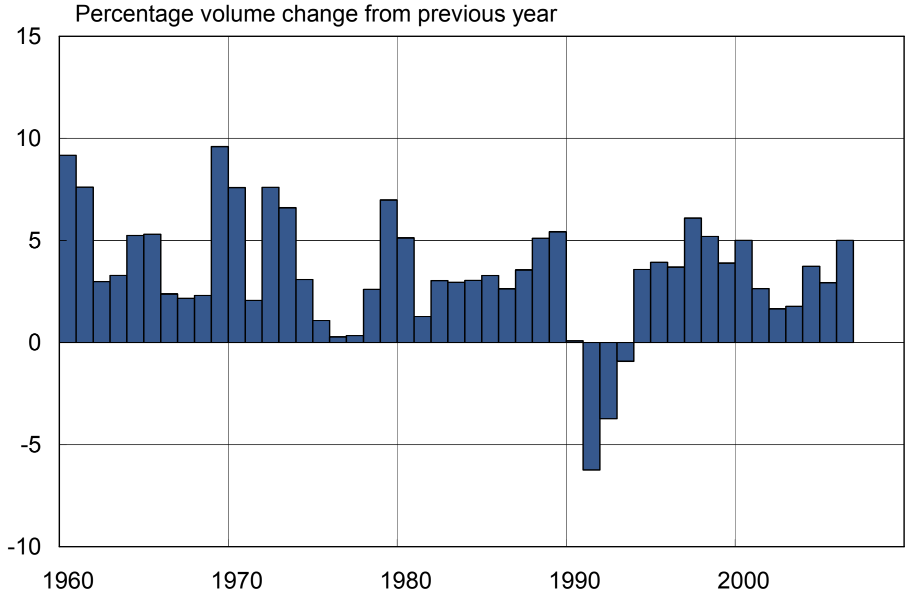
Chart 6. Banks' domestic foreign currency credits, before 1999



Source: Bank of Finland.

All this regrettably led to excess liquidity in the economy, overheating with soaring interest rates, a weakened current account and increased foreign debt at the end of the 1980's. These circumstances coincided with unfavourable international developments. Demand for the main export products in major western markets dropped sharply and the Soviet Union, a major trading partner, collapsed. It had been an important buyer of consumer and investment goods specifically designed for it. These products found no demand in western markets. The Finnish economy went into severe recession. The real GDP fell some 15 per cent during 1991–1993, unemployment rose from five percent to almost 20 percent, and public finances deteriorated dramatically.

Chart 7. Gross domestic product



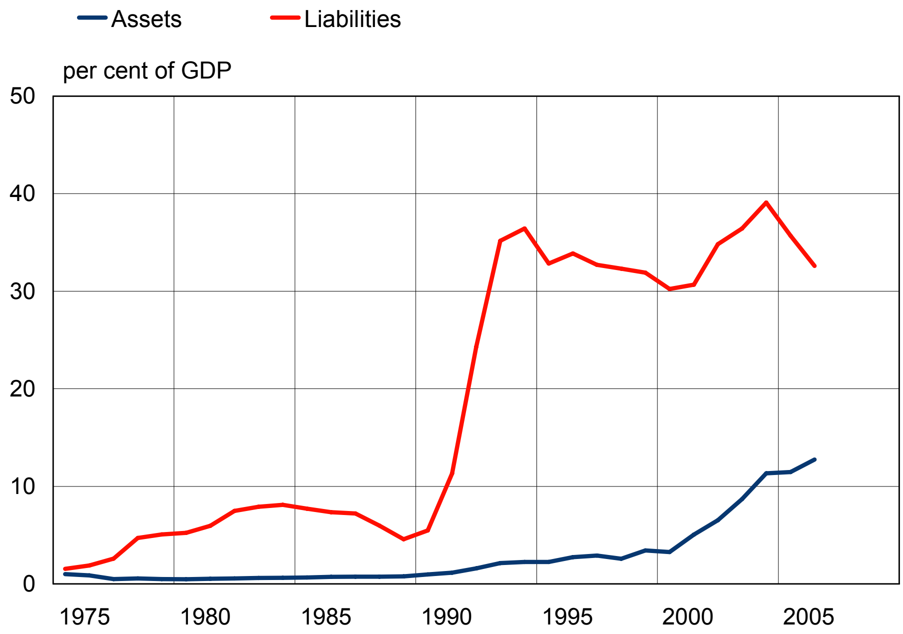
Sources: Bank of Finland and Statistics Finland.

Markets lost their confidence in markka leading to the November 1991 devaluation and float in September 1992 that resulted in further depreciation. Foreign currency credits with new exchange rates were fatal to many domestic market enterprises. Bank crises broke out, the worst case being the savings bank group.

Obvious reasons for the recession were bad monetary and fiscal policies, bad behaviour by economic agents in liberalised environment, and bad luck through global change.

Tough structural measures were taken to restore the solvency of the entire banking sector. The Central Bank and Government were called in to shore up the banks. Central government borrowing from abroad rose dramatically to cover the outlays for unemployment and bank subsidies, to mention some. A bulk of the bank subsidies landed up abroad when banks amortised their foreign credits.

Chart 8. Central Government, foreign assets and liabilities, stocks

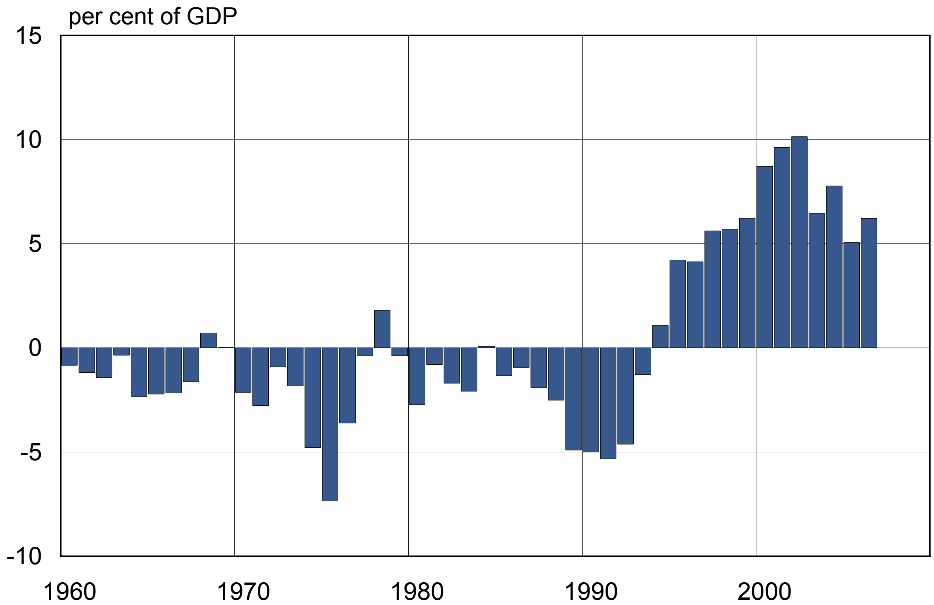


Sources: Bank of Finland and Statistics Finland.

3 Structural reform, economic recovery, the EMU and current account surpluses

The enterprise sector restructured export products, trading partners and cost structures. The adjustments took place rapidly and current account moved to surplus in 1993. The first annual surplus was recorded in 1994, and has since prevailed.

Chart 9. Current Account in Finland

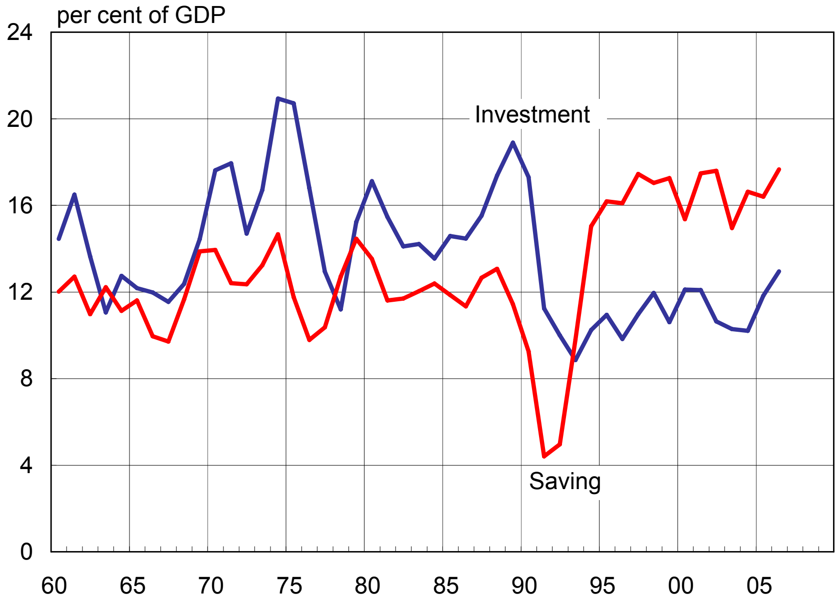


Sources: Bank of Finland and Statistics Finland.

Following a draconian reform the enterprise sector became efficient and financially strong as did the banking sector. Majority of savings banks disappeared and Nordic banking integration began. A major factor for the recovery was the emergence of the ICT sector, and Nokia in particular. To restore a sound public sector, strict government budgetary discipline was introduced, and outlays were slashed.

The pre-recession investment rates never returned, but a high growth rate could be maintained with lower investment. On the contrary, the over-all savings rate bounced back to pre-recession levels. The fruit of education and university reforms were ripened along with investment in technology and knowledge. To quote the Word Bank study[5], Finland had become a knowledge based economy.

Chart 10. Saving and investment, corporate sector and financial institutions



Source: Statistics Finland.

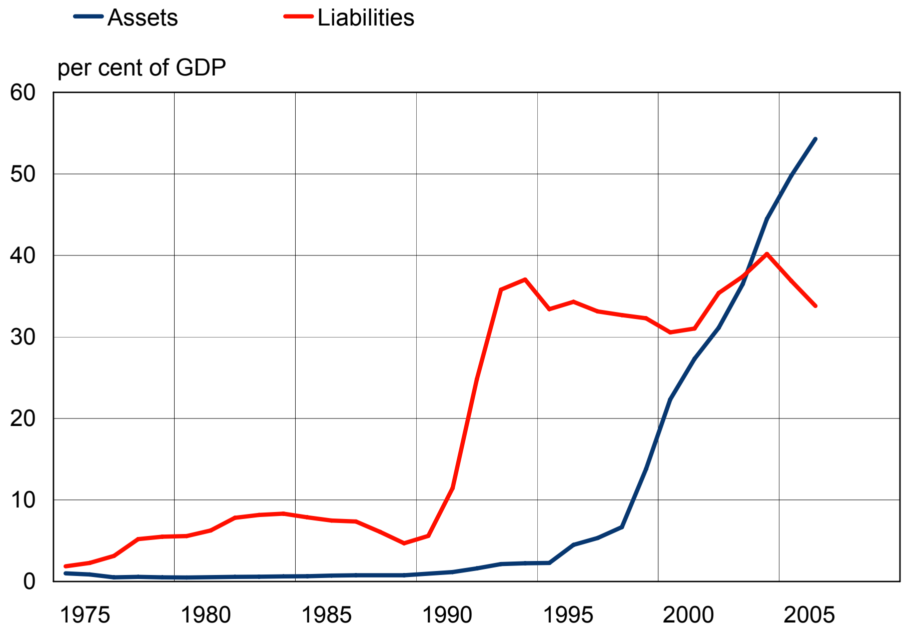
European integration widened when Finland joined the EU in 1995 along with Sweden and Austria. Optimistic integration ideas gained ground and in1996 the markka was linked to the European Exchange Rate mechanism. Then in 1999, Finland became a member of the European Monetary Union. Given the experience from the recession, EMU membership was a natural choice. Some now argue that the final conversion rate from markka to euro was too low, thus favouring Finnish exports, but also the opposite has been heard.

The foundation and the structure of the Finnish Balance of Payments altered completely. The Monetary Union membership made autonomous monetary policy meaningless and dampened exchange rate risks. With a current account surplus, Finland became a net lender to the rest of the world. Finnish institutional investors such as other financial institutions and

[5] See Carl J. Dahlman – Jorma Routti – Pekka Ylä-Anttila, eds.: Finland as a Knowledge Economy, Elements of Success and Lessons Learned: Introduction by editors, page 6. World Bank Institute, Washington D.C. 2006.

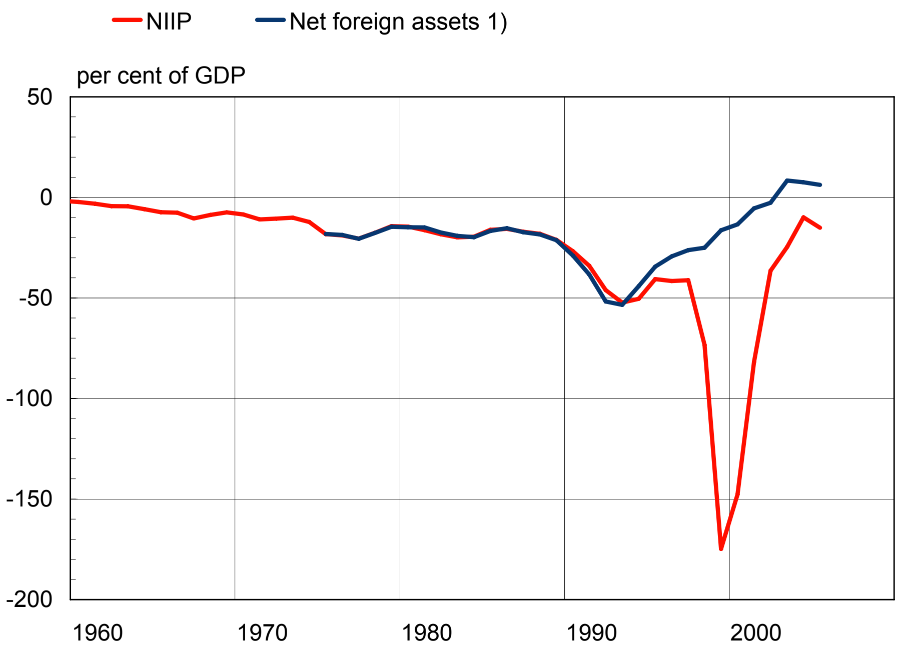
pension funds, the latter forming a part of the general government sector, invested in euro area securities (chart 11) – these now being home currency papers with no exchange rate risk and with a better yield than from Finnish government bonds. Central government debt became in this process totally foreign. Having restored budgetary stability, central government was awarded high ratings and enjoyed low interest rates in borrowing. The net foreign debt gradually declined, turning into net assets (chart 12).

Chart 11. General Government, foreign assets and liabilities, stocks



Sources: Bank of Finland and Statistics Finland.

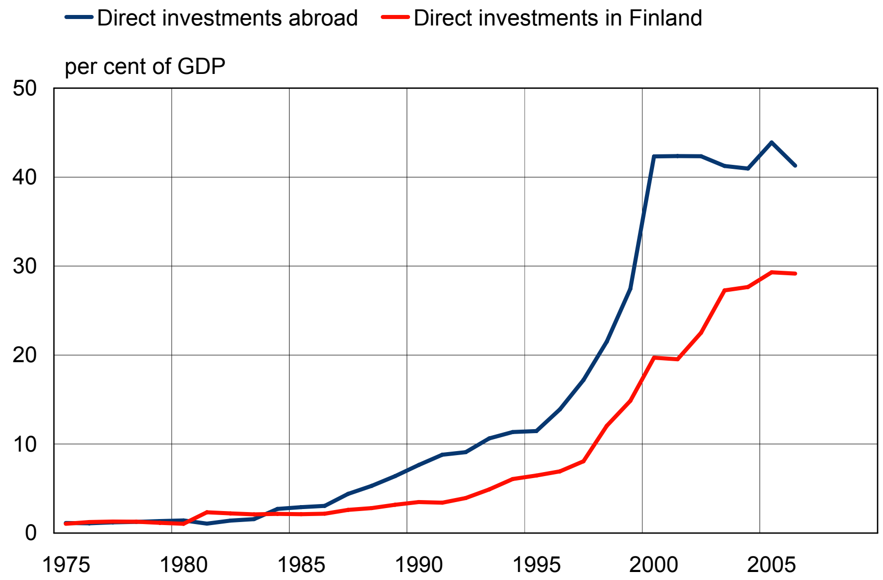
Chart 12. Finland's Net International Investment Position (NIIP)



1) NIIP excluding equity items.
Sources: Bank of Finland and Statistics Finland.

The ICT industry share prices rocketed in 1998-2000 causing the Finnish IIP (some 90 per cent of Nokia shares in foreign ownership) to diverge from net foreign debt. The growth of Nokia and other multinational enterprises along with Nordic banking integration boosted volatility of Balance Payments time series to an unprecedented extent. Large ups and downs appear between years but also within a given year. The value and volume of foreign direct investments grew multifold compared to the past.

Chart 13. Direct Investments, stocks



Sources: Bank of Finland and Statistics Finland.

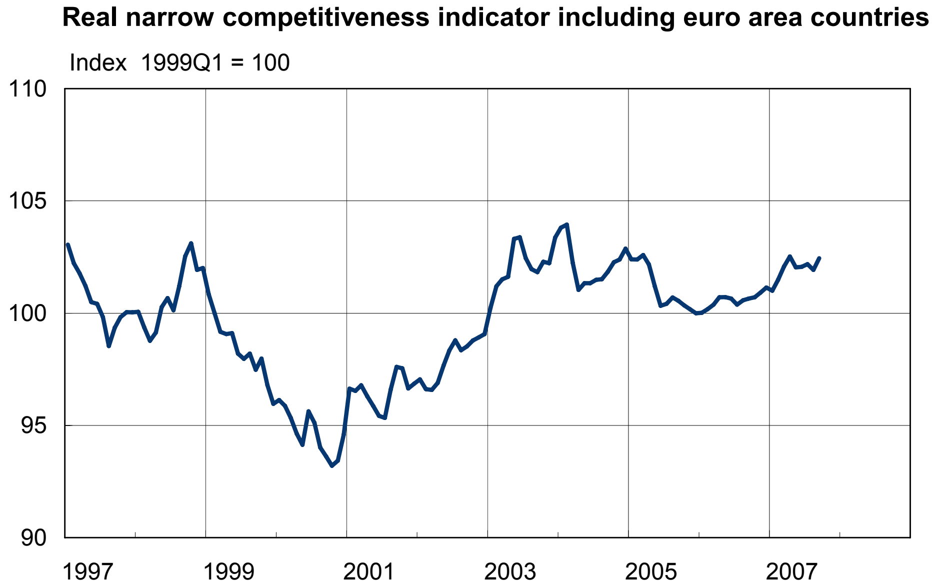
The predominance of major agents and transactions rose to new levels, to affect even the National Accounts aggregates. After the change of the millennia, the share of the five largest enterprises in the foreign loan stock was more than 70 per cent and some 60 per cent in other capital stock of the FDI abroad. More recently, the five largest enterprises have accounted for some 45 per cent of the total value in the FDI abroad stock and some 30 per cent in the FDI in Finland stock. Macroeconomic interpretation of such data is seldom valid.

4 In the 2000's, globalisation and the China phenomenon

In foreign trade, the 2000's have been different from the preceding decades. Trading partners are changing and the pattern of foreign trade growth reveals that we now face globalisation instead of integration. The concentration of Finnish exports is gradually decreasing as new countries assume a more important role. This is confirmed using

Herfindahl concentration index[6] calculations. World economic growth is increasingly based on the rapid growth of China, India and other Far-East countries and the share of these countries in the Finnish foreign trade is rising. The old Europe is lagging behind in growth. In the first years of EMU, weakening euro supported Finnish exports.

Chart 14. Competitiveness indicators for Finland



Based on trade-weighted exchange rates. An upward movement of the index represents a weakening in Finnish competitiveness.

Source: Bank of Finland.

Neighbouring countries have different integration policy solutions which seemingly has no effect of the Finnish trade growth. Trade with Russia constitutes a special case due to the large transit trade. According to Finnish customs statistics exports to Russia have grown clearly faster than ten per cent a year during most of the 2000's. Similarly, the energy imports from Russia have expanded. Sweden has maintained its significance as a trading partner due to the exceptionally deep economic integration of Sweden and Finland while the trade shares of other EU and euro area countries have declined.

[6] See OECD: Measuring globalisation, OECD Handbook on Economic Globalisation Indicators, Paris 2005, p 73, The index varies between 1/n, where n is the number of trading partners, and 1. The Finnish statistics has recently been slightly above 0.05 and decreasing, indicating low concentration.

Globalisation enters the picture when the fastest growing trade flows are viewed. Both exports to China and India and imports from China, South Korea and Taiwan are growing more rapidly than trade flows to and from the EU15Europe. Exceptions in Europe are the Netherlands and Sweden. This might partly be because of the re-exports via Rotterdam and Gothenburg. China itself is a major export partner with a share of three per cent and as high as seven per cent in imports, to be fourth in rank. This is merely indicative, however, due to recording difficulties in the trade logistics of multinational enterprises and to misleading recording convention of exports and imports on a consignment basis. Accordingly, commodity flows from the Far-East to Russia, and to St. Petersburg and Moscow in particular, via Finnish harbours produce impacts upon the Finnish foreign trade as recorded in statistics.

Table 1. Finnish exports and imports of goods by countries in 2006, value indexes 1999=100

	Exports	***Imports***
China	*202*	*597*
India	*208*	*243*
Korea and Taiwan	*122*	*281*
Russia	*287*	*362*
Germany	*136*	*169*
Sweden	*166*	*163*
Netherlands	*185*	*201*
EU15	*133*	*158*
Euro area (12)	*130*	*161*

* Exports by consignment, imports by origin
Source: Board of Customs.

In the short run, globalisation effects will most likely be adverse to current account surplus as the levels of the fast growing exports are still relatively low. Similarly, as Finnish enterprises resettle in China, exports will regress while imports grow. Richard Baldwin writes[7]: 'it is no more necessary to perform most manufacturing stages near each other and this has spread from factories to offices with the result being offshoring service sector jobs'. This would also imply in statistics less service exports and more service imports. The terms-of-trade developments will be adverse in the near future due to structural factors such as low forest

[7] Richard Baldwin: Globalisation the great unbundling(s), Prime Minister's Office, Economic Council of Finland , 20 September 2006.

and ICT industry export prices and a high energy intensity of the economy when energy prices rise.

Globalisation has reshaped and will further reshape Finnish statistics on foreign trade in ser-vices in a special way. Finland was considered a low performer in the service trade. The re-form of the National Accounts reformulated this truth in 2006 with a revision upwards in the exports of services by some two per cent of GDP annually during the 2000's. New in-formation available from the ICT branch lies behind this major revision. Recording the logistics of multinational giants with numerous subcontractors is complicated and new revisions are more than probable. All this has worked to change in a stroke the understanding of the Finnish history of the foreign trade in services.

What are the prospects for the current account? All ramifications described are negative. Domestic factors, such as ageing population, new energy and environmental investments, point to higher investment rates and worsening current account. The positive overall effect on the terms of trade has not yet appeared. On the contrary, high energy import prices have deteriorated the terms of trade. Resettled enterprises should be more profitable in China than in Finland, raising investment income. The current positive net FDI effect on investment income is 1.5 per cent of GDP. On the other hand, dividends paid out by the 90 per cent foreign owned Nokia fully load the Finnish current account. Most likely, some of the surplus will be garnered in the form of income rather than through goods and services.

The new FDI net flows have been low in value, partly due to uncostly investments in emerging economies financed from international markets rather than by the parent company. However, major flows have appeared in the subitems of both the FDI in Finland and the FDI abroad. The globalisation effect can be verified employing the foreign affiliate trade statistics (FATS) data on the number of employees in the foreign affiliates where the number of employees in China and in other emerging economies has grown vigorously[8]. Large single transactions will occur, such as Nokia Networks-Siemens and Sampo-Danske Bank mergers. In the financial account, the banking transactions will continue to dominate other investments. Nordic banking integration will further add to these flows. Some of these recordings are purely technical because the bank books are kept in one capital while business takes place in all countries. A growth trend in portfolio investments abroad will continue. As an example, a bulk of our pension funds have been invested in foreign paper.

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[8] See Bank of Finland web-site: www.bof.fi/statistics/balance of payments and international investment position/Direct in-vestment, long time series.

Globalisation and integration are trends in business life, and basic statistical concepts, such as residency in a particular country, have become irrelevant to global agents. In the Balance of Payments, the difference between goods and services has become blurred, and complex international logistics in trade, and equally complex ownership chains in the FDI, for example, complicate statistical booking. Indications received from national statistics will be ambivalent, and the uncertainty in major national aggregates as GDP, demand and supply components and prices will be increased.

5 Concluding remarks

Finnish current account prospects in brief: The economy has been booming in 2007, and competitiveness remains strong. What we do face is ageing of the population, labour shortages in hand with unemployment, and moreover, a rising domestic investment rate. Recent unfavourable globalisation effects on foreign trade and on terms of trade will persist. The fastest growing markets lie far from Finland and successful trade calls for creativity and new ways of thinking. Membership in the Monetary Union reinforces the stability of the economy. The enterprise and banking sectors must maintain high productivity and competitiveness, while public outlays are to be kept in check.