

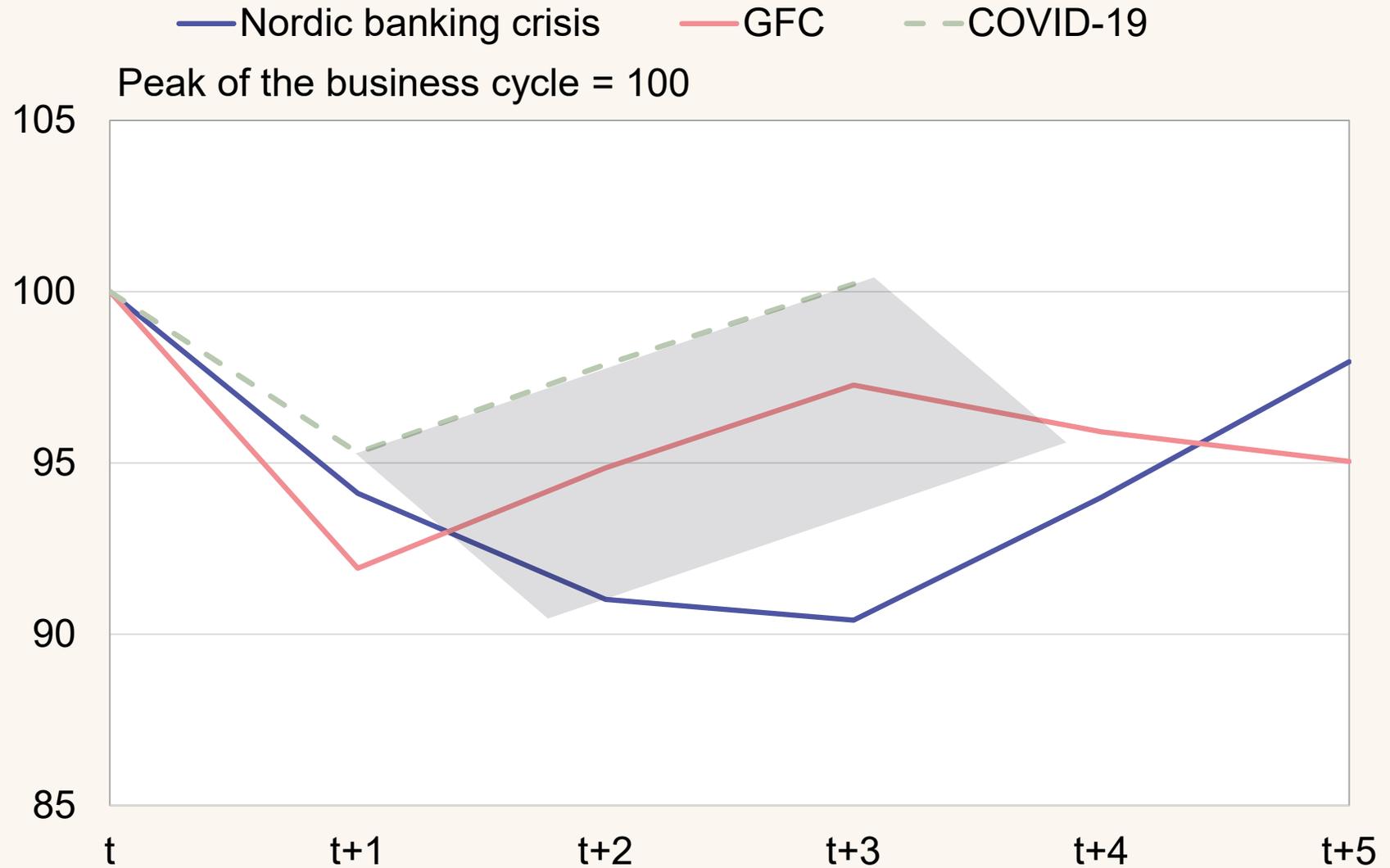


# Finland through three crises

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Tuomas Välimäki  
The Board, Bank of Finland

# GDP development 5 years since the peak of the 3 crisis



Source: Statistics Finland, Bank of Finland.

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# *Short description of the crisis*

## *Finnish perspective*

# I Nordic Banking crisis in Finland

- One of the "Big Five" recessions in Reinhart and Rogoff (2009)
  - Typical boom-bust cycle where *monetary* and *fiscal policies* played a role first in *creating* and subsequently in *alleviating* the crisis
  - Financial deregulation together with low real rates of interest initiated rapid credit expansion. Lending in foreign currency rose dramatically exposing many SMEs to foreign exchange risk.
  - Rapid wage increases led to weaker foreign competitiveness and growing trade deficits.
  - Biggest trading partner (exports market) was lost.

## II Finland and the Global Financial Crisis (GFC)

- This time was different...
  - Thanks to the memory of the previous crisis, Finnish banking sector was in a good shape after major restructuring in the 1990s.
  - *Corporate sector balance sheets were strong. Households' mortgage credit had grown hand in hand with disposable income and the public sector's debt to GDP ratio had been brought down to around 35%.*
    - *In Finland, GFC wasn't really a financial crisis, rather a huge shock to external demand.*
- Single monetary policy

## II Finland and the Global Financial Crisis (GFC)

- ... although with some major similarities:
  - Rapid wage increases at the onset of the crisis led to weaker foreign competitiveness and deteriorating trade balance.
  - (One of the) Biggest exports market lost.
  - Other idiosyncratic events (ITC sector, forest industry,...).
  - Single monetary policy.

## III COVID-19

- Pandemic with unexperienced lockdowns brought about a major drop in domestic demand (*first phase*).
- As a global phenomenon, external demand will drop hurting our economy that exports investment goods (*the coming phase*).
- Global shock – with global crisis response.
- Biggest uncertainty: health.

# *On crisis responses*

# Monetary policy in the 1990's crisis

- In the boom phase, the tightening of domestic monetary conditions was offset by the inflow of foreign capital.
- Fixed exchange rate policy constrained Monetary Policy, leaving economic stabilization to the fiscal side.
- Eventually the unilateral ECU-peg was discontinued (devaluation in 1991, followed by floating markka in 1992)
- Unprecedented wave of bankruptcies, credit losses in the banking sector, surge in unemployment and fall in house prices.

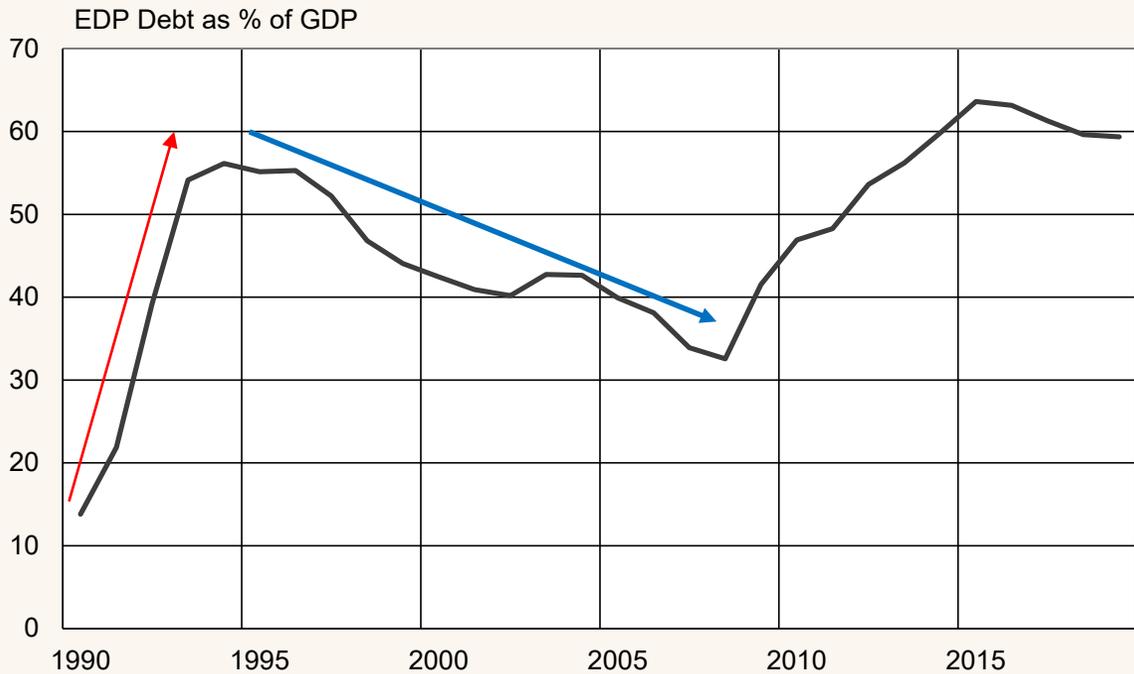
# The trilemma for an open economy

- The crisis is a good illustration of the impossible trinity (trilemma): *one cannot combine free capital mobility, fixed exchange rate and monetary policy sovereignty.*
  - Prior to the crisis, the stable (or strong) markka policy was supported by theories stressing the role of rules and credibility.
  - New theories suggested, however, that monetary policy should concentrate on fighting inflation as the anchor for economic policy – *domestic instead of external price stability.*
- In February 1993, Bank of Finland assumed inflation target: *stabilization of inflation at about and on average 2%.*

# Recovery and lessons from the 1990's crisis

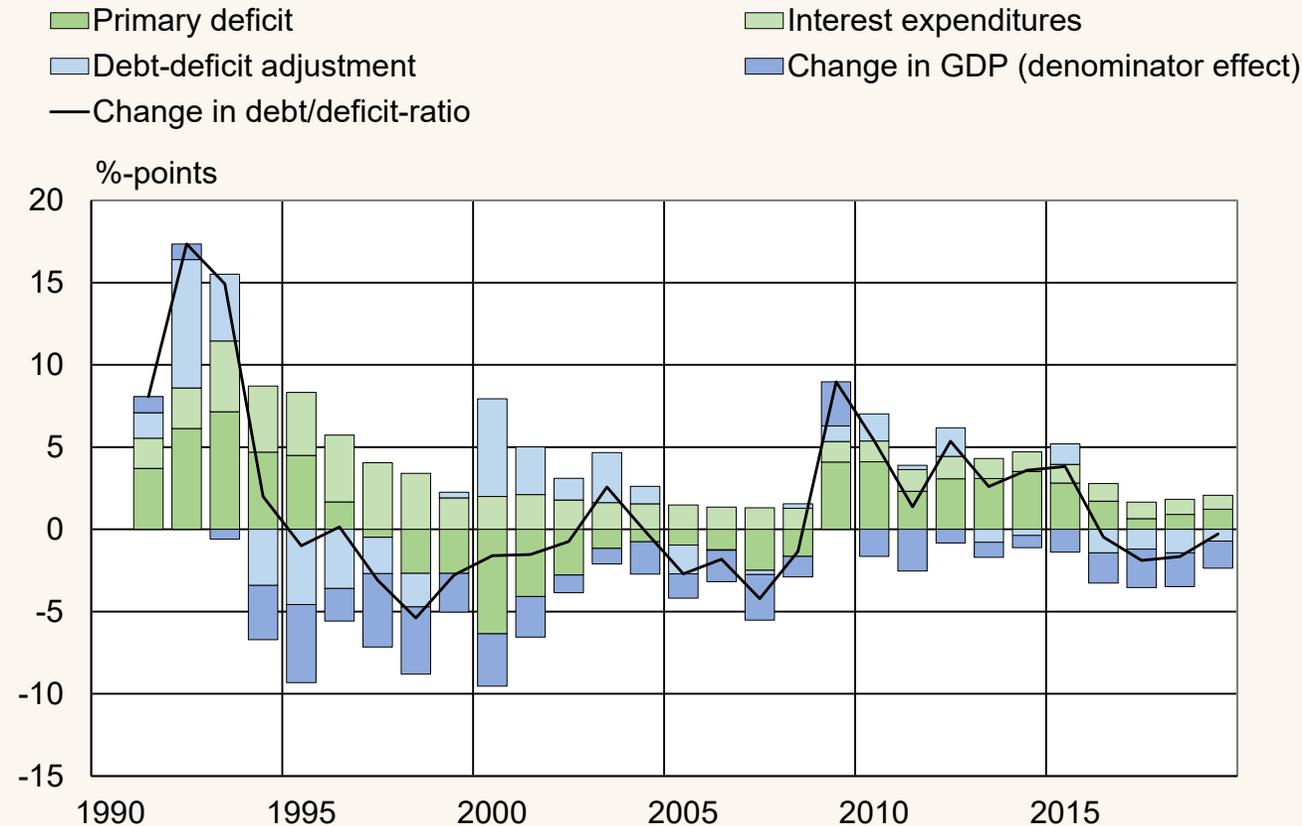
- Long recovery facilitated by
  - Strong external demand
  - Rapid fall in the short- and long-term interest rates
  - Luck: rapid growth of the ICT sector (Nokia cluster) boosting productivity
- Lessons
  - Indebtedness and financial risks within the private sector need to be more closely supervised
    - *Banking Supervision Office was established to the proximity of the Bank of Finland*
  - Buffers needed to mitigate the consequences of a crisis: public debt to GDP can suddenly jump due to excessive leveraging in the private sector.

# Improvement in fiscal balances was supported by strong growth, declining interest payments and smaller unemployment costs



Source: Statistics Finland, Bank of Finland.

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Source: Statistics Finland, Bank of Finland.

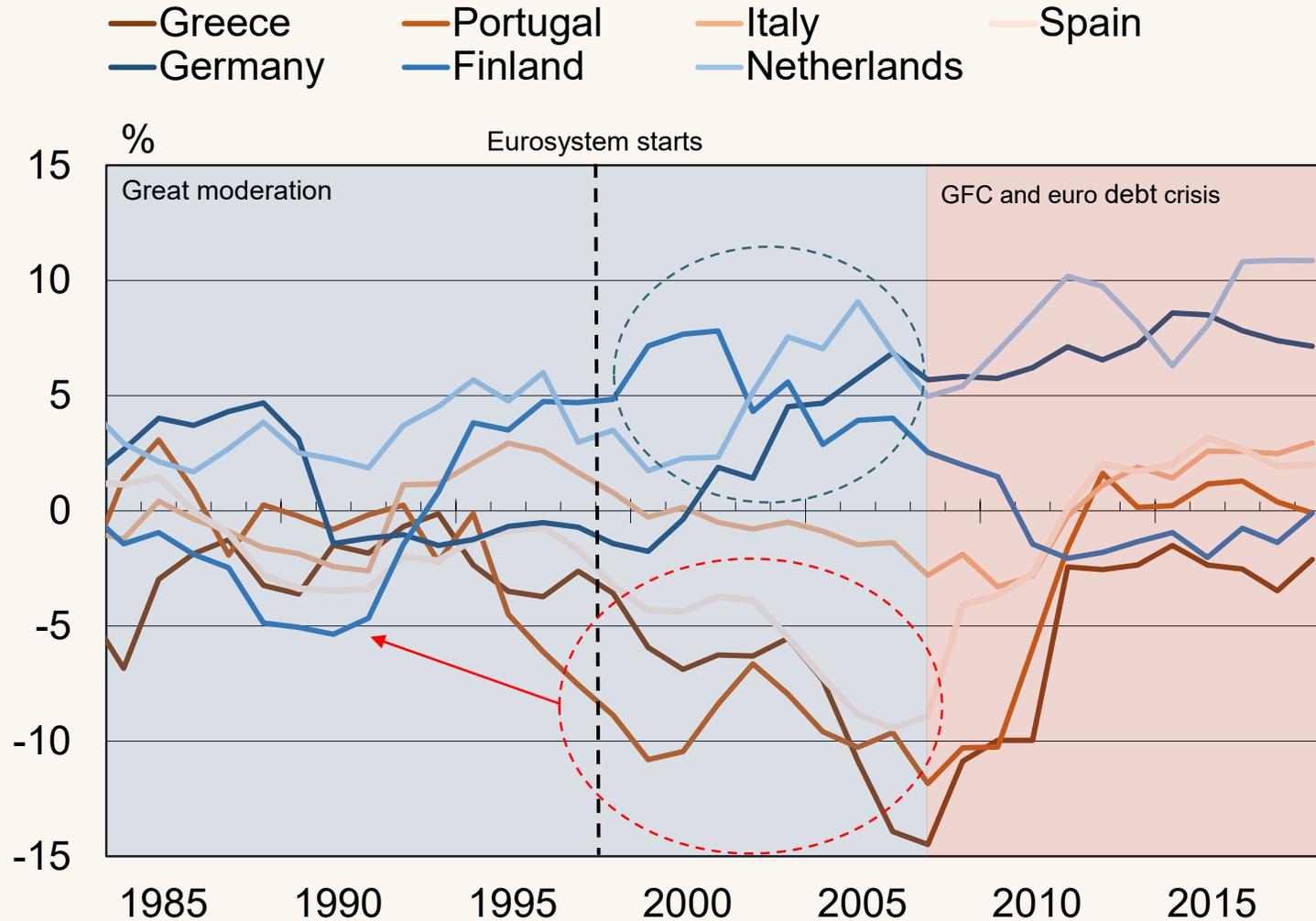
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# Planting the seeds of the Great Recession

- The great moderation lowered crisis awareness (globally) and allowed macroeconomic and financial imbalances to grow under the surface
- Macroeconomic imbalances manifested as high and uneven credit growth
  - With single monetary policy, higher wage growth and inflation resulted in lower real interest rates in the periphery
- Regulatory and supervisory failings
  - Before the financial crisis, financial stability was more seen as a precondition to price stability rather than a separate goal
- Beliefs that this time is different
  - Large current account deficits can be permanently financed in a currency union

Similar failures that we faced before the 1990s' crisis, only this time in European/global level

# Macroeconomic imbalances in the euro area



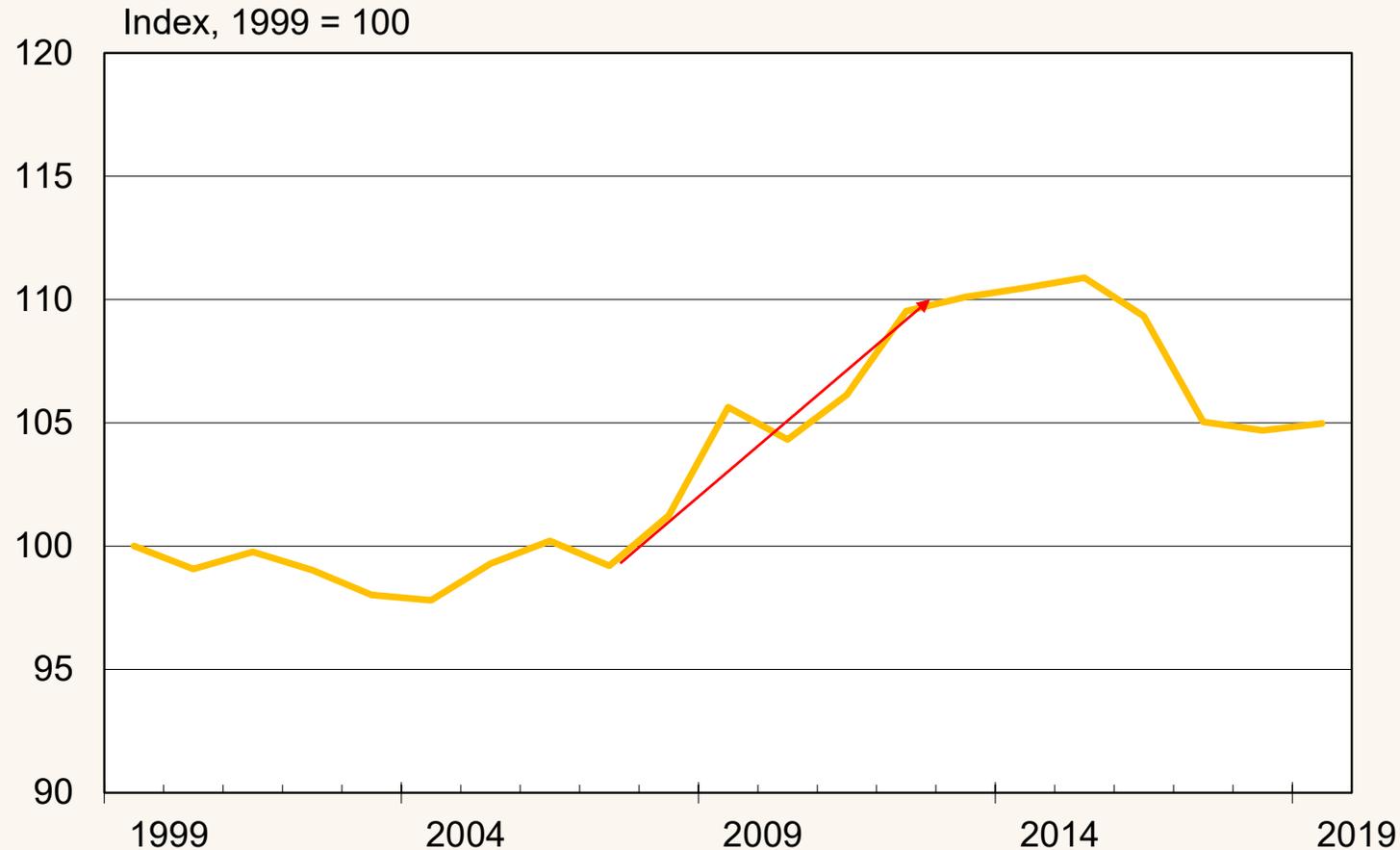
Source: IMF World Economic Outlook Database

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# Managing the crisis from monetary policy perspective

- ...see the article 😊

# In Finland, terms of trade adjusted cost competitiveness decreased considerably before and during the GFC



Good luck was not handled perfectly:

*Productivity growth in the ICT sector, resulted in high wage increases also in closed sectors*

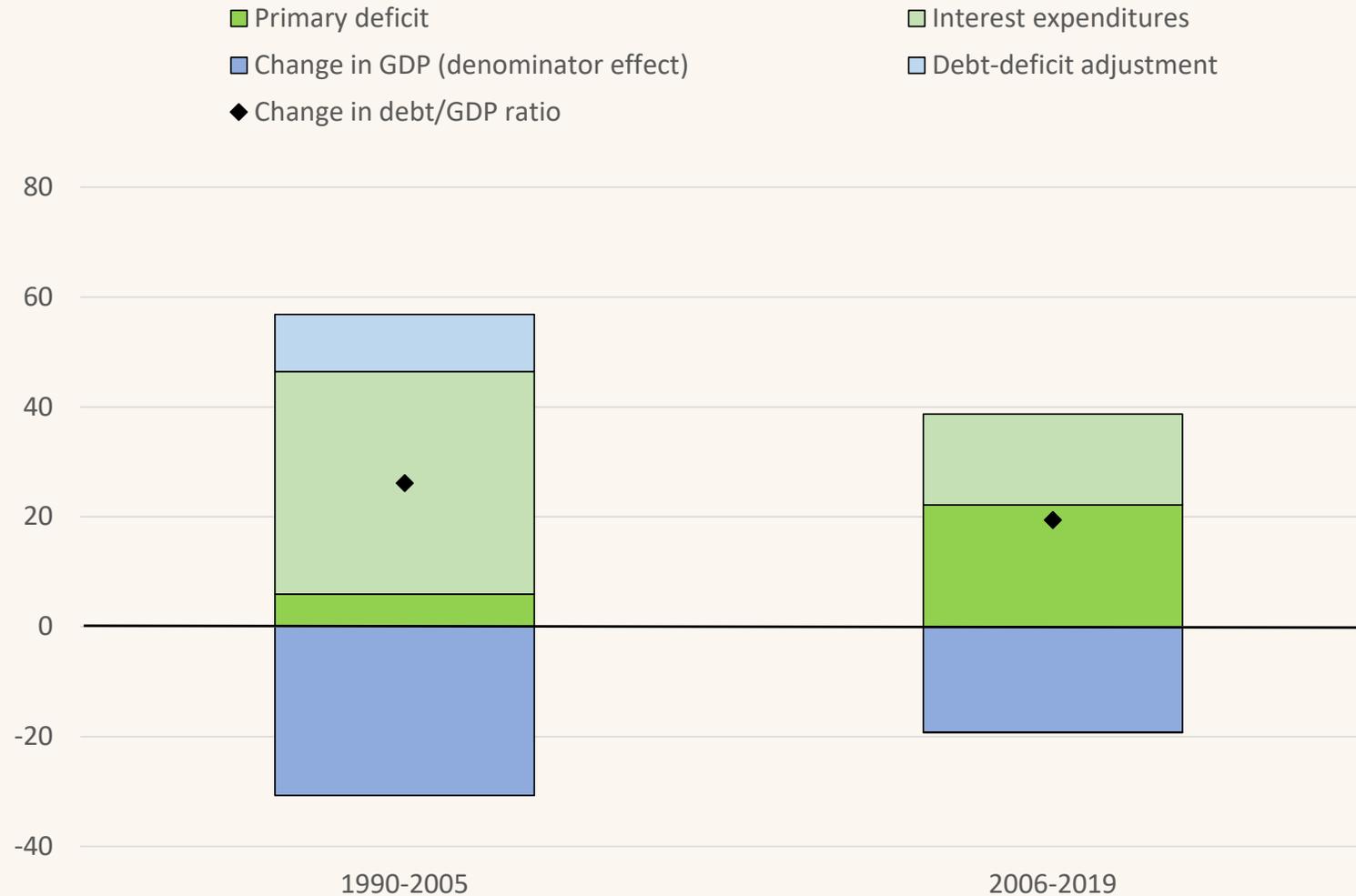
Relative to the 12 original euro area member states.

Compensation of employees relative to real domestic income, total economy.

Sources: European Commission, OECD, Macrobond and Bank of Finland calculations.

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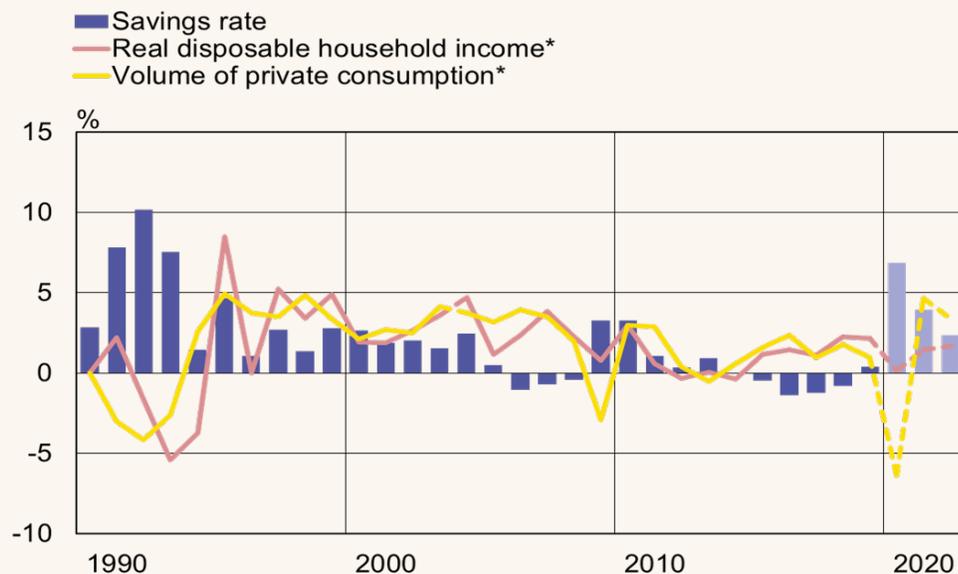
# Role of different factors in the growth of Finnish debt to GDP ratio



# Lessons from the two previous crises and way forward

- Banking sector resilience and credit developments are key factors behind economic stability: *macroprudential tools are needed, BU and CMU should be completed*
- The public debt to GDP ratio decreased in the euro area during the recovery from the GFC. However, despite the very accommodative monetary policy stance, deleveraging has been modest and uneven across member states.
- Also in Finland, persistent deficit in public finances since the financial crisis and only marginal decrease in debt ratio
- Monetary policy not normalized since financial crisis: a need to review the strategy

# Recovery from the ongoing crisis will be slow



Households = households and non-profit institutions serving households

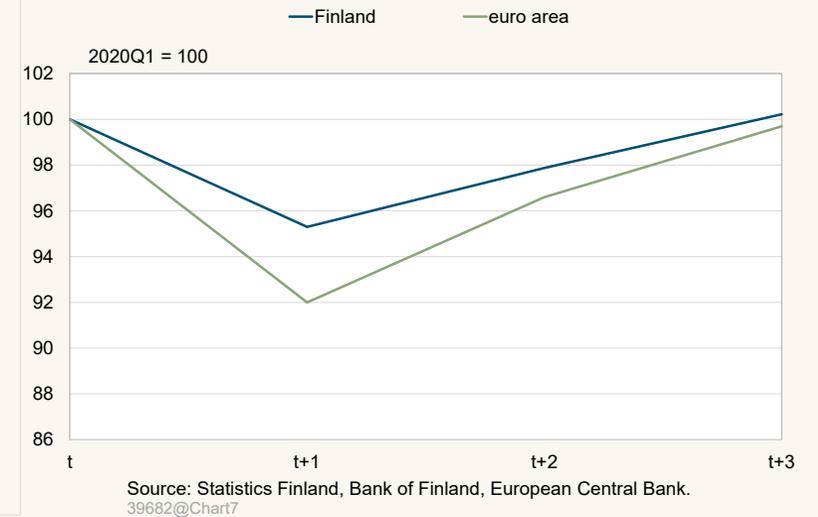
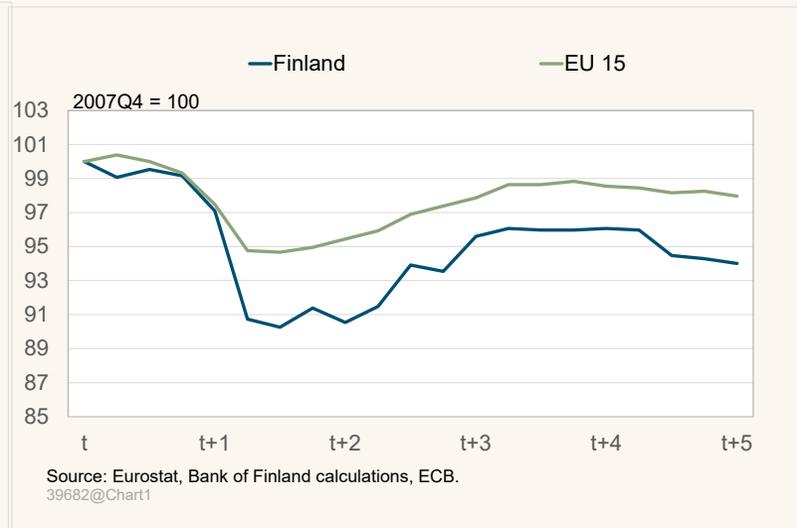
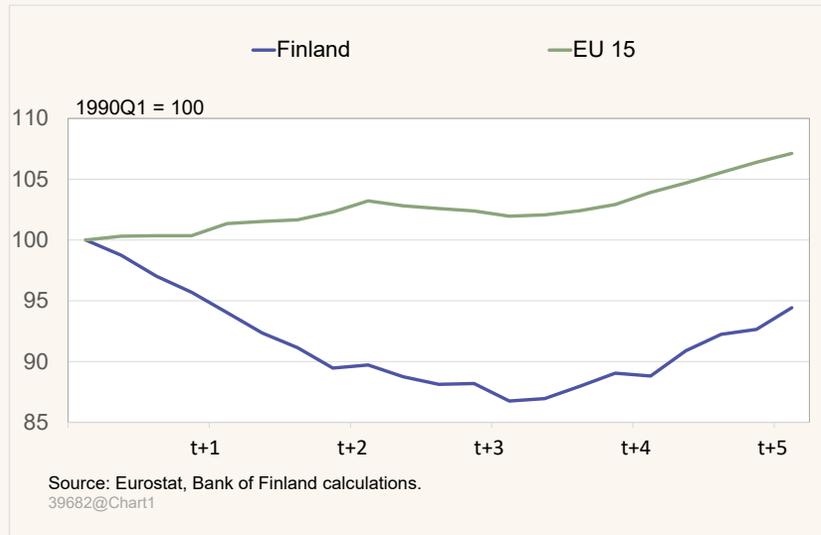
\* Percentage change on previous year

Sources: Statistics Finland and Bank of Finland.

Jun 9 2020  
eurojatalous.fi  
38284@TulotJaKulutus(en)

- Global recession and weak investment in export markets keep export outlook gloomy
- Growth rests on private consumption – outlook very sensitive to a resurgence of the epidemic
- High uncertainty to act as a drag on growth? Extended period of high saving?
- Fiscal policy space further reduced – role of fiscal monetary policy coordination (?)

# For Finland: this time exporting ourselves out of the crisis won't be so easy



# Summing up

- Excess credit growth common for deep recessions and a cause of slow recoveries (despite monetary policy regime)  
→ *macro prudential tools, regulation, BU, CMU...*
- Sustainable fiscal policy is a key condition for everyone, but especially for a sovereign in single currency area  
→ *significant monetary accommodation also an opportunity to create fiscal space*
- Single monetary policy brought stability for Finland in the GFC and euro crisis  
→ *interest rates remained extremely low throughout the crisis period*
- Lack of flexibility (labor market in particular) a key vulnerabilities of Finland: deterioration of cost competitiveness, slow recovery from the crisis  
→ *Important to avoid same mistakes in the current crisis (structural reforms needed)*

**Thanks!**