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To: Members of the Executive Board
From: The Acting Secretary
Subject: Finland - Exchange Arrangements

Attached for the information of the Executive Directors is a paper on the recent devaluation of the Finnish markka.

Mr. Anayiotos (ext. 8817) is available to answer technical or factual questions relating to this paper.

Att: (1)

Other Distribution:
Department Heads

INTERNATIONAL MONETARY FUND

FINLAND

Exchange Arrangements

Prepared by the European Department and the
Exchange and Trade Relations Department

(In consultation with the Legal Department)

Approved by J.R. Artus and S. Kanasa-Thanan

November 19, 1991

As described in EBD/91/303 (11/15/91), the markka was temporarily floated as of November 14, 1991 and was devalued by 12.3 percent on November 15, 1991. This note sets out the context of this action by the Finnish authorities.

During the recent Interim Article IV consultation discussions (SM/91/157, 8/8/91), the authorities stated their commitment to a stable exchange rate. On June 7, 1991 the markka was formally linked to the ECU with a midpoint of 4.87580 (FIM/ECU) and fluctuation margins of 3 percent on either side of the midpoint, i.e., between Fmk 4.72953 and Fmk 5.02207. The midpoint and fluctuation margins were set so as to correspond to the midpoint and fluctuation margins applied in the old currency index to which the markka was pegged previously. While the authorities acknowledged that there was a need to reduce real wages, they had considered that incomes policy rather than exchange rate policy was the more efficient instrument to that end.

In recent months, however, the balance of payments position has continued to worsen. Exports were particularly weak, in part because of the collapse of the U.S.S.R. market, but also because of the loss in competitiveness (Chart 1). From the third quarter of 1990 to the third quarter of 1991, real GDP decreased by 7 percent, with half of the decrease due to the decline in exports. The unemployment rate is projected to reach at least 12 percent by end-1991. Furthermore, while an incomes policy agreement was concluded October 21, 1991 by the central labor market organizations to reduce wage and salary recipients' after-tax net earnings on average by 5 percent, the sector specific collective agreements that would implement it are not expected to be implemented before the end of November 1991. In spite of a sharp rise in domestic short-term interest rates, uncertainty related to the implementation of the incomes policy agreement and devaluation speculations led to capital outflows and a loss of foreign exchange reserves. During the period end-July 1991 to end-October 1991 foreign exchange reserves declined by about US\$4 billion. Further, large foreign exchange losses were increased in the first half of November.

It is expected that the devaluation action taken by the authorities will contribute to a strengthening of the balance of payments. Its inflationary impact should be moderate, owing to the weakness in economic activity. The effect of the devaluation on the incomes policy agreement is not yet clear.

CHART 1
FINLAND
REAL EFFECTIVE EXCHANGE RATE (1980 q1 to 1991 q2)
(index 1980 = 100)



