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Correction 1

CONTAINS CONFIDENTIAL
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February 28, 1984

To: Members of the Executive Board

From: The Secretary

Subject: Finland - Staff Report for the 1983 Article IV Consultation

The following corrections have been made in SM/84/39 (2/3/84):

Page 1, para. 2, last line: for "less than 2 percent"
read "around 2 percent"

Page 5, para. 1, 2nd and 3rd lines from bottom: for "increased by one sixth"
read "increased,"

Page 12, para. 5, line 1: for "payments agreements" read "payments agreement"

Page 22, under column 1984, line 1: for "3 1/2" read "1 1/2"

under Labor Market, last two lines:

for "Participation rate (in percent of population aged 15-74)"
read "Participation rate (labor force in percent of population
aged 15-74)"

Corrected pages are attached.

Att: (4)

Other Distribution:
Department Heads

SM/84/39
Corrected: 2/27/84

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INFORMATION

INTERNATIONAL MONETARY FUND

FINLAND

Staff Report for the 1983 Article IV Consultation

Prepared by Staff Representatives for the
1983 Consultation with Finland

Approved by L.A. Whittome and S. Kanesa-Thasan

February 2, 1984

I. Introduction

Article IV consultation discussions were held with the Finnish authorities in Helsinki during the period November 16 to 30, 1983. The staff team consisted of Messrs. H. Ungerer, P. Hedfors, R. Hicks, W. Hemphill, and M. Rodlauer, with Ms. H. Walters as secretary (all EUR). The mission had meetings with officials from the Bank of Finland, the Ministries of Finance, Trade and Industry, and Foreign Affairs, and with representatives of a private research institute and a large commercial bank. In addition, the head of the mission met with the Governor of the Bank of Finland. Mr. A. Lindå, Alternate Executive Director, attended the discussions as an observer. Finland has accepted the obligations of Article VIII, Sections 2, 3, and 4.

II. Background

The Finnish economic performance in the late 1970s and early 1980s was favorable by international standards. Over 1978-82, economic growth--while weakening perceptibly towards the end of the period--was significantly higher on average in Finland (4 percent) than in its main trading partners (less than 2 percent) (Chart 1). The rate of inflation corresponded broadly to international developments and, indeed, was running below the average of partner countries until mid-1980 (Chart 3). The external current account--albeit in deficit for most of the time--posed no immediate constraint. However, the unemployment rate, at an average of almost 6 percent for the period, compared with rates of around 2 percent in the early 1970s (Chart 2).

While several factors contributed to these relatively favorable developments, it is notable that they date back to the adoption in 1977 of a medium-term economic program for the period 1978-82. In 1977 the Finnish economy was in a recession that had followed upon a serious overheating in 1974-75. As the severe imbalances caused by the overheating were receding under the influence of restrictive policies, the emphasis of policy shifted toward economic recovery and the restoration of full employment. Under the 1978-82 program, economic policies were given a medium-term supply-side orientation although they also incorporated traditional demand management measures.

The principal aim of the program was to achieve export-led recovery based on the expansion of the enterprise sector, while the growth of the public sector was to be restrained. To this end, policies aimed at strengthening competitiveness and profitability of enterprises; they began with a substantial devaluation of the markka in 1977-78 and included reductions in employers' social security charges, the introduction of investment incentives for the manufacturing sector, and the use of tax concessions to encourage moderate wage settlements. At the same time limits were set for the share of taxes in GDP.

Exports were targeted to grow at an average rate of 7 percent in volume terms in 1978-82. This objective came close to being met, as exports rose on average by 6 percent. Similarly, economic growth in 1978-82--although declining in the course of the period--was close to the targeted rate, which had been set at an annual average of 4 1/4 percent. Nevertheless, policies failed to bring about the desired reduction in unemployment. However, this resulted mainly from an unexpectedly strong increase in the participation rates of both men and women. Inflation had been targeted to run slightly below the expected international rate as a means of maintaining competitiveness; in this respect, performance under the program deteriorated somewhat in the second half of the period, following the second large oil-price increase.

In sustaining a relatively high rate of growth without major external imbalances, Finland was helped by its trading relations with the U.S.S.R. Under the bilateral trade and payments agreement in place, changes in exports to the U.S.S.R. have broadly offset fluctuations in Finland's trade with market economies (Chart 7). Moreover, the Finnish economy weathered the second round of oil price increases without major current account difficulties as the initially large bilateral imbalance arising from Finnish purchases of Soviet oil was corrected through increased Soviet purchases of Finnish products.

In early 1982, the Finnish authorities, given the continuing international recession, viewed economic prospects as very weak. Official forecasts made in early 1982 suggested an increase in real GDP of only 1.5 percent. Unemployment had been rising since 1980, had reached more than 5 1/2 percent by early 1982, and was forecast to increase further. The inflation rate--while on a downward trend--remained high at about 11 percent in January 1982 as against 9 1/2 percent in the major trading partners.

III. The Finnish Econony in 1982 and 1983

1. Policies and Developments in 1982

Confronted with the unfavorable prospects for 1982, the Finnish authorities decided to adopt a more expansionary monetary and fiscal

The trade account of the balance of payments in 1982 deteriorated somewhat as exports to market economies (about three quarters of total exports) continued to fall in real terms, while exports to state-trading countries shifted abruptly from strong real growth to slight decline. The latter development reflected the large creditor position of Finland that had developed on the bilateral account with the Soviet Union. Imports of consumer products rose sharply under the influence of anticipatory purchases. Nevertheless, total imports rose by only 1 percent in volume terms. There was a substantial deterioration on the services account in 1982. A major component of this decline was the fall in net investment income, linked especially to the continuing increase in the average rate of interest on foreign debt. Overall, the deficit on the current account increased from the equivalent of 1/2 percent of GDP in 1981 to 2 percent in 1982 (Table 3). With respect to market economies, the change is estimated to have been somewhat larger. The short-term capital account including net errors and omissions was in moderate surplus for the year as a whole. This development reflects foreign borrowing by banks for on-lending in the domestic market as well as the reflows of speculative funds that had occurred at year-end. However, a larger portion of the current account balance was financed by net long-term capital inflows, almost exclusively representing foreign borrowing by the Central Government. In large part because of valuation changes gross convertible reserve assets of the Bank of Finland increased, to SDR 1.5 billion, the equivalent of ten weeks' imports from market economies.

2. Policies and developments in 1983

The original intention for fiscal policy in 1983, as proposed in the budget of the Central Government submitted to Parliament in the early fall of 1982, was that it should take a broadly neutral stance. However, as indicated above, the background situation subsequently changed because of the devaluations of October 1982 and the measures taken around that time, while continuation of the international recession was causing concern. In this new situation, the authorities formulated a fiscal policy that implied a continuation of the reflationary stance until mid-1983, to be followed by a gradually more restrictive emphasis. In mid-1983, additional expenditures were authorized in a supplementary budget, but at this time the sales tax increase (announced in October 1982) took effect and the temporary cut in withholding taxes, granted to employees in early 1982, was reversed. As the year went on, fiscal policy became significantly less stimulatory.

In the event, the budget is estimated to have been in deficit (on a cash basis) by Fmk 7.7 billion (equivalent to 2.9 percent of GDP) in 1983, compared with Fmk 5.2 billion (2.2 percent of GDP) in 1982 (Table 2, Chart 6). As in other recent years, external borrowing played an important role in financing this deficit, but in a departure from normal practice, the Central Government borrowed Fmk 1 billion from the Bank of Finland during the year. The financial position of the municipalities, after weakening significantly in 1982, showed a modest improvement in 1983 due, in part, to the agreement reached with the Central Government that growth in the volume of their spending would be reduced. The expansionary fiscal impact of general government operations in 1983 was estimated by the authorities at around 1/2 a percentage point of GDP.

The authorities also made renewed attempts to tighten monetary policy. The Bank of Finland's call money rate 1/ was raised in several steps from 11 percent at the beginning of 1983 to 15 percent by May 1983, raising further the cost of commercial bank borrowing from the Bank of Finland. In July, the Bank of Finland's base (discount) rate was raised by 1 percentage point to 9 1/2 percent and there was a corresponding adjustment to the average lending rate of the banks. The cash reserve deposits which commercial banks are required to maintain with the Bank of Finland had already been raised in April. Despite this gradual tightening of monetary policy, monetary aggregates in the first three quarters continued to grow quite strongly (Chart 5 and Table 1); in particular, net domestic credit to the private sector rose by 21 percent during the one-year period ending August 1983. Around September 1983, there was renewed restlessness in foreign exchange markets, resulting in a significant outflow of capital. On September 15, 1983 the Bank of Finland responded by raising the call money rate from 15 to 18 percent. The move arrested capital outflows and signalled to the markets the authorities' view that there was no need for a further devaluation and that external and domestic monetary stability would be accorded high priority. In late September and in October, the call money rate was lowered in steps to 16.7 percent in view of restored confidence in currency markets.

With the fiscal package adopted in the context of the devaluations of October 1982, the Government had hoped to moderate wage demands for the 1983 round of negotiations. However, with a 10 percent rise in average wage and salary earnings the results outstripped by far the gains in labor productivity, and unit labor costs for the whole economy increased by 7.0 percent. The Finnish representatives said that one reason for the disappointing outcome of wage negotiations in 1983 was that it proved impossible to arrive at a comprehensive, centralized wage agreement of the kind concluded in 1981. Under the decentralized bargaining procedure, contractual increases that were negotiated relatively late in the wage round tended to be successively higher than those agreed earlier.

The growth of domestic demand is estimated to have slowed down in 1983. This reflected mainly a weakening of private consumption demand in reaction to the anticipatory purchases in 1982 and a somewhat slower growth in disposable incomes in 1983. In contrast, private fixed investment may have risen slightly faster than in 1982. With the foreign

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1/ The call money market is a facility through which the Bank of Finland either provides financing to, or accepts deposits from, the commercial banks. These deposits are not counted against obligatory cash reserve deposits.

purpose, the external value of the markka is defined in terms of an index reflecting a weighted average of the exchange rates most important for Finland's foreign trade. The level of the index is kept fixed, and accordingly the Bank of Finland stands prepared to buy or sell the intervention currency (the U.S. dollar).

There is a formal "band of fluctuation" around the index with a width of 4 1/2 percent (until October 1982, 6 percent, Chart 9). In practice, it is not utilized to absorb short-term variations in the supply and demand for foreign exchange, since the thinness of the exchange market could result in excessive exchange rate fluctuations. Instead, the band constitutes a range within which the Bank of Finland is empowered to make discretionary changes in the exchange rate. Movements outside the band require the consent of the Government.

The operation of the index was changed in several respects with effect from January 1, 1984. Most significantly, the Soviet ruble was dropped from the index calculations. Its share, formerly about 25 percent, was redistributed among the 12 remaining currencies; at the same time the weights for these currencies were revised by replacing the former base year (1974) by a moving reference year (at present, 1981). These modifications implied no change in the effective exchange rate at the time of transition but, of course, may subsequently lead to developments different from what would otherwise occur.

The Finnish authorities observed that the Soviet ruble had followed the U.S. dollar rather closely during the preceding couple of years, which in effect tended to increase the weight of the U.S. dollar and at times had amplified exchange rate fluctuations. Henceforth, only the convertible currencies most important for Finland's foreign trade will be taken into account when calculating the currency value of the markka. The Bank of Finland will continue quoting the Finnish markka rate for the ruble as at present, based on the ruble/U.S. dollar exchange rate as quoted by the Soviet State Bank.

2. Foreign debt

During 1982, total foreign indebtedness of the Finnish economy increased by the equivalent of 2 1/2 percentage points of GDP (including valuation effects from the exchange rate changes), to 17 1/2 percent, a ratio below the peak of 21 percent in 1977. Beyond 1982, illustrative staff projections (see Appendix I) suggest a further increase amounting to 1-2 percentage points of GDP during the mid-1980s, depending on the specific assumptions adopted regarding the 1984 current account. After the middle of the decade the debt ratio is projected to decrease gradually. The Finnish authorities would expect this ratio to decline in the longer run as well, reflecting amortization of loans obtained in the late 1970s to finance a major increase in investment in infrastructure and in productive capacity in key industries. They regard a ratio as high as 20 percent over the medium term as manageable.

3. Trade policy, official development assistance

The Finnish authorities hold firmly to the view that a liberal trade policy serves best the interests of a small open economy like Finland whose performance is highly dependent on exports. Therefore, the worsening climate in international trade is observed with increased concern. A cornerstone of Finnish trade policy in the years to come will therefore be to take a stance against worldwide protectionist tendencies.

The Finnish trading system has remained highly open except for trade in agricultural products and, to a minor extent, textiles and clothing. Finland participates in the European free trade system through its association with EFTA, its free trade agreement with the EC, and a similar agreement with Spain. Trade arrangements corresponding to those embodied in the free trade agreements with European market economies have been concluded with the Soviet Union and five other European state-trading countries.

In 1980, the Government announced its intention to reach a level of official development assistance corresponding to 0.7 percent of GDP by the latter part of the decade. The Finnish authorities reaffirmed this objective and noted that the level had been constantly raised since 1979, from 0.20 percent of GDP to 0.36 percent in 1983. The 1984 budget proposal embodies a further increase of ODA appropriations to Fmk 1.1 billion, which represents 0.39 percent of forecast GDP.

4. Bilateral payments agreements

Finland maintains bilateral payments agreements with Bulgaria, the German Democratic Republic, Hungary, and the Soviet Union. In January 1982 and January 1983, respectively, the bilateral payments agreements with Romania and China were terminated. Since then, Finland has not imposed any restrictions on the making of payments and transfers for current transactions with these two countries.

Finland's bilateral payments agreement with Hungary, concluded in 1948, became subject to Article VIII after Hungary became a Fund member in 1982. The agreement provides a clearing account system for the purpose of settling all bilateral current transactions; it involves a restriction subject to approval by the Executive Board. In September 1983, both parties agreed to terminate the agreement as early as practicable but not before the end of 1984. During the discussions, the Finnish authorities indicated to the mission that they strongly favor early termination and that the matter will be discussed again in the next meeting of the Finnish-Hungarian trade commission in the fall of 1984.

Finland - Fund Relations

(As of December 31, 1983)

Date of membership	January 14, 1948
Status	Article VIII
Quota	SDR 574.9 million
Fund holdings of Finnish markkaa	SDR 451.94 million or 78.61 percent of quota
Finland's holdings of SDRs	SDR 36.96 million or 25.91 percent of net cumulative allocation of SDR 142.69 million
Gold distribution	162,608 fine troy ounces
Exchange system	Effective November 1977, the external value of the markka has been expressed formally in terms of a trade-weighted basket of currencies of Finland's most important trading partners. On November 30, 1983 US$1 = Fmk 5.7790
Last consultation	The Staff Report for the 1981 Article IV Consultation (SM/82/1) was considered by the Board on January 25, 1982 (EBM/82/10:1) when the following decision was taken:

1. The Fund takes this decision relating to Finland's exchange measures subject to Article VIII, Sections 2 and 3, in light of the 1981 Article IV consultation with Finland conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Finland maintains a bilateral payments arrangement with a Fund member. The Fund welcomes the intention of the authorities to terminate this bilateral payments arrangement and grants approval until January 31, 1983 of the restriction on the making of transfers of balances for current international transactions arising from the arrangement.

Finland: Basic Data

Area and population	1982
Total area	337,000 square kilometers
Total population	4,827,000
GDP	Fmk 236.7 billion; per capita US$10,174; per capita SDR 9,243

	1982 (In billions of markkaa)	1982 (In percent)	1980	1981	1982 1/	1983 2/	1984 2/
			(Volume changes in percent)				
Demand and Supply							
Private consumption	131.3	55.5	2.9	1.6	3.9	2	1 1/2
Public consumption	47.4	20.0	4.4	3.5	5.3	3 1/2	3 1/2
Gross fixed investment	56.9	24.0	10.5	1.3	3.0	2 1/2	2 1/2
Public	7.9	3.3	9.1	0.8	5.6	-1/2	-3
Private	49.0	20.7	10.8	1.3	2.5	3 1/2	3
Stockbuilding 3/	--	--	1.6	-2.8	0.5	--	1/2
Total domestic demand	235.6	99.5	6.7	-1.1	4.5	2 1/2	3
Exports of goods and services	75.5	31.9	9.0	4.3	-3.8	1 1/2	4
Imports of goods and services	74.3	31.4	11.8	-3.9	1.3	1 1/2	3
Foreign balance 3/	1.1	0.5	-0.4	2.6	-1.7	--	1/2
Gross domestic product	236.7	100.0	6.0	1.5	2.5	2 1/2	3
National savings ratio 4/	...	...	26.8	26.2	24.5	24.5	24.9
Labor market 5/ (annual averages; in thousands)							
Labor force			2,442	2,481	2,526	2,544	2,550
Employment			2,328	2,353	2,377	2,387	2,405
Unemployment rate (in percent of labor force)			(4.7)	(5.1)	(5.9)	(6.2)	(5.7)
Participation rate (labor force in percent of population aged aged 15-74)			(67.5)	(68.2)	(69.0)	(69.1)	(68.9)

1/ Preliminary.
2/ Official estimates and forecasts as of September 1983.
3/ Changes as a percentage of previous year's GDP.
4/ National savings (defined as GDP minus consumption) as a percentage of GDP.
5/ Figures adjusted to correspond to the new data collection method introduced in 1983.