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THE FINNISH ECONOMY IN THE LAST 25 YEARS: DEPRESSION, GROWTH AND RECESSION

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ANNO ACCADEMICO 2014 – 2015

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ABSTRACT

This thesis aimed at examining in depth the business cycle experienced by Finland during the last 25 years. In particular, I wanted to show the strong relation that existed between the three economic scenarios that composed the time-span taken into consideration. In addition, my further objective was investigating Finland's capabilities to cope with the three different economic periods that I analyzed in details.

The first one concerns the deepest crisis that Finland experienced during the XX century: the Great Depression of the 1990s. Although the collapse of the Soviet Union and the subsequent decline of the Soviet market had a role in worsening the economic downturn, it was substantially caused by the deregulation of the financial markets in the 1980s, leading to an unexpected bubble in the stock and real-estate markets which was designed to burst. The second economic context examined is constituted by the recovery phase that lasted since 1994 until the first years of the 2000s, namely over a period in which the Finnish growth rate was higher than the EU average. Efficient macroeconomic moves, the process of European integration and the spread of the ICT sector helped Finland to come out from the crisis, starting a strong period of economic growth. Finally, the third context is provided by the global crisis that disturbed and still disturbs the international economic equilibrium since 2008. Indeed, as a small open economy, Finland was not able to avoid it, going through severe repercussions in its GDP, industrial productivity, exports and labour market.

The choice of this topic is strictly related to my personal experience. One year ago, I spent four months in Jyväskylä, a small town in the south of Finland, for my Erasmus

experience. I have always been fascinated by the Scandinavian countries, their economic structure, their strong welfare state, their culture, and their essence, permanently divided between two worlds, the East and the West. Living in Finland allowed me to go through the reality of a country which was experiencing the severe consequences of the last global economic collapse since the depression of the 1930s. Speaking with Finnish people and living on site, I realized the gravity of the economic period and the pressure that its repercussions was exerting on the population, afflicted by a static economic growth and a high rate of unemployment. However, during my LUISS university course of International Economics, I was surprised of how, at the beginning of the 2008 crisis, Finland, together with a few other countries, could boast a deficit/GDP ratio and a debt/GDP ratio still within the limits established by the European Stability and Growth Pact. What had changed? It was the question that I wanted to answer. To receive guiding ideas and useful instructions for a correct analysis, I asked the help of Kari Heimonen, the School of Business and Economics' vice dean of Jyväskylä University. After having spent a long cold afternoon debating about Finnish economy, paper industries, Nokia and Soviet Union, he recommended to me to reconstruct the entire Finnish economic cycle since the collapse of the USSR until today. Indeed, the Professor emphasized the considerable importance of the Great Depression of the 1990s, stressing how overcoming it gave to the Nordic country the necessary strength to rebuild its economy during the recovery period. However, the industrial sectors responsible of the growth experienced during the first years of the new millennium (ICT and paper firms) were precisely the same that undergone a decline in their share of exports during the 2008 crisis. For this reason, Professor Heimonen wisely suggested to me to embrace the entire century's quarter, analyzing each different phase. That was the birth of my thesis.

In the first chapter, after a brief overview of the floating development of the Finnish economy during the 20th century, I focused on the last, significant and heaviest peace time crisis of the 1990s: the Great Depression of 1990 – 1993. Indeed, during the years 1991-1993, "Finland experienced the deepest economic slump in an industrialized country since the 1930s and the deepest peace-time recorded recession in Finnish history"[1]. Over this period, real GDP declined by 14%, real consumption dropped by

[1] Gorodnichenko Y., Mendoza E. G., Tesar L., *The Finnish Great Depression: From Russia with Love*, Cambridge, National Bureau of Economic Research, 2009.

10% and investment fell to 55% respect to the 1990 level. However, the most significant indicator of the crisis was the level of unemployment. During the depression, the Nordic country went through a quadrupling of unemployment, moving from 4% to a peak of 18%, and the stock market lost 60% of its value. Firstly, I analyzed the collapse of the Finnish-Soviet trade relation, examining the thesis of Gorodnichenko *et al.* according to which the latter can be considered the decisive factor of the crisis taken into consideration. Indeed, the collapse of the Soviet market caused a costly restructuring of the manufacturing sector and a rapid, important increase in the cost of energy. The USSR-Finland barter type trade arrangements had always allowed the Nordic country to export competitive manufacturing products in exchange for energy imports at an overvalued exchange rate. Looking at the analysis of Gorodnichenko *et al*. from an overall perspective, the key information that stands out is that the event investigated produced two distinct shocks for Finland. The first one interests the loss of one of its major exports markets and the Finnish firms' impossibility to redirect trade to other countries because of the high degree of specialization with the USSR. This implied that exports to the USSR vanished. At the same time, it was registered a permanent drop in Soviet oil imports to zero for all *t*. Hence, the second shock was the end of the USSR's provision of subsidized energy for Finland. In particular, this subsidy was at least 10% of the world oil price. Therefore, the Soviet trade collapse ended in a substantial increase in the oil price. Secondly, I will go deeper in the second and most plausible explanation of the crisis: the financial liberalization of the 1980s. Indeed, although the collapse of Finnish-Soviet trade played a substantial role in aggravating the crisis, it can only account for no more than a half of the GDP's drop. Finland's annual current account deficits were 2.1%, 3%, 6.2% and 6.7% of the GDP in the years 1987 – 1990 respectively. The total dip of Russian trade over the two years 1991 – 1992 totaled less than 2 per cent of the GDP and visibly recovered thereafter, reaching its pre-crisis level in 1996. Hence, it was as law as the smallest of the annual current account deficits during the four years preceding the crisis. Declines in export demand of a larger magnitude had been handled in the past without difficulties when the Finnish economy was in a normal condition. On the contrary, the liberalization led to a sharp credit expansion and to the blast of house and stock prices. The result was the so called "crazy years"[2], during which housing and stock prices nearly doubled and general inflation accelerated, leading to an explosion of credit and to a serious erosion of price competitiveness. Moreover, measures were implemented without those prerequisites that make it efficient: financial liberalization was not conveniently implemented and it was not accompanied by the parallel introduction of modern safety measures in the financial sector. As a result, the financial and banking crises that followed the asset bubble burst produced large amount of debt which made more difficult for the Nordic economy to recover. Finally, I examined in depth the effects of the crisis on the Finnish welfare system, the most peculiar feature of the Nordic economic model. The welfare state has been one of the most important political invention in Western Europe after the Second World War. In particular, the Nordic welfare model has always referred to an ideal based on universal basic services and redistributive social security benefits, ensured thanks to relatively high and progressive taxation[3]. This idea started to be implemented in the Nordic countries during the post-war decades, reaching its peak in the 1980s. However, at the same time, the Nordic welfare model inevitably started to face the new international economic order of free capital movements, post industrialization, European regional integration and global competition. According to Kantola and Kananen, in Finland the ideas of the Nordic welfare state started to be dismantled in Government policies from the 1990s, when the Schumpeterian competition state paradigm, based on the assumption that the state and the society have to be examined in terms of market efficiency and competitiveness, replaced the Keynesian one.

In the second chapter, I investigated the subsequent recovery phase, that lasted since 1994 until the first years of the 2000s. Indeed, it seemed like the long-run consequences of the Great Depression of the 1990s were all but negative. As Jonung[4] shows, the growth rate of Finland during the post-crisis period was higher than the EU average. The financial crisis and the following financial integration that took place contributed to a very great extent to the radical transformation of the Nordic economy, making it more

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[2] Ahtiala P., Junttila J., *The collapse of Soviet trade and Finland's great depression of the 1990s: a re-examination*, University of Tampere and University of Jyväskylä, p. 8.
[3] Kantola A., Kananen J., *Seize the Moment: Financial Crisis and the Making of the Finnish Competition State*, New Political Economy, 18:6, 811-826, Helsinki, 2013.
[4] Jonung L., *Lessons from the Nordic Financial Crisis*, report based on chapter 12 in *The Great Financial Crisis in Finland and Sweden. The Nordic Experience of Financial Liberalization*, edited by Jonung L., Kiander J. and Vartia P., Edward Elgar, 2009, p. 17.

reactive, totally increasing its growth prospect. The crisis "served as a window of opportunity for policy makers to carry out growth-enhancing structural reforms"[5] and the economic downturn undoubtedly affected in a positive way the growth potential of the economy. Firstly, I offered an overview of the macroeconomic moves that followed the depression, considering their effects on the economy. Indeed, it is logic affirming that the loosening monetary policy and the devaluation of the early years of the 1990s represented the strong macroeconomic factors that brought Finland out of the catastrophe. Floating let the central bank cut short term interest rate by 10 percentage points in a couple of months: abolishing the fixed exchange rate system meant no need to defend the exchange rate anymore and rates started to fall. This have clearly an effect on the asset prices, stabilizing them and boosting private consumption and investment in 1994. Secondly, I analyzed in details the process of European integration started by Finland in 1994. The demise of the communist empire in Eastern Europe and the subsequent disintegration of the Soviet Union led to a radical change of Finland's radical position. The collapse of the USSR meant the end of the Finnish-Soviet trade relations, leading the exporting country to find possible compensatory markets in western Europe. In that period the European Community was experiencing a great influence on the continent, assuming the major politico-economic power and slowly attracting the European Free Trade Association (EFTA) members in its irresistible vortex. In short, "disintegration in the east was offset by the prospect of still greater integration in the west"[6]. In the meantime, the unification of Germany, the inclusion of the former German Democratic Republic in the Community and the approval of the Treaty on European Union by the EC leaders during the Maastricht summit in December 1991 fostered the widening of the EC members, predicting deep cooperation between the future member states. The events described above substantially modified Finland's durable position between Western Europe and USSR, obliging the Nordic country to pursue a new *Westpolitik* and to reconsider its position in relation to the western institutions, such as EFTA, the European Economic Area (EEA), the European Community and even NATO. Therefore, on 16 October 1994, the question "Should Finland join the EU on the basis of the negotiated settlement?" found an answer. Using a standard with ballot paper, 57% of Finns opted for a "yes". Subsequently I focused on

[5] Ivi.
[6] Arter D., *The EU Referendum in Finland on 16 October 1994: a vote for the West not for Maastricht*, Journal of Common Market Studies, Vol. 33, No 3, September 1995.

the pros and cons of a single currency area, particularly focusing on the benefits and the risks that derived from the euro zone. A prominent pro-EMU argument in the Finnish political debate on the euro area was that the euro-entry would have safeguarded Finland's position in the 'EU core'. Indeed, the so called policy of 'being in the core' was the security policy's key goal of Finland which, as a small state with real security concerns, could not accept to be excluded from any of those official or unofficial forums where fundamental decisions about the Union's future are taken. As a consequence, Finland succeeded in obtaining some important nomination in the field of economic and monetary policy, such as Sirkka Hämäläinen, the former governor of the Bank of Finland, who was nominated to the ECB's executive board for its first five years. In addition, the country was able to affect the practices of the Euro-Group and, consequently, to influence the Union's political system. This made possible safeguarding its position in the EU, notwithstanding the further development of *integration asymmetry*. Furthermore, the economic benefits cannot be underestimated. EMU membership was predicted to reduce transaction costs and increase competition, integrating Finland in the European single market, and giving households, firms and governments access to more efficient financial markets. This would have accelerated structural change in the production sector and high productivity growth. On the other hand, "the government identified the key risks and challenges related to the EMU Third Stage from the Finnish perspective and called for further national adjustments and/or further studies of their consequences"[7]. Tiilikainen described two potential risks concerning the effects of Finnish subordination to the European Central Bank's common monetary policy objectives on national economic policy. The first one regarded the possibility that the ECB's commitment to low inflation could constrain national labor market policy and the Finnish system of collective agreements. The second risk was related with the fear that the ECB's common monetary policy could lead problems to several policy areas, such as the stability of regional development, sustainable growth, social equity and gender equality among women and men. Moreover, joining the euro would have meant giving up the option to devalue, and this was considered a great challenge for Finland that resorted to the 'D option' several times in the past. However, the most dangerous risk associated with the entrance in the euro area was perceived to be the possibility of potential 'asymmetric shocks'. The

[7] Ivi, p. 28.

latter can be defined as economic traumas affecting Finland without affecting the rest of the member states. The concern was related to the consideration that, in case of inefficient currency area, common monetary policy could not be able to react to the shocks as effectively as national monetary policies could. Indeed, the latter and exchange rate movements facilitate adjustments to these kind of shock and a country might face more severe economic fluctuations if it gives up its national currency. To conclude this part, I considered the relation between integration and growth, explaining how the former effectively fosters the latter. Indeed, European leaders have long put the emphasis on the growth effect. It operates "changing the rate at which new factors of production – mainly capital – are accumulated, hence the name 'accumulation effects'"[8]. EU rules allow free movement of capital, altering the amount of productive factors employed in any member state, and leading to an allocation-of-resources effect from the EU perspective but to an accumulation effect from the national one. It is well known that the output growth is determined by physical, human and capital accumulation and European integration influences growth considerably affecting the rate of investment in them. While the medium-term growth effect is the capital formation derived from the high rate of investment in productive factors, the long term growth effect concerns the rate of accumulation of knowledge capital, namely the technological progress. Hence, I described the strong development of the ICT sector, as the most productive industrial sector of the Finnish economy since the mid of the 1990s. It is evident that Finland underwent a radical transformation of its economy. For centuries, Finland's economic progress was based on the large forests covering 76% of the country's total land area. During the 18th century, timber and wooden ships constituted the main products and since the late 19th century, pulp and paper have dominated the Finnish exports, undoubtedly contributing to the internationalization of several large forest-based corporations. Forest industries played a significant role in the evolution of Finland's economy: until the late 1950s they provided the 90% of Finnish export income. Obviously, the sector included several branches, such as forestry, different mechanical and chemical forest industries, supplier and customer industries, creating country-wide clusters which exercised a strong influence on the society as well. "The forest sector also benefited from the belief, emerging since the nineteenth century, in technological modernism, which enabled the brightest young people to acquire an

[8] Baldwin, R., Wyplosz, C., *The economics of European Integration*, McGraw-Hill Education, Fourth Edition, United Kingdom, 2012, p. 188.

education in engineering- and often a job in the forest industry"[9]. The turning point was in the 1980s, when, for the first time, the idea that Finland could modernize and become an 'information society' started to spread. Among the launchers of this innovation, a key role was covered by Kari Kairamo, the chief executive officer of Nokia, at that time on of the largest, diversified corporation with strong influence in paper and pulp production of Finland. Consequently, the forest companies started to invest in product development and modern machinery, trying to convince decision-makers that the paper industry was a science-based, high technology industry. It can be affirmed that Finland made a qualitative leap from an economic structure led by resource-based heavy industries to one dominated by knowledge-based, mostly ICT sectors. Indeed, if during the 1990s, Finnish industrial production and exports were monopolized by pulp, paper, machinery and metal products, by 2000 the electronics had become the leading sector of the economy.

In the third and last chapter, I identified the principal features of the last economic scenario taken into consideration: the 2008 economic crisis. Firstly, I outlined the principal differences between the two crises. Indeed, the Finnish Great Depression of the early 1990s was essentially due to a lethal combination of mistreat financial liberalization and failure of macroeconomic policies. Even though the end of the trade relation with the Soviet Union was decisive in determining the collapse of the Nordic economy, the 1990s economic collapse was predominantly homemade. The contraction of the manufacturing sector was modest and temporary, while the decline in private services was deep and long. The depression was principally due to the high interest rates and it involved mainly the domestic market. Furthermore, the international economic recovery of that period boosted exports and lifted up the economy again. Differently, the current Finnish crisis was primarily due to the collapse of export demand, which clearly played a key role in a small open economy as Finland. Indeed, the weak development of the global economy and its restructuring affected services only slightly, while it had a significant repercussion on the manufacturing. In addition, other differences have to be underlined. As Gylfason *et al*.[10] emphasized, in the recent crisis the corporate and household sectors' balance sheets have proved to be much stronger than before, making them less vulnerable to temporary income losses. Moreover, the

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[9] Oinas, P., *Finland: A Success Story?*, European Planning Studies, Vol. 13., N° 8, December 2005.
[10] Gylfason, T., Holmström, B., Korkman, S., Söderström, H. T., Vihriälä, V., *Nordics in Global Crisis. Vulnerability and resilience*, The Research Institute of the Finnish Economy (ETLA), Taloustleto Oy, 2010.

macroeconomic framework and the policies did not contribute in accelerating the downturn. Indeed, when the crisis erupted, Finland was part of the euro area, being characterized by lower interest rates. Hence, if, on the one hand, budget deficits increased rapidly, on the other hand, public sector indebtedness remained relatively low and the strength of the public finances helped to ensure that risk premia on government debt remained small. Secondly, I focused on the present economic downturn, analyzing in details the effects that it has had and is still having on Finnish GDP, industrial production, exports and labour market. According to the data published by Statistics Finland[11], Finnish GDP growth in 2011 was 2.9%, basically fostered by private consumption. The average quarterly growth rate of the economy in the same year was much slower than in 2010, standing at 0.3%. In 2012, GDP was down by 0.2%, reflecting a contraction in domestic demand. Progressively, it further declined in 2013 by 1.4% and it continued to decrease in 2014. On the supply side, it can be affirmed that the weak economic developments impacted on the real industrial output, leading to a considerable contraction since 2011. Indeed, looking more closely at the key industrial sectors, during 2011 a marked reduction in output was witnessed in the forest industry while the output of electrical engineering and electronics declined only slightly. Since 2012 the decline started to be more pronounced in the metal (namely electrical engineering and electronics) and chemical industries, but the significant deterioration of the real industrial output was clearly visible at the turn of 2012 and at the beginning of 2013. During the last two years, cyclical conditions in industry remained weak. The decrease in real industrial output gained momentum towards the end of 2013 and, at the beginning of 2014, real output was much lower than the previous year. While the output in the chemical industry has remained generally unchanged from early 2013, the trend decline in the metal industry has continued, with the output in the electronics lowering in early 2014 more than a year earlier. Equivalently, exports have experienced a setback during these last years as well. The value of goods exports grew at a fast pace during the early years of the new millennium, with the rate of growth achieving more than 17% in 2006. Considering the period 2004 – 2008, Finland's goods exports were still closely following developments in world trade. The latter was growing rapidly and the value of goods exports from euro area countries was growing by an average 9% per annum. In Finland, the corresponding figure was 10%. Moreover, Finland's most important export

[11] Statistics Finland is the National statistics institution in Finland, established on 4 November 1865. https://www.stat.fi/index_en.html

markets – Sweden, Germany and Russia – experienced rapid economic growth during these years, boosting demand for the most important products exported by Finland. However, this growth came to a halt in 2008, and in 2009 the value of exports dropped by more than 31%, leaving Finland's exports growth behind that of other euro area countries. Indeed, in 2009, goods exports were down 25% compared to the previous year, with no subsequent return of export volumes to the pre-crisis level. From the previous brief sectors' analysis, it is a matter of fact that the weak performance of Finnish exports since 2009 can be mainly explained by the rapid contraction in the output of telecommunications equipment and of the forest sector. Undoubtedly, it can be affirmed that the significance of these sectors to exports as a whole was more central in Finland that, for example, in Germany and Sweden. To better understand, in 2013, the forest sector's share of exports from Finland stood at almost 19%, against approximately 11% for Sweden and only around 2% in Germany and France. Hence, changes in demand for forest industry products were considerably more significant for Finnish exports than for the other countries in the comparison. However, in the years following the financial crisis, world trade has expanded, and there is hope for a further acceleration always in line with growth in the global economy. In these recent years, the situation has not significantly improved and growth in world trade has been much stronger than growth in Finland's export markets. Moreover, when the situation in Crimea exploded in late February and early March 2014, the recovery of the Finnish economy was exposed to many potential disturbances. As expected, in 2015, no significant revival in manufacturing employment has been experienced, leaving the number of people employed unchanged from the previous year. Indeed, it is a matter of fact that, in the recession years, it has become harder for unemployed people to find work and periods of unemployment have grown longer. Moreover, it is intriguing underlying how unemployment growth is due less to new unemployed entering in the labor market and more to weaker employment opportunities for the already unemployed. One reason behind the shortage of new jobs is the lack of new firms, which create the largest number of jobs. According to the forecast, the employment rate in 2016 will be 69.4%, still lower than before the onset of the financial crisis in 2008; in 2016, the average unemployment rate will come down to 7.8%, around 1 percentage point lower than in 2014[12]. Indeed, as the pace of output growth slowed, there was no

[12] Bank of Finland, March 2014 Bullettin, Articles on Economy by Bank of Finland.

need for labour in industrial concerns, leading to a substantial decrease in labour demand over the crisis period. The slow pace of growth in output has led to a rise in labour cost, which started to exceed the productivity growth. Cost competitiveness will not improved in the future and unit labour costs in many of Finland's competitors will grow at the same pace or slower than in Finland. Finally, I briefly described possible solution to foster growth, in order to improve the long-term sustainability of public finances, reduce unemployment and raise labour productivity. Indeed, although Finland ranked third in the World Economic Forum Global Competitiveness Index 2012 – 2013, behind Switzerland and Singapore and ahead of the other Nordic countries[13], growth enhancing measures are still the primary objective of Finnish government. Structural reforms and clearest possible plans are needed to correct structural problems, leading to an increase in production potential.

Summing up, with the analysis of the sequence of the economic scenarios provided so far, I wanted to investigate Finland's ability to handle the different problems and difficulties experienced in each single period. It can be affirmed that Finland proved to be a country able to learn from its previous mistakes. The homemade depression of the 1990s was a traumatic experience for the Nordic country, but it gave to Finland the necessary strength to undertake a durable growth path, achieving a post-crisis growth rate higher than the EU average. In addition, the Great Depression, left behind several lessons and instruction, which proved to be essential during the 2008 economic crisis. At that time, a financial crisis was not a new experience for the Nordic economy, and, as a consequence, the mental shock caused by the recession was smaller than in many other countries. Finland did not underestimate the first signs of financial fragility, understanding the importance of regulation and supervision in reducing the risks of financial instability and basing the policy planning on a worst case scenario and Moreover, when the crisis erupted, the Nordic economy was part of the euro area, being characterized by low interest rates, balancing the increasing budget deficit with a low public sector indebtedness and strong public finances. To conclude, going deeper in the Finnish business cycle of the last 25 years allowed me to find out how effectively each economic downturn might be due to different economic reasons and influenced by several factors. In particular, in the case of Finland, the process of integration in the European Union played a key role. It let the Nordic country to come out of the crisis,

[13] Schwab, K. *The Global Competitiveness Report 2012-2013*, World Economic Forum, Geneva, 2013.

increasing its GDP and providing the needed tools to counterbalance the negative effects of the subsequent recession. However, integration could also have unfavorable consequences, to the extent that any negative economic trend experienced by one country have repercussions on the others. Hence, it clearly emerged that international coordination and the abandonment of the local way of thinking are definitely crucial to manage the different economic shocks of an integrated and composite system as the European Union.

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