

EBD/82/242
Supplement 1

October 12, 1982

To: Members of the Executive Board
From: The Acting Secretary
Subject: Finland - Changes in Exchange Rate

The Fund has received the following notification dated October 10, 1982 from the Director of the Suomen Pankki - Finland's Bank:

The Government of Finland has today decided to change the fluctuation limits of the Bank of Finland currency index. The new upper limit is 127.5 and the new lower limit 121.9 (1974 is 100). The Board of Management of the Bank of Finland has decided to raise the currency index number by 6 per cent compared with the level prevailing on October 6, 1982. The new level of the index number is 125.1.

The Fund has also received the attached memorandum of the Finnish authorities giving background information relating to the decisions they have taken.

Att: (1)

Other Distribution:
Department Heads

Economic policy measures in Finland on October 6 and 10, 1982

1. Background

During the summer and fall of 1982 foreign exchange market pressures started to build up in Finland. This was largely due to speculative expectations about a possible devaluation in Sweden after the September Parliamentary elections. It was generally assumed that the social democrats would win the election and when in power they would resort to a devaluation as part of an economic policy package to improve the performance and competitiveness of the Swedish economy. Sweden had already devalued by 10 per cent in September 1981. Denmark had devalued its krone within the European Monetary System (EMS) by 3 per cent in February 1982 and in addition to the EMS currencies as a group, had depreciated quite significantly against other currencies. Norway has also devalued its currency by a total of 6 per cent in two steps in August and September 1982. Finland on the other hand had kept its foreign exchange index steady since early 1980 following two minor revaluations in late 1979 and early 1980. In these circumstances, the foreign exchange market participants had increasing expectations that any further major devaluation by Finland's Scandinavian neighbors would force Finland to follow suit in order to safeguard its industry's competitive position. This was all the more so since Finland's international competitiveness had deteriorated by about 10 per cent during 1981-82.

After the social democratic victory in the Swedish elections, speculative pressures increased further in Finland. The Bank of Finland was forced into large interventions in the foreign exchange markets to counter the speculative flight of short-term capital. From about mid-September till early October the Bank of Finland's net sales of currency in support of the markka in the foreign exchange market amounted to 2 billion markkaa, i.e., about one third of available convertible foreign exchange reserves. This scale of intervention had to be financed partly by substantial drawings on the Bank of Finland's network of stand-by facilities with international commercial banks. The convertible foreign exchange reserves were thus being depleted at a highly alarming rate.

2. October 6, 1982 - exchange rate adjustment

In order to counter the speculative pressures, the Bank of Finland, after informal consultations with the Government, let the markka depreciate within the permitted range of fluctuations of the currency index by 4 per cent on October 6, 1982. This moderate measure seemed to re-establish confidence in the exchange rate and short-term capital flows were turning around. The next morning, however, it became obvious that Sweden was about to devalue the krona substantially and that the foreign exchange market in Sweden would be closed. In view of the very nervous and speculative atmosphere prevailing in the markets, the foreign exchange market in Finland had also to be closed in order to avoid a spectacular outflow of foreign exchange and to give the authorities time to assess the effects of the imminent Swedish devaluation.

3. October 10, 1982 - devaluation and economic policy package

Sweden announced an unexpectedly large devaluation of 16 per cent on Friday, October 8, 1982. This forced the Finnish authorities to assess their whole economic policy stance in a new light. It was strongly felt that the Swedish devaluation had put Sweden on a much too large a competitive advantage vis-à-vis Finland. It was also quite obvious that without a further depreciation of the markka the speculative pressure on the foreign exchange reserves would grow to an insurmountable level. In these circumstances, economic measures to safeguard the competitive position of the Finnish economy and to build up confidence in the exchange rate were needed. At the same time any devaluation as part of the comprehensive economic policy package was to be kept as small as possible so as not to endanger the pursuit of a stable price and cost level. Consequently, the following measures were taken.

At the proposal of the Bank of Finland, the Government decided to devalue the Finnish markka by setting new fluctuation limits for the currency index. The new upper limit was set at 127.5 and the lower at 121.9 (previous 119.0 and 112.0). This reduced the permitted range of fluctuation from 6 per cent to 4.5 per cent. The Bank of Finland opened the foreign exchange market on Monday, October 11, 1982 at a level corresponding to a currency index number of 125.1. This was equal to a rise of 6 per cent in the foreign exchange rate index over the level prevailing on Wednesday, October 6. This, taken together with the depreciation on Wednesday, October 6, meant that the external value of the markka was devalued in total by about 9.6 per cent and that foreign exchange rates in Finland in markka terms rose on average by 10.6 per cent.

In order to keep the devaluation as small as possible, it was supported by a number of policy measures, the most important of which are the following:

- The health insurance contributions of employers will be lowered by one percentage point on January 1, 1983.
- Refunds of sales taxes on industrial investment in plant and equipment will be raised from 33.3 per cent to 80 per cent on January 1, 1983. The increase will be effective until further notice. This is also the case for the exemption from sales tax of investments in industrial buildings.
- Electricity tax refunds of 120 million markkaa will be made to selected industries.
- The pension fund contribution of employers will be lowered by half a percentage point.

- The effective period of the deductibility of productive investment and procurement investment reserves will be extended to cover constructions which are started no later than September 30, 1983 and are finished by July 30, 1984. This applies also to machinery and equipment installed by June 30, 1984.
- The period applying to the tax-free investment reserves of enterprises will be extended to cover reserves set aside in the accounting year ended December 31, 1981. The special investment deduction of 6 per cent will from now on cover all investment.
- A committee of representatives from the Central Bank, the ministry of finance, and the forestry industry shall study ways to secure the forest industry with raw material at stable prices.
- The sales tax will be raised by two percentage points on July 1, 1983.
- Alcohol and tobacco prices will be raised beyond what is assumed in the budget proposal for 1983. Anticipated additional revenue yield is 100 million markkaa.
- A price freeze will be in effect from October 13, 1982 to December 15, 1982. Expanded price regulations and controls will be in force thereafter until March 31, 1983.
- The Government will present a supplementary budget proposal amounting to 448 million markkaa directed mainly to measures to stimulate employment.
- The Bank of Finland has decided to raise the call money rate immediately from 11 per cent to 12 per cent and the supplementary interest charge applied to call money overdrafts from 3 per cent to 4 per cent as from the beginning of November.

In addition, the Bank of Finland has announced that while the general level of interest rates for the present time will be kept unchanged, the maintenance of this level is dependent upon the progress in stabilization policies in Finland. Further monetary policy measures will be taken, if needed, so as to ensure that financial markets in Finland do not ease in a manner jeopardizing the overall balance within the economy.

The above-mentioned set of economic policy measures will improve Finland's scope for overcoming the effects of the prolonged international recession while at the same time ensuring a reasonable degree of stability in the Finnish foreign exchange markets.