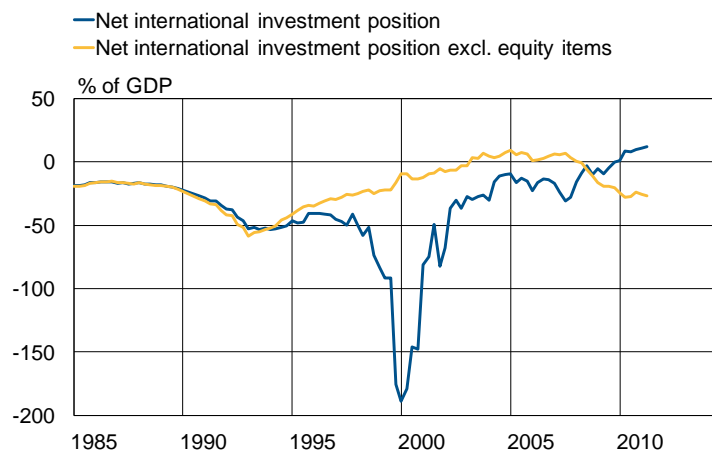


Finland's Balance of Payments

Annual Review 2010–2011/I–II



Sources: Bank of Finland and Statistics Finland.

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1 Current account posted a clear deficit in the first half of 2011

The current account deficit increased to almost EUR 1.7 billion in the first half of 2011, which was EUR 1.2 billion more than a year earlier. The deficit increase was due mainly to a weak trade balance¹ in the first half of the year, but the services and income deficits also increased compared to the year-earlier period. The weakening of the trade balance was partly attributable to higher energy prices, which have raised the value of imports relatively more than that of exports.

1.1 Growth in goods trade restrained towards summer

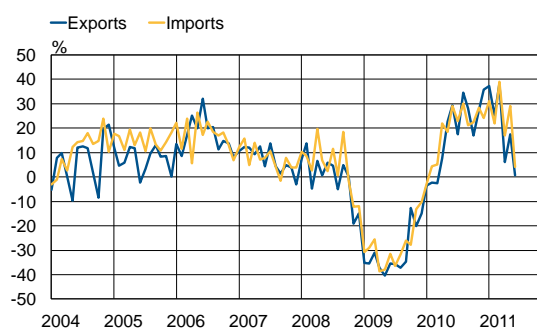
The value of Finnish exports of goods increased in the first half of 2011 to almost EUR 29 billion, which was about 19% more than in the year-earlier period.

Growth was fuelled by the economic recovery that began in early 2010 and continued to the first quarter of 2011. However, growth began to moderate towards the summer, and in June it dropped to almost zero.

¹ The balance of payments (BOP) goods data differ from the National Board of Customs' foreign trade statistics because of freight and insurance cost adjustments: in BOP statistics, the share of foreign carriers and insurers is deducted from the National Board of Customs' cif-based goods imports and entered under transportation and insurance costs.

Sweden was Finland's most important export country in the first half of 2011, with a share of over 12% of total exports. Other major export countries were Germany, Russia and the Netherlands. Exports to Russia grew the most in the first half of the year, by almost 27% compared with a year-earlier period.

Chart 1. Annual change in value of goods trade, 2004–2011/I–II



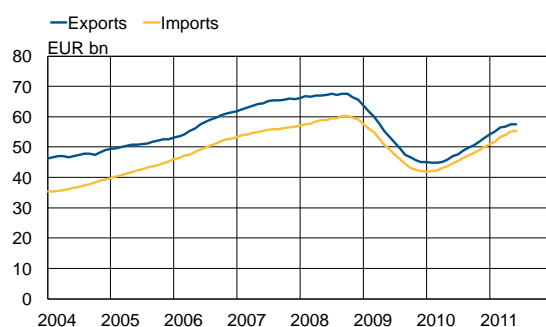
Sources: Bank of Finland and National Board of Customs.

In BOP terms, the value of goods imports increased in the first half of 2011 to almost the same level as that of goods exports, to EUR 29 billion, up by 23% on a year earlier. Growth in the value of goods imports was strongly affected eg by higher energy prices, such as oil. This was also clearly visible in the fact that Russia is Finland's most significant import country² with a share of almost 19% of total imports in the first half of 2011. In addition, imports from Norway have more than doubled in the first half of 2011 compared with the year-earlier period. The next major import countries after Russia were Sweden and Germany.

² In BOP, data on imports by country are recorded according to the country of dispatch in the case of EU countries and according to the country of origin in the case of non-EU countries.

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Chart 2. 12-month moving total of Finnish exports and imports of goods, 2004–2011/I–II



Sources: Bank of Finland and National Board of Customs.

According to the 12-month moving total, the annual growth in goods exports has only reached the level recorded in summer 2006. The 12-month moving total for goods imports to up to the end of June 2011 was almost at the same level as at the end of 2007. Hence, the traditional significant trade-balance surplus has begun to erode. The current account surplus accumulated for the first half of 2011 amounted to just under EUR 100 million, compared with almost EUR 900 million in the year-earlier period.

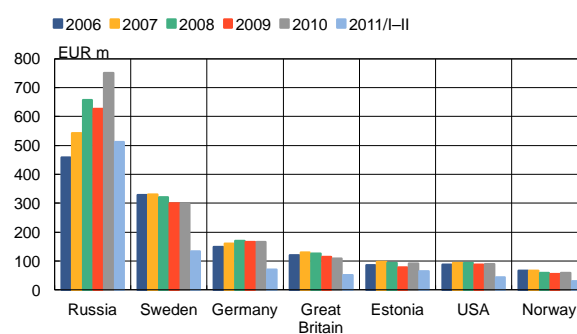
1.2 Services did not boost the current account

The services account recorded a deficit of over EUR 600 million in the first half of 2011, contracting by almost EUR 400 million from the previous year. The weakening of the services account stemmed mainly from a fall in exports of other services and higher transportation costs.

Transportation services showed a deficit of over EUR 1 billion in the first half of 2011, which was almost EUR 200 million more than a year earlier. Transportation services include eg sea, air and road freight. The majority of transportation costs consist of sea freight, but the share of air freight has also

increased in recent years. Sea freight has traditionally sowed a high deficit among the services items, since the great majority of goods imports are transported to Finland via sea.

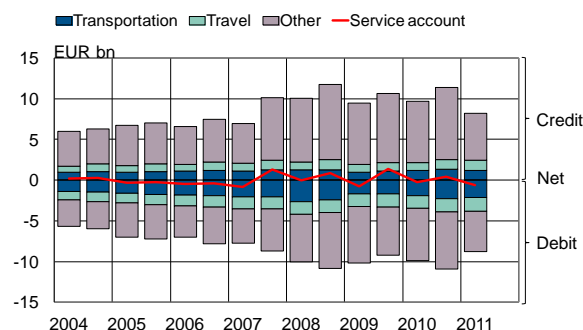
Chart 3. Income from travel to Finland, 2006–2011/I–II



Sources: Bank of Finland and Statistics Finland.

Travel services posted a deficit of almost EUR 450 million in the first half of 2011, up by over EUR 100 million from the previous year. Income from travel grew in the first quarter of 2011 by over EUR 125 million from a year-earlier period. The largest income flows came from Russian tourists, which made over half of Finland's travel income in the first quarter of 2011. Finnish expenditure on travel grew in the second quarter of 2011 by almost EUR 140 million. Spain, the United Kingdom and Estonia gained most in popularity as holiday destinations.

Chart 4. Breakdown of services, semi-annual data, 2004–2011/I–II



Source: Bank of Finland.

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The bulk of services exports and imports is included in the “other services” item that composes business services such as construction, IT, information, and royalty, licence and other business services.³

The other services account recorded a surplus of over EUR 800 million in the first half of 2011. Nevertheless, this was over EUR 300 million less than a year ago. In addition to a smaller surplus, income and expenditure relating to other services have also decreased by over 20% compared with a year-earlier period. The recession that followed the financial crisis was hardly reflected in services imports and exports in 2009 and 2010, but in 2011 there has been a clear change in this respect.

The fall in other services income and expenditure was most evident in other business services that include eg merchanting, advertising and marketing, research and development, and intra-group services not classified elsewhere. In the first half of 2011, income from other business services amounted to about EUR 2.3 billion, which was almost EUR 1.5 billion less than a year earlier. The respective expenditures totalled almost EUR 3.4 billion, down by about EUR 1 billion on the previous year.

Table 1. Current account, 2006–2011/I–II

EUR m		2006	2007	2008	2009	2010	January– June 2011
Current account	Net	6 997	7 650	4 727	3 362	3 301	-1 676
Goods	Net	8 628	9 128	6 535	3 016	2 999	93
	Credit	61 436	65 744	65 637	45 103	52 954	28 662
	Debit	52 808	56 616	59 102	42 087	49 955	28 569
Services	Net	-913	455	862	576	138	-630
	Credit	13 945	16 977	21 792	20 072	20 995	8 149
	Debit	14 858	16 522	20 931	19 496	20 857	8 780
Income	Net	640	-521	-1 056	1 459	1 831	-605
	Credit	14 620	17 335	15 718	11 000	13 833	6 968
	Debit	13 979	17 855	16 774	9 541	12 001	7 574
Current transfers	Net	-1 358	-1 412	-1 613	-1 689	-1 667	-534
	Credit	1 600	1 665	1 663	1 625	1 692	1 225
	Debit	2 958	3 077	3 276	3 314	3 359	1 759

Source: Bank of Finland.

³ Other business services include eg advertising and marketing services, research and development services, merchanting and intra-group services not classified elsewhere.

1.3 Investment income increased in 2010

In 2010 Finnish investors' net investment income was about EUR 400 million higher than a year earlier. Investment income credits increased by about EUR 2.8 billion and debits by about EUR 2.4 billion.

Finnish investors' income on direct investment abroad rose by about EUR 2.2 billion from 2009 and totalled EUR 8.3 billion in 2010. Foreign investors' income on direct investment in Finland grew by EUR 2.3 billion, to EUR 4.1 billion. (Direct investment income is discussed in more detail in section 2.)

Interest and dividend payments to Finnish investors on portfolio investment abroad were almost EUR 1.2 billion higher in 2010 than a year earlier. Dividends and interest paid to foreign investors increased by about EUR 500 million. Interest income and expenditure relating to other investments (loans, deposits and trade credits) decreased from the previous year; income by over EUR 500 million and expenditure by over EUR 300 million.

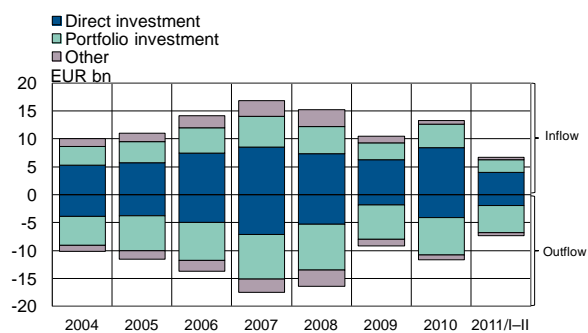
In the first half of 2011, investment income outflows exceeded inflows by almost EUR 800 million. Estimated net income on direct investment was almost EUR 200 million less than in the year-earlier period. Direct investment data for 2011 are only preliminary and mainly based on actual figures for 2010.

In the first half of 2011, outward dividend and interest payments on portfolio investment exceeded inward payments by EUR 2.5 billion. The reason for this is that Finnish companies pay dividends mostly in March–May, whereas foreign companies pay dividends more evenly throughout the year. Dividend payments were almost EUR 300 million higher in the first half of 2011 than a year earlier. Inward dividend

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payments grew by almost EUR 200 million from a year-earlier period.

Chart 5. Net investment income by investment type, 2004–2011/I–II



Source: Bank of Finland.

2 Capital passing through Finland

increased direct investment in 2010

In 2010, direct investment⁴ outflows and inflows were both substantially higher than in the previous year. Foreign investors' channelling of investment abroad via Finnish investment enterprises contributed to an exceptional enlargement of investment flows.

2.1 Investment flows were exceptionally high

Inward direct investment totalled EUR 5.2 billion in 2010. Compared with investments in 2008–2009, capital inflow from abroad was exceptionally robust. Approximately EUR 3.7 billion of investments in 2010 was capital invested by foreign investors in Finland, which Finnish investment enterprises reinvested again as direct investment abroad. In other words, foreign groups channelled capital from foreign group enterprises to other foreign group enterprises via Finnish group enterprises.

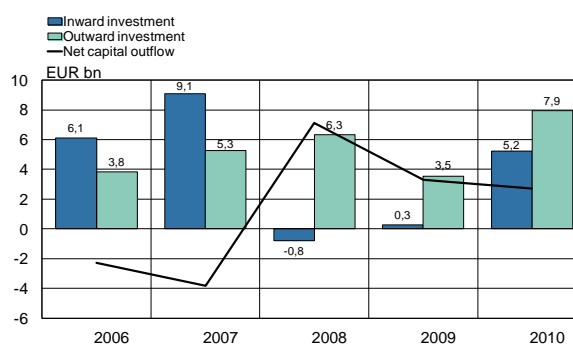
In 2010, approximately only about EUR 1.5 billion of inward direct investment was financing of business

⁴ A direct investment relation exists between an investor and an enterprise resident in another country when the investor has control (over 50% of the voting power) or influence (min. 10%–max. 50% of voting power) over the enterprise. The direction of the investment (*inward* or *outward*) is determined in the statistics on the basis of the direction of the control/influence between parties. Direct investment refers to financial transactions between entities in a direct investment relationship.

operations of investment enterprises in Finland. This was largely additional financing to investment enterprises already acquired by foreign investors in previous years. As a result of the global financial crisis, international corporate acquisitions have been modest since 2008, so that corporate acquisitions cannot explain growth in investment flows in 2010.

The results of Finnish investment enterprises improved compared with 2009, and EUR 0.7 billion from earnings after dividends was retained to boost foreign investors' investment in Finland. In 2009, retained earnings in Finnish investment enterprises had contracted by as much as EUR 2.1 billion.

Chart 6. Direct investment, net capital flows, 2006–2010



Source: Bank of Finland.

Outward direct investment totalled EUR 7.9 billion in 2010. Compared with the previous year, capital outflow increased by EUR 4.4 billion. Approximately EUR 3.7 billion of investment in 2010 was capital passing through Finland, which was channelled to foreign group enterprises via foreign group

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enterprises' investment enterprises in Finland. In addition, Finnish investors increased their investment abroad by retaining earnings in investment enterprises by EUR 2.6 billion and providing them other additional financing of EUR 1.6 billion.

A comparison of direct investment outflows and inflows shows that Finnish investors' direct investment abroad has exceeded foreign investors' direct investment in Finland since 2008. Foreign direct investment has therefore been outward on net.

2.2 Direct investment income increased after the contraction in 2009

Chart 7. Direct investment income, 2006–2010



In 2010, income received by **foreign investors** on direct investment in Finland totalled EUR 4.1 billion. Of this, EUR 3.4 billion was return on equity⁵ and EUR 0.7 billion interest on other capital. Of return on equity, EUR 0.7 billion was reinvested in Finnish investment enterprises and EUR 2.7 billion was distributed as dividends to foreign investors.

⁵ Return on equity (ROE) in a direct investment enterprise reflects the investor's share in the earnings of the enterprise.

Income on inward direct investment fell sharply in 2009, by EUR 3.5 billion, to only EUR 1.8 billion. This major change was due to weaker results of few individual investment enterprises. Even though income increased in 2010 compared with 2009, aggregate earnings of investment enterprises did not return to the level recorded in 2008. Income relative to the average investment stock was 6.7%.

Income received by **Finnish investors** on direct investment abroad totalled EUR 8.3 billion, of which return on equity was EUR 8 billion and interest on other capital was EUR 0.3 billion. Of return on equity, EUR 2.6 billion was reinvested in investment enterprises and EUR 5.4 billion was distributed as dividends to Finnish investors.

Finnish investors' income on outward direct investment increased after the contraction in 2009 and was almost as high as in 2007 when it peaked in absolute terms. Income relative to the average investment stock was 8.7%. This was slightly less than the average income of 9% in 2008 and substantially less than the record level of 11.2% observed in 2007.

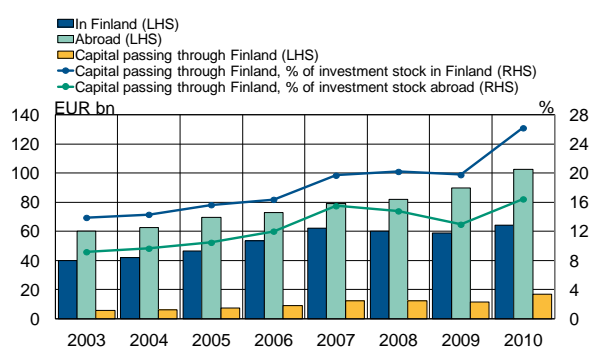
2.3 The share of capital passing through Finland has increased in the 2000s

The stock of **inward** direct investment was EUR 64 billion at the end of 2010. Of this, equity capital accounted for EUR 54 billion and other capital for EUR 10 billion. The stock of **outward** direct investment was EUR 102 billion, of which equity capital accounted for EUR 98 billion and other capital for EUR 4 billion.

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Of direct investment stocks at the end of 2010, approximately⁶ just under EUR 17 billion was capital passing through Finland. This was 26% of the stock of inward direct investment and 16% of the stock of outward direct investment. Compared with the early years of the 2000s, the amount of capital passing through Finland has tripled.

Chart 8. Direct investment, stocks, 2003–2010



Source: Bank of Finland.

The traditional view is that changes in the extent of foreign-owned business activities in Finland are a reflection of changes in foreign direct investment in Finland. Correspondingly, changes in the extent of Finnish-owned business activities abroad reflect changes in Finnish direct investment abroad. However, international groups increasingly minimise group-level costs by taking globally advantage of various countries' taxation and funding benefits. For this reason groups have established special purpose entities (SPEs) that do not have any economic activity in their

location country but through which financing is channelled within the group. Group enterprises that conduct actual business operations are also engaged in this transmission of funding. Since also these intra-group funding transactions are recorded in direct investment statistics, not all investments denote changes in the extent of foreign-owned business activities. Part of foreign investment merely passes through the country.

⁶ Capital passing through Finland has been estimated by analysing Finnish groups that have received direct investment from abroad and that have also made direct investment abroad themselves. If foreign capital invested in a Finnish group is less than capital invested abroad by the group, foreign capital invested in Finland is regarded as capital passing through Finland. Correspondingly, if foreign capital invested in a Finnish group exceeds capital invested abroad by the group, capital invested abroad from Finland is regarded as capital passing through Finland.

Box 1. Introduction of new Standard Industrial Classification TOL 2008 in the breakdown of direct investment by economic activity

The percentage shares of manufacturing and services in the stocks of direct investment in 2008–2009 changed only by few percentage points with the changeover from the old Standard Industrial Classification TOL 2002 to the new TOL 2008.

Starting from data from 2008, the statistical breakdowns of direct investment flows, income and stocks by economic activity have been compiled applying the revised Finnish Standard Industrial Classification TOL 2008. The TOL 2008 classification is based on the European Union classification of economic activities, the NACE Rev.2. The TOL 2008 standard replaces the old classification standard TOL 2002. Direct investment statistics by economic activity for 2008–2009 have been compiled using both the old and the new classification standards. Since 2010 the data has only been available according to TOL 2008 classification. Statistics on direct investment by economic activity are available on the Bank of Finland website.⁷

The changeover to the revised classification was carried out in line with the guidelines on direct investment statistics issued by Eurostat, the statistical office of the European Community. In direct investment statistics, the breakdown by economic

activity is based on the industrial sector of the entity resident in Finland. The entity's economic activity is classified with the Business Register maintained by Statistics Finland. Further information on the TOL 2008 and TOL 2002 classifications and their differences is available on the Statistics Finland's website.⁸

1.1 Inward direct investment

Viewed by economic activity, the value of foreign investors' direct investment in Finnish service-sector companies has exceeded investment in manufacturing sector companies ever since the beginning of the 2000s. At the end of 2010, the stock of inward direct investment amounted to EUR 64 billion, of which services accounted for EUR 41 billion (64%) and manufacturing for EUR 21 billion (33%).

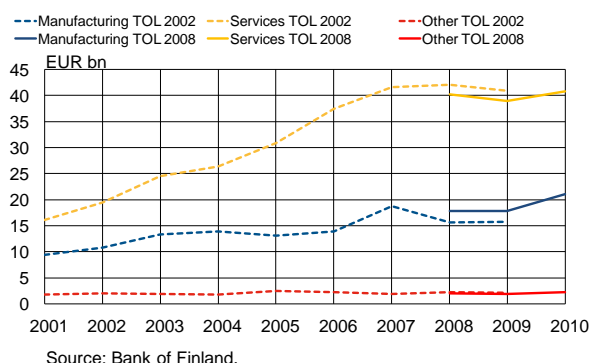
Within services, the largest investments were made in financial and insurance companies, which accounted for EUR 21 billion of the capital stock. Other major service subsectors attracting investments were information and communications (EUR 7 billion) and wholesale and retail trade (EUR 6 billion). Within manufacturing, metal industry accounted for EUR 10 billion and chemical industry for EUR 7 billion of the capital stock.

⁷ For the Bank of Finland statistics on direct investment by economic activity, see <http://www.suomenpankki.fi/en/tilastot/maksutase/Pages/taulukot.aspx>.

⁸ For the Statistics Finland's Standard Industrial Classification TOL 2008, see http://tilastokeskus.fi/meta/luokitukset/toimiala/001-2008/index_en.html.

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Chart 9. Foreign direct investment in Finland, stock by economic activity, 2001–2010



A comparison of TOL 2008 and TOL 2002 data on the stocks of inward direct investment in services and manufacturing in 2008–2009 reveals no significant differences. The capital stock of services contracted and the stock of manufacturing grew respectively by about EUR 2 billion. The percentage shares of these economic activity sectors in inward direct investment stocks changed by 3–4 percentage points. Within manufacturing, the capital stock of metal industry grew by over EUR 1 billion.

1.2 Outward direct investment

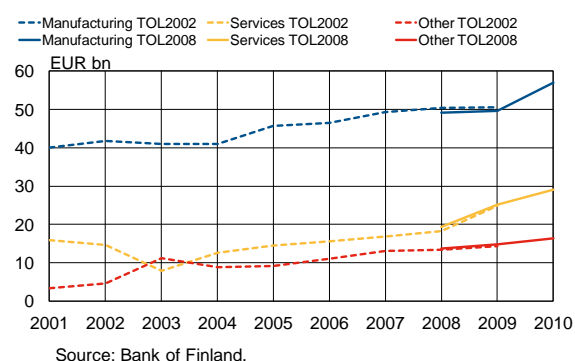
Finnish manufacturing companies have always made a considerably larger share of Finnish direct investment abroad than other economic activity sectors. At the end of 2010, manufacturing accounted for EUR 57 billion (56%) of the stock of outward direct investment. Metal industry invested EUR 30 billion, forest industry EUR 12 billion and chemical industry EUR 9 billion.

The value of outward direct investment by Finnish service-sector companies at the end of 2010 was EUR 29 billion (28% of the capital stock). Financial and insurance companies invested EUR 16 billion,

information and communications sector companies EUR 6 billion and wholesale and retail trade EUR 3 billion.

The value of outward direct investment by other economic activity sectors totalled EUR 16 billion at the end of the year. Major investor subsectors were electricity, gas and steam supply as well as construction.

Chart 10. Finnish direct investment abroad, stock by economic activity, 2001–2010



Stocks of outward direct investment by manufacturing and services for 2008–2009 according to the TOL 2008 classification remained almost unchanged compared with data according to the old TOL 2002 classification. The capital stock of manufacturing contracted and the stock of services grew respectively by about EUR 1 billion. The percentage shares of these economic activity sectors in outward direct investment stocks changed by 1–2 percentage points. Within services, the capital stock of financial and insurance investors grew by about EUR 4 billion.

3 Portfolio investment flows were still brisk

Capital outflows and inflows of portfolio investment were still brisk in 2010, but contracted slightly from the previous year. Portfolio investment was abundantly outward on net. Capital flows have largely followed the same pattern since the latter part of 2009, and current developments generally also correspond to the situation prevailing in the 2000s, prior to the global financial crisis. In January-June 2011, a fall in Finnish share prices notably lowered the market value of inward portfolio investment.

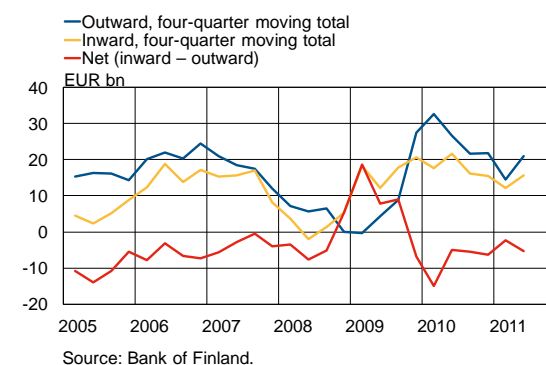
3.1 Capital flows have recovered since the financial crisis of 2008

In 2010, Finnish investors' purchases of foreign securities totalled EUR 21.8 billion on net, whereas foreign investors increased their investments in Finnish securities by EUR 15.5 billion. Portfolio investment in 2010 was therefore EUR 6.8 billion outward on net. Compared with the corresponding investments in 2009, net capital outflow contracted slightly.

When looking at the long term, overall capital flows of portfolio investment have largely returned to following the pattern prevailing before 2008, prior to the financial crisis (Chart 11). Capital outflows and inflows are both relatively brisk. However, investment

flows in foreign securities are slightly higher than flows in Finnish securities, so that investment flow is regularly outward on net. Analysed by quarterly moving totals, the net outflow of portfolio investment was almost EUR 15 billion in the first quarter of 2010. At an annual level, this was already higher than the previous peak in capital outflow (about EUR 14 billion) recorded prior to the financial crisis, in the second quarter of 2005.

Chart 11. Portfolio investment, net cumulative flows, quarterly data, 2005/I–2011/II



Even though aggregate capital flows have largely recovered, the sectoral breakdown reveals differences compared with the pre-crisis period. In outward portfolio investment, monetary financial institutions (MFIs)⁹ clearly constituted the most important domestic investor sector, notably since the latter part of 2010 (Chart 12). Capital outflow by the general government¹⁰ picked up in the latter part of 2009 but

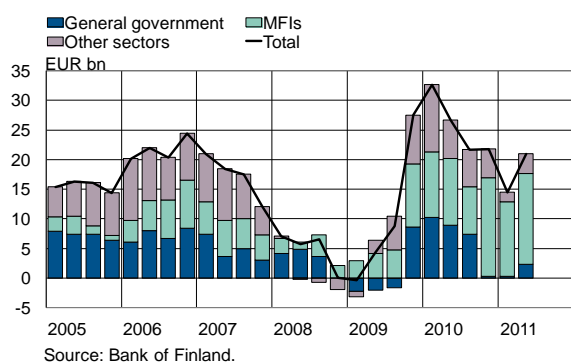
⁹ Incl. the Bank of Finland and money market funds.

¹⁰ The Finnish central government, employment pension funds and other social security funds, and local government.

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waned almost entirely by the end of 2010. Similarly, aggregate capital outflows by other investor sectors¹¹ have also contracted substantially since the middle of 2010. Prior to the crisis the shares of the various investor sectors were almost equal and remained relatively stable for several consecutive periods.

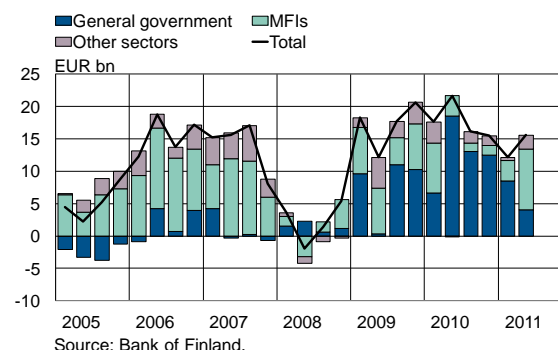
Chart 12. Outward portfolio investment, net cumulative flows by investor sector, 2005/I–2011/II (for-quarter moving totals)



Looking at the issuing sector, inward portfolio investment has largely consisted of general government – in practice central government – securities since 2009 (Chart 13). Prior to 2008, foreign investors mainly acquired securities issued by Finnish MFIs, and the Finnish central government paid off foreign portfolio investment liabilities for several periods. In the first half of 2011, the share of MFIs in capital inflows has increased again.

¹¹ Non-financial corporations, other monetary financial institutions (incl. investment funds and insurance corporations) and households and non-profit institutions serving households.

Chart 13. Inward portfolio investment, net cumulative flows by issuer sector, 2005/I–2011/II (four-quarter moving totals)



3.2 Lower securities prices had a considerable impact on market values of investment stocks in the first half of 2011

3.2.1 Outward portfolio investment

In the first half of 2011, capital outflow of portfolio investment totalled EUR 5.3 billion (Table 2). The bulk of Finnish portfolio investment was made in shares of investment funds registered abroad, which amounted to about EUR 5.0 billion. Net purchases of foreign bonds and notes amounted to EUR 3.2 billion. By contrast, investment in shares contracted by EUR 1.0 billion and in money market instruments by EUR 1.8 billion. Looking at investor sectors, within the general government sector, employment pension funds and other social security funds increased their foreign portfolio investments by EUR 4.3 billion, whereas the central government reduced its investments by EUR 2.2 billion. Capital outflow by MFIs was EUR 2.6 billion.

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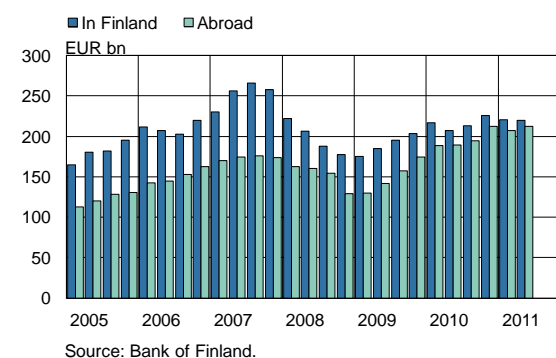
Table 2. Portfolio investment abroad and in Finland by investment type in the first half of 2011

EUR m	Investment stock, 31 December 2010	Net capital flows, January-June 2011	Exchange rate and other valuation changes, January-June 2011	Investment stock, 30 June 2011	Dividends and interest, January-June 2011
Finnish portfolio investment abroad					
Shares	35 316	-1 020	-2 088	32 207	539
Fund shares	61 486	4 954	-1 833	64 606	229
Bonds and notes	110 385	3 170	-1 128	112 427	1 499
Money market instruments	4 899	-1 836	-68	2 995	28
Total	212 085	5 267	-5 118	212 235	2 295
Foreign portfolio investment in Finland					
Shares and fund shares	79 048	909	-10 714	69 242	2 818
Bonds and notes	118 133	11 806	-2 219	127 720	1 832
Money market instruments	28 830	-5 921	-163	22 746	146
Total	226 010	6 794	-13 096	219 708	4 797

Source: Bank of Finland.

The market value of Finnish portfolio investment abroad was EUR 212.2 billion at the end of June 2011, ie almost the same as at the end of 2010 (Table 2 and Chart 14). Despite capital outflow, the investment stock grew only slightly since, besides capital outflow, the stock was also strongly affected by valuation changes of almost the same magnitude but in the opposite direction, which reduced the market value of Finnish outward portfolio investment by a total of EUR 5.2 bn in January-June 2011. Valuation changes were due to lower prices of foreign shares and fund shares as well as the strengthening of the euro mainly against the US dollar.

Chart 14. Stock of portfolio investment, quarterly data, 2005/I–2011/II



At the end of June 2011, employment pension and other social security funds accounted for EUR 86.4 billion of the stock of outward portfolio investment, ie 41% of the total value of investment. Of this, over half, ie EUR 43.4 billion, was in shares of foreign investment funds. MFIs' portion in the investment stock increased to EUR 56.2 billion (27%). The MFI investment stock consisted almost entirely of foreign

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bonds and notes, the holdings of which were EUR 52.2 billion. Finnish-registered investment funds accounted for 18% of the outward portfolio investment stock and those of insurance corporations for 12%.

3.2.2 Inward portfolio investment

Capital inflow of portfolio investment totalled EUR 6.8 billion in January-June 2011. The bulk of securities acquired by foreign investors consisted of bonds and notes issued by MFIs, the net sales of which abroad totalled EUR 6.7 billion. The net sales abroad of bonds issued by the Finnish central government increased to EUR 4.7 billion. Nevertheless, the government's foreign portfolio investment liabilities decreased through capital flows by a total of EUR 0.8 billion in the first half of the year, since the government paid off short-term treasury bills by the considerable sum of EUR 5.6 billion. Net sales abroad of Finnish shares remained at EUR 0.6 billion. Foreign investors reduced their investments in shares of Finnish-registered investment funds by EUR 0.3 billion.

The market value of inward portfolio investment, ie portfolio investment liabilities, contracted to EUR 219.7 billion at the end of June 2011, from EUR 226.0 billion at the end of 2010. The investment stock was strongly affected by valuation changes that were considerably higher than inward portfolio investment and in a negative direction, which reduced the market value of liabilities by EUR 13.1 billion. Negative valuation changes in turn were mainly due to lower prices of Finnish shares held by foreign investors. The OMX Helsinki index fell by slightly over 12% in the first half of the year.

The Finnish central government was – despite net redemptions in the first half of the year – the most notable issuer of portfolio investment liabilities at the

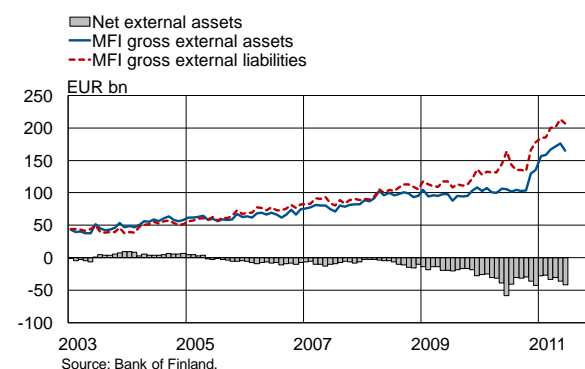
end of June 2011. It accounted for a little less than a third of the stock of liabilities at market value. The majority of foreign investors' holdings of Finnish central government instruments comprise bonds and notes, totalling EUR 65.8 billion. The corporate sector's share in the stock of liabilities was about 30% and consisted mainly of shares. The share of MFIs in the liability stock increased due to buoyant bond issues and was already close to the corporate sector share, at almost 29%. At the end of June 2011, MFIs' foreign bond liabilities amounted already to EUR 43.2 billion.

4 Finnish MFIs' net external assets have turned negative

Growth of Finnish monetary financial institutions' (MFIs) gross external assets and liabilities has accelerated since the latter part of 2010. Net assets relating to other investment contracted strongly due to increased indebtedness to foreign MFIs. Finnish MFIs' total claims on Greece, Ireland, Italy, Portugal and Spain decreased.

Finnish MFI gross external assets and liabilities, excluding equity items and financial derivatives, continued to grow in 2010 and in the first half of 2011. Growth has continued throughout the 2000s, and in the second half of 2010 it accelerated further. At the end of June 2011, Finnish MFI gross external assets totalled EUR 165 billion and liabilities EUR 206 billion. The difference between MFI external assets and liabilities has increased since 2008 (Chart 15). In June 2011 MFI net liabilities already amounted to EUR 41 billion, indicating that MFIs' external liabilities exceeded their external assets.

Chart 15. Finnish MFI gross external assets and liabilities, 2003–2011



Gross assets, 73% consisted of assets relating to other investment and 27% of MFI holdings of foreign securities. Of gross liabilities, 70% were liabilities related to other investment and 30% those related to MFI issuance of debt securities. Deposit and loan stocks of money-holding non-residents¹² are of relatively low importance in Finnish MFI balance sheets. For instance, in June 2011 euro area households' and non-financial corporations' loans from and deposits in Finnish MFIs totalled EUR 1.6 billion and EUR 1.4 billion respectively.

The counterparty of a derivative contract concluded by Finnish MFIs is almost always a non-resident. Gross balance sheet values of financial derivatives are therefore substantial items from the balance of payments perspective. Increased volatility

¹² Money-holding non-residents comprise non-financial corporations, financial and insurance corporations (excl. banks), general government (excl. central government), non-profit institutions serving households, and households.

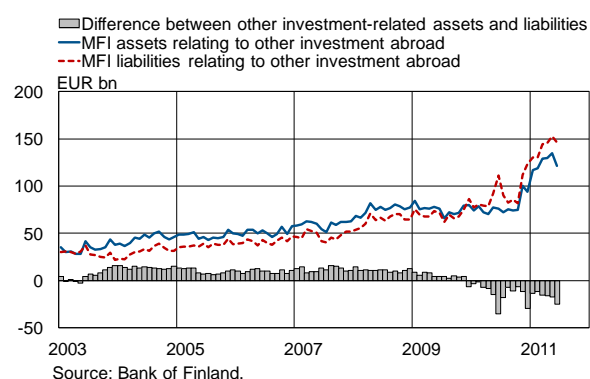
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in the financial markets doubled the gross value of financial derivatives in MFI balance sheets in the first half of 2010. In August 2010 MFI external assets relating to financial derivatives totalled EUR 155 billion and liabilities EUR 151 billion. However, derivative valuations dropped markedly in the following six months, and in June 2011 financial derivative-related assets and liabilities totalled EUR 84 billion and EUR 82 billion respectively. Most of financial derivatives are interest and currency derivatives for hedging purposes.

4.1 Finnish MFIs in the international interbank market

In June 2011, Finnish MFI assets relating to other investment amounted to EUR 146 billion and the corresponding liabilities to EUR 121 billion. Since the beginning of 2010, the stocks of other investment-related MFI assets and liabilities have increased by EUR 47 billion and EUR 69 billion respectively. The net asset position for other investment abroad, which has been positive since 2003 (Chart 16), turned negative in 2010 due to faster growth in gross liabilities. In June 2011, MFI net liabilities relating to other investment totalled EUR 25 billion.

Chart 16. Finnish MFI assets and liabilities relating to other investment, 2003–2011

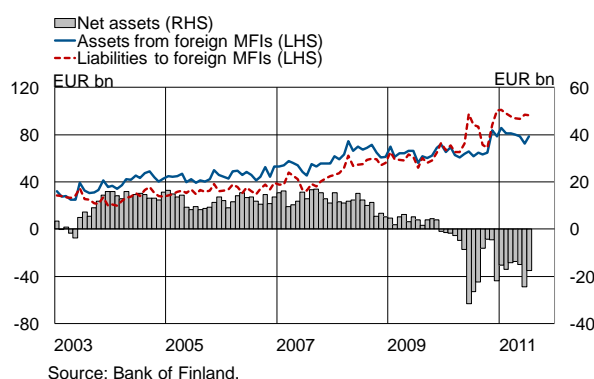


The internationalisation of Finnish MFIs has been rapid in the 2000s, partly due to foreign investment capital flows to banks. The integration of Nordic MFIs in particular has had a powerful influence in shaping the domestic MFI sector.

A significant part of other investment stocks on both the assets and liabilities side of the balance sheet consists of money market investments and deposits made in the wholesale interbank money market. The purpose of the wholesale money market is for example to ease the management of banks' short-term liquidity. Maturities of instruments traded in the interbank market vary typically from overnight deposits to few-week deposit maturities, which makes the other investment item highly volatile. In June 2011, Finnish MFI deposit liabilities to foreign MFIs totalled EUR 97 billion, while loans to foreign MFIs amounted to EUR 72 billion. In the past two years, Finnish MFIs have become indebted to foreign MFIs on net (Chart 17). From January 2010 to June 2011, MFI gross liabilities to foreign MFIs grew by EUR 30 billion, while gross assets only increased by EUR 7 billion. Finnish banks have had a net asset position vis-à-vis the rest of the world since 2003, but in June 2011 it turned negative on net, in the amount of EUR 24 billion. Hence, Finnish banks have incurred more debt to foreign MFIs than have granted them loans.

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Chart 17. Finnish MFI loans to and deposits from foreign MFIs, 2003–2011



Only a fraction of the stocks of Finnish MFI foreign interbank deposits and loans originates in the euro area. In June 2011, other euro area MFIs accounted for EUR 3.8 billion of the loan stock (5% of foreign MFI loans) and for EUR 7.1 billion of the deposit stock (7% of foreign MFI deposits). Despite the internationalisation of the financial sector in the 2000s, the integration of Finnish MFIs into other euro area money-holding residents and MFIs has remained relatively limited.

One factor explaining the growth in foreign MFI loans and deposits in the 2000s is the integration of Nordic – extra-euro area – MFIs. A total of EUR 43 billion of loans to foreign MFIs (59% of foreign MFI loans) were granted to Sweden and Denmark. Of the rest, EUR 16 billion (22%) was granted to non-EU countries and EUR 8 billion (11%) to non-euro area EU countries. Of MFI deposits, EUR 40 billion came from Sweden and Denmark (42% of foreign MFI deposits). Deposits from non-EU countries totalled EUR 42 billion (43%) and from United Kingdom EUR 6 billion (7%). It is worth noting that a significant part of the stocks of MFI foreign interbank deposits and loans are internal items of multinational banking groups.

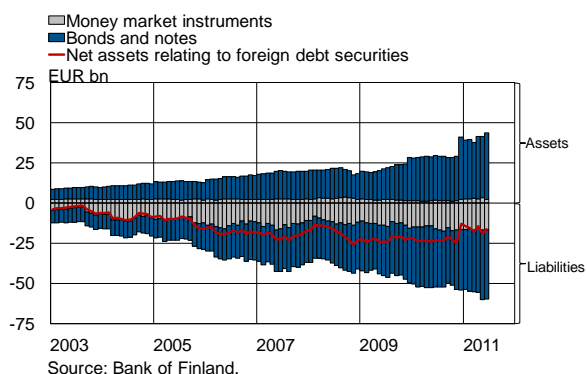
4.2 MFIs' debt security issuance and portfolio investment

After deposits from the public, debt security issuance is the second most important source of funding for MFIs. At present, purchasers of debt securities issued by Finnish MFIs are primarily international investors, and therefore the majority of issues are also abroad. In the first half of 2011, the difference between gross emissions and redemptions of debt securities issued by Finnish MFIs in Finland was EUR -54 billion, while the difference for debt securities issued abroad was EUR 7 billion.

At the end of June 2011, MFIs' external liabilities relating to debt securities totalled EUR 60 billion, of which EUR 17 billion consisted of short-term money market instruments. MFI investments in foreign debt securities were in turn EUR 44 billion, of which investment in money market instruments amounted to EUR 2 billion. Since the beginning of 2010, the stock of MFI debt securities issued abroad has grown by EUR 9 billion, whereas MFI assets relating to debt securities have increased by EUR 16 billion (Chart 18). This means that net liabilities have decreased since 2010.

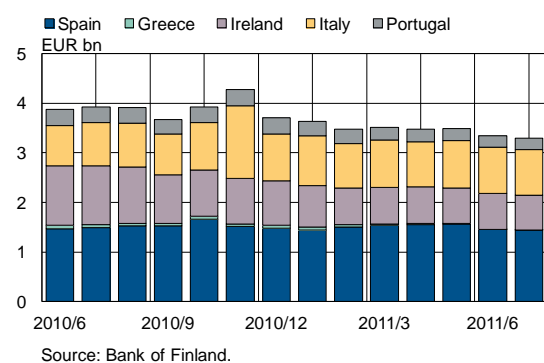
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Chart 18. Finnish MFI issuance of debt securities abroad and holdings of foreign debt securities, 2003–2011



Finnish MFI claims on Greece, Ireland, Italy, Portugal and Spain (GIIPS countries), which were most affected by the European financial crisis, have decreased since the middle of 2010. At the end of June 2011, MFIs' total claims on GIIPS countries amounted to EUR 4.6 billion (Chart 19). The largest claims were on Spain (EUR 2.0 billion) and Italy (EUR 1.5 billion), where the majority were investments in Spanish and Italian debt securities. Claims on Greece decreased from EUR 111 million in mid-2010 to EUR 36 million in mid-2011. MFIs' portfolio investment in GIIPS countries totalled EUR 3.1 billion, other investment EUR 0.3 billion and financial derivatives EUR 1.2 billion.

Chart 19. Finnish MFI claims on GIIPS countries, 2010–2011



Box 2. Progress in identifying the causes behind balance of payments errors and omissions

The balance of payment statistics are a systematic presentation of the transactions of one country vis-à-vis the rest of the world, for a specific period. It consists of the current account, capital account, financial account and errors and omissions.

2.1 Balance of payments entries and the origins of errors and omissions

In balance of payments (BOP) statistics, every external transaction is connected to two entries, debit (–) and credit (+). Credit entries are related to exports, increase in external liabilities or decrease in external assets. Correspondingly, debit entries are related to imports, increase in external assets or decrease in external liabilities. For example, when a Finnish company purchases industrial machinery from Germany, a debit entry is made in the current account under imports of goods. The credit entry related to the transaction can be recorded in a number of ways. Typically, if the Finnish importer pays for the purchase into the German seller's account in a commercial bank located in Finland, the entry is recorded as an increase in deposit liabilities of commercial banks in Finland, which are presented in the financial account. Another common method is to connect the credit entry with an increase in the Bank of Finland TARGET liabilities shown in the financial account. This is the case if the Finnish importer transfers the funds from an account of a bank located

in Finland to the German seller's bank account in Germany. Correspondingly, if a Finnish industrial company sells a shipment of mobile phones to Brazil and receives the payment in Brazilian Real, a credit entry is recorded in the current account under exports of goods. The related debit entry is usually recorded in the financial account as an increase in Finnish companies' deposit assets. This is the case if the Brazilian importer pays the goods into the Finnish seller's account in a bank located in Brazil. Another common method is to show the debit entry in the financial account as an increase in the Bank of Finland's foreign reserves. This is the case if the Brazilian importer transfers the payment from a bank account in Brazil to the Finnish purchaser's bank account in Finland.

The BOP errors and omissions, or the residual or balancing item, consists of data not allocated in the BOP, erroneously entered data and other deficiencies and discrepancies. The item covers missing debit or credit entries and is the counteritem of overestimated debit or credit entries. If credit entries exceed debit entries, errors and omissions are negative. Correspondingly, if debit entries exceed credit entries, errors and omissions are positive. However, if debit or credit entries are missing or excessive to an equal amount, there are no errors and omissions.

Since every external transaction recorded in the BOP is connected to two opposing entries, The BOP or the sum of its components¹³ is in principle zero. Since the capital account is usually of relatively low

¹³ Current account, capital account, financial account and errors and omissions.

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importance in developed countries, it follows that the current account surplus/deficit for such countries is roughly the same size as the financial account “deficit/surplus”. The sum of the financial account “deficit” and the revaluation changes of the net international investment position (NIIP) correspond in turn to the growth in NIIP. This results in the generally known correlation, ie that the current account surplus corresponds to the growth in NIIP minus NIIP revaluation changes. Errors and omissions blur this correlation.¹⁴

2.2 Errors and omissions in Finland's balance of payments

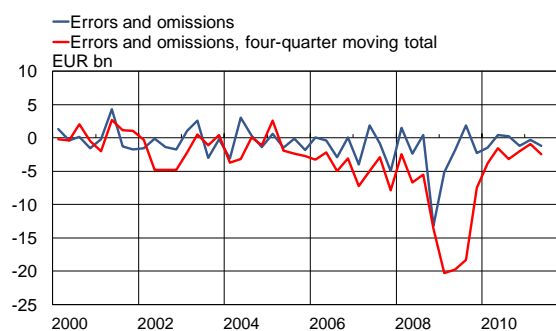
In Finland's BOP, errors and omissions have been substantial especially in 2008 and 2009, notably in the last quarter of 2008 and the first quarter of 2009 (see Chart 20).¹⁵ The item has also been considerable in several other EU countries, such as the Netherlands and Sweden, and even in the euro area.¹⁶

¹⁴ See the Bank of Finland Bulletin 3/2011: Economic outlook, box 6 (http://www.suomenpankki.fi/en/julkaisut/bulletin/economic_outlook/Pages/b_3EO_2011.aspx).

¹⁵ See Finland's Balance of Payments, Annual Review 2008, chapter 5 (<http://www.suomenpankki.fi/en/tilastot/maksutase/Pages/vuosikatsaukset.aspx>).

¹⁶ See the ECB's Monthly Bulletin 12/2009, box 11 (<http://www.ecb.europa.eu/pub/pdf/mobu/mb200912en.pdf>).

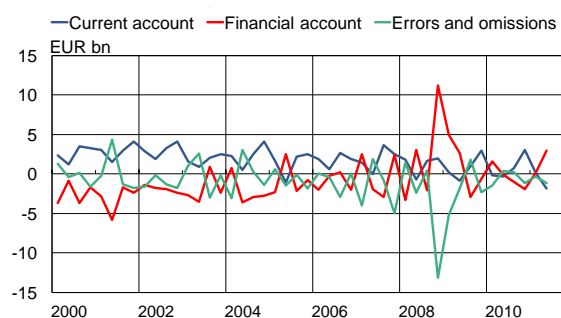
Chart 20. Errors and omissions in Finland's balance of payments, 2000–2011/I–II



Source: Bank of Finland.

Errors and omissions have been negative in Finland's BOP, which indicates that there has been overreporting of credit entries or underreporting of debit entries. It would appear that the financial account is principally a counteritem of errors and omissions (Chart 21). This would mean that, in practice, errors and omissions are largely attributable to overestimation of growth in external debt or underestimation of growth in external assets. Bank of Finland analyses have shown that there has in fact been some underreporting of general government's foreign portfolio investment assets. These revisions have reduced the errors and omissions item (Chart 22).

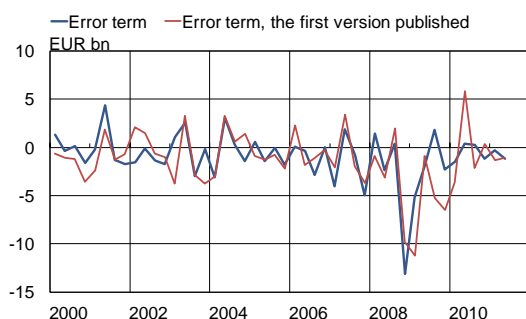
Chart 21. Finland's current account, financial account and balance of payments errors and omissions, 2000–2011/I–II



Source: Bank of Finland.

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Chart 22. Errors and omissions in Finland's balance of payments relative to the first version published, 2000–2011/I–II



Source: Bank of Finland.

Despite these revisions errors and omissions have still been substantial, particularly in 2008 and 2009.

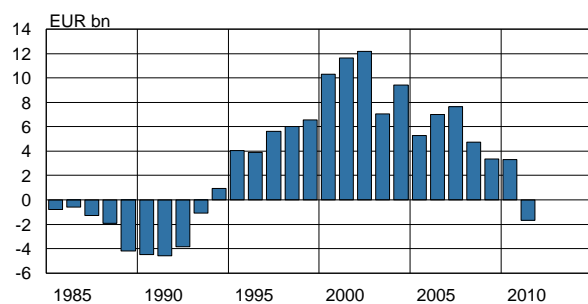
Studies at De Nederlandsche Bank have shown that the Dutch BOP overestimates foreign holdings of Dutch debt securities. The reason for this is that Dutch custodians reporting to De Nederlandsche Bank cannot always distinguish between securities sold to foreign investors and securities lent out only temporarily.¹⁷ As a result, part of the domestic debt was recorded as external debt, ie there was overrecording of growth in external debt. The Bank of Finland findings show that it is probable that part of the domestic debt has also been recorded as external debt in Finland. This is mostly due to the internationalisation of securities custody services. The Bank of Finland has already launched an investigation into the matter.

¹⁷ See De Nederlandsche Bank, Statistical Bulletin 12/2010 (<http://www.dnb.nl/en/publications/dnb-publications/statistical-bulletin/index.jsp>).

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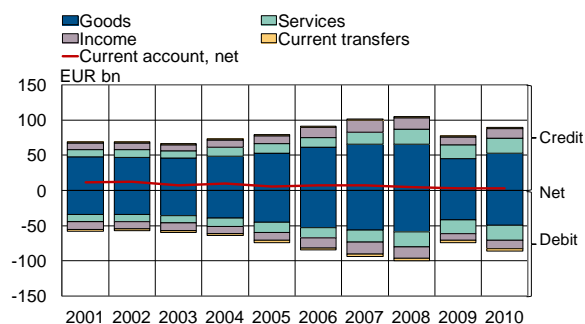
Appendix 1. Charts

Chart 23. Current account, 1985–2011/I–II



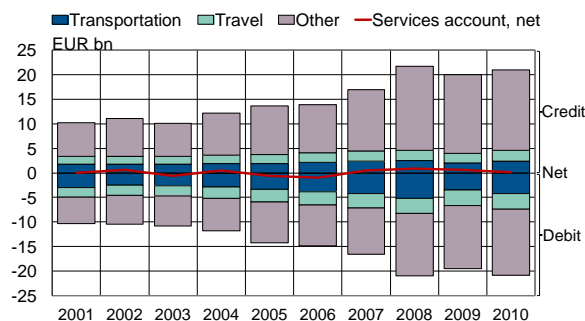
Source: Bank of Finland.

Chart 24. Distribution of credit and debit in current account, 2001–2010



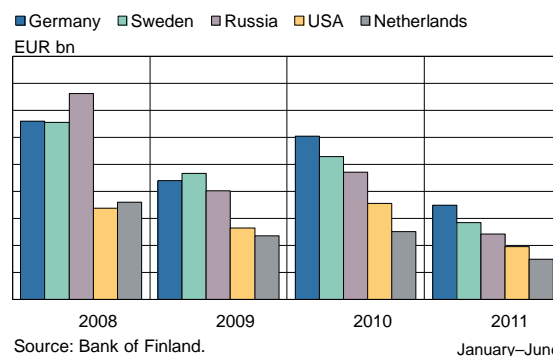
Source: Bank of Finland.

Chart 25. Current account in 2001–2010: breakdown of services exports and imports



Sources: Bank of Finland and Statistics Finland.

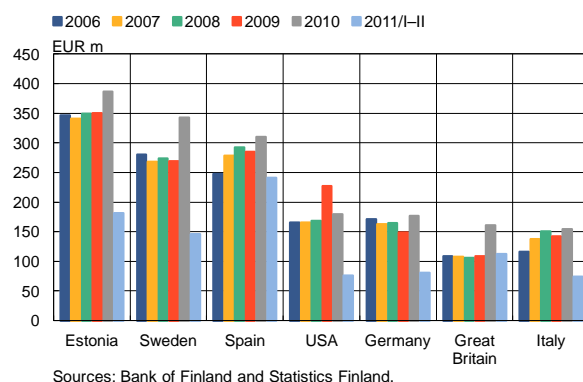
Chart 26. Goods exports by country, 5 largest countries, 2008–2011/I–II



Source: Bank of Finland.

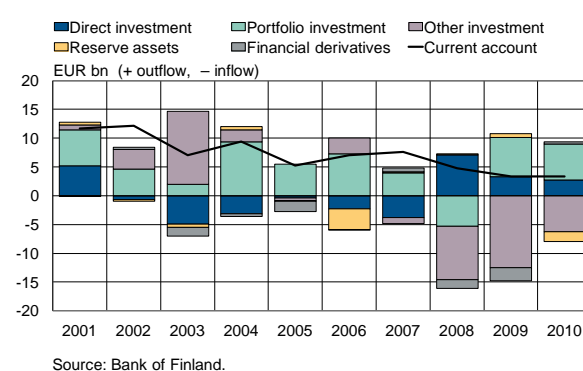
January–June

Chart 27. Expenditure on travel abroad, 2006–2011/I–II



Sources: Bank of Finland and Statistics Finland.

Chart 28. Capital movements by investment type, 2001–2010



Source: Bank of Finland.

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Chart 29. Capital movements by sector, 2001–2010

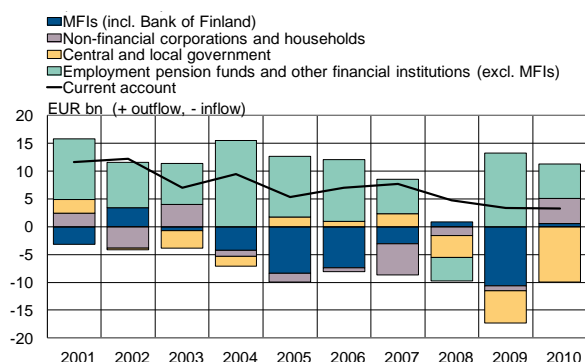


Chart 30. Finland's external assets and liabilities by sector, 2001–2010

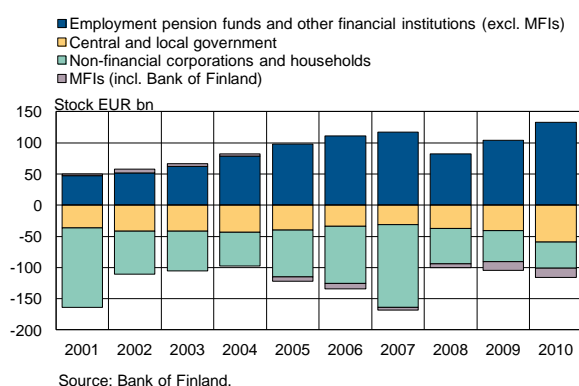


Chart 31. Finland's net international investment position (assets – liabilities), 1985–2011/II



Chart 32. Direct investment, net capital flows, 2001–2010

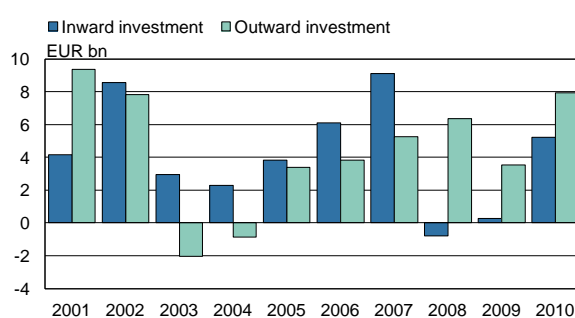


Chart 33. Direct investment, stock, 2001–2010

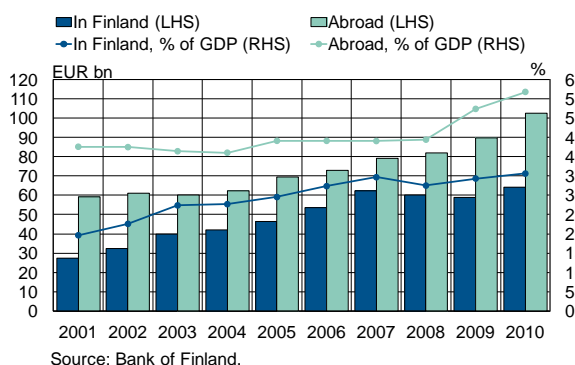
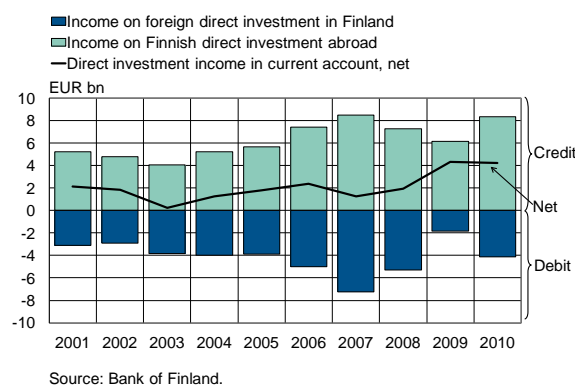


Chart 34. Direct investment income, 2001–2010



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Chart 35. Inward portfolio investment, 2001–2010

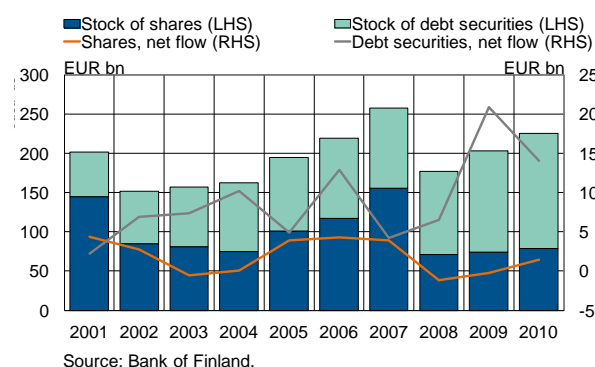


Chart 38. Outward portfolio investment by sector, stock of investment at 30 June 2011

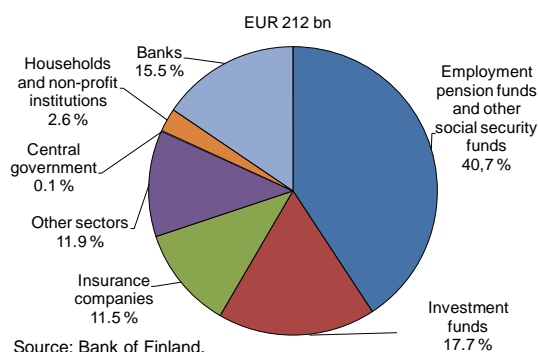


Chart 36. Outward portfolio investment, 2001–2010

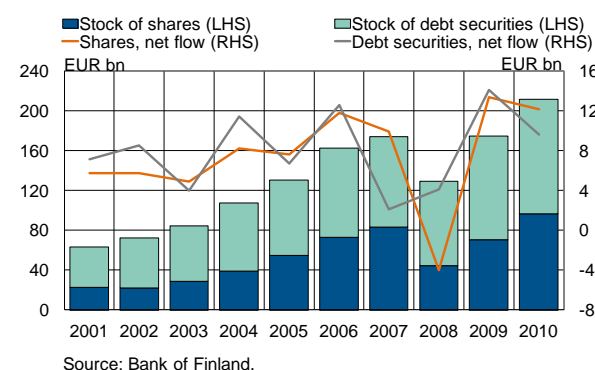


Chart 39. Geographical breakdown of Finnish portfolio investment abroad: stock 30 June 2011

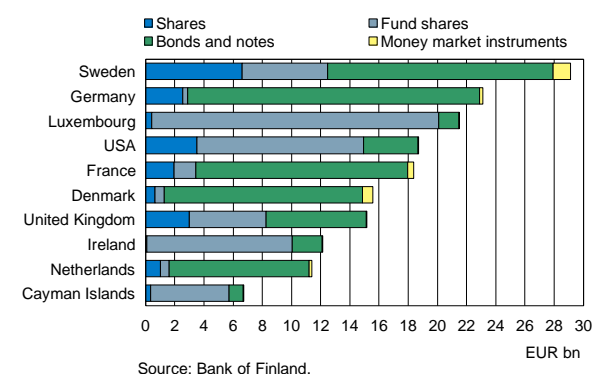


Chart 37. Inward portfolio investment by issuing sector: stock of investment at 30 June 2011

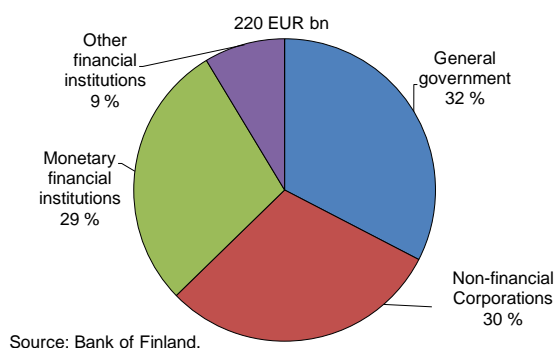
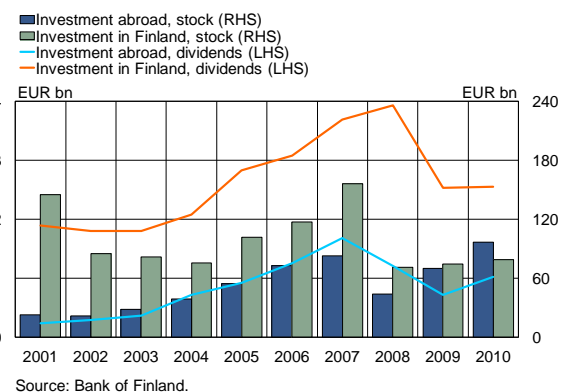
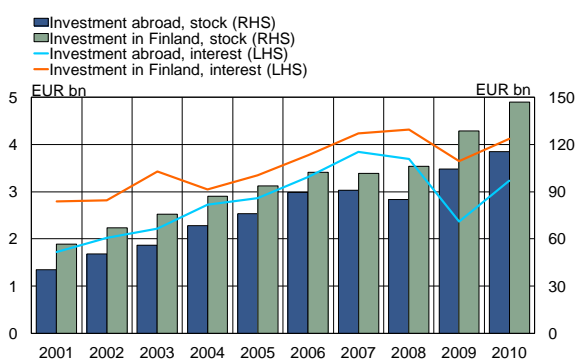


Chart 40. Portfolio investment, shares and fund shares, stock and dividends 2001–2010



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Chart 41. Portfolio investment, debt securities, stock and interest 2001–2010



Source: Bank of Finland.