Confederation of Finnish Industries EK
Jukka Koivisto, Director, Communications and Strategic Planning
Reykjavik, Iceland
20.1.2009

The Recovery of the Finnish Economy in the early 1990s

Dear Listeners,

1) Finland's industrial structure has changed over the past 20 years faster and more comprehensively than any other OECD country since the Second World War.

2) Still in the 1980s the technology level of our industrial production was among the lowest of OECD countries. A period of "creative destruction" began to change our industrial structure. This change was accelerated by the collapse of the Soviet Union. Today Finland has more global market leader companies in terms of the size of its national economy than any other country in the world.

3) In the first half of the 1990s the amount of exports as a share of GDP fell to as low as 20 percent. The creation of clusters and stronger investments in R&D became the core of industrial policies.

4) By the mid-1990s the "Nokia effect" was discernible. The Finnish economy grew rapidly, as much as 4-5 percent a year by the end of the decade. A new phenomenon was that a single cluster, the electrical and electronics industry, accounted for up to 1.5 percent of the growth in GDP. Today Nokia's net sales are bigger than Finland's state budget.

5) Finland has experienced its longest period of economic growth since the Second World War.

Dear Listeners,

The period of post-war economic growth for Finland ended abruptly with the financial crisis at the start of the 1990s. Many hopes and aspirations hinged on positive economic growth. When this growth ended, many things had to be rethought. Finns had of course heard about financial and bank crises, but they were things that happened in faraway countries that meant little or nothing to us.

Economic recessions endure as topics of conservation for a long time. They influence the behaviour of economic units – citizens, households, companies, municipalities and the state – for generations to come. From the outset of the most recent crisis, many opinions have been expressed about the Finnish recession in the early 1990s. Unemployment, the banking crisis and the role of the welfare state have dominated the debate.

When explaining recent developments, it has been necessary to take a stand regarding the "driftwood" theory: was the recession the unavoidable consequence of certain previous actions?

The basic financial mechanisms have a powerful influence on economic development, and they easily feed off of each other. The expectations of economic actors are also to a degree self-fulfilling. The optimism of good times leads to decisions that strengthen growth, while the pessimism of bad times breeds caution, which reduces economic activeness and thus further deepens the recession.

Economic decisions have to be made in an atmosphere of considerable uncertainty regarding future events. Genuine uncertainty also means that in hindsight – once the development has already occurred – it is easy to find better decisions than the ones that were made in the original situation. It is, in fact, almost impossible to discuss the recession without hindsight.

If Finns were asked 20 years ago – at the end of the 1980s – about their views on severe economic recessions, most would have mentioned the years of hardship in the 1930s. The post-war generations seem to have had a poor comprehension of events 70 years earlier. Major periods of recession were considered phenomena that belonged to the past. Many did not believe that a similar crisis could recur in the future.

The recession of the 1930s was marked in Finland and elsewhere by high unemployment and the enforced auctioning off of farms. Many Finns lost everything when they were forced to sell their belongings at a fraction of their former value in order to pay off their debts and warranties. This understandably provoked resentment. The recession also taught Finns to be cautious about taking too many loans.

Finland experienced relatively fast economic growth in the 20th century. Only a few countries in the world could match its average 3 percent annual growth. Total output increased 7- or 8-fold in a hundred years. Measured in terms of internationally comparable prices, Finland clearly exceeded the average income level for industrialised nations in the 1980s. At the start of the century output per capita had been just half that of industrialised nations.

Finland's rapid post-war economic growth was largely due to increased production, and especially to a high level of investments. In addition to physical investments, Finland also invested heavily in human resources. At the start of the 1990s Finland spent more of its GDP on education than any other country in the world. The period of post-war growth in Finland has also been called a "project in corporatism". The creation of a welfare state received broad popular support, and it progressed more or less on the basis of commonly accepted plans and agreements. Employees were encouraged to agree to modest wage increases through collective agreements, in return for which the social security system was developed. Agricultural entrepreneurs also participated in this corporatist project as one of the parties to these comprehensive income policy agreements. They had their good sides, but they also bred inflexibility and discouraged competition.

One of the models for the comprehensive income policy system adopted by Finland in the 1960s was the solidary income policy practised in Sweden since the 1940s. The idea was to ensure the same level of wage increases for employees in all industries, but in such a way that earnings in low-paid industries increased relatively faster. It was thought that the system supports successful companies, since they did not have to raise wages as fast as their productivity increased.

It is interesting to consider whether the prevalence for large companies in Finnish and Swedish industry can be explained by the long history of solidary income policies and currency devaluations. Minimising wage differences and the exchange rate policies that have been practised have perhaps retarded the creation of smaller companies and favoured powerful large corporations. It is also possible that the relative comforts of wage earners have lessened the attractiveness of entrepreneurship and the desire to take risks.

In Finland the 1970s and 1980s were a period of powerful union-led income policies. The negotiations covered not only wages and working times, but also new social reforms and state-funded residential construction. Macroeconomics emphasised the belief in the 1980s that centralised wage agreements were good for employment. The main argument was that the parties to these agreements were forced to consider their impact on inflation and unemployment.

Even if the general level of inflation remains low, the problem with centralised agreements remains the inflexibility of wage structures; identical increases are not always appropriate for all industries and all companies alike.

Finland's post-war GDP did not contract once before the 1990s. By the 1980s, the economic fluctuations seemed to have flattened out further. The deep recession at the start of the 1990s was truly an exceptional situation for the Finnish people, who had grown use to continuous economic growth. Many of the decisions that had been taken within Finnish society rested on the assumption that the economy would continue to grow steadily from one year to the next. Consumers relied on growing amounts of real income, businesses on growing demand for their products, and the government on growing tax revenues. When income began to fall, against all expectations, the entire national economy found itself in big trouble.

The recession in Finland in the 1990s was thus a question not only of a severe economic disruption, but also of the disintegration of the old operating model. The “growth machine” that had worked so well after the Second World War began to “sputter” in the new conditions. Changes in global politics, the opening of financial and currency markets, the unification process of Europe and the internationalisation of companies changed the business environment for Finns. We found it hard to consider all these aspects. The situation was complicated by the fact that most of the changes came as a shock to the general public, which had not prepared in advance.

Bilateral trade with the Soviet Union had also been a key component of Finland’s post-war operating model. War reparations created the foundation for wide-ranging exports to the Soviet Union, which came to account for up to a quarter of total Finnish exports. However, the Kremlin’s political and economic influence cannot be measured in terms of foreign trade alone. The role of the Soviet Union in Finland’s post-war political and social development was larger than Finns wanted to admit at the time.

The Finnish markka had a history of devaluation after the Second World War. The aim after each devaluation was low inflation and the assurance that this was the last devaluation. Repeated devaluations nevertheless meant that the theoretically stable exchange rate policy was in practice flexible. Although this flexible exchange rate policy was accepted due to its focus on growth, it was still never considered the best possible policy. Already in the 1970s the belief spread that the benefits of repeated devaluation were no longer as great as before. It was felt that devaluations reflected on expectations and behaviour in a way that gradually eroded the benefits of the devaluation policy. In fact, a doctrine of devaluation cycles was born, according to which the benefits of devaluations evaporate within a few years, and all that remains is inflation that accelerates faster than in other countries.

This view concerning the disastrous effects of devaluation policies began to influence wider thinking in Europe as well. Faced with accelerating inflation in the 1970s, European countries began emphasising the importance of anti-inflation policies as an economic and political goal. The EEC countries made stable exchange rates a key goal already in 1979 when creating the EMS system.

Finland’s economy overheats

The overheating of the Finnish economy at the end of the 1980s helps to explain the onset of the recession at the beginning of the 1990s. The legacy of the 1980s was a structural current account deficit and, as a result, a growing foreign debt and increased economic vulnerability.

The financial markets in all industrialised countries were regulated in the post-war period. Reconstruction forced many countries to rely on regulation in order to steer sufficient capital into investments. The deregulation that followed in the 1980s was also a global phenomenon. It was due partly to a change in economic thinking and partly to technological developments. As technology improved and companies expanded internationally, it became easier to circumvent regulation. In Europe deregulation was seen as part of broader economic integration, the goal of which was to make it easier for goods and capital to move from one country to another. Deregulation eventually became a condition for countries who wanted to participate in this integration.

Finland too adopted the aim of participating in the western integration process, strengthening the market economy and thus, unavoidably, promoting deregulation. Arguably, the proximity of the Soviet Union and the need to find a balance between the two blocs delayed somewhat Finland's participation in these European developments.

The financial markets were gradually deregulated in Finland during the 1980s. Finns monitored the recommendations of other industrialised nations and international organisations, such as the OECD. Finland's deregulation occurred step by step over a long period, and at no stage was any ideological decision taken to liberate the financial markets in principle.

The overheating of the Finnish economy was connected with the rapid rise in prices in the second half of the 1980s. In just under four years, from autumn 1985 to spring 1989, share prices tripled in value. Real estate prices doubled. Finnish households and companies were more indebted at the end of the 1980s than at any other time since the Second World War. Nevertheless, household debt was still less extreme than in other Nordic countries or the USA, for example.

How did Finland recover from the recession?

A significant change in Finland's economic policy was the disintegrating support for a strong markka, which began in November 1991 when Finland was forced to devalue its currency. The previous policy was finally shattered in September 1992, when the markka was floated. The rapid growth in exports and decline in imports created a current account surplus as early as 1994. The recovery of financial policies was nevertheless restricted by the rapid increase in the national debt. On the monetary side, the floating of the markka allowed for lower interest rates, which in turn promoted investments and consumption. Thanks to the positive development of exports, industrial output began growing again by the end of 1992 and GDP by 1993. In other words, Finland recovered from its recession relatively fast.

One of the lessons of these years is that traditional economic trend policies offer few opportunities in bad recessions. Financial policies do not offer much room for manoeuvre due to the rapid increase in public debt. The biggest problem was high unemployment, which began to fall again only very slowly. Finland's unemployment rate in 1994 was as high as 18.4 percent.

Economic crises nearly always promote reforms. In retrospect it can also be seen that Finland's crisis policies conformed with the dynamic economic renewal theories of Joseph Schumpeter. Accordingly, if economic policies do not attempt to balance all economic fluctuations, there is more room for the renewal, or "creative destruction", of the economy. The economic units that survive the crisis become more powerful, so economic growth can be rapid.

Another problem in Finland was its one-sided industrial structure. Although the growth of the forest industry began to decelerate in the 1980s, there were no new exports to fill the gap. There was also much room for improvement in the return on investments. Finns began to consider the importance of R&D in the light of the relative inactivity of Finnish companies in this regard. Following the recession, investments in the "information society" became an extremely important part of Finland's survival strategy.

Finnish R&D expenditure gradually reached leading international levels, and income from the sale of state-owned companies was earmarked for R&D. Finland continues to invest heavily in R&D to this day, only now we don't speak of the "information society" but of the "innovation society".

Joining the European Union

Sometimes the march of history takes sudden turns that would have been difficult or even impossible to predict in advance. Almost no one foresaw the collapse of the Iron Curtain going into the 1990s. Very few believed that the Soviet Union itself would collapse and cease to exist. But it happened, and it did so with great speed.

For Finland, keeping the doors to its export markets in Western Europe open has been a matter of survival for the entire post-war period. Indeed, Western Europe accounts for two-thirds of Finnish exports. In order to maintain the competitiveness of its exports, and to keep them free of customs, Finland signed free-trade agreements with EFTA in the early 1960s and the EEC in 1973.

The debate in Finland over the possibility of joining the European Union began in the late 1980s but failed initially to receive a lot of support. The political elite felt that membership would contradict Finnish neutrality. Some voices within industry were also critical about joining, above all due to the lucrative trade with the East. The situation changed rapidly, however. The Iron Curtain disappeared, and the Soviet Union collapsed. Furthermore, Sweden surprisingly announced in autumn 1991 that it would apply for EU membership. Finland was quick to follow and submitted its application to Brussels in the winter of 1992. Soon there were two more applicants: Norway and Austria.

Finnish industry and a majority within the trade union movement came out in favour of membership. They were opposed by the farmers and some unions, which saw the liberalisation of agricultural imports as a threat to the future of food production in Finland. EU support was higher in the cities and towns than in the countryside. Cynics questioned the future of Finnish independence and sovereignty. Supporters emphasised that each country could best take care of its future by sitting around the tables where their futures were decided. Finland's future would be more uncertain outside the EU than as a Member State. Furthermore, the EU's belief in economic stability, low inflation and low interest rates would enhance stability and predictability in Finland with its history of continuous devaluations and higher-than-average inflation.

The accession negotiations lasted almost a year. As expected, the most contentious issue was agriculture and above all whether Finland had the right to subsidise its own farmers in areas where the natural conditions were harsh. This was finally agreed to, but only for a set period.

I myself was closely involved in the campaign for membership prior to the referendum in October 1994. Our theme was that "membership is the better alternative". Finland could survive outside the EU, but not as well as it could as a member. We did not want to suggest that the European Union would be a rose garden or that it would solve all our problems. Even Member States have to manage their own affairs well. We also did not want to form a united "national front" that would speak with one voice. We gave everyone the chance to support membership from their own perspective and with their own arguments. Finland does not have a tradition of holding referenda, which partially explained the intensity of the debate at times.

The yes votes eventually prevailed by a margin of 57 to 43. Large majorities are rare in referenda offering only two alternatives. Austrians and Swedes also favoured membership, whereas Norwegians voted against.

Finland's EU membership began at the start of 1995. Viewed from above, Finland made the right decision when it chose to play a strong role in EU policy making right from the start. Finland sent its best and most active experts in trade policy to Brussels. Whereas previously the home market for Finnish industry had been the Nordic countries, it now extended to all of Western Europe. Of course, since then this market has continued to expand with the accession of new Member States.

The Finnish government set a goal to be active in the core of the EU, which meant participation in the EU's economic and monetary union. Today Finland is the only Nordic country that has adopted the euro. On the whole, the ten-year history of the euro has been a success story. The euro has become a stable and credible currency that has provided continuity, also to the Finnish economy. Devaluation is no longer available as an economic policy, so financial discipline and continuous improvements in productivity are called for. At the same time it should be pointed out that the strength of the euro will ultimately be weighed in the current economic and financial crisis.

According to public opinion surveys, Finns have remained critical of the EU, although there is no wide social debate as to the wisdom of the decision to join. We in Finnish industry want to emphasise above all the unification of Europe as a project to strengthen European competitiveness. There are other goals as well. The growing strength of the European Parliament emphasises social, climate and energy issues. These ideals do not necessarily contradict each other, but safeguarding welfare is not possible without competitive companies.

As a result of the recession of the early 1990s and EU membership, Finland today has a more diversified industrial structure than ever before. The nation's success strategy has been investments – in research, development and innovations. In fact, Finland today has an entirely new industrial sector led by Nokia, the electrical and electronics industry, the success of which is based above all on effective networking. The assembly industry, whose success is based primarily on inexpensive labour, has been shifting production away from Finland for many years already.

One of the key questions for the future is whether we can succeed in keeping R&D operations in Finland, or will they also move closer to the main markets. Finland's age structure is also becoming more unbalanced and the dependency ratio contorted. This places continuous pressures on the sustainability of our public finances. Will the success of Finnish companies and the increase in productivity be enough to maintain such a large public sector? These are the key challenges that face Finland.

Dear Listeners,

I have tried to describe how Finland fell into recession, and it how the recovery began. The consequences of all the decisions that were made in often extremely chaotic circumstances were not always predictable. This is why so much economic research has been made into the recession in Finland. Ultimately economic downturns always come as a surprise, just like now. Perhaps it is human nature to try and avoid unpleasant realities and to trust that all is well and will remain so.

Thank you very much for your attention!