

Joining Europe's Monetary Club
The Challenges for Smaller Member States

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CHAPTER FOUR

Finland and EMU

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This chapter aims to explain Finnish attitudes and ambitions with regard to joining an eventual economic and monetary union (EMU). To do so, it examines the Finnish body politic from several disparate angles; the intent is to provide an economic and a political analysis of the current movement toward EMU. As one of the youngest members of the European Union (EU), the character of the debate in Finland on EU issues is somewhat less developed than it is in some of the older member states. In some ways, Finnish support for the EU is vocal, endearing, and almost naive. In other ways, the discussion is more muted and nuanced. On matters regarding EMU, there is support and concern in both the public and private debates. This chapter tries to map these conflicting concerns.

The chapter is divided into six sections: The first section provides a historical backdrop: Finland relied heavily on exchange rate changes as an active policy instrument throughout the postwar period. This history, along with that of the successful EU referendum campaign, is important for understanding the radical nature of the changes currently being considered. The second section looks at the potential economic costs and criteria for Finland's participation in EMU. The third section examines Finland's institutional arrangements, in particular its labor market institutions, for signs of costly constraints on effective EMU participation. The fourth section speculates on the distributional divides that can be expected on the road to EMU and after; the fifth section—on issue linkages—returns us full circle, describing how EMU is linked to other significant Finnish policy issues in an attempt to make EMU membership more attractive. The sixth section forms a conclusion.

In general, the picture painted is one of cautious support. Whereas Finland's economic structure is not very well suited for participation in EMU and its history with past exchange rate adjustments makes a currency union of questionable utility, the country is in the mood for change. Finns want and need an economic transformation of some sort and apparently they are willing to pay the costs. In terms of meeting the convergence criteria and providing enthusiastic support more generally, Finns are strong candidates for participating in EMU. These ambitions, however, will require rather large social costs.

The Finnish Context

Over the postwar period, Finland, probably more than any other European country, relied on devaluations as a regular and systematic part of its economic policy arsenal. It is important to understand this history in order to evaluate the difficulties that lie ahead for Finland in a future EMU.

Exchange Rate History

Finnish economists introduced the world to the phrase and concept of a "devaluation cycle" (Korkman, 1978, 1980). Throughout the century, Finns have effectively wielded an offensive exchange rate policy to protect their domestic price level and/or secure its competitiveness in a world economy. In the postwar period, devaluations were used in roughly ten-year intervals (1949, 1957, 1968, and 1977-78) to rescue the Finnish economy from self-induced recessions. The devaluation cycle now is perceived to have been a vicious cycle. Since 1973, the value of the markka has been adjusted nearly a dozen times (see Table 4.1); devaluations were, until quite recently, an explicit part of the Finnish competitiveness policy. It would be costly to forget this history in the rush to establish EMU. (See Moses, 1995b.)

Finland's flexible exchange rate history is a long one. The Bank of Finland withdrew from the gold standard in the fall of 1914, allowing the markka to decline to about one-eighth its previous value by 1923. Accepting inflation, Finland was one of the very few countries that avoided the international depression of 1921 and learned a valuable lesson in the use of flexible exchange rates (Haavisto and Jonung, 1993; Lester, 1939/1970). This lesson was not quickly lost on following generations. During the 1930s, Finland avoided the deepest depths of the international depression by using an undervalued currency to protect its domestic price level and afterward rebuild its economy on the back of an export-led recovery.

This tradition was maintained even under the relatively rigid Bretton Woods regime. As a signatory since 1948, Finland was granted adjustments

Table 4.1. Postwar Exchange Rate Adjustments of the Finnish Markka

Date	Movement	Notes
31 May 1945	42.9 percent devaluation	
27 July 1945	28.5 percent devaluation	
16 October 1945	11.2 percent devaluation	
4 July 1949	15.0 percent devaluation	
19 September 1949	30.8 percent devaluation	
16 September 1957	28.1 percent devaluation	Bretton Woods period
12 October 1967	23.8 percent devaluation	
21 December 1970	2.4 percent revaluation	
15 February 1973	5.1 percent revaluation	
4 June 1973		Markka floats
5 April 1977	5.7 percent devaluation	
1 September 1977	3.0 percent devaluation	
17 February 1978	8.0 percent devaluation	
21 September 1979	1.3 percent revaluation	Trade-weighted basket peg
25 March 1980	2.0 percent revaluation	
6 October 1982	4.3 percent devaluation	
11 October 1982	6.0 percent devaluation	
16 May 1986	1.6 percent devaluation	
17 March 1989	4.0 percent revaluation	
7 June 1991	(no adjustment)	ECU peg
15 November 1991	12.3 percent devaluation	
8 September 1992		Markka floats

Source: Moses (1995a).

to its exchange rate several times: Each adjustment was submitted to, and accepted by, the International Monetary Fund (IMF) on its own criteria of "fundamental disequilibrium." In the wake of Bretton Woods, in 1973, Finland was one of the first countries (following Austria) to set an autonomous exchange rate course on the basis of a trade-weighted basket. This basket facilitated frequent adjustments; an aspect of the regime used with great enthusiasm throughout most of the 1970s.

In 1982—following in the wake of the Swedish "Big Bang" devaluation and the new Swedish commitment to fixed rates of exchange—Finland's

government announced its intent to establish a more fixed exchange rate regime. Unlike the Swedish attempt, however, the Finnish regime was tested frequently, and adjustments continued throughout the 1980s. The most recent promise of fixed rates came with Finland's unilateral fixing of the markka to an ECU basket in June of 1991. This commitment lasted five months before the 12.3 percent devaluation in November.

As was the case in Sweden (see Chapter 9), the 1992 market-forced devaluation has been instrumental in orchestrating Finland's most recent economic recovery: Finland's international competitiveness has been boosted significantly. Although it remains to be seen how long it will take before this competitive edge is worn away by increased wage demands, the current slack in the Finnish economy—with unemployment approaching 20 percent—has lessened the expected inflationary legacy.

As we shall see, Finland hopes to overcome its past reliance on the devaluation cycle: participation in a common currency area is seen as an important link in an effort to restructure the Finnish economy on a broader footing. But the structure of the Finnish economy and its (not unrelated) reliance on adjustable exchange rates act as a strong counterbalance to these reformist ambitions. Movement toward the convergence criteria and participation in a future EMU will cause significant economic and social discomfort for a country that has been so reliant on flexible exchange rates in the past.

European Union Membership

In the 16 October 1994 referendum, 56.9 percent of the Finnish voting public supported EU-membership; but the outcome was even more divided than the aggregate figures suggest: Support was strongly divided along regional lines. Indeed, over 70 percent of the 445 municipalities opposed membership, with the southern urban centers providing the strongest support. (See Moses and Jensen, 1998.) All of Finland's northern rural districts were opposed to membership; they were simply outnumbered by the urban vote. It is along these regional lines that we also can expect to find divided support for Finnish participation in EMU. The reasons for this will become more evident after a short description of the Finnish EU campaign.

Finland's enthusiasm for EU membership was driven (by and large) by the same factors found in the other Nordic countries, only the stakes in Finland were much higher. The collapse of the former Soviet Union has meant a radical reorientation of Finland's security as well as economic policies. Throughout most of the postwar era, Finland relied heavily on Soviet bilateral trade arrangements; its precarious neutrality made EC-membership a nonissue in the years prior to 1988.

The reasons for Finland's European policy turnaround are fairly obvious, and we need touch upon them only briefly. The security issue is probably paramount, although Finns deny that they are searching for extra security; but changes in the international political order undoubtedly have made Finnish EU membership less controversial. A second argument for membership also relates to the fall of the Soviet Union. No other Western industrialized country was more dependent on trade with the Soviet Union. Whereas the Soviet share of Finnish exports was at 27 percent in 1982, it fell precipitously to 11 percent in 1990. The repercussions on the Finnish economy were enormous. EU membership, generally, is seen as a means of reinvigorating the Finnish economy and reorienting it toward Western markets: Both the type of exports and the markets they are sold in required immediate attention.

In the first round of Finland's 1995 presidential campaign, party (and particularly party leader) positions with respect to EU membership were established. Of the six candidates, all four of the major-party candidates originally supported EU membership.² Only Claes Andersson from the Left Party and the independent Keijo Korhonen—each representing fairly small groups—opposed membership. After the election, the Center Party's Paavo Väyrynen actively opposed Finnish membership (a change that reflects the underlying tensions within the Center Party on the issue of EU membership).³

While security and economic issues appear to play a significant role in influencing Finland's positive attitudes toward EU membership, pessimism has grown with the more recent extension of Community powers. Support for membership (at its peak in Finland in 1992) took a beating after the Danish no vote to the Maastricht Treaty—in every party setting. (See Table 4.2.) The opposition, however, did not seem to reap the full benefit of this fall in support, as the difference was split between the opposition and those with no opinion. Still, indecision in Europe (particularly in Denmark) about the benefits of greater integration can be seen as one of the primary causes of the pre-referendum increase in Euro-skepticism among Finns.

This interpretation was reflected in a survey taken in November 1993. Finns were weary of a European Union with too much power: 82 percent of those asked believed security and defense should remain primarily the responsibility of the Finnish government; 90 percent thought that health and social welfare policies should be decided by national governments (and not jointly with the European Community); 65 percent thought that industrial policy; 64 percent thought that value-added tax (VAT) rates, and 53 percent of those polled thought that the currency should remain in the hands of national, not EC governments (Ludlow, 1994). The Finnish general public, like many in Europe, is apparently leery of too much power centered in Brussels.

Table 4.2. Party Support for EC/EU Membership Before and After the Danish Veto

Left	Social Democrats	Green	Agricultural	Conservative	Total
<i>Before the Danish Veto (May 1992, percent)</i>					
For	42	65	69	46	85
Against	50	22	24	43	7
Other	9	12	7	11	8
<i>After the Danish Veto (June 1992, percent)</i>					
For	51	59	51	34	74
Against	30	26	27	50	14
Other	19	16	22	16	12
					18

Source: Lindström, (1992) 24-25.

During the referendum campaign, there was little explicit reference to monetary issues. Finns expect great economic gains from EU membership, but this optimism is attached more to the opportunities offered by the single market than to any dynamic potential of an EMU. On EMU, Finnish attitudes seem to be influenced more by the fears of capital flight, the extra incentive it provides for fiscal rectitude, and the hopes of restructuring the Finnish economy on a broader, more productive footing.

EMU support in Finland is complicated. Finland's exchange rate history does not speak well for its ability to embrace a common currency area. In the postwar period, Finland has relied heavily on exchange rate adjustments, and they have—by and large—been successful. Still, since the early 1980s, there has been a concentrated effort to try and move in the direction of more fixed rates of exchange; it may be that EMU membership will provide the extra confidence and support necessary to facilitate that move. Whereas the exchange rate picture is not clear-cut, the nature and strength of Finnish support for the EU suggests that voters will be willing to bear what adjustment costs are necessary to achieve EMU. Not only do they see great economic benefit from being associated with the other aspects of EU membership, but they are also willing to pay a large security deposit for protection against potential Eastern aggressors.

Economic Criteria

The economic prospects of participating in EMU can be evaluated in two ways. First, one can ask whether Finland will be able to satisfy the Maastricht criteria, and if so, when. The second issue concerns the structural character-

istics of the Finnish economy. If Finland's economy is not well integrated with the rest of Europe's, and/or if the Finnish economy is particularly susceptible to asymmetric shocks, the costs of participating in EMU can be quite large.

Convergence Criteria

The Finnish economy is in a shambles: Unemployment hovers around 20 percent. Still, Finland can be considered an honorary member of Europe's elite convergence club. In 1993, Finland was one of a handful of countries that actually met three of the four convergence criteria.⁴ Finland's record in terms of the Maastricht criteria is impressive, especially when one considers the severity of the current crisis (and ignores the exchange rate clause, as is the vogue). The debt figure in 1994 was within a whisper of the criterion, and two of the remaining three criteria were satisfied. Although the deficit remains a problem, there is broad consensus that this indicator also will fall within the criterion in the very near future. Indeed, the European Commission expects Finland's deficit to fall to 1.1 percent in 1996 and its debt level to hold steady at around 64 percent (Barber, 1995).

Nor is this record a single-shot performance: Finland has a history of fiscal conservatism. It is only with the enormity of the current crisis that Finland's debt burden has come even close to approaching the 60 percent (of gross domestic product, or GDP) level. Throughout most of the 1980s, Finnish government debt hovered around 20 percent.⁵ The same could be said for Finnish budget deficits, which stayed within the 3 percent of GDP margins throughout the entire postwar period—up to 1990. On the other two criteria, inflation and interest rates, the Finnish postwar period is less impressive. Still, over the past four years, the Finnish inflation rate has been held under the Maastricht criterion, and the same can be said for Finnish long-term interest rates after January 1993.

Thus there is little doubt that Finland can and will fulfill the convergence criteria in the very near future. The Organization for Economic Cooperation and Development (OECD, 1993a) calculated that more than 90 percent of the Finnish budget deficit was cyclical, mostly a reflection of the current economic crisis. The surge in public spending (from 40 to 55 percent of GDP from 1989 to 1992) is also a result of the crisis, as is the decline in public revenues (Söderström, 1993: 188–192). The government has accepted strict spending guidelines for the next few years, and to fulfill these it has made explicit and concrete decisions on how to reduce the deficit. Once the current, deep depression is over, Finland should be able to adapt fairly easily to meeting the demands of the Maastricht criteria. Indeed, Finland's economy may have turned the corner: Industrial output in 1995 grew

by 7.5 percent, and trade with the former Soviet Union (particularly Russia) is reviving.

Economic Structure

While Finland's record with respect to the convergence criteria is positive, the structure of its economy lends itself to rather severe asymmetric demand shocks. This section looks at Finland's economic structure from two vantage points: trade and production.

Like the other Nordic countries on the periphery of Europe, Finland relies on Europe as both a market for its exports and a producer of its imports.⁶ Forty percent of Finland's exports and 40 percent of its imports are with EU member states. Indeed, four out of Finland's top five export markets are within the EU: Germany (13 percent of all exports), Sweden (11 percent), the United Kingdom (10 percent), and France (5 percent). Still, the Finnish economy is less open than that of other small European countries, and its openness is decreasing. During the 1980s, Finland's ratio of exports (to GDP) fell from about one third to less than one-quarter (Currie, 1993: 106). In the share of both value added and employment, the Finnish tradables' sector shrank over the 1990s.

What may be more relevant is the type of export goods upon which the Finnish economy is most dependent. Table 4.3 suggests that the country is heavily reliant on the forest industry—in particular paper and paper products, but also cork and wood exports. Paper and paper products make up a quarter of Finland's total exports, significantly more than the percentiles for any of the other export goods. Studies of European trade structures and their interaction find Finland's trade structure, like Greece's, to be clearly different from the EU average.

Another way to measure export dependence is in terms of the proportion of total manufacturing that goes to export. Although production and export figures are not completely complementary, Table 4.4 attempts to gauge the share of manufactures that is exported in some of Finland's most significant industries.⁷ Table 4.4 begins like the previous table by listing the five most important export industries for 1992 (at the two-digit SITC level). It then gives the nearest production equivalent, measured in ISIC terms. Comparing these two gives us a rough estimate of how much of an industry's production goes to export. For Finland's most significant export industry (paper and paper products), nearly 60 percent of production is exported. This industry also represents a substantial percentage (18.5 percent) of industrial employees in Finland (*Yearbook of Nordic Statistics*, 1994). Indeed, this sector represents the largest industrial employer at the two-digit ISIC level in 1992. In short, the nation's

Table 4.3: Five Most Important Finnish Export Items, 1993

SITC Product Group	Description	Export Share (percent)
64	Paper and paper products	25
67	Iron and steel	6
72	Specialized industrial machinery	6
76	Telecommunications equipment	5
24	Cork and wood	5
Total export share of all five products		47

Source: *Yearbook of Nordic Statistics*, (1995).

Table 4.4: Top Five Export Industries and Export Composition of Manufacturing, 1992

SITC Code	Export Industry Description	Share in Total Exports (percent)	Nearest Product Equivalent	
			ISIC Code	Description
64	Paper, paper products	26.7	34	Paper, paper products
67	Iron and steel	6.3	371	Iron-steel, basic industry
72	Specialized machinery	5.1	n/a	
24	Cork and wood	4.7	n/a	
78	Road vehicles	4.6	384	Transport manufacturing

Note: The ranking of export industries differs from that in Table 4.3 because in 1992 "road vehicles" was a more important export industry than "telecommunications equipment."
Source: *Yearbook of Nordic Statistics*, (1994, 1995).

employment and economic dependence on these export sectors is quite large, especially in the paper and paper products industries.

Another way to capture the degree of economic integration is to try to measure a nation's reliance on intraindustrial and interindustrial trade. The study by Assarsson and Olsson (1993) used in the Swedish case also included Finland, so its results are directly comparable. Using a Grubel-Lloyds (GL) index for measuring the degree of intraindustrial trade (see chapter 9 for details), they found Finland to be modestly placed among its European brethren: below Sweden, Denmark, and Britain, but above others such as Greece. Like Sweden, only more so, Finland's large export of forest industry

products handicaps its ability to score highly in either the GL or the reinindustry indices. Like the other Nordic countries, the Finnish economy is not particularly well integrated or diversified compared to other West European economies.

Finland's economy is highly susceptible to negative external demand shocks because of its overreliance on forest industry exports. On this point there is fairly broad consensus. The price of timber products fluctuates widely in world markets and is affected significantly by the dollar's value. Price slumps can be exacerbated by a low dollar level because a low dollar will increase the supply of timber and paper products from North American producers, depressing world timber and paper prices in European currency terms. Maintaining fixed exchange rates to a basket that does not include the dollar will exacerbate booms and slumps in the Finnish economy.

However, studies that have looked at the symmetry of shocks between Finland and specific EU member states have found their relationship to be more nuanced than the export figures might suggest. In particular, Finland's shocks with respect to Europe's core economies (Germany, France and the United Kingdom) appear to be predominantly symmetric. Haaparanta and Heinonen (1991) found this to be the case, although they found that asymmetries increased during the 1980s.⁸ These conclusions were supported (at least with respect to the core economies) by Tarkka and Åkerholm's (1992) study, although they found significant asymmetric disturbances between Finland's economy and some of Europe's more marginal economies (for example, Denmark, Portugal, Ireland, and Greece).

Thus the structure of the Finnish economy, as it now stands, would not appear to support an argument for participation in a future EMU. Finland's reliance on forest industry exports—an industry that experiences volatile price movements, and is influenced by the value of the dollar—suggests that Finland will pay in terms of exaggerated business cycles without recourse to exchange rate adjustments.

The lessons here are mixed. On the one hand, Finland's ability to quickly reach the Maastricht criteria suggests that the cost of adapting during the transition period to a single currency will be relatively small. The costs are small, because these are decisions that would be made regardless of the convergence criteria: Finland's fiscal history is a conservative one. The social and employment costs can be considerable. On the other hand, should Finland enjoy the rewards of meeting the criteria and become a member of EMU, the costs may be quite large. If the Finnish economy does not go through a radical, structural transition at the same time, its overreliance on forest industry products is likely to exacerbate the Finnish boom-bust cycle.

Institutional Setting

My primary concern here is to investigate the degree to which specific institutional cleavages in Finland can be expected to facilitate or handicap the move to EMU and its performance afterward. While the focus of my investigation is on labor market institutions, the end of the section investigates the potential for both bureaucratic and political party cleavages.

The Finnish labor market—like the Swedish, and in contrast to those in much of the rest of the world—is characterized by high levels of unionization and centralization under peak bargaining organizations. Finland's bargaining coverage rate is 95 percent, second only to Austria (at 98 percent), while 72 percent of its labor force is unionized (Traxler, 1994: 173). More than in Sweden, economy-wide bargaining is entrenched in Finland: Peak associations of employers and employees negotiate package deals on wages and prices as well as economic and social policy. The degree of coverage and coordination is such that Traxler describes Finland's capacity for implementation as "high" (Traxler, 1994: 175).

The Finnish labor market, however, is unique in that its peak labor organizations are split along ideological lines—which happen to correspond with different sectors of the economy. This division has not only made the attainment of centralized agreements more difficult (and tardy; in the Nordic context, Finland's move to centralized bargaining was quite late), but it also has led to some lack of discipline among collective bargaining partners. Thus some of the benefits of collective, centralized bargaining have been lost because of the internecine struggles among unions.⁹

Workers in Finland's private sector are mainly organized under four umbrella organizations: the Central Organization of Finnish Trade Unions (SAK; about 60 percent of unionized employees), the Confederation of Salaried Employees (TVK; about 21 percent), the Finnish Central Organization of Professional Workers (Akava; about 12 percent) and the Confederation of Technical Employees' Organizations in Finland (STTK; about 7 percent). Both ideologically and organizationally, the labor movement is divided broadly into a Social Democratic majority and a strong Communist minority. Trade union leadership, both in the central unions and in most branch unions, is in the hands of the Social Democrats. The principal Communist-led unions are those organizing the construction and foodstuffs industries; however, the Communists are active also in a number of other industries. On the employer side of the Finnish equation, there are two major organizations: the Finnish Employers' Federation (STK) and the Employers' Confederation of Service Industries (LTK). Together these two organizations cover over 60 percent of private sector employees.

Since 1977, these institutions have been formally linked to, and informed about, exchange rate policy decisions. In that year, the SAK would accept the terms of a comprehensive wage agreement only if it contained a devaluation clause. The Bank of Finland was strongly opposed to this clause, but its resistance was in vain. The eventual agreement called for the initiation of negotiations between labor market representatives on the possible compensation of wage earners in the event of a substantive devaluation (Wärts, 1979). As a result, wage-earner organizations are both aware of and instrumentally involved in decisions regarding exchange rate adjustments.

What is the effect of this institutional framework? For present purposes, the most important consequence of this would be whether it can facilitate the adjustments that will be required in EMU—given Finland's rather unique economic structure. In particular, does the high degree of coverage facilitate greater or less wage flexibility?

Characterizing the flexibility of national labor markets is not easy, and I have applied some of the same measures used in Chapter 9 to try to find a comparable measure of wage rigidity in the Finnish economy. As Table 4.5 suggests, Finnish real wage growth greatly outstripped productivity increases throughout most of the past two decades. Compared to the other Nordic countries, Finland scored exceptionally low in terms of the discrepancy remainder. Although the difference between product real wage and productivity growth rates appears to be diminishing, by 1987 the Finnish record was still disturbing. Yet the picture may be changing. During the mid-1990s, because of the depression, there have been no negotiated collective pay rises. Because of the carry-over effects and a small wage drift, wages and salaries did rise by one percent over this period, but real wages in Finland actually declined. (See *Nordic Economic Outlook*, 14 February 1994, p. 9.) Neither did the 1991-92 depreciations lead to immediate compensatory wage claims, as might have been expected.

Christian Bordes (1993) has investigated the degree of wage flexibility in Finland. He found that the country has a particularly high value of elasticity for its nominal wage rate with respect to inflation, and a relatively high value with respect to unemployment. Compared to other OECD economies, Finland has the highest value for its elasticity of nominal wage rates with respect to inflation. These conditions facilitated the devaluation cycle: The economy adjusted to negative shocks with a deterioration in employment. This, in turn, slowed nominal pay increases. The adjustment itself was facilitated by the high elasticity of nominal wages to unemployment (Bordes, 1993: 83).

This is not to suggest that the centralized bargaining structure in Finland can be held responsible for the current economic difficulties. Throughout the 1980s, this system delivered rather moderate wage increases, even during the boom conditions that followed the liberalization of

Table 4.5: Finnish Labor Productivity and Real Wage Development in Manufacturing

	1967-72	1973-77	1978-83	1984-87
Product real wage growth	6.4	5.0	3.8	5.0
Productivity Growth	4.8	-0.4	4.8	5.0
Discrepancy	1.6	5.4	-1.0	0.0

Note: Data are average annual percentage change.

Source: Calimtors (1990b), p. 24.

Finland's financial markets. Indeed, Finland's share of total wage costs to national income actually fell throughout the 1970s and 1980s, boosting the Finnish profit levels. Wage shares increased only after the Finnish output fell off, suggesting that the country's high wage share is a consequence, rather than a cause, of the current slump (Currie, 1993: 123).

The relevant question is: How will wages be affected by EMU? The lessons here are more encouraging. If we assume that the EMU will be inflation adverse, Finland's high nominal wage elasticities with respect to inflation will be less problematic. More important, should Finland be hit hard by an asymmetric demand shock, such that unemployment levels begin to rise, we can expect fairly strong nominal wage drops (due to the strong negative elasticity of nominal wages with respect to unemployment). This is significant, as the burden of adjustment costs within EMU most likely will be borne on the backs of workers. Under these unique conditions, one might suggest that Finnish labor benefits from lower wages.

Two other institutional legacies in Finland are significant with respect to movement toward EMU. First, divisions between the Finnish central bank and government over the necessity of fixed exchange rates have been developing for some time. This difference came to light in 1991, when the markka was linked to an ECU basket. The then central bank governor, Rolf Kullberg, forced the hands of the government on the issue: He unexpectedly announced in a press conference that Finland would benefit by following the Swedish example (in linking to the ECU). Eventually—in the beginning of 1992—Kullberg was forced to resign, taking with him much of the credibility of Finland's hard-currency policy.

Whereas the government may have won its 1992 skirmish with the central bank, its victory was almost certainly pyrrhic. In order to participate in the third stage of EMU, legislation governing Finland's bank will have to be reformed significantly—granting it more independence. In the short to medium term, then, the central bank and its long-standing preference for fixed rates will benefit. Eventually, however, this hard-won independence might be lost in the halls of the European Monetary Institute (EMI). In this

way, the recent division between the central bank and the government will be of historical interest only. For the time being, both the government and its central bank have their sights set on EMU.

The final arena in which we might expect institutional division is the political one. But, as in Sweden, this does not appear to be so. During the February 1995 general election campaign, for example, all of the main parties appeared to compete with one another in terms of fiscal virtuosity: Each promised its own ambitious cuts to public expenditures. The result, Paavo Lipponen's "rainbow" government, found broad ideological support for deep cuts in public expenditures and its balanced budget ambitions.¹⁰ The depth of the current crisis seems to have numbed Finland's ideological senses. Indeed, recent history suggests that ideological divisions may be less than relevant for understanding fixed or floating preferences. On the decision to link to ECU, for example, another government itself was split along sectoral lines (within the parties): While the finance minister was in favor of linking, his colleagues from the same Conservative Party were opposed (Moses, 1997).

Despite the fact that Finnish labor market conditions were not particularly well suited for utilizing frequent devaluations, devaluations were the hallmark of Finnish postwar adjustment strategy. Apparently, however, these labor market institutions will not hamper the move to EMU, and they may even thrive under those conditions. Other institutional divisions appear to be less significant, and are more likely ephemeral in nature.

Distributional Consequences

Here I ask what the move to an EMU might entail in terms of distributional consequences. In particular, there are two overlapping distributional concerns: one sectoral, the other more wide-ranging. At an even more general level, however, the anti-inflationary discipline imposed by EMU membership will act as a serious constraint on labor in those industries where the bargaining power of trade unions is strong. EMU, combined with free trade and factor mobility, will tend to equalize the prices of input factors between participating countries. As labor is less mobile than other production factors, relative production costs within EMU will be determined largely by unit labor costs. So, while the institutional framework of the Finnish labor market will not hamper moves to EMU, participation in a monetary union will limit the bargaining power of labor (*vis-à-vis* capital) within those institutions. In addition to this general tendency, however, we can expect sectoral and social cleavages to develop.

Providing an overview or survey of partisan and societal interests in Finland on monetary issues is not an easy task. Not only are such issues kept

out of the light of public debate; the institutional arrangement in Finland (among Finland's central bank, the Parliamentary Supervisory Board, and the government) allows these decisions to be made by a small group of relatively autonomous actors. Interest rates, exchange rate policy, and monetary policy in general have been described traditionally in technical, apolitical terms.

Having said that, two important sectoral interests predominate in the battle for Finnish monetary policy (and hence in the fight for support of EMU): those more traditional interests that benefited and actively encouraged a Finnish adjustment policy based on frequent exchange rate adjustments, and those more nascent interests that want to pursue a fixed rate policy in order to discipline wage earners and encourage investments in high-tech industries.

The forest industry sector in Finland has enormous political and economic resources at its disposal.¹¹ With these resources it has been able to influence monetary policy and has benefited tremendously by Finland's active devaluation policy. This reliance on devaluations has, however, undermined the price competitiveness of labor-dependent productive firms in the nascent Finnish high-tech sectors. These industries argue that frequent devaluations encourage continued investment in the forest industry sector at the expense of other sectors. The original hope of the fixed exchange rate strategy (since 1982) was that it would aid in diversifying the Finnish economy: to force a move out of the forest and into more high-tech industries.¹² These industries benefit less from a devaluation strategy and are more dependent on domestic wage competitiveness. Although the original strategy failed, the new push for EMU in Finland can be seen as a second attempt to employ this sort of diversification strategy. Should this strategy prove successful, distributional consequences along sectoral, and hence regional (that is, rural-urban), lines can be expected.

The organization of Finland's peak union affiliations also provides some interesting insights into sectoral interests with respect to support for a potential EMU. As mentioned earlier, unions are divided along sectoral and ideological lines. This division provides us with an opportunity to see how different sectors react to a given monetary policy (at least among organized workers in that sector). These divisions can be seen in the 1991 "Sorsa proposal," which called for a 7 percent wage cut instead of a devaluation. While the closed sector unions preferred this proposal, exposed unions were vehemently opposed, preferring instead an equivalent devaluation. In the end, the exposed unions were strong-armed into conceding, but there was a great deal of uncertainty during the industry-level bargaining round. The threat of exit haunted the whole process. Eventually, because of a run on the reserves, the central bank devalued, and the markka fell by 15 percent.

As a result, the Sorsa proposal collapsed. However, the proposal—and the divided response to it by closed and exposed sectors—shows how salient these sectoral divisions can be, given institutional fortification and an appropriate venue.

The second main distributional concern is the potential effect on unemployment. Traditionally, Finns have been less willing than their Nordic neighbors to employ counter-cyclical solutions to economic woes; the result is an acceptance in Finland of a higher rate of unemployment than in either Norway or Sweden. It was not peculiar to run the Finnish economy at the 5 percent unemployment level throughout most of the 1980s. However, in recent years there has obviously been a very large shock to the economy; Adjustment will require some time and resources.

As many of the economic costs to fulfilling the convergence criteria are being paid already, the additional costs of bringing the budget deficit into line will be minimal (at least in political terms). There is a fairly broad and historical consensus in Finland over the need to maintain fiscal conservatism and pursue classical/neoclassical solutions to the country's economic problems. The Ministry of Finance's medium-term survey from February 1993 predicted that unemployment would remain at 12.5 percent in 1997 (Currie, 1993: 141). This is a phenomenal social cost to be paid, but one that cannot be mitigated given the overriding ambition to meet the demands of a balanced budget.

The Finnish policy model always has emphasized supply, cost, and competitiveness factors; it might even be described as anti-Keynesian. Until recently, the state was nearly always a net saver; it fostered savings and generally avoided loan financing. Throughout most of the postwar era, Finnish fiscal policy has been strongly pro-cyclical. Although the picture began to change in the 1980s, the tradition of fiscal conservatism is long-lived in Finland. Fiscal adjustment is perceived as necessary, regardless of the Maastricht criteria, and the political costs of budget cutting (although high in a period with overwhelming unemployment levels) are affordable.

Linkage Issues

Because of the historical and economic arguments against Finnish participation in EMU, support for EMU is generated by linking it to issues that are more important to Finnish voters. In particular, participation is seen as part in parcel of three larger policy issues: political participation, economic restructuring, and as an incentive to attract increasingly mobile finance capital.

Politically, support for EMU is linked to participation, more generally, in the European Union. As mentioned earlier, Finns support EU membership

for a variety of reasons, and full membership—in all EU projects—is seen as a necessary and important element in convincing others of their new geopolitical position. But political support need not be read only in security terms. For the time being, there is great hope that participating in the EU will bring about the investment and employment sparks currently lacking in the Finnish economy. While the 1992–93 depreciation has helped to increase competitiveness in Finland, there remains a great deal of uncertainty. Because of this, the fortunes of Finland's economic and political future have been tied to the hope of an economic recovery in the rest of Europe. The sagacity of this decision remains to be seen. Politically, however, there is great support for European solutions. In contrast to Sweden, Finns have maintained optimism about the EU. Polls taken in June of 1995 showed stable support for EU membership, with 55 percent of the people polled being "fairly satisfied" with membership and 40 percent being dissatisfied (Carney, 1995b). These results were close to those of the referendum outcome in October 1994, where 56.9 percent supported membership.

In addition, as is the case in many other countries, there is a hope that Finland may have some say about the nature of European monetary policy in the European Central Bank. Under contemporary economic conditions, Finns have effectively lost control of their monetary policy. Because of the increased mobility of finance capital, it has been difficult for them to maintain confidence in, and support for, their basket-pegged exchange rates. Popular opinion has it that Finnish monetary policy is now being made in Germany. The hope is that participating in EMU will return some element of Finnish control over the interest rate policies that affect the domestic economy.

The second main linkage issue has to do with restructuring the Finnish economy. As previous sections have alluded to, participation in EMU is seen as bitter but necessary medicine for improving the health of the Finnish economy. In Finland there is broad consensus about the importance of further integrating with the rest of Europe. Economic integration is seen as the only hope for escaping from the threat of economic volatility. With the collapse of its near-monopolistic trade relationship with the Soviet Union, Finland is facing a world economy that demands higher product standards than did the Soviet Union and it remains an export economy in search of a market. Almost overnight, Finland lost its principal supplier of cheap energy. Membership in the EU, with its generous transition funds, is seen as a means of restructuring the Finnish economy to meet the needs of a new, more demanding marketplace. Participation in EMU is seen as a significant element in this restructuring process.

Over the past decade, there has been a general recognition of the need for the Finnish economy to move away from its heavy dependence on the

forest industry sector and into a more diversified, more production-based economy. Forsman, Haaparanta, and Heinonen (1993) argue that an active exchange rate policy, like the one Finland pursued throughout most of the postwar period, accommodates negative demand shocks for key export industries; but in so doing, it also may prevent an economy from achieving a higher degree of diversification by blocking structural change. As we saw earlier, devotion to a new fixed-exchange-rate regime is one important aspect of a policy designed to spur diversification.

In order to meet the requirements of the European Common Market and maintain competitiveness, Finland has had to streamline its trade and subsidy policies, liberalize large segments of its economy, and reorient its export outlook. As Finland has the most liberal (that is, noninterventionist) of the Nordic economies, this transition might have been less painful for it than for the others—had it not been for the severe depression. Preparing for European integration, although painful, is seen as part of the necessary costs of re-orienting the Finnish economy in a more westerly direction. One main element of this restructuring plan has to do with the final linkage item: attracting European investment capital.

Although the most recent depreciation has not prompted inflation, fears of previous devaluation cycles still haunt the Finnish investment environment—at least that part of it which is potentially mobile. In the middle of the 1980s, Finnish companies rapidly began expanding their foreign direct investments in Europe both in reaction to the Single European Act and out of concern that the government would return to its devaluation cycle. By the late 1980s, every third marka was invested abroad by a handful of major Finnish international firms. In the 1990s, the outflow has decreased, but it is still substantially higher than the inflow (Väyrynen, 1993: 70).¹³ It is hoped that participation in EMU will stop the outflow of Finnish capital. (See Figure 4.1.)

Curiously, the devaluation cycle may have contributed to Finland's relatively high level of general investment; its removal as an instrument could have drastic consequences on domestic investment. The earlier environment was described by Korkman (1992: 289): "A common interpretation is that there used to be an 'implicit understanding' between industry, the forest industry in particular, and the central bank, that investment activity should be strong, and that, as part of such a policy, the exchange rate would be devalued if this was necessary to ensure some minimum return on investment. Arguably, this is one explanation for the high investment ratio which has been characteristic of the Finnish economy. . . ."

Thus more mobile investment capital—fearing future devaluations—has begun to flee. The remaining investment capital can no longer expect to benefit from future devaluations. Arguably, the Finnish investment climate

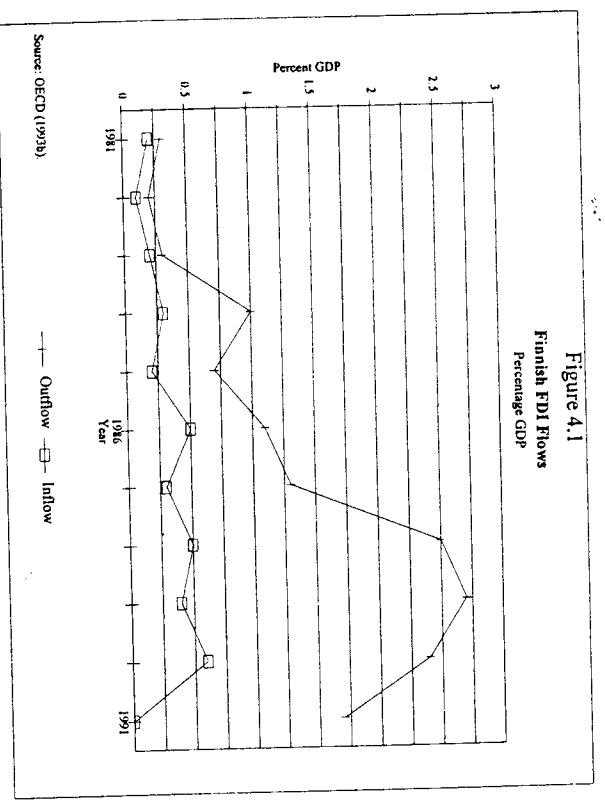
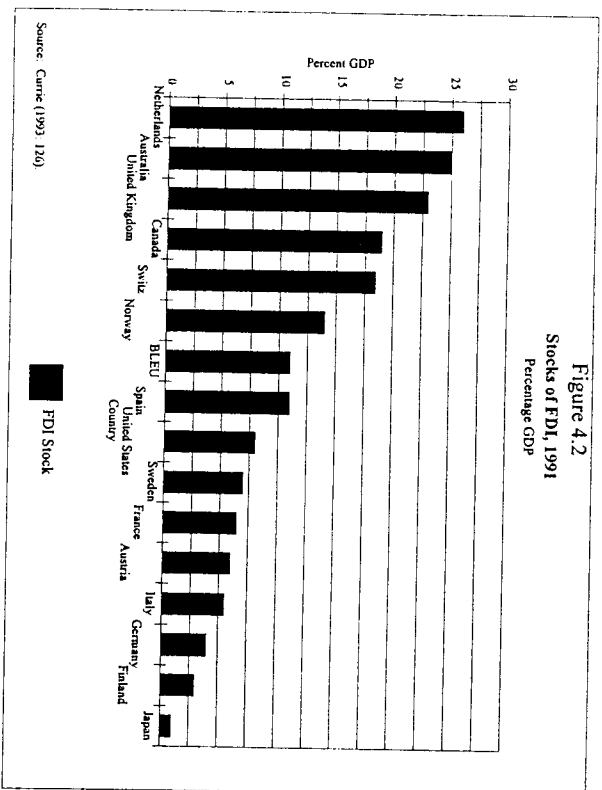


Figure 4.1
Finnish FDI Flows
Percentage GDP

Source: OECD (1993b)

is in transition. During this transitional period, until more mobile capital pools can be encouraged to return to the country, the domestic investment environment looks dim. The difference, unfortunately, has not been made up for with stocks of inward foreign direct investment (FDI). In this regard, the Finnish case is strikingly deviant: Finland has a very small stock of FDI. (See Figure 4.2.) Thus EMU participation could be seen as part of a larger strategy to minimize the potential risks for foreign capital in an attempt to attract more of it.

As a result of the overlapping (as opposed to crosscutting) nature of Finnish political, regional, and ideological cleavages, there remain strong sectoral and societal pressures for future devaluations. How these will be played along the road to EMU remains to be seen. As in the rest of the Nordic region, financial markets in Finland are small, young, and relatively unfluent. The strongest advocate for EMU membership is (and will remain) the Finnish central bank. For the Bank of Finland, EMU membership will finally provide a firm nominal constraint on Finnish wage earners and eager governments—a policy for which it has been arguing over several decades. It also will relieve the bank from (traditionally strong) governmental and industrial pressure to devalue. In this policy, the central bank has converted most of Finland: Finns are willing and confident that they will be among the first group of countries to constitute the EMU.



Conclusion

In conclusion we might ask: What are the costs of Finnish membership in EMU, and what is the likelihood of Finland achieving membership, given those costs? As is the case with many of the other countries discussed in this volume, answers to these questions are difficult and subtle. Economically, there are strong arguments against Finland's joining EMU. Politically, there appears to be strong support for participation. How can these differences be reconciled?

From a historical perspective, the conclusion is quite clear: Finns always have relied on flexible exchange rates. Unless there is a radical transformation of the Finnish economy, participation in EMU will be very costly. Finns have developed other adjustment mechanisms in the past and have become heavily reliant on them. The reason for this reliance on exchange rate adjustments is clearly demonstrated in the unique production and export structure of the Finnish economy. Overdependence on a specific export sector, forest products, makes the Finnish economy terribly susceptible to asymmetric demand shocks. Without recourse to adjustable exchange rates, the Finnish economy—should it not undergo a radical restructuring—will have to rely even more heavily on unemployment and wage flexibility as mechanisms for adjusting to these shocks.

The key element of the economic analysis is locked in the phrase "unless there is a radical restructuring or transformation." This is where the political argument enters and takes center stage. In Finland there are strong political pressures for just that sort of economic restructuring. Using the collapse of the Soviet market as an excuse and an engine for change, Finland hopes to begin rebuilding its economy on a broader, more Western-oriented export foundation. Participation in the European Union and its EMU are seen as important elements in that restructuring drive.

Because of these ambitions, there is an apparent willingness to pay what could amount to be very significant social costs of transformation. To be fair, the alternative—maintaining an overdependence on the forest industry—could be equally costly as the fortunes of this industry are notoriously cyclical. Still, Finland's economic past does not bode well for membership in a European currency union. Restructuring will mean that adjustments to international demand shocks will be taken from the macropolicy arena and forced down to the microlevel: onto the pay slips of wage earners. Thus, in the long run, participation in EMU is linked to a strategy for restructuring the Finnish economy. This strategy, in turn, will depend on the ability of Finland's elites to maintain political support for a transformation that will be both enduring and costly.

Notes

1. I would like to thank Jeffrey Frieden and Erik Jones, along with all of the other members of the EPG, for their comments and suggestions over the many drafts of this chapter. Of course, I alone remain responsible.
2. Specifically, they were: Martti Ahtisaari (Social Democrats), Paavo Väyrynen (Center Party); Raimo Ilaskivi (Samlingspartiet; the Conservative Party); and Elisabeth Rehn (Swedish People's Party).
3. Politically, agrarian interests have been more powerful in Finland than in the other Nordic countries. See Andersson, Kosonen, and Vartiainen (1993).
4. The members that met three of the four criteria (none met all four) in 1993 were: France, Ireland (exempted debt), Luxembourg, the Netherlands, and the United Kingdom.
5. According to Bank of Finland figures, about half of the central government's debt is denominated in foreign currencies.
6. Unless otherwise noted, the figures in this paragraph are from *Yearbook of Nordic Statistics* (1995).
7. In 1992, the most recent year for which we have comparable statistics, Finland's export structure changed from the year after (1993). In 1992, Road

Vehicles were more important than Telecommunications Equipment in Finnish export terms. Contrast Table 4.3 with Table 4.4.

8. These asymmetries, the authors argue, are probably the result of the relatively late deregulation of the Finnish financial sector; the radical change in Finland's eastward trade; and, of course, dependence on the forest industry.
9. Industrial negotiations did not really become centralized until the 1960s, since which time they have taken on several of the characteristics of the Swedish and Norwegian models. See Golden and Wallerstein (1995).
10. Though Liponen, the prime minister, is a Social Democrat, his crisis government included Conservatives, Greens, and former Communists.
11. In 1992, the manufacturing of paper and paper products alone (SIC 34) accounted for 20 percent of all Finnish industrial production and 12 percent of Finnish GDP (*Yearbook of Nordic Statistics*, 1995).
12. Two examples are almost universally presented as the sort of firms that the adjustment policy was supposed to encourage: Nokia (a high-tech, electronics firm) and Kone (a forklift producer).
13. Väyrynen notes that in 1992, Finnish companies invested about 8.9 billion markkas (net) abroad, while a total of 1.7 billion was invested in Finland.

CHAPTER FIVE

Greece and EMU

Miranda Xafa¹

This chapter addresses a number of issues in assessing Greece's prospects for convergence with the European Union and its integration in EMU:

- Is Greece a good candidate for monetary union with the rest of the EU based on the criteria set out in the optimum currency area literature?
- What drives positive sentiment toward EMU and support for the "hard drachma" policy?
- How far is Greece from fulfilling the convergence criteria laid out in the Treaty as a prerequisite for joining EMU?
- What are the prospects for, and obstacles to, convergence?
- Does compliance with the fiscal convergence criteria ensure convergence?

Political Economy Considerations

Support for membership in the European Community (EC) in public opinion and across political parties has increased significantly since full membership in January 1981. (See Figure 5.1.) Public opinion turned mildly negative with the election of a Socialist government in October 1981, which denounced the European Community (and the North Atlantic Treaty Organization [NATO]) on grounds of conspiring to reduce Greece's sovereignty. Nonetheless, growing transfers to Greece from the EC structural funds and agricultural support funds subsequently helped increase public support for membership.

The deepening of European integration with the Single Market program and the Maastricht Treaty, the collapse of the Soviet Union, and the end of