

**FOR  
AGENDA**

SM/82/1

CONTAINS CONFIDENTIAL  
INFORMATION

January 4, 1982

To: Members of the Executive Board  
From: The Acting Secretary  
Subject: Finland - Staff Report for the 1981 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1981 Article IV consultation with Finland. A draft decision appears on page 13.

This subject has been tentatively scheduled for discussion on Monday, January 25, 1982.

Att: (1)

Other Distribution:  
Department Heads

INTERNATIONAL MONETARY FUND

FINLAND

Staff Report for the 1981 Article IV Consultation

Prepared by Staff Representatives for the 1981  
Article IV Consultation with Finland

Approved by L.A. Whittome and Donald K. Palmer

January 4, 1982

I. Introduction

Article IV consultation discussions were held with the Finnish authorities in Helsinki during the period October 23-November 4, 1981. The staff team comprised D.M.Ripley, B.V.Christensen, W.L.Hemphill, and K.W.Riechel, with V. Pabst as secretary (all EUR). The mission met with officials of the Bank of Finland and of the Ministries of Finance, Foreign Affairs, Labor, and Trade and Industry, as well as with a number of representatives of the private sector. Mr. J. Sigurdsson, Executive Director, attended the discussions and Mr. K. Jännäri, Advisor, was present at the concluding meeting.

II. Recent Economic Developments

1. The setting

Following the first oil shock, the Finnish authorities pursued expansionary policies designed to maintain economic activity. Cost competitiveness, profitability, and the current account balance deteriorated dramatically (Charts 1 and 2), while inflation accelerated to 18 per cent in 1975. Restrictive policies were introduced toward the end of 1975, and the Finnish markka was depreciated by 16 per cent vis-à-vis a basket of currencies during 1977 and early 1978 (Chart 3). A medium-term fiscal strategy to foster employment and external balance through the revitalization of the business sector was announced in 1977, specifying certain objectives for the development of tax revenues and public sector expenditures that still play an important role in the formulation of policy.

By 1978, success had been achieved in a number of fields. The rate of inflation had been reduced to 7 3/4 per cent per annum, and the current account balance had strengthened, moving into substantial surplus. This strengthening reflected the improvement in competitiveness of Finnish products, both abroad and at home, as well as weak import demand on account of a low level of real domestic demand (Chart 4). Real GDP in 1978 rose modestly, while unemployment increased further to 7 1/2 per cent (Chart 5). In keeping with the stabilization strategy, financial policies were relaxed in 1978 as scope for expansion emerged, and domestic demand started to revive toward the end of the year.

At the time of the last consultation discussions in November 1979, the Finnish authorities had much cause for satisfaction. Real GDP rose in that year by 7 1/2 per cent, on account of continued strong export growth and a further pickup in domestic demand, while the unemployment rate declined to 5 1/2 per cent by late 1979. As productivity gains offset the large increases in wages to a considerable extent, no deterioration in competitiveness was experienced, notwithstanding two small appreciations of the markka, cumulating to some 3 per cent during the course of the year.

The swing of the current account into small deficit in 1979 (1/2 per cent of GDP) was relatively modest, taking into account Finland's relative cyclical position and the large increase in the price of oil, and did not give rise to undue alarm. Of great importance, in addition to Finland's good competitive position, was the fact that some two thirds of Finland's imports of oil and oil products were obtained from the U.S.S.R. under a bilateral payments agreement, <sup>1/</sup> and a strong rise in real exports to the U.S.S.R.--albeit with a lag--could be expected to offset the increase in the value of oil imports from this source, reflected in the deterioration in the terms of trade (Chart 1). A cause of concern, however, was the tendency of price increases to accelerate during the course of 1979 (in December the consumer price index stood some 8 1/2 per cent higher than a year earlier), and a more cautious stance of monetary policy was assumed toward the end of the year. The need for a moderate wage settlement in 1980 was apparent, if inflationary pressures were to be dampened and the competitiveness of Finnish products maintained.

## 2. Developments in 1980 and 1981

Economic developments over the past two years still reflect the strength of the economic rebound. In 1980 real GDP increased by 5 per cent and is expected to rise by 1-2 per cent in 1981, again among the higher rates of growth experienced by the European industrial countries. Gross fixed private investment increased by almost 11 per cent in 1980. Exports in volume terms rose again by more than 9 per cent. On account of cyclical factors, exports to Western trading partners--which accounted for some 80 per cent of the total value of exports in 1980--increased by only 4 per cent. At the same time, those to the state trading countries rose by almost 30 per cent, largely on account of the supplementary trade protocol concluded with the U.S.S.R. in the spring of 1980. Since imports grew even

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<sup>1/</sup> Trade with the U.S.S.R. is governed by five-year frame agreements, the most recent one having been concluded in late 1980 for the years 1981-85. These agreements set out in general the types and quantities of goods to be traded, taking into account the need to achieve balance in the clearing account. In addition, more precise trade protocols are drawn up every year, when the values of the various traded goods can be better ascertained. Finnish exports to the U.S.S.R. are valued at world market prices, while the prices of Soviet exports of crude oil tend to move closely in line with OPEC prices. Following the second oil shock, a supplementary trade protocol was agreed in April 1980 to allow for the rapid growth of Finnish exports to the U.S.S.R. to balance the increased value of oil imports.

more rapidly than exports in 1980, the foreign balance made a negative contribution to growth of 1/4 per cent (Chart 4).

Official projections dating from September 1981 foresee a real rate of growth for GDP of 2 per cent in 1981, though more recent estimates suggest a somewhat weaker performance. Particular uncertainty attaches to the development of gross fixed investment, with estimates of growth ranging from minus 1 1/2 to plus 4 per cent, and to movements in inventories which, according to the official forecast, are estimated to make a negative contribution to GDP growth of 2 1/2 per cent. Real exports are expected to increase only modestly: a rise in exports of again almost a third to state trading countries will be largely offset by a fall in exports to Western trading partners. Since imports are forecast to fall sharply, the foreign balance is expected to make a positive contribution to growth of 2 per cent. After declining further in 1980, the unemployment rate has shown a tendency to rise slightly in 1981, and is expected to average just over 5 per cent for the year.

Less success has been achieved in moderating inflationary pressures than in sustaining real growth. The year-on-year increases in consumer prices accelerated from the fourth quarter of 1979 through 1980, averaging 13 per cent during the first half of 1981; by autumn they decelerated to about 11 1/2 per cent. Some of the rise in consumer prices may be traced to import prices, but there is also a substantial component of homemade inflation, with the growth in unit labor costs accelerating sharply to 11 per cent per annum in 1980 and 1981.

Following three small appreciations in 1979 and the beginning of 1980 cumulating to 5 per cent, the effective exchange rate, as measured by the exchange rate index of the Bank of Finland, has remained stable (Chart 3). Since partner countries have attained greater success in holding down labor costs in 1981, relative unit labor costs for Finland are estimated to have risen by about 4 per cent. However, the current level of competitiveness was still regarded as satisfactory by the authorities. They pointed to the maintenance of market shares for important products, though the performance differed widely among commodities, and profits in some sectors were certainly compressed (Chart 2). It was also noted that a lag of some 3-4 years could be expected between the time that competitiveness deteriorated significantly and the time that the effects became apparent in the external balance.

In the event, the deficits on current account for 1980 turned out to be more moderate than forecast earlier, while projections for 1981 have also been revised downward. The 1980 deficit of Fmk 5 billion (2 3/4 per cent of GDP) was shared equally between the state trading countries and the market economies and reflected, in the first instance, largely the rise in energy prices, and, in the second, a change in relative cyclical positions. In 1981, the deficit is expected to moderate to Fmk 3 billion (1 1/2 per cent of GDP). For the first three quarters of 1981 the current account registered a deficit of Fmk 1.5 billion on a seasonally adjusted basis.

The authorities argued that the situation prevailing now in Finland differed in several important respects from similar turning points in earlier cycles. The concentration of Finnish exports on cyclically sensitive products had often exacerbated the effects of fluctuations in foreign demand. In the present cycle, however, it was stressed that the usual strong linkage between the cyclical position of Finland vis-à-vis its Western trading partners and its real foreign balance had weakened substantially (Chart 1). In part, this was due to some shift in the composition of exports towards less cyclically sensitive products, but also to the fact that the demand for paper products, which usually is quite dependent on cycles, had been relatively stable during the recent downturn abroad. The main explanation for the greater stability of the external balance, however, was the surge in the volume of exports to the U.S.S.R., which coincided with the tapering off of demand from the Western economies. Real exports to the U.S.S.R. cannot be expected to provide significant on-going support for growth in coming years. Indeed, exports to the U.S.S.R. have increased at an unsustainable rate, and a fall in the volume of exports to the state trading countries is foreseen for 1982.

During the recent cyclical upswing, the overheating has been relatively moderate and the investment behavior of firms, cautious. The distribution of income between labor and capital has also remained rather stable. Thus profits, though squeezed somewhat, have not been nearly as volatile as during earlier cyclical swings (Chart 1). As a consequence of the relatively favorable external and domestic developments, the authorities felt that the costly stabilization measures required in earlier periods, including devaluations, would not be needed.

### III. The Stance of Policies

Since the mid-1970s, the Finnish authorities have pursued an integrated approach in which policy instruments have been assigned to targets according to their comparative advantage. The main objective has been to assure growth and employment over the medium term by promoting the competitiveness of the business sector. Large exchange rate depreciations were implemented in 1977 and 1978 to restore external competitiveness, but more recently small exchange rate appreciations have been used to dampen inflationary impulses from abroad. Monetary and fiscal policy have tended to concentrate on stabilization objectives, but have also provided special support for investment and export activities. Incomes policy, supported by fiscal measures, has tended to moderate the rise in labor costs. Much weight is given to medium-term considerations, particularly the containment of the share of taxes in GDP and the real rate of growth of public expenditure, while the importance of sustaining a strong social consensus to assure that the economy attains its growth potential is widely stressed.

#### 1. External policies

The external value of the Finnish markka is defined in terms of the exchange rate index of the Bank of Finland, which now includes currencies of 15 main partner countries including the U.S.S.R. (Chart 3). Precise upper

and lower limits for the index are set. In September 1979, the permissible range of fluctuation was widened from 4 1/2 to 6 per cent. In late March 1980, the rate was allowed to appreciate by 2 per cent within the permitted margins to moderate the domestic impact of high rates of inflation abroad. Though there has been scope for some fluctuation of the index, it has been stable for the last 20 months. The authorities explained that movements in the index would have a disruptive effect on the expectations of market participants. The current level of the exchange rate index was judged broadly appropriate, notwithstanding the devaluation of the Swedish krona and other measures recently taken in Sweden. Intervention, which has been no more than modest, has nevertheless been effective in stabilizing the exchange rate index because of the narrowness of the exchange market and the various regulations used to affect the incentives for capital movements. <sup>1/</sup> The interest sensitivity of short-term capital movements was thought to have increased somewhat over the last five years, however, and could cause reserves to fluctuate sharply at times. It was noted that short-term flows had recently proved less interest-sensitive than might have been expected.

The authorities expressed their support for increased liberalization of trade. In their view, free trade was not only endangered by restrictive trade agreements and tariffs, but also by state aid in the form of subsidies or tax benefits to particular industries, which artificially enhanced their competitiveness. They remarked on the absence of state aid in Finland to either the steel or the shipbuilding industries. Finally, technical barriers, which are harder to identify, were also thought to pose dangers for free trade.

In connection with the liberalization of trade and payments, the authorities noted the signing of a long-term trade agreement with Romania on October 30, 1981 that would come into effect on January 1, 1982. Consequently, Finland will no longer maintain any restrictions subject to the Fund's Article VIII vis-à-vis Romania. They also indicated their intention to continue negotiations with the People's Republic of China and to conclude a new agreement by the end of 1982 which would not give rise to a restriction subject to the Fund's Article VIII.

The authorities reaffirmed their commitment to increase official development assistance to 0.7 per cent of GNP by the end of the decade. They noted that the intermediate target of 0.32 per cent of GNP by 1982, established in 1977, was embodied in the budget proposal for 1982, and that aid to low-income, less developed countries in principle took the form of grants.

## 2. Monetary policy

The focus of monetary policy in Finland is on maintaining a rate of growth of bank credit to the private sector consistent with the needs of the economy, but no target rates of growth are announced for any monetary aggre-

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<sup>1/</sup> These regulations are described in Chapters III and V of Recent Economic Developments.

gates. Interest rates for bank lending and the borrowing of banks from the central bank are controlled by the Bank of Finland. They tend to be rather stable, and bank lending rates have typically been negative in real terms, giving rise to excess demand for credit. Thus the allocation of credit is decided largely by the banks. The total volume of credit made available by the banking system is controlled by the Bank of Finland, operating on the spread between the average lending rate of commercial banks and the average and/or the marginal cost of finance to these banks from the central bank so as to affect their profitability. In recent years the "grey market" for the intermediation of short-term funds between enterprises and financial institutions--outside the control of the Bank of Finland--had gained in importance, though its present magnitude was difficult to estimate. It was suggested that this market had added to the efficiency of the financial sector while, at the present time, it did not pose significant problems for the pursuit of monetary policy objectives.

The authorities explained that three instruments were used to indicate the basic stance of monetary policy: the discount rate, which represented the minimum interest rate at which commercial banks could borrow from the central bank and to which the average lending rate of banks was geared; quotas for central bank borrowing by the commercial banks; and the cash reserve deposit ratio. <sup>1/</sup> A second set of instruments for fine-tuning comprised the call money rate, supplementary interest charges for banks borrowing large amounts in the call money market in excess of quota, and the quota multiples at which these supplementary charges took effect. Guidelines laid down by the Bank of Finland were also used to direct the growth of bank credit, and particularly to encourage lending for investment rather than consumption purposes. Investment was further encouraged by the maintenance of low real interest rates (Chart 6). The time horizon for monetary policy decisions tended to be 12-18 months, an estimate of the lagged response of domestic demand to policy changes.

Monetary policy assumed a more restrictive stance toward the end of 1979 in view of the strong pick-up in activity and the emergence of inflationary pressures. The cash reserve deposit ratio, introduced in May 1979, was raised during the remainder of 1979 and during 1980, reaching 4.6 per cent in the four months ending March 1981. The discount rate was raised in stages to its current level of 9 1/4 per cent on February 1, 1980 (Chart 6). On account of these measures, but also fine-tuning changes, including a sharp rise in the call money rate, the average cost of credit from the central bank rose sharply in the last quarter of 1979 and remained high during 1980 and early 1981. By contrast, the average lending rate increased by only 2 percentage points between mid-1979 and early 1980, to its current level of 9 3/4 per cent. Thus the difference between the average cost of central bank

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<sup>1/</sup> The cash reserve deposit ratio scheme was agreed by the Bank of Finland and the commercial banks in the spring of 1979 (see Recent Economic Developments, Chapter III). This scheme was designed to absorb liquidity from the commercial banks by requiring reserves to be held with the Bank of Finland against deposits and to be used at a time when banks, uncharacteristically, were not dependent on credit from the Bank of Finland.

credit and the average bank lending rate rose from approximately zero in mid-1979 to some 3 3/4 per cent in 1980 and early 1981, resulting in a compression of bank profits and increased caution in bank lending. The rate of growth of commercial bank credit to the private sector abated between the third quarter of 1980 and the first quarter of 1981, but, in the first half of 1981, it increased at an annual rate of 15 per cent, slightly exceeding the rate of growth of nominal GDP.

In view of the anticipated weakening in activity, the call money rate was allowed to decline to 11 per cent by May, while the cash reserve ratio was reduced to 3 per cent by June 1981. The call money rate was raised somewhat in August, and the multiples of quota were reduced in September 1981, however, leading to a rise in the average cost of credit. Nonetheless, money market conditions continued to be described as essentially easy, and no change in the basic stance of policy was expected in the immediate future.

### 3. Fiscal policy

The Government sector consists of the Central Government, the municipalities, the social insurance system, and, in addition, a number of extra-budgetary funds. Fiscal policy in Finland tends to focus to a large extent on medium-term objectives. It continues to be bound by the constraints laid down in the 1977 stabilization plan, particularly of limiting the share of taxes in GDP to its 1977 level and of restraining the growth of the public sector. These objectives have been largely attained. The real growth of public consumption was limited to an average rate of 3 1/2-4 per cent in 1980 and 1981, and the 1982 budget foresees growth again of 3 1/2 per cent. The gross tax revenue of the general government as a per cent of GDP remained some 3 3/4 percentage points below its 1977 level in 1979 and 1980. Although it is expected to rise somewhat in 1981 and again in 1982, the ratio will remain well below its 1977 level. The general government balance on a national accounts basis moved from a position of overall deficit in 1979 and 1980, into slight surplus in 1981, and approximate balance is projected for 1982 (Chart 7).

Gross borrowing of the Central Government has, however, continued to be sizable in recent years, at Fmk 5 billion in 1980 and 1981 (about 2 1/2 per cent of GDP in 1981). This borrowing partly reflects large net financial investments of some Fmk 3 billion, mostly in the form of housing loans and, increasingly, the redemption of state debt (Fmk 2 billion in 1981). The Central Government budget for 1982 foresees an increase in gross borrowing to Fmk 6 1/2 billion (2 3/4 per cent of GDP), largely because of a rise in debt service expenditures. The Government has recently financed about half of its credit needs domestically, and half abroad, and this pattern is expected to continue in 1982. Though Central Government debt has risen more rapidly than GDP since 1974 and exceeds 10 per cent of nominal GDP, it remains low by international comparison (Chart 7).

Countercyclical deposits and, to a lesser extent, taxes have played an important role in moderating demand and preventing bottlenecks from emerging



during the recent upswing. In the business sector these have taken the form of relatively high yielding voluntary "investment reserve" deposits with the central bank; compulsory deposits for sectors whose export revenues are rising especially rapidly; and compulsory deposits out of profits for enterprises in general. In April 1980 the investment reserve scheme was extended, while in June export proceed deposits were implemented for a period of a year for certain forestry products. Additional compulsory countercyclical deposits for all enterprises were introduced in the fall of 1980, and heavy taxation was imposed on nonpriority investments. In view of the expected decline in economic activity and profits, a release of countercyclical funds estimated at Fmk 1 3/4 billion (3/4 per cent of GDP) is scheduled between late 1981 and early 1983, as well as a lifting of the investment tax on nonpriority construction.

Two analytical approaches are used in Finland to assess the fiscal stance of the general government, the so-called high employment budget balance and the weighted budget balance. The first approach abstracts from the cyclical position of the economy and the workings of automatic stabilizers to estimate the impact of policy changes on the financial surplus of the general government. The second approach takes into account the different multiplier effects of both spending and tax measures, whether discretionary or automatic, on the growth of real GDP. According to the first measure, fiscal policy became less restrictive in 1979, but has changed little since. In 1981, the stance is calculated to have become somewhat more restrictive, and in 1982 it is expected to ease somewhat, though the shifts are not large. A similar pattern emerges from the second approach: largely on account of changes in the central government deficit, fiscal policy is estimated to have been stimulative in 1979, very modestly stimulative in 1980, and essentially neutral in 1981. For 1982, general government stimulus is estimated at 1 per cent of GDP.

The room for maneuver in the 1982 budget is seen by the authorities to be quite limited in view of the medium-term objectives for the growth of consumption expenditures and the magnitude of the gross borrowing requirement. No major new initiatives are embodied in the budget. 1/

#### 4. Incomes, labor market, and structural policies

The Government attempts to promote incomes settlements that are consistent with a satisfactory competitive position for the economy and with the longer-term requirements of safeguarding investment and employment. The Government appoints the central incomes negotiator but does not participate actively in the discussions. The outturns of the discussions may be binding for a large portion of the labor force, with implications for income from agriculture and forestry. The general discussions may also break down, leaving settlements to be made at the sectoral or firm level. Incomes settlements in line with the Government's general goals have been promoted through fiscal concessions and exchange rate appreciations to moderate the impact of external influences on the domestic rate of inflation.

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1/ See Recent Economic Developments, Chapter II.

In 1980, no comprehensive wage settlement was negotiated, but in March 1981 a new two-year wage agreement was accepted according to which wages are to be adjusted by fixed percentages twice a year broadly in line with the expected rate of inflation. <sup>1/</sup> Additional adjustments are called for once a year, if a cost of living threshold, adjusted for any change in the terms of trade, is exceeded. Legislative action was required to make these threshold adjustments consistent with the general law restricting indexation. The novel feature, that the implications of a change in the terms of trade for real wages must be accepted, suggests unusual awareness of the economic realities. It is still uncertain whether the threshold set for the December 1981 index will be exceeded, resulting in a small supplementary adjustment of wages and salaries in February 1982. The second threshold is set for developments through November 1982.

The authorities viewed the unemployment situation as unsatisfactory. Although manpower programs, in principal, were to be of a temporary nature, they had assumed an important role in the budget since 1978. These programs focused primarily on young workers. It was still felt that such programs should be of limited duration and that improvement in the employment situation was to be sought through greater regional mobility of labor and capital and an upgrading of vocational skills. However, the target set in the 1977 fiscal plan of limiting the unemployment rate to 2 1/2 per cent of the labor force by 1982 was no longer considered realistic. Instead, goals of 3 1/2-4 per cent were presented in medium-term strategies.

The Government has actively pursued a policy of promoting business investments. Fiscal measures to this end have included sales tax concessions on investment goods as well as generous depreciation allowances. Investment in the private sector has also benefited from the monetary policy measures noted above. Admittedly, the absence of a well-developed private capital market, especially for equity capital, could have adverse consequences for investment. Indeed, questions arose as to whether earlier measures to promote investment were still appropriate in current circumstances; whether such measures might have promoted to an excessive extent capital-intensive projects at the expense of higher levels of employment; and whether capital productivity might not also be enhanced by a broader based domestic capital market and an increase in interest rate flexibility.

The medium-term energy program announced in 1979 is still in place, and new initiatives were not thought to be necessary. Energy conservation is to be furthered through subsidies to encourage the use of energy conserving devices, the promotion of public awareness of conservation needs, and especially through the price mechanism. The authorities noted that the second oil shock had obviated, to a large extent, the need for many of the expenditures planned under the program by increasing directly the financial incentives to conserve energy. The second objective of the program is to increase the use of indigenous energy resources, and especially wood and peat. The Finnish nuclear program has met with little opposition and, in 1980, electricity generated by nuclear energy accounted for 30 per cent of the total electricity supply.

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<sup>1/</sup> See Recent Economic Developments, Chapter I.

#### IV. The Prospects for 1982

For 1982, real GDP is officially forecast to increase by some 2 per cent. Growth will again be supported by an improvement in the real foreign balance, as imports are expected to decline by 3 1/2 per cent, whereas exports may increase by 4 per cent. The volume of exports to the state trading countries is expected to decline by some 4 per cent, while the volume to the Western trading partners will grow by 6 per cent, consistent with output growth in the OECD countries of 3 per cent that year. In view of the recent downward revisions in the projected rate of growth for the OECD area, the staff expects exports to Western trading partners to rise at a lower rate, implying a somewhat weaker growth in real output than officially forecast.

With an increase in real disposable income of households officially projected at 1 1/2 per cent, private consumption in real terms may increase by 1 per cent. However, fixed investment is projected to decline as large new projects are completed, notwithstanding the release of countercyclical deposits and easy credit markets. The decline is not expected to be as sharp as that experienced in earlier cycles, partly because the much more modest upswing in investment in recent years held the ratio of private fixed investment to GDP (21 per cent) well below the averages of the early 1970s (27 per cent).

The unemployment rate is expected to rise to more than 6 per cent by the end of 1982, notwithstanding little change in the labor force. Prospects on the wage and price side are also not satisfactory. The rate of increase of the consumer price index is officially forecast to decelerate on a year-on-year basis by 2 1/2 percentage points, to some 9 1/2 per cent. Opinions differ, however, on whether the upswing in activity and the easy liquidity situation expected to prevail in the economy toward the end of the year will be accompanied by an acceleration in inflation. In any event, it was generally agreed that the index clause in the wage agreement for November 1982 would almost certainly be triggered, giving rise to supplementary wage adjustments in early 1983 as the next wage negotiations got under way. Projections also foresaw a further increase in relative unit labor costs by some 4 per cent, on average, in 1982, and a further rise in 1983.

The official forecast of the Ministry of Finance was for a small current account surplus in 1982, but others foresaw a continuing deficit of the order of Fmk 2-3 billion. If, as expected, a substantial share of the Central Government borrowing requirement is satisfied by loans taken up abroad, and if the private sector also imports capital as foreign interest rates decline, domestic liquidity will be increased significantly during the course of the year. Commercial banks could become largely independent of credit from the Bank of Finland, a development which would reduce, under current circumstances, the control of the Bank of Finland over monetary developments.

## V. Staff Appraisal

The present economic situation in Finland compares favorably both with the situation following the first oil price increase, when the rate of inflation was substantially higher and the external balance posed major problems, and with the situation now prevailing in many other European countries. It owes much to the special trade arrangements with the U.S.S.R. that have contributed to the strengthening of the foreign balance. However, the rapid rise in exports to the U.S.S.R. to compensate for the rise in oil prices appears to be of a once-for-all character. If Western markets were to prove more sluggish than now expected, the foreign balance might well exert a dampening influence on growth, all the more so if competitiveness were to deteriorate further, and the traditional linkage between Finland's external balance and its relative cyclical position could re-emerge.

Given the importance that the foreign balance holds for growth and employment, it is essential that the authorities pursue policies conducive to a level of competitiveness that permits Finnish producers to benefit fully from market growth at home and abroad. At the moment, competitiveness is judged by the authorities to be adequate. Further, some new measures are included in the 1982 budget to promote nonprice competitiveness, although, in the view of the staff, the timing and magnitude of their potential impact are uncertain. Of immediate concern, however, is the projected rise in relative costs over the next two years. Notwithstanding difficulties in assessing developments in competitiveness precisely, there is general agreement that, on the basis of the projected stance of policies, costs and prices in Finland will clearly rise more than in partner countries. The implementation of policies designed to reverse this trend at an early stage would assure the maintenance of the progress already achieved, and contribute to a more moderate outturn for the 1983 wage round.

Identification of measures to support competitiveness in the short term is difficult. Some adjustment of nominal wages for continuing, significant inflation is normal, even though it constitutes an important aspect of the underlying inflationary momentum. However, Finnish labor has taken a more medium-term perspective in recent years and has shown unusual perception in proposing a terms of trade adjustment for the price calculations in the 1981 incomes agreement. As a consequence, the staff feels that an early reopening of the dialogue with the social partners about sustainable rates of wage and price increases, taking into account prospective developments abroad, could be helpful in containing adverse developments. The staff questions the appropriateness, in the somewhat longer run, of a number of measures whose immediate application would dampen inflationary pressures for a time: possible measures included, in particular, a reduction in the discount rate, which would affect mortgage rates and rental costs.

As inflationary pressures presently appear to emanate primarily from the cost side, a general tightening of monetary policy could be ineffective at this time. The recent measures to raise the cost of credit somewhat are welcomed as a signal of the willingness to take action, should the need arise. And if excess liquidity starts building up in the economy in

1982, as currently projected, monetary policy should move quickly and decisively to moderate the growth of liquidity so as to forestall adverse price developments that would affect the next wage round. In this connection, consideration might be given to the vigorous and timely use of the cash reserve deposit scheme and to the placement of a larger amount of government securities on the domestic market than now proposed.

For a number of years the Finnish economy has been characterized by negative real rates of interest for borrowers. Bank credit has been rationed and investment decisions have been strongly influenced by tax incentives. It may be questioned whether such pricing and allocation procedures are conducive to an optimal allocation and an optimal level of the capital stock. Some movement toward a more flexible interest rate policy would permit the banking sector to respond more fully to the financial needs of the economy. The development of the grey market in Finland would seem indicative of evolving needs that cannot be satisfied within the existing regulated financial markets, and this market could eventually jeopardize the effectiveness of monetary instruments.

The level of unemployment poses a significant problem, but one not susceptible to short-term solutions and particularly not to active demand management, because a large portion of those who are unemployed can be characterized as "hard to place." Thus, the intention of the authorities to pursue manpower programs rather than general demand stimulation seems fully appropriate. The medium-term objectives of holding down the tax burden and restraining the growth of government consumption appear to have had favorable effects on incentives in the private sector, and have now been adopted in other industrial countries.

The staff welcomes the elimination of the bilateral payments agreement between Finland and Romania, which involved an exchange restriction. It also notes the clearly-stated intention of the authorities to conclude a new agreement with the People's Republic of China by the end of 1982 that will not give rise to a restriction under the Fund's Article VIII. In view of this stated intention, the staff recommends that the Executive Board approve the restriction on the transferability of balances under the current agreement with the People's Republic of China until the end of January 1983.

**VI. Proposed Decision**

The following draft decision is proposed for adoption by the Executive Board.

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.

Fund Relations with Finland  
(As of November 30, 1981)

Date of membership: January 14, 1948.

Status: Finland accepted the obligations of Article VIII, Sections 2, 3, and 4 with effect from September 25, 1979.

Quota: SDR 393 million.

Fund holdings of Finnish markkaa: SDR 372.1 million or 94.7 per cent of quota, of which 14.4 per cent under the oil facility.

Finland's holdings of SDRs: SDR 128.7 million or 90.2 per cent of net cumulative allocation.

Gold distribution: 162,608 fine troy ounces.

Exchange system: Since 1972, the Finnish authorities have moved gradually toward expressing the external value of the Finnish markka in terms of a trade-weighted basket of the currencies of Finland's most important trading partners. Effective November 1, 1977, the Currency Act was amended to express formally the external value of the markka in terms of the currency index of the Bank of Finland. The index includes the currencies of those countries which have accounted for not less than 1 per cent of the total of Finland's commodity imports and exports in each of the last three calendar years. In October 1981, 15 currencies were included in the index. The permitted margin of fluctuation has been 6 per cent since September 1979.

Last consultation: The staff report for the 1979 Article IV consultation (SM/80/10, 1/11/80) was considered by the Executive Board on February 15, 1980 (EBM/80/24).

Basic Data 1/

Area and population

Total area	337,000 square kilometers
Total population (June 1981)	4,708,000
GDP per capita (1980)	\$10,400

	1980	1978	1979	1980	1981	1982
	In billions of Finnish markkaa	<u>Annual volume changes in per cent</u>				
<u>Demand and supply</u>						
Private consumption	101.9	2.6	5.6	2.5	1.0	1
Public consumption	34.5	3.8	3.7	4.1	3.5	3 1/2
Gross fixed investment	45.8	-8.7	3.8	9.6	4.0	-3 1/2
Construction	28.4	-3.3	-0.9	5.9	1.5	-2
Machinery and equipment	17.4	-18.2	13.4	16.5	9.0	-6
Stockbuilding <u>2/</u>	5.4	-0.9	4.1	1.0	-2.5	-1/2
Total domestic demand	187.6	-1.1	9.4	5.6	--	-1/2
Exports of goods and services	63.8	8.1	9.2	9.4	2.0	4
Imports of goods and services	65.3	-3.1	16.1	11.9	-4.5	-3 1/2
Foreign balance <u>2/</u>	-1.5	3.3	-1.2	-0.3	2.0	2
GDP	186.1	2.3	7.6	5.0	2.0	2
Value added in manufacturing	47.9	4.1	11.0	8.1	2.4	2 1/2

Annual averages

Employment and unemployment

Employment (in thousands)	2,084	2,134	2,203	2,235	2,222
Unemployment (in thousands)	169	139	112	119	134
Unemployment rate (in per cent)	7.5	6.1	4.8	5.1	5.7
Participation rate (in per cent)	63.0	63.3	64.2	64.9	64.7

Annual changes in per cent

Prices and incomes

GDP deflator	7.7	7.6	9.4	11.0	8 1/2
Consumer price index	7.8	7.5	11.6	12.0	9 1/2
Export unit values	6.2	12.4	11.5	10.0	8
Import unit values	10.9	15.6	16.8	13.0	9
Terms of trade	-4.2	-2.8	-4.5	-2.7	-1
Unit labor costs	2.5	6.5	11.1	11.0	8 1/2
Wages and salaries (index)	6.7	11.5	11.9	12.5	10 1/2
Real disposable household income	4.1	5.2	2.7	--	1 1/2
Savings rate 3/	7.3	6.9	7.1	6.0	6

1/ Changes are based on annual averages. Figures for 1981 are official estimates and those for 1982 are official forecasts of the Ministry of Finance, unless otherwise indicated.

2/ Change as per cent of previous year's GDP. The stockbuilding figure includes the statistical discrepancy.

3/ Household savings as a per cent of disposable income.



	1978	1979	1980	1981	1/ 1982
<u>Government finances 2/</u>	<u>In per cent of GDP</u>				
General government					
Revenue	39.5	38.0	37.9	39.0	39 1/2
Expenditures	39.0	38.3	38.0	38.5	39 1/2
Budget balance	0.5	-0.3	-0.1	0.5	--
Central Government					
Revenue	24.7	23.6	23.7	24.6	...
Expenditures	26.4	26.4	25.9	26.3	...
Budget balance	-1.8	-2.9	-2.2	-1.7	-1 3/4
Effects of fiscal stance of general government 3/					
High employment balance	3.0	1 1/4	1.0	1 3/4	1 1/4
Weighted budget balance	...	1.1	0.2	--	0.9
	<u>Annual averages</u> <u>Changes in per cent</u>				
<u>Monetary data</u>					
Narrow money (M1)	11.3	16.5	11.0	7.6	...
Broad money (M3)	14.6	15.9	16.0	14.0	...
Credit to the private sector	10.7	13.5	19.4	15.7	...
	<u>In per cent</u>				
Discount rate	7.6	7.5	9.2	9.3	...
Official call money market rate	12.0	9.7	12.4	11.5	...
Average cost of bank borrowing from central bank	8.9	9.0	12.4	11.5	...
Average bank lending rate	8.2	8.0	9.8	9.8	...
	<u>In billions of Finnish markkaa</u>				
<u>Balance of payments</u>					
Merchandise exports (f.o.b.)	35.2	43.4	52.8	50.7	66 3/4
Merchandise imports (c.i.f.)	32.3	44.2	58.3	62.7	66
Services and transfers	-0.3	--	0.3	-0.1	--
Current account	2.6	-0.8	-5.2	-3.1	3/4
Long-term capital	3.7	0.9	0.2	3.5	...
Short-term capital	-3.1	0.5	5.5	1.8	...
Errors and omissions	0.9	-0.1	0.6	0.2	...
Monetary movements, Bank of Finland 4/	4.2	0.6	1.1	2.4	...

1/ Data for monetary aggregates give growth rates for first half of 1981 over the first half of 1980. Data on interest rates give averages for the period January-October. Foreign debt data are those of June 1981.

2/ General government data are on a national accounts basis; expenditures cover current outlays and gross investment. Central Government data are on a cash flow basis.

3/ The "high employment balance" is a cyclically adjusted measure of the general government budgetary surplus, expressed as a percentage of cyclically adjusted GDP. A decline signifies an increase in stimulus. By contrast, the "weighted budget balance" is an estimate of the contribution of actual general government transactions to real GDP growth in the same period, with a positive figure signifying stimulus.

4/ A positive figure indicates an increase in net reserves.

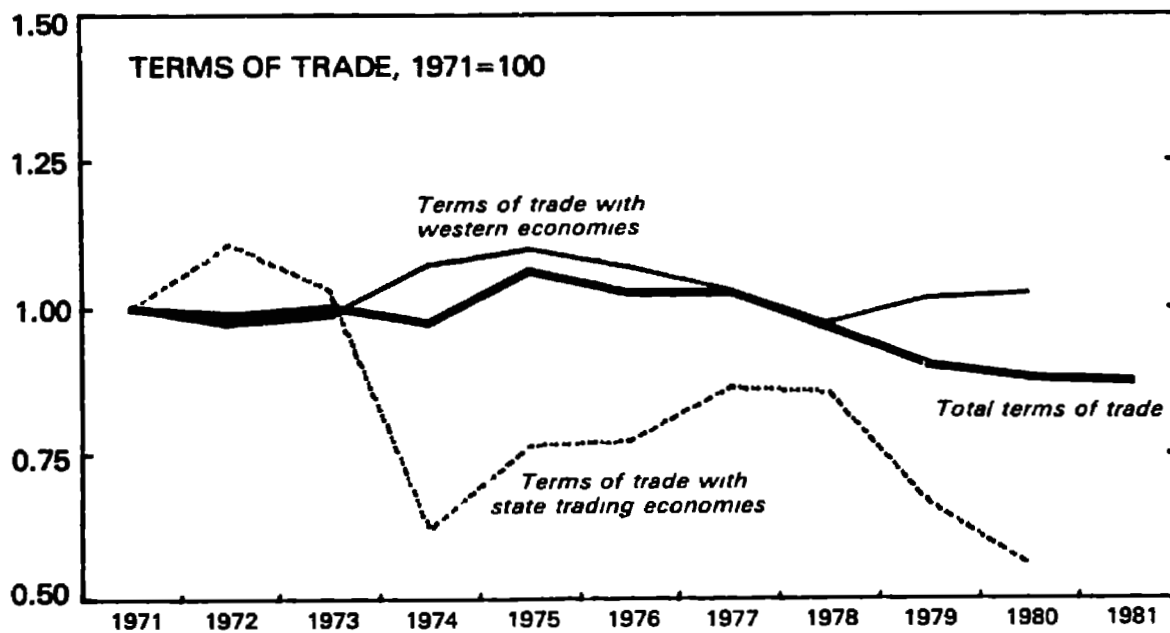
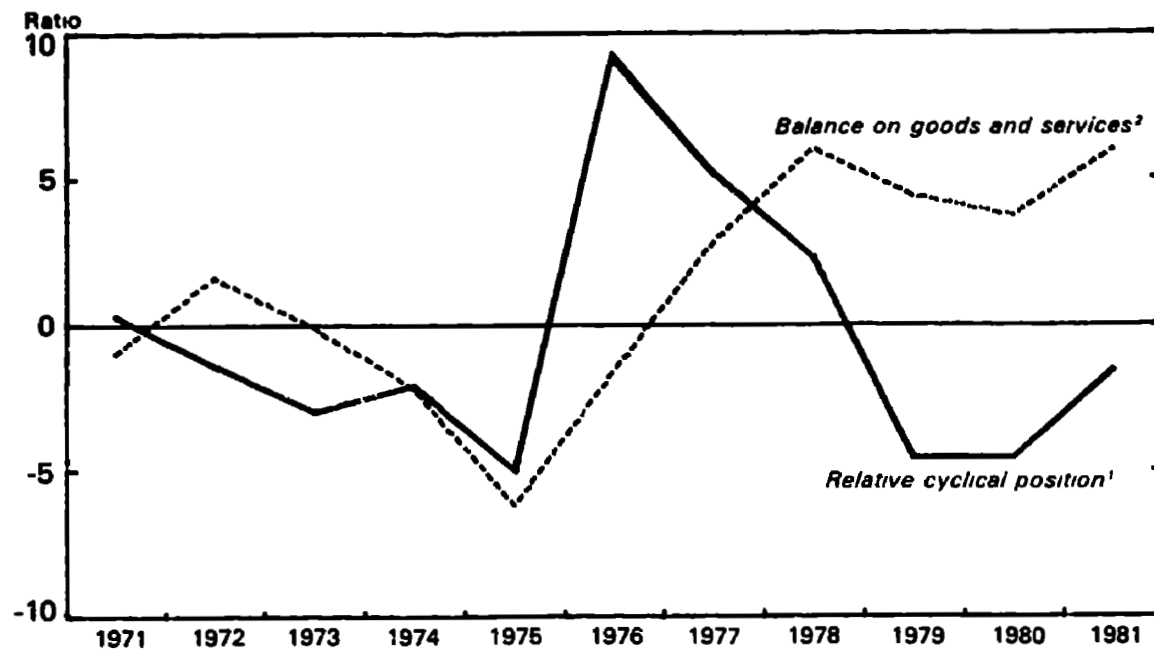
	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u> <u>1/</u>
Current account balance (in billions of U.S. dollars)	0.6	-0.2	-1.4	-0.7
Current account balance (in per cent of GDP)	1.9	-0.5	-2.8	-1.5
Total net foreign debt (at end of period in per cent of GDP)	18.2	15.2	15.7	16.0
<u>In millions of SDRs; end of period</u>				
<u>Official reserves</u>				
Gold <u>2/</u>	33.3	34.7	34.7	34.7
SDRs	61.8	88.1	81.3	138.5
Reserve position in the Fund	46.1	44.6	77.5	77.9
Foreign exchange	<u>830.8</u>	<u>1,036.3</u>	<u>1,307.6</u>	<u>1,104.7</u>
Total	972.0	1,203.7	1,501.1	1,355.8
<u>Changes in per cent; period averages</u>				
<u>Exchange rates and international competitiveness</u>				
U.S. dollar per markkaa	-2.1	5.7	4.4	-13.7
Effective rate				
Bank of Finland	-9.5	-0.1	3.3	0.5
MERM	-9.5	3.1	4.5	-4.2
"Real effective exchange rate" <u>3/</u>	-14.6	-1.8	-1.1	3.9

1/ Net foreign debt as of end-June and reserves as of end-September 1981.  
Exchange rates are average January to November 1981, compared to same period 1980.

2/ Gold valued at SDR 35 per fine troy ounce.

3/ Bank of Finland index of relative unit labor costs in common currency.

CHART 1  
FINLAND  
BALANCE OF PAYMENTS INDICATORS

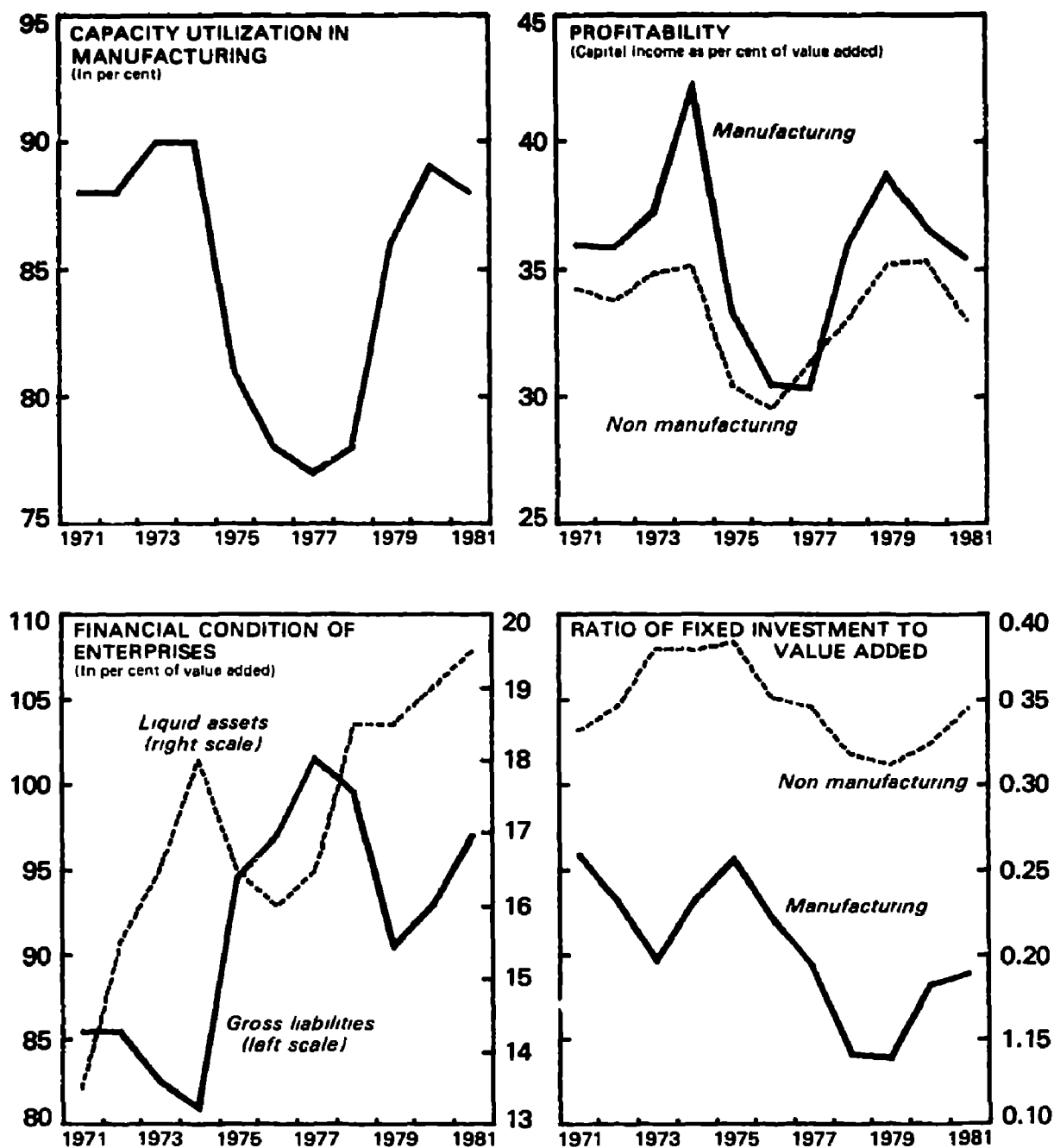


Sources: Central Statistical Office *Statistical Report*; information provided by the Finnish authorities; and staff estimates

<sup>1</sup>Weighted growth rate of total domestic demand (real terms) in 13 partner countries minus growth rate of total domestic demand in Finland

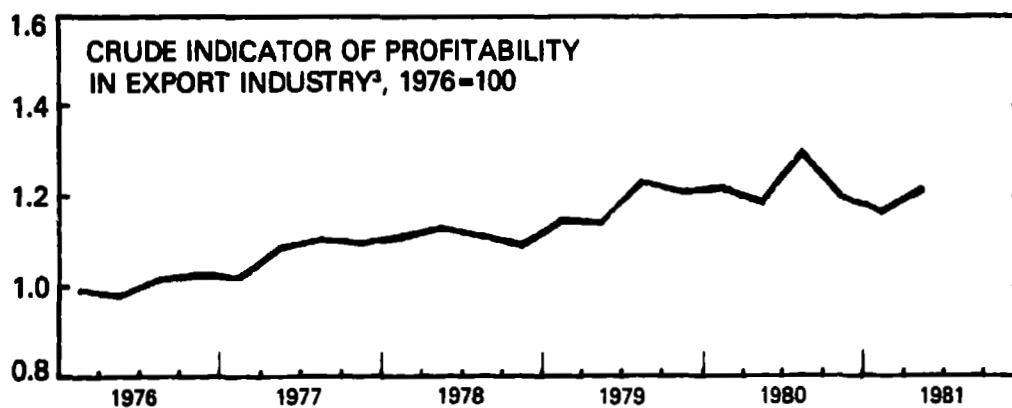
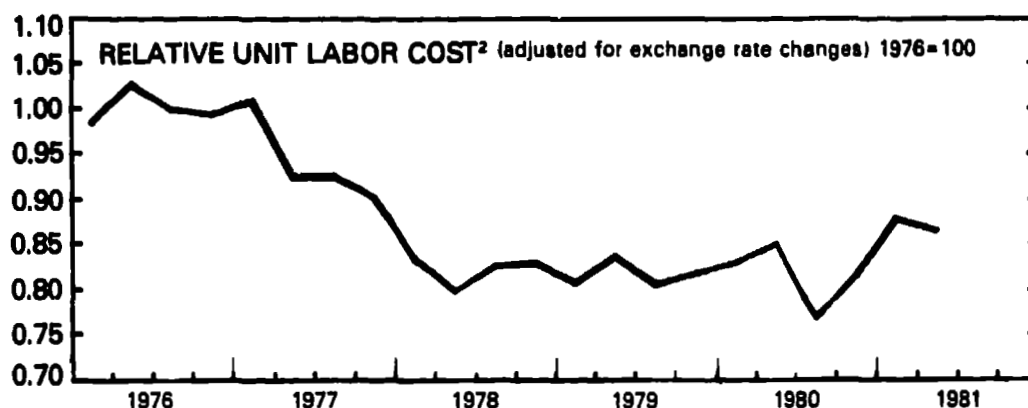
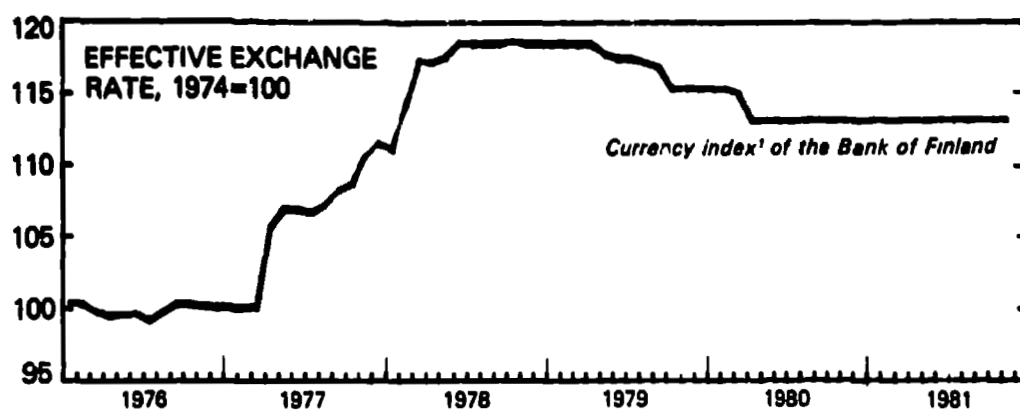
<sup>2</sup>In 1975 prices

**CHART 2**  
**FINLAND**  
**ENTERPRISE SECTOR INDICATORS**



Sources: Central Statistical Office *Tilastotiedotus*, National Accounts and Bank of Finland

CHART 3  
FINLAND  
INDICATORS OF COMPETITIVENESS



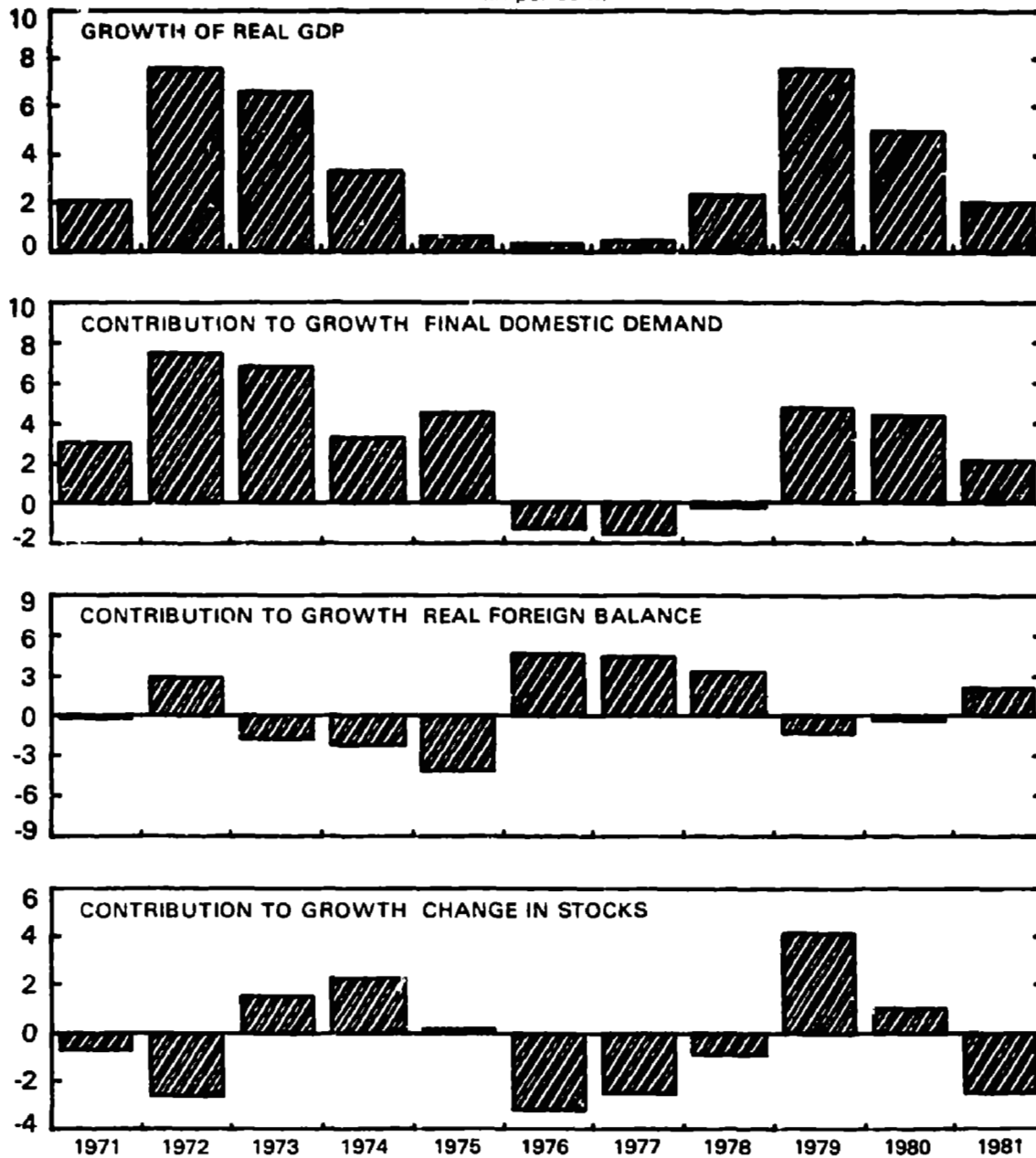
Sources: Bank of Finland *Monthly Bulletin*; Central Statistical Office *Bulletin of Statistics*; and staff calculations.

<sup>1</sup>A trade weighted index. In October 1981 15 currencies were included in the index, including the ruble (22.0 per cent), the Swedish krona (16.5 per cent), the pound sterling (13.2 per cent), the deutsche mark (13.0 per cent), and the U.S. dollar (9.9 per cent). An increase (decrease) in the index signifies a depreciation (appreciation) of the markka.

<sup>2</sup>Manufacturing industry.

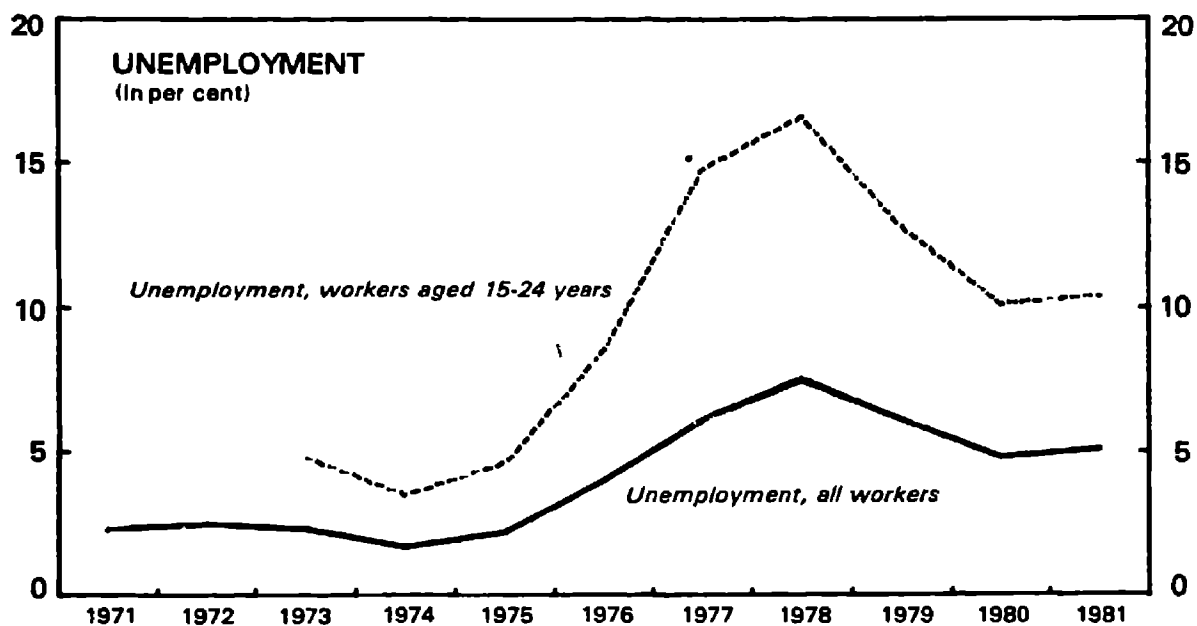
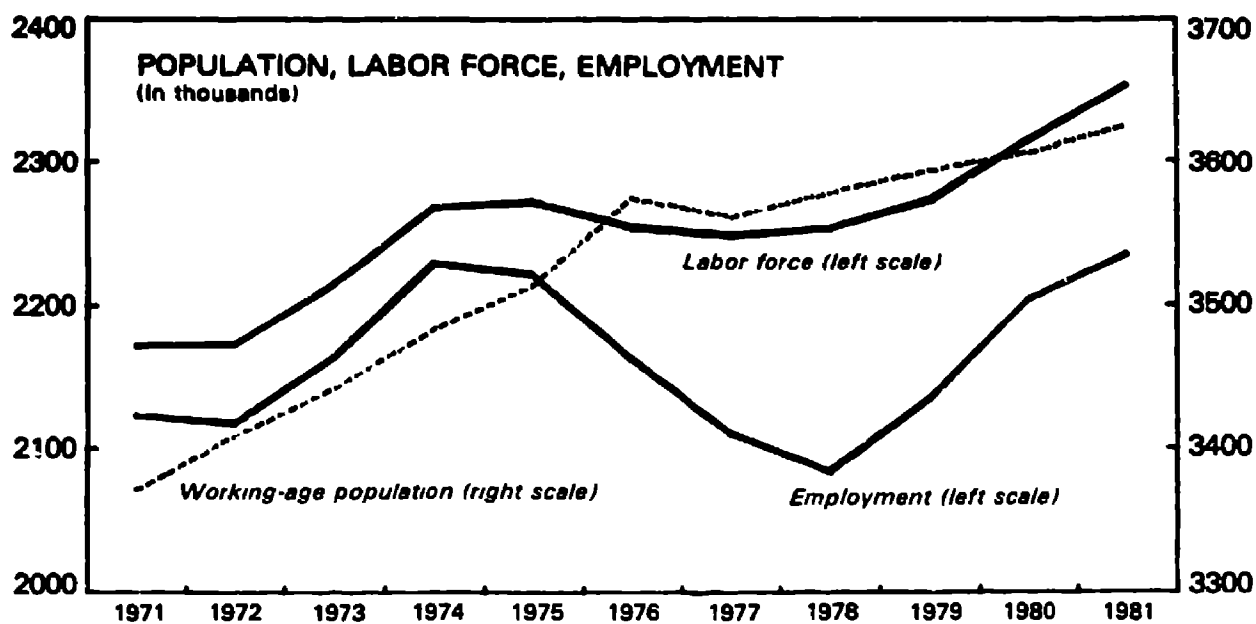
<sup>3</sup>Finnish export prices for manufacturing goods divided by unit labor cost in manufacturing industry in Finland.

CHART 4  
FINLAND  
CONTRIBUTIONS TO GROWTH  
(In per cent)



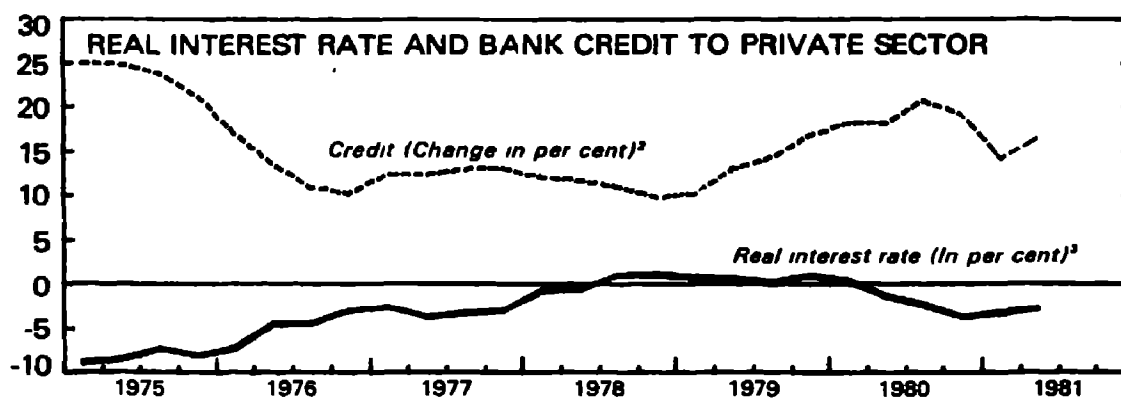
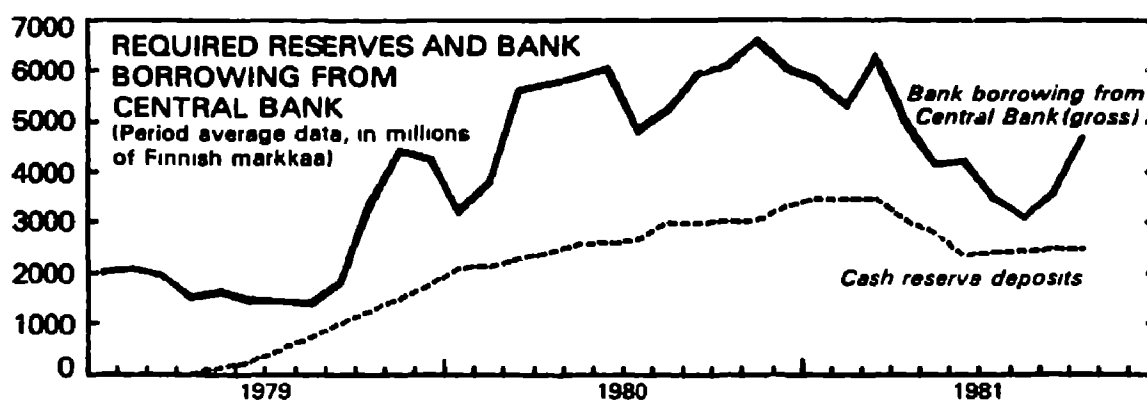
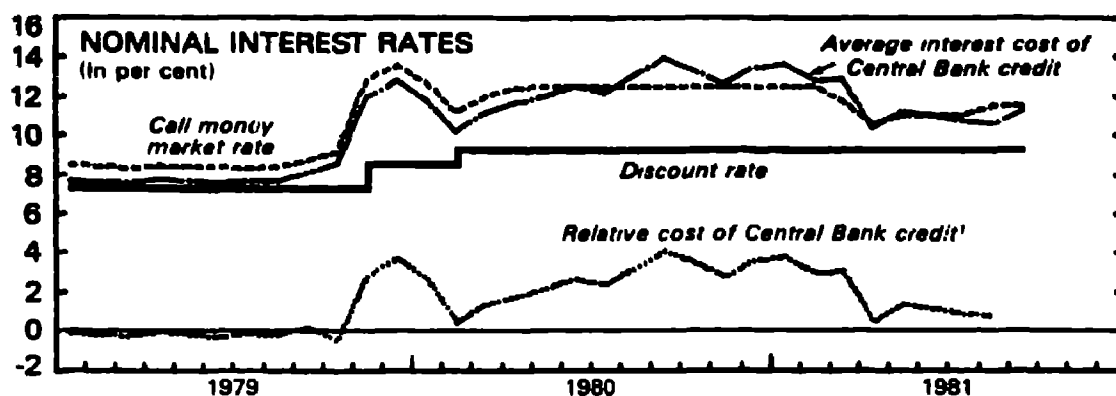
Sources Central Statistical Office *Tilastotiedotus* National Accounts and Ministry of Finance, *Economic Survey 1981*

# CHART 5 FINLAND EMPLOYMENT



Sources: Central Statistical Office *Bulletin of Statistics* and information provided by the Finnish authorities

CHART 6  
FINLAND  
SELECTED INDICATORS OF MONETARY POLICY



Sources: Bank of Finland *Monthly Bulletin* and IMF *International Financial Statistics*

<sup>1</sup> Equals average interest cost of central bank credit minus average lending rate of commercial banks

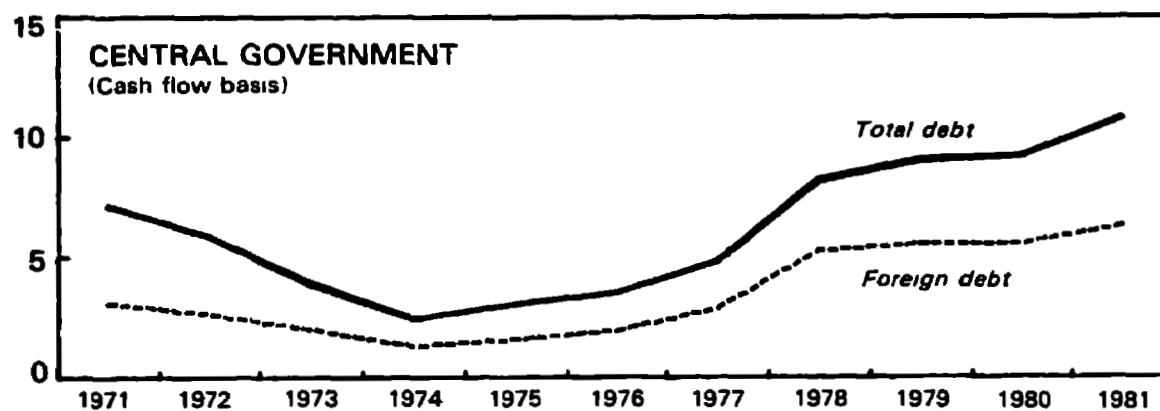
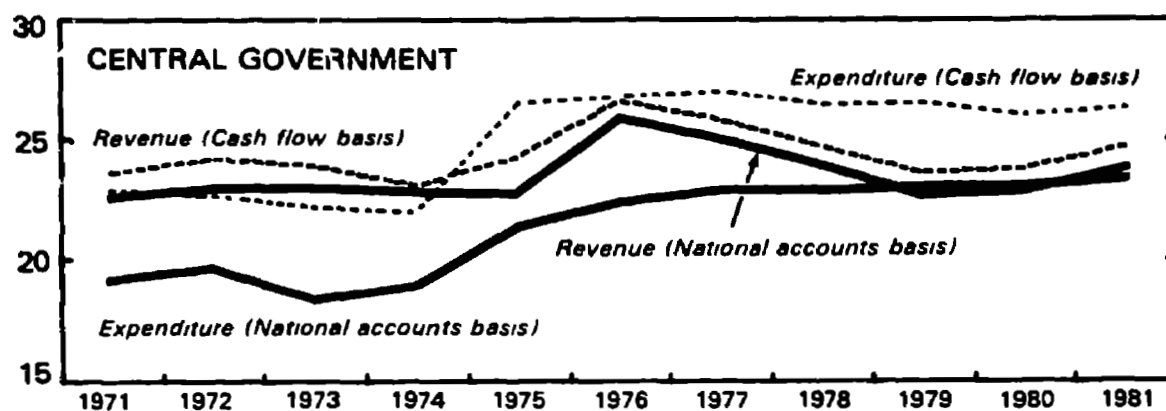
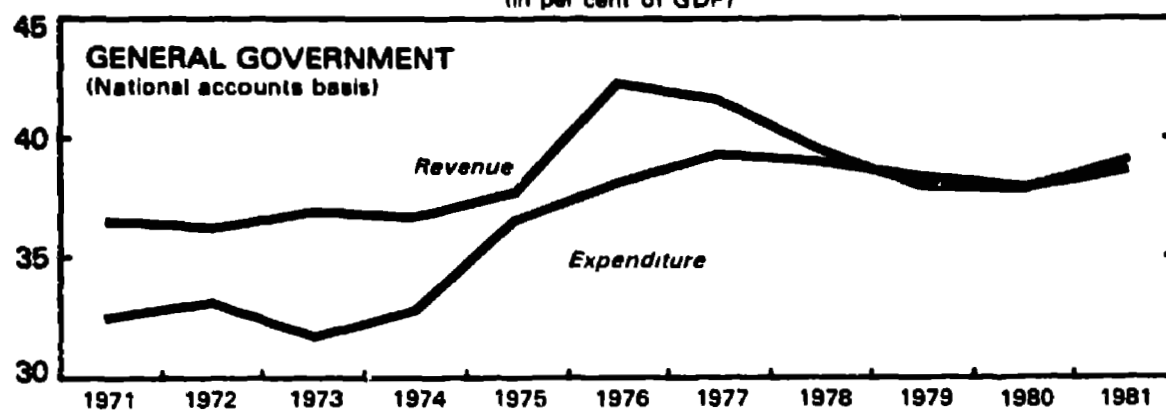
<sup>2</sup> Year on year growth rate of quarterly averages

<sup>3</sup> Nominal average lending rate of commercial banks minus year over year change in consumer price index



CHART 7  
FINLAND  
**SELECTED INDICATORS OF FISCAL POLICY**

(In per cent of GDP)



Sources: Central Statistical Office *Bulletin of Statistics* and information provided by the Finnish authorities