



Antti Kuusterä & Juha Tarkka

BANK OF
FINLAND
200
YEARS

PARLIAMENT'S
BANK

II



EUROJÄRJESTELMÄ
EUROSYSTEMET

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One of the greats of economics, Joseph Schumpeter, compared money to a veil that obscures what is real and important in the economy, but the history of central banks shows that this veil can expose more than it conceals. The progress of monetary policy, with its twists and turns, tells much about the forces that drive the economic and political life of a nation. Writing this 200th anniversary history of the Bank of Finland has been more than the study of a single institution. It has been a gripping and challenging expedition into the annals of Finnish society.

The confluence of economics and politics at the Bank of Finland over two centuries is expressed in the names of the two volumes of this work. The essence of the first period was Finland's institutional and economic development into an independent nation but, at the same time, its integration into the world economy. The evolving status and operations of the bank are expressed in the name of the first book, *Imperial Cashier to Central Bank*. This second volume, which we have entitled *Parliament's Bank*, focuses on the period from the outbreak of World War II to the early years of Finland's EU membership. It was a time when economic operations were increasingly subject to political influence, a stage that served to give parliamentary parties and government policies a growing role at the Bank of Finland. We have tried to avoid a narrow, economic approach and to present central bank monetary policy against its political backdrop. Another context essential to an understanding of this period has been the development of the international monetary order.

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as well as the Bank of Finland's chief archivist Vappu Ikonen. We would like to express our thanks for their valuable advice.

Although we have sought to present the Bank of Finland's operations in their national and international context, most of the original source material used has come from the bank itself. We have enjoyed unfettered access to its archives and unstinting aid from its archive and library staff. As the project comes to a close, we must thank them once again. We have been assisted in editorial work and in drawing up tables and diagrams by Petri Uusitalo, with Tarja Yrjölä, Teresa Magi and Päivi Nietosvaara. In the search for statistical material we have turned to Nina Björklund, Jonna Elonen-Kulmala and Essi Tamminen. There are others, too, who have generously supported our work.

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The acknowledgements of the first volume already expressed thanks to the board of the Bank of Finland for the opportunity to work on this major project and for the confidence they have shown in us. Now that the second part is completed, there is all the more reason for gratitude. As events move closer to the present day, the amount of material available steadily grows but so does the diversity of perspectives. Even in this situation, where objectivity is harder to achieve, the board has granted the authors complete academic freedom. It is therefore natural that the opinions expressed in the book and the interpretations of past events are not necessarily the official viewpoint of the Bank of Finland, but our own.

Helsinki 13 May 2012

Antti Kuusterä Juha Tarkka

TURN OF AN ERA

This second volume of the 200-year History of the Bank of Finland examines national monetary policy and central bank operations from the outbreak of the Winter War until the mid-1990s, when Finland joined the European Union and, soon after, linked its currency to Europe's Exchange Rate Mechanism. The span of almost six decades forms a coherent period that is sharply differentiated from the history of the bank hitherto. It bears separate analysis, almost without reference to the events and developments that preceded the war.

The Second World War and the ensuing years were times of great turbulence for Finland in general and the Bank of Finland in particular. Until 1939 the bank had operated in ways that largely evolved during the 19th century, with the gold standard and economic liberalism. Its chief foreign models had been the central banks of Great Britain, France and Sweden. Finland's money and foreign exchange markets had operated freely, with negligible official regulation. The Bank of Finland had pursued very independent monetary policy; its separation from the government had been axiomatic. In accordance with classical central banking principles, its lending was mainly against short-term commercial bills of exchange. It did not finance public spending, even if its investment portfolio did contain some bonds issued by the Finnish government.

Although Finland, like the other Nordic countries and Britain, had been forced off the gold standard in 1931, the instruments and aims of monetary policy on the eve of the Second World War were still practically unchanged. The Bank of Finland used the rate at which it lent against bills of exchange (discount rate) as its main monetary policy tool, by which it managed the lending rates of Finnish banks. Since the deflation of the early 1930s, it had managed to stabilise the

national price level, avoiding strong inflation and deflation alike. For several years, foreign trade had been so strongly in surplus that most foreign loans had been paid off and the foreign exchange reserves had mounted. In its exchange rate policies, Finland had, soon after leaving the gold standard, fixed the value of its markka firmly to the British pound sterling. This peg endured until the Second World War.

The shift from the old era to the new could hardly have taken place in more dramatic circumstances. On the morning of Friday 1 December 1939, Finance minister Väinö Tanner stepped through the main door of the Bank of Finland on Snellman Square. He was on his way to meet Risto Ryti, seeking to persuade the bank's governor to resign and take up the position of prime minister. Their talks were interrupted by the arrival of the president of the republic, Kyösti Kallio, who was on the same mission.

The day before, war had broken out between Finland and the Soviet Union. The Red Army had crossed the border early on Thursday morning and Helsinki had been bombed. On the first day of the war, the government of Prime minister A. Cajander had received a vote of confidence in parliament but, behind the scenes, Finance minister Tanner was already working to convince his own Social Democratic Party, and then the leaders of the other ruling parties, that a change of government was essential to pave the way for peace talks. Both Tanner and President Kallio believed that the ideal candidate for prime minister was central bank governor Risto Ryti.

Ryti had headed the board of the Bank of Finland since 1924. During his long term of office, the bank had become the unchallenged leader of Finnish economic policy. Its financial position and the standing of its governor were beyond question. It was a sign of the esteem enjoyed by the governor that, at a critical juncture in wartime, he was asked to take on the mantle of prime minister. Both people who came to petition him were, in their ways, men of the Bank of Finland. Kyösti Kallio had spent a decade on its board before being elected to the presidency in 1937. Väinö Tanner had served as chairman of the supervisory council since 1933.

Risto Ryti saw himself as a banker first and foremost. He was initially reluctant to become prime minister but, when president Kallio continued their meeting into Friday afternoon, he finally agreed. The

government was quickly formed and appointed on the same day, and held its first session the day after. Because of the danger of bombing, it convened in the gold vault of the Bank of Finland. Ryti's close colleague on the Bank of Finland's board, J.W. Rangell, was appointed acting-governor in his place.

The events of early December foreshadowed how the outbreak of war would affect the position of the Bank of Finland. Its almost total independence from the government came to a practical end. In particular, most operations of the Finance ministry were merged with those of the central bank for the duration of the war. The previous disinclination to provide money for the government had to be set aside and the Bank of Finland began to cover public expenses by printing money on a large scale. Moreover, the far-going regulation of wartime economic life left hardly any room for monetary policy in its traditional forms. Meanwhile, currency rationing brought the bank many new practical duties, which endured and increased long after the war had ended.

The 1940s marked the start of an entirely new era for the Bank of Finland because the climate for monetary and foreign exchange policies did not revert to its former state when the war ended. Even after peace had been restored, the bank's role and environment remained different in many ways from the pre-war period. One reason was that the international monetary system had changed. There was no return to the gold standard, which was replaced by the Bretton Woods system, founded on the dollar and overseen by the International Monetary Fund. Efforts to restore complete convertibility between currencies met unanticipated obstacles; in many countries various exchange controls were still in force decades into peacetime. Finland continued general rationing of foreign exchange for a long time, which emphasized its role as a rationing authority among the tasks of the Bank of Finland.

The setting for monetary policy was changed not only by international conditions but also by the internal transformation of Finnish society. The main feature of this change, for the Bank of Finland and economic policy in general, was that after the Second World War Finland became a kind of corporatist economy, where organisations representing the interests of different social groups took a leading role

in economic management. Labour unions, employers and agricultural producers were some of the groups represented in this way. It was an abrupt change from Finland's previous economic system. Organized interest groups came to play a strong role in setting wages, agricultural policy and pricing, the latter meaning the area of economic policy consisting of price controls, taxes and subsidies. Import controls, which remained very important in Finland until the end of the 1950s, were also often subject to negotiations between the government and interest groups.

Finnish corporatism was born and became established during the regulated conditions of the war and subsequent reconstruction. The government's authority to impose controls led to an unprecedented politicisation of prices and wages after the close of the Second World War. During the reconstruction period, regulations were gradually relaxed and, by the end of the 1950s, most controls over business had been dismantled but, even in the 1970s, the government still had significant powers to intervene in the pricing of consumer goods and the like. This model, typical of a corporative economy, endured in Finland even after deregulation. Price and wage policies developed into incomes policy, a set of collective agreements aimed at curbing cost pressures and inflation. Incomes policy closely involved not merely interest groups but also the government, which participated via taxes, subsidies, social policies, and so on.

A corporative economy meant, on the national level, an organised struggle over income distribution. It manifested itself in ways that varied according to circumstances, from broad social accords to open conflicts. The Standstill Agreement of 1951 and the Liinamaa Pact of 1968 are examples of the former; the 1956 general strike was a case of the latter. The organisational struggle over income distribution naturally involved party politics, too. The generally short-lived governments of Finland from the 1940s to the 1970s often collapsed over disputes concerning price and wage policies. Until the 1970s, fierce rivalry between the Communists and the Social Democrats for influence in the labour union movement brought extra tension to Finnish corporatism.

From the perspective of the Bank of Finland, the transition from a market economy to a corporatist economy had a particularly strong effect on the use of interest rates. As this volume will show, the pursuit

of active interest rate policies proved, time and again, to be extremely difficult if not entirely impossible in the decades after the Second World War. In the Finnish financial market a comprehensive system was developed for regulating interest rates, by which the rates applied by banks were kept stable and low. The board of management of the Bank of Finland responded by developing various indirect means for controlling the supply of credit, in place of the interest rate. The main method was to control the amount of central bank credit available to the banks, and the conditions for granting it. Indeed, controls over interest rates and foreign capital were some of the most important differences between “classical” monetary policy and the monetary policy that took shape after the war.

On the other hand, within corporatism even the perceived tasks of monetary policy changed as inflation began to be regarded principally as a political problem and a matter for the labour market to resolve. For decades anti-inflationary measures were focused on labour market settlements aimed at keeping nominal wage increases as “moderate” as possible. It was thought that monetary policy had little hope of influencing inflation in a world of centralised agreements. Klaus Waris, who served as governor of the Bank of Finland in 1957–1967, summed up this pessimistic attitude towards the efficacy of monetary policy when he commented that “The Currency Act assigns the duty of defending currency stability to the Bank of Finland but without saying which tools should be used. The bank needs to talk all the parties concerned into backing the markka.” It is striking that, in combating inflation, the governor of the central bank gave priority to persuasion and sidelined the traditional tools of monetary policy.¹

Although Finland’s move to corporatism imposed significant impediments on interest rate policies, the Bank of Finland remained one of the main economic policy decision-makers in Finnish society. Apart from its monetary policy functions, its status was undoubtedly enhanced by being the regulatory authority for exchange control. By granting or refusing capital import permits, the bank had a crucial say regarding the prospects for financing individual industrial investment projects. It retained this role for decades, lasting right up to the 1980s, and was thus very influential in decisions concerning structural policy and industrial finance. In the words of the author of the bank’s history

written at the time of its 150th anniversary: “In a regulated economy the influence of the Bank of Finland went well beyond the formal boundaries of its authority.”²

A similar assessment has been made by President Mauno Koivisto, who before becoming the head of state was an economic policy leader from the 1960s to the 1980s as finance minister, governor of the Bank of Finland and prime minister. In Koivisto’s view “during the period under review (the 1960s and 1970s) the Bank of Finland shaped economic policy more than it publicly appeared to. (It) influenced events not merely by the decisions which it was empowered to take but also through its intellectual contribution.”³ Koivisto was referring to the bank’s economic research institute, which made it a strong focus of policy expertise in Finland and served as a leading think tank in the country, at least until other Finnish centres of economic research began to develop in the 1970s.

The image of the bank’s social importance is also certainly founded on the prominence attained by many of its leading figures. During the period covered by this book, three presidents of the republic hailed from the board of management of the Bank of Finland (Risto Ryti, Urho Kekkonen and Mauno Koivisto), as did eight of Finland’s prime ministers. This does not directly indicate the bank’s role in economic policy but clearly shows that the nation’s political elite served on its board.

Established in 1811, the Bank of Finland spent its early years subordinated to the government of the country, which at that time was the Imperial Finnish Senate. However, in the 1860s, when the Diet of the Estates began to hold regular sessions, the bank was transferred to its “guarantee and management” (1868). The system established in this way, whereby the national bank was responsible to parliament and not the government, is still in force in Finland. It originated from Sweden, where a national bank was established under the ambit of the Estates as early as the 17th century. In fact this was an expression of the general principle that the Grand Duchy of Finland sought, as far as possible, to observe constitutional precedents from the period of Swedish rule. Finland’s independence, its new constitution of 1919 and the new regulations enacted for the Bank of Finland in 1925 did not bring about significant changes in the way the bank was administered.

In practice parliament exercised authority over the Bank of Finland via the members of the supervisory council, chosen in parliamentary

session. Until Finland became part of the euro area, most major monetary policy decisions were taken by the supervisory council, or by the bank's board of management as authorised by the council. Among other matters, the bank's policy on interest rates was decided in this way, although deregulation of the money market in the 1980s reduced the council's *de facto* power over many relevant interest rates. The supervisory council is an elected body that has generally consisted of members of parliament. It supervises the bank's full-time board of management, which is responsible for practical banking operations, such as lending. The chairman of the board, the bank's governor, is its highest official. In monetary policy the bank's governors were long overshadowed by the supervisory council, until Risto Ryti became governor in the early 1920's. During his long term and thereafter, the central bank's governor became the undisputed leader in monetary policy.

After the Second World War, central banks became less independent in many European countries and governments came to exercise more influence over monetary policy. The nationalisations of major European central banks (France in 1945 and Britain in 1946) were milestones in this respect. In Finland, where the central bank was already within the ambit of parliament, no institutional changes took place, and the Bank of Finland remained legally independent of the national government. Political influence over its operations was via the supervisory council instead. Because of the bank's institutional independence, the Bank of Finland and the national government inevitably became partners. A large part of this book is devoted to charting their cooperation.

In Finnish research and articles on economic policy, the prevailing view of national monetary and exchange rate policies during the period covered by this book, from the 1940s to the 1990s, is rather critical. This negative image is best explained by the chronic instability experienced in the Finnish monetary system. It emerged first as a problem of inflation and as repeated devaluations of the markka, evoking the image of a spiral of inflation and devaluation. In the 1990s this already unfavourable image was made even darker by the experience of monetary instability more traumatic than devaluation, when Finland faced its worst-ever economic crisis in peacetime history, involving a devastating banking crisis and the collapse of its fixed exchange rate

system. The recovery did not come until the middle of the decade, which made possible Finland's participation in European monetary cooperation and ultimately joining the euro area.

The junctures of domestic policy and labour market relations are essential to understanding the monetary and exchange rate policies of the Bank of Finland, but a national perspective alone is not enough. The activities of the Bank of Finland must also be seen in an international context, one of the points of focus of this book. Finland's economic history from the 1940s to the present day is above all a story of international economic integration. At the end of the Second World War, the country was economically isolated and had to entirely rebuild its trading relations, creditworthiness and international liquidity. Its economic emergence, which began from the dismantling of foreign trade controls in the 1950s, continued in the European Free Trade Association EFTA and culminated in membership of the EU in 1995, followed in 1999 by participation in European monetary union as a founding member. Economic integration with western market economies was regarded in Finland as an important objective, even though the process was hindered by the suspicious attitude of the Soviet Union. In the words of Juhana Aunesluoma, an authority on the subject, Finland's trade and integration policies paint the picture of "a small figure walking the tightrope between economic necessity and political possibility"⁴

International economic integration always has its monetary side, a field where the Bank of Finland has naturally played a central role. Finland's international economic relations have also been determined to a large extent by exchange rate policies. For example, successive choices of an exchange rate system, from Bretton Woods to European monetary union, have been a central part of Finnish integration policy. On the other hand, as this book shows, the Bank of Finland's domestic monetary policy objectives and priorities have, perhaps to a surprising extent, been set by international developments and the nation's balance of payments. A mark of the impact of the payments account on monetary policy was the balance of payments crisis of 1975–1976, leading to extremely tight monetary policy that sharply curbed economic growth and employment. A similar situation arose at the start of the 1990s, when the Bank of Finland sought to defend the system of a fixed exchange rates.

The Bank of Finland was thus operated on the interface between politics and the market and, at the same time, at the intersection between the domestic and international economy. This is a challenge for a work of history. The key questions of Finnish monetary history, such as inflation, balance of payments problems and exchange rate policies can be answered only by examining both the political and international dimensions of the Bank of Finland. It is the main objective of this book.

BANK OF FINLAND IN THE WAR YEARS

NEW TIMES, NEW ROLES

During the Second World War, economic life in all countries, Finland included, was subjected to unprecedentedly broad state controls. The goals and forms of peacetime economic policies were put aside and replaced with new modes of operation that aimed at making each nation's economic resources serve the war effort as effectively as possible. The outbreak of war brought especially tight monitoring and regulation to foreign trade, which became largely a political and military matter. In all belligerent countries, monetary policy was no longer aimed at keeping the value of money stable, but at meeting the financial needs of the government. The task of combating inflationary pressures was left to price controls, imposed with varying degrees of success.

The effect of the war on the status of the central bank was similar in Finland to elsewhere. In general, institutional independence grew weaker and the Bank of Finland became more explicitly a cog in the administrative machinery, under the control of the national government. Even though there were no fundamental changes in the bank's legal position vis-à-vis the government and its ministries, in reality it forfeited a large part of its independence. For the duration of the war and to some extent in the subsequent reconstruction phase, it became a mere tool of government economic policy.

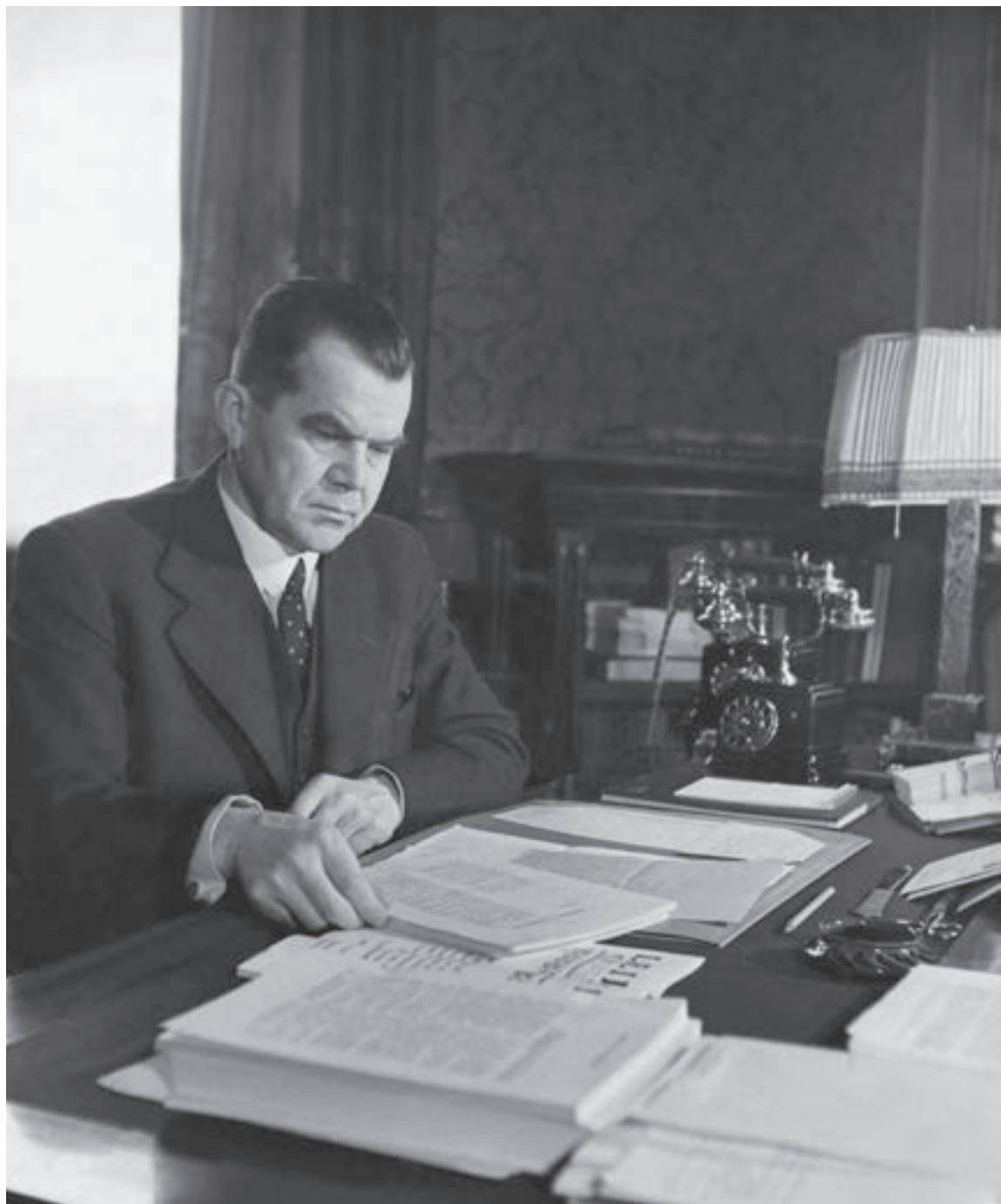
On the other hand the administrative significance of the Bank of Finland and its role in Finnish economic life increased greatly during

the war. It received many new practical tasks: financing the government budget deficit, regulating the financial markets and, above all, controlling foreign currency and handling foreign exchange. In this respect its existing role as a link between the national economy and the outside world was actually reinforced, as transactions that had been handled by private banks during peacetime came under its supervision and management. During the war and for years afterwards, almost all foreign payments and capital movements took place via Bank of Finland accounts or were at least subject to its licensing.

There is another way in which the bank's significance can be seen as having increased during the war. Many people who had previously served as its directors or senior officials moved into high positions in Finland's political leadership and government machinery. The most important of these was of course the bank's governor, Risto Ryti, who was appointed prime minister immediately after the outbreak of the Winter War on 1 December 1939. Ryti served at the helm of two governments before becoming president of the republic. While he was prime minister, J.W. Rangell, Ryti's confidant since the early 1930's, served as acting governor.

The movement of personnel between the board and the government took place with remarkable smoothness. When President Kyösti Kallio announced his resignation for reasons of health, the same members of the college of electors who had chosen Kallio for president in 1937 appointed Ryti on 19 December 1940 to serve until the end of Kallio's term. Ryti successor as prime minister again came from the board of the Bank of Finland; the next government was formed by Rangell and took office on 3 January 1941. At the end of the presidential term in spring 1943, Ryti was reappointed by the same electors. Randell's government resigned at the same time, allowing the situation on the Bank of Finland's board to be normalised. President Ryti resigned from the central bank and Randell was appointed governor of the bank with effect from 2 April 1943.

It would be no exaggeration to say that, at the same time as the war changed the institution of the Bank of Finland into a fairly passive tool of government economic policy, much of the country's political leadership shifted to people who had served at the helm of the bank. The exceptional conditions of the war created an operational merger between bank and government. Institutional boundaries



■ J. W. Rangell served on the board of the Bank of Finland from 1937 to 1945 and was governor during the war, save a stint as prime minister in 1941–1943 of an all-party government.

– Finnish Press Agency/Hede-Foto.

lost their significance. The government even held meetings in the Bank of Finland's vault from time to time, because of the danger of bombing.

INSTITUTIONAL STATUS IN WARTIME

Because of its tight operational link with governmental financial management, the Bank of Finland's operations and status in the war years cannot be examined merely on the basis of decisions by its board of management or supervisory council. Its position within integrated wartime economic management and regulation also needs to be considered. The close personal links between officials of the bank and the government reinforced the bank's strategically important position. The architects of wartime financial planning were mostly recruited from the Bank of Finland. Professor Bruno Suviranta, the head of the bank's research department, came to play a key role in this work. In 1940 he was commissioned by Prime minister Ryti to draft a framework for financial planning and governance. One concrete result was the establishment of an economics department at the Finance ministry in 1942, which Suviranta was appointed to run. He brought with him his closest assistants from the Bank of Finland. In fact the economic department worked from the premises of the bank's research department and several of its employees continue to receive their wages from the bank. The relationship between the department and the bank was obviously extremely close.⁵

To support the work of the economics department, the Economic Council was reorganised to embrace representatives of various interest groups. This 34-member body was chaired by the finance minister, while the head of the ministry's economic department was its deputy chairman. Practical planning was steered by a financial committee set up by the council. Its members were Rainer von Fieandt, the Minister for Supply; Kaaperi Kivialho, the acting governor of the Bank of Finland; A. E. Tudeer, the head of the bank's statistical department; Matti Leppo, who had transferred from the bank to the economics department; and Sakari Tuomioja from the Finance ministry. It was chaired by Suviranta and its secretary was Tuure Junnila.⁶ The framework for public finances was drafted in the form of a proposed general financial programme for the year. The first was completed on 20 March 1942 and was

followed by two more during the war years. The central elements of the programme were taxation for the coming year; the government's borrowing policy; the curbing of private consumption through austerity; and price and wage controls. The work of the Financial committee thus integrated the Bank of Finland into the management of public finances by the Finance ministry. Decisions about interest rates, borrowing or lending controls, and the direction of central bank lending, which had previously been made within the bank, were now taken in close cooperation with the Finance ministry. The firewall between ministry and bank disappeared almost completely.⁷

A striking feature of the war years was the increased importance of the Council of State, meaning the government meeting under the chairmanship of the president of the republic, at the expense of Parliament. This in itself is not surprising because extraordinary conditions demanded rapid decision-making, and the transparency required for parliamentary procedure was not often possible. However, it was important for key social interest groups to be involved in decision-making; in economic questions, part of the solution was the aforementioned Economic Council. It was a way of committing the main interest groups to the decisions taken.

The unofficial trappings of bank governance were also transformed. Although first Ryti and then Rangell had, in becoming prime ministers, left the bank's board of management and were members of the government, a new permanent bank governor had not been appointed, which stressed the prime minister's role in Bank of Finland matters. In this sense the situation was not normalised until spring 1943, when Rangell returned to the central bank and was appointed governor. The Bank of Finland was formally subordinated to parliament, which had delegated control to the Parliamentary supervisory council and in this respect the war years brought no formal change. In practice, however, the council was less important when the bank's function was to handle matters that had already been decided in advance at the Finance ministry. The chairman of the council remained the supreme authority over the bank but this position was held by Väinö Tanner who, being a minister, actually represented the government.

Being a councillor and a minister at the same time involved – or would have involved under normal conditions – a conflict of interest, as was pointed out by council member Erik von Frenckell in the

council in autumn 1944. He foresaw potentially difficult conflicts, if the same person were a councillor and a minister, between stabilising the present value of money and meeting the government's borrowing requirement. Other members of the council held varying opinions about the magnitude of the problem. Some took it seriously but also saw benefits in combining these two functions. The council felt that it was not responsible for resolving the matter and asked the banking committee of parliament to note that the question had been raised and to take the necessary action. The banking committee in turn felt that a change in parliamentary regulations was needed and passed it back to the supervisory council. The council responded that such a complex process was unwarranted and could be settled with a small modification of the council regulations, so that if a member of the council became a government minister he was to resign from the council and be replaced by a new councillor, elected for the rest of outgoing member's term. A proposal to this effect was indeed sent to the banking committee and forwarded to parliament but it was overtaken by more urgent matters and forgotten.⁸ The question of a conflict of interest was very important in principle because a similar situation could have occurred through dual membership of the Bank of Finland's board of management and the government. However, this did not happen during the war years because, on becoming prime minister, both Ryti and Rangell had taken leave of absence from the board.

PREPARING FOR WAR, REVISING THE REGULATIONS

Before 1939 the minutes of the Bank of Finland board contain hardly a mention of preparations for the outbreak of war. Naturally the senior management of the central bank was fully aware of the precautions that had been taken in civilian and military circles. From the mid-1930s governor Risto Ryti had been a member of several committees that had deliberated Finland's defence capabilities and questions related to rearmament. The chairman of the supervisory council, Väinö Tanner, was at least as well-informed about ongoing rearmament because he served as Finance minister from 1937 to the outbreak of war. Before the war began, Ryti and Tanner did not have reputations for being particularly defence-minded. A common feature was their tough

critical stand on increasing public expenditure and this attitude extended to defence spending.⁹

During summer 1939, increasing international tension had caused public uncertainty, to which the Bank of Finland had to react. There was turbulence in the foreign exchange market and greater demand for cash, so the cash reserves of branch offices were increased substantially. A decision, taken in 1937, to issue a new 5,000-markka banknote, was also expedited and 500-markka banknotes already printed were overprinted with the new value.¹⁰

By 14 November 1939 there was open admission that the war might soon engulf Finland, because the board asked the supervisory council for the right to grant guarantees against war damage to industrial establishments. Finnish industrial companies had established a mutual consortium to pay compensation in cases when fire insurance companies had no liability because of a state of war. Bank of Finland customers who were members of the consortium asked the bank for a guarantee so that they could meet potential demands for compensation. The agreement clearly defined the liability to pay compensation and the supervisory council had no reservations about the board's proposal.¹¹

An important step towards wartime monetary policy was taken in December 1939 after the Winter War had started. The Bank of Finland now faced an entirely new situation. Export trade was at a standstill and it was foreseeable that all reserves of foreign currency would gradually be exhausted, eroding the basis of banknote cover. At the same time, government finances were at an impasse because the tax base was shrinking while expenditure was increasing steeply. The Bank of Finland was needed to provide finance for the government, and to do so required new regulations on banknote issue.

The banknote cover regulations were changed to eliminate the distinction between primary cover (foreign exchange and gold) and secondary cover (domestic bills). Furthermore, three-month domestic bills of exchange, which could be counted as banknote cover, no longer needed to be guaranteed by two persons or firms "of good financial standing" as previously required. After these changes, acceptance credit granted to the government could be counted as banknote cover. The changes were essential for two distinct reasons. They allowed the bank to finance the government with fiat money, while ensuring that

it remained in compliance with its regulations on banknote cover at a time when its gold reserves, its undisputed assets held by foreign agents and its other receivables in foreign currency were shrinking. These changes had to be pushed through with record speed; parliament approved the proposal on 5 December and the law took effect on the 15th of the month.

THE BANK'S WARTIME TASKS

A memorandum found in Bruno Suviranta's archives paints a broad picture of the Bank of Finland's wartime role. In it he examines the changes that had taken place in various areas of state financial administration since the outbreak of war. He focuses on how government functions were organised in different areas, which functions were the responsibility of which official body and what labour resources were needed in each area.¹² According to the memorandum, the general functions of the Bank of Finland during the war were primarily to facilitate payments and secondly to preserve the value of money, so its key tasks were almost unchanged. The only function mentioned in the law but not mentioned in the memorandum was keeping the monetary system on a stable and safe footing. Obviously it was thought that in a wartime command economy, the risks faced by banks and other credit institutions would be eliminated so a central bank would not be needed in this respect. In fact, this was not the case and already the first news of growing international tension had put pressure on liquidity in the financial system.

Facilitating payment and transactions meant in practice satisfying a steeply increased demand for banknotes. At the end of 1938 the volume of banknotes had been about 2 billion markkaa but by the early months of the Winter War it had doubled. The 10-billion-markka level was passed in winter 1943 and when the war ended in autumn 1944 the total value of banknotes was in excess of 14 billion markkaa. It had risen seven times over in five years.

The capacity of the security printing house was adequate and the bank faced no technical problems in producing the number of banknotes required. On the other hand, handling so much money meant a significant increase in the work of cashiers at head office and

the branches. Their burden was further increased by the logistics of moving money at a time when the transport system had been commandeered for military use and when bombing and other factors made money transfer even harder.

A separate function was the Bank of Finland's collaboration with the army in organising banking services at the front. This was not done during the Winter War although initial plans were made, largely by G. A. Myreen, the head of the bank's branch office in Joensuu. The matter was reopened in spring 1941, when General Staff contacted the Bank of Finland and asked it to organise wartime banking for the military, meaning mainly in areas on the front line. This became the responsibility of department head P.M. Blomqvist at the bank and the office of the intendant-in-chief at General Staff, where the intermediary was initially Major W.E. Kiiveri and subsequently Major E. Kyläsalo.¹³

After Finland had joined the Second World War at the end of June 1941, the Finnish forces rapidly reconquered the territory lost in the Winter War and then advanced further in East Karelia as far as Lake Onega. Petrozavodsk, the capital of Soviet Karelia, was captured at the beginning of October and was renamed Äänislinna. Finnish forces stopped their advance in December and a phase of positional warfare ensued, lasting about two and a half years.

Finland's wartime army of about half a million men required banking services in order to function. To supply the services required, the Bank of Finland organized a frontline office network which was managed by the aforementioned P.M. Blomqvist. On the front itself, eight offices were set up, five in East Karelia and the rest in Northern Finland.

FRONTLINE OFFICES OF THE BANK OF FINLAND

East Karelia	Northern Finland
Pitkäranta	Kemijärvi
Aunus (today Olonets)	Kuusamo
Karhumäki (Medvezhyegorsk)	Lieksa
Äänislinna (Petrozavodsk)	
Kiviniemi (Losevo)	

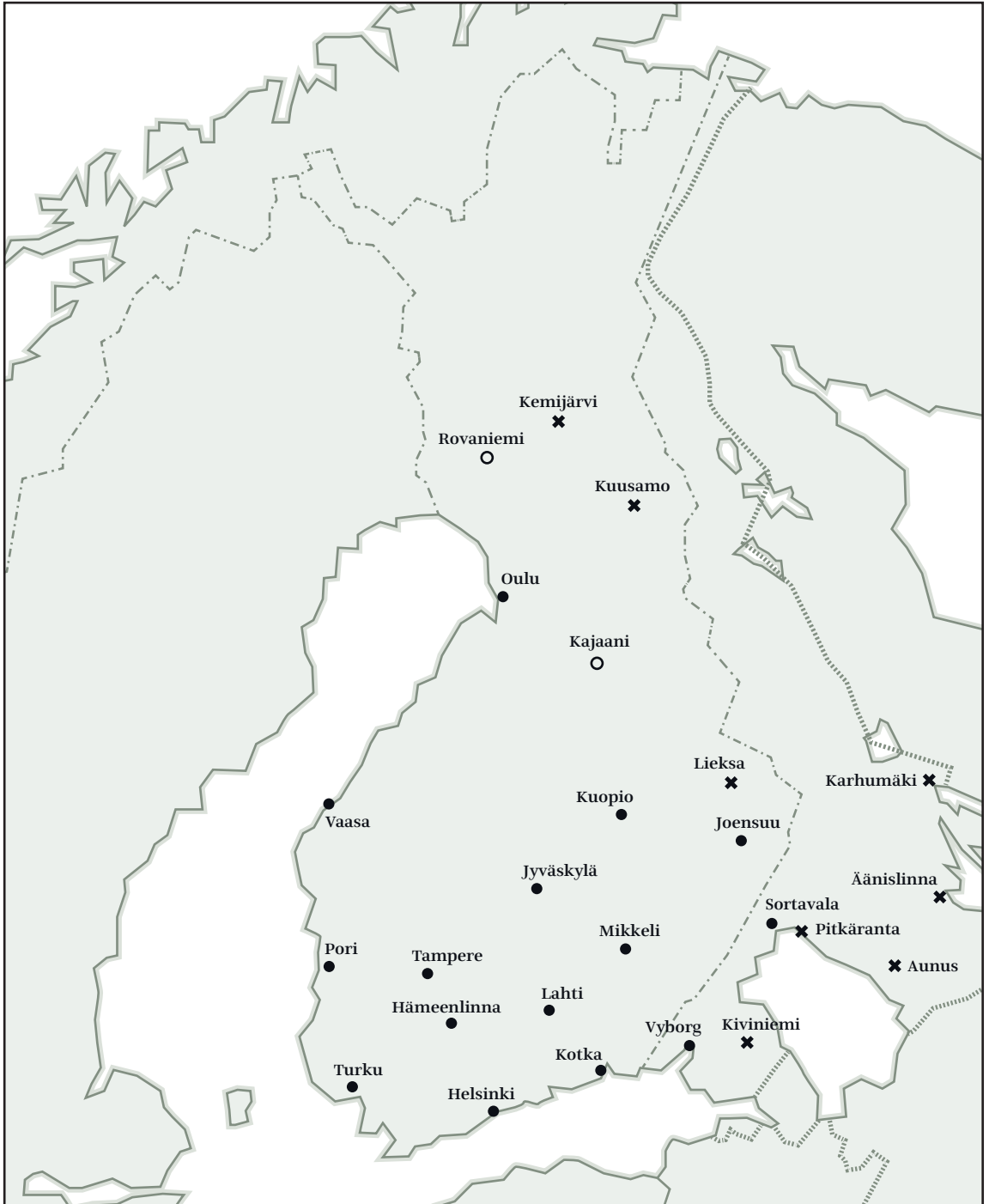
Offices were established as the line advanced, the first in East Karelia being Pitkäranta on 5 August 1941 and the last at Kiviniemi on 23 October. The need for an office was also determined by the situation on the front. Kiviniemi was closed at the end of December 1941 and Pitkäranta at the start of the following year, when their operations were merged with the Bank of Finland's branch office at Sortavala. During summer 1944 the offices moved towards the old border as the front line did. For example the office at Karhumäki moved to Taavetti, where it was closed on 28 November 1944.

The frontline offices in northern Finland came slightly later, in October 1941, when they were established at Kemijärvi, Lieksa and Kuusamo. The location of these offices, too, depended on the situation at the front. The most mobile was the Kuusamo office, which moved to Hyrynsalmi in 1942 and to Kajaani and then Tornio in 1944, before being closed on 15 December.

The number of employees at a frontline office varied but the minimum configuration was an office manager, a cashier, an assistant cashier and a doorman. All staff were recruited either from head office in Helsinki or one of the branches because professional skills were required from the outset in the exceptional and difficult conditions of wartime. The period also showed in the high proportion of women. The work at frontline offices consisted mainly of recording deposits and withdrawals, selling cashier's cheques, sorting banknotes and counting coins. The busiest days were when soldiers were paid their per diem allowances. The offices also served civilians and in Northern Finland a large number of German soldiers, who wanted to exchange their Norwegian money for markkaa. The number of people employed in frontline branches peaked at about 30.¹⁴ Overall, the Bank of Finland employed about 60 people more for payment and cash services, annually, than had been needed in this work in 1938. The army was not dependent solely on the Bank of Finland for its banking, though. At the end of 1939 the Post and Savings bank had begun postal giro operations and during the war all government offices and institutions were required to use it for claiming fees and making payment, in order to reduce the demand for cash and make payment simpler.¹⁵

The other distinct function mentioned in Suviranta's memorandum was to safeguard the value of money. In this respect the Bank of Finland was restricted to managing foreign assets and liabilities, and domestic

BANK OF FINLAND OFFICES AT THE START OF 1942



- Branch
- ✕ Front line office
- Agency
- Border after 1940
- Front line 1942



■ Wartime withdrawal from a front-line account.

– Army photograph/Finnish Press Agency.

lending. Both functions were closely connected with the wartime economy and controls and in fact had nothing to do with monetary stability. On the contrary, the regulations on lending had been changed so that the Bank of Finland could finance the government and this finance in practice became a threat to the value of money.

While strict controls on foreign trade were in place, the Bank of Finland needed far greater resources for controlling and managing foreign payments. This work was done in its foreign exchange department. It had always been one of the most important departments of the central bank, but the decline in conventional foreign trade arrangements had changed the character of its work. Now the objective was to use the central bank's scarce foreign exchange resources in the most sparing way possible. Foreign currency was disbursed only after a written application had been made and the department's officials were in charge of currency rationing. Controls were also extended to trade at the border between Finland and Sweden. Cooperation between the central bank and customs officials was stepped up.¹⁶

A new department established at the Bank of Finland was the clearing department, which processed most incoming and outgoing foreign payments. Under extraordinary wartime conditions, most foreign trade was based on bilateral trading and payment agreements between countries. The clearing department was responsible for the operation of the whole system and can be regarded as the administrative centre of Finland's wartime foreign trade.

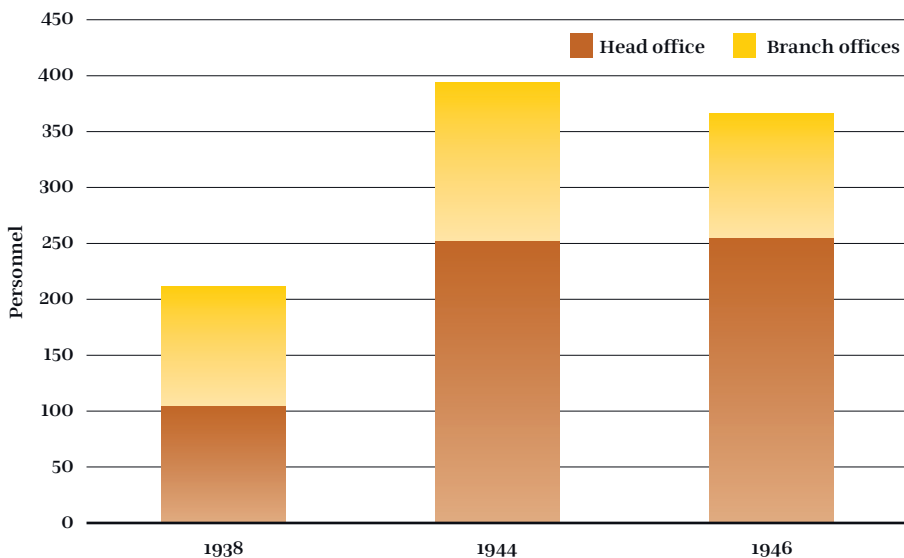
When trade had been free, export and import payments had been handled by the commercial banks, often using letters of credit. This meant that payment was made only after the conditions agreed by the parties had been fulfilled, and the payment transaction involved not merely the buyer and the seller but also the banks of both parties. A letter of credit minimised the risks connected with international payments. Now these payments had been transferred from the commercial banks to the Bank of Finland, and management of payment agreements demanded a great deal of technical work. This led to the establishment of an entirely new documentary credit department at the bank. As a whole, foreign trade controls and payment required a lot of staff. By the end of 1942 more than 50 new officials had been recruited for these functions. Most of the new officials at head office were involved in this work.¹⁷

To promote efficiency of Bank of Finland operations, a monitoring department was set up. Its establishment was related to a shift in the nature of the bank; its function as a regulatory authority of the wartime economy brought a new formality to operations. There were also new pressures to make public administration more effective, to which the bank endeavoured to respond. In 1942 a total of 14 people worked in the monitoring department, so it was quite a big department for the bank at that time.¹⁸

An interesting detail of Suviranta’s memorandum is that it did not mention economic policy planning, macroeconomic research or analysis of central bank monetary policy in connection with the Bank of Finland. One interpretation for these omissions could be that Suviranta, who had moved from the bank to be head of the finance ministry’s economics department, felt that he had taken these duties with him.

The diagram gives an overall view of how the Bank of Finland’s operations grew during the war years.

BANK OF FINLAND STAFF IN 1938, 1944 AND 1946



Sources: Supervisory council minutes 7 March 1939; Bank of Finland board minutes 24 August 1945 and 15 December 1947.

The bank's payroll approximately doubled to 400 persons during the war. Most of the growth took place at head office, as noted earlier. The number of branch office employees had turned down but rose again slightly after 1941 because of offices established near the front line. The total of employees began to fall at the very end of 1944, partly because the network of frontline offices was being run down, although a significant proportion of the people working at frontline offices returned to their old duties at the bank. The war years also meant a final breakthrough for female officials at the Bank of Finland; a distinct majority of officials recruited during the war were women.

BRUNO SUVIRANTA (1893–1967)

A doctor of economics, Bruno Suviranta was a trailblazer both in economic science and policy planning. Unlike most Finnish economists of his time, he was drawn to neoclassical economics and the English language area. During the depression years of the 1930s, Suviranta closely followed the work of young Swedish economics of the Stockholm school and, throughout his career, he spread new trends in Finland. His academic vocation began as an associate professor at the University of Helsinki in 1931. He was subsequently appointed to Helsinki University of Technology and then to Helsinki's University's faculty of political science as professor of economics. The chancellorship of the Helsinki School of Economics marked his apogee in academia.

In public administration his career may not have been quite so conspicuous but was at least as significant. His first contacts with policy makers were made when he became secretary of the Economic Council in 1928. No more than a year had passed when Finnish business conditions turned down sharply and the Bank of Finland felt that more business studies were needed. The solution was to establish, alongside its statistical department, a separate department for "conjunctural research", which Dr Suviranta was appointed to head in 1930. Under his leadership the department developed into the leading research centre in its field in Finland.

Suviranta's contacts with governor Risto Ryti were not confined to work; he belonged to an economic policy

discussion circle that developed around Ryti. Its other members included director K.J. Kalliala of the Central Bank of Savings Banks, director Rainer von Fieandt of the Union Bank, director J.W. Rangell of the Central Bank of Cooperative Banks and the statistician A.E. Tudeer of the Bank of Finland. Almost all participated in the 1933 London Monetary and Economic Conference of the League of Nations. It was there that the debating circle's name was invented. The "Society of Simple Men" later became legendary.

After the outbreak of war, the Bank of Finland and the Finance ministry began to work more closely together. From the outset Suviranta played a crucial role in designing economic policy for the state of emergency. The work began in 1940, when Risto Ryti, then prime minister, asked Suviranta, Tudeer and Hugo Pipping to propose near-term economic guidelines. This led to the establishment of the Finance ministry's economic department, which Suviranta headed until 1946.

Although he was a key architect of wartime economic controls, Bruno Suviranta was ideologically a staunch advocate of the market economy. Government management had to leave room for private enterprise. The farther the economy moved towards state planning, the greater would be the problems when peace was restored. As early as 1940, he used the phrase "peace crisis", and the post-war years showed his fears were well placed. It took at least a decade to dismantle the machinery of regulations.



■ Economics professor Bruno Suviranta was a top adviser in economic decision-making from the 1930s to the 1950s.

– Finnish Press Agency/
Mikko Pohtola.

WARTIME FINANCIAL MARKETS

BANK OF FINLAND FINANCES THE GOVERNMENT

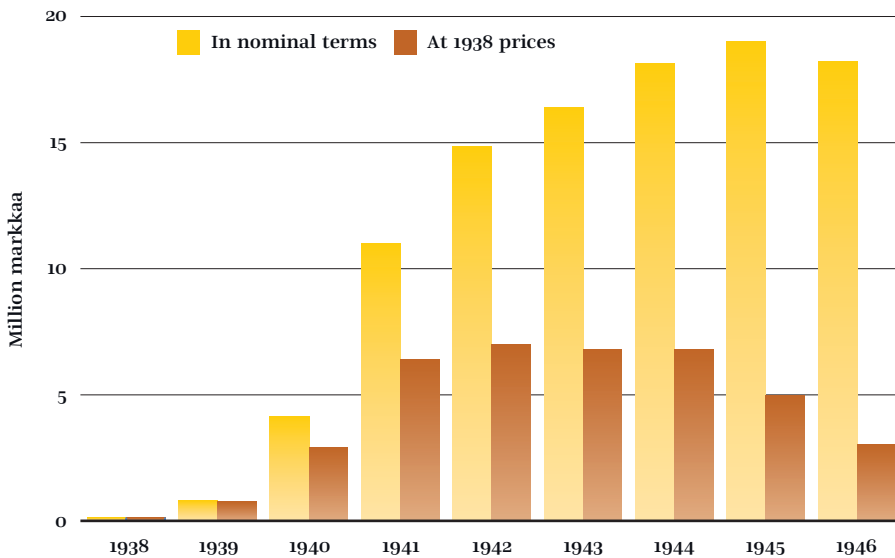
A striking feature of the financial markets during the war was the wide gap between government revenue and expenditure, resulting from a simultaneous rise in spending and loss of income. Expenditure was obviously boosted by the cost of the defence forces which, at its peak, took 70–80 percent of all government spending. At the same time withering foreign trade brought a collapse in customs revenue and other indirect taxes. It was hard to find compensating revenue. The number of taxpayers declined as the strength of the Army grew, it took time before new taxes began to yield revenue, and taxes were imposed retroactively, which reduced the real value of revenue at a time of rapid inflation. Among the most important reforms in wartime tax policy were a gradual shift to withholding tax from 1942 onwards and the introduction of turnover sales tax in 1941.¹⁹

Under these conditions public finances began to show a structural deficit which was in the region of 30–40 percent of expenditure, so a significant proportion of government spending had to be financed by borrowing. Loans were obtained from the Bank of Finland, the Post and Savings Bank, the funds of the Social Insurance Institution, private banks and institutions, and insurance companies. Bonds were sold to the public, too, but most of them ended up in the hands of the banks and other financial institutions. By far the most bond issues were domestic because international capital markets were almost closed in the prevailing conditions.

The Bank of Finland was extremely important as a source of loans to the government. This involved a major policy change. Classic central bank policy decreed that it was not the responsibility of a central bank to finance the government and in peacetime the bank's regulations had restricted it. Forced by circumstances, the regulations were quickly changed, as noted previously, and the obstacles ceased to exist after the start of 1939. The scope for lending to the government then became limitless in practice, because short-term acceptance credit granted to the state could be counted as banknote cover.

The diagram below shows both the nominal and real trend for the stock of loans but, because of fast inflation, the real figure is more relevant. Lending by the Bank of Finland to the government stabilised by 1941 and thereafter remained almost unchanged at about 6.5 billion markkaa until the middle of 1945. The diagram also reveals the shock effect of the start of the Winter War but how, after a few years, the national economy adapted to military conditions.

BANK OF FINLAND LENDING TO THE GOVERNMENT 1938–1946

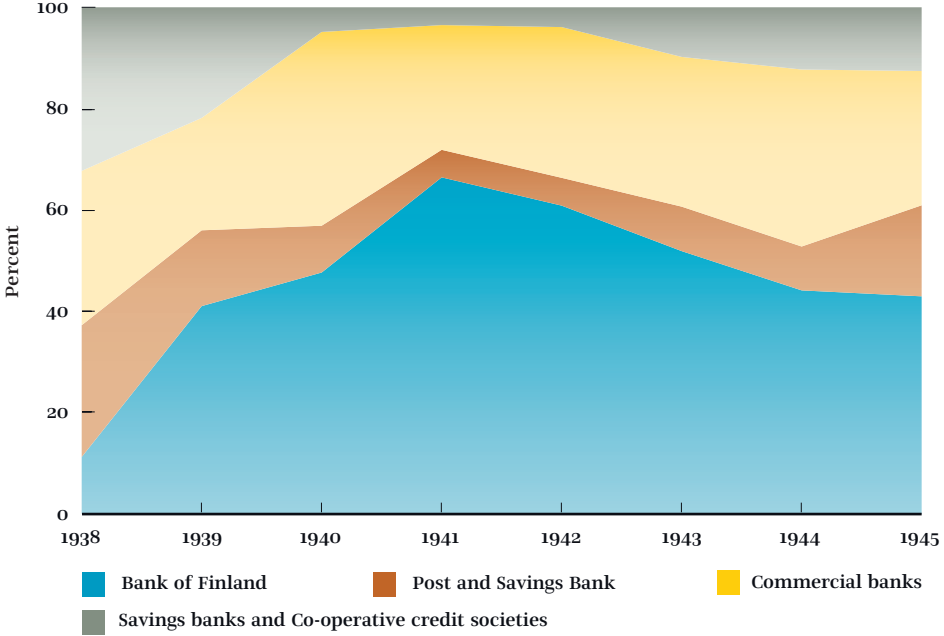


Source: Supervisory council reports 1938–1946.

Finance for the government meant an almost complete cessation of the Bank of Finland's other forms of lending: rediscount credit to companies and commercial banks. In 1938 more than 90 percent of its credit had gone to companies but this proportion turned down sharply and settled at about 10 percent from 1941 onwards. Funds lent to the government ended up as deposits in the accounts of commercial banks, providing them with such good liquidity that they did not need rediscount credit during the war years. This meant that from 1940 to 1944 almost all central bank lending was to meet the credit needs of the government.

In 1938, the last year of peace, when the government's credit requirement was still modest, the savings banks had been its main financiers in the debt market and their investment portfolios contained many government bonds. From 1939 onwards the Bank of Finland was

GOVERNMENT DEBT TO BANKS BY BANK GROUP, 1938-1945



Sources: Bank of Finland Economic studies 1943 and 1946; Savings Bank statistics 1938-1945; Cooperative credit society statistics 1938-1945.

constantly the government's main lender and provided almost half of the bank credit it received in the period 1941–1944. The commercial banks were the second most important source of credit; their share was at its highest in the last year of war, 1944.

STEEP GROWTH IN BANKNOTES ISSUED

During the war the Bank of Finland's role in safeguarding the value of money became blurred and the job largely moved to the Ministry of Supply and its Council on Prices and Wages. This responsibility was almost overwhelming because there were inflationary pressures from many directions. Resources were being devoted to the war effort and there was little production for private consumption. The glaring shortage of almost all commodities stimulated demand-pull inflation. The tough controls applied in an effort to curb price rises were doomed to partial failure and, beyond the system of official controls, a large black market developed.

Another major question mark was the abrupt increase in banknotes issued. The value of notes in circulation began rising already in autumn 1939. Changes in the volume of banknotes in circulation are, in principle, caused by any of the following three factors: lending by the central bank to the business sector, to the government, and changes in its holdings of foreign assets (incl. gold). There was very little lending to business during the war and it hardly varied, while foreign assets had shrunk to a very low level and in fact become negative. Accordingly, the mechanism for the increase in banknotes was very simple and driven entirely by the central bank's lending to the government.²⁰

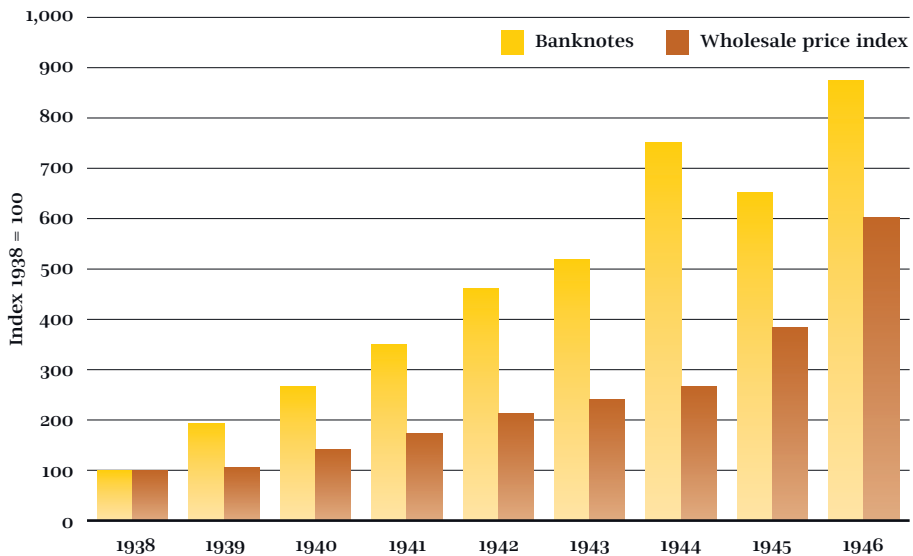
Admittedly the exceptional conditions meant that the demand for means of payment exceeded normal levels. Demand for banknotes was also boosted by general uncertainty, poor transport conditions and delays in postal services, with the result that the public increased their cash reserves. They also needed cash on hand for black-market purchases, while black market traders avoided depositing their income in bank accounts so as to hide it. Moreover, the number of people in paid employment, and therefore holding cash funds, increased as female workers replaced those at the front. The volume of banknotes in circulation was further boosted by compensation paid in 1943 to Karelians who had lost their homes during the war.

The outcome of all this was a situation where inflation was stimulated simultaneously by demand-pull inflation, resulting from a shortage of goods, and money-supply inflation, caused by a steep increase in the volume of banknotes. The tight wartime controls intended to curb inflation did have some success but, when the war ended, pent-up pressures gradually erupted, as the diagram below shows.

REGULATING LIQUIDITY

Instead of focussing on price stability, the Bank of Finland concentrated on coordinating the operations of financial institutions so that all the resources of the national economy could be devoted to military needs. Another key objective was to regulate general liquidity in order to hold private consumption at the lowest possible level. In these tasks the Bank of Finland worked in close cooperation with the Economics

BANK OF FINLAND BANKNOTES IN CIRCULATION AND THE WHOLESALE PRICE INDEX, 1938–1946



Sources: Bank of Finland Yearbooks 1938–1946; Bank of Finland Economic Studies 1947, appendix 1.

department of the Finance ministry. The guidelines were set in the state financial plan, approved in advance for each upcoming year. In practice the main plans were made in the Financial committee, on which the Bank of Finland was represented by its acting governor, Kaaperi Kivialho.

Under normal conditions the main way of regulating liquidity had been to adjust the central bank discount rate. At the Bank of Finland this course of action was considered in autumn 1940 when economic activity was expected to pick up, and the liquidity of the commercial banks to tighten. At the request of the Parliamentary supervisory council, the board drew up a proposal on a possible increase in discount rate and the matter was presented to the council by (then interim) governor J.W. Rangell. The proposal stated that a tighter money market was anticipated so, according to classic discounting policy, the time was ripe for an increase in the interest rate. The rate hike would primarily be a warning signal to the business and financial world. Secondly a higher discount rate would result in higher lending rates, which would have a deflationary impact and thus would support efforts to stabilise the value of money. Thirdly, because borrowing rates would also rise, thrift would be encouraged and it was even possible that some of the banknotes in circulation would be deposited at credit institutions.

Under the exceptional circumstances, however, many arguments could be presented against an increase in the discount rate. Business life was well aware of the probable dangers ahead, so a warning signal like a rate hike was pointless. Production was already suffering and it would be unwise to burden it with the costs of an interest rate increase. A rise in general interest rates would be reflected in higher general prices and costs. A higher interest rate level would also make it harder to balance public finances. The hike of half a percentage point mentioned in the proposal was too small to have a significant effect in stimulating deposits; under the prevailing conditions of uncertainty, money would remain outside the banking sector. The board of management therefore felt that an interest rate hike entailed more disadvantages than benefits and that the discount rate should be left unchanged.

The supervisory council chairman Väinö Tanner argued forcefully against higher interest rates. In current circumstances enterprise

should be encouraged rather than penalised. Central banks abroad had kept their discount rates steady, and the Bank of Finland should not deviate from the prevailing practice. Only one council member, Erik von Frenckell, urged a rate hike. In his view the central bank had the enduring responsibility of protecting monetary stability and a higher interest rate was needed to do this. Summarising the discussions on this theme, J.W. Rangell noted that Frenckell had been the only advocate of classic interest rate policies.²¹

The question of interest rates was raised in a wider arena, too. The interest rate pact of 1931 between financial institutions had been allowed by the commercial banks to expire in 1938. In the course of autumn 1940, insurance companies had begun to raise interest rates on long-term mortgage loans. The Economic council felt that interest rate hikes were hindering efforts to stabilise prices, so Finance minister Mauno Pekkala invited the larger commercial banks, the central institutions of savings and cooperative banks, the cooperative credit societies and the insurance companies to a meeting on 13 January 1941. The message was clear: the government would not allow interest rate increases so financial institutions would be wise to reach a voluntary agreement on the matter. They did so and a special interest rate board was set up, composed of representatives of the founding organisations and chaired by Kaaperi Kivialho of the Bank of Finland. The new interest rate board urged that borrowing and lending rates be kept at the level of 1 October 1940. Although it was stated to be a voluntary pact, K.J. Kalliala, who represented the savings banks in the negotiations, noted that it was backed by the will of the Bank of Finland and the government. "It must therefore to be regarded as a recommendation that is compulsory."²² Being wartime, it was.

Apart from its discount rate, the central bank could, under normal conditions, have regulated the liquidity of individual banks by changing its rediscounting terms. In this respect, too, the situation was abnormal. The liquidity of commercial banks during the war was so good that they did not need to resort to rediscounting, so this facility was not a useful central banking tool. The Bank of Finland also lacked the legal authority to steer individual banks so regulation of the financial markets was based on unofficial rules of play. With wartime patriotic unity of purpose, financial institutions took instructions from the

central bank seriously. Its instructions aimed to ensure that the government could borrow the funds it needed, that investments in materiel production would be financed and that excess liquidity in the economy would be neutralised.

These matters were presented to credit institutions in the form of circulars from the Bank of Finland, after their content – the principles for lending – had been talked over in the Economic council and the Financial committee. This practice began in spring 1940 and continued until the close of the war. The first circular, dated 6 April 1940, stressed the primacy of financing reconstruction. Circulars in 1941–1944 emphasised that lending should be tied to the general public interest, by which it chiefly meant satisfying the government's need for credit. Furthermore, lending was not to stimulate price rises so loans could not be granted for any kind of speculative purpose, a category that included acquiring shares, housing, farms, and so on. Credit could be granted only for healthy productive functions that would directly aid the production of military materiel or essential foodstuffs. Repairs of damage caused by bombing were to be limited to providing essential cover. Because of the need to neutralise excess purchasing power, loans could not be granted for paying gift taxes and similar tax surcharges nor for buying war bonds.²³

From autumn 1941 onwards the Bank of Finland required commercial banks to provide regular statistical reports on all the large loans they had granted. It also organised regular meetings with commercial bank leaders at which the central bank presented its views on the economic situation and the measures required. At the same time the central bank leadership received up-to-date information about commercial banking.

Measures to neutralise general liquidity did not lead to the desired result of lower inflation because central bank lending to the government continued. However, tentative plans for reducing the volume of banknotes in circulation were put forward. The matter was first raised in public by Mauno Pekkala, the Finance minister during the Winter War, who gave a press interview that vaguely referred to the possibility of exchanging banknotes for new ones. Väinö Tanner, who succeeded him as Finance minister, asked the Financial committee in 1942 to consider the question of a general banknote exchange but no concrete measures were undertaken. The issue was raised a third time in

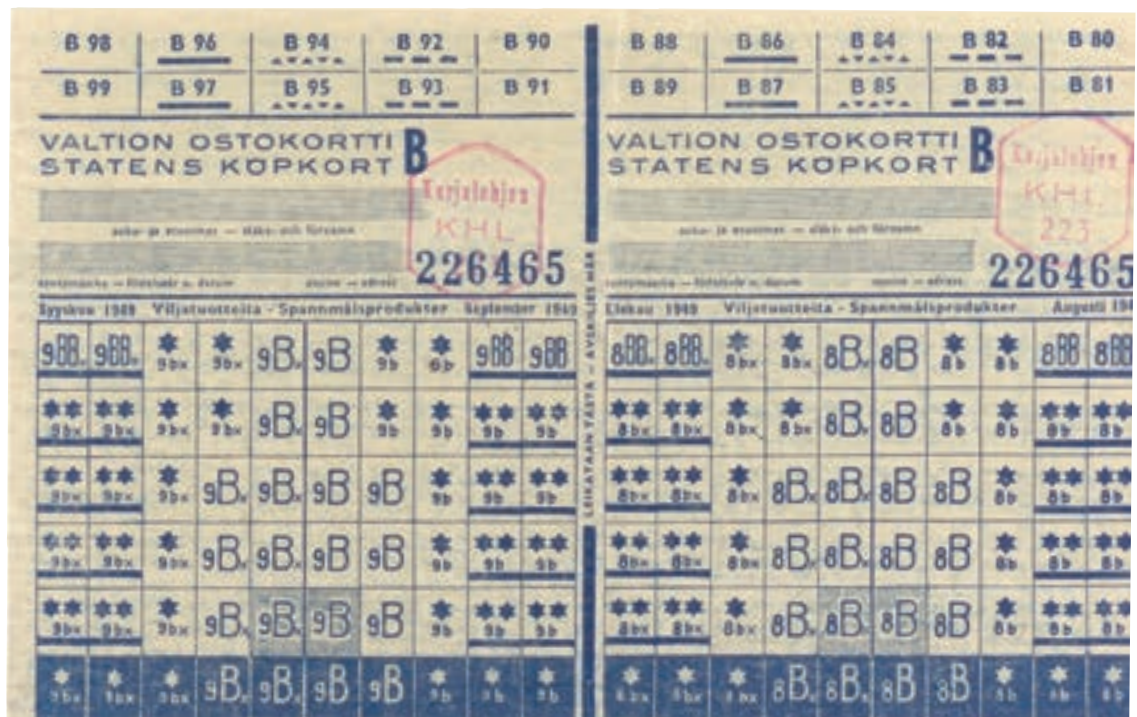
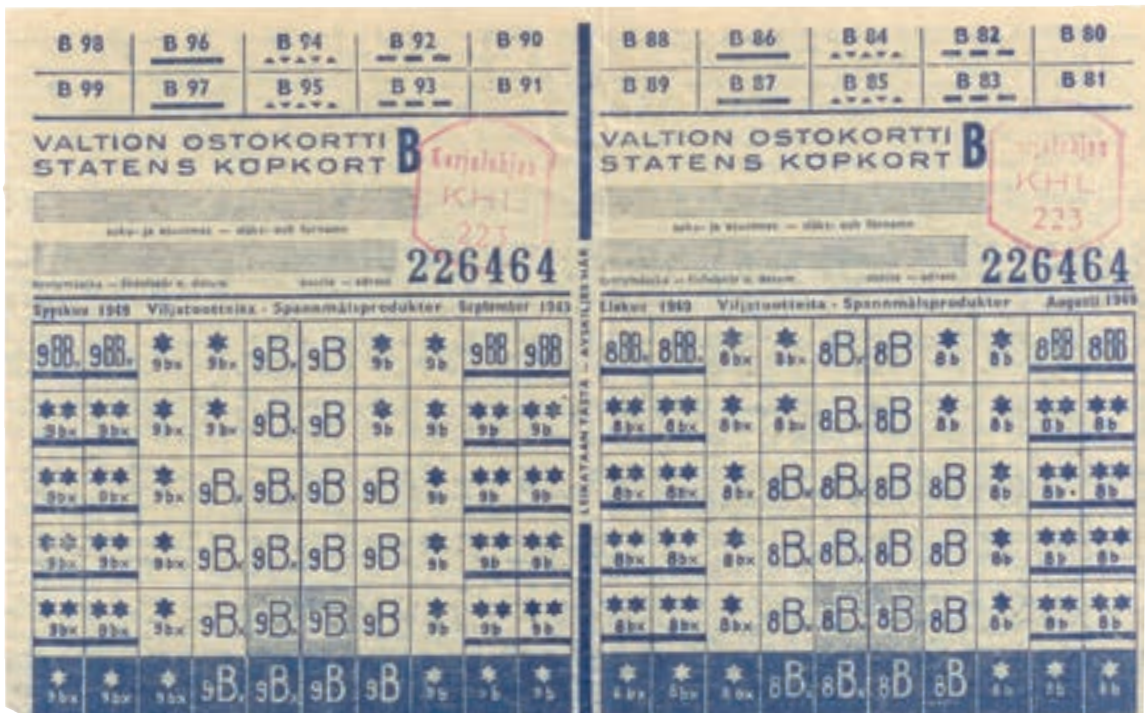
summer 1943 when the government, acting at the initiative of Deputy Finance minister Tyko Reinikka, presented Parliament with a bill on 22 July 1943 for imposing monetary controls. However the matter went no further and the government withdrew the bill from Parliament.²⁴ The matter was taken up again at the end of 1945, as will be explained later.

In the supervisory council, Erik von Frenckell had raised similar questions in autumn 1942 in a memorandum on inflation. He had built a reputation for his prominent stands against inflation and had served on the board of the central bank for a brief period in the early 1920s. His memorandum to the council stated that, despite the price and wage standstill and tax rises, efforts to prevent a decline in the value of the markkaa had largely failed. New methods were needed that would offset the inflationary impact of the increased supply of banknotes. Ways had to be found that would withdraw notes from use or at least remove them from circulation for a while.

Frenckell's proposed solution was a second, parallel type of banknote. The state would issue them when paying wages and other regular disbursements, and the public would be able to use them only for payments to the state. The notes could also be deposited in the Post and Savings Bank but they could be withdrawn from accounts only for paying state fees. To encourage saving, the interest rate on accounts could be made tax-free. A corresponding number of normal banknotes would be withdrawn from circulation, thereby reducing purchasing power and inflationary pressures.

The proposal led to a lively debate in the supervisory council, which felt that Frenckell's idea was worth developing. However the chairman of the council and then Finance minister Väinö Tanner regarded it as questionable. To introduce parallel circulation would be tantamount to surrendering before the forces of inflation. It would be a declaration of failure or at least an admission that the government and the Bank of Finland were unable to maintain the value of money. This could give the public the wrong message.

Despite Tanner's doubts, a majority in the council were willing to let the proposal go forward and Frenckell's memorandum was sent to the Finance ministry for consideration by the Financial committee. The committee's statement stressed the similarities between Frenckell's ideas and ongoing plans for curbing purchasing



■ Rationing was used during wartime and the Great Depression, under the economic enabling act. Ration cards were in use until 1954, when coffee rationing ended.

– Private collection.

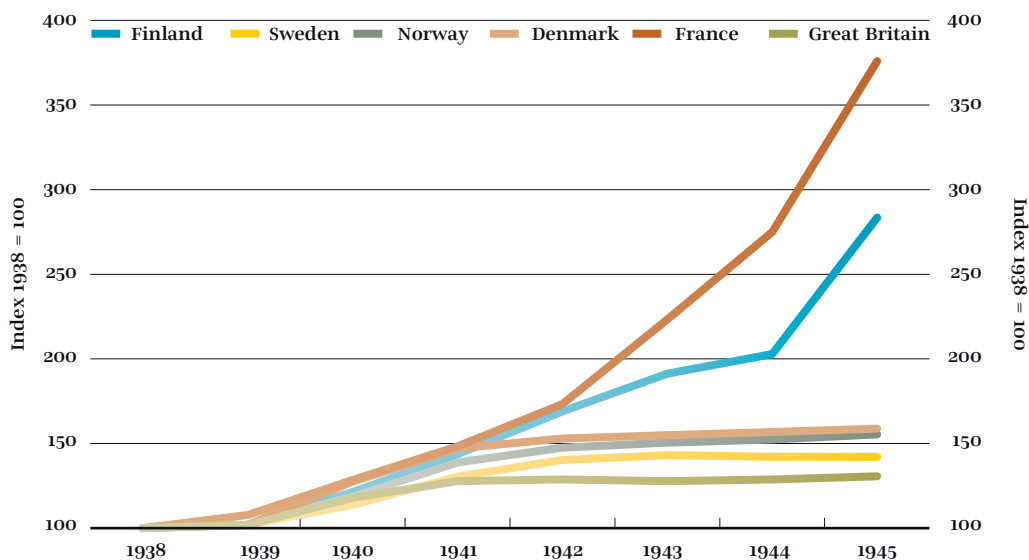
power and thereby slowing down inflation. These plans included a transition to advance collection of taxes, the implementation of compulsory loans from the public and the introduction of “iron-clad” savings accounts that would offer protection from inflation. However the Financial committee felt that adopting a parallel series of banknotes would facilitate speculation. Low-income officials, soldiers and others of modest means might receive more of the new banknotes than they needed for taxes and other payments to the state. People who had to make large payments to the state would seek to purchase the state banknotes at a discount. The economy would therefore contain two types of money of different values, which was always problematic. On this basis the Financial committee rejected Frenckell’s idea. The board of management of the Bank of Finland concurred, so no further action was taken.²⁵

A wide-ranging wartime propaganda campaign for austerity deserves separate mention. The ideas originated with the Finance ministry but the Bank of Finland had a key role in coordinating its practical implementation. This was specifically propaganda, which harnessed the press, radio, cinema and shop windows. However, tax-driven incentives proved to be the most effective way of encouraging thrift and a law was approved on 6 August 1943 that made interest on bank deposits and bonds exempt from taxation for a limited period.²⁶

Despite efforts to the contrary, inflation accelerated strongly in Finland, especially towards the end of the war. The increase in the cost of living indexes during the war in Finland and some other European countries is depicted in the diagram. For Germany, useful statistics on consumer prices do not seem to be available.

Comparing changes in the cost of living in the countries selected is naturally difficult because their external circumstances were so different. Sweden remained outside the war, France and Norway were occupied by Germany, while Finland and Great Britain were belligerents in total war. What is undeniable is that Finnish prices experienced steep inflation; of the countries included here, only France suffered more.

WARTIME COST OF LIVING INDICES IN SELECTED COUNTRIES



Source: Nars, K., 1966.

BANK OF FINLAND'S FINANCIAL CONDITION DURING THE WAR

Superficially the operations of the Bank of Finland developed favourably during the war but this was an illusion induced by inflation. In real terms the bank's balance sheet hardly grew at all after 1941, as the diagram on page 49 shows. Practically speaking, the bank was in the same position in 1946 as it had been in 1938.

In reality the situation was far more disturbing because the bank's sources of income had developed in a very unsatisfactory way during the war. In the second half of the 1930s, most of its income had come from interest on domestic lending, foreign bonds and assets held overseas in correspondent banks. It had also received commission and profits on exchange. The war changed the situation because its foreign assets and foreign bonds shrank to almost nothing. Its only significant source of income was now interest on domestic lending and domestic bonds, although it did also receive

more commission because the central bank was responsible for mediating foreign trade payments.²⁷

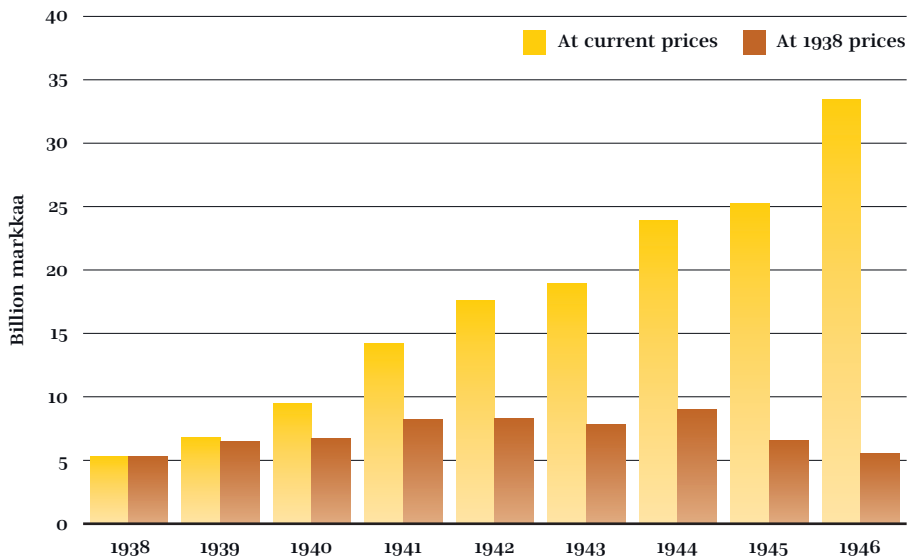
Domestic lending and domestic bonds were associated with meeting the government's needs for finance, which was reflected in their low interest rates. The interest rate was purely administrative and, from the government's perspective, merely an item of expenditure, so the rate charged by the Bank of Finland on bills of exchange was reduced to a record-low level. In 1941 it was 2½ percent, in 1942 it was lowered to 2 percent and from 1943 onwards it was 1½ percent. Such a low interest rate obviously represented the Bank of Finland's contribution to the wartime public purse. Any higher rate would probably have been clawed back by the government anyway in the form of a transfer of the bank's greater surplus.²⁸

Meanwhile the central bank's payroll costs had risen appreciably, because the number of employees almost doubled during the war. Consequently the bank's capital adequacy deteriorated alarmingly, as the diagram on page 49 indicates.

The bank had shown a favourable result from the mid-1920s onwards, because interest rates had been high and credit losses, hitherto chronically large, had been reduced. Its capital adequacy ratio had steadily improved and in 1938, the last year of peace, stood at nearly 35 percent of the balance sheet total, although the rapid growth of the balance sheet in the second half of the 1930s had eroded it slightly. In the early stages of the war the main cause of its decline was the bank's fading surplus. In 1945 and 1946 the principal factor was accelerating inflation.

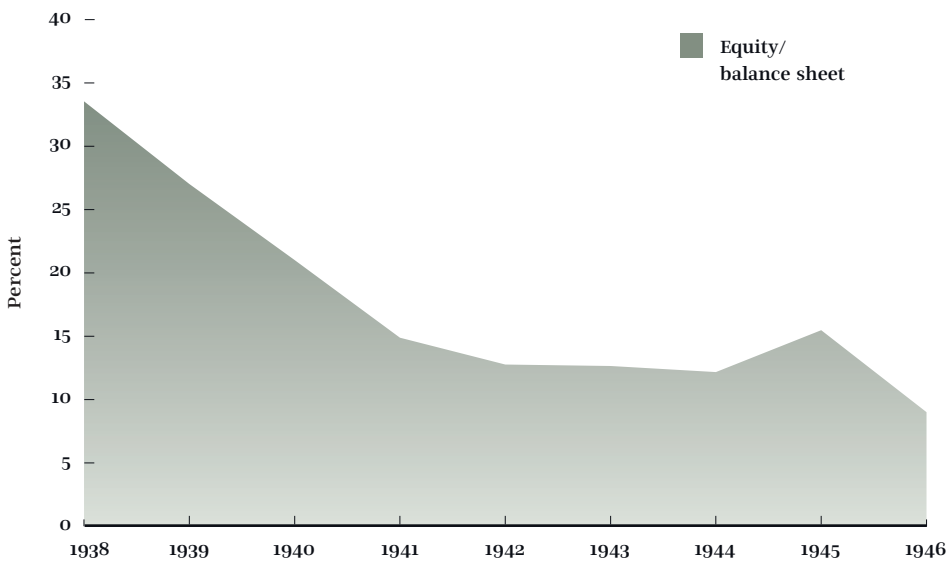
During its history the Bank of Finland had twice had to restart operations from a position of almost zero capital. This had happened first after the crises of the 1860s and again because of the losses caused by the First World War. Following the Second World War the Bank of Finland would be once more in almost the same position.

BANK OF FINLAND BALANCE SHEET TOTALS, 1938–1946



Source: Bank of Finland financial statements 1938–1946.

BANK OF FINLAND SOLVENCY 1938–1946



Source: Supervisory council reports 1938–1946.

FOREIGN RELATIONS AND FOREIGN EXCHANGE

CHANGING POLITICAL CONDITIONS

Foreign relations and currency policy were important at the Bank of Finland even before the Second World War broke out, but the war and wartime regulations changed the market orientation of central bank activities in this field almost entirely. As the regulating official, the Bank of Finland was now obliged to handle thousands of permits related to payments abroad. It also acquired many practical tasks in managing this payment traffic, tasks that had mostly been handled by the commercial banks in peacetime. Apart from the foreign currency rationing that the bank itself imposed, it also had an expert role in the system of rationing goods for sale that was adopted during the war. Naturally, rationing was tightly linked to currency policy although the key objectives of foreign trade controls were to promote national supply and defence.

Another of the Bank of Finland's roles during the war was to help finance the war effort and the military economy. In addition to large scale domestic lending, mostly to the government, its war finance had an international aspect as well. During the war the bank liquidated nearly all its gold reserves and used up practically all its foreign currency reserves to finance imports. Payments to Germany, Finland's most important wartime trading partner, and the countries in Germany's sphere of influence, took place via Bank of Finland clearing accounts, so the Bank of Finland intermediated the very substantial financial support that Germany provided to Finland, especially in the

early years of the Continuation War of 1941–1944. The bank also had a key role in managing commercial relations with Sweden, another important trading partner. As gold and currency reserves were exhausted, imports from Sweden were purchased on credit from Sweden, often arranged by and usually guaranteed by the Bank of Finland.

Finland's foreign exchange policy during the Second World War was not constant, varying greatly according to political and economic circumstances. From the Finnish perspective, the Second World War can be divided into several periods, as follows:

Neutral Finland	01 Sep 1939–29 Nov 1939	3 months
Winter War	30 Nov 1939–12 Mar 1940	4 months
Interim Peace	13 Mar 1940–24 Jun 1941	15 months
Co-belligerence with Germany	25 Jun 1941–04 Sep 1944	39 months
War against Germany	15 Sep 1944–25 Apr 1945	7 months

Each of these periods has its own special features, some of which vary strikingly. The period when Finland was fighting alongside Germany – called the Continuation War in Finland – can be divided into two sub-periods in a political and even an economic sense: the time before spring 1943, when relations between Finland and Germany were still good, and the time afterwards, when Finland was trying to distance itself from Germany politically while Germany was seeking to bind Finland more closely in an alliance to prevent it seeking a separate peace. These sub-periods have different economic characters. During the first (from spring 1941 to spring 1943) Germany financed supplies to Finland and the Finnish war effort fairly liberally but in the latter period (from summer 1943 to summer 1944) it sought to limit its economic support, partly because its resources were dwindling and partly to force Finland into a more accommodating policy. The difference is clear in the growth of clearing account debt between Finland and Germany.

After the war had ended the Bank of Finland received new duties related to rebuilding foreign economic relations for peacetime conditions. Currency policy returned to the agenda and, before long, so did Finland's relationship to the international currency system that began to develop after the Second World War. Because of the time

required to rebuild foreign economic relations and stabilise public finances, many of the Bank of Finland's operations remained unchanged for several years into peacetime.

WARTIME CURRENCY POLICY

The first impact of the war on currency policy was a shift from a sterling-oriented policy to a dollar-oriented policy, and then the start of currency rationing. The Finnish markka had been tightly pegged to the pound sterling since spring 1933, as had the currencies of the other Nordic countries. The pound in turn had long had a fixed rate against the US dollar. In keeping with its sterling-based currency policy, the Bank of Finland held a significant proportion of its foreign currency reserves in pounds, on deposit in various London banks. Some of its gold reserves were also deposited with the Bank of England in London.

As political tension in Europe worsened, Great Britain's foreign currency position began to deteriorate from spring 1939, when Germany occupied Czechoslovakia (15 March 1939) and Italy attacked Albania (7 April). Declining confidence eroded London's position as a financial centre. The Bank of England suffered an almost continuous outflow of gold from April 1939 onwards, and foreign banks withdrew their deposits from banks in London. The Bank of Finland too transferred most of its reserves from London to New York in the course of spring and summer 1939. At the start of the year its deposits in London had been worth over 1.1 billion markkaa but by the end of September 1939 only 77 million was left. At the same time foreign currency held in New York had increased from 42 million to 719 million markkaa. But despite the exodus of gold and currencies, Britain's Exchange Stabilisation Fund continued to support the pound's exchange rate, which was held at 4.68 dollars, until the last week of August.²⁹

Mistrust in the pound worsened into an outright crisis when Germany and the Soviet Union signed the Molotov-Ribbentrop non-aggression pact, announced on 24 August 1939. An early outbreak of war in Europe now seemed very likely and the decision was taken on the same day in London to stop supporting the pound in order to protect Britain's gold reserves. The day after, Friday 25 August, the pound floated freely and its rate began to drop steeply against the dollar.

For Finland and other countries in the sterling club, flotation of the pound was a crucial event. The lynchpin of their currency policies had failed. In this situation the governors of the Nordic central banks convened in Stockholm on Sunday 27 August to discuss a common line of action. Those present – Carl Bransnæs from Denmark, Risto Ryti from Finland, Nicolai Rygg from Norway and Ivar Rooth of Sweden – were agreed that the sterling peg of Nordic currencies could not be continued because it would cause unwanted fluctuations in Nordic price levels. A new focus had to be found.

They also agreed that it was undesirable to peg Nordic currencies to gold because the price of gold in current conditions was artificial. Instead they looked to the dollar. In Ryti's view it was the best alternative "because the dollar is becoming a common currency in international trade and it is emerging as the basis for a new area of stable currencies and free currency markets".

The governors also discussed the principles for setting new dollar exchange rates, with the objective that mutual rates between Nordic currencies would not change. Ivar Rooth initially proposed using the dollar exchange rate on Friday 25 August but that would have meant an effective revaluation of the krona and the markka because it would have ignored the fall in the pound's exchange rate. Ryti proposed that 80 percent of the pound's devaluation against the dollar should be used to revalue Nordic currencies against the pound and the remaining 20 percent to devalue them against the dollar. This would reduce the revaluation effect of a dollar peg. The others regarded this as a good solution although naturally no one present could commit their country to it before the competent authorities at home had been consulted.³⁰

On Monday morning, 28 August, the Swedish Riksbank announced that it would act in line with Ryti's proposal and the Bank of Finland decided to follow suit the same day. Consequently the exchange rate between the Swedish krona and the Finnish markka would not change when they were pegged to the dollar. When the new dollar exchange rates were announced, both currencies had been devalued 1.2% against the dollar, compared with the rate preceding the August crisis.

Norway's decision came the next day. It devalued slightly more than Sweden and Norway, fixing its krone to the dollar at a level that was 3% weaker than before the crisis, so it was devalued slightly against the Finnish and Swedish currencies, too. Denmark took the longest to decide,

setting its dollar peg rate on 1 September 1939, a week after the collapse of the pound. It chose a greater devaluation than Norway, pegging its krone to the dollar at a rate 8% below the pre-crisis rate.

On 1st September Germany attacked Poland and two days later Britain and France declared war on Germany. The Second World War had begun. At the outbreak of war, Finland declared itself neutral and expressed the desire for continuing trade with both Germany and the Western alliance, but the declaration of war hurt Finnish foreign trade because both Germany and Britain sought to prevent neutral countries from exporting goods that could end up in the hands of the enemy. Transport through the Straits of Denmark, the key channel for Finland's foreign trade, came under German control from the very start of the war, while the British fleet controlled shipping in the North Sea. It was particularly hard for Finland to trade with the Western allies but trade with Germany continued largely as normal during the first months of the war.³¹

Finland managed to remain neutral and outside the war for only three months. On the last day of November 1939 it was attacked by the Soviet Union and the Winter War began. Obviously this had an immediate effect on trading relations and international payments. Trade declined steeply and for the duration of the war most trade was with Sweden. Trade with Germany, which enjoyed cordial relations with the Soviet Union at this time, came to a standstill.

The Bank of Finland stopped quoting foreign currencies entirely during the first week of the war but resumed on 9 September. The dollar was then quoted at a new rate (49.35 markkaa) but it was little different (0.3%) from the rate chosen at the end of August and it remained in force until the end of the war. The rate against the Swedish krona was entirely unchanged. On the same day that currency quotations were resumed, the compulsory disclosure of "assets and debts abroad or denominated in foreign currency" took effect. The government decreed that everyone – companies as well as private individuals – should inform the Bank of Finland by the end of September about all their foreign liabilities and receivables.

At this point a few general observations can be made about the wartime exchange rate policy, which was entirely passive. Exchange rates were held almost unchanged between September 1939 and spring 1945. Although no legally binding decision was made on a dollar peg,

the decision taken at the turn of September 1939 to hold the dollar exchange rate steady remained in force. The rate for the Swedish krona, itself pegged to the dollar, was also fixed. During 1940 and in early 1941 there were a few insignificant fluctuations in the rates for the pound sterling and continental currencies but after Finland entered the Second World War in summer 1941 the rates were frozen. The only wartime rate change that had any significance for Finnish foreign trade was when the Danish krone was revalued in January 1942. When the krone was revalued against the currency of Germany, then occupying Denmark, the Bank of Finland revalued its own krone quotation by 8.5%.

Exchange rates – fluctuating or fixed – were less economically important during the war than in peacetime. Soon after the start of the World War, comprehensive controls on currency trading and foreign trade were introduced, which made exchange rates more a matter of administration and accounting. Rationing was used to balance the supply and demand for foreign exchange, while foreign currency was allocated to those who needed it by regulations rather than the price mechanism, distributing foreign exchange on the basis of applications and only for purposes important for armament and national supply.

At a time when there was a severe shortage of foreign currency, fixed exchange rates were possible only because currency reserves were protected by currency rationing, which can be seen as an alternative to devaluation, at least in theory.³² The shortage of foreign currencies was one of the most acute Finnish economic problems during the war. While foreign trade was regulated and based on bilateral and often very detailed agreements, an active exchange rate policy would obviously have been little help in balancing the payments account. In this sense the policy of fixing exchange rates can be seen as a consequence of the obvious ineffectiveness of varying them while foreign trade was subject to government controls.

An examination of wartime exchange rates must also take into account that the number of currencies genuinely important to Finland or its central bank declined as Finland's international economic relations became more and more confined to Germany, the countries in Germany's sphere of influence, and Sweden. From summer 1941 onwards, when economic relations with Great Britain were severed and those with the United States curtailed, the Swedish krona was the

only fairly free currency that had any commercial significance for Finland. Germany and the countries in its sphere came to dominate trade completely from summer 1941 until autumn 1944, and this trade took place within a framework of bilateral payments agreements using various clearing accounts. Foreign currency in the traditional sense was not used at all. In 1942 the Bank of Finland quoted rates for 17 different clearing currencies used by Germany, its allies and the countries it was occupying, plus neutral Spain, Portugal and Turkey. By far the most important of these for Finnish trade were the German Reichsmark and the Danish krone.

It had been customary in Finland, as in other countries, to estimate the “natural” level for exchange rates by calculating purchasing power parities. It was thought that exchange rates should normally move to offset differences between national price levels. However the clearing system that dominated international trade tended to reduce the significance of exchange rates and the relevance of purchasing power analyses. Mikko Tamminen’s review of currency policy states that, at least during the war years, trade based on clearing agreements made it possible “to sever the interdependence between two countries’ cost and price levels and their exchange rate, which would have existed at times of a freer exchange of goods and capital”.³³ This assessment is supported by the fact that Finland experienced no compelling need to alter its exchange rates until the time arrived to prepare for the move to less fettered foreign trade.

However, even in a wartime economy, exchange rates were a cost factor because they influenced import prices and therefore inflation. The issue became relevant in 1941, when Finland was increasingly dependent on Germany for imports. Germany had imposed protectionist trade barriers since the 1930s and its price level had risen far above that of Finland or the other Nordic countries. Moreover, unlike Finland and many other countries, Germany had not carried out a major devaluation when it left the gold standard but had instead imposed foreign currency rationing. The German Reichsmark was therefore overvalued against many currencies, including the Finnish markka. When goods from Germany replaced what had previously been obtained from elsewhere in the world, imports became significantly more expensive than before, which in turn spurred inflation in Finland.

Rainer von Fieandt, a member of the board of the Nordic Union

Bank and Finland's Minister of Supply during the Winter War, publicly referred to the effect of expensive German imports on inflation in Finland in a presentation in October 1941 on the challenges to monetary policy.³⁴ The same phenomenon was experienced in Denmark when its economy began to be more closely integrated with Germany's after the occupation in spring 1940. After a series of negotiations Denmark managed to get German permission to revalue the krone by eight percent in January 1942. The specific aim was to combat rising inflation.³⁵

Finland apparently never gave serious consideration to revaluing the markka in order to reduce cost pressures. In his presentation, mentioned above, von Fieandt instead used the difference between Finnish and German price levels to explain why Finland was able to maintain a fixed exchange rate with Germany despite raging inflation. Because the Reichsmark was overvalued, Finland's faster rate of inflation would tend over time to reduce rather than increase tension between the two countries' price levels. Von Fieandt also said that, because of the convergence in price levels caused by Finland's faster inflation, the fixed exchange rate between the markka and the Reichsmark might prove to be tenable even after the war ended.³⁶

In trade with Sweden, the constancy of the exchange rate during the war was, in a sense, merely superficial. In December 1942, the Finnish government decided that a 20% surcharge would be levied on imports from Sweden, and that exports to Sweden would be subsidised by special compensation payments. The payments varied according to the category of goods but were generally 30–40%. The combined effect of import surcharges and export payments was much the same as a devaluation against the Swedish krona would have been, but more selective in treating different exports in different ways. Furthermore the surcharges and subsidies were specifically aimed at Sweden and did not raise the markka prices of imports from Germany and the inflationary pressure they caused, as a general devaluation would have done.

EXCHANGE CONTROLS ADOPTED

When the war began Finland had experienced exchange controls only during the First World War and then briefly in autumn 1931. Since the beginning of 1932 the foreign exchange market and capital movements had been completely free. In this respect Finland differed from most

continental European countries, which had been compelled in the 1930s to enact and extend sometimes quite draconian restrictions on foreign exchange transactions and capital movements in order to protect their exchange rates. The war meant a total change for Finland in this respect.

With the approach of war, the first steps to restrict foreign capital movements were the laws on foreign economic operations in Finland, enacted in summer 1939. The most important of these was “the Act on the right of foreigners and certain corporations to own and administer real estate and shares”. It stated that foreigners required special permission from the government to own more than 20 percent of the stock of any Finnish company. This law was sent to parliament in the spring and came into force at the start of August 1939.³⁷

The outbreak of war meant broadly-based exchange controls in Finland. The objectives were initially to protect foreign currency reserves and ultimately to prevent an exodus of currency that would lead to a devaluation, but when Finland’s involvement in the war began to appear ever more likely, exchange controls took on the character of trade policy. It was part of a system of administrative measures for focusing the resources of the nation on the most vital needs of the defence forces and national supply.

A prelude to currency rationing was the compulsory registration of assets and debts denominated in foreign currencies, mentioned earlier. It came into effect only a few days before the Second World War began. Actual and comprehensive exchange control was implemented by decision of the government on 25 October 1939, which forbade the export of money and securities and all payments abroad in general unless individually licensed by the Bank of Finland. At the same time the repatriation of foreign assets and foreign currency income was made compulsory.³⁸

The decree stated that the purchase of imports and the payment of foreign debts, interest charges or other fees due abroad were permitted only if the payer had a merchandise import permit or if the need for foreign currency was based on a commitment made before October or on some other commitment for which the payer had obtained permission from the Bank of Finland to send currency abroad. Payments abroad could be mediated only by the Bank of Finland or by a domestic commercial bank that it had licensed to do so.

The repatriation requirement meant that all foreign currency and all foreign assets denominated in foreign currency had to be surrendered (sold) to the Bank of Finland no later than eight days after it had been obtained. The Bank of Finland paid compensation in markkaa. The intention was to prevent companies or individuals who had foreign earnings from circumventing the exchange control by selling them on the black market directly to those who needed it. The government wanted to centralize all the nation's foreign currency holdings at the Bank of Finland, where they would be administered according to official policy.

Alongside and partly overlapping the exchange control was a system for regulating foreign trade. Already in September the import and export of many forms of merchandise were restricted by statute and at the end of October foreign trade was entirely regulated by the Act "on proscribing the import and export of merchandise", which made all foreign trade subject to export and import permits granted by the government. The practical management of foreign trade rationing was immediately placed in the hands of the License Commission from the start of September 1939. In autumn 1940 the Foreign Trade Committee was set up, consisting of representatives of the private sector (various export and import branches), the ministries of defence, supply and foreign affairs, and the Bank of Finland. For practical implementation of rationing, various consortia were established to allocate imports and exports "justly and equitably" between different companies. The consortia were each responsible to an elected council. The Foreign Trade Committee continued operating until autumn 1942, when it was disbanded and its functions transferred to the Trade Agreement Committee. The elected councils continued to function.³⁹

Participation by the Bank of Finland, the official body responsible for exchange control, in decisions on import licences meant that currency policy aspects could be considered. C.E. Knoellinger's broad study of exchange controls points out, however, that import licensing and exchange control remained separate operations and although the granting of an import licence generally entailed permission to buy the currency required, the separation of these two functions made it possible in exceptional circumstances to restrict currency sales to the purchase of imports already licensed. Furthermore the use of foreign

exchange for purposes other than the licensed import of merchandise, for example for foreign travel, was subject to case-by-case examination.⁴⁰

Although foreign trade shrank greatly during the war, exchange and trade controls were fairly sizeable administrative challenges. According to a study by Kari Nars, the official machinery had to consider almost 700,000 applications between September 1939 and December 1946. About 85 percent of them were approved. Perhaps partly due to the exchange controls of the Bank of Finland and partly because of difficulties in deliveries abroad, the value of actual imports during the period was only two-thirds that of the licences granted. A significant proportion of the practical work involved in exchange control was delegated to licensed commercial banks, however, who applied the instructions of the Bank of Finland in selling their customers foreign exchange (and buying it from them).⁴¹

In his aforementioned contemporary study of exchange control, C. E. Knoellinger concluded that the laws and statutes on rationing in Finland were far less specific than those of, for example, Germany and Sweden, because they gave the Bank of Finland very wide discretion in its decisions.⁴² The bank was also one party in the decisions on licensing merchandise imports. Another sign of the great expansion of central bank responsibilities in foreign currency transactions is the statute of December 1940 that made the possession of adequate foreign exchange a condition for foreign travel by Finnish citizen. Subsequently all those travelling abroad needed not only a travel permit from the police in their passport but also the stamp of the Bank of Finland, to confirm that travel permission could be granted.

The controls of foreign exchange and trade begun in 1939 were founded mainly on the Martial Law Act of 1930, which gave the government the right to ration goods only if they were specifically defined by law. For this reason it was necessary to enact many separate laws for different commodities, until May 1941, just before the German attack on the Soviet Union and Finland's involvement in the hostilities. At that time an emergency powers act (the Act on Regulating the Economy in Extraordinary Conditions) was passed. This gave the government broad authority to regulate "production, consumption, trade, transport, exports, imports and prices as well as rents, transport charges, tolls, service fees and other payments" and also, among other things, "to issue instructions on the confiscation or surrender to the

government of products, commodities and other chattels for production or consumption as well as for the maintenance of property ordered to be confiscated or surrendered". The emergency powers act made exchange control legal in peacetime, too, to protect the country's solvency and maintain the value of money. It also gave the government the authority to expand the jurisdiction and duties of the Bank of Finland.⁴³

Specifically, section 2 of the emergency powers act gave the government the authority "in order to protect national solvency or maintain monetary value" to restrict the possession and trading of foreign currency and to order foreign currencies, securities, and the like to be surrendered to the Bank of Finland. Section 5 of the law stated that, if necessary for implementation and application of the emergency powers act, the jurisdiction and duties of the Bank of Finland could be expanded by decision of the Council of State after a proposal on the subject had been made by the Parliamentary supervisory council at the initiative of the Board of management. On the authority granted by the emergency powers act, the government made a new decision on exchange control on 5 September 1941, expanding the powers of the Bank of Finland. The bank could now individually direct practically all foreign trade, capital movements, foreign investments and foreign payments mediated by Finnish banks. The bank obtained, in effect, a monopoly in foreign exchange in Finland.

Restrictions on the foreign exchange market in Finland naturally did not stem from Finnish laws and regulations alone. Freedom in foreign exchange and capital movements or barriers to them also depend on the situation in the country of the currency in question, its regulations on capital movements, and so on. Foreign-exchange operations can be carried out only if both countries permit it so the foreign currency situation in Finland also depended on controls applied abroad. In this respect the outbreak of the war brought a major change. By spring 1941 only four countries in the world were regarded as having "freely convertible" currencies – Switzerland, Portugal, Argentina and the United States – and even in these countries the freedom was not absolute.⁴⁴ The US decision of June 1941 to freeze the assets of a large number of countries was very important. The foreign exchange market of the United State had then ceased to be free to Finland and the other countries affected by the freeze.⁴⁵

GOLD MOVED TO SAFETY

After the outbreak of the war in Europe, at the start of September 1939, the Bank of Finland embarked on measures to protect its gold reserves. It did so first by distributing the gold reserves held at head office to the branch offices and then by transferring them to Sweden. Stockholm was only a first stop, because ultimately Finland aimed to move its gold to the United States and convert it into dollars there.

Protecting and realising the gold reserves were a part of the effort to solve Finland's wartime financial problems. The use of gold reserves for financing should not be underestimated but it did not play a crucially important part in financing the wartime trade deficit. Compared with many other countries in the second half of the 1930s, Finland held a relatively small proportion of its gold and foreign currency reserves in gold. Most of the banknote cover was kept in foreign exchange, deposited in the bank's foreign correspondent banks. At the end of 1938 only about a third of the Bank of Finland's international reserves were in gold while two-thirds were held in foreign currencies.

The small size of the gold reserve was a consequence of policies that the Bank of Finland had long pursued. Since the start of the 1920s it had been operating on the principles of the gold currency standard, in line with the recommendations of the Genoa conference of 1922. The idea was that smaller central banks would hold their international reserves in the form of currencies tied to gold instead of the metal itself. This was intended to reduce demand for gold and concentrate the world's gold reserves in a few financial centres such as London, New York and Paris. Finland's policy contrasted with that of the other Nordic countries. At the end of 1938 the gold reserves of Sweden were a full 12 times greater, Norway had three times as much and Denmark twice as much.

In summer 1939 the Bank of Finland's total gold reserves were about 23.5 tonnes, booked at a value of 1,128 million markkaa. The bookkeeping value (48 markkaa per gram) was about 12 percent below the market price of gold. At prevailing prices in summer 1939 (35 dollars/ounce) and the current exchange rate (48.60 markkaa/dollar) the market price of gold was 54.7 markkaa/gram so the current value of Bank of Finland gold not minted into coin was 1,285 million markkaa.⁴⁶

In the last summer of peacetime some 10 tonnes of the Bank of Finland's gold were in the form of bars in the vault at head office. It had further reserves of gold coins with a bookkeeping value of 385 million markkaa, equivalent to about 8 tonnes of gold. The coins were mostly at the Vaasa branch and only a small proportion in Helsinki. Thus the bank's gold reserves in Finland totalled about 18 tonnes. The rest of its gold was deposited in London with the Bank of England (4.5 tonnes) and a smaller amount (equivalent to about 700 kilos) at the Bank for International Settlements in Basel. On 15 August, the eve of the Second World War, the Bank of Finland acquired about a tonne of gold in the United States, which was left on deposit at the Federal Reserve Bank of New York.⁴⁷

Germany's attack on Poland on 1st September set in motion the relocation of Bank of Finland gold, first out of Helsinki and then abroad. During the last two weeks of September at least half of the gold bars were moved from head office to the branch offices, mostly to Pori but some to Turku and Mikkeli. In October the bank began to transfer its gold onwards to Sweden.

The first consignment for Sweden left Mikkeli on 6 October. The gold in Turku was dispatched on 10 October and the vault at the Pori branch was emptied on 13 October. The vault at head office was almost completely empty after consignments to Stockholm of about 5 tonnes on 6 and 12 October. During the war years gold reserves at head office consisted only of 1,000 old Austrian coins of 20 Kronen. Apart from these, the gold reserves of the Bank of Finland were entirely abroad during the Winter War, except for the last consignment from the Vaasa branch to Sweden, which took place on 5 December, after the war had started.⁴⁸

Location of the gold reserves of the Bank of Finland at the start of the Winter War is shown in the following table:

Bank of England (London)	4.5 tonnes
Swedish Riksbank (Stockholm)	18.1 tonnes
Federal Reserve Bank of New York	1.3 tonnes
BIS (Basel)	0.7 tonnes
Total	24.6 tonnes

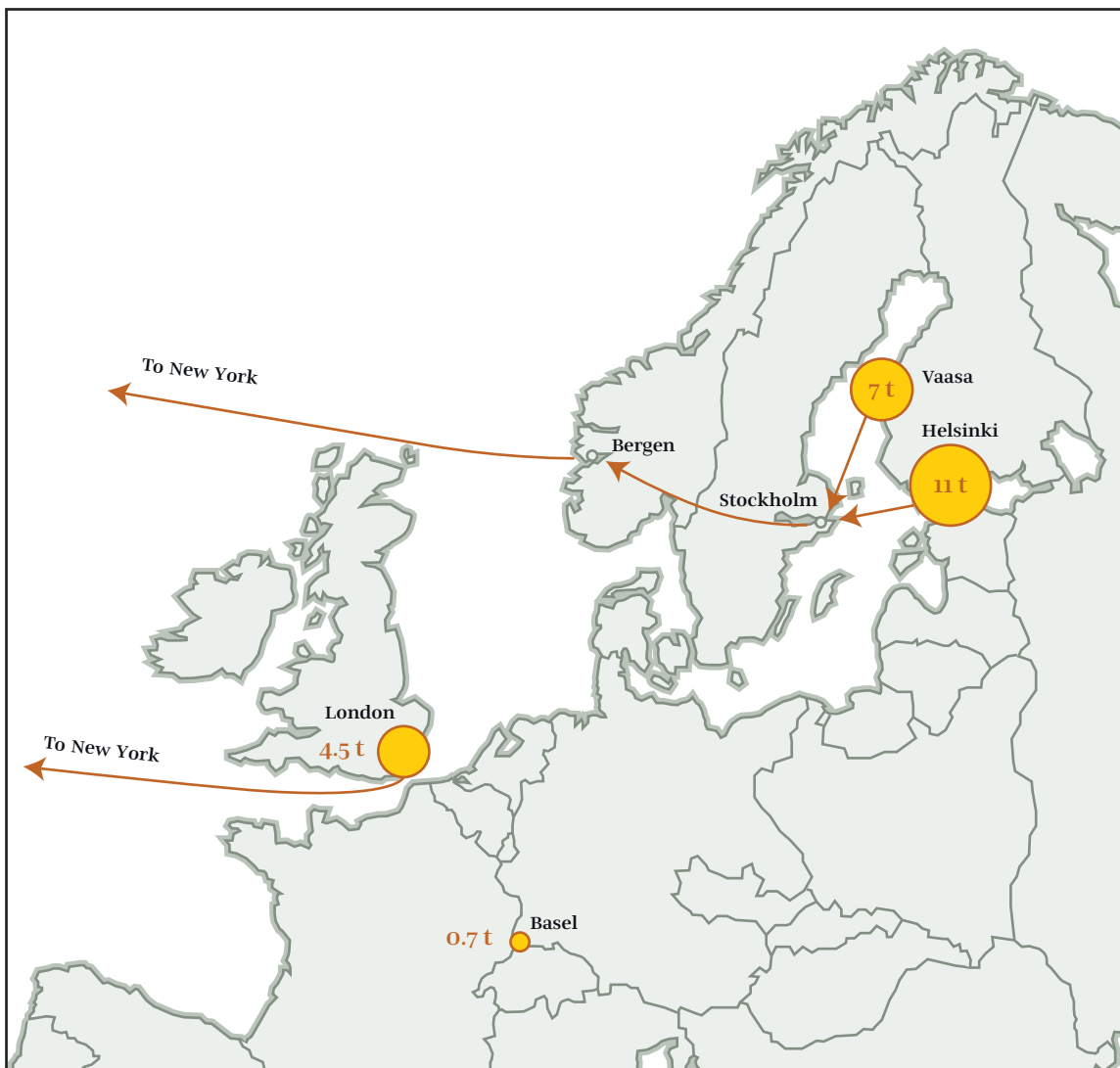
At the start of 1940 the Bank of Finland began extensive gold sales. First it liquidated the gold that it had sent to Sweden. About 5.4 tonnes was sold to the Swedish Riksbank on 31 January. The 12.8 tonnes remaining in Stockholm was shipped in six separate consignments via Bergen to New York at the end of January and start of February. In New York 1.9 tonnes was sold on 7 March, a week before the end of the Winter War. During the Winter War, more than two-thirds of the gold reserves – 17.3 tonnes – were sold, raising over 840 million markkaa in foreign currencies, mostly US dollars.

The transfer of gold continued in summer 1940 during the Interim Peace, when the Bank of Finland moved its gold reserves from London to New York. This was done in July and August, soon after Finland had reached a politically and economically important trading agreement with Britain's enemy, Germany (late-June). London was apparently regarded as too uncertain a refuge, which might freeze assets held there in response to the new political circumstances. In any case, converting the gold into the best foreign currency of the time, the dollar, was easier to arrange on the New York market than in London. The Bank of Finland's gold travelled to New York in at least six shipments on the SS Samaria, the SS Scythia (twice), the SS Eastern Prince, the SS Port Freemantle and the SS Britannic. All 4.5 tonnes of gold held in London were moved to the United States and deposited at the Federal Reserve Bank of New York.⁴⁹

In spring 1941 the Bank of Finland had gold reserves of 12.5 tonnes, almost all of which (11.8 tonnes) was now held in New York and the rest at the Bank for International Settlements in Basel. Relations with the United States had already become strained in late spring 1941, because of Finland's perceived cooperation with Germany although it had not yet joined the war proper, but this did not prevent the sale of its gold in New York. One tonne was sold on 30 May to the Federal Reserve Bank of New York and then two batches totalling 7 tonnes were sold to the Swedish Riksbank on 12 and 18 June. One more sale of one tonne of gold was made in New York to Sweden's Riksbank on 5 September, while Finland was already fighting alongside Germany against the Soviet Union. It was the last time the Bank of Finland sold gold during the war.

The sales in New York in May-September 1941 liquidated most of the bank's gold reserves. Only about three tonnes of gold remained

BANK OF FINLAND GOLD RESERVES: LOCATIONS IN SUMMER 1939 AND MOVEMENTS 1939-1940



Source: Bank of Finland, gold accounts.

with the Federal Reserve Bank of New York for the duration of the war, frozen beyond the reach of the Bank of Finland. These reserves were subsequently realised at the end of 1945, after peace had been restored, to cover Finland's acute shortage of foreign currency.

GERMAN CLEARING TRADE AND FINLAND'S BALANCE OF PAYMENTS

The Moscow Peace Treaty that ended the Winter War was signed on 12 March 1940 and hostilities between Finland and the Soviet Union ceased the following day. According to the terms of the treaty, Finland had to cede to the Soviet Union about 10 per cent of its pre-war territory, including the important town of Vyborg. The population of the area was evacuated to Finland.

In the immediate aftermath Finland sought a closer alliance with Sweden and Norway but these endeavours led nowhere. Soon the widening war in Europe changed the political situation in Finland's environs completely. In April Germany attacked Denmark and Norway. Denmark was occupied immediately and the whole of Norway by early June. A period of calm on the western front, nicknamed the *Sitzkrieg* (sitting war) in Germany, came to an end as Germany attacked westwards in May 1940. Its forces advanced rapidly; the Netherlands surrendered on 15 May, Belgium on 28 May and France on 22 June. At the same time, the Soviet Union invaded and occupied the Baltic States, which it incorporated as Soviet republics in August 1940.

The Molotov-Ribbentrop Pact and the division of Poland had created a brief period of warmth between Germany and the Soviet Union but, as German-Soviet relations cooled and as the Soviet Union tightened its grip on the Baltic States, German-Finnish relations warmed. Events in Europe were intensifying Finland's isolation, geographically and thus militarily and commercially. Forewarned by the Winter War and the fate of the Baltic States, Finland put no trust in a partnership with the Soviet Union. Trade was still possible with the western allies via the arctic port of Petsamo but it was limited and monitored by Britain's "Navycert" system.⁵⁰ Finland's response to the situation was to make approaches to Germany and develop ever closer cooperation, first economic and soon also military. The first talks with Germany on reopening trade had taken place during the

Winter War and agreement was reached the day before the Moscow Peace Treaty was signed. The restoration of peace then allowed Finno-German trade to be resumed.⁵¹

In August 1940 Germany had begun talks with Marshall Mannerheim and the Finnish government on troop transfer rights through Finland to northern Norway for “military leave traffic”. A transfer agreement was signed on 22 September. It was the first step towards ever closer military cooperation between the two countries in the months that followed. Ultimately by summer 1941 Germany had significant forces in northern Finland.

By May Finland was planning military cooperation with Germany while Germany was preparing to attack the Soviet Union. Finland declared general mobilisation on 17 May 1941. Five weeks later, on 22 June, Germany attacked the Soviet Union. However, Finland did not begin hostilities until 26 June, after the Soviet Union had bombed several of its towns. The Finnish government then announced that it was at war with the Soviet Union.⁵²

After Finland had joined Germany’s sphere of military and economic influence, German interests began to shape Finland’s foreign economic relations. Finland had to adapt to German’s mechanism for foreign trade, which differed significantly from “conventional” foreign trade conducted in freely convertible currencies.

Germany’s wartime trade policy aimed at turning Europe into a “greater economic area” (*Grossraumwirtschaft*) serving German military and economic interests. Europe was to become as self-sufficient as possible and foreign trade would be conducted under German supervision. Payments were to be made via Germany’s clearing account system that would net the claims and receivables of different countries.⁵³

Germany had in fact moved to bilateral clearing arrangements in its foreign trade soon after the rise of Adolf Hitler to power. The aim was to save scarce foreign currencies and to create a system whereby Germany, which had long suffered a bitter shortage of foreign currency, could purchase imports with its own products. This would maintain German industrial competitiveness on the export market and support employment at home – mass unemployment had been a major problem when the National Socialists had come to power in 1933.

The clearing system meant that Germany's trading partners received payment for their exports in a "tied currency" held in a clearing account, where it could not be used for any other purpose than purchases from Germany. The clearing system not only reduced German outlays of foreign currency (and in part made foreign currency reserves unnecessary) but also compelled Germany's trading partners to become the customers of German exporters. Germany had also formed its own industries into various sectoral consortia in order to prevent competition in export markets. The result was a system which, even during peacetime, could effectively exploit countries within Germany's sphere of commercial influence, especially in Southeast Europe. The economic dependence created by clearing trade and the absence of competition were reflected in the high prices of German products (compared to world market prices) and in the disadvantageous terms of trade (the ratio between export and import prices) for Germany's trading partners.⁵⁴

In principle, the bilateral clearing arrangements required that trade should be kept in balance and no major surpluses or deficits should build up in clearing accounts. Imbalances were to be eliminated principally by trade negotiations between the countries concerned. They could also be deterred by preventing payments from an account that contained inadequate funds. If the account was in deficit, payments would be executed in a preordained order, set in practice by trade agreements. Sometimes clearing agreements contained a clause that allowed excessive surpluses and deficits to be paid in convertible currencies or the like.⁵⁵

After the outbreak of war, however, Germany had begun to use the clearing system as a way of financing its own economy and had run up large debts to various satellites and occupied countries. In practice this meant that Germany did not pay for its imports from these countries but simply allowed its clearing account deficit to mount. Countries dependent on Germany had a weak negotiating position and could not prevent this.

But economic relations between Germany and Finland in 1940–1944 constituted a very interesting exception to the "normal" state of affairs in trade between Germany and its satellites or conquests. While Germany ruthlessly borrowed from the other countries dependent on it, it initially allowed to Finland run up a debt, thereby supporting the

Finnish economy and war effort, for obvious strategic reasons.⁵⁶

Finland had signed a bilateral payment agreement with Germany back in 1934. Later, payment agreements were signed with some other countries as well, and in the 1940's, Finland's foreign trade became almost entirely clearing trade. During the war the US dollar and the Swedish krona were the only convertible currencies that mattered to Finland and after economic relations with the United States were almost terminated in summer 1941 for four years, the Swedish krona remained the only freely convertible currency that had any real significance for Finland's foreign economic relations. In 1940, however, Finland's trade with the Western allies was still relatively brisk and a trade agreement was reached with the Soviet Union, too.

Trade talks between Finland and Germany in Berlin in summer 1940 laid the basis for closer economic relations, tying Finland economically to Germany. Ilkka Seppinen says that these trade negotiations, led on the Finnish side by Rainer von Fieandt, marked "a decisive step from one side of the great war to the other".⁵⁷ A new Finnish-German payment agreement, signed on 29 June, became a crucial element in trading relations because it allowed a payment imbalance in the bilateral clearing accounts. This aspect supports Seppinen's assertion that the 1940 trade agreement marked political convergence. Germany's willingness to deviate from its strict barter principles and grant book credit showed its desire to strengthen Finland economically – hardly for selfless reasons but rather as a potential partner.⁵⁸

Germany became increasingly important to Finnish trade in the latter half of 1940 after the trade and payments agreement took effect. At the same time trade relations with the Soviet Union, which had briefly revived, began to falter. At the turn of 1941 the Soviet Union cancelled its trade agreement with Finland. This, together with the practically complete closure of western trading routes in summer 1941, led to the situation in 1943 where 77% of recorded Finnish imports came from Germany alone and a full 95% from Germany and its satellites. (Italy is included in this figure.)

Payments traffic between Finland and Germany was handled via various accounts in accordance with the mutual payments agreement. At the core of the system were the actual clearing accounts that each party maintained for the other. The Bank of Finland had an account

denominated in Reichsmarks at the clearing office for German foreign trade, the Deutsche Verrechnungskasse, while the Deutsche Verrechnungskasse had a markka-denominated account at the Bank of Finland.

The Deutsche Verrechnungskasse also had a special markka account, the Sonderkonto, at the Bank of Finland, which became very important for financial relations between Finland and Germany. This account constituted the Bank of Finland's debt to Germany and it was treated as one of the freely usable markka accounts of foreign account holders at the bank. Of all payments being mediated to Germany, a 20 percent share was transferred of the Sonderkonto and only 80% went to the actual clearing account. Germans could use funds held on the Sonderkonto for various purchases from Finland; apparently German troops in northern Finland received the markkaa they needed from this account. In practice, however, Germany did not need or could not use all the funds that accumulated in the Sonderkonto, so its balance and the Finnish debt to Germany that it represented increased year after year, especially after the start of 1943. In addition to these three main accounts, payments between Finland and Germany used several other accounts of less significance, such as for travel expenses and capital earnings like interest and dividends.

The payment agreement with Germany also applied to payments traffic with Norway, the Netherlands, Belgium and the General Government (meaning the part of Poland annexed to the German Reich). Payments traffic with these areas took place in principle via the German clearing account. For "statistical reasons" the Bank of Finland kept its own separate accounts for these countries although they were sub-accounts of the main Reichsmark clearing account. Of the areas conquered by Germany, payments of the Protectorate of Bohemia and Moravia, Alsace-Lorraine and Luxembourg were also handled from October 1940 onwards via German clearing accounts.⁵⁹

As Germany defined it, Denmark was not an occupied country although it belonged to Germany's sphere of influence, so Finland had a separate payments agreement and separate clearing accounts denominated in markkaa and kroner for Denmark. There were bilateral payments agreements and clearing accounts with several other countries that were occupied by or dependent on Germany but many of these arrangements had already been made before the outbreak of

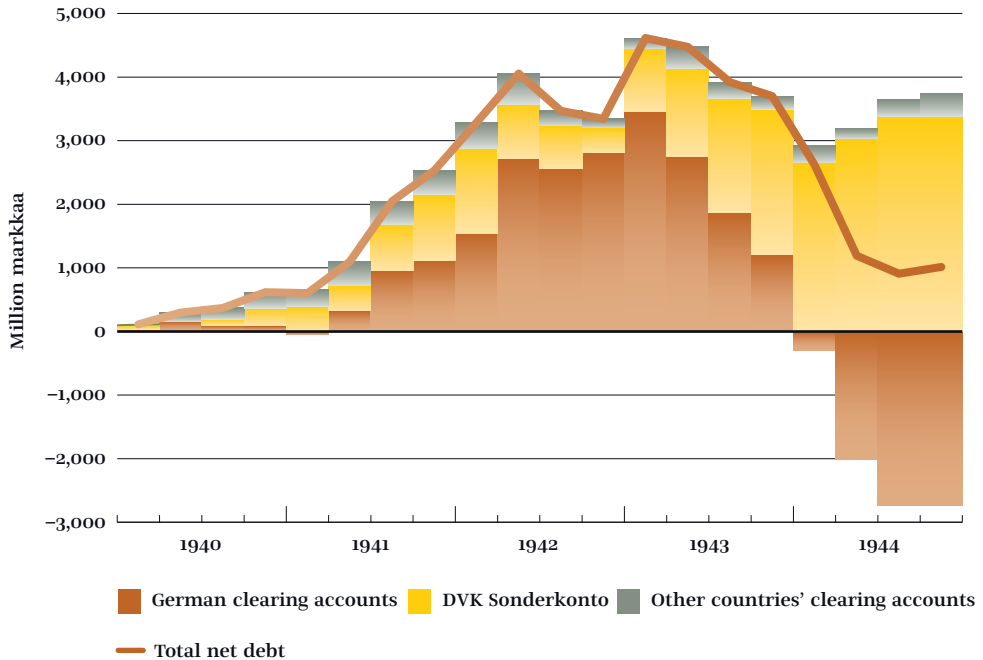
the war. Among the countries with separate payments agreements and clearing accounts with Finland were Italy, Vichy France and Hungary.

For a period of two and a half years following the payments agreement between Finland and Germany, Finland ran a large deficit on the clearing accounts and even the Sonderkonto to some extent. The deficit represented heavy borrowing from Germany; Finland's exports to Germany were nowhere near enough to pay for its purchases. The shortfall was recorded as book credit on the various accounts and had, by the end of March 1943, reached over 4.4 billion markkaa. The finance that Germany granted to Finland's wartime economy remained extremely significant until the early months of 1943. It was large in money terms alone but, even more crucially, it reflected vital supplies including grain and fuel.

Soon after the fateful German defeat in the battle of Stalingrad at the turn of February 1943, Finland began to try to distance itself politically from Germany. The Rangell government resigned and a government led by Edvin Linkomies took its place on 5 March. The new government lasted for more than a year until August 1944, when Finland decided to sever relations with Germany. In spring 1943 Finland had made enquiries about the possibility of a separate peace, about which it had also informed the German government. Germany feared a separate peace between Finland and the Soviet Union and demanded a formal political alliance. It backed its demand with certain forms of "blackmail", such as delays in deliveries and a less generous attitude to providing foodstuffs, fuel and sometimes even weapons. Apart from political motives, supplies to Finland were apparently also hindered by the worsening supply situation in Germany itself in the final years of the war. From spring 1943 onwards, Finland's balance of payments with Germany moved into surplus and its accounting debt to Germany turned down. However, although the deficit on the various clearing accounts fell, the reduction was partly offset by the Sonderkonto debt balance, which continued to rise.

Finland's negotiating position vis-a-vis Germany deteriorated markedly in June 1944. Three days after the Allied landings had begun in Normandy, the Soviet Union launched a major offensive on the front in the Karelian isthmus (10 June 1944). Its forces broke through immediately and the Soviet army advanced rapidly towards Vyborg. Finnish General staff turned to German General headquarters (OKW)

**BANK OF FINLAND NET CLEARING ACCOUNT DEBT 1940–1944 AND
DEUTSCHE VERRECHNUNGSKASSE SPECIAL MARKKA ACCOUNT**



Source: Bank of Finland archives, Account statements.

and asked for the ban on arms supplies to be lifted and for the Luftwaffe to give air support in the Karelian isthmus.⁶⁰ Not only did the failure of Karelian defence lines force a rapprochement with Germany; the new military situation also had a negative effect on Finland's status in the United States, where the staff of Finland's embassy in Washington were asked to leave the country on 16 June 1944.

The Karelian town of Vyborg fell to the Red Army on 20 June 1944. Two days later German Foreign minister von Ribbentrop arrived without warning in Helsinki, to demand an official pledge that Finland would not make a separate peace with the Soviet Union. It was a German effort to exploit Finland's need for aid and to establish the political alliance that Germany had sought since spring 1943. If it made the requested promise, Finland would be renouncing its claim that it

was conducting its own separate war against the Soviet Union and was not in an alliance with Germany. If it refused, Germany would terminate military assistance and there was a danger that Finland's defence would collapse completely and the country would be occupied by the Soviet Union or become a theatre of battle between the armies of the Soviet Union and Germany.

No official state treaty was signed but instead President Ryti sent a letter to German leader Adolf Hitler on 26 June 1944 that was to become famous. Referring to German military aid, the letter gave Ryti's personal promise to continue the war alongside Germany. In fact, however, Finland resumed its search for peace soon after. On 1 August, Ryti tendered his resignation and, three days later, parliament enacted special legislation to appoint Marshall Mannerheim president of Finland. The first new peace overtures to the Soviet Union were made in the last week of August.⁶¹

The effect of President Ryti's written promise on supplies from Germany has been the subject of much later debate. Judging from the accounts held at the Bank of Finland, the political events of 1944 came too late to cause a visible turn in Finland's payments surplus, which had grown almost continuously since spring 1943. Finland's net debt to Germany on the clearing accounts and the Sonderkonto continued to decline in summer 1944 until the beginning of September, when Finland agreed a ceasefire with the Soviet Union. At that time, when relations with Germany were severed, the deficit had fallen to 651 million markkaa, and Finland's total debt to Germany, including the trading debts of Finnish companies, was about 852 million markkaa. Under the armistice agreement, Germany's claims on Finland were transferred to the Soviet Union.

The ceasefire with the Soviet Union on 4 September 1944 meant the termination of payment arrangements with Germany. This was officially stated on 8 September, when the Finnish Foreign Minister Enckell sent a circular to Finnish officials, forbidding all trade with Germany. Diplomatic relations were severed on 10 September when Germany evacuated its embassy in Helsinki. On 15 September the Finns fought their first battle against German forces when the latter tried to invade the island of Hogland. Finland had changed sides.



■ The Bank of Finland was targeted by Soviet bombing missions. Destruction wrought at head office in February 1944.
– Bank of Finland / Fred Runeberg.

CONVERTIBLE CURRENCIES

In the years preceding the Second World War, most of the convertible currency reserves of the Bank of Finland, about 2.3 billion markkaa, were held on deposit in banks in London and Stockholm, about half in each. A small amount of currency was invested in New York. Naturally the Bank of Finland had correspondent banks in other financial centres around Europe but the amount of currency held outside London, Stockholm and New York was negligibly small.

As mentioned earlier, the Bank of Finland began to shift its foreign exchange reserves out of London, mainly to New York, as international tension grew in spring 1939. During the Winter War the reserves, then held mainly in New York and Stockholm, fell steeply to about half their prewar level (about 1 billion markkaa), despite sales of gold to the Swedish Riksbank and the US government. Krona-denominated reserves in Stockholm fell the most.

In 1940 after the Winter War, reserves held in the United States increased, reaching their peak during the Interim Peace in the autumn. At the end of September 1940 dollar reserves held in New York were worth over 1 billion markkaa and accounted for four-fifths of Finland's foreign exchange reserves. Subsequently the Bank of Finland began to shift its dollar currency reserves out of New York.

Finland's political and hence also financial relations with western powers could not remain unaffected after June 1941 when Finland joined the war on the German side. Although it coordinated military action with Germany, and despite the operations of German troops in northern Finland, Finland avoided a formal political alliance with Germany. It became the official doctrine that Finland was pursuing its own, separate war against the Soviet Union, albeit alongside Germany but not as its ally. The refusal to enter a formal alliance with Germany had both internal and foreign policy motivations. At home it ensured that the war enjoyed the broadest possible political support, even in circles (such as the Social Democrats) that regarded Hitler and National Socialism with revulsion. Abroad, the Finnish government sought to maintain some level of relations with the Western allies and preserve the right to disengage from the war at a moment suitable for Finland, regardless of the fate of Germany and without its consent.

Finland's desire for continuing relations with the western powers was not fulfilled. Great Britain severed diplomatic relations on 1 August 1941. The following day the British Board of Trade declared Finland to be enemy territory, which meant that the tiny remaining sterling reserves held in London were frozen. Transactions on Bank of Finland accounts in various London banks also ended in early August. In November 1941, after Finland had joined the revised Anti-Comintern Pact, Britain issued an ultimatum, demanding the end of military action against the Soviet Union. When Finland did not comply, Britain declared war on Finland on 6 December. However the reserves of the Bank of Finland that were stuck in London for the rest of the war were only about 100,000 pounds (equivalent to about 20 million markkaa).

During the war Finland sought to maintain functional relations with the United States. Although diplomatic relations did indeed last almost to the end of the war, economic relations with the US deteriorated as Finland drew closer to Germany. The Bank of Finland's policy for investing currency reserves shows this estrangement. As early as the end of 1940 it transferred a substantial volume of dollars from New York to the Bank for International Settlements in Basel and in spring 1941 it began to transfer reserves from New York to dollar accounts in Argentina and Brazil. During the spring it shifted over 3 million dollars – 162 million markkaa – from New York to South American banks. The last transfers were made on 13 June.

The June transfers obviously anticipated upcoming US currency controls. On 14 June, the very next day, President Roosevelt issued an executive order freezing the reserves of Finland and several other countries. The order was issued under the US "Trading with the Enemy Act" so Finland was defined as an enemy country within the meaning of the act. Funds could not now be used without the permission of the US Treasury Department.⁶² It is worth noting, however, that defining a country as an enemy for the purposes of the act was certainly not equivalent to a declaration of war. The same executive order froze the US funds, not only of Finland, Germany and Italy, but also of neutral countries including Sweden and Switzerland.

At the time of the order, the United States was still not at war even with Germany. In December, a day after Great Britain had declared war on Finland, Japan attacked Pearl Harbor. When the US then declared

war on Japan, Germany and Italy declared war on the United States on 11 December. At no point did the United States declare war on Finland, however, thus lending indirect support to the Finnish government's thesis that it was waging a separate war. The US also maintained diplomatic relations with Finland for a long time although they did steadily deteriorate as the war progressed. Tuomo Polvinen, in his study of Finland's international relations during the war, infers that Washington saw diplomatic relations as a means of influencing Finnish politics and trying to drive a wedge between Finland and Germany. The US embassy in Helsinki was also an interesting post from an intelligence viewpoint.⁶³

US consular relations with Finland were severed after Hitler had visited Finland on 4 June 1942, for the birthday of Marshall Mannerheim. After the Soviet Union's offensive had broken through in the Karelian isthmus, the staff of the Finnish Embassy in Washington were asked to leave on 16 June 1944. However diplomatic relations were not severed completely until 30 June, when the news arrived of the personal undertaking written by President Risto Ryti to Adolf Hitler.

EXCHANGE RATES RECONSIDERED

The armistice of 4 September 1944 and the interim peace treaty which followed did not of course restore commercial and financial relations at a single stroke. The severing of relations with Germany meant almost complete economic isolation for Finland until October, when foodstuffs, coal and other items were obtained on credit from Sweden, and the end of the year, when the Soviet Union supplied grain. It was not until the second half of 1945 that normal trading relations began to be opened with the Western powers and the Soviet Union.

The process was facilitated by the restoration of diplomatic relations. At the start of August 1945 the Allies, meeting at the Potsdam Conference, approved a communiqué that "the three Governments (the United States, Britain and the Soviet Union) agree to examine each separately in the near future in the light of the conditions then prevailing, the establishment of diplomatic relations with Finland, Romania, Bulgaria, and Hungary to the extent possible prior to the conclusion of peace treaties with those countries". During August all the allied great powers did indeed announce the opening of diplomatic

relations with Finland.⁶⁴ Regular foreign trade and payments traffic with the western powers began at the same time.

In the course of spring 1945, as the resumption of foreign trade and a return to normal conditions began to dawn, the question of the exchange rate returned to the agenda. Wartime inflation had been much faster in Finland than in its main – at this time, still potential – western trading partners, and the markkaa was clearly overvalued at the rate at which it had been held during the war. A partial solution had been found to the problem of poor competitiveness and unprofitability of exports when the surcharge on imports from Sweden was raised to 40% in October 1944, from the level of 20% that had been set two years earlier. This was a logical move, because costs and prices had risen much faster in Finland than in Sweden since 1942, but it was only a stop-gap solution, while Finland waited for the international situation to become clearer.⁶⁵

The question of changing the exchange rates to reflect the relative price changes that had taken place during the war was raised in the supervisory council by Erik von Frenckell on 15 March 1945. Even during the war, he had had a high profile and reputation for independence on the council that was unusual for the times. Now, he said, it was essential to examine the value of the markka, look at ways to combat the danger of inflation and decide what the exchange rate should be. The council responded by asking the Bank of Finland's board of management for a statement on the matter. The board's extensive memorandum, dated 28 May 1945 and later published in a booklet,⁶⁶ was then debated in a Council meeting on 30 May. The memorandum and the ensuing debate marked the end of the policy of fixed exchange rates that had been followed in the exceptional wartime conditions since 1939. In the months ahead, a series of devaluations took place, aimed at eliminating the overvaluation of the markka and at making exchange rates more commensurate with the markka's actual purchasing power.⁶⁷

In its memorandum to the supervisory council, the board had painted a broad picture of current exchange rate policies and mentioned, among other things, the plan approved at the Bretton Woods Conference for rebuilding the world monetary system. Naturally Finland as a co-belligerent with Germany had not participated in this meeting, arranged by the Allies. The board's statement reflects a

certain scepticism about the Bretton Woods agreement and notes in passing that the “Keynes Plan” for multilateral clearing, which had been proposed by Britain, would be “at least initially more appropriate for poor nations than the Bretton Woods plan for a system based on gold”.

Regarding the Finnish markka, the board noted cautiously that “when contacts are re-established with numerous foreign countries and we can discuss and agree on the exchange of goods, the matter (i.e. the currency question) will reach a new juncture. While it is true that no particular emerging payments system can yet be discerned, international economic life, the exchange of goods, needs a basis of accounting. For this very reason, although many matters are still obscure, the relative values of currencies must be studied and defined.” The memorandum also refers to exchange rate adjustments carried out by various other countries and notes: “when stabilizing our currency, it would hardly be expedient to seek to raise the value of the markka, which would create thorny conflicts of interest in productive life and labour relations and delay progress in economic life and the rise of output”.

Finally the memorandum considers the usefulness of purchasing power parity in setting exchange rates and notes that, despite all their weaknesses, purchasing power calculations “shed light on the exchange rate issue and give for their part an indication of the course to be charted towards balanced exchange rates”. The board saw no reason to embark on deflationary politics but did not want the value of the markka to be deliberately lowered, either. Therefore, plans for new exchange rates “should aim as closely as possible at the equilibrium level demanded by current circumstances, principally by considering the markka’s rate against the currencies of the countries with which we have the strongest trade and other economic connections”.

The supervisory council backed the views expressed in memorandum and endorsed the board’s proposal that the values of foreign currencies in Finnish markka terms should be raised 75%. The new rates took effect on the following day, 31 May 1945, but the adjustment “proved inadequate at a time when the cost and price level was steeply rising”. Just two months later (27 July) a new general devaluation was carried out, raising the value of foreign currencies by 40 percent and again on 16 October by 12.5%. The combined effect of

these exchange rate adjustments was that the exchange rate of the most important foreign currencies had been raised 176% in half a year. Thus, by winter, only 36% was left of the external value of the markka measured in dollars or Swedish kronor.

According to purchasing power parity calculations, these devaluations should have been enough but they were not. The pent-up demand for imports kept Finland's foreign currency position extremely tense until the Korean War Boom at the start of the 1950s. At a time of internal political and economic instability, it was impossible to tighten monetary policy enough to bring the balance of payments into better balance and halt inflation. The balance of payments problem was also exacerbated by the heavy reparations that Finland had to pay to the Soviet Union under the peace treaty. Although these could be paid with Finnish products instead of hard currency, they tied up resources and production capacity that could otherwise have been used for merchandise exports, and thereby improving the balance of payments.

In the same meeting where the board's memorandum on exchange rates was discussed, the supervisory council initiated action to dismiss Risto Ryti, the governor of the bank, and J.W. Rangell from its board of management. The reason was their wartime roles in government, as president and prime minister respectively, for which both were later impeached. The supervisory council presented Ryti with a statement, noting that certain parliamentary groups (the Finnish People's Democratic League, the Social Democratic Party, the Swedish People's Party and the Rural League) had discussed the prevailing situation and felt that it would be in the national interest to change the management of the Bank of Finland. The supervisory council concurred with this view. Ryti and Rangell resigned on 19 June after the council had renewed its request and specified that it referred to Rangell as well as Ryti.

AFTER THE WAR

CHANGING ROLE OF CENTRAL BANKING

During the war, the Bank of Finland had had little practical independence and the situation remained thus until the 1950s. Its more passive stance in formulating economic policy was far from exceptional. This was an international trend among central banks at that time.

The Second World War had radically changed the prevailing economic philosophy in Europe, which was now distinctly different to the period after the First World War. In the 1920s the consensus favoured returning economic policy to the *status quo ante bellum*, where monetary systems would again be based on the gold standard and monetary policy would be managed according to classic central banking principles. The situation after the Second World War was the reverse. The aim was now to prevent a recurrence of the economic problems – unemployment and payment account crises – that had preceded the war. Economic policy was seeking a new direction.

The new era brought a re-evaluation of the functions of monetary policy and consequently of the position of central banks. Under Keynesian theory, the key function of economic policy was to regulate aggregate demand in the national economy. Active and systematic measures to regulate demand were needed to maintain full employment and economic growth. In the economic philosophy that became established in the 1940s, monetary policy was not a special case but merely one instrument in the toolbox for regulating aggregate demand. The other set of tools fell under the category of fiscal policy, meaning the fine-tuning of public expenditure and taxation. The “invention” of

fiscal policy – how the government budget could be used to secure the macroeconomic objectives of full employment and rapid economic growth – was the crucial element of Keynesian economics. Successful economic policymaking was seen as requiring the harmonisation of monetary and fiscal policy. The general conclusion was that they were best coordinated by letting the government have its way in both.

Thus the status of central banks in many countries changed after the Second World War. Their independence declined and government gained correspondingly greater influence over monetary policy, for example in setting interest rates. In many instances, tighter government control was associated with the nationalisation of the central bank. A milestone was passed on 14 February 1946, when the Labour government of Clement Attlee nationalised the Bank of England, the orthodox exemplar of central banks. Slightly earlier, at the start of 1946, the Banque de France had been taken over by the government. By 1948 the central banks of the Netherlands, Hungary, Czechoslovakia and Yugoslavia were under state ownership.⁶⁸ In the Nordic countries, Norges Bank, which had formally been a private limited company, was nationalised in 1949, when privately held shares were redeemed by the government.

In many countries, changes had already been precipitated by the economic crises of the 1930s. The government's mandate at the Banque de France, for instance, had become much stronger with the election of Léon Blum's Popular Front in 1936. Denmark's Nationalbank had been nationalised in the same year. In the United States, central government power had been increased by the Banking Act of 1935, which ended the semi-autonomous position of the Federal Reserve Banks, privately owned regional central banks, and moved the pivot of monetary policy decisions to the Federal Open Market Committee and the Federal Reserve Board in Washington. Unlike the management of the regional Reserve Banks, the Federal Reserve Board governors are appointed by the President.⁶⁹

Throughout its history the Bank of Finland had been an institution of the state. Since 1868 it had been under the supervision of parliament, on the Swedish model, so there was no need for a formal change in its status. Even so, its relationship with governments and parties in parliament was significantly different and less independent from the mid-1940s onwards, compared with the situation before the Second

World War. Overlapping membership in the supervisory council and the national government were a sign of this. Moreover, governor Sakari Tuomioja kept his position in the Bank of Finland while serving as a government minister in the early 1950's.

After the end of the war, the two major economic problems facing Finland and its central bank were an acute shortage of foreign currency and raging domestic inflation. Both pertained directly to the bank's key responsibilities, to safeguard of the value of money and to protect Finland's international liquidity. However, the bank had little practical means to resolve the problems.

Regarding inflation, the opportunity to protect the value of money by tightening monetary policy was only theoretical. The bank was not even regarded as the main institution responsible for curbing inflation. During the war an emergency powers act had been used to impose general price and wage controls, which remained in force for a long time after war ended. However these administrative powers were unable to prevent the acceleration of inflation through a vicious circle of rising prices, wages and agricultural incomes. Neither the price officials nor the Bank of Finland had any real control over it.

The Bank of Finland's annual report for 1945, the first year of peace, characterised inflation as having "run amok". The cost of living index had almost doubled (99 percent up) during the year, December to December, while the wholesale price index had risen 93 percent. The devaluations of May, July and October, which raised the exchange rates for foreign currency by a combined 176% during one year, deserve some of the blame but they had relatively little direct impact in 1945 because imports accounted for an exceptionally small proportion of goods at a time when most foreign trade was blocked. Large wage increases had a greater direct effect on prices and are generally regarded as having triggered inflation.

The underlying factors behind faster inflation were strong excess demand within the economy and political unrest in the labour market. In the wake of the war, the supply of goods was below normal and, furthermore, much of industrial output was being diverted to the USSR as reparations. There was great pent-up purchasing power in the form of money accumulated by the general public during the war. Stringently tighter monetary policy was out of the question because of the possible disruption of reparation deliveries or other vital production. At the

same time, labour unions were demanding wage rises, not merely in response to inflation but also because of an emerging political struggle in the labour union movement between the Communists (within the People's Democratic League organization) and the Social Democrats. The parties of the right and also the Social Democrats suspected that communist labour union activity was motivated not merely by a desire to raise real wages but also by the aim of destabilising Finnish politics and creating "revolutionary conditions", as had happened in Poland, Czechoslovakia and elsewhere in central Europe in the latter half of the 1940s.

Consequently the Bank of Finland felt that it was unrealistic to use monetary policy as the main tool in the fight against inflation. Its interest rate policy remained rather cautious during the early years of peace. Instead, hopes of reducing inflation pressures were pinned mainly on defusing tension by balancing public finances and reaching moderate labour market agreements.

Any study of inflationary problem of the second half of the 1940s must take into account that prices and wages were being controlled, by authority of the emergency powers act. These controls remained in force as late as the 1950s. Inflation could therefore be formally treated as an administrative issue. Although controls could not prevent inflation when the general economy was suffering from excess demand, the existence of controls made price (and wage) rises into a matter of politics. This state of affairs did nothing to reduce political pressure in the labour market. At the same time, while price controls were in force, the connection between monetary policy and inflation did not attract very great attention. By and large, the expectations directed at the Bank of Finland were mainly to keep interest charges low and to make credit more easily available.

BANK'S LEADERSHIP EXPELLED

During the 1920s, expertise in banking had become the main criterion for membership of the Bank of Finland's board of management. A long career at the bank was de-emphasized. In the interwar period, political factors also started to be openly considered when filling board vacancies, with the aim of promoting candidates who enjoyed the trust of the agricultural population and the labour movement. In the 1940s,

contemporary conditions changed the status of the board and the profile of its members once again. Defeat in the war had disrupted the balance of political power in Finnish society because of the greater weight of the left wing – particularly the communist-led extreme left that was now competing against the Social Democrats – and also of the Agrarian League, which had adopted a new political orientation. The new political balance was concretely expressed by Prime minister Juho Kusti Paasikivi when he publicly urged politicians tainted by the war to step aside and make way for new forces.⁷⁰

This was the situation faced by the Bank of Finland in summer 1945 but the story is better begun from August the year before. Risto Ryti had resigned the presidency and withdrawn from day-to-day politics. J.W. Rangell, who had served as governor of the Bank of Finland since spring 1943, felt that it would be in the interests of the bank for Ryti to resume his post as governor. This proposition certainly suited the chairman of the supervisory council Väinö Tanner, so it faced no obstacles. To implement the change, Rangell sent a letter to the supervisory council, proposing that Ryti be invited to fill a vacant place on the board. At the same time Rangell announced he was ready to resign his governorship in Ryti's favour and become a rank-and-file board member again. To reinforce his stand, he appended his letter of resignation from the chair, sent to President Mannerheim, with effect from 1 September 1944.⁷¹ The matter had obviously been predetermined because, acting on a proposal from the supervisory council, the President of the Republic reappointed Risto Ryti governor of the Bank of Finland with effect from 1 September. Ryti, who had been on several weeks of sick leave, returned to the bank on 20 October 1944.

The position of Ryti and Rangell at the central bank after the war was raised in spring 1945. Prime minister Paasikivi, among others, discussed the status of the bank's board with President Mannerheim in April and expressed the view that the resignation of Ryti and Rangell would send a necessary political signal to the Soviet Union. Ryti was aware of these manoeuvres but approached the question from a purely legal standpoint, not a political one. He did not regard demands for his resignation as legally tenable and furthermore as governor of the bank he enjoyed the complete confidence of Väinö Tanner, chairman of the supervisory council.⁷²

The situation changed after the parliamentary election in March 1945. The parliamentary groups of the Social Democrats, the communist-led People's Democrats, the Swedish People's Party and the Rural League had let it be known that the composition of the Bank of Finland's board was hindering the establishment of trade and financial relations with the Allied powers. Because of the political aspects, a change in the bank's management would be warranted. The supervisory council had also changed greatly; Väinö Tanner and Erik von Frenckell were some of those who had been sidelined. The new council chairman was Mauno Pekkala, who had been the social democratic Finance minister during the war but had defected to the People's Democratic League afterwards. It was a sign of the tight symbiosis between the government and the supervisory council in the 1940s that, for the whole time that Pekkala was chairman of the supervisory council, he also served as a minister and, for part of the time, even as prime minister.

On 28 May Risto Ryti received a letter from the supervisory council, giving its support to the proposal by parliamentary groups for changes on the board of the Bank of Finland. The matter was repeated explicitly in a new letter, dated 14 June, stating that "the parliamentary supervisory council members respectfully enquire whether you, Mr (former) President, intend to resign from the post of governor of the Bank of Finland and when your resignation is to be expected. The councillors desire a reply to their enquiry by the 20th day of this same June." Only the President of the Republic had the legal power to relieve the governor of his responsibilities so the supervisory council could not refer directly to dismissal, but the phrasing of their letter left no room for conjecture. The council received Ryti's resignation on 19 June 1945 and the President of the Republic approved it on 30 June. The same process was applied to board member J. W. Rangell.⁷³

It would have been practicable to terminate the contracts of the two senior bank directors slightly faster but a final conclusion was delayed by the associated question of a pension. Both Ryti and Rangell appended a request for a pension to their resignations and the supervisory council found it hard to decide. To aid them the councillors requested the opinion of F. A. Pehkonen, a former president of the Supreme Court, who replied that, under the current retirement regulation of the Bank of Finland, Ryti was unquestionably entitled to

a normal pension but Rangell was not. The matter had to be put to the vote in the council because councillor Manninen wanted to postpone the matter. He appended his dissenting opinion to the decision, referring to the upcoming trial on culpability for the war. In his view the decision was “precipitant and not to the good of our people”. However the council decided by eight votes to one that Ryti should receive a pension in line with the pension regulation. As there were no grounds for granting one to Rangell, he was to receive compensation equivalent to six months’ salary. In fact the council reverted to the pension question in the 1950s and granted a pension to Rangell, too, calculated from his years of service.

The careers of Ryti and Rangell at the Bank of Finland were therefore terminated by external pressure. Their dismissal did nothing to shake the public esteem they generally enjoyed, which was aptly expressed in the preface that the Bank of Finland’s auditors added to their report to the supervisory council on 22 February 1946. “In the year under review, as in the preceding years, the Bank of Finland has supported public finances with large loans and by charging very modest interest. In this way our central bank has rendered invaluable assistance, not always fully appreciated, to a government serving amid difficult conditions. Now that our country has passed through the most difficult time that it has ever had to traverse, we can bear witness that the Bank of Finland as a source of economic support has been a safe haven for the Fatherland, without which the heavy burden of adversity would have been more terrible to endure.”⁷⁴

In view of the circumstances, an even more noteworthy assessment of president Ryti’s work as governor of the Bank of Finland was received from Harry Siepmann, the deputy governor of the Bank of England, who was responsible for foreign affairs. Siepman wrote a letter to the British Foreign Office in February expressing surprise that London was deserting its old friend. “He was a man in a million. It may be – though I doubt it – that we can afford to discard such men. It cannot be that they are dangerous, whatever part they are called on to play.” Siepmann’s letter shows the esteem that Ryti enjoyed in the banking world but in spring 1945 it could no longer prevent political considerations from displacing him.⁷⁵



■ Mauno Pekkala was prime minister of the “popular front” coalition of centre and leftist parties in 1946–1948 and chairman of the Parliamentary supervisory council in 1945–1948.

– Lehtikuva news photo archives/Hede-Foto.

SELECTING NEW BOARD MEMBERS

In summer 1945, the Bank of Finland had vacancies for a governor and a board member. Initially the supervisory council concentrated on finding a new governor. Two competing camps formed within the council, one arguing that a new governor should be sought from outside the bank, mainly among politicians, and the other that an existing board member could be chosen. Two ministers emerged as the candidates of the former camp; Johan Helo had been a Social Democrat but had joined the People's Democratic League after the war and was presently the Education minister, while Sakari Tuomioja was from the liberal National Progressive Party and was currently Finance minister.

Of current members of the board, Kaaperi Kivialho or Kalle Jutila were regarded as the most suitable candidates. However, the majority of council members wanted to see a genuine change so the scales tipped in favour of appointing an outside candidate. Initially the leftist councillors continue to insist on Johan Helo while those of the right favoured Sakari Tuomioja but the matter was urgent and it was eventually realised that Tuomioja was the only candidate that the entire council could support.⁷⁶

At the time of his appointment as governor, Sakari Tuomioja was a 34-year-old civil servant who obviously had a brilliant career ahead of him. He had begun as the secretary of parliament's Finance committee and had been appointed a counsellor at the Finance ministry in 1940. Via the ministry he had become acquainted with influential figures in financial and economic policymaking, such as Bruno Suviranta and Kaaperi Kivialho.

He was a member of the same political party as the two preceding governors of the Bank of Finland, but the National Progressive Party had lost support and was nearing the end of its life. In 1951 the party broke up and was succeeded by the People's Party of Finland, but Tuomioja together with a few other like-minded members instead formed the Liberal League. It did not do well. Tuomioja can best be described as an all-round politician who had very good relations with the new leaders of the Agrarian League and the parties of the left. In this respect he represented the new forces, untainted by the war, that Prime minister Paasikivi sought.

SAKARI TUOMIOJA (1911–1964)

Sakari Tuomioja began his career in the civil service in 1937 as a parliamentary committee secretary. Before his 30th birthday he had risen to be budget director at the Finance ministry, where he helped shape wartime economic policies. He got on well with Finance ministers Mauno Pekkala and Väinö Tanner, particularly the former, who had great confidence in his young assistant. Tuomioja's authority was reinforced by his participation in the Financial committee, established in 1942. As budget director he was a member of the board of the Post and Savings Bank, which brought him a grasp of practical banking to complement his training in law. At the same time, he developed a good relationship with the new chief executive of the bank, Teuvo Aura.

The political arena had been familiar since his childhood. His father, Walto W. Tuomioja, was a leading light of the National Progressive Party during the 1920s and a member of parliament, as well as chief editor of Helsingin Sanomat daily. Sakari Tuomioja's own first taste of politics came during his student years, when he was part of the small minority opposed to the control exerted over the student union of the University of Helsinki by the nationalist Academic Karelia Society. He met the future prime minister and president Urho Kekkonen at this time. His independence showed in 1943, when a group of Swedish-speaking liberals and leftist social democrats sought to

disengage Finland from the war at the first opportunity. Because of his official position, Tuomioja could not sign the petition presented to President Ryti by the "peace opposition", but his links to them were close.

In the post-war period Prime minister Paasikivi sought fresh forces to lead the nation. When governor Risto Ryti had to resign from the Bank of Finland in summer 1945, Tuomioja, then the finance minister, was a natural choice to replace him. It was around this time that a partnership was formed between Tuomioja, Teuvo Aura and Urho Kekkonen, who dominated the political scene until the early 1950s. The "triumvirate" broke up in 1953, and Tuomioja resigned from the Bank of Finland after nine years as governor to become ambassador to London in 1954. He did not entirely turn his back on domestic politics, because he consented to be the joint candidate of the National Coalition party and the Liberal league in the presidential elections of 1956, but he was beaten by Kekkonen.

Tuomioja's son Erkki, who also went into parliament, said of his father "It was his principle that in Finnish politics there could be no matters or disputes that could not be resolved between sensible people." Sakari Tuomioja put this principle to good use at the Bank of Finland during the period of reconstruction and reparations. His time as governor was an era of pragmatism.



■ Sakari Tuomioja was a distinguished figure in business, politics and diplomacy. He was governor of the Bank of Finland from 1945 to 1955, prime minister of a caretaker government in 1953, finance minister in 1944–1945 and foreign minister in 1951–1952.

– Finnish Press Agency.

In the early 1950s Tuomioja came to be known as an internationally oriented economic policy maker who was a member of the inner circle of prominent politicians of the time like Urho Kekkonen and Teuvo Aura. His career as governor of the Bank of Finland was also characterised by close ties to government politics. At the time of his appointment to the Bank of Finland he was Finance minister in the second government of J.K. Paasikivi. In 1950–51 he was Foreign minister in Urho Kekkonen's first government and, for a half-year period, also minister for Trade and Industry. In 1951–1952 he returned to the Foreign ministry in Kekkonen's third government. In 1953–1954 he was prime minister. The period when he exercised influence only as governor of the Bank of Finland therefore lasted for about five years from 1945 to 1949.⁷⁷

The board seat vacated by J. W. Rangell was not filled until 1946, when the supervisory council nominated Urho Kekkonen, a doctor of laws, for the position. At least according to the minutes of the meeting, the council's decision was unanimous and took place without discussions, as if it had been settled in advance. Kekkonen's first official position had been as a lawyer for the Association of Rural Municipalities. He then moved to the Agriculture ministry as a referendant. During the war he served as the director of the Evacuees' Welfare Centre, which helps to explain the strength of his political support among evacuees from Karelia. At the time of his appointment to the Bank of Finland's board, he was commissioner for coordination at the Finance ministry, responsible for rationalising public administration. From the second half of the 1930s, however, he could be described as a professional politician and had been a minister several times, although not during the war. His ministerial career resumed in the Paasikivi government of 1944, when he was Justice minister. That government resigned on 26 March 1946, allowing Kekkonen to start at the Bank of Finland on 29 March. His appointment to the board of management looked like a consolation prize for an important politician left without a post when Mauno Pekkala formed his new government.⁷⁸

For the entire period that Kekkonen was a member of the Bank of Finland's board of management, he was a member of parliament; he was also first deputy speaker of parliament in 1946–1947 and then speaker in 1948–1950. Apart from a half-year period he was a government minister continuously from March 1950 until 1956, when he was elected

president of the republic and resigned from the Bank of Finland's board. During his ten years on the board he was prime minister five times. His period as an active board member was therefore confined to the first four years from 1946 to 1950.⁷⁹

Although both Sakari Tuomioja and Urho Kekkonen came to the Bank of Finland from the Finance ministry, they cannot be regarded as specialists in economics, to say nothing of central banking, and during their time at the bank they did not try to win credentials in these fields. Their mission was to steer the operations of the central bank in the new course that political conditions required and in that they succeeded. The central bank became an integral part of the new economic philosophy, which focussed mainly on controlling the sharp conflicts within society. Purely economic viewpoints were subordinated to political considerations. At the same time these new circumstances meant that the central bank lost its place at the hub of economic policy and the government took over in the driving seat. However, because of political instability, governments were strikingly short-lived, which boosted the importance of the main parties in parliament as the real forces in policymaking.

BANKNOTE CLIPPING

THE PROBLEM OF EXCESS CASH

The operation to clip banknotes, carried out at the start of 1946, was an exception to the rule of cautious monetary policy in the first couple of years after the war. Unsurprisingly, banknote clipping left indelible memories and achieved almost mythical repute in Finland. The operation was expected to result in slower inflation but it had other objectives too, related to uprooting the grey economy.

In extraordinary conditions such as the years of the First and Second World War, monetary systems often falter. Governments resort to printing money, the volume of banknotes climbs steeply and prices soar. To stabilise the monetary system after such a crisis, very drastic measures may be required, such as exchanging one banknote series for a new one, adopting a new unit of currency or legally voiding some of the banknotes in circulation. Such radical measures can be justified by the need to stabilise the value of money or with arguments related to fiscal policy, tax or legality.

Under the classic quantity theory of money, it was believed that a reduction in the volume of banknotes would lower inflation. At the same time a reduction in banknotes could take place in tandem with a compulsory, universal loan to the government. In connection with a banknote exchange, information could be collected on the assets of private individuals, thereby making taxation more efficient and effective. After the First World War, banknotes had been exchanged for new ones in Hungary and Greece, which suffered from galloping inflation. In both countries the banknote holder was compelled to make a loan to the government of half of the value of the note. In

Hungary this was done by stamping the banknote and taking half its value as a loan. In Greece the notes were physically cut in two, half remaining in circulation as tender and the other half seized by the government. In technical terms, the half-note had become a bond that the government would redeem within an agreed period.⁸⁰

Finland did not change banknote series after the First World War although there would have been grounds for doing so. Instead the Bank of Finland was exempted from redeeming banknotes issued under the People's Delegation, the short-lived Red regime, except for its small one-markka notes. The Bank of Finland knew the serial numbers of notes issued at that time so it was technically simple to refuse to honour them. In effect the banknotes issued by an illegal government were deemed to be counterfeit and had to be surrendered. This was not applied to the smallest banknote because of the economic harm this would have caused to the poorest members of society and because there were so many such banknotes that there would have been technical problems in removing them from circulation.⁸¹

After the Second World War many European countries came under great pressure to implement a banknote exchange. A common denominator of these countries was occupation; banknotes were exchanged for new ones in Belgium, the Netherlands, Hungary, Denmark and Norway. At the same time, many of these countries linked the banknote exchange to a compulsory declaration of various types of property and the confiscation of illegal holdings, aimed at eliminating wealth obtained by questionable means during the occupation.

Although there was concern in Finland about a steep climb in the volume of banknotes during the Second World War, price controls remained the main defence against inflation until the peace came. Another was war bonds, which were issued (such as the "Labour and struggle loan" of 1941) in an effort to curb purchasing power. As we have already seen, various other options for reducing excess liquidity were also considered during the war, including an exchange of all banknotes in circulation. All these came to nothing.⁸²

The initiative which came closest to being implemented was a bill which was presented by the government to the parliament on 22 July 1943. It would have granted the government the right "to regulate the possession of Finnish money by voiding some or all of Bank of Finland

banknotes in circulation. In this connection the government would have the right to seize voided banknotes as a compulsory loan.” However, the proposal did not advance through its parliamentary stages and the government withdrew it.⁸³

According to a study of the banknote exchange by Tuure Junnila, the whole legislative proposal was political theatre. Its underlying purpose was not to replace existing banknotes and obtain a compulsory loan, but to encourage bank deposits and intimidate banknote hoarders. Initially it was successful because the volume of banknotes shrank by almost 1.5 billion markkaa between April and July 1943. After that, the deception being played out in parliament was unmasked and the situation soon returned to its previous state.

The end of the war did nothing to halt inflation. On the contrary, prices, which had been held back by tough regulations, erupted. Around this time, in July and September 1945, both Denmark and Norway replaced their banknotes and implemented tough rules on declaring bank account and securities holdings. At the start of September, Finance minister Ralf Törngren ordered the Financial committee to draw up plans for a similar operation in Finland. The committee acted swiftly because a tentative proposal was ready at the Finance ministry by the middle of October.

Two alternative models were advanced for replacing banknotes. The first model was the method used by Greece in 1922, when notes had been cut in half, one half remaining in circulation and the other serving as a certificate for a loan to the government. This model was named the “Balkan” method. The other model was based on Denmark and Norway, which had declared all notes void from a certain day onwards, after which they had to be rapidly exchanged at banks for new notes. The maximum number of new notes that could be obtained in the exchange was set at a relatively low level. This was dubbed the “Nordic” model.

The Financial committee felt that the Nordic model had the advantage that it would remove old notes from circulation fairly comprehensively. Its disadvantage was that the new banknotes would have to be available very soon, or else normal life would be crippled by the lack of means of payment. There were also major political passions associated with limiting the number of banknotes that could be obtained in the swap. The committee therefore opted for the

“Balkan” model, which would be technically easier to implement and would not cause unreasonable problems for the public. Cutting notes in half represented only a loan to the government, and a proper amount of time could be reserved for actually issuing a new banknote series.⁸⁴

THE CLIPPING OPERATION

It took more than a month for the government to draft its final bill. The proposal was laid before parliament on 20 November 1945 under the title “Act on regulation of the monetary circulation”, to authorise the government to safeguard the value of money and to make taxation more effective. In pursuit of the former objective, the government would be able to order banknotes of the Bank of Finland to be exchanged within a fixed period and to take up to half of their value as a temporary loan. To make taxation more effective, the law ordered all deposits and other funds as well as domestic shares and bonds to be reported to officials and certified. Parliament approved the proposal on 21 December, and it was ratified and published on 28 December 1945.⁸⁵

The details of the operation could not be announced in advance for fear of complete chaos among the general public. This was understood, and only the general outlines of the banknote exchange and the government’s mandate were made public on 28 December. The timing and technical details of the operation were not revealed, and were published only in the decision of the government on regulating the monetary circulation, released on 31 December. In a radio speech on New Year’s Eve, Finance minister Unto Takki announced that banknotes were to be clipped, and the loan to the government implemented, on the following day.

Technically the operation was carried out in the “Balkan” way by cutting banknotes in two. The left half of the note was to be tender for half of the note’s original value from the date of clipping until 16 February. By the end of February this half had to be exchanged for a new banknote. The other half, the compulsory loan to the government, could be placed in an account under the holder’s name. In practice this would be done by surrendering the half-note to some financial institution by 16 February. The receipt given would be evidence that the

holder had made a loan to the government, which would be repaid with 2 percent interest no later than 1949. The banknotes to be clipped were those with denominations of 500, 1,000 and 5,000 markkaa; 100-markka and smaller notes were exempted. The reasoning was that holders of the smaller notes would be poor people, who should not be compelled to make a loan to the government. Another reason was that the small banknotes were so numerous that they would have caused an unreasonable amount of work. The denominations subject to clipping accounted for about 85 percent of the value of money in circulation, but in fact the proportion clipped was far lower because public bodies, the government, municipalities, banks and credit institutions were allowed to exchange banknotes in their possession at their full value and were not therefore forced to participate in the loan.⁸⁶

RESULTS OF BANKNOTE CLIPPING

Technically the operation went fairly well. At no stage was there a shortage of means of payment and the longish transitional period kept bank queues short. The volume of banknotes in circulation also fell in line with expectations, although the decline had begun in advance, as the first intimations of the upcoming reform began spreading among the public. The volume of banknotes was at its highest – 18.9 billion markkaa – at the end of July; by the end of the year it had already dropped to 13.6 billion. Right after the clipping on 1 January 1946, the banknotes in circulation were worth 7.9 billion markkaa. The figures confirm the view that information about the upcoming operation had leaked fairly widely, and individuals and companies had deposited their cash reserves into accounts or used them for consumption, in order to avoid lending the government half of their value.⁸⁷

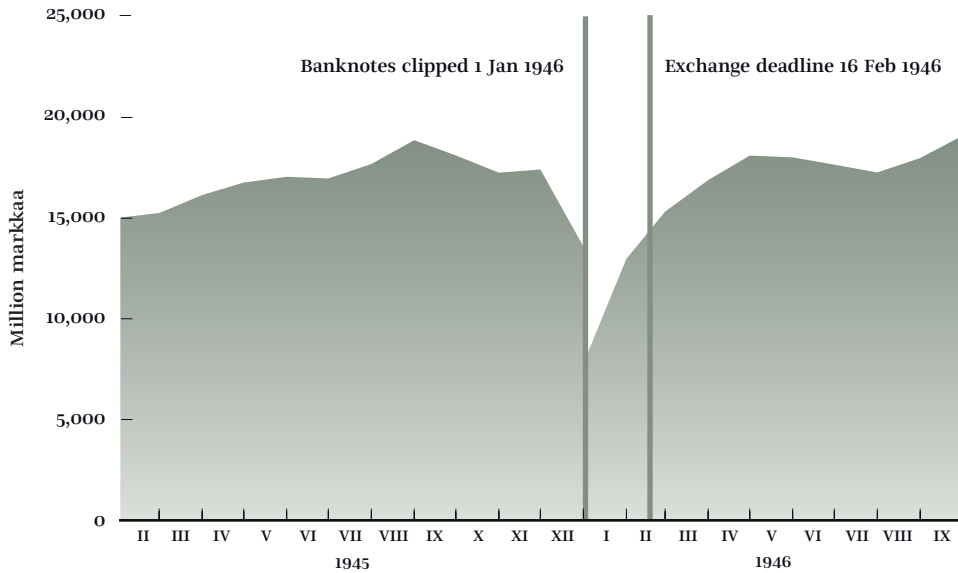
For many ordinary people, banknote clipping was a severe psychological blow. Although inflation had indeed eroded the value of money, it had been furtive and almost discreet. The physical amputation of half a banknote was a shock of quite a different magnitude, and was widely perceived as an affront to the right of ownership. Many people lost their faith in the government and its accomplice, the Bank of Finland. Banknote clipping left a scar on the collective psyche that was slow to heal. Traces remained decades later. The events were recalled



■ Banknotes were clipped on New Year's Day 1946. Half of the note was legal tender until 16 February. The other half became a compulsory loan to the government.

- Finnish Press Agency.

BANKNOTES IN CIRCULATION 31 JAN 1945–30 SEP 1946



Source: Junnila, T., 1946.

vidily at the time of the 1957 devaluation and again in the crisis at the start of the 1990s, when the press played on fears of banknote clipping.

The clipping of banknotes and related operations, such as the responsibility to declare various asset holdings, were explained on monetary, fiscal and legal grounds. In public the justification most often used was probably the need to check the steadily growing banknote volume and consequent inflation, but the reform did not tackle the factors underlying the growth in the number of banknotes. Government spending continued to be financed by loans from the central bank, so the amount of money in circulation automatically increased. The government's measures had a transient effect in reducing the number of banknotes but by spring 1946 they were approaching the same level as in the previous summer. The previous peak volume, recorded at the end of August 1945, was regained and overtaken in September 1946. Awareness of the upcoming banknote swap showed in the inflation figures; prices rose faster in autumn 1945, as people sought to dispose of cash funds and worried about the tax consequences of the related compulsory wealth declaration. In the

months immediately after banknote clipping, the cost of living index stopped rising but by March 1946 prices had turned up again. As an isolated measure, therefore, banknote clipping had a marginal impact on the value of money. It can in fact be regarded as a sign that the traditional simplistic quantity theory of money was alive and well in Finland.⁸⁸

In fiscal terms the compulsory loan involved in the clipping operation provided the government with 3.1 billion markkaa. Government debt at the end of 1945 totalled about 85 billion markkaa, compared to which a loan of 3.1 billion from banknote clipping was rather modest. However the government's access to new credit was extremely poor at the time so the sum was not fiscally insignificant, especially as the interest rate was significantly lower than the general rate and very low compared with prevailing inflation. The compulsory loan also contained an important psychological dimension; it was a way in which almost every Finn shared the experience of helping to reconstruct Finland.

The associated obligation to declare various property holdings was of greater significance than the compulsory loan itself. This information made taxation more effective and increased government revenue, and the operation also helped to reveal property obtained by illegal means, as concretely shown by the fact that some of the right-hand halves of clipped banknotes were never surrendered to financial institutions in return for a receipt for the compulsory loan. Naturally some of these notes had been lost or taken abroad but the rest represented wealth that the holder did not want to reveal to officials because of the tax consequences. The same phenomenon was observable in the obligation to declare company holdings. Shareholders were prepared to lose illegally obtained shares rather than reveal who owned them.⁸⁹

FINLAND JOINS THE INTERNATIONAL MONETARY SYSTEM

EXCHANGE RATE POLICY PROBLEMS

The shortage of foreign exchange was a burning economic problem, perhaps even worse than inflation in its effect on Finland's economic recovery and reparations production in the first few years after the war. Foreign currencies continued to be extremely scarce until 1950, when the Korean Boom created a strong improvement in exports and brought Finland substantial foreign earnings for the first time since the war.

Annual average foreign currency reserves (booked at the accounting exchange rates of the Bank of Finland, which were 10–12% lower than official exchange rates) are shown in the following table:

FOREIGN CURRENCY RESERVES (EXCL. GOLD),
ANNUAL AVERAGES, 1945–1951⁹⁰

	million markkaa	relative to annual imports
1945	341	5.0%
1946	1,318	5.4%
1947	1,553	3.3%
1948	1,037	1.6%
1949	1,791	2.7%
1950	4,888	5.5%
1951	9,464	6.1%

Any analysis of these figures must take into account that imports were exceptionally low, especially in 1945 when foreign trade was almost at a standstill. Not merely was Finland's international liquidity low in proportion to imports; imports were also exceptionally low because foreign trade connections had been disrupted and foreign exchange was in short supply.

The small size of foreign currency reserves reveals the sorry state of national liquidity in the early post-war period. It could be said that, until the 1950s, the economy lived from hand to mouth; all currency obtained from exports and loans was used almost immediately for purchasing imported goods. Liquidity was even tighter than the currency reserves suggest because, under the bilateral trading arrangements in use in the 1940s and in the 1950s, foreign currencies were not universally acceptable. Only convertible currencies, meaning in practice the US dollar, could be used for purchases from any country. How other currencies could be used depended on Finland's various bilateral payments agreements.

The problem was not particular to Finland. Under the shortage of international liquidity which was prevalent until the end of the 1940s, most foreign trade of European nations was bilateral, regulated by agreements between pairs of nations. Imports were subject to quotas and allocated by import licences. Strict import controls were essential under bilateral trade so that mutual payments could be balanced in the way set by the trade agreements. Bilateral trade, which sought to balance imports and exports by country, also meant that imported goods could not always be selected on the basis of quality or price. Instead the country of origin was resolved by trading agreements between countries and often depended on where the foreign currency necessary to pay for them had been obtained from.

Finland's unresolved international position also complicated its economic relations in the early years after the war. Conditions did not begin to stabilise until 1947, when the peace treaty of Paris was signed, the Allied Control Commission left the country and it began to be clear that Finland would successfully complete the heavy schedule of reparations (originally set at 300 million gold dollars) due to the Soviet Union in the reparations agreement of December 1944.⁹¹

In these conditions, obtaining foreign credit was one of the major concerns of Finnish economic policy. Reconstruction of the country's infrastructure and industry required capital, which could not have

been financed by domestic savings alone without crushing popular expectations of a rise in living standards. Furthermore many of the investment goods required had to be imported, so foreign currency was needed to purchase them. Indeed, access to foreign credit became a major if not the main consideration when Finland was considering its attitude to the new international monetary system that began to develop after the war on the foundations built by the Bretton Woods conference.

THE BRETTON WOODS SYSTEM

After the Second World War, the “Western”, non-communist world rebuilt its monetary system on principles that were shaped at the Bretton Woods conference (officially the United Nations Monetary and Financial Conference) in July 1944. It was held in Mount Washington Hotel in the town of Bretton Woods, New Hampshire, USA, and attended by delegates of all 44 allied nations. Iceland and Norway were the only Nordic participants but Denmark was among the nations that sent observers (as did certain international organisations such as the ILO and the League of Nations). The Soviet Union participated with the other Allies but it did not ultimately join the organisations – the International Monetary Fund and the World Bank – that the conference agreed to establish.

As a country fighting alongside Germany, Finland was not of course present at this meeting of Allied Powers. While delegates were arriving at Bretton Woods Finland was conducting one of its most bitter struggles of the whole war. A major offensive launched by the Soviet Union in the Karelian isthmus had just culminated in the great defensive battle of Tali-Ihantala, and the United States had broken off diplomatic relations with Finland. No invitations to the conference were received by the neutral countries either, which then included Argentina, Portugal, Spain, Switzerland and Sweden, because their trading and other contacts with Germany were regarded with great suspicion among the Allies.

The main features of the new international monetary system established in Bretton Woods took shape largely on the basis of plans made by the governments of the United States and Britain. The key figures in the design phase were the famous British economist John

Maynard Keynes and the assistant to the US Secretary of the Treasury, Harry Dexter White. Both Keynes and White had announced their plans for restructuring the world's monetary system back in 1943.

Keynes called for the establishment of an International Currency Union. At its clearing centre, the central banks of member countries would have had accounts for balancing international payments surpluses and deficits. If accumulated imbalances became excessive, the board of the International Currency Union would have had the right to demand corrective measures from both surplus and deficit countries, such as devaluation or revaluation. Exchange rates and clearing accounts would have been denominated in a new international currency unit called the *bancor*. Its value in gold would not be immovable; the currency union board would have been able to change it.⁹²

White's plan differed from Keynes's proposal in several central elements. It was based not on a clearing centre but on a reserve pool, the United Nations Stabilisation Fund, provided by each country. In the original plan this was to be mostly gold or equivalent promissory notes. Subject to certain conditions, members would be able to purchase currency from the fund with their national currency. White intended exchange rates to be far less flexible than Keynes did. Rates could be changed only if the country in question was suffering "a fundamental disequilibrium" in its balance of payments and, even then, only with the consent of a qualified majority of the fund's executive directors. In later versions White's plan did make exchange rate changes slightly easier; rates would be set in an international currency unit, the "*unitas*", pegged to gold.⁹³

It is not worth studying the course of Bretton Woods negotiations in more detail here because Finland could not participate. At the Bank of Finland, the Keynes plan seems to have been regarded as better for small countries that were short of foreign currency. This attitude is indicated by an article by Ragni Bärnlund, a respected expert at the bank, written in 1944 before the Bretton Woods conference, and by the board of management's report to the supervisory council in 1945, when the outcome of the conference was known.⁹⁴

The results of the Bretton Woods conference followed the main lines of White's plan. It was decided to establish an International Monetary Fund. Its purpose, as laid down in its articles of agreement was:



■ The future monetary order of the world was settled at the Bretton Woods conference in the United States in 1944.

– Lehtikuva news photo archives.

- “to promote international monetary cooperation through a permanent institution which provides the machinery for consultation and collaboration on international monetary problems.
- to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.
- to promote exchange stability, to maintain orderly exchange arrangements among members, and to avoid competitive exchange depreciation.
- to assist in the establishment of a multilateral system of payments in respect of current transactions between members and in the elimination of foreign exchange restrictions which hamper the growth of world trade.
- to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity.
- in accordance with the above, to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members.”⁹⁵

The Bretton Woods system was based on fixed exchange rates, which were to be set against gold or the US dollar. In practice the lynchpin of the exchange rate system became the US dollar, which the central banks of other countries could convert into gold at the rate of 35 dollars per ounce. This was the value that had been set after President Roosevelt’s devaluation of 1934.

To prevent competitive devaluations, the member countries of the International Monetary Fund were required to hold their exchange rates constant and could not allow them to move up or down by more than one percent from their official “par values”. A change in par value was permitted only to correct “fundamental disequilibrium”. When a member country wished to change its exchange rate, the IMF had the final say if the proposed change together with previous changes moved the currency by more than ten percent from its original par value. If not, the change would be allowed but, if so, the IMF could refuse.

“Fundamental disequilibrium” was a key concept in the new system and the IMF’s official history mentions prolonged but unsuccessful attempts to define it.⁹⁶ Fundamental imbalance came to mean a balance of payments deficit that was so persistent that it could not be resolved by loans granted by the fund and that the deficit country could not reasonably be expected to tackle with measures that restricted its own aggregate demand. Under these conditions the IMF was required by its founding articles to agree to a change in par value. The articles stated that “if (the Fund) is satisfied that the change is necessary ... (it) shall not object because of the domestic social or political policies of the member proposing the change.”

These regulations for exchange rates sought to solve problems that had been experienced in currency policies in the 1930s. The aim was to protect exchange rate stability while allowing the possibility for corrective measures when maintenance of a fixed exchange rate would have led to an economic or social impasse. Member countries were to be prevented from resorting to competitive devaluations in which they sought to strengthen their own employment or balance of payments by damaging the economies of their trading partners. On the other hand there was no desire to return to the immutability of the gold standard period because the experiences of the 1930s had shown that, if the only alternative to changing the exchange rate was fierce deflation, the social costs could be incalculably great. An extreme example of these conditions and their political consequences was Germany in the 1930s, where Chancellor Brüning’s deflationary measures, intended to keep the country on the gold standard, had provided a breeding ground for the ascent of Adolf Hitler and National Socialism.⁹⁷

Apart from exchange rate stability, the other key objective of the Bretton Woods agreement was currency convertibility and an open, multilateral payments system. The aim was to break away from the bilateral payments agreements that countries had signed during the 1930s and even more so during the war. In a bilateral system, money received from exports to a certain country had to be used for buying imports from the same country. Payments accounts remained “automatically” in balance and there could be no liquidity crises resulting from a shortage of foreign currency, but a bilateral international payments system kept international trade at a much

lower level than a multilateral payment system and thereby hindered economic recovery after the Second World War.

In the IMF's founding articles, the member countries agreed to make their own currencies convertible, so that export earnings from one country could be used for purchases from any country. They agreed that "no member shall ... impose restrictions on the making of payments and transfers for current international transactions". They also made a commitment not to "engage in any discriminatory currency arrangements".

The agreement allowed a transitional period for implementation of convertibility. No maximum period was imposed but it was thought that convertibility would be achieved fairly rapidly because the articles stated that, after three years of operations, the IMF would begin reporting on the remaining currency restrictions of member countries. After five years, the fund would start conducting annual discussions with member countries that had not yet dismantled their foreign exchange controls.

It's worth noting that the Bretton Woods obligation to eliminate foreign exchange controls concerned only "current transactions", meaning export and import payments, capital income and income transfers. Controls on capital movements, such as borrowing and lending, did not have to be eliminated.

The rules imposed in the fund's founding articles were mainly intended to prevent members from exercising their sovereignty in foreign exchange policies to employ discrimination, currency controls or aggressive exchange rate policies that would harm other countries. The system was not entirely symmetric, even in theory, because of the special position held by the US dollar as a reserve currency. Even so, the system of reciprocal obligations and the liberalisation of international payments that it allowed were a significant achievement, which spurred the world economy to unprecedented growth in the decades that followed.

Membership of the IMF brought not only obligations but also distinct advantages, the main one being access to financial aid in case of temporary payments problems. Members could borrow reserve currencies from the fund and against their own currency ("purchases and repurchases"). The borrowing facility was in proportion to each member country's membership share or "quota" in the fund. In the

early days of the system there was a dispute between European members and the United States about whether access to the borrowing facility was automatic or depended on the Fund's decision. This dispute originated from the differences between the Keynes and White plans. According to the articles of agreement, a member who wish to purchase foreign currency (with his own currency), had to show that it was needed immediately for payments in harmony with IMF regulations.

The dispute about whether the borrowing facility was automatic ended in the decision that it was at the discretion of its executive directors. This was to prevent members using IMF loans as a source of long-term capital. At the same time it was agreed that the fund could make its financial support conditional on certain economic policies.⁹⁸

Another important benefit of IMF membership was the ability to influence the organisation's decisions. The fund had a two-tier structure. Each member had a representative on the board of governors, usually the governor of its central bank. The board of governors were the supreme authority but practical decision-making in many matters was delegated to a board of executive directors which, unlike the board of governors, sat continuously at the IMF's head office in Washington D.C. The executive directors choose the fund's managing director, who is in charge of operational management and also chairs the executive board.

The voting rights of member countries on the board of governors were in proportion to their membership share or "quota". The quota also constituted the sum that the member country had transferred to the fund, partly in gold and partly in its own currency. The quotas of the founding members were agreed at Bretton Woods and totalled 8,800 million dollars (plus a quota from Denmark that was not yet determined). However the sum of 8,800 million included the quota of the Soviet Union, set at 1,200 million dollars, which was not paid when Moscow ultimately decided not to join the IMF.

The largest countries each had their own representative on the executive board but smaller countries were divided into constituencies, each of which could elect one executive director.

The countries present at the Bretton Woods meeting were originally due to ratify the IMF's articles by 27 December 1945. Only 30 of the participating countries managed to do so by the end of 1945, so the inaugural meeting of the board of governors, in Savannah, Georgia in

spring 1946, extended the deadline for ratification by the founding members to the end of 1946. During 1946 the total of ratifications rose to 40.⁹⁹

Membership of the fund by the countries represented at the Bretton Woods meeting was simply a matter of registration – assuming, of course, that they were prepared to pay their membership quota. Membership by other countries was subject to approval by the Board of Governors. According to article 2, other countries would have the opportunity to join at the time and on the conditions set by the IMF.

One of the countries that did not ratify the agreement by the deadline of 27 December 1945 was the Soviet Union, which ultimately decided not to join the organisation at all. Soviet Foreign minister Molotov announced his country's decision to George Kennan, the deputy chief of the U.S. mission in Moscow, in December 1945 just before the ratification deadline expired. This can be taken as a clear and useful marker for the start of the Cold War between the great powers. As late as 1946 Soviet membership of the IMF fund was regarded as possible at least in theory, but it did not transpire.¹⁰⁰

By 1946 it was clear that the wartime alliance between the Soviet Union and the Western Powers was changing into a relationship of sharp confrontation and competition for influence in the world – at this point in time focused on Europe. The Cold War was beginning, marked by Winston Churchill's renowned speech of March 1946 in Fulton, Missouri in which he said that an Iron Curtain had descended across the continent of Europe.

At a time when the Soviet Union was tightening its grip over Eastern and Central Europe and was supporting the rise to power of communists in its neighbouring countries, the aim of US policy became to restrict the influence of the Soviet Union and the spread of communism. Tensions increased at the Paris Peace Conference in July-October 1946, where treaties were drafted for the countries that had fought alongside Germany, meaning Bulgaria, Finland, Hungary, Italy and Romania. The breach between the Great Powers and the looming division of Europe was coming clearly into view.¹⁰¹

Before long the Soviet Union became openly antagonistic towards the IMF. Politically this was because it regarded the fund as a tool of the policies of its opponent, the United States. Economically, too, it would have been difficult if not impossible for the Soviet Union to

reconcile its state monopoly in foreign trade with the multilateral system of convertible currencies required by the IMF's founding articles. In fact convertibility was not even achieved by the Western countries until the 1950s, but this delay was not obvious, and perhaps not even foreseeable, until the failure of Britain's attempt to restore convertibility in August 1947.¹⁰²

The division of Europe was institutionalised and cemented when the United States formed the Organisation for European Economic Co-operation – OEEC, officially in 1948, to coordinate Marshall aid to Europe. The Soviet Union in turn set up its Council for Mutual Economic Assistance – CMEA to coordinate the economies of its political satellites at the start of 1949. After this the International Monetary Fund became branded as a “western” organisation, especially after founding members Poland and later Czechoslovakia, too, resigned from it.

FINLAND JOINS THE IMF

Finland's international position was extremely difficult in the first years after the war, not only economically but also politically. Its relations with the victorious countries were prescribed by the interim peace treaty signed on 19 September 1944. The government was overseen by an Allied Control Commission and relations with the Great Powers were still unsettled. This also had economic implications, especially for Finnish creditworthiness, which was overshadowed by doubts about whether Finland could manage the reparations demanded by the Soviet Union and fears for Finland's internal political stability.

The nation's political situation did not really begin to stabilise until after ratification of the peace treaty. The main content of the treaty was set in Paris in summer 1946 although that conference was formally only consultative in nature; the final negotiations that refined the peace agreements with Finland and Germany's other co-belligerents were conducted in New York in November and December. The Finns were presented with the final rubric of their peace treaty at the start of 1947 and the agreement was signed in Paris on 10 February.

The process of ratification took longer than expected because the Soviet Union insisted that all five countries that had fought alongside Germany (Bulgaria, Finland, Hungary, Italy and Romania) should ratify

their treaties before it did. Finland ratified its treaty in March but the Soviet Union waited until September because of delays in Italian ratification. Only when the Soviet Union had ratified the treaty did the Allied Control Commission finally leave Finland, at the end of September 1947. Ratification of the peace treaty and the exit of the control commission confirmed Finland's state sovereignty and dismantled barriers to cooperation with other nations.

Even then, however, Finland's aspirations for full membership of the international community were not easily fulfilled. It applied to the United Nations Organisation on 19 September 1947, just four days after Soviet ratification of the peace agreement, but its path was barred by growing great power conflicts. When the United States rejected the applications of Soviet-backed Bulgaria, Hungary and Romania, the Soviet Union used its veto in the Security Council on 1 October 1947 to block the memberships of Finland and Italy. The latter two did not become members of the UN until 1955.

Under these circumstances, joining the IMF and the World Bank were economically appealing to Finland but fraught with political consequences. The dominant economic motivation at the time was to obtain dollar loans. Opting out of Marshall aid in summer 1947 had intensified Finland's need for foreign currency in the form of credit. Politically the IMF and the World Bank offered a way to bolster Finland's international standing. However, as the end of the 1940s approached, the Soviet Union grew ever more suspicious of the western orientation of these organisations and the United States' *de facto* leadership of them.

Intensely concerned for its neutrality, Sweden postponed joining the IMF specifically in order to avoid tension with the Soviet Union. Dag Hammarskjöld, then the Swedish government's adviser on financial and economic problems, wrote in spring 1946 that Sweden should go no further in pursuing "western-oriented currency policy" at the present time, in view of uncertainty about the Soviet response.¹⁰³ Finland's foreign policy leeway was of course far more limited than Sweden's but its lack of foreign currency was all the more severe. On the other hand, it was not until the turn of 1950 that relations between the Soviet bloc and the IMF reached an open breach; in 1946 there was still a possibility that the Soviet Union might join the International Monetary Fund and the World Bank.

The process that led to Finland's membership of the organisations set up in Bretton Woods got underway in autumn 1946, after efforts to obtain a loan from the US administration had been stymied. The problem was obviously unexpected because Finland had received credit of 5 million dollars from the US Export-Import Bank to purchase American cotton at the end of 1945 and another 35 million dollars for other goods in January 1946. The loans were of enormous importance for Finland at that time. The Export-Import Bank was the official export credit institution of the US administration and financed supplies from American producers for European reconstruction after the Second World War. The bank's activities were of course co-ordinated with US foreign policy which was focused increasingly on combating the spread of Soviet influence in Europe.

In August 1946 Finland tried to send a delegation to the United States consisting of Walter Gräsbeck, an influential and well-connected businessman, and Matti Virkkunen, head of the department for external economic relations at the Ministry for Foreign Affairs. Their mission would have been to obtain credit for the purchase of goods in the following year but Washington rebuffed the plan, stating that the Export-Import Bank would not even consider new credit for Finland. The State Department telegram to the US embassy in Helsinki noted: "The visit of the proposed delegation most undesirable. Should be postponed indefinitely."¹⁰⁴

According to a study by Hannu Heikkilä, the reason for the negative US attitude was that peace negotiations had not been concluded and, in particular, that the size of reparations to be paid by Finland was unknown. The Allied Powers discussed the details of the peace treaty in New York in November 1946. Heikkilä shows that the United States did not want Finland to use loans from the west for paying reparations. It also seems credible that granting a loan to Finland before the reparations total was certain would have hindered efforts to reduce the magnitude of reparations, which the Americans tried to do at the discussions in New York.¹⁰⁵

The unexpected difficulty – if not outright impossibility – of obtaining a loan directly from the US administration moved the focus of debate towards joining the World Bank, and also the International Monetary Fund, participation in which was a condition of World Bank membership. President Paasikivi met the US ambassador Maxwell

Hamilton on 25 September 1946 to discuss the situation after the US refusal to consider more loans. Hamilton raised the question of the “International Bank” (the World Bank, which had begun operations in summer 1946) and said Finland should seek credit there. Paasikivi replied that Finland would indeed apply for membership of the “International Bank” as soon as the peace treaty had been concluded. Paasikivi anticipated that, after signing the peace treaty, Finland would first enter the United Nations and only then apply for membership of the “International Bank”. Moreover, joining the IMF and the World Bank would require capital and take time. Finland had neither.

Paasikivi told Hamilton that Finland was turning to the United States for political reasons, too: “We want to emerge from our difficulties without forfeiting our freedom. This is why we have turned to the West with our request for aid. We do not want to turn to the east.”¹⁰⁶ This statement can certainly be seen partly as a sales pitch intended to appeal to the political objectives of the United States in Europe but there can be no doubt that, in seeking western connections, Finland was pursuing not only economic objectives but also a political agenda that sought a counterbalance to its dependence on the Soviet Union.

The marching order that Paasikivi proposed to Hamilton – first the peace treaty, then the UN, finally the IMF – became obsolete in a couple of days. The first annual meeting of the International Monetary Fund and the World Bank began in Washington on 27 September, just two days after Hamilton had visited Paasikivi, and decided that Italy could be accepted as a member of the organisations although its peace treaty had not been signed.

The verdict on Italy was important for Finland, which was in the same position of having no peace treaty. Soon after the news arrived that Italy was eligible for membership, the Finnish Foreign ministry began to put out feelers about the possibility of submitting its own membership application. There would be no waiting for a peace treaty, nor for UN admission, which would not be possible, as it turned out, for another nine years.

A month after Italy’s application had been accepted at the IMF, Matti Virkkunen of the Finnish Ministry for Foreign Affairs asked the Bank of Finland (on 5 November 1946) for a statement on Finland’s ability to observe exchange rate policies in line with IMF regulations:

“As the Bank of Finland will be aware, members of the International Monetary Fund must undertake not to move their exchange rates by more than 10 percent without the permission of the IMF. Greater changes can be made only with the IMF’s consent. Because Finland’s application to join the International Monetary Fund is apparently becoming a matter of current relevance, the Foreign ministry respectfully requests the Bank of Finland to express its views on whether it is possible for Finland under the present circumstances to provide the aforementioned commitment about exchange rate constancy.”¹⁰⁷

The board of Bank of Finland issued its reply within two weeks and did not confine itself to answering the one question. It set out a broader analysis of the advantages and risks pursuant to IMF membership. The first barrier to membership was the quota payable by Finland but the board felt that, as it could mostly be paid in Finland’s own currency, the obstacle “may not prove insurmountable”. The second barrier was the restriction on exchange rate flexibility, referred to in Virkkunen’s question.

“The regulation mentioned will be hazardous for Finland in the probable event of a continuing upward movement in the domestic price and cost level, largely due to pay rises. (...) In that case, exports could be maintained only by steadily raising the prices of foreign currency and the permitted 10% leeway would be consumed fairly rapidly, compelling Finland to ask the fund’s permission to reduce the markka’s external value by a greater amount. (...) The possibility exists that such requests, if made repeatedly, would not ultimately be granted. Finland would then face extremely difficult decisions in economic policy because it would either have to resign from the fund, which would surely be disadvantageous for international prestige, or would have to take action to lower its price and wage level, which would certainly constitute a difficult and onerous task.”¹⁰⁸

The danger of inflation was an argument for postponing membership, the board felt, until “the economic life of the country and above all the level of wages” were more stable. It could not, however, foresee when such a juncture would be at hand.

On the other hand the Bank of Finland felt that “eminently weighty arguments” could be presented for IMF membership in the near future. It mentioned the advantages of being better able to participate in post-

war international economic cooperation and the concrete benefits provided to IMF members (i.e. access to support credit in the case of balance of payments problems). Moreover, commitment to a new international monetary system would have a favourable effect on domestic economic policy, “compelling Finland to take purposeful action to stabilise its economy and especially its wage level”.

Having weighed the benefits and disadvantages of membership, the board reached the conclusion that Finland should not delay its application to the IMF but that “before joining, the Bank of Finland should be given the opportunity to adjust exchange rates so that there would be reasonable hope of maintaining them over the longer term.” According to the board, Finland should apply to join the World Bank at the same time, so as to be eligible for long-term loans. In conclusion, the board stated that it was “of the utmost importance that it should have the opportunity to participate in discussions about questions touched on in this statement”.

After the sum of reparations payable by Finland had been settled in the New York negotiations, the United States adopted a more favourable stance on loans to Finland. Walter Gräsbeck and Matti Virkkunen travelled to the United States at the start of December and the Export-Import Bank subsequently granted Finland a loan of 25 million dollars. When the loans were being considered in January 1947 the United States noted the fact that Finland had expressed its intention of applying for membership of the IMF and World Bank, which supported Finland’s creditworthiness. The Export-Import bank granted Finland yet another loan of 10 million dollars in autumn 1948.¹⁰⁹

Back in November 1946, Virkkunen had obtained a mandate to explore support for Finnish membership of the IMF and World Bank, at first mainly from the United States and Britain. Both responded favourably to enquiries from Finnish embassies. The government’s foreign affairs committee considered the matter in April 1947 and raised no objections to membership. In a session of the Council of State on 11 April, President Paasikivi authorised the Foreign minister to submit formal applications, which were received by the organisations on 14 April.

While Finland was planning its membership, the nation’s economic position strengthened, thanks to improved export performance in late 1946 and at the start of 1947. Because of export growth at the end of

1946, export earnings for the whole years were four times that of 1945. Part of the increase was illusory, because the devaluations carried out in 1945 had raised the markka value of every dollar earned by 176%, but even so the recovery was significant in real terms. At the start of 1947 Governor Tuomioja of the Bank of Finland wrote to his friend Per Jacobsson, economic advisor to the Bank for International Settlements in Basel, thus:

“As you will see our position regarding our foreign balance of payment is no longer to be considered entirely hopeless, but that in a near future we perhaps can answer the demand which generally lays on a borrower before a loan is granted to him, i.e. that he is in a position to prove that he is not in need of credit. Also some other rays of light can be perceived. Our index of living expenses has gone down some points (...) the debt of the Finnish state to the Bank of Finland has decreased considerably since a year ago, this debt is even somewhat lower than two years ago. (...) The maintenance of our money-value depends entirely on the development of wages, but I am not either in this regard entire pessimist, although the political fraught struggle between two equally strong labourer parties of the Diet as well as the relative weakness of the Government make the situation difficult.”¹¹⁰

The improvement in the foreign currency position proved to be temporary, when imports also took off, but not before the improvement in the business climate and the foreign exchange situation had been reflected in an assessment that the Bank of Finland requested from its main currency experts. Written by Bruno Suviranta, A.E. Tudeer, Ragni Bärlund and Mikko Tamminen, it was entitled “Pro memoria on Finland’s accession to Bretton Woods” and was delivered to Governor Tuomioja on 29 May 1947.

At the time that the memorandum was written, the Bank of Finland’s favourable stand on membership was already clear. Instead of looking at the advantages and disadvantages of membership itself, the authors examined the issues that membership of the International Monetary Fund raised at the Bank of Finland. They calculated the size of a suitable membership quota for Finland and predicted the form it would take, i.e. how much would have to be paid in gold or dollars and how much could be paid in Finland’s own currency. But most of the memorandum dealt with the choice of a suitable exchange rate at

which to join the fund. A key perspective was export industry competitiveness:

“When considering the level of exchange rates, the principal consideration is the effect on export profitability. The *conditio sine qua non* for revitalising Finland’s economic life is exporting to an adequate extent, because it is the only way of being able to import enough to supply the nation. If the supply situation deteriorates there will be no possibilities for stabilising the domestic value of the markka.”¹¹¹

Suviranta’s group presented a set of purchasing power parity calculations to assess whether the prevailing exchange rate (136 markkaa/dollar) was a suitable rate for joining the IMF. The calculations showed that the current dollar price in markkaa was about 18% too low measured by the wholesale price indices, and 20% too low according to the consumer price indices. Nonetheless the authors concluded that export profitability and the balance of payments required no devaluation.

“(It) seems apparent that current conditions do not call for raising exchange rates. It must also be taken into account that frequent changes in exchange rates are harmful to the country’s economy. Especially at the present time (of economic upturn), raising exchange rates would harm the value of money because import prices would become more expensive and thereby the general price level would rise.”

The experts noted, however, that the choice of a suitable exchange rate should not be based on the prevailing situation but that Finland should seek an exchange rate level that would be tenable in the longer term. This was the key consideration, particularly because it would be harder to change rates after membership had taken effect. The authors predicted that the export climate would deteriorate, compared with the position at the time when they were writing their report in spring 1947. They also anticipated a rise in the level of domestic costs. They concluded with a recommendation that the markka should be devalued in connection with IMF membership:

“When the arguments against raising exchange rates are weighed against those in favour, the latter tip the scales. How much rates should be increased when Finland joins the International Monetary Fund will of course depend on anticipated developments in the export market price level on the one hand and the export industry cost level on the

RAGNI BÄRLUND (1902–2001) AND THE FIRST FEMALE ECONOMISTS

From the 1920s onwards, the Bank of Finland's statistical department was a good place to get a training in economics. One of the young lions who worked there, Miriam Ekholm, can be regarded as the first female economist at the central bank. She was also the first woman to publish articles under her own name in the Bank of Finland Monthly Bulletin.

When Ekholm moved abroad in 1938, leaving the bank after 14 years of service, Ragni Bärlund was recruited to replace her in the statistical department. Bärlund may have been the first Finnish economist to have trained in the United States. In autumn 1923 at the age of 21, she had been awarded a place in New York State at Vassar, then an elite US women's college, where she studied psychology as well as economics. She had already studied jurisprudence in Finland.

On her return to Finland, she decided to augment her American degree by enrolling at Helsinki University's historical and linguistics department, which offered a course in economics. On receiving her master's degree in spring 1927, she took a job at the Central statistical office, where she was given the task of drawing up the balance of payments accounts.

The work brought her into regular contact with the statistical department of the Bank of Finland so it was logical that she would inherit the position that Miriam Ekholm had

filled. On joining the Bank of Finland Bärlund literally brought the balance of payments with her because the job of compiling them was taken over by the bank. She also served as secretary to governor Risto Ryti, duties that continued during governor J. W. Rangell's term of office.

Ragni Bärlund published her first balance of payments accounts at the Bank of Finland in 1938 and continued producing them until 1962. In the following year she retired from the position of senior actuary. The accounts had not taken up all her time; she had also assisted A. E. Tudeer, the director of the Bank of Finland's Institute for Economic Research, with economic reports.

After her retirement she co-authored *Finlands näringsliv*, a book about Finnish industry, with professor Hugo E. Pipping, which was published in 1965. Their working partnership had begun in a historical project at the Bank of Finland, for which Bärlund had estimated the balance of payments accounts in 1890–1913. At the start of the 1990s it became clear that economic historians had not improved on Bärlund's calculations, which were still the best. Her results were published in 1992, when she was 90 years old.

Bärlund's colleagues in the 1940s had nicknamed her "Iron Ragni". It was apparently a well-deserved moniker.



■ Ragni Bärlund was one of Finland's first female economists and perhaps the first Finnish economic researcher to have trained in the United States.

– Finnish Press Agency

other. (...) A suitable initial exchange rate of, say, 150 markkaa to the dollar would still leave the markka 'overvalued' in comparison with its present purchasing power parity."¹¹²

The proposed rate would have meant a devaluation by about 9%, or an increase in the dollar rate by about 10%.

Finland was accepted as a member of the IMF and the IBRD (the World Bank) at the second annual meeting of the organisations in London on 18 September 1947. Its quota was set at 38 million dollars and it was given until 15 March 1948 to ratify the agreement. The matter first had to be debated in parliament, which received the government's proposal on agreements with the fund and the bank in November 1947.

A study by Andrea Lorenz-Wende draws attention to the fact that, although the proposal was made in the name of the government of Prime minister Mauno Pekkala, himself of the People's Democratic League, it was stridently criticised in parliament by this party. They were concerned about the western character of the IMF and World Bank and the fact that the Soviet Union had not joined the organisations. They also thought the terms for borrowing from the World Bank were disadvantageous and that membership would impinge on Finland's sovereignty. Central bank governor Tuomioja and the Foreign ministry tried to make the agreements appear more acceptable by pointing out that Poland and Czechoslovakia, which by this time belonged to the Soviet bloc, were members and that membership by the Soviet Union was still possible. Ultimately the parliamentary members of the People's Democratic League absented themselves from the meeting of the Foreign Affairs committee that endorsed membership.¹¹³

Despite a strong attack in the plenary session by people's democrat Mauri Ryömä, parliament approved the agreements on 13 December 1947. The ratification documents were deposited in Washington on 14 January 1948, after which Finland was a member of the Bretton Woods organisations.

Disregarding the Suviranta working group's recommendation, Finland did not adjust the markka exchange rate upon joining the IMF. This decision was possibly influenced by the view, expressed in the same memorandum, that devaluation would not suit the current economic climate even if it were desirable in the long run. On the other hand, Finland did not set the par value of its markka either but, time and again for several years, asked the permission of the IMF to

postpone this, arguing that its economic circumstances were unsettled. It was not until 1951 that the markka's par value was finally set. By that time it had already been devalued twice since joining, in July and September 1949. In fact, therefore, Finland managed to achieve both of the priorities of Suviranta's working group: an "adequate" devaluation of the markka before its official par value was set but only when it appeared to suit the economic climate. The working group had simply not considered the possibility (or at least not recorded it in its memorandum) that Finland might be able to join the IMF without setting its currency's par value at the same time.

Beyond paying a membership quota and keeping exchange rates stable, IMF membership involved a third obligation. The country should make its currency convertible and move from bilateral or other discriminatory payment systems to a multilateral system of foreign payments. It was obviously unrealistic for Finland to think of implementing convertibility at the time but little attention was paid to the requirement in the early stages of membership. Convertibility was regarded as a fairly remote matter.

Mikko Tamminen, an economist at the Bank of Finland's research institute and perhaps the foremost expert on foreign exchange policy, wrote in the institute's annual publication in 1947 about the upcoming choices Finland had to make. The section on future prospects at the end of the article gives a good and well-structured picture of the thinking prevailing in autumn 1947, when Finland was already knocking at the IMF's door. The article was written half a year after the memorandum of Suviranta's working group and presents largely the same perspectives, but what is remarkable is that the desirability of devaluation in connection with IMF membership is openly expressed. This was not an internal, confidential memorandum but an article intended for the general public in an official publication of the Bank of Finland.¹¹⁴

A new element in Tamminen's article is that he takes up the question of foreign exchange controls. He notes that one of the obligations of IMF membership was that, within about 5 years, a member country must eliminate currency controls and restore a free foreign exchange market for current payments. In Tamminen's view this principle presented problems because "regarding the current situation, there seem to be no realistic prospects for dismantling Finland's system of foreign exchange

controls by the aforementioned (five-year) deadline". In practice, however, this requirement seemed to be less of a threat because "the same (impossibility of dismantling currency controls) holds true for almost all other countries, to a greater or lesser extent; perhaps the most tangible example of the type and extent of the problem that the various countries of the world are now struggling with is the payments account and recent foreign currency situation of England. In view of the English case in particular, it does not seem impossible that the Bretton Woods rules about deregulation of the foreign exchange market will in fact be applied more leniently than intended – in order not to jeopardise the principle itself."¹¹⁵

Examples abroad did indeed support the view that a general dismantling of currency controls was being postponed into the future. The most dramatic sign that a fast return to complete convertibility was impossible amid a worldwide dollar shortage was the sterling crisis of summer 1947. Great Britain eliminated foreign currency controls in July 1947 as part of a financial package agreed with the United States. This led to immediate catastrophe and the free convertibility of the pound against the dollar had to be suspended on 20 August, after just six weeks.¹¹⁶

If Britain, the second most important IMF member after the United States, had been forced to backtrack in this way, it began to be clear that the time was not yet ripe for general convertibility of currencies in line with the Bretton Woods agreement. The experience of Sweden was another indication that the road to freer international trade would not be a fast and easy one, even in countries that were economically stronger than Finland. Sweden had implemented a major 17 percent revaluation in July 1946 in order to deflect inflationary pressures, but the result was an acute foreign exchange crisis in spring 1947 and the government was forced to impose severe import controls.¹¹⁷

When Finland was officially accepted as a member of the IMF its membership quota was set at 38 million dollars. It was the 46th member of the IMF. Although an international par value in gold and the dollar was not set for the markka at this time, Finland was not the only country in this position. At the end of 1948 there were eight members without officially confirmed par values, including Austria, Greece, Italy and Poland.¹¹⁸

FINLAND'S REFERENCE GROUP CHANGES

When Finland became a member of the IMF in spring 1948, it was placed in the East European constituency. The member countries in this group were represented on the executive board by Bohumil Sucharda of Czechoslovakia, who subsequently served as his country's finance minister in the 1960s. Alongside Finland in the East European constituency were Poland, Czechoslovakia and Yugoslavia. The Nordic countries, who later constituted one constituency in the fund, were still divided. Denmark was in the same constituency as Belgium and Luxembourg, Norway was with the Netherlands, Iceland was with Canada, and Sweden had not joined the IMF yet.¹¹⁹

For Finland's aspirations of neutrality, the East European constituency was the most politically awkward place possible. As Cold War tensions increased, the relationship to the IMF of the larger countries in the constituency, Poland and Czechoslovakia, became ever more strained and ultimately reached an impasse. In Poland the Communists had seized absolute power in January 1947 and in Czechoslovakia in February 1948. A couple of years after these events the East European constituency broke up when first Poland and then Czechoslovakia left the fund amid the worsening Cold War.

The growing tension between the communist "east" and the capitalist "west" was especially uncomfortable for Finland because it hindered the government's efforts to develop economic relations with the Western powers. The problems came to a head when Finland had to decide its attitude to the US offer of Marshall aid to European countries.

While Finland's membership application was being considered by the International Monetary Fund, various European countries including Finland received an invitation from the governments of France and Great Britain to participate in a conference in Paris about the Marshall Plan. The invitation arrived on 4 July 1947. The plan was officially named the European Recovery Program but was widely known by the name of the US Secretary of State General George Marshall. Its aim was to support the reconstruction of Europe and the recovery of trade within the area by means of aid and loans from the United States. Marshall aid would have enormous significance for the reconstruction of Europe. At the same time it bound European countries to the OEEC,

the organisation set up to coordinate it, and to the policies of cooperation in trade and economic matters between western democracies.

Originally the Marshall Plan was open to all European countries but the Soviet Union took a severely negative stance, regarding it as an attempt to increase the political influence of the United States in Europe, and prevented participation by the countries of eastern and central Europe in its sphere of influence. Ultimately, as a counterweight to the Marshall plan and the OEEC, it established the Council for Mutual Economic Assistance (CMEA) in January 1949 for itself and its satellites in eastern and central Europe.

Finland naturally had a great need and desire for economic aid, particularly in craved American dollars, so the invitation was tempting, but Finnish participation in the Marshall Plan proved to be impossible for foreign policy reasons. Only three days after the invitation had been received, Prime minister Peckala was told by the chairman of the Allied Control Commission Lieutenant-General Savonenkov that the Soviet Union opposed Finnish participation in the Marshall Aid conference. Tuomo Polvinen in his study of the period regards it as extraordinary that this message was not sent to the Finnish government using normal diplomatic channels but via the Control Commission.¹²⁰

The government responded by declining to participate in the Paris conference and, at the same time, the Marshall Plan. Although the foreign affairs committee of parliament had recommended participation in the Paris conference, the government of Finland replied to France and Britain that: "while Finland's position as a state has not yet been settled in the form of a permanent peace treaty, and as the Marshall Plan has developed into an issue of serious disagreement between the great powers, Finland wishing to remain outside world political conflicts, the government unfortunately does not regard it as possible to participate in the conference in question". In fact, this statement was made at a time when the peace treaty had already been signed and Finland for its own part had ratified it.

Opting out of Marshall aid was a serious economic loss of Finland. Norway, for instance, received a total of 255 million dollars in Marshall aid and Denmark 273 million, most of it with no strings attached. At the same time Finland was sending reparations to the Soviet Union



■ The headquarters of the IMF
in Washington D.C.

- Bank of Finland.

worth approximately the total of these two sums.¹²¹ Jukka Nevakivi states that the rejection of Marshall aid was a precedent that served as a model for Finland's later response to other western European integration projects. It meant, among other things, that Finland did not join the Organisation for European Economic Co-operation (OEEC) nor therefore the European Payments Union (EPU), which was set up to manage the western European multilateral clearing system for international payments.¹²²

For Finnish currency policy, the rejection of Marshall aid naturally had the immediate effect of closing one avenue for solving balance of payments problems. Membership of the World Bank and thereby the International Monetary Fund therefore became extremely important, although this factor did not influence the decision to seek membership because Finland had already applied months before receiving its invitation to the Paris conference.

Rejection of Marshall aid underlined the political importance to Finland of its membership of the Bretton Woods institutions. It shows what a sensitive course had to be steered in integration policy in the 1940s and long afterwards, and what a major achievement membership of the IMF was. Caution in foreign policy was obviously the reason why Finland also opted out of the Geneva conference, arranged in autumn 1947, which concluded the far-reaching General Agreement on Tariffs and Trade. GATT came to be the foundation of the multilateral free-trade system between market economies, and it economically integrated a large part of the world in the decades ahead. The first five GATT rounds reduced world trading tariffs (trade-weighted average) from about 50 percent to 12 percent.

Although Finland was not present at the foundation of GATT it did participate in the organisation's second round at Annecy in autumn 1949 and became a signatory to GATT in May 1950. Tapani Paavonen believes that the Soviet Union was not ultimately very antagonistic towards GATT although the members of the People's Democratic League in Finland's parliament argued against membership at the time, claiming that GATT was an anti-Soviet coalition. Perhaps the shape of Finland's foreign and domestic policies towards the Bretton Woods organisations can be interpreted in the same way – at least until the final breach between the IMF and the Soviet Union's allies at the start of 1950.¹²³

Growing Cold War tension broke up the East European constituency of the IMF and thereby changed Finland's place in the fund's governance. This train of events began soon after the People's Republic of China was founded on 1 October 1949. In February 1950, Bohumil Sucharda, representing the East European block of countries and Finland on the IMF's executive board, was instructed by the governments of Czechoslovakia and Poland to propose that the Republic of China (in effect, Taiwan) led by the *Kuomintang* or Chinese Nationalist Party should no longer represent China at the IMF. Sucharda wrote to Governor Tuomioja of the Bank of Finland about the matter on 10 February. In his statement to the Executive Board of the IMF, he asked for "support from the countries that had recognised the central government of the People's Republic of China and from others who have common sense in this matter". However, the board rejected Sucharda's proposal on the grounds that matters of membership were the province of the Board of Governors and therefore had to be decided by the annual meeting of the IMF. Sucharda responded that he could no longer participate in the work of the executive board if representatives of the Kuomintang were permitted to do so.¹²⁴

As the executive board had indicated, the Chinese question was placed on the agenda of the IMF's annual meeting in Paris in September 1950, where the delegation from Czechoslovakia demanded that the Chinese Nationalists should be excluded from the meeting. This proposal did not meet with general approval and was rejected in a trial vote. Finland's representatives had been instructed in a letter from the Foreign minister, dated 1 September 1950, to abstain in the vote on the subject.¹²⁵

The dispute over Chinese representation led ultimately to the resignation of eastern European socialist countries from the IMF. The first to leave was Poland, soon after the dispute (13 March 1950). A letter from the Polish ambassador gave the reason that "the IMF has failed in its responsibilities and has become a tool of the domineering policies of the US government". The Fund was said to be "acting in cohorts with the US administration, which recently forced several members to devalue their currencies." This was a reference to a round of devaluations in September 1949, which will be described later in connection with Finland's exchange rate policy. Around the same time, Czechoslovakia ceased sending economic information to the IMF. When, in 1953, it

revalued its currency without consulting the IMF, a process was set in motion that resulted in Czechoslovakia's expulsion from the IMF in August 1954.¹²⁶

When the East European constituency of the IMF broke up at the Paris annual meeting in September 1950, Finland joined the group containing Belgium, Luxembourg and Denmark, represented on the executive board by a Belgian, Ernest de Selliers. The constituency had a combined voting weight of 4.48% in the IMF. Finland's share of the vote was the second smallest in the group, and only a quarter of Belgium's.

Participation in the Belgian constituency was a stop-gap solution until it became possible to establish a Nordic constituency. The critical mass in this respect came from Sweden, after it finally overcame its hesitation about the IMF. Of the Nordic countries, Norway and Iceland had joined at the end of 1945 and Denmark soon after, in March 1946, but they were counted as Allied powers and had been present at the Bretton Woods meeting. The situation for Sweden was more difficult. As a neutral country it had not been invited to Bretton Woods and even a couple of years later its relationship to the Western allies was overshadowed by its wartime ties with Germany. A particular problem was posed by assets that Germans had transferred to Sweden during the war and a dispute over their repatriation.

After the start of the Cold War, it became the aim of the United States to bind Sweden to the IMF, the OEEC and other "western" structures of cooperation. Sweden was doubtful about these projects, fearing that they were incompatible with its policy of neutrality. Ultimately its decision on IMF membership was determined by the desire to participate in the global round of tariff reductions within the GATT framework. Sweden applied to the IMF in June 1950 and its membership took effect from 31 August 1951.¹²⁷

Thus Sweden joined the institutions of Bretton Woods a full three years after Finland. Nonetheless, its position in the IMF was destined to be far from weak. On the same day that it joined, Ivar Rooth, the long-serving governor of the Bank of Sweden, became managing director of the IMF. The job stayed with Sweden for a long time because, in 1956, Rooth was succeeded by Per Jacobsson, who held the post until his death in 1963.

After Sweden had joined the IMF, the Nordic countries had enough votes to establish a constituency and elect a joint representative to the executive board. Preparations for this began the following summer, when plans were being made for the annual meeting of the IMF and the IBRD in autumn in Mexico City. At least four new members were to be elected to the executive board at the meeting. On 27 June 1952, professor Klaus Waris, who had just been appointed an acting board member of the Bank of Finland, received a letter from the governor of Bank of Norway, Gunnar Jahn, explaining that Iceland had proposed Nordic cooperation during the election. The matter was agreed and the Mexico City meeting led to the establishment of a Nordic constituency. Alf Kristian Eriksen was the first Nordic representative on the executive board.¹²⁸

To create a Nordic constituency, Finland and Denmark left the Belgian constituency, Iceland resigned from the Canadian constituency and Norway from the Dutch one. Together, the Nordic countries controlled 3.84% of the total IMF vote. Within the constituency, votes were distributed as follows: Sweden 1,250 votes, Denmark 930, Norway 750, Finland 630 and Iceland 260. Within the constituency, it was agreed that the executive board position would rotate between the members every second year. The first Finnish executive director at the IMF was Eero Asp, whose two-year term began at the annual meeting in autumn 1958.

Membership of the Bretton Woods system can be regarded as one of the most far-reaching decisions that Finland took in trade and the entire field of foreign policy in the decades after the Second World War. Membership of the IMF was one great step on the path it chose in its international economic relations, of western integration based on free trade. The most tangible consequence of the IMF was the resultant commitment to a process that made the Finnish markka externally convertible. Another part of the same package was membership of GATT, which meant a reduction in tariff barriers and a commitment to implementing the principles of free trade.

The impact of membership of these global economic organisations was not restricted to foreign trade alone but had a deep influence on the whole of Finnish society. A convertible currency and diminishing customs barriers gradually brought Finnish prices in line with international markets. The gradual deregulation of foreign trade

initiated a major restructuring of Finnish industry and focused the nation's efforts on improving national productivity and competitiveness. Together with later steps towards free trade, they transformed Finland into a modern industrial country over the next quarter of a century, and made it possible to raise Finnish living standards to the western European level.

In view of Finland's position as a country defeated in the war, its membership of the IMF came at a relatively early time. Neutral Sweden delayed its application for a long time and joined the Bretton Woods institutions a full three years after Finland. Finland also preceded Austria, which applied for IMF membership half a year after Finland and was accepted on 7 April 1948. West Germany applied on 7 February 1951 and was accepted in 1952. Of the European countries that were counted as neutral during the war, Spain did not apply and join the IMF until 1958 and Portugal until 1959. Ireland's application and membership took place in 1957.

Finland joined the IMF while the fund still had relations with the Soviet bloc. Whether Soviet objections would have prevented Finland's membership if its application had been delayed is hypothetical but cannot be ruled out. The countries within the Soviet Union's sphere of influence severed their relations with the IMF soon after Finland had joined. Moreover, Soviet resistance stopped Finland joining the OEEC around 1958; Finland did not join the OECD, which superseded the OEEC, until 1969.¹²⁹ It is therefore quite possible that if Finland had awaited Sweden's decision on the Bretton Woods organisations, membership would have become more difficult if not impossible amid the ever tenser international climate.

SEEKING A MONETARY POLICY LINE

REVIVING ACTIVE INTEREST RATES

Monetary policy during the war and in the early years of reconstruction had been founded on low and regulated interest rates and on quantitative restrictions on lending. The interest rates of credit institutions were set by the interest rate board, established in 1941, in which the Bank of Finland played a leading role. Formally, the decisions of the board were only recommendations but in reality they were binding because the banks had no alternative but to follow them. Practically speaking, interest rates had been completely static since the mid-1930's.

A bank's lending policies were required, at least in theory, to follow credit guidelines issued by the Bank of Finland. The principles were laid down by the Bank of Finland during the war, the last set of guidelines being issued on 25 January 1943. These tough wartime regulations remained in force until January 1947 when the board of the Bank of Finland sent new instructions better suited to peacetime in the form of a circular to "financial institutions that grant credit". The circular referred to a programme drafted slightly earlier in the Economic council and noted that "in approving the principles proposed by the Economic council, the Finance ministry had asked the Bank of Finland to draw up general instructions on lending and to transmit them to financial institutions for implementation".¹³⁰

The new instructions were not very detailed and entailed a distinct relaxation of the wartime instructions, when the main priority had

been financing the government and the production of military supplies. The new instructions emphasized reparations production, export industries and agriculture, where they aimed to improve arable yields and increase animal husbandry. Lending to municipalities was discouraged. As far as possible, lending should be based on short-term acceptance credit against bills of exchange, which, it was argued, would strengthen the liquidity of financial institutions at a time when their funding was increasingly from short-term current account deposits. Under no circumstances was credit to be granted for speculative purposes or for financing consumption. All new loans over 500,000 markkaa had to be reported to the Bank of Finland. The proscription on financing speculation meant, among other things, that loans could not be granted against securities quoted on the stock exchange, although a later circular issued in December 1948 overturned the absolute ban on financing securities trading.

Inflation slowed down slightly in 1946, when year-on-year price rises were “only” 16 percent measured by the cost of living index and 19 percent by the wholesale price index. However, prices shot up again in 1947, a full 54 percent measured by the cost of living index and 39 percent according to the wholesale price index. Such a fierce acceleration in inflation led the Bank of Finland to reinstate interest rates as a policy tool, first cautiously and after the start of 1948 more purposefully. Despite the small size of rate changes, they marked a major change in principle because 13 years had passed since the bank had last moved its rates (by lowering them in 1934).

The question of using interest rates as a policy tool was initiated at the Bank of Finland in spring 1947. On 18 March the board of management sent the supervisory council a proposal that all interest rates applied by the bank should be increased by half a percentage point. This meant that the lowest discount rate would rise to 4½ percent. It argued that rates needed to be raised because they had not kept pace with rates charged by other banks. The board pointed out that “in the prevailing conditions of tight money, commercial banks have gradually raised their lending rates to the current ceiling of 6¾%. Consequently the banks obtain an unreasonable gratuitous profit when they rediscount their bills of exchange at the Bank of Finland. Nor is it proper for equitable competition that the businesses that are the customers of the Bank of Finland can service their debts at

significantly lower interest charges than the customers of private banks. These reasons make it appropriate to consider raising the Bank of Finland discount rate and thus reducing the difference between its rates and those applied by commercial banks.”

The matter was difficult for the supervisory council, which understood the great psychological impact of an increase after the long period of unchanged interest rates. It was feared that higher interest rates at the Bank of Finland would lead to an undesirable increase in interest rates throughout the banking system, although governor Tuomioja pointed out that “the proposed increase in rates applied by the Bank of Finland is a question that is entirely separate from increasing the general interest rate level, which (has) currently not yet reached the stage for a decision”.¹³¹ Discussion of the board’s proposal was postponed twice but then placed on the agenda for 5 June 1947 when the council approved it. At the demand of the council, the Bank of Finland ordered the commercial banks not to respond by raising their own lending rates.

In fact the long period of static interest rates finally came to an end on 6 October 1947 when the interest rate board of the financial institutions decided that, from the start of 1948, banks would raise rates paid on deposits by half a percentage point and rates charged on loans by three-quarters of a percentage point.¹³² Shortly after the interest rate board’s decision, the board of the Bank of Finland asked the supervisory council for permission to follow suit and raise its own rates by the same amount (i.e. three-quarters of a percentage point). The council approved the proposal and the increase took effect from 15 December 1947.

At the Bank of Finland, these interest rate changes, although cautious in relation to the inflation rate, were taken as a sign that it might gradually be possible to return to more normal and responsive monetary policy. In a review written at the end of the year, Reino Rossi, then a researcher at the Bank of Finland just beginning his great career in monetary policy, commented as follows on the reintroduction of active interest rates:

“Because of great tightness in the money market, it has been, in any case, extremely hard to hold down the interest rate and ration credit for the past two years. This has manifested itself partly in circumvention of the regulations and a major increase in private

lending (and) partly in efforts to raise interest rates within the limits permitted by the 1941 agreement. Hence the average rate on credit to enterprise granted by commercial banks reached 6.33% in 1946, compared with 6.11% the year before and 5.93% in 1944. In June the Bank of Finland also increased its lending rates, except for its lowest discount rate, by half a percent. The official discount rate was raised to 4½ percent on 6 June, at the same time as the (bank's) other lending rates rose correspondingly (...) The aim at that time was not to raise the general level of interest rates; in fact the central bank specifically forbade commercial banks to increase their rates."

"However, severe pressure on the current system of regulations and the deteriorating profitability of savings banks and cooperative credit societies in particular, caused by rising wages and other costs, have forced the interest rate board (of the financial institutions) to consider ways of mitigating these and other aforementioned flaws. Despite the unfavourable consequences of higher interest rates it was therefore decided to raise the general interest rate level somewhat from the start of 1948, i.e. deposit rates by half a percentage point and lending rates by three-quarters."

"Although (...) the main focus is still on regulating lending, the hike (...) may be regarded as a sign that, in future, interest rates will again be used by us as a general tool for regulating investment as and when the general economic situation permits and requires a higher interest rate level."¹³³

During 1947 the Bank of Finland's lowest interest rate had therefore already risen from the level of 4 percent that had prevailed since the 1930s to 5¼ percent. The average lending rate charged by commercial banks had risen too, although by distinctly less, from 6.33 percent to 6.74 percent. Compared with the rate of inflation, interest rates were still very modest but at least the path to greater flexibility seemed to be more open. It was also obvious that the interest rate level was still extremely low in relation to the state of the money market.

Indeed, at the end of January 1948 the board made a proposal to the supervisory council on raising interest rates again, pointing to the need to check speculation on inflation, for which the rate hikes of the previous year had not been sufficient. This time the board's statement to the council no longer denied that its interest rate policies would have an effect on the general level of interest. Instead it noted that "the

commercial and savings banks will naturally take the same course of action and, as deposit rates increase, there are grounds for believing that deposits will begin to increase. This would be a step in the right direction, in the sense that lenders, who benefit from inflation, would be forced to share some of their gains with savers.” The board also stated that “achieving some kind of balance between credit demand and supply will apparently require interest rates to be raised to the same level as after the First World War, meaning at least 3–4 percentage points higher than today. However the board has concluded that this time it would suffice to raise the discount rates applied to banks by only 2 percentage points.”¹³⁴

Prime minister Mauno Pekkala, who chaired the council meeting on 5 February, supported the board’s proposal on behalf of the government. Juhani Leppälä of the Agrarian League, who had often argued in the council for low interest rates during the 1930s, tried to postpone the decision but without success and the board’s proposal for higher interest rates was approved. The lowest interest rate of the Bank of Finland rose to 7¼ percent with effect from 6 February 1948. The Bank’s policy on interest rates now seemed clearly to favour higher rates but its lending to the government constituted an exception to this general trend. On government bills of exchange it continued to apply the rate of only 1%, which it had adopted during the war.

An aspect worth mentioning is that governor Tuomioja told the supervisory council that the board had considered adopting an index clause as an alternate to setting higher lending rates. The idea of indexing central bank lending was unusual and, if it had been implemented, would apparently have been a unique experiment.¹³⁵

A few days after the Bank of Finland’s rate hike, the interest rate board of financial institutions decided to raise bank deposit rates by the same amount and lending rates by even more, 2½ percentage points. The maximum rate charged for “high-quality secured loans” could now be 9%.¹³⁶

DEVALUATION 1949

The spring of 1948, after Finland had joined the International Monetary Fund, was an exceptionally restless time. Following the communist seizure of power in Czechoslovakia in February, tension increased in

Finnish domestic politics. However, in the elections of July 1948 the communist-led People's Democratic League suffered a major defeat and at the end of July a minority Social Democratic government was formed under Karl-August Fagerholm. The composition of the government was exceptional for the times because the communists were excluded. In his memoirs Fagerholm described the main purpose of the government as being "to safeguard democracy in the country."¹³⁷ The government also tried to steer a Scandinavian course in its economic policies.

The section on economic policy in the new government's programme stated that "the system of regulations will be gradually dismantled where regulations in some fields do not prove to be entirely indispensable. The government feels economic planning and full employment to be essential. To manage this and other similar economic matters, it will maintain close contacts with labour market organisations. The difficulties ahead and the burdens to be borne must be shared equally between different civic groups. With this end, the government wishes to be able to present parliament with concrete proposals at the very earliest opportunity."¹³⁸

In the second half of 1948 inflation slowed down and at the end of the year prices actually fell. This encouraged hopes for lower interest rates and in December the new supervisory council now led by Vihtori Vesterinen of the Agrarian League urged the board of the Bank of Finland to consider the interest rate question and make a proposal on the matter in the following month. In January the board presented the council with the desired request to lower interest rates by half a percentage point from the start of February. The motion was carried. As was becoming the custom, the banks followed suit with a decision by their interest rate board.

In line with its programme, the government established a very broadly based committee in February 1949 to plan the normalisation of the Finnish national economy and reconstruction after the war. This extremely broad, 22-member "General Programme committee" consisted of representatives of the major forces of business life and politics, with all the main interest groups and parties represented in parliament, as well as the government and the Bank of Finland. Governor Tuomioja of the Bank of Finland became its chairman and Reino Rossi of the bank's economic research institute its secretary. The

committee was divided into various sections. Dr. Klaus Waris chaired the section for monetary policy, where Teuvo Aura, Rainer von Fieandt and Ralf Törngren were some of the members. Reino Rossi again served as its secretary.

The General Programme committee delivered its proposals at the end of May. They covered a wide range of economic matters, such as reforming agricultural policies; dismantling distribution and price controls on consumer goods; removing wage regulations (the committee felt that “as other areas of the economy are being rapidly deregulated, it is unthinkable that wage controls would remain unchanged”); rent controls; foreign trade controls (which the committee felt had to be continued for the time being); and financial policy. The committee report “endeavoured to find solutions that would gradually promote the flexible adaptation of economic life over the long term to conditions of normality”¹³⁹.

The committee’s report closely studied monetary policy questions, too. While its work was ongoing, it sent a letter to the board of the Bank of Finland on 13 April 1949, proposing that interest rates be lowered by one percentage point. It argued that the economic climate had significantly changed since the preceding autumn, inflation having been replaced by deflation and the investment propensity of industry having declined. The committee felt that “to ensure high steady and effective employment, which is the most important general objective of economic policy, it would be appropriate under present circumstances to seek to improve the climate for investment and enterprise”¹⁴⁰.

The board of the Bank of Finland approved the committee’s proposal – hardly surprisingly, considering that the chairman of the committee was the governor of the bank – and asked the supervisory council for permission to cut interest rates at its meeting on 4 May. Councillor Leppälä remained true to his convictions and proposed a greater reduction, 1.5 percentage points, but the board rejected the idea. In the discussions, governor Tuomioja said “the natural rate of interest would be higher than the present one”¹⁴¹. Of the members of the board Urho Kekkonen, who like Leppälä was from the Agrarian League, made an intervention supporting a cut of one percentage point and rejecting the greater reduction proposed by his party fellow. So, interest rates were lowered from the start of July in line with the wishes of the General Programme committee.

As well as interest rates, the General Programme committee discussed exchange rate and credit policies. The exchange rate question was regarded as absolutely fundamental. When it was discussed in a meeting of the general section on 14 March, the deputy chairman of the committee Klaus Waris and governor Sakari Tuomioja both stated that the fundamental direction of the committee's work was determined by the exchange rate. The question was whether current exchange rates were a viable basis or not.

The economic policy strategist of the Social Democratic Party, Unto Varjonen, appealed strongly for a devaluation. In his memorandum to the committee dated 14 March, he said that economic policy problems could not be resolved at the current value of money. He proposed a "managed inflation jump and an increase in exchange rates" and called for an alternative general programme to be drawn up on this basis. Varjonen's idea was to make exports more profitable and thereby more diversified. He believed that "the profit margin obtained via higher exchange rates should be siphoned off in one way or another (e.g. with the aid of export tariffs) into a fund of capital that can be used for developing more advanced industry. This cannot be achieved without an active government industrial policy and a government-backed expansion of lending, for example via the Bank of Finland."¹⁴²

The committee's report did not include the alternative programme that Varjonen wanted. In the same meeting of the general section on 14 March, the chief general manager of the Post and Savings Bank, Teuvo Aura, proposed that the current level of exchange rates be accepted as the basis for the discussion, and Klaus Waris seconded the proposal. Waris said that it was not the right moment to alter exchange rates, although it would be a different matter if the general cost level changed. The report of the General Programme committee, delivered at the end of May, conceded that the markka was overvalued at current exchange rates but concluded that "in the view of the committee and in the light of preceding considerations, there do not presently seem to be compelling reasons or favourable prospects for raising exchange rates, regardless of the latent need. The present exchange rate level should not therefore be abandoned unless changes in international currency rates or market trends affecting domestic employment conditions make it absolutely necessary."¹⁴³

While the general programme committee was considering the future direction of Finnish economic policy, the time was becoming ripe for a reorganisation of the exchange rates of European currencies against the dollar. The United States in particular thought so. The background was the “dollar crisis”, the chronic payments deficits of European countries and their consequent shortage of dollars. In Britain, for example, scarce dollar reserves were under constant pressure and there were fresh memories of the 1947 failed experiment to make the pound convertible. That episode, ending in catastrophe, had shown that overvaluation of a currency would prevent the dismantling of foreign exchange controls. In the United States, more realistic exchange rates, meaning European-wide devaluations, were regarded as important specifically because they would allow European countries to deregulate their foreign trade and make their currencies freely convertible. In the American view Europeans were excessively reluctant to change exchange rates.

The executive board of the International Monetary Fund discussed the European exchange rate question for the first time on 28 March 1949. The United States took the opportunity to request the IMF to take a more active role in the matter. Executive director Frank Southard, representing the US, pointed out that although the IMF could not dictate the exchange rates of its members, it could not be regarded as a useful body if it remained silent about unrealistic exchange rates.¹⁴⁴

The executive board reached the decision on 6 April that western Europe’s balance of payments problem would be handled “using the Fund’s established methods of consultation with the members”. It said that attention would be paid to how prevailing exchange rates and exchange controls were related to the payments account positions of the countries in questions and “the tendency towards price distortion”. The decision meant that the managing director of the IMF was to consult informally with West European member countries on the exchange rate question as soon as possible.¹⁴⁵

Managing director Camille Gutt consequently toured the main European countries in May and at the start of June. At the end of May, Bohumil Sucharda, representing the east European countries and Finland on the executive board, wrote to governor Tuomioja of the Bank of Finland that he thought the fact that Gutt and other leaders were travelling at the same time was a sign that the adjustment of

European exchange rates had reached the planning stage. He added that US representatives felt it was in the interests of Western Europe not merely to devalue but to do so without delay. Sucharda thought that the pound might be devalued even before the start of July.¹⁴⁶

The end of May and the start of June were therefore a time of active international diplomacy on exchange rates although the journeys and their purpose were kept as secret as possible. Governor Tuomioja also travelled to Washington for talks at the start of June and did not return to the Bank of Finland until 20 June. After his own tour of Europe, Gutt reported to the executive board of the IMF that Europeans had shown increased interest in planning exchange rate changes. It had also become clear that the pound's exchange rate was regarded as the key to the whole situation. Before Britain devalued, other countries would not be able to decide on their future dollar exchange rates.¹⁴⁷

Finland did not wait for the British government to make up its mind. In the spring of 1949, forest industry export prices suddenly dipped sharply, especially for pulp, an important export product at the time. Underlying this development were an economic recession in the United States and Sweden's elimination of the export surcharge on pulp. In May–June pulp prices had collapsed by as much as 40 percent compared with the end of the preceding year.¹⁴⁸ Although Finnish export prices as a whole fell by much less (about 7%), the abrupt shift in the export market, together with the information that governor Tuomioja had obtained on his trip to Washington, was enough to change the hitherto latent need for devaluation into an urgent one.

On 28 June, about a week after Tuomioja's return, the Bank of Finland telegraphed the International Monetary Fund to announce Finland's intention to devalue the markka by about 20 percent. The IMF executive board discussed the matter on 30 June, at a meeting where Finland was represented by secretary of legation Jaakko Hallama from the embassy in Washington. In a message to Helsinki about the course of the meeting, Bohumil Sucharda informed Tuomioja that the IMF was in favour of a markka devaluation. He said that during the meeting he had recommended to Hallama that Finland should carry out the devaluation immediately because news of it might have leaked and a delay could therefore cause damage to the Finnish economy. Sucharda added that, in the view of the IMF secretariat, the devaluation

proposed would not suffice and Finland would have to devalue again when the anticipated devaluation of west European currencies took place.¹⁴⁹

On receipt of the IMF's approval for the principle of a devaluation, Finland could go ahead. At its meeting on 4 July the board of the Bank of Finland decided to raise exchange rates of foreign currencies 17.7 percent. The minutes record that "because of a deterioration in business conditions that has taken place on international export markets and particularly the great decline in our export prices, an adjustment of exchange rates has become essential".¹⁵⁰ The higher foreign currency rates meant that the value of the markka had declined by 15 percent. A laconic telegram on the matter was sent immediately to the IMF in Washington.¹⁵¹

The executive board of the International Monetary Fund approved Finland's exchange rate change, in accordance with its decision four days earlier. The notice of approval stated that "When on July 4, 1949 the Bank of Finland had announced a devaluation of the currency by 15 per cent (...) The Fund recognized this change as a necessary step toward reconciling domestic and foreign prices without impairing domestic price stability. The degree of devaluation thus approved was judged to be sufficient to maintain Finland's position in European markets. Further devaluation at that time without similar action by other European countries might have had a dangerous inflationary impact on (Finland's) internal prices and wages."¹⁵²

The meaning was clear. In the view of the IMF, Finland's 15 percent devaluation of the markka would correct its exchange rate misalignment against European currencies but left it overvalued against the dollar, as were the other west European currencies. However, the general exchange rate realignment urged by the United States was at hand and Britain's decision was the key to it, as Gutt had concluded from his European tour.

Britain's foreign currency reserves continued to dwindle in summer 1949. In the last week of July the British government ended its long prevarication and started planning a devaluation of the pound. It decided to carry this out during the fourth annual meeting of the International Monetary Fund in mid-September, when central bank governors would be assembled in Washington. Even the magnitude of the devaluation was not decided until 12 September, the day before the

IMF meeting began. The new exchange rate chosen was 2.80 dollars to the pound, which raised the value of the dollar in pounds by a full 44 percent.¹⁵³

The official devaluation of the pound took place on 18 September 1949 and was followed by a fairly worldwide round of exchange rate changes. The countries in the sterling area (such as Ireland, Australia, New Zealand, South Africa and India) followed suit as expected. So did the Netherlands and the Nordic countries, even Sweden though it was not yet a member of the IMF. France and West Germany devalued by somewhat less (just over 20 percent), Belgium and Italy by even less (12 and 18 percent). Britain was by far Finland's most important export market, taking about 29 percent of Finnish exports at that time so it was clear that Finland had to react, as the IMF Secretariat had recommended at the time of Finland's lone devaluation in July. Within the wave of west European currency devaluations, Finland raised the markka price of the dollar by 44 percent on 20 September which left its value unchanged against the pound and the Nordic currencies. The new rate for the dollar was 231 markkaa.

From an international perspective, the devaluations of September 1949 were principally about raising the value of the dollar vis-a-vis numerous other currencies, while the exchange rate changes between the other currencies were much smaller. This is illustrated by calculations of the effect of the markka exchange rate change. Weighted by shares of different currencies in Finnish foreign trade, the markka depreciated by only about 7% despite the great nominal magnitude of the devaluation against the dollar, because the United States was a minor trading partner for Finland at the time.¹⁵⁴

Finland's devaluations of 1949 can be seen as part of purposeful preparations for liberalisation of wartime economic regulations. There were both internal and external pressures to do this. Finland had decided to participate in the GATT round of tariff cuts which, in time, would lead to the dismantling of customs barriers protecting Finnish industry. At the same time membership of the IMF meant that in the long run Finland had to end bilateral payments arrangements in its foreign trade (or at least in trade with other IMF members) and make the markka externally convertible. This could not be done unless exchange rates were at a realistic level, so the markka's overvaluation had to be eliminated.

The Bank of Finland's take on the issue was presented in "The Devaluation of the Mark", published under Sakari Tuomioja's name in its *Monthly Bulletin* of summer 1949. The article was written and published after the July devaluation but before the global exchange rate adjustment of September. It said that purchasing power parity calculated from price indices could "naturally" not be used to set the size of the devaluation because the decisive matter was not the relationship between price levels but the need to make export production and exporting profitable. The aim was to devalue enough to create the conditions for effective production but not so much as to create inflationary pressure in the economy.

The article contained a few key figures for assessing the overvaluation of the markka. Changes in the price level in Finland, the United States, Great Britain, Sweden and Switzerland were compared over the period 1937–1949. According to the figures, relative wholesale prices had risen 4.8 -fold in Finland compared to the United States while the dollar's value against the markka had risen only 2.76 times over. Tuomioja's figures indicated that purchasing power parity against the United States, calculated from wholesale price indices, would have been achieved at a dollar rate of 237 markkaa. The rate after the July devaluation, 160 markkaa, was still very far from this but the rate after the September devaluation was surprisingly close to Tuomioja's quoted figure at 231 markkaa. Taking into account the margin of error, the gap was entirely insignificant. Because the September exchange rate realignments had not changed the markka's value against the pound sterling or the Swedish krona, the markka was still substantially overvalued against them.¹⁵⁵

In his memoirs, published in 1977, Prime minister Fagerholm wrote that the Bank of Finland carried out the devaluation of July 1949 without first contacting the prime minister or the finance minister and that he himself learned about it from the press, like the rest of the public. He described his discussions with governor Tuomioja after the devaluation as "not entirely friendly". Fagerholm felt that his government had been blamed for a decision of which it was "completely innocent".¹⁵⁶ In fact the government was formally involved in carrying out the 1949 devaluation, at least insofar as its representative from the Washington embassy was present at the June meeting of the IMF executive board, which endorsed the devaluation. The government's

representative knew of the IMF's approval for the plan to devalue even before the Bank of Finland did, and four days before it was done.

When the decision was being taken in 1949 to devalue the markka, it was realised that Finland would have to set the official par value of the markka against the dollar in the fairly near future. The postponement Finland had obtained lasted until January 1950. However the Finns then postponed it again, for fear that if inflation could not be curbed, the current rate could soon prove to be unrealistic. In mid-January Tuomioja wrote to Bohumil Sucharda on the IMF executive board, thanking him for having succeeded in obtaining a new postponement. In his letter Tuomioja comments that the inflationary outlook in Finland had worsened again and the situation was therefore even more insecure than before.¹⁵⁷

Despite many postponements, though, the rate at which Finland officially joined the Bretton Woods organisation turned out to be 231 markkaa to the dollar, as set in the round of devaluations of September 1949. The government screwed up the courage to confirm this rate as par value after a major improvement in the foreign exchange situation caused by the Korean Boom of 1951. During the spring of 1951 there was growing realisation that a decision was needed. On 15 May governor Tuomioja wrote to Ernest de Selliers, representing the constituency of Belgium, Denmark, Luxembourg and Finland on the executive board of the IMF, that when the current deadline for fixing the markka's value expired at the end of summer 1951, Finland would seek no more postponements and at the start of June Johan Nykopp, its ambassador to Washington, would propose a permanent par value.

Tuomioja gave de Selliers three reasons why par value could now be fixed:

- Foreign trade had developed very favourably; in particular, the terms of trade had improved about 30 percent and the volume of exports was also on the rise.
- The government budget had been strongly in surplus for several months and government debt to the Bank of Finland had shrunk from 26 billion markkaa in November 1950 to only 10 billion in January in May 1951.
- Interest groups had agreed on a wage and price freeze, a standstill agreement between economic interest groups. This would continue

until the end of September, giving a breathing space for measures to halt the rise in prices.

The par value confirmed on 28 June 1951 was the rate that had already been in force for almost 2 years, 231 markkaa per dollar. In the same connection Finland paid its IMF membership quota of 38 million dollars. Two percent of this was paid in gold (21,720 ounces of fine gold, equivalent to 760,000 dollars). About one percent (90 million markkaa) was paid to the IMF's markka account at the Bank of Finland. The rest (8,475 million markkaa) was paid in the form of markka-denominated bonds, held at the Bank of Finland on behalf of the IMF. Finland was now in every respect a member of the International Monetary Fund and at the same time of the Bretton Woods organisation, with all the responsibilities of membership. At the same time it paid its capital subscription – another 38 million dollars – to the World Bank.

FROM KOREAN BOOM TO STABILISATION PACT

Most of the controls on prices and wages and rationing of consumer goods were due to be eliminated in 1949. This objective underpinned the programme of the Fagerholm government and the recommendations of the government-appointed General Programme committee. For the public, the clearest sign of normalisation was the end of the ration card system for most household commodities. It is easy to understand how it felt when purchases of milk and grain products were no longer restricted to a monthly maximum. At the end of 1949 the dismantling of rationing was so advanced that the Ministry for Supply, responsible for it, was abolished. At the turn of the 1950s the only goods still rationed were sugar, coffee, margarine and rice although it was not until spring 1954 that coffee became freely available and all rationing ended.

The Bank of Finland participated in deregulation by easing its instructions to the banks about their lending. In a central bank circular on 9 September 1949, restrictions were lifted to such an extent that bank lending can be said to have returned to normal after the war and reconstruction period. The circular noted that “the increase in deposits since July 1948 has facilitated lending and subsequently the stabilisation and downturn in prices have made entrepreneurs cautious and reduced the propensity to invest. In the changed circumstances it is

appropriate for the bank to desist from issuing detailed lending instructions. The restrictions contained in the ... circular (sent on 23 January 1947) are hereby overturned.” The circular had urged banks granting credit to pay special attention to “recipients who provide job opportunities in the winter months” and mentioned among others the forest industry and winter building work.¹⁵⁸

Regarding the value of money and thus monetary policy, an important part of economic deregulation was the dismantling of price and wage controls, in force since the war. After autumn 1947 the system of wage controls had also contained an index clause that overcompensated for inflation because, whenever the cost of living index rose 5 percent, the system stipulated that wages had to be increased by 5.5 percent. It was practically impossible for price and wage controls to halt the inflationary spiral but they created various inefficiencies and politicised prices and wages. The government automatically became a party to many disputes about prices and wages, even at the individual company level. One notorious example was “Bloody Thursday” of 1949 in the northern port of Kemi, when two strikers died in a riot caused by a dispute over how wage regulations should be applied.

The government dismantled wage regulations in February 1950. It was one of the last acts of the Fagerholm administration, which resigned soon afterwards when a new presidential term began. Voting for the electoral college was held in January 1950 and on 15 February, the same day that wage regulations ended, J.K. Paasikivi was re-elected president of the republic. A new government was subsequently formed by Urho Kekkonen of the Agrarian League, who was a member of the Bank of Finland’s board as well as a member of parliament. It was the first in a series of short-lived Kekkonen governments that dominated Finnish politics for several years; he was prime minister of five governments between 1950 and 1956.

In addition to his being led by a member of the board of the Bank of Finland, Kekkonen’s first government had other strong ties to the central bank. The bank’s governor Sakari Tuomioja was one of its most important ministers while continuing to fill his position at the bank. Moreover, the chairman of the supervisory council of the bank, Vihtori Vesterinen, was the second minister of social affairs before later becoming the second minister of transport.

Sakari Tuomioja originally held two portfolios in the Kekkonen

government, as minister of foreign trade and minister of trade and industry, although he resigned the second post after half a year. From a modern perspective it seems strange that he could be a government minister at the same time as he was governor of the central bank and that the supervisory council simply “sanctioned (his) absences from the bank when ministerial duties required it”. However, such an arrangement was not possible for the prime minister, and Kekkonen was granted leave of absence from the board of the bank. His place on the board of management was taken by Kaaperi Kivialho.

After the end of wage controls in February 1950, notice was given to terminate a great number of wage agreements in various sectors. The subsequent wage negotiations were extremely difficult. A centralised settlement was ultimately agreed, based on a conciliation proposal by Karl-August Fagerholm, who had now become speaker of parliament. Part of the F-settlement, as it was known, was an across-the-board 15 percent wage increase from 15 May and index-linking to compensate for all increases in consumer prices.¹⁵⁹ In June a general increase in rents and agricultural prices, which was part of the F-settlement, was implemented by government decree. Dismantling wage controls had triggered a new wave of inflation.

The acceleration in inflation after the end of wage controls coincided with unusually fierce inflationary impulses from abroad. The outbreak of the Korean War at the end of June 1950 caused a great demand spike and pushed up prices in many raw material markets although ultimately not for long. Markets were hit by fears that the power struggle in Korea between the West and the Communist countries would widen into a global great power conflict and this triggered a wave of speculative stockpiling. Raw material prices already began to rise in summer 1950 and peaked in 1951. As often happens, a boom driven by speculative demand contained the seeds of its own destruction. The growth of demand for raw materials and the rise in prices was so strong that many countries experienced problems in their balance of payments, aggravated by the gradual deregulation of imports that had begun in 1950 within the OEEC. The first country to suffer balance of payments problems was Germany, followed by Britain and France in 1951. These difficulties led to new controls in 1952 and tighter economic policy to curb aggregate demand. As world demand for raw materials subsided, prices turned down again.¹⁶⁰

URHO KEKKONEN (1900–1986)

Urho Kekkonen was Finland's most powerful politician for three decades, first as a five-time Prime minister and then for a quarter of a century as President of the republic. His political career was so towering that it eclipsed his work at the Bank of Finland, but his appointment to the board of management speaks realms about the place of the central bank at the hub of Finnish political life in the post-war period.

A doctor of laws, Kekkonen began his political career in 1936 as a member of parliament for the Agrarian league (subsequently the Centre party). He became minister of Justice in the same year. Later he worked as a civil servant and, for part of the war, was at the Finance ministry, in charge of rationalising public administration. With the restoration of peace he became Justice minister in the Paasikivi government, a position that involved him in the arraignment of Finland's wartime leaders for war culpability. Those tried included Bank of Finland board members Risto Ryti and J. W. Rangell.

Kekkonen was appointed to the board of management of the Bank of Finland in 1946. It was apparently meant as a consolation prize after he had been forced to resign his ministerial position in spring 1946 when the government of Mauno Pekkala was formed. Kekkonen himself regarded his fall from power as "a personal political failure".

On the Bank of Finland's board, he was the member learned in law,

charged with ensuring the legality of operations. He was also responsible for the bank's real estate and its audit department, and he was in charge of preparations for meetings of the parliamentary supervisory council.

His official responsibilities were not onerous, perhaps for the reason that he continued to serve as a member of parliament at the time and also as speaker of the house (1948–1950). His work on the board of management lasted for only four years because he took leave of absence on becoming prime minister in March 1950. He subsequently returned to the Bank of Finland in November 1953 but for only half a year, while governor Sakari Tuomioja served as prime minister of a caretaker government in which Kekkonen was not a member. When the government changed again after the elections in spring 1954, Kekkonen returned to the cabinet. He never resumed his duties at the Bank of Finland although he did not ultimately resign from the board of management until he had been elected president of the republic in 1956.

As president, Kekkonen's influence on the Bank of Finland was generally indirect only, mostly via appointments to the board of management. In his economic policies he sought to heal social rifts. In 1967 he appointed a social democrat, Mauno Koivisto, as governor of the Bank of Finland because he believed that "a man of the left" would be best placed to gain the vital support of the labour unions for safeguarding price stability.



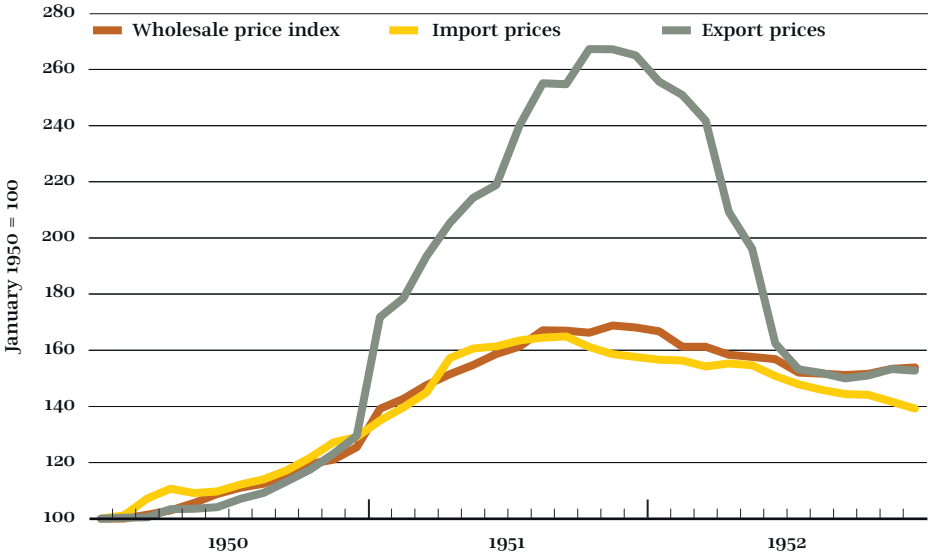
■ Prime minister Urho Kekkonen meets the press on 15 June 1950, on his return from trade talks in Moscow.

- Lehtikuva news photo archives / Hede-Foto.

The Korean Boom had an exceptionally powerful impact on Finland, because of the structure of its exports. Unlike the large industrial countries of Western Europe, Finland gained great benefit from the growth in demand for raw materials. Its export prices (as measured by the unit value index) reached a level in 1951 that was twice as high as in the first half of 1950, before the Korean Boom. Finnish foreign trade in the peak year of 1951 showed a significant surplus for the first time since the war, and the volume of both exports and imports exceeded the pre-war level (1938), also for the first time. The boom pushed up export prices by about 50%, producing record export earnings, but at the same time it caused substantial cost pressures because prices of imported goods also rose.

Despite its brief fairly brief duration the Korean Boom became one of the main milestones in Finland’s post-war economic development. On the one hand it spurred the government to complete the measures required by its membership of the Bretton Woods system, fixing the par value of the markka and paying its fees to the IMF and the World

THE KOREAN BOOM: FOREIGN TRADE PRICE INDICES 1950-1952



Sources: Central statistical office; Bank of Finland Bulletin.

Bank, which underlined Finland's position among the western market economies. On the other hand, the boom had an effect on domestic economic policies that was at least as far-reaching. Problems of economic disequilibrium halted progress towards market-driven policies and established in Finland a strongly interventionist negotiated economy where the main policy tools were price controls and centralised pay settlements backed by government intervention.

A natural consequence of accelerating inflation during 1950 was that interest rate increases returned to the agenda. Already in spring, the Finnish Bankers Association recommended to the Bank of Finland that general interest rates should be increased, although the matter was postponed at that time. During the summer a system of indexing the loan and deposit markets to inflation was explored as a possible alternative, and the association asked the central bank's Institute for Economic Research whether it would work in Finland's situation.¹⁶¹

The institute replied that the acceleration in inflation in the first half of 1950 had induced "a flight into real assets, a diminution of deposits, an increase in withdrawals and greater demand for credit". Special action would be required, it said, "to ease conditions in the money market, to alleviate inflationary sentiment, to allay fears of inflation and to restore stability of monetary value". It regarded the use of index linking in the financial market as technically feasible but "harmful and regrettable (...) for economic flexibility and development prospects". Compared with raising interest rates, however, the use of indexing "might be easier to implement because of the politically sensitive side-effects of increasing interest rates".¹⁶²

The institute's statement, which was published by the bank, ended in the following assessment of monetary conditions and the scope for combating inflation by monetary policy: "In any case it seems apparent that applying index terms to credit will not, at least alone, suffice to overcome current difficulties, any more than raising the interest rate level will. The underlying reasons for current inflationary conditions can be found on the political side, i.e. in a struggle over the division of national income. Unless this dispute between social groups can be conducted in some way other than by harming the value of money or unless it can be ended by a sensible accord between different interest groups, monetary policy measures alone will obviously not be able to save the day."¹⁶³

The problem of interest rate policies therefore lay in their political side effects, but plans to use indexing of the credit market instead did not advance either. While the Bank of Finland prevaricated, the commercial banks seized the initiative. After the Finnish Bankers Association had discussed the question on 6 September the banks jointly raised their interest rates at the start of October by two full percentage points. Soon after this, on 25 September, the board of the Bank of Finland sent a letter to the supervisory council, proposing that central bank rates should also be increased. At its first meeting the council took no decision but it approved an increase in interest rates at the next meeting on 2 November. The Bank of Finland increased interest rates with effect from 3 November, a month after the commercial banks.

The increase was sharp. At one fell swoop the average rate on bank lending had risen to 9.75 percent. Interest rates on most deposits had been increased by the same amount. On the other hand the rate of inflation in 1950 was so steep that the real rate on bank loans remained substantially negative. The prospects for curbing inflation via monetary policy looked poor.

In November, the Kekkonen government sought to halt the inflationary spiral by ordering a temporary wage freeze that prevented indexed increases in wages. The freeze inflamed relations between the government and the labour union movement and led among other things to a strike at the Bank of Finland's security printing house. At an informal evening meeting of government ministers, prime minister Kekkonen commented sarcastically on the strike of the banknote printers, saying that "inflation has been terminated".¹⁶⁴ In December and January there were negotiations between political parties on enlarging the base of the government by including the social democrats, to create a coalition with a parliamentary majority. The talks resulted in the resignation of the government and the appointment, on 17 January 1951, of a second Kekkonen administration, containing ministers of the Agrarian League and the Social Democratic Party as well as the National Progressive Party and the Swedish People's Party. Governor Tuomioja of the Bank of Finland was not among the new ministers.¹⁶⁵

The programme of Kekkonen's second government gave priority to curbing inflation: "In economic policy the government regards halting

inflation and restoring confidence in the value of the markka as its most important task. It intends resolutely to tackle all the factors that serve to maintain the wage-price spiral and cause unhealthy social tension. In this regard the government will allow wage increases equal to the rise in living costs and then take firm action against unwarranted price rises, and will resist the effects of price fluctuations in the world market on the domestic value of the markka.”¹⁶⁶

Practical responsibility for combating inflation had now shifted entirely to the government and the tools available were price controls, subsidies, and negotiations with labour market organisations. In keeping with its programme, however, the government ended the pay freeze ordered by its predecessor and, as the government programme had promised, the previously blocked indexed increases were added to wages. Driven by higher export prices as well as wage increases, inflation continued to accelerate throughout the spring. By April the wholesale price index had risen 47% and the cost of living index 22%, year on year.

The vicious circle was broken in a way that set the course of Finnish economic policy long into the future. At the start of May 1951, the day after May Day celebrations, the government and the main central organisations representing various interest groups reached a standstill agreement; for the period until the end of September, there would be no wage rises at all. At the same time the government committed itself to price regulation in the form of “a strict line against price increases.”¹⁶⁷ The agreement was signed on behalf of the government by Prime minister Urho Kekkonen, by the central organisations of employers and employees, and also by the two central organisations of agricultural producers, one for Finnish-speakers and the other for Swedish-speakers.

Part of the standstill agreement was the establishment of a new and very broadly-based committee, the Economic Policy Planning Council. It was to “discuss plans prepared by the government for action to improve the condition of our national economy and to achieve an equilibrium between prices and wages, as well as to prepare a detailed long-term economic programme in cooperation with the government.”¹⁶⁸

Kekkonen’s second government resigned on 12 September 1951. Parliamentary elections had been held in July but talks on forming a new government had been delayed by the economic stabilisation

question. In the new government, appointed on 20 September, governor Tuomioja of the Bank of Finland was foreign minister. Kekkonen's third government lasted almost 2 years, until the summer of 1953, which was quite a long time by the Finnish standards of the day.

The stabilisation programme, proposed by the Economic Policy Planning Council, was published immediately after the new government was sworn in, on 29 September. It was an extensive programme. From the Bank of Finland's perspective, its most important points were of course its monetary and credit policy recommendations. The programme stated that "the current unreasonably high level of interest rates, resulting from inflationary trends to date, serves to boost production costs. In particular it makes housing more expensive". For this reason "the lending rates of credit institutions should be lowered by 2 percentage points at the earliest opportunity and no later than the end of the present year". The reasoning shows that the authors of the stabilisation programme saw interest rates mainly as a cost factor, not a way of regulating aggregate demand. The stabilisation programme did indeed, seek to rein in aggregate demand but wanted it to be done in the following way: "implementation of an investment programme should be supported with credit controls" and "separate consideration should be given to the possibility of obtaining a compulsory loan [from the population]".¹⁶⁹

The programme of the newly appointed government gave an important role to the stabilisation pact: "In economic policy the government regards its main task as the purposeful implementation of the stabilisation programme achieved during the standstill and now approved by the parties in the new government coalition. The measures contained in this comprehensive programme will allow inflation to be halted, thereby placing our economic life on a stable footing."¹⁷⁰

On 1 October 1951, just a couple of days after the Economic Policy Planning Council had completed its programme, the supervisory council of the Bank of Finland told the board of management to prepare a proposal for lowering interest rates, as the programme stipulated. The board did as requested although not entirely with good grace. Its proposal to the supervisory council on lowering interest rates argued that "the state of our country's money market has still not been sufficiently stabilized to justify lower interest rates ... but because a reduction in interest rates is part of the government's stabilisation



■ Trade and Industry minister Teuvo Aura was one of the main architects of the Standstill Agreement of 1951. - Finnish Press Agency.

programme and the failure to do so might disrupt the whole plan, it is probably a political necessity to approve it". The reduction in central bank interest rates was put into effect on 16 December. The lowest discount rate fell from 7¾ to 5¾. The Finnish Bankers Association subsequently recommended a corresponding rate reduction to its members. The lending and deposit rates of commercial banks fell from the start of January 1952 by two percentage points.¹⁷¹

BALANCE OF PAYMENTS PROBLEMS RETURN

In 1952 the Korean Boom faded into a recession. Finnish export prices turned steeply downwards during the year and so did export volume. Imports, on the other hand, grew strongly and volume was 24% up on the year before. A large number of import licences had been granted, partly in response to the positive trade balance of the previous year, and partly in an effort to reduce the cost of living index by making imported goods increasingly available.¹⁷² The new business conditions meant that the scourge of the balance of payments – a shortage of foreign currencies – which had lifted for a while, returned to dominate Finnish economic policy. The decline of exports and the growth of imports caused a deep trade deficit and the foreign currency reserves of the Bank of Finland dwindled rapidly. Conditions required tighter monetary policy – but, for political reasons, without raising interest rates – as well as other special measures to protect foreign liquidity.

The economic deterioration was already visible in spring 1952, and letters were exchanged in February between governor Tuomioja and Ernest de Selliers, the representative of Finland's constituency at the International Monetary Fund, about the possibility of using IMF resources to support Finland's international liquidity.¹⁷³ The executive board of the IMF had recently been discussing ways of restricting members' access to IMF financing so as to prevent the resources of the fund being tied up for extended periods by just a few individual members. By the start of 1952 Britain, France, Brazil and India had made the most use of the fund, by purchasing dollars with their own currencies. The managing director of the IMF Ivar Rooth wanted tighter credit terms that would require a member country to sell back dollars it had purchased from the fund within a fixed period of no more than five years. The new principles were approved by the executive board on 13 February.¹⁷⁴

In autumn the policy of the IMF on how support to members was available was supplemented with standardised standby credit; the matter was approved by the executive board at the start of October. A member country that had agreed a standby facility with the fund would now be able to obtain currency, within the terms of the agreement, for a period of six months at the time of its choosing without separate negotiations.

In November Ernest Sturc, who was handling Finnish affairs on the IMF secretariat, made an “entirely unofficial” proposal to the Finns on solving their foreign exchange problems with a nine million-dollar package. Part of it could be drawn immediately and part would be standby credit available on demand. Finland’s ambassador to Washington Johan Nykopp told Klaus Waris of the Bank of Finland about his talks with the IMF in a letter of 21 November: “Yesterday (Veikko) Makkonen and I visited the Fund to talk with (Ernest) Sturc about our drawing operation.... The fund is ready to provide 4.5 million dollars to be drawn immediately after the board has formally approved the application. In the same application the board will be asked to grant a 5-million standby arrangement, so total credit is 9.5 million dollars. Sturc said there was no cause for concern about the board’s decision because the agreement of the main forces has been obtained.” Nykopp concluded his message with the hope that “this dollar injection will keep the board of the Bank of Finland warm for a while”¹⁷⁵.

The board of the bank decided to ask for an IMF credit line at its meeting on 28 November 1952 and by 5 December the bank had obtained the agreed 4.5 million dollars. Standby credit of 5 million dollars was arranged at the same time, and the bank drew it in spring of the following year. It was agreed that the loans would be repaid by the end of 1955 but in fact the Bank of Finland was able to sell back 2 million dollars early, during 1953. Finland thus took advantage of IMF membership just over a year after it had fulfilled its membership obligations by fixing par value and paying membership quotas. The credit line was not ultimately very great – it was less than two percent of the value of imports in 1953 – but it was in dollars, a hard currency and the currency that Finland needed the most.

The IMF secretariat was striking positive in its attitude to Finland’s requirements during credit negotiations. A three-member delegation from the fund, led by the head of its European office M. R. Wyczalkowski,

visited Finland at the turn of December. Its subsequent report treated Finland's balance of payments difficulties as transitory in nature. In its recommendations the report said that more restrictive economic policy was not an option: "...any further strengthening of contractionary policies would probably now carry economic activity below the politically acceptable minimum level. It is therefore the view of the [IMF] staff that under present circumstances general monetary and fiscal policies could hardly be expected to provide any substantially increased contribution to the solution of the [balance of] payments difficulties which still are in evidence. Provided, however, that the economy is not affected adversely by political events inside or outside of the country, Finland's economic conditions should be expected to improve steadily."¹⁷⁶ In its economic review, the delegation predicted that "Finland, with its very hard working population, will be able to augment its external reserves and gradually relax also the present [currency] restrictions."¹⁷⁷ In a fondly phrased letter of thanks following the mission to Finland, Marcin Wyczalkowski mentioned that the positive outcome of the mission was a foregone conclusion.¹⁷⁸

ODDITIES OF FINLAND'S FOREIGN EXCHANGE MARKET

Despite the International Monetary Fund's generally positive evaluation, Finland did not emerge entirely unscathed from its consultations at the end of 1952. The IMF drew attention to Finland's foreign exchange controls and particularly to two factors which were in violation of the IMF's articles of agreement. These were the quotation of a special set of exchange rates for tourist currency and the use of so-called compensation transactions in bilateral trade. Both matters chafed relations with the IMF for several years after autumn 1952.

Underlying the problem was of course Finland's shortage of foreign currency. Foreign exchange controls and the overvaluation of the markka at the official rate created a great deal of pent-up demand for foreign exchange. There was an obvious danger that a "grey" unofficial foreign exchange market might grow up, despite compulsory currency repatriation, in other words the regulations that required recipients of foreign income to sell their currency to the Bank of Finland or to a commercial bank licensed to deal in foreign currency. Companies

engaged in foreign trade tried to sidestep the foreign exchange shortage by various barter and compensation trade arrangements, where exports and imports were coupled to reduce the amount of payment in currency.¹⁷⁹ Finland's need to control this situation led to the creation of two different mechanisms in the 1950s, which allowed a higher parallel exchange rate to be applied in certain defined situations. One set special foreign exchange rates for foreign travel and the other established a clearing house system for foreign trade, outlined below. Neither was very significant economically but they showed that foreign exchange policy was not yet on a normal footing.

Quoting a different exchange rate for tourists was of course a very prominent sign that the markka was overvalued at its official rate. In January 1952 the Bank of Finland transferred the task of providing travellers with currency to private banks, who were permitted to quote special rates at which they would sell Finnish markkaa to foreign tourists and foreign currency to Finns going abroad.

The intention was to prevent a black market in foreign currency, especially during the Olympic Games in Helsinki in summer 1952, when many foreign visitors were expected. The banks could freely sell small quantities of foreign exchange but had to obtain the approval of the Bank of Finland for larger amounts. At the start of the 1950s travellers' exchange rates were about 50% higher than official exchange rates and the system apparently did go a long way to preventing the growth of black-market foreign exchange dealing. At the start of 1955 the Bank of Finland took back the right to set travellers' exchange rates and lowered them slightly. From then onwards they were only about 42% higher than the official rates; the travellers' rate was 330 markkaa to the dollar, compared with the official rate of 231 markkaa. At the same time the amount of travel currency that could be freely sold was increased slightly to 50,000 markkaa per person per foreign trip, but was still very small, worth only about 152 US dollars at the travellers' rate.¹⁸⁰

The traveller's exchange rate system was not to be the only manifestation of multiple exchange rates in the Finnish currency market of the 1950s. After the International Monetary Fund had drawn attention to the use of compensation, or offset, mechanisms in foreign trade during its consultations of 1952, the Bank of Finland forbade compensation transactions unless they took place under official

supervision and if the linkage between export and import deals was not eliminated.¹⁸¹ Soon after this, in February 1953, the main trading companies and organisations met at the Kämp Hotel in Helsinki to establish a cooperative known as the Trade Clearing Agency (Clearingkunta), which moved the compensation trade onto a semi-official basis.¹⁸²

The point of the Trade Clearing Agency was to systematise forms of trading that had become common during the period of trade controls, when export and import licences had been coupled to save foreign currency. Now the Clearing Agency promoted the exports of member companies by subsidizing them, and the subsidies were financed by surcharges on imports of certain goods that were regarded as non-essential. The agency worked in cooperation with the Bank of Finland and the government's trade license office. The holder of a special licence for the export of certain goods received an export subsidy or "compensation" from the Clearing Agency in the form of a fixed percentage. The subsidy depended on the currency and type of goods in question but was generally no more than 20 percent. Export subsidies were financed from surcharges for licences to import certain goods that were normally proscribed by import controls. The Clearing Agency generally imposed a 20 percent surcharge or "clearing fee" on imports by special licence. The agency was organized as a private consortium but the Bank of Finland controlled its operations by setting the level of export subsidies and the total amount to be paid, which the licence office then took into account when granting licences.¹⁸³

The clearinghouse system was a clear sign of the problems of Finland's foreign exchange policies in the 1950s. The pent-up demand for foreign currency created a golden opportunity for what was in fact a system of multiple exchange rates. However, the system was not allowed to grow very large, perhaps because of the criticism voiced by the International Monetary Fund. In 1954, for instance, about 7.5% of exports took place via the Clearing Agency, so the average effect of its subsidies on the export price level was low, although in certain product groups a 20% subsidy made a big difference.¹⁸⁴

The International Monetary Fund again tackled travellers' currency rates and the trade clearing agency during consultations in 1953, when the IMF's representatives noted that these systems were "objectionable" and discriminatory in nature. Finland was urged to cease these

practices as soon as possible.¹⁸⁵ The same criticism was repeated in all discussions with the IMF until both systems were terminated after the 1957 devaluation.

FROM COST CRISIS TO INDEX MANIPULATION

By spring 1953 Finland was already in a recession and the unemployment rate rose to a post-war peak. This meant that measures to restrict investment, contained in the stabilisation programme, could be abandoned. Now the key issue of economic policy became the imbalance between export industry costs and export prices. The “cost crisis” had been precipitated by inflation in 1950 and 1951, when Finland’s costs had increased far more than those abroad, especially for forest products, where export prices had fallen to an even lower level after the end of the Korean Boom. In the words of the Bank of Finland yearbook “the Finnish national economy lacked flexibility to adapt to the new situation.”¹⁸⁶

Prime minister Kekkonen put forward a 17-point programme to deal with the cost crisis in summer 1953. Named the K plan, it consisted of across-the-board 10-percent wage cuts, a cut in bank lending rates by one percentage point and tax reductions. The proposal did not suit the other governing party, the social democrats, who put forward an alternative programme known as the Threshold plan. This was the issue on which the government collapsed, when the social democrats resigned. The next government, formed on 9 July 1953 and also under Urho Kekkonen, was without social democratic participation and commanded only a minority of seats in parliament. Alongside representatives of the Agrarian League and the Swedish People’s Party, it contained three ministers without party affiliations.

The day after the formation of the new government, prime minister Kekkonen gave a radio speech in which he argued for his wage cut plan and presented it as the only way to avoid devaluation. It was regrettable, he said, that his previous government, formed in the spirit of the stabilisation pact, had fallen. That government’s greatest achievement, he felt, had been that the value of money had been stabilised and living standards had improved up to the end of the previous year. In summer 1953, however, he saw “only two paths for Finland to choose from: one

to lower costs and the other to lower the value of the markkaa. (...) The government had chosen lower costs and rejected the path of devaluation. Unfortunately powerful social groupings were determined to oppose measures that would make production profitable by lowering costs without lowering the value of our money. The government realises that the country is drifting into devaluation and inflation without end, unless the profitability of production can be restored by sensible measures targeted at the cost level. What is the point of unchanged or rising markka-wages if the merciless fist of devaluation has delivered a knockout blow to the Finnish markka?"¹⁸⁷

Kekkonen's fourth government was in office only four months. It continued to try to get the K plan accepted but failed and fell in November. The part of the plan involving lower interest rates was also unfulfilled. Actually, the 1953 "cost crisis" that the K plan was intended to combat proved to be a false alarm because the fall in export prices after the Korean Boom was fairly short-lived. By spring 1954 export conditions had already improved and the export recovery led the national economy into strong growth. For a while, the improvement in business conditions relegated talk about devaluation and wage cuts to the sidelines and the focus of economic policy shifted to controlling the nascent upturn, and particularly to preventing an acceleration of inflation. It proved politically difficult; the index linkages of wages and agricultural incomes, combined with the price controls administered by the government, was a major sore point of economic policies in the 1950s.

The control of inflation was seen specifically as the government's problem. There was limited scope for using monetary policy to safeguard the value of money because interest rates had become more politicised since the 1951 stabilisation pact and, via index linking, formed a Gordian knot with price and wage policies. Monetary policy remained passive. The ways that were regarded as politically viable were to control prices and to "buy index points", meaning to pay subsidies that just prevented the cost of living index rising enough to trigger cost-of-living adjustments to wages. In this way the government succeeded in keeping the cost of living index entirely unchanged from October 1951 until 1955.

After the fall of the government and the failure of the K plan, Bank of Finland governor Sakari Tuomioja was appointed prime minister of

a brief caretaker government on 17 November 1953. President Paasikivi then called early elections because the nation's "domestic political developments have led to conditions that complicate the management of economic affairs". Elections were held at the start of March 1954. The next government consisted mostly of ministers of the Agrarian League and the Social Democratic Party (six portfolios each) although prime minister Ralf Törngren hailed from the Swedish People's Party. Urho Kekkonen became foreign minister.

The Törngren government was short-lived and foundered on disagreement about combating inflation. The roots of the problem lay in the stabilisation pact of autumn 1951, when it was decided that if the cost of living index rose by more than five percent (from October 1951), employees would receive index-linked wage rises. In summer it began to look certain that the threshold would soon be breached. By July 1954 the cost of living index had already reached 103.8. In August the national federation of trade unions (SAK) demanded that the government should either push the cost of living index back down to its level of October 1951 or, under wage control regulations, allow employees to receive increases of 5 percent. Meanwhile, MTK, the central organisation of agricultural producers, presented demands for price increases that it too claimed under the 1951 stabilisation pact. The SAK backed its demands with the threat of a general strike, while the MTK threatened to withhold food supplies. When prime minister Törngren's mediation proposals were not unanimously supported even by the governing parties, the government tendered its resignation.

After Törngren, Urho Kekkonen became prime minister again on 20 October 1954. As in the preceding government, most of the ministers were from the Social Democratic Party and the Agrarian League, plus one "neutral" non-party minister at the justice ministry, as there had been in Törngren's government. Kekkonen's fifth government stayed in office until he was elected president in March 1956.

When the government was being formed, the coalition parties agreed on a 19-point economic programme, constructed around measures to reduce the cost of living. The programme implemented the SAK's demand that the cost of living index be pushed down – the demand that had led to the collapse of the Törngren government – and also raised agricultural subsidies. By controlling the prices of certain goods, subsidizing agricultural products and reducing various indirect

taxes, the cost of living index was lowered to 98 by November 1954, although it had been 104 as recently as August. Threats of a general strike and a food blockade were averted. The events epitomise the structure and problems of price and wage policies in the 1950s.

The 19-point economic programme agreed by the governing parties included action on interest rates. It pledged a general reduction in interest rates by one percentage point before the end of 1954, plus a further half-percentage point cut on first-time loans for housebuilding. In addition to cutting interest rates, the government also promised to ask parliament for the authority to compel banks to make cash reserve deposits at the Bank of Finland. The aim was to improve the effectiveness of monetary policy.¹⁸⁸

The general cut in interest rates pledged in the government accord was never implemented; the board of the Bank of Finland failed to propose the cut to the supervisory council. In the wording of the council's report to the parliament, the reason was that "credit institutions regarded the timing – during a strong upswing and accelerating demand – as inappropriate, for which reason there was no reduction in general interest rates before the end of the year."¹⁸⁹

Instead of a rate cut, the board sent a letter to the council on 18 October, just before the government was sworn in, stressing the need for more flexibility in the system of interest rates and greater rate differentiation. It proposed that the Bank of Finland's lowest discount rate should be lowered from 5¾% to 5% but that the highest rate should be raised from 6¾% to 7½%. In this way, it reasoned, the interest rates on loans granted by the central bank to its direct customers would be closer to the rates charged by commercial banks. At first the supervisory council postponed its decision but then approved the proposal on 24 November 1954. The new broader interest rate spread took effect from the start of December, but the rate revisions did not cause immediate changes in the general interest rate level.¹⁹⁰

After rejecting the government's plan for a general reduction in interest rates, the board of the Bank of Finland next tried to make the money market tighter. Raising interest rates was not an option so instead it sought to mop up liquidity by requiring the banks to transfer some of the deposits they held to the central bank. Although the government accord had promised a law on compulsory cash reserve deposits, none was enacted, but in December the Bank of Finland

began talks with the banks about voluntary deposits. Its powers of persuasion were naturally aided by the threat that the failure of a voluntary approach would lead to a law on the same subject. In February 1955 the Bank of Finland signed agreements on cash reserve deposits first with the commercial banks and then with the savings banks, the cooperative credit societies and the central organisations of both. The agreement was due to last only until the end of September but it was later extended till autumn 1956.

The 1955 boom continued into its second year and the volume of Finnish exports hit all-time highs, greater even than the export spike during the Korean Boom. The upswing did not trigger inflation, largely because of tough price controls and the government's grandiose programme of subsidies. This situation changed in the following year, when price controls broke down and the labour market experienced a legendary event in Finnish political history, the general strike of spring 1956. Before studying that, however, it is worth examining how the structure of Finnish monetary policy changed after the 1951 stabilisation pact.

THE FINNISH MONETARY POLICY MODEL

AN END TO MONETARY FINANCING

As a legacy of the war, the Bank of Finland was still providing finance to the government in the second half of the 1940s by readily discounting government bills of exchange at the low interest rate of one percent. Once the war had ended, the bank wanted to stop printing money for the government as soon as possible but it was not feasible to terminate the practice. Public spending on reparations, resettlement and reconstruction could not be financed without central bank loans because the tax burden was already felt to be at its upper limit. Furthermore social relations were unstable and a sudden contraction of public expenditure might have had untenable political consequences. The central bank had to accept that there was no real alternative to printing money. Safeguarding social harmony was seen as more important than maintaining the value of money. The Bank of Finland's actions were also influenced by the dual roles of governor Sakari Tuomioja and board member Urho Kekkonen, who held major ministerial positions at the same time. The perspective of a member of the government might differ somewhat from the viewpoint of a board member of the central bank.

The first attempts to rein in government borrowing from the central bank came in spring 1947, when the Bank of Finland felt that the state of public finances was gradually stabilising. The board began to prepare a change in the banknote cover regulations, designed for wartime, so that printing banknotes to allow extra state spending

would no longer be automatic. The plans advanced slowly and it was not until April 1950 that the first concrete step could be taken, limiting the maximum acceptance credit available to the government to 30 billion markkaa. The ceiling was so high, however, that the regulation had no practical effect. This was particularly true during the boom caused by the Korean War. A sharp rise in the volume of exports combined with the rise in import prices boosted revenue so much that the government reduced its debt at the Bank of Finland from 18.8 billion markkaa in 1950 to seven billion in 1951. Admittedly the debt almost doubled again in the following year.

Such steep fluctuations in government debt were a matter of concern to the supervisory council and the Bank of Finland's board of management because they made monetary policy very difficult to manage. This was stated explicitly in a memorandum written jointly by board members Unto Varjonen and Klaus Waris. They pointed out that the central bank had to be continuously ready to lend unreasonably large sums to the government because the maximum amount of acceptance credit was so high. Furthermore funds lent to the government ought to have been deducted from the funds available to commercial banks and other customers, but sudden reductions in the amount of rediscounting were not practically possible. To eliminate the problem they urged a two-part programme in which (a) the maximum for government bills of exchange would be lowered to 20 billion markkaa and (b) private financial institutions would be required to finance the government by subscribing bonds, promissory notes or bills of exchange. In this way a significant proportion of the government borrowing requirement would be transferred to private banks. To make this work, participation by private banks would need to be compulsory and it was proposed that a fixed amount of any increase in bank deposits (for example 20 percent) would have to be invested in government debt. The board members cited examples from various other countries, which they had become familiar with at the International Credit Conference in Rome in 1951. A similar model, in use in France, would be a suitable exemplar for Finland.¹⁹¹

The proposal was made to a meeting of the full supervisory council on 27 August 1952 and discussion on the subject was extremely animated. Väinö Tanner, who had been re-elected to the council, and Juho Niukkanen (Agrarian League) who was then minister of finance,

entirely agreed with the board of the Bank of Finland. The two other agrarian representatives, Kusti Eskola and Vihtori Vesterinen, thought that a 20-billion markkaa ceiling was too low and proposed 25 billion. Aimo Aaltonen (People's Democratic League) said it was important for the government to have room for manoeuvre in economic matters, especially in promoting high employment. If there was to be such a lending ceiling, the government would need to have alternative sources of financing already in place.¹⁹²

The second half of the board's proposal, to require private banks to subscribe government debt, had already met opposition. Board member Kaaperi Kivialho had discussed it with commercial, savings and cooperative bank executives, who were all opposed. They felt that the demand for credit was so great that they could not finance the government too. Councillor J.O. Söderhjelm (Swedish People's Party), who had close connections with major industrial companies and commercial banks, regarded the proposal as pernicious. In his view "the ideal state was for banks to operate as freely as possible and no new regulations should be created in a country that has enough of them already". Most other council members supported the board's proposal but wanted the matter to be planned more carefully; before a final proposal was made, the question ought to be deliberated by a committee of experts.¹⁹³

Summarising the discussion, council chairman Vesterinen noted that the majority supported part (a) of the proposal, to set an upper limit of 20 billion markkaa on acceptance credit that could be granted to the government, but that the majority of council members felt that part (b) required further study. After this had been done, the board could make a final proposal to the council on the wording of a report to be sent to the government.¹⁹⁴

The board obliged promptly and a council meeting on 24 September unanimously approved the formulation of a report to the government. Bank regulation 6 would be changed to lower the maximum value of government bills of exchange from 30 billion markkaa to 20 billion. Imposing this reduction naturally did nothing to eliminate the government borrowing need so the government was asked to initiate measures to create a system whereby private credit institutions would be required to invest funds in short-term bills of exchange or other government securities in a fixed ratio to the growth of deposits. Thus

the report sent to the government contained both parts of the board's original proposal.¹⁹⁵

Around the time that the report was sent, a committee on government borrowing had begun work under Klaus Waris and by spring 1953 the board of the Bank of Finland had reached a consensus that the new ceiling on acceptance credit, proposed to the government in the previous autumn, was still too high. "Such a solution would be unsatisfactory for protecting the value of money because the very existence of such a credit facility would, judging from experience, allow government spending to be raised above revenue, which in turn would lead to inflation."¹⁹⁶

A similar opinion had been expressed the previous summer by elder councillor Väinö Tanner, when the matter had first been raised in the supervisory council. "Inflation's worst agitator is the increase in banknotes printed by the Bank of Finland, an increase that stems from the credit used by the government. At various times the government has made very free use of the Bank of Finland, various large sums have been lent to the government, and the upper limit or ceiling is presently as high as 30 billion markkaa. If we compare it with the present government budget, it is about one seventh. In many countries the central bank is absolutely forbidden to lend to the government. Although we cannot at present forbid it absolutely, it would be useful to limit the government's opportunities for using the Bank of Finland's banknote printing presses to satisfy its financial needs. The government should be compelled, when planning its spending, to consider the revenue available from taxes and other sources to meet these needs."¹⁹⁷

The board now wanted to set the government the objective of paying off all the credit obtained from the Bank of Finland against bills of exchange. Because no repeat of the Korean Boom was expected, the entire debt could not be paid off at the same time so the Waris committee recommended that the government would repay its short-term acceptance credit with long-term bonds. This 1953 issue of "stabilisation bonds" would provide the government with 20 billion markkaa. Amortisation would start in 1956 and the repayment period would be ten years. The interest rate would be the same as on the government's existing acceptance credit, one percent. The change would not be allowed to reduce the volume of banknotes in circulation; the bonds could be used for banknote cover. The supervisory council

approved the proposal of 7 May 1953 and asked the government urgently to send a bill to parliament to change Bank of Finland regulation 6 and to start arranging the bond issue. The government's proposal went before Parliament on the 20th day of the same month, was approved on the 29th and took effect from the middle of September.¹⁹⁸

When the matter was discussed by the government and parliament, the arrangement was made less stringent. The proposal of the Bank of Finland and the supervisory council had set the size of the bond issue at 20 billion markkaa and Prime minister Kekkonen, on leave of absence from the board, was certainly aware of the position of the central bank's board of management. However the government decided on a rather larger bond issue of 25 billion markkaa. By adding 5 billion to the sum, it gave itself extra economic leeway because it needed only 20 billion markkaa to pay down the central bank credit it had received against bills of exchange. The extra 5 billion markkaa was a reserve.

Part (b) of the proposal to the government in 1953 – the requirement for private banks and financial institutions to invest a proportion of rising bank deposits in government securities – had been omitted entirely. Apparently the banking sector was expected to resist the plan so strongly that this was not worth trying to control money market liquidity in this way. Instead the board put forward plans for new cash reserve deposit requirements, to make monetary policy more effective.

It cannot be a coincidence that these measures to restrict the government's access to central bank financing were taken in 1953, at a time that the state of public finances began to look slightly less forlorn. The most important individual factor had been the completion of reparations in 1952. Reparations, especially in their early years, had been a major burden on the public purse, accounting for 14–15 percent of all government spending in the second half of the 1940s. By the early 1950's their share had fallen to 5–7 percent. At least until the end of the 1940s reparations made up such a large proportion of government spending that it would have been practically impossible to pay them without constant borrowing. After 1952 the government also needed less money for the agricultural resettlement programme of the post-war years, which now eased pressure on the budget.¹⁹⁹

MONETARY POLICY SHIFTS TO CREDIT RATIONING

The stabilisation programme of 1951 and its implemented recommendations meant a very far-reaching change in the nature and function of Finnish monetary policy. Since the end of the war the Bank of Finland had gradually tried to revert to interest rates to control the money market. The principles were clear and long-established. Inflationary pressures were thought to require higher interest rates while rates could justifiably be lowered as inflation slowed down. The stabilisation programme changed the shape of monetary policy and also the perception of its functions. It treated interest rates as a cost factor and entrusted the regulation of aggregate demand to “credit controls” and administrative rules rather than monetary policy. Following the standstill agreement and the stabilisation programme, interest rates policies were sidelined for more than two decades and alternative money market tools, described later, were developed.

Were active interest rates renounced because they were not properly understood or because political myopia triumphed over healthy economic principles? Or were there reasonable grounds? For mainstream monetary policy theorists, the monetary policy recommendations of the stabilisation programme were certainly heretical. On the other hand Finland’s institutional conditions contained features that genuinely amplified the cost impact of interest rate movements, while reducing their impact on investment and aggregate demand in general. One such feature was excess demand for goods while prices were controlled by the government. In the price control mechanism, all production costs including nominal interest outlays were valid grounds for allowing price rises. Because wages were index-linked, there were fears that interest rate hikes would trigger a price–wage spiral.

A second institutional feature that hindered the active use of interest rates was the prevalence of floating interest charges in Finnish loan agreements. When interest rates changed, the costs of servicing old loans also changed. Widespread use of floating rate contracts eliminated interest rate risks for the banks but at the same time increased the impact of interest rate changes on production costs while reducing their importance for long-term investment decisions.



■ The last train bearing reparations to the Soviet Union crosses the border at Vainikkala in September 1952.

- Lehtikuva news photo archives.

In a system of floating-rate contracts, interest rate policy obviously has much less influence on investment demand than in a world of fixed-rate loan agreements.

The stabilisation programme first dictated a cut in the interest rate and then made the traditional use of interest rates practically impossible, so the Bank of Finland had to develop new monetary policy tools. As its main tool it chose to regulate the terms by which it provided credit to commercial banks. The choice had far-reaching consequences. Controls based on central bank refinancing terms became the central set of monetary policy tools for almost three decades.

After the stabilisation pact of 1951, interest rates were seen as an inseparable part of the package of price and wage policies. The interest rate level had become politicised and was consequently sluggish and relatively low with regard to the prevailing demand for credit. The general interest rate level could no longer be used to control demand for loans and indeed remained mostly static. Instead the Bank of Finland had to influence bank lending to the public directly, which it tried to do by restricting the ability of private banks to fund their lending by borrowing from the central bank.

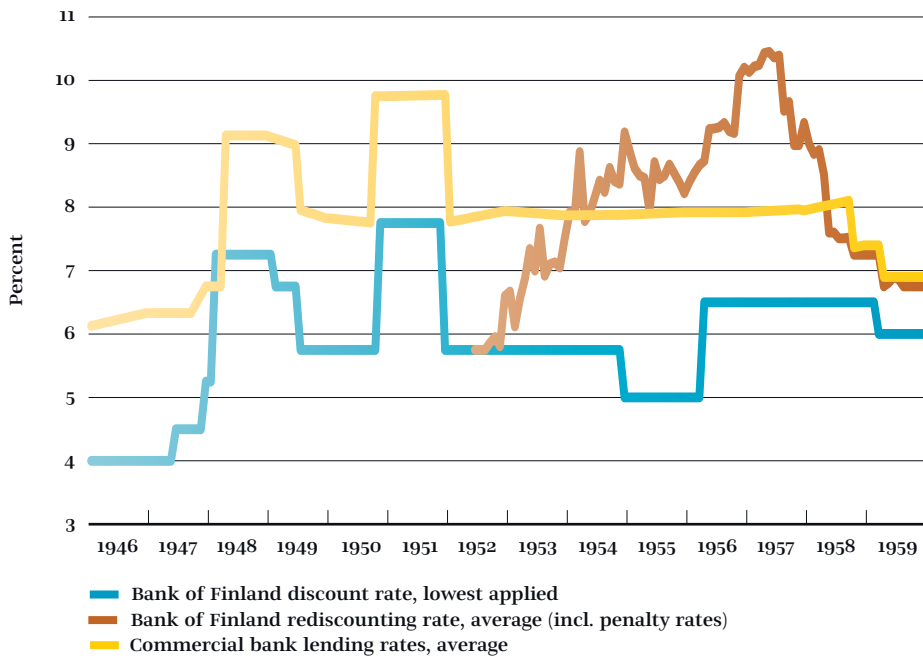
Most commercial bank borrowing from the central bank took place in the traditional manner. When banks needed funds, they took the discounted bills of exchange of their customers to the Bank of Finland which re-discounted them, in effect bought them from the commercial banks. This had been a universal practice in the world since the 19th century, for a central bank to provide liquidity for commercial banks when needed, and level out temporary and seasonal fluctuations. However at the start of the 1950s in Finland, borrowing from the central bank became an established part of the money market structure for decades. The banks' persistent dependence on borrowing from the central bank made it possible to use central bank debt as a tool of monetary policy.

To regulate re-discounting, the Bank of Finland set individual credit limits or "quotas" for each commercial bank, in proportion to their respective equity capital. The use of variable credit quotas as a monetary tool can be said to have started as early as summer 1950, when the end of wage controls and the Korean Boom precipitated a sharp rise in inflation. At that time the rediscounting quotas of the commercial banks were cut in half, reducing them to the size of each bank's equity

capital. In October of the same year, at a meeting where an increase in the general rate of interest was on the agenda although the decision was postponed, the supervisory council authorised the board of the Bank of Finland to charge the banks half a percentage point more for rediscounting than the rate at which the bill of exchange had originally been discounted. The aim was that “financial institutions will have to observe a certain restraint in their lending”²⁰⁰

This did not yet amount to a significant change in the policy toolkit traditional to central banks. The transition came at the end of the Korean Boom, when countercyclical policy began to be managed by regulating central bank financing, in effect monetary policy. This was to be the basis for monetary policy for the next quarter of a century. The standstill agreement had made active interest rates impossible so the only available way to tighten the monetary market was to restrict the supply of money quantitatively, by trying to reduce private bank borrowing from the central bank.

INTEREST RATES 1946–1959



Sources: Bank of Finland; Saarinen, V., 1986.

Tighter monetary policy was needed in summer 1952, after the banks had sharply increased their borrowing from the Bank of Finland during the spring. In a proposal to the supervisory council, the board of the Bank of Finland stated that the extra charge of half a percentage point used to date “was obviously nowhere near high enough to curb excessive growth of rediscounting and to force financial institutions to consider whether it was still worthwhile increasing their lending with funds from the Bank of Finland”. The board wanted to be allowed to apply penalty rediscounting rates of up to three percentage points above the discount rate. The higher rate would be applied when any bank had exceeded its rediscounting quota.

The council approved the board’s proposal on 17 June 1952 and thereafter the board set a scale of penalty rates on rediscounting in excess of a bank’s quota, applied on the amount of the excess, rising to a maximum of three percentage points. As before, the rediscount quota was in proportion to a bank’s equity capital, initially 140 percent.²⁰¹

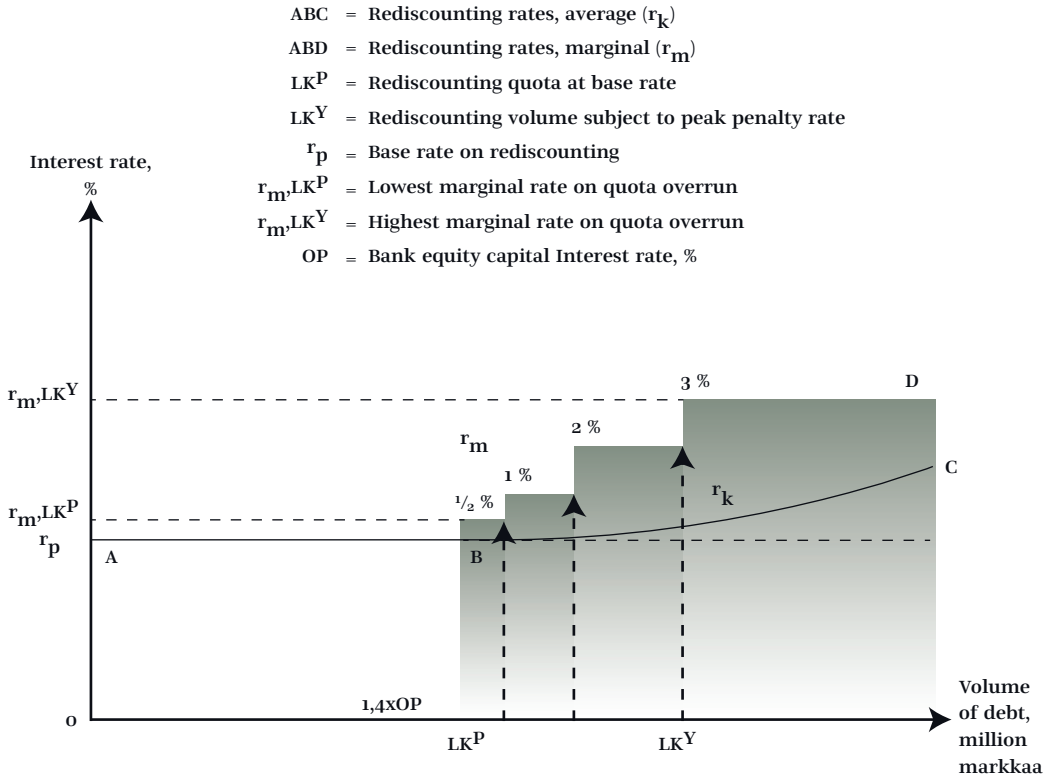
The regulation of a bank’s borrowing by varying the range of penalty interest rates now became the key tool of monetary policy and remained so until the end of the 1970s. The regulations were changed fairly often as monetary policy requirements changed. The scale of quotas and penalties was often extremely complex, consisting of different penalty rate thresholds or scales for deterring bank borrowing from the central bank and thereby bank lending to the public.

An exhaustive historical review of the changing terms of central bank financing, written at the start of the 1980s by Bank of Finland office manager Veikko Saarinen, found 17 different scales of penalty rates in use in 1951–1979. On average the scale was changed every 20 months. The changes did not concern merely the size of credit quotas or the amount of penalty rates but also the shape and structure of the scale and how the penalty rate was calculated.²⁰²

The diagram overleaf illustrates the penalty interest rate system by showing the scale of rates on central bank borrowing in force from June 1952 to July 1957.

Saarinen studied the effect of the penalty interest rates system on the marginal cost to banks of borrowing from the central bank, in other words how much their most expensive central bank funding cost them. This can be taken as a fairly good indicator of the tightness of

PENALTY RATE SCALE ON COMMERCIAL BANK DEBT
TO CENTRAL BANK 1952-1957



Source: Saarinen, V., 1986.

monetary policy from the start of the 1950s to the end of the 1970s. The marginal interest rate is a key concept because it determines the strength of incentives to the banks to limit their lending. Saarinen found that in the 1950s the marginal rates on central bank borrowing were still relatively low compared with the rates charged in the 1960s and 1970s. In 1954-1957, the tight money years of the 1950s, the rate paid by the commercial banks was never more than three percentage points above what they charged their customers. In the tight-money periods of the 1960s and 1970s, the marginal penalty rate charged was sometimes well above 10 percent, and the cost of central bank financing (base rate plus marginal penalty rates) was sometimes in excess of 20 percent.²⁰³

Apart from penalty interest rates on central bank debt, the Bank of Finland had to create another monetary policy tool in the early 1950s. This was administrative control of bank lending rates and it too had great importance for the development (or the lack of it) of Finnish financial markets right up to the 1980s.

In the 1940s and still at the start of the 1950s, bank lending rates were set by a cartel agreement. It was overseen by the interest rate board, set up by Finance minister Mauno Pekkala in 1941, on which large banks and other credit institution groups were represented. The meetings were chaired by the governor of the Bank of Finland.

After the Bank of Finland started to use interest rates more actively at the end of the 1940s, the interest rate board ceased operations. In its place, the deposit banks established a committee of financial institutions in 1948, headed by the chief executive of the Union Bank of Finland, Rainer von Fieandt. The Bank of Finland was not a member of this organisation, which later became known as the Joint Council of Credit Institutions (*Rahalaitosten neuvottelukunta*). It was a deposit rate cartel in which the banks also discussed their lending rates.²⁰⁴

When the system of penalty rates on central bank borrowing began to have a real effect on bank funding costs in 1953, there was a danger that the banks would pass on the cost to their customers, especially because the 1951 stabilisation pact had pushed their lending rates very low compared with the demand for credit. From a political viewpoint, a rise in bank lending rates would clearly have violated the stabilisation pact. A way was needed to stop excess demand for credit and rising funding costs from being translated into higher bank lending rates. This led to the system of official lending rate controls.

On 5 June 1953 the Bank of Finland changed the management of lending rates, hitherto based formally on recommendations only, into a system of outright controls. In a circular to the commercial banks and the central organisations of co-operative credit societies and savings banks, it stated that the board had set a new condition of rediscounting rights: "that the lending of a financial institution is not at a rate of interest higher than the highest rate on bills of exchange approved by the Bank of Finland for rediscounting, currently meaning not more than 8%".²⁰⁵

The wording meant that the Bank of Finland was tying the interest-rate ceiling on lending by private banks to its own interest rates. When

the Bank of Finland moved its interest rates, the ceiling on lending rates by private banks would change accordingly. The Bank of Finland did not need statutory authority to control interest rates because its board already had the authority to grant or deny loans. The commercial banks depended on the right to have their bills rediscounted at the Bank of Finland, and so had to observe the conditions of this facility. The savings banks and the commercial credit societies were not Bank of Finland customers directly but their central organisations were required to ensure that each group observed the lending rate regulations. In practice lending rate controls extended throughout the Finnish banking system.

The regulations on bank lending rates remained in use for decades although they changed slightly over time. The board of the Bank of Finland originally embarked on interest rate controls reluctantly because they were expected to make the credit market less flexible. It soon adopted the objective of a wider dispersion of interest rates within the system of control. By autumn 1954 it had divided its own lending rates into a greater number of categories according to the purpose of the credit. In 1960 the system of lending rate controls was changed so that private credit institutions could differentiate their rates more widely, depending on the credit recipient and the purpose of the loan. At that time, the main principle became that the Bank of Finland set the ceiling which no bank's average rate could exceed. A system of controls based on the maximum interest rate changed into one based on the average interest rate. Regulations were still issued setting the highest permitted interest rate but after 1960 they were no longer central to the system of lending rate controls.²⁰⁶

SYSTEM OF FINANCIAL MARKET REGULATION

With interest rate controls, Finland developed a special system of regulated financial markets. The main features of it endured until the middle of the 1980s. During the era of "shackled money"²⁰⁷ competition and market forces lost their relevance in the banking system and the financial markets as a whole. Much of the finance of the national economy was channelled from savers to borrowers under conditions that were administratively imposed and not set by demand and supply.

The central features of the Finnish system of interest rate controls were managed lending rates, the history of which has already been discussed, and administrative deposit rates, which were founded on an interest rate pact between the banks. In practice both sets of rates were tied to the Bank of Finland's discount rate (later renamed base rate), and therefore did not usually change until the supervisory council changed base rate. It rarely did. For private banks, a system of administrative interest rates produced very stable interest-rate margins, yielding steady profits that were largely unaffected by competition. The competition that did exist between banks was mainly for market shares, which a bank tried to boost by extending its branch network and developing its customer services.

For loan customers, the system of interest rate controls kept financing costs steady at a rate of interest that was low in comparison with the state of demand and supply. Because lending rates were not responsive to demand and supply, there was generally surplus demand for bank loans, which the banks had to ration using various criteria. The process of choosing between loan applications varied in its rigour over time but favoured industrial companies that had close relations with the banks. The Bank of Finland tried to influence selection criteria with its guidelines on lending policies which were updated from time to time.

This sort of system of administratively controlled interest rates was sustainable only as long as it was not widely circumvented. In the decades after the war, it was buttressed in three main ways: preferential tax treatment for bank deposits, regulation of foreign capital movements and control of private bond issues. These created an effective system for channelling public savings within the national economy into the regulated banking system. At the same time they prevented the formation of a private credit market based on a free interest rate or the flight of savings abroad in search of better yields.

There had been tax breaks on the interest paid on bank deposits since the war. The first preferential tax rules on deposits and government bonds came into force in 1943. Initially the tax relief was partial and applied only up to a certain total expressed in markkaa. From the start of 1956 the yields on all ordinary deposits and all government bonds intended for the general public were entirely tax-free. Tax relief was first enacted by listing the accounts that were

tax-exempt. From 1970 onwards, the type of account was classified as tax exempt if at least two bank groups accepted deposits in it on the same terms. By linking tax exemption to the interest-rate agreement, the tax system was openly used to enforce the banks' interest rate cartel.²⁰⁸

Controls on bond issues came into force during the war. Under the Bond Act of 1942, government permission was required for the issue of any non-government bonds. This gave the State of Finland a privileged position on the capital market, reinforced by the tax exemption of its bonds. After 1956, the government could grant tax exemption to other bond issuers. Bond issue restrictions were rather effective and for several decades after the Second World War, the financial market revolved around the banks in years when the government issued relatively few bonds.

Regulation of capital movements complemented the system of financial market controls. Although there were some theoretical loopholes in the regulations that governed international capital movements, practically all capital movements were subject to control by the Bank of Finland until the 1980s. The exception was short-term commercial credit, granted by deferring foreign trade payments. This was deregulated in 1959, after the Finnish markka had become a convertible currency and other trading terms also had to be liberalised. Even afterwards, the right of Finnish importers to accept foreign commercial credit was restricted from time to time, by requiring cash payment for imports when the government wanted to tighten the money market and impede importing.

The main aim and rationale of the Finnish financial system, based on market controls and administrative interest rates, was industrialisation. The financial resources available were to be devoted to achieving the fastest possible growth of industry. Industrial companies had little capital or ability to bear risk, so most of their investments had to be financed by borrowing. There were three sources: primarily domestic credit institutions, secondly foreign capital imports (especially from the World Bank in the 1950s and 1960s), and thirdly funds accumulated in the government budget and the pension system. On this foundation, Finland's investment rate was raised to 25–30 percent of GDP in the 1950s and remained very high until the end of the 1970s.

Government financing played an important role in Finland's growth-oriented policy. In the 1950s public savings, mostly from the budget and the national pension fund, provided about 40 percent of the finance for aggregate investment and even in the 1960s the proportion was about 30 percent. Public sector surpluses were channelled not only into infrastructure construction but also into investments by state-owned industrial companies and as credit for private industry and agriculture. The pamphlet "Does our country have the patience to get rich?", written by Prime minister Urho Kekkonen in 1952, can be regarded as the classic manifesto of this policy, calling for sacrifices to be made in the rise in living standards in order to finance industrial investments, especially in northern Finland, via forced saving and the government budget.²⁰⁹

RAPID GROWTH AND RESTRUCTURING

At the outbreak of the Second World War Finland had been an agriculturally intensive society and exceptionally so by European standards. Two-thirds of the working population were engaged in agriculture and forestry, while only about a fifth of the people lived in towns. After the war, restructuring lay ahead but it was delayed by new problems. Under the terms of its peace treaty, Finland ceded to the Soviet Union territory equivalent to more than 12% of its area. The entire population of this land, about 425,000 people, relocated to within the new borders of Finland. At the same time, demobilisation of the army returned about 500,000 soldiers to civilian life. For a country of only 3.7 million at this time, the resettlement of Karelian evacuees and demobilisation of the army were a major challenge for the whole society. The response was a broad land reform to the benefit of not only the farming population of the ceded parts of Karelia but also families of front-line soldiers.²¹⁰

After the end of the war some 70,000 new landholdings were established and the number of independent farms increased by more than a third. Most of the land required for this was obtained from government and municipal holdings but legislation was also enacted to expropriate private land. There was not merely a redistribution of existing farmland. Thanks to a large-scale land clearing programme, the arable area surrendered to the Soviet Union had been replaced by

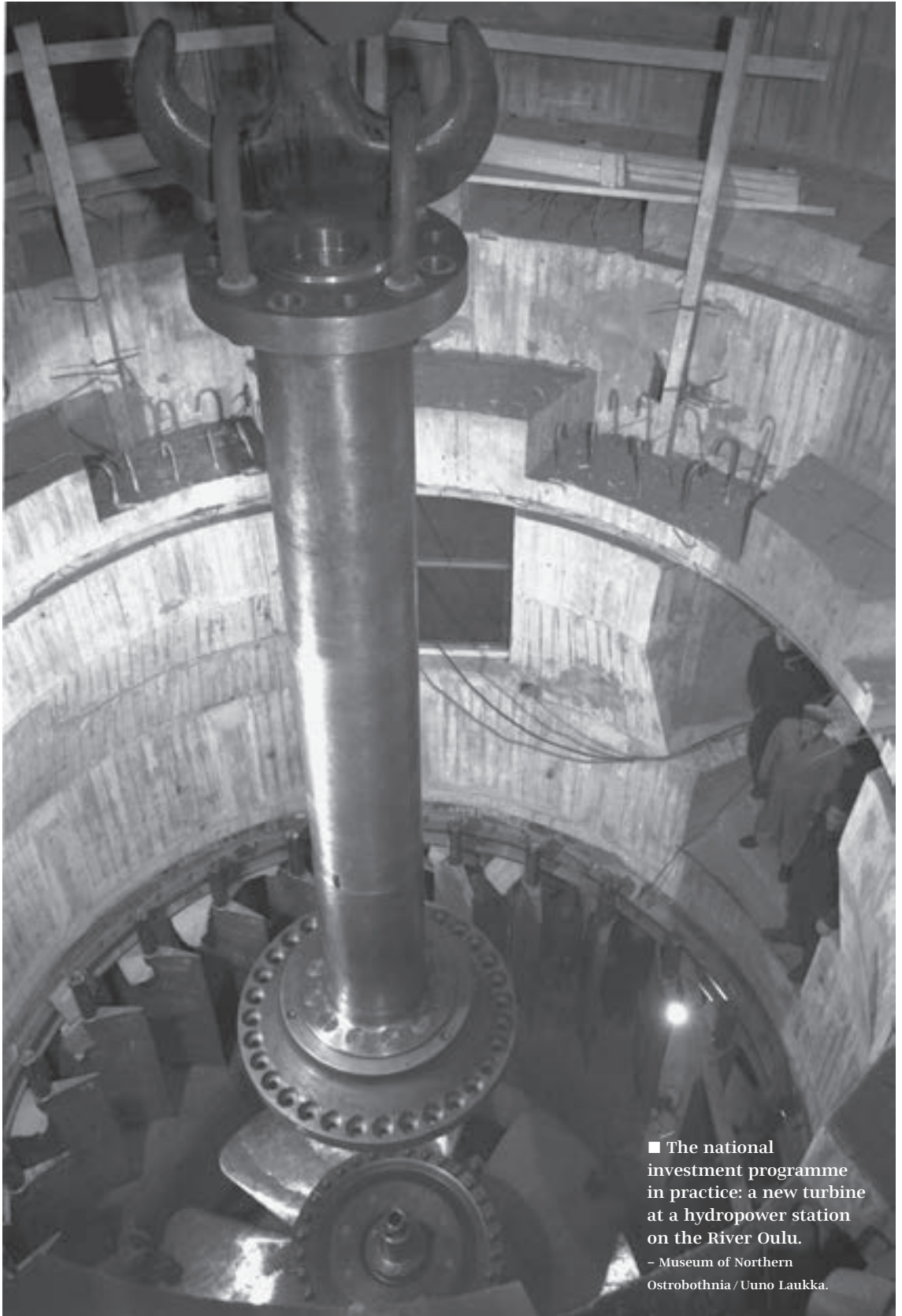
the early 1950s. At the same time the average size of Finnish farms shrank still smaller and in 1959, for example, more than 70% of farms had less than 10 hectares of fields.²¹¹ This meant that smallholders could not support themselves by agriculture alone and needed additional income from logging. Agriculture and forestry became tightly connected.

Resettlement by land reform was problematic for the national economy because it delayed social modernisation, resulted in large and unprofitable investments in agriculture and preserved the inefficient use of labour in the countryside. Politically, however, this may have been the only solution possible. It meant that all segments of society shouldered the burden of war and reconstruction, and that the army could be successfully demobilised and re-employed, which attenuated social tensions.

As a consequence of resettlement policies, Finland at the start of the 1950s was still dominated by agriculture and forestry and only a fifth of its 4 million inhabitants lived in towns. In this respect it differed greatly from the other Nordic countries where no more than a fifth of the employed population now supported itself from agriculture. In Finland the corresponding proportion was nearly a half. In fact the nearest such agricultural societies at this time were in eastern and central Europe; the structure of employment was similar in Poland and Hungary.²¹²

The structure of the economy changed little in the 1950s. Post-war resettlement was completed and the number of farms continued to increase. At the same time, however, production became more efficient as investment in new machinery and equipment got under way. Among other things the number of tractors rose six times over during the decade and family farms had less and less need to employ labourers. Changes accelerated in the 1960s. In particular the broad adoption of chainsaws and tractors led to a steep decline in the demand for labour in forestry.

At the same time, the baby boom generation entered the labour market. The number of childbirths almost doubled after the end of the war and baby boomers in Finland generally mean those born in 1945–1950.²¹³ The number of people of working age began to rise distinctly in the early 1960s, and in 1965 there was a quantum rise labour market entrants.²¹⁴ Agriculture and the countryside were entirely unable to



■ The national investment programme in practice: a new turbine at a hydropower station on the River Oulu.
– Museum of Northern Ostrobothnia / Uno Laukka.

absorb the increase in the labour supply. The consequence was an exodus from the country to the towns and also to Sweden. Migration began to pick up at the start of the 1960s and was particularly brisk in the early 1970s. Urbanisation was only now really transforming Finnish society. The combined population of towns and market boroughs exceeded the population of rural municipalities for the first time in the early 1960s.²¹⁵

With migration, the social structure of Finland was changing at record speed. The proportion of workers in agriculture and forestry declined ever faster, while those in industry, construction and the service sector increased. Restructuring was exceptionally fast by international standards. Another special feature was that labour shifted directly from primary production to services. The growth of employment in public services was especially rapid.

EMPLOYED POPULATION BY BRANCH OF INDUSTRY
DURING FINLAND'S GREAT RESTRUCTURING, %

	1940	1950	1960	1970	1975
Agriculture and forestry	64	46	35	20	15
Industry and construction	17	27	31	34	36
Services	17	26	34	46	47
Others	2	1	0	0	2
Totals	100	100	100	100	100

Source: Suomen taloushistoria (Economic history of Finland) 3, 1983; Alestalo, 1986.

Within just one generation, Finland was being restructured to resemble its western neighbours. Changes in social structures had proceeded there at a far slower rate, over at least four decades.

Economic development throughout West was favourable throughout the restructuring period and the years from 1950 to 1973 are often seen as a golden age. Economies were growing very fast, business conditions were not fluctuating much and inflation remained at tolerable figures.²¹⁶ In West European countries, gross national product per capita increased on average by 3.8% a year in real terms. In Finland it rose even faster, averaging 4.2% a year.

Finland's position in international markets was improved by the favourable trend in prices of its exports, especially in the forest

industry. At the same time, bilateral trade with the Soviet Union encouraged the development of engineering, diversifying the country's industrial structure. It was not merely international demand and the favourable terms of trade that promoted economic development; domestic factors naturally had an influence too. The age structure favoured development because the proportion of the population that was active in the labour market increased.²¹⁷ Migration from the countryside to the towns and from agriculture to more productive sectors raised average labour productivity. Growth was also boosted by active policies of industrialisation, which supported the relatively high level of economic activity.

The Bank of Finland sought to play its own part in promoting restructuring and economic modernisation. Its tools included the guidelines on lending that were sent to banks, capital import policies and its own special financing programs, discussed in more detail below. In other ways too, the bank sought to promote the spread of growth-oriented thinking in society and was obviously successful in this. At the start of the 1960s it invited Swedish economist Professor Erik Dahmén to write a report on the development problems of the Finnish economy. Dahmén's report, published in 1963, apparently had a significant influence on the growth policy programme drafted by the Economic council in 1964, which highlighted the importance of promoting restructuring.²¹⁸

It was during these decades that Europe was converging economically. Differences in the level of development were narrowing as less developed countries caught up. Finland was successful in this and, by the start of the 1970s, its GDP per capita was close to the level of Great Britain. The gap with Sweden also shrank significantly. In terms both of social structure and economic performance, Finland had quickly become one of the economic success stories of Europe. Consumption also increased significantly although until the middle of the 1970s a relatively great share of economic resources was spent on investment.

Although Finland's relative economic development was indeed good, the urbanisation and industrialisation of the 1970s were not without problems. Labour productivity remained poor by international standards and capital productivity even worse, features that emerged as international economic integration opened the Finnish market to

foreign competitors.²¹⁹ It was only tougher competition that revealed the seriousness of these questions.

A striking feature of both commerce and banking was the high degree of concentration, which in turn led to inadequate competition and allowed inefficient units to survive. Bilateral trade with the Soviet Union promoted collaboration between export companies and public authorities and reinforced the mechanisms of a negotiated corporatist economy at the expense of a competitive one. Regulation of financial markets supported the position of existing companies and did not promote competition or changes in corporate structures. The Finnish economy operated behind an array of safety nets and barriers to competition. Adaptation to the tough world of free markets would be a painful process.

POLITICIANS AND BANKERS

SAKARI TUOMIOJA RESIGNS

In 1955, after almost a decade as governor of the Bank of Finland, Sakari Tuomioja left day-to-day politics and also the bank. Several things influenced his decision. His previous political home, the National Progressive Party, had broken up and his party was now the tiny Liberal League, which had no members of parliament. To have continued in politics, he would have had to change political affiliation. The chances of retaining his former status in Finnish politics had also been damaged by a rupture with prime minister Urho Kekkonen, the strongest Finnish politician at the time. Kekkonen had not approved of Tuomioja's government and their relations never recovered after its appointment in 1953. Faced with this situation, he accepted the post of ambassador to Great Britain when it was offered. It was the first step on an international career which culminated in his appointment by the UN as a mediator in the Cyprus dispute.²²⁰

But there were more than political factors behind his decision to leave the board of the Bank of Finland. Tuomioja was also dissatisfied with his own contribution as governor of the central bank, which he openly admitted to the supervisory council on 17 December 1954. At this meeting J.O. Söderhjelm remarked on press reports of Tuomioja's resignation, a matter that had not been brought before the council. Tuomioja responded that "because under the present circumstances he felt he was no longer well fitted to perform the duties of governor satisfactorily, and having been offered a post abroad, he had expressed

his willingness to accept such a post". Councillor Söderhjelm replied that "to the best of his knowledge the members of the supervisory council had had no complaints to make about the work of governor Tuomioja, as the councillors would jointly attest. It is unfortunate that governor Tuomioja regards himself as having failed in his duties."²²¹

Tuomioja's unfavourable appraisal of his own role as chairman of the central bank's board was influenced by a debate around the same time on "charitable business arrangements", by which political parties and affiliated associations had financed their operations. Charitable business arrangements were one loophole in the tough system of foreign currency controls and unrealistic exchange rates and in the equally tough regulation of imports based on precise and detailed licensing. The system constituted an outright encouragement to exploit its vulnerabilities, and this was widely done. The system of licences and permits distorted competition and was abused by the issue of import licences to party organisations and charitable associations and by private speculation in import licences.²²²

The problems became public knowledge by 11 December 1952, when the government established a committee, under Jaakko Enäjärvi, to report on the shortcomings of the licensing system and possible abuses, and to make proposals on how it should be reorganised. The committee published a total of six preliminary reports, appearing between 14 March 1953 and 9 June 1954. Sakari Tuomioja was mentioned on several occasions. It was not implied that he had pursued personal gain, but it was demonstrated how lightly he took applications for import licences and foreign currency. This is shown by one quote from the report: "At Koponen's request governor Tuomioja had endorsed the licence application. Governor Tuomioja has explained that his endorsement was given as a private individual and he had not noticed the beneficiary of the application. He thought Koponen needed the car because of his official position and felt that it could be imported cheaply because it could be purchased using Danish kroner instead of West German currency." Osmo Koponen was an official at the Ministry of Trade and Industry whose licensing irregularities were examined in detail by the committee.²²³

The report underlined the inadequacy of coordination between the two most important organs for regulating foreign trade, the licence office and the Bank of Finland. The licence office took decisions on

import licences while the Bank of Finland was in charge of foreign currency prescriptions but the two did not cooperate systematically. Import licences might be granted in the situation where the nation's currency reserves had already been used up. No single person had an overall view of the situation but Tuomioja could have been expected to, as he was in a position to see the question from at least two angles, as a government minister and as governor of the Bank of Finland.²²⁴

Obviously Tuomioja's self-assessment at the supervisory council meeting that he was "no longer well fitted to perform the duties of governor satisfactorily" was largely related to these events, as Erkki Tuomioja notes in the biography of his father. Furthermore, during Sakari Tuomioja's term of office, the Bank of Finland had failed in its efforts to stop the government relying on printing banknotes to finance its expenditure.²²⁵

The appointment of his successor was in fact the last time that power was wielded by President J.K. Paasikivi, an old commercial bank man, who had closely followed the operations of the Bank of Finland for more than half a century. The Parliamentary supervisory council was originally intending to propose Klaus Waris, acting member of the board since 1952 and a full member since 1954, as the new governor. Waris had been head of the economics department at the Finance ministry in the late 1940s. He had then worked for several years as a professor of economics at Helsinki University of Technology, and subsequently been appointed to the board of the Nordic Union Bank. On the board of management of the Bank of Finland, his duties included relations with international organisations, of which the International Monetary Fund was emerging as the most important. Waris was one of Finland's leading economists and had risen to a position of great esteem on the board in just a few years. Many regarded him as a worthy successor to Sakari Tuomioja.²²⁶

Waris had been one of the two possible successors to Sakari Tuomioja considered by the supervisory council, the other being Rainer von Fieandt, the general director of the Nordic Union Bank. During their discussions the majority of council members opted for Waris but at this point President Paasikivi seized the initiative. At an interim meeting with the three-member inner council, he stated that he was in favour of Rainer von Fieandt: "The president said that he regards von Fieandt as an eminent banker and that, as (von Fieandt) is at the

council's disposal, the opportunity should not be squandered, although at the same time (the president) admits the merits of Waris." When the full council resumed its meeting, it was not swayed by the president's message and voted by seven to two to propose Waris. (In the minority were Kusti Eskola, the chairman of the council and Arvo Korsimo, the other council member from the Agrarian League.)²²⁷ The president was unmoved by the vote and appointed Rainer von Fieandt at a session of the Council of State on 25 January 1955, although the government minister responsible for proposing the governor and the majority of the government were in favour of Waris.

At the time of his appointment as governor, Rainer von Fieandt had enjoyed a prominent career at the helm of one of the country's two major commercial banks, where he had been a board member since the 1920s. Public finances were familiar to him because he had headed the Ministry of Supply during the Winter War. He had also belonged to the wartime financial committee of the economic commission, where he had worked closely with Bank of Finland representatives.

President Paasikivi's decision clearly reflects the upheaval taking place in economic and monetary policy thinking. The president himself represented classical central banking theory. He regarded central bank independence as axiomatic and had trouble accepting the new philosophy adopted in public finance. In his view, the public sector should be kept as small as possible and budget deficits were anathema. At the age of 65 Rainer von Fieandt shared these traditional neoclassical economic views, and Paasikivi believed he would be able to restore the independence and reputation of the Bank of Finland, battered by the 1940s and 1950s. Since the late 1940s von Fieandt had regularly discussed economic questions with Paasikivi, who trusted in his judgement. Waris, about 20 years younger, represented the new Keynesian economic doctrine that accepted an active role for the government in managing the economy. Active countercyclical measures were altering the general perception of the role of the public sector.

Fundamentally, however, the changes in economic policy reflected a quantum shift in the balance of power between different groups. President Paasikivi understood the direction of recent events. Wartime economic regulation and emergency powers had reached the end of the road. Ahead lay the deregulation of foreign exchange and a move towards freely convertible currencies. As an experienced banker

President Paasikivi knew that these reforms would pose major challenges to the governor of the Bank of Finland and he believed that his old fellow banker would best be able to meet the challenges. "The Bank of Finland must get at least one board member who understands banking."²²⁸ But a grasp of banking matters was not the only thing that mattered. Paasikivi believed that only von Fieandt was mentally tough enough to restore the authority of the central bank.

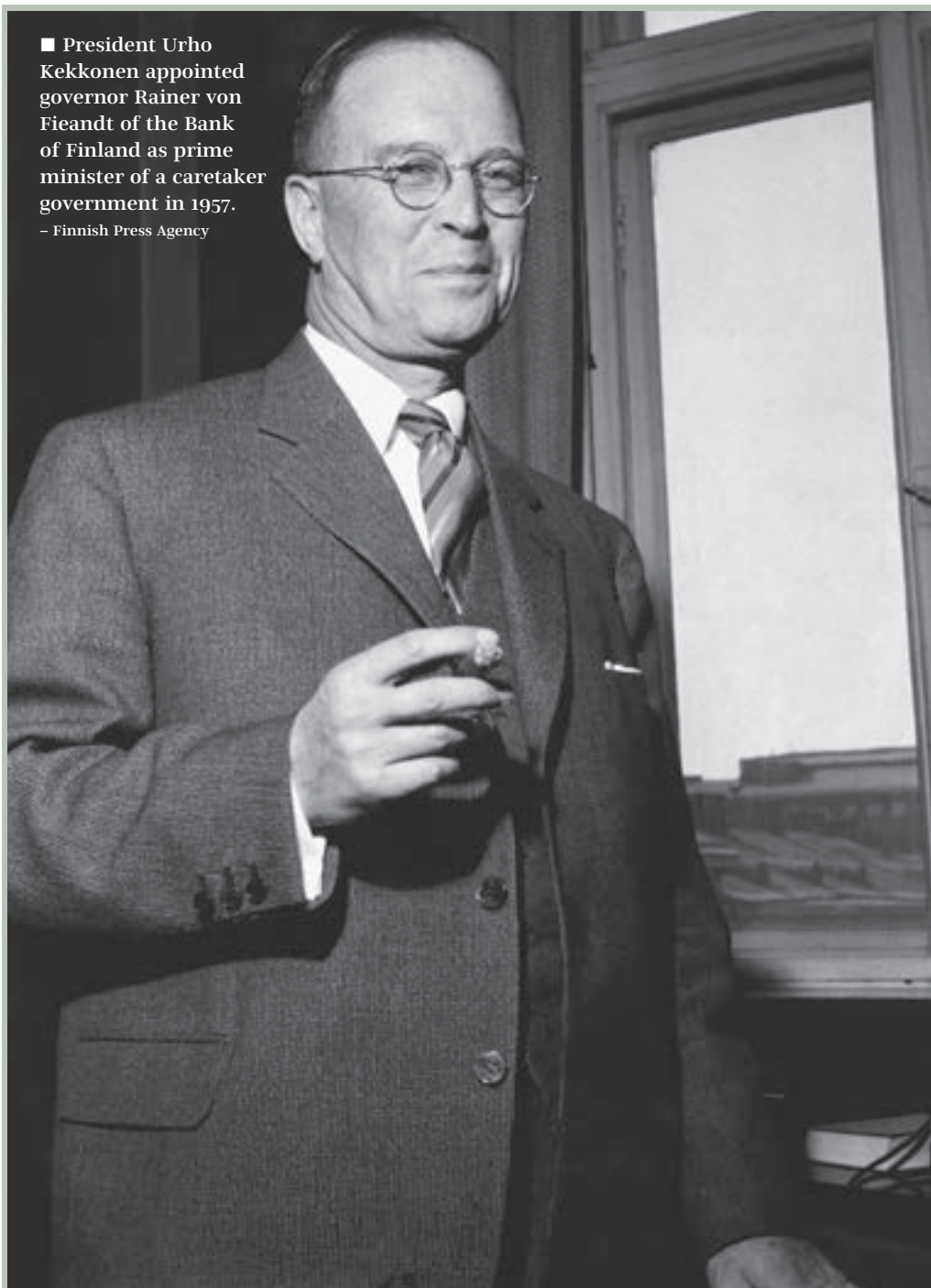
PARTY LOYALTY OR EXPERTISE?

Members of the board changed fairly rapidly in the 1950s. In choosing new members the supervisory council tried to strike a balance between politics and competence. It wanted the board to represent the range of political parties but, as the central bank expanded into new areas, it also needed individuals with ever better understanding of banking theory and practice. The bank's own Institute for Economic Research, dating from 1943, was of great assistance in developing professionalism. One of its main aims was to train high-quality economists, for the bank itself and to serve broader circles of administration and research. By the start of the 1950s the institute had become Finland's leading organisation for training economists, and the alma mater of many prominent figures in the academic world and the Bank of Finland.

The appointment of Unto Varjonen as an acting board member in 1953 serves as an example of the influence of party politics. Varjonen was regarded as a leading rightist social democrat and, by the end of the 1940s, had become his party's top expert in economics. Among other things he had been involved in planning the 1949 devaluation. Even before he was elevated to full membership of the board he had been transferred to a temporary management post at the World Bank. His secondment to the World Bank was due to last until 1954 but sudden illness cut short his banking career and his life.²²⁹

At the start of 1955, Penna Tervo was chosen to replace Varjonen. Tervo was another leading figure of influence in the Social Democratic Party. He had won his spurs as financial officer for the Finnish League of Comrades in Arms and as editor-in-chief of the party's newspaper, but by the 1950s his reputation was mainly that of an economic tactician. He had been a minister on several occasions since the start of the 1950s and had managed to build a good working relationship

■ President Urho
Kekkonen appointed
governor Rainer von
Fieandt of the Bank
of Finland as prime
minister of a caretaker
government in 1957.
– Finnish Press Agency



RAINER VON FIEANDT (1890–1972)

Rainer von Fieandt had a fine career in banking lasting more than 30 years before moving to the Bank of Finland. He had been on the board of management of the Nordic Union Bank since 1924 and its chief executive since 1945, then the most influential position in the Finnish commercial banking world. Prior to his years in commercial banking, this third-generation lawyer had had a legal practice in Helsinki and also been a board member of the Real Estate Bank of Finland.

It was after the outbreak of the Second World War that he was called to public service. He was Minister of Supply in the governments of A.K. Cajander and then Risto Ryti until the end of the Winter War. In summer 1940 he led a Finnish government trade delegation to Berlin to negotiate with Germany on a very important trade pact. It was a sign that Finland was then moving economically and politically into Germany's sphere of influence.

President Paasikivi appointed him governor of the Bank of Finland in March 1955. In his memoirs, von Fieandt wrote that he accepted the president's offer "with gratitude" and with the idea that "I will now be able to carry out the monetary policy that I have been urging". He was specifically the choice of the president, who appointed him in defiance of the wishes of the nominating body, the Parliamentary supervisory council.

As governor of the Bank of Finland, von Fieandt became known as a fierce opponent of inflation. This was an

image that he himself sought to project with colourful public pronouncements, such as "there's no easy route to a hard currency". He was unsuccessful, however. Inflation accelerated during his term of office, partly because of labour market conflicts and the dismantling of price controls. To protect savers he promoted index linkages in the Finnish financial markets. With the devaluation of autumn 1957 he laid the way for the elimination of import controls and thus for Finland's transition from protectionism to free trade.

Rainer von Fieandt's work as governor of the Bank of Finland lasted under three years. Beset by a budgetary crisis, the government of V.J. Sukselainen fell in October 1957. When six weeks of negotiations failed to put together a majority government, president Kekkonen asked von Fieandt to form a caretaker government. In accepting the post, von Fieandt resigned from the Bank of Finland on 18 December 1957.

In his own words, his government set "a Finnish record for parsimony" in imposing various austerity measures to try to improve the poor state of public finances. His government did not last long. It was forced to resign in April 1958 in a dispute over agricultural policy, after it had decided to stop subsidising the price of cereals. Both the Agrarian league and the Social Democratic party proposed motions of no confidence on the matter and the latter brought down von Fieandt's government on 18 April 1958.

with Urho Kekkonen. At the time of his appointment to the Bank of Finland he was Finance minister in Kekkonen's fifth government, and did not in fact live long enough to take up his position at the bank, dying in a car accident in February 1956.²³⁰

It was not until October that the selection of Tervo's successor was first raised in the supervisory council. Governor von Fieandt began the discussion by reviewing the regulations regarding selection. He stated that there were "no other criteria in the bank's regulations for a board member, other than that he should be suitable for the position, in addition to which it should be noted that the board must contain one member with legal training". In assessing suitability von Fieandt felt that the council should be guided by article 86 of the constitution, which said that "skills, ability and recognised civic worthiness" were general requirements for public office. The requirement of a board member with legal training had already been met earlier in the year when Esko Leinonen, a lawyer who had served the central bank since 1931, had taken the place of Urho Kekkonen, who had become president of the republic. The governor thus gave the members of the supervisory council very free hands.

Three names were raised at a meeting of the inner supervisory council on the last day of October. Väinö Tanner's candidate was the chief civil servant at the Finance ministry, Toivo Takki. The centrist chairman of the supervisory council, Kusti Eskola, preferred the current Finance minister, Aarre Simonen, at the time still a member of the Social Democratic Party but representing internal opposition to the party's leadership. Councillor Erkki Leikola of the National Conservative Party proposed the head of the Central Chamber of Commerce, T.A. Wiherheimo.²³¹ The council's candidate was to be chosen at a meeting of the full council on the same day. At this decisive meeting Simonen was endorsed by the two other Agrarian representatives on the council, Arvo Korsimo, the party secretary, and Eemil Luukka, who had been a government minister several times. The social democratic councillors Väinö Tanner and Onni Peltonen continued to support Toivo Takki. Erkki Leikola of the National Coalition Party stayed behind T.A. Wiherheimo. The swing vote was therefore held by the communist council members Aimo Aaltonen and Yrjö Murro, but they rejected all three candidates and proposed their own, Matti Janhunen, a journalist who had been the council candidate

of the extreme left previously. Thus the Agrarian League won the vote and the supervisory council proposed Aarre Simonen as the new member of the board of management. His appointment was ratified by the president with effect from 1 September 1957.²³²

From the end of the 1950s men with training in economics who had worked in the bank's Institute of Economic Research began to be appointed to the board. In a sense the first of these was Ahti Karjalainen, who became a board member in 1958. However, he had political connections and merits as the long-term political secretary of Urho Kekkonen so his directorship cannot be taken as founded on expertise but, to at least an equal extent, as a political appointment. It was the following year when a distinctly professional economist was elevated to the board. Reino Rossi had begun his career at the Institute of Economic Research in 1946 and had completed a doctoral thesis in 1951 on the interest rate policies of the Bank of Finland in 1914–1938. He had been appointed head of the research institute in 1956. Rossi held a seat on the board of management until 1970, when he resigned to become head of the Finnish Sugar Company.²³³

Another major figure of influence with a background at the Institute of Economic Research was Heikki Valvanne, who was appointed to the board in 1964. His career at the Bank of Finland had begun at the institute in 1945 and he succeeded Reino Rossi as its director. Valvanne was appointed acting member of the board in 1964 when Ahti Karjalainen was granted leave of absence. He became a full member in 1968.²³⁴

FROM GENERAL STRIKE TO DEVALUATION

THE END OF PRICE CONTROLS AND A GENERAL STRIKE

An epochal event occurred in 1956, with the collapse of the methods that had been successfully used to contain inflation since the stabilisation pact of 1951. Price and wage controls were based on an emergency powers act, dating from wartime, that had to be extended one year at a time. Because the law infringed constitutional rights, a 5/6 majority of votes in parliament was needed to extend it annually. The necessary majority was obtained each year until 1955. Then, in the wake of disputes over agricultural incomes, rightist parties in opposition (the conservative National Coalition Party, the liberal Finnish People's Party and the Swedish People's Party) combined forces to prevent the law being renewed. Thus, from the start of 1956, the government no longer had the authority to control prices. Urho Kekkonen's government was then approaching the end of its span. Due in January 1956 were presidential elections, at which time the government normally resigned, and it had been certain since September 1955 that prime minister Kekkonen would be the presidential candidate of the Agrarian League. Campaigning for the presidency was at its height at the end of 1955.²³⁵

The cessation of price controls at the start of 1956 was to be a watershed in Finnish economic policy although the period when prices were free lasted only a few months on this occasion. The end of price controls released pent-up inflationary pressures and triggered a labour

market reaction that led to a general strike. Labour unions responded all the more vigorously because of an internal power struggle between communists and social democrats.

The end of price controls was soon followed by many notable price hikes, particularly for agricultural products. The cost of living index, which had been held almost unchanged by controls and subsidies since the stabilisation pact of October 1951, rose sharply. The labour union movement demanded compensation in the form of wage increases. Negotiations were held between the central organisations of labour unions and employers, the SAK and the STK, throughout February but to no avail. The unions demanded an immediate increase of 12 markkaa in hourly wages, which would have boosted wages by an average of about 6–10%, an increase unacceptable to the employers. To back up its demands the SAK threatened a general strike, as it had done on several occasions in the 1940s and 1950s. Previously a strike had always ultimately been avoided, but not this time.

It began on 1 March 1956, on the same day that Urho Kekkonen became president of the republic. On the third day of the strike, a new government took office, led by Karl-August Fagerholm of the Social Democratic Party, who had narrowly lost the fight for the presidency. About half a million workers were on strike for 19 days. The strike ended in an agreement in which the SAK received the 12-markkaa wage increase it was demanding, plus further increases averaging 3% that were to be negotiated later in the spring. A semi-automatic index clause was inserted into wage contracts; it recommended that rises in the cost of living should be matched by wage rises, subject to negotiations between labour market parties. To encourage agreement and end the strike, Fagerholm's government promised that it would "use the methods available to it so as to seek to safeguard essential credit that would maintain production". Obviously this promise was in the sphere of monetary policy. The government also announced that it would seek authority to control prices. It obtained this authority, so the period of no price controls in the 1950s lasted for only three months.²³⁶

Once the outcome of the strike was clear, it became more certain that inflation would continue. The board of management of the Bank of Finland reported to the supervisory council on 18 April 1956 that inflation had picked up strongly in the early year, and pointed to the

additional consequences of the general strike: “It has recently been decided to implement major wage increases that will evidently exert extra pressure on the price level. To combat a fall in the value of money it is essential to undertake countermeasures in monetary policy (...) Under these circumstances the Bank of Finland must continue its tight monetary policy and to impose certain new measures in order to halt the spiral of prices and wages. The bank will not seek to reduce the amount of money in circulation at this time but will act to prevent it increasing and in particular to restrict investment and speculation based by inflationary sentiment.”

The report continues: “The board has held talks with the commercial banks, the savings banks and the cooperative credit societies to establish whether the general interest rate level could be increased while predicating that (a) interest charges on real estate lending would not be increased so that rents would not rise, (b) all financial institutions would continue to pay the same rate of interest on deposits and (c) financial institutions would not increase their profits. For many reasons, these conditions cannot be met, so the board does not propose to increase the general interest rate level.”²³⁷

The board felt that, despite faster inflation, it could not raise interest rates, partly because hikes could have been used to justify higher rents which, via various index-related agreements, could then have pushed inflation even higher. Instead the Bank of Finland merely raised the rates it charged its own customers. Parliament’s banking committee had expressed its disapproval, in 1955, about the rates at which the Bank of Finland provided its own corporate clients, which were less than the going rate of interest. Referring to the committee statement, the board now proposed to the supervisory council that “the rates of 5–7½% so far applied by the Bank of Finland should be raised, setting the lowest rate at 6½% and the highest at 8%. The interest rates charged to the bank’s own customers would rise ½–¾ percentage points.”²³⁸ In November the lowest rate that the bank actually charged was increased again, this time to 7½ percent. Because these rate hikes in 1956 applied only to the Bank of Finland’s own lending, there were no changes in the general interest rate level – in other words, in the rates charged and paid by deposit banks – after the general strike. This remained true for the next three years, despite faster inflation.



■ Chairman Eero Antikainen of the SAK labour union organisation addresses a demonstration in Senate Square during the 1956 general strike. The wage rise won was soon wiped out by inflation.

- Finnish Press Agency.

The real interest rates on lending had been substantially positive for many years. Now, in 1956, when the cost of living index rose by 17 percent and even wholesale prices by 9 percent, real interest rates became distinctly negative. Meanwhile the money market was becoming tighter as foreign currency reserves quickly shrank, and the banks were therefore starting to borrow more from the Bank of Finland. Compared with previous years, the indebtedness of banks to the central bank rose to an entirely new level, and the focus of Bank of Finland policy shifted to reducing it. This was done by easing the money market, which reduced the need to borrow from the central bank, and by raising the cost of borrowing from the central bank.

As part of measures to ease the money market, the agreement on cash reserve deposits was not renewed and the deposits made earlier were returned to the banks during autumn 1956. At the same time, compulsory deposits by importers at the Bank of Finland, related to the granting of import licences, were relaxed. Counterbalancing these concessions, the board of management obtained authorisation from the supervisory council in May 1956 to raise the penalty interest rates charged on excessive rediscounting. The highest penalty rate, 5%, was charged when a bank's rediscounting totalled twice its equity.

Overall, the measures taken by the Bank of Finland did not have a very restrictive effect on monetary policy, compared to what conditions required. In fact, as a whole they tended to neutralize the monetary tightening that resulted automatically from the fall in foreign currency reserves. However, the growth of debt to the central bank raised the costs of this form of funding – because of the penalty surcharges – to a level that was higher than at any time since the end of the war. As the year continued, lending by the banks slowed down quite distinctly.

The caution of the Bank of Finland in tightening the money market may be explained in part by concern about the liquidity of the banks. In a report on the money market to the supervisory council in 18 April the board mentioned that “in certain cases the Bank of Finland has had to arrange special credit facilities (for banks) in addition to rediscounting”.²³⁹ As a whole the money market in 1956 remained far too easy to curb inflation or to counteract the deteriorating foreign currency position. The later assessment of the Bank of Finland was that aggregate demand had expanded to an inflationary extent.²⁴⁰

It was typical of the economic policy of the period that the government sought to control inflation by intervening directly in prices and wages. After the end of the general strike the Finance ministry's Economic council was directed to draw up a new macroeconomic stabilisation programme. By the end of the year it had produced two sets of proposals, but neither was accepted. The Economic council proposed to eliminate, or reduce, the index-linking of wages and agricultural incomes but interest groups were opposed to this. The Bank of Finland also disliked the Economic council's plans, which were founded on a markka devaluation although that assumption was not explicitly stated. By the end of November 1956 it was clear that the stabilisation programme would not be implemented, and the chairman of the Economic council, Teuvo Aura, resigned. From now on, the corporatist mechanism having failed, the drafting of a stabilisation programme became the responsibility of the government itself.²⁴¹

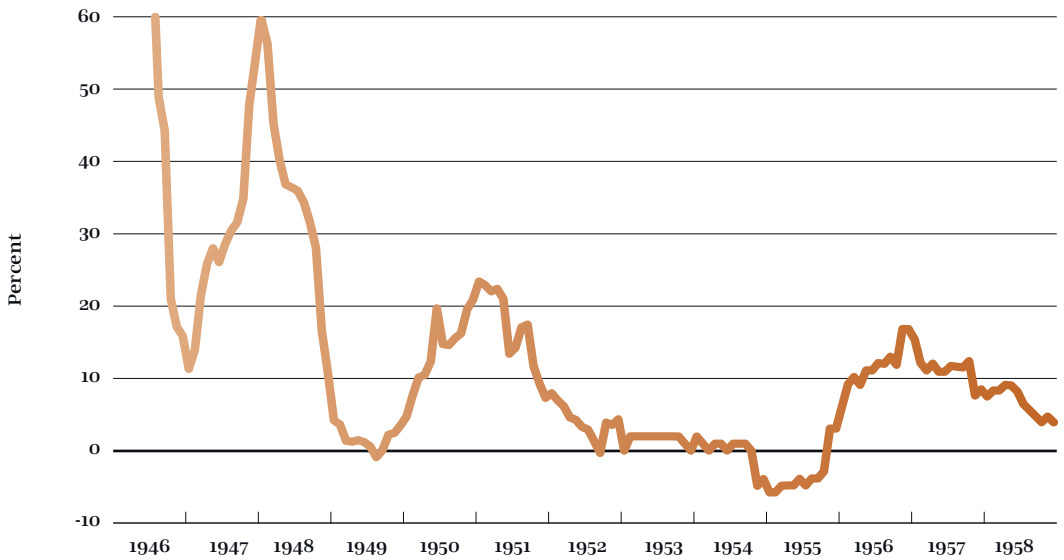
THE DEVALUATION OF 1957

After inflation had flared up in 1956, the Finnish markka was distinctly overvalued. The consequent problems came to a head in 1957 when export conditions deteriorated. There was a large trade deficit until spring 1957, when tougher trade licensing and tighter economic policies gradually began to reduce the flow of imports. Almost half of Finland's foreign currency reserves had been lost in 1956 and they continued to shrink in spring 1957. By June, their lowest point, there were practically none left. The situation had been worsened by the scheduled repayment in February 1957 of the last tranche of support loans received from the International Monetary Fund in 1952.²⁴²

It had now become a practical impossibility to avoid devaluation, especially since Finland wanted to dismantle import controls in the fairly near future and, like other western European countries, to make its currency convertible. These aims were incompatible with ever tighter physical controls on imports, although import licences were toughened as a temporary measure.

In his memoirs Rainer von Fieandt notes that secret planning for a devaluation was begun as early as autumn 1956.²⁴³ At that time and in early 1957, the Bank of Finland took the line that devaluation would

**INFLATION RATE 1946-1958:
YEAR-ON-YEAR CHANGE IN COST OF LIVING INDEX**



Sources: Central statistical office; Bank of Finland Bulletin.

be possible only when the inflationary spiral had been halted and macro-economic demand and supply were in better balance. Naturally in public pronouncements the bank and its governor ruled out any possibility of a devaluation and instead underlined the need for economic policies to control inflation. In a sense the bank began to put pressure on the government, industry and interest groups by refusing to resolve the equilibrium problems of the national economy with a devaluation before other measures to tighten the economy had been implemented.

Devaluation planning began when governor von Fieandt invited Ernest Sturc, a long-time expert on Finland at the IMF, and Eduard Wolf, director at the German central bank, to visit Finland in the second half of November. Talks with the IMF resumed at the start of February when an IMF delegation, including Ernest Sturc, visited Finland in connection with regular annual consultations. During their talks the IMF representatives noted that Finnish economic balance had

distinctly worsened, the symptoms being an unprecedented acceleration of inflation and an emergence of a foreign trade deficit. To halt inflation and restore balance they proposed cuts in government spending and tighter monetary policy. Only as a very temporary measure were they prepared to endorse the tighter controls on imports that Finland planned.²⁴⁴

After the failure of the Economic council's proposals for a stabilisation programme, the government completed its own programme, about which the Bank of Finland was consulted. The bank was initially dissatisfied with the rigour of the programme, which it expressed in memoranda sent to the government on March 16th and 18th. It called for lower government spending and less index-linking of wages, and also warned that the announcement of the programme should not arouse excessive expectations that import controls could soon be dismantled.

On the evening before the stabilisation programme was to be announced, governor von Fieandt wrote a sharply worded, personal letter to Prime minister Fagerholm in which he deplored the fact that the draft of the stabilisation programme shown to the board of the Bank of Finland seemed to encourage expectations of a devaluation. In particular the rationale of the programme hinted indirectly at the possibility of devaluation. Fieandt ended his letter thus: "In the past few weeks I have been delighted at our ability to work together for the good of the whole country. But fire and water do not go together and, at the present moment, I see no possibility for reconciliation."²⁴⁵

Fagerholm replied on the following day with a brief conciliatory message: "I hope that you will now read the communiqué attentively. The day before yesterday, no one had studied the reasoning of the text so there was no reason to be annoyed. We have now toned it all down and to a great extent have taken the wishes of (Klaus) Waris into account. (...) If the Bank of Finland is unwilling to support the programme the difficulties will be even greater than otherwise. Everyone is against me and I am tired of fighting them all. The bank can now render a service to our common efforts by supporting the programme. I would be grateful if I could today receive a written message that I can release in Parliament in case of need. Think seriously on the matter. You can be certain no other government could achieve a better programme."²⁴⁶

On the same day, the governor sent the message of support that Prime minister Fagerholm had asked for. It was drafted in the style typical of von Fieandt: "I have closely read your speech to be given in Parliament today. It is now substantially better and, in using influence to bring about the changes, I think that the Bank of Finland has done a service not only to the country but even more so to the government. You may however be aware that even in its present form the programme does not entirely satisfy us. The Bank of Finland has a responsibility for the monetary and foreign exchange policies of the country. It is difficult for the bank to carry out its duties if the public has the impression that the objectives of the government and the bank differ. The Bank of Finland notes with satisfaction the following part of the government's statement. 'Many circles appear to have assumed that our problems would be solved by quickly adjusting our exchange rates. This is an erroneous assumption because such an adjustment cannot be made unless our domestic economy has been brought into balance.' The Bank of Finland naturally supports the efforts of the government to create the equilibrium which the programme now drafted is meant to underpin. The Bank of Finland has no lack of desire for fruitful cooperation with the government you lead."²⁴⁷

The stabilisation programme was presented to parliament as a government statement on the evening of 21 March. Its obvious aim was to balance the deficit that had emerged in the budget and at the same time to create conditions for a successful devaluation. It included tax hikes and the establishment of a committee to prune government spending. Levies to be imposed on exporters, contained in the programme, were an outright hint at preparations for devaluation. Revenue collected in this way would be used to pay down government debt to the Bank of Finland and later for loans, mostly for expanding the forest industry. As part of the stabilisation package the government recommended that labour market organisations should agree indexed wage contracts that provided compensation for only two-thirds of price rises, instead of the full rise in the cost of living index. A similar change was to be proposed for the law on agricultural incomes, which determined agricultural producer prices.

The stabilisation programme stimulated a colourful debate in Parliament that lasted into the early hours of the morning. It was attacked from both the left and the right. Communist members saw it

as a programme for reducing living standards and part of a broader strategy for binding Finland to the economic integration of western Europe. Rightist members of parliament deplored the tax increases in the stabilisation programme and particularly the Export Levy Act. At the conclusion of the debate the government received a vote of confidence and the programme was therefore approved in principle. However, apart from the increases in corporation tax and employers' national pension contributions, the laws contained in the programme were not enacted, nor was there any progress before the summer in dismantling wage indexing. During the spring, then, the preconditions for a successful devaluation as set by von Fieandt were not fulfilled. A special cash reserve deposit act (aimed at restricting the credit markets) was approved but at the request of the Bank of Finland, President Kekkonen did not ratify it, so it did not take effect either.

Even among governing parties, not all members of parliament gave their unreserved support to the programme during the plenary session. In the background was the opposition of labour unions to the programme, especially the weakening of wage indexation. The attitude of organised labour was revealed in a speech by the chairman of the Metal Workers' Union, Valdemar Liljeström, of the Social Democratic Party. He predicted an upcoming devaluation and deplored the fact that exchange rate policies were to be used to erode real wages.

Liljeström told parliament that "a devaluation is understood to have been the subject of long negotiations between the government and the Bank of Finland, and the Bank of Finland's approval was finally obtained by promising that the real wage level would be lowered sufficiently before the devaluation and lowered once more by the devaluation. This is all well and good but the negotiating partners do not seem to have grasped who negotiates about the incomes of employees in this country. To my knowledge it is not the Bank of Finland but the SAK organisation and its member unions."²⁴⁸

Liljeström's speech exemplifies the mistrust that the labour union movement felt about exchange rate policies then and in the decades ahead. Its dissatisfaction with the economic policies of the Fagerholm government – and especially in the stabilisation programme of spring 1957 – was one cause of the internal rift at the Social Democratic Party's conference in April and later the split in the party and the SAK.²⁴⁹ The day after the conference had ended, Prime minister Fagerholm

presented his government's resignation to President Kekkonen. The President asked him to continue until stabilisation negotiations had been completed, and the resignation was delayed for about a month, until 22 May. The day before he left office Fagerholm said in a speech on the radio that it was apparently impossible to agree on the wage recommendations central to the stabilisation programme and that he was now being treated like a "pariah".²⁵⁰

The directors of the IMF discussed the results of consultations with Finland at a meeting in Washington on 27 March. At this point Fagerholm's government was still in office so the main focus of the discussions was the stabilisation programme that had just been announced. Also debated were the foreign trade restrictions that Finland was still using – in other words, import licensing, bilateral payments agreements with certain countries, the clearing agency system of export subsidies and, since the Olympic games, separate higher tourist rates of exchange that benefited visitors arriving from abroad but penalised Finns travelling abroad by making them buy foreign currencies at rates more expensive than the official exchange rates. The IMF had repeatedly sent complaints to Finland about the clearing house system and the maintenance of separate tourist exchange rates.²⁵¹

In a statement approved at the end of the discussions the IMF board recommended a devaluation to Finland. Its turn of phrase did little to disguise the message: "...In order to attain conditions which would facilitate the expansion of investment in the most productive sectors of the economy and a rise in the standard of living under conditions of internal price stability, it is necessary that the *distortions in internal relative prices and between Finnish and foreign prices should be eliminated...*" In the language of the IMF, a recommendation to eliminate imbalance between domestic and foreign prices was a fairly explicit incitement to devalue. The IMF also expressed the hope that after the restoration of internal and external balance, (the Finnish national economy) would be able to abandon foreign-exchange controls and multiple exchange rates.²⁵²

The next government was formed by V.J. Sukselainen of the Agrarian League. Initially there was no participation by the Social Democratic Party but it was joined at the start of September by a few members of the left-wing faction of the party, which was now breaking up. Among the

new ministers were Valdemar Liljeström, the chairman of the Metal Workers Union, who had criticised the previous government's statement on the stabilisation programme, and Aarre Simonen. Simonen was appointed to the board of the Bank of Finland at the same time but took immediate leave of absence because of his ministerial duties.

The conditions required for a devaluation were gradually met during summer 1957. Early in the summer, labour unions gave up their demands of full compensation for cost-of-living increases and adopted the line of two-thirds compensation, the compromise that had already been written into the stabilisation programme. At the same, the Bank of Finland sharpened its monetary policy tools by changing the interest rate surcharge system for commercial banks. On 27 June 1957, it announced that, from the start of August, the penalty rate, increasing stepwise according to the amount by which banks exceeded their credit limits, would henceforth be applied to the entire debt of the banks. Previously each step of the penalty fee schedule had been applied only to the tranche of the debt borrowed at each particular step. This change led to a significant increase in the costs of excess borrowing and meant that the marginal cost of borrowing from the central bank could now be far higher than the average cost. It was because of this change that marginal charges became so high in the 1960s and 1970s even though the supervisory council usually authorised the Bank of Finland to charge no more than four percent penalty interest.²⁵³

In August parliament was summoned for an extraordinary "dog days" session to debate an emergency economic programme drafted by the Sukselainen government. This included new tax increases and the export levy that had been part of the stabilisation programme of the preceding Fagerholm government. The rationale for the export surcharge proposed by the Sukselainen government, and given in the first article of the bill, contained explicit references to devaluation as the event that would cause the law to be applied: "When there is a rise in export prices, denominated in Finnish currency, as a consequence of a change in the external value of the Finnish markka, that could disrupt the monetary equilibrium of the country, the exporter must pay an export levy on the goods as enacted in this law."²⁵⁴ The law, approved by parliament on 2 September 1957, was to be in force for one year. The economic policy preconditions for a devaluation were now in place.

After approval of the Export Levy Act, the Bank of Finland began practical implementation of the devaluation. In a memorandum written in English on 11 September, von Fieandt notes that he had previously been opposed to devaluation because it would have caused an immediate increase in wages and prices, as it had in 1949. However, the money market had now been successfully tightened and the government had been induced to cut its spending. In von Fieandt's view the labour unions had agreed to accept $\frac{2}{3}$ index-linked compensation because of the tightness of the money market. Now that a law had been created that would neutralise some of the benefits accruing to exporters, there was no longer cause to postpone devaluation. It would be done by raising the official exchange rates to the level of the tourist exchange rates.

On Friday 13 September, the Bank of Finland sent an official telegram to the IMF in which it proposed a change in the par value of the Finnish markka. The proposed new par value was sent in a separate telegram to Jouko J. Voutilainen, the bank's representative in Washington. The new exchange rate was 320 markkaa to the dollar – the old one had been 230 markkaa/dollar. Thus the value of the US dollar rose 39.1 percent and the value of the markka against foreign currencies declined by 28.1 percent. The message to Washington promised that the Trade Clearing Agency and tourist exchange rates would be ended and that a major part of import controls would be dismantled by the start of October. It was also stated that the government would propose an extraordinary budget for 1958 and that the Bank of Finland would continue tight monetary policy.

The Bank of Finland's telegram had expressed the hope that the IMF would reply by 18:00 hours on Monday so that the devaluation could be announced in Finland later in the evening. The managing director of the IMF Per Jacobsson replied that he was convening the executive directors of the IMF on Sunday 15 September, so Finland also had to convene a session of the Council of State on Sunday so that the Export Levy Act could be ratified by the President at the same time. In 1957 the board of management of the Bank of Finland still had the right to determine the exchange rates so no meeting of the supervisory council was necessary for that purpose and governor von Fieandt simply informed council chairman Kusti Eskola in advance. On Sunday at 17:00 hours a telephone message reached Helsinki that the directors

of the IMF had approved Finland's proposal for a change in the markka's par value. At 19:55 hours the markka was devalued and the Export Levy Act ratified.²⁵⁵

The minutes of the Bank of Finland board meeting that implemented the devaluation record that "to create conditions for this measure to ameliorate foreign exchange conditions, the Bank of Finland has kept monetary policy tight in recent years, preventing ongoing credit expansion and eliminating excess purchasing power. It can already be seen to have achieved a satisfactory result in neutralising inflationary demand pressure, and further deflationary phenomena can no longer be regarded as desirable."

The bank also recorded its rationale for the size of the devaluation and the link to trade liberalisation. According to the minutes, the two were intimately linked: "Immediately after the devaluation, the board believes that import controls should be dismantled to such a great extent that foreign competition with domestic producers will effectively increase, and that most import quotas can be eliminated in trade agreements with countries to which Finland can freely export. Such a source of action, pledged by the Prime minister, required a far greater devaluation than would have been needed to safeguard the profitability of exporting as such. For this reason it was essential to create a system (the Export Levy Act) that would withhold a certain amount of the extra income that the devaluation brings to exporters."

The board of management also called on the Finnish government to participate in the OEEC, the forerunner of today's OECD. According to the minutes "the board has also informed the government that a condition for devaluation is that Finland will seek membership of the Organisation of European Economic Cooperation, in order to be able to take part in the clearing of foreign trade surpluses and deficits within the framework of the European Payments Union and to have access to the credit facilities of the Union. A decision of principle to apply to the said organisations was made by the Council of State on the ninth day of this month."²⁵⁶

On the evening of the devaluation, governor von Fieandt made a speech on the radio in which he explained the measure and its reasons. Using characteristically strong rhetoric, he took the opportunity to demand a change in the nation's economic management:

“I would like to point to the experiences of our earlier devaluations, which came to nothing, leaving the economy soon as unhealthy as before. This cannot be allowed to recur. Finland has become renowned as a country of routine budget and government liquidity crises and its reputation in the eyes of the rest of the world has fallen to a low point. Now we must win respect for ourselves. After the devaluation we have the opportunity to reinvigorate our economic life. But he who thinks that this means halcyon days and easy living is mistaken. Both the public and private sectors must learn good housekeeping. And the first requirement is thrift in all circles and all sectors.”

The governor ended his speech rather eloquently: “The Bank of Finland expresses its hope that all will show restraint and will not allow selfishness to impede the economic revitalisation that is now possible. Give us a year for this endeavour. Know that the vital prerequisite for national welfare and success is a stable value of money! In closing. If you regard our policies as too tough, recall what I have said on previous occasions: a strong currency is not forged with weak will!”²⁵⁷

A CHANGE OF GOVERNOR

When Rainer von Fieandt had become governor of the Bank of Finland in 1955, and President Paasikivi had passed over Klaus Waris, the favourite of the supervisory council, Paasikivi had not doubted Waris' competence. He obviously regarded Waris as young and inexperienced but felt that he had the makings of a governor; a few years under von Fieandt would be good training for the future. In fact Paasikivi was more concerned about ensuring that Waris would stay on the board of the central bank after he had failed to be appointed governor. Among other things, Paasikivi feared that Waris might be invited to succeed von Fieandt as general director of the Nordic Union Bank. This did not happen, however, and Klaus Waris was still on the board of the Bank of Finland nearly three years later, at the end of 1957, when von Fieandt was appointed prime minister of a non-party government.²⁵⁸

Previously if the governor had become prime minister he would merely have been granted leave of absence from the bank but the times had changed. Independence had once more become a significant principle for the Bank of Finland, and von Fieandt announced his

resignation. It also certainly had some bearing on the matter that he would turn 67 in December and so was obviously close to retirement. This time the choice of new governor went rather smoothly and Klaus Waris took up the post on 20 December 1957. He was not unopposed; the communist People's Democratic League representatives on the supervisory council, Aaltonen and Murto, proposed Matti Janhunen, a journalist, for the position of governor.²⁵⁹

In the early part of the decade while Klaus Waris was at the helm of the bank, he concentrated on a revision of the outdated Currency Act, remembered for the 1963 monetary reform with its "knocking off the zeros". The new Currency Act closely reflected Waris' views and clarified the relative powers of the government and the Bank of Finland, allowing more far-sighted economic and monetary policy.

Apart from his stewardship of everyday central banking, Waris' great mission was a resolute reform of the structure of the economy so that a country so dependent on foreign trade would be successful in international markets. This in turn required great structural reforms in the way industry was financed. Klaus Waris' major role in planning these reforms is analysed later.

IMPORT DEREGULATION AND MARKKA CONVERTIBILITY

In Finland and other countries of western Europe, the 1950s was a decade of transition from the regulated foreign trade of the 1940s towards free trade and convertible currency. However, compared with the countries that had received Marshall aid, Finland took a different path towards convertibility. They managed their foreign payments by multilateral agreements within the framework of the Organisation for European Economic Cooperation, but Finland could not join the OEEC for foreign policy reasons – in other words, because of the opposition of the Soviet Union – so it followed a separate route.

Established to implement the Marshall Plan, the OEEC played a major – if not the leading – role in promoting European economic integration in the 1950s. It was a very comprehensive organisation. Its founding members were 18 western European countries including neutral countries like Austria and Sweden. Another important European organisation was established in 1951 but the European Coal and Steel

Community consisted of only six countries (Italy, France, West Germany and Benelux) and its operations were initially confined to building a common market for coal and steel. For the whole of non-communist Europe, economic co-operation was led by the OEEC at least until the end of the 1950s, after which it developed in new ways with the establishment of the EEC and EFTA.

Among the greatest achievements of the OEEC in the 1950s was the creation of a multilateral payment system for western Europe. After the war all European countries suffered a chronic shortage of foreign currency. In practice the US dollar was the only “hard” currency that could be used without restrictions in international trade, and European countries had very small dollar reserves. Most payments between them were based on bilateral agreements, which restricted the growth of foreign trade and so hindered economic recovery. To ameliorate the shortage of foreign currency, the OEEC countries established the European Payments Union (EPU), a clearing system that saved “hard currency” – dollars – while allowing the deregulation of trade between members.

Established in 1950, the EPU had three objectives: to eliminate barriers to the mutual convertibility of European currencies, to remove quantitative restrictions on foreign trade and to end bilateral trade arrangements between the member countries. It therefore gave its members the tools to free themselves from the chains of bilateral payments agreements in trade within Europe. The EPU created a multilateral clearing system, managed on its behalf by the Bank for International Settlements in Basel. The system allowed the foreign currency earnings of any EPU member country to be used for purchases from any member country. Receivables and claims between member countries were cleared on a monthly basis and the net amounts were recorded as assets or debts at the clearing centre of each country. Multilateral netting significantly reduced the need for dollars in mutual trade and gave a major boost to trade within Europe. For the countries within the system, it was almost equivalent to currency convertibility for commercial payments, except in payments to the dollar area.²⁶⁰

In the 1950s the EPU was the foundation of the international payments system between west European countries. At the same time its members were constantly engaged in negotiations about the

complete convertibility of their currencies, predicated by the Bretton Woods agreement. The problem was how this could be attained without precipitating a foreign exchange crisis, as Great Britain had suffered in 1947 in its ill-fated experiment with convertibility. The EPU members had different objectives in seeking convertibility. Great Britain wanted to restore the pound to its previous role as an international reserve currency but was delayed by the weakness of its international payments account. France was also beset by persistent balance of payments deficits and in 1956 was forced to backtrack on the deregulation of imports and to toughen import controls again. But notwithstanding the practical problems, political preparations advanced and a European Monetary Agreement was signed in 1955, intended to replace the EPU when its members made their currencies freely convertible against the dollar.

Because of Soviet resistance, Finland had not participated in the Marshall plan and, not being a member of the OEEC, had been unable to join the European Payments Union. Apart from trade with the dollar area, most of Finland's external payments were still handled on a bilateral basis but in the latter half of the 1950s administrative control was not as tight as in the first post-war years. In 1955 the system described as automatic import licensing was expanded so that certain products, mainly raw materials and semi-finished goods, could be imported fairly freely (although not from the dollar area). The government envisaged that 40 percent of imports would be covered by automatic licensing.

However automatic licensing led to unexpectedly strong growth of imports, which coincided with a decline in exports, so import controls had to be tightened again in spring 1957. To avoid accusations of discrimination this was done using global quotas; an importer who had received a licence to import of certain type of product was free to choose the country it came from. The system was agreed with Finland's most important western European trading partners, within a framework which became known as the Helsinki Club. The Helsinki protocol was signed on 31 July 1957 but came into force retroactively from the start of April, which was when import controls had been tightened.²⁶¹

The new import controls in early 1957 were meant to be temporary because the government was seeking to link Finland, one way or another,

with western European progress towards general currency convertibility and free trade. Olavi Munkki, a top official at the Foreign ministry's department of international economic relations during the late 1950s and early 1960s, noted that, by the end of 1956, there was already agreement between foreign trade officials that "something had to be done about our foreign trade to change rigid bilateralism towards increasing multilateralism (...) Even the best bilateral arrangement is hardly ever a substitute for multilateralism, be it imperfect."²⁶² The aim to create conditions for convertibility of the Finnish markka was one of the main considerations when the size of the 1957 devaluation was set.

The first Helsinki protocol was in force only until the start of October 1957. Import controls began to be dismantled quickly after the September devaluation. Most import controls had already disappeared by December, when the next Helsinki protocol was signed, deregulating a wide range of imports and establishing the transferability of export revenues. By 1958 80 percent of Finland's imports from western Europe were licence-free.

At the time of the 1957 devaluation, the Finnish government had decided to begin confidential negotiations with the OEEC. During the talks, held in the early months of 1958, it became clear Finland could not join the European Payment Union without becoming an OEEC member. The Soviet Union was so suspicious of the idea of Finnish OEEC membership that President Kekkonen ultimately decided in autumn 1958 to discontinue membership preparations. In the background was growing tension between the powers blocs, which culminated in November 1958, when the Soviet leader Nikita Khrushchev sent the Western powers an ultimatum, demanding their withdrawal from West Berlin.

While Finland was putting out feelers about membership of the OEEC and EPU, western Europe was reaching the point when it could implement full currency convertibility and dismantle the EPU. The key element was that currencies would be freely convertible against the US dollar. Among the large western European countries, the balance of payments problems obstructing convertibility had eased, at least for the time being. Britain's payments account improved strongly in 1957. France had reinforced its competitiveness with a covert devaluation in August 1957 and, when Charles de Gaulle rose to power the following year, first as prime minister and then as president, he decided to

resolve the balance of payments problem with tight economic policies and a new devaluation. In December 1958 France devalued the franc 14.9 percent and removed import controls.

On 27 December 1958, the same day that France devalued, the EPU was terminated and western European countries made their currencies convertible against the dollar. Initially 10 European countries – Belgium, Denmark, France, West Germany, Italy, Luxembourg, the Netherlands, Norway, Sweden and Great Britain – told the International Monetary Fund that their currencies were convertible. Only days later, Austria, Finland, Greece, Ireland and Portugal made the same announcements. Like other west European currencies, the Finnish markka was freely convertible for foreigners from the start of 1959.²⁶³

Convertibility did not mean that Finland eliminated all foreign exchange controls, far from it. It was only for commercial payments related to the import of goods that Finnish markkaa could be used freely to buy foreign currencies. Payments related to capital movements and the purchase of services still required permission from the Bank of Finland. Furthermore, Finnish travellers were subject to quotas in their purchases of foreign currencies (for example in 1959 the quota was 20,000 markkaa for trips to the Nordic countries and 40,000 markkaa for trips beyond).

Despite the remaining foreign exchange restrictions, the liberalisation of imports and foreign payments implemented in 1957–58 marked a major and far-reaching step for Finnish economic policy. It reinforced commercial ties to the market economy countries of the west and significantly increased competition in the Finnish market. It also ruled out foreign currency controls as a way of protecting the balance of payments, which became more distinctly the task of general economic policies and, in practice, mainly the monetary policy of the Bank of Finland. From the end of the 1950s, changes in Finland's monetary policies can indeed be largely explained by the state of the country's current account.

The Helsinki club agreement on Finland's multilateral trade and payments was later renewed annually until 1968. It ceased to exist from the start of the following year. Finland was then in the process of joining the OECD, established in 1961 to succeed the OEEC and it was felt that there were now other adequate safeguards for the interests of exporters, Finland's to western Europe and western Europe's to Finland.

Accordingly, the Bank of Finland had notified the Foreign ministry a year earlier, in October 1967, that Finland's foreign trade no longer required renewal of the Helsinki club protocol. Finland was now, if not earlier, a "normal" country with regard to its multilateral trade and payment arrangements.²⁶⁴

MODERNISING THE CURRENCY ACT

TEMPORARY REGULATIONS REPEALED

Although Finland had abandoned the gold standard in 1931, the Currency Act, which regulated the operations of the Bank of Finland, had not been changed then or during the war and reconstruction years. Instead temporary changes, required by the new circumstances, had been inserted into the bank's regulations. The first major change naturally concerned regulation 8 section 1, which required the Bank of Finland to redeem its banknotes in gold. A third section was added to this regulation stating that, in exceptional external conditions, the board could be empowered by the supervisory council to discontinue redemption in gold for a period of time. This was legally implemented by a periodic government statute. In the same way, this appendix to regulation 8 cancelled regulation 1 of the Currency Act, which stated that "the only measure of value in Finland's monetary standard is gold".

Another change had been required when Finland went to war in autumn 1939 and the Bank of Finland was required to provide extensive finance for the government, in practice by printing extra money. It required a revision of the banknote cover regulations, to eliminate the difference between primary and secondary cover and to allow short-term government bills of exchange to be used as cover. These changes in the regulations entered force on 13 December 1939.

During the war the bank's operating parameters were set by these stop-gap changes. It was generally assumed that when peace was

restored, the old ways would resume, although it was understood in all circles that the old-style gold standard would not be reinstated. Furthermore, reconstruction, resettlement and reparations left so few resources unused that there was very great pressure to continue note financing. The balance of power between different social groups had changed greatly and at the end of the 1940s it was not politically possible to terminate central bank financing for the government overnight, as had been done at the start of the 1920s. The first article of the regulations stated that the task of the Bank of Finland was to safeguard monetary stability, which in practice meant keeping the value of the markkaa stable. To ensure this, there were detailed regulations on banknote cover, but these had been compromised so as to make note financing possible. In theory the board of management could have refused the government's request for loans at any time, but not in reality.

The Bank of Finland felt its situation to be unsatisfactory and in 1947 the board asked the supervisory council to ask the government to change regulation 6 and set an upper limit on the government bills of exchange that the bank could accept. Parliament's banking committee was of the same opinion, but the government did not respond because it felt acceptance credit from the Bank of Finland to be essential.²⁶⁵

The matter was taken up again in 1949 and parliament approved a government proposal in 1950 that imposed an upper limit of 30 million markkaa on the acceptance credit that could be granted to the government. The regulations of the bank were changed to set the contingency of banknotes backed by secondary cover at 50 billion markkaa, of which 30 billion could be covered by government bills of exchange. The board of the Bank of Finland wanted to stop financing the government altogether and its next step was to send a letter to the government in autumn 1952, proposing that the upper limit on acceptance credit should be lowered to 20 billion markkaa. After closer examination it was concluded that it would be wiser to end the discounting of government bills of exchange completely. An overnight change would have disrupted the budget so the board proposed an alternative procedure. The Bank of Finland would subscribe government bonds worth 20 billion markkaa. The funds would be used to redeem government bills of exchange and any surplus would be deposited in

a government current account at the Bank of Finland to satisfy its seasonal and temporary cash needs. Bond amortisation would begin in 1956 and last ten years. To ensure that the volume of banknotes in circulation remained adequate, the bonds would be acceptable banknote cover up to the amount of 25 billion markkaa. The law implementing this arrangement took effect on 16 September 1953.²⁶⁶

Thus it was not until autumn 1953 that banknote cover regulations were again on a normal basis. Normalisation lasted much longer than after the First World War, when the government's credit facility at the Bank of Finland had been closed at the very start of the 1920s. The delay in the 1940s surely reflected a lack of real commitment to safeguarding the stability of the markka. A committee set up in 1949 to consider monetary reform underlined the need to take stability more seriously. Its report stated that stable monetary value must be accepted as the main aim of economic policy and that stabilisation of the markka's internal value required balanced government finances so that note financing would become unnecessary. The Korean Boom of 1951 played a major role in ending the government's need for central bank finance. Export volume and export prices both rose to unprecedented levels, public finances quickly stabilised and foreign currency reserves rose steeply. Even so, the government could not manage entirely without loans from the Bank of Finland for several more years.

NEW CURRENCY ACT CHANGES BALANCE OF POWER

The Currency Act of 1925 was not revised in the 1950s because the Bank of Finland felt that it should not be done until the external and internal stability of the markka were dependable. The time was seen to be ripe by the start of the 1960s. The final impetus for revising the whole Currency Act was a monetary reform, mulled over since the end of the 1940s, with the idea to raise the value of Finland's monetary unit by a factor of 100. This would not have been possible without a change in the Currency Act. The monetary reform is discussed in more detail below. The new Currency Act was approved by parliament in 1962 and took force from the start of the following year. The dead letter of the gold standard, which had been not operative for three decades, was

laid to rest. Although the act was proposed to parliament by the government, the Bank of Finland had been firmly in charge of its planning.

The Bank of Finland had been preparing the reform since the start of the 1960s although it was not until spring 1961 that the supervisory council had given its formal authorisation.²⁶⁷ Subsequently, in June, the board sent the government a letter proposing preparatory measures to revise the Currency Act. The prime minister at this time was V.J. Sukselainen but he was replaced by Martti Miettunen in mid-July and it was during the term of Miettunen's government that practical arrangements were completed. Reform of the Currency Act was not a matter of great consequence for the government, and there was no mention of monetary questions or the Bank of Finland in the new government's programme.²⁶⁸ Admittedly government programmes at that time were typically very noncommittal declarations that put the main stress on foreign policy. In any case, the government surely knew the intentions of the Bank of Finland because Ahti Karjalainen, a member of the bank's board, was Foreign minister.

When the full supervisory council had considered the board's proposal at the turn of September, the second section of the new Currency Act had caused the most discussion. It stated that the markka's par value, expressed in gold, was to be set by the government upon a proposal by the Bank of Finland. The board of management argued for the new formulation as follows: "According to the old currency act, during the gold standard period, setting normal exchange rates was one of the matters decided by the board but conditions are now different. Naturally and obviously the board of management of the Bank of Finland is the body responsible for assessing whether relative payments between Finland and other countries are so fundamentally out of equilibrium that the value of the markka should be changed, just as (the Bank of Finland) has the right to analyse how great such a change should be. However the economic effects of a change in markka value are so strong that the event also demands the reassessment of other economic policies and perhaps the implementation of measures to support the stability of the new parity and the value of money. For this reason it seems justified that changing the par value should not be merely a matter for the board of the Bank of Finland – as were ordinary exchange rate quotations at the time of

the gold standard or the gold-exchange standard – but should ultimately be the responsibility of the government, which is responsible for the nation's economic policies as a whole.²⁶⁹

The board added that this formulation was in harmony with the regulations the International Monetary Fund; the Bank of Finland is the intermediary in relations between the IMF and Finland, but the member of the IMF is the State of Finland. Hence the government is the body that decides Finland's representation at the IMF and makes official proposals about Finland to the IMF.²⁷⁰

As a matter of principle, this formulation created a major shift in the balance of power between the government and the board of the Bank of Finland because, at least in the eyes of outsiders, the body that set exchange rates had the greatest powers over the bank. However, this was not a question of a power struggle between the central bank and the government. The board saw devaluations as such major pieces of economic policy that the central bank could not alone bear the responsibility for them. Besides, the success of a devaluation was dependent on an overall economic programme. Drafting such a programme required smooth cooperation between the government and the central bank, both of whom had to be committed to it. To guarantee this commitment, the decision to devalue should be transferred to the government.²⁷¹ The Bank of Finland had certainly been influenced by its experiences of the 1957 devaluation. At that time the right to devalue was still held by the bank and in its board's view the government had not been sufficiently committed to the follow-up economic measures required. For the bank to be able to fulfil its mission of protecting the stability of the monetary system, seamless cooperation with the government was seen as vital.

Matters were seen differently in the supervisory council, where the members most vociferously opposed to the change were K.J. Söderhjelm and Aimo Aaltonen. Söderhjelm, a doctor of laws who represented the Swedish People's Party, pointed to the Bank of Finland's long history of subordination to the Estates, a status that had its roots back in the period when Finland was part of Sweden. In his view the Bank of Finland was the People's Bank, not the government's bank, and he was not ready to abandon this relationship. By the constitutional principles of Finland, he thought, a change in the value of money was the prerogative of the Bank of Finland and the decision should be taken

by the Parliamentary supervisory council. Söderhjelm felt that section 2 of the currency Act should state that “the international reference value of the Finnish markka, expressed in gold, is to be set by the Bank of Finland after consulting the government. The regulations of the Bank of Finland should also be changed so that the Parliamentary supervisory council takes the decision on the markka’s international value.”²⁷²

Council member Aimo Aaltonen, who was also chairman of the Finnish Communist Party, went even further in his demands and sharply underscored the role of the Bank of Finland as parliament’s bank. The external value of the markka concerned everyone so decisions about it should not be transferred to the government but belonged to the people as represented by parliament. His formulation would have been as follows: “Because a significant change in the value of the markka deeply affects the income of the working classes, it should be ultimately decided by parliament or its appointed supervisory council.”²⁷³

A third member of the council who took a stand on the question was Olli J. Uoti, a young representative of the “Social Democratic Union of Workers and Smallholders”, the leftist faction which had recently broken away from the Social Democratic Party. He said that that Sweden and Finland were the only countries where parliament controlled the central bank and that the time for this “fossilised” form of governance was over. He thought the board’s proposal was a step in the right direction but could have gone further; the government should have a tighter grip on the central bank.²⁷⁴

In other respects the supervisory council largely confined itself to matters of formality, such as whether to use the expression “par value” or “international reference value”. Several councillors also felt that a reform of the Currency Act was a good opportunity to merge the mint, which was subordinate to the Finance ministry, with the security printing house of the Bank of Finland. This remained merely wishful thinking; no changes were made in the position of the mint, at that time or in the future.

After the council debate, the only real change to the proposal of the board was made in section 2, where the role of the Bank of Finland was slightly underlined: “the international reference value of the markka, expressed in gold, is to be set by the government upon

proposal by the Bank of Finland. The (bank's) proposal must be either accepted or rejected without modification." Councillor Söderholm, supported by Aimo Aaltonen, proposed the formulation that "the international reference value of the markka, expressed in gold, is set by the Bank of Finland after hearing the government" but this alternative was voted down.²⁷⁵

The modified draft Currency Bill was sent by the bank to the government on 5 September 1961. The bill that the government sent to parliament on 1 December followed the proposal that had been drawn up at the Bank of Finland. Its preamble noted that the Bank of Finland and the government should work together and declared, among other things, that before the board of the Bank of Finland made a final proposal on changing the external value of the markka, it should first negotiate with the relevant members of the government.²⁷⁶

In parliament's banking committee, the only members not favourably disposed to the government's proposal were the prominent conservatives Tuure Junnila (National Coalition Party) and Georg C. Ehrnrooth (Swedish People's Party). They appended a dissenting opinion to the committee's report, stating that the Currency Act would deprive the Bank of Finland of its independence and lead to the politicisation of all monetary policy. They also noted that a decision on changing the value of the markka would always have to be taken in secrecy because its premature publication would be very harmful to the central bank and the whole national economy. Under the old Currency Act, the decision could be taken by the governor of the Bank of Finland with the support of two members of the board, so the smallest number of decision-makers involved was three. Under the new act the decision would involve all nine members of the supervisory council, the board of the Bank of Finland and the members of the government and their referendants. When as many as twenty people received advance information about an upcoming change in the exchange rate, could one still expect it to remain secret? Furthermore, removing this prerogative from the board of the Bank of Finland could erode the esteem it enjoyed.²⁷⁷ This dissenting view did not receive broader support, and the government's currency bill was approved by parliament on 30 March 1962. The act came into force from the start of 1963.

REFORM OF THE BANK OF FINLAND REGULATIONS

Naturally the revised Currency Act of 1962 was reflected in the regulations of the Bank of Finland. There was no need to change their structure but defunct sections related to the gold standard, which had had no practical significance for years, could be removed. Other amendments to the regulations were made necessary by the inflation that had been raging for two decades, changes in banking and the growing size of the bank, with the consequent need for organisational change.

Because of inflation and the expansion of the bank's activities, sections 4 and 30 of the regulations, which set the size of the primary capital and the total of primary and reserve funds had to be changed at about five-year intervals. This had high priority for the bank because as long as the fund total set in regulation 30 had not been attained, at least half of the bank's annual surplus had to be used to build up its secondary fund. When the new Currency Act came into force in 1963, the primary capital of the bank was set at 100 million new markkaa and the primary and secondary fund total at 200 million new markkaa. Subsequently, the regulations were amended to raise the size of the funds in 1965, 1970, 1975 and 1981, with the aim of holding the amount of primary capital at about 15 percent of the balance sheet total.²⁷⁸

Section 6 in the regulations, which set banknote cover regulations, had to be similarly changed. In 1965 section 11, concerning loan collateral and the amount of lending, was modified, because of changes in the shape of Bank of Finland lending. Hitherto, apart from rediscounting, the bank could grant loans only against gold, bonds, or mortgaged securities and the amount of credit thus granted could not exceed half the bank's equity. In practice gold was no longer offered as collateral, but other securities, such as debentures, had become viable collateral.²⁷⁹

The board of management felt that the section on acceptable collateral could be eliminated from the regulations entirely, because board regulation 2 already stated that "when granting loans and in all other operations, the board must be mindful of the bank's security and interests". At the same time, the board proposed that the maximum for loans other than acceptance credit should be the value of the bank's

equity. This improved the bank's scope for granting credit to financial institutions against the bonds that they owned, which was clearly a more flexible form of credit than rediscounting bills of exchange. Parliament approved these changes to the Bank of Finland regulations at the very end of 1965.

The Bank of Finland's regulations and the supplementary rules for its board of management, the supervisory council, the auditors, calculation of wages, and the payment of pensions and family pensions imposed rather strict parameters on its operations. On the practical level, however, situations constantly arose where regulations did not exist or were interpreted fairly liberally. In certain matters there was a strict commitment to keeping the regulations up to date. In other matters the reins were kept slack to allow greater freedom of operations.

A concrete example of this polarity is regulation 11, which defined banking operations. On lending it was fairly detailed, as noted earlier, but it said nothing about guarantees granted by the bank. In practice the risks contained in guarantees and loans are of the same magnitude so it would have been logical to regulate both. When the regulations had been comprehensively revised in 1925, guarantees were not part of the bank's operations so they were understandably not mentioned. When the board began to grant guarantees at the end of the 1940s, it apparently did so on the authorisation granted by regulation 11 section 6 which stated that the Bank of Finland was permitted to pursue other business related to regular banking.²⁸⁰

The following regulation 12 stated unambiguously that "the bank's funds may not be invested in shares" although the proscription was relaxed immediately by allowing investment in shares that was necessary for the production of banknotes, or for the acquisition of supplies to be used for their production, or for the printing of banknotes, or if the supervisory council felt it was necessary for other reasons especially important for the bank's operations.²⁸¹ Undeterred by the regulation, the Bank of Finland was relatively active in investing in the shares of individual industrial companies in the 1940s and 1950s although these investments could not be called particularly important for the bank's operations. In this respect both the board of management and the supervisory council interpreted the regulations in a fairly lax way.

Regulation 13 on borrowing by the Bank of Finland was fairly ambiguous. It stated that “the bank is entitled to pay interest on funds held in the current accounts of foreign correspondent banks. In other cases the bank shall not pay interest on deposits except on exceptional occasions because of special circumstances. The payment of interest must cease when the reasons for it cease.”²⁸² So, generally the Bank of Finland did not pay interest on the deposits it raised. However, from the 1950s onwards, the bank was on several occasions mandated to collect compulsory deposits, imposed to regulate economic conditions. These included cash reserve deposits demanded of banks, export deposits applied after devaluations and import deposits intended to restrict imports. The Bank of Finland paid interest on all of these. The regulations also contained a subsection stating that tasks carried out by the bank on behalf of the government would be separately regulated. The question of interest payable was of considerable importance for the bank’s operations as, from the 1950s onwards, interest payments became a major item of expenditure.

In the first half of the 1950s there was very active discussion in the supervisory council about conflicts of interest. It was stimulated by the positions of Sakari Tuomioja and Urho Kekkonen, who were ministers in the government and members of the bank’s board at the same time, although both Kekkonen and Tuomioja had taken leave of absence from the board while they were prime minister.

There were no regulations on recusal for board members and the discussions of the supervisory council did not lead to any. On the other hand, members of the board began to observe an unwritten rule that they would automatically apply for leave of absence when appointed a minister of the government. Rainer von Fieandt went even further in 1957 when he resigned from the board as soon as he became prime minister. There were no bank regulations or board rules concerning board members being directors of other companies and no practical obstacles seem to have existed.

Since 1925, rule § 12 of the supervisory council had required a councillor “to resign if he accepts a position that, by the unanimous agreement of the council, cannot properly be reconciled with council duties”. Members of the council often served as government ministers. The matter had been debated since the 1940s but no decisions were reached until 1970, when rule § 12 was amended to read that “a member

of the supervisory council is required to resign if he is appointed a member of the Council of State (i.e. government).²⁸³ The unwritten rule on recusal was also tightened, as shown by the case of Kusti Eskola. In the mid-1960s Eskola was both chairman of the council and head of the board of OKO, the Central Bank of Cooperative Banks. This dual role became a matter of concern after OKO became, in effect, a ward of the Bank of Finland. Eskola finally stood aside when a new supervisory council was formed in 1967.

TOWARDS A LARGER MONETARY UNIT

Soon after the clipping of banknotes at the start of 1946, the Bank of Finland raised the question of a larger national unit of currency because, when the value of money plunged, banknotes with an impractically large nominal value had had to be issued. The largest, issued in 1955, had been the 10 000 markkaa banknote, with a violet shade and a portrait of J. V. Snellman that came to symbolise the Finnish currency for a long time.

The matter of a new monetary unit was first raised in the supervisory council in June 1946, when the decision was taken to begin planning for a new banknote series. This was expected to take several years so there was still no need for decisions about a larger monetary unit. A competition was arranged for the new banknotes after which the renowned artist and sculptor, Tapio Wirkkala, began to design them in 1947. The council approved Wirkkala's proposals at the start of 1949 and the notes were actually issued before the currency unit was changed. In line with the council's proposal, the portrait on the largest, 10,000 markkaa, banknote would, as before, be J. V. Snellman; on the second largest, 5,000 markkaa, note former president K. J. Ståhlberg; and on the third largest, 1,000 markkaa, note president J. K. Paasikivi.²⁸⁴

The next step undertaken by the board of the Bank of Finland was to establish a committee to draw up a proposal on reforming the monetary system. The general director of the central bank of savings banks, K. J. Kalliala was appointed its chairman. The bank's representative on the committee was board member Kaaperi Kivialho. The committee completed its report at the end of the year. Its attitude to past economic policies was fairly negative: "In the years since the war a frequent characteristic of the government's economic policy was the effort to

overcome various difficulties via the path of least resistance. It is important in current conditions that stabilisation of the value of money should be adopted as the most important aim of economic policy and that this aspect should be considered in everything that is done. It is among the first preconditions for stabilising the domestic value of the markka that public finances be rebalanced sufficiently that the financing of the government by the printing press can finally be terminated.”

At the time that the report was written, domestic and foreign conditions were both so uncertain that there were no prospects for overall stabilisation but the committee hoped it could be done within 6–8 years at the latest. It felt that a decision on moving to a larger unit of currency should be taken as soon as possible but not before parliament and the government were clearly committed to ending inflation. Regarding the size of the new monetary unit, the committee had no hesitation in recommending that its value should be 100 times the value of the old markka, meaning the elimination of two zeros from all monetary magnitudes. It also felt that to avoid confusion and misunderstanding the name of the monetary unit should be changed. It had some national suggestions – auri, fenno, pirkka, raho, sampo, sata, silva, soli, suomo, suure, voltti – and some that followed international traditions in proposing Finnish versions of crown, pound, dollar and great mark. In the board of management, too, there was lively discussion about the name of the new monetary unit, most members favouring “riksi”, which was easy to pronounce and had an honourable place in Finnish monetary history right back to the riksdalers minted in the times of King Gustav Wasa of Sweden. For the monetary subunit, formerly “penni”, the board recommended “markka”²⁸⁵

When it forwarded the matter to the supervisory council at the start of 1951, the board commented that conditions were still too unstable to initiate a currency reform, but felt that a final decision on the name of the new monetary unit might now be made. The board’s suggestion of the “riksi” was unpopular and the matter made no progress.²⁸⁶ In autumn of the following year the board proposed the matter again but the supervisory council sent it back for further preparation. Now there was disagreement not only on the name but about the need for the whole reform. In this situation the board

thought it best to suspend the whole project. To solve the problems of a shrunken monetary unit, the council merely decided to introduce a new 10 000 markkaa banknote.²⁸⁷

The impasse in the monetary reform, sometimes in the banking council, sometimes in the board of management, was not due to a struggle between these two bodies but to the premises of the committee that had planned the reform. It had to be part of a programme to stabilise the whole economy, which could not be undertaken without the commitment of all the main parties to economic policy making. In the early 1950's the board of the Bank of Finland, at least, was unconvinced about the degree of commitment of parliament and the government. It also realised that moving to a new monetary unit required modernisation of the whole Currency Act, for which it was not yet ready. The advocates of monetary reform still trusted in the old quantity theory of money with its direct link between the quantity of money and inflation. At the same time they grasped the complexity of the situation, which could not be resolved merely by reducing the money supply.

MONETARY REFORM IMPLEMENTED

By the start of the 1960s the conditions for monetary reform were starting to be right both at home and abroad. Wartime rationing had been dismantled by 1956 although in a few sectors, such as rents and finance, regulations continued to be very onerous. After the devaluation of 1957, the markka had become a convertible currency and the strict licensing system of imports had been radically dismantled. Inflation as shown by the cost of living index had become rather moderate. France's example provided an extra encouragement for monetary reform. In the years after the Second World War the French franc and the Finnish markka had depreciated in the same way. At the start of 1960 France introduced a new franc equivalent to 100 old francs. The Soviet Union had also adopted a new rouble, equal to 10 old roubles. By the start of the 1960s Finland's monetary unit was one of the least valuable in Europe. Only Italy and Yugoslavia had such tiny monetary units that no separate subunit was needed. The board of management of the Bank of Finland felt that the time was now right to complete a reform that had not advanced since the early 1950s. The Currency Act would be revised at the same time.²⁸⁸



■ The 10,000-markkaa banknote designed by Tapio Wirkkala had the highest denomination of any issued in Finland. The portrait on the note, part of the 1955 banknote series, was of J. V. Snellman.

– Bank of Finland.

TAPIO WIRKKALA (1915–1985) AND FINNISH BANKNOTES

In 1946 the board of management presented a memorandum to the supervisory council on modernising Finland's banknotes. The council accordingly announced a competition in November 1946 for the design of a new banknote series. Two sets of proposals from Tapio Wirkkala, a renowned artist and industrial designer, stood out above the other entries to the competition and in 1949 they were approved as models for the new banknotes. At the same time it was agreed that the highest-denomination banknote would display a portrait of the 19th century statesman J. V. Snellman, the second-highest would show Finland's first president K. J. Ståhlberg and the third the current president J. K. Paasikivi. The themes of the two smallest banknotes were as chosen by Wirkkala: twigs of pine and ears of corn. The series as a whole reflected the artistic ethos of era, aspiring towards extreme simplicity and asceticism.

The banknote reform took place at the time when a larger monetary unit was being planned. It was determined however that it could not be implemented until the raging inflation of the 1940s had been overcome, and this was not expected happen for another 6–8 years. Because new banknotes were already needed, it was decided to introduce the new banknote series in autumn 1955, before the change in currency unit. The denominations of the new notes were fixed as 10,000, 5,000, 1,000, 500 and 100 markkaa.

The public response to Wirkkala's banknote series was fairly disdainful.

People were being used to being able to tell the value of a banknote from its size and thought that the uniformity of the new notes made them impractical. They were also regarded as bland in colour and difficult to distinguish from each other. The Bank of Finland took the criticism to heart and changed the colouring of the notes in the years ahead. At the time of the monetary reform of 1963 (elimination of two zeroes) and afterwards, more changes were made. The banknotes gradually drifted rather a long way from Tapio Wirkkala's original elegant vision.

Wirkkala's banknotes did not finally disappear until an entirely new series was issued in 1986. The crucial impetus came from advances in colour copying machines, which made it necessary to incorporate new security features in banknotes. The design of the new series was entrusted to Erik Bruun, Torsten Ekström and Pentti Rahikainen. The motifs of the new banknotes were personalities from Finnish history from the 18th century to the present day. The period of Swedish rule was represented by the philosopher Anders Chydenius, the early part of the Grand Duchy by the philologist Elias Lönnroth and the latter part by composer Jean Sibelius. Of the era of independence, the Olympic athlete Paavo Nurmi was to symbolise the early years and the architect Alvar Aalto the later period. When a new 20-markkaa note was issued in 1993, it displayed the author Väinö Linna. This series was to be Finland's last: euro banknotes replaced it at the start of 2002.

The inner supervisory council discussed the board's proposal for a new monetary unit on 26 April 1961. The main theme of the proposal was that all currency legislation should be reformed, as explained above. The change in monetary unit was therefore linked to the reforms contained in the new currency act, regarding how the value of the markka would be set and how authority over exchange rate policy would be divided. After the debate of the early 1950s, the board had dropped the idea of changing the name of the currency; one new markka would be worth 100 old ones and one new penni would be the same as one old markka. Although the new markka was thought to be an unusually large unit of currency (then worth about 31 U.S. cents), the board foresaw no practical difficulties with it.

The changeover to new banknotes would be straightforward because the existing banknote designs could easily be altered. In the new series the largest note would be 100 markkaa, compared with 10,000 before the reform. Issue of the new banknotes would begin from the day the reform took effect but old notes would continue to be legal tender with a nominal value of one hundredth of their previous value. There would be no need to clip old notes, which would be withdrawn from circulation as they returned to the bank.

The board proposed the enactment of a separate law for contracts, court decisions, tariffs, etc., made before the reform, in which it would be practically impossible to revise monetary amounts individually. It would be decreed that all monetary sums determined and agreed before the reform, and all stamps for posts, taxes, etc. issued before the reform, would remain valid afterwards at a value that was one hundredth of the stated nominal value. The law would also state that prices, wages, tariffs, etc., were to be converted into the new monetary unit at the exact rate of 100:1 and that the use of any other conversion rate would be unlawful. The reform would also confirm the "international reference value" – equivalent to the par value agreed by the IMF – of the markka, 0.277771 grams of fine gold.²⁸⁹

Following the debate the inner supervisory council informed the full council that it approved the principle of a general plan for monetary reform. Next the matter was to be debated in the full banking council. The debate took place on 5 September 1961, and only a few small amendments were made, mostly of a formal nature, before the board's proposal was sent to the government. After this

the plans advanced on schedule and the reform was implemented on 1 January 1963.

Preparations had been made in good time and the issue of new banknotes went well. The parallel existence of two currencies did not cause inordinate problems for the public and by the end of 1963 only 3.1 percent of the old banknotes were still in circulation. The old notes had been withdrawn without special measures and the situation was normalised fairly rapidly.²⁹⁰ Admittedly the general public still talked for years about “old markkaa” or “new markkaa”. Especially where large purchases were concerned, prices were commonly expressed in old markka. Naturally the rate of 1:100 made the conversion easy.²⁹¹

INDEXING IN BANKING

PROTECTING DEPOSITORS FROM INFLATION

One of the most peculiar features of the Finnish money market in the 1950s and 1960s was the widespread use of index-linking for bank deposits and indirectly for bank lending, too. The idea was to protect the wealth of depositors from inflation and thus to promote saving. The system constituted an option offered to depositors. Alongside ordinary unindexed deposit accounts, the banks offered indexed accounts, which were time deposits where the capital sum was tied to the cost of living index. When depositors withdrew their funds they received either full compensation for inflation (A-accounts) or 50 percent compensation (B-accounts).

At the time when the index system was adopted, it was exceptional by international standards. According to Jussi Linnamo's study in 1958, index clauses had been applied to bank deposits in only a few countries and in a very limited way (he mentions Iceland, Israel and France). Index-linking was somewhat more common for bonds but its widespread use in bank borrowing and lending was apparently a Finnish speciality.²⁹²

The index system in Finland's financial market had its roots in the period after the Second World War, when the government distributed Indemnity Bonds to those who had lost property in the parts of Karelia that were ceded to the Soviet Union. The 1950s saw a growing use of indexing with government bonds and ultimately most government

borrowing contained an index clause. At the same time, the National Pension Fund began to apply partial indexing to its lending. Indexing had become familiar to the general public via the index-linking of wages which, in a variety of forms, was prevalent almost without interruption from 1942 until the end of the 1950s and again from 1964.²⁹³

The Joint Council of Credit Institutions, the body overseeing the interest rate cartel of banks, discussed whether to implement indexing in banking from 1950 onwards. A notable advocate was the general director of the Nordic Union Bank, Rainer von Fieandt, who regarded the protection of savers during times of rapid inflation as an important matter of principle. Inflation soared in 1950, and the implementation of indexing was seen as an alternative to raising interest rates. The Bank of Finland was initially interested in the indexing alternative but ultimately decided to oppose it and began to implement monetary policy based on flexible interest rates instead. When the Joint Council of Credit Institutions asked the Bank of Finland's economic research institute, in May 1950, for its views on how the adoption of indexing "would affect the value of money and the national economy", the institute's reply was not particularly encouraging.²⁹⁴ In autumn the banks and then the Bank of Finland raised interest rates by a dramatic two percentage points.

THE FIRST PHASE OF INDEXING

The situation changed when the government and various interest groups agreed on the momentous stabilisation pact of autumn 1951. Part of the pact was a major interest rate cut. Flexible interest rates had now become politically impossible, which revived interest in indexing among banking circles. By October, soon after the stabilisation pact had been agreed, the Joint Council of Credit Institutions set up a working group to consider the technical ramifications of indexing.²⁹⁵ However, little progress was made, certainly in part because the stabilisation pact halted inflation for many years. After the government had begun apply index clauses to bonds for ordinary investors, the banks understandably became keener on index-linked deposit accounts. Within the banking community, the Savings Banks Association was particularly active and recommended index clauses to its members in March 1955.²⁹⁶

Soon afterwards, the Joint Council of Credit Institutions recommended the introduction of indexed deposit accounts in all financial institutions from the start of May 1955. The attitude of the Bank of Finland was no longer a deterrent because Rainer von Fieandt, a longstanding advocate of indexing in banking, had been appointed governor in February. Before moving to the Bank of Finland, von Fieandt had served for several years as chairman of the Joint Council where he had argued for indexing, against the reluctance of the majority of members.²⁹⁷

In line with the new recommendations of their cartel organization, banks now began to accept indexed deposits but the popularity of indexed accounts remained negligible in 1955. The indexed accounts offered to the public from May 1955 onwards were 100 percent index-linked, offering full protection from inflation. When depositors withdrew their funds, they received compensation for every increase of a two full percentage points in the cost of living index.

A study by Matti Ranki quotes four main reasons why indexing spread into banking. By the early 1950s, indexing was used in all sectors of the economy apart from banking. The value of money had fallen and there was no confidence that the government would be able to combat inflation in the future. The government itself had begun to issue index-linked bonds. Finally, the general interest rate level was at a low level, pushed down by official edict, and held below the level that would have reflected the real state of the financial market.²⁹⁸

The commercial banks stopped accepting indexed deposits at the start of 1956 because of low demand for them. This decision proved to be a mistake, because in 1956 demand rose to its highest level for a long time and the indexed accounts marketed by the savings banks and the cooperative credit societies began to attract a lot of funds. The commercial banks returned to the indexed deposit account market in December 1956. From then onwards all banks offered their customers index-linked accounts as an alternative to conventional deposit accounts. During 1957 the volume of indexed deposits rose steeply and by the end of the year accounted for about a quarter of all bank deposits by the public.

Because of raging inflation in 1957 and 1958, the index system became a very important source of protection for depositors and

a major item of cost for borrowers. The compensation paid to depositors – in addition to the interest on their deposits – was as much as 10–12% for A-accounts in 1957 and averaged about 7% the following year. The banks passed on the cost of compensation to borrowers with what was called an index surcharge. For example in 1957 the commercial banks charged extra interest of one percentage point on all lending, on top of their normal rate of interest. At the savings banks and commercial credit societies, the index surcharge was 1.9–2.0 percent in 1957. The following year the surcharge became negligible as inflation slowed down.

STAGE TWO OF THE INDEXING SYSTEM

The first period of indexed account popularity ended when inflation was brought under control in 1958. At the start of 1959, the banks stopped accepting deposits on 100% index-linked A-accounts, in line with a decision by the Joint Council of Credit Institutions in November 1958. The organization noted that the value of money had stabilised and that new contracts of employment had no index clause.²⁹⁹ After A-accounts had disappeared from the market, the popularity of indexed accounts collapsed and by the end of 1959 they held only a few percent of all bank deposits. Indexed accounts were not to have any real economic significance again before 1964.

The second golden age of indexed accounts was as brief as the first. After a hiatus of several years, inflation soared in 1964. The banks had already begun to market fully inflation-proof accounts in 1963 and, when inflation topped 10 percent in spring 1964, demand for indexed accounts took off. Over the year, the volume of indexed deposits rose by a factor of more than four and the growth continued in the years ahead. By 1965 they accounted for 18 percent of all bank deposits by the public and, in spring 1968, when the index system was discontinued, indexed accounts held 38 percent of all bank deposits. In both periods of peak popularity 1957–1958 and 1965–1968, far more funds were in A-accounts than B-accounts.

Index linking in the financial markets was dismantled as part of the nationwide incomes settlement agreed on 27 March 1968, known as the Liinamaa Agreement after Keijo Liinamaa, a labour market

conciliator. The agreement included the termination of all index linkage; in return for renouncing index-linked wages, labour unions had insisted on the same for capital income in the financial markets. Governor Mauno Koivisto of the Bank of Finland met with bank representatives in February 1968 and recommended that they cease accepting indexed deposits. The Joint Council of Credit Institutions concurred and the banks stopped at the start of April 1968. The use of indexed clauses in wage agreements, in the financial market and in various other contracts, was forbidden by law in spring 1968. A year later, the last indexed deposits had been repaid and eliminated from bank balance sheets.

During the second peak period of index linkage 1964–68, it sometimes had a significant effect on the real interest rates on bank deposits and loans. In the second half of 1964, 10% compensation was added to capital on deposit in fully indexed A-accounts; in 1968 average compensation for inflation was 8%. In the spring of 1968, for example, when over a third of the stock of deposits was in indexed accounts, the index system had indisputable economic importance for the banks and their customers. In 1967 the commercial banks charged borrowers an index surcharge of one percentage point. In the savings banks and cooperative credit societies, where more indexed deposits were held, the index surcharge was higher: 1.75% in the savings banks and 2.5% in the cooperative credit societies. Index surcharges peaked in the spring of 1968, just before the index system was discontinued. At that time, borrowers were paying a surcharge of 2% at commercial banks, 3½% at savings banks and a huge 4% at cooperative credit societies. On the other hand for most of its existence, the index system had less impact on interest rates. At the start of the 1960s, when inflation was slow and there were few indexed deposits, indexed compensation and index surcharges were negligible.

Although the period constitutes an interesting episode in the history of Finnish banking, the index-linking of deposits and loans apparently had little impact on monetary policy. They mattered only during two fairly short periods, 1956–59 and 1964–68. Perhaps the greatest significance of the index system was that it protected banking from large-scale disintermediation – the transfer of funds outside the banking system when inflation was exceptionally high – for several years in the 1950s and 1960s. In this way the indexing

system helped to support the structure of the financial market, based on official interest rate controls, that prevailed after the 1951 stabilisation pact.

FROM DEVALUATION TO DEVALUATION: MONETARY POLICY WITH A CONVERTIBLE MARKKA

THE 1962 INTEREST RATE WAR

The dismantling of import controls at the end of the 1950s and the restoration of external convertibility after two decades of exchange controls were major steps towards efficiency and competition in the Finnish economy. However the end of import regulation was a challenge for monetary policy and the Bank of Finland. There could be no more resort to quantitative limits on imports in order to protect the external liquidity of the country – the adequacy of the nation's foreign currency reserves. Keeping international payments in balance now depended on preventing excessive growth of domestic demand and safeguarding the international competitiveness of exports. In fact, for more than three decades after import deregulation, the balance of payments was the overriding consideration in monetary policy and the principal factor that determined shifts in its direction.

The end of import controls could therefore be said to represent a step towards the monetary conditions of the gold standard era. Under gold, monetary policy was practically always directed by the balance of payments. While it is true that even import controls had not been very effective in ensuring an equilibrium in the balance of payments, now controls were almost out of the question. The remaining main ways to look after external liquidity were either to change interest

rates, which was politically difficult as the monetary history of the 1960s shows, or to use the special tools of the Bank of Finland for regulating the central bank refinancing of private banks. Ultimately, if monetary or other economic policies failed to maintain an equilibrium in the balance of payments, a “fundamental disequilibrium” would have to be corrected by an exchange rate adjustment – devaluation. Perhaps the most important theme of monetary policy in the 1960s is how Finland ended up in the great devaluation of 1967.

The disruption of external equilibrium of Finland during the 1960s can be explained, depending on the perspective, either by excessive inflation and rising costs, or by investment in excess of the savings rate, or by a combination of these. Whichever of the explanations is accepted, monetary policy must bear at least part of the blame for the accumulating problems, because both the control of inflation and regulation of investment demand are generally regarded as responsibilities of monetary policy.

In the first few years after the 1957 devaluation, monetary conditions seemed straightforward. A recession began in 1957 and continued until spring 1959. At the same time inflation gradually came to a halt and the currency reserves of the Bank of Finland increased. Under these circumstances, it seemed warranted to support growth and employment by easy monetary policy. As the slump continued, the new central bank governor, Klaus Waris, began actively to adjust interest rates and their level was lowered twice at the end of the 1950s.

Rates were first cut in October 1958. At the same time the system for rediscounting bills of exchange was changed slightly, and a unified Bank of Finland rediscount rate was introduced. Previously, when the Bank of Finland had granted rediscount credit to a commercial bank, it had charged a rate related to the rate that the bank in question had charged its own customer when the bill of exchange had first been discounted. Now this linkage was eliminated. The Bank of Finland’s rediscount rate was set at 7¼ percent, which was three-quarters of a percentage point less than the rate most commonly applied hitherto. However, the rediscount rate could be higher if the commercial bank in question was paying a penalty surcharge, the tool used by the Bank of Finland for regulating the central bank debt of each commercial bank. At the same time as rediscount rates were harmonised and the Bank of Finland’s interest rates were lowered, the highest permitted

lending rates for private banks were lowered by $\frac{3}{4}$ of a percentage point.³⁰⁰

As the recession continued into the spring of 1959, monetary easing remained on the agenda. In February the board of management asked the supervisory council to authorise a new rate cut of half a percentage point. It argued that the cut was justified by growing unemployment and the stabilisation of the price level, adding that Finland's interest rates were high by international standards. The council approved the recommendation and decided to reduce the bank's lowest discount rate to $6\frac{3}{4}$ percent with effect from 1 April 1959. A corresponding cut was made at the same time in general interest rates; the highest permitted lending rate by private banks was now only 7 percent.³⁰¹

The rate cuts of 1958 and 1959 had taken place without major disagreement but things became very different when conditions called for interest rates to be increased. Soon after the rate cut of spring 1959, the economy began to recover and the upswing reached its peak in 1961. Despite fast economic growth, inflation initially remained very low, but the Bank of Finland was concerned that the economy might be destabilized by the rise in government spending and particularly the budget deficit, and in November the board sent a letter on the matter to the Finance ministry. In December it became clear that parliament was raising the budget deficit for 1962 to a level even higher than in the government's budget proposal, so the Bank of Finland asked the supervisory council to agree to a general increase in interest rates by one percentage point. It also wanted to raise the bank's rediscount rate slightly more, from $6\frac{3}{4}$ percent to 8 percent. Its rationale was that the rising government deficit created a danger of inflation. Although the proposed hike in interest rates would reduce private investment, it thought that "this alternative is better than wilfully surrendering to inflation, which would be the consequence if public and private sector demand were allowed to exceed our economic resources".³⁰²

The majority on the supervisory council, including its chairman Kusti Eskola, did not agree, and the proposal for higher interest rates was rejected in a council meeting on 20 December 1961. In his closing speech Waris said that "it remains to be seen how long the situation can be managed in this way".³⁰³ The negative attitude of the council may possibly have been influenced by the proximity of elections; higher borrowing rates would have been an unpopular measure that could



■ Bank of Finland director Reino Rossi (at left) and plenipotentiary Olavi Munkki at Seutula airport on 13 January 1960, bound for an EFTA meeting in Paris.
- Lehtikuva news photo archives / Holger Eklund.

have affected the election outcome. Elections to parliament were held on 4–5 February 1962 and a new supervisory council was appointed on 13 March. Kusti Eskola continued to chair it but Väinö Tanner was no longer a member of parliament or the council. The elections were followed by fairly protracted negotiations on forming a new government, which lasted six weeks.

On 28 March, when the new council had been elected but government negotiations were not yet concluded, Klaus Waris presented the council with a report in which he repeated the proposal, rejected in December, for a rise in general interest rates by one percentage point. The need for higher rates had become still more compelling, the report said. Aggregate demand had grown too strongly and had largely been directed to imports, with the consequence that the balance of payments deficit had increased. The proposal evidently took the supervisory council by surprise because it suspended its meeting so that the inner council could debate the matter. The outcome was that the decision was postponed to the following day, when it was approved in a vote. Although the socialist representatives voted against it, the majority of the council agreed to a rate hike, subject to the provision that a statement would be added to their decision in which the (next) government would be asked to take action to curb inflation. The possible methods mentioned in this appendix were price controls, lower customs duties and avoidance of “inflationary methods” of financing the budget.³⁰⁴

Thus the Bank of Finland’s rediscount rate was raised to 8 percent on the following day, 30 March. However, before other banks had time to pass on this increase in their own lending and deposit rates, events took an unexpected turn. A new government was sworn in on 13 April, headed by Ahti Karjalainen. The new Prime minister was a board member of the Bank of Finland, although he had been on leave of absence since 1959 because of ministerial duties. The government depended on the support of the political right and centre, and contained ministers from Karjalainen’s Agrarian League, the National Coalition Party, the liberal Finnish People’s Party and the Swedish People’s Party. But although the parties of the left were in opposition, the government remarkably contained three ministers who represented the SAK central organisation of labour unions. On the subject of monetary policy, the government programme stated that “the government will strive for a consensus with

the Bank of Finland so as to be able to pursue a production policy that ensures full employment. The government calls for action to reduce interest rates at the first opportunity.”³⁰⁵

At a meeting of the inner supervisory council on 27 April, prior to a meeting of the full council, chairman Eskola asked the board of management to make a new proposal on interest rates. The board did as requested but its proposal did not include a rate cut. On the contrary, it noted that the reasons why interest rates had been raised a month earlier still existed and stated that it was therefore inappropriate to reverse the previous decision. Opinions were divided at the subsequent meeting of the full council but the majority were in favour of reducing the Bank of Finland’s interest rates in defiance of the board’s proposal. It was argued that lower rates were part of the new government’s programme and that a parliamentary majority was opposed to higher rates.

The most strident opponent to a rate cut was council member Grels Teir, representing the Swedish People’s Party, as the following excerpt from his statement shows. “After the decision (to raise rates) was taken, political groups have intervened and demanded that it be overturned. It is clear that if we do not resist the trend for political groups to decide on matters and choose the tone of monetary policy, and in this manner, we have no reason to be sitting here. We should put all politics and philosophies aside; it is our duty to handle matters only with regard to monetary policy. I for one see no new circumstances that require a change in the line on interest rates.”³⁰⁶

Teir’s stand represented the viewpoint that the supervisory council was an independent organ of the Bank of Finland which, even if it were chosen by parliament, should not take instructions from parliament or the government. A few years prior to the 1962 “interest rate war”, the prominent lawyer and Parliamentary ombudsman Paavo Kastari had analysed the question in his classical work of jurisprudence “The Special Position of the Bank of Finland in the Machinery of State” (1955). Kastari had concluded that parliament could not give legally binding instructions to the supervisory council or other bodies of the Bank of Finland in any individual cases apart from the question of how the bank’s profits were to be used. On the other hand, he conceded that parliament had significant influence over the bank, as exemplified by the fact that it supervised the bank’s operations.³⁰⁷

The Bank of Finland rediscount rate was cut to 6 percent with effect from 2 April. Measured in terms of its immediate impact, the whole business of first raising rates and then cancelling the decision after a few weeks did not ultimately matter much. After the rate cut, the lending and borrowing rates of private banks could remain at the level to which they had fallen in 1959. The only concrete difference since the start of 1962 was that the Bank of Finland's rediscount rate (which served as the basis for the scale of interest charges on central bank lending to private banks) was a quarter of a percentage point higher. However, the longer term political consequences of this series of events were significant and enduring.

The council dispute of spring 1962 about the direction of interest rates policies, which the board of management and particularly the governor lost, cast a long shadow on central bank monetary policy. It tended to cement the situation, created in the 1951 stabilisation agreement, in which Finland's general interest rate level was set by administrative fiat and was not a price that reflected market conditions. It was not even an instrument for counter-cyclical policies but merely a cost factor with mainly social implications, related to the pricing of goods and the distribution of income. For governor Waris the whole operation was obviously demeaning and frustrating. After the spring 1962 episode, he regarded flexible interest rates as impossible and, in his long term as governor, made no further proposals to change interest rates. So, the general level of interest rates in Finland was completely frozen for more than a decade from 1959 until 1971, when Waris' successor, governor Mauno Koivisto, began to reactivate interest rates and implemented the next rate hike.

LOSING BALANCE

The boom, which had strained productive capacity to its limits, subsided in 1962, but inflation picked up to around 6 percent and stayed at roughly this level in the following year, despite government price controls. In summer 1963 the government asked governor Waris for a proposal on how to stabilise the price level. The programme he offered, dubbed the W Plan, included budget cuts, price and wage controls and compulsory deposits. It was never implemented but the dispute it caused led to a government crisis at the end of August, when all three

SAK ministers resigned over the W Plan's agricultural incomes section, which would have raised food prices. The Karjalainen government continued almost to the year's end, however. It was succeeded briefly by a caretaker administration under Reino Lehto, which was in office until September 1964, when a government was formed by the Centre Party (the Agrarian League's new name) and the National Coalition Party, under Johannes Virolainen.³⁰⁸

An economic upswing that began in late 1963 gathered strength in 1964 and continued until 1965. This time the growth of demand distinctly "exceeded our economic resources", to use Waris' phrase from 1961. The boom created an exceptional rapid growth of demand for imports. For example the volume of imports rose 19% in 1964 which, as the Finance ministry's economic review noted, was almost four times more than the rise in exports at the same time.³⁰⁹ Inevitably the balance of payments deficit widened. In 1964, though, the gap was covered by capital imports so that the currency reserves actually grew despite the trade deficit.

In 1965 international capital markets became distinctly tighter and it proved harder to place Finnish bonds abroad than in the previous year. At the same time Finnish exports were hit by a deterioration of foreign markets, particularly Britain, where economic policies were being tightened because of the United Kingdom's own balance of payments problems. The Bank of Finland's currency reserves fell noticeably in early 1965. At the start of April the bank approached the government with a proposal for joint action to improve the balance of payments. In May 1965 the government agreed its own package of measures, targeted largely at imports of consumer durables. Among other things, motor vehicle tax was raised and regulations on the terms of hire purchase credit were tightened.

For its part, the Bank of Finland issued new, tighter credit guidelines to the banks at the end of April 1965. They were targeted mainly at import financing, hire purchase and consumer credit. At the same time quantitative limits were set on the growth of bank lending. From the start of the year to the end of May lending was not to grow by more than 9%. As an incentive, banks would be repaid their penalty charges on central bank debt if they stayed within the limits. Incidentally, similar restrictions on the growth of bank lending in the form of credit ceilings were issued at the same time

■ Klaus Waris was governor of the Bank of Finland in 1957–1967, a period of rapid economic growth and development following post-war reconstruction.

– Finnish Press Agency/
Mirjam Salomaa.



KLAUS WARIS (1914–1994)

Klaus Waris was governor of the Bank of Finland at a time of rapid transformation of the Finnish economy. The population urbanised, the share of agriculture in the economy shrank rapidly and import controls gave way to free trade. Waris was himself active in advocating and promoting these changes.

He had studied economics at the University of Turku (when the family name was still Warén). After graduating in 1935 he worked for the Nordic Union Bank and began postgraduate studies. He was a founder of the Economics Club, a band of young economists with whom he became acquainted with the recently published *General Theory* of John Maynard Keynes. Waris was a pioneer of Keynesian economics in Finland. This was evident from his dissertation, completed in 1945, which dealt with Finnish private consumption and saving in the 1920s and 1930s from a macroeconomic perspective.

He headed the economics department at the Finance ministry from 1946 to 1949, when he became a professor at Helsinki University of Technology and subsequently a member of the board of the Nordic Union Bank. He was appointed to the board of management of the Bank of Finland in 1952, initially as an acting member when Urho Kekkonen took leave of absence to serve in the government. Waris became a permanent member of the board two years later. In 1957, when Rainer von Fieandt resigned, he was appointed governor.

Klaus Waris was not a politician but a professional economist. He remained fairly aloof from the supervisory council, which may be why he failed to convince the council of the need for interest rate flexibility. In 1962 the council humbled him by annulling an increase in interest rates that he had just pushed through. He did not try a second time, and the general level of interest rates in Finland was not increased once during his ten-year term as governor. Monetary policy was forced to rely on indirect methods of controlling bank lending. These proved to be inadequate to maintain economic equilibrium, and another devaluation lay ahead in 1967.

Waris was especially interested in development finance. During his term the Bank of Finland backed many projects to develop industry and diversify exports. One of his achievements in this area was Sitra, a fund to promote innovation, established by the Bank of Finland in 1967 to mark half a century of Finnish independence.

After resigning soon after the 1967 devaluation, Waris became chancellor of the Helsinki School of Economics, a post he filled until 1980. At the same time he worked for a few years as the first director general of Sitra and as managing director of the Mortgage Bank of Finland. He was also active in public debate and became known as an advocate of social consensus and the market economy.

in the United States. In Finland the system had to be kept in force for more than two years because the foreign currency situation remained difficult. In September 1965 the Bank of Finland announced a new target period for growth of lending, stretching from November 1965 to April 1966. In spring 1966 restrictions on lending growth were continued first from May to October and finally from November 1966 to June 1967.

The objectives of these measures, begun in spring 1965, to rebalance the external accounts of the country were not achieved. Despite tight monetary policy the balance of payments remained in deficit in 1966 and 1967 and currency reserves continued their downward trend. Finland's first decade with a convertible markka and deregulated foreign trade was threatening to end in a currency crisis.

THE BRETTON WOODS SYSTEM UNDER PRESSURE

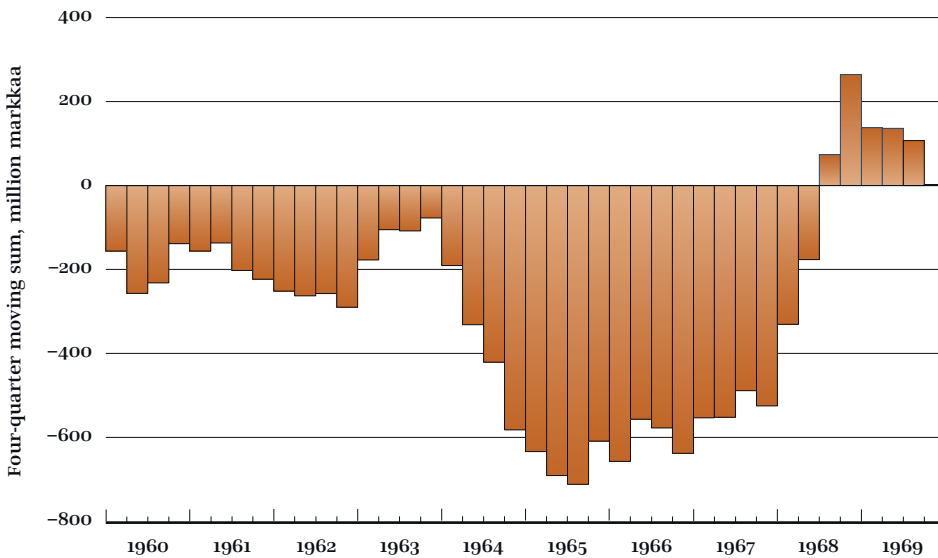
The 1960s were a testing time for the functionality of the Bretton Woods system. It was not until the start of the decade that the international currency system was finally in the shape envisaged when it was planned in 1944. The last step came in 1958, when the currencies of Europe – including Finland's markka – were made convertible against the US dollar. However soon afterwards it became clear that the structure was very vulnerable and Finland was far from being the only country that ran into worsening balance of payments problems in the course of the 1960s.

Seen from an international perspective, the functionality and stability of the Bretton Woods system hinged on two factors. On the one hand, the United States had to fulfil the role of providing the international reserve currency and, on the other, other countries had to keep their international payments in sustainable, long-term balance, either by regulating demand or, if all else failed, by changing their exchange rates. As the 1960s advanced, it became clear that the preconditions for stability were unobtainable. To make the system work would have required closer international monetary coordination than had been anticipated. Instead, national goals and political considerations prevailed over any loyalty to the international currency system.³¹⁰ As early as 1959, the Belgian-American economist Professor

Robert Triffin of Yale University had judged the Bretton Woods system to be dangerously unstable because the United States would be unable to meet growing world demand for reserves nor to maintain dollar convertibility against gold.³¹¹

The international gold market, which operated in practice from London, constituted one source on instability for foreign exchange flows. The gold market was a meeting place for gold producers, national central banks, and manufacturers who needed gold for their own production. Upward price pressure in the gold market during the 1960s threatened to raise the price of gold above the level set by US law of 35 dollars per ounce. While the price of gold was rising, the United States was compelled to sell gold from its reserves to support the dollar's official parity. This was dangerous because uncertainty about the adequacy of US gold reserves would undermine the foundations of the Bretton Woods system. To stabilise the gold market, eight major central banks established the London

FINLAND'S CURRENT ACCOUNT 1960-1969



Adjusted for 1963 monetary reform.
Source: Bank of Finland.

Gold Pool in 1961, an agreement that was fairly successful in fixing the price of gold for several years.

One reason for upward pressure on the gold price in the 1960s was that the dollar shortage, which had afflicted the world long after the Second World War, turned into a dollar flood as the US balance of payments deteriorated. Underlying the payments deficit was initially an outflow of capital as Americans invested abroad, and then also an increase in US military expenditure, on the Vietnam War among other things. Finally a deficit emerged on the US current account, too. As its balance of payments deteriorated, the dollar fell from grace and, despite the existence of the London Gold Pool, US gold reserves dwindled alarmingly during the 1960s.³¹²

US authorities reacted by trying to stem the outflow of capital in various ways. In 1963, an interest equalisation tax was imposed to penalise Americans investing in foreign markets by taxing their interest earnings from abroad. In 1965 the Federal Reserve imposed an upper limit – formally a voluntary one – on the growth of bank lending, including loans abroad. Initially the credit ceiling was five percent growth since 1964. This quantitative restriction on lending was later extended to 1966, when a new ceiling was set of nine percent growth since 1964.

It was serious for Finland that not merely the dollar but also the British pound – the foreign currency still most important for Finland – came under growing pressure during the 1960s. The problems can be said to have begun in 1964, when Britain's trade deficit suddenly widened, causing unrest in the foreign exchange market. The immediate reason for this deterioration was overheating of the economy caused by a boom the year before. In order the balance its international payments account, Britain was forced to tighten its economy, an example of the stop-go policies that became typical for countries suffering chronic payments problems under the fixed exchange rate system. Not only Britain but also France, Italy and Finland were typical European countries in this respect.

One of the measures used to tighten the British economy was a hike in the Bank of England's discount rate – what it called its bank rate. This was raised sharply from 5 percent to 7 percent in November 1964, but the increase did not solve the problem and Britain was compelled to take large-scale IMF loans to support the pound in the

second half of 1964 and for several years afterwards. The pound came under speculative pressure again in 1965 and 1966. Ultimately the government of Harold Wilson was forced to take extreme measures in summer 1966. Its tax increases and other restrictive policies helped for a while and monetary policy was eased, but this proved to be premature. In the following summer Britain's currency reserves began to dwindle again. Its application for membership of the EEC in May 1967 brought no relief, and the renewed bank rate hikes of the Bank of England in autumn 1967 provided no solution.

By the start of November 1967 Prime minister Wilson had begun to come round to the idea of a devaluation to remedy the situation. The decision was taken on 13 November and the pound was devalued by 14.3 percent on 18 November.

The British naturally hoped that their devaluation would not precipitate similar devaluations in the main countries of Europe, and they were fairly lucky; apart from Ireland and Cyprus, which were practically in monetary union with Britain at the time, the only other European countries to follow suit were Denmark, Iceland and Spain. The British devaluation was accompanied by new fiscal policy measures to control aggregate demand, and the Bank of England raised its bank rate to 8 percent. In the aftermath of these events, James Callaghan, the British Chancellor of the Exchequer, resigned at the end of November.³¹³

Britain's foreign exchange problems naturally had an impact on its trading partners. For Finland, the measures imposed in 1966 to tighten the British economy were particularly serious. They had a great impact on Finnish exports, Britain still being by far their most important market. It took about 21 percent of Finland's exports and provided an even larger proportion, about 26%, of the convertible currency earnings of the country. This was Britain's share of Finnish exports to "the west" excluding Finland's trade with the Soviet Union and other communist countries, with which it had bilateral payment agreements.

Because of the orientation of Finnish exports, there had been a fateful connection with the foreign exchange policies of Britain at least since 1925, when the pound's return to the gold standard had cleared the way for the markka to follow suit. Finland had again followed the British example in 1931, when the gold standard had been abandoned, and in 1949, when the pound was devalued. This interconnection

between the pound and the markka still existed in 1967, when both countries decided to solve their protracted balance of payments problems by devaluation. This time, however, the order was reversed, and Finland took the initiative based on its own situation, as explained below. It seems fairly certain, however, that if Finland had not devalued first in 1967, the same action would have been triggered by Britain's decision at the latest.

FINLAND TURNS TO THE IMF

Finnish elections held on 21 and 22 March 1966 produced a majority of socialist members in parliament for the first time since 1917. The new government was formed by the leader of the Social Democratic Party, Rafael Paasio. The general manager of Helsinki Workers' Savings Bank, Mauno Koivisto, became Finance minister. Ahti Karjalainen, a member of the board of the Bank of Finland, was Foreign minister. Another board member, Aarre Simonen, was Justice minister.

The new government faced a situation where Finland's external liquidity was extremely weak. The government's own cash situation at home was also poor and the Bank of Finland provided it with an exceptional loan of 300 million markkaa in December. Naturally the loan resulted in monetary easing, which was criticised by the International Monetary Fund in connection with its annual economic review of Finland at the start of the following year. The Bank of Finland replied that the loan was warranted because the budget drawn up in autumn 1966 had promised a significant improvement in public finances.

Amid ongoing deterioration in the currency situation, Finland turned to the IMF in early 1967 for a standby loan. The application was prepared after the regular economic review, in other words, the annual consultations under IMF article 14. These were originally planned for the end of 1966 but were postponed at Finland's request, and began on 10 January. The IMF delegation consisted of A. Pfeifer, A.C. Woodward, E. Holm and H. Gerhard. In his opening address, governor Klaus Waris said the main reason for the delay in consultations had been an acute crisis of public finances at the end of the previous year, when the Bank of Finland had been compelled by circumstances to grant the government a loan.



■ Motorists aspired to own a western car. Fashion on display at the Helsinki Motor Show in 1960.

- Lehtikuva news photo archives / Kalevi Pöyhönen.

Apart from the government's liquidity problem, Waris said, the other matter that had worried the bank in 1966 had been the excessively fast growth of bank lending. He attributed this to corporate demand for credit. Business had become less profitable and moreover forest industry companies had been compelled to finance amortisation payments to the World Bank with loans from domestic banks. Waris also mentioned the lack of cooperation received from the central institution of cooperative banks, OKO, but added that its senior management had been entirely replaced during 1966 and OKO was now genuinely cooperating with the Bank of Finland. He referred to Finland's tighter monetary policy since October and said he believed that the real credit squeeze was just beginning.

As for the future, Waris said that he saw no chance of GDP growth if the Bank of Finland were to achieve its credit objectives and if the government kept its promises of tough budget policies. In these circumstances, he continued, some members of government and other circles would prefer easier solutions, such as import controls and devaluation. However, he said, the Bank of Finland and the Finance ministry were adamant that easy solutions were out of the question and that the only option was to "advance along the narrow stony path that lies before us".

The governor underlined the bleakness of future prospects and took up his favourite theme, the diversification of Finnish exports. He predicted that the economy would continue slow, not just for the current year but also the year ahead, 1968. Planning the future was hard. The feedstock resources available to the forest industry did not permit its expansion. Instead Finland should begin to produce investment and consumer goods. Because this diversification of exports was still at an early stage, Finland's balance of payments problems would not soon be over.

On the other hand he expected the international payments situation to be improved by tight economic policies. The early year would be very difficult and the foreseeable decline in currency reserves threatened the credibility of the path chosen by Finland to adapt to its circumstances, meaning a fixed exchange rate and measures to curb aggregate demand. Standby credit from the IMF was needed to ride out the anticipated spring decline in currency reserves.³¹⁴

Consultations with the IMF ended on 21 January and by 2 February the government was discussing asking for standby credit. Governor Waris was present as an advisor. Finance minister Koivisto handed out a memorandum explaining Finland's request to the IMF for standby credit of 200 million markkaa in March. Together with the gold tranche of 100 million markkaa available to Finland at the IMF, the total credit facility would be equivalent to three quarters of Finland's quota in the Fund, which was 125 million dollars. Koivisto's memorandum also noted that the standby credit would be conditional on proposing a realistic and binding stabilisation programme.

The memorandum sketched out the part of the programme required that was related to public finances. Its monetary policy component would be the responsibility of the Bank of Finland. It would suffice, Koivisto felt, if the government affirmed the contents of fiscal policies "that had been observed in planning the 1967 budget proposal among other things, and which it intended to observe in the future". According to the memorandum "it is the aim of Finnish economic policy to halt the decline of currency reserves in a way that creates conditions for future economic growth at the same time (...) It aims to control the growth of domestic demand, to curb imports and to focus more resources on export promotion. The balancing of the public purse is central to this policy." The message of the memorandum was that the policies needed would be tough until at least 1968 but would be in line with the choices that the government had already made. The use of import quotas, proposed by the communists, was rejected.³¹⁵

Koivisto's memorandum was approved. A week after the government session, on 10 February, Klaus Waris sent an official letter of intent on behalf of the Finnish government to the managing director of the International Monetary Fund, requesting standby credit for a year of 93.75 million dollars. The letter laid out Finnish economic action designed to bring the current account into balance. The programme was based on tighter fiscal and monetary policies while meeting Finland's trade commitments, meaning the continuing deregulation of imports. It promised that the global quotas used in import licensing would be eliminated by the end of 1967, as agreed in the free trade agreement with EFTA. The last remaining bilateral payment agreement

with an IMF member country, France, would be terminated by the end of 1967. Finland would seek to restore balance to its payments account without import controls.

Regarding monetary policy the letter of intent included detailed objectives for how the Bank of Finland would restrict net domestic lending for a 12-month period from the start of March 1967. At the same time it stated that the bank would use of selective means and instructions (regarding bank lending policies) to protect the financing of sectors important for economic growth. The letter noted that the standby credit requested would be needed to finance the current account deficit and bolster confidence in the value of the markka until the restrictive economic policies proposed in the programme had taken effect.³¹⁶

The executive board of the International Monetary Fund discussed Finland's economic situation and its application for standby credit on 6 March. The IMF secretariat had made a statement in favour of Finland's request, and recommended the granting of standby credit for a year. Sums drawn down were to be repaid within three years. The executive directors approved the credit facility unanimously. Jorma Aranko, who was present at the meeting, reported that the discussions were "extremely favourable" and Finland's stabilisation programme was regarded as exemplary. Aranko was then a deputy member of the IMF's executive board. The executive director for the Nordic countries at the time was Torben Friis of Denmark.³¹⁷

The day after the decision, the Bank of Finland and the Finance ministry called a press conference in Helsinki to announce it. The government and the Bank of Finland were in full agreement on the matter, it was said, and standby credit would allow Finland enough time to balance its trade account without a devaluation. A statement by Finance minister Koivisto noted that "in turning for support to the International Monetary Fund, the government and the Bank of Finland have, at the same time, turned their backs on devaluation and quantitative restraints on importing" and that "the balance of payments problem is manageable and will be managed using fiscal, monetary and income policy measures, and within the framework of the responsibilities that we have accepted in international treaties."³¹⁸

The mere existence of standby credit was meant to inspire confidence in the Finnish markka, although it could also be used to

top up currency reserves if necessary. The first instalment, worth 100 million markkaa, was soon drawn down on 17 March, when the convertible currency reserves of the Bank of Finland had shrunk to an alarming 188 million markkaa, from 273 million at the start of the year. As reserves continued to dwindle in the weeks ahead, a second instalment of standby credit, 76 million markkaa, was taken on 19 April.

The balance of payments problem was apparently not disappearing. The main objective of monetary policy had long been import reduction but it seemed to be having a painfully slow effect. Finland was committed to abstain from the use of currency controls, although it came close to contravening its promise on 21 April, when the Bank of Finland greatly expanded the list of import types that had to be purchased with cash – that is, without accepting any credit from the seller. A large proportion of the goods imported from the West now had to be paid for at the moment they entered the country.

Customs trade figures indicated month by month that the deficit in early 1967 was going to be almost as great as the year before. The announcement by the British government that the UK was applying for membership of the European Economic Community did nothing to ease Finland worries. Although Britain's application was vetoed in the same year by the French leader Charles de Gaulle, its impact in the Nordic countries was significant. On 26 June, soon after the British announcement, Sweden sent the EEC a rather ambiguously worded request for talks about its inclusion in EEC expansion. For Finland, the situation was uncomfortable. Britain had traditionally been Finland's most important export market but a closer connection between Finland and the EEC was a difficult issue for Finnish foreign policy because of the suspicions of the Soviet Union.

The string of bad economic news continued. In late spring preliminary drafts became available on the medium-term assessment of the national economy until 1970. The picture was desolate. Prepared by the secretariat of the Economic Council under the leadership of Erkki Laatto, the report examined all the economic policy alternatives except devaluation. It was not published until the autumn, after the devaluation. Its calculations indicated that Finland was at an economic impasse: "In conclusion it can be noted that each of the economic

policy alternatives presented appears to lead to a situation unsustainable in some respect (...) The current account deficit cannot be reduced without rapid growth of exports.”³¹⁹

DEVALUATION LOOMS

By late spring 1967 the inner circle of Finland’s economic leadership, consisting principally of Finance minister Mauno Koivisto and central bank governor Klaus Waris, had reached the conclusion that Finland would have to devalue before long. Koivisto wrote later that he had discussed the devaluation option with Waris since early in the early year although “using metaphors rather than the word itself”. He has also said that criticism about the balance of payments problems during spring 1967 “brought repeatedly to mind the aphorism: better one great scandal than a thousand whispers.”³²⁰ It’s hard to say exactly when the decision to devalue matured but Koivisto later told the supervisory council that it was he and not Waris who took the initiative.³²¹

A likely sign of the impending decision to devalue was Klaus Waris’ decision to resign from the Bank of Finland, made early in May, and to take the position of chancellor at the Helsinki School of Economics that had been offered to him. On 8 May he sent a letter to the supervisory council telling of his intention but adding that he was ready to continue as interim governor, although not beyond the end of the year. In a later interview Waris said his resignation was prompted by the upcoming “prospect of a forced devaluation that felt so humiliating that it was better to resign.”³²² Around the same time Mauno Koivisto accepted the position of general manager of Elanto, the influential Helsinki consumer cooperative. The post was due to become vacant in August.

Undoubtedly another mark of new winds in economic policy was that the Bank of Finland eased the money market at the start of June, if only cautiously. On 5 June it sent the banks less onerous new instructions on the granting of loans and increased the rediscounting quotas of the central institutions of the savings banks and the cooperative credit societies, SKOP and OKO. In addition it began to include half of a bank’s cash reserve deposits when it calculated the size of its rediscounting quota. Soon afterwards, the cash reserve

requirement was reduced from 3 percent to 2 percent of a bank's growth of deposits. This rather complicated package of measures is indicative of the nature of monetary policy tools at the time. The circular that announced the changes tried to disguise the fact that monetary policy was being eased, and stated that the balance of payments trend did not yet justify any relaxation in the bank's tough line on money and lending.³²³

There was an extraordinary discussion on monetary policy in the supervisory council on 20 June, extraordinary in that the finance minister was present. A review of economic activity was presented by the deputy chairman of the Economic council, Timo Helelä, who was also head of the Bank of Finland's Institute for Economic Research. Anticipating the future report of the council's secretariat, then under preparation, Helelä said that "despite a substantial slowdown in growth of economic activity and a deterioration in employment, it has not been possible to achieve balance on the external payments account nor stabilisation in the price level". Even so, he felt it reasonable to assume that the economic adjustment was under way and that it would gain strength after initial inertia.³²⁴

Nothing was said by Waris or Koivisto on this occasion to imply that they already regarded devaluation as inevitable. Waris analysed the devaluation option fairly broadly but in rather a negative tone. He said that it "would achieve a slowdown in the economy – 1958 is the year that comes to mind – meaning a reduction in national income. The balance of payments might well be rectified in this way but I would prefer to start by considering whether the fairly low level of economic activity can be stimulated in some way and, looking at devaluation, the conclusion is that it would certainly not be a stimulus."³²⁵

Koivisto's contribution to the discussion concentrated on fiscal policy. He said it was not very restrictive at all, despite the impression that had been created, and had not managed to correct fundamental imbalances in the economy, except in public finances. He made no reference to the devaluation option and concluded his presentation by saying that "the way to deal with this is still fiscal policy, accompanied by monetary policy, until we reached the point where incomes policy will actually solve the question and that will be the situation in autumn next year (1968)".

The third instalment of standby credit – 48 million markkaa – was drawn down on 26 June and the fourth and final instalment – 76 million markka – on 26 September.

Planning for how the devaluation would be implemented started in the first half of August when Timo Helelä wrote a memorandum on the subject, dated 12 August 1967 and entitled *Operation Esther*. The memorandum lists the people who knew about the devaluation. The “working group” numbered seven: Finance minister Koivisto and the chief civil servant at the ministry, Heikki Tuominen, plus Klaus Waris, Reino Rossi, Heikki Valvanne, Jouko J. Voutilainen and Timo Helelä from the Bank of Finland. Later President Kekkonen, Prime minister Paasio and Foreign minister Karjalainen were informed of the plan.³²⁶

The memorandum talks of the need “to address again the kind of economic policy to be followed in the months and years ahead. The course to be chosen should provide enough leeway in the balance of payments to allow a growth policy and should serve to accelerate restructuring and an adequate improvement in the competitiveness of the national economy.”

Devaluation was portrayed as part of a comprehensive package to promote growth, not merely a change of the exchange rate but also other measures such as an export levy to siphon off some of the profits that the devaluation would bring to exporters, and a feedstock tax to be paid by the forest products industry. The yield from these taxes would be used to promote productive investments and establish a new public credit institution, a “development bank”. Inflationary pressures would be checked by reducing import duties ahead of the schedule required by the EFTA treaty, and by implementing an incomes policy.

Helelä also sought to define the appropriate devaluation rate. He started his analysis from the fact that, between 1958 and 1967, consumer prices in Finland had risen 14% more than the average increase in the western countries that were important for Finnish exports, and a full 20 percent more than the OECD average. He assessed the corresponding figures for wholesale prices at 13% and 18%. In addition to the amount of price competitiveness that had already been lost, he took other matters into account, such as Britain’s anticipated devaluation and past and future cuts in import

duties. He assumed (correctly) that the British devaluation would come after Finland's.

The potential devaluation rates charted by Helelä were relatively large. Since the 1957 devaluation, the markka parity had been 3.20 to the dollar. The new dollar rates proposed by Helelä ranged between 4.00 and 4.50 markkaa. Even the lowest of these would have raised the dollar price by 25% and the most radical alternative by a full 40.6%.

The rate ultimately chosen was 4.20 markkaa, which raised the dollar 31.25% or, correspondingly, lowered the markka 23.8%. The aim was not only to restore the competitive position of exporters on world markets but to create opportunities for new export goods. Klaus Waris later commented on the devaluation rate that it was "meant to be the kind that would also give export diversification a bit of a kick"³²⁷.

The devaluation was timed to take place after the annual meeting of the International Monetary Fund, which in 1967 was held in Rio de Janeiro on 25–29 September. Finland's plan was revealed to the leadership of the IMF and the Nordic constituency at the Rio meeting. Afterwards Reino Rossi, who represented Finland as a Waris' deputy, would travel to Washington to discuss the matter.

Helelä's *Operation Esther* memorandum set the weekend of 14–15 October as the date of the devaluation but for some reason it was brought forward by a couple of days. Finland officially informed the IMF of its intentions in a letter from Klaus Waris on 6 October 1967. It laid out the time of the upcoming devaluation (Wednesday 11 October), the new exchange rate level (4.20 markkaa per dollar) and the grounds for it, the "fundamental imbalance in the Finnish economy". This was shown, the letter said, by the rise in Finland's price and cost level and a large current account deficit that had persisted despite fiscal and credit policy measures to correct it. The letter also described the measures that Finland intended to implement alongside the devaluation. Export levies would be imposed for 12 months after the devaluation and import duties would be eliminated from the start of 1968, even on goods that were exempted from deregulation under article 3 of the EFTA agreement. Furthermore Finland promised to eliminate current regulations requiring cash payment for imports.³²⁸

The supervisory council was summoned on 11 October. The agenda listed a discussion about the change of governor and a review by governor Waris “on employment and monetary policy”. Waris told the council that the board of management of the central bank could no longer support the position that it had taken in the June council meeting on monetary policy. It now proposed that the external value of the markka should be reduced without delay. The supervisory council was then presented with a concrete proposal for a devaluation, which it proceeded to discuss. According to the memoirs of Tuure Junnila, the council was taken by surprise. This had indeed been the Bank of Finland’s intention, because it had not wanted the information to leak, giving rise to a currency flight and insider trading. Even the council chairman Veikko Kokkola was apparently not informed about the matter until just before the start of the meeting.

The majority of council members supported the board’s proposal but the two communist councillors, Aarne Saarinen and Oiva Lehto, put forward the dissenting view that devaluation would accelerate the rise in prices and living costs, which would hurt poor people the worst. Instead they proposed that the trade account should be balanced by restricting imports and increasing trade “with countries where our trade and payments accounts are in approximate balance”, a reference to the socialist countries with which Finland had bilateral payments agreements. The objections of the communists had no great influence. Waris went on to say that the government had a crucial responsibility for economic development after the devaluation. He pinned little hope on the efficacy of monetary policy and said that responsibility for maintaining competitiveness “will fall on political bodies for many years to come”.

The devaluation of 1967 was the first to be implemented in the order laid down by the Currency Act of 1961, so the final decision on changing the markka’s parity was taken by the government. The government in turn had to obtain the official approval of the IMF for its own decision. The Finnish government and the IMF executive board considered Finland’s devaluation at the same time, late in the evening Finnish time. The government’s decision was taken at an unofficial evening session. The complex choreography was successful. Jorma Aranko, who was present at the IMF’s discussions, reported that their

tone was “very sympathetic” and the steps being taken by the Finnish government were regarded as fully justified and necessary. One director did, however, query whether the exchange rate adjustment was large enough.³²⁹

Five weeks after Finland’s devaluation, on 11 November 1967, Britain’s pound sterling was devalued by 14.3%.



■ A government press conference after the decision to devalue on 13 October 1967. In the foreground, Finance minister Mauno Koivisto and governor Klaus Waris.

- Lehtikuva news photo archives.

THE OKO AFFAIR: BANK OF FINLAND AS THE GUARDIAN OF STABILITY

OKO'S POSITION AND STRATEGY

Financial market stability is a time-honoured aim of central banks and one of their most important objectives. Although the value of money was very unsteady in Finland after the war, with devaluations and periods of inflation, the banking system remained conspicuously stable. The reasons are obvious; a system of financial market controls kept interest rates fixed and restricted banking competition and risk-taking. Banks generally faced minimal interest rate risks and credit losses. It became common practice for them to respond to fluctuations in their cash position by borrowing from the central bank. This kept them liquid but at the same time reduced their interest in managing liquidity for themselves.

Until the 1980s, protecting financial market stability was usually a relatively minor concern for the Bank of Finland. For four decades from the 1940s onwards, the Finnish banking world experienced really only one crisis to speak of. It is illustrative that a major underlying factor was that the body in question had systematically neglected its liquidity. *Osuuskassojen Keskus Oy*, or OKO for short, served as the central financial institution of the cooperative credit societies. The serious financial difficulties that overtook it in autumn 1966 had their roots in decisions taken in the preceding decade. The Bank of Finland

played an important role in untangling and solving the affair, so the case is worth examining in greater detail.

The OKO crisis can be seen as a textbook example of the effects of inadequate legislation: the wrong incentives and excessive risks. By the 1960s Finland's banking legislation was all obsolete, much of it dating from the early 1930s. The cooperative credit societies were the most problematic part. They were not subject to banking law at all but regulated merely by three articles in the third section of the Cooperatives Act of 1955, which governed cooperative societies engaged in lending. As for their central financial institution, OKO, it was simply a limited company and so was subject only to the Companies Act. As a consequence of its legal status, it was very inadequately supervised.³³⁰ As it was not a commercial bank, OKO did not fall under the bank inspectorate nor was it even subject to the inspection of the cooperative credit society group.

After the war the market share of the cooperative credit societies turned sharply upwards and by the start of the 1960s the group's share of loans by all financial institutions had already reached one fifth. At the same time the cooperative credit group, which had previously concentrated on agricultural credit, was developing into a banking group serving all segments of the population. The brisk growth of cooperative credit societies also boosted the resources of its central institution, largely because cash reserve deposits with OKO increased at the same pace as deposits with the commercial credit societies. Another important element was that OKO could use a rediscounting quota provided by the Bank of Finland to protect its liquidity.

Traditionally OKO had served cooperative credit societies by safeguarding the internal liquidity of their network, managing payments between them, providing foreign currency services and looking after large customers on behalf of individual credit societies. As its financial resources grew, OKO's own operations rapidly increased and extended beyond the banking sector proper. A striking example was its construction operations after it had acquired the Otto Wuorio company, a major builder active in the Helsinki region. OKO even moved beyond construction to real estate investment. By the turn of the 1960s it had acquired a large stock of building plots in Otto Wuorio's name, with a view to future construction operations.

In 1962 OKO increased its presence in corporate finance, when it took responsibility for providing finance for Mekes. Mekes was a company operating on a model drawn from central Europe that was entirely new in Finland. It was established in 1962 to provide central coordination for small and medium-sized engineering workshops, planning their production, allocating work between subcontractors and marketing their output. It aimed to counterbalance the major corporations that dominated the Finnish engineering industry and to facilitate the operations of small workshops in the countryside. In summer 1963 it claimed that it was already working with 400 companies.³³¹

Mekes' functions mirrored the regional policy objectives of the Agrarian League, the main party of government, and the company received support from the highest political levels. Mekes appointed as its managing director a trusted ally of President Kekkonen and former head of Raisio Mills, K.E. Kivivuori, who was also its largest individual shareholder. The Mekes' supervisory council also had close ties to political circles. When it was being established, the chairman of the council was Foreign minister Ahti Karjalainen, who was also on the board of the Bank of Finland. Other council members were Reino R. Lehto, the senior civil servant at the Ministry of Trade and Industry; Jouni Hakkarainen, head of the labour department of the Ministry of Transport and Public Works; Toivo Tarkka, the inspector general of the same department; and Tyko Vanhala, a director of the state-owned Post and Savings Bank. Among Mekes' auditors was Esko Rekola, head of the budget department at the Finance ministry.³³² Mekes had such strong political support that in practice OKO had no choice but to agree to finance it. OKO's management also trusted that the liabilities created by Mekes would be covered by a government guarantee, about which there had been preliminary discussions and agreement with senior political leaders.

In 1963 and 1964, the management of OKO became intoxicated with growth as it expanded into ever-new fields. Apart from Mekes it was now financing other major companies such as Tikkakoski and Kylmäkoski, which had colourful histories. Shares in the Tikkakoski rifle factory had been bought by a German arms manufacturer Willi Daus in the 1930s and, because of its German ownership, the company had been seized by the Soviet Union in 1946. Around this time its field

of operations changed and instead of firearms the factory began to make Tikka sewing machines for export to the Soviet Union. In 1957, Moscow sold it back to Finnish businessmen. Heavily indebted, it gradually came to depend on OKO. Kylmäkoski in turn had been a modest producer of prefabricated houses. Now with OKO's financial muscle, it was trying to become a major operator in its field. There were even plans for seizing a foothold in the West German market.³³³

Banking legislation put no brakes on OKO's ambitions because, prior to 1970, it was not legally a commercial bank but merely a limited company carrying on bank-like operations, owned by the cooperative credit societies and operating as their central unit. Because of its legal status and unregulated nature, it could accept customer and liquidity risks that were very large in proportion to its size. One reason why its liquidity was under pressure was that funds were tied up for years ahead in housing plots. This was an especially serious problem for the cooperative credit society group, which suffered sharper seasonal fluctuations in the demand for credit than other bank groups because of the large number of agricultural customers. OKO actually needed better-than-good liquidity.³³⁴

The nature of operations by Mekes had also changed in the early 1960s. Its aspirations to become a planning, coordination and sales organisation for small enterprises had come to nothing. Instead it was changing into an engineering company in its own right, of a considerable size by Finnish standards, and with large investment projects under way. This change was unacceptable to the large commercial bank that had originally been the other source of Mekes corporate finance, and Nordic Union Bank withdrew its backing.³³⁵

TIGHTER MONEY PLUNGES OKO INTO CRISIS

Finland's current account deteriorated in 1964 and the Bank of Finland began tightening its monetary policy to curb the growth of imports. In the following year, amid even greater concern about dwindling foreign currency reserves, the government and the Bank of Finland drafted a joint programme on balancing the payments account within two years, as described earlier in the book. Part of the balance of payments programme consisted of detailed instructions to banks about how

much their lending could increase in the months ahead. The first control period stretched from the start of January to the end of October, the next period from the start of November to the end of April 1966, and the third period from the start of May to the end of October 1966. The instructions, issued at the beginning of 1966, also emphasized that the banks should not use discounting quotas granted by the Bank of Finland to increase their own lending.

The Bank of Finland's success in curbing bank lending is shown in the following table, which contrasts monthly rediscounting averages with prevailing rediscount quotas.

REDISCOUNT QUOTAS GRANTED TO THE COMMERCIAL BANKS 1964-1966 AND THEIR UPTAKE, MILLION MARKKAA

Bank	Quota till 30 Apr 1966	Uptake Dec. 64	Dec. 65	Apr. 66	Quota from 1 May 1966	Uptake Oct. 66	Jan 67
Kansallis	180	174	246	168	230	257	203
Union	180	180	213	241	230	262	214
Helsinki	40	22	27	39	50	28	28
Åland	5	3	5	6	6	6	5
SKOP	70	-	-	2	90	43	56
OKO	70	70	150	137	90	209	212

Source: Parliamentary supervisory council report 1963-1966.

The figures indicate that OKO was able to stay within the permitted limits of its central bank rediscounting quota during 1964. However, in 1965 it began more actively to exploit the opportunity to expand its operations by exceeding its rediscounting quota. By the end of 1965 OKO's rediscounting was more than twice the quota and OKO was already exceeding its quota by far more than by any other bank. At this time, no commercial bank was exceeding its quota by more than 36 percent, while OKO's overrun was 114 percent. SKOP, the central bank of the savings bank group, was very liquid and had no rediscounting at all.

In 1966, as Finland's foreign currency reserves continued to decline, the Bank of Finland was compelled to impose even tighter monetary policy. Many banks now began to find it hard to reduce their lending

at the pace demanded by the central bank, and their rediscounting began to rise in autumn 1966. However OKO was in a class of its own; by the end of October, its rediscounting exceeded 200 million markkaa, compared with a quota of 70 million.

Its position began to weaken in other respects too, because the tighter state of the economy meant that its largest credit customers were experiencing growing difficulties in servicing their debts. The leadership of the Bank of Finland had already been concerned about the state of OKO for several years; now, as monetary policy became tighter, OKO's position deteriorated further. The increase in its discounting showed that, at least in 1966, it systematically ignored the central bank's instructions and the specific ban on using rediscount quota overruns to increase its own lending. The concrete evidence of this is that OKO's credit to its own customers (i.e. excluding loans to cooperative credit societies) had reached 337 million markkaa by the end of 1966. Without much exaggeration it can be said that most of OKO's lending to its corporate customers was being refinanced from the Bank of Finland.³³⁶

THE CENTRAL BANK INTERVENES

The situation at OKO was first discussed in the parliamentary supervisory council at a meeting on 23 September 1966, where the subject was curbs on the lending of all banks. Governor Waris criticised OKO for failing to bring its lending into line with the framework imposed by the central bank. The supervisory council approved a proposal by the board of management for additional instructions to OKO regarding its lending. These instructions stated that, from 1 October 1966, OKO was to "provide the Bank of Finland with a weekly assessment each Saturday by 10 o'clock about the next calendar week's (a) total repayments of all outstanding credits; (b) change in your own lending to the public; (c) change in the net account position of the cooperative credit societies vis-a-vis OKO (d) amount of previously agreed credits that would be drawn down; and (e) possible other factors influencing your financial position. On this basis the Bank of Finland will inform you in writing on the same Saturday about the amount of new credit you may grant in the following week (weekly limit)." The Bank of Finland also issued precise instructions about the maximum

size of new loans and about new customer relationships in general that OKO could establish. These new instructions were so tough that in practice OKO was placed under direct central bank supervision at the start of October 1966.³³⁷

It was around this time that the board of the Bank of Finland reached the conclusion that OKO's operations could not be put on a healthy footing without changes in OKO's management. The matter began to be openly discussed during the autumn, and reached public awareness by 13 October 1966, at the opening of the Co-operative Credit Society Week in Turku. The main speaker at the event, Klaus Waris of the Bank of Finland, made a presentation entitled "Time to face facts", which criticised the banks in very strong language for their rash lending and contemptuous attitude to central bank instructions. Waris said that the time might come when the central bank would have to intervene in the operations of individual banks; reading between the lines, it was clear that he meant OKO.³³⁸ In effect this was a demand that the senior management of OKO be replaced.

The speech did not come as a surprise to absolutely everyone. Waris had earlier called a meeting at the Bank of Finland with Kusti Eskola and Johannes Virolainen, who were chairmen of the supervisory boards of OKO and the central association of cooperative credit societies OKL, respectively. At the meeting Waris presented these leading elected officials with OKO's main problem customers and their liabilities, a list that covered his whole desk. He felt that matters could not be resolved without fundamental action and, when asked to be more specific, he said that the right place to start was to change OKO's management.³³⁹

The matter was next discussed in the supervisory council on 26 October 1966. During a debate on lending policies and rediscounting terms, Waris described the situation at OKO quite openly:

"Regarding OKO I'd first like to say that if you look at the relationship between OKO and the cooperative credit societies over the long run, for example this decade, you can see that the societies have not been a burden on OKO. The growth of its rediscounting by 200 million markkaa in five years is not because the cooperative credit societies have received loans of 200 million markkaa or even 1 million markkaa; in fact their net position vis-a-vis OKO has improved during this period. The so-called provincial and national

customers that OKO has helped have contributed (to the growth of rediscounting), but their weight is not large enough to explain this trend. In fact it is the strategies of 'head office' that have made these mistakes that are now being paid for. As supervisory council member Saarinen has mentioned, there are certain extremely flagrant cases that would have made no sense even if there had been funds to spare; the whole foundation for the loans is false and substantial losses are certain. There are so many such loans from OKO on our list that, without them, the whole problem would not exist and OKO would be operating normally. The biggest such case is Mekes. It has grown and grown again. But I should mention that, since the last meeting of the supervisory council, I have spoken with the chairmen of the administrative councils of OKO and OKL and since these discussions I have become convinced that these organisations too now have the genuine goal of putting matters on a sound footing."³⁴⁰

By autumn 1966 OKO was in such distress that there was no time to be lost. At a meeting at the start of November, OKO's supervisory board accepted the resignation of its chief general manager Aarno Nisula. A little later all the other board members apart from Sampsa Mantere, the head of OKL, were displaced, although in some cases age was given as the reason. For the next three months, OKO operated under the guardianship of the Bank of Finland even more tightly than before, if that were possible. It was overseen by Pertti Tammivuori, representing the Bank of Finland, and Kusti Eskola and Åke Ahlmark, representing OKO's supervisory board. Its new chief general manager, Seppo Konttinen, was a confidant of Klaus Waris. Konttinen had begun his banking career as a lawyer in OKO's notary department and had subsequently been appointed managing director of the Industrialisation Fund of Finland when it was reorganised by the Bank of Finland in 1963. He was therefore already familiar with OKO, but also aware of modern methods of management and risk management from his time at the Industrialisation Fund. In practice, however, OKO was run by Pertti Tammivuori of the Bank of Finland until the end of 1966 because Konttinen could not take up his new appointment until the start of 1967.

The task assigned to Seppo Konttinen was explicit. Rediscounting had to be brought within the limits imposed by the central bank. At the same time OKO was to align its lending with central bank

instructions. In addition the bank's finances were to be stabilised and its balance sheet exposures controlled. The situation was critical because, according to internal estimates, the value of loans to, and other claims on, defaulting debtors might rise as high as 100 million markkaa. OKO's equity was only 55 million.³⁴¹

The Bank of Finland played a major role in restoring OKO's liquidity to a sound level. At the start of June 1967 it raised OKO's rediscounting quota by a third to 120 million markkaa. In the same month it made an interesting agreement on the purchase and resale of OKO loans. OKO sold to the Bank of Finland loans worth 46 million markkaa that it had granted to good customers, while agreeing to purchase them back in three instalments by 15 April 1970. The loan transfer together with the higher rediscounting quota made a decisive contribution to OKO's liquidity and brought the bank's rediscounting within the central bank's limits. Thus OKO stopped having to pay penalty charges on quota overruns. The promissory notes purchased from OKO by the Bank of Finland were from a total of 10 customers. The largest were from Metsäliiton Paperi and Metsäliiton Selluloosa, paper and pulp companies owned by a cooperative of forest owners, and Hakaniemen Merikiinteistö, a property company. The smaller debtors included the University of Helsinki, a dairy cooperative named Tuottajain Maito and Nurmes Cooperative Dairy.³⁴²

Steady progress was made in reducing risk exposures on OKO's balance sheet. The biggest source of risk, Mekes, was taken over completely by OKO and changed its name to Parkano Oy at the same time. Its debts to OKO were paid by an issue to cooperative credit societies of debentures worth 34 million markkaa, which carried no interest but which OKO pledged to redeem. In other crisis companies the situation was brought under control by lowering interest rates and partly by writing off debts. OKO's financial position was already stable by the end of 1967.

Part of the financial reorganisation plan involved staff reductions at OKO and OKL. As an immediate measure OKO turned to the central bank for relief. Initially the board of the Bank of Finland planned to provide OKO with an interest rate subsidy in connection with the takeover of OKO's loans. The Bank of Finland would have charged only four percent interest on the debts in question, while the borrowers would have paid the interest rate originally agreed. The difference

would have been credited to OKO, generating an estimated annual income of about 3 million markkaa. When the matter was raised in the supervisory council, councillor Tuure Junnula opposed the board's proposal. He said that it was the duty of the Bank of Finland to treat all banks equally, whereas this model would have given OKO an unfair advantage. The board abandoned the model and provided economic support for OKO in another way. On 28 August 1967 the supervisory council decided that the penalty interest charges paid by all banks for their rediscounting during the period January-May 1967 would be refunded. This transferred 3 million markkaa to OKO, the same amount as the interest rate differential model would have contributed. Only two other banks, Kansallis and the Union Bank of Finland, benefitted from this scheme and their combined refund was little more than 0.2 million markkaa. The refund model therefore offered OKO the same support as the model criticised by Tuure Junnula in the supervisory council, while formally meeting his demand that all banks be treated equally. As it did not involve extra costs for the Bank of Finland either, it satisfied all parties.³⁴³

OKO's stabilisation was facilitated by its legal status. As a company not subject to banking acts, it did not have to realise the risks in its balance sheet immediately. This averted a collapse in collateral values, a serious danger during the prevailing recession. OKO thus gained time to move cautiously until after the devaluation of autumn 1967, when the economy turned sharply upwards and collateral values held up. Moreover, years of relatively fast inflation lay ahead, during which the value of OKO's assets increased, at least in nominal terms, so inflation repaired earlier mistakes. By the middle of the 1970s the position of OKO was already good in all respects. The years of inflation also eased OKO's burden in redeeming the interest-free debentures issued to cooperative credit societies.

The crisis at OKO raised several important questions related to management structures and conflicts of interest. An example of the former was that a representative appointed by the Bank of Finland had been sitting on the supervisory board of OKO since the mid-1920s. At least in theory, the leadership of the Bank of Finland should have had inside information on OKO's operations. Conflicts of interest were an even greater problem. Kusti Eskola, a member of parliament, was chairman of the OKO supervisory board at the same time as he was

chairing the supervisory council of the Bank of Finland. Ahti Karjalainen of the Bank of Finland's board of management had been the first chairman of Metes' administrative council. The OKO affair led to personnel replacements among supervisors as well as managers. Eskola was not re-elected to the supervisory council of the Bank of Finland in 1967 and Veikko Kokkola (Social Democratic Party) became its new chairman. Professor Samuli Suomela, director of the Agricultural Economics Research Institute, took over as chairman of OKO's supervisory board and Eskola became an ordinary member. The Bank of Finland's representative on the OKO's supervisory board, board member Esko Leinonen, was replaced by Heikki Valvanne.³⁴⁴

OKO's operations from the 1950s to the crisis of the 1960s followed a conventional pattern of dysfunction. First, outside factors encouraged the bank to operate in business areas outside its own sphere of expertise, accumulating risks that were excessive in proportion to its equity. Deliberate exploitation of central bank rediscount credit in order to fund its own long term lending led to liquidity risks. The risks to capital adequacy and liquidity were then realised when the economy went into recession and the money market became tighter in the mid-1960s. Liquidity worsened from 1964 onwards as the Bank of Finland again tightened its monetary policy and no longer allowed rediscount quota overruns. Indeed, the OKO affair contains surprisingly many parallels with the even more dramatic crisis at SKOP Bank at the start of the 1990s. In both cases the bank in trouble had begun to operate outside its core area, and in both cases tried to use central bank credit, intended for regulating liquidity only, as a source of long-term funding. Furthermore, in both cases the central bank realised the need for corrective measures too late.

While OKO's position was deteriorating and finally plunging into crisis, a comprehensive reform of Finnish banking legislation was already under way, aimed at putting the several extant banking laws on an equal footing. Part of this reform was the conversion of OKO into a "conventional" commercial bank. The OKO affair could have underlined the need of banks for adequate capital but instead the main focus of the reform became harmonisation of the prerogatives of the different banking groups, as explained in the next section.

REFORM OF BANKING LEGISLATION

THE INCOHERENCE OF BANKING LAWS

A new Currency Act came into effect at the start of 1963 and, with it, a revision of the Bank of Finland's regulations. This facilitated the management of the bank, which had long operated on the basis of temporary and emergency regulations that were constantly amended. But the legislation governing the whole financial system had also become outdated; most of the laws on banking had been enacted in the early 1930s. Major structural changes had taken place within the banking sector during the post-war years, rendering the legislation even more superannuated.³⁴⁵ The situation for the central bank was problematic to say the least and complicated its tasks in various areas. Inadequate legislation also increased banking risks and made monetary policy goals harder to achieve.

Surprisingly enough, the obsolescence of legislation and related problems were not raised in meetings of the board of management or the supervisory council. Nor did the central bank urge the Finance ministry to commence reforms, at least not in official communications, although naturally there were discussions about it behind the scenes. Perhaps the main reason why the law was ultimately modernised was that the operations of the three largest banking groups – the commercial banks, the savings banks and the cooperative credit societies – had become very similar, as shown by the convergence of their rates and a blurring of the divisions between them. At the same time other

financial entities such as mortgage credit institutions had become very unimportant.

Banking legislation was extremely disparate. The savings banks and commercial banks were each governed by special laws dating from 1932 and 1933 while the cooperative credit societies operated entirely outside banking legislation, guided only by the Cooperative Act, last revised in 1955, and the regulations in its third chapter on banking. The name “cooperative credit society” was used because until the Cooperative Banking Act took force in 1970, the societies had no right to use the word bank. Only afterwards did they become known as cooperative banks.

The incoherence of the law had created problems in many ways. It was difficult to monitor banking risks. From the banks’ own perspective, the law did not provide a level playing field. From the viewpoint of the authorities, banking supervision was impaired. The absence of major banking crises in the years up to the early 1960s was largely because the system of administrative regulation developed during the war had generally stayed in force, restricting banking competition and risks. However a genuine crisis was brewing within the banking system. As we have already seen, the financial problems of the central institution of the group of cooperative credit societies, OKO, ultimately came to a head in autumn 1966.³⁴⁶

REINO ROSSI TAKES THE REINS

A comprehensive reform of banking legislation was set in motion at the start of 1961, when the government established the Banking Law Committee. Its chairman was Reino Rossi, a member of the board of management of the Bank of Finland, while its other members represented the Finance ministry and the Bank inspectorate, in addition to the main banking groups and the consumer cooperatives that were entitled to accept deposits through their shop networks. There was also one outside expert representing the academic world. Two secretaries were appointed to assist the chairman, one with a knowledge of economics and banking and the other of banking law.³⁴⁷

The weightiest members of the committee were the representatives of the major banking groups. Raimo Ilaskivi represented the commercial

banks, Toivo Hietala the savings banks and Eino Salolainen the cooperative credit societies. The associations of savings banks and cooperative credit societies each drew up their own proposals about the legislation required and passed them to the committee.³⁴⁸ The Finnish Bankers Association, representing the commercial banks, did not draft a new model because the existing law on commercial banking already served as an adequate basis. The composition of the Banking Law committee and the way it worked are tangible examples of the heightened power of interest groups in the decades after the war. The Bank of Finland was also well placed to influence the focus of the committee's report via the committee chairman and secretary. Reino Rossi probably also discussed the principles of the reform of banking legislation with his superior, governor Klaus Waris.

The committee worked on the reform for a relatively long time and its report to the government was not ready until summer 1967. It had a very broad mandate to modernise the laws on commercial banking, savings banks, cooperative organisations, mortgage credit institutions, credit companies and banking inspection. Another reason for the length of its deliberations is that it sought from the outset to produce a unanimous report so that it would be easier for parliament to enact the reform. From the perspective of this historical study, the most important aspect of its work was the regulation of financial institutions that accepted public deposits, meaning the commercial banks, savings banks and cooperative credit societies.

The committee's job was to harmonise banking laws and create neutral conditions for the different financial and credit institutions. In the committee's own words, "the rights and responsibilities imposed by law should be balanced". The committee's starting point was that depositors should be protected. The liquidity and capital adequacy of banks should be guaranteed by law and public supervision, so that investors in a bank (savers) could be confident that their money was safe. An ordinary customer could not be expected to understand investment risks but at the same time the financial markets should evolve so that an investor knowingly seeking risk and a high yield would be able to find other, suitable investment objects. The committee's primary objective was to protect liquidity and capital adequacy.³⁴⁹

Another aim was to make the financial markets more efficient, so as to improve the conditions for economic growth. It was essential to

foster a financial system that would channel capital into sectors that could grow and withstand international competition. This part of the committee's mandate could well have been penned by governor Waris himself. The committee's priorities were thus influenced by the pressure to boost economic growth and by the deregulation of foreign trade, which was making competition tougher.

To improve the efficiency of the financial system, the committee opted for dismantling the specific legal restrictions on the various banking groups.³⁵⁰ Relaxation of the restrictions on bank investment operations was not however, under any circumstances, to jeopardise capital adequacy because the position of banks in the financial market depended on the trust of customers.

The internationalisation of the Finnish economy had also contributed to the need to modernise banking law. It was becoming more important for Finnish banks to be trusted abroad, so banks had to be regulated by internationally comparable legislation and effectively supervised by the authorities.³⁵¹

However, these general arguments referred to in the assignment given to the Banking Law committee were largely rhetoric; in fact, the principal aim was not to improve systemic stability but to eliminate different legal restrictions hitherto imposed on the various banking groups.

COMMITTEE PROPOSALS

The committee proposed that a bank should be entitled to carry on all kinds of business consistent with good banking practices unless an activity was specifically proscribed. This formulation meant a major change for the savings banks which, under existing legislation, were allowed to engage only in operations that were specifically permitted.

The preamble to the report underlined the need for efficient allocation of capital resources, so banks should be as neutral as possible when they channelled the flow of investable funds. If a bank had its own interests in some productive sector or company, its handling of loan applications and other investment options could be prejudiced. Consequently the committee recommended that banks should be forbidden to carry on business activities unrelated to

banking, such as construction, insurance and real estate brokerage. On the other hand, excessive restrictions might hinder the development of new companies and healthy financial structures, so the committee said that deposit banks should have a limited right to be shareholders and part-owners in companies that operated outside the field of banking. In this way a bank could monitor the operations of new companies and reduce the risks associated with financing start-ups. The committee proposed an upper limit of 20 percent of the shares of the company and, to control banking risks, said that no more than 10 percent of a bank's equity should be invested in other companies. Investments in the property needed in the bank's own operations were not to exceed 10 percent of its balance sheet total either.³⁵²

The report also took into account the major role played by banks in saving for home purchase, for which special arrangements, home saving plans, were commonplace at the time. Although the committee did not propose that professional real estate brokerage should be a generally acceptable business area for banks, it felt that banks should be allowed to broker homes in connection to their customers' home saving plans. Banks should be permitted to do this directly as well as through separate companies established for this purpose.³⁵³

The main rule in deposit operations was that banks could accept deposits from the public only on accounts that had been certified by the bank inspectorate. A bank should not make deposit agreements where the funds were to be loaned to a specified borrower. No brokerage fees should be charged on lending. Within the groups of savings banks and co-operative banks, interbank deposits or loans should not be permitted, for instance when the cash reserves of any member bank needed topping up.³⁵⁴

In the committee's recommendations, the greatest differences between the main banking groups concerned limitations on bank lending. The only practical restriction on a commercial bank was that it would not be permitted to provide such great credit or guarantees to the same person, or people with a significant common interest, that the bank's capital adequacy was endangered. All credit provided by savings and cooperative banks had to be secured, although the nature of the collateral security was not specified. The savings and cooperative bank groups also faced limits on loan amortisation periods and notice of termination.³⁵⁵

Savings and cooperative banks were to be granted the right to issue guarantees but the value of guarantees was not to exceed 10 percent of a bank's stock of loans. However, this restriction did not concern the counter-guarantees that a savings or cooperative bank gave to the central institution (SKOP or OKO) of its respective banking network. It was argued that such guarantees would be subject to separate supervision because of the involvement of the network's central institution, so they could be exempted from percentage limits.³⁵⁶

The new law was to take the special historical nature of cooperative banks into account. As a general rule, cooperative credit societies had provided credit to their members only but, over time, operations had changed greatly and some loans were granted regardless of membership. The new law would allow loans to anyone if the articles of the cooperative bank in question permitted it. What makes the regulation interesting is that, since the war, the cooperative credit group had granted an ever greater share of its loans to non-members. The link between loan eligibility and membership is explained largely by the original ideology of the cooperative credit societies. Members used to have an unlimited liability to make additional payments to the society if these were needed to meet its commitments, and this obligation was thought to compensate for the low amount of equity. As operations grew, the liability of members for the society's debts was widely terminated and, after the reform of the Cooperative Act in 1955, only a few small credit societies had retained this condition. (The last Mohican was the cooperative credit society of the village of Ylä-Kintaus.) This historical tradition was still evident in the new Cooperative Bank Act although its practical significance had already disappeared.³⁵⁷

As noted earlier, the committee's report argued the importance of liquidity and capital adequacy for protecting customers. The trust that a financial institution had to enjoy if it were to continue operating would disintegrate immediately if it was unable to meet its contractual obligations. Under all circumstances, it had to be able to repay deposits on demand. For deposit banks in all groups, the report proposed a statutory cash reserve that should be structurally simple so that it would be easy to implement and to monitor. At the same time the committee again sought to promote economic growth; the cash reserve requirement should not constitute an unreasonable burden on the

banking system nor prevent banks from investing funds in a socially efficient way.

The committee believed that the banks knew from their own experience, and better than any legislator, what kind of cash (or liquidity) reserves were needed, so it would have allowed them to keep some of the reserve in securities that could be relatively hard to liquidate, such as domestic bonds. At the same time it renounced the practice, common abroad, whereby a proportion of cash reserves had to be kept in non-interest-bearing accounts, such as at the central bank. As a general rule, the size of the cash reserve should be at least 20 percent of the bank's debts payable on demand. Regarding other liabilities the cash reserve requirement for savings and cooperative banks would be 10 percent and for commercial banks five percent of them. In practice the proposal meant that the cash reserve burden for savings and commercial banks would be largely unchanged while for commercial banks it would be slightly more onerous than in the previous law.³⁵⁸

The committee's biggest headache was in setting the capital adequacy requirements for financial institutions. The initial position was already problematic. The three competing banking groups varied greatly in their real capital ratios, so it would be hard to create a banking act that would treat them equally. The committee settled on a model in which capital requirements would be determined in relation to the total liabilities of each bank. The equity capital of commercial banks was to be four percent of their liabilities while savings and cooperative banks would need capital adequacy of three percent of their respective liabilities. This represented a relaxation for commercial banks, required to have 6.7 percent equity capital by the previous law, which only one small commercial bank had difficulties in meeting. The combined equity capital of the savings banks – 2.9 percent – was almost equal to the proposed new minimum but this aggregate figure hid a very wide range of ratios. Half of the savings banks had less than the proposed three percent capital adequacy. Generally speaking the small rural banks were below the limit while large savings banks in cities had capital adequacy as high as 4–5 percent. The situation was even more difficult in the cooperative credit societies, whose combined equity capital was only 1.6 percent of their liabilities. Fewer than a fifth of all cooperative credit societies could

meet the proposed three-percent limit. Such low capital levels were largely due to the existing law, where the capital adequacy of savings banks was calculated only from loans assessed to be particularly risky, while cooperative credit societies had no capital adequacy requirements at all.³⁵⁹

However, the committee's report explained that capital ratios gave a slightly misleading impression of the capital adequacy of savings and cooperative banks. By nature, these groups were networks of banks that could unite to nurse troubled members back to health. The voluntary guarantee funds of savings and cooperative banks were a model for this, and it was proposed that a guarantee fund be made statutory for the commercial banks, too. This would allow more flexible handling of the question of capital adequacy, with individual banks being allowed to operate at lower levels of capital adequacy for a period of transition. For commercial banks, the minimum temporary ratio over the period of transition could be three percent and for savings and cooperative banks one percent. The proposal of a 10-year transitional period for savings and cooperative banks recognized their problems in achieving statutory capital adequacy.

Between the lines, the committee's report admitted that it was proposing a low level of capital adequacy but at the same time it stressed the elements that complemented equity capital, such as the aforementioned statutory guarantee funds. Moreover, an important element in its proposal for modernising banking law was more effective public supervision of banks. The committee stressed centralised inspection as the only way that supervision could be effective and even-handed at the same time. Centralised inspection of all banking groups would produce a common pool of expertise.

The old bank inspection agency that oversaw the commercial banks would become a supreme bank inspectorate, under the Finance ministry. It would be charged with supervising the operations of commercial banks, savings banks, cooperative banks, mortgage credit banks, credit companies and bank guarantee funds as well as the saving operations of consumer cooperatives. However, cooperative and savings banks would continue to be supervised as before, in fact internally, under the umbrella of their central organisations, because otherwise dozens of new bank inspector jobs would have to be created. Given the government's financial position, the committee saw a great

expansion of the bank inspectorate as unrealistic so it settled on the solution of allowing these two banking groups to continue operating their own inspection organs, but directed and monitored by the supreme bank inspectorate. For the bank inspectorate to work effectively, its staff would have to be of an extremely high standard. The interpretations of the bank inspectorate would mould the development of banking for years to come. Success would depend on raising the salaries of bank inspectors so that they would not constitute a barrier to the recruitment of skilled personnel. To ensure the independence of inspection, the committee proposed that expenditure on the bank inspectorate should be met from government funds.³⁶⁰

THE GOVERNMENT'S BILL

In the government's hands the report of the Banking Law Committee was altered slightly before being passed to parliament in April 1969. The biggest change concerned the capital adequacy requirement for savings and cooperative banks, which was lowered from three percent to two percent. Banks in these two groups would also be permitted to issue guarantees up to 20 percent of their stock of loans, instead of the 10 percent proposed by the committee. Inspection was to be more modest, too. The title of supreme bank inspectorate was dropped and the agency would continue under its old name. Moreover, the government's proposal entirely exempted the deposit accounts at cooperative shops from bank inspections.³⁶¹

Parliament approved the government's bill with very few changes. In fact parliament's banking committee would have liked the government to pay for the bank inspectorate, as the banking law committee had proposed, but the government was relentless and insisted that the costs be covered by a fee levied on the banks. The banking committee also wanted the upper limit on bank shareholdings in other credit institutions to be set at 30 percent instead of the 20 percent proposed by the banking law committee and the government.

The first speaker in the parliamentary debate on the banking bills was Raimo Ilaskivi, National Coalition Party, who was a member of the banking committee and explained the background of the reform of banking legislation. He criticised the government's proposal to set the equity capital requirement for savings and cooperative banks at 2

percent, one percentage point less than proposed by the committee that had planned the reform. This would distort competition to the benefit of the savings and cooperative banks and defeat the committee's aim of balancing rights granted with obligations imposed. Also the government's aim to avoid paying the costs of bank inspection was wrong, Ilaskivi said, because "even if only in a formal sense, an organisation carrying out an inspection cannot be dependent on payment by the organisation being inspected". The same point was taken up by another representative of the commercial banking sector, Tuure Junnilla, also of the National Coalition Party. Moreover, Junnilla deplored the proposed ban on bonuses, which stated that the wages, fees or other remuneration paid by any bank must not depend on the bank's profits or the size of its business. In his view this restriction could turn major financial institutions into rigid official bureaus. It was a remnant, he said, of the banking crises of the 1920s and 1930s, and was no longer relevant.

Toivo Hietala (National Coalition Party) had represented the savings banks on the Banking Law Committee and now, as a member of parliament, drew attention to the capital adequacy requirement proposed. He had an intimate knowledge of the savings banks and cooperative credit societies and stated that the smaller ones would not be able to meet the two percent ratio even within the ten-year transitional period proposed. However an overall reform of banking law was such a significant improvement for these two groups of banks that this capital adequacy requirement simply had to be accepted, although a situation might arise in future when the matter could be reopened.

The only socialist member of parliament to speak on the banking bills was Tyne Leivo-Larsson (of the SDP breakaway faction, the Social Democratic Union of Workers and Smallholders) who said that the biggest defect was their obeisance to the objectives of private banks. She believed that reforming the banking acts would have given the government an excellent opportunity to intervene in how loanable funds were being channelled, a subject of continuous political debate at the time. She felt that an initial cautious step would have been for the government to nominate one member to the supervisory board of every commercial bank. This would create at least some kind of dialogue between the government and the major commercial banks.³⁶²

The government and parliament enacted the proposal of the banking law committee with fairly few alterations. The most important change was the reduction in the capital adequacy requirement for savings banks and cooperative banks to two percent. Thanks to the considerable amount of advance preparation, the other changes were slight. A reform of banking legislation was such an important matter that the government kept a firm grip on it. This was pointed out by the aforementioned Tyne Leivo-Larsson, who said that parliament had not been given the opportunity that it deserved to study the content of the bills properly.

The capital adequacy requirements approved by parliament reflected a new kind of banking culture that had grown up in the post-war period of repressed financial markets. Credit risks were small and economic policy gave a high priority to investment. These conditions gave rise to a growing tendency to downplay the significance of capital adequacy in banking. Equity was seen mostly as an additional cost factor and a harmful brake on lending.

The same phenomenon is observable elsewhere in the world but Finland went farther in its disdain for capital adequacy, as a comparison with Sweden shows. Firstly, all Swedish banking groups had the same capital adequacy requirement so competition neutrality, the aim of both countries, was better achieved in Sweden. Another significant distinguishing factor was that in Sweden, capital was calculated on a bank's assets and not its liabilities, as in Finland. Moreover Sweden used a risk-weighted model for calculating the capital required, so a bank could reduce the need for capital by concentrating on low-risk investments. This was a decisive reason why new capital adequacy requirements could be adopted in Sweden in 1969, as soon as the new law took effect, without long transitional periods.³⁶³

The regulations on which balance sheet items could be classed as equity and which items could be exempted from capital adequacy requirements vary greatly from country to country so direct quantitative comparisons are difficult. Despite these reservations, it is clear that the capital adequacy demands faced by Finnish banks were low by international standards. Roughly speaking, most European countries imposed statutory minimum capital adequacy at least 5–6 percent at the start of the 1970s. This was almost 3 times higher than Finnish savings and cooperative banks were required to have. At the other

extreme was Denmark, where a bank was required to have net capital of at least 8 percent of all its liabilities and guarantees and this was just the starting point; Danish banks were required to raise their equity annually by transfers from net profits until it reached 15% of their debts and issued guarantees.³⁶⁴

PRODUCT OF REPEATED COMPROMISES

The primary purpose of the new laws was clearly defined; the position of bank customers – depositors – had to be safeguarded, so as to avoid any erosion of confidence in the whole financial system. This confidence was to be founded on statutory liquidity and capital adequacy levels. On the other hand, neither set of requirements should interfere with the lending capacity of the banks. The third element was that the three main groups of banks – commercial, savings and cooperative – should have equal standing under the law. This was a way of increasing competition in the Finnish financial market, which was characterised by an extremely concentrated structure. In practice the three major commercial banks had an almost dominant market position. It was felt that the best way to increase competition was to implement structural changes in the savings and cooperative bank groups, leading to the creation of provincial banks that would be worthy regional competitors for the main commercial banks. This competition aspect was underlined by Reino Rossi, the chairman of the Banking Law Committee, and professor Gösta Mickwitz, the member who represented the academic world.³⁶⁵ Rossi's views on ways to restructure provincial savings and cooperative banks were in line with the policies of governor Klaus Waris, who wanted to diversify the whole financial system so that the creation of companies and the development of new business sectors would not be constrained by a lack of finance.

However there was a distinct conflict between what the Banking Law Committee said it was trying to do and what the new banking acts implemented. A level playing field between the three main banking groups was indeed achieved but the other objectives were not. The capital adequacy requirements proposed were very low by international standards, and bank capital and risks were calculated in a way that overstated strength. It was argued that savings and cooperative banks

required less equity capital because of the guarantee funds available to each bank and their long tradition of mutual responsibility. In any case, it was believed that effective, centralized banking supervision would obviate the problem. In reality, these hopes were utopian because the system of supervision changed very little. This was already clear from the fact that the reform brought practically no additional resources to bank supervision. But perhaps the most fateful deficiency was that an exceptionally long transitional period was granted for the new legislation to take effect. The most flagrant was the ten years allowed to the savings and cooperative banks to reach statutory capital adequacy.³⁶⁶

To a large extent, the content of the 1969 reform of banking law was the outcome of conflicts regarding monetary policy, government spending, regional policy, competition policy, bank finances, party politics and ideologies. Seen from the central bank's perspective there was a burning need to modernise incoherent laws that hindered or prevented the pursuit of consistent monetary policy. Moreover, the deficiencies of the old legislation had played a major part in the deep crisis that befell the cooperative central bank OKO in September 1966. Disparate banking law made it hard for the Bank of Finland to fulfil its primary mission of keeping the monetary system on a safe and stable footing.

Problems in public finances deterred the government from supporting the committee's proposal for a significant improvement in the effectiveness of public banking supervision. Competition policy became a smokescreen for measures to favour the countryside. Representatives of non-urban areas were antagonistic towards the commercial banks, and wanted to create a counterforce. By appealing to competition neutrality, they aimed to gain the broadest possible prerequisites for the credit cooperatives anchored in the countryside, and to some extent also for the savings banks.

Attitudes towards the different banking groups also showed deep ideological differences. The large parties of the left, the Social Democrats and the People's Democrats, were critical of private commercial banks or entirely opposed to them. Both parties' programmes had demanded nationalisation of commercial banks, which symbolised the capitalist market economy system. The People's Democratic League was vociferous in this, as illustrated by the plenary session of parliament

in 1969, when one of its representatives, Aarne Saarinen, put forward a request motion, urging the transfer of two commercial banks to government ownership. "Much is rotten in the state of banking," Saarinen said. "It looks more and more like a parasite; it grows like a tapeworm." In his view the two large commercial banks had far too much economic power and their inefficient operations led to an unreasonably fast growth of interest-rate margins, which hurt the poorest members of society the most. By transferring the large commercial banks to public control and combining them with other government financial institutions, a financial institution could be created, under parliament, that would benefit the whole national economy.³⁶⁷

Saarinen's proposal aroused very animated debate in parliament. The main defenders of the commercial banks were members of the National Coalition Party and their main critics were from the People's Democratic League. In the vote, the proposal was supported by 46 members and opposed by 130, so the advocates of commercial banks could breathe a sigh of relief. Within the Social Democratic Party, attitudes towards commercial banks were considerably less antagonistic than in the People's Democratic League. The social democratic programme did refer to bank nationalisation but passions had cooled during the 1960s and now the party preferred democratic control of credit flows to outright nationalisation.

Amid this climate of opinions, many left-wing members of parliament saw the savings banks and cooperative credit societies as alternatives to capitalistic commercial banks, alternatives which would be viable if their operating rights were improved. In this respect there was a convergence of views and objectives between representatives of several political groups – those in the National Coalition Party who supported the savings banks, the Social Democratic Party that backed the workers' savings banks, the Swedish People's Party that supported Swedish-language savings banks and the Centre Party that backed the cooperative credit societies.

To ensure passage of the bill, the Banking Law Committee had sought consensus above all. In pursuit of consensus the majority of committee members was composed of representatives of the different banking groups while civil service representatives and independent experts were in a minority. Originally sensible objectives were watered

down. Via its representatives, each banking group clung on to its own privileges and chairman Reino Rossi could not induce the committee to make proposals regarded as unfavourable to any individual group. Parliamentary handling of the reform sought accord in the same way. The commercial, savings and cooperative banks each had their own advocates in parliament in several parties. Even in the final stages of making the law, all changes unfavourable to any reference group were blocked.

THE INSTITUTE FOR ECONOMIC RESEARCH AND THE EMERGENCE OF INCOMES POLICY

BANK OF FINLAND ESTABLISHES A RESEARCH INSTITUTE

The Bank of Finland's reputation for strength, in its status and social influence, can be partly explained by its institutional position. At least formally it has always been independent of the national government and was an important authority for many decades in the foreign exchange and money markets. But this is not the whole picture. The bank moulded Finnish economic policy beyond the ambit of its formal tasks and duties. Its influence stemmed from its position as a centre of economic research and expertise. This role was reinforced and underpinned by its Institute for Economic Research, which was the hub of the bank's analytical and publishing operations from the early 1940s until the 1970s. During this period it was Finland's first and foremost economic think tank. Naturally the ideas it developed shaped the bank itself but, via the work of various committees and people who had been employed at the Institute, they also spread into Finnish society at large.

The board of the Bank of Finland first discussed merging the separate statistical and conjunctural research departments into an economic research institute in the late-1930s. These plans came to fruition when the supervisory council approved a board proposal in

1943. The new institute began operations on 1 March 1944. It was not an auspicious moment because Helsinki had just experienced the worst bombing raid in its history and peace feelers towards the Soviet Union about peace had come to nothing.

The work of the institute did not get under way properly until after the war, when the economists who had been “on loan” to the economics department of the Finance ministry returned to the Bank of Finland. Things were different, now that Dr Bruno Suviranta, who had previously headed the bank’s conjunctural research department and been its chief economic expert in the 1930s and 1940s, had moved instead to Helsinki University as a professor of economics at its faculty of political science. However Suviranta made the transition gradually, working as a “part-time supernumerary official” at the research institute until 1946 and then as an advisor to the board until 1949, when he left the bank completely.³⁶⁸

DIRECTORS OF THE INSTITUTE OF ECONOMIC RESEARCH

director	degree	period	joined the bank
A. E. Tudeer	D.Phil.	1944–1955	1925
Reino Rossi	D.Phil.	1955–1957	1946
Heikki Valvanne	D.Pol.sc.	1957–1966	1945
Timo Helelä	D.Pol.sc.	1966–1967	1957
Lauri Korpelainen	D.Pol.sc.	1968–1969	1961
Pertti Kukkonen	D.Pol.sc.	1970–1971	1960

In terms of years of service, A. E. Tudeer and Heikki Valvanne stand out from their colleagues because each led the institute for about a decade, far longer than the others.³⁶⁹ Tudeer represented continuity. A statistician by training, he had joined the Bank of Finland as long ago as 1925 to head its statistical department. His career had begun as a junior actuary at the Central Statistical Office. His economic philosophy had been shaped most by the German historical school and by close collaboration since the 1930s with Bruno Suviranta, who had put him in touch with neoclassical economic theory. Tudeer saw the Bank of Finland’s role in the light of classical central banking doctrine. His influence at the bank was reinforced by a relationship of trust with governor Risto Ryti. An independent central bank operating within the

gold standard was the ideal of both men. Ryti's dismissal from the Bank of Finland came as a shock to Tudeer, and had an unavoidable influence on his work at the bank.

During the institute's early decades of operation, Tudeer's closest subordinates played a decisive role in shaping its profile. Among the main figures were Mikko Tamminen, Heikki Valvanne and Reino Rossi.

The function of the Research Institute, defined at its time of foundation, was to draft reports and undertake research that would enlighten the Bank of Finland's operations and Finland's general economic development. It was also to perform special tasks commissioned by the board of management.³⁷⁰ Apart from these specified duties, it served for two decades as a college of post-graduate education for some of Finland's leading economists, and a training unit for the central bank's top experts and managers.

In practice its sphere of operations was far wider, and it performed many functions for the bank in addition to research. At the start of the 1950s, for example, it managed the bank's library and archives, checked the language of its publications, did translations, edited the bank's magnificent *Monthly Bulletin* and its annual reports and produced many key sets of statistics. Among other things, the Institute for Economic Research compiled Finland's balance of payments statistics, the regular surveys of outstanding credit, the construction cost index, and official bond statistics. Its research work included forecasts for the level of economic activity, although these were not generally published and were intended for the eyes of the bank's directors only. Later it also became responsible for producing special reports requested by the board and for representing the bank in various committees and international organisations.

When the institute began operations, it had 17 employees transferred from its predecessors, the statistical department and the conjunctural research department. Among these staff members were the director of the institute, two heads of department, junior and senior actuaries, chancery officers, typists, draughtsmen and actual researchers. One of Finland's first female economists, Ragni Bärlund, was to become the most prominent actuary in the institute's history. She had begun her career at the central bank in 1938 and for many years was responsible for drawing up the balance of payments. A mark of the esteem she enjoyed was her election to the chair of the

Association of Bank of Finland Officials in 1955, the first woman in the position. A future governor of the Bank of Finland, Sirkka Hämäläinen, began her central banking career in the same place; she joined the institute in 1961.³⁷¹

The researchers fell into three groups. There were economists and students of political science who were working towards their bachelor's degrees, graduates studying for their postgraduate licentiate examinations, and licentiates working on their doctoral theses. Generally the researchers worked on specific projects, and a new assignment began when the previous one was completed. In the mid-1950s the staff already numbered 25 and by the end of the 1960s there were 45. The number of actual researchers was eight at the start of the 1950s and 15 at the end of the 1960s. At the very start of the 1970s, just before the institute was dismantled, the number of researchers rose again slightly and the staff of the whole institute reached 52.³⁷²

The premises of the new research institute were at Kirkkokatu 14, close by the head office of the Bank of Finland. The old Empire-style building, known as Mäyrälä – the Badger's House – provided cosy if increasingly cramped working rooms. At the start of 1962 the institute moved into proper premises in head office, where many new rooms had been created in an adjoining modern four-storey annex. The building, called the bank's "new side" had been built after the old security printing house and the bank's wing on the Kirkkokatu side had been demolished.

FINLAND'S LEADING ECONOMIC RESEARCH CENTRE

In the years of reconstruction after the war, the state of Finnish economics was unsatisfactory in many respects. In contrast to neighbouring Sweden, Finland was still clearly influenced by the antiquated German historical school. Neo-classical microeconomics and Keynesian macroeconomics were barely becoming the mainstream. The main figure in the transition to new schools of thought was Bruno Suviranta. Also a few new-generation economists like Lauri af Heurlin, Klaus Waris and Mikko Tamminen had become familiar even before the war with the new theories developed by Keynes as well as young economists of the Stockholm school of thought. Unfortunately the war

had severed these links, and the spread of new ideas was also hindered by institutional factors; economics faculties in Finnish universities were small, and the turnover of their teaching staff was slow.³⁷³

An informal circle of researchers, that came to be known as the O Group, played a significant role in the modernisation of Finnish economic research. At its core were Timo Helelä, Erkki Laatto, Jussi Linnamo, Jouko Paunio and Erkki Railo and its activities largely revolved around the Bank of Finland's Institute for Economic Research. The name "O Group" came from the fact that the names of many of its members happened to end with the letter O. The future members of the group were beginning their postgraduate academic studies in the early 1950s and a few of them had already done postgraduate work abroad in British and American universities so they had a grasp of the latest trends in economics. In other respects Finland was fairly isolated from foreign influences at this time, because of the shortages of the war and the reconstruction period. The new winds in economics were blowing mainly from the English-speaking countries, the new focus of analytical research. The aim of the O Group was to modernise Finland's economic research and end the intellectual backwardness that had lasted for nearly a generation.³⁷⁴

The Bank of Finland's Institute for Economic Research was to play a strategically important role in this modernisation. Board member Klaus Waris was well informed about the new trends in economics and although he had left the academic world he understood the importance of analytical research and the need for modernisation. Under his wing and the leadership of Heikki Valvanne, the Institute became an important base for the new pioneers of Finnish economics.

In the conditions of the time the Bank of Finland offered a unique environment for research work. Its library could acquire the latest scientific literature and it could invite foreign researchers to Finland and help the new generation of Finnish researchers network into the international scientific community. From 1957 onwards, the institute's researchers met weekly for seminars that presented the newest trends of economic research and discussed ongoing projects in a critical but constructive spirit. At any one time almost 20 doctoral students were working under the auspices of the Institute, creating the critical mass that fruitful cooperation required. For the authors of dissertations it was a far more favourable climate than in the economics departments

of universities, where perhaps only one or two people would be working full-time on their dissertations.

Beginning in 1960, economic growth became a special focus of the institute's research into economic history. The project was modelled on growth studies in the United States by Simon Kuznets, who sought to draw up comparable quantitative data – historical statistics – on the development of various sectors of the economy from the mid-19th century to the present day. The statistics were made comparable by using the United Nations System for National Accounts, approved in 1953. The original intention was to carry out the Finnish studies using finance from the United States but Klaus Waris felt that the central bank had a national duty to provide finance for a project of this type, and the money was found. In the period from 1966 to 1988, a total of 13 studies were published in the growth research series.³⁷⁵

At the end of 1972 the status of the institute changed because of an overall reorganisation of the bank. Its staff were divided as new departments were set up within the bank's regular line organization for economics, monetary policy and foreign exchange policy. The publishing operations that had been managed from the research institute were transferred to an information department. A small research department, set up in connection with the reorganisation, had a diminished staff of about 10 persons, and the type of research shifted from doctoral studies to work that would immediately serve the central bank. The change in emphasis was influenced in part by the fact that Finnish economics had advanced to the stage where universities could take over the main responsibility for directing research. The professors of the old school had made way for a new generation of researchers who had gained their doctorates after the mid-1950s.

During its heyday, the Institute for Economic Research had a very active programme of publications that were high in quality for the times. The reports, studies and statistics of the institute were published in four different series, as well as a separate series for Bank of Finland growth studies. These can be delineated as follows:

A series, Economic reports

- originally an annual survey containing topical studies of various sectors of the economy

- regular sets of statistics on the stock of outstanding credit and the balance of payments
- a total of 35 volumes published by the end of 1972

B series, Scientific monographs

- doctoral dissertations and other comparable monographs by the institute's researchers
- a total of 31 volumes published by the end of 1972

C series, studies commissioned from outside researchers

- six published by the end of 1972

D series, research mimeographs starting from 1963

- ideas for discussion prior to actual research publications
- subsequently also licentiate theses
- 30 volumes by 1972

Growth studies

- results of a separate wide-ranging project
- total of 13 volumes

While the institute was operating, the Bank of Finland published a great number of doctoral dissertations – 14 studies carried out under its auspices. There were a further three doctoral studies whose authors had worked at the institute although the publication of their dissertations was not in the Bank of Finland series. During the same period, 60 dissertations broadly related to economic science or economic history were published in Finland, so the Bank of Finland's Institute for Economic Research accounted for about a quarter of them.³⁷⁶ The bank's goal of promoting Finland's international economic integration was also reflected in the institute's publications. In 1962 the bank published the founding treaty of the European Economic Community translated into Finnish (Series C: 1) and in 1969 a broad review of the Common Market (Series C: 6).

Of the publications edited by the institute, the Monthly Bulletin and the bank's annual report, published as its Yearbook, have been mentioned earlier. Another annual publication provided information about all the bonds issued in Finland. With the evolution of methods

for seasonal adjustment, the institute established a publication named “Suunta ja suhdanne” (Trend and Cycle), beginning in 1967 and lasting for several years, which collated the main seasonally adjusted graphs of the Finnish economy. It contained about 100 time series and appeared four times a year with Finnish and English captions.

Another way in which the institute fostered debate about the economy and economic policy was that staff served as editor-in-chief and managing editor of the Finnish Economic Journal (*Kansantaloudellinen Aikakauskirja*), the flagship publication of the Finnish Economic Association. A.E. Tudeer was editor-in-chief for nearly four decades, beginning in 1921 and continuing until 1958, which was several years after he had retired. After Tudeer things were handled differently and the job of editor-in-chief was rotated annually between the institute’s researchers.

As a training ground for economists, the institute and its predecessor had an influence that extended well beyond the bank’s officialdom into society at large. During Bruno Suviranta’s term of office, it became established that a position in the Bank of Finland’s research department and later its institute offered a good springboard for a career in academia, the central bank, the civil service and the private sector too. The careers of a few individuals passed through all these worlds. By 1972, ten former members of the institute’s staff had ended up as professors of economics, economic history or statistics, including Mikko Tamminen, Heimer Björkqvist, Jouko Paunio, and Ahti Molander. Ahti Karjalainen and Sirkka Hämäläinen, who became governors of the bank, were protégés of the institute. So were Bank of Finland board members Heikki Valvanne, Seppo Lindblom and Markku Punttila. Erik Törnqvist, who worked at the institute from 1940 to 1946, was a long-serving civil servant at the Finance ministry as director of its economics department before becoming an ambassador. Erkki Laatto moved from the institute in 1967 to be director general of the Economic Council and then in 1970 director of the planning department of the Prime Minister’s office. Jussi Linnamo worked for the institute for ten years until 1967, when he was appointed managing director of Peruspankki, a commercial bank established by the labour movement, and then in 1970 the head of the Bank Inspectorate. Jaakko Lassila joined the board of the Bank of Finland from the institute and went on to head Finland’s largest insurance company, Pohjola, in 1974, and then the largest commercial bank Kansallis in 1983.

INCOMES POLICY PIONEER

Incomes policy was perhaps the most important and far-reaching example of the institute's influence. Timo Helelä, appointed director of the institute in 1966, was a strong advocate of incomes policy which, although no Finnish invention, strongly took root in Finland. The concept may have originated with the OECD which, in its 1962 report *Policies for Price Stability*, stated that incomes policy meant that "the authorities should have a view about the kind of evolution of incomes that is consistent with their economic objectives and in particular with price stability; that they should seek to promote public agreement on the principles which should guide the growth of incomes; and that they should try to induce people voluntarily to follow this guidance."³⁷⁷ In short, monetary policies would be better at supporting economic growth and full employment if inflation could be controlled with incomes policy.

The Economic Council, composed of representatives from the government and various interest groups, became the forum for debate on an incomes policy for Finland. Helelä, who had joined the institute in 1957, completed his doctoral thesis in 1963 on wage formation in Finnish industry and, after putting it in the mail to the printing house, took up the post of secretary of the Economic Council. Its chairman at this time was Ahti Karjalainen and its deputy chairman Reino Rossi, both of whom hailed from the Institute for Economic Research.

In 1964 the Economic council published a wide-ranging report, *Near-term growth policies*, that included many recommendations for stimulating economic growth in Finland. The first of them was that, in order to curb rising production costs and prices, decisions affecting incomes should take into account the long-term effects on production, employment, prices and the balance of payments. This should be done in a special negotiating body that would uniformly discuss questions related to the income formation of different groups of wage earners.³⁷⁸

The Economic council argued that this recommendation was justified by the events of the past decade. "Much of the blame for rising prices and costs is borne by the incoherence of our incomes policy, which has led to wage settlements that have pushed up nominal earnings too fast(...) Stabilisation of the price and cost level requires more than just consistent and credible fiscal and monetary policies.

The wage-earner groups directly concerned with the development of nominal incomes must also perceive and consider their macroeconomic effects. Thus we should focus on achieving a voluntary negotiating procedure in which wage increases will be integrated into a rational growth policy.”

The report reflected disappointment in the results of mere monetary and fiscal policies in combating inflation. It also incorporated the view that had developed in the 1950s and 1960s that monetary stability was not the responsibility of the central bank alone. Inflation was not primarily a problem of the monetary system but depended on political and social structures and therefore had to be controlled in other ways. The idea of incomes policy was to conduct negotiations on nominal incomes at a national level, where demands could be coordinated so that the aggregate increase in nominal earnings would not exceed the limits set by productive resources.

The development of an incomes policy accelerated after the report. In spring 1965 the Economic Council asked Helelä and Jouko Paunio, another member of the Institute for Economic Research, for an expert statement on how to “investigate an incomes policy and examine related problems”. Their statement *Memorandum on the basis and guidelines for incomes policy* was completed in August 1965. They wrote that “successful employment policy in Finland requires the parallel pursuit of a consistent incomes policy”. In successful incomes policy, “wage earners’ organisations each set their own income targets within the framework of the distribution of national income; they then jointly agree a general objective and establish their individual objectives accordingly”. They proposed that the Economic Council should urgently draw up a report on how an incomes policy could be created, laying out the stages that would guide its progress over the next few years.³⁷⁹

The Economic Council then set up an incomes policy study group chaired by Reino Rossi, a member of the Bank of Finland’s board of management and the former director of its Institute for Economic Research. The other members were Timo Helelä, the current director of the Institute and deputy chairman of the Council; Eino H. Laurila, the head of the Central Statistical Office; and Jukka Wallenius, the Economic Council’s new secretary general. On the basis of their teamwork, the Council published a wide-ranging report at the start of 1967, titled *On the Development of an Income policy*. By this time the

chairman of the Economic Council was the social democratic Finance minister Mauno Koivisto, who would become governor of the Bank of Finland a year later. The report stated that Finland's inflation rate, being higher than in many competing countries, was the fundamental problem and incomes policy was the solution. It recommended a process of talks "aiming to take all incomes and all income recipients into account", which should be started between the government and different interest groups before the end of the year. For the time being, the talks would be conducted under the auspices of the Economic Council.³⁸⁰

On 17 March, Timo Helelä gave a presentation to the Finnish Economic Society entitled "Incomes policy – the latest name or a new direction". He said the policy was a response to the current situation and the concerns of the Bank of Finland: "We are currently struggling with an extremely difficult balance of payments problem. Moreover it appears that this problem will continue to trouble our national economy in the years ahead. In these circumstances our possibilities for expansion depend on the success of incomes policy in the next few years."³⁸¹ The most critical comment on Helelä's presentation came from Nils Nilsson, economic research secretary at the SAK trade union association, who doubted whether the system would be viable. "It sometimes feels as if the incomes policy debate has been imported wholesale without considering whether it suits Finnish conditions." Nilsson felt that the solution to economic problems should be sought from the real economy and not from monetary matters or nominal incomes. "Nevertheless we (SAK) are ready to participate in investigations and discussions. But the chances of successful negotiations depend on these and on the economic policies of the months ahead."³⁸²

For a long time the labour union movement remained suspicious about and even opposed to the idea of a centralised incomes policy. There were fears that it would encroach on contractual freedom and that it was specifically intended to hold down wages. In his history of the SAK organisation, Tapio Bergholm has shown how it and its experts continued to oppose incomes policy at various stages until spring 1967. The other central organisation on the blue-collar employee side, the SAJ, was even more negative. Not until the 1967 devaluation did a situation arise where the organisations were ready to begin negotiations on a centralised income policy settlement. The talks started at the

beginning of December 1967 under the leadership of Keijo Liinamaa, who had been appointed by the government as special incomes policy negotiator. They ended with the signing of a broad agreement in March 1968.³⁸³ It was the start of several decades of efforts to control inflation by incomes policy, which met with varying degrees of success.

Despite the original plan, the Economic Council did not become the organisation that led income policy negotiations in Finland, a role for which it was obviously too broad. Its contribution was mainly to produce background information and serve as a forum for general backroom discussions. Naturally, once the establishment of incomes policy was properly under way, the Bank of Finland's Institute for Economic Research faded out of the picture but until that time the Institute, and especially Timo Helelä and other members of the O Group, played a key part – perhaps even the leading role – in introducing incomes policy to Finland and in promoting it among interest groups and politicians.

FROM RECONSTRUCTION TO INDUSTRIALISATION

NOT BY MONETARY POLICY ALONE

The lending policies of the Bank of Finland from the close of the Second World War to the 1970s have distinct features that differ from its more general monetary policy. The bank was pursuing wider objectives. Initially it gave priority to financing government expenditure, as noted previously, but as the government was weaned from its dependence on acceptance credit from the bank, opportunities for other forms of lending arose. The central bank moved into the economically and politically interesting areas of corporate finance and domestic investment.

The factors behind the growth of its corporate finance operations are obvious. In the conditions prevailing after the war, the private banking sector was ill-equipped to satisfy credit needs because of low private savings at the banks. There were few opportunities to import foreign capital, and the domestic capital market was small and underdeveloped. Despite some bond issues, the government and major companies saw little potential for obtaining finance in this way. The long-prevailing shortage of capital underscored the role of the central bank and its lending began to be shaped by the priorities of promoting industrialisation and exports. Thus economic restructuring and growth became central bank objectives, alongside its mission of monetary stability.

It's worth noting that, adjusting for inflation, there was no secular growth in loans by the Bank of Finland during this period. In real

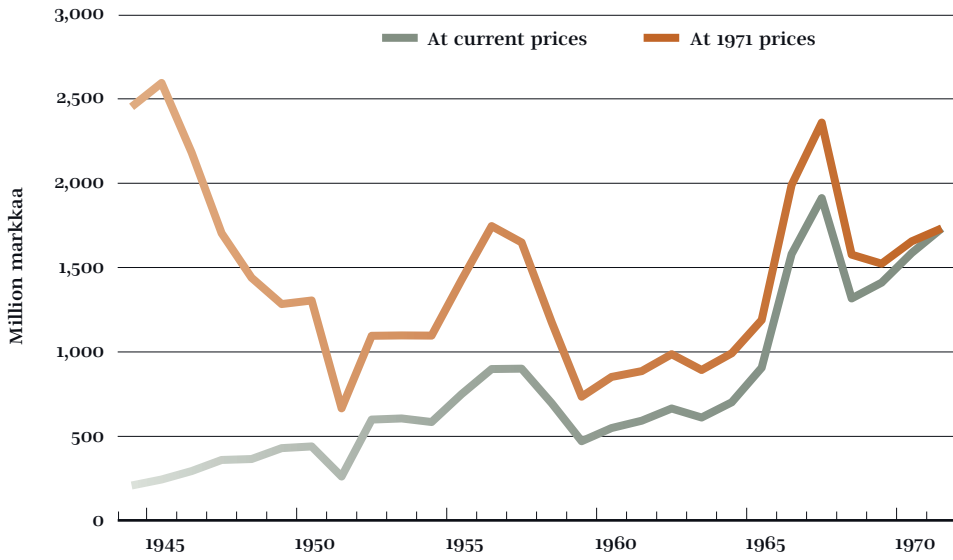
terms, its volume of outstanding credit was smaller at the start of the 1970s than immediately after the war. Large variations were typical of Bank of Finland lending, however, mainly because of fluctuations in foreign currency reserves. When the reserves increased, so did the liquidity of private banks, which were able to reduce their borrowing from the central bank; correspondingly, as currency reserves declined they borrowed more. The devaluations of 1957 and 1967 were both preceded by a two-year period of tight money markets, when central bank lending increased. After each devaluation, currency reserves began to grow again and the banks paid down their central bank debt. In fact a similar phenomenon is visible at the very start of the 1950s, when the Korean War caused a global increase in demand for forest industry products. As forest industry prices shot up, borrowings from the Bank of Finland declined.

Despite the great cyclical variations, the structural changes which occurred in lending by the Bank of Finland from the 1940s to the 1970s are also worth examining. Its loans can be divided into three segments: to private borrowers, to banks and other financial institutions, and to the public sector, meaning the government. Most of the loans granted by the bank took the form of short-term credit against bills of exchange, which far exceeded other kinds of credit mentioned in the bank's regulations. In this connection, the stock of loans must include various bonds issued by the three categories of borrowers and subscribed by the Bank of Finland. Despite their securitisation, these bond issues were often, from the perspective of the borrower, longer-term substitutes for loans against bills of exchange or promissory notes.

Until the start of the 1950s, the largest customer for Bank of Finland credit was the government, although its share declined gradually from nearly 90 percent in 1944 to just below 50 percent in 1950. After the start of the 1950s, the largest segment became private borrowers, in practice Finland's largest companies. Throughout the 1950s these loans generally accounted for about 40–50 percent of all central bank lending. After the start of the 1960s, their share declined and the largest segment of Bank of Finland lending was to banks and other financial institutions, especially large commercial banks. At its peak the financial sector received about 70 percent of all central bank loans.

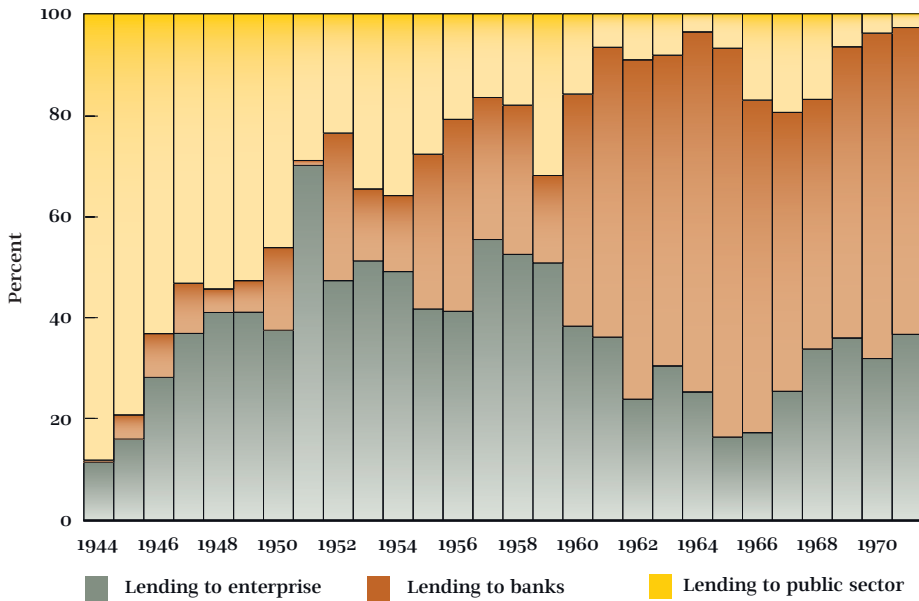
The breakdown of Bank of Finland lending between sectors illustrates the evolution of economic policy and the economy. From

BANK OF FINLAND'S STOCK OF LENDING 1944-1971



Adjusted for 1963 monetary reform.
Source: Bank of Finland.

DISTRIBUTION OF BANK OF FINLAND STOCK OF LENDING BY BORROWER 1944-1971



Source: Bank of Finland.

the end of the war until the start of the next decade, the allocation of resources was mainly determined by the government and what it did. Then came a ten-year period when the central bank took over the lead role in finance, until the other banks became dominant in the 1960s. During the 1960s, however, the actual role of the Bank of Finland in industrial finance did not decline as fast as its direct lending to companies did. As will be examined later, it continued to exercise its priorities for economic development by establishing special financial institutions.

CREDIT FOR BUSINESS DURING RECONSTRUCTION

In the post-war years, there was a major shift in the structure of lending as companies became the main recipients of central bank loans, overtaking the government in 1951. The corporate segment continued to grow and the central bank soon became a major source of finance for companies. Liquidity had built up in the economy during the war and many of the bank's old borrowers had paid off all their loans, so by the end of the war the number of corporate customers of the Bank of Finland had shrunk below 30. As reconstruction and reparations got underway the situation rapidly changed. The commercial banks were poorly placed to finance business because their funding was founded on deposits and the real value of deposits was growing slowly. At a time of inflation, the public had lost confidence in bank deposits as a store of value and the banks were hard put to encourage people to start saving again.

Major industrial companies with large investments to make faced an especially difficult situation. As the money market became tighter, the Bank of Finland also came under greater political pressure. All political parties saw it as a potential source of finance for investments, and debates in the supervisory council, representing the various parties, took on an entirely new dimension. The central bank was seen as a way of furthering the interests of the councillors' reference groups and home districts.

The external forms of Bank of Finland lending remained unchanged; the focal point was still on short-term acceptance credit. In reality, however, most of these bills of exchange were long-term loans because

customers were confident that their bills could be rolled over time and again. In its loan decisions the board of management of the Bank of Finland tried to observe the same policies that it expected of other financial institutions. In the late-1940s the overriding principle was to confine lending to projects that would promote the use of existing productive machinery.

The observance of this principle led to an interesting clash on the bank's board in 1947. The Economic Council had proposed that iron mining operations be started at Otanmäki and that a state-owned nitrogen plant should be established. The board of the Bank of Finland replied that it was opposed to both projects at a time when all investment opportunities were limited by the shortage of labour and of real and money capital. It thought that investment should be focused on sectors that would immediately raise production and were related to existing production, and it believed these principles should be followed in the public sector as well as the private one. Moreover the board doubted that the projects would be economically viable because, in both cases, calculations of their profitability were predicated on low-interest loans from the government. However one board member, Urho Kekkonen, appended a dissenting opinion, stating that the proposals of the Economic Council for the start-up of mining in Otanmäki and the establishment of a nitrogen plant would be worthwhile for the nation.³⁸⁴ Five years later he expounded his vision of an "extensive" industrial growth policy in his book *Onko maallamme malttia vaurastua* (Does our country have the patience to get rich) but we see that his views had already coalesced in 1947.

Naturally Finland's new conditions after the war were reflected in the direction of central bank lending. Export industries no longer had axiomatic priority for loans which they had enjoyed in the interwar years. The main recipients were now engineering companies producing reparation products and the power companies that urgently sought to build new hydropower stations to replace the power plants in territory ceded to the Soviet Union. This phase of central bank lending lasted until the early 1950s and the number of corporate customers varied between 60 and 70 major corporations. Among the main recipients were Ab Kemi Oy and Serlachius Oy (forest industry), A. Ahlström (forest products and engineering), Pohjolan Voima and Imatran Voima (power generation), OTK and SOK (cooperative societies), Outokumpu

Oy (mining), Rikkihappo- ja Superfosfaattitehtaat (chemicals), Yhtyneet Paperitehtaat (paper mills) and Lohjan Kalkkitechdas (lime production).³⁸⁵

The board was already worried about the distorting effects of high inflation. It felt that a long-term loan at a time when the value of money was falling created an unreasonable advantage for the borrower. It was at this time that the governor of the bank Sakari Tuomioja raised the idea of applying indexing to loan terms, although the initiative ultimately came to nothing. For a few major companies, however, the bank took special action and demanded to be allowed to buy shares in them. As a shareholder the Bank of Finland could enjoy some of the company's gains from inflation and be compensated for its potential losses as a lender. At the same time the increase in share capital, implemented by a targeted share issue, improved the financial position of the company in question. In this way the Bank of Finland became a 10 percent shareholder in Pohjolan Voima in 1948 and the holder of about a fifth of the shares of the engineering firm, Ab Strömberg Oy.³⁸⁶ In 1951 the bank significantly enlarged its shareholding in the big state-controlled engineering company, Valmet Oy.³⁸⁷ It already owned a major proportion of the pulp and paper giant Enso-Gutzeit Oy and it retained its relative position by subscribing its quota of new shares each time that the company raised its share capital.³⁸⁸ In 1921 the bank had become a shareholder in Tervakoski Oy, which specialised in producing banknote paper, and in 1928 it became the majority shareholder. By the 1950s it was practically the only shareholder.³⁸⁹

A very interesting operation took place involving Hackman & Co, a limited partnership that was a shareholder in the Outokumpu mining company. In 1948 the board of the Bank of Finland informed Hackman that its loans from the central bank, now above 300 million markkaa, constituted such an advantage that Hackman should also sell tangible assets to meet its capital needs. Hackman & Co then offered to sell the Bank of Finland its share and rights, as landowner, to exploit a find of copper ore "in the claim area of the village of Kuusjärvi that constituted the mining district known as Outokumpu". The share and exploitation rights would be in force for 50 years and the price would be 10 million markkaa. Mining would begin within 25 years. According to expert statements, commissioned by the board of the Bank of Finland, the value of the mining rights exceeded 10 million markkaa so the supervisory council approved the deal.³⁹⁰

But an investment like this was very alien to a central bank, where good liquidity was the guiding light of investment operations, and the Bank of Finland understood this. The following spring its board proposed to the supervisory council that it would divest by donating its mining claim to the charitable fund of the Outokumpu company. The fund had been established in 1937 to promote teaching and research in mining technology, metallurgy and geology but had not been able to develop its research as planned, the board said, because of a cash shortage. By donating its mining rights to the fund the bank would be able to support research in the field. The supervisory council agreed, the donation was made, and the Bank of Finland withdrew from mining operations.³⁹¹

PARTICIPATION IN CORPORATE REORGANISATIONS

In addition to its role as a shareholder, the Bank of Finland was active in promoting corporate reorganisations during this period. In 1950 the state-owned industrial company Valmet Oy was formed from the government's wartime engineering plants. The Bank of Finland participated in this arrangement with a modest investment of one share but the following year, when Valmet raised its share capital by 175 million markkaa, the Bank of Finland subscribed the whole amount. It did not however pay in cash but with the shares of Oy Strömberg Ab. It had acquired these from the family-owned company A. Ahlstrom a few years earlier as part of a programme to improve Ahlström's financial structure, which included the conversion of short-term central bank credit against bills of exchange into long-term bonds. In the supervisory council the transfer of Strömberg shares to Valmet was not universally acclaimed. Councillor J.O. Söderhjelm, representing the Swedish People's Party, was strongly opposed to the deal and felt the shares should be offered on the free market so that all companies would have an equal opportunity to buy them. However the majority of bank councillors approved the board's proposal.³⁹² The Bank of Finland retained its position as a Valmet shareholder in 1953 when it subscribed its quota of an issue of new shares.³⁹³

The most financially complex reorganisation, and one that lasted several decades, was of Kemi Oy, the largest forest products company

in northern Finland. It was a family enterprise, established by the Oulu trading houses of Snellman and Bergbom, and one of the biggest debtors of the central bank. It ran into solvency problems at the start of 1950s because of the complete destruction of its Karihaara sawmill in a fire in autumn 1949. Its financial plight was not eased even by the Korean War boom of 1951 and the board of the Bank of Finland saw no alternative to becoming actively involved in its operations. Board member Kaaperi Kivialho joined Kemi's board and pushed through a plan to almost treble its share capital. The old shareholders were unable to finance such a large capital injection so the Bank of Finland arranged negotiations about bringing in other forest industry companies as shareholders. The largest individual shareholder became the state-owned company Veitsiluoto Oy, with 23 percent. This share plus the holdings of Tervakoski Oy, the National Pension Fund and the Bank of Finland brought the proportion of state-owned shares up to 34 percent. From the private sector, Oy Kaukas Ab, Kymi Oy, W. Rosenlew & Co, and Tampella became shareholders, along with the cooperatives Metsäliitto and SOK. The shareholdings of the families that had previously controlled Kemi shrank to 37 percent.³⁹⁴

The increase in share capital successfully stabilised Kemi's financial position but in the long term the solution proved to be problematic. The shareholders that were Kemi's competitors had no commitment to the purposeful development of the company, which remained fairly unprofitable and invested little. In 1978 its financial position was again critical and it needed new capital. This was done by increasing the holdings of Veitsiluoto and the other public sector shareholders to 49 percent, while the Pellervo cooperative movement headed by Metsäliitto took another 49 percent. The other two percent was subscribed by the Bank of Finland, which thus had the casting vote between the two groups. The solution was not merely financial but also had implications for regional policy so the government participated in the negotiations. Even this ownership structure did not eliminate disputes in corporate governance. Not until 1986 was a durable solution found, when Metsäliitto Group became the largest shareholder. This was part of a broad restructuring of operations between forest industry companies of the whole of northern Finland. With the ownership and future of Kemi Oy finally resolved, the Bank of Finland sold its own shares. In 1952–1953 the bank had been active in seeking the solution

but by the 1980s the national government and major corporations were in the driving seat.³⁹⁵ The bank's role as an industrial player was already history and during 1987 it sold its last shares in industry.

Sometimes the bank played a less direct part in strategic deals. In the mid-1960s Finland's eighth largest company Yhtyneet Paperitehtaat Oy (United Paper Mills) was in a state of crisis that worried its main financial backers, Kansallis bank, Pohjola insurance and the Bank of Finland. They agreed jointly that the first thing to be done was to raise the share capital from 56 million to 83 million markkaa. The present shareholders could not afford this capital injection so a holding company, Teollisuuden Rahoitustuki Oy, was established by Kansallis bank to subscribe the new shares. The Bank of Finland had originally intended to become a shareholder in the holding company but by the late 1960s it no longer wanted to participate directly in an operation such as this. Instead it is granted the holding company a loan of 15 million markkaa to subscribe shares in a placement arranged in autumn 1967.³⁹⁶ Because of the Bank of Finland's tight monetary stance at the time, the commercial banks were far from being liquid enough to participate without central bank financing.

Financing from the Bank of Finland also facilitated the first meaningful international expansion of Kone, a company specialising in manufacturing lifts. In 1968 it acquired the entire elevator business of Sweden's ASEA group. In proportion to the financial resources of Kone Oy, this was an extremely large deal that domestic commercial banks were unable, or unwilling, to underwrite. The plans seemed likely to fall through because of lack of finance until the Bank of Finland stepped in, subscribing all the company's debentures in three separate issues worth a total of 16 million markkaa. The main benefit to Kone was of course the finance as such, but it was also provided on significantly advantageous terms, at a rate of interest lower than the going market rate.³⁹⁷ Financing in this way was administratively simple because the purchase of debentures was not considered to be a loan but an investment in securities, which the Bank of Finland's regulations did not really restrict at all.

The loans granted to industrial corporations in the 1950s against bills of exchange were in reality long-term credit, which was regularly rolled over. By nature this kind of long-term corporate finance went against conventional central banking principles, a point noted by Klaus

Waris, who became governor in 1957. The traditional view was that a bank of issue should not be committed to lending in a form from which it could not disengage rapidly when it needed to. From 1959 onwards, the annual reports of the supervisory council contain references to the fact that other financial institutions were taking over the bank's corporate acceptance credit, meaning in fact its relationship with corporate customers. The report of 1961 notes "the transfer of several customers to other financial institutions" and in 1962 "the transfer of remaining permanent customers to other financial institutions".³⁹⁸ This was also apparent in a decline in the stock of credit against bills of exchange in the first half of the 1960s, although the total turned up again as the money market quickly became tighter on the eve of the 1967 devaluation. The largest exporters were again receiving short-term financial support from the Bank of Finland.

ESTABLISHMENT OF THE MORTGAGE BANK AND THE INDUSTRIALISATION FUND

In the late 1940s the World Bank began making loans to large Finnish companies. These were very valuable to the national economy and one of the reasons why Finland had joined the International Monetary Fund and the World Bank in the first place.

The Bank of Finland acted as the intermediary for these large foreign currency loans so they were included in the figures for its corporate lending. Although they were long-term loans, to be amortised over 10–20 years, they were recorded in the accounts as foreign bills of exchange, more precisely as bank drafts for loans from the World Bank. The first such loans were received as early as 1949. From 1951 onwards they began to have genuine importance in alleviating the chronic shortage of capital and foreign currency affecting industry. This finance facilitated many industrially important infrastructure investments, such as new power stations to increase electrical output. In losing the war, Finland had lost more than a quarter of its generating capacity, so it could afford no delay in constructing replacement hydropower stations. Foreign credit also backed a broad modernisation programme by the forest industry – in particular, paper producers – to allow these exporters to hold their own on international markets. The Bank of Finland continued to mediate these loans until 1956, at which

time they accounted for more than 60 percent of all acceptance credit granted by the bank to domestic companies.

Mediating long-term loans was ill-suited to the function of the Bank of Finland and its board of management discussed a reorganisation of long-term foreign borrowing in summer 1955. In September the board proposed a new model to the supervisory council. A separate mortgage credit bank, owned by the Bank of Finland, would be established to handle such loans and it would also be able fund further lending by issuing bonds. In practice it would be run from the Bank of Finland, with no additional staff or no extra administrative costs. This arrangement would be acceptable to the World Bank so the availability of credit would not be jeopardised. The board suggested that the share capital of the new bank should be 100 million markkaa and it included draft articles of association in its proposal.

The first council discussions on the establishment of a mortgage credit bank were held on 28 September 1955 and were extremely animated. Councillors agreed that mediating foreign credit was an unsuitable duty for a central bank but disagreed about the solution, and the debate continued over several meetings. Among representatives of non-socialist parties, the point of contention was that the new institution would compete with existing banks, where it would have the advantage of close ties with the central bank. J.O. Söderhjelm was a particularly vociferous opponent of the new bank. He believed that the mortgage model was unsuitable because it would require collateral for loans. The best collateral of companies would be pledged to the mortgage bank and the private commercial banks would be left with worse securities and therefore riskier lending. In his view the entire business of establishing a new credit institution could be left to forest industry companies.³⁹⁹

Meanwhile, representatives of the socialist parties feared that the standing of the supervisory council would be diminished in the process if decision-making authority shifted from the council to the board of the Bank of Finland and the operational management of the new bank. To alleviate these concerns the board modified its draft articles of association to ensure that the supervisory council would not be sidelined in overseeing the mortgage bank. Furthermore, the approval of the supervisory council would always be needed for bond issues and other borrowing and for the sale of shares of the mortgage bank.⁴⁰⁰

The new bank was named the Mortgage Bank of Finland, as proposed by Rainer von Fieandt. The Bank of Finland subscribed 98 of its 100 shares, while the remainder were divided between the National Pension Fund and Tervakoski Oy. It took up residence in the main building of the Bank of Finland and started operations in the second half of 1956. Its lending was slow to increase in the early 1960s. World Bank loans were intended primarily for developing countries and to foster new sectors. The Finland of the 1960s no longer fulfilled these criteria because it was too advanced to be called a developing country and papermaking did not constitute a new growth segment. In the 1960s and 1970s the Mortgage Bank of Finland obtained only five new loans from the World Bank. The first three were intended for development of a network of highways, the fourth to finance a programme to boost forest growth and the last, signed in 1975, to initiate a large-scale environmental programme for the containment of water pollution. However the Mortgage Bank had established itself on international capital markets during the 1960s and it fairly soon found new sources of finance. Its lending turned sharply upwards and, by 1971, its portfolio of outstanding loans was 515 million markkaa. For comparison, the Bank of Finland's loans to the corporate sector at this time totalled 638 million.⁴⁰¹

The post of managing director of the Mortgage Bank was first held by Uno Vatanen, a part-time job in which he was assisted by only one official. The World Bank loans that had been granted before its establishment were not transferred away from the Bank of Finland and remained on its accounts to a diminishing extent until 1970. The Mortgage Bank of Finland began to separate itself from the Bank of Finland in 1967, when it moved out of the central bank building and its officers became staff of the Mortgage Bank only.

The governor of the Bank of Finland, Klaus Waris, represented Finland on the board of directors of the World Bank so he was aware of its evolving ideas for promoting development. He received additional information from Jaakko Lassila, who had worked in the economic research institute of the Bank of Finland and in 1960–1962 was a World Bank executive director representing the Nordic countries. The ambit of the World Bank and its associated International Finance Corporation included granting development loans to diversify the industrial structures of member countries. Unlike ordinary loans, development

finance did not have onerous collateral requirements but was granted after a broad study of a company's finances. The future cash flow of the recipient was more important than collateral. The loans were intended to launch operations by small and medium-sized companies and to develop new sectors.

World Bank development finance was mediated by national development credit institutions. For this purpose the World Bank favoured private development companies that had international investment companies among their shareholders. The national development institutions had to undertake to use business research concepts that the World Bank had developed and to obtain separate approval from the World Bank for every financing decision in excess of 50,000 dollars.

The first concrete discussions with the World Bank on establishing such a bank in Finland began in 1961 and confirmation that development finance would be available was received in 1963. At this time the Industrialisation Fund of Finland already existed, having been established in 1954. It was an institution owned by commercial banks and insurance companies but its operations had remained very modest because of a shortage of funds. It had tried to involve the government in its plans but less public finance than hoped for had been forthcoming. Klaus Waris felt that the Industrialisation Fund offered a good platform for cooperation with the World Bank. By combining public and private capital it could be transformed into an effective modern development finance bank.

Although the World Bank would have preferred a purely private organisation, it accepted plans steered by the Bank of Finland for restructuring the Industrialisation Fund of Finland. At the World Bank's request the capital of the Industrialisation Fund was raised from 0.5 million markkaa to 15 million. The shares were divided into an A-series and a B-series. The combined nominal value of A-shares was 6 million markkaa and they were subscribed by financial institutions, insurance companies and industry organisations. The B-shares were held by the Bank of Finland alone and were worth 9 million markkaa. At the demand of the World Bank, the authority of the Bank of Finland was restricted by giving B-shares only one tenth of the voting rights of A-shares and by agreeing that the Industrialisation Fund would buy back the B-shares in the future.

The A-shares were distributed so as to deny an absolute majority to any single shareholder. The World Bank's wishes for an international element were also recognised when the International Finance Corporation became a shareholder to the tune of 2 million markkaa. The proportion of shares held in foreign hands increased in the years ahead. Foreign ownership was made possible by a change in the Companies Act in autumn 1963.⁴⁰²

The first loan from the World Bank was signed on 18 September 1963 and by the end of the year more than 200 enterprises had applied for a part of it. Between 1963 and 1970 the Industrialisation Fund received four major loans from the World Bank. In addition, the Fund's domestic shareholders agreed to subscribe its debentures and bonds, so the scope for lending by the "new" Industrialisation Fund was in a completely different class from that of the "old" fund. The role of the Bank of Finland was underlined by the fact that its governor was chairman of the Fund's board of supervisors until 1984. From 1969 to 1986, a member of the bank's board of management was chairman of the fund's board. The first stage of operations by the Industrialisation Fund ended in 1971 when the World Bank said that it would grant no new loans, explaining that the Fund was so established that World Bank financial support was no longer needed. The World Bank had made an almost identical decision some 10 years earlier when it stopped financing the Mortgage Bank of Finland.⁴⁰³

In the period from 1949 to 1975 Finland received 18 loans from the World Bank, totalling 317 million dollars. The credit was distributed as follows:

Target	Share of total, %
Hydropower stations and electrical grid	20
Forest product companies	32
SMEs	18
Highway construction	13
Civil engineering, forestry and other equipment	1
Water purification projects	8
Forest improvement investments (MERA)	8

Source: www.worldbank.org (22 Mar 2010).

For the World Bank Finland was a significant borrower, as shown by a Nordic comparison. Norway and Denmark were the two other Nordic countries that received loans from the World Bank but Finland received significantly more than either. Norway received a total of six loans worth 145 million dollars and Denmark three loans worth 85 million dollars. Sweden had reached such an advanced stage of development that it received none. Finland's favour in the eyes of the World Bank was certainly influenced by considerations other than economic ones. The loans were granted during the Cold War when Finland was in a sensitive political position as a neutral country between the Soviet Union and Western Europe. Politics had prevented its participation in the US programme of Marshall Aid so World Bank loans were a way of deliberately strengthening Finland's economic foundation and thereby its political stability. At the same time the World Bank ensured that Finland would be able to continue in its role as a major producer of paper products for developed western countries.

SPECIAL CORPORATE FINANCING

The Bank of Finland also granted special credit direct from its balance sheet. It took its first steps in this area in the late 1940s when Finnish companies began exporting to the Soviet Union. These commercial exports increased as capacity was released from the forced deliveries of reparations. To support exports to the Soviet Union the bank began in spring 1949 to grant advance payments to exporters in the form of loans. Special finance as a proportion of all central bank lending was at its highest in the second half of the 1950s, when it reached 30–40 percent of all loans to companies. From 1958 onwards the volume of export advances began to decline fairly rapidly as trade payment terms changed.⁴⁰⁴

Special financing of exports began to be properly organised in the early 1960s. A committee on special financing arrangements was established by the Trade and Industry minister T.A. Wiherheimo, who also held talks with governor Klaus Waris of the Bank of Finland on ways to develop the financing of engineering exports. They concluded that the resources of private financial institutions were far from adequate, and a way had to be found to combine private and public resources. The initial solution was to reorganise the private export

credit company, Vientiluotto Oy, into a company with a majority state shareholding and to establish alongside it an export guarantee board. Although one was formally a limited company and the other an institution of the Ministry of Trade and Industry, they worked closely together from their establishment in 1962 and had a common managing director.

The appointment of their shared managing director reflects the influence of the Bank of Finland. The appointee was Eero Asp, a confidant of governor Waris, who had handled foreign relations at the Bank of Finland and also played an important role in the success of negotiations on the founding of the two institutions. Asp had won his international spurs in 1958–1960 when, under a Nordic mandate, he was the first Finn on the executive board of the International Monetary Fund.⁴⁰⁵ The important role of the Bank of Finland in the export credit institutions was also shown by the fact that there was a member of the bank's board both on the supervisory council of the export credit company and on its board of directors.

As early as 1960, the Bank of Finland participated in another arrangement for export finance. It rediscounted *export bills of exchange*, payable to exporters and discounted by commercial banks if the bills had been approved by the export credit company. This rediscounting was not counted as part of the rediscounting quota of each commercial bank, so it was a form of export financing that was exempt from monetary policy measures that restricted credit and imposed penalty rates on excess discounting. The Bank of Finland also agreed to subscribe bonds and debentures issued by the export credit company, which enhanced the company's financing potential. In 1962 the Bank of Finland initiated a short-term financial operation for the grain trade. There had been an exceptionally poor harvest, after which it had been difficult to obtain finance for purchasing seed grain. Central bank intervention removed the bottleneck.⁴⁰⁶

In 1963 the Bank of Finland began to grant *special delivery credits* to the metals and engineering sector, as a joint programme with commercial banks. The commercial banks discounted bills of exchange with a tenor of six months to five years, payable to engineering companies for goods supplied, and the Bank of Finland rediscounted them. Bills of exchange were eligible for this treatment only up to a certain proportion, set by the Bank of Finland, of the value of goods

supplied. In 1963, the maximum proportion was 75%. The commercial banks also agreed to buy the bills back from the central bank if their borrowing from the public exceeded a limit set by the central bank, although this repurchase obligation was discontinued in 1966. In autumn 1963, the Bank of Finland, together with the Post and Savings Bank and the National Pension Fund, launched a short-term credit programme intended to support the order books of the shipbuilding industry. The central bank allocated 30 million markkaa for this purpose and began granting the credits in 1964.⁴⁰⁷

In 1965 the Bank of Finland and other financial institutions reached agreement on a programme of *novel export finance*, intended to diversify Finnish exporting beyond the traditional forest industry. Credits was to be granted to small and medium-sized companies to meet the short-term financial burdens of manufacture, warehousing and marketing of exports, if this finance would promote new types of exports or would increase existing exports. In practice, the credit was granted by each company's own bank against short-term bills of exchange, which the Bank of Finland then rediscounted. Credit in this form could account for no more than 50 percent of all credit to the company. The system began operating in 1966. Almost all the recipients of new export credit were metals and engineering companies exporting to the western markets.

A programme for *domestic delivery credits* was developed in 1967 with the commercial banks and the Central Bank of Cooperative Credit Societies. Known by its Finnish acronym KTR, its purpose was to improve the competitive position of engineering companies and shipbuilders in the home market by ensuring that they could offer their domestic customers delivery credit terms as good as those offered by their foreign competitors. The KTR system concerned deliveries of vessels, machines and machinery where the domestic supplier gave a domestic buyer time to pay. The Bank of Finland provided the same amount of finance for KTR credit as the cooperating financial institutions combined. KTR credit was conditional on the purchaser paying at least 20 percent of the price by the time of delivery. KTR financing began during 1968 and it gradually became one of the most important forms of central bank credit to companies. By the early 1980s, it was the Bank of Finland's largest corporate credit programme by value of credit granted.⁴⁰⁸

The aim of these very varied programmes of special finance was to diversify the structure of industry and speed up structural change. A striking feature was their catalytic nature. The Bank of Finland specifically sought to create new forms of finance where the amount of capital required for the purpose could be relatively low. In addition to its own programmes, the bank supported national development finance organisations by subscribing their bonds or debentures. In many projects, credit from the central bank was contingent on commercial bank participation, so the Bank of Finland's investment had a significant multiplier effect. The central bank deliberately took the initiative to create new forms of finance but, when operations became established, it shifted most of the responsibility to the private banking sector and their special finance institutions.

BANK OF FINLAND TURNS TO RESTRUCTURING POLICY

KLAUS WARIS' MISSION

It is no exaggeration to say that Klaus Waris, who joined the board of the Bank of Finland in 1952, personified the history of Finnish post-war development financing. The report of the export credit committee, completed under his leadership in 1954, marks the starting point. The committee reached the conclusion that shipbuilders and engineering companies needed special financial arrangements to gain access to international markets because other countries were already offering such finance.⁴⁰⁹ The need became more acute after the association agreement between Finland and the European Free Trade Association EFTA in 1961. To gain unfettered access to international markets, a country had to gradually dismantle domestic tariffs, while participation in the Bretton Woods system restricted the scope for unilateral foreign exchange policies. In this situation many developed countries had begun to support their exporters and protect their domestic market with various financial arrangements.

Waris' restructuring drive was encouraged by the Swedish economist Erik Dahmén, whom he asked for an analysis of the development potential the Finnish economy. Dahmén's study, completed in 1963, stressed Finland's structural underdevelopment, noting the dominant position of agriculture and the consequent characteristic inefficiency of the national economy. Finland was wasting its economic resources and opportunities. It should accelerate

industrialisation and at the same time diversify to reduce its dependence on the forest industry. This meant a focus on developing the metals and engineering sector, particularly engineering. The shift of manpower from agriculture to industry would be a transition to areas of higher productivity, which would allow a relatively fast rate of economic growth.⁴¹⁰

Waris and Dahmén had parallel views about Finland's situation. As a member of the board of management of the Bank of Finland and ultimately its governor, Waris was familiar with Finland's chronic current account problem, which had often forced the central bank to impose monetary policies that were too restrictive in other respects and hindered growth. He believed that economic success required Finland to diversify its industry so that the whole of society would not be at the mercy of fluctuations of one sector, forest products. Diversification would not take place by itself so public sector efforts were needed. Special finance arrangements had an important role to play, because in them, a fairly modest investment could have a major effect. Waris trusted and advocated the market economy but his general attitude to government participation was pragmatic. He understood that many economic innovations needed public support, particularly in the start-up phase, because competing countries granted the same. He therefore endorsed an active role for the central bank both in initiating new projects and in correcting financial market inadequacies.

To promote Finnish restructuring and economic growth, Governor Waris also took initiatives to develop the forest industry, particularly to make more wood feedstock available. He became chairman of the MERA Committee, established in 1963 to finance forest improvements that would help satisfy the raw material requirements of the fast-growing forest industry. The committee's work resulted in three programmes. MERA I and MERA II were financed partly from the government budget and partly by domestic bond issues. The success of the bond issues was ultimately ensured by the Bank of Finland, which subscribed unsold bonds. For the final MERA III programme a loan of 20 million dollars was obtained from the World Bank in 1972, the penultimate World Bank loan granted to Finland.

SITRA FILLS A GAP

Klaus Waris was active in many special finance programmes but perhaps his ideas were expressed most tangibly in the Sitra Innovation Fund. Established in 1967, the name is an acronym for the Fund for Commemorating Finnish Independence. Its exemplar was Sweden's similar *Riksbankens Jubileumsfond*, created by the Swedish Riksbank in honour of its three hundredth year, though its establishment in 1965 preceded the actual anniversary by three years. The function of the Swedish foundation was to support academic research. Its main stress was on social studies that would examine the effects on society and the individual of technical, economic and social change. By creating a separate foundation the Swedish Riksbank wanted to give it the broadest possible freedom of operation. Klaus Waris thought the same in devising the administrative model of a foundation operating in conjunction with the Bank of Finland. However his pragmatic nature shows in the fact that, instead of focusing on academic research, he wanted the Bank of Finland's foundation to finance product development as well as research. He also felt that its ambit should include spreading awareness among decision-makers about the principles of the market economy.

The bank's board of management considered the governor's ideas in winter 1966, when information first became available about how the Swedish Riksbank's foundation was working out. The Bank of Finland itself had no upcoming jubilee or centennial to celebrate but was not deterred and instead picked the fiftieth anniversary of Finnish independence, impending in 1967. The board thought that 100 million markkaa would be suitable founding capital, which could be transferred to the foundation without difficulty in the form of bonds that were owned by the bank but had already been written off. Assuming a 7–8 percent yield, the foundation would be able to spend 7–8 million markkaa a year, which was quite a lot. At that time, the Finnish Cultural Foundation, one of country's main sources of sponsorship for humanities and science, annually distributed only about 1.5 million markkaa in grants.⁴¹¹ The board's designs were first discussed in the supervisory council in October 1966 and received the green light. The board was then able to draft its final plans, which the supervisory council approved on 13 December 1966.⁴¹²

ERIK DAHMÉN (1916–2005)

The Bank of Finland has at times turned to economists in Sweden for recommendations. One example is when it commissioned a report from professor Eli Heckscher in 1923 on the restoration of the gold standard. Another is the study requested in 1993 from professor Hans Tson Söderström into the reasons for the Finnish economic crisis. Its longest-serving consultant was professor Erik Dahmén of the Stockholm School of Economics, who wrote two wide-ranging reports on Finnish economic policies in 1963 and 1984 and established a rapport with the leadership of the Bank of Finland, in particular governors Klaus Waris and Rolf Kullberg.

As an economist, Erik Dahmén was a maverick. At a time when the mainstream was drawn to econometrics, Dahmén concentrated on matters that were hard to quantify, such as innovation, enterprise and the role of institutions. He was partly an economic historian but mainly a researcher into economic transformation and development. In his view, economists had become “prisoners within their own toolshed” in their efforts to mathematically formalise the science.

At the start of the 1950s Dahmén worked for Stockholms Enskilda Bank, where he became an adviser to Marcus Wallenberg, a pillar of Swedish business and industry. His close relationship with the Wallenberg family continued even after he became a professor at the Stockholm School of Economics in 1958.

In 1961 Bank of Finland governor Klaus Waris, who knew Dahmén of old, invited him to draw up a report on Finnish economic development and policies. Completed in 1963, the report recommended a radical downsizing of the inefficient agricultural sector and the diversification of exports, particularly into engineering. Dahmén believed that too much emphasis had been placed on monetary policy in the fight against inflation; he thought that budgetary policy would be a better tool for curbing the excess demand from which Finland suffered. The report aroused great interest at the time and its influence in the 1960s can be seen in the report of the Economic Council on growth policies (1964) and in Klaus Waris’ work for export diversification.

At the start of the 1980s governor Rolf Kullberg asked Dahmén to write a new report on Finnish economic policy, which was completed in 1984. It singled out the control of inflation as the pivotal issue facing the Finnish economy as it became more internationally integrated. Dahmén believed that inflation could not be halted by policies aimed at creating a strong markka and that the battle against inflation should begin on the home front and be targeted against the inflation mechanisms of the mixed economy. If this was won, then exchange rate policy could be very useful. Dahmén was astute in his observation that Finland in the 1980s was “on the cusp of major changes that differ in many respects from those of the past”.

A black and white portrait of Professor Eric Dahmén, a middle-aged man with short, light-colored hair, wearing dark-rimmed glasses, a white collared shirt, a dark tie with diagonal stripes, and a dark suit jacket. He is looking slightly to the left of the camera with a neutral expression. The background is dark and out of focus.

■ Professor Eric Dahmén of Sweden was a confidant of two governors of the Bank of Finland.
– Finnish Press Agency.

The board proposed that the Sitra foundation, operating with founding capital of 100 million markkaa, should be subordinate to the board of the Bank of Finland and the supervisory council. It could begin operations after parliament had approved the transfer of the necessary capital and confirmed its rules. The definition of the foundation's mission reflected the regulations of the Bank of Finland and also the economic philosophy of governor Waris. "The foundation is to finance activity that, while supporting monetary stability, encourages a faster rate of economic growth in our country and an improvement in its international competitiveness." Because Finland was part of the global economy, the foundation could support studies of the relative performance of Finnish companies. To protect competitiveness, models should be developed for increasing productivity and improving the effectiveness of public administration. The aim should be to remove barriers to the full utilisation of productive resources and to promote restructuring, particularly in areas where Finland lagged behind. More broadly, the foundation should support the development of products and means of production, and should seek to facilitate the rapid adoption of foreign technological advances. In its definition of the foundation's purpose, the board had therefore adopted an attitude very similar to the recommendations of Erik Dahmén's report. Finland's economic growth depended on its success in global markets and, before it could be integrated into the world economy, an abrupt structural change from a semi-peripheral agricultural society to an industrial society was needed.⁴¹³

In pursuit of these objectives Sitra would be able to commission studies and reports. Using either grants or loans, it could support individuals or organisations in carrying out research and applying inventions and ideas to productive operations. And it could finance the trialling of new methods and forms of governance both in companies and in the public sector. Furthermore the foundation could act as a small-scale risk investor. To prevent gradual ossification of the foundation, it was proposed from the outset that Sitra's regulations should be revised at five-year intervals to take practical experiences and social changes into account.⁴¹⁴

Parliament gave the proposal a favourable reception. In the view of its banking committee, monetary stability, faster economic growth

and better international competitiveness were such important issues that the creation of a foundation was fully justified. Final approval for the establishment of the Sitra Innovation Fund was given in the parliamentary session that marked the fiftieth anniversary of Finnish independence on 5 December 1967. The most eloquent description of the fund came from Tyne Leivo-Larsson, a member of the banking committee, who said that Sitra “might serve to liberate us from our current economic plight, help us to achieve ever more advanced modes of living for the benefit of the nation, and even to play our part in the historical development of all mankind”.⁴¹⁵

Although Waris resigned from the board of the Bank of Finland at the end of 1967 to become chancellor of Helsinki School of Economics, his connection with Sitra did not end. He became its first president in a term that lasted until 1972, during which time he laid the foundations for its operation. It formed a sequel to the work done under his leadership at the Bank of Finland to develop the country’s system of credit and economic life. The Bank of Finland’s financial investment in Sitra did not end with the grant of 100 million markkaa founding capital. At the proposal of the supervisory council the capital base was doubled to 200 million in 1971, which the bank provided by transferring bonds and other securities of 100 million markkaa. More capital injections were made in 1977 and 1981, justified by the fact that inflation had eroded Sitra’s capital; since 1974 its capital had been less in real terms than at the time of its foundation. In the supervisory council it was also argued that the sums were not a donation to an outside body but a transfer within the bank. By the end of 1981, Sitra’s capital base had reached 400 million markkaa.

SPONSOR

In autumn 1967 the Bank of Finland was involved in the creation of Finland’s first development company, Sponsor Oy. Part of Sponsor’s mission was to develop new products and production innovations into a form that could be industrially exploited and to advise on corporate reorganisations and structural rationalisation of industries. Its targets were small and medium-sized companies and its underlying objective was to broaden and diversify the range of production for export and to increase the range of import substitutes. The Bank of Finland became



■ The presentation at the Helsinki School of Economics of a study of management training, ordered by Sitra, in 1970. In the centre, chancellor Klaus Waris and rector Jaakko Honko.

– Lehtikuva news photo archives / Hannu Lindroos.

SITRA

In 1965 the Bank of Sweden established the *Riksbankens Jubileumsfond*, a fund for the promotion of science and research, to mark its 300th anniversary. At the Bank of Finland, governor Waris thought it a worthy exemplar. In the following autumn, the board proposed to the supervisory council that a fund be established to support projects promoting economic growth. Finland's central bank had no jubilee to celebrate but its fund could commemorate the 50th anniversary of Finnish independence. The board said that 100 million markkaa of bonds held by the Bank of Finland could be transferred to the fund as founding capital. Later it increased the fund by another 300 million markkaa.

On 5 December 1967, a jubilee sitting of parliament approved the establishment of the fund that became known by the acronym Sitra, derived from the words Fund for the Commemoration of Finnish Independence. Sitra's function was defined as financing projects to promote the stability of the Finnish markka, faster economic growth and international competitiveness. The fund was to be owned and run by the Bank of Finland. The bank's board would be assisted in managing Sitra by a commissioner and other staff as necessary.

Klaus Waris, who had just left the post of governor of the Bank of Finland, became Sitra's first commissioner and ran it until 1972, setting the direction

for practical operations. Until the mid-1980s Sitra sought to finance research projects and industrial product development, and to spread an understanding of economics. In the mid-1980s it began to plan large-scale venture capital operations.

Around this time doubts arose about whether Sitra had a suitable management structure. The Bank of Finland was concerned about financial commitments when Sitra prepared projects but the bank's board of management was responsible for them. To transform Sitra into a risk-bearing investor was also in conflict with the bank's nascent desire to concentrate on core central banking functions. The solution was to make Sitra into an independent fund answerable to parliament. Sitra would be administered by a supervisory board, a board of directors and a commissioner.

The new management model came into effect at the start of 1991. The impact of the reform was lessened by the fact that Sitra's supervisory board was composed of members of the parliamentary supervisory council of the Bank of Finland, and that a member of the bank's board of management, Esko Ollila, chaired Sitra's board of directors from 1991 to 1994. The reorganisation was accompanied by an increase in Sitra's capital, implemented by the government, which transferred its holdings in Nokia Corporation to the fund. The vertiginous rise in the value of Nokia shares in the 1990s carried Sitra's financial resources to an entirely new level.

Sponsor's main shareholder, while the other shares were subscribed by Finland's largest commercial banks, the Industrialisation Fund, the Mortgage Bank and the main industrial organisations. The Bank of Finland provided 6.5 million of the founding capital of 10 million markkaa. It was intended that the number of shareholders would expand later and the Bank of Finland promised to sell them shares from its own portfolio.

Sponsor collaborated with the Industrialisation Fund, as shown by the fact that they shared premises and staff when Sponsor began operations in 1968.⁴¹⁶ In the area of development finance, the Bank of Finland was also asked to participate in the Tourism Development Finance Company in 1964 and initially both the board and the supervisory council were in favour. During the autumn, however, the plans changed and the Bank of Finland did not ultimately become a shareholder although it did promise to subscribe debentures issued by the company to twice the value of its share capital.⁴¹⁷

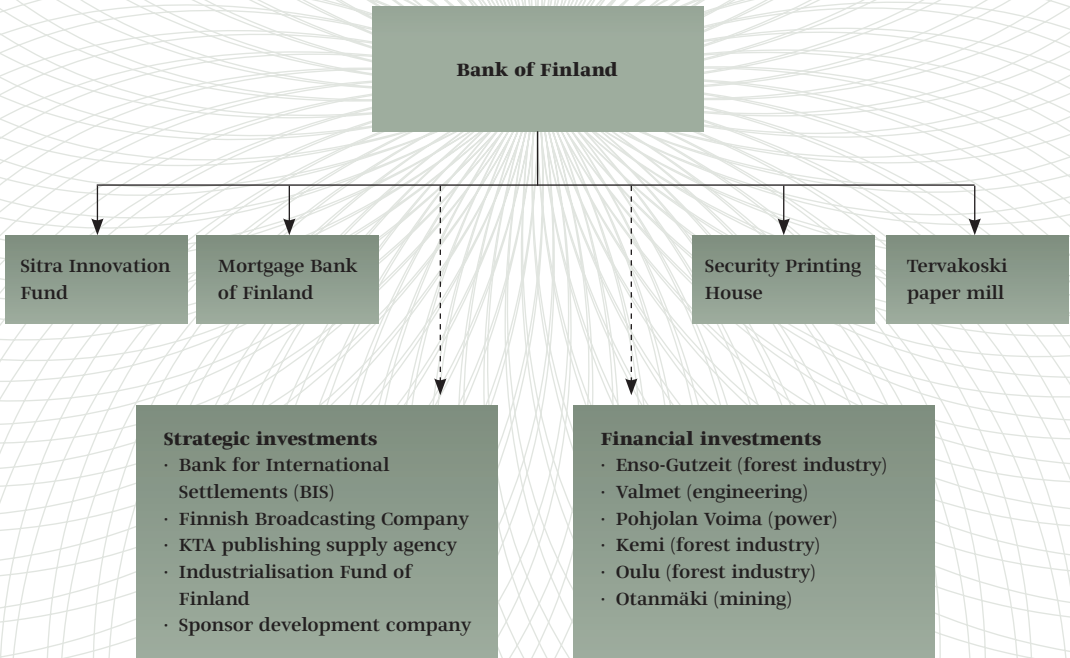
A GROUP STRUCTURE

By the start of the 1970s, a fairly complex financial organization had been created at the Bank of Finland. At its core was the bank itself, surrounded by the companies and institutions it controlled and complemented by its minority investments in other companies. It is not much exaggeration to speak of the Bank of Finland Group, and of Group industrial investment operations, although the term was probably never used at the time.

The core of group, apart from the bank itself, can be thought of as consisting primarily of two subsidiaries that were directly owned by the bank, the Security Printing House, which operated as an independent unit of the bank, and Tervakoski Oy, which specialised in producing banknote paper. Meanwhile, the bank's development and special finance policies were implemented via the Mortgage Bank of Finland, Sitra, the Industrialisation Fund and Sponsor, in all of which it was the majority or sole owner during the 1970s.

In most of these institutions, the board of the central bank held a strong position that extended beyond mere supervision into operational matters. For example, its governor served as chairman of the board of the Mortgage Bank and other members of its board of management

BANK OF FINLAND GROUP STRUCTURE IN THE 1970S



Source: Bank of Finland, appendices to financial statements 1950–1985.

regularly belonged to the Mortgage Bank's board. So did the chairman of the supervisory council, implementing the council's desire to participate directly in overseeing the Mortgage Bank and not merely via the Bank of Finland. According to the statute regulating Sitra's operations, it was owned and overseen by the Bank of Finland. The fund was managed by the central bank's board, aided by the necessary staff. Decisions on how to use the yield from its capital were made by

the supervisory council at the proposal of the board of management of the Bank of Finland.⁴¹⁸

The governor of the Bank of Finland also chaired the board of Tervakoski Oy, on which two other Bank of Finland representatives also sat. Since 1945 the Security Printing House had operated as a financial unit of the Bank of Finland and had been run by its board until in 1977 it was hived off and given rules of management, equivalent to articles of association. The board of the Bank of Finland settled only important issues of principle, while operational decisions were transferred to the separate board of the Security Printing House. However, the majority of members of that board were representatives of the Bank of Finland.⁴¹⁹

These wholly-owned units constituted the core of the Bank of Finland group, where the main authority was the board of management. Because of its strategic position the Bank of Finland group exercised major economic power in Finland in the 1960s and 1970s. It was also a significant employer, as well as a producer of financial expertise; in 1975, for example, the bank had 1 870 workers in its wholly-owned units in addition to its own staff of 911. The Industrialisation Fund and Sponsor had other important shareowners apart from the Bank of Finland, so the bank's role was understandably supervision rather than executive management, although these companies should clearly be counted as belonging to the Bank of Finland group in the 1960s and 1970s. At the Industrialisation Fund, the board of supervisors and the board of directors were both chaired by a representative of the Bank of Finland. On the board of supervisors it was the governor, on the board of directors some other member of the Bank of Finland's board.

In addition to group companies, the Bank of Finland had minority, strategic or financial investments in various companies. Three dated from the period between the wars. The bank had subscribed several shares in the Finnish Broadcasting Company in the 1920s in order to have a channel for relaying financial information, such as exchange rates, to the general public. After the Second World War the informational aspect of this holding may have been less pronounced but the shares were still on its balance sheet. Another special case was Kirjateollisuusasioimisto Oy, the "agency for the printing industry", a company established by printing houses in 1910 to stockpile inks and other important materials so as to guarantee their availability during

the winter and in times of crisis. The Bank of Finland's involvement dated from when it had taken control of the Security Printing House, and was intended to safeguard the uninterrupted printing of banknotes. Shares in the agency remained on the books until the start of the 1980s. Finland had become a shareholder in the Bank for International Settlements when it was established in Basel, Switzerland in 1930.

The bank's holdings in other individual corporations can be regarded largely as financial investments. It had significant holdings in the state-owned forest company Enso-Gutzeit Oy and the state-owned engineering company Valmet Oy. In each case, the bank's proportion of the share capital was around 10 percent at its highest and had come about because of the majority state holdings in these companies. In building up their share capital, the government had enlisted the support of the Bank of Finland, which had subscribed shares in a number of issues over the years. This was particularly true of Enso-Gutzeit, where the Bank of Finland exercised its subscription rights in every issue until the mid-1980s, so that its proportion of the share capital remained unchanged at 9.9 percent. The bank controlled 1.7 percent of Enso-Gutzeit voting rights.

In certain cases the bank's investment was only temporary. It sold its shares in the Pohjolan Voima power company in the mid-1950s, and its holdings in Oulu Oy (forest industry) and Otanmäki Oy (mining) were also quite short-lived. As already told, it subscribed shares in Kemi Oy in the 1950s and 1970s as part of measures to stabilise the company's financial position but most of the shares were sold fairly soon afterwards to major forest industry companies. In addition to the holdings mentioned above, the Bank of Finland held shares in the various real estate companies and condominiums in Helsinki and in other towns where it had branch offices as well as some shares in sports facilities used by its staff for recreational purposes.

The bank did not always need shareholdings to exercise authority in the financial world. When a board of directors was first appointed in 1945 for the Post and Savings Bank, the governor of the Bank of Finland became its chairman, an arrangement that continued until the 1980s. This was considered natural at the time although the Post and Savings Bank – from 1970 onwards called Postbank – was a customer for credit from the Bank of Finland and although it competed fiercely on the deposit market with other Bank of Finland customers, the

commercial banks. The Bank of Finland's position on its board is a sign that before the financial markets were deregulated in the 1980s, the effectiveness of official control was regarded as more important than competition neutrality. The Bank of Finland's representatives also served regularly on the governing bodies of the Export Credit company, where the state was the majority shareholder.

THE IMPACT OF THE CENTRAL BANK'S FINANCING POLICY

The significance of the Bank of Finland as a source of corporate credit became more pronounced in the second half of the 1940s, mainly because private banks and credit institutions had scant funds at a time when all the spare resources of society were being devoted to financing resettlement, reconstruction and reparations. Lending by the Bank of Finland topped 14 percent of the stock of all lending by banks and credit institutions in 1948. Conditions gradually normalised in the following decade and the central bank's share turned down. By the end of the 1950s it was less than three percent and during the 1960s it fell again from 2 to 1 percent. By this time the central bank was not an important lender to companies if measured by total value.⁴²⁰

However, percentages are misleading because, in areas such as power generation and the export sector, the Bank of Finland was a major lender. By ceding territory to the Soviet Union, Finland had lost much of its electrical generating capacity so a large-scale hydropower construction programme was needed when the war ended. The Bank of Finland played an important role in financing it and cooperated closely with the Social Insurance Institution and the Post and Savings Bank. These three public lenders were, almost alone, responsible for financing new power stations, mostly during the mid-1950s. It enhanced the lending potential of the public sector that the Social Insurance Institution was operating a funded pension system and could help finance investments by practically all state-controlled companies. By the 1960s the situation changed quickly after it became a pay-as-you-go pension institution.⁴²¹

The other major beneficiary of central bank lending was industry. At the end of the 1940s, the Bank of Finland provided almost 15% of all loans received by industry. Even in the following decade its share

remained around 10 percent but in the 1960s it fell below five percent. This decline was largely due to the fact that granting long-term credit to industry had been transferred from the Bank of Finland to the Mortgage Bank of Finland as the central bank consistently tried to end its direct ties to corporate clients. Naturally this was reflected in the volume and proportion of loans to industry on its own balance sheet.

In financing industry the Bank of Finland concentrated on the main exporters so it had few customers. At most they numbered about 70. The sector that received the most central bank finance was the paper industry. At one time around 40 percent of the borrowing of paper mills was from the Bank of Finland, which was thus one of the sector's most important financiers. In the 1950s and 1960s paper machine investments were among the greatest individual investments that Finnish industry was making.

In judging the importance of the Bank of Finland in restructuring, a slightly wider perspective is needed than the amount of lending alone. The central bank's role in creating the parameters for business financing should be noted. In the decades after the war, one of the main jobs of the whole financial system was to secure the financing of investments by the export sector. The Bank of Finland, particularly under the governorship of Klaus Waris, interpreted this mission broadly. The financial system had to support not merely the enlargement of the forest industry but also the creation of new export sectors and diversification of the whole structure of production. The Bank of Finland played a decisive role in this by establishing and supporting special credit institutions in the 1960s. Other financial arrangements concerning exports had the same objective, and the Bank of Finland participated prominently.

Central bank policies on lending and capital imports were overwhelmingly determined by two factors. On the one hand it sought to manage the level of economic activity as far as possible, but at the same time it tried to promote structural change. In the first role, its most important monetary policy tools were the terms of rediscounting, as noted in this book's sections on monetary policy. Other methods included modifying the conditions for obtaining short-term import financing. The most extreme example may be the cash payment requirement imposed in 1962, whereby imports of certain officially

defined categories of goods could not be cleared through customs until they had been paid for or until a deposit equal to their purchase price had been made at the Bank of Finland. This system was introduced at a time when foreign currency reserves had declined to an exceptionally low level and imports had to be restricted by all methods possible. Economic management objectives were also observable in the bank's policies on permitting imports of long-term foreign capital. In granting licences, it took into account the prevailing state of the domestic financial market with the aim of preventing the loans interfering with domestic monetary policy.

The second concern, structural change, was equally important. The leadership of the central bank – particularly Klaus Waris – understood the backwardness of Finland's social structure. The proportion of the economy related to agriculture was particularly high compared with Western Europe while industrial and service sectors were small. To trigger restructuring Finland needed new special credit institutions, which had performed well in many continental European countries. However the private sector had inadequate resources for establishing development finance institutions and the Bank of Finland was needed to set them up and to overcome initial resistance. The bank's role both in providing the founding capital and in opening channels to foreign capital was absolutely crucial in the 1960s. These operations were complemented by the bank's own special lending programmes. Its contribution to stimulating structural reform took its most concrete form in the establishment of Sitra.

Nonetheless, some caution should be exercised when assessing the bank's role as an economic reformer. Even when its resources and those of the private sector were combined, the total was modest in relation to the country's needs. Moreover the policies of the Bank of Finland on lending and capital imports contained elements that indisputably bolstered existing economic structures. When the bank granted loans and especially when it issued permits for importing capital, it gave priority to large companies. Because of the balance of payments concerns, exporters were especially favoured. As a consequence, large companies that already had an established position had the best access to finance, a system that served, at least indirectly, to underpin structural rigidity. At the same time, the bank's constant concern about Finland's shortage of foreign

currency, tended to mean that it gave existing export sectors and their investments the best access to finance. Thus it allowed short-term concern about the balance of payments deficits to supersede the need to finance structural reforms. Even so, Finland took certain initiatives to promote “novel exports” by small and medium-sized companies, and its state-owned companies implemented very forceful national restructuring policies. Many such companies, such as Valmet, Neste and Rikkihappo (after 1972 named Kemira) embarked on bold, even rash, projects aimed at diversifying the narrow structure of production. The Bank of Finland participated in financing all of these.

BANK OF FINLAND'S ROLE IN REGULATING CAPITAL IMPORTS

Up to the mid-1980s all foreign borrowing was under the strict supervision of the Bank of Finland. Until the end of the 1950s practically the only organisations borrowing capital from abroad were the government and the Bank of Finland but the situation changed in the 1960s with the emergence and growth of the eurodollar market. Major US banks transferred capital to Europe in order to circumvent their own country's tough margin regulations and to exploit international interest rate differentials. The growth of the eurodollar market changed international financial markets as far away as Finland, where commercial banks and major companies were interested in access to new kinds of credit.⁴²²

Under the Act on Foreign Exchange the Bank of Finland alone determined who could borrow abroad and it monitored long-term credit the most closely. In regulating overseas borrowing the bank made sure that the resultant increase in liquidity was not in conflict with its monetary policy objectives. Its secondary consideration was to protect Finland's creditworthiness on international capital markets. All contracts related to foreign borrowing were studied by the bank to make sure, among other things, that the loan terms were appropriate. Meanwhile central bank's corporate researchers studied the company applying for the permit, examining its financial position in general and the profitability of the investment being financed. Thirdly, the Bank of Finland wanted to ensure that interest and amortisation payments on

foreign loans would not be an excessive burden on foreign currency reserves. It closely monitored the debt servicing ratio, meaning interest and amortisation payments in proportion to current account income. In 1960 the ratio was four percent, by the end of the decade it had risen to about 10 percent, and the Bank of Finland tried to cap it at this level.⁴²³

Loans from abroad went mainly to major exporters and in a few cases to municipalities. Credits were intended for financing major industrial investments but, until the first half of the 1970s, permits applied the 40 percent rule: no more than 40% of the investment could be borrowed from abroad, while the rest had to be obtained from Finland. Of the domestic 60%, a third had to be self-financed. Loans were to be used primarily for expanding operations, secondly for replacement investments that rationalised production and thirdly for early amortisation of existing loans. Admittedly, during the recession that began in the mid-1970s, several major companies manage to get permission to import working capital, too.

Long-term foreign loans also included long-term delivery credit from abroad. Generally this was for financing investment in fixed capital, meaning machines and equipment for industrial production, plus ships and aircraft. In granting permission the Bank of Finland tried to observe international trading practices and by the 1970s was guided by the recommendations of the OECD. The amount borrowed was not generally allowed to rise above 80 percent of the purchase price of the imported goods and the repayment period could not be longer than eight years. For used equipment and ships the permissible proportion borrowed was smaller and repayment period shorter.⁴²⁴

Loan applications could be examined in detail because there were so few of them; each year about 80 export companies took long-term foreign loans. Moreover, the Bank of Finland granted loan quotas to special credit institutions, such as the Industrialisation Fund and the Mortgage Bank, as well as commercial banks with currency trading rights. Within these quotas the recipient could mediate foreign loans to smaller companies although these loans were also examined case-by-case at the central bank. Credit applications were studied in two departments, the foreign exchange monitoring department and foreign capital department. In terms of the number of staff employed, these

operations were some of the bank's biggest. The largest applications of all were decided by the board of management itself.

In 1973 the Bank of Finland began to chart financial requirements by asking the biggest borrowers about their investment plans and financial needs in the upcoming year. By adding this data to estimates of the investment plans of smaller companies it was possible to construct a financial budget for industry as a whole. This allowed the bank to estimate the annual amount of long-term credit needed and to set criteria for allocating permits. In 1975 it established its own credit committee to examine all major applications. This gave it a good overall view of project financing and helped share information between its departments.

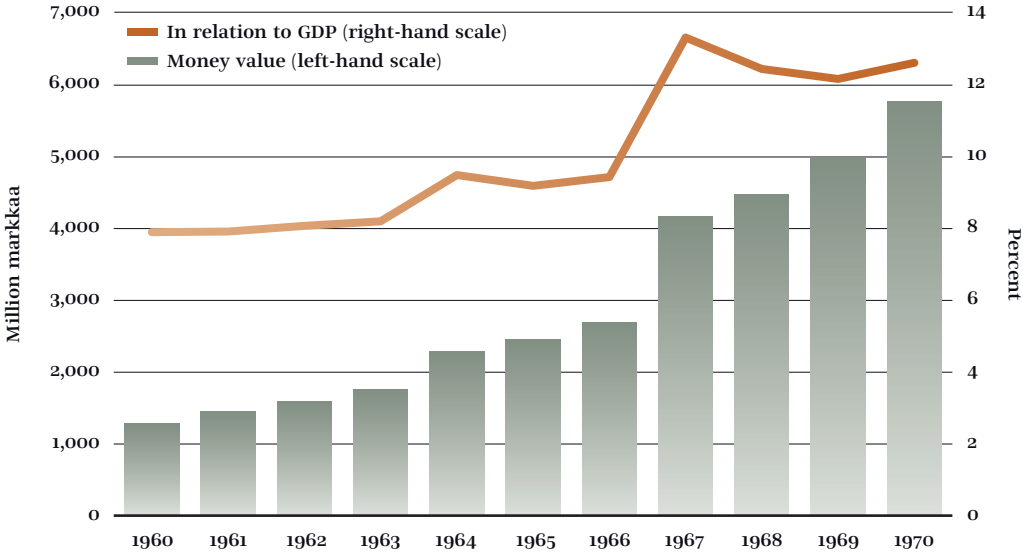
The right to regulate long-term imports of capital meant that the Bank of Finland was indirectly involved in the financing of all but the smallest investments, because the large investment needs of exporters could in no way be met from domestic savings only. Naturally the large commercial banks were also involved in organising investment financing but they would have been imprudent to embark on a project without first securing permission to import long-term foreign capital. In this sense the Bank of Finland had a very prominent role in regulating the allocation of resources in the country from the 1950s to the start of the 1980s. Generally speaking, its policy on permits was fairly liberal and it was sympathetic to the needs of large companies for foreign loans. A few refusals also made headlines. Those that received the most publicity were the bank's entirely negative stand on plans by Neste Oy to build a completely new oil refinery in Pyhåmaa, south-west Finland and its rejection of a permit for a foreign loan to purchase two large tankers from Japan. Both applications were made in the first half of the 1970s.⁴²⁵ The board of the Bank of Finland was also wary of investment projects by the forest products industry at the start of the 1970s, fearing that the new plants would lead to excessive forest felling.⁴²⁶

Short-term foreign loans, on the other hand, were mainly related to foreign trade and used for financing export receivables and the production period, as well as various types of import financing. These credits were regulated differently, in many respects, from long-term foreign loans. Instead of granting individual permits, the Bank of Finland licensed loans that were restricted to certain functions. They

were generally granted until further notice or for a fixed period of time, often a year. The absolute volume of credit was not restricted but the types of transaction that could be financed were. Within the parameters set by the Bank of Finland, the loans were mediated either by Finnish banks licensed to deal in foreign currency or, to a lesser extent, by foreign banks directly. The Bank of Finland required exact reports on how these loans were used.⁴²⁷

Although the import of foreign capital increased substantially after the late 1950s, Finland’s foreign debt remained low in proportion to GDP. By the end of the 1960s Finland’s net foreign debt had exceeded 13 percent of GDP only once, in the devaluation year of 1967.

STOCK OF FINLAND’S LONG-TERM FOREIGN LOANS 1960–1970



Adjusted for 1963 monetary reform.
 Source: Bank of Finland yearbooks 1960–1970.

BANK OF FINLAND AS A GUARANTOR

Apart from issuing permits for foreign loans, the Bank of Finland shaped foreign corporate financing with the sureties that it granted. Usually these were normal loan guarantees but in the latter half of the 1970s the bank also began to guarantee the deliveries of exporters. A central bank loan was very valuable in establishing a company's credibility so it is hardly surprising that the number of guarantees granted was at its highest in the second half of the 1950s, when as many as 100 guarantees might be in force at the end of a year. This did not mean that the number of guarantee recipients was as large, because the same company might have several guarantees in force at the same time. Among the recipients of guarantees were major exporters such as G.A. Serlachius or A. Ahlström (forest products), state-controlled companies like Valmet (engineering) or Neste (petroleum), medium-sized companies like Tammer Tehtaat (plastics) or Kolho (sawn goods), and sales organisations for forest products such as the associations of pulp mills and paper mills. It was striking, if not unnatural, that many state-controlled companies received central bank guarantees.⁴²⁸ In the 1960s and 1970s the number of recipient companies declined considerably but the bank's guarantee liability did not fall to the same extent because the sums increased. At the same time a new group of recipients emerged, special credit institutions such as the Export Credit Company as well as the Industrialisation Fund and Mortgage Bank that were within the ambit of the Bank of Finland.⁴²⁹

The bank's policies on guarantees were fairly consistent with its lending policy. Initially guarantees were used to ease the chronic shortage of capital in the corporate sector. This was particularly important for state-controlled companies that had not yet properly established themselves and needed central bank surety in their funding. In the following phase from the 1960s onwards, the Bank of Finland supported the new special credit institutions by guaranteeing the foreign loans they took. Private companies continued to receive guarantees but they tended to be large companies. In the final phase, roughly between 1977 and 1990, guarantees were used to complemented central bank policies on special financing. At that time they facilitated the start-up and implementation of major building projects in such exotic countries as Iraq, Iran and Libya.

QUEST FOR STABILITY IN AN UNSTABLE WORLD

MAUNO KOIVISTO BECOMES GOVERNOR

After spring 1967, when Klaus Waris announced his intention of resigning later in the year, talks about his successor began amid new political conditions. The parliament elected in 1966 had a majority of socialist members. As the biggest winner, the Social Democratic Party was naturally interested in the position of central bank governor. Party insiders understood the key role of the Bank of Finland in economic policy; in the words of party chairman Rafael Paasio, there was now a possibility, for the first time, of implementing working-class monetary policy at a central bank level. Naturally, Finance minister Mauno Koivisto was aware of these plans and in autumn 1967 he announced that he was willing to stand for governor.⁴³⁰

Negotiations on the choice of a new governor got underway in October 1967, when the inner supervisory council picked Finance minister Koivisto and Foreign minister Ahti Karjalainen as the two main candidates. The latter had been a member of the bank's board of management for almost a decade although, as a member of the government, he had been on leave of absence for most of this time. The critical meeting of the supervisory council was held on 11 October 1967. It was opened by council chairman Veikko Kokkola (Social Democratic Party) who announced the names of the two candidates selected by the inner council. The first one to speak in the ensuing debate was councillor Tuure Junnila (National Coalition Party, in opposition), who was rather strongly critical of both candidates, regarding them as largely political

figures. The balance of political power was always changing, he said, so the bank's governor should not be chosen on political grounds. Moreover, using political criteria could shake confidence in the central bank and also harm its working atmosphere if the impression spread that it was no longer possible for a civil servant to rise to the summit of the bank. Junnula proposed his former colleague at the bank's Research Institute, Reino Rossi, for governor. Rossi had many years of experience as a member of the board of management, he said, and his undisputed knowledge of banking theory made him the most meretricious candidate for the governor's position.

Councillor Saarinen (People's Democratic League) argued instead that the appointment should be part of a larger package. Its other elements would be the appointment of the People's Democratic League chairman Ele Alenius to the board of management, and a decision to ease central bank monetary policy in order to promote investment and employment. However council chairman Kokkola rejected the proposal to link the governor's appointment to other matters and the council concentrated on selecting a governor only. Before the final vote the council was adjourned so that members could negotiate privately among themselves. The meeting accepted the chairman's proposal that members would first vote to decide between Karjalainen and Rossi, after which the winner would stand against Koivisto. The two candidates in the final vote were the original two, and Koivisto defeated Karjalainen by five votes to three. Mauno Koivisto was backed by all the socialist council members while Ahti Karjalainen received the votes of the representatives of the Centre Party and the Swedish People's Party. One councillor, Tuure Junnula, abstained from voting entirely.⁴³¹ President Kekkonen had anticipated the victory of Koivisto, and appointed him in line with the council's proposal.

Mauno Koivisto, PhD, was aged 44 on becoming governor. In a short period of time he had risen to become a leading social democratic expert in economic policy. Before entering politics he had served for some 10 years as managing director of the Helsinki Workers Savings Bank, taking leave of absence on becoming a minister. Earlier in the year he had been appointed managing director of the Elanto cooperative movement but had not yet taken up the position. Although his doctoral thesis was in sociology, on industrial relations in the Port of Turku, his academic interest had turned to economic policy and theory in the

course of the 1950s. He had been an active member of the O Group of young economists so, when he joined the Bank of Finland, he was well aware of the latest trends in economics.⁴³²

He began as governor at the start of 1968 but held the position for less than three months before returning to government, this time as prime minister. The change of government and his ascendancy were connected with the presidential elections held in January 1968. After the elections the government had resigned, as was traditional, and a new government had to be formed. Unexpectedly, the party council of the prime minister's own Social Democratic Party then decided that the same person could no longer be both the party chairman and the prime minister. The aim may have been to overthrow the chairman but instead Rafael Paasio announced that he would not stand for prime minister.⁴³³

Talks on who should be the new prime minister continued in the social democratic party organs for several weeks until Mauno Koivisto was ultimately selected on 27 February 1968. Paasio explained the choice by the fact that Koivisto was well-informed about the plans of the government-appointed conciliator Keijo Liinamaa to stabilise the economy with a centralized incomes policy agreement. Also President Kekkonen had indicated that Koivisto would be a good choice "because he is just the man to make this stabilisation agreement work."⁴³⁴

The Koivisto government was sworn in on 22 March. It had the same composition as its predecessor, constructed around the Social Democratic, Centre and People's Democrat parties but slightly enlarged by one minister from the Swedish People's Party. Many of the ministers were indeed the same as in the previous government so in fact the biggest change was the identity of the prime minister. It is noteworthy that half of the members of the Bank of Finland's board became ministers in Koivisto's government and therefore had to take leave of absence from the bank. Reino Rossi was selected to be acting governor in Koivisto's absence. He subsequently dictated a statement into the minutes of the supervisory council, in which he deplored such a large overlap between the government and the board, which he regarded as hazardous for the bank's independence. Underlying his comment was apparently the idea that Koivisto should have resigned the governorship on becoming prime minister. In that case, Rossi would have been a prominent candidate to replace him.⁴³⁵

The new government's programme stressed incomes policy. The government said it would use its influence to get an overall incomes policy settlement agreed during spring of the same year, which would "hold the average growth of incomes within the limits set by growth of productivity". The government promised to facilitate the agreement by taking "immediate action to halt the rise in price and cost levels and to dismantle inflation indexing in accord with labour market organisations and other interest groups". Regarding monetary policy the government programme promised that "implementation of the aforementioned incomes policy objectives will allow money market easing and facilitate investment financing".⁴³⁶

Within a few months of the government's formation, on 27 March, a comprehensive incomes policy had been agreed. Acclaimed as historic, the Liinamaa Agreement was aimed at preventing erosion of the improvement in competitiveness that had resulted from devaluation, and at creating conditions that would allow economic policy to promote rapid economic growth. The agreement was signed by a total of 12 interest groups. Index clauses were to be forbidden by law and their use in wage agreements and in the financial market was to be terminated immediately. Wage increases were to be within the estimated increase in productivity, on average 3.5 percent. Price controls would be toughened by enacting a new Emergency Powers Act that would give the government broad authority over prices. The Liinamaa Agreement also contained certain reforms in social policies.

The board of the Bank of Finland had already informed the supervisory council about the impact on monetary policy of the Liinamaa Agreement on 20 March, when most of it had been finalised. The most tangible matter was the termination of indexing for bank deposits and the related technical arrangements. The board said it was also issuing a statement, in the name of deputy governor (and soon-to-be acting governor) Reino Rossi, in which it noted "progress in a favourable direction on the balance of payments" and that "the Bank of Finland believes that this has created conditions for supporting investment financing". However, the concrete measures promised by the bank, such as credit for housebuilding and industrial investment, were very modest in magnitude.⁴³⁷

But although the special measures in the credit market that the bank promised in connection with the incomes policy agreement



■ The lower the curve in Bank of Finland forecasts (shown here in 1971), the higher rose Mauno Koivisto's national popularity.

– Lehtikuva news photo archives/
Ensio Ilmanen.

MAUNO KOIVISTO (1923–)

Mauno Koivisto's governorship of the Bank of Finland was seasoned by the collapse of the Bretton Woods system and the first oil crisis, at home by economic overheating and accelerating inflation. In 1975 Finland plunged into an acute balance of payments crisis and the government had to turn to the International Monetary Fund for support. The Bank of Finland made curbing inflation and the balancing of the current account its main objectives. Koivisto's tight monetary policies were criticised but did no harm to his exceptional personal popularity.

He had been born to a working-class family in Turku. During the war he served in the infantry. When peace came he purposefully began to educate himself, while at the same time becoming active in politics in the social democratic movement. He passed his secondary school-level examinations at the age of 25 and received his doctorate from Turku University seven years later (1956).

His career in banking began in 1958 at the Helsinki Workers' Savings Bank, of which he was soon general manager. Around this time, he developed a close rapport with young researchers at the Bank of Finland's Institute for Economic Research. When the social democrats won the 1966 parliamentary elections, Koivisto became Finance minister.

When governor Klaus Waris resigned from the Bank of Finland after the 1967 devaluation, Koivisto was elected as his successor. His candidacy was supported by President Kekkonen, who believed that the paramount duty of a central

bank, to protect price stability, needed the support of the labour unions and thought that Koivisto had the best chances of obtaining it. Just a month after his appointment, Koivisto became prime minister so his term as governor did not begin properly until after the following parliamentary elections in May 1970.

His period at the helm of the Bank of Finland ended in 1979, when he became prime minister following elections that spring. By this time he was already seen as a likely successor to the ageing president. After Kekkonen's illness and resignation, Koivisto was elected president of the republic in January 1982.

As president, Koivisto generally kept out of the limelight in economic policies, supporting what the government did. When governor Kullberg of the Bank of Finland fell out with Prime minister Esko Aho in spring 1992, Koivisto sided with the prime minister and Kullberg had to resign. When the Finnish markka came under speculative attack in autumn of the same year, Koivisto was in favour of letting it float, a solution that the Bank of Finland and the government also reached.

He played a crucial role when Finland decided to apply for membership of the European Community, today's EU. He announced his support for Finnish membership in his address to the opening of parliament in February 1992. The membership negotiations were concluded on 1 March 1994, the same day that Koivisto's second presidential term ended.

were little more than a symbolic expression of support, the hopes of spring 1968 for easier monetary conditions were fulfilled in full measure. For borrowers, the dismantling of indexing in the financial market greatly reduced the cost of debt servicing. The index surcharge, imposed on borrowers to finance the index compensation paid to depositors, was reduced to one percent from the start of April 1968 and eliminated entirely during 1970. As recently as the start of 1968, the commercial banks had imposed an index surcharge of two percentage points and the savings banks and cooperative credit societies 3½–4 percentage points, so the reduction in borrowing costs was of a significant size.

At the same time the money market eased greatly during 1968 because foreign exchange reserves rose sharply after the devaluation, partly due to the improved trade account but largely as a result of capital imports. Total foreign currency reserves doubled during the year although it took some time before the improvement in liquidity and the lower cost of borrowing (after the end of index surcharges) had an impact on bank lending, which did not start to accelerate much until 1969.

In summer 1969, before the Liinamaa Agreement expired, a second agreement was negotiated which extended it to the end of the following year. The two Liinamaa Agreements, covering about three years from 1968 to 1970, were a time of success for economic strategy based on an incomes policy. During the period the Finnish economy grew rapidly (on average by more than six percent annually in real terms) and the unemployment rate fell by half. When the first agreement was being signed, unemployment had exceeded four percent; in 1970 it fell below two percent. Despite rapid growth, inflation was pushed below three percent. Taking into account that the chronically negative balance of payments went into surplus in 1968 and 1969 and foreign exchange reserves grew substantially, it is understandable that there was widespread satisfaction with the results of combining an incomes policy and a devaluation.

The aim of the devaluation and the comprehensive incomes policy settlement was to allow Finland to adopt a coordinated, “growth oriented” economic policy. The Liinamaa Agreement marked the start of a period when the policies of the Bank of Finland on interest and exchange rates were tightly linked to the government’s general

economic policies. At the same time, organized interest groups gained a stronger role in influencing economic policies during the 1970s than they had had in the previous decade.

CRISIS STRIKES THE BRETTON WOODS SYSTEM

While the Liinamaa Agreement was being reached in Finland, events were taking place in the international currency markets that meant the “beginning of the end” for the Bretton Woods system. In response to the continuing outflow of gold, US President Johnson eliminated the gold cover requirement in the Federal Reserve system in March 1968. Dollars could now be issued without limit. At the same time the London Gold Pool ceased operations and was replaced by an agreement between major central banks not to sell “monetary gold” on the free market. This was hoped to maintain fixed exchange rates while protecting US gold reserves by preventing the flow of central bank gold into the private market. The gold market was now divided into two parts, a central banks’ market where the official price of 35 dollars per ounce was still in force, and a free market.

The measures implemented in March 1968 eliminated the limitations that the gold market had imposed on easy US money. Allan Meltzer notes that these measures were a short-term answer to the US balance of payments problem but left the long-term problem without a solution because they did not correct the dollar’s overvaluation nor anything else to create a sustainable balance: monetary policy was not tightened, US federal budget deficits continued unabated and the costs of the Vietnam war went on rising.⁴³⁸

As tensions built up in the Bretton Woods system, efforts began to develop a more balanced and somewhat more symmetric international monetary system, by giving the IMF the means to create a synthetic reserve currency. It had been under discussion since the start of the 1960s but agreement was finally reached spring 1968, at roughly the same time that the Gold Pool was dismantled. The IMF was to create and manage an international reserve currency constituted by Special Drawing Rights (SDRs). The value of an SDR was originally defined in gold and so it was often called paper gold. It was hoped that SDRs would at least partly satisfy the demand for international liquidity,

which would otherwise have required a steady rise in US borrowing from abroad and caused a growing threat to US gold reserves. At the same time SDRs were intended to reduce the asymmetry of the international currency system and the “exorbitant privilege” of the United States as the issuer of the only international currency, the dollar.

The first SDRs were distributed to IMF members in 1970–1972. In this first allocation Finland received 60 million (which at that time were worth 60 million US dollars). SDRs did not become such an important form of international liquidity as was hoped in the planning phase, largely because, after the system of fixed exchange rates collapsed in 1971, they became rather expensive to use.⁴³⁹

US gold reserves stopped declining for a while in 1969–1970 but exchange rate tensions in Europe were unabated. Now it was France’s turn to come under pressure to devalue, which was worsened by political uncertainty following a spring of unrest in Paris in 1968 and large subsequent pay rises. At the same time another European country, Germany, was running a major balance of payments surplus. The United States wanted both countries to bring their exchange rates into better balance but French and German leaders resisted.⁴⁴⁰ The adjustments did not take place until autumn 1969, after a change of governments in France and Germany.

Soon after President Charles de Gaulle of France had resigned and Georges Pompidou had been elected to succeed him in summer 1969, France devalued its franc by about 11 percent, on 8 August. In September the Social Democratic Party rose to power in Germany. The council of the German central bank had already called for a revaluation of the Mark and the new government did so by about 9 percent on 24 October. These changes ended a long period of exchange rate stability in the European Economic Community. The French devaluation was the first since the franc parity in the Bretton Woods system had finally been ratified in 1958. Germany had last revalued its Mark in 1961.

Europe’s exchange-rate adjustments were obviously essential for resolving chronic imbalances but exchange rate changes were even more abhorrent to the EEC than to the United States. Bold advances had been made in the EEC in the 1960s which, in view of the history of the continent, were very successful moves towards creating a common

market. The Common Agricultural Policy had come into force at the start of the 1960s and the EEC had become a customs union in 1968. It was feared that exchange rate changes would disrupt the working of the emerging internal European market. Thus it became prevailing policy in western Europe in the 1970s and 1980s to try to restrict exchange rate fluctuations between EEC member countries although the rest of the world was drifting towards a “regime” of flexible exchange rates at the time.

THE WERNER REPORT

Exchange rate adjustments by France and Germany in 1969 underlined the need for closer cooperation in monetary policy between EEC countries, so as to avoid such problems in the future. At a summit in the Hague in December 1969, leaders of the six EEC member nations agreed to prepare a plan for economic and monetary union between them. In March 1970 a committee was established to plan the project, chaired by Pierre Werner, the prime minister of Luxembourg. It worked quickly and the report was completed by October 1970.

The integration debate within the EEC is often characterised by dividing opinions into two camps, the economists and the monetarists. (The names are not related to how the same terms are used in other connections, economists as a profession and monetarists being the followers of a certain economic doctrine.) In European arguments about integration, the “economists” stressed that the real convergence of national economies must come first and monetary union only puts the final seal on what integration has achieved. The “monetarists” believed that fixing exchange rates, ultimately expressed as monetary union, is an effective way of promoting integration in the economic policies and real economic development of member countries. Pierre Werner sought to reconcile the different views by stressing the need to advance simultaneously but gradually on both the economic and monetary fronts.⁴⁴¹

The Werner plan was for the creation of economic and monetary union between the EEC countries in three stages by 1980. In the first stage, which would last three years, economic policy coordination would be improved between member countries and their tax systems and monetary policy tools would be harmonised. The margins within

which their currencies fluctuated against each other would be reduced, initially on a trial basis and then by imposing narrower official bands. Member countries would not be able to change their currencies' parities without prior discussions with other members. Their policies regarding exchange rates with third countries (such as the USA) and international organisations (such as the IMF) would be harmonised. Preparations would begin for changing the founding treaty of the EEC to make economic and monetary union possible.

In the second stage, the EEC countries would move from coordination to harmonisation of their economic and monetary policies by means of common decisions or directives. Responsibility for economic and monetary policy would ultimately be transferred to community bodies. Norms for the size of members' budgets and budget deficits would become increasingly restrictive. A common capital market would be established. Members would renounce revaluations and devaluations during the second phase although it would not yet be utterly impossible to change exchange rates.

The third stage would be monetary union, bringing exchange rate adjustments to an end. The currencies of the member countries would be fixed and irrevocably tied to each other. Capital movements would be entirely deregulated. The Werner report believed that national monetary units could still be used but psychological and political factors argued for the adoption of a common unit, which would stress the irrevocable nature of monetary union.

A Decision Centre for Economic Policy would be established to direct budgetary and economic policy in the whole EEC area. The Centre would be responsible to the European Parliament and would have control over all national budgets "especially as regards the level and the direction of the balances and the methods for financing the deficits or utilizing the surpluses". It would also decide the EEC's exchange rate policies against the currencies of other countries such as the dollar.

To handle common monetary policy, an EEC central bank system would be established, consisting of national central banks in the same way as the US Federal Reserve system combines the regional reserve banks. The central bank system would decide common interest rate and credit policies. It would manage the EEC's currency reserves and could intervene in the foreign exchange market.⁴⁴²

The Werner report appears very ambitious in view of the amount of economic decision-making it wanted to shift from the national level to the community level. On the one hand it stated that “the union as it is described here represents the minimum that must be done, and is a stage in dynamic evolution which the pressure of events and political will can model in a different way. Economic and monetary union will make it possible to realize an area within which goods and services, people and capital will circulate freely and without competitive distortions, without thereby giving rise to structural or regional disequilibrium. The implementation of such a union will effect a lasting improvement in welfare in the Community and will reinforce the contribution of the Community to economic and monetary equilibrium in the world.”⁴⁴³

The European Council discussed the Werner report on several occasions before managing to agree a joint statement. Their communiqué, issued on 22 March 1971, expressed their governments’ political will for economic and monetary union over the next ten years from 1 January 1971, implemented by stages according to the Werner plan. However it concentrated on general objectives in most matters and contained few concrete measures.

In a nod to the *economist* viewpoint, the communiqué recognised that “in all fields, the measures to be undertaken shall be interdependent and complementary; in particular, the development of monetary unification should be based on parallel progress in harmonising and subsequently unifying economic policies”.

The leaders pledged to improve their economic policy coordination and to harmonise monetary policy tools and tax systems. In practice, however, the most concrete part of the communiqué concerned foreign exchange policy and the margins within which their exchange rates fluctuated. The central banks of EEC countries were urged, on a trial basis, to keep the fluctuations between member currencies smaller than the fluctuation margins set for the dollar exchange rate. In fact, in April EEC central banks did agree that from June they would start using narrower fluctuation margins for mutual exchange rates.

The communiqué of March 1971 was very unspecific and contained no schedule for creation of the economic and monetary union, but it was now an official objective of the EEC. The political will to renounce exchange rate changes between member countries was clear. However

only six weeks had elapsed from publication of the communiqué when the next global currency crisis erupted, shifting plans for EEC economic and monetary union into the vague future.

TRADE POLICY CONCERNS

At the same Hague summit in December 1969 where the European Economic Community decided to begin planning economic and monetary union, the EEC also unexpectedly announced that it was ready to begin enlargement negotiations with Britain, Ireland, Denmark and Norway. This decision marked a new stage in the European integration process which, over the years, had great effect on the economy and politics of Finland, too. The most important tool of Finnish trade policy had been EFTA, the free trade association formed around Britain, with which Finland had an associate agreement. Now it was beginning to break up and there was a danger that a major part of Finland's western export markets, principally Britain, would move behind an EEC customs barrier. Enlargement of the community also put the Nordic project for economic union, Nordek, in a new light, although the negotiations between Norway, Sweden, Finland, Denmark and Iceland had been going on since 1968.

What made EEC enlargement particularly difficult for Finland was that the Soviet Union was so suspicious of the community, which had a political dimension. Its members were all Nato countries and one of them was West Germany, whose growing strength filled Moscow with foreboding. Because of the Soviet Union's attitude, EEC membership was politically unthinkable for Finland in the 1970s and was not seriously considered. When it became possible and even likely that Denmark and Norway would join the EEC, Moscow's attitude toward Nordek also soured and the project lapsed in March 1970 after Finland had decided not to sign the agreement that had already been negotiated.

Parliamentary elections were held in Finland in March 1970. Speaking at the opening of the new parliament on 6 April, President Kekkonen took up Finland's connection with European integration. The country could not remain passive, he said. "The question of enlargement of the European Economic Community faces us with a possible change in the shape of the European market. In this situation we have to safeguard our position in this (western) direction too."⁴⁴ As membership

was out of the question it was clear that some kind of customs or free trade agreement would be involved.

The governing parties had suffered major losses in the March elections and the socialists lost the majority that they had won in 1966. It proved to be difficult to form a new government so the outgoing Koivisto administration had to carry on for a while. On 14 May President Kekkonen appointed a stop-gap non-political government led by Teuvo Aura, so Koivisto and two of his ministerial colleagues, Ahti Karjalainen and Aarre Simonen, could resume their positions on the board of the Bank of Finland.

Karjalainen did not spend long back at the bank. On 15 July he became prime minister of a new centre-left government coalition, the second government he had led. The other ministers were social democrats, centrists, communists and members of the smaller Swedish People's and Liberal Parties. The main challenge facing his government was to shape Finland's relations with the EEC and to overcome the Soviet Union's suspicion about this deepening of western integration. Regarding monetary policy, the programme of Karjalainen government stated: "The use of indexing in contracts will continue to be forbidden and a rise in interest rates prevented."⁴⁴⁵

The government programme shows the care with which the Finns sought to balance their objectives concerning western integration with what was possible for their relationship with the Soviet Union. The part of the programme where the government expressed its desire for discussions on commercial arrangements with the growing EEC was formulated as follows. "The government will in rigorous accordance with a policy of neutrality safeguard the commercial interests of our country in the course of European integration. In particular, economic cooperation with the Soviet Union and the other socialist countries will be promoted, including an increase in cross-border trade with the Soviet Union."⁴⁴⁶

At the end of June 1970 the aforementioned applicant countries began negotiations with the EEC. These talks led to EEC membership for Britain, Ireland and Denmark, which joined the community at the start of 1973. In July 1970, soon after the negotiations had begun, the European Council announced that it was ready to begin talks with other countries later in the autumn. Finland accepted the invitation on 28 July. It was still uncertain at this stage whether Sweden would

also join the EEC or whether it would make some other treaty arrangement. It did not become clear until March 1971, when the Swedish government announced that full or associate membership of the EEC was out of the question for Sweden.⁴⁴⁷

In December 1970 Finland began preliminary discussions with representatives of the European Council of Ministers in Brussels. In his opening statement, Foreign trade minister Olavi J. Mattila announced that Finland would seek a free trade agreement with the EEC in a manner that would at the same time safeguard the continuation of Finnish trade with the Soviet Union and EFTA countries. However the start of negotiations of substance between Finnish and EEC officials was postponed until the end of 1971.⁴⁴⁸

The losses suffered by the socialist and centrist parties in Finland's 1970 election, and Finland's announced interest in developing commercial relations with the EEC, aroused concern in the Soviet Union. Its leadership feared that Finland would move economically closer to Nato countries and thereby also politically closer. Part of Moscow's response to fears of a western drift was to send a new ambassador, Aleksei Belyakov, to Finland in July 1970. Kimmo Rentola, who has studied Belyakov's activities, believes that the ambassador's mission was to "unite the Finnish Communist party under the auspices of more incisive politics, and maintain it as a leading force in the government". If this was Belyakov's mission he failed, but his brief term in Finland did have an impact on monetary policy, as the following section shows.⁴⁴⁹

INCOME POLICY SPLINTERS

Economic strategy founded on an incomes policy began to come apart at the end of 1970s. The first sign came when it proved difficult to put together a centralised incomes policy settlement in the autumn of 1970. To break the deadlock, President Kekkonen ultimately intervened and made his own mediation proposal, which the central organisations soon accepted. The incomes policy settlement thus created, known as the UKK Agreement after the initials of the president, was something of a surrender to pent-up inflation pressures.

The central national organisations of workers, employers and agricultural producers agreed to the president's proposal on 8

December 1970. The UKK Agreement was an incomes policy settlement intended to last 15 months. It included contract increases of 14.5 percent – many times those of the earlier Liinamaa agreements – plus a retroactive 2.5 percent one-year tax on export earnings of the forest industry and the continuation of the government’s mandate to control prices in a somewhat diluted form.

The UKK Agreement was unsuccessful in restraining inflation. Unlike the first and second Liinamaa agreements, the pay rises it contained were indisputably greater than the rise in productivity and in that sense inflationary. It should also be noted that, during the term of the agreement, wages rose by much more than the agreement promised, on average by about 19 percent. Inflation took off at the same time; in 1971 (that is, from December 1970 to December 1971) the cost of living index rose by nearly 9 percent, which in itself was an extraordinary departure from the excellent price stability obtained during the Liinamaa agreements. The UKK Agreement marked the start of a period of faster inflation that continued until the mid-1970s.

There are both economic and political explanations for the failure of incomes policy and the acceleration of inflation in the 1970s. A contemporary view founded on economic causes is contained in the 1971 Finland report of the OECD, which stated that the main barriers to a successful incomes policy were differences in the growth of income between different sectors of production: “There was apparently scope for wage increases in the export industries without endangering their overall profitability; but pay increases (...) could not be met by other industries under the existing price regulation guidelines. Moreover, in some fields there was need for some softening of the price freeze, requiring some changes in the framework of stabilisation policy.”⁴⁵⁰

According to the OECD’s analysis, the problems facing stabilisation policy were not surprising in view of the intrinsic conflicts related to the long-term application of strict price controls and income regulation. The mood of crisis that had prevailed when the Liinamaa agreements were signed had dissipated and the goodwill attached to incomes policy had declined. Arguments about the distribution of income between sectors, between professions and between labour and capital had come to dominate stabilisation policy. The OECD believed that this was partly because inflation abroad had picked up. The disparity between sectors benefiting from international conditions and sectors

in difficulty was not easy to reconcile within a system of rigid income and price regulation.⁴⁵¹

The OECD also pointed out that fiscal policies had lost their effectiveness in managing an economic upturn because, as part of the overall incomes policy settlement, the government had promised not to raise taxes. Meanwhile large inflows of short-term foreign capital reduced the effectiveness of monetary policy.⁴⁵²

There were also political reasons for the failure of the incomes policy system and the consequent acceleration in inflation. The political explanation is that the difficulties in incomes policy negotiations in autumn 1970 had stemmed from the actions of the radical minority of the Communist Party, which made it hard for other political groups within the labour union movement to concede realistic compromises. It was feared that the communists were seeking to organise strikes and create a political crisis in Finland. Those who believe this theory interpret the UKK agreement as intended to avert widespread strikes and prevent the growth of communist influence, and that control of inflation had become a secondary objective. In the words of the historian of the Central Association of Finnish Employers, Markku Mansner: "In the priorities of economic policy, economic stability had to yield to the maintenance of peace in society and the workplace."⁴⁵³

President Kekkonen received a lot of intelligence data during autumn 1970 indicating that the real objective of communist labour union activity was to create widespread strikes and that they were being incited by the new Soviet ambassador Aleksei Belyakov, who had arrived in Finland in July. It appeared that Belyakov was trying to exploit the labour market situation in order to change the balance of political power in Finland to the benefit of the communists.⁴⁵⁴

The managing director of the Central Association of Finnish Employers, Päiviö Hetemäki, went to see the president on 11 November and informed him that incomes policy negotiations were at an impasse and the Communist Party was fomenting a general strike. To end the deadlock, Hetemäki wanted the president would make a mediation proposal that could be based on raising minimum wages.⁴⁵⁵ It was after this meeting that the president became actively involved in the matter and ultimately made his own proposal. The desire to maintain social peace explains the content of the agreement, including its inflationary wage increases. It is a mark of the faith that the president had in

Hetemäki that, a few months after the UKK Agreement had been signed, Kekkonen appointed him to the board of the Bank of Finland. It is even said that that the president himself offered the position to Hetemäki.⁴⁵⁶

The UKK Agreement did not entirely pacify the labour market. Although the SAK umbrella organisation of unions had approved the agreement, certain important member unions had not. Two unions, representing engineering and building workers, went on strike in spring 1971. The engineering strike that began on February 8 was the main labour dispute of the 1970s in Finland politically and perhaps also economically. It lasted seven weeks until 26 March and ended in wage rises that were somewhat above those awarded in the UKK Agreement.

It was during the engineering strike that the Karjalainen government broke up over the implementation of price controls, when communist ministers rejected price rises for some consumer goods that had already been accepted by the other governing parties. The episode went down in history as the “biscuit war”. In the end the government continued as before, except that the communist ministers were replaced by social democratic ones – coincidentally, on the same day that the engineering strike ended. Ambassador Belyakov had left Finland slightly earlier and did not return.⁴⁵⁷

Monetary policy was unable to prevent rising inflation, although the Bank of Finland tried to tighten the money market in 1970 by restricting its lending to commercial banks. The banks were forbidden to exceed their central bank credit quota and had to obtain any additional funding they needed by selling government bonds to the Bank of Finland for a week at a time. These forward trades as they were then called (in modern terms, repurchase agreements) imposed a cost on the banks equivalent to annual interest of 26 percent, so the marginal cost of central bank credit became very high for many banks, but there was no significant impact on the growth of bank lending. On 12 December, soon after the UKK Agreement had been signed, the Bank of Finland decided once more to allow commercial banks to exceed their credit quotas. It reintroduced the sliding scale of interest surcharges on quota excesses and stopped using bond repos as a monetary policy tool. The marginal cost of central bank funding fell again. At the same time, the credit quotas of the commercial banks

were increased, so the effect was to ease the money market, despite the growing inflation pressures.

The acceleration of wage inflation after the UKK Agreement and the engineering strike foretold a deterioration of the country's economic balance. As inflation picked up in 1971, the current account began to deteriorate distinctly for the first time since the big devaluation of 1967. This led to measures by both the government and the Bank of Finland to tighten economic policy in the spring. In May the government agreed on a package of measures to improve the balance of payments by penalising imports. The programme included a temporary extra tax on imports of vehicles and certain consumer durables, as well as a surcharge on merchandise imports in general, described as an equalisation tax on imports to counterbalance the turnover tax contained in the price of domestic produced goods.

A few days after the government had announced its "balance of payments package" it was the turn of the Bank of Finland. On 17 May 1971 its board asked the supervisory council to raise base rate by one and a half percentage points to 8½ percent and at the same time to raise the general interest rate level by one percentage point. The board argued that the programme approved by the government for balancing the payments account needed the support of "relatively tough monetary and credit measures so that the foreign trade deficit can be adequately reduced".

The proposal to raise interest rates was not in itself surprising at a time when inflation had clearly accelerated and could be expected to continue rising. As an issue of principle, however, it was conspicuous because there had been no attempt to use interest rates as a policy tool since 1962. In the discussions in the supervisory council, Tuure Junnila of the National Coalition Party spoke of interest rate policy being awoken from its enchanted sleep of nine years, with the Bank of Finland in the role of bold prince.⁴⁵⁸

During the discussion governor Koivisto argued that an interest rate hike was needed to keep real interest rates at a level that would encourage saving. He added that the board would have proposed higher rates in the preceding autumn but that Keijo Liinamaa, the chief civil servant at the Ministry of Labour and a central incomes policy architect, had said that it would have been in conflict with the incomes policy settlement then in force. The UKK Agreement presented no such obstacles, Koivisto said.⁴⁵⁹

Councillor Aarne Saarinen of the Communist Party and Councillor Veikko Vennamo of the Rural Party opposed the rate increase. Saarinen suspected that it would only increase the general cost level and worsen inflation, without aiding the balance of payments. Vennamo thought that the measure was unsuited to current economic conditions because growth was slowing down. In the vote, however, the council approved the board's proposal and interest rates were increased at the start of June.

At the same time the Bank of Finland made interest rate controls on bank lending slightly more flexible. The fixed ceiling that had hitherto been applied to average bank lending rates was eliminated but the central bank said that it would continue to "monitor the situation" and would permit no appreciable drift, so the practical effect was small. The banks obediently changed all their lending and borrowing rates in line with the Bank of Finland's instructions which, in June 1971, meant that they increased them by one percentage point.

The Karjalainen government broke up at the end of October over a dispute concerning compensation to agricultural producers for wage rises in excess of the UKK Agreement. After the government had resigned, the president called early elections for January 1972. Until that time there was to be a non-political government led once more by the general manager of the Post and Savings Bank, Teuvo Aura. The Finance minister was Päiviö Hetemäki, appointed to the central bank board in the spring, and the Foreign trade minister was Reino Rossi, who had left the board a little earlier to become general manager of the Finnish Sugar Company.

Yet despite the connections between the new government and the central bank, the Bank of Finland was soon to backtrack on the question of interest rates. The pressure to do so mounted during the autumn. The SAK union organisation had attacked the interest rate hikes as soon as they were agreed in May.⁴⁶⁰ At the start of September the president himself tried to persuade governor Koivisto to cancel the increases, although initially without success. Next, in his column in the current affairs magazine *Suomen Kuvalehti*, under the pseudonym "Liimatainen", the president criticised the Bank of Finland and the government for the spring balance of payments package which, with its "dictated" increase in interest rates and its import surcharge, had undermined future negotiations on contracts of employment.⁴⁶¹ Kekkonen obviously regarded the rate hike as contrary to the spirit of the UKK Agreement.

SYLVI SILTANEN (1909–1986)

Until 1991 the members of the supervisory council of the Bank of Finland were officially designated as “supervisory councilmen”. Unlikely as it now seems, parliament chose no women at all for the council before the start of the 1970s. Perhaps one sign of the changing times came in 1947, however, when a veteran social democratic member of parliament, Kaisa Hiilelä, became an auditor of the Bank of Finland. In 1959 she was succeeded by a first-time member of parliament, Sylvi Siltanen. When Olavi Salonen resigned from the council in 1971, Siltanen was elected in his place, becoming the first female member ever. A trailblazer’s role suited her well; in the 1960s she had chaired a committee investigating the status of women. However her council career was to be short. Only four years later she resigned from parliament, having been appointed governor of Turku and Pori Province.

Sylvi Siltanen typified the parliamentarians of her generation who, despite modest beginnings, rose to prominence through work in political organisations. Her only formal education after primary school was a course on bookkeeping at the Central Association of Consumer Cooperatives. It made a useful addition to her practical experience of it. She had moved in labour circles as a child but her

activism dated from the war years when she belonged to a women’s section in Turku of a voluntary organisation aiding war invalids, the displaced and families of the fallen. During her parliamentary career, which began in 1958, she was considered to be one of the group of Social Democrats opposed to President Kekkonen’s foreign policy. Kekkonen and Prime minister Karjalainen even blocked her appointment as a minister on those grounds in 1971.

Siltanen’s arrival at the supervisory council did not yet mark a permanent change in its gender distribution. Women did not feature strongly in the council until the 1990s, although Irma Rosnell (People’s Democratic league) was there in 1982–1983 and Pirkko Työläjärvi (Social Democratic party) in 1983–1987. The elections of 1991 brought a bigger change because two women, Anneli Jätteenmäki (Centre party) and Tuulikki Hämäläinen (Social Democratic party), joined the council at the same time. A few years later the number of female members rose to three and by the end of the millennium it had settled at four. Women arrived properly in 1999, when Virpa Puisto (Social Democratic party) was elected deputy chair of the council. The first female chair was Mari Kiviniemi (Centre party), elected in 2005.



■ Sylvi Siltanen was the first female member of parliament to be elected to the supervisory council.

– Finnish Press Agency / Juha Tujunen.

Governor Koivisto explained his views at a meeting of the supervisory council on 17 September. He believed that the policy on interest rates should depend on whether a moderate wage solution was obtained at the turn of the following year. "We have announced our intention of pursuing active policies on interest rates and have left behind the long period when rates were frozen. It is the first time since 1955 (sic, actually 1956) that interest rates have been increased by this kind of general decision. Since 1955 rates have been reduced three times while one attempt has been made to raise them (...) I feel that the freedom to use interest rate policies is very important and that monetary policy should not be restrained in a way that we know will lead to deadlock."⁴⁶²

Koivisto had to back down, however, after the new prime minister had also publicly demanded a cut in the bank rate. On 18 November the board asked the supervisory council to lower the base rate and the general interest rate level by three quarters of a percentage point from the start of 1972. The council agreed although several members deplored the government interference in the matter. The council chairman, Harri Holkeri of the National Coalition Party, dictated the following statement into the minutes:

"The constitutional independence of the Bank of Finland from the government must be regarded as an important principle. In connection with the interest-rate decision that has now been taken, the government has acted publicly in a way that must be seen as applying pressure to the Bank of Finland and as a serious violation of the aforementioned principle."⁴⁶³

Governor Koivisto published a more moderate statement in which he said that the reasons for which it had been decided in May to increase rates still existed but that "since May arguments for lower interest rates have become weightier. The Bank of Finland hopes that the reduction in the interest rate level now implemented will promote the kind of comprehensive incomes policy settlement that will preserve conditions for balanced economic development and allow the continuation of a monetary policy that supports growth and employment."

At the end of the statement he underlined the central bank's independence: "In deciding to lower the interest rate level, the Bank of Finland's premise is that a policy of active interest rates can be

pursued in future, as part of general economic policy. We will seek in a balanced way to take into account not only the effects of interest rate decisions on economic conditions and income policy but also the effects of the domestic interest rate level on the balance of payments and the structure of investment.”⁴⁶⁴

The end of Koivisto’s statement meant that, although the bank had had to retreat from its decision to raise rates in May, he felt that the interest rate had returned to the set of monetary policy tools. In future the central bank would consider arguments for raising interest rates as well as reasons for lowering them. The interest rate increase in 1971 and the subsequent retreat under pressure from the government and the president were reminiscent of the humiliating defeat suffered by Klaus Waris in 1962, which had led to the abandonment of interest rate policy. Koivisto’s obvious aim was to communicate that it would not happen this time.

INFLATION TAKES OFF

FIXED EXCHANGE RATES CRUMBLE

At the same time as inflation was picking up in Finland and the Bank of Finland was trying to reactivate its use of interest rates, the global system of fixed exchange rates was approaching its demise. In 1970, when the US economy went into recession, the US administration reacted with monetary easing. One consequence was that short-term capital began to flow abroad, damaging already fragile confidence in the dollar. By April 1971 the flight of capital from the United States to Germany had become distinctly speculative in nature, according to the International Monetary Fund. This currency exodus threatened dwindling US gold reserves and at the same time hindered German monetary policy. The flow of international capital into Germany increased its money supply and raised the risk of inflation.

In May 1971 Germany's influential Advisory Council (Sachsverständigenrat) recommended that the German Mark should be let float against the dollar although at this time the German central bank was still opposed to adopting flexible exchange rates, regarding them as a breach of European commitments. However Economy minister Schiller decided to endorse the idea and from 9 May onwards Germany ceased to maintain a fixed exchange rate against the dollar.⁴⁶⁵ The floating Mark now began to appreciate. The Netherlands followed suit in abandoning the fixed dollar exchange rate while Austria and Switzerland revalued their own currencies. Harold James takes the view that Germany renounced a multilateral currency policy founded on international treaties because it saw that multilateral coordination had failed to influence US economic

policies, and even European coordination had not led to tangible results.⁴⁶⁶

During summer 1971 the US balance of payments continued to deteriorate and the German Mark grew stronger. Between the date when it was floated in May to early August it gained about five percent in value. At the start of August the Congressional Joint Economic Committee of the US Senate and House of Representatives published a report stating that the dollar was overvalued and that probably the only way to correct it was to detach it from gold.⁴⁶⁷ President Nixon made a historic television speech on 15 August, announcing that the United States would no longer convert dollars into gold. This was part of a broader economic package that included a three-month price and wage freeze and 10 percent temporary import surcharge to balance the trade account.

Naturally the decision to sever the link between the dollar and gold caused turmoil on the world's money markets and in international financial diplomacy. As Bank of Finland director Jorma Aranko told the supervisory council on 18 August: "With a few words President Nixon brought international payments traffic to a standstill."⁴⁶⁸ The markets did not reopen until 23 August and then in an unsettled state. Broad international negotiations on reforming the world's currency system continued over the months ahead. No real progress was made at the annual meeting of the IMF at the end of September and the initiative passed to the G-10 group of nations. This group had been established in 1962 by ten major western economies that were committed to the GAB (General Arrangements to Borrow), an agreement to lend resources to the IMF when needed. Since then the G-10 had constituted an inner circle of international financial diplomacy. Sweden was the only Nordic member.

The crisis of the international currency system faced Finland's central bank and government with difficult choices. The legalistic approach was that Finland had made international commitments to keeping its exchange rate stable against the dollar. However, at a time when many currencies were appreciating against the dollar, this would have meant a devaluation of the markka, in an economic sense if not a legal one. In summer 1971, when the German Mark and the Dutch guilder departed from their official parities and began to rise in value against the dollar, the Bank of Finland was unmoved

and kept the markka rate against the dollar fairly stable through the summer.

Finland's options became more difficult in August when the dollar went off the gold standard. Experts such as Pekka Korpinen and Kari Puumanen at the Bank of Finland's Economic Research Institute thought that the markka should be allowed to appreciate against the dollar. Their memorandum, dated 17 August, ended with the recommendation: "The exchange rate of the Finnish markkaa should be held stable against the currencies of the most important competing countries on average. In practice this may entail a small revaluation."⁴⁶⁹ In other words: "As long as the system of fixed exchange rates is retained, the markka's value is to be kept constant against the currencies that are most important, measured for example by export shares." It was argued that this would be a way of blunting the compensation demands of wage earners' organisations, of reinforcing confidence in the markka and of improving the ability of industry to compete with Sweden for labour.⁴⁷⁰

The recommendations of the central bank's young experts were not followed. When foreign exchange markets reopened on 23 August after the US announcement, Finland followed Great Britain and Sweden in ignoring the formal ceiling on the dollar rate but did not actually revalue its currency against the dollar by as much as the other Nordic countries and Britain did. As a consequence of Finland's very conservative policy on exchange rates, the markka followed the dollar fairly closely and appreciated by only 0.7 percent against it between the start of May to 17 December 1971. The values of the other Nordic currencies and the pound sterling rose by about five percent during the same period, and the German Mark by 11 percent.⁴⁷¹ The markka depreciated against foreign currencies by an average of about 4.5 percent, if its average exchange rate is computed according to each country's share of Finnish foreign trade.

The principles of the bank's policy on exchange rates were explained to the supervisory council several times during the autumn. The board stressed that the bank had not actively sought to intervene in the foreign exchange market. For example at the meeting on 17 September, Jaakko Lassila, the board member responsible for foreign exchange matters, said that quotations had been based on the supply of and demand for dollars in Finland. The banks dealing in foreign

exchange had exhibited a greater propensity to buy dollars than to sell them so the dollar rate had not deteriorated much. There had been no plain interventions by the Bank of Finland to speak of, Lassila said.⁴⁷²

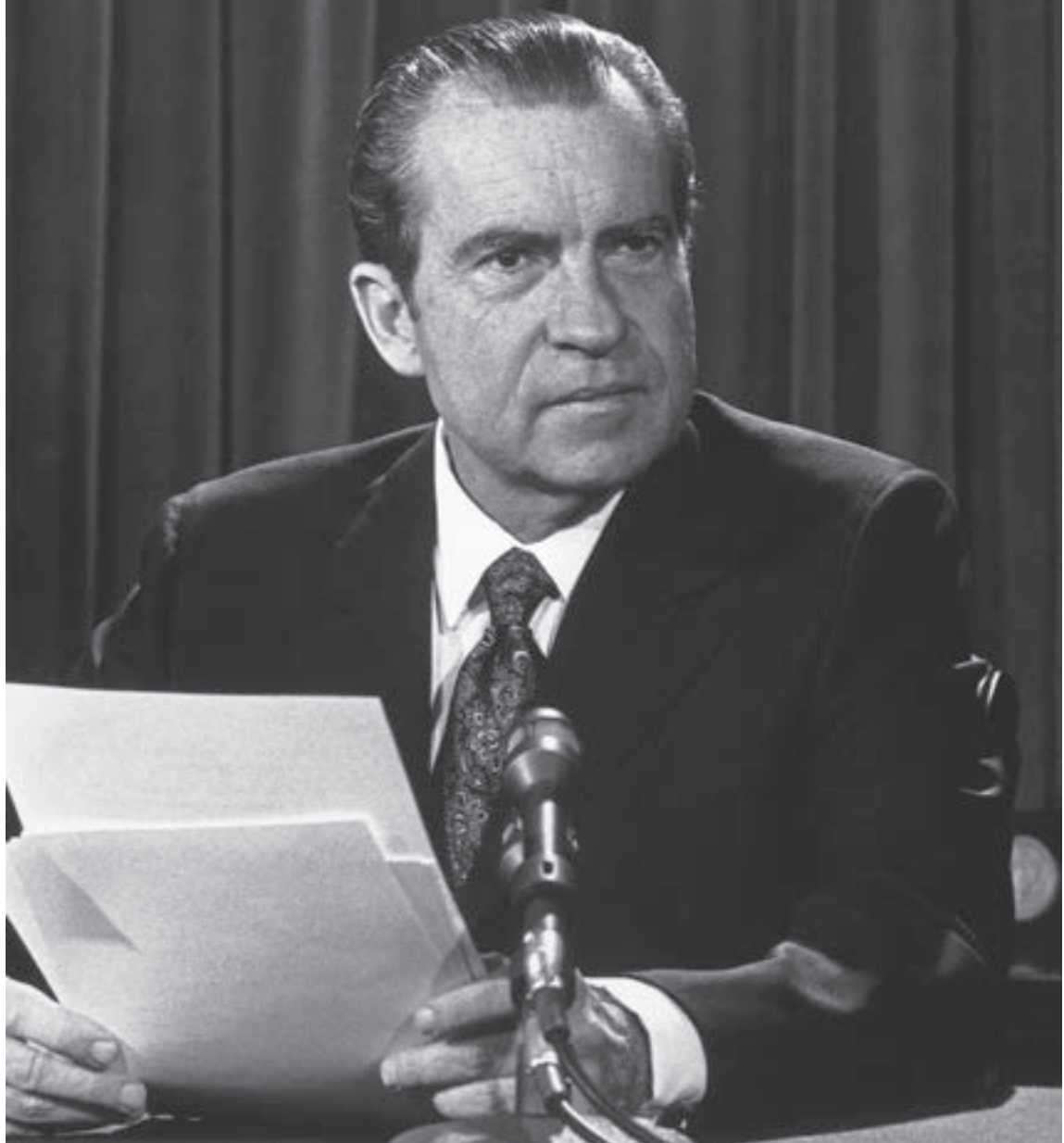
Jaakko Lassila's explanation, that the Bank of Finland did not influence the markka exchange rate in autumn 1971 with its own currency purchases or sales, does not conflict with changes in the bank's currency reserves until the end of November. Between the "Nixon shock" and the end of November, the bank's foreign currency reserves remained largely unchanged. They changed in early December, however, when the bank purchased a significant volume of dollars and so prevented the markka from appreciating. Between the end of November and 17 December the bank's dollar reserves increased by 110 million dollars. The bank also began buying dollar forwards on 13 December and had acquired 34 million by 17 December.⁴⁷³

The currency purchases at the start of December were not enormous but were exceptional for the Bank of Finland. Their size can be judged in comparison to the bank's total dollar reserves, which were only 210 million before they began. This departure from normal practice can be explained by strong expectations on the eve of international currency reorganisation that the markka would be revalued. These expectations caused a flow of dollars into Finland, which would have raised the markka's exchange rate unless the Bank of Finland had purchased them itself. However, it is hard to assess the quantitative impact of the bank's currency trading on the exchange rate.

On 17 and 18 December the leaders of the G-10 countries met at the Smithsonian Institution in Washington to decide on new exchange rates. The result was an attempt to reinstate the system of fixed rates, at different and hopefully more realistic levels, but without the immediate restoration of the dollar's peg to gold. In the Smithsonian Agreement the G-10 countries agreed to set "central rates" that would replace the official parities of the International Monetary Fund in guiding their exchange rate policies. The calculation of central rates would start from a higher gold price, now 38 dollars an ounce. In principle this meant a dollar devaluation of 7.9 percent against gold but because dollar convertibility into gold was not restored, the new gold price was only a mathematical aid for calculating a new exchange rate structure.

■ Richard Nixon in 1971.

– Corbis / Finnish Press Agency /
Bettman.



The central rates of the Smithsonian Agreement brought large revaluations against the dollar for surplus countries like Japan, Germany, Belgium and the Netherlands. The value of the Japanese yen rose by a full 16.9 percent against the dollar, the German Mark by 13.6 percent. The central rates for British and French currencies were calculated so as to leave their parity in gold unchanged; they appreciated by 8.6 percent against the dollar. Sweden, the only Nordic country in the G-10, revalued its krona 7.5 percent against the dollar.

The Smithsonian Agreement not only changed “official” dollar exchange rates but also introduced broader fluctuation bands than had been allowed by the Bretton Woods agreement. Exchange rates could now be within 2¼ percent of the central rate against the dollar, on either side. The mutual rates between other currencies could fluctuate even more, by plus or minus 4½ percent from the central rates.

As soon as the G-10 countries had reached agreement, the board of the International Monetary Fund approved the result as a temporary system, allowing other countries to set their new central rates. The Nordic countries made their decisions on Monday, 20 December 1971. Finland was then faced with the question of how to react to the uncertain new situation on the foreign exchange market. The solutions of the central bank and government were to have very far-reaching consequences for economic development in the 1970s and subsequent economic policy debate.

FINLAND BREAKS NORDIC RANKS

During the crucial G-10 weekend discussions in Washington, governor Mauno Koivisto of the Bank of Finland was in touch with the Swedish Finance minister Gunnar Sträng, who passed on news from Sweden’s negotiator, Foreign trade minister Kjell-Olof Feldt. After the G-10 had reached its decision Sträng called Koivisto once more to say that Norway and Denmark were going to follow Sweden’s line and revalue their currencies against the dollar by 7.5 percent. Sträng said he hoped Finland would too. According to his memoirs, Koivisto answered that this would be difficult but did not give a definitive answer.

Finland’s line was decided in talks between the government and the Bank of Finland on the evening of 19 December. The central rate was not established according to the terms of the Currency Act because

the gold parity of the markka, defined by the act, was unchanged, but Koivisto felt that the Bank of Finland could not take a decision on exchange rates without the participation and approval of the government. The bank prepared three alternatives to be presented to the government: (a) the markka could be revalued 7.5 percent against the dollar like the other Nordic currencies, (b) its average value vis-a-vis other currencies could be returned to the level of May 1971 or (c) it could be maintained at its average value in the first week of December. Of these alternatives the first two were almost identical.⁴⁷⁴ The final version of the memorandum on exchange rates written at the Bank of Finland said that the revaluation options (a) and (b) would mean exchange rates of 3.910 and 3.905 markkaa to the dollar, while option (c) of keeping the rate unchanged meant an exchange rate of 4.110.⁴⁷⁵

The board of the Bank of Finland did not present a united front in its discussions with the government. According to governor Koivisto's later report to the supervisory council, he felt "to the bitter end" that Finland should have followed the example of the other Nordic countries and revalued its currency against the dollar. However, according to Aarre Simonen, the other central bank directors thought that the markka could not be allowed to rise more against the dollar than it had already done during the autumn. This opposing view was also presented to the Prime minister.⁴⁷⁶

If Finland had followed the other Nordic countries, the markka's value would have risen suddenly because it had risen far less than the other Nordic currencies during the autumn. The government did not like the revaluation options, so the exchange rate was kept at the level prevailing in early December. The autumn depreciation of the markka against all currencies apart from the dollar was formalized thus. The central rate was to be 4.10 markkaa per dollar.

The central rate settled in the talks between the Bank of Finland and the government was wired to the International Monetary Fund on 20 December. The telegram said the decision was justified by a deterioration in competitiveness in 1971 and the growth of the current account deficit. The IMF secretariat accepted these arguments, noting that the average depreciation of about six percent entailed by the new markka central rate (compared with the situation at the start of May) was "appropriate to Finland's external position". The IMF board marked

Finland's decision "notice served", as it did the decisions of other countries about their central rates.

If one looks merely at the "official" value of the markka, the central rate chosen was 2.4 percent stronger against the dollar than the parity value of 4.2 set by the Bretton Woods system. However this is hardly significant because daily quotes could vary by the aforementioned 2¼ percent from the central rate. In reality the outcome of the currency realignment was that the markka appreciated by only about one percent against the dollar during 1971 but at the same time it depreciated against all the other currencies quoted in Helsinki, with the exception of the Icelandic krona. If the value of the markka is compared with a basket of currencies weighted in accordance with each country's share of Finnish foreign trade, the Bank of Finland calculated that the markka fell in effective terms by about 5.3% during 1971.⁴⁷⁷

The exchange rate decision was immediately controversial in Finland. On 23 December, the newspaper of the SAK labour union organisation headlined it "One more devaluation" and wrote that the Bank of Finland had covertly devalued the markka during the autumn. This was unfair play, it said, and asked: "How will wage earners get access to the estimated 200–300 million markkaa of benefits that the devaluation will give companies." The newspaper concluded: "If the Bank of Finland had paid closer attention to the interests of wage earners and less to those of corporations, there would certainly have been far better chances of reaching sensible wage agreements. Now the situation is gloomier than ever." In Sweden, Dagens Nyheter newspaper wrote of the decision under the title "Finländsk valutakupp" – Finland's currency coup.⁴⁷⁸

At the turn of 1972 the Bank of Finland considered the possibility of cancelling the devaluation with a revaluation, as part of an overall incomes policy settlement, then under preparation. Bank economists Reino Airikkala, Pekka Korpinen and Kari Puumanen wrote a memorandum recommending an immediate revaluation of the markkaa by 5% that would be fully taken into account in incomes policy talks. Korpinen and Puumanen had already proposed a revaluation against the dollar in August, as mentioned earlier. Governor Koivisto was also interested in the revaluation option at the end of December and in January. Later he recorded his ideas when the central rate decision had been taken: "For my own part I thought, let the

temporary government make a temporary decision now, and when a political government is formed it can make better decisions.”

But the early elections held on 2 and 3 January did little to change the relative strengths of parties in parliament and it proved impossible to establish a majority government. On 23 February a minority social democratic government was formed, headed by Rafael Paasio, already 68, and with Mauno Koivisto as Finance minister and deputy Prime minister. During his leave of absence from the central bank, Koivisto was replaced by the deputy chairman of the board of management, Aarre Simonen.

After the government had been established, talks began on a new incomes policy settlement but the idea of using the exchange rate to “buy” lower wage increases, as Koivisto had hoped at the start of the year, was dashed and the concept was abandoned.⁴⁷⁹ The markka then followed the dollar very closely during 1972, while the German Mark and other currencies of continental Europe continued to appreciate. Consequently, the markka depreciated slightly in effective (average) terms during the early months but in mid-June its direction changed when the pound sterling came under pressure on foreign exchange markets. After a defensive struggle of about a week, during which the central banks of the EEC and the Bank of England tried to support the pound, it was finally allowed to float on 23 June 1972. The pound had soon depreciated by about six percent from its pre-crisis value. Because the pound was an important currency for Finnish foreign trade, this had the effect of raising the average value of the markka so that, by the end of 1972, it was approximately the same as at the start of the year against the key currencies for Finland.

Among the most important tasks facing Paasio’s minority government was to negotiate the free trade agreement with the EEC. The negotiations were concluded in July 1972 and the agreement was initialled on 22 July. The government thought that the agreement would be signed soon and would come into force on 1 January 1973 but political changes delayed its implementation by a year. Paasio tendered his government’s resignation in the summer and was replaced on 4 September by Kalevi Sorsa, heading a majority government underpinned by the Social Democratic Party and the Centre Party. There were also two ministers each from the Swedish People’s Party and the Liberal Party. Koivisto now went back to

being governor of the Bank of Finland but Ahti Karjalainen left the central bank's board to become Foreign minister. On October 1973 the government finally signed the EEC trade agreement, which took force from the start of 1974. Socialist support for the agreement had been won by passing a number of "protective laws", standby powers intended to reinforce government regulatory authority in case of need. At the same time, foreign policy obstacles – the suspicions of Moscow – to an agreement with the EEC were overcome when parliament extended the term of President Kekkonen to 1978. It would normally have expired at the start of 1974.

MONETARY POLICY ADRIFT

In 1972 the money market was very easy, in fact far too much so. Interest rates fell when the general cut that the government had forced on the Bank of Finland in November 1971 took effect at the start of the year. At the same time, the position of commercial banks vis-a-vis the central bank also became very easy: their quotas of central bank credit had been substantially increased in autumn 1971 and their central bank debt had declined because of capital imports. As a result, the marginal rate they paid for central bank funding fell to the level of base rate, 7¾ percent. In May the Bank of Finland sent them new and expansionary instructions on lending policy in the form of a circular. It emphasised the desirability of initiating investment as fast as possible, especially productive investments that, during their construction period, would have an employment effect at the end of 1972 and the start of 1973.

Monetary easing was intended to support economic growth and was founded on the forecasts available at the start of the year, which indicated that growth would be low. In fact, 1972 marked the start of an exceptionally strong boom. GDP increased by a full 7½ percent that year and 6½ percent the following year. During the boom, which easy money had certainly helped to stoke, the seeds of economic imbalance were sown. They led to an unquestionable overheating of the national economy in 1973–1974 and then to a serious balance of payments crisis in the mid-1970s. Koivisto wrote later: "The forecasts for 1972 proved to be wrong to an exceptional extent. Or else the ensuing policy of supporting growth was successful beyond all expectations."⁴⁸⁰

In Finland, 1973 began under the auspices of an economic boom and accelerating inflation. In the United States, the government announced on 13 February that the dollar's price in gold was being lowered 10 percent. In fact, this was a dollar devaluation in the central exchange rate system created by the Smithsonian Agreement. The measure had very little to do with gold, because dollar convertibility into gold had been and would remain suspended. The day after the US announcement, the board of the Bank of Finland decided to revalue the markkaa about five percent against the dollar. The central rate of 4.10 markkaa per dollar, set after the Smithsonian Agreement, was changed to 3.90 markkaa.

In a meeting of the supervisory council on the same day, governor Koivisto explained the decision by pointing out that it would keep the average value of the markka unchanged against other currencies, assuming that Sweden revalued by about 5%. This largely accurate assumption was based on information that Koivisto had received on the previous day at a meeting of Nordic central bank governors in Arlanda, Sweden. The supervisory council was not regarded as having formal authority in the matter, because the change had been made in the temporary central rate of the Smithsonian Agreement, not in the international parity of the markka laid down in the Currency Act. The council did not therefore take a formal decision about the new central rate but merely noted that it had received a report on the matter from the board of the Bank of Finland. Communist councillor Aarne Saarinen deplored the decision. His dissenting opinion, recorded in the minutes, was that the board should revise its decision so that the markka would not be devalued, which is what he believed had happened.

Councillors from the opposition parties were particularly concerned that the influence of the supervisory council on exchange rate policies had declined or even ceased entirely since the collapse of the Bretton Woods system. In the meeting on 14 February, Tuure Junnila of the National Coalition Party stated that "the Currency Act of Finland and the role accorded to members of the supervisory council have in fact been wiped out by the actions of the United States administration. When such a state of affairs is prolonged, it is starting to be, if not intolerable, then at least unpleasant for the members of the council and all others concerned..." Two days after the markka's central rate had been changed by decision of the board of the Bank of Finland, the



■ A demonstration in Hakaniemi Square on 17 May 1973, arranged by the National Anti-EEC Committee and local civic organisations.

– Lehtikuva news photo archives / Jarmo Matilainen.

council agreed to a proposal by their chairman Harri Holkeri to record the following statement in the minutes: "The members of the supervisory council require the board of the Bank of Finland to deliver a report on the possible need for a change in regulations concerning the determination of the international value of the markka, taking into account the development of the international currency system." This statement set in motion lengthy legal preparations for a change in the Currency Act, preparations which would last for more than four years.

A devaluation of the dollar did not suffice to restore confidence in central exchange rates. European central banks, particularly Germany's Bundesbank, had to continue supporting the dollar with extremely large purchases. At the start of March 1973, however, Germany stopped intervening and the foreign exchange markets of many countries were closed. After negotiations over the following two weeks, the currencies of six EEC countries (Belgium, Denmark, France, Germany, Luxembourg and the Netherlands) moved to a system where they floated together against the dollar. Norway and Sweden also joined the European currency snake, as it was called, but EEC members Italy and Britain opted out at this time. The snake linked its members' mutual exchange rates within fluctuation bands of 2.25 percent but they floated against the dollar and other "third" currencies. Because of the key role of the German Mark, it can be said that in practice the Mark began to float against the dollar and the other currencies in the snake were pegged to the Mark.

When European currencies began to float together on 19 March 1973, a new era began in world foreign exchange policy. Central banks had hardly any experience of floating exchange rates, apart from a short period after the First World War and Canada's experiment with a floating rate in the 1950s. Many economic experts, the best known being the US monetary theorist Milton Friedman, had long been arguing for a system of floating rates because it would free central banks to pursue domestic objectives in monetary policy (Friedman supported regulation of money supply growth in order to control inflation). But no one could predict with certainty how a system of floating rates would work.

The Bank of Finland did not immediately react to the decision to float German and other European currencies, and continued to observe the fluctuation limits on the dollar rate set under the Smithsonian

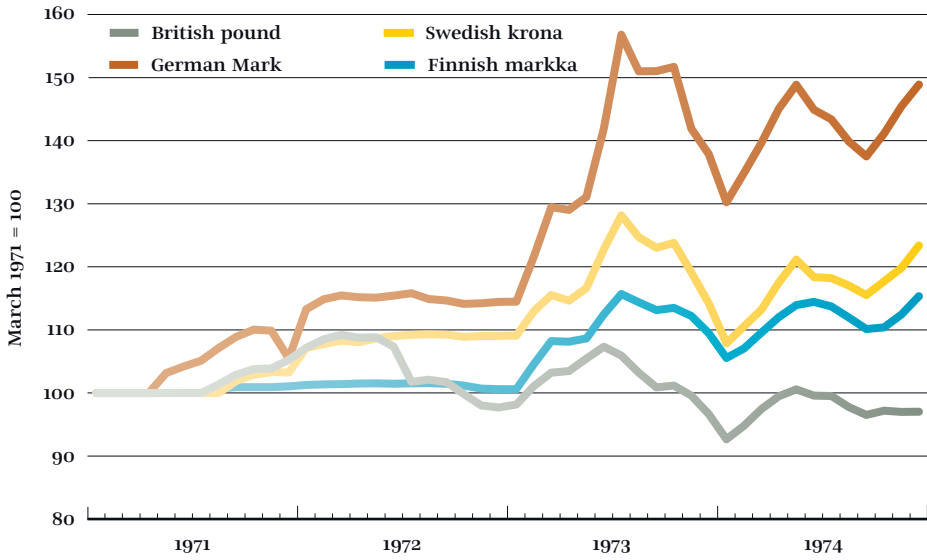
Agreement. However, when the dollar began to fall steeply against most European currencies in May, the Bank of Finland was unwilling to follow it down. With effect from 4 June 1973, it stopped observing the prevailing fluctuation limits, and the markka was now allowed to rise against the dollar.

On the same day that the markka broke through its ceiling against the dollar, the Bank of Finland announced that this was a consistent continuation of existing policy, aimed at keeping the average external value of the markka steady. Finland's exchange rate was now being steered according to an index of exchange rates, a kind of a currency basket, for the obvious reason that different currencies were moving in different directions. Many currencies appreciated against the markka but the pound sterling, important for Finnish exports, depreciated with the dollar. Finland's decision, which was also announced to the International Monetary Fund, meant that it was moving from a fixed exchange rate system to managed floating, where the guideline was a foreign trade-weighted currency index developed by the Bank of Finland. Managed floating meant that, although the Bank of Finland no longer had a fixed objective for the exchange rate, it did not withdraw from the foreign exchange market but was ready to buy and sell currencies and thereby influence fluctuations in the exchange rate.

Finland's exchange rate policy was now in uncharted waters as the currencies of the world floated freely and Finland experimented with a system of managed floating, with no support from the Currency Act and no experience in managing it. At the same time, domestic monetary equilibrium was already clearly disturbed and monetary policy measures were required.

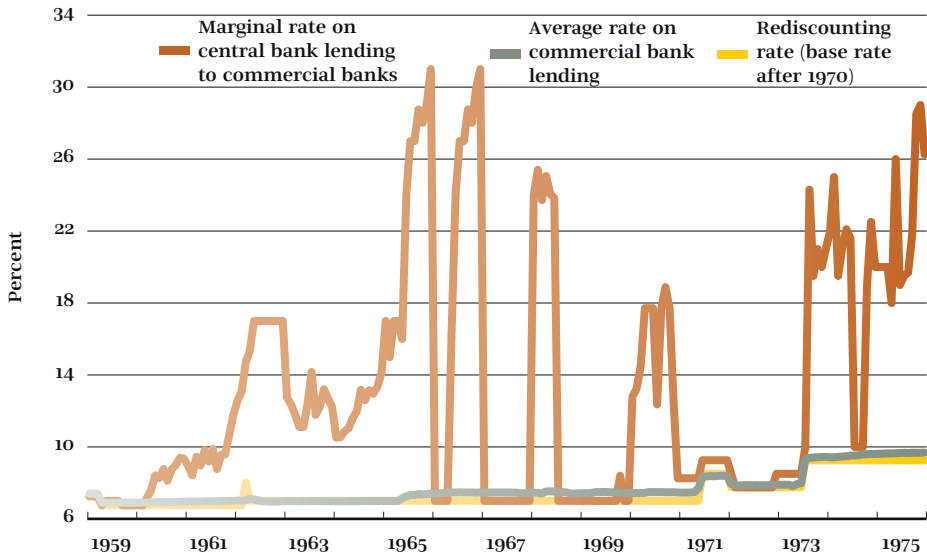
On 14 June 1973 the board sent a letter to the supervisory council in which it pointed out that inflation had accelerated, deposits had declined and real interest rates had become negative. These were stoking a boom that had already led to "alarming production bottlenecks that had disrupted economic equilibrium in southern Finland and harmed the balance of payments". There was a danger in future, the board said, that economic growth would be distorted and hindered, when even the most inefficient investments had become profitable to make. The board therefore proposed a three percentage point hike in general interest rates.

SELECTED EXCHANGE RATES AGAINST THE DOLLAR DURING THE BREAKDOWN OF THE BRETTON WOODS SYSTEM



Source: International Monetary Fund.

KEY INTEREST RATES 1959-1975



Sources: Bank of Finland; Saarinen, V., 1986.

This was the second attempt by the Bank of Finland during Mauno Koivisto's term as governor to activate interest rate policies. The previous attempt in 1971 had ended after half a year in the climb-down demanded by the president and the government. This time the situation was still more serious; inflation was in double digits and the current account was clearly deteriorating. Foreign exchange reserves had begun to dwindle at an alarming rate during the spring. There was an obvious need for tighter money. Even so, a rate hike of three percentage points was severe, a historically unique increase that would have caused a considerable shock to the whole economy. It seems clear that the board's proposal was meant to contain room for bargaining, in order to get the council to accept at least some sort of increase. According to Koivisto's notes, written later, he had needed to obtain backing from the government, meaning Prime minister Sorsa and Finance minister Virolainen, to ensure that the increase would be passed.⁴⁸¹

An interest rate hike was indeed obtained. Governor Koivisto told the supervisory council that it had previously been intended to take up the matter first in the autumn but economic conditions had changed in an unanticipated way. Action had already been needed in the spring, but a banking strike had intervened at that time. Thus the matter was being raised now. He cushioned the board's proposal for a savage rate hike by saying that "if you are unanimous on something a bit lower, we can talk and agree about that". He added that, in the same connection, the board would take other action to tighten monetary policy, related to capital import deposits and the adoption of a cash payment requirement for imports.

As previously, councillors Aarne Saarinen and Veikko Vennamo were opposed to an increase in interest rates. However, Valdemar Sandelin of the Social Democratic Party said that social democratic members would approve the increase if the board's proposal was halved, so that rates would rise by 1½ percentage points. Chairman Holkeri seized on the compromise and proposed that the council accept an increase of this size. It did, and the Bank of Finland's base rate became 9¼ percent from the start of July 1973, a rate that remained in force for about four years.⁴⁸²

OIL CRISIS FANS INFLATION

The acceleration of inflation that triggered higher Bank of Finland interest rates in summer 1973 was just a prelude. Economies around the world overheated in 1973 and world market prices for raw materials began to rise steeply, in a way that had not been seen since the wave of speculation triggered by the Korean War at the start of the 1950s. Because of the boom and rising raw material prices, inflation began to soar in all western countries. The situation was aggravated in late 1973 by the first oil crisis, which disrupted economic structures and policies throughout the world. It gave a major new thrust to inflation, at the same time as it killed the international boom, which was soon replaced by a deep recession.

The oil crisis had its roots in the Arab-Israeli Yom Kippur War of October 1973, when the Arab members of the petroleum exporting organisation OPEC declared an embargo on sales to the United States and decided to restrict oil output. The consequences were dramatic. In two months the cost of oil on international markets rose four times over. Its price had long been under three dollars a barrel, but by the start of 1974 it was about 11 dollars. The oil price rise was not to be a temporary phenomenon. The price settled permanently at a new level, and trebled again during the second oil crisis of 1979–1980.

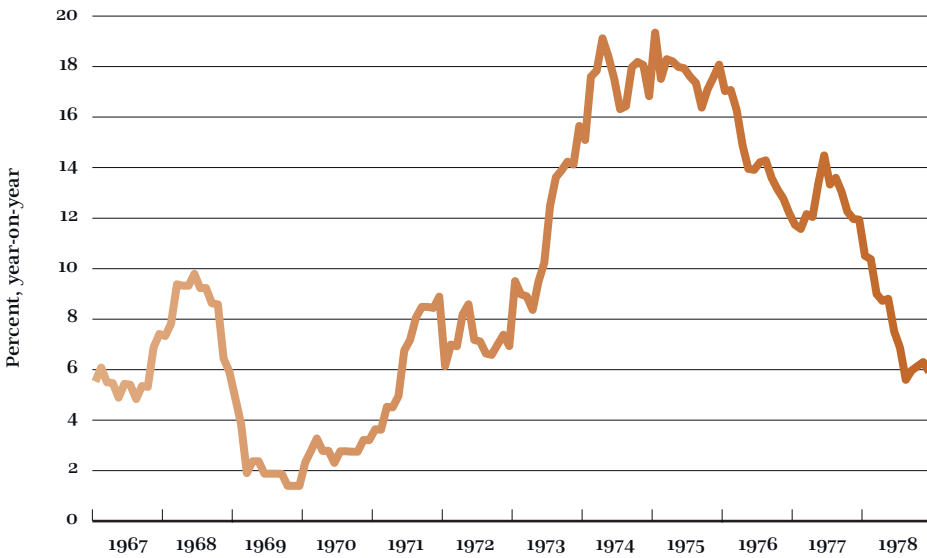
It is hard to overstate the importance of the oil crisis for economic policy throughout the world in the 1970s and still in the 1980s. As an event in economic history, it bears comparison to the slump of the 1930s and, like the Great Depression, it gradually set off a reassessment of the theoretical foundations of economic policy. Its direct economic impact alone was dramatic. Economic growth came to a standstill during 1974 in most western industrialised countries, and current accounts in the industrial world swung deeply into deficit. Correspondingly, the oil producing countries recorded growing surpluses, which peaked in 1974 at about 35 billion dollars.⁴⁸³ The key question of international economic policy was how these “petrodollars” could be recycled as investments in deficit countries so as to alleviate their balance of payments problems and economic disruption.

The International Monetary Fund sought to help economies adapt to the new conditions by establishing an oil facility in 1974. It consisted of funds borrowed from the oil producing countries, which the IMF

could loan to countries experiencing balance of payments problems because of the oil price rise. A second oil facility was created in 1975 but came with tighter economic conditions attached. The facilities lasted until May 1976.⁴⁸⁴ The 1975 facility has particular importance for Finnish economic history and the Bank of Finland because Finland was one of the few industrial countries that turned to it and because its conditionality was decisive in bringing about an abrupt change in the direction of economic policies in 1975–1976.

Although economic growth halted during 1974 in most western industrial countries, Finnish growth continued brisk on the strength of domestic demand. Unemployment fell to a very low level, reaching about 1½ percent by the end of the year. At the same time inflation was picking up. In February 1974 it was already over 17 percent, measured by the cost of living index. These were the conditions when a two-year centralised incomes settlement was reached in spring 1974. The Lindblom Agreement, named after the then incomes policy official Seppo Lindblom, contained large wage increases as well as various

**INFLATION 1967–1978:
YEAR-ON-YEAR CHANGE IN CONSUMER PRICES**



Source: Statistics Finland.

measures of economic and social policy, such as tax cuts, extra income transfers and tighter price controls. In its section bearing on monetary policy, the agreement fantastically predicated that “living costs will be lowered by reducing interest rates or in other ways”.⁴⁸⁵

The wage rises it warranted were the largest for decades, promising more than 12 percent in the private sector in the first year alone. With demand for labour continuing strong, wages rose by even more, increasing by over 25 percent in the private sector during 1974. Spurred by wage increases and steeply rising import prices, consumer price inflation continued fast and rose to 17 percent during the year.⁴⁸⁶

Because inflation was being fanned by the simultaneous sharp rise of import and export prices, about 40 percent year-on-year in 1974, the idea was understandably floated of combating inflation pressures by raising the foreign exchange value of the markka. This possibility was also the subject of government talks during the spring and summer, although a revaluation was not ultimately carried out. However, measured by the currency index, the markka was slightly (about 2.5%) stronger in 1974 than the previous year.

Inflation was not the only macroeconomic imbalance. Another reason why Finnish economic conditions became unsustainable during 1974 was that foreign trade moved deeply into deficit, as export markets faded while domestic demand continued to grow. Towards the end of the year, the foreign trade deficit only worsened. Ultimately it was the balance of payments that reoriented economic policy away from supporting growth towards sharply restricting aggregate demand. The ensuing period of restrictive measures reinforced the role of monetary policy and the independence of the Bank of Finland, after incomes policy had failed to live up to the expectations that it would control inflation.

Commercial bank indebtedness to the Bank of Finland had begun to grow in 1973 and the marginal rate on central bank credit became very high – over 20 percent – as the discounting moved higher on the sliding scale of interest surcharges. Initially the plight of the banks had been eased by increasing the quotas of credit available at base rate, once at the end of 1973 and again substantially during the first half of the following year. This accommodating monetary policy was terminated in autumn 1974 and the central bank deliberately began to tighten the money market. A concrete sign of this was the circular sent

to financial institutions on 7 November, laying out the new “guidelines for lending”. It stated that monetary policy was to be extremely tight and that “applications for credit were to be subjected to continuing fierce pruning, including credit applications for the whole of 1975”. At the end of the year the Bank of Finland also managed to circumvent the rather vaguely phrased demand in the Lindblom Agreement for lower interest rates. Governor Koivisto had to discuss the matter with labour market organisations and Finance minister Virolainen.⁴⁸⁷



■ The oil crisis affected the whole nation. Reading government guidelines on saving energy, 8 January 1974.

– Lehtikuva news photo archives/Ari Ojala.

“A NATIONAL EMERGENCY”

PAYMENTS CRISIS AND IMF PROGRAMMES

A radical deterioration in the current account was already observable in spring 1974, when deputy director Charles Woodward of the IMF's European department visited Helsinki for talks about Finland's economic situation following the oil crisis. During the visit, from 25 to 28 March, there were also talks about the scope for using IMF standby credit to top up currency reserves but the idea did not advance farther at that time. Because of very large short term capital imports, the Bank of Finland's convertible currency reserves were still fairly stable at the end of the year, despite the record deficit on the current account. The effect of the oil crisis on Finland's balance of payments was first seen in bilateral trade with the Soviet Union. The "oil bill" did not have to be paid in convertible currencies, so the cost initially appeared in the form of growing Finnish debt to the Soviet Union in the bilateral clearing account.

Short-term borrowing could not cover such a large current account deficit indefinitely. The foreign assets of the commercial banks had already begun to shrink fast by the end of 1974 and in the early months of 1975 the convertible currency reserves of the Bank of Finland went into steep decline too. The looming balance of payments crisis called for an approach to be made to the International Monetary Fund. In March the Bank of Finland and the Finance ministry estimated that the current account deficit for 1975 would be about 5 billion markkaa,

slightly more than in the previous year. A deficit of that size was equivalent to about five percent of gross national product, gloomy enough to spur measures to tighten the economy and begin credit talks with the IMF, but the estimate proved to be far too optimistic. Although monetary policy was tightened fiercely over the year, the deficit reached nearly 8 billion markkaa.

At the start of March governor Koivisto contacted Finance minister Virolainen to warn that the current account deficit was reaching unsustainable proportions. His letter, sent on 4 March, stated that “the rate at which convertible reserves are shrinking daily is now such that we will lose all our convertible foreign exchange in the first half of this year unless we start drawing down our agreed private standby credits and/or turn to the International Monetary Fund (...) The lodestar of monetary policy is now to reduce the current account deficit. This will curb economic activity and also government revenue. On this perspective an obvious conflict is emerging between monetary policy and fiscal policy (...) It would be a good thing if next Friday (at a meeting of the ministerial economic policy committee on 7 March 1975) I could hear something about how government finances as a whole could be made to serve efforts to balance the current account.”

Koivisto also raised the question of support from the IMF: “In March it would obviously be wise to turn to the International Monetary Fund, from whom there may be hope of obtaining credit from the 1975 oil facility. At the same time it is worth negotiating about using one or two tranches of our membership quota (...) In such cases the IMF will require a report from the government on the measures by which it intends to restore external balance.”⁴⁸⁸

The government soon completed a programme of tough economic policy decisions. On 11 March it published a resolution “on general lines of economic policy for balancing the external payments account”. The communiqué stated that the excess of imports in foreign trade had increased so much that, within a few weeks, it would become extremely difficult to finance imports. The government had therefore undertaken measures to bring foreign trade into balance. Its programme would forcefully – by the standards of the time – restrict the growth of government spending in 1975–1976. The volume of government consumption spending would grow no more than 3½ percent in 1975 and 2 percent the following year; growth of its spending on investment

would be capped at half a percent annually. A separate section of the programme recorded: "The government's notes that the monetary policies of the Bank of Finland are aimed at balancing the current account by means of greater overall tightness in the domestic money market and more selective lending."⁴⁸⁹

A separate measure in the programme was the import deposit scheme, which was aimed at curbing imports and tightening the money market at the same time. Importers of most kinds of merchandise were to be required to deposit a proportion of the import price for six months in a non-interest-bearing closed account at the Bank of Finland. The proportion varied according to the goods in question but averaged 20 percent.⁴⁹⁰

Planning continued during spring 1975, after which Mauno Koivisto sent two letters to managing director Johannes Witteveen of the International Monetary Fund on 21 May. One described the nature of Finland's balance of payments problems, asked the IMF to make standby credit available to Finland of 95 million SDRs for one year, and described the measures that the government was committed to in order to restore equilibrium in the balance of payments. The second letter told of Finland's intention to purchase 71.25 million SDRs under the 1975 oil facility.

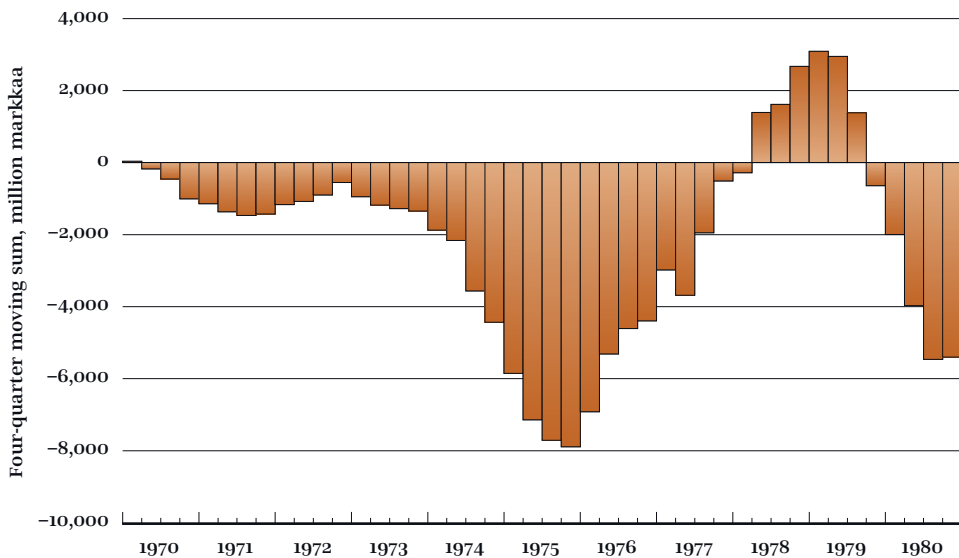
The programme outlined to the IMF consisted of tighter policies on both the fiscal and monetary side, aimed at a steep reduction in the growth of domestic demand. This would bring the balance of payments to equilibrium and slow down inflation. Finland pledged to keep the value of the markka stable "within a relatively narrow range" against a weighted average of the exchange rates of its most important trading partners, so there would be no resort to devaluation. It added that the government would also abstain from any system of multiple exchange rates. Furthermore it would not impose new restrictions on imports or foreign payments and would not tighten existing restrictions. The main existing measure to limit imports, the import deposit scheme, would gradually be phased out and would end by March 1976 at the latest.

The central and most unconditional part of the programme presented to the IMF, on which access to standby credit depended, concerned monetary policy objectives, in addition to the foreign exchange commitments mentioned earlier. The Bank of Finland would

seek to limit domestic credit expansion in the banking system to 19 percent in 1975 and 17 percent in 1976. At the same time it promised to limit growth of the central bank's own domestic lending. From the level of its domestic receivables on 27 March, they would grow by no more than 550 million markkaa by 30 September, 1,100 million by 31 December, 1,100 million by 30 March 1976 and 1,400 million by June 1976 when the standby credit arrangement ended.

The fiscal part of the programme presented to the IMF was the same as the government had decided in March although expressed more precisely. The concrete numerical objectives concerned government expenditure and the “monetary” financing of the budget deficit from the banking system. The growth of government spending was limited to a certain percentage in 1975 and 1976 and a ceiling was also imposed on government borrowing from domestic banks. It was further promised to cut the growth of municipal spending and take action to improve energy efficiency, although these objectives were not expressed in numerical detail.

FINLAND'S CURRENT ACCOUNT 1970-1980



Source: Bank of Finland.

The IMF secretariat commented that it regarded Finland's programme as "an appropriate response to the situation" and endorsed the request for IMF support. On 4 June the IMF board granted Finland 71.25 million SDRs from the oil facility and another 95 million SDRs as standby credit that could be drawn down within a year. At the time, the exchange rate was 4.42 markkaa per SDR.⁴⁹¹

On the day that the executive directors of the IMF decided to grant credit to Finland, President Kekkonen called early elections for September. Various explanations have been put forward for his decision to dissolve the government and hold new elections. According to the memoirs of Kalevi Sorsa, the outgoing prime minister, the reason was Kekkonen's power struggle with Foreign minister Ahti Karjalainen, who had begun campaigning for the presidency by seeking support from the Soviet Union. Kekkonen's biographer Juhani Suomi believes the main reason was Kekkonen's desire to bring the communists into the government so that they could not complicate the solution of a difficult economic situation from the sidelines of the opposition. Sorsa's government tendered its resignation and a temporary non-political administration under Keijo Liinamaa was then formed on 13 June 1975. It would handle matters until a political government could be formed after the elections.⁴⁹²

"AT CROSSED SWORDS"

Parliamentary elections were held on 21 and 22 September but the subsequent government negotiations were protracted. President Kekkonen wanted to bring the social democrats and the communists into the coalition but this proved difficult. Ultimately, on 27 November, Kekkonen executed one of the public stunts for which he was famous, inviting representatives of five parties to a televised event at the presidential palace. It was the same gambit that he had used in 1970 to get various interest groups and particularly the communists behind the UKK Agreement. This time he announced, under the glare of TV lamps, that the negotiations now beginning were aimed at "knocking together" a five-party government with a parliamentary majority. It was to be a "government of national emergency" with the mission of safeguarding employment and eliminating unemployment. He explained that the government had to be broadly based so that the

Bank of Finland could not stand in its way. If it were to “cross swords” with the Bank of Finland, the government would prevail, the president said.

Kekkonen’s tactic worked. When matters were expressed in this way, even the communists dared not opt out for fear of losing face. A government of social democrats and centrists augmented by communists and the Swedish People’s Party was formed three days later under Martti Miettunen of the Centre Party. The government did not finalise its programme for another three months but instead it published a declaration, which expressed monetary policy in the spirit of Kekkonen’s palace speech: “The government predicates that monetary policy should actively support the maintenance of employment.”⁴⁹³

It is difficult to say with certainty what policies the president expected the government to follow and, in particular, what he meant about a conflict between the government and the Bank of Finland. Did he imagine that the government would be able to contribute to monetary easing? One logical theory is that President Kekkonen knew from his discussions with governor Koivisto among others that the balance of payments problem would impose a period of economic stringency. The government would have to observe such a strict line of austerity that its decisions were likely to be very unpopular and the consequences for employment very negative, at least in the short term. This was why it was important for the government coalition to contain the forces that, if in opposition, would probably have been most strident critics of its policies and would perhaps have prevented their implementation. The president’s talk of a “national emergency” and of keeping the Bank of Finland in check were successful although his tactics in this respect seem to be duplicitous to say the least. In any case, the actual policies of the government proved to be largely in line with the tough guidelines that Finland had presented to the International Monetary Fund.

An IMF delegation arrived in Finland on 28 January 1976 for two weeks. To its regular annual assessment of Finnish economic policies had been added the task of monitoring progress of the stabilisation programme, on which standby credit arrangements were conditional. The IMF experts did not commend what they found. Their report stated that Finland’s current account deficit had grown



■ President Urho Kekkonen paces up and down the lobby of the President's Palace on 27 November 1975 as negotiations on forming an emergency government are about to start. - Lehtikuva news photo archives / Erkki Laitila.

to unsustainable proportions, 8 percent of GDP, during the past year. Domestic economic performance had also been poor, in particular ongoing rapid inflation of 17–18 percent. The report was especially critical of Finland's failure to live up to its promise to phase out the import deposit scheme.

Poor economic development was the result of the large government budget deficit, the IMF delegation believed, much of which had been financed by withdrawing deposits made at the Bank of Finland in better times. The withdrawal of government deposits and borrowing of funds from abroad had led to excessive monetary easing, yet the central bank had waited until September before acting to curb the supply of domestic and foreign credit. The government had made a reasonable start in tightening the budget but its measures were not tough enough yet, in the IMF's view. On the other hand, Finnish officials had indicated that they were aware of the need to correct both the internal and external financial position.

Finland's new programme was presented in a letter that governor Koivisto sent to IMF managing director Johannes Witteveen on 10 March, three weeks after the International Monetary Fund's representatives had left Finland but before they had completed their report. The new programme for reducing the current account deficit, laid out in Koivisto's letter, was tougher than the one of the year before. It targeted a current account deficit of no more than 3 billion markkaa in 1976, achieved by restricting domestic demand. The letter also referred to an overall incomes policy settlement, agreed in February, that contained contract pay increases averaging seven percent and a five-month price freeze.

In the section on fiscal policy, the programme noted that the government intended to continue its tough line and if necessary tighten it. It aimed to slash the budget deficit to 1.2 billion markkaa (calculated according to a formula contained in the letter). If tax increases were needed, it was pledged that these would mainly be on consumption, in other words a higher turnover tax (the Finnish precursor to VAT, imposed on the sale of physical goods to consumers).

The letter promised that the monetary policy of the Bank of Finland would be aligned with the current account target and the objective of slowing of inflation. The aim of monetary policy was defined as

controlling the growth of net assets of the domestic banking sector (a concept largely equivalent to the total lending of the banks) to about 11 percent during 1976, compared with 26 percent in 1975.

The IMF delegation's report had criticised Finland for failing to dismantle the import deposit scheme despite earlier promises. Now a precise timetable for it was laid down. This thorn in the flesh of the IMF would be terminated by the end of 1976.

The IMF secretariat approved the programme and recommended the granting of new credit to Finland while deploring the fact that the import deposit scheme had not been eliminated in accordance with the previous year's programme. On the last day of March 1976 the International Monetary Fund lent Finland 155.1 million SDRs (420 million markkaa) from its oil facility. On the following day the Finnish government agreed a resolution "on objectives and measures for balancing the economy and safeguarding employment", which committed it to the current account programme. Included were the fiscal policy measures announced in the letter sent to the IMF. Regarding monetary policy it noted that cooperation would be developed between the government and the Bank of Finland in the management of fiscal and monetary matters. It promised that monetary policy would be made more selective, giving priority to investments that would support employment but cause the least possible burden to the current account.⁴⁹⁴

Finland drew down the funds granted from the IMF oil facilities during 1975 and 1976 but did not use the standby credit it had been granted in summer 1975. Naturally even unused standby credit supported the nation's international liquidity during the 12 months when it was available. The oil facility funds also made a contribution although they amounted to only about seven percent of the total current account deficit for 1975 and 1976. It is beyond doubt that the credibility that IMF lending gave to Finland's international creditworthiness was more important than the currency itself. IMF involvement convinced private lenders that Finland had an economic policy programme approved by experts which would in time balance the payments account and keep the country solvent over the long term, too.

The fundamental aim of economic programmes in 1975 and 1976 was not to obtain money from the IMF but to "step on the brakes" of

the national economy in order to balance foreign trade and slow down inflation. It is evidence of this that one of the ways used by the Bank of Finland to tighten the money market and cut the current account deficit was to reduce the number of permits to import capital in 1976, although obviously this had the side-effect of reducing the amount of foreign exchange entering the country. According to a study by Juhani Laurila, 44% of long-term capital import applications were rejected in 1976, compared with only 15% in 1975.⁴⁹⁵

Tighter economic policies had a powerful effect in balancing foreign trade and at the same time slowing down economic growth. The current account deficit fell by half in 1976 and disappeared entirely the following year. The rate of inflation, measured by the rise in consumer prices, slowed down from about 18 percent in 1974 and 1975 to about eight percent in 1977. The cost of these policies was that economic growth practically came to a standstill in 1975 and continued to mark time in 1976 and 1977. At the same time the unemployment rate rose some three times over to an average six percent in 1977. It was a rise of unemployment in a way never before experienced in Finland that made it into a social problem, even in the south of the country. It created a new situation in politics and the labour market that subsequent stimulation policies would then tackle.

During the brief period of time when the programmes presented to the IMF were drawn up and put into force, meaning from spring 1975 to the end of 1976, Finland was ruled by four governments and there were two elections, one for parliament and one for municipal councils. In the unstable circumstances, the targets drawn by finance ministry and central bank officials, to which IMF support was tied, constituted a medium-term plan. Drawing up such a plan and committing to it might not have been possible without the participation of the IMF.

President Kekkonen's objective in March 1975 had been to create a government that was sufficiently broadly-based to take the difficult decisions demanded by the economic crisis and, in particular, to make the communists share government responsibility. As it turned out, the coalition "knocked together" by Kekkonen did not withstand the tensions created by implementing the stabilisation programme. The stumbling block was the turnover tax. The Miettunen government tendered its resignation as early as May 1976, when the communist



■ Pekka Korpinen was a former Bank of Finland researcher who became a prominent and influential critic of its exchange rate policies in the 1970s and 1980s. He accused the bank of pandering to exporters with its devaluations.

– Finnish Press Agency/Jorma Komulainen.

ministers rejected the rise in turnover tax that had been part of the package. Initially President Kekkonen refused to accept its resignation but the government broke up nevertheless in September, when the social democrats as well as the communists left the coalition. Martti Miettunen then formed a minority government, backed by the Centre Party, which sat from 29 September 1976 to 15 May 1977.

CHANGING TOOLS OF MONETARY POLICY

FROM BILLS OF EXCHANGE TO CALL MONEY CREDIT

Part of the monetary policy programme, planned and presented to the International Monetary Fund in spring 1975, was strict control by the Bank of Finland over growth of domestic lending. The aim was to reduce Finland's balance of payments deficit and halt the decline in currency reserves. The threat of a balance of payments crisis was so severe that the existing means of tightening monetary policy were inadequate. In the next couple of years, tools used for decades were replaced by new instruments that were expected to be more flexible and effective.

Until this time, the tone of monetary policy had been set by the size of credit quotas that the Bank of Finland allowed to commercial banks and the level of penalty interest rates charged on quota overruns. Banks had borrowed from the central bank by rediscounting, meaning that they resold their customers' bills of exchange to the Bank of Finland. At the start of 1970 the system had been modified so that commercial banks no longer reassigned thousands of individual bills but borrowed directly from the central bank against their own acceptances. This was intended to reduce the cost of bureaucracy and unnecessary office work.⁴⁹⁶ It also eliminated the link, applied since the 19th century, between central bank credit and lending of a "commercial character". This point was no longer considered important in the conditions of the 1970s. The "real bills" doctrine was abandoned and in practice central bank credit now became unsecured.

Since 1970, the commercial banks also had had access to another form of central bank finance although it was intended only for emergencies. After a bank had used up its normal credit quotas and even the extra allowance available at penalty interest rates, the Bank of Finland was prepared to make forward bond trades with it. These repo agreements, as they would be called today, were intended to be the most expensive source of liquidity for commercial banks, loans of last resort. The Bank of Finland purchased government and other bonds from the bank in question, which agreed to repurchase the same bonds within a week at a price half a percent higher. The interest rate on this form of central bank finance was thus about 26 percent annually.⁴⁹⁷

When monetary policy was abruptly tightened in spring 1975, central bank finance in the form of forward bond trades was restricted and made discretionary. After the change came into effect on 1 March 1975, the commercial banks began to offer each other very short-term loans, known as overnight credit. Because the money market was so tight, the interest rate on the unofficial short-term interbank market was very high, sometimes as much as 25 percent.⁴⁹⁸

Growth of interbank trading set in motion a project by the Bank of Finland to manage and supervise this market. The central bank had in fact been planning to revive the overnight market since the end of 1974 and had considered various alternative forms of organisation.⁴⁹⁹ The matter became more urgent when the money market was tightened in spring 1975. Markku Puntila, the board member with responsibility for monetary policy, wrote a memorandum in May proposing the establishment of an official “call money market”, where banks with surplus short-term funds could lend them to deficit banks. The call money interest rate would be set by supply and demand but, by making investments in the market, the Bank of Finland would be able to influence interest rate formation.

Puntila’s memorandum said that the call money market would efficiently reward the banks who showed restraint in their lending or who were best at attracting deposits, both traits being favourable for balancing the national economy. Banks that were too expansive would be correspondingly penalised. The call money market would also pool liquidity variations between the banks so it would “significantly reduce” the need for Bank of Finland credit to support bank liquidity.⁵⁰⁰

On 29 May 1975, a week after governor Mauno Koivisto had sent the

letter of intent to the IMF on Finland's balance of payments programme, the board sent a proposal to the supervisory council on establishing an interbank call money market. The proposal argued that the serious imbalance on the current account and an impending deterioration in employment required an extremely tight money market but, on the other hand, a serious domestic liquidity crisis had to be avoided. The call money market mechanism would use accounts at the Bank of Finland, where interest would be paid on deposits and interest deducted for overnight borrowing. The difference between deposits and loans would constitute the Bank of Finland's net investment in the overnight market. Rolf Kullberg, the board member then responsible for monetary policy, pointed out that interbank markets were common elsewhere in the world and that overnight markets were already operating in all other Nordic countries.⁵⁰¹

The supervisory council postponed a decision on the matter in May but approved the establishment of a call money market at its next meeting on 19 June. It gave the Bank of Finland far-reaching authority to set interest rates, which could vary between 9¼ and 30% percent (the board had originally proposed a ceiling as high as 36%). The Bank of Finland thereby established an official interbank money market in Finland, in which its board had free hands in managing the interest rate.

Such a broad mandate to set interest rates may seem surprising in view of the bitterness of previous political struggles over even tiny changes in the rate. The council's decision was fairly unanimous, however, with only Aarne Saarinen of the Communist Party abstaining, on the grounds that he was opposed to monetary policy based on central bank credit to commercial banks.

The supervisory council's lack of greater political passions regarding the overnight interest rate was naturally because it was a rate charged between banks and not directly impinging on, or paid by, ordinary borrowers. Furthermore the board of management stressed that the Bank of Finland's net investment in the market would be limited: "Even after this, the general direction of monetary policy will be set by bank quotas (of central bank credit), with only fine tuning to be handled in the call money market."⁵⁰²

When the call money market opened at the start of September 1975, the first day's interest rate was 20 percent. During September it

averaged 22 percent, at a time when the Bank of Finland's own investment was still only marginal. Initially, therefore, it was a largely genuine interbank money market. Later in the autumn, central bank credit quotas were reduced and the call money rate approached 29 percent, although the Bank of Finland did slightly increase its investment in the call money market.

Postbank, the former Post and Savings Bank, was allowed to join the call money market as a depositor from the start of 1976 and its deposits eased the market greatly. The Bank of Finland could now reduce its net investment to a very low level without pushing the call money rate back to its peak of the preceding autumn. However the average rate in 1976 was still as high as 18.4 percent.⁵⁰³

The call money credit system was originally intended mainly as a place for trading liquidity differences between commercial banks and not as a new channel for central bank finance; this point had been emphasised to the supervisory council when it had discussed establishment of the market. It was also hoped that the call money market would make monetary policy more effective. Governor Koivisto later recalled its importance as follows: "Until the time (when the market was established), the commercial banks had different quotas for the size of loans they could obtain fairly cheaply from the Bank of Finland. If the quota was exceeded, the bank was penalised. In this situation it was very difficult to be reasonable and even-handed. Then the supervisory council fortunately took decisions that opened a call money market. I realised immediately that it was a good thing. Previously, when (the Bank of Finland) had discussions with (commercial) bank directors, they ardently promised to tighten their purse strings but nothing actually happened. When the call money rate was set at 28 percent, things started to happen right away."⁵⁰⁴

THE CALL MONEY MARKET IN OPERATION

In the first few years that the call money market operated, the Bank of Finland invested fairly little of its own funds. Later the situation changed and an ever-growing proportion of its finance for banks was provided via the call money market. The main changes took place in 1978 and 1979, when the quotas of central bank credit available to banks at base rate were strongly reduced (in four separate stages from

1.9 billion markkaa to 0.2 billion). Credit quotas at base rate were not entirely discontinued until the end of 1983 but, from 1979 onwards, call money credit was by far the most important form of central bank financing available to banks. It became the main monetary policy tool until the second half of the 1980s, when the Bank of Finland began to use operations in certificates of deposit (CD's) to achieve its monetary aims, as detailed later in this book.⁵⁰⁵

The call money market did not become a textbook-style interbank money market, because it was soon subjected to various controls and compensation mechanisms, mainly intended to reduce the burden that tight monetary policy placed on commercial bank profitability. As early as the end of 1976, part of Postbank's interest earnings from the call money market were later refunded to the commercial banks in what was called interest equalisation. After the start of the interest equalisation system, the officially quoted call money rate no longer indicated the real cost to commercial banks of overnight borrowing, which was actually somewhat lower. However the interest equalisation system mattered only in 1977 and 1978. In those years, call money credits cost the commercial banks about 1.4 percentage points less than the official call money rate. Later the rate reductions they obtained via the interest equalisation system were only a few tenths of a percentage point. The system was terminated at the start of 1983.

In 1980 the banks were set individual ceilings for call money borrowing and were charged penalty interest rates on quota overruns, in the same way that they had previously been penalised for excess rediscounting of bills of exchange. Thus, monetary policy could be tightened without having such a serious impact on bank profitability as higher call money rates would have caused. However the system of penalty charges on excess call money borrowing was abandoned in May 1983. Thereafter the call money rate genuinely expressed the cost to banks of using the central bank's marginal lending facility.

During the second half of the 1970s, the call money rate was determined almost entirely by the supply of and demand for funds in the market. The Bank of Finland's investments in the market were relatively small and subject to separate regulation, an investment rule confirmed by the board of management. However, with the start of the 1980s the system changed and the call money rate became itself a monetary policy tool under the direct control of the board.

At the same time, it became the main instrument of monetary policy. The change took place in early 1980 and was triggered by expectations during the winter of a markka revaluation. Speculation on a possible revaluation boosted currency reserves and cut demand for overnight funds correspondingly. The Bank of Finland felt that the economic climate required tight monetary policy so, to prevent the call money rate falling, the board disregarded the “investment rule” it had agreed at the start of February and began a series of hikes in the call money rate. Two weeks later, it instituted a new, less explicit “investment rule” that largely severed the link between demand for call money funds and the interest rate. The “investment rule” was ultimately abandoned on 24 July 1980, after which the board imposed rates on the market directly.

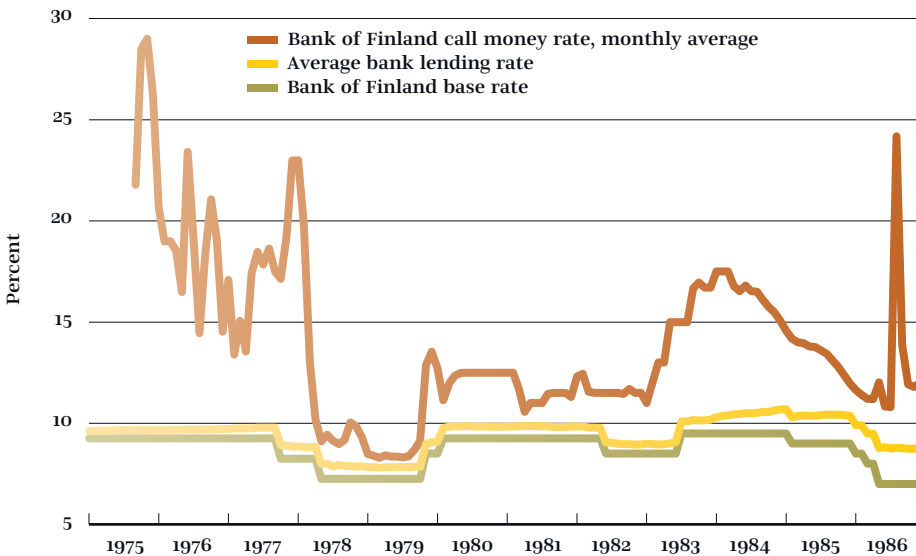
The authority provided by the supervisory council to operate the call money market was initially temporary and granted for a year. It was renewed in 1976 and then, in 1977, for three years. In 1980 the board finally asked for permanent authorisation. Its proposal referred to the changing nature of the call money market and its increased significance for monetary policy: “(Central bank) experiences of call money market operations have continued to be favourable. Over the years, the market’s status has changed from being a source of marginal financing and a tool for fine-tuning monetary policy to serving as an ever more important way of regulating central bank financing.” The supervisory council granted the board the right to continue operating the call money market and renewed its broad authority to set interest rates. The call money rate could be up to 15 percentage points higher than the Bank of Finland’s base rate.

By the start of the 1980s, when the call money market had become the main channel of central bank finance to the banks and the principal tool of monetary policy, the balance of power between the board of management and the supervisory council of the Bank of Finland had changed significantly. Previously the board had been able to set the tone of its monetary policy by altering the quotas of central bank credit to the banks and modifying the scale of penalty interest rates for credit overruns. Such tools were indirect and inevitably sluggish even when they were changed almost every year. When, in summer 1980, the board began to set the call money interest rate directly, it obtained a flexible tool, which had an immediate effect on

the money market and which could be adjusted at any time. The board's authority was underlined by the fact that the interest rate range allowed by the supervisory council was so wide. It hardly constituted any limitations on monetary policy during normal conditions.

The supervisory council was not particularly jealous of this *coup d'état*, at least judging from the minutes of its meetings. Even in 1980, when the call money market had become Finland's principal money market and the main monetary policy tool, the supervisory council appeared unconcerned about this delegation of power to the Bank of Finland's board. Almost the only explanation is that council members were still preoccupied by the loan rates paid by individual bank customers – and voters – which at this time were still tied to the Bank of Finland's base rate. There was apparently less political dynamite in the interbank borrowing rate, even though it set the entire direction and tone of monetary policy.

KEY INTEREST RATES 1975-1986



Source: Bank of Finland.

The birth of the call money market foreshadowed the expansion of the money market in Finland in the first half of the 1980s. Its growth led first to a split of the market into two segments, one subject to interest rate controls and one not, and subsequently to a collapse of the system of administratively controlled interest rates. However it would be an exaggeration to say that the creation of the call money market was the root cause of the emergence of “market money” and the end of interest rate controls. In fact the cause was the acceleration of inflation in the 1970s, and the subsequent need for tighter monetary policy, which made interest rate controls anachronistic and destroyed the foundations of government-regulated rates in general, as it did in many other countries. The establishment of Finland’s call money market was the first symptom of this change rather than its cause.

FROM STABILISATION TO STIMULATION

ECONOMIC POLICY CRITICISM – AND DEVALUATION

At the start of 1977 Finland was in a deep recession. The economy had already experienced two years of almost zero growth and the unemployment rate was rising. Seasonally adjusted unemployment in January reached 4.6 percent, which at that time was regarded as very high. On the other hand, external balance, which economic policies had been tightened to correct, was improving distinctly; the balance of payments deficit had begun to shrink. Inflation was also slowing down, although year-on-year consumer prices were still 11 percent up in January 1977. Figures for the current account and inflation showed that the stabilisation programme presented to the International Monetary Fund had begun to work. At a meeting of the supervisory council on 4 February, governor Koivisto of the Bank of Finland concluded a brief economic report as follows: “The possibilities of obtaining better equilibrium are good. The possibilities of achieving the current account target are good. And the possibilities of bringing down the rate of inflation substantially are good. The prospects for growth and employment are bad.”⁵⁰⁶

Tight economic policies were arousing increasingly critical comments. A prominent contribution came from Jouko Paunio, a professor of economics at the University of Helsinki, who was a personal friend of governor Koivisto from the era of the O-Group and a former department head of the Bank of Finland’s economic research

institute. At an annual presentation of sciences arranged by the learned societies of Finland, Paunio had harsh words for current monetary and fiscal policies, which he considered excessively tight. He thought Finland was paying too heavy a price for curbing inflation.

As an alternative counter-inflationary policy, Paunio recommended exchange rate flexibility: "It seems obvious that the Bank of Finland, the government and the country in general have assumed that, within a few years, Finland will be able to emerge from its present plight without changing exchange rates. Yet it is worth remembering that we live in a world where exchange rates can change and are changed (...) At a time when politicians both within the civil service and outside of it seem to have been scared into accepting restrictive fiscal policy, we are finally reaching the point where, by permitting the markka to be devalued, we can start using exchange rate changes as a tool for active countercyclical policy and to improve the competitiveness of our economy. Finland is not currently close to a situation where inflation will easily flare up."⁵⁰⁷

Koivisto responded to the rebuke in the Finnish Economic Journal with a defence of current policies. "Paunio complains about production losses caused by the fight against inflation and laments that they are distributed unequally among the people. This gives the impression that Paunio assumes that the effects of inflation are distributed equally and equitably (...) One could also ask how much better the economy has developed in the countries that have been forced into, or have resorted to, a devaluation-inflation spiral, in comparison with the countries that have kept their inflation in check. The economic policies pursued in our country have more objectives than merely maximising economic growth. But specifically from the perspective of protecting growth, it is absolutely essential that we safeguard the stability of the Finnish markka."⁵⁰⁸

Their dialogue did not end in reconciliation. Paunio answered in colourful language: "Koivisto evidently thinks that reckless extravagance has become ingrained in Finnish society in bygone years and we should now suffer the consequences. To rid ourselves of this evil the Finnish national economy must pay heavy penance and only Koivisto knows how much and how long; the very embodiment of sin is inflation, which must be resisted at all costs."⁵⁰⁹

Soon, though, the exchange rate question returned to the agenda and Koivisto was able to show his pragmatic side. On Friday, 1 April

1977, Sweden, Norway and Denmark announced they were devaluing their currencies. They were all still members of the European currency “snake” at the time so in practice they were devaluing against the German Mark, which the snake was pegged to. Sweden devalued by 6 percent, Norway and Denmark only 3 percent.

The Scandinavian devaluations naturally raised the question of how Finland should react. Should it follow their examples and devalue the markka? A devaluation would improve competitiveness and increase exports but there was a danger that it would fan inflation, which had just been pushed down at great cost during 1976. Ultimately the decision hinged on how the labour market organisations would respond. The two-year employment contracts that had taken effect at the start of March 1977 contained a clause specifically protecting wages from devaluation. The clause stated that any “significant” deterioration in the value of the markka would entitle wage-earners’ organisations to negotiate about compensation, meaning larger pay rises, at the start of 1978.

The Bank of Finland, the government and the labour market organisations met for talks on Monday 4 April, and it became clear that labour unions felt that they would not have to demand compensation if the devaluation was 4–6 percent. The parliamentary supervisory council asked for the expert opinion of the leading incomes policy official, Keijo Liinamaa, who said that, in his view, a devaluation of 10 percent would be enough to trigger the wage protection clause, although he emphasised that the judgment was ultimately up to the unions themselves. The board made a proposal to the supervisory council that the average price of foreign currencies in markkaa should be raised six percent, which meant that the markka’s value would fall by 5.7 percent. The board argued in its statement that devaluation was justified as a measure to protect the competitiveness of Finnish exports. The proposal was approved by the supervisory council and then the government, although, according to Koivisto’s account, the minority government of Martti Miettunen was “horrified” at the amount proposed, and had pressed Koivisto to explain why he wanted six percent rather than four. The new exchange rates came into effect on 5 April.⁵¹⁰

Finland’s determination to devalue in Sweden’s wake conflicted, to some extent, with its policy on exchange rates since 1973. The exchange

rate had been based on a trade-weighted currency index, meaning that when the value of any currency changed, the markka would automatically follow it to the extent required to keep the average level of exchange rates constant. This would happen precisely if the official currency basket was kept intact. If this principle had been followed in spring 1977, Finland would have responded to the Swedish devaluation with an exchange rate that would have devalued the markka against third currencies by about one percent but revalued it against the Swedish krona by about five percent. However, in practice Sweden had far more impact on Finland's currency policy than its share in foreign trade and the krona's weight in the currency index indicated (at that time about 19%). So, Finland was not content with the "automatic" protection offered by the foreign currency index but responded actively to Sweden's devaluation, with a devaluation that was actually slightly greater. Consequently the markka weakened against third currencies by about seven percent and against even the Swedish krona by about one percent.

STIMULATION POLICIES BEGIN

The devaluation of spring 1977 was authorised by a minority centrist government, led by Martti Miettunen, which had been in office since the preceding autumn and was supported mainly by the right wing in parliament. It was to be a short-lived government because at the end of spring the Social Democrats, Centre party and Communists reached agreement on a majority coalition. Miettunen tendered his resignation and Kalevi Sorsa of the Social Democratic party formed a new government on 15 May 1977, his second administration. It contained ministers from the Centre party, the Social Democrats, the Communists and the tiny Liberal party.

The programme of Sorsa's second government stated that its most important aim in economic policy was "stimulating production". The phrase – in Finnish synonymous to "resuscitation" – became one of the most frequently repeated slogans in Finland during the two-year term of the government and even afterwards, although what it meant varied according to the occasion. Regarding the content of stimulation policies, the government programme said that, among other things, it would "begin to stimulate active economic activity deliberately and

selectively. The government will increase foreign borrowing for purposes including financing investments in export industries that have dependable sales prospects, developing production to replace imports, raising the share capital of state-owned companies and financing a special energy economy programme that will be prepared.”

In view of what subsequently transpired, it is significant that the government’s programme promised to refrain from “significant” devaluations. This was the thrust of the following sentence in which the devaluation clause in existing labour agreements was referred to, if not entirely explicitly: “The government will pursue policies on prices, taxes and agriculture such that it will be unnecessary in 1978 to re-examine the two-or-more-year collective bargaining agreements signed in the past spring.”⁵¹¹

Understandably the new government wanted to stress that its programme meant a fresh approach to economic policies. Foreign trade figures at the start of 1977 showed that there was an opportunity for a new beginning. The trade and current accounts were quickly coming into balance and by the first quarter the Finnish economy was surprisingly already in surplus. The shape of economic stimulation was influenced by the fact, while they were in opposition during the term of the previous government, the Social Democrats had adopted a more pragmatic line that had greater sympathy for a market economy. The party was now openly courting the organisations representing business and industry. The finance minister in Sorsa’s second government, Paul Paavela, has been regarded as a key architect in this reorientation. He had previously been a secretary of state at the Finance ministry, before being appointed to head the Board of Railways. During the 1970s he had become a central figure of influence in Social Democratic economic policies.⁵¹²

The governor of the Bank of Finland was not happy with the government’s programme for stimulating economic activity by borrowing from abroad. Koivisto was concerned that this might cause the current account deficit to rise again. At the end of May, he wrote to Finance minister Paavela, criticising the government programme for its attitude to foreign borrowing: “One can only wonder at the recklessness with which the government now seems ready to increase the nation’s vulnerability and dependence regarding international capital markets (...) Its attitude suggests that a government with a

broad base is seen as having the right to be open-handed.”⁵¹³ The government’s programme reflected frustration with Finland’s promises to the IMF that it would improve the current account with tight economic policies. Koivisto was unwilling to compromise these objectives. He continued to believe in the primacy of the balance of payments.

On 23 June, after just over a month in office, the government moved from plans to action when it published what was called its first stimulation package, officially known as “a resolution on economic policy objectives, operating principles and near-term economic stimulation measures”. The package included a declaration on long-term objectives and a set of measures aimed at improving the international competitiveness of companies, increasing investment and boosting employment.

The economic policy objectives for the next five-year period were as follows: pushing the unemployment rate permanently below 2½ percent; keeping the current account deficit permanently below 2 percent of GDP; halting the rise in gross taxation; restricting growth of the volume of state spending to about 2 percent; and reducing inflation enough “to improve the price competitiveness of our products from next year onwards”. Econometric model simulations supplied by the Finance ministry showed that the unemployment rate could not be permanently lowered without causing an increase in the current account deficit unless Finland’s price competitiveness was shifted onto an upward trend.

The government measures included in the stimulation package of June 1977 – a total of 21 were listed – were focused on lowering business costs. Among other things, they promised to reduce social security contributions and ease taxation on investments in industrial construction. The programme was a conspicuous act of good faith towards industry. A striking feature of this first stimulation programme is that monetary and exchange rate policies were not mentioned at all.⁵¹⁴

Despite the signs in spring of improving balance, the economic situation remained difficult in summer 1977. The Bank of Finland again became especially concerned about currency reserves which, during the summer, declined to a record-low level. Kari Nars, the director responsible for currency, reported to the board on 9 August that the reserves were now worth only 10 days of imports in convertible

currencies. Nars put part of the blame on rumours of a new devaluation of the Swedish krona. The market believed that a possible new devaluation of the krona – the second in 1977 – would once more drag the Finnish markka down with it. Mistrust in the value of the markka was apparently encouraging exporters to delay repatriation of their earnings and importers to pay their invoices as quickly as possible. Thus, the Bank of Finland's currency reserves were declining despite the better balance in foreign trade.⁵¹⁵

The rumours proved correct on Monday 29 August, when Sweden devalued 10 percent and also left the European “currency snake”. It now tied its exchange rate to a foreign currency index or basket, the same system that Finland had been using since 1973. At the same time, Denmark and Norway devalued their currencies five percent within the snake. Governor Koivisto of the Bank of Finland was informed of the Swedish decision at the preceding week's meeting of Nordic central bank governors in Mariehamn, Åland islands. However, despite the advance warning, the Finns had no plan of action prepared and the Bank of Finland decided to close the foreign exchange market until the situation became clearer.

As in April, the key economic policy problem was once more how much Finland could devalue without causing the labour union movement to terminate existing employment contracts and demand compensation. According to governor Koivisto's report to the supervisory council on the day of Sweden's devaluation, the Finance ministry now had great reservations about the scope for a Finnish devaluation because of the possible reaction of the unions. The debate was dominated by the previous spring's assessment, by income policy official Keijo Liinamaa, that an exchange rate movement of 10 percent would be interpreted as “significant”. There had already been a devaluation of 5.7 percent in the spring so the assumption prevailed that there was a 4.2 “devaluation margin” left.

The Bank of Finland, the government and various interest groups held fairly intensive mutual discussions for two days. At this time Mauno Koivisto told the government of his own view that a 5-percent devaluation would be the most justified. However the government's more cautious line, apparently based on Liinamaa's assessment of the labour market, carried the day. The Bank of Finland concluded that it could not propose to change the exchange rate in a way that the

government could not accept and, when the government's stand became clear on Wednesday 31 August, the board of management of the Bank of Finland proposed a 3-percent devaluation accordingly.

At the meeting of the board where the devaluation proposal was decided, two members, Päiviö Hetemäki and Ele Alenius, recorded significantly dissenting opinions in the minutes. Hetemäki, with a background in employers' organizations, thought the devaluation would not protect the profitability of industry. Alenius, who despite of having just been nominated to the board, was still party chairman of the People's Democrats, believed the devaluation would depress the economy and thereby hurt employment. He would have preferred Finland not to devalue at all. However both men agreed that the Bank of Finland could not go against the government's wish for a three-percent devaluation and neither made a dissenting proposal.

When the supervisory council met on the same day, two councillors, Harri Holkeri and Tuure Junnila, deplored the fact that the government had become the main force in deciding exchange rates. In Junnila's words "the board of the Bank of Finland has contented itself with seconding the government in this matter". Both men represented the conservative National Coalition Party, which was in opposition. They had repeatedly advanced similar views in the supervisory council since autumn 1971, when the exchange rate clauses of the Currency Act had ceased to have practical effect. Those clauses stated that the supervisory council should be the prime force in deciding exchange rates.

It is not surprising that opposition representatives were the most critical of increased government influence in monetary and currency policy, and felt that the Bank of Finland had lost independence. At the same meeting governor Koivisto replied to Junnila that it was "not worth making a great fuss about the independence aspect" and took the view that the bank ought to act in accordance with the government's wishes. The supervisory council approved the board's proposal without a vote. After a meeting of the government, held on the same day, the foreign exchange market reopened on 1 September at the new exchange rate.

In connection with the devaluation of September 1977, the government decided on a second stimulation package, which contained increases in agricultural subsidies. There were also to be tougher price controls, to be achieved, strangely enough, by "slowing down the

approval process of price increases” at the Board of Trade, the official organisation for sanctioning price changes. Moreover the government promised to lower the cost of capital and asked the Bank of Finland to lower interest rates by one percentage point “in order to curb inflation and improve industrial profitability”.⁵¹⁶

The Sorsa government wanted to obtain broad support for its stimulation policies from the business world as well as the labour unions, and it arranged a major conference on the subject at Korpilampi Congress Centre near Helsinki on 5–6 September 1977. Planning for the conference had begun at the start of June so its timing in the week after the devaluation was pure coincidence. More than 350 participants were invited to Korpilampi to hear speeches by Finland’s main economic decision-makers and representatives of interest groups. The Korpilampi Conference subsequently gained a legendary reputation as the springboard for national consensus policies. It has a celebrated position in Finnish lore similar to the Liinamaa Pact on an overall incomes policy settlement, signed in spring 1968.

The Bank of Finland was represented at Korpilampi by governor Koivisto and executive board member Seppo Lindblom. Their speeches were somewhat at variance with the optimistic spirit that otherwise prevailed at the conference. Lindblom’s address dealt with the international economic environment in a rather pessimistic tone. He said that the world’s economic problems since the oil crisis were structural rather than cyclical “and our mixed economy has not actually been developed to deal with problems of the present sort at all”. He barely disguised his scepticism about the government’s stimulation programme: “Naturally it is important to ask how we will achieve an unemployment rate of about two percent in the next few years. But in my view it is even more important to ask how we will manage our economic policies, social policies, pension policies and labour policies, in conditions where an unemployment rate of 4–5 percent is regarded as a sign of economic success, not failure.”

Governor Koivisto told the conference about the reasons why the Finnish money market was currently tight. The Bank of Finland was not the cause, he said, and in fact the market was tighter than the Bank of Finland regarded as necessary. But it remained tight because of continuing expectations of inflation and devaluation, which made borrowers less willing to take loans in foreign currency from abroad.

“These expectations must now be changed. Changing expectations is the only way to achieve the easier money market conditions that suit us better in the present situation. But expectations cannot be changed without creating reasonable belief that the trend in inflation and costs will become significantly slower in the next few years.”⁵¹⁷

Koivisto concluded his speech with barbed remarks that were less charged with a spirit of consensus: “Our economic development now depends principally on the attitudes taken by economic interest groups. In both economic growth and employment, we can choose between a gentle ascent or a steep descent. Now that the acceptance of reality is thankfully back in fashion, there should be good prospects for an agreement on practical measures that will create the stimulation that everyone says they esteem.”⁵¹⁸

Even if one resists the interpretation that the Bank of Finland was a reluctant participant in the consensus-building at Korpilampi, it must be said that its representatives were harbingers of unpleasant truths at a conference that otherwise sought to imbue hope for a better economic future and social harmony.

The board of the Bank of Finland made the interest rate cut proposal requested by the government on 20 September 1977. Despite a few critical speeches, the supervisory council endorsed it. Only Tuure Junnila of the National Coalition party repeated the criticism that he had made at the time of the devaluation decision and voted against the rate cut. In his view the Bank of Finland had lost its independence. “The bank no longer takes the initiative or makes independent decisions. It operates merely as a registry, rubber-stamping decisions made elsewhere so that the proper formalities are fulfilled. If the independent position of the Bank of Finland was sometimes stressed too much in Fieandt’s time, we have now moved to the opposite extreme.”

Base rate fell by one percentage point at the start of November. In order to get the full reduction passed on to the general bank loan rates, the Bank of Finland tightened its bank lending regulations at the same time. In 1971, its controls on lending rates had been demoted to mere “monitoring” but now the board of the Bank of Finland sent the banks a circular demanding that the “long upward ratcheting” of lending rates should be halted. The average lending rate of each financial institution at the end of 1977 and later was not to be higher than its

level in June 1977. The aim was to ensure that, despite the tightness of the financial markets, the banks would not exploit the situation by raising interest rates.

CURRENCY BASKET ENACTED

The devaluations of 1977 observed the spirit of the 1962 Currency Act as far as possible, although the letter of the law could no longer be observed after 1971, when Finland had left the Bretton Woods system. In 1973 Finland also stopped using the central rate system, the dollar fluctuation band that had replaced Bretton Woods. Now the exchange rate had no external norm set by law or international agreements. Nevertheless the board of the Bank of Finland carried out both devaluations of 1977 in the order laid down in the Currency Act, by making a proposal to the supervisory council, which then made a proposal to the government. What differed from the decision-making in the Bretton Woods era was that devaluations were not recorded against the dollar or gold but against the Bank of Finland's currency index, a trade-weighted basket.

By adhering to the procedure of the Currency Act, the Bank of Finland underlined that it was not devaluing unilaterally but with the approval of the government and presumably in accordance with government economic policies. Government involvement in the devaluations of 1977 was not confined to formally approving a proposal from the Bank of Finland. The bank discussed the devaluation and its size with the government before even sending the matter to the supervisory council.

At the end of August 1977, when Finland decided to devalue, the interregnum affecting exchange rate policies was coming to a close. At the start of 1976, at its Jamaica meeting, the International Monetary Fund had given members the right to choose their own exchange rate systems so international agreements no longer posed an obstacle to reforming Finland's Currency Act. In fact the government had presented parliament with a bill containing such reform in spring 1977. Based on a proposal that the supervisory council had made back in 1975, the reform changed only one article in the Currency Act. The value of the Finnish markka was no longer to be set in terms of gold but defined according to a currency index,

calculated by the Bank of Finland and weighted according to each currency's proportion of Finnish foreign trade. The Bank of Finland would propose, and the government would decide, the limits within which the currency index could fluctuate. The task of the Bank of Finland would be to ensure that the value of the markka, as expressed by the currency index, stayed within those limits.

The preamble to the Currency Bill stated that the government intended to set a fluctuation band of $2\frac{1}{4}$ percent either side of the index-based central rate. This was the same bandwidth as in the Smithsonian Agreement of 1971. In this respect the exchange rate system that Finland enacted in 1977 was a successor to the Smithsonian Agreement although the agreement itself was defunct. However the same currency band of $\pm 2\frac{1}{4}$ percent was being applied to mutual rates between EU currencies in the European "snake". Although many EU countries and Sweden had left the snake, it was still used by Germany, the Benelux countries, Denmark, non-EU member Norway and, informally, Austria. To this extent the currency bandwidth was in accordance with international practice.

The government's proposal for changing the Currency Act was approved by parliament without much debate on 20 September 1977. On 28 October the supervisory council and the government each discussed the matter and, by order of the government, exchange rate fluctuation bands were set of 112.0 and 107.1, where 100 represented the average of the exchange rate index in 1974. The fluctuation limits were set at values that were roughly equidistant from the currency index when the new exchange rate system began operating at the start of November.

The new system of a currency index and a fluctuation band did not result, in practice, in a freely floating markka within the permitted range. It was felt that Finland's foreign exchange market was too thin, and political passions about exchange rates were too great, to allow the markka to float freely within the band. The Bank of Finland used market interventions to manage exchange rates fairly precisely.

In fact, the fluctuation band system determined the division of responsibilities between the Bank of Finland's board of management and the government. The bank could use its own discretion in setting exchange rates as long as the currency index was within the

fluctuation band, but if the band needed to or had to be changed, the matter passed to the supervisory council and ultimately the government.

A TWO-HEADED SNAKE?

The reform of the Currency Act that took force in 1977 was intended to return decision-making about exchange rates to the order laid down in the 1962 Currency Act, to the extent possible in new conditions. However, placing the final decision on major exchange rate changes in the hands of the government led to a political crisis within a few months. The markka continued to come under pressure in the foreign exchange market at the end of 1977 and in the early weeks of 1978. The government was soon facing a new and disagreeable decision about devaluation.

As the end of 1977 approached, the convertible currency reserves of the Bank of Finland continued to dwindle. The flight of currency was particularly strong in November. In the last week of November and first of December, Finland was compelled to draw down 300 million dollars in foreign currencies from a private credit facility agreed earlier. This boosted currency reserves but not with Finland's own resources; at the end of the year the reserves consisted entirely of borrowed currency. Under foreign exchange market pressure, the Bank of Finland allowed the markka to depreciate against the currency index and its average value in December was only half a percent away from the edge of the fluctuation band. At the same time the money market became tighter and, although the Bank of Finland increased its investments in the call money market, the prevailing interest rate there rose very high. In December 1977 it reached 23 percent.⁵¹⁹

As the economic outlook deteriorated, the government decided on 8 December that a third stimulation package was needed, to be focused on slowing down the rate of inflation by controlling wages and prices. Among other things, it postponed pay rises; the increases agreed for spring 1978 were deferred to the autumn and those agreed for autumn 1978 were moved into 1979. Its aim was that the devaluation that had taken place would not lead to higher inflation because of the income protection clauses written into wage agreements. The government urged business organisations to advise their members to refrain from

price increases until September 1978. To make sure that wages rises were postponed and price increases avoided, the government asked parliament for broader authority to control prices until the end of 1979. Apart from tougher wage and price controls, the stimulation package contained reductions in social security contributions and limitations on dividends.⁵²⁰

Governor Koivisto's memoirs tell that he supported the efforts (meaning the third stimulation package) of Finance minister Paavela "while not putting any faith in their success". Even while the package was being prepared in negotiations with the government in mid-November, Koivisto regarded a new devaluation as one option. Perhaps it was ultimately the most realistic one, because he did not regard the other alternatives he considered (deflation to lower costs, or increased foreign borrowing) as very promising.⁵²¹

Presidential elections were held in January 1978. For the first time all the major parties were backing the incumbent President Kekkonen so the result was almost a foregone conclusion. When the Electoral College was elected on 15 and 16 January, Kekkonen's candidates received over 82 percent of votes cast. Governor Mauno Koivisto of the Bank of Finland, who was standing as an elector, received more votes than any other candidate, a reflection of his broad national popularity. He was seen ever more widely as a potential successor to Kekkonen. The Electoral College met on 15 February and re-elected Kekkonen to his fourth term of office, which began on 1 March 1978. In contrast to previous practice, the government had not intended to resign when the presidential term ended but to continue until the 1979 parliamentary elections.

Amid the presidential election process, on 9 February, Koivisto received advance warning from the Bank of Norway about its intention to devalue the krone by 8 percent. The Norwegian devaluation was announced on the following day, which was Friday. In Koivisto's view Norway's move came at "a rather propitious time for the government", meaning that he felt it offered an opportunity for breaking the impasse in Finnish economic policy.⁵²² In a television news interview on Sunday he said that the devaluation of the krone had affected the position of the markka and that some kind of exchange-rate adjustment was probable. It would have been hard for the government to ignore the Norwegian devaluation after this. On the very same day Koivisto met

Prime minister Sorsa and Finance minister Paavela and said that the markka should be devalued by up to eight percent.

On Monday 13 February the Bank of Finland kept the foreign exchange market closed for the time being, pending Finland's reaction to Norway's devaluation. At a meeting of the supervisory council on the same day, Koivisto emphatically stated his view that Norway had given Finland a welcome opportunity to devalue and that other economic policy alternatives (meaning reducing the cost level and increasing foreign borrowing) had been practically exhausted: "I am presently of the opinion that this could be a solution with a positive impact on the course of our economy."⁵²³

After devaluation had been discussed by the board of the Bank of Finland on the following day, Koivisto concluded the meeting with the observation that all members except Ele Alenius agreed that an eight percent devaluation "ought to be obtainable" without compensation (in wages). However, in a meeting of the supervisory council on the same evening, he said that the devaluation had apparently become unexpectedly more difficult politically. No exchange rate proposal was made to the government on Tuesday and, because the college of electors was due to choose a new president on Wednesday, the next supervisory council meeting was scheduled for Thursday 16 February.

The political difficulty in devaluation to which Koivisto referred was of course that the labour unions had been persuaded in the autumn to accept postponements in wage rises, part of Finance minister Paavela's third stimulation package, specifically to prevent devaluation. It was therefore truly uncomfortable for the government and especially the Finance minister to devalue now. Meanwhile it had proved impossible to put together a package of measures that would induce unions to accept a devaluation without demanding negotiations on compensation.

Lacking a broader consensus on devaluation, Koivisto decided that the Bank of Finland would act in accordance with its formal authority and not seek advance government approval. On Thursday 16 February the board of the Bank of Finland asked the supervisory council to propose to the government that the exchange rate fluctuation band should be moved by an amount equivalent to an eight percent devaluation. In its statement to the council, the board

argued that the proposal was justified by the ineffectiveness of the stimulation measures implemented, the low level of industrial profitability and competitiveness, and the unrest in the foreign exchange market after the Norwegian devaluation. The supervisory council was divided on the matter. A majority (five members) supported the proposal. Both People's Democratic councillors, Aarne Saarinen and Ilkka-Christian Björklund, were opposed to it. Social Democratic councillors Jermu Laine and Ulf Sundqvist made a statement that they could not agree with the board's proposal because the devaluation amount was not "moderate" and because the government had been unable to agree on other economic policy measures to accompany the devaluation.

The government discussed the Bank of Finland's proposal on the same day and was forced to vote on it. The proposal was approved by eight votes to four but Prime minister Sorsa and Finance minister Paavela voted against it. So did the two People's Democrats in the government. Paavela was opposed to a devaluation of more than five percent. He also wanted a related fourth stimulation package, with temporary tax breaks on industrial investment, to be financed by a loan of 700 million markkaa from the Bank of Finland, reductions in social security contributions, and a cut in the interest rate by one percentage point.

The situation on 16 February 1978, when the government decided to devalue against the votes of the Prime minister and the Finance minister, was obviously extraordinary and it is fair to assume that it was partly political theatre, intended to contain the damage caused by a devaluation. In any case, the logical consequence was that Prime minister Sorsa had to tender his government's resignation. After discussions with the president, however, he continued in office with a slightly different set of ministers. The administration known in Finnish political history as Sorsa IIb was appointed on 2 March 1978, the day after Urho Kekkonen had begun his new presidential term.

After the devaluation, governor Koivisto of the Bank of Finland issued a public statement that "for several weeks the question has been when Finland will recognise that it is at an impasse and in what circumstances this will happen". His implication was that the Norwegian devaluation had offered these circumstances and his message was that expectations of yet another Finnish devaluation

were unwarranted. At the same time he was laying the political groundwork for more flexible exchange rate policies in future: "Discussions at the Bank of Finland over the past week have also shown understanding towards the option to adjust exchange rates in the reverse direction, meaning revaluation, if justified by trends in the economy." The final part of his statement is a classic example of Koivisto's style: "The decision taken was reached with surprisingly difficulty. I tried to console the decision-makers that the question we faced was rather minor compared with the problems of public finances that we will soon encounter."⁵²⁴

The apparent defeat suffered by the Finance minister in the government's devaluation vote did not halt preparations for a fourth stimulation package. In the next few weeks the government continued to negotiate about it with the Bank of Finland and the labour market organisations. Wage negotiations were taking place at the same time because of the recent devaluation. The largest central organisation of unions, SAK, announced on 21 February 1978 that it was invoking the exchange rate clause in employment contracts and starting talks with employers' organisations about "protecting the purchasing power of wages". More than wages were at stake; its list of demands contained an interest rate cut to stimulate investment.

On 28 February Prime minister Sorsa made a speech in the Social Democratic party council that aroused great attention with its barbed summary of the recent events. "The question is who is in charge of economic policy in Finland, the government or the Bank of Finland (...) I seriously believe that Finland cannot long endure a state of affairs where the government follows one line and the Bank of Finland another. The aims that each pursues will cancel themselves out and the national economy will pick up the tab." Sorsa demanded more explicit ascendancy for the government in economic policy: "The position of the Bank of Finland vis-a-vis the government, which is exceptionally independent by international standards, makes it easy to predict in the aforementioned conditions that dangerous rifts will open between the bank and the government whenever there is a government that is not conservative in its economic policies. There are many methods for solving the problem in one way or another but as long as the present situation endures, Finland is harbouring a two-headed economic policy snake in its bosom."⁵²⁵

But in the implementation of the fourth stimulation package, the loyalty of the Bank of Finland left the government nothing to desire. Compensation negotiations between labour market organisations lasted until 30 March, when the parties approved a proposal by income policy official Keijo Liinamaa. Among other things, this brought forward the date of some wage increases already agreed and gave workers two extra days off each year. As soon as agreement had been reached in the labour market the government announced the fourth stimulation package, “a resolution on measures to curb inflation, to protect the purchasing power of households and to stimulate investment and employment” (31 March 1978). It also contained the parts of the package concerning the Bank of Finland that Finance minister Paavela had put forward on 16 February.

After the government’s resolution, the Bank of Finland implemented its part of the stimulation package, bearing on the exchange rate, interest rates and lending policies, within a month. Regarding the exchange rate, the bank promised that in 1978 it would keep the currency index below the midpoint of its fluctuation band, which meant that the actual devaluation was to be less than the official 8 percent. The result was that, all in all, the markka fell by some 5 percent in value (measured from the change in monthly average between January and April). The devaluation of spring 1978 was therefore reduced to exactly the size that Finance minister Paavela had advocated earlier.

The interest rate was tackled within a week of publication of the stimulation package. On 7 April, the board of the Bank of Finland asked the supervisory council to approve a cut in base rate (and the lending and borrowing rates of the banks) by one percentage point. This came into effect from the start of May. The board wanted the council to add a statement to its decision that expressed willingness to raise interest rates in future “if inflation becomes distinctly stronger than now”. The council could not agree on the statement to be included in its decision but compromised by adding a warning about a possible future rate increase in the preamble to its decision.

On 27 April the Bank of Finland granted the government a loan of 700 million markkaa. A direct loan by the central bank to the government was exceptional in Finland; the last time this had happened was in 1967 while Koivisto was Finance minister. However the

government took only 188 million markkaa – a quarter – of the loan during 1978, and it was not until 1980 that the whole amount had been drawn down.

In a press conference on 30 March, Prime minister Sorsa had said that the fourth stimulation package would conclude most of the measures to stimulate the economy that had been begun the year before: “The ball of recovery is now in the court of business and industry.” The events of spring also marked the end of the period, starting in 1975, when the balance of payments crisis and frequent changes of government had given the Bank of Finland an unusually important role in economic policymaking, perhaps even a predominant one. The government had now shown that it was back in the driving seat.

The success of the government in reclaiming the initiative in economic policy from the Bank of Finland was partly the result of its own deliberate efforts but it was aided by changed economic circumstances. As long as the current account deficit and currency flight were the overriding problems, the Bank of Finland’s role was enhanced, because these were matters that fell most directly within its ambit. As they became less burning, there was more room to manoeuvre in economic policy and the government’s role grew stronger. Completion of the long-mooted reform of the Currency Act had a parallel influence, reconfirming the government’s position as the supreme arbiter of the exchange rate.

Spring 1978 saw a sudden easing in the Finnish money market, mainly because foreign currency began to flood into the country after the devaluation. This boosted the Bank of Finland’s currency reserves, as did the emerging surplus on the current account. By May, convertible currency reserves had risen to an all-time record level of 3.3 billion markkaa. They would have risen even higher as the year wore on, but for the fact that the Bank of Finland used 1.2 billion of the influx to pay back the private standby credit that it had drawn down in 1977. The balance of payments crisis was over. Rising currency reserves eased the money market so much that the call money interest rate fell to about 9 percent in May. At the start of the year it had been 23 percent. The money market was now suddenly easier than it had been since the 1973 oil crisis.

The mood of crisis that had dominated economic policy for many years was dispersing. Not only was the currency situation easier than

for many years, but the problem of inflation had also been tamed if not entirely overcome. At its worst, in 1974 and 1975, galloping inflation had reached 17–18 percent annually. By the end of 1978 it had been pushed below six percent. The achievement with respect to inflation was heightened by the fact that it had been achieved even though the value of the markka in relation to the currency index had been lowered by a combined amount of about 16 percent in 1977 and 1978. Inflation was now slower in Finland than in most other countries. The average rate for industrial countries (the OECD area) was 8.8 percent. Of important trading partners, only Germany had slower inflation than Finland. Germany was applying monetarist policy in allowing its exchange rate to appreciate in order to bring down inflation, which had fallen as low as 2.4 percent.

The impression given by the currency index, which shows average changes in the external value of the Finnish markka, disguises the great dispersion of exchange rate changes against individual currencies. Exchange rates fluctuated greatly in the 1970s so the size of bilateral changes depends greatly on the point of reference and the method of calculation. In the five-year period from 1974 to 1978 the value of the markkaa fell only two percent against the US dollar and 8 percent against the Swedish krona, but a full 34 percent against the German Mark. Yet in the same period, the markka rose 11 percent against the pound sterling

The improvement of Finnish economic conditions, first experienced in the money market, began to be felt in the real economy at the end of 1978. Industrial production turned up and the rise in unemployment halted. This reversal was significant because economic growth had been at a standstill for more than three years. In the following year a strong general upswing developed; real growth of GDP accelerated to nearly 7 percent and the unemployment rate turned down. On the other hand, inflation stopped falling. Measured by the consumer price index, it reached a low of 5.9 percent at the end of 1978 and then began to pick up again.



■ The Bank of Finland's security printing house at Tuupakka near Helsinki. When the building was completed in 1979, the Mint of Finland also moved there.

– Bank of Finland.

CASH RESERVE DEPOSIT SCHEME

Amid changing economic conditions, the sources of economic concern also changed. The Bank of Finland began to worry about the strong growth in bank liquidity which, if it vented into excessive lending for housing, real estate, etc., might push up inflation. The bank reacted by reducing the credit quotas that commercial banks could use at base rate. Quotas were almost halved in 1978, from 1.9 billion to 1 billion markkaa, and cut again to only 0.2 billion in 1979. Subsequently central bank lending to the banks was in practice via the call money market only, although the Bank of Finland did not begin to raise the call money interest rate until close to the end of 1979.

As growth in currency reserves made the money market easier, the Bank of Finland began in autumn 1978 to plan the adoption of a cash reserve deposit scheme. The idea was that banks would have to meet a minimum cash reserve requirement, defined as a certain percentage of their deposits, which would be held at the Bank of Finland. This would reduce the funds available for lending and tighten the money market. Cash reserve deposits had originally been implemented by agreements between the Bank of Finland and the commercial banks in 1955–1956, 1961–1962 and most recently 1967–1970 but these earlier trials had apparently been fairly ineffective.⁵²⁶ Now the central bank wanted to impose a scheme that would genuinely tighten the money market and reduce bank liquidity.

Once again the scheme was adopted in the form of an agreement between the Bank of Finland and the banks. There was already a law in force, enacted in 1965, on special deposits at the Bank of Finland but it was applicable only if negotiations with the banks failed. Furthermore the Bank of Finland regarded the cash reserve deposit scheme defined in that law as “unsatisfactory in many respects”. At the start of 1979, it completed negotiations with the banks on a new cash reserve agreement, which was signed on 8 March 1979. The banks were to make deposits in proportion to their “borrowing”, which in practice meant funds on deposit. The Bank of Finland would be allowed to increase the cash reserve requirement by up to 0.4 percentage points a month, to a maximum of five percent of the banks’ borrowing. It would pay interest on cash reserve deposits at a rate of 0.75 percentage points below the current base rate.⁵²⁷

The first cash reserve deposits were made in April 1979. The Bank of Finland increased the cash reserve requirement month after month and by the end of 1979 it was already 3.2 percent. The requirement continued rising in 1980, as the central bank continued to tighten monetary policy in response to the upswing in Finland's business climate and the world economy. The cash reserve deposit system had become a permanent part of the monetary policy system, as a way of controlling bank liquidity. It also helped to boost the profitability of the Bank of Finland because the rate paid on deposits was distinctly below the market rate.

Cash reserve deposits remained a fairly unimportant tool of monetary policy, however, as long as the overnight interest rate remained the main one. Deposits became more important after the start of 1987, when the Bank of Finland began to focus on open market operations in certificates of deposit as a way of implementing monetary policy. This emphasized the control of bank liquidity in an entirely new way. Later, in 1988 and 1989, the cash reserve system was forcefully and purposefully used by the Bank of Finland in its efforts to tighten the money market and curb an unbridled explosion of bank lending.

FOREIGN EXCHANGE POLICIES RECONSIDERED

FROM DEVALUATION CRITICISM TO THE IDEA OF REVALUATION

After the balance of payments crisis, a new upswing in the Finnish economy spurred discussion on the principles of exchange rate policies. The devaluations of 1977 and 1978 had been politically difficult. In the wake of the Korpilampi Conference, labour market partners had tried to defuse the heated struggle of the 1970s over income distribution. In the world at large, halting inflation was becoming a major objective of economic policies. For Finland the key question became whether the decades-long spiral of inflation and devaluation could now be halted.

The devaluation cycle had become a widespread concept in Finland in the 1970s. It had been launched by Professor Jouko Paunio soon after the large devaluation of 1967. His reasoning was that a devaluation to solve problems of competitiveness and the balance of payments easily triggered a new inflationary spiral that gradually consumed the competitive edge that the devaluation had brought. After a certain period of time, the economy was back where it started, in a new balance of payments crisis that called for another devaluation. Finland had experienced a ten-year cycle like this, from 1957 to 1967, which had caused harmful economic instability.

Paunio was not opposed to the use of exchange rates to solve balance of payments problems but he criticised the “jerkiness” of Finnish policies. He felt the exchange rate ought to have been more flexible, changing by small, steady amounts when balance-of-payments

deficits occurred. This kind of flexibility would, in his view, have blunted economic recessions and liberated domestic economic policy from its fixation on international competitiveness. He thought that domestic inflation could have been kept in check more easily if the cost impulses caused by large devaluations had been avoided. Paunio's proposal for exchange rates that would flexibly adapt to the state of the balance of payments met with little response. However, his idea of a devaluation cycle lived on and became an axiomatic element of Finnish economic policy discussions long into the future.⁵²⁸

The most prominent critic of Finland's devaluations was Pekka Korpinen, who had resigned from the position of office manager at the Bank of Finland in 1973 to head the Labour Institute for Economic Research. While he was still working at the central bank, he had voiced criticism, internally, of the decision in 1971 to allow the markka to depreciate in pace with the dollar against other world currencies. Korpinen and some other young experts at the bank proposed instead that the markka should be stabilised against a basket of various currencies. He regarded it as a "covert devaluation" of the markka to follow suit when the dollar fell against the German Mark.

The policy that Korpinen and some other young economists advocated at the start of the 1970s, intended to strengthen the markka, won a major victory in summer 1973, when Finland finally abandoned the dollar peg of the Smithsonian Agreement, and let the markka rise against the dollar. Finland thus became the first Nordic country to adopt a basket consisting of all the currencies important for foreign trade – a trade-weighted currency index – as the guideline for its exchange rate. Later, in 1977, the currency index system devised by the Bank of Finland's economists was incorporated into the Currency Act.

Pekka Korpinen began his very public criticisms of devaluation soon after he had left the Bank of Finland for the Labour Institute for Economic Research – TTT. There had been talk in Finland in spring 1974 about the possibility of revaluing the markka, although the exchange rate was not ultimately changed at that time. In the autumn, TTT published a special edition of its journal on the theme of the role and policies of the Bank of Finland. One striking article in this thematic edition was written by two young economists working for the Bank of Finland, who demanded, in the name of democracy, that the central

bank be transferred to the ambit of the government.⁵²⁹ However an article by Korpinen and his colleague Seppo Kykkänen, *Exchange rate policies of the Bank of Finland 1945–1973* was to be far more influential. For one and a half decades it became the basis and focus of debate on Finnish exchange rate policies, setting the framework by which all other contributions to the debate were written and read. At the same time it established the concept of a devaluation cycle, which subsequently became an unchallenged “given” in the debate.⁵³⁰

The article by Korpinen and Kykkänen started with criticism of the devaluations of 1949, 1957 and 1967, which the authors thought were excessive, inflationary and economically destabilising. The article also reflected a lack of confidence in the intentions of decision-makers, particularly the leadership of the Bank of Finland, and referred to “a policy to devalue”. The authors’ mistrust in the management of the Bank of Finland was even more explicit in their criticism of central bank operations during the foreign exchange crisis in autumn 1971. They claimed that the Bank of Finland had at that time been complicit in a kind of conspiracy against the value of the markka: “When the board of management saw that the general foreign currency crisis contained a covert opportunity to lower the external value of the markka without the government decision required by the Currency Act, the desires of exporters and forest owners (...) could be fulfilled once more.”⁵³¹

The great impact of the article stemmed from the fact that many of its perspectives revolutionised Finnish debate on the subject. One of these was to turn the causal relationship of inflation and devaluation on its head. Traditionally Finnish devaluations had been understood from the aspect of competitiveness. A devaluation was seen as the outcome of Finland’s inherent tendency to inflation, which caused prices to rise faster than in competing countries. The resultant erosion of competitiveness had to be corrected from time to time by changing the exchange rate. Korpinen and Kykkänen rejected this viewpoint and proposed instead that “the devaluation policy pursued in our country has been a significant factor in fanning inflation”. Excessive devaluations had created ingrained expectations of inflation and devaluation in the national economy, which had a strong tendency to self-fulfilment.⁵³²

Another conventional wisdom attacked by the authors was that

devaluation was a remedy for a foreign trade deficit. It had traditionally been reasoned that devaluation would improve the economy's external balance (mainly the trade account), and so it was the correct response to a large trade deficit. The same idea had underpinned the Bretton Woods system, where a "fundamental imbalance" in the balance of payments was seen as justifying a change in the exchange rate. Korpinen and Kykkänen disagreed. They reasoned that a devaluation increased corporate profits and thereby investments so much that it ultimately harmed the current account rather than helping it. Finland imported most of its investment goods so, the authors said, economic policies that favoured investment weakened the external balance of the economy. "Devaluations always seem to be a prelude to an even greater imbalance on the current account."⁵³³

Their criticisms were linked to the argument that Finland invested too much and too inefficiently, and that these excessive investments were the very cause of chronic balance of payments difficulties. Korpinen and Kykkänen examined devaluation from the perspective of income distribution. Past devaluations had transferred income from consumers to companies and thus promoted excess investment and inefficient use of capital. If Finland had not devalued, they wrote, "faster growth of real wages would have forced companies to make their operations more efficient; instead, exchange rate policies have been aimed at giving capitalists (...) an easy way out. Furthermore, lower inflation would have improved productivity by shifting investment away from speculative and low-yielding investment objects." They therefore concluded that "a significant element in Finland's chronic balance of payments problem is lax and bad investment decisions, not excessive consumption. However, policy measures which have been used to balance the economy, such as devaluation and tighter taxation, have always hit consumers and wage-earners. The more we try to promote investment by restricting consumption, the less productive our investment seems to become."⁵³⁴

Korpinen and Kykkänen felt that Finland's stubborn balance of payments problem was not due to poor competitiveness caused by high labour costs. It was because economic policies had distorted income distribution and pushed up capital income. High corporate profits, aided by exchange rate policies, had led to inefficient

investments and a lower standard of living for wage earners. They had also been the fundamental reason for Finland's repeated balance of payments crises and inflation. Ultimately the target of their criticism was the industrialisation strategy of President Urho Kekkonen, set out in his 1952 book entitled "Onko maallamme malttia vaurastua" (Does our country have the patience to get rich). The book had recommended an accelerated investment programme based on curbing private consumption.⁵³⁵

The article by Korpinen and Kykkänen ended with the claim that "the exchange rate policies pursued by the Bank of Finland must be regarded as anything but successful (...) They have created an extremely favourable atmosphere in the economy for all kinds of speculation and unsound enterprise, with the consequence that the yield on investments has steadily declined and the tendency to a deficit in foreign trade has seriously increased. It is high time to restore confidence in a markka of stable external value. Otherwise all attempts to curb inflation are doomed. But how can devaluation expectations be countered when the board of management of the Bank of Finland has come, in recent years, to consist only of representatives of employers, exporters and commercial banking circles, who stand to gain from the continuation of previous policies?"⁵³⁶

For a while after the writing of Korpinen's and Kykkänen's article, Finland's balance of payments crisis made it unrealistic to consider a new policy founded on a strong markka. The direction of exchange rate policies did not return to the agenda until the end of the decade, when the balance of payments was in better shape, economic growth was underway and the world market price of oil was again showing ominous signs of rising. Furthermore, the devaluations of 1977 and 1978 seemed to have confirmed the existence of a devaluation cycle, as Paunio, Korpinen and Kykkänen had proposed, because the new exchange rate changes had again taken place about 10 years after the previous one.

The presentation put forward by Korpinen and Kykkänen suggested that it might be possible to break the devaluation cycle by revaluing the currency at a suitable moment, thereby preventing the acceleration of inflation and overheated investment. Indeed, the idea of a revaluation policy gained some support in 1979, both among economists and in the government, and transformed a theoretical possibility into a political

option. For several years, this was a hot monetary policy issue in Finland.

The Labour Institute for Economic Research, led by Pekka Korpinen, was very active in publicly advocating a policy for revaluation. According to an article in its journal, published in 1978, Finland would be able to escape from the devaluation cycle “in the first half of the 1980s”. Heikki Oksanen, one of the Institute’s researchers, wrote: “It is possible that over the next few years, Finland’s rate of inflation will be lower than the rate abroad. In that case, even if the growth of demand is only modest, a rise in the external value of the markka will be required to keep the economy in balance. (A revaluation) then ought to be a possible course of action, even though it conflicts with the immediate interests of exporters and forest owners.”⁵³⁷ The issue became germane sooner than Oksanen had anticipated. By spring 1979 (after the start of the second oil crisis) the Labour Institute’s economic review was declaring revaluation to be essential “to combat a new invasion into Finland of international inflationary forces.”⁵³⁸

As the 1970s reached their end, the principles of exchange rate policies had become a subject of active scientific research at the Bank of Finland, too. In 1980, the bank published a dissertation by Sixten Korkman that examined the theoretical strategies for exchange rate policies in a small open economy. Korkman distinguished three alternatives or “norms”: a fixed-exchange-rate strategy, a strategy targeting competitiveness, and a strategy targeting low inflation. He opted for the anti-inflation strategy. If the main source of disruptions in the Finnish economy were inflationary impulses from abroad (as he implicitly assumed), the economy could successfully be stabilised by using inflation as the guideline for exchange rate changes, instead of keeping the exchange rate stable. In practice this meant that if inflation abroad accelerated, the domestic currency should be revalued; if foreign prices fell, it should be devalued.⁵³⁹

In the same year the Bank of Finland published another dissertation, by Hannu Halttunen, that studied the effects of exchange rate policies empirically. Halttunen’s results supported Korkman’s theoretical conclusions. He found that changes in the exchange rate had had a large and permanent effect on Finland’s price level but a weak and temporary effect on its economic growth. This implied that revaluations would be an effective weapon against inflation, while having only a modest cost in terms of growth lost.⁵⁴⁰

The dissertations of Korkman and Halttunen were a reflection of the idea then gaining ground among Finnish economists (and also at the Bank of Finland) that Finland should move to an active, incremental exchange rate policy. However the objectives of this new flexibility would differ from those proposed by Professor Paunio, of balancing the external payments account. Above all, the aim of the new doctrine was to establish a stable and low rate of inflation in Finland. The new doctrine was not universally acclaimed; far from it. Klaus Waris, the former governor of the Bank of Finland, was a stern public critic of revaluation policy, which he regarded as unrealistic. “On the downside of a strong currency is the dark shadow of deflation – would our society be ready to accept it?” Waris asked.⁵⁴¹

In any case the idea of an active exchange rate policy, flexible in both directions, strongly influenced Finnish economic discourse for a while, and the policies of the Bank of Finland between 1979 and 1982 must be seen in this light. However, the criticisms of devaluation formulated by Korpinen and Kykkänen had a far more durable effect, lasting into the next phase of exchange rate policies in the second half of the 1980s, when the doctrine of the strong markka became a cornerstone of Finland’s economic strategy.

A NEW OIL CRISIS

First we must go back to the turn of the 1980s. The new decade ushered in a new era at the Bank of Finland, in monetary policy and in leadership. If the 1970s had been characterised by fast inflation, a balance of payments crisis and ultimately devaluations and economic stimulation, the 1980s became a decade when the Finnish money market was no longer insulated from the outside world, its regulations were dismantled and monetary policy became “market driven”. The new decade also marked a new era for the Bank of Finland because, after parliamentary elections in spring 1979, governor Mauno Koivisto became Prime minister, never to return to the central bank’s board of management. Koivisto’s rise to the Prime minister’s office was related to preparations among political parties for a struggle to succeed the ageing president Urho Kekkonen.

In the elections of March 1979 the governing parties suffered distinct losses while the largest opposition group, the National Coalition

Party, won a full 12 extra seats in parliament. As was the practice, the government of Prime minister Kalevi Sorsa offered its resignation after the election and President Kekkonen then asked the chairman of the National Coalition Party, Harri Holkeri, "to explore the possibilities for forming a politically viable majority government". At the time, Holkeri was no longer a member of parliament. He had resigned his seat the previous autumn, upon being appointed to the board of management of the Bank of Finland. He had also resigned from the position as chairman of the Parliamentary supervisory council, which he had held since 1971.

Holkeri found that it was impossible to establish a majority government containing the victorious National Coalition Party; too few other parties were willing to join it in government. The only politically viable base proved to be the same coalition of Social Democrats, Centrists and People's Democrats that had made up the previous government. Nevertheless, Kalevi Sorsa did not resume his previous position as prime minister, and the Social Democrats instead offered Mauno Koivisto, the governor of the Bank of Finland, as their candidate to head the government. Public opinion polls had shown that Koivisto, a social democrat, was by far the popular potential candidate to be the next president. The political historian Hannu Soikkanen says that, even before the elections, Sorsa as chairman of the Social Democratic Party had reached the conclusion that Koivisto's great popularity should be exploited and that the party should try to make him prime minister so that he would be well placed when the looming presidential election was held.⁵⁴²

On 11 May, President Kekkonen asked Koivisto to form the government, which was sworn in on 26 May 1979. The supervisory council granted Koivisto leave of absence from the Bank of Finland on 5 June and Ahti Karjalainen became acting governor. To make up numbers on the board, Seppo Lindblom was appointed acting member. Two members of the supervisory council became ministers in Koivisto's government and had to resign from the council. These were Ahti Pekkala of the Centre Party, who became Finance minister, and Ulf Sundqvist of the Social Democratic Party, who became Minister for Trade and Industry.

At the time when Mauno Koivisto was moving from the Bank of Finland to the government, monetary policy was facing new challenges

as worldwide inflation picked up in the wake of the second oil crisis. The crisis resulted from political tension in the Persian Gulf following the revolution in Iran. The Shah of Iran had been forced to flee the country in January 1979 and an Islamic republic had been established by the religious leader Ayatollah Khomeini. Iran was one of the world's major oil producers, so the decline in its output and increased uncertainty caused a dramatic rise in oil prices in 1979.

The price of crude oil doubled in 1979. The situation in the oil-producing area of the Persian Gulf was worsened by Iraq's attack on Iran in autumn 1980, after which the oil price rose even higher. The era of expensive oil was to last till the mid-1980s. Higher oil prices had an effect on other raw materials and Finnish import prices began to rise steeply even before the end of 1979. Export prices also began to climb faster. This raised the question of how accelerating foreign inflation could be prevented from spreading to Finland. Because the Finnish inflation rate was lower than in many other countries, the possibility of revaluing the markka was raised. Pekka Korpinen's Labour Institute for Economic Research, which was close to the trade unions, was the main proponent of this and, in the context of a forecast report published in March, proposed a markka revaluation "to combat a new invasion by international inflation"⁵⁴³.

In the programme of the Koivisto government, the section on economic policy had had the same focus on economic stimulation as the previous government's. Now, the danger of faster inflation and an emerging strong economic upturn shifted the government's focus away from supporting growth towards controlling inflation. Soon after the start of his government, Prime minister Koivisto began actively to advocate the revaluation of the markka in order to check inflation pressures. He saw nothing improper in government proactiveness, even though the law stated that the formal proposal for a revaluation had to come from the Bank of Finland. However no agreement on the matter could be reached within the government during the summer, because of hesitation by Centre party ministers, nor did the board of management of the Bank of Finland seize the initiative. Meanwhile, talk of revaluation naturally had an effect on the market, where a kindling of revaluation expectations caused a surge of capital imports. During the summer, currency reserves increased, making the money market even easier.

As acting governor of the Bank of Finland, Ahti Karjalainen took up the question of revaluation at a meeting of the supervisory council on 26 June 1979. He said that the bank's board of management had felt unable to propose a revaluation, at least for the time being. Such was the political situation, Karjalainen said, that if the Bank of Finland had proposed a revaluation to the government, "the coalition that had been so hard to put together would have collapsed", meaning that the Social Democratic and Centre parties disagreed on the matter. Karjalainen was referring to the events of spring 1978, when the Sorsa government had broken up in a dispute over a devaluation proposal made by the Bank of Finland. This time, Karjalainen seemed to be saying, Centre party ministers would have rejected the revaluation, even if it caused the collapse of the government. He said he would prefer not to see a repetition of the situation of 1978 and expressed the hope that government circles would continue "together to seek a common way forward".⁵⁴⁴

The exceptional strength of the upturn under way in Finland and the acceleration of inflation caught forecasters by surprise. An internal forecast prepared at the Bank of Finland in September raised the GDP growth estimate for the current year to 7.6 percent and the inflation prediction to 7.5 percent.⁵⁴⁵ Because of the situation, the *central bank policy working group* sent the board a memorandum, dated 19 September, on measures to combat inflation. It proposed a revaluation, lowering the currency index fluctuation band six percent and the index value itself by five percent. In monetary policy it wanted an increase of one percentage point in the general interest rate level, plus a substantial hike in overnight interest rates.

The authors of the memorandum – Ralf Pauli, Kari Pekonen and Kari Puumanen – were the bank's main monetary policy experts and advocates of flexibility in exchange rates: "If this revaluation were to take place, it would also be a statement of principle in favour of more flexible exchange rate policies. If the ominous inflation trend is successfully combated, and if international economic activity subsequently weakens, the market shares of the open sector could if necessary be supported by exchange rate policies, without the need to resort first to tough controls on demand. Moreover, successful anti-inflation policy might, in itself, strengthen competitiveness after the immediate deterioration caused by the revaluation."

In connection with exchange rate flexibility, the staff had also discussed widening the fluctuation band, but Pauli, Pekonen and Puumanen did not recommend it: “A wider fluctuation band for the exchange rate index would in principle improve the scope for exchange rate flexibility. But there is a danger that if this reform took place in connection with a revaluation, it would raise doubts about the permanence of the new exchange rate level and could bring about efforts to link exchange rate changes to incomes policy settlements.”⁵⁴⁶

The dispute about revaluation was ultimately resolved with a compromise, in which the markka was revalued less than had been proposed during the summer. Another part of the compromise was that, despite the prescription of the central bank’s experts, the currency index fluctuation band was widened anyway. This gave the Bank of Finland more leeway in setting exchange rates, so that the revaluation could if necessary be reversed by decision of the bank’s own board of management.

The revaluation was put forward at a meeting of the supervisory council on Friday 21 September. The bank proposed that the floor of the index fluctuation band should be lowered about 2.1% but the ceiling by only 0.6%. The band would therefore widen from the previous 4.5 percent to 6 percent. Concurrently with its proposal, the Bank of Finland informed the supervisory council that it intended to lower the value of the exchange rate index by about 2 percent. This would be the direct effect on exchange rates.

At the same meeting of the council, the board of the Bank of Finland proposed an increase in base rate by 1¼ percentage points from the start of November. It argued that the hike was needed because inflation had accelerated, interest rates abroad had risen, and Finland’s current account was deteriorating as a result of higher aggregate domestic demand.

In the supervisory council discussions, Kalevi Sorsa of the Social Democratic Party voiced doubts about widening the currency index fluctuation band and requested a statement from the Justice chancellor – the chief attorney and legal adviser of the government – about its legality. Sorsa’s suspicions reflected the traditional line of the social democrats, who favoured the pre-eminence of the government in exchange rate questions. The meeting was adjourned

until an answer had been obtained. Justice chancellor Risto Leskinen responded that a wider fluctuation band was not contrary to the Currency Act, which contained no mention of the size of the band. Nevertheless Sorsa dictated a statement into the council minutes in which he said that, while he supported the rest of the revaluation proposal, he regarded the widening of the fluctuation band as questionable. It should be restored to its original 4.5 percent "in the nearest possible future", he said.

The size of the revaluation had to be put to a vote because Aarne Saarinen and Ilkka-Christian Björklund, councillors representing the People's Democratic League, thought that the proposal was flawed. They wanted a revaluation of 5 percent but not a broader index fluctuation band. However, they were outvoted by the other members of the council.⁵⁴⁷ The government approved the supervisory council's proposal on the same day and the following Monday the board of the Bank of Finland kept its promise by moving the currency index to 115.4, which raised the value of the markka about 2 percent. Measured by the currency index the markka's value rose by about 2.7 percent in the period May-September.

After the exchange rate adjustment and general interest rate hike in September 1979, revaluation expectations had been fulfilled and convertible currency reserves went into decline. Another reason that reserves fell was that the current account had moved into deficit. Inflation was picking up at the same time and, at the start of November, the board of the Bank of Finland began to tighten monetary policy via the call money market, by curbing its investments in the market. The call money rate rose distinctly. During the first 10 months of the year it had averaged about 8 percent but in November it rose to 12.9 percent and in December it reached 13.5 percent. Monetary policy was finally actually moving in a more restrictive direction. The period of economic stimulation, which had begun in spring 1978, had come to an end.

In 1979 the sharp rise in interest rates was a worldwide phenomenon as monetary policy was tightened to combat inflation. It also marked a change in economic strategy in many countries, where monetary policy was given a more distinct role in controlling inflation. The reorientation of monetary policy had been inspired by Professor Milton Friedman of the University of Chicago. His economic doctrine of monetarism stated that, by managing the rate of growth of the money

supply, inflation could be controlled in a way that would not cause long-term damage to employment or economic growth. Friedman had been developing his ideas since the 1950s but soaring inflation in the 1970s created fertile ground for the theory among economic policy makers.

The breakthrough of monetarism in the major industrial countries at the end of the 1970s was not due to faith in theoretical dogma alone. The West German central bank had given the world an example of the new monetary philosophy. Since 1974 the monetary policy of the Deutsche Bundesbank had been founded on targets for growth of the money supply, and this strategy had controlled inflation in Germany better than in any other large industrial power. Germany's success brought new support for monetarism and the ensuing regulation of money supply among the major industrial countries. Meanwhile, among Europe's small countries, following German policy by pegging exchange rate to the Mark became an increasingly attractive policy option, taken by a growing number of governments in the early 1980s. Moreover, within the EEC, there was an extra argument for stabilising exchange rates, because rate changes disrupted the Common Market.

In Britain the government of Margaret Thatcher took power in 1979 and began a determined tightening of monetary policy. The reference rate of the Bank of England, the *bank rate*, was raised by a full five percentage points at the end of the year. After a hike of three percentage points on 21 November, it stood at 17 percent, the highest in British history. In the United States the trend was the same. Paul Volcker, appointed chairman of the US Federal Reserve in August, soon began to control money supply growth, which raised dollar-denominated money market rates from about 10 percent in the first half of 1979 to about 14 percent by November. The Swedish central bank raised its discount rate at the end of September to 8 percent, at the end of November to 9 percent and on 18 January 1980 to 10 percent.

As mentioned earlier, the board of the Bank of Finland had responded to higher foreign rates by allowing Finland's call money interest rate to rise distinctly at the start of November. As a result, the lending and borrowing rates of Finnish banks were now very low in comparison with the rate prevailing in the interbank call money market. Inflation accelerated at the same time. In December 1979,

consumer prices were almost 9 percent higher than a year earlier. The time was approaching for a new increase in base rate.

National negotiations on wages began at the start of 1980. On 29 January the SAK confederation of unions, laid out its objectives, which were estimated to mean a 13 percent rise in labour costs if they were achieved. On the following day the Bank of Finland sent two proposals to a meeting of the supervisory council. It wanted to raise base rate by one percentage point and also to move the fluctuation band of the currency index so that the markka would be able to rise an extra two percent in value. The bank said that it would leave the currency index – meaning the actual exchange rate – unchanged for the time being. Its intention was to make a de facto revaluation of the markka possible if conditions allowed it and thereby to reward moderation in wage negotiations.

The board of management argued for the rate hike by pointing to the continuing rise of interest rates in many countries and on international markets since the last increase in Finnish rates in September. This was putting Finland's currency reserves under pressure, it said. However, the supervisory council did not agree with the proposal to raise base rate by one percentage point and the board revised it to three-quarters of a percentage point. This was approved by the council and a new base rate of 9¼ percent took effect from the start of February. The shift of the currency band to allow a markka revaluation by 2 percent was approved unanimously by the council. The government ratified it on the same day, 30 January 1980.

The Bank of Finland did not let the new position of the currency band to be reflected in daily exchange rate quotes, and the currency index value stayed unchanged. In the weeks that followed, it became clear that a centralised wage settlement would not be possible. Instead, the agreements of spring 1980 were made at the individual union level. The contract increases in March were fairly high, averaging over 11 percent in the private sector. After wage contracts had been agreed, agricultural income negotiations continued. They proved to be exceptionally difficult, and the Bank of Finland became an indirect participant in them.⁵⁴⁸

On 25 March acting governor Karjalainen surprised the central bank's board of management with a proposal that the leeway for a revaluation, obtained in January, should be used and the value of the

currency index reduced by two percent. The board agreed but not unanimously. Rolf Kullberg deplored the linking of exchange rate policies to “current decisions on income distribution policy” – that is, the agricultural income negotiations – and dictated his dissenting opinion into the minutes. Acting governor Karjalainen then added a statement to the minutes that the measure was not part of “any bundle of deals in any matter.”⁵⁴⁹

In fact the exchange rate decision of 25 March was related to a dispute between the Social Democrats and the Centre party over the agricultural income settlement. According to Mauno Koivisto’s memoirs, Interior minister Eino Uusitalo had come up with the idea of helping agricultural income talks by revaluing the markka, which would serve to recompense left-wing parties and wage earners’ organisations. As prime minister, Koivisto had accepted the idea but had assumed it would be an official revaluation, meaning that the government would move the currency band. He was not satisfied with Karjalainen’s unexpected change in the exchange rate on 25 March, which affected only day-to-day quotations and could easily be cancelled again, especially as the currency index was now close to the floor of its fluctuation band. When the long-running agricultural income negotiations were finally concluded at the end of March, the governing parties secretly agreed that their members in government would approve a shift in the fluctuation band of the currency index if the Bank of Finland proposed it. The board of management of the Bank of Finland and the supervisory council were informed of the existence of this agreement.⁵⁵⁰

At the start of April the central bank policy committee, an internal working group consisting of the Bank of Finland’s main experts, drew up a briefing for the board on the basis of the bank’s latest forecast for economic activity. Directors Markku Puntila and Kari Nars presented the working group’s memorandum, which contained monetary and exchange rate recommendations, to a board meeting on Monday, 14 April 1980. The memorandum came out in favour of flexible exchange rate policies: “Flexibility ... in both directions would be analytically the clearest way” of reducing the national tendency to inflation. The memorandum also stated that “extra measures to curb inflation should be commenced immediately”. As urgent measures it proposed a rise in domestic interest rates and a revaluation of the markka, by shifting

the fluctuation band of the currency index “either so that the present (currency) index value is closer to the midpoint of the new fluctuation band or by also raising the external value of the markka slightly at the same time”⁵⁵¹

In subsequent discussions, the board was divided on the subject. The board members with a background on the political left, Seppo Lindblom and Ele Alenius, were in favour of revaluation but the majority did not warm to the idea. Acting governor Karjalainen and Rolf Kullberg, the member responsible for monetary policy, were in favour of raising interest rates but no action was taken on this, either. Karjalainen announced that no concrete proposals would be made to the next meeting of the supervisory council.

When the council met, on Friday 18 April, councillor Jermu Laine of the Social Democratic Party said that a formal proposal for a revaluation should be requested from the board. In the ensuing discussion, acting governor Karjalainen said that inflation pressures had increased “for internal reasons”, meaning the recently agreed wage settlements, so conditions were not right for proposing a revaluation to the government. Laine was not supported by council members from the Centre or National Coalition parties either. Mauri Miettinen of the National Coalition Party reiterated Karjalainen’s view that the inflationary pressures were coming mainly from within the country. Finland had created “an inflation machine”, and this was what efforts to combat inflation should focus on; a revaluation would not help much. The matter went to the vote and the council decided by five votes to three not to ask the board to propose a formal revaluation. The currency index fluctuation band was to stay where it was.⁵⁵²

Prime Minister Koivisto was clearly frustrated by the reluctance of the Bank of Finland to revalue the markka. He felt it was “reasonable” to expect the bank to observe the wishes of the government in this matter and to propose a formal change in the exchange rate. When no proposal was forthcoming, the disappointed Koivisto concluded that “the only recompense received by the left for accommodating the agricultural income settlement was a temporary exchange rate movement.”⁵⁵³ By temporary Koivisto meant that the revaluation of 25 March had been made within the fluctuation band and not cemented by a government decision to move the band. In practice, however, it

became fairly permanent. The currency index value and the government-ratified fluctuation band were not changed for another one and a half years, until October 1982.

Spring 1980 did not present a very promising picture for the scope for flexible exchange rate policies. Even small exchange rate movements, those that took place and those that did not, were the subjects of such great political passion that the idea of actively using them to serve monetary policy in a flexible way seemed fairly unrealistic. It is especially significant for later developments that the events of spring 1980 apparently led to a decisive lack of trust in exchange rate policies between two leading parties. The disagreement born in spring 1980, and the confidence deficit between them, made the exchange rate into one of the main issues that differentiated the Centre Party and the Social Democrats for a whole decade.

Spring 1980 also showed the independence of the Bank of Finland to be fairly superficial in politically contentious questions. In the prevailing political situation the institutional boundaries between the national government, the supervisory council and the Bank of Finland board lost much of their relevance when the same political groups – principally the Centre Party and the Social Democrats – were jousting for power in all these forums. Even the board of management of the Bank of Finland was now the scene of an unusual amount of party political manoeuvring in economic policy. The situation at the start of the 1980s was somewhat exceptional but the reason is obvious. Politics were inflamed because President Kekkonen was growing weaker and the parties were vying for the succession. It is not surprising that the independence of the Bank of Finland was diminished. The political situation and interparty relations remained tense to a greater or lesser degree until the presidential election had been held at the start of 1982, after Urho Kekkonen had first taken sick leave in September and then tendered his resignation on 26 October 1981.

THE EUROPEAN MONETARY SYSTEM

At the turn of the decade, while Finland was pondering the question of exchange rate flexibility, new efforts were beginning in continental Europe to create more fixed exchange rates. Cooperation on exchange rates, begun by EEC countries in the 1970s, had not succeeded in

creating permanent stability in mutual exchange rates. They created a system of coordination, the “currency snake”, but exchange rates had to be frequently adjusted within it, and many community countries opted out. Of the large member countries, Britain withdrew in 1972, before its membership of the EEC had even come into force. Italy left in 1973 and France resigned twice, in 1974 and again in 1976. By the spring of 1979 the snake contained only Germany and four small countries that were tracking the German Mark: Belgium, Luxembourg, the Netherlands and Denmark. Sweden and Norway were “outside members” of the snake for a while but left it, Sweden in 1977 and Norway in 1979.⁵⁵⁴

The EEC felt that exchange rate volatility and the hiatus in European integration were a problem. In April 1978, the leaders of France and Germany, President Valéry Giscard d’Estaing and Federal Chancellor Helmut Schmidt, presented other Community heads of state with a joint initiative on closer exchange rate cooperation. The concept of a European Monetary System (EMS) was accepted in principle at the EEC summit in Bremen in July 1978, and was due to start operating at the beginning of 1979. It was delayed slightly by political disagreements but was in operation by 13 March 1979, less than a year after it had been proposed by d’Estaing and Schmidt. All EEC members at the time except for Britain joined the new fixed exchange rate mechanism (ERM) of the European Monetary System.⁵⁵⁵

The establishment of the European Monetary System halted the divergence of European monetary systems and gradually moved Europe towards closer monetary integration in the 1980s. In the 1990s, EMS came to be the foundation on which European Monetary Union was built. Inevitably, monetary integration would have a critical long-term effect on Finland’s monetary system, even though, in 1979, fuller Finnish participation in European integration was not on the agenda in any shape or form. Finland followed developments from the sidelines, but it felt that the EMS would eliminate some exchange rate uncertainty. According to a brief memorandum on the subject, written at the Bank of Finland, the creation of a new European monetary system could therefore be regarded as a favourable development although it would not alter the basis of Finnish exchange rate policies.⁵⁵⁶

Finland had developed its own exchange rate system based on a trade-weighted currency index and was psychologically very committed

to it. One reason was that the EMS area was not commercially very important for it. In 1983 Kaarlo Jännäri wrote in a Bank of Finland publication that “because EMS countries account for only about a third of Finnish foreign trade, Finland has no special interest to consider a closer link than today between its exchange rate policies and the EMS; present practice is better in line with our interests”. By present practice he meant exchange rates based on the trade-weighted currency index, the system used in Finland, Sweden and Norway.⁵⁵⁷ At the time when the EMS had been set up, Finland was talking mainly about increasing exchange rate flexibility and, in particular, about the viability of revaluations as a tool of economic policy.

The rather complex structure and methodology of the EMS cannot be explored here but, for a better understanding of later exchange rate policies, it is worth noting the system’s main features. The key elements of the EMS were the European currency unit ECU, the exchange rate mechanism ERM for controlling rate fluctuations between member currencies and the various financial arrangements available to member central banks to defend their jointly agreed exchange rates.

The ECU was a basket of currencies of the EEC member countries. It contained fixed amounts of member currencies so its value constituted a kind of EEC currency average. For a long time after its creation, the ECU was little used as a medium for payment but it was important as a bookkeeping unit in the EMS system. It was also used as an accounting currency in financial arrangements between member central banks.

The establishment of an Exchange Rate Mechanism was an important step towards more fixed mutual exchange rates between EEC members. It was especially important that France and Italy joined in exchange rate coordination again, after a gap of several years. All currencies linked by the ERM were given ECU central rates, from which their bilateral central rates were derived. Only a joint decision of the member countries could change the central rates, so unilateral devaluations (or revaluations) were out of the question. In practice, decisions on adjusting central rates were taken at a meeting of finance ministers and central bank governors. Administratively the decisions were prepared in the EEC’s monetary policy committee.⁵⁵⁸

ERM currencies were allowed to deviate from their fixed central rates by no more than 2¼ percent in each direction (for the Italian lira

± 6 percent was permitted). If an exchange rate moved outside its permitted fluctuation band, there was an unlimited obligation to intervene and restore its correct value. An unlimited intervention requirement meant that if (for example) the French franc fell against the German Mark so much that it had reached the edge of the fluctuation band, the French central bank was required to sell an unlimited number of German Marks (as many as the market would absorb) to buy up its own currency.

To ensure that central banks, even large ones, could engage in the interventions needed to fix their exchange rates, the very short term financing facility (VSTF) was created, allowing each central bank unlimited credit from any other central bank within the system. Credit drawn down within the VSTF was originally to be paid back within 45 days but postponements could be obtained subject to certain conditions. Besides the VSTF the EMS contained certain other financial arrangements but they had less practical significance.⁵⁵⁹

The early EMS years were fairly turbulent because the divergent economic development of the member countries created frequent strains on exchange rates. The pressures were vented by repeated exchange rate adjustments, generally in which the central rates of one or more currencies were reduced against the German Mark. During 1979–1983 ERM parities changed a total of seven times. These early years could be called the “soft EMS” period. During 1983–1987 the nature of the system changed and it became rather more rigid. From 1987 onwards the EMS was in its “hard” period. By this time, Finnish policies had also moved on, and the impact of the solidifying EMS on Finland’s approach to exchange rates began to grow stronger.

FOREIGN EXCHANGE DEREGULATION BEGINS

As the balance-of-payments pressures eased in the late 1970s it became possible to ease foreign exchange controls, which had been tightened earlier that decade. International organisations (the IMF, OECD and EEC) had frequently criticised the requirement that imports be paid in cash. It had been imposed by the Bank of Finland five years earlier to prevent the sale of certain foreign goods to Finland on credit. Now that the trade account was improving, the Bank of Finland terminated the

import cash payment requirement at the start of March 1979. Even before this, it had been relaxed several times and ultimately applied to only 18 percent of all merchandise imports.

Elimination of the import cash payment requirement meant that Finland could finally accept Article VII of the International Monetary Fund, concerning the avoidance of restrictions on current payments and discriminatory currency practices. Finland informed the IMF in September 1979, after which the markka was formally classified as a convertible currency. In practice, however, it had been entirely convertible for foreigners since 1958.⁵⁶⁰ The main significance of the announcement was that Finland now promised not to impose currency controls in the future either.

The next step in dismantling foreign exchange regulations was taken in 1980, when the Bank of Finland deregulated the forward market for foreign exchange. Forward contracts could be used to reduce currency risks, an exporter by selling future foreign earnings in advance, an importer by buying in advance the currency needed for future payments. The forward market offered a way to hedge against exchange rate changes but it also provided an opportunity to speculate on exchange rates.

Forward markets between the markka and other currencies had begun to develop after December 1971, when the Bank of Finland started to quote forward dollar rates, amid exchange rate uncertainty, caused by the collapse of the Bretton Woods system. In 1974, the bank had begun to quote forward rouble rates, too. Throughout the 1970s the forward foreign exchange market was under the tight control of the Bank of Finland. Exporters and importers made their forward contracts with commercial banks but the Bank of Finland set the forward rates and made up the difference between supply and demand in currency futures. In general the commercial banks were just brokers in the forward market and covered their customers' forward deals immediately at the Bank of Finland.

In 1978 the forward exchange rate policies of the Bank of Finland aroused some public discussion, partly at the instigation of the Labour Institute for Economic Research.⁵⁶¹ The Bank of Finland was believed to be favouring exporters by paying more on average for forward currency than was justified by the interest rate differential between the markka and the US dollar.⁵⁶² Perhaps this discussion contributed

to a proposal, made by the central bank's internal policy working group at the end of 1978, that it should gradually withdraw from the forward market. The market would then be managed by commercial banks and forward rates would be set by the differential between foreign and domestic interest rates. Planning for this reform began in the following year. In April 1979 the Bank of Finland changed its forward exchange rate policies by reducing the forward dollar rate to correspond to the interest rate difference between the markka and the dollar.⁵⁶³

In November 1979 the board of management discussed the principles of its forward market policies on the basis of a memorandum written by the exchange rate policy department. The memorandum confirmed the suspicion that the forward rates quoted by the Bank of Finland had been "almost continuously" higher than interest rate parity would have warranted. It proposed that the bank should withdraw from the forward dollar market and should henceforth be a market party "only when seeking to mitigate the effects of foreign exchange market disturbances on domestic liquidity". The memorandum made no allusion to any particular consequences for monetary policy of a withdrawal from the forward market, although it noted that exchange rate expectations could have a significant impact on supply and demand of currency futures. At the same time, it predicted that "effective forward markets could, on the contrary, limit actual capital movements driven by expectations, in which case the currency reserves of the whole country will fluctuate less."⁵⁶⁴

Concluding the debate on forward market policies, the board resolved to try to implement the changes proposed in the memorandum by the end of the year. In practice it took a few more months, but on 1 April 1980 the Bank of Finland withdrew from the forward currency market and left it in the hands of the commercial banks. At the same time it deregulated foreign borrowing by banks to the extent that they borrowed in order to cover forward positions.⁵⁶⁵ However the Bank of Finland continued to offer rouble-denominated forward contracts until 1983.

The change in forward market policies implemented in spring 1980 turned out to be the most important decision so far on deregulating Finnish capital movements, and nothing else as significant was done until 1986. The key aspect about deregulating capital imports to cover

forward contracts was that, from the start of the 1980s onwards, the Finnish market was far more closely linked to the international money markets. Short-term capital movements were henceforth distinctly more sensitive to interest rate differentials between Finland and abroad, and to exchange rate expectations. As late as 1978, the head of the central bank's monetary policy department Ralf Pauli had written, in a publication about Finnish interest rate policies, that "the effect of foreign interest rates on interest policy decisions in Finland has been slight. The differential between foreign and domestic rates does not generally cause strong capital movements for Finland, sufficient to jeopardise the implementation of domestic economic policies."⁵⁶⁶ In the 1980s this assessment was clearly no longer true, although the full sensitivity of capital movements to interest rates did not immediately emerge. But when Finnish monetary policy was tightened in 1983 and 1984, it caused an unprecedentedly strong influx of short-term capital imports, mostly in 1984.

CHANGING OF THE GUARD

SOVIET TRADE AND THE BANK OF FINLAND

The oil crises of the 1970s and 1980s affected the Finnish economy in a way different to other western countries. Finland imported almost all of the petroleum it needed from the Soviet Union, and trade between the two was balanced on a bilateral basis. In accordance with the mutual payment agreement, payments were made via clearing accounts at the Bank of Finland and the Soviet Bank for Foreign Trade (Vneshtorgbank) and denominated in special clearing roubles. The system had remained largely unchanged since 1951, when the first five-year trade and payments agreement between Finland and the Soviet Union had entered into force.⁵⁶⁷

The effect of the bilateral trade system was that the Soviet Union had to use its export earnings from Finland for purchases from Finland. Finland was therefore able to pay its “oil bill” with its own export products. The rising price of oil was not a direct burden on Finland’s convertible currency reserves even though the Soviet oil that it purchased was supposed to be priced according to world market prices.

Because of bilateral trade, the higher oil price during the first and second oil crisis was reflected in strong growth of demand for Finnish exports as the Soviet Union used its sharply increased clearing rouble earnings for purchases from Finland. Naturally the system did not protect Finland from the cost effects of the oil price rise because the



■ The 25th trade protocol between Finland and the USSR is signed at Smolna banquet hall in Helsinki on 13 December 1982. Toasting the trade package worth 38 billion markkaa are Soviet Foreign Trade minister Nikolai Patolichev (left), the Soviet ambassador to Finland V.M. Sobolev, the Finnish chairman of the mutual trade commission Ahti Karjalainen, second Finance minister Jermu Laine and Finnish Foreign Trade minister Esko Rekola.

– Lehtikuva news photo archives / Peter Jansson

volume of exports needed to pay for oil imports obviously increased as oil became more expensive. But because of the short-term demand fillip, the oil crisis had a more expansionary effect on the Finnish economy than on most other countries dependent on petroleum imports.

By the early 1970s, Finland's bilateral trade with the Soviet Union and most East European countries was already very unusual. Of the other OECD countries, Sweden and Austria, for example, switched to convertible currency-based trade with the East at the start of the 1970s.⁵⁶⁸ Finland was an exception among market economy countries not merely in the payment system of its eastern trade but also because Socialist countries played a major role in Finnish foreign trade. Before the first oil crisis the Soviet Union had provided less than 12 percent (1972) of Finnish imports but the proportion grew strongly in the 1970s. On the eve of the second oil crisis in 1978 the Soviet Union was already the source of 19 percent of Finnish imports. The bulk of these imports were crude oil and fuels.

As a member of the International Monetary Fund, Finland was committed in principle to multilateral foreign trade, paid in convertible currencies. Since the 1970s the IMF had deliberately sought to end bilateral payment systems between its members and been very successful in this. In practice, however, the IMF accepted that some members (such as Finland) had bilateral agreements with non-IMF countries where foreign trade was under government control, although the IMF discouraged the use of these agreements.

In the 1970s Finland informed the IMF of its aim to seek free trade with all other socialist countries, but in trade with the Soviet Union Finland wanted to continue the bilateral system, which Finnish exporters in particular regarded as beneficial. At the same time, the Finns tried to demonstrate to the IMF that bilateral trading arrangements with the Soviet Union did not discriminate against third countries but were intended only to protect the balanced development of mutual trade.⁵⁶⁹

The use of freely convertible currencies in trade between Finland and the socialist countries increased somewhat in the 1970s and 1980s. Trade with Poland and Czechoslovakia shifted to convertible currencies from the start of 1970 although Finland's bilateral agreements with them theoretically remained in force. Trade with certain socialist

countries became convertible as they joined of the IMF, with Romania in 1982, the Chinese People's Republic⁵⁷⁰ in 1983 and Hungary in 1985. However these were very unimportant trading partners for Finland compared with the Soviet Union.⁵⁷¹

The retention of clearing trade between Finland and the Soviet Union in the 1970s and 1980s, in the face of prevailing international trends in east-west trade, was due to the wishes of the Finnish side only, and particularly the attitude of Finnish exporters. The payments basis was set for five years at a time in the so-called framework agreement. Even the agreement for 1976–1980 preserved the clearing payments system at the express request of Finland. The Soviet side “as often before” would have preferred to move to payments in convertible currency.⁵⁷²

The situation was the same when the new agreement was being negotiated for 1981–1985. At an event arranged at the Bank of Finland in November 1978 to discuss the payments system, industry said it continued to be in favour of clearing trade. Pentti Uusivirta of the central bank's board of management warned that the agreement being negotiated could be the last long-term agreement on a clearing basis. He predicted that “in the long run” the payment system for trade between Finland and the Soviet Union would have to change in any case but added that the Bank of Finland would not take any particular stand on the question without the go-ahead from industry.⁵⁷³

The Soviet Union's preference for trade in convertible currency was understandable because its main export product, crude oil, would have brought it dollars and not clearing roubles that had to be spent in Finland. On the other hand it was not apparently hard for Finland to persuade the Soviet Union. The clearing system kept trade at a high level, which obviously had a broader political significance.

The desire of Finnish industry to preserve the clearing system was partly due to its fear that a shift to trade in convertible currency would lead to tougher competition on the Soviet market and partly to the large advance payments that Finnish exporters (particularly shipyards) could obtain prior to completion of projects. One of the special features of clearing was that, as long as the balances on clearing accounts permitted it, the Soviet Union financed its advances to Finnish companies by drawing interest-free credit from its clearing account at the Bank of Finland. During the period of clearing trade, the Bank of

Finland was thus providing large *de facto*, if indirect, interest-free loans to Finnish shipyards. Industry wanted to retain the system; the Bank of Finland as the source of finance regarded it as problematic.⁵⁷⁴

The Bank of Finland's role in bilateral trade with the Soviet Union was to maintain the clearing account for trade through which payments were made. Technically the account was managed as if it had been Vneshtorgbank's account, just as the Bank of Finland had its own account at Vneshtorgbank. The Bank of Finland thought of the accounts as being managed on behalf of the Finnish government and did not regard itself as responsible for their credit or exchange rate risks. However, it consolidated the accounts in its balance sheet, and treated them as its assets and debts.⁵⁷⁵

As the official body responsible for clearing accounts on the Finnish side, the Bank of Finland supervised payments from and to the Soviet Union and managed their balance, meaning the totals held in clearing accounts. The bank was also represented on the board of the License office, the Finnish authority which controlled exports to the Soviet Union, so as to keep them roughly in balance with imports. The Bank of Finland's possession of information about payments traffic and the clearing account balance naturally enhanced the status of its representative at the License office.

The Bank of Finland's role in trade between Finland and the Soviet Union was reinforced by the position of board member Ahti Karjalainen, who was the Finnish chairman of the Finnish-Soviet Economic Commission from 1967 until 1983, when he was dismissed from the post of governor of the Bank of Finland. The commission directed mutual trade by managing the preparation of five-year frame agreements and "also participated directly in the planning of mutual trade."⁵⁷⁶ Admittedly Karjalainen was on leave of absence from the bank until May 1977, serving continuously as a minister in various governments, but thereafter he was simultaneously chairman of the joint commission and a serving board member of the central bank for a period of six years

Karjalainen's status and the importance of Soviet trade to Finland are shown by the support he received during a period of manoeuvring for the Finnish presidency at the end of the 1970s and start of the 1980s. Many captains of industry in the export sector saw him as the guarantor of the favoured clearing system and supported him to succeed the ageing Urho Kekkonen as president of Finland. The plan collapsed in

autumn 1981, when Karjalainen did not receive the backing of his own party. Instead the Centre Party chose the senior parliamentarian, Johannes Virolainen as its candidate for the presidency.⁵⁷⁷

Bilateral trade was intended to be balanced. The mechanism for achieving balance was the annual round of negotiations on goods to be exchanged (usually conducted in November), which took into account any accumulated surpluses and sought to eliminate them in the following year.⁵⁷⁸ In practice, however, considerable surpluses and deficits built up in the clearing accounts because it was not possible or desirable to balance trade quickly.

To create flexibility, the accounts were given credit ceilings, within which payments could be made. From the start of 1961 right up to the first oil crisis, the credit limits were ± 18 million roubles, which in 1972, for example, was equivalent to about six percent of the value of annual imports from the Soviet Union. On the eve of the first oil crisis at the start of 1973, the credit ceiling was raised to ± 30 million roubles and in 1976 and 1977 it was increased by stages to ± 100 million roubles.

Bilateral trade had no great effect on the Finnish money market as long as its payments remained roughly in balance, which was the aim of the clearing system. The income received by Finnish exporters, credited to them by the Bank of Finland in markkaa, was equal to the spending of Finnish importers, debited from them in markkaa. Trade generally remained in fairly good balance until the mid-1970s, when oil price swings began to disrupt it. Fluctuations in the clearing account then began to grow and the account total was sometimes well outside the credit limits. A report written by Inkeri Hirvensalo in 1979 notes that "to some extent, clearing credit has been the item that adapts to accommodate trade flows."⁵⁷⁹ But the problems experienced in Finnish-Soviet trade during the 1970s were just a prelude to the much greater troubles encountered during the second oil crisis and afterwards.

As oil prices began to rise on international markets in 1979, the oil bill soared; the value of Finnish imports from the Soviet Union increased a full 43 percent in 1980. Finland's debt on the Soviet clearing account grew to an unprecedented size. At the end of October, when it peaked, it was about 390 million roubles, which was many times above the agreed credit ceiling. In order to equalise trade it was agreed that Finland would export more, mostly during 1980, and the value of sales to the Soviet Union increased almost 60 percent that year. At the same

time negotiations were conducted on raising the clearing account's credit ceiling which, in March 1981, was set at ± 150 million roubles. Having gained momentum, Finland's exports to the Soviet Union continued to grow furiously, recording another 60 percent growth in the following year.

The second oil crisis had dramatic effects both on the structure of Finnish exports and on the Finnish money market. The Soviet Union's share of all Finnish merchandise exports was at its highest, at about 27 percent, in 1982. The combined share of all CMEA countries was about 29 percent. The Soviet Union was now buying more than twice as much from Finland as before the first oil crisis. Finnish economic dependence on trade with the east had increased perhaps even more, because a very large proportion of these exports were from engineering and textiles, both labour-intensive sectors.⁵⁸⁰ Exporting to the east had become a major employer, which gave it extra political weight.

The second oil crisis had an effect on the money market because eastern exports continued to grow strongly even after Finland's clearing debt of 1980 had been eliminated and had turned into a clearing credit. After the oil crisis, Finland started running a trade surplus with the Soviet Union which, by autumn 1982, had a clearing debt of a record 5.3 billion markkaa. This sum was about 800 million clearing roubles, or more than five times the credit ceiling set for the clearing account. To put this sum into perspective, receivables from the Soviet Union in the Bank of Finland's balance sheet were roughly equal to the value of all Finnish banknotes in circulation. All advance payments from the Soviet Union to Finnish exporters were, in effect, roubles lent by the Bank of Finland to the Soviet Union. When the Bank of Finland credited them, in markkaa, to the accounts of Finnish exporters, it caused a significant easing of the Finnish money market.

The imbalance in eastern trade after the oil crisis was countered by a variety of special measures aimed at preventing a sharp fall in exporting to the Soviet Union. In October 1982 – a week after Finland had devalued its currency in Sweden's wake – 200 million roubles of Finland's clearing claims were transferred to a special interest-bearing account. This constituted a temporary rouble-denominated loan by Finland to the Soviet Union, which was due to be repaid in 1986. In December 1982, the clearing account's credit ceiling was doubled to ± 300 million roubles. Both measures postponed the decline of Finnish



■ Ahti Karjalainen

– Finnish Press Agency/Heikki Y. Rissanen.

exports into the future. The third mechanism for bringing down the accumulated clearing surplus and maintaining eastern exports was “brokerage oil”. Finland began to import oil from the Soviet Union in excess of its own requirements, buying it with clearing roubles and reselling it on western markets for convertible currency. In 1982–1987 Finland imported more than 10 million tonnes of Soviet crude oil within this framework, for resale on Western markets.⁵⁸¹

INTEREST RATES CUT

Mauno Koivisto was elected president in January 1982. He was the fourth president of the republic to come to the job from the board of management of the Bank of Finland, the others being Kyösti Kallio, Risto Ryti and Urho Kekkonen. On 5 February, President Koivisto endorsed a proposal by the supervisory council and appointed Ahti Karjalainen as the governor of the Bank of Finland. Karjalainen had already been acting governor in Koivisto’s absence for two and a half years and there had been speculation during that time that he was Koivisto’s main competitor for the presidency.

After Koivisto’s election as president, the government of which he had been prime minister naturally resigned and a government headed by Kalevi Sorsa was formed on 19 February. The new government, Sorsa’s third, was a centre-left coalition, as Koivisto’s been. Sorsa’s own party, the Social Democrats, had five ministerial portfolios and the People’s Democratic League three. The Centre Party occupied six ministerial positions, including First Finance minister (Ahti Pekkala, who had held the same position in the preceding Koivisto government). The Swedish People’s Party had two ministers. There was also one non-party minister, Esko Rekola, for Foreign trade.

The economic policy section of the new government’s programme emphasised economic stimulation. It said that the government would seek to reduce costs of production and curb inflation, among other things by lowering taxes and social security contributions, as the government stimulation package of the late 1970s had. Before the end of spring, the first such measures had been agreed and took effect at the beginning of May. On 21 May, the government continued in the same way with a special “resolution on certain measures to curb inflation and lower costs” but the new package was of fairly

minor importance; its main thrust was to cut the price of sugar and vehicle tax.⁵⁸²

Immediately after the government's latest resolution, the board of management of the Bank of Finland asked the supervisory council, on 25 May, to lower the base rate. The board argued that Finland's unemployment problem was worsening as the international recession dragged on, and because of a slowdown in growth in Finnish exports to the Soviet Union. Inflation was faster in Finland than in competing countries but on the other hand the current account was expected to be in surplus.

The board's idea of a base rate cut was typical of the period of interest rate regulation, insofar as it saw interest rates principally as a cost factor. Its proposal to the council expressed this as follows: "The board believes that in this situation it would be possible by lowering interest rates to help reduce inflation pressures and support domestic demand. The anticipated slow-down in inflation, which is boosting real interest rates at a time unsuitable for anti-cyclical policies, and the reduction in foreign interest rates, are further arguments for an interest rate cut." On the other hand the role of interest rates as a tool of anti-cyclical policies was not denied: "Unless we succeed in dampening down inflation, nominal interest rates will have to be raised. Although we may now decide to cut rates, we must in any case be prepared to raise them again when an economic upswing begins."

On these grounds the board proposed that base rate be lowered by three-quarters of a percentage point to 8½ percent from 1 June. Deposit banks were urged to change their lending and borrowing rates accordingly. Indeed it was the most important part of the whole measure, as it had been in all decisions concerning base rate throughout the period of interest rate controls since the start of the 1950s.

The board was not unanimous in its proposal. Its deputy chairman Rolf Kullberg appended a dissenting opinion to the minutes of the board meeting where it was decided. In his view, interest rates should not be lowered while the inflation rate was close to 10 percent. His statement also pointed to the high level of foreign interest rates and the government's great borrowing requirement. In Kullberg's view a rate cut would not provide permanent relief, even from the perspective of incomes policy: "Naturally most interest groups will welcome an

interest rate cut. But it would be wrong to think that the cost reduction achieved is free of charge. The price will be paid mainly by depositors, who are already suffering continuous losses.⁵⁸³

When the matter was presented, another board member, Harri Holkeri, concurred with Rolf Kullberg and said that the board should not have proposed to cut interest rates “at this point in time”. The matter was voted on, because supervisory council member Ingvar S. Melin, from the Swedish People’s Party, made a compromise proposal, seconded by Matti Majjala of the Centre Party, that base rate should be reduced by only half a percentage point. However a majority in the council backed the board’s proposal and it was approved. The decision was then announced, as usual, in a press release, but Rolf Kullberg published his dissenting opinion in a separate release. To air the internal differences of the board in this way was unprecedented in the history of the Bank of Finland.

In proposing the interest rate cut, the board of management had not been concerned about Finland’s currency situation. The preamble to the proposal noted that “the level of currency reserves seems likely to remain moderate”.⁵⁸⁴ By late summer, however, the situation began to deteriorate rapidly. An underlying factor was a major international credit crisis that struck in August, but the immediate reason was a change in Sweden’s political landscape.

FINLAND AND SWEDEN DEVALUE AGAIN

Finland’s exchange rate policies in autumn 1982 were overshadowed by the Latin American Debt Crisis. The countries of Latin America had taken on debt very rapidly during the second half of the 1970s, continuing into the early 1980s. Many of the loans were petrodollars, surpluses of the oil-producing countries, brokered by US banks with the encouragement of Washington. When US monetary policy was tightened at the start of the 1980s to halt inflation, the level of interest on loans to Latin America rose to an unexpected level. Debt servicing became ever more difficult. As often happens in the financial markets, a long-festering problem suddenly erupted into a crisis.

On 12 August 1982, Mexico’s new finance minister Jesus Silva Herzog Flores announced that his country would no longer be able to service

its foreign debt. This triggered a Latin American crisis as international money markets awoke to the seriousness of the debt problem that had built up in developing countries over the past decade. Banks that had previously been generous with their financing suddenly cut back lending to countries that they feared were overextended. As loans became increasingly hard to roll over, debt servicing problems worsened and 40 countries, mostly developing countries, were behind in their payments by the end of 1982.⁵⁸⁵ Because of the strain caused by Latin American countries on major international banks, there was also a wider effect on the availability of international finance.

Nervousness in the foreign exchange markets of the Nordic countries was worsened by speculation about Sweden's exchange rate. The Swedish Social Democrats returned to power in the election of 19 September 1982, after being in opposition for six years. The new government was expected to take action on long-standing structural problems. Swedish industrial output had been on a declining trend since the first oil crisis and the government's expedient of industrial subsidies had become increasingly expensive. Economic studies had stressed that the competitiveness of Swedish exports had to be restored. This was also part of the "crisis programme" that the Social Democrats had published before the election.

The Bank of Finland had closely monitored Sweden's difficult current economic situation and had published an exceptional report on the economic prospects of the neighbour country in 1981.⁵⁸⁶ Sweden had already devalued its krona by 10 percent in September 1981 but this was not enough to restore competitiveness.⁵⁸⁷ Even before the elections of September 1982 there had been rumours about a new devaluation. When this possibility was mentioned in passing in the supervisory council on 27 August, governor Karjalainen had stated that "as long as nothing happens elsewhere, nothing will here either. It would be a different matter if Sweden and others took action; we would be faced with a new situation to consider."⁵⁸⁸

During September, as the Swedish elections approached, confidence in the Finnish markka deteriorated rapidly and the Bank of Finland was compelled to sell increasing amounts of currency from its reserves. It did not want its reserves to decline too much and started using a revolving credit facility negotiated earlier with foreign commercial banks. The first such loan, 200 million dollars in size, was drawn down

on 15 September. More was borrowed in the weeks that followed. Thus, the level of foreign currency reserves appeared to be almost unchanged.

In the first week of October, the currency flight accelerated. By 5 October the Bank of Finland had bolstered its currency reserves with 650 million markkaa in loans and 50 million dollars in forward market interventions. A large proportion of the convertible reserves of the Bank of Finland was now borrowed money. Amid a deteriorating currency situation, the board of management of the Bank of Finland met under deputy governor Rolf Kullberg on the evening of Tuesday 5 October and decided to devalue the markka within its fluctuation band. The board was allowed by law to adjust the exchange rate within the band without the permission of the supervisory council or the government, although now it had first consulted Prime minister Sorsa, Finance minister Pekkala and other government representatives. Governor Ahti Karjalainen was unable to participate because he was on holiday in Spain during this dramatic week. The supervisory council was informed about the devaluation only afterwards.

So, by decision of the board of management, the foreign exchange index was raised about four percent on Wednesday, 6 October, which correspondingly reduced the value of the markka against other currencies. The press release on the subject mentioned past losses in industrial competitiveness and the prolonged international recession but said that the specific reason for the devaluation was the decline in currency reserves. For Finland to maintain its foreign liquidity at the previous exchange rate level, monetary policy would have had to be tightened, which was unreasonable at the prevailing level of economic activity. The press release emphasized that the exchange rate decision was “consistent with the exchange rate policy adopted in the 1970s of flexible, small steps”. The release stated that the aim of exchange rate policy was “to even out fluctuations in foreign trade prices where necessary, to mitigate excessively steep variations in industrial competitiveness and thereby to support the adaptation of our national economy on a path of declining inflation”. At the end of the release it was noted that as the economic situation improved, a revaluation of the markka could become pertinent.⁵⁸⁹

On the very day that Finland announced its devaluation, an invitation was received from Sweden to a meeting in Stockholm on the following morning, Thursday 7 October. Invitations had been sent to

all Nordic finance ministers and central bank governors. The meeting took place in a conference room at Arlanda airport. Acting governor Kullberg attended because Ahti Karjalainen was still on holiday. The government of Finland was represented by Foreign Trade minister Esko Rekola.

The participants were told that Sweden was planning to devalue the krona by 20 percent and peg it to the German Mark. The new government of Prime minister Olof Palme would announce its programme in the Swedish parliament on Friday, 8 October 1982 and the krona would have to be devalued before that. The new Finance minister, Kjell-Olof Feldt, said that the move was necessary because Swedish industry was in a permanent crisis, the current account was in structural deficit and the foreign exchange market had been in turmoil. Feldt said that devaluation was needed specifically to lower real wages. The size of the planned devaluation was a shock to the meeting and was strongly opposed by the participants, who saw it an aggressive move. According to Finance minister Feldt, Rolf Kullberg of the Bank of Finland was particularly incensed but his protests were regarded as “somewhat ludicrous” because Finland had devalued by 4 percent the day before.

After later discussions with the governor of the German central bank, Karl Otto Pöhl, Feldt decided to reduce the size of exchange rate adjustment, and a devaluation of 16 percent was announced the following morning. The Swedish government also abandoned the idea of pegging the krona to the strong German Mark, perhaps because of Pöhl’s objections. Sweden continued to manage its exchange rate according to a currency index.⁵⁹⁰

The Swedish exchange rate adjustment was so great that the Finns felt obliged to respond. The board of the Bank of Finland kept the foreign exchange market closed on Friday to gain time for discussions on the matter with the government and the supervisory council. Negotiations continued late into Saturday night and Sunday morning. The government conducted its own talks with the labour market organisations but the Bank of Finland did not participate in these.

The supervisory council held a meeting on Saturday. This was not for decisions to be taken but for talks on the main theme of a package of measures that the government could append to a devaluation,

designed to make industry more competitive. No concrete proposals for the size of the devaluation had yet been put forward. Rolf Kullberg, who reported on the talks held with the government, said that the Bank of Finland's reasoning was that its recommendation for the devaluation rate would depend on the other measures the government could put forward to improve industrial competitiveness.⁵⁹¹

The inner council met on Sunday at 13:00 hrs to hear what had been decided in talks between the Bank of Finland and the government. The government's economic policy package contained various measures to lower corporate costs, a reduction in sickness and pension insurance contributions paid by employers, a lower rate of turnover tax on machinery investments and a cut in the tax on electricity. These were to be financed by raising the general turnover (sales) tax rate by two percentage points. Rolf Kullberg gave the estimate that the government's measures would have an effect (on industrial competitiveness) equivalent to a devaluation of about three percentage points. The board had taken these measures into account in setting the size of the devaluation.

The proposal that the board placed before the supervisory council on Sunday, 10 October 1982 was to raise the currency index fluctuation band by about 8% (the floor about 8.8% and the ceiling about 7.1%). The council gave its approval after a vote. The communist councillors from the People's Democratic League, Aarne Saarinen and Irma Rosnell, were opposed to a devaluation but the other councillors backed it so the board's proposal was accepted. The government approved the proposal without amendment on the same day.⁵⁹²

The exchange rate decision worked out between the government and the Bank of Finland meant not merely that the markka was devalued but also that the currency index fluctuation band was shrunk from ± 3 percent back to the original width of ± 2.25 percent that had been enacted in 1977. The narrower fluctuation band caused quite a lot of discussion in the supervisory council. The minutes of the supervisory council make it clear that the idea of a narrower band, which thus reduced the power of the Bank of Finland's board of management to set exchange rates, had originated with the government. The government had also obtained a statement on the matter from the Justice chancellor Kai Korte, who maintained that it would be justified to reduce the currency fluctuation band because "largish changes in the value of the

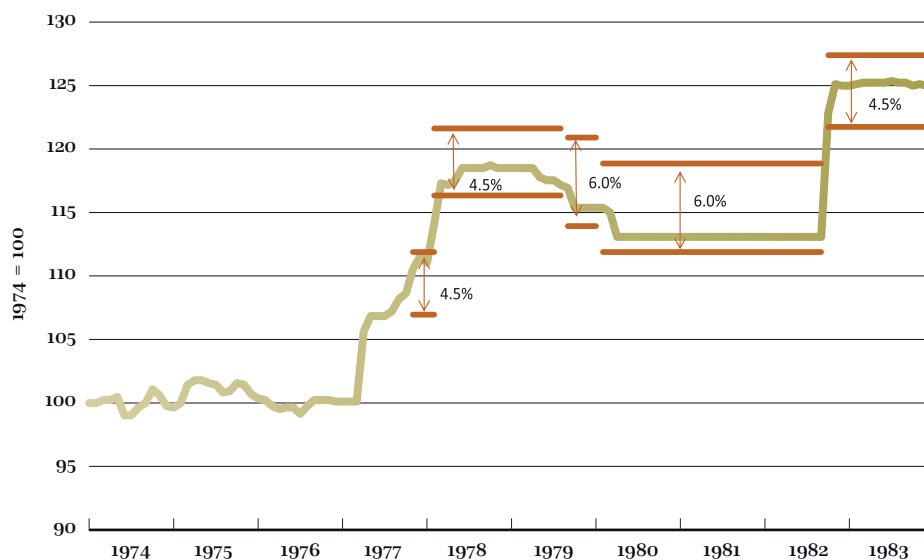
markkaa within the band [might] lead to quite contradictory results for economic policies undertaken.”⁵⁹³

The Bank of Finland had not opposed this limitation on its authority because it wanted unanimous agreement. There was also active support on the board of management for a narrower band. Members Alenius and Lindblom, who hailed from the political left, spoke in favour of it; they believed a narrower bandwidth would bolster the credibility of exchange rate policy. Although the supervisory council approved this part of the board’s proposal too, it appended to the minutes a statement proposed by councillor Paavo Väyrynen (Centre Party) that “the supervisory council members feel that the width of the currency index fluctuation band depends on the situation at the time in question, and that a wider band than the one now proposed remains feasible”.

Within the limits set by the new band, the board of the Bank of Finland next decided to raise the currency index about 6%. Together with its previous exchange rate adjustment of 6 October, it meant that the value of foreign currencies rose by an average of about 10½ percent and the value of the markka in foreign currencies declined by about 9½ percent. Taking into account the weighting used to construct Finland’s currency index, the combined effect of the Finnish and Swedish devaluations was that the value of the krona fell about three percent in Finnish markkaa but the value of all other currencies – such as the dollar – rose about 13 percent.

The markka devaluation therefore had a rather large effect on the rates for all currencies apart from the Swedish krona. Nevertheless, the press release published by the Bank of Finland in connection with the devaluation sought to explain variously why the devaluation had not been even greater. It stated that “the devaluation has been dimensioned so that, on the one hand, it is big enough to provide adequate support for competitiveness and employment but, on the other hand, small enough that a stable course for economic policy is maintained. Its size has been significantly influenced by the government’s decision at the same time to implement financial measures that will reduce corporate sector cost developments. Furthermore, the size of the devaluation takes into account that the underlying equilibrium in our national economy is satisfactory and there is therefore no need to go farther in following the Swedish krona.”⁵⁹⁴

BANK OF FINLAND CURRENCY INDEX AND ITS FLUCTUATION LIMITS 1974–1983



Rising index shows depreciation of markka.
Source: Bank of Finland.

The bank’s economists later reached the conclusion that the devaluation of the markkaa in 1982 had been unnecessary for economic equilibrium and was done only in response to market speculation. The operation of the currency index system, left intact, would have served to ensure that the lower value of the Swedish kronor would have raised the prices of other currencies anyway, even without a markka devaluation, so Finland’s competitiveness would have remained unchanged. This opinion of the bank’s experts emerged in the Country Report of the International Monetary Fund in autumn 1983. When members of the IMF delegation had asked for an assessment of the effects of the 1982 devaluation, the Bank of Finland’s representatives had observed that the second act of the devaluation, Finland’s rate adjustment after Sweden’s devaluation, had not stemmed from economic fundamentals but had been a reaction to speculative attack following the Swedish devaluation. This devaluation was “hard to perceive as part of a consistent medium-term strategy”.⁵⁹⁵

With hindsight it can be said that the devaluation of autumn 1982 put a practical end to active management of the exchange rate, using both devaluations and revaluations, which had been central bank policy since 1977. Even the statement issued after the rate adjustment on 6 October 1982 spoke of a policy of consistent incremental measures and noted that the external value of the markka could subsequently be raised, but in practice exchange rate policies became more cautious and rigid after Sweden's surprise devaluation. This and other experiences from the turn of the decade had shown that flexible exchange rates were politically more difficult to implement in Finland than the plans of macroeconomists had assumed.

GOVERNOR KARJALAINEN DISMISSED

On becoming governor of the Bank of Finland at the start of 1982, Ahti Karjalainen was 59. A close confidant of Urho Kekkonen, he had devoted his life to politics but his greatest goal, presidency of the republic, had escaped his grasp and gone instead to a political rival Mauno Koivisto. The post of governor of the central bank was a mere consolation prize to him, which may have been what intensified his existing weakness for strong drink. His condition drew public attention at the time of the devaluation in autumn 1982, when he returned to Finland from a foreign holiday but was not fit to work and was granted sick leave. By November, President Koivisto and the chairman of the supervisory council, Matti Jaatinen, were discussing the possibility of dismissing him.⁵⁹⁶

As Karjalainen's problem with alcohol continued in spring 1983, leading figures from his own Centre Party concluded that he should be replaced. Party chairman Paavo Väyrynen, deputy chairman Ahti Pekkala, parliamentary group chairman Matti Ruokola and party secretary Seppo Kääriäinen went to the Bank of Finland on 20 April 1983 and urged him to resign in the public interest. Their message was blunt because they had brought with them a pre-drafted letter of resignation, but Karjalainen refused to sign it and was dismayed by his friends' request. To underline his refusal, he publicly resigned from the Centre Party a couple of weeks later, on 9 May.⁵⁹⁷

By this time governor Karjalainen's condition was becoming a serious threat to the central bank's credibility, so the only remaining

option was to dismiss him. When the chairman of the supervisory council Matti Jaatinen discussed the matter with President Koivisto on 10 May, the president concurred with the council and was ready to discharge the governor. To avoid delay, it was decided to convene a meeting of the full council on the same day at 9 p.m. Despite the unusual time, the meeting was attended by councillors Liikanen, Maijala, Saarinen, Miettinen and Vennamo in addition to the chairman and the council secretary Helenius. Having learned of the ongoing operation, governor Karjalainen also arrived but his presence did not prevent the plan from being fulfilled. After he had left, the council decided unanimously to make the following submission to the president: "The parliamentary supervisory council feels that the central position of the Bank of Finland requires the elimination of the prevailing uncertainty regarding the capability of its senior leadership."⁵⁹⁸ In plain language it was calling for the dismissal of the governor. The president officially discharged Ahti Karjalainen from the post of governor of the central bank with effect from 13 May 1983.⁵⁹⁹

In practice the duties of the governor had already been performed for some time by his deputy Rolf Kullberg. After Karjalainen's dismissal, the president formally moved Kullberg to the position. The appointment, from 1 June onwards, took place without drama or contention. Kullberg was not a politician but a technocrat so his appointment reinstated the practice from Klaus Waris' time that the central bank governor was not a political player such as a government minister.

ROLF KULLBERG (1930–2007)

The liberalisation of Finland's financial markets in the 1980s, their overheating and the subsequent economic collapse were largely personified in the public imagination by the then-governor of the Bank of Finland, Rolf Kullberg. His warnings about "a festival of consumerism" have lived on in the collective memory of the nation.

Kullberg studied economics at Åbo Akademi University, receiving his master's degree in 1955. After graduating he first worked as advertising manager for Finland's oldest industrial company, Fiskars Oy, but soon moved to the Nordic Union Bank as an economist.

At this major commercial bank, Kullberg was in charge of research as head of its economic secretariat. The work included editing the bank's economic review, *Unitas*, which, for a long while, was one of Finland's most important professional publications in the field of economic affairs. In this work Kullberg became known as a painstaking grammarian, both in Finnish and his mother tongue Swedish.

He worked as acting head of the Finance Ministry's economics department in 1971–1972, receiving his first taste of what it meant to be a civil servant. During this period of only one and a half years he served four different governments. On his return to Union Bank he joined its board of directors. When Heikki Valvanne, who was in charge of monetary policy, resigned from the Bank of Finland's board of management in 1974, the bank sought a professional to replace him.

The main candidates were Kullberg and Jussi Linnamo, the director-general of the bank inspectorate. Kullberg had greater support in the supervisory council and the president appointed him to the board.

When governor Karjalainen resigned in spring 1983, the supervisory council was unanimous in proposing Kullberg as next governor. He had already been serving as Karjalainen's deputy. As governor, he had an often bitter relationship with politicians, including the government. After a public falling out in April 1992 with Prime minister Aho, whom he accused of populism, Kullberg heeded president Koivisto's advice to resign.

In his memoirs '*...And so the party ended*' (1996) Kullberg described the monetary policy pursued during his term of office and assessed the events that led to the economic crisis at the start of the 1990s. He said he was the most cautious on the Bank of Finland's board of management about dismantling capital and money market controls, but regarded liberalisation as inevitable, if only because it was a precondition for accession to the European Union. It was depressing, he thought, that banks, companies and private individuals used their new freedoms "irresponsibly and thoughtlessly". He also wrote that, during the liberalisation process, the Bank of Finland did not receive enough support from the government's fiscal policies and from labour market organisations in maintaining equilibrium in the economy.

■ Rolf Kullberg
- Lehtikuva news photo
archives/Jarmo Matilainen.



BANKING REGULATION REFORM DILUTED

BASEL COMMITTEE TACKLES BANK REGULATION

Profound changes took place in the financial systems of industrialised countries in the 1970s. The individual phenomena may not have appeared so striking but their combined effect was epochal. The developments included the internationalisation of finance, the acceleration of financial innovations and the rise of speculation, spurred by faster inflation and floating exchange rates.

Internationalisation meant that major banks began operating across national borders in both funding and investment operations. As a consequence, the distinction between the national and the international became blurred and banking was harder to supervise. A major force driving financial internationalisation was the desire to exploit differences between national legislative frameworks. Risks also grew as the commitments of foreign subsidiary banks operating beyond national control increased the liabilities of the parent bank.⁶⁰⁰

Meanwhile the changing external business environment hastened the development of financial innovations; the term “financial engineering” began to be widely used. One such innovation was the securitisation of claims, so that they could be used in the secondary market. In this way, ordinary debts, such as mortgage loans, could be resold and thus eliminated from the balance sheet of the bank that had originally granted them. Securitisation eroded the link between the lender and the borrower committed to repaying the loan. At the

same time the boundary between investment and commercial banking operations became less distinct. Another new business activity was the transfer of an increasing amount of financing out of the balance sheet. This was done by developing new types of financial instruments, like derivative contracts. Banks took the view that these contractual obligations did not have to be shown in their balance sheets and, surprisingly, the supervisory authorities approved this interpretation of accounting regulations. One aim both of securitisation and of off-balance-sheet transactions was to reduce the bank's need for equity capital.⁶⁰¹

A third trend was the increase in operations that were speculative in nature. One of the reasons for this was the macroeconomic instability that had followed the collapse of the Bretton Woods system. Its effects on the foreign exchange and bond markets had been distinct. The last indirect tie to gold had been severed, and rapid and sharp changes had become characteristic of national exchange rates and interest rates. These circumstances offered the banks new income sources but they were opportunities that involved greater risks. An ever-increasing number of banks began to participate in speculative projects, some of them extremely risky.⁶⁰² An interesting conflict between theory and the real world was involved. In many cases, the original aim of new financial instruments like forward contracts had been to hedge against abrupt market fluctuations but now, in reality, they magnified the fluctuations.⁶⁰³

As a consequence of market changes such as these, a banking system developed from the early 1970s onwards that was global in nature and increased the supply of finance. Large international financial institutions were, in principle at least, able to diversify regional and sectoral banking risks but, at the same time, the scale of risks increased. Moreover national supervision of internationally active banks could not keep up with the developments, especially because transparency in banking was impaired.

Among the first concrete examples of greater risks and their realisation were the bankruptcies in 1974 of Herstatt Bank in Germany and Franklin National Bank in the United States. They shattered the tranquil image of stability that had grown up around financial institutions during the decades of comprehensive regulation. These bank bankruptcies were a wake-up call in both Europe and the United

States. They had such a worrying effect that the “group of ten” leading economies began actively to examine ways of ensuring financial systemic stability.

The G10 had originally been formed in the first half of the 1960s by Belgium, Canada, France, Italy, Japan, the Netherlands, Great Britain and the United States, the leading industrialised countries of the time. A few years later they were joined by West Germany and Sweden. The name G10 remained in use even after Switzerland subsequently joined as the 11th member. Central bank governors of the G10 convened at the initiative of the Bank of England in autumn 1974 and established the *Standing Committee on Banking Regulations and Supervisory Practices* to consider ways of ensuring the stability of the global financial system. The committee operated under the auspices of the Bank for International Settlements in Basel and was widely known as the Basel Committee. The committee was aided by a small permanent secretariat, whose number reached 12 by the start of the 1990s. The same questions of systemic stability were also debated in OECD and IMF circles and in discussions between the US Federal Reserve and the Bank of England.⁶⁰⁴

The first meeting of the Basel Committee was held in January 1975 and thereafter the committee convened regularly 3–4 times a year. Participation was by senior executives from the central banks of the aforementioned countries and senior bank inspection officials from countries where the bank inspectorate was not a division of the central bank. The chair of the committee rotated at intervals of a few years, except for the period 1977–1988, when the deputy governor of the Bank of England, W.P. Cook, served as chairman for more than a decade. At that time the Basel Committee was also sometimes called the Cook Committee.

The principal matters on the committee’s agenda were related to the supervision of banks with international operations. Committee discussions highlighted the need to increase public understanding of the important role played by public bank supervision and the need to develop the quality of the supervision. To this end, the bank inspectorates of different countries were to exchange more information about their supervisory systems; to develop methods for supervising banks with international operations; and to consider which sectors of banking would benefit from the adoption of minimum supervision

standards. The committee did not demand transnational legislation; its main aim was to get participating countries to approve common ground rules for bank supervision. The first concrete result was the Basel Concordat, approved in 1975, which laid out on a very general level the procedures for handling bank crises. On its basis the proposal *Principles for the supervision of banks' foreign establishments* was approved in 1983.⁶⁰⁵

In the early stages of its operation, the committee concentrated on discovering what supervision reforms were required by the internationalisation of banking operations. The communiqués and opinions that it issued were very general in nature and, prior to the 1990s, had no transnational force. Consequently the committee's recommendations had very modest practical importance.

Until the start of the 1980s, the Basel Committee focused on questions of supervision. By its nature, supervision tends to be *post factum* and so needs to be backed up by regulatory norms. With the start of the 1980s the thrust of committee activities changed as it started to seek ways to increase the stability of the financial system pre-emptively. This was a return to the key issue for all banking, capital adequacy. According to information available to the committee, an almost universal characteristic of the preceding decades had been a dismissive attitude to the size of a bank's core capital, the concrete evidence being that capital ratios had certainly declined. Furthermore, the actual capital adequacy of large banks with international operations was even lower than their accounts indicated, because a significant part of their banking was off-balance-sheet. Questions of capital adequacy came to the fore in the Latin American debt crisis in 1982, which was touched off by Mexico's inability to service its debts, and then spread to other developing countries. The issue was no longer of individual bank crises but of financial crises affecting entire nations which, via the difficulties of large international banks, threatened the stability of the global financial system.⁶⁰⁶

The Basel Committee gave high priority to obtaining an agreement that would strengthen the international banking system. It also sought to prevent situations where the diverse capital requirements in force in different countries could be exploited by individual banks. These were very challenging objectives because of the large national differences both in the definition of a bank's equity and

in the measurement of its risks. In autumn 1987 the committee finally completed its preliminary proposal for common norms on capital adequacy, which was approved in July 1988. The committee recommended that the rules should come into force by the end of 1992.

The 1988 recommendations of the Basel Committee were known as the Basel Capital Accord and later, when development of a next generation of regulations had begun, Basel I. It was recommended that a bank's equity should be divided into two classes, primary and secondary. Primary equity, consisting of shareholders capital and retained profits, was the "best" for capital adequacy, while secondary equity could contain claims like subordinated loans, which did not have a preferred status like deposits or money market debts if the bank became insolvent. The equity of a credit institution was then compared to its risk-weighted assets and investments, which were divided into four categories, according to their risk content. The ratio of capital to risk-weighted assets and liabilities had to be at least eight percent.

An important new element in the recommendation was that the different levels of risk in various investments were to be taken into account when calculating capital adequacy. The model came mostly from the Bank of England, which had steered the adoption of a similar risk-weighted model in Britain back in 1980⁶⁰⁷ although Sweden had been using a very similar type of risk-weighting since as long ago as 1969. Sweden was a G10 member so its experiences may have helped influence the committee's views.

This rather large-scale joint project to increase the stability of the international banking system had been initiated by the G10 countries but in practice the recommendations governed all international banking, including that of non-members. In Europe the Basel Committee recommendations became the basis for developing all banking legislation after the European Economic Community adopted the committee's recommendations. The EEC's decision naturally had a decisive influence on the policies of countries beyond community borders too.

Consequently the Basel Capital Accord, approved in summer 1988, would set the main lines of Finland's banking legislation. Cooperation between the bank inspectorates of the EEC and EFTA had begun in 1987

and one of the main issues was the adoption of the Basel Committee recommendations.⁶⁰⁸ By this time it was clear how Finnish banking legislation needed to be modernised. Still, the publication of the preliminary Basel proposal caused a considerable shock in Finland in autumn 1987. The long-planned reform of bank capital adequacy regulations in Finland became obsolete before it was completed, as explained in more detail below.

The recommendations of the Basel Committee and the EEC's capital adequacy directives were not formally implemented in Finland until 1992, with the signing of the agreement on a European Economic Area (EEA) between the 12 nations of the European Community and all members of the European Free Trade Association (EFTA) except Switzerland. In the EEA agreement the EFTA signatories adopted all the directives and regulations of the European Community that were necessary to expand the Common Market to cover the whole area. Negotiations on forming a European Economic Area had started in summer 1990 and the agreement came into force at the start of 1994.

INTERNATIONALISATION AND CAPITAL ADEQUACY

The process of amending Finnish banking legislation in force since 1970 was commenced after only a few years. In winter 1973 the Finance ministry set up a committee to study the deficiencies and defects of the law. The creation of the committee was precipitated by the desire of Finnish commercial banks to expand their operations in international centres of capital such as London, Luxembourg or Paris. They were motivated both by the accelerating internationalisation of Finnish companies and by a desire to increase their funding opportunities. Finnish officials wanted to bring international banking operations within the framework of national banking legislation. The expansion overseas of Finnish banks demanded reciprocity so foreign banks also had to be permitted, at least in principle, to set up operations in Finland. At the same time the committee was given the task of correcting any other possible defects in existing banking legislation.

The head of the Finance ministry's General department, Osmo Kalliala, was appointed to chair the committee. Its other members were representatives of the State Treasury, the Bank of Finland, the

Bank inspectorate and the Justice ministry, plus two members of parliament.⁶⁰⁹ There were two secretaries, Olli Paaaja, who was a referendary, and Kalevi Kauniskangas, who was also designated the committee's standing expert advisor. The latter's status in the committee is interesting because he was a director of the Savings Banks Association and furthermore the secretary of Parliament's banking committee. The majority on the committee thus represented institutions that supervised banking. Over time the balance of power shifted. In June 1974 the Finance Ministry decided to appoint two more members of parliament, Raimo Ilaskivi (National Coalition Party) and Ilkka-Christian Björklund (People's Democratic League), to the committee. The Bank of Finland's representative, director Markku Puntila, was aided in the planning of legislative reform by office manager Veikko Saarinen, who, among other things, drew up two memoranda on the development of banking laws and the changes planned.⁶¹⁰

A striking aspect of the committee's work from the very outset was the divergence of views between the members representing the authorities and those representing the savings and cooperative banks. The aforementioned group, which included Markku Puntila of the Bank of Finland, thought it was axiomatic that the principal duty of banking laws was to safeguard stability of the financial system. The previous committee of 1967 on banking law had given priority to ensuring a level playing field for commercial, savings, and cooperative banking organisations. It was now realised that the groups were different and the law should recognise their differences. At the same time, the committee abandoned the spirit of extreme consensus-seeking that had been typical of its predecessor's work.

The first part of the committee's report concentrated on the ways that legislation had to be amended, to allow the impending internationalisation of banking. Since the mid-1960s the largest commercial banks had taken shareholdings in associate banks operating abroad, ranging from a few percent to 20–30 percent of their share capital. The first wholly-owned subsidiary was Union Bank of Finland International S.A., established in 1976 in Luxembourg by the Union Bank of Finland. Finnish commercial banks also had representative offices abroad, although these were not entitled to carry on actual banking business. The committee felt that, in order for Finnish banks to develop international operations, they should be

permitted to establish branches abroad and acquire holdings in foreign credit institutions, but the committee also wanted to control foreign risks with legislation and official supervision. Foreign subsidiaries should not be allowed to endanger the liquidity or capital adequacy of the domestic parent institution.

In the committee's view, the largest commercial and mortgage banks had the greatest need to operate abroad and, at the same time, the best financial resources and necessary expertise. Individual savings or cooperative banks lacked these preconditions so it would be wiser for the foreign business of their customers to be handled by their central banks, meaning SKOP and OKO, which had commercial bank status. In most countries the right of a foreign bank to carry on banking business via a branch or a subsidiary required reciprocity, which meant that Finland had to offer the banks of the country in question the same privileges. This reciprocity requirement should be taken into account in the new banking legislation, the committee urged.

Even this first part of the committee's proposal was marked by disagreement between the "officials' party" and the "banking party". Ahti Pekkala, a member of parliament who also served on the governing boards of the cooperative bank group, appended a dissenting opinion, complaining that the report discriminated against savings and cooperative banks. They too should be given the right to handle international business themselves and even to establish service points abroad, he said. Pekkala, who was a long-serving cooperative bank director, noted that existing banking legislation was based on the premise that the competing commercial, savings and cooperative banks were to receive equal treatment under the law. If an individual savings or cooperative bank could meet the capital adequacy demands imposed on a commercial bank, it should be licensed by the Finance ministry to operate abroad. The committee's standing expert advisor, Kalevi Kauniskangas, with a background in the savings banks, endorsed this dissenting opinion. On the same grounds, two other committee members, Kalervo Haapasalo and Ilkka-Christian Björklund, appended their own dissenting opinions to the report.⁶¹¹

The second part of the committee's report dealt with the need to revise the banking laws. The main question of principle was the amendment of regulations on capital adequacy. The other matters were to improve safeguards for customers; to define the business

operations that constituted banking more precisely; and to ensure that the new law would not unnecessarily hinder or complicate bank mergers and thereby a structural rationalisation of banking.

According to the committee's report, the capital adequacy regulations did not need to be changed. It reached this finding even though, although according to the latest available information at the end of 1975, the capital adequacy ratios of the smallest commercial bank, 115 savings banks and 216 cooperative banks were still below the minimum laid down in the law which had entered in force in 1970. The committee pointed out that there were still three years left in the transitional period for reaching capital adequacy and that not all savings and cooperative banks had actually even tried to raise capital adequacy. The report noted that capital adequacy requirements in Finland were extremely low by international standards and did not want them to be further relaxed. Instead it proposed a change in the laws governing savings and cooperative banks that would allow them to accumulate supplementary reserve funds that could be equated with equity. The banking laws of Sweden and Denmark provided examples of similar arrangements.

On this issue, Ahti Pekkala wrote another dissenting opinion, stating that the report paid insufficient attention to the *de facto* ability of savings and cooperative banks to bear the risks in their business. Observance of the letter of the law would therefore impose unreasonable demands on the smallest local banks. Pekkala felt that "the committee should have proposed an amendment to the capital adequacy regulations in the Cooperative Bank Act and the Savings Bank Act, so that an assessment of their financial reliability would equitably take into account their credit loss reserves and the insurance of their lending". In practice he proposed a model where half of credit loss reserves could be included in required equity and where half of the stock of loans insured with the banks' mutual insurance company could be deducted from the bank's liabilities when required capital was calculated. The committee's standing expert advisor, Kalevi Kauniskangas, endorsed this dissenting opinion, while Raimo Ilaskivi, representing the commercial banks, demanded that they too should be permitted, by a change in the Commercial Bank Act, to use credit loss reserves in this way.⁶¹²

ASCENT OF THE “BANKING PARTY”

The interest groups of the cooperative and savings banks were very worried about the direction that the amendment of banking laws was taking. To steer the government's view of the matter, a Centrist member of parliament, Matti Mattila, introduced a private members bill in 1977 to amend the regulations on capital adequacy in the savings bank and cooperative bank acts. Mattila's bill stated that the existing regulations were fundamentally flawed because their definition of bank capital adequacy did not take into account the practical ways in which the local banks covered any credit losses they incurred. The relationship between equity and liabilities laid down in law did not correctly measure material resilience because it ignored the reserves against credit losses that these banks had built up and the insurance that they had taken against credit risk. A similar form of protection was that the savings banks and the cooperative banks were members of strong central associations, which effectively guaranteed the commitments of individual banks. Small local banks, operating in remote regions and important for local development, faced the greatest difficulties in achieving capital adequacy, and the supplementary reserve funds proposed by parliament's banking committee would not resolve the problem. Mattila believed that the only solution was to amend the law, to take credit loss reserves and loan insurance into account.⁶¹³ The savings and cooperative banks had anticipated this situation by establishing mutual companies to insure the loans and guarantees granted by individual banks of each group.

Mattila's bill obviously had the support of both central organisations of local banks. He was managing director of Virrat Savings Bank and a board member of the savings bank association of Tampere district; moreover, as a member of parliament for the Centre Party, he also had good connections with the cooperative bank organisation. He had built a parliamentary reputation as an expert in financial matters because he had served on the Parliamentary supervisory council of the Bank of Finland, and on parliament's banking committee since 1975.⁶¹⁴

The government's own bill to amend the banking laws incorporated the proposals that had been put forward in Mattila's bill, although not to their full extent. The government was to allow some of a bank's insured stock of loans to be deducted from its liabilities when the ratio

between equity and liabilities was calculated; the proportion (generally 40–50 percent) was to be set by the bank inspectorate. Furthermore, subject to certain conditions, a bank would be able to treat half of its credit loss reserve, allocated in accordance with the law on taxation of business income, as its own equity. The government's bill also offered the savings and cooperative banks the opportunity to build up supplementary reserve funds that would be counted as equity.⁶¹⁵

The banking committee of parliament approved the government's proposals almost untouched. In practice the most far-reaching amendment by the committee concerned guarantees granted by a savings or cooperative bank. The committee had received reports that the rights of savings and cooperative banks to grant guarantees needed to be enlarged, by authorising the bank inspectorate, in special cases, to allow an individual bank to exceed the legal guarantee ceiling, 20 percent of a bank's stock of loans. The committee argued that allowing the limit to be exceeded would help local banks to respond flexibly to the needs of their customers.⁶¹⁶

These amendments and additions to banking law were approved in parliament on 31 August 1978 and entered into force at the start of 1979. At the same time the banks were granted another five years to bring their capital adequacy ratios up to the level set by the new law. Thus, the transitional period for satisfying the capital requirements, which had started in 1970 and was due to end in 1980, was extended five more years into the future.

Judged from its effect on the stability of the financial system, the most questionable aspects of the changes in the law concerned capital adequacy. Snubbing the representatives of officialdom on the committee for banking law reform, first the government and then parliament ignored the committee's view that the capital adequacy requirements of the 1969 law should not be changed. Especially questionable was the new provision that allowed a proportion of a bank's commitments to be ignored when calculating the ratio of equity to commitments, if its stock of loans was insured by a "publicly supervised mutual insurance company" set up by each banking group. This amendment to the savings and cooperative bank acts diluted the whole concept of capital adequacy because this insurance, by a company that was owned by and responsible to the group itself, did not mean that the group's ability to bear risk had increased. The intention was that the whole group would bear any losses

by an individual bank, and reflected the prevalent view, in the second half of the 1970s, that while individual banks might well get into trouble, a whole group of banks could not. The change in law also took the pressure off the savings and cooperative banks that had still not achieved the legal minimum capital adequacy – two percent – by the mid-1970s.

PARLIAMENT'S BANKING COMMITTEE TAKES THE INITIATIVE

In its report completed in 1976, the committee on banking law stated that there was no need yet for a major reform in the structure of the law and that Finland could well advance by making small amendments to existing legislation.⁶¹⁷ However the international environment changed so greatly that the national framework eventually ceased to be adequate. The need for reform was raised by parliament's banking committee in autumn 1983, in connection with parliament's handling of a government proposal for minor amendments in the savings and cooperative bank acts. The director-general of the bank inspectorate, Jussi Linnamo, who had been summoned as an expert adviser, told the committee that Finnish banking legislation lagged behind the times. In its own statement, the committee then called on the government to start examining whether a complete reform of the law was needed and how the matter should proceed.

The result was the establishment of a working group on banking at the end of November 1983. Its chairman was to be Antti Hartikka of the Finance ministry and its members Jussi Linnamo of the Bank inspectorate, Markku Puntila of the Bank of Finland, Olli Ikkala of the Bank of Helsinki – a commercial bank – and Kalevi Kauniskangas of the Savings Bank Association. The chancellor of Helsinki School of Economics, Jaakko Honko, had originally been slated as chairman but his appointment was blocked by representatives of the savings and cooperatives banks because he was deputy chairman of the board of supervisors of the Union Bank of Finland. The next candidate Heikki Valvanne turned the job down. The chairmanship issue was regrettable insofar as it postponed the start-up of the working group for several months, at a time when the need for new banking law was indisputable.⁶¹⁸

The working group's findings were that the regulations on banking were relatively up-to-date and that the most urgent amendments had

already been made, so there was no immediate need for major changes. However it urged a continuation of the trend, originating from the 1969 banking acts, towards equal treatment of the different bank groups. In pursuit of this, the position of Postbank, which operated under a government guarantee, should be changed, and it should be regulated in the same way as the other banks. The working group did not propose uniform equity requirements for all banks but said that competition neutrality could be served by linking the amount of a bank's capital to limitations on the business it was permitted to carry on. The committee also noted that certain other countries had moved to a model of risk-weighted capital requirements, and had started to consolidate corporate groups when assessing their capital adequacy. The working group felt that the advantages and drawbacks of these new methods were worth considering in future reforms. The working group saw two alternative ways of proceeding; either (a) to seek a uniform law on banking that would regulate the operations of all banks, while separate laws regulated the different forms of incorporation and management within each type of banking organisation (limited company, mutual bank or cooperative), or (b) to develop the existing legislative model. The working group proposed the establishment of an expert committee to move the reform forward.

It took the government seven months to establish the committee, which began work on 9 February 1984, headed by Markku Puntila of the Bank of Finland. Its composition reflected the stronger position of banks, because its eight members were now divided equally between those with an official background and those from banking. Alongside Markku Puntila, the members were Antti Hartikka and Pekka Laajanen of the Finance ministry, Jussi Linnamo of the Bank inspectorate, Olli Ikkala of the Bank of Helsinki, Olli Härmänmaa of Postbank, Taisto Joensuu of the Cooperative Banks Association and Kalevi Kauniskangas of the Savings Banks Association. The committee's secretaries were Erkki Kontkanen (Bank of Finland), Kari Liedes (Finance ministry) and Risto Telaranta (Commercial Banks Association). The work was due to be completed by the end of 1985, a deadline that it almost met; its report was presented to the government on 15 February 1986.⁶¹⁹

The committee had been commissioned to study the reform and unification of regulations affecting the operations of all deposit banks,

meaning the commercial banks, the savings banks, the cooperative banks and Postbank (which was *sui generis* as a government operation). In particular, the committee was to examine whether the conditions for deposit banking could be appropriately standardised so as to grant the same rights to all, in proportion to capital adequacy and without regard to the form of incorporation.

The preamble to the report noted that increased internationalisation and international competition required fairly far-reaching standardisation of regulations on banking. The Bank for International Settlements (BIS), the Organisation for Economic Cooperation and Development (OECD) and the European Economic Community (EEC) had long sought the international harmonisation of banking legislation. Consequently banking law in almost all OECD countries had been reformed in the past few years. Nonetheless the committee assumed that no international recommendations binding on Finland would be completed in the near future and its work took only national aspects into account.⁶²⁰

It recommended the enactment of a banking law that would regulate all deposit banking, which meant uniform treatment for all types of bank. Deposit bank groups should face the same regulations on capital adequacy and liquidity. The banks would also be subject to a commercial bank act, a savings bank act, a cooperative bank act or a post office bank act, depending on their form of incorporation. In this area, the largest changes were related to the status of Postbank. The committee felt that the optimal solution would be to convert it into a state-owned commercial bank, a limited company subject to the commercial bank act. This would best ensure competition neutrality between the banking groups.⁶²¹

The greatest reforms proposed by the committee concerned regulations on the capital adequacy of deposit banks. In line with the international model, a deposit bank's capital adequacy would be calculated as a ratio of its equity to its claims, investments and contingent liabilities. Assets and liabilities would be divided into five classes of risk, each class with its own capital requirement. There would be an overall four-percent capital adequacy requirement for all banking groups, and capital adequacy calculations would use the consolidated group model, meaning that capital was also needed to cover the operations of a bank's subsidiaries engaged in banking.⁶²²

The committee report in 1986 proposed no immediate legislative reforms but said that the skeleton law under preparation to regulate deposit banks should be linked to special legislation for each type of bank. This meant that the planned skeleton act and the special acts had to be drafted at the same time. Questions relating to Postbank's status were left unresolved. The committee had touched on the subject but some of its members, especially those from the Finance ministry, were not yet ready to take a final stand on the bank's form of incorporation. The majority felt that competition neutrality demanded that Postbank become a limited company but the Finance ministry was concerned about the costs involved in providing the share capital required.

So far, the work of reforming banking legislation had proceeded at a leisurely pace but the Finance ministry no longer wanted to wait for the post office bank legislation to be completed. By the end of March 1986 it had already established yet another working group to continue the reform. In the new working group's own words, the task was "to draw up a proposal, in coordination with the preparatory work taking place in the commercial, savings and cooperative banks associations, for amendments to the commercial, savings and cooperative bank acts required by the banking committee report's (1986:2) proposal for a deposit banking act, as well as for other possible legal changes required in this connection". In concrete terms this meant that the committee should draft a proposal for a skeleton act on deposit banking, in the form of a government bill, and the consequent changes in the special acts for each bank group. Moreover the committee should propose changes in the Postbank Act.⁶²³

The chairman of the working group was Pekka Laajanen of the Finance ministry. Its other members were Antti Hartikka (Finance ministry), Jussi Linnamo (Bank inspectorate), Tuomas Hinttula (Cooperative Banks Association), Olli Härmänmaa (Postbank), Kalevi Kauniskangas (Savings Banks Association), Risto Piepponen (Commercial Banks Association) and Kauko Satonen (Workers Savings Bank). During the course of its work, Erkki Kontkanen replaced Risto Piepponen and Lasse Kurvonen replaced Kauko Satonen. The composition of the working group was rather interesting because now official representatives were in a minority of three, while the different banking groups had five members. The Bank of Finland had no representative in the working group, nor even among its

two secretaries, both of whom came from the Finance ministry. To be blunt, the central bank had been completely sidelined at this important stage in the drafting of reforms. The main responsibility had shifted from officialdom to banking interest groups.⁶²⁴

The Justice ministry now drew attention to this point. In a statement it noted that to entrust the preparation of regulations to organisations representing the subjects of the regulations could be regarded as unusual and questionable. “The procedure could damage confidence among other public circles in the equitable drafting of laws and cause deterioration in the content and quality of the material prepared to serve as a basis for politically accountable decision-making.” However, it had been felt that, by transferring drafting responsibility to the banks themselves, the process would be speeded up and all the bank groups would be committed to the solution.⁶²⁵

Problems emerged even during the working group’s sessions, as a result of internal changes in the banking sector. Postbank was being transformed into a limited company. The competing bank groups believed that the government’s bill to do this would give the future Postbank distinct competitive advantages, and wanted the new banking law to counterbalance these. Meanwhile, the Workers Savings Bank of Finland had asked the government to allow this old national savings bank to become a commercial bank. This matter was not in the ambit of the working group but had to be taken into account in the new legislation. However, the greatest problem for the working group was to reach a conclusion satisfactory to all deposit bank groups.

The most important issues faced by the working group were related to capital adequacy. In this matter it kept to the same lines as the previous banking committee report: equity was to be compared with a bank’s risk-weighted assets and not its liabilities as in the existing law. The underlying idea was to establish capital requirements of the same magnitude for all groups of deposit banks, roughly equivalent to the capital currently required of the commercial banks. Most of the practical work of legal drafting was done within each deposit bank group, while the bank act working group served mainly as a coordinator. All deposit banks wanted the broadest possible definition of equity capital so that, although requirements seemed to be tougher than before, no new capital would be needed. The solution they favoured was to treat as equity the entire amount of credit loss reserves, plus

revaluation reserves. Subject to the permission of the Bank inspectorate, subordinated bonds would also be counted as equity. Together these constituted secondary, tier II capital. To make it easier for savings and cooperative banks to increase their capital, they were to be allowed to issue shares in separately constituted equity capital funds.⁶²⁶

The greatest disagreements in drafting the reform concerned how bank assets would be allocated between the five risk classes. The representatives of the savings and cooperative banks clung tightly to the privileges they had been granted earlier; in their view, the insurance of their stock of loans should continue to be counted in their favour when calculating capital adequacy. A new element was to use collateral to lower the capital adequacy requirement. For the commercial banks these factors had no significance but the representatives of local banks insisted on what they felt were the only ways of reaching the level of capital adequacy consistent with the reform. Their demands were accepted. Loans and other such claims that were insured in an institution subject to public supervision were included in the second risk class, where the capital requirement was only one percent. Receivables secured by “generally accepted collateral” were placed in class three, where the capital requirement was three percent.⁶²⁷

The unstated assumption of the working group’s report was that banking legislation had to be reformed to meet international requirements in a way that would not significantly increase the equity required of any group of banks. This is vividly demonstrated by the assessment contained in the report of the economic burdens imposed on each bank group by the reform in capital regulations. It analyses how much the model proposed by the group would boost bank equity and how much the minimum equity required would grow.

EFFECTS OF THE PROPOSALS OF THE 1987 BANK ACT
WORKING GROUP

	Boost to equity due to redefinition	Additional equity required by the reform
Commercial banks	10–15 percent	25–30 percent
Savings banks	55 percent	30 percent
Cooperative banks	60 percent	45 percent
Postbank	10 percent	10 percent

The capital adequacy of commercial banks was already over four percent so slightly higher demands would not create problems for them and their representatives in the working group did not ask for major changes. For the savings and cooperative banks the reform undeniably meant an increase in capital required, so their representatives demanded and received a model for calculating capital adequacy that boosted their equity by the largest possible amount of their reserves and placed a significant part of their assets, meaning loans against collateral, in the risk class that required little equity.⁶²⁸

NATIONAL MODEL STUMBLES

The recommendations of the bank act working group led nowhere, because at the same time the BIS published its recommendations on minimum capital requirements for banks carrying on international business. Although Finland had been aware of the ongoing work, their publication came as a surprise, as shown in an unofficial letter sent on 12 November 1987 by Jussi Linnamo to the chairman of the working group Pekka Laajanen. Linnamo had been present at the meeting of the BIS committee on banking supervision so he had first-hand knowledge of the new recommendations. He said they contained “three dreadful matters” from Finland’s point of view. They required equity of eight percent of risk-weighted claims, which was clearly higher than the Finnish committee report had proposed. Secondly the BIS recommended that only G10 and EU members’ government securities should be accepted as zero-risk assets. Finland’s newly completed proposal for a new bank act had to be redrafted completely.⁶²⁹

So, in late-1987, the question of reforming banking law was still open. To find a solution, the working group that had been established in spring 1986 continued operations unofficially under the leadership of Pekka Laajanen. The greatest change in its composition was that a Bank of Finland representative, Kaarlo Jännäri, was invited to participate. Jussi Linnamo left the working group upon his retirement, and his replacement as head of the Bank inspectorate, Jorma Aranko, joined the group. With Jännäri’s participation, the Bank of Finland returned to the centre stage of bank law drafting after an absence of a few years. It also intended to be firm; when the board of management

briefed Jännäri, he was told that the capital adequacy regulations of all bank groups had to be in line with international recommendations.

Ahead lay a struggle of nearly 2 years to finalise the content of a new bank act. The battle lines were fairly distinct: the local (i.e. savings and cooperative banks) versus the rest. The representatives of local banks insisted that they would be unable to achieve the necessary level of capital without using the model originally adopted in the working group. The insurance of loans in the bank's own insurance company and loans granted against collateral had to be accepted as factors that reduced the need for capital; moreover, credit loss reserves and revaluation reserves had to be treated as tier 1 capital. The regulation of concentration risk was simply non-negotiable. They could not accept a model where the maximum risk exposure from a single customer was compared to a bank's capital. On the other hand, the representatives of the commercial banks were ready to accept the modifications required by the BIS recommendations.⁶³⁰

At the start of 1989 the Bank of Finland and the Bank inspectorate held talks to try to resolve the deadlock. The outcome was that the Bank of Finland's representatives accepted a compromise that went a long way to meeting the demands of the local banks. In the central bank's view this was the only way to get all bank groups on board. In the compromise, mutual guarantees were treated as a factor that lowered risk and the limits on risk concentration were decoupled from the amount of equity. However the Bank of Finland insisted on the qualification that licensed foreign currency banks carrying on international banking had to meet the capital requirements of the Basel Committee.⁶³¹

The proposal for new banking legislation was laid before parliament in December 1989. The bill's parliamentary stages took the whole following year, and the new bank acts entered into force on 1 January 1991. It had taken nine years to reform deposit banking law, a delay that can justifiably be regarded as a fateful. The years when the law was being drafted coincided with deregulation of the financial market. Finland drifted into conditions where the regulatory framework of banking was extremely ill-suited to the new business environment. The problems stemmed from outdated capital requirements as well as dysfunctional incentives. The old capital adequacy model, in which capital was calculated from a bank's liabilities in the form of risk-free

deposits, was itself a questionable solution, to say nothing of the unreasonably small amount of capital – two percent – required from local banks. Capital requirements were further debased by permitting the local banks significant concessions when calculating their capital levels. During the delay of the reform, they were able to increase their balance sheets almost without limit, taking on extra risk at the same time. The old banking legislation also contained many individual exceptions which, in practical business, encouraged individual banks to accept unreasonably great risk.

Another element of banking law is bank supervision, where a similar laxity was observable. The approach of the Bank inspectorate was permissive in nature. In many cases where the law gave it discretionary powers, the inspectorate favoured the banks in its decisions. It generally accepted requests from banks to raise their equity by revaluing assets. Without these increases, bank balance sheets would not have shown sufficient equity. In the same way the inspectorate usually approved applications from banks to exceed legal limits on providing bank guarantees. It was already clear from the report of the banking law committee in the 1960s that although officials regarded a crisis in an individual bank as quite possible, they did not foresee it happening to an entire bank group. This same attitude was visible in all the operations of the Bank inspectorate, which did not grasp how exemptions granted to individual banks could culminate in systemic crisis. Because of lax legislation, this is what eventually happened.

With hindsight it is clear that the banking law reform should have come into force at the very start of the 1980s, the time when the first plans to reform the law were raised. The project advanced very slowly for a variety of reasons. As late as the early 1980s Finland was, in many respects, a psychologically inward-looking society where it was widely felt that banking regulation was a matter of national preference. Few realised that the ongoing internationalisation of finance would have a direct effect on Finland. The economic system was very corporatist and the banking sector had a particularly strong position. A spirit of ultra-consensus characterised institutional reforms and, in many areas, interest groups outranked officials, so even small changes in banking law took a great deal of time. In the mid-1980s the reform was further delayed by disagreement about the legal status of Postbank when the

Finance ministry questioned the need to transform the bank into a state-owned limited company, because of fears of what this would cost. This caused a couple of years' delay when other reform work was at a standstill.

The 1976 report of the committee on banking law can be regarded as a crucial turning point. Officials representing the Finance ministry and the Bank of Finland made up the majority of members of that committee, and the committee proposed no change in the capital adequacy demands that had been in force since 1970. As the report noted, Finland's requirements were already very low by international standards and could not be further reduced. Its report was ignored. The ensuing government bill to reform the law made extremely significant relaxations in capital requirements, in keeping with the wishes of the cooperative and savings banks, which paralysed the officials charged with the task of supervising banking. Representatives of the different bank groups had an even stronger position in the machinery that drafted the next reform. Seeking the greatest possible consensus, the new proposals contained only the elements that satisfied all bank groups. The interest groups of the savings and cooperative banks had a particularly strong position at this point and clung tooth and nail to the privileges granted by existing bank legislation.

THE END OF NATIONAL MONETARY POLICY

MONETARY TIGHTENING CREATES CURRENCY INFLUX

After the 1982 devaluation, Finland's rate of inflation remained fairly high, averaging 8.5 percent in 1983. This was distinctly above the OECD average. There were other signs, too, that the money market was too easy. Bank lending accelerated at an unprecedented rate during spring 1983, to more than 20 percent year on year. The Bank of Finland argued that the sharp growth in lending was explained, on the demand side, by higher inflation expectations and, on the supply side, by the increasing share of funding that the banks were obtaining as "market money", i.e. wholesale deposits by companies, at high interest rates, which were outside the interest rate controls on ordinary deposit accounts. The banks were using these borrowed funds to increase their lending.⁶³²

As bank lending accelerated, the Bank of Finland began to tighten monetary policy. In the first half of the 1983 it raised the cash reserve deposit requirement for banks (from 3.3 percent to 4.7 percent) and also the call money interest rate (from 11 to 15 percent). However, at the same time it abolished the penalty rates on its call money lending, which it had been imposing since 1980 on banks that exceeded their individual quotas of call money borrowing from the central bank. The elimination of penalties cancelled out most of the effect that the higher call money rates would have had in tightening the money market in spring 1983.⁶³³

Now that the proportion of market money in bank funding had begun to rise steeply, the Bank of Finland relaxed its controls on average lending rates. From the start of May the banks could charge borrowers part of the costs of market funding, known officially as “special borrowing”. Initially they were permitted to pass on 40 percent of these costs, increased in autumn to 50 percent and at the end of the year to 60 percent.⁶³⁴ The idea was to inject a market element into lending even when it was still subject to interest controls.

The board of the Bank of Finland had reached the conclusion that regulated interest rates had lagged too far behind “special borrowing” rates. On 15 June 1983 it presented the supervisory council with a proposal for a hike in base rate by one percentage point (and thereby the same rise in regulated lending and borrowing rates). It argued that inflation had accelerated and also pointed out that the use of “special borrowing” in banks’ funding had begun to grow strongly. The rates paid on these deposits, which roughly followed the Bank of Finland’s call money rate, was now very high compared to the regulated lending and borrowing rates, causing “significant tensions” between the different segments of the financial market. It was obviously the board’s hope that a higher base rate would reduce these money market tensions by narrowing the gap that had recently emerged between the unregulated and regulated markets. In discussions with the supervisory council, governor Kullberg said that the board believed Finland should move towards more flexible interest rate policies.

A clear majority of the council approved the board’s proposal and base rate was raised by one percentage point from the start of July 1983. It was now 9½ percent, its highest level since the 1920s. As usual, interest rates on all bank loans were raised together with the base rate. The average lending rate of commercial banks was now 10.1 percent. However, the tensions in the market were still great: the call money rate at this time was 15 percent and, in the fast-growing segment of “special borrowing”, banks were paying about 13.7 percent for large deposits exempt from rate controls.⁶³⁵

In mid-September the Finnish markka came under speculative pressure in the foreign exchange market. The board raised the overnight rate by three percentage points to 18 percent on 15 September, which halted the currency outflow. Over the next few weeks the call money rate was lowered gradually to 16.7 percent. The Bank of Finland’s

internal policy committee, consisting of the main experts, reported on 28 October that exchange rate speculation was the consequence of high Finnish inflation expectations. The committee recommended that monetary policy be tightened by raising both call money and base rates, with the aim of bringing inflation down.⁶³⁶ The committee's recommendations were followed in the overnight interest rate, which was raised at the start of 1984 to 17.5 percent.

Once confidence in the Finnish markka had been restored and the overnight interest rate had been raised, foreign currency began to flow into Finland at an exceptionally strong rate, lasting for the rest of 1984. The capital influx created a truly massive increase in currency reserves. At the start of 1984 the convertible reserves of the Bank of Finland had been about 8 billion markkaa, of which, moreover, 2 billion was on loan from abroad. By the end of the year the reserves had reached 19 billion.

This increase took place despite the fact that the central bank neutralised most of the influx of corporate capital imports by buying forward positions. By the end of the year the Bank of Finland had forward currency purchase agreements in force worth more than 20 billion markkaa, which was about 18 billion more than at the start of the year. This means that, if the Bank of Finland had not carried out such major forward operations, its convertible reserves would have reached about 39 billion markkaa in 1984, worth almost 14 percent of the country's GDP.

These figures for the reserves and forward positions were unprecedentedly large for Finland and showed that, within a few years, monetary policy had lost most of its bite. In the second half of the 1970s, when inflation had been high and the balance of payments in crisis, the central bank had managed to tighten the money market so much that the current account deficit had been eliminated within a couple of years and even inflation had been brought under control. But that had happened at a time of strict controls over capital movements. By 1984 the situation was entirely different. Now, when the bank tried to slow down inflation by raising overnight rates, capital imports increased so much that they became a substantial problem.

Forward currency positions were, quantitatively, the main way by which the Bank of Finland sought to manage the sudden influx of foreign currency in 1984 but other methods were tried. At the start of

the year, it stopped providing banks with quotas of central bank credit at base rate, so all their borrowing from the central bank was now at the call money rate. Subsequently it set about toughening the cash reserve deposit requirements. The percentage of funds that banks were required to deposit at the central bank was raised from 4.7 percent to 5.6 percent during the spring. In autumn a new agreement with the commercial banks expanded the basis for calculating cash reserves by about 30 percent. Now “market money” and foreign borrowing of the banks – after certain deductions – became subject to the cash reserve system, and banks had to deposit part of these, too, at the central bank. The new agreement came into force by stages during the last quarter of the year.

After foreign currency reserves had begun to increase steeply, the Bank of Finland allowed the markka to appreciate slightly against the foreign currency index in January and February. On 27 March 1984 the board of management decided to raise the markka’s value a little more distinctly, although only by one percent. The fluctuation bands of the currency index were not changed; the small revaluation took place within them. Since the start of the year, the markka had risen about 1.5 percent in value.

On the same day as the board revalued the markka, it took other action to tighten the money market. The most important measure was that it eliminated the ceiling on the value of call money deposits that banks could make with the central bank. Hitherto the upper limit had been 20 percent of a bank’s balance sheet total. The practical significance of removing the ceiling was that it disrupted the loose cartel between banks on interest paid for money market deposits. The small foreign-owned banks that had recently been allowed to set up in Finland for the first time could now freely compete for market money and the rate cartel was broken. The prevailing interest rate for short-term money now rose very close to the Bank of Finland’s call money rate.⁶³⁷

Inflation gradually slowed down during 1984 and by December the year-on-year rate was only 6 percent. The reduction of inflation and the end of the banks’ money market cartel allowed the Bank of Finland to gradually lower the overnight rate. By the end of the year it was 14.8 percent, which meant that it had fallen by almost 3 percentage points in 12 months. Nonetheless it was still fairly high in real terms and in relation to the interest rates of the most important foreign currencies.

Under these circumstances the Bank of Finland felt it was appropriate to lower general interest rates slightly. There were still substantial convertible currency reserves, despite the cuts in overnight rates in 1984. On 8 January 1985 it proposed to the supervisory council that base rate should be lowered by half a percentage point, citing the change in business conditions. Economic growth was expected to slow down and inflation pressures were low enough to justify a “cautious reduction” in the level of interest rates. In a letter to the supervisory council, the board of management said it intended to continue lowering the overnight rate as and when possible. The supervisory council had no hesitation in approving the proposal and base rate was lowered from the start of February 1985 to 9 percent.⁶³⁸

The foreign capital influx, stimulated by interest rate differentials, took a new form at the start of 1985. Companies, financial institutions and municipalities now started borrowing from abroad by issuing markka-denominated bonds in Finland that were resold abroad. This was possible because Finland’s otherwise tough foreign exchange controls had not hitherto restricted the sale abroad of Finnish-quoted securities. As this loophole began to be exploited to the full, the Bank of Finland implemented its last major control measure on foreign capital movements. On 24 June it forbade the sale abroad of bonds quoted on the Helsinki Stock Exchange. The rationale was that exporting securities injected new liquidity into the money market when central bank policy was to reduce it. The restriction was therefore intended to keep the money market tight and it was successful; the flow of capital into Finland through the sale of bonds dried up. The ban remained in force for a long time and was not eliminated until five years later, when most of the other restrictions on capital movements had already been lifted.⁶³⁹

The anticipated change in business climate, used to justify the interest rate cut in January 1985, did not transpire. The economic expansion failed to slow down so, in this sense, the rate cut was based on a miscalculation. However, inflation continued to fall during the year and, when the other main determinant of monetary policy, the foreign currency reserves, remained stable, the call money rate was steadily reduced during the year in line with the board’s promise. By December it was already below 12 percent and the troublesome tension between controlled interest rates and “special borrowing” rates had

obviously subsided as a result. At the same time the credit market continued to be liberalised. The Bank of Finland eased its controls on average interest rates in bank lending and eliminated the rate ceiling. In the Bank of Finland's yearbook, the measure was described thus: "The upper limit imposed on average bank lending rates will now be used mainly as a safety measure in case of certain disturbances."⁶⁴⁰ On the same day as it eased interest rate controls (13 December 1985), the bank asked the supervisory council to lower base rate by one percentage point. The supervisory council agreed and, from the start of 1986, base rate was 8½ percent.

In a statement issued at the start of 1986, governor Kullberg expressed satisfaction at the slowdown in inflation. He implied that monetary policy would continue to be eased during the coming year, if only "gradually and cautiously", although business conditions in Finland now genuinely merited a reduction in real interest rates. The previous year had been a period of unusual calm on the Finnish money market and a balanced market appeared to be at hand. World economic turmoil and Finnish political tensions were to disrupt this, however, and the year became an exceptionally stormy and fateful one for the Bank of Finland.⁶⁴¹

THE TURNING POINT OF 1986

In the history of Finnish monetary policy, 1986 marked a turning point. Bank lending rates were deregulated and capital controls were significantly dismantled in the same year. It was the single most important milestone in the process of liberalisation of Finland's financial market. The external backdrop to these events was a major shift in the international economy, particularly an oil price collapse and a steep drop in the value of the dollar.

The price of crude oil on world markets fell by half in a very short period at the start of 1986. The cartel of oil-producing countries, OPEC, ceased to be able to coordinate production and prices when the leading oil producer, Saudi Arabia, reversed its output policy at the end of 1985. After it had boosted production and tried to raise its market share of crude oil, the other OPEC members reacted by increasing their own output. The excess supply of crude on world markets sent the price into steep decline. According to the US Department of Energy, the

average price of OPEC crude was 23.29 dollars a barrel in December 1985 but only 9.85 dollars in June 1986.⁶⁴²

The oil price collapse naturally reduced inflationary pressures, a trend that was amplified in Finland by the falling dollar exchange rate. In September 1985, finance ministers of the leading economic powers – the United States, West Germany, Japan, France and Britain – had met at the Plaza Hotel in New York and agreed on joint action to lower the value of the dollar. Their reason was that tough US monetary policy in the early 1980s had raised the dollar exchange rate to an exceptionally high level and created a serious deficit in US foreign trade. After the Plaza Accord the dollar began to tumble and the values of the German Mark and the Japanese yen, among others, increased correspondingly. The dollar also fell significantly against the Finnish markka and dropped below 5 markkaa in summer 1986. It was already 20 percent below its average value in 1985 and it was still falling.

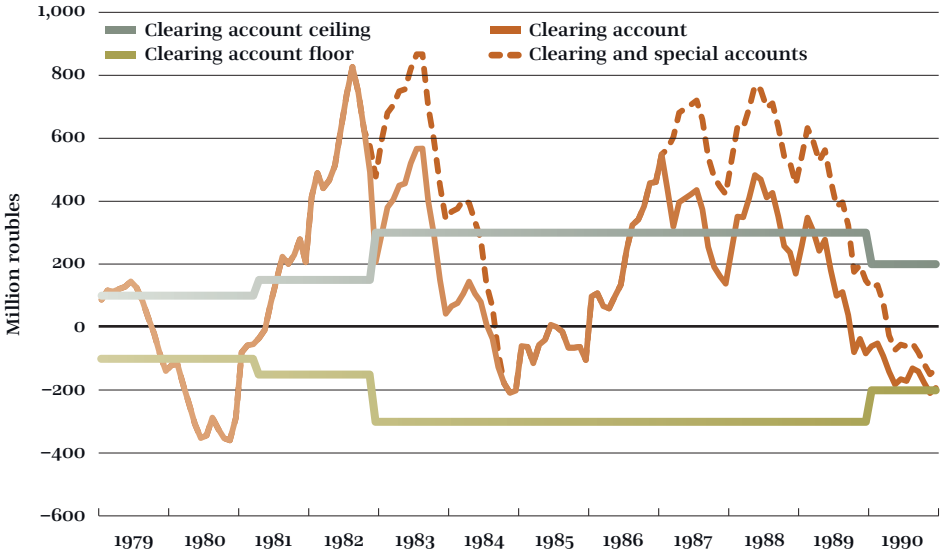
Because the dollar was the most important pricing currency in international trade, its depreciation pushed down Finnish export and import prices. Cheaper oil had the same effect. As inflation declined and economic growth in Finland came to a halt, a series of general interest rate cuts was implemented. The first came at the start of the year. On 13 December 1985 the board of management asked the supervisory council to cut base rate (and thereby bank lending and deposit rates) by half a percentage point from the start of January 1986. In a statement attached to the proposal, the board said interest rates could be lowered further during 1986 if inflation continued to weaken. The council members approved the board's proposal unanimously although, in discussions preceding the vote, some had voiced opinions in favour of a greater cut.

The rate was soon to be reduced again. In January it became clear that inflation in December 1985, measured by consumer prices, had been below five percent, the slowest rate experienced in Finland since the first oil crisis. Industrial producer prices and as well as export and import prices had already turned down. On 4 February governor Kullberg told the inner supervisory council that Finland was already "facing deflation", but he was unwilling to lower interest rates yet because the economic situation was still under discussion in the government and the incomes policy information commission. However, a meeting of the full council later on the same day decided to ask the board for a proposal on lower interest rates.⁶⁴³

The board did as requested on 21 February 1986. The preamble to its proposal referred to an unexpectedly great drop in inflation and a rapid deterioration in economic prospects. On the other hand, the board felt that the growing current account deficit and the government's budget deficit restricted the scope for lower interest rates, as did the unsettled state of the centralised negotiations on wage increases. For this reason, it was proposing a cut of only half a percentage point in general interest rates, which the council approved after a vote. A counter-proposal by councillor Aarne Saarinen, the chairman of the Finnish Communist Party, that base rate should be reduced by 1½ percentage points, was defeated. Base rate was lowered by just half a percentage point to 8 percent from the start of March.⁶⁴⁴

The collapse in oil prices affected not only the rate of inflation; it also had a dramatic impact on the outlook for Finnish exports to the Soviet Union. The level of this trade was very dependent on the price of crude oil. Just as the oil crisis had boosted Finnish exports to the Soviet Union, the oil price collapse of 1986 was now sharply curbing Moscow's

SOVIET CLEARING ACCOUNT DEBT TO FINLAND, 1979–1990



Source: Bank of Finland.

ability to buy Finnish products. If the principle of balance in clearing trade was to be maintained, Finnish exports to the Soviet Union would have to decline steeply. In 1985 the Soviet Union had taken 22 percent of Finnish exports so a reduction would have a great impact on employment. There were fears that the reorientation of export capacity towards Western markets would be neither easy nor rapid.

The board of the Bank of Finland discussed the situation that had arisen in Soviet trade on 3 March, on the basis of a memorandum written by Kari Holopainen, head of the bank's department for eastern trade. Holopainen noted that Finland's exports to the Soviet Union could be expected to drop sharply if mutual trade were kept in balance. His memorandum stated that Finland "should decide which has priority, keeping (Finland's) clearing receivables at the lowest possible level or promoting the favourable development of exports. In the light of near-term prospects for overall development of our economy, our primary attention should obviously be focussed on exports, at least until a recovery of exports to the West can be expected"

Holopainen recommended that, to prevent a steep decline in exports, Finland's receivables should be permitted to grow – in other words, credit should be granted to the Soviet Union via the balance sheet of the Bank of Finland. It seemed feasible that credit in excess of the maximum permitted on the clearing account could be converted into an interest-bearing loan denominated in convertible currency or, alternatively, could be transferred to a special interest-bearing account denominated in clearing roubles. Holopainen said that the former would be less acceptable to the Soviet Union unless the interest rate was below the market rate. The precedent for using special accounts dated from 1982–1984, when Finland's exports surplus had first become worryingly large. Holopainen added that, as a matter of negotiating tactics, Finland would be unwise to propose the credit arrangement but should wait for the Soviet side to raise the issue.⁶⁴⁵

Regarding the board's discussions, the minutes recorded that "the alternative measures proposed in a memorandum by the head of the department for eastern trade were regarded as realistic. The prioritisation was also felt to be correct." In other words, like Holopainen, the board thought it was more important to support exports in the present circumstances than to balance the clearing account quickly.⁶⁴⁶

The effect of oil prices on trade was that the value of Finland's imports from the Soviet Union shrank by a full 30 percent in 1986. In the same year the value of exports shrank by only seven percent, so trade with the Soviet Union produced a surplus for Finland which, measured by the Finnish-Soviet current account balance, reached 5.8 billion markkaa. Because of the export surplus, the surplus on the clearing account rose above the permitted credit ceiling in August. By the end of 1986, the account stood at 460 million roubles or 3.3 billion markkaa.

When the Soviet clearing account debt reached the credit ceiling in August, talks were started on transferring the surplus to a special loan account. The negotiations continued throughout the autumn. Originally the Bank of Finland had wanted the loan to be denominated and repaid in convertible currencies but the Soviet side rejected this. Instead it was denominated in clearing roubles but, to reduce the exchange rate risk to Finland, the loan was pegged to the same currency basket that the state bank of the USSR, Gosbank, used to peg the clearing rouble. Thus the Soviet Union could not unilaterally devalue the debt by changing the exchange rate of the clearing rouble. It was agreed that the loan on the special account would be amortised by the end of 1991.

The agreement negotiated in autumn 1986 on a special interest-bearing account was not signed until the New Year. In February 1987, 285 million roubles (equivalent to about 2 billion markkaa) were transferred out of the clearing account, but despite this, the Soviet Union's clearing account deficit still remained above the permitted credit ceiling until August 1987. Thus, the special arrangement blunted the impact on Finnish exports but did not eliminate it. Only about a third of the surplus of 1986 was transferred to the special account, so exports fell significantly.

Oil brokering played a greater role in eliminating the surplus. Finland imported oil from Soviet Union above its own requirements and resold it on western markets. In this way, 450 million roubles were reduced from the clearing account balance during 1987. Nonetheless, the curtailment of exports also had a considerable role in balancing the trade. Finland's sales to the Soviet Union declined about 20 percent in value in 1987. Measured in clearing roubles, exports shrank by about 430 million roubles. Even so, trade with a Soviet Union still produced a distinct surplus for Finland in 1987.⁶⁴⁷

CAPITAL IMPORTS DEREGULATED

In spring 1986 there was a disturbingly sharp decline in the currency reserves of the Bank of Finland – apart from clearing roubles, of which the bank had too many as we have already described. Dwindling foreign currency reserves were one of the main subjects at a meeting of the board of management on 21 April. The discussions were based on a forecast drawn up by the economics department and a policy memorandum drafted by the central bank policy working group, consisting of the bank's main experts. The forecast showed that economic growth was slowing down. The policy memorandum said that the main problem of the Finnish economic situation was the steep decline in exports to the East, which would not be offset in the short term by growth of exports to the West. Although the current account as a whole did not seem to constitute a problem, the deficit in trade with the West was a burden on the convertible currency reserves and reduced monetary policy leeway.

Regarding exchange rates, the policy memorandum was distinctly opposed to devaluation. It noted that the Bank of Finland had been trying for several years to break the devaluation-inflation spiral but the onus of history meant that the credibility of this line was not fully established. Hence Finland still needed higher short-term interest rates than other countries. The memorandum defended the commitment to fixed exchange rates because “it will allow us to board the world train of low inflation in the 1980s”. It was questionable whether, in the present circumstances, devaluation would promote significant growth, even in the medium term. “If the Bank of Finland does not advocate the crushing of inflation, no one else will.”

The memorandum concluded that the devaluation option should be rejected because “a small exchange rate adjustment could have a negative effect on expectations, while there are no grounds for a large rate change”. If necessary the call money credit rate could be raised to prevent currency reserves falling to a level that would trigger speculation about a devaluation. Supporting the currency reserves would increase the room of manoeuvre in monetary policy somewhat; the memorandum said that it would be appropriate to grant more capital import permits or increase government borrowing from abroad.⁶⁴⁸

Its recommendation for solving the currency shortage by increasing capital imports evoked an even more radical and far-reaching idea at the board's meeting on 21 April. The idea was presented by the head of the economics department, Kari Puumanen, who told the board that he thought "we should apply the liberalisation of capital imports to solving the interest rate policy impasse". Three days later, he distributed a memorandum in which he presented more details to justify the concept of liberalising capital imports. He rejected the view that controls on capital movements were an appropriate tool for increasing national autonomy in monetary policy. In the previous autumn, there had already been some surprise, he pointed out, that a notable differential between Finnish and foreign interest rates was not creating enough capital imports "to cover the nascent current-account deficit".

In Puumanen's view, there were many advantages to a significant liberalisation of capital imports. A current consideration was that more capital imports would support the currency reserves and strengthen confidence in the bank's policies, but there were other benefits, too. The cost of finance would decline, especially for industrial companies. Interest-rate competition would increase and the bureaucracy surrounding currency rationing would decline. His memorandum proposed that a "considerable degree" of liberalisation could be achieved "by means of a circular letter", without yet tackling the underlying currency legislation. Although, he wrote, the time might not yet be ripe to advocate the relaxation of currency regulations beyond what was needed to promote capital imports, he was generally critical of all currency controls: "If we want to give monetary policy the internal national autonomy within which it can properly manage the very limited functions for which it is suited, free capital movements are the best guarantee of this."⁶⁴⁹

The Bank of Finland's currency reserves began to fall faster during the spring. This situation and the base rate were the main themes in a report by governor Kullberg to the supervisory council on 29 April. Kullberg said the decline in currency reserves was due "mainly to natural factors". Of these he specified the current account, which had gone into substantial deficit in the early year. He pointed out that the central bank's reserves, including currencies purchased in forward contracts, which had totalled over 30 billion markkaa at the start of the year, were now only 21 billion in the last week of April. This trend

had caused market unrest, he said, and so the currency situation was somewhat disturbed. Prior to the meeting, council members had expressed the desire for a new cut in base rate but the governor said that the situation was so unsettled that the board could not propose it. The interest rate question was therefore postponed for a couple of weeks.⁶⁵⁰

Before the next council meeting, Finland's speculation-prone currency situation reached crisis point. The impetus came from abroad. A new government was formed in Norway on 9 May. The Norwegian economy was strongly dependent on oil and the collapse in oil prices during the spring had hurt the country's trade balance. The first act of the new Labour Party government, led by Gro Harlem Brundtland, was to devalue the Norwegian krone by about 12 percent (the decision was announced on Sunday 11 May). The Norwegian devaluation spurred market uncertainty about the external value of the Finnish markka.

To halt the capital flight triggered by Norway's devaluation, the board of management of the Bank of Finland raised the call money interest rate to 13 percent on 13 May, a hike of almost 2 percentage points. When this did not halt the currency outflow, it raised the rate to 16 percent on the following day. At the same time it decided to allow the value of the markka to decline against the currency index by about two percent "to kill expectations and rumours." The decision, which did not involve a change in the currency index fluctuation band, came into effect the following day, 15 May.⁶⁵¹

May's wave of speculation against the markka came at the same time as the board of the Bank of Finland was preparing the proposal, requested by the supervisory council, for a new reduction in base rate, which meant lower general interest rates. The board was undeterred by unrest in the foreign exchange market, and proposed a base rate cut from 8 percent to 7 percent, on the same day as it raised the overnight credit rate and allowed the markka to depreciate. The council approved the rate cut unanimously and it came into effect on 19 May 1986.

On 16 May the board of the Bank of Finland discussed the phasing out of currency regulations on the basis of a report by two of the bank's economists, Esko Aurikko and Vesa Vihriälä. Entitled "A strategy for decreasing regulation of financial and foreign exchange markets," the report had been completed by 24 April, at the same time as Kari Puumanen had made his aforementioned proposal for deregulating

capital imports in order to support currency reserves. However the wide-ranging report by Aurikko and Vihriälä had been drawn up over a longer period during the spring and its recommendations were distinctly more cautious than Puumanen's radical proposal.

In the abstract of their report, they wrote that "in our view there is a sound rationale for regulating foreign capital flows. If we wish to maintain a system of fixed exchange rates, currency controls bolster monetary policy independence. On the other hand, it is harder to find sustainable grounds for controls on interest rates for domestic financial claims. This analysis points to the fact that it would be appropriate to seek to dismantle the remaining interest rate controls as quickly as possible, while simplifying currency controls and eliminating the rationing features of them that are irrelevant for overall capital movements."

Aurikko and Vihriälä recommended that deregulation should start with bank lending rates. On the other hand, the liberalisation of rates on ordinary deposits was a more difficult question, which could not be tackled without changing the taxability of interest income on bank deposits. The law exempted interest income from income tax if the deposits were made in accounts operated under the interest rate cartel of the banks. In the authors' view, "to prevent growing margins in bank intermediation, it is not appropriate, for the time being, to abandon active use of the possibility for regulating bank borrowing rates".

Regarding the relaxation of regulations on capital movements they recommended a gradual approach. "Relaxation of currency controls could commence with easier rules on long-term capital imports. The rules on short-term imports for bank funding could also be simplified and the funding quotas for imports eliminated." They regarded markka-denominated capital movements as more significant for the maintenance of monetary policy independence and so wanted their regulation to continue for the time being. "For the domestic financial market to be opened to foreign residents, it must first operate efficiently and competitively, and foreign financial markets must be relatively open to Finnish residents. At this stage it is also obvious that independence in short-term monetary policy would have to end. Thus, at this stage, it may not be appropriate to proceed in the dismantling of the currency controls earlier than in the medium term."⁷⁶⁵²

After the speculation in May, which had been combated by hikes in the call money interest rate, conditions for the Finnish markka settled down for a while, allowing the board of the Bank of Finland to reduce call money rates again. This was done by stages and by the end of May the rate was back at a pre-crisis level (11 percent). On 16 June governor Kullberg reported on the situation to the supervisory council. He was untroubled even by the current problems in eastern trade, and expressed the hope that the recovery visible in western markets would compensate for the negative outlook for eastern exports: "We can only hope that the green light from the West and the red light in eastern trade will both grow stronger at the same time, because this will allow us to get the economy back into better balance."

At the same supervisory council meeting on 16 June, there was an interesting if brief discussion on dismantling interest rate and currency controls. Councillor Veikko Vennamo, the chairman of the small Rural Party, asked about possibilities for deregulating Finland's capital markets. Pointing to the liberalisation recently implemented by the Australian Labour Party, he predicted that Finland would have to follow the same trend. Governor Kullberg answered that "we do not feel that the deregulation of foreign exchange should proceed very far before the situation is under control here at home. The domestic situation is related very closely to the tax exemption of deposits. If we want more liberalisation, we will also have to deregulate interest rates. At that time, interest rates will not necessarily settle at the present level and could be far higher."⁶⁵³

Kullberg's answer was in accordance with the strategy drafted by Aurikko and Vihriälä in their memorandum, which gave higher priority to liberalising the domestic money market than deregulating capital imports. On the other hand, the deregulation of foreign capital flows was envisaged as taking place by stages and, while Kullberg was answering Vennamo's question, the central bank's foreign exchange policy department was already starting to plan the lifting of controls on capital imports in the form of long-term loans denominated in foreign currencies. A memorandum on the subject, dated 18 June, reached the conclusion that "present conditions seem to be best served by regulating foreign borrowing on the basis of a loan's maturity and not according to what it will be used for. This system will achieve significant advantages over the current system, mainly a reduction in

corporate financing costs, greater equality between companies and stronger competition between banks.” The memorandum predicted that if the reform (with deregulated long-term borrowing) replaced some short-term capital imports, capital movements would become less sensitive to interest rates. Thus, it would not harm short-term national autonomy in monetary policy.⁶⁵⁴

The foreign exchange market remained stable throughout the early summer but, after mid-July, the Bank of Finland had to sell foreign currency to hold the exchange rate steady and the monthly proposal of the monetary policy department recorded that “if expectations continue, the use of monetary policy tools and particularly the call money interest rate will have to be reconsidered”. As it turned out, the resumed currency flight determined the timing of measures to deregulate the financial market. On 25 July the board of the Bank of Finland set its next meeting for the last day of July and invited the supervisory council to convene on the same day, at the bank’s villa at Ramsinniemi, east of Helsinki.

On that day, a little before the meeting of the supervisory council, the board of the Bank of Finland decided on radical measures to halt the drop in currency reserves. Firstly it would ask the council for unlimited authority to raise the call money interest rate, so that the cost of overnight borrowing would be pegged inversely to the level of currency reserves. When the Bank of Finland was forced to sell foreign currencies from its reserves in order to hold to support the value of the markka, there would be an “automatic” increase in the call money interest rate, intended to offset the loss of reserves. Secondly, the board decided on significant measures to deregulate the financial market. It would eliminate the ceiling on average interest rates on bank loans and abolish controls on long-term (over five years) foreign borrowing by industry and shipowners. Banks were to be granted the right to act as intermediaries for this credit.

The decisions taken by the board on 31 July 1986 were probably the most important individual steps in the process of dismantling of Finnish financial market controls, which took place throughout the 1980s. Two other major liberalisation measures, in 1980 when the forward currency market was deregulated, and in 1987 when the right to import long-term capital was extended to cover all companies, were also far-reaching, but in 1986 the Bank of Finland reached a resolution that set the course of

foreign exchange and monetary policy far into the future. Finland's financial market would now be managed on market terms.

At the meeting of the supervisory council held on the same day, governor Kullberg explained the background to the deregulation measures and the request for unlimited authority in setting the call money interest rate. He pointed to the loss of currency reserves and said that two weeks of talks within the bank and with the government had led to the unanimous conclusion that there were no serious alternatives. For this reason the defence of the markka and the currency reserves needed to be continued. It must be made clear to possible "speculators and prevaricators" that an attack (against the markka) would not be worthwhile. To do this, the board of management needed free hands regarding the call money rate.

The liberalisation measures that the board had agreed would support the defence of the markka, Kullberg said. By abandoning average interest rate controls on lending, the call money rate would be made into an effective and fast-acting instrument in steering the money market. The simultaneous deregulation of long-term foreign borrowing by industry and shipowners would achieve more competition in the financial market, although it would apply only to loans denominated in foreign currencies.

Kullberg said that he had met Prime minister Kalevi Sorsa and Finance minister Esko Ollilla in the countryside outside Heinola, in the Finnish lake district, on Monday 28 July and discussed the matters thoroughly with them. They had concurred that the action being taken (to defend the value of the markka) remained the only viable policy. It would not be easy, Kullberg said, and if things went badly, it could result in many difficulties and troubles, including higher interest rates, "but any other solution involving the oft-mentioned devaluation is out of the question for many reasons. Perhaps the main one is that the economy today is underpinned by so many index clauses, relative wage guarantees and other linkages that (devaluation) would soon have broad second-round effects and we would obviously be in a new spiral of inflation and devaluation, perhaps even worse than before."

Kullberg added that the policy chosen was largely based on the assessment that a nascent economic upswing in western markets would help the Finnish economy adapt, although the problems in trade with the East would be particularly painful in the years ahead.

The policy choice was also supported by many factors that had improved Finland's international competitiveness, he said, such as the mini-devaluation of May, the spring cuts in base rate and the energy tax reform planned by the government.

The supervisory council unanimously gave the board the authority it had requested for the call money interest rate. This authorisation was to be in force until the next council meeting, as the board had proposed. In a fairly brief debate, the councillors of left-wing parties, Erkki Liikanen of the Social Democrats and Aarne Saarinen of the Communists, emphasized the importance of avoiding a devaluation to explain why they were in favour of extending the powers of the central bank's board.⁶⁵⁵

A statement on the bank's new powers over overnight rates and the elimination of lending rate controls was published on the same day, with an appended statement by governor Kullberg. It noted that the Bank of Finland had decided to hold the external value of the markka unchanged and that the government had given its full support to this policy. Finnish competitiveness was "entirely adequate for the national economy to be able to adjust to the current exchange rate, given the support of measures already decided. Its adjustment was a difficult task which required a common goal in all segments of economic policy."

The new interest rate formula, set by the board on the last day of July, which tied the level of currency reserves to the call money credit rate, came into force on Friday 1 August but was not long-lived. It was applied only on that day and the following Monday, because the new policy did not restore market confidence. By Tuesday 5 August, currency flight had reached such serious proportions that the board ceased to apply the formula and switched to "manual override". The call money rate was now set at 25 percent (compared with only 10.8 percent at the end of July) and, on Thursday 7 August, when the currency flight continued, the rate was raised to a record 40 percent. On Monday 11 August, the flow of currency finally turned slightly in Finland's favour and on Thursday and Friday the call money rate was lowered again. By the end of the week it was 25 percent.

The pressure on currency reserves gradually eased in late August and early September. The call money rate was lowered gradually at intervals of a few days and by the end of September it was 12.5 percent. It then remained around 12 percent for the rest of the year.

“THE STRONG MARKKA”

INFLAMED RELATIONS BETWEEN GOVERNING PARTIES

In autumn 1986, debate over economic policy began to be influenced by the parliamentary elections, due the following spring. A very visible dispute blew up between the governing parties. Its explicit subject was eastern trade – its problems of imbalance and its effect on economic prospects – but exchange rate policy was the issue that lurked in the background. The exchange rate had always been politically sensitive in Finland and was even more delicate when there was reason to fear that speculation against the markka, experienced in the summer, might flare up again. The debate began over the question of eastern trade and took place at a time when representatives of the Bank of Finland were negotiating with the Soviet Union about financial arrangements to soften the impact of the oil price collapse on Finnish exports.

The dispute was initiated by the chairman of the Centre Party, Foreign minister Paavo Väyrynen, in a press interview published on 10 September. He stated that the main reason for speculation against the markka and the consequent high interest rate level was the surplus in trade with the Soviet Union and the need to reorient Finnish exports to western markets. A month later Väyrynen gave another wide-ranging interview in which he pronounced Finnish economic prospects to be gloomy because of the pressure to reduce exports to the Soviet Union and the poor price competitiveness of Finnish companies. In Väyrynen's view Finland's situation “demanded a reduction in wages, agricultural incomes and the agreed level of stumpage prices”.⁶⁵⁶ Stumpage is a contractual pricing unit for wood.

Väyrynen had not come out openly in favour of a devaluation of the markka but had proposed the lowering of incomes as a way of avoiding it. However he was interpreted as inciting speculation about devaluation, and the Social Democratic Party, especially Prime minister Sorsa, condemned his statements severely. Sorsa was particularly annoyed that problems in trade with the East were being turned into an election weapon and told President Koivisto that relations between the major governing parties, the Centre and the Social Democrats, were completely deadlocked. He hinted at the possibility of the government's resignation but Koivisto rejected the idea and the government ultimately stayed together until the elections.⁶⁵⁷

Despite the inflamed state of policy debate, the foreign exchange market remained relatively calm over the second half of the year and the summer's flight of capital was not repeated. The dwindling of currency reserves, which had characterised the first half of 1986, came to an end, probably because of the deregulation of long-term foreign borrowing, implemented in August for this very purpose. However the call money interest rate remained at about 12 percent and the real interest rates on bank loans etc. were also fairly high. At a time when inflation had dropped to about 3 percent (as measured by consumer prices), the real call money rate was around 9 percent and real bank lending rates were above 5 percent.

In December 1986 the Bank of Finland celebrated 175 years. On the eve of its anniversary, on 11 December, a banquet was arranged at the Kalastajatorppa hotel, Helsinki, where Prime minister Sorsa was a keynote speaker. His speech laid down an economic policy line that would be significant for many years to come.

Initially he dealt with the institutional position of the Bank of Finland and emphasised the government's primacy in economic policy. Sorsa pointed to a 1955 study by Professor Paavo Kastari, who had concluded that the Bank of Finland, in its growing independence over the years, had distanced itself from the government on the one hand and parliament on the other, becoming one of the world's most independent central banks. Sorsa observed that the short duration and weakness of Finnish governments had often been used to justify the strong position of the central bank. Referring to a trend dating from the late-1970s, Sorsa said that, as Finnish political life had become more stable, this argument had lost relevance.

According to the rules of democracy, economic choices were to be decided by politically responsible bodies, ultimately the government, Sorsa said. Because the government was responsible for economic policy and the Bank of Finland for monetary policy, it was clear that the prime minister and finance minister had to be in regular contact with the leadership of the Bank of Finland “about momentous questions of economic policy”. He added that “cooperation between government leaders and the Bank of Finland has indeed continued to improve but, from the perspective of the government, the dialogue has sometimes seemed one-sided. The government’s representatives have explained their economic plans while our central bank has shrouded itself in crusty obscurity. Secrecy seems to be the besetting sin of central banks everywhere.”

After these observations on the position of the bank, Sorsa moved on to his main theme, exchange rate policies. He pointed to the speculative attacks against the markka exchange rate during the summer and said that the policy of a strong markka, as pursued by the Bank of Finland, had had and continued to have the unswerving support of the government. The crushing of inflation was an achievement that needed to be made permanent: “our national economy, the economy of our citizens, needs reliable moorings. A strong markka is one.”

Sorsa regretted the “ever-wider fears that the established Nordic way of reviving an economy is with a ‘vitamin D injection’ at the time of a change of government”. Parliamentary elections would be held in Finland in March. This time the parties going into government should take devaluation off the table in advance, Sorsa said.

“Now is the time for our political system to show its effectiveness. After the election the government will resign, in line with established practice, and the defence of the markka will then fall, to an unreasonably great degree, on the Bank of Finland alone. I have no doubt that the bank will be successful in its mission, but forceful action against speculators would, at the same time, cause needless harm to employment and growth. To avoid this it is essential that the political forces keen to form the new government should announce in advance that they will resolutely adhere to the policy of a strong markka. If speculators grasp in time that a strong parliamentary fire brigade stands alongside the Bank of Finland, the temptation to arson will evaporate.”⁶⁵⁸



■ Prime minister Kalevi Sorsa addresses the Bank of Finland's 175th anniversary celebrations in 1986, proposing that the next government programme should rule out devaluation.

- Bank of Finland.

Sorsa had cleared the theme of his speech in advance with governor Kullberg. Kullberg applauded the idea of obtaining policy commitment from the parties although he felt that the prime minister might have had some ulterior motives. Sorsa said later that the speech originally had no other purpose than to pre-empt currency speculation but admitted that the attitude of different parties to exchange rate policies was important when the government began to be formed after the elections.⁶⁵⁹

GOVERNMENT PROGRAMME INCLUDES STABLE EXCHANGE RATE

The conservative National Coalition Party made the greatest gains in the parliamentary elections of March 1987, winning nine extra seats in parliament, but the Social Democrats retained the position of largest single party. Prior to the elections, the chairs of the Centre, National Coalition and Swedish People's parties had made a secret agreement to work together after the election when the new government was formed but President Koivisto blocked the plan and, on 10 April, appointed Harri Holkeri to head talks on forming a new government. Holkeri was a former chairman of the National Coalition Party but had been a board member of the Bank of Finland since 1978. With the president's mandate, Holkeri put together a government founded on the Social Democratic Party, the National Coalition Party and some smaller parties. It was appointed on 29 April 1987. The new Finance minister was a Social Democrat, Erkki Liikanen, who had earlier served as deputy chairman of the bank's supervisory council for five years.⁶⁶⁰

The day after the parliamentary elections, Holkeri had given a speech at the Helsinki Bourse Club, in which he had referred to Sorsa's December speech and remarked that "the next government, too, must be made up of those who are in favour of a strong markka". He thought that the Social Democrats and the National Coalition Party were closer to each other in this respect than the Centre Party "whose leadership has publicly played politics with devaluation".⁶⁶¹

According to the programme of the Holkeri government, "a substantial reduction in unemployment, curbing of price rises and the continued stability of the markka's external value are key objectives of government economic policy". Regarding monetary policy, the

programme pledged that “the government will work together with the Bank of Finland to reduce the current interest rate level. It is important that real interest rates remain positive because of the way they steer the economy and in order to put financial structures on a healthy footing.”⁶⁶²

At a time when exchange rate policies had become critical in party political rivalry, the Bank of Finland was conducting an internal debate on the exchange rate system. In February 1987, Matti Vanhala, the director responsible for foreign exchange, had asked his department to write a fairly radical memorandum on exchange rate flexibility. The policy memorandum stated that the increased volatility of international capital movements meant that protecting Finland’s external liquidity would very probably become a steadily more pronounced limitation on monetary policy. There were no fast-acting solutions to alleviate these problems if the exchange rate was to be kept fixed in the future. Finland could no longer return to conditions of capital controls.

The memorandum recommended greater flexibility in the exchange rate because it would increase the scope for independent monetary policy. The policy objective could shift from protecting external balance towards protecting internal (economic) equilibrium. It would then become easier to select an interest rate level or certain growth of money supply as the objective of monetary policy, the memorandum stated. As practical measures it recommended, first, that the fluctuation range of the currency index be widened to 10 percent and, later, that the Currency Act be amended to abolish fluctuation limits entirely. However Vanhala did not regard a pure floating exchange rate regime as suitable for Finland, so some central bank operations in the foreign exchange market would still be needed.⁶⁶³

It was not until 28 April, the day before the Holkeri government was appointed, that Vanhala presented his memorandum on exchange rate flexibility to the board of the Bank of Finland. In their discussions on the matter, the board did not endorse his ideas. The board members felt that at the present moment there was “almost certainly” no scope for widening the currency index fluctuation band. “The complete abolition of the fluctuation limits in general seems neither justified nor possible”, it was concluded. The idea of greater exchange rate flexibility was therefore laid to rest for the time being, and the system of floating rates was rejected outright.⁶⁶⁴

About a month after the government's appointment, Prime minister Holkeri explained the foundations of the government's economic policy and its line on exchange rates in a speech at the spring meeting of the Central Chamber of Commerce. He said that the government aimed at 3 percent annual economic growth over the next five years, which would require curbing the upward pressure on costs. On exchange rate policy he said the government was unequivocally in favour of a strong markka. "Our stand in this respect is important and central. It lays down a functional framework for economic policy in the longer term, too, while giving clear guidelines to other economic players and labour market organisations. The government has laid down this policy line in the belief that a stable markka will best promote the process of economic restructuring over the longer term. At the same time it is obvious that abandoning this objective would no longer create significant room for economic policy manoeuvre, even in the short term (...) Nor would the policy of a weak currency in any way serve the government's economic aims."

The government programme had set the objective of a lower interest rate level. In his speech Holkeri said that this could be targeted by tightening fiscal policy:

"The government regards some degree of change in the present pattern of economic policy as essential. It will seek to tighten the fiscal policy framework and thereby promote preconditions for a gradual easing of monetary policy."⁶⁶⁵

In May, when governor Kullberg made his first report to the new supervisory council appointed after the election, he commented that Finland's economic situation was surprisingly good and predicted that some sort of economic upswing lay ahead. Conditions had become calmer "on the currency side" and that the bank had therefore allowed the interest rate gradually to slip downwards. The level of (convertible) currency reserves was over 21 billion, which he regarded as very good, particularly compared with the reserves of less than 8 billion markkaa in August of the year before, when the currency crisis had been at its worst.⁶⁶⁶

The elections of spring 1987 and the change of government did not ultimately cause the wave of foreign exchange market unrest that had been anticipated, and the assurances about exchange rate policies, given by various political parties before the elections, naturally may have

HARRI HOLKERI (1937–2011)

The newly elected chairman of the National Coalition party, Harri Holkeri, joined the supervisory council in 1971 amid the electoral term when Juha Rihtniemi died. Holkeri became chairman of the council at the same time, although he was only a first-time member of parliament. He held a master's degree in political science and had made his career in the service of his party, most recently as party secretary.

On the supervisory council Holkeri became known as an advocate of the independence of the Bank of Finland from the government. One of the occasions when this became clear was in 1974, when the council was discussing a controversial article by two central bank economists, Peter Nyberg and Eero Vuohula, that urged that the Bank of Finland should be controlled by the government instead of parliament. Some council members thought it was inappropriate for central bank officials to publish such views while others felt that freedom of expression was more important. No action was taken but Holkeri was adamant that the Bank of Finland's status as an institution under parliament should not be changed.

When Päiviö Hetemäki of the National Coalition party resigned from the board of management of the Bank of Finland in 1978, Holkeri was chosen to replace him. Although Holkeri was not professional in monetary policy, the chairmanship of the supervisory council had given him a firm grasp of central bank operations and finances. On the board he was responsible for

administration and, among other things, began comprehensive internal budgeting.

Although he had left everyday politics soon after joining the board of management, he was appointed to take soundings on forming a new government after the election of 1979 and was his party's candidate for the presidency in 1982. He made a return to politics in spring 1987, when president Koivisto unexpectedly gave him the task of forming a government, at the same time blocking a secret collaboration agreement made before the elections between the National Coalition party and the Centre party.

The Holkeri government, in which the Social Democratic party served alongside the National Coalition party, lasted until spring 1991. In its economic policies it struggled with economic overheating and worsening economic imbalances, which it ultimately did not overcome. With the end of the Cold War in Europe, Finland joined the negotiations on forming a European Economic Area, but Holkeri remained very cautious in his foreign policy formulations. To the end of his premiership he was very sceptical about the idea of Finnish EU membership.

After retiring from the Bank of Finland in 1997, he was active in international diplomacy. He was a member of the commission that brokered Northern Irish peace talks and chaired the United Nations General Assembly in 2000–2001. Later he was UN special representative in Kosovo, until illness made it impossible for him to continue. In 1998 he received the rare honorary title of Councillor of State.



■ Harri Holkeri

– Finnish Press Agency / Jorma Pouta.

played their part in this. The improvement in confidence showed in both the foreign exchange and the money markets. Market interest rates (which the bank had just begun to monitor) fell by three percentage points between the start of the year and May. At the same time the currency reserves grew at a breakneck pace. The money market had started to experience a period of easing that lasted right up to 1989.

FIXED-RATE REGIME SWEEPS EUROPE

The policy of a “strong markka”, adopted in Finland in spring 1987, was no mere national phenomenon. It was a pan-European trend that gained momentum throughout the 1980s. Finland’s internal debate on exchange rate policies was conducted largely on domestic terms, and references to foreign exemplars were unusual. However, it is obvious that officials and economic experts closely followed foreign developments both in Sweden and elsewhere in Europe via the channels offered by the OECD and other international organisations. Foreign influences shaped their views about the policy options that would be realistic for Finland.

Swedish exchange rate policy became distinctly more rigid in June 1985. Until then the Bank of Sweden, which was authorised to set exchange rates, had not officially announced a fluctuation range for the currency index, used to determine the value of the Swedish krona. In spring 1985 there was speculation in Sweden against the krona, which forced the central bank to raise interest rates steeply in May. Among the measures aimed at restoring confidence in the currency, the bank announced in June 1985 that it would henceforth hold the value of the krona within a very narrow band of the currency index, a mere ± 1.5 percent around a reference value. This step can be seen as marking the beginning of hard currency policy in Sweden and it was felt to have increased confidence in the krona at the time. The exchange rate policy adopted in 1985 continued unchanged throughout the 1980s until spring of 1991, when Sweden pegged its krona to the European currency basket, the ECU.⁶⁶⁷

Sweden was an important model for Finland but not the only one. It was a pronounced trend in continental Europe in the mid-1980s that central banks tried to eliminate exchange rate changes entirely and to liberate capital movements. For Finland the relevant peers in exchange

rate policies were small European states such as Austria, the Netherlands and Denmark. These countries sought to link their currencies very closely with the German Mark in order to be able to benefit from the strong credibility that German monetary policy had obtained. The desired goals were slower inflation and sustainably lower interest rates.

The linking of Austria, the Netherlands and Denmark to German monetary policy happened by stages and in varying ways. *Austria* was the first to adopt a tight D-mark peg. It had begun to pursue a hard currency policy (*Hartwährungspolitik*) in the 1970s, when the Austrian Schilling was allowed to appreciate against other currencies in order to curb inflation. The National Bank of Austria announced that it was managing the Schilling exchange rate against a basket of different currencies, but in practice it was tracking the German Mark, which became an ever more important anchor for the Austrian exchange rate during the 1970s. The aim was to control the rise in consumer prices and thus create conditions for moderate wage rises in Austria's centrally negotiated incomes policy system. The nation's labour unions, the finance ministry and the national bank were firm advocates of a hard currency.⁶⁶⁸

The last exchange rate adjustments of the Austrian Schilling vis-a-vis the German Mark were made in 1979 and 1980, during the second oil crisis, when the Schilling was allowed to appreciate slightly. After this, Austrian exchange rate policy became entirely passive in tracking the Mark. The mutual exchange rate was kept virtually unchanged at 7.03 shillings per Mark throughout the 1980s and 1990s. This successful policy of a fixed exchange rate was pursued until Austria entered European Monetary Union as one of its founder members. For most of this time its policy was based on a unilateral commitment because the Schilling was not officially linked to Europe's Exchange Rate Mechanism until January 1995, when Austria joined the EU.

The Netherlands was one of the European countries that had pursued a strong exchange rate ever since the collapse of the Bretton Woods system. Although it attempted to shadow German policy, the Dutch guilder (gulden) depreciated against the Mark during the 1970s. The establishment of the European Monetary System (EMS) in 1979 reinforced the link with the Mark however, and in the EMS realignments of the 1980's the guilder was already tracking Germany's currency.

There was only one exception to this policy. In the realignment that took place on 21 March 1983, the guilder was devalued by 2 percent against the Mark, a move advocated by Finance minister Onno Ruding but deplored by governor Wim Duisenberg of the Dutch central bank. The results of this small but controversial devaluation were not encouraging, which is seen as the reason why the guilder was kept tightly pegged to the German Mark from spring 1983 until European Monetary Union at the end of 1998. The guilder's central rate (1 guilder = 0.887526 Marks) thus remained in force for almost 16 years.⁶⁶⁹

In the 1970s, *Denmark* like the Netherlands was a member of the currency snake of the EC countries and it joined the Exchange Rate Mechanism when it was established. However, inflation in Denmark was faster than in the anchor country of the system, Germany, and the Danish krone was devalued on several occasions during the 1970s and in the early 1980s. In September 1982, the new government of conservative Prime minister Poul Schlüter announced that Denmark was renouncing devaluation as a tool of economic policy. Its new hard currency policy was severely tested only four weeks later when Sweden devalued by 16 percent but the Danish krone withstood the strain.⁶⁷⁰

Within the European Monetary System the Danish krone was no longer formally devalued after 1982 but because Denmark did not always follow Germany's revaluations when exchange rates within the system were adjusted, the krone's central rate deteriorated slightly against the German Mark in 1983, 1986 and finally in January 1987. At the same time the Danish current account deficit increased. In October 1986 the Schlüter government initiated an economic programme, known as the potato diet (*kartoffelkuren*), intended to control borrowing. The programme toughened conditions for home purchase loans and imposed a tax on consumption credit to households. In the years ahead the balance on the current account improved significantly. The exchange rate adjustment against the German Mark in January 1987 was the last. Thereafter the krone was pegged first to the Mark and from 1999 to the euro. Denmark was not alone in this. In spring 1987 the whole of the EMS moved to a period of stable exchange rates, not merely for small countries but also now for France.⁶⁷¹

France adopted a fixed exchange rate policy after the failure of flexible exchange rates at the start of the 1980s. The short-lived experiment with a soft currency began when the socialists rose to

power after the elections in 1981, when François Mitterrand became president. The expansionary economic policies initiated by the socialist government soon led to balance of payments problems and a series of franc devaluations within the EMS. Measured in German Marks, these exchange rate changes reduced the value of the franc first by 8.1 percent in October 1981, then by 9.6 percent in June 1982 and again by 7.6 percent in March 1983.

By this point it was clear that France had to choose between leaving the Exchange Rate Mechanism or revising its economic policies. A few days after the devaluation of March 1983, Finance minister Jacques Delors published a new government economic programme aimed at slowing down inflation and balancing the trade account. It was in fact a U-turn in economic policies. It applied tax hikes, froze public spending and ended the index linkage of wages.

In the years ahead France's inflation was reduced but its international competitiveness still had to be corrected with two exchange rate adjustments against the German Mark. The government of Jacques Chirac, formed after the election victory of the right in spring 1986, devalued the franc 5.8 percent against the German Mark on 6 April. At the start of 1987, when the franc came under speculative attack, the crisis was resolved by revaluing the German Mark against the franc by 3 percent (12 January 1987).

Thereafter France redoubled its efforts to create a *franc fort*, and tried to avoid exchange rate adjustments entirely. The central rate of the franc set on 12 January 1987 (1 German Mark = 3.35386 francs) became the cornerstone of this policy and was successful. The central rate did not have to be changed at all until both currencies were merged into the euro 12 years later. Reflecting the growing credibility of the franc fort, interest rate differentials between France and Germany shrank steadily and became much smaller than in the early 1980s.

In other respects, too, 1987 marked a transition within the EMS to a new stage in European exchange rate policies. After the realignment of rates in January, preparations began for a strengthening of the EMS system so that it would be better able to withstand speculative pressures. The result was the Basel-Nyborg Agreement, signed in September 1987, which strengthened lending arrangements between central banks of the system and improved the flexibility of loans to

support currencies. At the same time the member countries pledged to increase their monetary policy coordination and to make better use of interest rate policies so as to increase the stability of exchange rates.

The effectiveness of the Basel-Nyborg Agreement was tested within a few months of its birth, by a crisis which originated in the dollar market. The New York Stock Exchange experienced a Black Monday on 19 October 1987, when share prices collapsed. The US dollar fell significantly against the German Mark and other currencies, by over 10 percent in a few weeks. The declining dollar caused strong tensions between European currencies but the EMS withstood them. Part of its resilience was due to the new tools that the Basel-Nyborg Agreement had given central banks.⁶⁷²

The evolution of a “hard EMS” formed the backdrop, during the last years of the 1980s, for the resurrection of plans for European Monetary Union, and also for a more ambitious approach to exchange rate policies by non-EMS countries. The wave of fixed rate policies advanced in Europe throughout the 1980s and culminated in October 1990 when Britain finally joined Europe’s Exchange Rate Mechanism. As exchange rates became more immovable, Germany’s monetary policy came to set the target and benchmark for other countries, whether they admitted it or not.⁶⁷³

Although Finland and Sweden were not members of the European Community, their endeavours in exchange rate policies in the late 1980s and early 1990s have to be seen against the backdrop of increasingly fixed European exchange rates. Naturally, other factors played a part, too. On the side of economic theory, Keynesianism had yielded to a new doctrine that was more categorically opposed to inflation. In large economies this was expressed in monetarism but in the smaller countries the new trend was generally expressed as an emphasis on fixed exchange rates. Finnish policy was influenced also by the traditional critical attitude of the labour unions to devaluations because of the effects on inflation and income distribution. However during the 1980s Finland was opening its economy to the outside world and Finnish companies were becoming more international so, while in no way disparaging the considerations of economic doctrine or incomes policy, the change taking place in European exchange rate policies has to be seen as a critical stimulus for Finland’s “strong markka” policy.

THE YEARS OF OVERHEATING

In the course of 1987 it became clear that there was no foundation for the fears that Finland would drift into recession, which had been raised during the strident debate in 1986 on eastern trade and exchange rates. The growth of exports to western markets was quite adequate to compensate for the decline in sales to the east. When Finnish real incomes were further boosted by the declining price of oil imports, domestic consumption also picked up. Even inflation was relatively moderate (thanks in part to lower oil prices) and remained below 4 percent, as measured by consumer prices.

Amid the apparently tranquil money market conditions of summer 1987, the board of management of the Bank of Finland decided to continue the deregulation of capital imports, begun the previous year. In 1986 long-term borrowing by industry had been decontrolled and now the same freedom was extended to all enterprises. Service and construction companies would also be allowed to obtain bank-mediated foreign currency loans from abroad.

A key argument for deregulating foreign borrowing by all companies was that special treatment for industry and some other branches had led to distortions in the money market. One consequence was that industrial enterprises had begun to pass foreign loans on to other companies in the form of notarial credit, denominated in foreign currency and brokered by the banks. A proposal on the subject by the Bank of Finland's foreign exchange department called this a "subsidy privilege" to banks and the companies permitted to import capital. The proposal, to the board of management, said that "an effective and durable way to decrease these problems is to act on their original cause. An expansion of the set of companies permitted to import of long-term capital will increase competition and efficiency in the domestic money market. At the same time it will give equal treatment to all companies regarding foreign finance, the subsidy privilege will decline and the rationale for notarial credit in foreign currencies will disappear."⁶⁷⁴

The decision to allow all companies to take long-term loans from abroad – also through banks – came into effect from the start of August. According to a press release, it was not expected to lead to a significant increase in capital imports.⁶⁷⁵ It was also proposed in

summer 1987 that foreign borrowing by municipalities should be allowed but this was not yet done. It was not their turn, nor the turn of municipally-controlled companies, until summer 1988.

The government programme had expressed the desire for lower interest rates but in autumn it became clear that the Bank of Finland had no intention of reducing rates below their present level, where 3-month Helibor, the newly defined short-term market rate, was now about 9.5 percent and the Bank of Finland's base rate was 7 percent. The main reason was that the outlook had changed in the bank's economic forecast, completed in September. Aggregate consumption and its component forecast for growth of private consumption had been revised sharply upwards. Inflation was expected to accelerate. The forecast for the current account pointed to a distinctly larger deficit. The governor of the Bank of Finland announced that the government's budget proposal would not create conditions for a cut in interest rates, coining the phrase "a festival of consumerism".⁶⁷⁶

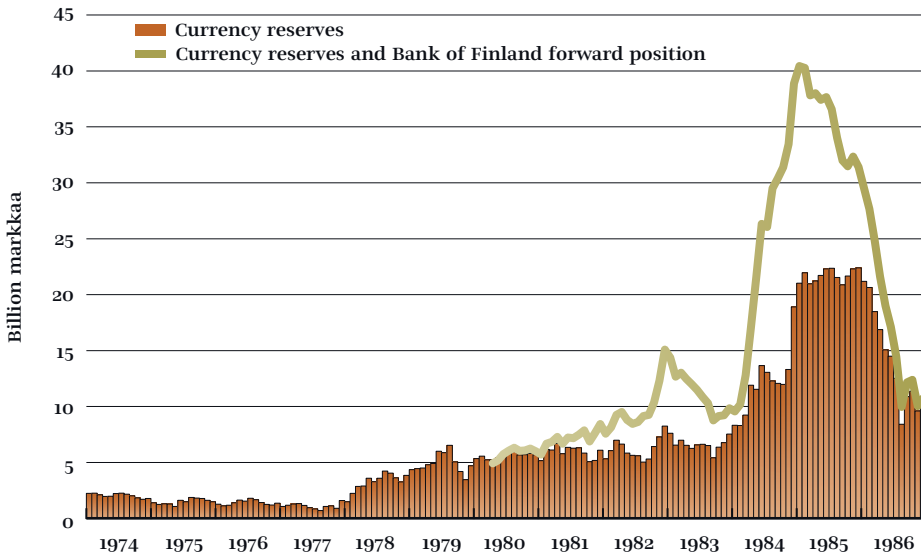
The matter evolved into a public debate between the finance minister and the governor. In a speech in parliament on the budget, Finance minister Liikanen mentioned Kullberg's statement and said that it could create problems for the Bank of Finland's credibility if it encouraged the view that, whatever the conditions, there would always be one more reason to postpone a cut in interest rates. It was important for the bank's credibility that, at some point in time, it would play its part in a policy it had been demanding, Liikanen said. The dispute about coordinating fiscal and monetary policy ended after just over a week in a joint appearance by the finance minister and the governor, when they announced their common view that the interest-rate level could be reduced the following spring, subject to the condition that the incomes policy settlement supported slower inflation and that the government's budget proposal was passed by parliament without amendments.

Meanwhile, however, officials at the Bank of Finland had reached the conclusion that the economy required tight monetary policy in the near term and that a reduction in the interest rate level was impossible. In connection with an overall economic forecast, presented to the board of management in October 1987, a policy memorandum was also distributed that examined various ways to combat economic imbalances. Written by the bank's foreign exchange department, the

memorandum stated that Finland faced the dual problems of faster inflation and current account deficits. The memorandum proposed tighter monetary policy: “market interest rates should be no less than the present level” and there was no “economic justification” for a cut in base rate. The effect of interest rates should be reinforced “by permitting the external value of the markka to continue to strengthen rather freely under market pressures”. It also recommended that the board should consider symmetric enlargement of the fluctuation band of the currency index, for example to the 6-percent band prevailing in 1979–1982 or, alternatively, to dismantle controls on capital exports in order to tighten the money market. Furthermore the cash reserve deposit requirement should be increased and the Bank of Finland should try to influence fiscal policy.

Responding to strong capital imports in 1987, the Bank of Finland allowed the markka to appreciate gradually on the foreign exchange market. By the end of the year the currency index was already very

BANK OF FINLAND CURRENCY RESERVES 1974–1986



New time series method used from 1975.

Source: Bank of Finland.

close to the floor of the fluctuation band so it was not surprising that the idea, raised in the autumn, of widening the band was taken up again in January 1988. According to a memorandum to the board of management “there will apparently be a future need to set exchange rates more flexibly, to give more leeway in monetary policy and to stabilise interest rate movements. This requires the fluctuation band, which is relatively narrow for the present conditions, to be widened.” The board regarded the idea as warranted because in other respects the bank’s influence over the national economy had declined in recent years. However it regarded the timing as problematic and decided to revisit the matter later.⁶⁷⁷

In 1988 bank lending in Finland began to increase month after month. Lending by savings and cooperative banks had already turned sharply upwards the year before, but now the commercial banks too began to expand their lending. At the same time the current account deficit widened and inflation began to accelerate. These conditions offered no opportunity for the cut in interest rates that had been promised in the previous autumn. On the contrary, at the start of May the board presented the supervisory council with a proposal for raising base rate by one percentage point, arguing that consumption growth had to be curbed. Otherwise economic balance might even worsen “at the end of the year or by the start of next year”.

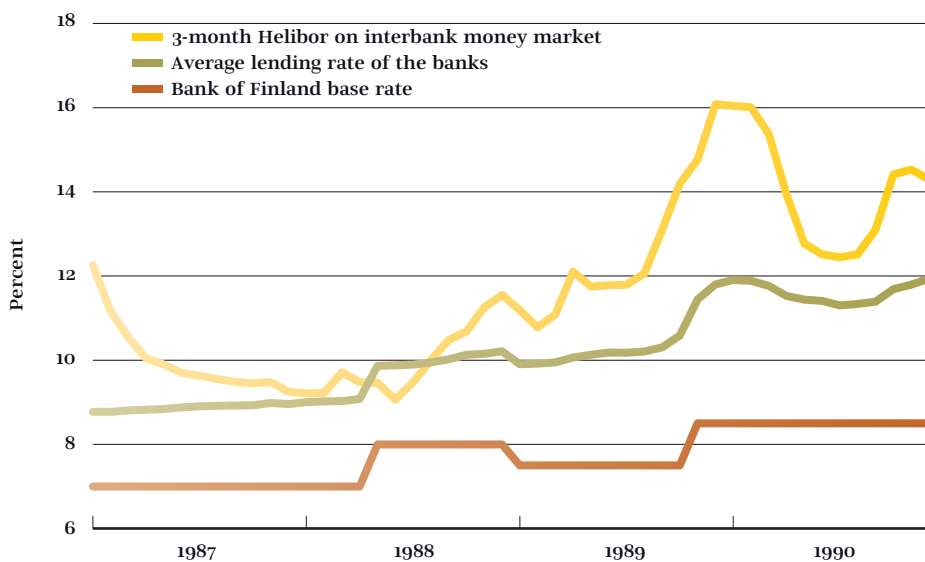
The board said that it was forced to move the base rate because market rates were already relatively high and could not be increased much without the danger of stimulating capital imports. In the board’s view, therefore, the efficacy of market rates as a tool of monetary policy had already been eroded. Furthermore, it wanted to focus the measures to restrict growth of aggregate demand specifically on private consumption which, it told the council, had not been very strongly affected by market rates.⁶⁷⁸ During the council meeting the board said that the interest rate increase had also been discussed with the government. The supervisory council approved the rate hike, which came into effect on 16 May 1988. Base rate was now 8 percent.

At the end of the year, however, the board had to reverse itself on interest rates, because of incomes policy. The government was aiming to reduce inflation by means of an overall incomes policy settlement, in which the state’s part was the promise of income tax cuts for wage earners in return for moderate wage agreements. The *Recommendation*

for a joint settlement of economic and incomes policies was signed between the government and central labour market organisations on 23 August. It recommended nominal wage increases of only slightly over 1 percent in 1989. A couple of weeks later, after the central labour market organisations had approved the package, governor Kullberg announced that the board of the Bank of Finland was ready to propose a cut in base rate by half a percentage point in December, if all the relevant parts of the package were adopted in the labour market.

After matters were settled at the individual union level too, the board kept its promise and, in November, asked the supervisory council to cut base rate to 7.5 percent from the start of 1989. However, as an additional element to tighten the money market, it also proposed that the fluctuation band of the currency index be widened from 2.25 percent to 3 percent around the central point of the band, while leaving the central point unchanged. Because the markka had been close to the floor of the band, the practical significance was that the markka would have a little extra room to appreciate. The supervisory council approved both proposals at its meeting on 30 November 1988.

KEY INTEREST RATES 1987-1990



Source: Bank of Finland.

As noted above, an enlargement of the currency index fluctuation band had been under preparation within the Bank of Finland since the start of 1987. It had now been triggered by the appreciation of the markka and the fulfilment of the bank's promise to cut base rate. The extent of permitted fluctuations in the markka's external value had long been an issue that pitted the authority of the government against the powers of the Bank of Finland. This time, too, the Justice Chancellor was asked for a statement on widening the fluctuation band. He endorsed it. Meanwhile (acting) board member Markku Puntila told the council that an even greater enlargement of the band was probably needed but that, judging from past discussions, this was as much as was possible now. There were no chances of getting a wider band than 6 percent, Puntila felt.⁶⁷⁹

At the turn of 1989, therefore, the Bank of Finland cut interest rates only reluctantly. According to its yearbook, "the cut in base rate would have been in conflict with the state of the economy if it had been an isolated measure, because a high interest rate level was still needed to curb domestic demand. But the Bank of Finland regarded the implementation of the general stabilisation measures as important and wanted to play its part in promoting them. Broadly adopted, the package of measures served to curb the rise in costs so base rate could be reduced."

In practice, however, it was not till the following spring that effective action was taken to control overheating in the credit market. The new and exceptional tools then employed to curb lending came too late to balance the economy. But to interpret the trends of the time in the money market, one must examine the liberalisation that took place in the 1980s and its impact on bank lending. That is the subject of the next chapter.

CRUMBLING FOUNDATIONS

MONEY MARKET IN FLUX

The weak and ultimately inadequate attempts to control the cyclical upswing and overheating of the economy in the last years of the 1980s relied partly on traditional economic policy instruments (such as the base rate, incomes policy agreements and budgetary policy), and partly on new instruments of market-oriented monetary policy (the market rates of interest and the flexibility of the exchange rate within its defined band). It became clear only later that the stability of the Finnish economy was threatened by an entirely new set of problems, caused by the instability of the banking system.

Over the decades when the financial system had been administratively regulated, its stability was almost axiomatic. Most of the risks that characterise banking were conspicuous by their absence. Administrative control of interest rates, and the tax system on which it was based, created conditions where interest competition and interest rate risk were almost unknown to bankers. The system kept interest margins stable and fairly wide. From the 1950s onwards the margin between bank borrowing and lending rates steadily increased and passed the level of 4 percentage points in the 1970s. From the present-day perspective, bank profitability should have been rather good, but it was not, because the banks were preoccupied with offering more free services and making their already elaborate branch networks even denser. In fact, this competition in services between the banks was the substitute for competition with interest rates. The result for

the banks was a heavy cost structure, relatively low profitability and little opportunity for accumulating equity capital.

Tough controls over capital imports had prevented loans denominated in foreign currencies and eliminated exchange rate risk. The risk of credit losses in turn was reduced by systemic elements. Tough controls on funding together with regulated interest rates resulted in general excess demand for credit, so unsuitable applicants were routinely weeded out. Furthermore, the average interest rate cap that formed the basis of lending rate controls meant that if a debtor got into difficulties, a bank could lower interest rate charges on that customer, or charge him no interest at all, without incurring much overall loss. This further reduced credit losses. In practice the only real risk faced by the banks was the risk of being unable to refinance. Under conditions of continuous excess demand for credit, there was a great temptation to risk their liquidity and increase lending. A stabilising feature of the old system was that the rate of growth of the stock of credit had to remain within the limits set by the growth of deposits and was therefore rather modest. Without structural changes in the savings rate, deposits could not grow much faster than the national economy as a whole.⁶⁸⁰

The central bank, responsible for systemic stability, was also convinced that Finland was immune to any crisis threatening the whole financial system. This was clearly expressed in reports in the 1960s and 1970s of committees and working groups dealing with banking law. Individual banks might get into trouble but they could be bailed out by the mutual support arrangements of their respective banking group. The only exception had been the crisis at OKO in 1966, when the Bank of Finland had to come to the rescue. There were tools in place for dealing with such crises; each banking group – commercial, savings and cooperative – had its own statutory guarantee fund that always looked after individual banks in trouble. It was believed that systemic risk did not exist. Neither the central bank nor the bank inspectorate had expressed concern when banking legislation, taking effect in 1970, did nothing to raise capital adequacy requirements, although they were low by international standards. Only this background makes it explicable that, in the 1970s, these low capital adequacy requirements were further relaxed. It could even be said that the law was eviscerated.

However conditions changed after the start of the 1980s, as the regulations began to spring leaks and pressure grew for the gradual

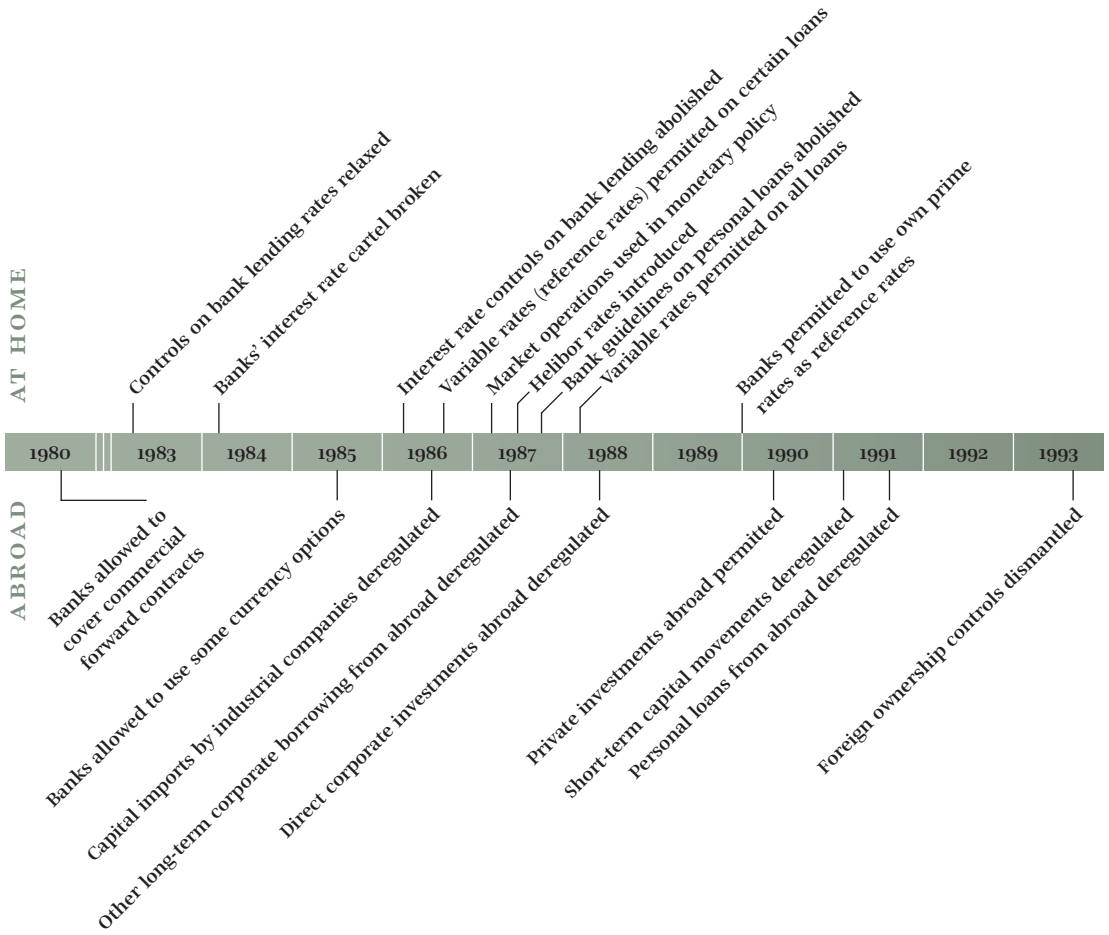
abolition of the whole system of controls. This was a self-sustaining process, one leak leading to the elimination of dysfunctional restrictions, which created new leaks and more deregulation.

The Bank of Finland's operations in dismantling regulations were focused on three sectors. These were the deregulation of capital imports from abroad, the elimination of interest rate controls on lending, and the bank's own move to open market operations for regulating liquidity in the financial system, in place of credit quotas and administratively determined interest rates. This last measure created a genuine short-term Finnish money market operating on market terms.

The deregulation of capital imports from abroad was part of an international trend dating from the 1970s. Finland, as a member of the OECD, was committed to the gradual deregulation of capital movements, although in fact it was repeatedly allowed to postpone practical implementation. European economic integration increased the pressures for deregulation in the 1980s.

Finland's first concrete step towards deregulating capital imports had come when forward currency market operations, used by exporters to hedge their foreign claims, were moved from the Bank of Finland to the commercial banks in 1980.⁶⁸¹ This soon resulted in a rapid growth of foreign funding for commercial banks. During the 1970s, foreign funding on the balance sheets of commercial banks (excluding OKO and SKOP, the central institutions of the cooperative and savings banks groups) was at a settled level of some 20 percent but by 1984 the share had doubled more than 40 percent.⁶⁸² This shows that short-term foreign funding had become very significant in the operations of commercial banks, even before the actual elimination of currency controls. There was no return from the nascent path of deregulation. It also meant that, when the dismantling of capital controls got properly underway in 1986, the main beneficiaries were the savings and cooperative banks, because the commercial banks had already adapted to the new business environment. Virtually all companies were granted the right to borrow in foreign currencies in 1987. For public bodies – municipalities and towns – this was allowed in 1988. The freedom was finally extended to private individuals in 1991 so, for all but individuals, the restrictions were dismantled on a fairly rapid schedule, within a couple of years.

DEREGULATION OF FINNISH FINANCIAL MARKETS



Source: Hämäläinen, S., 1996.

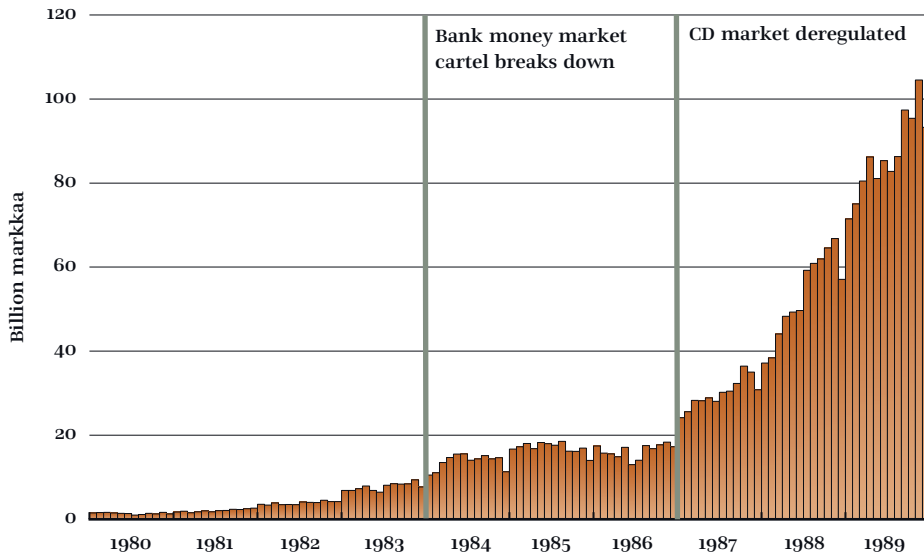
The abolition of interest rate controls was preceded by a sort of backward step at the turn of the 1980s, when the Bank of Finland suddenly began to tighten the system of regulations. In autumn 1977 it announced a plan for interest rate moderation meant to apply to all banks, in order to support government measures to stimulate the economy. The long rise in lending interest rates had to cease, the Bank

of Finland said, and the banks were instructed to lower their average lending rates by 1982, in accordance with a schedule set for each bank group. The cooperative and savings banks in particular responded that the schedule was impossible to implement, whereupon the Bank of Finland granted them two more years – till 1984 – to implement the cuts. Their schedule of rate cuts was also back-loaded. The plan was imposed not merely by a circular sent to the banks; each was also required to send the Bank of Finland detailed implementation reports.⁶⁸³

In fact, the central bank reversed its policy while the rate reduction plan was still in force, because of the market distortions it created. High inflation in the 1970s had led to a situation where real deposit rates were negative, so it was very unprofitable for companies to invest liquid funds at a bank. At the same time, tough controls had created chronic excess demand for credit. Under these conditions, companies preferred to handle their own deposit and lending operations without bank intermediation. The emergence of this grey money market greatly worried the banks because it ate into their traditional business. They responded fairly rapidly with financial brokerage operations that were beyond the sphere of interest rate controls and even to some extent taxation. They transferred the money brokerage operations to their notarial departments or to subsidiary finance companies that were not governed by bank laws. They also began offering debt securities such as debentures as investment objects that bypassed interest rate controls. The most profitable sort of activity was “round-tripping” where funds obtained cheaply in the regulated sector were channelled into unregulated markets.⁶⁸⁴ The greater the differential between rates in the two markets, the greater was the incentive to transfer funds from the former to the latter.

The special features of Finland’s trade with the Soviet Union added to the flows of money outside the regulated system. Major corporations trading with the Soviet Union received large advance payments, which they wished to relend so as to maximise profits. Initially they lent the money direct to other companies but soon the banks began acting as brokers, in operations classed as “special lending”. Another major source of finance was capital inflow linked to forward contracts in foreign currency. The commercial banks offered their customers forward contracts and hedged the associated currency risk by

MARKET MONEY VOLUME 1980–1989; BANK FUNDING BY
 “SPECIAL BORROWING” AND CERTIFICATES OF DEPOSIT



Source: Bank of Finland.

borrowing in international markets . The funds so acquired could then be deposited in the call money facility at the Bank of Finland. When the Bank of Finland had allowed the commercial banks to start taking forward positions in foreign currencies, it had regarded this as a technical solution that would not have much impact on the system for regulating international capital movements. This assessment proved to be wrong. Forward contracts soon developed into an important mechanism for mediating short-term capital imports.⁶⁸⁵

Detailed data on the volume of market money is not available but a study by ETLA research institute shows that the volume of market money in the balance sheet of commercial bank groups began growing rapidly in the second half of 1981 and continued to accelerate until 1984. At that time money constituted slightly over 20 percent of markka deposits in commercial banks (excluding SKOP and OKO) and about 7 percent in the savings and cooperative bank groups.⁶⁸⁶ If off-balance-sheet notarial deposits had been included, the proportion would have been slightly higher still.

The term “market money” was used to describe the special funding from domestic markets obtained by the banks or their subsidiary finance companies, at interest rates higher than the cap allowed for the banks’ average lending rate. The diagram opposite indicates how abruptly the change happened. The volume of market money had increased during the first half of the 1980s but by the mid-decade the stock had stabilized to about 15 billion markkaa. The emergence of a genuine money market in the form of large-denomination certificates of deposit in 1987 changed the situation dramatically. Within the year, CDs became the most important instrument in the money market and by the end of 1989 the volume of special deposits and CDs had grown fivefold, compared to the situation in 1986.

This was a difficult situation for the Bank of Finland because the expanding grey money market meant that an increasing amount of banking was unaffected by the monetary policy of the central bank. It saw that interest rate controls were no longer impermeable and thought that the only realistic option was interest rate deregulation, so as to eliminate the incentives to operate outside the system. It began this process in 1983, when it allowed the banks to pass on some of the interest charges on funds obtained on the grey money market. Initially it allowed 40 percent of these costs to be reflected in lending rates. In the following year it gradually raised the proportion to 60 percent. As already mentioned, average interest rate controls on lending were finally entirely abandoned in 1986. An interesting detail of this process is that the prevailing terminology changed at the same time; “grey market money” was replaced in 1983 by “funding on market terms”. The shift to market funding was accelerated by the collapse in 1984 of the banks’ money market cartel.⁶⁸⁷

The elimination of interest rate controls allowed the development of a genuine short-term interbank money market. It can be said to have begun in 1983–1984, when the central bank stopped using individual bank credit quotas to regulate liquidity and moved to a fixed overnight interest rate. In 1986 the call money credit rate and the call money deposit rate were separated because the Bank of Finland wanted liquidity equalisation in the financial system to be handled by an interbank market. It replaced its overnight lending to banks with fixed-term loans of 1–3 months that were auctioned to the banks. The regulation of liquidity by open market operations was ultimately

implemented in 1987, when the central bank ceased to provide these fixed-term loans. In its place came a genuine interbank short-term money market, in which the central bank was but one participant. Certificates of deposit issued by the banks and the Bank of Finland were used as the basis for open market operations. The Bank of Finland encouraged the use of CDs by exempting them from the cash reserve deposit requirement in 1987. At the same time the Finance ministry raised each bank's CD quota high enough to eliminate all restraints on the market. The first CDs were issued in 1982.⁶⁸⁸

By buying CDs in the market, the central bank increased liquidity in the financial system and by selling them it reduced liquidity. The prevailing money market interest rate was set by supply and demand. When monetary policy shifted to market mechanisms steered by the Bank of Finland, short-term capital flows in the form of CDs, which had previously been off bank balance sheets, moved back into the banking system.

The deregulation process described above had effects on the whole national economy that were to be extremely important, good and bad. It diversified the banks' funding sources and caused a sharp increase in their balance sheet totals. Growth of lending was no longer linked to savings by the public. The banks could also grant foreign currency loans and obtain funding from the short-term money market, which regulations had previously placed off-limits. Meanwhile, the deregulation of interest meant that rates were set by the market on the basis of supply and demand, rather than being imposed by officials. The interest rate regained its primary function as an allocator of capital.

During the transitional period lasting through the 1980s, all banking risks increased many times over. The right to grant foreign currency loans entailed an exchange rate risk, even though the central bank insisted that there would be no return to the old devaluation cycle. Funding on the short-term money market led to a widening gap between borrowing and lending maturities, which in turn meant an increase in liquidity risk. This form of funding also contained a greater interest rate risk than before and the term "interest rate squeeze" now began to be heard in the Finnish banking world. The main cause of the squeeze was that market funding increased immediately while fixed-rate lending remained at a high level for years ahead. There was also a new credit loss risk, when banks with greater opportunities to lend

began to compete for customers for the first time in decades. The proportion of risky loans started to climb.

There is no doubt that risks were amplified by the way deregulation decisions were taken. Controls were generally abolished step by step, the central bank noting that banks had already found ways to circumvent them so eliminating them would have no great practical impact on banking. At the same time, however, the way that individual actions combined to change behaviour was forgotten. One example is the 1987 decision on open market operations. The central bank's aim was to control financial market liquidity using certificates of deposit but at the same time it ignored the opportunity that CDs offered to individual banks for almost unrestricted funding. Another example was the tightening of monetary policy in 1988, which brought a steep increase in domestic interest rates.⁶⁸⁹ The consequence was a sharp increase in foreign currency lending, stimulated by the rate differential between Finnish and international capital markets. However, the greatest risks of all came from the defunct philosophies that underpinned banking legislation and supervision, and that remained in force throughout the deregulation process. These philosophies had their roots in the period when banking was tightly regulated. They failed to recognise such basic banking concepts as asymmetric information, moral hazard and the relationship between return and risk.

CREDIT EXPANSION ACCELERATES

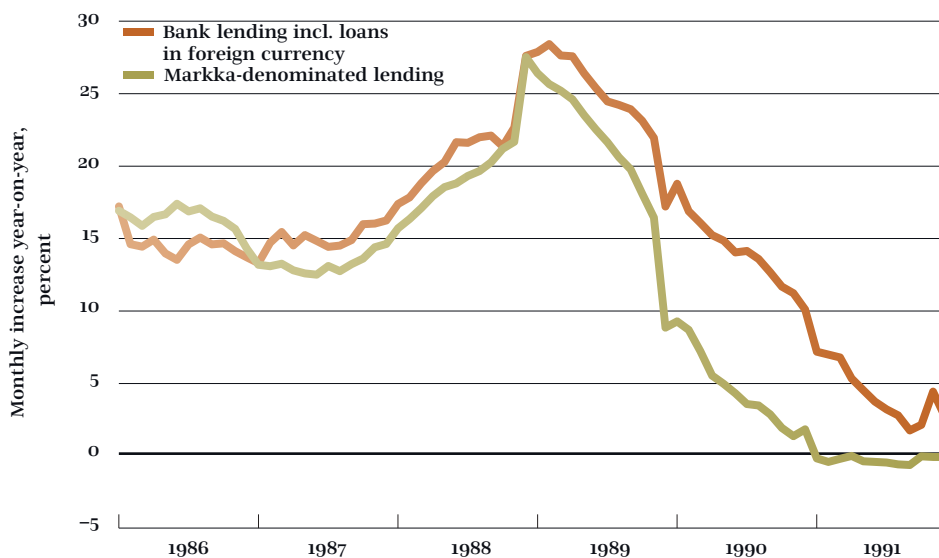
The combined stock of bank loans in markkaa and foreign currencies continued to grow at the still fairly moderate pace of 10–15 percent until mid-1987. Surprisingly, the first phase of deregulation in summer 1986, regarding currency loans, initially led to hardly any growth of lending. On the contrary, devaluation speculation in summer 1986 created general economic uncertainty, which in turn led to a slowdown in the demand for credit in the second half. An uptick did not begin until autumn 1987, when the rate of growth of lending rose above 15 percent. At that time the volume of markka-denominated loans funded from foreign currency and market money began to increase steeply. Finnish banks had finally broken with their old ways, dating from the years of administrative banking regulation, where the expansion of lending depended on little else than the growth of retail deposits.

In 1987 bank lending already increased by about 19 percent but this was only a prelude. By summer 1988 the growth rate had surpassed 25 percent and, at the very end of the year, lending growth was completely unfettered. In December 1988 alone, the stock of lending was nearly 6 percent higher than the month earlier, the fastest monthly increase in Finnish economic history. The growth of loans in 1988 as a whole was some 31 percent. Naturally there were differences between banking groups. The fastest growth was in the savings bank group, above 35 percent, and the slowest in Postbank, a little below 30 percent.

Such large demand for credit cannot be explained by fast economic growth alone. A tax reform coinciding with the end of 1988 provided strong extra impetus. The watchwords of the reform were equitable taxation for different sources of income, simplification, less progressivity and a broader tax base. It was due to take effect from the start of 1989, but it had been mooted since 1987. By autumn 1988, the schedule for the reform was very widely known.⁶⁹⁰ One of the changes due at the start of 1989 was tougher taxation of capital gains. With just a few exceptions, they were now to be taxed regardless of the period from which they accrued, whereas previously the capital gains on assets held for longer than 10 years had been untaxed. The old system was to remain in force until the end of 1988, so private entrepreneurs had a strong incentive to sell their businesses before then and avoid tax on the income generated. The effects culminated in December 1988, when the stock of credit was boosted by sales of businesses to the record level noted above.

According to data collated by *Talouselämä* business magazine, only about 400–500 businesses were sold each year in 1984–1987. In 1988 the figure rose to 680 and in 1989 it reached 820. The 1989 figure is actually too high because it contains many deals finalised in 1988 but not recorded until later because of a backlog at the registry. The number of businesses sold in 1988 was at least twice as high as in earlier years. If the statistics had also recorded real estate deals, they would have been far higher still.⁶⁹¹ The situation suited bankers because large commercial banks not only benefited from the financial transactions involved but also served as brokers in many deals. Nor did financing the buyers strain a bank's liquidity, because it was common for the seller to deposit the sum received in a fixed-term account at the bank that had financed the deal. This is shown by the stock of bank deposits, which turned up very steeply at the same time, in December 1988.

GROWTH OF LENDING BY DEPOSIT BANKS 1986–1991



Source: Bank of Finland.

The organisations that monitored banking, such as the bank inspectorate and the central bank, became aware of these developments only afterwards but banking insiders realised what was going on at the time. In a later interview, the then-CEO of the Union Bank of Finland, Ahti Hirvonen, commented: “There’s one matter that I’ve hardly seen aired at all. It was certainly a question of bad luck but of course it was also bad government coordination that led to the change in taxation on capital gains at the end of 1988. For us, at least, it cost billions in credit losses. I have tried to make sense of it since then – this enormous boom in business and real estate deals. Everyone wanted to get the profits tax-free and I also talked about it with (Bank of Finland director) Markku Puntila. These deals were completely unaffected by any monetary policy measures because, when they were financed, the seller deposited the money in tax-free accounts that paid relatively low interest. The buyer received a low-cost loan from the same bank and the whole operation looked good to the buyer’s bank. The only problem was that the sums paid rose far too high. Then the prices of businesses

and property dropped 50 percent and almost all the buyers went bust. I think this was a process that no one had thought through properly. I believe it was one of the fundamental reasons for the banking crisis.”⁶⁹² Hirvonen believed that the boom had jeopardised the stability of the whole financial system but that no one had realised the consequences at the time.

It was not until 1991 that the credit stock growth rate started to fade, and by that time the volume of loans was approaching 400 billion markkaa. It had more-than-doubled in the six years since 1986, when deregulation had begun. It still increased slightly in 1991 but this was mainly because the devaluation on 15 November 1991 increased the markka value of loans denominated in foreign currencies.

This phase of excessively fast credit growth after deregulation has been widely discussed and is regarded as one of the main factors behind the banking crisis.⁶⁹³ Less attention has been focused on how short the phase of rapid growth actually was. A study of growth by calendar year shows that in only three years, from 1987 to 1989, were growth rates distinctly higher than before and afterwards, specifically 19%, 31% and 16%. The period of exceptional growth was even shorter. Monthly figures show that lending did not begin climbing fast until January 1988 and was already fading by March 1989. By this measure the credit boom lasted only 14–15 months.

The situation for bank funding remained fairly normal until spring 1987. At that time the stocks of markka loans and the volume of markka deposits were roughly equal in size. When loans began to grow faster it was because they were being financed from international money markets. At the start of the 1980s foreign currency loans accounted for “only” about 10 percent of all lending by Finnish banks. This proportion almost doubled to 20 percent by the end of 1985. The differences between banking groups were fairly large at this stage. Among commercial banks, foreign funding was about 40 percent of the balance sheet while in the savings bank group it was less than 8 percent and among cooperative banks under 5 percent.

The uptick began in summer 1988 but it was not until the second half of 1989 that foreign currency loans entered a period of real boom. By the end of 1990, loans denominated in foreign currency were almost 40 percent of the value of markka loans and remained at this level for several more years. Their volume had increased by a factor of four in

1985–1991, from 25.7 billion markkaa to 110 billion markkaa. The stock rose fastest in 1990, the year before the financial collapse in Finland, when the increase was 31.8 billion.

Demand for foreign currency loans was fatefully linked to monetary policy, in a way that may not have been immediately grasped at the Bank of Finland. When monetary policy was tightened in 1988, the practical result was higher domestic interest rates, which fanned the demand for foreign currency loans. With the growth of the interest rate differential between home and abroad, foreign currency loans became more attractive. Tighter monetary policy failed to slow down the overall growth of lending but shifted it towards lending in foreign currencies. The interest rate differential between the markka and the foreign currency basket was at its highest in 1990, which was also the year when the stock of foreign currency loans increased the most. Such was public confidence in the permanence of the markka exchange rate that borrowers did not interpret the interest rate differential as evidence of a higher exchange rate risk.

Alongside the growth of financing in terms of foreign currencies, another major change in bank funding was caused by the short-term money market. The market began to grow rapidly after the elimination, in 1987, of institutional barriers to using new money market instruments, such as certificates of deposit issued by banks and commercial paper issued by companies. The volume of these securities rose from some 5 billion markkaa in 1986 to more than 100 billion in 1989.

The Bank of Finland's aim had been to develop new monetary policy tools, replacing administrative controls with market-based control that could be directed by open market operations. For this it needed a money market, in which its operations could regulate interest rates and bank liquidity.

In Finland the government's domestic borrowing was so minor that government securities could not form the foundation for open market operations. Instead the Bank of Finland chose bank CDs and other commercial paper as the necessary financial instruments. Only later did short-term government bonds enter the picture. At the time of its move to market-oriented liquidity control, the central bank was concerned that the market for CDs might be too thin to allow genuine open market operations. To solve the problem, it agreed ground rules with the commercial banks that would expand

the volume of short-term money market securities and make them liquid enough. The rules predicated that CDs should have homogenous terms and all should be treated equally regardless of the issuer. In practice this meant that the CDs of different banks had the same interest rate and each bank had an obligation to accept any bank's CDs as readily as its own. Central bank monetary policy based on direct purchases of bank CDs therefore continued the approach that the Bank of Finland had adopted in the 1970s; it imposed no collateral requirements of any consequence for central bank financing of the banks.⁶⁹⁴

What undermined the stability of banking was that, as it turned out, the new system was not confined to short-term interbank transactions, used to regulate liquidity. The CD market could also be used as a source of permanent bank funding, which SKOP in particular began to exploit immediately. In 1988 and 1989, SKOP obtained the same amount of funding from CDs on the short-term money market as it did from abroad. As a major commercial bank it was obtaining finance without limit, without collateral and without paying interest rates that reflected risk. The system therefore contained strong elements that encouraged imprudent risk-taking. Together with the spread of foreign currency lending, it led to a very major increase in risks in the Finnish banking system from about 1987 onwards.⁶⁹⁵

CONCERN AT CENTRAL BANK

The stock of bank lending had turned upwards already in 1979, after a severe recession of several years that had followed the first oil crisis. From then onwards, credit continued to increase relatively rapidly, and it accelerated as deregulation advanced and more diverse funding opportunities became available to the banks. The growth of lending did not, however, cause concern at the Bank of Finland as long as the Finnish economy remained in satisfactory external balance as indicated by the balance of payments. The central bank was also apparently reassured by the fact that, in 1986, when the first moves were taken to deregulate long-term capital imports, the growth rate of bank lending had fallen to below 12 percent, an exceptionally low level. The stock of credit had not grown so slowly since 1978, at the end of the 1970s recession.

By autumn 1988, however, the Bank of Finland was becoming worried about the faster growth of lending. The matter was first raised in an internal memorandum dated 21 September 1988, when lending had already been growing fast for almost two years. The memorandum began by referring to experiences abroad with the liberalisation of the financial markets, which had resulted in a steep increase in indebtedness, thereby disturbing economic equilibrium and raising the danger that inflation would race out of control. Many countries had questioned whether such rapid deregulation was wise and whether the tools of monetary policy had disappeared or become too expensive for the central bank to use. The memorandum said that the governor of the Bank of Finland had drawn public attention to the rapid growth of private consumption and household debt. Although the current account deficit was still moderate, there was a danger that it would widen excessively in future. The central bank did not, therefore, see a problem in the high level of private and public investment but specifically in the growth of private consumption.⁶⁹⁶ It was around the same time that governor Kullberg had made statements to the press about the dangers of fast-growing private consumption and household indebtedness, launching the term “festival of consumerism” to describe excessive consumption that threatened national economic equilibrium.⁶⁹⁷

The above-mentioned memorandum, drawn up by the central bank policy department, examined the measures available to a central bank to curb consumer credit growth at a time when it had consistently sought to abolish old regulatory mechanisms and replace them with financial markets steered by market forces. Its conclusion was that mere recommendations to reduce consumer credit were unlikely to have much effect.

Although the Bank of Finland did not take any concrete measures at this time, the question of curbing credit was raised in several internal memoranda. For example, the policy department tackled the issue in “What central bank policy can do”, dated 28 October 1988, and in “Lending by banks”, dated 2 December 1988. A memorandum at the end of October considered ways of bringing the long-running boom under control, so as to prevent the current account deficit getting out of control. It was felt that fiscal policy offered the most effective tools under conditions of a fixed exchange rate but the central bank had

no faith that fiscal policy could be made tight enough. It thought that the strong markka policy was a fundamental reason why monetary policy was ineffectual, because it hindered the use of interest rates as a policy tool. Higher interest rates would simply lead to more capital imports because borrowers trusted in the permanence of the exchange rate.

The tax deductibility of interest payments also blunted the effects of interest rates. In theory a return to credit rationing would have been one way to sharpen monetary policy tools but the Bank of Finland thought that this option, too, was questionable. It had plenty of experience of how regulations could be circumvented and was sure that the banks would do it again if regulations were reintroduced.

The memorandum concluded that “the strength of demand growth clearly threatens economic equilibrium and there is an urgent need for restrictive measures. The Bank of Finland has no effective way to do this within the framework of the fixed exchange rate policy, but the stable currency band should not be abandoned. To do so would risk losing the only real anchor that the economy has, and triggering inflation (...) The Bank of Finland should therefore re-emphasise that incomes policy moderation and extremely tight fiscal policy are the only ways of keeping interest rates in check. At the same time interest rate policy should be toughened by eliminating tax deductibility of interest expenses.”⁶⁹⁸

Another memorandum at the start of December 1988 focused on the risks concomitant with the rapid growth in bank lending. The current period was a time of adaptation to deregulated conditions and it was typical of such a phase that enterprises took more loans from abroad while households made more use of domestic credit. The propensity to borrow had been boosted by favourable income developments and optimistic expectations about the future. Even the interest rate of the central bank had not curbed these expectations because of the tax-deductibility of interest expenses, which meant that the government paid part of the cost. The banks were active participants in the process of adaptation because of the banking model that had developed during the years of regulation, in which there was strong competition for market shares. “Ongoing adaptation to deregulated conditions has been characterised by an irresponsible growth in the supply of credit by banks.”⁶⁹⁹

There was a danger that the internal management systems of banks were not abreast of developments, that their lending criteria had been relaxed and that business and household loans now contained more risks than before. There was a threat that these risks would be realised as credit losses, especially if market interest rates rose far more steeply than the base rate. Lending for investments in securities, real estate and the like would contain very great risk if the investment objects were serving as collateral for the loans. Collateral values had been inflated by speculation and could collapse very quickly.

The banking environment as a whole was undergoing major changes, in which the common denominators were greater uncertainty and risk. Nascent interest-rate competition for household savings would boost the costs of bank funding. Moreover, the banks would have to compete for customers with the securities market and foreign sources of finance. Meanwhile, ahead lay a reform in the law that would increase capital adequacy requirements and thereby raise bank costs.

The memorandum stated that “in the past few years, deregulation and an economic upturn have pushed up bank profits but the favourable development in profitability has largely been due to the aforementioned temporary factors. It would be lamentable if the profitability of the past few years has lulled the banks into unwarranted optimism, when they should have been taking timely steps to cut costs. Thus it is entirely possible that bank profitability in 1988 will prove to be only a temporary spike.”⁷⁰⁰

These memoranda written in autumn 1988 show that, within the Bank of Finland, the rapid and uncontrolled growth of lending had certainly been observed. At this point, however, the central bank was almost powerless to act. A return to administrative regulations was not regarded as a realistic option because all central bank monetary policy was now based on a market-driven system. Furthermore, experience had shown that the system of regulation was impotent and had side-effects. The most optimistic assessments assumed that there was no serious cause for concern and that pent-up credit demand from the long period of regulation would work itself out within a few years. The bank’s internal view was that the effectiveness of monetary policy had been significantly weakened by the prevailing conditions of a fixed exchange rate, but it did not want to abandon the fixed exchange rate

because it saw no alternative.⁷⁰¹ The responsibility lay elsewhere; as long as the efficacy of monetary policy was impaired, tight fiscal policy was essential, although the central bank conceded that this involved political difficulties.

The finance ministry, too, was extremely concerned about the rapid growth of bank lending and especially about how it was causing overheating in the housing market. However, political factors were crucial in blocking the ministry's plan for ending the tax deductibility of interest expenses. Finance minister Liikanen saw it as an effective way of curbing the expansion of credit but the plans for reform were halted when his own party fiercely resisted them.⁷⁰²

The Bank of Finland saw the cash reserve deposit requirement as an ineffective method for regulating liquidity in the financial system, mainly because of special features of the system in Finland, which differed from most other developed countries. There was no statutory right in Finland for the central bank to demand cash reserve deposits from the banks. Finnish cash reserve deposits were made on the basis of contractual agreements between the banks and the central bank. Moreover, the cash reserve deposits were interest-bearing so they were hardly any burden on a bank's finances. This model had been in use since 1979 with few amendments. It was not only the Bank of Finland that had little faith in the current system, as the reports of parliament's banking committee show. A report in 1987, dealing with the Bank of Finland's operations in 1986, noted that the deregulation of international capital movements gave cause to reconsider the usefulness of the cash reserve system. In a report in the following year, the committee was even more doubtful about the system, although admittedly its phraseology on the subject was somewhat ambiguous.⁷⁰³

In autumn 1988, the board of management of the Bank of Finland turned to the supervisory council for support in an effort to renew the basis of the cash reserve system. The matter was placed on the agenda at a meeting of the inner council on 19 October 1988, at which the board was represented by governor Kullberg, as well as Markku Puntila who actually proposed the matter. Both stressed that, even in the post-regulation world, the central bank needed the cash reserve system as a monetary policy tool. In its present form, the system was not working. Instead Finland's central bank needed a statutory right to demand

cash reserve deposits. Mortgage loan banks and finance companies, as well as actual deposit banks, should be made subject to the requirement, so that at least some of the banks' off-balance-sheet items, such as guarantees, would be covered. To ensure the effectiveness of the system, cash reserve deposits had to be interest-free, so that they would affect a bank's result and thereby its behaviour.

Another reason at this time for the Bank of Finland's desire to toughen the cash reserve deposit system was concern about the continuing decline in banknotes in circulation. This was a result of rapid technological change, in which traditional cash had been supplanted by systems for electronic payments. For the central bank, the falling volume of cash meant loss of seigniorage, the revenue from the issue of currency. The matter had been actively discussed at the bank around this time; how was it to secure its future income base?

The board of the Bank of Finland was well aware of the problems surrounding reform of the cash reserve system. These were political in nature, as indicated by the following quote from governor Kullberg's address to the supervisory council at the end of November 1988: "Perhaps I should also tell this meeting of the full council that, when the bank was discussing and planning this matter, most of us thought that it should be kept secret for as long as possible. Because it is quite clear that when it becomes public the whole banking world will promptly start to campaign against it. This campaign will certainly continue as the matter advances and especially during parliamentary debate on the matter. The fact that we have decided to release information about it now is because we believe that this approach will have a psychological impact, as a threat and a warning to the banks at a time when lending is continuing to increase so strongly."⁷⁰⁴

There was a very lively debate in the supervisory council about the cash reserve deposit system and the councillors endorsed planning for a reform. Markku Puntila said that the order of business was to be that the government would set up a working group by the end of 1988 to prepare a new law. The opinions of experts and those concerned would have been heard by summer 1989, after which the bill could be sent to parliament. If there were no delays, the new cash reserve deposit law would come into effect during 1990.⁷⁰⁵ This schedule was ultimately not kept and the whole project was deferred until after the Finnish banking

crisis, in 1993, when cash reserve agreements were replaced by a statutory system of minimum deposits.

This episode well illustrates the situation of the Bank of Finland in the 1980s. The institutional framework on which the banking and financial system was founded had remained unchanged for decades. When regulation had been comprehensive, systemic stability had been protected. With deregulation, the move towards market-oriented operations had demanded a reform of this institutional framework but the need had been neglected. This was true both of bank capital adequacy and of monetary policy instruments. The leadership of the central bank had been aware of this conflict but repeated setbacks, such as in applying interest rate policy or reforming bank laws, had left it with a distinct sense of powerlessness. In the question of cash reserve requirements, the views of the board and the supervisory council were parallel but the board still doubted whether it would be able to push through the necessary legislative changes on a reasonable schedule. Against this background it is understandable that the bank's leadership wanted to work together with the supervisory council on reforming cash reserve legislation. They were convinced that the banks had so much influence in parliament that the project would fail unless the leaders of the main political parties, via their supervisory council members, were committed to it in advance.

MOVING TO TANGIBLE ACTION

In December 1988, when taxation of capital gains was about to come into effect, bank lending was growing at a rate that exceeded all previous records and the Bank of Finland had no alternative but to intervene. The Finance ministry agreed that a rapid growth of loans to households was the main reason for the looming current-account deficit, which was threatening the stability of the whole economy, and the cause of the sharp rise in house prices. Measures by the central bank had not managed to check credit growth so the ministry had begun to plan action of its own. It envisaged a model in which a ceiling would be imposed on the growth of lending and a special tax imposed on lending in excess of this amount.⁷⁰⁶

The Bank of Finland board member responsible for monetary policy, Markku Puntila, responded to the Finance ministry's plans with

a memorandum “Curbing the Growth of Credit”, dated 23 February 1989. He regarded the proposed interim tax on lending growth as a return to regulation and believed it would not achieve the desired result. Instead, Puntila urged an agreement between the banks and the Bank of Finland on an additional cash reserve deposit requirement, to be imposed temporarily on excessive credit growth. He believed it would have the following advantages:

- an agreement would be more flexible in its details and would not require the same amount of oversight
- it would keep monetary policy under the auspices of the Bank of Finland
- there would be major problems with a credit ceiling tax, even if it were imposed on personal credit only
- Such was the climate of competition between the banks that all loopholes would be exploited to protect market shares, to the detriment of the most honourable or least capable.⁷⁰⁷

The threat of intervention by the Finance ministry spurred not only the Bank of Finland but apparently also the banks into action because, from this point onwards, exceptionally rapid progress was made. Within four days, Puntila was presenting a preliminary draft on a supplementary cash reserve system to CEOs of the main banks, summoned to the Bank of Finland on 27 February. This was less a negotiating session than “an offer you can’t refuse” because a statement on the new cash reserve system was released on the same afternoon. Such rapid action was undoubtedly promoted by the aggressive growth strategy of the savings bank group, which was a major irritant for all competing bank groups. A supplementary cash reserve agreement was seen as an ideal way to check the excessively fast expansion of the savings banks. The normally united front of the banks had collapsed, which reinforced the central bank’s negotiating position.

A circular issued on 27 February 1989 told that the Bank of Finland and the banks had reached an agreement aimed at bringing down the steep growth of bank lending. The agreement gave the Bank of Finland the right to raise the cash reserve requirement to a maximum of 12 percent. This would be an additional non-interest bearing deposit requirement, which would be imposed on the whole banking sector on the basis of combined credit growth.

The tone of the statement was exceptionally “political”. It said that measures of this type, targeted at the supply of credit, would not ultimately suffice to bring the situation under control and that the demand for credit also had to be restricted. The key to controlling household demand for credit was the right to deduct interest expenses from taxable income. An obvious anomaly in the housing market was that interest payments were deductible even for housing purchased for investment purposes, the statement said, and immediate action on this was needed. It also stated that the deduction of interest payments on other types of housing loan should be restricted, for example with a sliding scale of deductibility that would give preference to housing for young families with children. The circular stressed that monetary policy could not safeguard economic equilibrium in the long term and that the main responsibility lay with fiscal policy. The government’s budget surplus had to be substantially raised, mainly by cutting the growth in spending. Future income settlements also had a role to play in restoring economic stability.⁷⁰⁸

The banks were not entirely sidelined in the planning of the reform because the next stage was the establishment of a joint working group to draft the final shape of the reinforced cash reserve system. Its members were Sirkka Hämäläinen and Tapio Korhonen from the Bank of Finland, Markku Pohjola (Union Bank of Finland), Antti Suvanto (the savings banks), Jaakko Eloranta (the cooperative banks) and Eero Tuomainen (Postbank). The working group rapidly reached agreement on how broadly the new system would apply, meaning how aggregate credit would be defined. It was to cover two categories of loans, (a) the credit of each entire banking group including off-balance-sheet notary department loans and (b) all personal loans of the banking group. In fact personal loans were seen as the most important item because the main aim was to curb the fast growth of loans for home purchase and consumption. By defining credit broadly, it aimed to be harder for banks to circumvent. In practice it was agreed that whichever category of credit grew faster would determine the supplementary deposit requirement.⁷⁰⁹

In Markku Puntila’s original plan, the combined credit growth of the whole banking sector would have been monitored, so it would have been a system where all the banks were jointly responsible. This did not suit the majority of the working group because of fears that

some banking group would not conform and that the costs of the freeloader would then be borne by the others. The main source of this fear was the attitude of the savings banks; Matti Ali-Melkkilä, the CEO of the savings banks' central bank, had said in an interview that the group would not curb its lending.⁷¹⁰ The working group's solution was to set a target band for each bank or bank group. A supplementary deposit would not be imposed as long as lending growth remained below it. If growth exceeded the limit, the supplementary deposit would rise progressively. The Bank of Finland would demand supplementary deposits by banking group.

The targets for credit growth were set as monthly amounts from the end of February to the end of December 1989. A banking group would be required to make an additional deposit if personal loans grew by more than 9 percent, or all credit by more than 11 percent, during the period. The amounts were defined on the basis of the working group's prediction for total credit growth and the reduction sought. Small banks like Peruspankki and STS Bank, allied to the labour movement, the Bank of Åland and four foreign banks were granted slightly more freedom in the definition of their target band. Under the agreement, the supplementary reserve deposits would continue until the end of 1989 although they could if necessary be continued into January and February 1990. The deposits would be non-interest-bearing and would be refunded to the banks during a period no later than July-December 1990, in instalments of equal sizes.

This protocol to the cash reserve agreement was signed on 16 March 1989 and on the same day the Bank of Finland issued new credit policy instructions to the banks, stating that the objective was to curb the growth of credit for consumption, house purchase and investment in securities. To reinforce this, the Bank of Finland recommended that the banks should raise interest charges on new loans in order to restrict demand for credit. The savings bank group, which had been critical of the new cash reserve agreement from the outset, continued to oppose it. This attitude is illustrated by a letter, signed by the board of the savings banks association on the day that the agreement was signed, and sent to all savings banks. It said that "the instructions of the Bank of Finland may lead the other banks to target the lower lending limits imposed by the Bank of Finland. In this situation the savings banks must safeguard competitiveness and

continuity in the growth of their volumes and market shares. These upward trends should not be compromised.” This was not the only sign of their opposition. On 20 April 1989 the Savings Bank Centre sent a new letter to their members, warning them of the costs caused by growth of their lending and encouraging them to invest vigorously in marketing.⁷¹¹

At the end of December 1989 the amount of supplementary cash reserve deposits had reached 2.9 billion markkaa, of which the savings bank group had paid 2.1 billion, more than 70 percent. The remainder had come roughly equally from the commercial bank group and the cooperative bank group. The savings banks had therefore remained consistent in their defiance and had continued their growth-oriented strategy. Their leadership had seen this phase as a favourable opportunity to increase market shares while competing banking groups lived up their promise to the central bank to control growth of lending. Naturally this came at a cost. According to an estimate made at the Bank of Finland, total supplementary cash deposits, calculated at 14 percent market interest forgone, were a cost item of more than 400 million markkaa to the banks. Most of this amount, about 300 million markkaa, was paid by the savings banks.⁷¹²

From the Bank of Finland’s perspective, the system of supplementary non-interest-bearing cash deposits had the desired effect. While it was in force in 1989, lending grew at less than half the rate of 1988. In line with the Bank of Finland’s recommendation, the banks had also begun to charge higher interest on new loans. During 1989 the rates on new loans, whether tied to base rate or at a fixed rate, rose by 2.5 percentage points, although base rate had increased by only one percentage point. Naturally the banks’ observance of the central bank’s recommendation to raise lending rates had an effect on the demand for credit and so served to curb lending growth.

In the history of the Bank of Finland, this operation was fairly exceptional. Hardly any other agreement had been achieved so rapidly and without postponements. At the same time it must be said that too much time was wasted before the agreement was proposed. In the light of the crisis to come, the agreement had been needed no later than the start of 1988, when lending growth began its steep climb. It would have been even more useful in the second half of 1987, when the growth of lending was approaching an annual rate of 19 percent.

Ideally, the central bank ought to have received the statutory right to set cash reserve deposits when deregulation of the financial market began. The leadership of the Bank of Finland suffered far too long from pessimism about whether it was politically realistic to seek such a cash reserve system. There was also a prevailing view that a cash reserve system was not really compatible with new market-oriented monetary policies.

HANDICAPS IN THE FINNISH MODEL

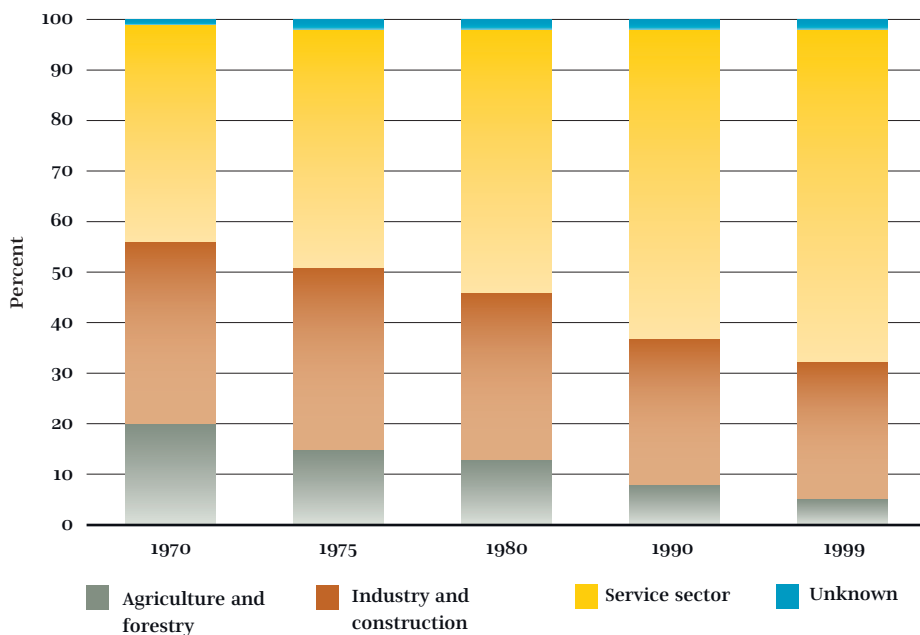
TOWARDS A POST-INDUSTRIAL SOCIETY

Finland did not become a mature industrial economy until the 1970s. During the next ten years, its structure continued to evolve but it was now moving towards a rapid expansion of service jobs. Industrial Finland was transformed in a brief period into a post-industrial, service-intensive nation.

This trend was somewhat different from the model of developed western European countries because so much of Finland's population moved directly from agricultural work into services. The period of industrial Finland was consequently brief. By the 1980s the proportion of the labour force employed by industry was already diminishing. In the late 1990s, industry was employing almost 130,000 people fewer than twenty years earlier. Industrial restructuring was taking place at the same time. Smokestack businesses and labour-intensive producers of textiles, shoes and clothing were losing ground. Transformed by technology, engineering and electronics were taking their place.

In services the change took place in two phases. First came the public sector because, in the 1970s, the government and municipalities were investing major sums in education, health care and social services. This was reflected in a corresponding increase in public sector employment, which continued into the following decade and was not interrupted until the slump of the 1990s curbed the number of public sector jobs. Private sector services started to dominate the Finnish economic transformation about 10 years after public services, in the

EMPLOYED POPULATION BY SECTOR 1970-1999



Source: Statistics Finland.

1980s. This was spurred by financial market deregulation, which stimulated a steep increase in private investments in private and business services, leading to increased demand for labour in that sector.

The Finland of the 1970s was a mixed economy, where the activities of government and organised interest groups were closely interweaved. A concrete example was in incomes policy settlements, which determined not merely wages but also questions related to social policy, taxation and monetary policy. The incomes policy domain even extended to policies on prices. There had been evolving legislation about competition since the start of the 1970s but it was not until 1988 that a modern competition law came into force, finally ending about half a century of official surveillance of prices.⁷¹³

For a long period, Finnish business life had two, opposite modes. Exporters operated in open, competitive markets but those fields of industry, commerce and finance which depended on the domestic

market were subject to many operational limitations on competition. A special segment where market principles were suspended was bilateral trade with the Soviet Union, still conducted on the basis of five-year frame agreements, with export quotas allocated to each company. This economic dualism between open and closed sectors began to disappear from the end of the 1980s onwards. Different sectors moved towards market principles at slightly different times, but the trend was already clear by the end of the decade. When the European Economic Area came into existence at the start of 1994, Finland became a part of the single European market. There would be no return to the protection of national regulations and restrictions on competition.⁷¹⁴

Seen from the perspective of economic growth the Finnish system was successful for a long time. Apart from a three-year recession caused by the first oil crisis, the Finnish economy grew well until the end of the 1980s. Admittedly it did not achieve such striking growth in the late 1970s and the 1980s as during the period of the Bretton Woods system but nor did other industrial countries.⁷¹⁵ Thanks to its good relative performance, Finland gradually moved up the table of international comparisons from the also-rans to the frontrunners.

High investment remained a cornerstone of its growth-oriented policies. In 1975–1989 the investment rate reached 25–35% of gross national product, exceptionally high by international standards and, among developed countries, exceeded only by Japan. Another special feature of Finnish economic growth was again the nature of trade with the Soviet Union. Bilateral arrangements meant that the oil price rise at the start of the 1970s automatically increased Finland's opportunities to export to the Soviet Union. During the period from the oil crises to the second half of the 1980s, Finnish exports to the Soviet Union remained at some 20% of all exports. They did not compensate for the higher cost of oil but were very important for industry and employment because the Soviet Union bought mainly labour-intensive industrial products.

Measured by gross national product per capita, Finland's level of economic development level reached that of Great Britain during the 1970s. By the end of the 1980s, Finnish living standards were little different from those of the most developed European economies, such as Germany and Sweden. In a few decades it has raced far ahead of the

countries of Eastern and Central Europe.⁷¹⁶ In the 1980s, however, economic growth was hiding a weakening economic balance. The foundations of exporting were being eroded by a steady decline in competitiveness as Finnish costs increased chronically faster than in competing countries. The incomes policy system failed to hold costs within the limits set by productivity growth. Then, in the second half of the 1980s, an economic crisis hit a major market for Finnish exports, the Soviet Union, and the share of exports going eastwards began to fall.

The export sector was atrophying, as its share of gross national product fell. At the start of the 1980s exports had been worth nearly 30% of GDP; ten years later they were about 20%. Poor export growth coupled with strong domestic demand upset the balance of foreign trade. By the end of the end of the 1980s the current account deficit was approaching 5% of GDP.

The economy suffered from structural problems that had built up for decades and were damaging productivity. Persistent regulation of the financial markets and the dominance of trade with the Soviet Union both served to weaken the incentives for higher corporate efficiency. The K guarantee system is an example of the special features of Soviet trade that is worth mentioning. It protected export contracts from the risk of financial losses, caused by the rising domestic cost level, while the cost increases were borne mainly by the government.⁷¹⁷ There were other sources of inefficiency, such as the competition between political parties for votes from the less developed parts of the country, which led to excessive regional policy investments and an inefficient allocation of resources. The phenomenon was observed by in the board of management of the Bank of Finland, especially in the 1970s, when its objections led to the cancellation of certain major investments planned.⁷¹⁸

Interest rate controls, inflation and distortionary taxation encouraged companies to operate on debt capital rather than shareholders equity, thus weakening corporate financial structures. By international standards Finnish companies were extremely indebted in the 1980s. As long as interest rates were controlled and inflation was high, it was no problem, but when the financial market was deregulated and other forms of competition also picked up, the financial weakness of companies meant that they had little ability to bear risk. In the 1980s, poor capital adequacy was not confined to Finnish banks alone.

In practice, structural problems manifested themselves as inefficient investments. Naturally there were major differences between companies but studies by Matti Pohjola have shown that investments by major Finnish companies in the 1970s and 1980s produced a low yield and used capital inefficiently.⁷¹⁹ Although Pohjola's research has concentrated on industrial companies, it is apparent that service sector companies suffered from similar inefficiency. Finnish banks constitute a concrete example, sacrificing their profitability until the end of the 1980s by developing extravagant branch networks.⁷²⁰

THE END OF SOVIET TRADE

In 1988, problems of the surplus in trade between Finland and the Soviet Union were continuing into their third year and were even larger than before. The price of oil, stubbornly below the level forecast, was one factor that made it harder to balance trade. The other was the Soviet Union's internal economic reforms, linked to the *perestroika* restructuring programme initiated by Mikhail Gorbachev, general secretary of the Soviet Communist Party since 1985. Gorbachev's reforms increased the independence of Soviet companies and, beginning in 1988, ever more of them received the right to conduct foreign trade on their own account. This began to curb the relevance of a centralised foreign trade organisation, which in turn eroded the foundations of bilateral trade with Finland.

To manage the problems of trade imbalances, several significant changes in the payments system were made in a joint government protocol in September 1988. The changes sought to reduce the economic risks to Finland and were very significant from the perspective of the Bank of Finland. The credit ceiling on the clearing account was lowered from ± 300 million roubles to ± 200 million roubles. Account overruns would be automatically equalised with freely convertible currencies and any account balances in excess of 100 million roubles would be interest-bearing (previously clearing account balances had been interest-free in practice). To reduce the exchange rate risk from the rouble, the account balance was tied to a currency index and index-adjusted on a quarterly basis.⁷²¹

In connection with the changes to the payments system in 1988, it was also agreed that Finnish exporters could grant credit to Soviet

buyers. In fact, Finnish credit institutions such as Suomen Vientiluotto, the official export credit agency, granted so much credit that the debt to Finland on the clearing account began to shrink and, during 1989, turned into a debt to the Soviet Union. Earlier in the 1980s, the Bank of Finland had been important as an indirect source of finance for eastern exports but this role had now ended. At the same time, claims on the Soviet Union held by other Finnish financial institutions increased and so did their associated risks.⁷²²

The head of the Bank of Finland's department for eastern trade, Kari Holopainen, makes the point in his memoirs that, after the changes to the payments agreement in autumn 1988, the clearing rouble became almost equivalent to a freely convertible currency, from the Bank of Finland's perspective.⁷²³ This gave the bank less cause to worry about the clearing account balance but the Soviet side was less sanguine about the clearing rouble. As the end of the 1980s approached, the Soviet Union had neither the interest nor the practical capability to continue centralised clearing trade with Finland. The Soviet attitude was concretely expressed in Moscow on 11–13 June 1990, in the Finno-Soviet joint economic commission. At that time, Soviet negotiators in the payments and finances group explicitly proposed that trade should be conducted henceforth in convertible currencies. In effect, this was more a proclamation rather than a proposal.

According to an internal memorandum at the Bank of Finland, representatives of the Soviet Foreign trade ministry said in Moscow in June that "the Finnish party should study the possibility of recording in the payments agreement that it would be possible to switch to the use of convertible currencies from the start of 1991". In fact this was not merely a question of "studying the possibility", because the Finnish negotiators soon realised that counterproposals were pointless and the Soviet stand was unshakeable. Trade was to move to convertible currency and no later than the start of the next year. Clearing trade was not reconcilable with the increased economic autonomy of Soviet enterprises and republics (i.e. the component states of the Soviet Union). There were no longer even political arguments for continuing the old system. In the discussions with Finland, a Gosplan representative observed that it was time to "separate politics from economics". Meanwhile a representative of the Soviet Energy ministry announced that the Soviet Union had no interest in exporting oil to Finland and

that clearing and protocols on the exchange of goods were no more than a nuisance.⁷²⁴

During autumn 1990, the Finns tried to obtain a transitional period for the clearing-based payment system but without success. On 10 December the Soviet Union finally officially announced that it would terminate bilateral trade and the payments systems with Finland from the start of the next year. An intergovernmental accord on the matter was signed at the eleventh hour, on 27 December 1990. From New Year's Day, mutual trade was conducted in convertible currencies. This caused an immediate and almost complete collapse of Finnish exports to the Soviet Union.

By 1989–1990 the Bank of Finland's receivables from the Soviet Union had fallen to a very low level compared with the peak years of the 1980s. When the Soviet Union's clearing accounts at the Bank of Finland were closed at the start of 1991, the final balance showed a Finnish debt of about 3 million roubles. This was converted into 5.7 million dollars and moved to a separate liquidation account. On the other hand, 60 million roubles (about 400 million markkaa) of the credit granted by Finland to the Soviet Union in 1987 on a special account was still unpaid. It was agreed that this sum would be due for payment at the end of 1991; the due date therefore happened to fall a few of days after the Soviet Union was officially dissolved (26 December 1991). Payment was delayed by the economic problems besetting the Soviet Union's successor, Russia, and in April 1992 the outstanding Russian debt was converted into dollars. At that time \$76 million was unpaid.

The Bank of Finland's claims on the Soviet Union at the start of 1991 would obviously have been far greater if most of the financing of eastern exports had not been transferred to other Finnish credit institutions in the agreement of September 1988. The magnitude of this transfer is shown by the claims of 3.4 billion markkaa (750 million dollars) held by the Finnish Guarantee Board when the clearing system ended. Most of this consisted of guarantees issued to the export credit agency and Finnish commercial banks. In addition, some Finnish companies had financed Soviet counterparties at their own risk. In autumn 1991 the Bank of Finland calculated that unguaranteed sums owing to Finnish companies were about 600 million markkaa.

The Bank of Finland had consistently taken the view that it was managing the clearing account, and also the special accounts, on

behalf of the State of Finland and that ultimately the state was responsible for the economic risks from clearing trade. A Finance ministry working group chaired by Director general Osmo Sarmavuori reached the same conclusion in spring 1991.⁷²⁵ On this basis the Bank of Finland asked the Finance ministry to discharge the outstanding Russian balance and accumulated interest charges in autumn 1993. The ministry paid it in Finnish markkaa at the end of the year 1993 – about 463 million markkaa – and so the remaining claims on Russia from the clearing trade period disappeared from the Bank of Finland's balance sheet and became government claims. This sum was subsequently paid off in the course of the 1990s, mainly in the form of merchandise deliveries by Russia.⁷²⁶

SETTING A COURSE FOR EUROPE

FROM OVERHEATING TO EMERGENCY BRAKING

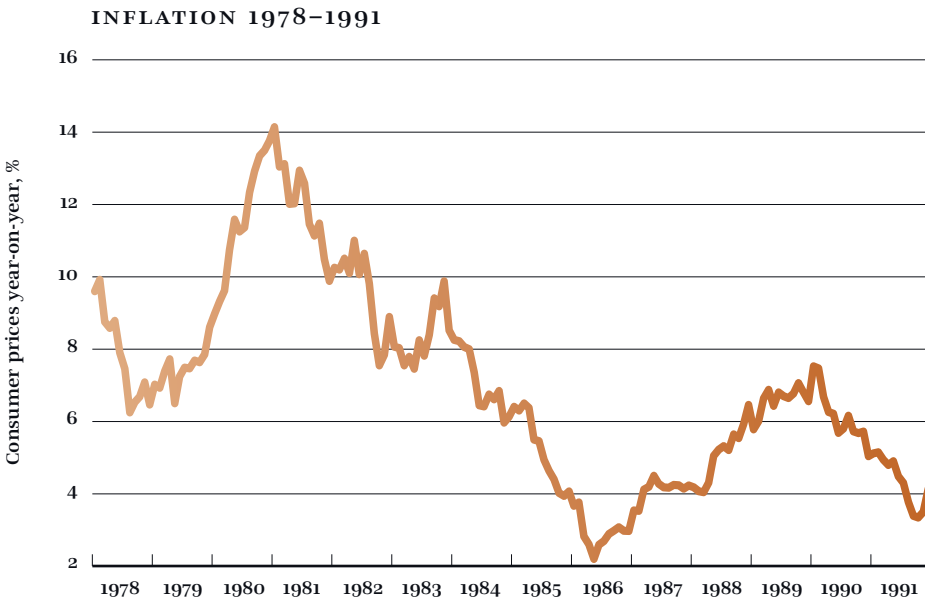
In 1989, the Finnish economy reached an apex of overheating, the result of a decade of deregulation in the foreign exchange and money markets. Driven by domestic demand, it was now growing so strongly that no stabilisation package sufficed to control inflation or trim the current account deficit. The unemployment rate fell to about 3%. Labour shortages resulted in severe wage drift; according to the wage and salary index, nominal earnings increased by more than 8% during the year. Consumer price inflation rose above 6%.

Not all of this was yet apparent in the spring of 1989 but news about the economic climate was already enough to spur new action by the government and the Bank of Finland, to curb aggregate demand and tighten monetary policy. The change in mood was abrupt and its abruptness was reflected in the measures implemented. At the end of January, the government announced its first resolutions on measures to restrain demand, by cutting the growth of government spending, extending the investment tax and imposing export deposits. In February, the Bank of Finland imposed the supplementary cash deposit requirement, a measure that subsequently proved to be effective.

By March the board of management of the Bank of Finland was considering annulling the cut in base rate that had been in force only since the start of the year. However, as Rolf Kullberg's memoirs record, the supervisory council was entirely unprepared to raise interest rates

so soon after lowering them, so no official proposal on the matter was even submitted. In the prevailing situation, “desperately” requiring tighter monetary policy, a revaluation was the last resort. The initiative came from the Bank of Finland; only Prime minister Holkeri and Finance minister Liikanen were informed of it in advance.⁷²⁷

The board of management discussed revaluating the markka at its morning meeting on 17 March 1989. Governor Kullberg and acting board member Markku Puntila told the other board members (Ele Alenius and Esko Ollila) that the prime minister and finance minister “had been favourably disposed to strengthening the value of the markka”. Another matter on the agenda had been the enlargement of the currency index fluctuation band to 10%, which would have given the bank more flexibility in monetary policy but Justice chancellor Jorma S. Aalto had not deemed this to be legally possible. According to the minutes of the meeting, the board noted that the best result in the longer term would have been obtained by widening the fluctuation band to 10 percent and moving it downwards at the same time, leaving its ceiling unchanged. However, as the justice chancellor had stated



Source: Statistics Finland.

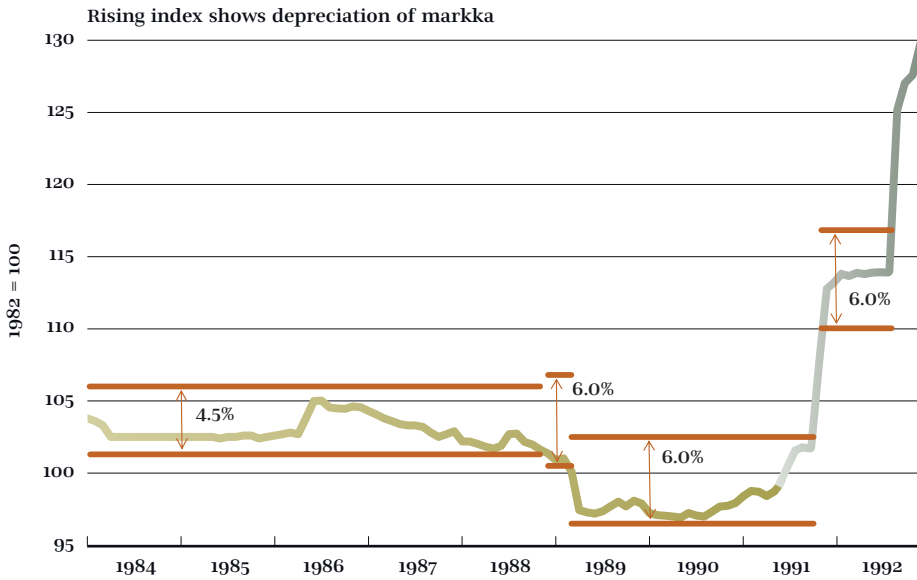
this was not an option, the board decided to ask the supervisory council to shift the fluctuation band downwards by 4 percent. It would remain 6 percent wide, that is, $\pm 3\%$ around its central point.⁷²⁸

The preamble to the board's proposal to the supervisory council was that "within the parameters set by the current exchange rate band, it has proved impossible to set an interest rate that would curb domestic demand sufficiently without inducing an influx of foreign currencies that would weaken the effect of that high interest rate. The government seems unable to pursue fiscal policies that would create a budget surplus adequate to clip the growth of domestic demand sufficiently. The only rapid and effective solution available for cooling down the national economy is a substantial increase in the external value of the markka." The council approved the board's proposal unanimously and the government ratified it on the same day.⁷²⁹

The lowering of the currency index fluctuation band was soon reflected in the actual exchange rates. Within a few days, the currency index fell (meaning that the markka strengthened) by over 3 percent. At the same time, the shortest market interest rates rose sharply by almost 2 percentage points. Longer market rates did not move much. The various money market rates – from the one-month Helsinki Interbank Offered Rate to 12-month Helibor – now stabilised around 12 percent for about half a year. Together with the supplementary cash deposit agreement announced a little earlier, the revaluation and the subsequent rise in interest rates created a distinctly tighter money market, as indicated by an abrupt reduction in the growth of bank lending.⁷³⁰

On the same day as the revaluation of spring 1989, the government announced new measures to tighten fiscal policy, focused on higher indirect taxation. Employers' sickness insurance payments and turnover tax – the precursor of VAT – were both raised temporarily, by half a percentage point each, for six months. The change in fiscal policy stance was not quantitatively great but the public sector was also having an automatic countercyclical effect on aggregate demand because rapid economic growth was boosting tax revenue. The budget surplus for 1989 was a record, over 11 billion markkaa, which was more than 2 percent of GDP. In the 1990 budget it was decided to establish the State Pension Fund and to allocate some of the surplus to it.

**BANK OF FINLAND CURRENCY INDEX AND
ITS FLUCTUATION LIMITS 1984–1992**



Component currencies weighted by share of foreign trade until May 1991, thereafter by their weight in the ecu basket.

Source: Bank of Finland.

In spring 1989 experts from the International Monetary Fund published a report to the IMF executive board based on their regular survey of the Finnish economy, which had been carried out in May. The report said that, after several years of favourable development, the Finnish economy was now overheating. One cause, the strong growth of investment, might be self-correcting, but a major problem was the lower household savings rate. Unless its decline could be reversed, savings by the public sector would have to be increased. It recommended that the tax deductibility of loan interest payments should be capped, fiscal policy tightened and base rate made more flexible so as to reflect market conditions. The report warned that Finland's commitment to a stable exchange rate would probably be tested if the current account deficit grew and inflationary pressures continued. In such a situation, interest rates might have to rise significantly.⁷³¹ The higher market rates predicted by the IMF were not long in coming. By autumn 1989,

confidence in the Finnish economy began to deteriorate. One clear sign of poorer economic prospects was the news that a major shipbuilding company, Wärtsilä Marine, was in difficulties. The events culminated in the company's bankruptcy on 23 October. As confidence in the markka fell, it now came under downward pressure. By September, the Bank of Finland was compelled to support the currency to prevent its depreciation. The convertible currency reserves began to shrink and market interest rates rose steeply. The rise in money market rates continued throughout the autumn. By December they were already around 16 percent. In real terms, Finnish market interest rates had now reached a level of about 10 percent.⁷³²

The rise in market interest rates was accompanied by an increase in base rate that came into effect at the start of November. The board of the Bank of Finland had been trying to raise base rate throughout the year but the supervisory council had been resisting it. In August the bank's economists had proposed a hike as great as three percentage points, although admittedly in two stages, but the idea of such a steep rise in debt servicing costs was of course completely unrealistic politically. At the time, most of the bank loans outstanding still had floating rate clauses linked to base rate. In September the board had wanted to raise base rate by 1½ percentage points but did not officially place the proposal before the supervisory council when it became clear from discussions that the council would refuse it. At least part of the resistance, governor Kullberg said, came from social democratic council members.

In September, however, the governor put pressure on the council by publishing a statement in which he said that a rise in base rate was inevitable, and that the longer restrictive economic policies were postponed, the more painful it would be to bring the economy back into equilibrium. "Balance would then be achievable only through higher market interest rates and losses in production."⁷³³

In October, the board made a compromise proposal on base rates to the supervisory council, in which it pared down the size of the hike to one percentage point. It further softened the blow by promising to send a circular to the banks instructing them to extend the term of new (issued since summer 1987) loans for home purchase so that monthly loan service costs would not rise despite the higher base rate. On the other hand, the circular would also state that interest rates on

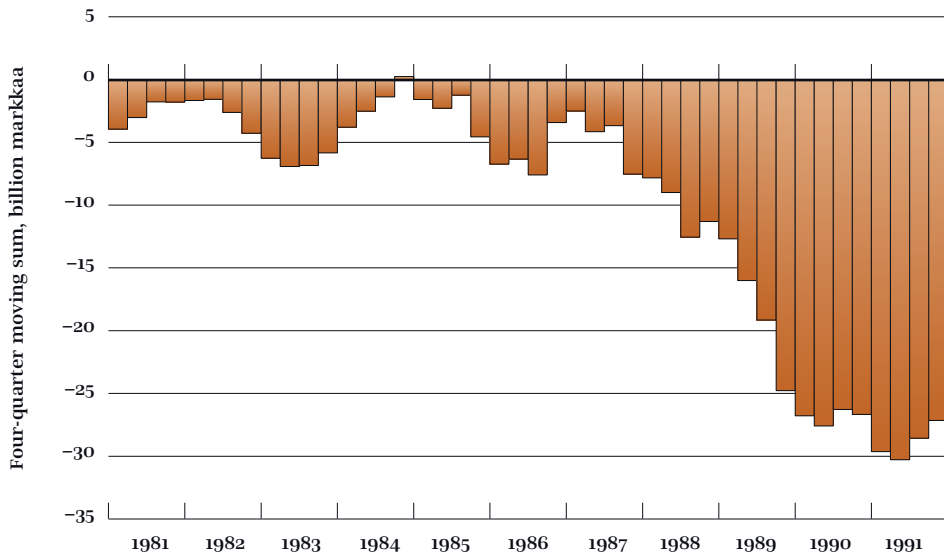
old loans, granted during the period of interest rate controls, could increase by as much as 1½ percentage points. In its proposal to the supervisory council, the board said higher interest rates were justified by inflation and the growing current account deficit. Government measures to curb aggregate demand had had their main effect on firms, but base rate could also influence household savings and borrowing. "All told, a rise in interest rates will curb the growth of domestic demand and thereby strengthen the current account while reducing inflationary pressures," the board wrote. The supervisory council approved the proposal on 20 October and base rate rose at the start of November by one percentage point.⁷³⁴

The spring revaluation, the supplementary cash reserve agreement to control bank lending, and the rise in market rates and base rate in the autumn had the combined effect of a sudden braking in monetary policy. Every possible method was now being used to curb the growth of aggregate demand. Fiscal policy, at least in terms of the budget surplus, was also restraining its growth. These policies were effective. In 1990, after three years of rapid increase, aggregate demand stopped growing and even turned down. Private investment fell the most. As the demand for goods and services faltered, economic output also stopped growing.

But the problems of imbalance caused by years of overheating did not go away. The current account deficit in 1990 was as large as the year before, about 5 percent of GDP. Inflation slowed down only slightly, reaching 5 percent (as measured by consumer prices) by the end of the year. Although the employment situation began to weaken towards the end of the year, the rate of pay increases continued to accelerate. In 1990 the wage and salary index rose by more than 9 percent

In the first half of 1990, confidence in the markka was restored for a while. Currency reserves, which had shrunk during the previous autumn, began to grow again, and capital imports were so strong that the reserves hit an all-time record. Apart from the high interest rate level, the capital import boom may have been induced by the fact that most of the remaining controls on capital imports were eliminated around this time. Foreign borrowing by companies had been deregulated in autumn 1989 and, at the start of February 1990, the ban on selling markka-denominated bonds abroad was rescinded. In order to offset monetary easing caused by capital imports, the Bank of

CURRENT ACCOUNT 1981–1991



Source: Bank of Finland.

Finland recommenced its forward interventions on the foreign exchange market, to “hide” some of the additional currency reserves. The total of currency reserves and forward deals outstanding reached about 43 billion markkaa during the spring of 1990.

Responding to substantial capital imports, the Bank of Finland permitted short-term money market rates to decline during the first half of the year, and the most important rate, three-month Helibor, fell to about 12 percent. However average rates on bank loans in markkaa remained around 14 percent so real interest rates were extremely high. With high interest rates and fading investment demand, the rate of growth of markka-denominated bank lending almost halted in 1990. The credit boom that had peaked at the end of 1988 was now entirely over. Supplementary cash reserve deposits, used to control the growth of lending, were refunded to the banks during the second half of 1990, as had been promised when they were introduced.

Despite the standstill in markka-denominated lending, foreign currency loans continued to grow strongly and their stock increased

by another 50% during 1990. The incentive to borrow in foreign currencies was understandably great because foreign interest rates were significantly below Finnish ones and the banks were active in marketing “inexpensive” foreign loans particularly to corporate clients. The public commitment of the Bank of Finland and the government to a stable exchange rate allayed any concerns about the exchange rate risks associated with currency loans.⁷³⁵ With hindsight this insouciance was rash. The growth of foreign currency debt was to have dramatic consequences only a short while later, when Finland was forced to repudiate the stable markka policy and exchange rates moved abruptly.

PLANNING FOR EUROPEAN MONETARY UNION

While Finland was struggling with economic overheating, European integration was reaching a new phase that could not be ignored even in countries such as Finland that did not belong to the European Community. The Single European Act had come into force in summer 1987 with the objective of creating a unified market in the EC by the end of 1992, in which goods, capital, labour and services would move freely across borders. A year later, in 1988, the question of monetary union, frozen when the currency turbulence of the 1970s had halted the Werner plan, returned to the EC’s agenda. Jacques Delors, who had become president of the European Commission in 1985, was on a mission to cure “eurosclerosis” and lead Europe once more towards deeper integration.⁷³⁶

To embark on monetary union was of course a political decision. The transformation of the European Monetary System into a more ambitious and binding “hard EMS” in 1987, together with moves towards a single market, had quickly revived the old idea of monetary union between the EC countries. Some member states, France in particular, had long resented the asymmetry of the European Monetary System, where the German Mark was the anchor and the German central bank the pilot that steered monetary policy throughout the EMS area. The satellites status of other EC countries was especially distasteful to the French. A monetary union would eliminate the asymmetry by making its members equals in monetary policy.

At the start of 1988 several member states proposed the restarting of preparations for monetary union. Crucial to the project was the attitude of the German Foreign minister, Hans-Dietrich Genscher, who had previously had reservations about it but now announced that he was in favour of monetary union. In a statement published in February 1988, Genscher noted that a joint European currency and a single central bank were needed to support the single market. Even so, Germany had preconditions: central bank independence and the fundamental objective of price stability. Genscher called for a committee of experts to make a concrete proposal on monetary union.⁷³⁷

An EC summit in Hanover in June 1988 established a Committee for the Study of Economic and Monetary Union. Under the chairmanship of president Delors of the European Commission, it consisted of the governors of the EC's central banks, deputy president Frans Andriessen of the European Commission and three other experts –Alexandre Lamfalussy, General manager of the Bank for International Settlements (BIS); Professor Niels Thygesen of Copenhagen University; and economist Miguel Boyer, a Spanish former finance minister. The committee's secretary was Tommaso Padoa-Schioppa, deputy governor of the Italian central bank, who subsequently served on the board of the European Central Bank.⁷³⁸

The Delors committee delivered its report on 12 April 1989. It stated that “the move towards economic and monetary union represents a quantum jump which could secure a significant increase in economic welfare in the Community”. It concluded that the preconditions for monetary union were

- total and irreversible convertibility of currencies
- the complete liberalization of capital movements and the full integration of banking and other financial markets
- the elimination of fluctuation bands and the irrevocable locking of exchange rate parities.

The committee observed that the community had met the two conditions already or would meet them with the completion of the internal market programme. What remained to be done was to fix exchange rates, which would require unified monetary policy “and convincing evidence of an effective coordination of non-monetary policies”. The Delors committee saw economic union and monetary

■ Jacques Delors.

- Lehtikuva news photo archives /

Martin Keene.



union as different sides of the same coin, to be implemented in tandem. It underlined that “monetary union without a sufficient degree of convergence of economic policies is unlikely to be durable and could be damaging to the Community”.

The Delors committee believed that a monetary union would not necessarily require a common currency. In practice, irrevocably fixed exchange rates would achieve the same thing. Nevertheless it regarded a common currency as logical and desirable “for economic as well as psychological and political reasons”. It therefore proposed that national currencies should be replaced by a single currency as soon as possible after the locking of parities.⁷³⁹

A common currency would also require moving to common monetary policy. Coordinated monetary policies would no longer be enough. A new institution, the European System of Central Banks (ESCB), would have to be created, vested with responsibility for unified monetary policy. The system should be federal in structure, somewhat like the US Federal Reserve system. It would consist of the national central banks of the member states, plus a separately appointed ESCB Board that would monitor monetary developments and oversee common monetary policy in national central banks. Policies would be implemented by the ESCB Council, consisting of national central bank governors and ESCB Board members.

The Delors committee report contains many of the principles on which the European central banking system was later established. It proposed that price stability should be the principal objective of monetary policy; that the system should be independent of the governments of member states and the organs of the European Community; and that financing of national budget deficits should be forbidden. It is interesting that the committee’s proposals do not mention a European Central Bank, such as was later established. The committee model, in this respect, was the US central banking system, where the Federal Reserve Board is the central governing institution but is not a bank and is not entitled to carry out banking operations itself.⁷⁴⁰

The 1970 Werner report, the previous plan for monetary union, proposed that common monetary policy should be accompanied by a significant concentration of authority over fiscal policy. The Werner plan’s “Decision Centre for Economic Policy” would have been able to

control the budgets of member states, particularly regarding deficits and how they were financed. The Delors plan was less ambitious in this respect and thought that a set of common rules would suffice. It did not propose a pan-European fiscal policy body, although it did note that “uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the Community”. To resolve this dilemma the committee proposed binding rules to cap the budget deficits of individual member countries (in addition to banning central bank financing of government spending, mentioned above).⁷⁴¹

The Delors committee believed that monetary union could be implemented in three stages. In the first stage all restrictions on capital movements between member states would be eliminated. At the same time preparations would begin for amending the community’s founding treaty in order to allow EMU. This would require an intergovernmental conference. The committee also thought it was important to bring all member states into the exchange rate mechanism during stage one.

The second stage could begin when the necessary changes had been made to the community’s founding treaty. Next the institutional changes required by EMU would be implemented. The European System of Central Banks would be established. Although monetary policy management would still be the remit of national officials, a system for implementing a unified monetary policy would be created and tested. Macroeconomic policy controls would be improved by, among other things, “precise although not yet binding” limits on budget deficits.

The third and final phase would begin when unified monetary policy was adopted. The exchange rates of member countries would be locked irrevocably, monetary policy would become the responsibility of the European System of Central Banks and preparations for a common currency would be started. Limits on member state budget deficits set by the Council of ministers (“in cooperation with the European Parliament”) would become binding at this time.⁷⁴²

The schedule for the start of EMU phase three would be decided by politicians, the Delors committee noted.⁷⁴³

The European Council summit in Madrid in summer 1989 discussed the Delors report and decided that EMU stage one would begin

from 1 February in the following year, meaning that member states should implement the directive deregulating capital movements by that time. It was furthermore decided to begin preparations for an intergovernmental conference to negotiate the necessary changes to the Community's founding treaty, because the establishment of an economic and monetary union would transfer some national sovereignty to community institutions.

In October 1990 the European Council decided that the second stage of EMU would begin on 1 January 1994, subject to certain criteria. The single market programme would need to have been achieved, and changes to the treaty ratified. Moreover the "greatest possible number" of member states would have to be within the exchange rate mechanism. And there would need to be adequate economic convergence between member states, particularly in the fields of price stability and sound public finances.

The creation of an economic and monetary union required a fundamental revision of the founding treaty of the European Communities. It would be negotiated at an intergovernmental conference, to begin in December 1990. Just before the start of the conference the European Commission published its renowned and authoritative report "One market, one money", meant as a briefing for the negotiators. The report laid out the wide-ranging benefits of EMU.

It stated that monetary union would create "microeconomic efficiency" by complementing a community-wide market with a single currency: "a single market needs a single currency". Another advantage would be macroeconomic stability. Better price stability (meaning low and unchanging inflation) were seen as some of the benefits, providing that central banking institutions were designed properly. It also foresaw probable benefits in stability in the real economy (fewer fluctuations in production and employment). In addition to these, balance between member countries and their regions would improve. EMU meant more equal opportunities and risks for all regions, with no *a priori* relative advantages for original or newer member states. Less-favoured regions had a genuine chance to catch up with the rest. "EMU, like 1992, is a positive-sum game."⁷⁴⁴

Negotiations at the intergovernmental conference on a new founding treaty and related technical details of EMU lasted about a

year. The talks were concluded at the Community's Maastricht Summit in December 1991 and the treaty was signed in the same town on 7 February 1992. Ratification of the Maastricht Treaty took longer than expected, partly because Denmark first rejected it in a referendum in summer 1992 and did not approve it until certain amendments had been made in May next.⁷⁴⁵ The Treaty on the European Union – and at the same time on the formation of an economic and monetary union – finally came into effect on 1 November 1993. The European Community had become the European Union and the EU would be an economic and monetary union from the start of 1999.

THE INDICATORS OF EQUILIBRIUM

From the perspective of Finland's monetary and economic policies in the 1990s, the most important parts of the Maastricht Treaty were its convergence criteria, setting out the conditions that a country had to meet before it was eligible for monetary union. The treaty set four economic conditions, concerning the rate of inflation, the public deficit and debt, long-term market interest rates and participation in the EMS exchange rate mechanism.⁷⁴⁶

Going into slightly more detail, the economic convergence criteria were as follows:

- A country entering the third stage of EMU should have an *annual rate of inflation* (measured from consumer prices) no greater than 1.5 percentage points above average inflation in the three EU countries with the lowest inflation.
- The country's *government financial position* should be sustainable, which the treaty assessed in terms both of the budget deficit and public debt. The deficit was not to exceed 3% of gross national product, except if the excess was exceptional and temporary or if the deficit was shrinking substantially and continuously and was close to 3%. Public debt could not exceed 60% of gross national product, except if the ratio was diminishing sufficiently and was approaching the reference value of 60% at a satisfactory rate.
- The *durability of convergence* was examined by long-term interest rates. Their average during the preceding year could not be more than two percentage points higher than their average in the three countries with the lowest rate of inflation.

- To enter monetary union, a country needed to have steadily observed the normal fluctuation margins set in the EMS *exchange rate mechanism* for at least two years previously. In particular, an EMU country could not have devalued its currency during those two years.

In addition to its economic criteria, the Maastricht Treaty stipulated that the legal status of national central banks in EU member countries should be aligned with the requirements of EMU. Central banks were to be independent politically and should also be able to operate properly as part of the European central banking system and carry out its operations under the direction of the European Central Bank. The treaty did not demand the complete harmonisation of national laws on central banking but required them to meet certain conditions. Each national central bank was to have price stability as its primary goal; it was not to take instructions from any outside organisation in the execution of its duties in the European central banking system; its governor and other leaders needed to have a fixed term of office and protection from dismissal; and it had to be financially capable of independent action.⁷⁴⁷

The Delors committee report had naturally aroused great interest in Finland when it was completed. The Bank of Finland deemed it important and distributed copies to all economists on staff. It was uncertain, however, whether EMU would actually be realised and the report was not seen as impinging directly on Finland, which was not an EU member and was only currently preparing for negotiations on the European Economic Area. Even so, the accelerating trend towards European integration stirred up debate. The question arose of Finland's relationship to the European exchange rate cooperation, meaning the European Monetary System of the EU countries, the EMS, and its exchange rate mechanism.

Bank of Finland governor Kullberg gave his views on the subject in a speech on 15 June 1989. The occasion was the 40th anniversary celebration of *Unitas*, a journal published by the Union Bank of Finland, although the EMS debate had been actively encouraged by the other main commercial bank, *Kansallis*. Kullberg expressed doubts about the benefits of linking the Finnish markka to the EMS. He felt it would limit Finland's opportunities to pursue national monetary and exchange rate policies in its own interests. It would be "naïve", he said,

to believe that mere membership of the EMS would attenuate price and cost inflation in Finland. Confidence in the stability of the Finnish markka would still depend on action by the Finns themselves and on the “self-discipline” of the various economic parties involved. Regarding Finland’s relationship to the European Community (and possible future monetary union) he said that only one matter was certain; Finnish membership was out of the question.⁷⁴⁸

Markku Puntila gave a presentation on the subject of “integration and the Finnish monetary system” to the Finnish Economic Society, the most prestigious forum for policy debate, in the following spring. He was opposed to changing the Finnish exchange rate system, because rate flexibility within a band of a certain width was a natural part of the dynamics of economic adaptation. Finland’s experience showed “rather clearly” that a tightly fixed exchange rate was problematic, at least at a time when the country’s terms of trade were changing. Puntila believed that Finland’s existing exchange rate system – in spring 1990 – was not far from the optimal. “Consequently, from a variety of perspectives, linking it to the EMS or joining the EMS, to say nothing of joining EMU, might constitute divergence from the optimum. There would be a greater need for adjustment in prices and the real economy and also the risk of a spiral of regional debilitation.”⁷⁴⁹

So Europe’s monetary plans did not induce the leadership of the Bank of Finland to reconsider its attitude to EMS. Although this attitude may have been underpinned by the traditional concern about the compatibility of European integration with Finland’s policy of neutrality, the arguments used were specifically economic ones. Perhaps it was also felt that the project for monetary union might remain unfulfilled. As late as summer 1990, a researcher at the Bank of Finland, Kerstin Heinonen, wrote in the *Unitas* journal – admittedly expressing personal views – that “there is an unworldly feeling about the whole EMU, for the very reason that these new visions of Europe are hard to conceptualise.”⁷⁵⁰ Not a year would pass before changing economic conditions, the advance of EEA negotiations, and Sweden’s example would force the Bank of Finland to re-examine its position, and steer a new course towards monetary integration.

CONSIDERING AN ECU LINKAGE

At the start of the 1990s, Finland, Sweden and Norway all had exchange rate systems based on trade-weighted indices. This exchange rate policy, developed in the 1970s, had to be re-examined at the start of the 1990s when the three Nordic countries moved closer to the European Community and, together with the other members of the European Free Trade Association (EFTA), held negotiations on the creation of a European Economic Area (EEA). The central bank policy department of the Bank of Finland noted in an internal memorandum at the start of 1990 that “discussion about developing the exchange rate system is becoming an issue of topical interest.”⁷⁵¹ EFTA countries could not yet join the European exchange rate mechanism (EMS), which was intended for European Community members only. However, in early 1990, EFTA’s economic committee was already talking about alternative exchange rate systems, when US professor William Branson recommended that the EFTA countries should move towards the EMS.⁷⁵²

The change in Nordic exchange rate systems was precipitated by Britain, which linked its pound to the European exchange rate mechanism on 8 October 1990. The first to react was Norway, which also provided an example of a practical solution that was open to non-EC countries. On Friday 19 October, Norway announced unilaterally that it was pegging its krone to the currency unit of the European Community, the ecu. The decision came into effect on the following Monday. The reasons why Norway changed its exchange rate system were largely political, but were also meant to show its commitment to fixed exchange rates and set clear limits on future price and cost inflation.⁷⁵³

A wave of integration was now advancing through the Nordic area. A week after Norway’s exchange rate peg, Sweden surprised Finland by stating that it would seek membership of the European Community. The announcement came as part of an economic crisis package presented by the Swedish government to parliament. This put Finland in a difficult position. As neutral countries during the Cold War, Sweden and Austria had been the reference group to which Finland had wanted to belong since the 1950s. Now the reference group of neutrals had disappeared, because combining neutrality with EU membership was, in the words of Prime minister Holkeri, as difficult as “squaring a

circle". The underlying concern in Finland was that its relations with the Soviet Union would suffer from EU membership. Finland was to remain ambivalent about the possibility of joining the EU as long as the Soviet Union continued to exist.⁷⁵⁴

These were the circumstances when the board of management of the Bank of Finland talked about exchange rate options at a meeting on 21 January 1991. The background brief for their discussion was a memorandum *The markka and the EMS*, written by department head Johnny Åkerholm, which stated that "we need action to reinforce anti-inflation policy. Experience has shown that the present exchange rate system does not give it sufficiently strong support" and that "to put the message across, we must do something concrete to show that the system and the policy have changed". The memorandum did not explicitly endorse pegging the markka to the ecu, which it regarded as "a fairly minor change". A direct peg to the German Mark (as Austria had done) was regarded as more attractive, because it would "give a far clearer signal than the ecu alternative of a change in economic policy objectives". At the same time, Åkerholm stated that "a change in the exchange rate system is not a substitute for the arduous economic policy measures needed. Ultimately, the question is whether economic policy can be improved by changing the exchange rate system."⁷⁵⁵

The board did not warm to the idea of changing the basis on which exchange rates were set. Of the conclusions of the meeting of 21 January, the minutes state only that "at the present moment there is no need to talk of changes to be made in Finland's exchange rate system" and that "participation in European exchange rate co-operation, for example within the EMS framework, will not become germane for Finland until there are no alternatives left". Nonetheless, it was decided to draft a Bank of Finland statement on alternative systems for setting exchange rates and to discuss it with members of the government.

At the end of January, director Markku Puntila and Johnny Åkerholm completed the paper commissioned by the board on 21 January 1991. Despite what had been concluded at that board meeting, their statement was favourable in principle to pegging the markka to the German Mark instead of using an exchange rate index because it "would create good preconditions for successful integration". They were less enthusiastic about the other alternative, pegging the markka

to the ecu. "If it was a question only of switching from the present basket of currencies (the currency index) to the ecu basket, the change would have little economic significance and would be questionable, at best, in its effects. In this matter there is no need to get ahead of ourselves."⁷⁵⁶

In spring 1991, Finland's economy plunged deeper into recession than at any time since the Second World War, but it took quite a long time before economic leaders began to grasp the depth of the slump. In a forecast completed in February the Bank of Finland estimated that gross national product would decline 1½ percent during the year. A forecast completed at the same time by the Finance ministry foresaw a contraction of only half a percent. It subsequently transpired that plunging investment demand and falling exports would push gross national product down by a full 7 percent in 1991.⁷⁵⁷ Industry sounded the alarm about the steepness of the recession sooner than the professional economists who trusted in statistics.⁷⁵⁸

Overshadowed by rapidly deteriorating economic conditions, parliamentary elections were held in March 1991. The main victor was the Centre party, which increased its number of seats in parliament by 15. The losers of the election were the two main parties in the previous government; the Social Democrats lost eight seats and the National Coalition party even more, 13 seats. The elections were followed by the resignation of the Holkeri government, which had first adopted the strong markka in its programme. It was replaced by a government consisting mainly of the Centre and National Coalition parties, together with the Swedish People's party (two ministerial portfolios) and the Christian league (one). The Prime minister was the chairman of the Centre party, Esko Aho, a mere 36 years old. The Finance minister was a member of parliament for the National Coalition party, Iiro Viinanen.

The Bank of Finland had already prepared a briefing for the negotiators from the various parties, who were to prepare the programme of the new government. It stated that economic policies in the years ahead had to continue to give priority to controlling inflation. Measures to reflate the economy or devalue the markka were ruled out: "To change relative prices by means of the exchange rate is not a suitable economic policy method for directing resources efficiently. Moving the currency band would immediately reduce the chances of bringing down inflation from the current level. It would fan

inflation sentiment and plunge the economy into a new inflationary spiral ... Moreover, achieving a lower domestic interest rate level requires a long-term strategy that realistically shows the government's intention to maintain the present exchange rate band."⁷⁵⁹

The Aho government took office on 26 April 1991. Its programme stated that economic prospects were "very problematic" because of the current account and budget deficits. Unemployment was also climbing steeply. To overcome the slump the government promised to implement "immediate measures to improve competitiveness and make savings in the public sector" as well as to "correct structural distortions in the economy".

In monetary and exchange rate policies, the Aho government had the same programme as the previous Holkeri government except that it now mentioned the possibility of pegging the markkaa to the ecu: "The objective of monetary and exchange rate policies is a stable markka and a reasonable and moderate interest rate level. To increase the credibility of monetary policy we shall consider aligning the external value of the markka to follow the ecu of the European Community, but without changing the currency index fluctuation band."⁷⁶⁰

The government had thus committed itself to a stable markka, as its predecessor had, but mentioning the ecu was a new element. Its addition is probably explained by the ongoing negotiations on a European Economic Area between the EFTA countries including Finland and the European Community, as well as expectations that Sweden would soon follow Norway's example of an ecu peg. At the time that the government programme was being written, the EEA negotiations were at an important stage and it was hoped to complete them by summer 1991. Ultimately they missed this deadline by about half a year.⁷⁶¹

POLITICAL HEAVYWEIGHTS JOIN THE BOARD

The new parliamentary term in spring 1991 also brought a change in the composition of the Bank of Finland's board. At the start of January, Kalevi Sorsa, who had been prime minister of four governments, joined the board. Sorsa had been chosen for the position on a Social Democratic

party mandate back in September 1987, after he had resigned the chair of his party. The place that traditionally belonged to the SDP had opened up when Seppo Lindblom, an economist and confidant of President Koivisto, had been appointed CEO of Postbank. At that time Sorsa had preferred to continue in politics, first as Foreign minister in Holkeri's government and then as Speaker of parliament, but when the parliamentary term neared its end he took up his position at the central bank.

The change of government after the election meant that the outgoing Prime minister Harri Holkeri was also free to return to his position on the board of the Bank of Finland. The board now boasted genuine heavyweights of Finnish politics – two former prime ministers Sorsa and Holkeri, plus Esko Ollila, who had been finance minister and minister of trade and industry. A study of party affiliations also produces arresting results. The board of the Bank of Finland contained three former chairmen of what had traditionally been the four top parties – Kalevi Sorsa of the Social Democrats, Harri Holkeri of the National Coalition party and Ele Alenius of the People's Democrats. The fourth party was represented on the board, too, by Esko Ollila, a leading light in economic affairs at the Centre party.

In addition to the aforementioned and governor Kullberg, the board contained Markku Puntila, who was responsible for monetary and exchange rate policies. He had been appointed permanently to the board only a year earlier, in May 1990, after the retirement of Pentti Uusivirta, whose responsibilities included trade with the Soviet Union. However, Puntila had very long experience of board work, having been an acting member continuously since 1983. Whenever a member had taken leave of absence to serve as a government minister, Puntila had been appointed in their place. He had risen to the managerial level of a director, reporting to the board, in 1972 and had coordinated monetary policy planning since then. Because of his long experience and unmatched expertise in monetary policy, Puntila was the board member to play a crucial role in the months ahead, when Finland's economic problems came to a head in an overt banking and currency crisis.

MARKKA PEGGED TO ECU WITHOUT DEVALUATION

After the parliamentary elections in March, Finnish market interest rates plunged, falling three percentage points in April and early May. A sign of the calm state of the money market was that the exchange rate and the central bank's currency reserves remained fairly stable at this time, but the situation changed suddenly for the worse in mid-May, when Sweden changed its exchange rate system.

By decision of its general council, the Swedish central bank pegged the krona to the ecu on Friday 17 May 1991. The stated aim was to clarify the long-term goals of Sweden's exchange rate policies and reduce uncertainty – in other words, to dispel expectations of a devaluation. An ecu peg also underlined the need to adapt the Swedish economy to the demands of future EU membership.⁷⁶²

Sweden's ecu peg seemed to have very favourable results. Short-term market interest rates fell distinctly and the Bank of Sweden's currency reserves grew strongly. Obviously results like these would have been very welcome in Finland, too, which was suffering from high interest rates. On the same day as Sweden announced its ecu peg, governor Kullberg of the Bank of Finland released a statement proposing that Finland should also give "more serious consideration" to the same. Tying the markka to the ecu would serve to increase stability and trust in Finland's exchange rate policies, he said.⁷⁶³

The governor knew in advance about Sweden's plans regarding the ecu; he had been told in Basel at a meeting of the Bank for International Settlements on 13 May 1991. Kullberg wrote later that as soon as he heard the news, he concluded that Finland should follow Sweden's example. He felt the Nordic countries should not have different exchange rate systems and also that, if the dollar continued to strengthen and if Finland persisted in fixing its markka to the old trade-weighted currency index, an ecu peg would give Sweden a competitive advantage over Finland.⁷⁶⁴

Immediately upon Kullberg's return from Basel, preparations were begun at the Bank of Finland for pegging the markka to the ecu. By 15 May, two days before the Swedish announcement, Kullberg outlined the situation to the supervisory council as follows: "Norway moved to an ecu basket last year. There are many signs

that Sweden will do something similar in the near term. We can reasonably conclude from all the evidence that Sweden will apply for EU membership before the summer and the ecu question will probably come up even earlier. This will leave Finland isolated with its (currency index) basket. I do not think it to be a good thing and we should prepare to take action.”⁷⁶⁵

In the supervisory council discussions, Kullberg admitted that he had changed his attitude to Finland’s old currency index because, he said, of the trend observable in Europe. “If we have roughly the same (exchange rate) system as elsewhere in Europe, the markka will remain stable against other European currencies. I think this is quite an advantage. Especially if every other country in Western Europe adopted the system, it would be pretty strange for Finland not to.”⁷⁶⁶

For two weeks after Sweden announced its ecu peg, there was a tough behind-the-scenes struggle in Finland over whether the markka should be devalued when it was pegged to the ecu. Industrial organisations pushed strongly for a devaluation, pointing to Finland’s poor competitiveness and the ever-deteriorating economic situation. Speculation about the possibility of a devaluation was reflected in the foreign exchange market, where the markka came under strong attack. An internal memorandum at the Bank of Finland stated: “On Thursday 23 May events began in the foreign exchange market. A flight of currency started.”⁷⁶⁷

On the first day that currency began flowing out of the country, the markka weakened by almost one percent against the currency index and short-term market interest rates rose. One-month Helibor rose the most, by about four percentage points, climbing above 15%. In a money market that was already tight, this was a considerable shock. In the week beginning 23 May, the Bank of Finland sold currency worth more than 9 billion markkaa from its reserves in order to support the exchange rate. This amount was about a quarter of the convertible reserves available when speculation began. In addition to its direct operations, the bank also intervened on the forward market to support the markka.⁷⁶⁸

The question of whether to change the exchange rate while pegging it to the ecu was resolved in talks between the government and the Bank of Finland on 2–3 June. On the government side, Prime minister

Aho had reached the conclusion that a small devaluation should be carried out, annulling the four-percent revaluation of 1989. Director-general Sixten Korkman, representing the Finance ministry, was also in favour of a four percent devaluation. However Finance minister Viinanen and the board members of the Bank of Finland present were opposed to the idea. On the Bank of Finland's side, governor Kullberg hesitated, however. The bank alone would be unable to secure the exchange rate, he said, unless it was supported by "a tough incomes policy and tough fiscal policy".⁷⁶⁹

On 3 June, the second day of the talks, Prime minister Aho phoned President Koivisto to ask for his opinion on the exchange rate. The president replied that he gave his backing to the government. In his subsequent memoirs Koivisto explained that he took this stand because Finland was a parliamentary country and exchange rate policies were primarily the remit of the government.⁷⁷⁰

After Aho had told the governor of the president's view, Kullberg suggested a form of compromise: there would be no formal devaluation (i.e. the limits of the fluctuation band would be unchanged) but the markka would be allowed to weaken within the existing band by the four percent that the government wanted.⁷⁷¹ In fact Kullberg's idea had been overtaken by events; by that Monday, a week of speculative pressure had pushed down the value of the markka so much that it could only have declined another 2.5 percent within the fluctuation band. However, allowing the currency index to rise to the top of the band would have reduced the markka's value by exactly the proposed 4 percent from the value prevailing before speculation began.⁷⁷²

According to Kullberg's account, he had the impression that most of the board of management would have accepted the compromise he proposed, but Markku Puntila and Kalevi Sorsa were unconditionally opposed to it. Kullberg concluded that the board could not put such an important matter to the vote so he conveyed to Prime minister Aho the "unanimous and unambiguous" response of the board that "nothing should be done". At the least this meant that the board of the Bank of Finland would propose that the ceiling and floor of the future ecu index should correspond to the same fluctuation band limits of the old index. The Currency Act did not allow the government to act alone in moving the currency index fluctuation limits. Its hands were tied and there would be no devaluation.⁷⁷³

The supervisory council met on the morning of Tuesday 4 June and made its proposal to the government for a change in the Currency Act. The matter was dealt with very rapidly by the government and parliament and the change came into effect on Friday 7 June. On the same day the supervisory council, acting on a motion by the board of the bank, made a proposal to the government for a decision on new “principles for calculating the external value of the markka and new fluctuation limits”.

To be precise, the markka was not pegged to the European currency unit but to a basket consisting of currencies of European Community members, weighted according to their weight in the ecu. The fluctuation limits of the fluctuation band and the initial value of the index were set so that, on the day the new index was adopted, they corresponded to the limits and value of the old currency index. At the middle of the fluctuation band, there were 4.8758 markkaa in an ecu.

The main difference between the old trade-weighted currency index and the ecu basket was that the latter did not contain the US dollar, the Japanese yen, the Swedish krona or the Norwegian krone, which had a combined weight of 37 percent in the trade-weighted index. On the other hand the currencies on which the ecu was based had a combined weight of about 59% in the old trade-weighted index. In practice the old and new indices were even more similar because the Norwegian and Swedish currencies had been pegged directly to the ecu and the Austrian currency indirectly, via the German Mark. As the result of these pegs, the currencies in the ecu and the currencies pegged to the ecu together had a weight of about 83 percent in Finland’s trade-weighted index.

WEIGHTS OF CURRENCIES IN FINLAND'S CURRENCY INDEX
AND THE ECU BASKET, 6 JUNE 1991

	Trade weighted index, %	Ecu,%
Swedish kronor	18.7	-
US dollar	8.6	-
Japanese yen	5.7	-
Norwegian krone	4.0	-
Swiss franc	2.4	-
Austrian Schilling	1.6	-
German Mark	19.4	30.3
British pound	12.6	12.6
French franc	6.9	19.1
Italian lira	5.2	10.0
Dutch guilder	5.0	9.5
Belgian franc	3.3	7.8
Spanish peseta	2.1	5.4
Danish krone	4.5	2.5
Irish punt	-	1.1
Portuguese escudo	-	0.8
Greek drachma	-	0.6
Luxembourg franc	-	0.3
Total of currencies in Ecu basket	59.0	100

After the markka was pegged to the ecu currency basket, calm quickly descended on the foreign exchange market. On 27 June Markku Puntila wrote in a brief memorandum that the ecu peg had worked well because interest rates had fallen substantially, currency had returned to Finland and, after the repatriation phase, the markets had been very stable, with the markka "hovering around its centre point in the band". With a view to the future, Puntila said that the objective should be to facilitate the adjustment of the economy by taking advantage of the scope for devaluation within the currency band, aiming at the lowest possible interest rate compatible with maintaining market confidence.⁷⁷⁴

During the summer the Bank of Finland followed the line proposed in Puntila's memorandum and allowed the markka to weaken against the ecu as far as the fluctuation band permitted. Between the start of

MARKKU PUNTILA (1937–)

Markku Puntila, one of the chief architects of Finland's monetary policy in the 1980s, sought to replace administrative interest rate controls with active, market-based interest rate policies in order to overcome the traditional weakness of the Finnish markka. After economic crisis struck Finland in 1991, he became known as a leading and untiring defender of the fixed exchange rate policy.

While reserved in his attitude to publicity, he presented his views on monetary policy forcefully in an interview published in *Kauppalehti* business daily on 7 June 1991. The subject was the debate about a devaluation of the markka that had erupted in connection with the recent ecu peg. Puntila's thesis was that a devaluation was not appropriate because the benefits in improved competitiveness would be only temporary. Inflation would accelerate and inflation expectations would increase, which would raise interest rates. The real adjustment of the economy would be delayed, foreign borrowing would become more difficult and Finland's international reputation would suffer. It would become "a third class state" that could not be depended on to manage its affairs without devaluations. The credibility of the central bank and the government would collapse because of the sharp contrast between words and deeds.

Puntila had joined the Bank of Finland as a researcher in 1960. After completing his dissertation in 1969 he rose to the position of head of department and was asked to examine

how the system for planning monetary policy could be modernised. At the start of 1972 he was promoted to the level of director, below the board of management, and became head of economic policy planning when the Bank of Finland's Institute for Economic Research was dismantled and incorporated into the bank's line organisation. In the years ahead there was a generation change at the Bank of Finland as many high-ranking executives, like Jaakko Lassila, Heikki Valvanne and Timo Helelä, left the bank. This provided room for new talents and it was Puntila who became the bank's leading technocrat in monetary policy during the 1970s. From 1983 he served in the board of management continuously, because whenever one of its permanent members was on leave of absence as a minister, Puntila was named acting member. He and Rolf Kullberg can be said to have directed monetary policy in this period. In 1990 he became a permanent member of the board.

The devaluation of autumn 1991 was a heavy blow; it meant the failure of the economic policies to which Puntila had been committed for many years. Finnish society was not, after all, prepared to give the support he demanded for a new monetary policy opposed to devaluation. He saw resignation from the board of management as his only option and President Koivisto, who knew him to be unconditional in nature, made no attempt to talk him out of it. Thus Markku Puntila stepped down from the bank at the age of only 54, but having served it for more than three decades.

■ Markku Puntila
was a Bank of Finland
researcher in 1960–1970,
a director in 1972–1990
and a member of the
board of management
in 1990–1991.

– Finnish Press Agency/
Teppo Lipasti.



June to the end of August, it fell almost 3 percent in value. Short-term market interest rates during the summer were around 10–11%, compared with over 14% in the early months of the year. On the surface of it, the ecu peg seemed to have had the desired effect in boosting credibility of economic policy. The convertible currency reserves of the Bank of Finland also stayed relatively stable until the second half of August. Then the situation in the foreign exchange market deteriorated again.

SAVINGS BANK PROBLEMS COME TO A HEAD

CONCERN ABOUT LIQUIDITY

As noted previously, deregulation of the financial markets increased banking risks many times over. By summer 1989 the central bank was seriously concerned about risk.⁷⁷⁵ At this point its greatest worry was the funding structure of the banks and the anticipated downturn in their profitability. The source of the funding problem was their strong dependence on the short-term interbank market and on the call money market, which had been originally intended only to pool liquidity. Funding was therefore mostly short-term market money and short-term credit from the central bank. Its growth had been fastest at SKOP, the Central Bank of Finnish Savings Bank, and this was where the problems first surfaced. However, it should be stated that, from the Bank of Finland's standpoint, many other banks also had an unsatisfactory funding structure. By spring 1990 the level of risk involved was seen as threatening the stability of the whole banking system. The central bank began to talk of systemic risk.⁷⁷⁶

The Bank of Finland had been aware of increasing risks in banking and the consequent threat of systemic risk for several years. In a departmental reorganisation, a risk monitoring had been set up under Matti Vanhala, although it is typical of the attitudes of the time that "the project was initially regarded, both at the Bank of Finland and among commercial banks, as officious overkill and a waste of resources".⁷⁷⁷ Kaarlo Jännäri was appointed head of department. Most of the work of monitoring bank profitability was done by Kjell Hemberg

and bank risk analysis by Liisa Halme. All three later played important roles in crisis management during the early 1990s.

At the end of the 1980s the Bank of Finland had been struck by the fact that SKOP's share of the total stock of certificates of deposit in circulation was far greater than its relative size among banks. In September 1989, for example, SKOP CDs in circulation were worth almost 20 billion markkaa, whereas Union and Kansallis banks, with balance sheet totals more than twice as large as SKOP's, had each issued only some 14 billion markkaa of CDs. The high proportion of SKOP CDs reflected the aggressive lending policies of the whole savings bank group; to gain market share, SKOP was exploiting all funding opportunities to the full. This had aroused irritation among its competitors and in September 1989 Kansallis and Postbank had refused to buy SKOP CDs unless they paid a higher yield than the CDs of other banks. They based this on the argument that the price of CDs should be set by supply and demand, although their demand was contrary to an agreement, sponsored by the Bank of Finland in 1987, that government bonds, central bank CDs and the CDs of major commercial banks should be treated equally.⁷⁷⁸

This dispute in autumn 1989 between the commercial banks also revealed to the experts and executives of the Bank of Finland that the unified pricing of CDs contained major problems. If CD prices had been freely determined, they would have reflected considerations of risk and liquidity at the banks that issued them. Uniform pricing had been intended to maximise liquidity and ensure an effective money market, but it was leading, and had partly led already, to a situation in which the most risk-prone banks could obtain money more cheaply than from the market, while the "good" banks paid more for CD financing than the market would have charged. The problem for the Bank of Finland was that it was the guarantor of this arrangement, which it now saw as a distortion of incentives. However, although the anomalies were recognised, the major banks finally agreed, in autumn 1989, to continue operating within this framework.⁷⁷⁹

SKOP's policy of aggressive growth was also apparent in the call money market, where the demand and supply of money market liquidity were ultimately pooled by overnight deposits at the central bank and credit from it. By autumn 1989 it was clear that SKOP was being forced to resort to overnight central bank financing more often

than the other banks. It was not even deterred by changes made to the system in November 1989, which significantly raised the cost of call money. It was not merely in markka loans than SKOP's funding was short-term. The maturities in its borrowing in foreign currencies were also extremely short, which meant an even higher liquidity risk.⁷⁸⁰

The Bank of Finland's new risk monitoring department had drawn attention to the risks in SKOP operations as early as 1988. From September 1989 onwards, SKOP was subject to special monitoring by the Bank inspectorate as well as the central bank. Much has subsequently been made of an unofficial exchange between governor Rolf Kullberg and SKOP's chief executive Matti Ali-Melkkilä, both in Washington for a World Bank meeting on 27 September 1989. Kullberg was sharply critical of the operations of the savings bank group and particularly annoyed by group's deliberate decision to act against the spirit of the supplementary cash reserve agreement of early 1989. The central bank was also concerned about SKOP's unhealthy funding structure and its aggressive investment policy even though previously fast-rising share and property prices had been falling since the summer. However, their unofficial discussion, at an evening reception at Finland's embassy in Washington, has subsequently been blown out of proportion. It was an isolated episode which later served as a metaphor for the tense relations between the central bank and SKOP.⁷⁸¹

The banking strike of February 1990 briefly froze SKOP's position but, as soon as it ended, the Bank of Finland intervened, summoning SKOP executives to a meeting on 2 March. They were now informed that the bank had 20 days to draw up a detailed proposal on how it would reduce its funding risks. It was the start of a series of negotiations in which the demands of the central bank grew steadily tougher. SKOP's own proposals for defusing the crisis were judged unsatisfactory and in April the Bank of Finland drafted its own detailed programme for improving SKOP's funding structure. The programme was approved by the Bank of Finland board on 3 May 1990, after it had heard reports from the risk monitoring department about the funding structure of Finnish banks and the changes that were needed. Although SKOP's difficulties were the greatest, the board stressed that the course it was adopting could be applied to other banks too, if necessary.⁷⁸² The statement underlined that the Bank of Finland sought to treat all banks neutrally.

The programme for extending the maturity of SKOP's markka debt was to be completed by the end of 1990. The demands were robust. The total of markka debt under 6 months was to be reduced from 30.2 billion to 22.7 billion; debt with a maturity of less than a month was to fall from 16.8 billion to 13.2 billion. SKOP was required to provide weekly reports on its progress, with milestones at the end of August and the end of October. Juggling payables and receivables between SKOP and the savings banks was forbidden. Sanctions were set for failure to observe the programme.⁷⁸³ To protect SKOP's credibility, outsiders were not informed about these negotiations. The restructuring programme approved on 3 May 1990 marked the end of over a year of talks between the Bank of Finland and SKOP management, aimed at changing SKOP's mode of operations without a formal restructuring programme. Now the central bank had moved from words to deeds, and SKOP had irreversibly become its ward.

INVESTMENT RISKS REALISED

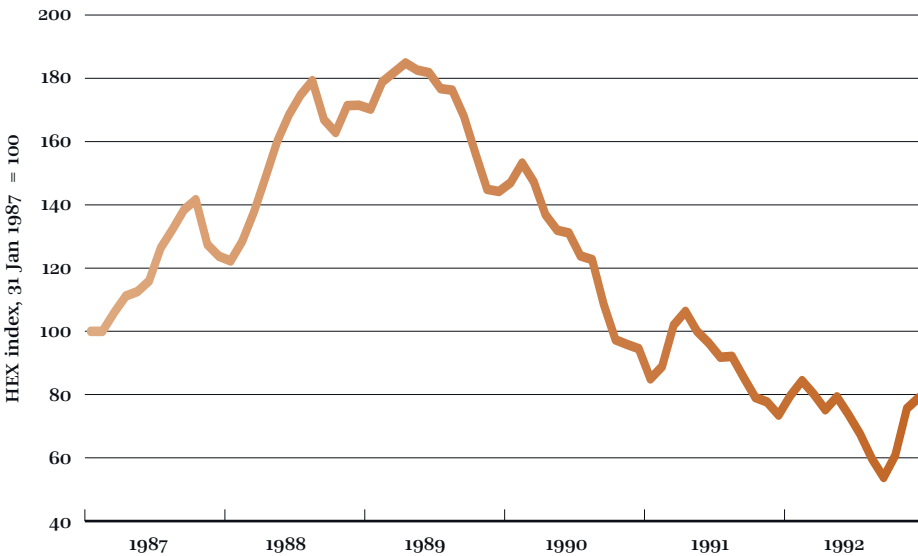
Soon after the programme for scaling down SKOP's liquidity risk had been approved, the Bank of Finland's risk monitoring department was faced with a new dilemma. This concerned SKOP's wide-ranging investment operations, although the assets were actually anchored in separate corporations owned by SKOP and its associates. The first department memoranda about SKOP's investment risks are dated early June. Their subjects included the investment companies SP-Sijoitus and Interpolator, which were in a financially untenable position after the fall in share prices. A member of the Bank of Finland board, Esko Ollila, sent a letter to SKOP management, demanding vigorous action to scale down the investment risk. The Bank inspectorate was also concerned and summoned SKOP executives to meeting on 20 August 1990, attended by its director general Jorma Aranko and Esko Ollila of the central bank.⁷⁸⁴

In fact the question of risk concentrations had first been brought up in 1986, when the head of the Bank inspectorate had asked SKOP for an explanation of how its shareholdings were compatible with banking law. At that time SKOP was saved by the impotence of the law, which allowed it to hive off some of its holdings into subsidiaries and individual savings banks.⁷⁸⁵ The consequences of weak legislation had thus been visible five years before the crisis came to a head, although

at that time the inspectorate was more concerned about the excessive economic power wielded by commercial banks rather than excessive investment risk.

Share prices continue to fall in the autumn of 1990 and by the end of September they were 40% lower than 18 months earlier. This had fateful consequences for SKOP's financial position. The Bank of Finland's risk monitoring department was now following the SKOP group and its affiliates in real-time. From 1987 onwards, SKOP had been prominent as Finland's most profitable commercial bank, with higher earnings and a better return on equity than the large old commercial banks. Its management duo, Christopher Wegelius and Juhani Riikonen, had become public symbols of modern banking. They were praised for their fast and full transformation of the savings bank group, which had reshaped the group's stuffy central financial institution into the country's most dynamic commercial bank. Not every aspect of their operations was admired, though, and the heads of the other bank groups accused them of breaking rules of play and sabotaging interbank cooperation.⁷⁸⁶

SHARE PRICES IN FINLAND 1987-1992



Source: Reuters.

SKOP's profits had not come in the traditional way, from the margin between lending and deposit rates, but from active investment operations, better described as aggressive, and the capital gains they yielded. After decades of slumber, the Helsinki Stock Exchange had come alive in 1986 and share prices had started to rise, which made it easier for SKOP to realise fast profits. The rise flattened out in September 1988 but resumed before the end of the autumn. These profits could not be produced when share prices were falling and, in summer 1990, the SKOP group and indeed all its affiliates were operating at a loss. SKOP's accounts still showed a positive result but this had been achieved by selling real estate to affiliates. The capital gains were no longer genuine because in most cases the buyer was Alexi, a property investment group affiliated to the savings banks, for which SKOP had arranged credit at zero or below-market interest.⁷⁸⁷

The board of management of the Bank of Finland considered SKOP's position at three consecutive meetings on 12–18 October 1990. The restructuring of SKOP's funding was still discussed but now urgent decisions were needed specifically about how its excessive share portfolio (worth 5.5 billion markkaa at a conservative estimate) could be dismantled in a controlled way. Protracted negotiations, also involving the Bank inspectorate, produced a model for transferring most of these shares to a holding company entirely owned by SKOP. However this had to be done in a way that respected the interests of small shareholders, which meant in practice that SP Sijoitus had to be delisted from the stock exchange as soon as possible and small shareholdings had to be redeemed at a reasonable price. SKOP was required to invest 1.3 billion markkaa in the share capital of the new company. Once the shares had been transferred to it, they could be valued freely, giving SKOP the necessary accounting flexibility.⁷⁸⁸ These arrangements also included a directed issue of SKOP shares to the savings banks and the sale to them of Sp-palvelu, an IT service company. In these operations, savings banks provided 1.8 billion markkaa.⁷⁸⁹

SKOP's investments and liabilities in industry, some on its own balance sheet and some on the balance sheet of its subsidiary Interpolator, had now become an even greater burden than SP-Sijoitus. The greatest risk was Tampella, an industrial corporation that it had acquired in March 1987, which had debts of 4.6 billion markkaa to the

SKOP group by the end of July 1990. The collateral for these loans was only 1 billion markkaa. On the subject of these risks, the Bank of Finland board meeting decided that the SKOP group would disinvest from Interpolator and Tampella in accordance with the schedule approved on 18 October. Correspondingly, foreign securities held by SKOP-Cayman, a company registered in the Cayman Islands, were to be sold in a manner approved by the Bank of Finland by the end of November 1990.

In addition to the above arrangements, the SKOP group and companies close to it were forbidden to increase their share and real estate holdings and associated commitments without the permission of the Bank of Finland. Claims and commitments were not to be transferred to other companies without the central bank's permission. SKOP was not to pay a dividend for 1990.⁷⁹⁰

After this meeting of 18 October, SKOP and the whole savings bank group was firmly under the tutelage of the central bank. SKOP was committed to providing the Bank of Finland with all information requested and anything additional of relevance. It also had to consult the Bank of Finland in advance about all significant measures related to the programme. On the other hand, the board of the Bank of Finland did not think it was necessary to intervene in personnel questions, in other words to replace the senior management of SKOP. To protect the general confidence necessary for banking, the board informed senior executives of all banks on the very next day about the programme for stabilising SKOP's position. It used the occasion to underline the central bank's support for the programme.

The supervisory council was informed about SKOP's problems at a meeting on 28 November 1990. Esko Ollila of the Bank of Finland's board of management explained the historical background, noting that SKOP's problems had been apparent for more than a year. This had led to the intervention of the Bank of Finland to reorganise its financial structure and main concentrations of investment risk. Now, in November 1990, the situation had been stabilised and, in the Bank of Finland's view, the programme would allow SKOP and the savings banks to cope with their problems. Council member Erkki Pystynen (National Coalition party) congratulated the central bank on the effectiveness of its supervision and action to protect the money market and the institution of banking. Councillor Tuure Junnila (also of the

National Coalition party) said how important it was to prevent an outbreak of panic and to contain information.⁷⁹¹

Although the council had been assured that the situation was under control, SKOP's market credibility was already under threat. On 21 and 22 November the board of the Bank of Finland had already been considering ways of improving SKOP's liquidity. Its funding position had degenerated and the profit expectations of the whole savings bank group had become gloomier than ever. According to Matti Vanhala and Kaarlo Jännäri, certificates of deposit issued by SKOP could not find buyers at any price, so the bank's funding was largely dependent on the shortest possible finance, call money provided by the Bank of Finland. The institution most strongly opposed to buying SKOP CDs was the state-owned Postbank. SKOP's financial woes went beyond the domestic market. Within six months, 26 billion markkaa of its foreign borrowing would fall due while only 6 billion markkaa of its foreign claims would become payable. The international funding of SKOP was reaching an impasse.⁷⁹²

However, its profitability was now in a bigger crisis than its liquidity. The Bank of Finland board could see from a memorandum written by the risk monitoring department that the SKOP group would probably lose more than half a billion markkaa in 1990 and that losses would remain at the same level for years ahead. The fateful question had become the group's structure, in particular its excessive exposure to Tampella. A very large proportion of its investment portfolio was non-performing, while its funding was on market terms. For example, a non-performing portfolio of 3 billion markkaa created annual losses of 450 million markkaa while the market interest rate was 15 percent. To deal with two simultaneous crises – liquidity and profitability – was literally impossible. To manage the liquidity crisis, the group's balance sheet needed to be downsized but this would also cut back productive operations so a return to profitability would be harder than ever.

The burden of Tampella was significantly worsened by an exceptionally steep fall in Tampella's share price. When the shares had been acquired in spring 1987 the price was as high as 163 markkaa but by mid-December 1990 they had collapsed more than 70 percent to 39 markkaa.⁷⁹³ No turn for the better was to be expected in the prevailing business climate.

The only real solution to the SKOP impasse would have been a *bare bones* solution, clearing the group's balance sheet of its investment portfolios by selling the shares at their market price of about 3.5–4 billion markkaa. This would realise a loss of 2–3 billion markkaa, reducing its equity to a level about 1.5 billion below minimum capital adequacy by international norms. The shortfall would be made up by issuing new SKOP shares or equity-rated bonds to this amount, to be subscribed by the buyer of the investment portfolios. These operations would make SKOP viable but there were two very large question marks. Firstly, who would buy the portfolio and finance the deal? Secondly, who would be willing to take over the whole burden of Tampella?

The *bare bones* model would not end there. After SKOP's balance sheet had been purged, it could be merged with another bank. The potential partners would be either OKO (the Central Bank of the Cooperative Banks) or Postbank, but no bank would be prepared to take over SKOP unless the deal was sweetened. To promote a merger, the Bank of Finland would have had to offer a dowry, either the SKOP shares it held or convertible bonds. Even this model did not offer a way out of the current crisis because finding a merger partner would take time. The historical differences between banking groups were so large that it was questionable whether synergy existed and whether the deal would ever yield any benefits. Why would anyone want to marry SKOP?⁷⁹⁴

The Bank of Finland was not yet ready for such radical solutions. There were probably fears of the public criticism that would be voiced about a *bare bones* model costing several billion markkaa. Instead, the board of management settled for a solution that would buy it time. To improve the profitability of SKOP and all the other banks, it decided to prepare a proposal for a significantly lower cash reserve requirement and a higher rate of interest on cash reserve deposits. It also decided on a loan programme of about 2 billion markkaa to support SKOP and bring its immediate liquidity crisis under control.⁷⁹⁵

In practice these decisions meant that the reorganisation programme of the SKOP group continued along the lines that the board had laid out on 18 October 1990. However, its perception of the crisis had changed during the autumn. Like others, the central bank was now aware that the main problem was not liquidity but SKOP's large liabilities, which were out of all proportion to its risk-bearing

ability. In this respect the crucial question was its ownership of Tampella. The central bank had also realised that the crisis was not confined to the central bank of the savings banks, SKOP. The finances of many major savings banks, the biggest owners of SKOP, were already in extremely poor shape in autumn 1990. SKOP could not expect to receive any financial support from them.

The year played out under the same auspices. Confidence in SKOP had collapsed and no amount of reassurance could restore it. The Bank of Finland repeatedly scolded the executives of commercial banks about the rules of play in the CD market. At the same time, these disagreements about SKOP's position in the market were problematic for the whole financial system, as illustrated by the following quotes from a memorandum to the board by Matti Vanhala:⁷⁹⁶

“The Bank of Finland itself is being forced into an awkward position. If it vouches for some bank in dealing with other banks, the risk to them becomes central bank risk, and it cannot then be acceptable for the other banks to refuse to play their part in ensuring monetary stability. Nor does such misbehaviour bring them any benefit in this situation.

“What had happened now is that the Bank of Finland has made commitments to the benefit of the other banks without eliciting from them the market ‘normalisation’ that its commitments were aimed at. The situation is embarrassing for the Bank of Finland, dangerous as a precedent, and unacceptable in the management of the SKOP affair.

“SKOP's creditworthiness on the interbank market must be restored unconditionally. To allow an important financial institution to be denied credit after the central bank's intervention contains an excessive risk of instability to the whole system. It then becomes a question of confidence in the central bank's abilities and its moral authority. The importance of the latter can hardly be overstated.”

By the end of autumn 1990 the problem had acquired a new dimension. The Bank of Finland began receiving enquiries from foreign banks about SKOP's fate. The problem was no longer confined to the savings bank group. Finland's international credibility was at stake⁷⁹⁷ and the position of the entire financial system had become more vulnerable.

THE NOOSE TIGHTENS

By autumn 1990 SKOP realised that Tampella and associated risks posed the greatest threat to its future. It had been trying since 1989 to make the Tampella group profitable with a massive investment programme of over 4.6 billion markkaa but by the second half of 1990 the plan had clearly failed.⁷⁹⁸ Tampella was still making a loss and its cash flow did not suffice even for interest payments. The only apparent option at that time was to sell it, which would be easier if it was first broken up into a number of smaller companies, for which buyers would be easier to find. The board of Tampella ratified the decision to demerge the company on 1 January 1991.

The implementation of the plan was not a matter solely for the company and its shareholder, SKOP. Among Tampella's creditors was an international banking syndicate that had protected its loan with tough covenants that required the syndicate's approval for a demerger. In the worst-case scenario, the break-up of the company might have required the immediate repayment of 1.7 billion markkaa. Meanwhile, the head of the Bank inspectorate, Jorma Aranko, had made it clear that no increase in SKOP's commitments would be acceptable. Furthermore, the programme for reorganising SKOP's funding position, approved by the Bank of Finland on 18 October 1990, had forbidden any increase in SKOP's exposure to Tampella. At the start of 1991, therefore, the path to demerging the company seemed to be blocked.

In March 1991 SKOP sent a new proposal to the Bank of Finland on increasing its Tampella liabilities. It was discussed by the board on 21 and 25 March, on the basis of a memorandum from the risk monitoring department. The memorandum noted that the need to increase SKOP's liabilities stemmed specifically from the difficulties that had arisen with Tampella's foreign financiers. These had threatened to call in their loan unless their conditions were accepted but the conditions were so stringent that they were unacceptable to Tampella and SKOP.

Financially this was a very significant issue, because the proposed increase would raise SKOP's exposure from Tampella to a total of about 9 billion markkaa. SKOP was in a hurry to get a decision because its negotiations with the foreign banks were currently underway

and its negotiators needed to know whether the Bank of Finland would permit an increase in SKOP's liabilities in the event that the negotiations failed to reach a satisfactory conclusion. Furthermore SKOP wanted the demerger to be completed by 25 March 1990, for legal and tax reasons.

If the foreign bankers called in their loan, if SKOP could not finance the resulting deficit, and if no new sources of finance were found, there was a serious threat that Tampella would go bankrupt. This in turn would lead to an acute crisis at SKOP, from which its only escape would be a capital injection cautiously estimated at 1 billion markkaa. At the same time SKOP's liquidity problems would escalate as the small remaining amount of confidence evaporated. At worst the bankruptcy option could lead to convulsions in the whole financial system.

The Bank of Finland's risk monitoring department had summarised the options as follows:

- accept SKOP's proposal, persuade the Bank Inspectorate to accept it too, and hope for the best, but be ready to provide financial support
- refuse and hope that the foreign banking syndicate will drop demands that prevent the sensible demerger of Tampella. At the same time, prepare for the eventuality that Tampella will go bankrupt and officials will be forced to rescue SKOP and the savings banks
- refuse SKOP's proposal but persuade the other Finnish banks to replace the foreign syndicate as financiers, and hope for the best.⁷⁹⁹

An exceptionally large number of people were present at the crucial meeting on 25 March 1991. In addition to the members of the board, it was attended by directors Pentti Koivikko, Sirkka Hämäläinen and Matti Vanhala of the Bank of Finland, Jorma Aranko and Arja Vakkari of the Bank inspectorate, CEO Christopher Wegelius of SKOP and Tampella's managing director Timo Summa.

In the ensuing debate the board endorsed the demerger of Tampella and negotiations with the foreign syndicate so as to avoid a loan default without increasing SKOP's liabilities. If the foreign syndicate decided to demand immediate repayment, SKOP should look beyond the savings banks for the necessary funds, because Tampella should not be driven into bankruptcy, at least not through the actions of foreign financiers. The discussion had been prefaced by a statement from Jorma Aranko, in which he noted that the risk concentration regulations of the deposit

banking act, in effect since 1 January 1991, made any increase in SKOP's liabilities completely inconceivable. If it was attempted, the Bank inspectorate would have to intervene and forbid it.

The conclusion of the meeting was that the board's programme for reorganising SKOP's funding structure, drafted on 18 October 1990, remained in force. Consequently, the central bank did not approve an increase in SKOP's Tampella liabilities so SKOP's plan to rescue Tampella was rejected.⁸⁰⁰

The decision of the Bank of Finland's board of management was inconsistent, to say the least. It had decided that foreign financiers should not be permitted to precipitate Tampella's bankruptcy, but allowed no kind of commitment to prevent it. In spring 1991 the board's prevailing ideas about the financial state of the savings banks were somewhat unrealistic. Plans had been advanced to form a consortium of the largest savings banks that would supply the finance SKOP needed. Another idea was that all the other commercial banks would show solidarity in arranging financing for SKOP. Quite obviously the board was afraid to take the decisive step and had postponed a decision into the future. Clutching at the phrase repeated in the risk monitoring department's memorandum, it was "hoping for the best".

From SKOP's perspective, the situation had become even more critical, because Tampella's share price had now fallen to 33 markkaa. Reading between the lines of materials prepared for the two meetings, held on 21 and 25 March, it is apparent that the Bank of Finland had become convinced that SKOP would be unable to survive without central bank intervention.

SKOP's management had indeed sought other external support. CEO Christopher Wegelius had negotiated with senior executives of Union Bank, one of the two big commercial banks, about collaboration between it and the savings bank group. The public were not told about the talks, codenamed *Alli 1* and *Alli 2*, but SKOP executives informed the Bank of Finland. A plan like this would have been acceptable to the central bank because a merger between SKOP and Union Bank would have solved the whole problem from the Bank of Finland's perspective. Unfortunately, Wegelius' negotiating position was undermined by the fact that a significant number of leading lights in the savings bank group regarded a merger with Union Bank as out of the question. Moreover, the savings banks had very little to offer in

these talks, and the pace was set by Union Bank. The talks were broken off in summer 1991.⁸⁰¹

After a hiatus of a couple of months, SKOP's problems were discussed again by the board of the Bank of Finland on 20, 27 and 28 June. Now the hopelessness of the situation was recognised. Ahead lay only two alternatives: either to let Tampella fail or to try to rescue it in one way or another. Separately, the board had begun talks with Kauko Juhantalo, the Trade and Industry minister, about the possibility that Tampella would go bankrupt. To facilitate the arrangements ahead, the board decided to allow SKOP to increase its liabilities by a billion markkaa, so that the foreign loan syndicate could be bought out.⁸⁰² By this point the Bank inspectorate was no longer objecting to a temporary increase in SKOP's exposure.

Talks were continued in the following week, mainly with the director general of the Trade and Industry ministry, Markku Mäkinen, about selling off parts of Tampella. Its Papertech unit was offered to the state-owned engineering company Valmet, while Tampella Forest was offered to two forest industry groups, Enso-Gutzeit and Metsäliitto. At the same time, a representative of the Ministry of Trade and Industry asked the central bank whether it was prepared to participate in funding possible acquisitions. The board saw no obstacles to this.⁸⁰³

These decisions were ultimately ratified at a board meeting on 28 June, after which a letter was sent to SKOP's board of management about scaling down its risks at Tampella. In reality there was no hope left, a situation reflected in the tough demands of the letter. Initially it reminded SKOP that it had failed to achieve the objectives laid out in the reorganisation programme agreed on 18 October 1990. The Bank of Finland would allow SKOP to finance the early repayment of the foreign syndicated loan to Tampella on condition that an officially approved source of finance outside the savings bank group made a written commitment to provide credit of about one billion markkaa to Tampella by the end of September, which would allow Tampella to repay SKOP's short-term credit. The Bank of Finland also required SKOP and the savings bank group to reduce its Tampella liabilities by one billion markkaa before the end of the year and a total of 3 billion markkaa before the end of 1992.

The last paragraph of the letter then stated the sanctions explicitly. "If SKOP is unable to fulfil the aforementioned objectives or if its

situation deteriorates significantly for other reasons, the Bank of Finland will be compelled to intervene forcefully in the administration of SKOP and in its capital base to avert the collapse of SKOP's credibility and the danger caused to the stability of the Finnish financial system.⁸⁰⁴

THE SEIZURE OF SKOP

PLANNING THE TAKEOVER

Preparations for the takeover of crisis-ridden SKOP commenced in July 1991 and were completed in early September. In practice this meant working days of almost 24 hours, especially at the Bank of Finland's financial markets department and its legal department, in order to be able to present alternative models to the board no later than the end of September. The subject was on the agenda of a board meeting on 11 September. At this point the directors did not have focused views on what was to be done but agreed that no time was to be wasted. SKOP's interim report was due to be published in early October and the information available showed that its figures would be so baleful that its credibility would be destroyed. The board also felt that a merger with Union Bank was not doable at such short notice. One option was for the Bank of Finland to take a majority shareholding in SKOP but an alternative still to be explored was a model in which the Bank of Finland would provide the government with finance to raise the share capital of Postbank, which would take over SKOP.

Reading between the lines of the minutes, however, the scale was apparently tipping towards a takeover by the Bank of Finland. An important consideration was that the Bank of Finland did not have the skills required for running a commercial bank so at least some of SKOP's new managers would have to be recruited externally. Also, the holding companies set up to contain SKOP's main risks would be Bank of Finland risks, and could be too great for the central bank's financial resources to bear. A takeover would reduce the central bank's neutrality so it had to be as brief as possible.⁸⁰⁵

The memoranda produced by the planners also stressed the complications of the situation. Department head Kaarlo Jännäri told the board that all the alternatives being laid before it were bad, and the question was of picking the least objectionable. Moreover, every alternative would be expensive to the Bank of Finland and society at large.⁸⁰⁶

The board agreed to meet next on the following Tuesday 17 September, when the model to be adopted would be settled. According to a memorandum produced by the Financial markets department on the day before the meeting, the Bank of Finland's options for recapitalising SKOP and dismantling its risks were as follows.

- a) Bank of Finland takes a majority share of SKOP and hives off its main risks into holding companies (makes SKOP easier to sell)
- b) Bank of Finland takes over SKOP, establishes no holding companies, scales down the risks in a controlled way (entails long-term control by the Bank of Finland)
- c) Bank of Finland takes over SKOP, establishes no holding companies, dismantles the risks quickly "whatever the price" (expensive for the Bank of Finland, would disrupt the market)
- d) Bank of Finland provides finance to the savings banks, SKOP's current owners, so they can increase its capital (but the savings banks are too weak)
- e) SKOP to be merged with some other Finnish commercial bank
- f) A state rescue fund (asset management company) to be established (government would share the Bank of Finland's burden)

At this point the board of the Bank of Finland was still uncertain about how to proceed. It was especially wary of the idea that the Bank of Finland would own SKOP, when the central bank would become involved, via the savings banks' joint guarantee fund, with the problems of the whole savings bank camp. Taking over SKOP might also jeopardise the Bank of Finland's neutrality, although it realised that, if there was going to be a conflict between the Bank of Finland's statutory mission (of keeping the monetary system on the stable and safe footing) and its neutrality towards different financial institutions, its mission would supersede its neutrality, at least temporarily.

After discussion the board decided to support alternative A, meaning that the Bank of Finland would become a majority shareholder in SKOP and SKOP's risk concentrations would be transferred to

holding companies owned by the central bank. Alternative F was not eliminated because the board still wanted to allow the government to participate one way or another in providing capital for SKOP. It understood, however, that it might take years to arrange government involvement in an asset management company like this, so it was not a solution to the acute crisis. The board resolved to take its final decision on the crisis management model at a meeting on Thursday, 19 September 1991. After that, its response would go before the supervisory council on 27 September.⁸⁰⁷

Although decisions about SKOP at board level were still a little opaque, a detailed schedule had already been drawn up at a lower level in the central bank's hierarchy for the different operations that would be involved in a possible takeover. Among other things, memoranda were available about how corresponding situations had been handled in the banking crises of other countries. The main theme for an action plan was that the takeover needed to be initiated flexibly and should take into account the legal regulations related to its various stages. The plan predicated that the decision would be made by the board of the Bank of Finland, which would then inform the inner supervisory council about it. The supervisory council was therefore to be involved only afterwards.⁸⁰⁸ Quite obviously the board thought the matter to be so sensitive and confidential that to inform the council in advance was not necessary and perhaps not possible. Other circles, such as the Bank inspectorate and the Finance ministry, had been helping to develop the plan since late summer. The management of the central bank had also discussed the situation with Prime minister Aho and Finance minister Viinanen after the board meeting on 11 September.

SKOP COLLAPSES

At this point the board believed it would still have 1–2 weeks before the takeover had to be launched, but the situation changed radically on the evening of the very next day, 19 September. The other banks had become more distrustful than ever and SKOP was having serious trouble arranging finance. Its situation seemed so difficult that, on the morning of the following day, even before the money market had opened at 10:00 hrs, governor Kullberg had called the chief executives

of all the commercial banks and asked them to tell their own dealing rooms that, from this moment onwards, the Bank of Finland would be guaranteeing SKOP's commitments. Thanks to this message, SKOP did indeed obtain funding but an even more difficult situation lay ahead. The news of Kullberg's intervention had leaked to a radio news journalist who overinterpreted it and began to spread the news that SKOP and perhaps also Tampella were headed for bankruptcy. There was a danger that these rumours might spread abroad via Reuters, which might have jeopardised the credibility of Finland's financial system.⁸⁰⁹

The board could postpone a decision no longer. After an urgent meeting, it decided to take over SKOP.⁸¹⁰ A statement published by the Reuters information network at 14:05 stated plainly: "To restore confidence in the operations of the Central Bank of Finnish Savings Banks, the Bank of Finland has today decided to take control of SKOP." A little later, at 15:30, an official press conference was held and the regime change at the savings bank group became tangible; in the place of SKOP's chief executive Wegelius, it was attended by the chairman of SKOP's board of supervisors Paavo Prepula.

In the plans for SKOP's takeover, it had been stated that the decision would be taken by the board, after which the supervisory council would be informed. Events did indeed go in this order, because the council did not convene until the following day, but it was not merely a question of notifying the council. The regulations of the Bank of Finland stated that the council's approval was need for the purchase of shares. The board therefore asked the council to authorise the Bank of Finland to establish one or more holding companies or comparable organisations to own a majority of shares in SKOP and manage SKOP's largest risks in shares, property and the Tampella/Interpolator companies. The Bank of Finland would subscribe the entire share capital of these holding companies, or make a capital investment in comparable organisations, up to maximum of 5 billion markkaa. At the same time the supervisory council was asked to allow the Bank of Finland, if necessary, to apply a lower rate of interest in financing these arrangements than it was currently permitted to do.⁸¹¹

The meeting of the inner supervisory council, consisting of Pentti Mäki-Hakola (National Coalition party) Jussi Ranta (Social Democratic party) and Seppo Kääriäinen (Centre party), was very brief and decided



■ SKOP was part of the pre-recession world. Taken down from the wall, the bank's logo lies on the pavement of Alexander Street on 17 September 1993, awaiting removal.

- Lehtikuva news photo archives/Matti Björkman.

to recommend the board's proposal to the full supervisory council after hardly any discussion. The full council meeting, held immediately afterwards, was distinctly tenser. Even governor Kullberg's opening statement was intemperately phrased, as the following quote shows: "This matter is probably fairly familiar to you if you read this morning's newspapers. Yesterday there was also a press conference on the subject and it was announced in the evening in various media." After this, Kullberg reiterated the previous day's events and noted that tight schedules had made it impossible to convene the council before now. He described SKOP's takeover as the first part of a long process aimed at eliminating its risks and reshaping it into a functioning commercial bank, which could then be resold. This operation required the central bank to allocate funds of up to 5 billion markkaa. Two billion had to be earmarked immediately to subscribe SKOP shares. Kullberg noted that the sums were substantial but added that they were gross amounts so there was hope that the final loss would be smaller.⁸¹²

In the debate, all the councillors except for chairman Mäki-Hakola expressed annoyance that they had not been kept abreast of SKOP's condition. The councillors conceded that the previous day's decisions had had to be made without first seeking authorisation from the council but felt that the central bank had not kept them sufficiently well informed about SKOP's financial state and the measures taken since the previous summer. The prevailing atmosphere is well illustrated by the comments of Councillor Jäätteenmäki: "I have been a council member for such a brief period that the matter has not once been raised during a meeting of this council. I feel it would have been good to get a little more information and not to be entirely dependent on press reports, and I for one have very many questions to ask."⁸¹³

Kullberg admitted that the criticism was justified but at the same time pointed out that the bank had been at the mercy of events. He said that the council had indeed been informed in autumn 1990 and March 1991 about the state of SKOP and the ongoing stabilisation programme but the new supervisory council, formed after the parliamentary elections, had not been briefed on the subject since then. The situation had been aggravated in the spring, when three members had left the council and been replaced by people who had not been on the council before. Of the nine members of the supervisory council, five were new and so had been left in the dark about SKOP's affairs.

The debate in this meeting shows that the views of the central bank about how to handle the SKOP crisis had quickly come into focus. The only viable option was now seen as model A, the acquisition of a majority of SKOP shares and the transfer of high-risk investments into separate holding companies. Financial responsibility for crisis management was in the hands of the Bank of Finland alone, and the Finance ministry was still a bystander. However, ownership of a commercial bank and large shareholdings was not within the ambit of the central bank so the solution had to be short-term. Tampella, SKOP's largest risk concentration, could not be allowed to go bankrupt because of the excessively negative fallout for Finland's industrial policy and its international credibility. The supervisory council endorsed these views and authorised the board of the Bank of Finland to subscribe SKOP shares. The maximum allocation was set at 5 billion markkaa, which gave the board adequate room to manoeuvre.⁸¹⁴

The board took to heart the criticism it had received. At a council meeting held in a week's time the main theme was a detailed review by Esko Ollila of the relationship between SKOP and the Bank of Finland over the preceding 2–3 years. Among other things Ollila pointed out that SKOP's oversized investments in real estate had been made as long ago as 1984 and 1988.⁸¹⁵ In practically all council meetings held after 27 September, the board presented very precise details of ongoing plans to eliminate SKOP risks and manage the situation. It was taking the line of asking the council to endorse a strategy for handling the crisis. Individual decisions taken in line with the strategy could then be submitted to the council afterwards.

The cooling relations between the board and the council that surfaced around this time were not directly related to the SKOP case but were part of a long-term process. Deregulation had changed the way the central bank operated and had an inevitable effect on the board's dealings with the council. The councillors felt that the balance of power between the board and the council had shifted too far in the board's favour. The move to market operations in monetary policy made it necessary to provide public information about them simultaneously, so that insider information could not distort the market. Under these new circumstances, the supervisory council had to be much more careful in ensuring that the confidential matters it debated did not spread beyond the central bank. The Bank of Finland's

management was not entirely satisfied with how the council operated; in one biting comment, it was described as “leaking like a sieve”.⁸¹⁶

Decisions about SKOP were particularly sensitive, as director Matti Vanhala told the council in one presentation. “An operation of this sort is planned in absolute secrecy. When you are talking about something as sensitive as confidence, any leak can trigger a crisis of the whole system.”⁸¹⁷ Furthermore, both SKOP and Tampella were quoted companies so, in this respect, the stock exchange’s own non-disclosure regulations had to be taken into account. Another reason for the central bank to want to preserve the confidentiality of matters presented in the council was to prevent a needless decline in its esteem. At a council meeting on 20 September 1991 the members were given detailed instructions about the parts of the takeover package that could be told to others. Regarding the billions to be spent on the operation, councillors were asked to be as laconic as possible. The size of the investment ceiling authorised – 5 billion markkaa – was certainly not to be disclosed.

Apart from the decision to take over SKOP, all important matters dealt with by the board were reported to the council. The problem that had arisen was that the matters being dealt with were new and complex and little time was available for councillors to study them. Most matters were confidential in nature, and there could have been fateful consequences if they had spread outside central bank walls, so background memoranda and briefings could not be given to the councillors in advance. The only alternative was to distribute the material at the meeting for the members to peruse quickly. Often the material was collected again when the meeting was over. It was almost impossible for the supervisory council to get a full grasp of matters about which it had to make significant decisions. Under these circumstances the council was compelled to accept the views of the board of management and the bank’s experts, a situation which understandably caused it some annoyance. The councillors’ impression of their own position is described by Kustaa Hulkko’s book about the supervisory council in the headline: “Completely out of it”.⁸¹⁸ It does not imply that the council was not fully informed; it refers to the situation where the amount of information was so enormous that it had become impossible to grasp.

BILLIONS GET THE UPPER HAND

After taking control of SKOP, the board moved on to planning the disposition of SKOP's risks. At the same time it looked at the alternatives for realising the risks that it had taken over. Negotiations were held with the top government ministers – Prime minister Aho, Finance minister Viinanen, and Trade and Industry minister Juhantalo – about transferring Tampella to state ownership. Another line of action would be to break Tampella up into five separate companies and sell them separately. The greatest progress was made in negotiations with the Enso-Gutzeit company but they ultimately came to nothing.

Another matter under consideration was the sale of SKOP. Esko Ollila reported to the board on 26 November 1991 that talks on the “Alliance plan” were under way between Union Bank, SKOP and the savings banks. The objective was a consortium where the savings banks would handle private customers while Union Bank provided services for corporate customers. The central banking services required by the savings bank group would be offered by Union Bank, whose subsidiary Unitas would buy the SKOP shares of the Bank of Finland. The board realised that the Bank of Finland lacked the skills needed to determine SKOP's true value or to find possible buyers for it. It took advice from the Bank of England in its search for a reliable international consultant and ultimately signed up the investment bank J.P. Morgan.⁸¹⁹ By using an outside expert it sought to establish central bank neutrality.

The main personnel changes related to the takeover were fairly soon in coming. At a board meeting on 26 September, Esko Ollila had been appointed chairman of the SKOP board of supervisors. Four of the seven members on SKOP's board were representatives of the Bank of Finland. Kaarlo Jännäri was granted leave of absence from his position as a head of department to become SKOP's chief executive. Also the Bank inspectorate picked a retired member of the board of Kansallis Bank as SKOP's attorney. Veli Korpi, chief financial officer of Enso-Gutzeit, was recruited to be managing director of the holding companies set up to manage SKOP's risk concentrations. The aim was that the holding companies would be in place by the end of 1991.⁸²⁰

The first step was to establish them. They were founded on 14 October and recorded in the registry of companies on 23 October.

Name	Function	Shareholders' capital
Scopulus	Management of SKOP	300 mill. markkaa
Sponda	SKOP's share and real estate risks	200 mill. markkaa
Solidium	SKOP's Tampella assets	200 mill. markkaa

The first to actually begin operations was Scopulus Oy, which subscribed 200 million SKOP shares in a directed issue on 12 November 1991. These "SP-series" shares, created for the purpose, had a nominal value of 10 markkaa and voting rights four times as great as publicly held shares. The issue brought the Bank of Finland's proportion of voting rights in SKOP to 64 percent. Scopulus received a shareholders' loan of 1.73 billion markkaa from the Bank of Finland to finance the subscription of the shares.⁸²¹

Next came the transfer of SKOP risks to Sponda and Solidium. This was a far more complex operation because there were many difficulties involved in setting a value on the shareholdings to be transferred. The biggest problem was to price the transfer so that SKOP would retain the 8 percent capital adequacy required by the banking act that had come into force in the same year. The central bank's auditors joined its officials in helping to plan this transfer. Also involved were significant issues of principle, such as the protection of SKOP's and Tampella's minority shareholders. The Bank inspectorate had emphasized that the shareholders should bear part of the financial burden and that operations carried out at the expense of the Bank of Finland should not result in a situation where individual shareholders had a chance to make speculative gains. On the other hand, the transfer pricing of high-risk assets had to guard against underpricing, which would harm the interests of private shareholders. The easiest way to have avoided these problems would have been to redeem privately held shares as soon as possible but there was no way of doing this.

While the reorganisation was being planned by the central bank in October and November, SKOP and its largest single risk concentration, Tampella, were forecasting larger losses week by week. Notably the supervisory council was given detailed briefings throughout this period. The crucial decisions were made at the start of December. On Sunday, 1 December 1991 at 17:00 hours the board began what is

apparently the longest meeting in its history; the minutes record that the meeting closed on the following day and run to 72 pages without appendices. Governor Kullberg's opening words were dramatic: "You have had a tough weekend. I too have tried to sleep with these billions but the billions got the upper hand."⁸²²

The meeting started with the easier things, setting a transfer price on the shares and real estate risks being transferred to Sponda. SKOP's portfolio of securities contained a very significant mass of property that had been purchased for a total price of 3.3 billion markkaa. With the fall in stock exchange prices, the market value of the portfolio at the end of November was 1.7 billion. Among the shares were the metaphorical crown jewels of Finnish business; moreover, SKOP's holding in several companies was so large that it had strategic significance. The largest holdings, given in order of market value were as follows. The figures in parenthesis show the proportion of the share capital of the company in question that was transferred to Sponda, thus indicating the strategic importance of Sponda's holdings. Kymmene Oy (4.8%); Nokia Oy (6.2%); Metsä-Serla Oy (20.5%); Amer Oy (14.9%); Enso-Gutzeit Oy (5.1%). The Bank of Finland formally paid SKOP one markka for this portfolio of shares but in practice the transfer price was 1.92 billion markkaa because that was the amount of SKOP debts that the Bank of Finland took over. The price paid was 12% higher than if it had been calculated from current stock exchange prices, the premium being due to the strategic nature of the holdings.⁸²³

SKOP's real estate holdings were worth more than its securities, and had been purchased for 5 billion markkaa. The total mass of real estate to be transferred consisted of 36 properties or property companies, five of which were in continental Europe. The most significant individual holdings were the Helsinki shopping malls Itäkeskus (1.1 billion markkaa) and Itämarket (0.5 billion), the Bensow Building in the centre of Helsinki (0.23 billion) and the headquarters of the Industrialisation Fund of Finland (0.22 billion). In autumn 1991 the real estate market was completely dead so it was even harder to set a price on property holdings than on the securities portfolio. The expert view was that, especially in the case of large holdings, there was significant upward potential so prices were set slightly above the market price. The outcome was that Sponda paid 1.55 billion markkaa for SKOP's real estate, in addition to which 2.9 billion markkaa of loans

received from SKOP by these real estate companies were taken over by the Bank of Finland. The real transfer price was therefore 4.45 billion markkaa.⁸²⁴

These transfers to Sponda realised more SKOP losses and its capital adequacy fell to 6.8 percent. To restore it to the statutory level of 8 percent, the best alternative was seen to be an accord of 400 million markkaa, meaning that the Bank of Finland excused that amount of its loans to SKOP. This arrangement avoided various tax consequences and ensured that the value per share of SKOP shares owned by the savings banks did not decline.⁸²⁵

The issue that caused the most debate, both in the board of management and in the supervisory council, was how the affairs of Tampella should be sorted out. In autumn 1991 the Tampella group was seen to be practically insolvent. Its equity capital had been used up and bankruptcy lay ahead unless new capital could be obtained. Its auditors had informed the company's board of this. Its excessive investments in earlier years had created such an onerous financial structure that operations could not safely continue without a major reorganisation. The most straightforward solution would have been liquidation but the economic, social and political consequences of bankruptcy were frightening. If Tampella filed for bankruptcy, SKOP's large liabilities at the company would have been realised, creating corresponding losses for the Bank of Finland. Nine thousand corporation employees would have lost their jobs and Finland would have lost Tampella's large export earnings of 6 billion markkaa per year. Furthermore, Tampella's bankruptcy would have dealt a serious blow to Finland's reputation on international capital markets. These arguments were so weighty that the innate response was to restructure Tampella's finance so that its operations could continue. In practice this required a capital injection to raise the proportion of shareholders' equity to 15 percent of Tampella's total assets.

This course of action had not been axiomatic, because the primary objective had been to arrange the takeover of Tampella by the government, but negotiations were not fruitful. Responsibility for Tampella remained with the Bank of Finland, which had to accept the reality that Tampella could not be transferred to state control before the Bank of Finland had put Tampella's house in order, no matter how difficult the whole board of management of the bank knew this to be.

To be an owner of a private industrial company was really not a suitable operation for a central bank in a market economy but, in the economic climate of autumn 1991, pragmatism triumphed over doctrine.⁸²⁶

The solution was that the majority shareholding in Tampella, which had been held by SKOP, was transferred to Solidium, which also took over SKOP's loans to Tampella of 3.4 billion markkaa. Of these loans, the amount of 530 million markkaa was converted into shareholders' equity. SKOP granted Tampella an accord of 1.5 billion markkaa while the Bank of Finland granted a corresponding accord to SKOP. In practice this meant that Tampella was excused debts of 2.03 billion markkaa while nearly 1.4 billion markkaa remained as secured debt at market interest rates.⁸²⁷

This package of measures, approved by the board of management of the Bank of Finland, was presented to the supervisory council on 3 December 1991. The process was completely transparent and the council members received detailed information about the state of affairs and about all the alternative models that were available to the board. Even so, the matter under examination was so complex that many councillors found it extremely hard to reach a decision. The confusion was expressed in a speech by Tuulikki Hämäläinen (Social Democratic Party): "I am dumb with amazement about what we are embarking on. This is terribly complex. I would hope that we could at least improve our handling of it by considering how a situation like this should be approached. If we are really required to authorise and decide a matter of this size, we have a moral responsibility even if we don't legally have a personal one. I for one can't read and listen at the same time to such a complex matter." However, hardly any criticism of the Bank of Finland's action was voiced, and the council approved the board's proposal unanimously.⁸²⁸

On this *Billionaire Sunday*, the Bank of Finland accepted accounting losses of 2.6 billion markkaa although some of them were recorded in 1992. The total consisted of shareholders' capital of 0.7 billion markkaa invested in three holding companies, and accords of 0.4 billion and 1.5 billion. The arrangements involved a commitment of up to 15.4 billion markkaa from the Bank of Finland, although the final loss was a matter of conjecture. It would depend on how successfully the three holding companies could realise the assets they had taken over.

SHIPWRECK OF THE STABLE MARKKA

A SOCIAL CONTRACT

A brief period of calm on the foreign exchange market and a fall in interest rates after the markka was pegged to the ecu at the start of June 1991 were not enough to resolve the worsening disequilibrium of the Finnish economy. More action was needed and the government sought the answer in incomes policy. In summer 1991 Prime minister Aho came out with the idea of what he called a social contract, meaning a general round of pay cuts to improve national competitiveness.⁸²⁹ However, talks between the government and labour market associations did not lead to tangible results because employees organisations disliked the idea.

A sudden strong flight of currency began in the last week of August. An internal Bank of Finland memorandum concluded that the market had reacted to the rejection by labour market organisations of wage reduction plans put forward in the government's budget proposal. However, the Bank of Finland did not rule out a conspiracy either: "Statistics for foreign currency dealings support the inference that uncertainty was deliberately stirred up". The obvious targets of suspicion were exporters who wanted a devaluation. Market interest rates shot up (on 29 August, the worst day, 1-month Helibor rose by 2.6 percentage points) and the Bank of Finland was compelled to support the markka to prevent its value falling.⁸³⁰

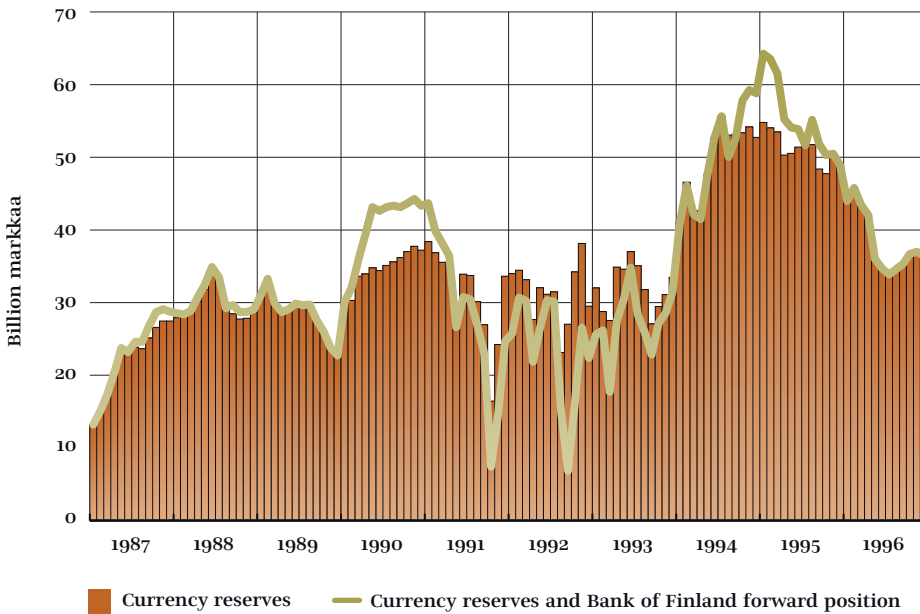
At the beginning of the autumn 1991, the national economy was revealed to be in a far worse state than had been predicted in the

spring. In the first week of September, the Bank of Finland's economics department completed its macroeconomic forecast, which said that gross national product would drop by a shocking 5½ percent in 1991. This estimate was now much closer to the real outcome than the 1½ percent drop that had been forecast in the spring. In the prevailing atmosphere of crisis, and because of ongoing discussion about a "social contract" that had begun in the summer, two versions of the forecast were published, based on different assumptions about what would happen to wages in 1992. The first scenario assumed that there would be no wage increases in 1992; the alternate version assumed that wages would fall by 5 percent, on the grounds that "in discussions about the economy, there has been strong emphasis on the need for a significant reduction in wages, because a zero-increase line may not be sufficient to restore the credibility of exchange rate policy fast enough". The wage-cut scenario was predicted to lead to a faster rebalancing of the economy, beginning in 1992. The accompanying report stated that the second scenario "may be the only way to restore confidence in the markka and avoid excessively high interest rates"⁸³¹

Soon afterwards, the Finance ministry published its own forecast, drawn up as an appendix to the budget. It was almost as pessimistic as the Bank of Finland, predicting that GNP volume would decline by 5 percent in 1991. By this point in time, the seriousness of the Finnish economic collapse in 1991 was becoming fairly well understood. What is striking about the forecasts of September 1991, however, is that the duration of the recession was still being underestimated. It was believed that aggregate output would stop falling in 1992 (Finance ministry) or might even rise a little (Bank of Finland). In reality GNP fell by another 3½ percent in 1992 and, year-on-year, continued to decline somewhat in 1993, too.

The flight of currency from Finland continued throughout September and October, and market interest rates remained extremely high. The Bank of Finland's takeover of the Central Bank of Finnish Savings Banks SKOP, announced on 19 September, had little impact on the market, however, despite its dramatic nature. An internal Bank of Finland report even concluded that news of the takeover "seems to have restored market confidence". However hopes that the situation would improve came to nothing because unrest in the money and foreign exchange markets continued into October. Eyes were focused

BANK OF FINLAND CURRENCY RESERVES 1987–1996



Source: Bank of Finland.

on the incomes policy negotiations, the success of which was regarded as essential for the policy of a stable markka. Consequently, the danger that they would fail fanned devaluation expectations.⁸³²

Conditions escalated on Friday 18 October, when the supervisory council was meeting in the morning. Under the pressure of speculation against the markka, the council issued a statement intended to calm the market and facilitate incomes policy negotiations. It said it had studied the state of the economy and found nothing that would require a change in the established exchange rate policy. The market was not convinced, and currency flight intensified during the day.⁸³³

Governor Kullberg, who had been in Bangkok, arrived in Finland on Saturday 19 October. On Sunday, he met Prime minister Aho and Finance minister Viinanen at the Bank of Finland. He has written that the three were unanimous that Monday was the critical day when the fate of the stable markka policy would be determined. Mere statements would no longer calm the market, which needed concrete evidence

that a labour market settlement to balance the economy was being reached.

At Prime minister Aho's initiative, the trio contacted Bank of Finland board member Kalevi Sorsa on Sunday afternoon and asked him to act as a mediator in bringing about a national incomes agreement during Sunday night. Sorsa accepted the mandate and, after talking with the various interest groups late into the night, made a final conciliation proposal which was published early in the morning. It would have reduced labour costs by about 7 percent during the two-year contract period. This would have been done partly by cutting wages (in practice, holiday pay), and partly by making employers' pension contributions payable by employees instead. The government was to participate in the settlement, among other things by withdrawing a legislative bill that would have allowed public sector workers to be laid off for 14 days without pay. The deadline for agreements to be made at the labour union level was set as 29 November.⁸³⁴

Despite publication of the conciliation proposal, the flight of currency continued on Monday 21 October while the executive bodies of the central labour market organisations were discussing the proposal. On Friday and Monday the Bank of Finland sold foreign currency worth a total of about 20 billion markkaa although, because half of these sales were in the form of forward contracts, the convertible currency reserves apparently shrank by "only" 10 billion markkaa. At the same time interest rates rose; one-month Helibor reached 20 percent. The other central labour market organisations approved the agreement on Monday but the largest organisation on the employees' side, the SAK, did not endorse it but merely forwarded it to its member unions.

Acting on an optimistic interpretation of the SAK's response, the government held a press conference on Monday afternoon at the House of the Estates, the 19th century parliament building opposite the Bank of Finland. There the representatives of the government, the Bank of Finland, and the employers together with the national conciliator said that the proposal had been accepted. It is interesting that representatives of employee's organisations were not present to comment on the solution. Governor Kullberg praised the agreement – which in fact had not yet been reached – and predicted that interest rates would soon fall and that currency would flow back to Finland.⁸³⁵

■ Former Prime minister, Bank of Finland board member Kalevi Sorsa (centre), with Prime minister Esko Aho (right) and Finance minister Iiro Viinanen explaining the stabilisation pact which they believed had been accepted, at the House of the Estates on 21 October 1991.

– Finnish Press Agency / Markku Niskanen.



Another meeting of the supervisory council was held later on Monday evening. It had been convened in case of a devaluation. The discussion at this meeting supports the conclusion that Kullberg and Sorsa both believed that the agreement had in effect already been reached. Kullberg told the council that if it had not, Finland would have had to devalue: "It's absolutely clear." There had already been a state of panic three or four times during the day, the governor said.⁸³⁶

THE BANK SURRENDERS

Governor Kullberg's prediction at the House of the Estates that currency would begin to be repatriated did not come true in the weeks ahead, and even the anticipated reduction in interest rates remained slight. The worst spike of speculation was over but market rates remained at the high level that they had reached in the early autumn. The poor general state of Finland's economy and its banking sector was not the only cause. Sorsa's conciliation proposal was not moving towards approval in union-level negotiations. On 25 October, the supervisory council increased the Bank of Finland's authorisation to take foreign credit from 1½ billion dollars to 5 billion, a change which at this point did nothing to help restore confidence in the durability of the exchange rate. The previous borrowing ceiling had been unchanged since the 1980s.

In the second week of November, with only two weeks left till union-level contracts were due to be concluded, currency flight accelerated again. At the same time, market interest rates rose. When the board discussed the situation on Wednesday evening on 13 November, director Sirkka Hämäläinen reported that 1 billion markkaa of foreign currency had been sold during the day. The board prepared for a defensive battle by convening the supervisory council on the following morning to ask for greater authority over interest rates, and on Thursday morning the council granted it. The Bank of Finland was now permitted to raise the interest rate on call money – the short-term central bank credit for the banks – to 20 percent, and the penalty rate related to use of this credit could be up to 40 percent. This created room for a rise in market interest rates.

In the interbank market, one-month Helibor rate went above 27 percent on Thursday 14 November but despite the high rate of interest,

convertible currency reserves of the Bank of Finland continued to dwindle at an accelerating pace. During the day, president Koivisto arrived at the bank for lunch, an appointment that had been made earlier. During the lunch, and prompted by the gravity of the situation, the conversation turned to devaluation or letting the markka float – Koivisto has written that he was the one to propose the latter option. At this point Prime minister Aho was invited to join the lunch meeting and did.⁸³⁷

At a board meeting after lunch Sirkka Hämäläinen reported on the day's foreign currency sales. She said that, if the foreign currency that had already been sold in forward interventions was deducted from the reserves, there were about 2.5 billion markkaa left. Calculated in this way, 90% of the reserves had been used up during October and November. Hämäläinen said that the departments that she led, responsible for central banking policy, were against leaving the markka to float. Esko Ollila passed on a message from Prime minister Aho that no good news was to be expected from the labour market and that the Bank of Finland “would be wise to take rapid decisions”.

At a time of massive currency flight, pressure from the government and extremely high interest rates, the board did not have much choice. It decided to allow the markkaa to float for a brief period, on the grounds that it would not be right to allow the currency reserves to become negative but that it was not possible to make “a dependable assessment of the amount by which the markka should be devalued”. The board published its decision via Reuters at 14:59 on Thursday, 14 November 1991 in the form of the following statement: “Pressure against the markkaa has become so great that the Bank of Finland has decided to allow the markka exchange rate to float on a temporary basis. After conditions in the foreign exchange market have stabilised the Bank of Finland will make a proposal to the Council of State on confirming a new fluctuation band. The aim is that the external value of the markkaa will depreciate as little as possible.”⁸³⁸

The supervisory council was convened on the same evening to consider the matter. It was told that, during the hour after the markka had been floated before the foreign exchange market had closed, the markka had fallen in value by about 6 percent. They were also informed that the Justice Chancellor had approved a temporary float provided that the government discussed the matter at the earliest opportunity.

This procedure was approved by the council. The only dissenting voice in the council was Esko Seppänen, a member of the People's Democratic league, who opposed floating. He preferred a fixed devaluation of 10 percent and proposed that the board of management did not enjoy the council's confidence. However, his proposal received no support from the other councillors and was therefore defeated.⁸³⁹

The board of management continued to discuss the foreign exchange situation on the morning of Friday 15 November amid dramatic circumstances. Markku Puntila announced he had tendered his resignation from the board and excused himself from its deliberations. In connection with the exchange rate itself, it was stated that the Prime minister had (on the previous evening) issued a "strong appeal" to the board to set the size of the devaluation on Friday by 13:00 hrs, when the government would submit an economic policy report to parliament. The board bowed to the Prime Minister's request and decided to convene the supervisory council at 12:00 hrs to end the float and fix the devaluation percentage. During the morning, both the Prime minister and the Finance minister called governor Kullberg to express the government's view that the size of the devaluation should be 14 percent. President Koivisto also called the governor and recommended that the Bank of Finland should endorse the government's line. However, many members of the board preferred a smaller, 10 percent devaluation. The discussion was concluded with a decision to present a proposal to the supervisory council in line with the government's wishes but to note at the same time verbally that the board itself was in favour of 10 percent.

At the council meeting, governor Kullberg said that, in the board's view, 10 percent would be a better solution than the 14 percent that the government desired and the board had felt compelled to propose. At this point, councillor Jussi Ranta (Social Democratic Party, in opposition) proposed a devaluation of 10 percent. In the vote, both Social Democratic councillors and Esko Seppänen of the People's Democratic league backed 10 percent but the majority of councillors, from governing parties, voted for the board's proposal of 14 percent.⁸⁴⁰

Technically the markka was devalued by raising the fluctuation limits of the ecu index 14 percent; in other words the value of the markka against the ecu was lowered by 12.3 percent. Since September the markka rate had already been at the weaker edge of the fluctuation

band so if the markka's market price had fallen by the full amount of the official devaluation rate, the markka would also have been at the weaker edge of the new fluctuation band. In fact this did not happen and, in the weeks ahead, the markka's price settled close to the centre of the new band. The actual devaluation rate worked out at about 10 percent, subject of course to slight daily fluctuations.

Being forced to devalue was of course humiliating for the Bank of Finland. The strong (or stable) markka policy, born from the experiences of summer 1986, was in tatters. Its origins had been political but the Bank of Finland had supported it. After the change of government in spring 1991, the Bank of Finland had, month by month, become steadily more identified with this policy, while the government's commitment to it had waned amid deteriorating economic conditions. Ultimately the divergence between the government and the Bank of Finland had become so pronounced that, after the devaluation, a headline in Helsingin Sanomat newspaper proclaimed that the bank had been "steamrollered" by the government. Markku Puntila and Kalevi Sorsa, the two central bank board members who had been most strongly identified with the stable markka policy, tendered their resignations on the very same day as the devaluation, although President Koivisto prevailed on Sorsa to withdraw his. Rolf Kullberg also discussed resigning with the president, who told him that this was not the right time.⁸⁴¹

A government economic policy report, precipitated by the termination of the markka float, was made to parliament on Friday 15 November at 13:00 hrs. It gave rise to an exceptionally long and colourful debate that lasted into the early hours of the next day, ending at 4:37 hrs. In the concluding vote of confidence, the government was backed by a majority of parliamentarians, as anticipated. In the debate, the Bank of Finland had been criticised forcefully by government and opposition party members alike. Seppo Kääriäinen, the leader of the largest parliamentary group, the Centre party, stated that "in due course there must be an exhaustive and constructive discussion about the mandate of the Bank of Finland in monetary and foreign exchange policies". On the opposition side, Erkki Tuomioja, the head of the Social Democratic parliamentary group, urged governor Kullberg to resign and said his party insisted on "an urgent clarification of the position and responsibility of the Bank of Finland, so that it will become, like

all other European central banks, an institution that is unambiguously responsible and subordinate to the government, with policies and action that the government in turn can be unequivocally answerable to parliament for”⁸⁴²

The idea of a general wage reduction, in line with Sorsa’s recommendation, was discarded by the unions after the devaluation. Instead there was a standstill settlement. On 29 November, labour market organisations agreed a two-year centralised wage settlement, in which wages were not to rise at all during the first year. Admittedly there was an index clause but the threshold for wage adjustments was fairly high. Wage increases would be triggered only if consumer prices rose by more than 5.9 percent during the first 10 months of 1992, which did not appear likely. The wage settlement included the transfer of a part of pension contributions from employers to employees, already part of the Sorsa proposal, although in a slightly ameliorated form.⁸⁴³

After the devaluation, the flow of currency was reversed as Finnish companies began to repatriate foreign exchange and hedge foreign claims. From the devaluation till the end of the year, the Bank of Finland bought foreign currency worth 21 billion markkaa, which returned its currency reserves to the level of the summer before the autumn turbulence. After fluctuating in the first few days, the markka rate against the ecu stabilised and remained around the centre point of the new fluctuation band long into 1992. At the same time market interest rates came down slightly, falling below 12 percent by February 1992.

In early 1992 markets were also reassured by the increasing likelihood that Finland would apply for membership of the European Community. President Koivisto signalled this in his speech at the opening of parliament on 7 February 1992 in which he endorsed membership. The formal application to Brussels was made on 18 March.

Soon, however, the tranquillity surrounding the Finnish markka was shattered. On the same day as Finland applied to the EU, the government held a press conference about capital support for the banks. At this conference Prime minister Aho demanded that bank executives be held accountable for their mistakes. Asked whether he included the Bank of Finland in this, he replied affirmatively. On 1 April, governor Kullberg accused the prime minister on television of populism. The following day President Koivisto met the sparring



■ A parting of ways. Bank of Finland governor Rolf Kullberg and Prime minister Esko Aho leave the President's Palace on 2 April 1992.
- Lehtikuva news photo archives / Markku Ulander.

partners, after which Kullberg announced his intention to retire at the end of June. However the flight of currency caused by the dispute continued to escalate on Friday 3 April and Kullberg resigned on the Sunday. The supervisory council unanimously replaced him with a recent board member, Sirkka Hämäläinen, who became the first female governor of the Bank of Finland.⁸⁴⁴

The strong money market reaction to this dispute and to the replacement of the central bank governor showed that the devaluation had not fixed the problems of the Finnish economy and that confidence that Finland's exchange rate policy was sustainable was still shaky. It was also a prelude to the turbulence of the following autumn that began with the Finnish markka but ultimately spread across all of Europe.⁸⁴⁵

Sirkka Hämäläinen had become a member of the Bank of Finland's board of management only four months before her appointment as governor, but she was far from inexperienced. She had previously served for almost 10 years at the managerial level below the board, with responsibility for economics and monetary policy, and her full working experience at the Bank of Finland stretched back nearly 30 years. She had been Markku Puntila's immediate subordinate and was therefore a natural candidate to replace him on the board when he resigned at the time of the devaluation in autumn 1991. She was appointed to the board on 9 December 1991. After governor Kullberg had been forced to resign, she was in line for the top post at the central bank. There were no serious competitors, apparently because her expertise was regarded as second to none. In the weeks prior to her appointment as governor, she had been in the public eye as chair of the banking support working group, set up by the government, another sign of the confidence she enjoyed. She had not been tarnished by the repeated bickering between the bank and the government over the preceding difficult year, and no political considerations were raised in the supervisory council when her candidacy was discussed.

THE MARKKA FLOATS

A LEAP INTO THE UNKNOWN

In the course of 1992, the European Monetary System moved into ever-deeper difficulties. Serious tensions began to build up in the summer, when the dollar weakened in the foreign exchange markets at the same time as the German Mark strengthened. The underlying causes were, on the one hand, the approach of US presidential elections and, on the other, tight German monetary policy as its central bank sought to curb the inflationary pressures stemming from the reunification of the country. Between the start of 1991 and July 1992, the Bundesbank raised its discount rate from 2¾ percent to 8¾ percent. The divergence of monetary policies caused the dollar to weaken by 15–20 percent against European currencies, including the Finnish markka, during the summer of 1992. By July the markka had risen against dollar so much that the effect of the 1991 devaluation on the markka/dollar rate had been eliminated.

Such a large depreciation of the dollar stoked tensions within the European exchange rate mechanism. Strains were also caused by doubts over whether the Maastricht Treaty would be ratified. On 2 June 1992, the Danish public voted against the treaty and on the following day French president Mitterrand announced that he too was calling a referendum about ratification. This raised doubts about whether monetary union would be implemented after all and if its possible failure would result in exchange rate adjustments. For all these reasons, foreign exchange markets at the end of summer began to show symptoms of speculation about a realignment of ERM currencies. The British pound and, even more so, the Italian lira were now targets of

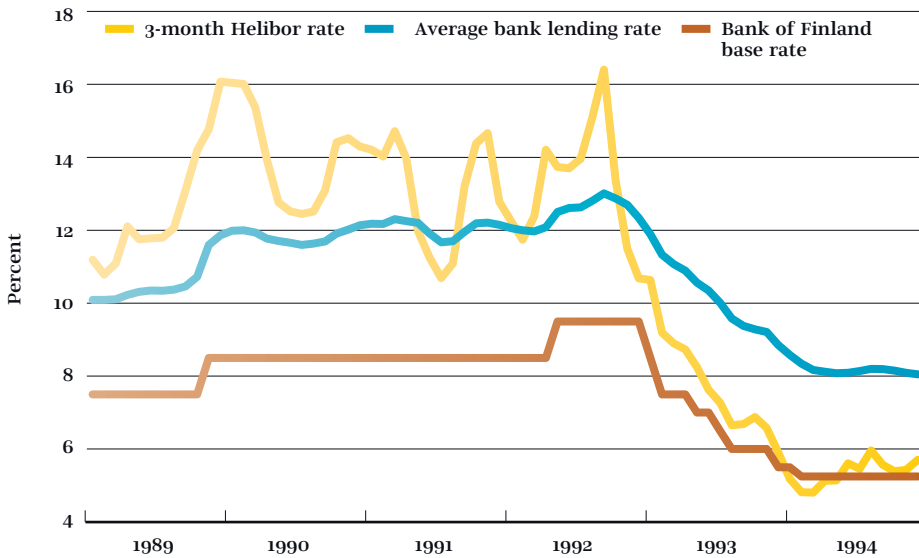
distrust. In the second half of August, non-ERM currencies like the Finnish markka, the Swedish krona and the Norwegian krone also began to falter.⁸⁴⁶

The first victim of this European currency turbulence was the Finnish markka. Speculation against it had already begun in the spring at the time of the public rupture between governor Kullberg and Prime minister Aho, followed by Kullberg's resignation. At that time, the shortest market interest rates had risen steeply (one-month Helibor reached nearly 17 percent) and there was a flight of currency. During the first balance sheet week of April, the Bank of Finland's foreign exchange position (reserves plus forward claims) shrank from about 31 billion markkaa to less than 18 billion. The crisis spurred the government to approve a fiscal policy programme of austerity and the Bank of Finland signed currency swap agreements with the central banks of the Nordic countries and Germany. These measures steadied Finland's currency situation but currency flight from Finland resumed in August 1992.⁸⁴⁷

The Bank of Finland began to raise its key interest rate (then the tender rate) on 4 August, from 13.4 percent to 14.6 percent. By the end of August the rate was 17 percent, but Finland was still losing currency reserves at an accelerating pace.

The markka's plunge into crisis at the turn of August was probably not due to the European foreign exchange market situation alone. There had also been a change in the tone of domestic economic policy debate, which had become more critical of the line pursued hitherto. At the start of September the news broke that five professors of economics had suggested a 20 percent devaluation or a floating exchange rate as possible ways of solving Finland's economic crisis. These options were contained in a memorandum on economic policy that professors Pertti Haaparanta, Bengt Holmström, Seppo Honkapohja, Erkki Koskela and Jouko Paunio had drafted and addressed to "the nation's political leadership" in the middle of August. In their view, the exchange rate could be left unchanged only if there were an international economic upswing and if other conditions were met, including a three-year freeze on Finnish wages and pensions. Later, on 3 September, American professor Rudiger Dornbusch told a current affairs interviewer on Finnish TV that a devaluation, even as large as 30 percent, would be the best solution for Finland.⁸⁴⁸

KEY INTEREST RATES 1989–1994



Source: Bank of Finland.

At the end of August the Bank of Finland had already begun to explore ways of moving to a system of flexible exchange rates, “floating the markka”. Even under duress, it was hard to do. It would be a leap into the unknown because it was hard to predict the value of a floating markka in the foreign exchange market, and the impact of a decision to float on inflation and interest rates. Furthermore, the move to a flexible exchange rate system would broaden the mandate and responsibility of the Bank of Finland in economic policy. This was politically and legally a hot potato. The exchange rate was one of the main parameters in Finnish economic policy, perhaps even the key one. Could the government now leave the exchange rate to be set by the market and the monetary policies of the Bank of Finland?

The memoranda prepared for the board of management of the Bank of Finland and discussions between its members leave the impression that the legalities of a float were seen as the most problematic. The question was how a floating markka could be squared with the Currency Act, which stated that exchange rate policy was

ultimately the government's remit, while the Bank of Finland's job was to hold the markka's external value within the band set by the government. It was permitted to move outside the ratified limits only on a temporary basis if there was severe imbalance in the foreign exchange market. However it was not clear what "temporary" meant and the Bank of Finland wanted to explore how long the law permitted a float to last.

The board discussed a memorandum on floating the markka, written by the bank's lawyers, on Tuesday 1 September 1992. They concluded with the formulation that "the best alternative for the bank would be if the current law could be interpreted to mean that the markka could be floated for a longer period than permitted by the prevailing interpretation". If this proved to be inadequate, the board believed plans could be made for amending the law, so that the government could authorise the bank to float the markka until further notice, and also cancel this authorisation at the bank's proposal or on its own initiative. The option of amending the Currency Act completely to suit a floating exchange rate regime was regarded by the board as only a last resort.⁸⁴⁹

In the first week of September the flight of currency worsened. On Friday 4 September the Bank of Finland was forced to sell foreign currency worth 6 billion markkaa. Although its balance sheet showed that currency reserves were still about 16 billion markkaa, it was in reality already entirely dependent on foreign currency swaps and forward dealing. Its overall currency position – taking into account currency forwards – was now negative. It may have contributed to the currency flight on Friday that the aforementioned statement by professor Dornbusch had been seen on television the previous evening. During Friday the board of management of the Bank of Finland listened to the view of president Koivisto, informed the supervisory council of the market situation and decided to determine by Monday the opinion of the Justice chancellor about the legality of a float.⁸⁵⁰

On Monday 7 September, governor Hämäläinen was in Basel at a meeting of the Bank for International Settlements. On the same morning in Finland, the Bank of Finland's lawyers were talking with Justice chancellor Jorma S. Aalto, as had been arranged the previous week. Aalto was of the opinion that a decision to float the currency needed to be ratified by the government but the Bank of

Finland representatives felt that they had not received a clear answer to whether the bank could let the markka float, and how long it could be floated without an amendment to the Currency Act being required.⁸⁵¹

During the day, the currency flight continued. In the evening a meeting was held at Kesäranta, the prime minister's official residence, between Matti Vanhala, responsible at the Bank of Finland for monetary and foreign exchange policies, Prime minister Aho and Finance minister Viinanen. Also present were the senior civil servants at the Finance ministry (secretary of state Eino Keinänen and director general Sixten Korkman).

During the Kesäranta meeting, news was received from Basel where there had been discussions about Finland during the afternoon. Governor Hämäläinen had explained Finland's situation and the various alternatives. Governor Bengt Dennis of the Swedish central bank gained the impression that Finland was coming to favour a floating exchange rate. After the end of the Basel discussions, Hämäläinen contacted Matti Vanhala at Kesäranta and told him that, in her view, the devaluation option was ruled out. Either the markka's exchange rate had to be defended with very high interest rates or it had to be unpegged and left to float. Hämäläinen added that a government crisis at this time was very undesirable.

Preparations were set in motion at Kesäranta for a decision to float on the following day. The government would convene in the morning from 8:30 onwards so that a decision could be made. Prior to this meeting, the board of management of the Bank of Finland and the supervisory council would convene. In practice these plans sealed the fate of the markka because no new information was received before the following morning, when the decisions were taken.⁸⁵²

Meeting early in the morning on Tuesday 8 September, the Bank of Finland's board of management decided "because of severe disequilibrium in the foreign exchange market... to cease observing the limits of the fluctuation band". The board then asked the supervisory council to pass the matter to the government for its decision. It also proposed that the supervisory council should, in conformity with the Currency Act, make a proposal to set new limits for the markka's fluctuation band "as soon as the state of the foreign exchange market makes this possible".

In the preamble to its proposal to the supervisory council, the board spelled out the bitter truth about the current state of the Finnish economy. “Despite the fiscal policy measures implemented by the government, the market has remained unconvinced about the value of the markka. This has led to high interest rates, a strong contraction in domestic demand, countless bankruptcies, growing problems in the banking sector and increasing unemployment.”

When the inner supervisory council met, prior to the full council meeting, the chairman, Pentti Mäki-Hakola of the National Coalition party, expressed his view that the Bank of Finland should have fought on for the markka, using the foreign credits that the supervisory council had authorised up to a ceiling of 40 billion markkaa. The Bank of Finland board objected to this idea. Governor Hämäläinen said that a battle for the markka would require interest rates to be raised to 40–50 percent, while Harri Holkeri observed that the fight to date had already pushed the foreign exchange reserves of the Bank of Finland 7.75 billion markkaa into the red. After hearing these objections, Mäki-Hakola agreed to relay the board’s proposal unaltered to the full council.

When the full council had convened Mäki-Hakola proposed an appendix to its decision to float the markka, stating this should be linked to “tough economic policies, a cut in public spending and action on interest rates so that currency will flow back”. This idea received no support from the other council members and so it lapsed. Tuulikki Hämäläinen, representing the largest opposition party, the Social Democrats, responded to Mäki-Hakola that the situation that had been arrived at “specifically marked the bankruptcy of the policy of attempted austerity”. Thus, on the morning of 8 September 1992, the supervisory council and then the government agreed that the Bank of Finland could allow the markka to float.⁸⁵³

In a statement concerning the floating of the markka, the Bank of Finland announced that “the central function of monetary policy remains the preservation of price stability and the maintenance of external liquidity”. The statement added that it was now more important than ever to improve public sector balance, and observed that “Finland’s involvement in European integration requires that, when economic conditions permit, it will restore a stable set of exchange rates with European currencies.”⁸⁵⁴

The news that the Finnish markka had been unpegged was released just before 10 o'clock Finnish time on Tuesday morning. When the market opened the markka depreciated rapidly by about 15% against the ecu index. Finland's decision immediately caused unrest on foreign exchange markets elsewhere in Europe. Sweden faced sudden difficulties and its central bank raised marginal rate (used in regulating the money market) to 24 percent. The next day the rate was raised again to 75 percent. However, by Monday 14 September, the situation in Sweden had calmed down enough to allow the Bank of Sweden to lower its marginal rate "cautiously" to 20 percent.⁸⁵⁵

A EUROPEAN CURRENCY CRISIS

Pressure was now being felt by many currencies in Europe's Exchange Rate Mechanism, too. The Italian lira was devalued on 14 September, when its rate against other ERM currencies was lowered by 7 percent. The German central bank lowered its interest rates at the same time, but Europe's currency turbulence refused to abate. Next the British pound and, with it, the Swedish krona came under strong attack. On the worst day of the crisis, 16 September 1992, the Bank of England raised its key "bank rate" first to 12 and then to 15 percent. The Bank of Sweden in turn raised its marginal lending rate first to 75 percent and finally to the legendary 500 percent. In the evening the British government decided that the pound would exit the ERM and from 17 September onwards it was a floating currency. The Italian lira was unpegged from the ERM on the same day. To complete what was possibly the gloomiest day in the history of the ERM, Spain devalued the peseta by 5 percent.

European efforts to achieve permanently fixed exchange rates en route to monetary union had suffered a serious and humiliating setback. Fortunately, a few days later on 20 September, a referendum in France approved ratification of the Maastricht Treaty by an extremely narrow majority of about 51 percent. After this "petit oui", speculative pressure eased in many countries and general interest rates turned down. In Sweden, marginal rate was gradually lowered from its record level. For a while it seemed that the Bank of Sweden's action and the Swedish government's austerity measures had succeeded in defending the krona exchange rate.

Meanwhile, the 15 percent depreciation of the markka when it was floated proved to be overkill; in the next few weeks it moved back slightly towards its old rate. The average value of the markka against the ecu in October was about 12 percent weaker than its pegged value had been. But no significant amounts of foreign currency returned to Finland so the Bank of Finland did not start to push down interest rates when the markka floated higher.

In the first half of October, Finnish money market rates were somewhat lower than during the height of the crisis at the start of September but still at about the same high level as before the crisis. For the national economy, therefore, the money market was still intolerably tight. There was no significant turn for the better in the money market until more than a month after the markka float, on 14 October, when the Finnish government agreed an important programme to balance the budget for 1993–1995, with spending cuts and tax rises. According to the government statement, the programme would improve budgetary balance by nearly 70 billion markkaa over three years.

In the two days after the government austerity programme was published, the Bank of Finland allowed its tender rate to fall significantly from 14.67 percent to 12.75 percent. Market interest rates now began to fall rapidly and by November 1-month Helibor was already down at about 11%. Finland had not experienced lower market interest rates for almost 4 years, apart from a short breathing space in summer 1991 immediately after the ecu peg. Even so, it would be an exaggeration to say that conditions were decidedly easier. The money market remained extremely tight and bank lending rates were crushingly high in relation to Finnish business conditions and the low rate of inflation, which was now below 3%. In March the banks were charging an average 13.5% interest on new loans.

When it was decided in September 1992 to let the markka float, the measure had been regarded as temporary but not transitory. At its meeting, the supervisory council had touched briefly on the question of how long the fixed fluctuation band would be suspended. At that time governor Hämäläinen had predicted that it would last “certainly weeks or months” while Matti Vanhala had not ruled out a duration of a year or longer. Prime minister Aho had issued a statement anticipating that the markka would float for perhaps a year, but the

chairman of the supervisory council Pentti Mäki-Hakola, who had been opposed to letting the markka float, told the Finnish Broadcasting Company on the very next day that a new fluctuation band should be set soon. He thought that a suitable devaluation rate would be 10 percent. His pronouncements were in marked conflict with statements made by the management of the Bank of Finland.

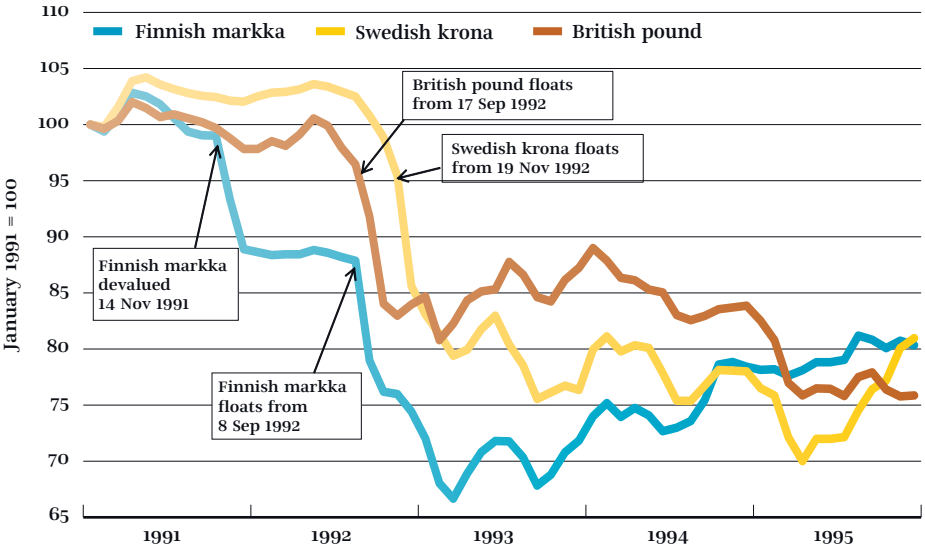
In the week following the unpegging of the markka, the board of management started preparing a proposal to amend the Currency Act so as to settle the legality of floating. Justice chancellor Aalto, Mäki-Hakola of the supervisory council and members of the government including the prime minister and the finance minister all regarded this as an urgent matter. The supervisory council presented the government with a proposal on amending the act on September 17 and the new law took force on 13 November. It allowed the government to authorise the Bank of Finland to float the markka “until further notice” and also to cancel this mandate after hearing the Bank of Finland’s opinion on the matter. Once the law was in force the government authorised the Bank of Finland accordingly. Finland had now formally moved to a floating exchange rate regime.⁸⁵⁶

In November, while Finland was still coming to terms with a floating exchange rate, the Swedish krona again came under speculative pressure similar to what it had experienced two months earlier. Underlying the market’s mistrust was a sudden growth in the Swedish government’s borrowing requirement. The Bank of Sweden defended the krona with large-scale operations on the foreign exchange market. On 19 November the government of Prime minister Carl Bildt presented parliament with an austerity programme, the third one proposed in the same autumn, in the hope of boosting market confidence in Swedish economic policy. Central bank governor Dennis had intended to use the occasion to propose pegging the krona to the German Mark instead of the ecu but the idea became moot when it transpired that the parliamentary opposition would not support the new austerity package. Following this, the Bank of Sweden stopped defending the exchange rate on the afternoon of 19 November and let the krona float. Its value immediately dropped about 8 percent and even more later in November and December. All in all, in the first months after it was unpegged, the krona lost about 14 percent of its value against the ecu and the German Mark.⁸⁵⁷

Sweden's decision to float the krona increased mistrust in other Nordic currencies and within the ERM. Portugal and Spain devalued on 21 November 1992 by 6 percent against the other ERM currencies. For the peseta this was the second devaluation within two months. Iceland also devalued its króna but Norway and Denmark decided to defend their exchange rates despite pressure in the foreign exchange market. Interest rates in both countries rose steeply. Denmark won the battle for the krone and, in Norway too, higher interest rates initially stabilised the market. However, when the Norwegian central bank tried to cut interest rates again, currency speculation resumed and it was ultimately forced to concede defeat and let its krone float freely on 10 December 1992.⁸⁵⁸

Finland escaped fairly lightly from the European currency turbulence in the wake of Sweden's float. The sharp fall in Swedish interest rates after the krona was unpegged were reflected to some extent in Finnish market rates but not much. In the foreign exchange market the markka weakened a little but not for long. When European

FINNISH, SWEDISH AND BRITISH EXCHANGE RATES AGAINST THE GERMAN MARK 1991-1995



Source: Bank of Finland.

foreign exchange markets finally settled down in December, the floating currencies of Finland, Sweden and Great Britain had depreciated by roughly equal amounts since their autumn turbulence. The markka rates for the pound and the krona in December were practically the same as they had been in June. All three had fallen 16–17 percent against the German Mark.⁸⁵⁹

The decline in Finnish market interest rates in October–November created an opportunity for a cut in base rate. The supervisory council discussed the matter in November although it was not until 17 December that the Bank of Finland proposed a base rate cut to the council. The proposal referred to falling market interest rates, government austerity decisions and the moderate labour market settlement, noting that these “laid the basis for moderate development in future interest rates”. The traditional problem with base rate was that it was too inflexible so the board proposed that the supervisory council should regularly examine base rate four times a year, taking into account long-term market rates, the level of bank interest rates on new loans, and so on.

As previously, the board proposed a cut in base rate very reluctantly because it calculated that bank profitability would be hurt. The capital adequacy of the banks was still extremely critical. Governor Hämäläinen told the council meeting tartly that a cut in base rate distributed income towards the well-to-do. She added that the supervisory council, which also supervised the Government Guarantee Fund, would, as a consequence of the cut, have to endorse at least 600 million markkaa in extra support for the banks. She admitted, however, that so much public attention had been paid to the base rate question that it was natural to make a decision on the matter in order to reassure the market.

Despite the governor’s remarks, the supervisory council approved a cut in base rate from 9½ to 8½ percent from the start of 1993. It did not, however, take up the idea of a quarterly discussion about base rate, so this part of the board’s proposal was rejected. The council settled for recording in the minutes that the board had said it would raise the base rate question in the council more frequently than before.

SETTING AN INFLATION TARGET

After the fixed exchange rate had been abandoned, the immediate question was how the stance of monetary policy would henceforth be determined. Under a fixed exchange regime, it had been fairly clear that the main function of monetary policy was to balance the balance of payments so as to make the exchange rate objective attainable. This had set narrow limits on interest rate policies, particularly after capital movements had been deregulated. When the markka was floating, the interest rate could in principle be set more freely although its effects on the exchange rate, inflation and economic growth could not be ignored. The conventional alternative to the fixed rate regime would have been monetarism, i.e. setting a target for growth of the money supply. However experiences of this policy abroad in the 1980s had not been very encouraging. The United States and Great Britain had stopped setting money supply targets and in Germany and Switzerland they had begun to be applied far more loosely than monetarist economists, such as Milton Friedman, had earlier recommended.⁸⁶⁰

Governor Hämäläinen talked about the problem of redefining monetary policy strategy in a speech to the Finnish Bankers Association on 20 November 1992, which stressed the importance of managing inflation expectations. She noted that Finnish conditions were unsuited for monetary policy based on targeting the money supply, because the relationship between money supply, inflation and economic growth was too uncertain. For this reason, monetary policy was being aimed at controlling inflation expectations directly, without any stated intermediate objective.⁸⁶¹

The monetary policy hiatus following the unpegging of the markka did not last long. Once more Finland took its exemplars for defining its monetary strategy from abroad, Britain and Sweden. Both were countries that, like Finland, had been forced to bow to market pressure during the autumn and abandon their fixed exchange rates. Britain had begun to work on a new monetary policy strategy soon after the pound had left the Exchange Rate Mechanism on 17 September. The result was published on 8 October when Chancellor Norman Lamont sent a letter to the House of Commons Treasury Committee that laid out the monetary policy to be pursued now that the pound was out of the ERM. It should be noted that, at the time, British monetary policy was

decided by the government. The Bank of England had lost its independence in 1946 and did not get it back till 1997.

Lamont observed that the British government intended to return the pound to the ERM but only when turbulence in the foreign exchange market ended and when the monetary policies of Germany and Britain had converged. He thought it was unlikely that these conditions would be met soon so a new monetary policy framework, based on an inflation target, needed to be set to fill the gap left by the exchange rate mechanism. The term “inflation target” subsequently became an everyday term although it might have been clearer to speak of an anti-inflation target or an inflation ceiling. The idea was to steer monetary policy with the objective of keeping inflation below an explicit numerical level.

In his letter Lamont said that Britain would apply monetary policy that targeted a rate of increase in consumer prices that would match the best in Europe. In the long term, he wrote, this meant inflation of no more than 2 percent. The immediate objective set out in Lamont’s letter was that inflation would be held between 1 percent and 4 percent during the present term of parliament and that, at the close of the parliamentary term, it would be in the lower half of this band. Parliament was due to be dissolved no later than spring 1997, so inflation was to be pushed below 2.5 percent by then.

The rate being targeted by the British government was core, or underlying, inflation, meaning the consumer price index adjusted for the effects of interest charges on home loans. At the time that it published this target, core inflation had been slowing down for some time but was still about 4 percent, so the target amounted to a pledge that the British government would not allow the floating of the pound to lead to a higher inflation rate.⁸⁶²

Britain was not the first country to try to link its monetary policy to an inflation target and a floating exchange rate. Earlier examples were New Zealand and Canada. Since 1990 New Zealand’s monetary policy had been based on a “Policy Targets Agreement” between the central bank and the government, which included a numerical inflation target (initially 0–2%). The central bank was allowed independence in implementing monetary policy to achieve the inflation target but had to report on it twice a year to parliament. Canada had moved to a similar system in 1991.⁸⁶³

After the Swedish krona had floated for about two months, Sweden followed Britain's model in announcing that it was going to start steering monetary policy according to an inflation target. In an announcement on 15 January 1993, the Bank of Sweden said that the aim of monetary policy would be to hold inflation, measured by the rise in consumer prices, at 2 percent from 1995 onwards, but with a band of ± 1 percentage points around the 2% target. The central bank added that its monetary policy in 1993 and 1994 would be aimed at preventing a faster rate of (underlying) inflation if the krona's value floated down.⁸⁶⁴

The Bank of Finland began to look at monetary policies strategies at the end of November. On 1 December the board of management discussed the subject on the basis of a memorandum jointly drawn up by the economics and monetary policy departments. The memorandum noted that "in the current situation" (i.e. while the exchange rate was floating) there was a greater need for a public inflation target. It said that the "final objective" of monetary policy could be derived from the inflation criteria in the Maastricht Treaty. It was estimated that the three lowest rates of inflation in the EU would average 2.6 percent in 1993, so the memorandum concluded that a Maastricht-compliant maximum inflation target for Finland would be about 4.1%. It also considered the various intermediate objectives that might be applied to monetary policy under conditions of a floating exchange rate, such as target growth of money supply, but concluded that no specific intermediate objective should be set.⁸⁶⁵

When the board discussed the matter on 1 December, it endorsed the economics department's recommendations for monetary policy strategy but made no decisions on action to be taken. Even so, the meeting spurred Matti Vanhala to write a very toughly worded memorandum on the very next day, in which he criticised the bank's economists and most of the board members for their reasoning and their deduction that the Maastricht Treaty allowed a 4.1 percent inflation target or ceiling. Vanhala pointed out that 4% inflation was not low. It was not even the EMU inflation target but the absolute upper limit and, even then, variable and dependent on changes in inflation in other countries. While he supported setting an objective for monetary policy that would protect price stability, the inflation band chosen must be derived "from our own economic circumstances". Even

the 2.6 percent quoted in the memorandum was not an adequately ambitious objective while EMU was approaching within “the next few years”. Vanhala’s conclusion was that, before anything new was said in public about an inflation target, the Bank of Finland should itself be aware of where it wanted to go and how committed it wanted to be.⁸⁶⁶

The monetary policy strategy of the Bank of Finland was not expressed more explicitly until the end of January 1993, when Finland was suffering from still-deteriorating economic conditions. The board of management and the bank’s advisors convened on 26 January to assess economic policy. Briefing papers noted that unemployment had increased strongly and far faster than expected. At the same time the central government deficit had risen very sharply and threatened to worsen during 1993. This made it increasingly difficult to support economic activity by fiscal means, so there would be strong pressure to use monetary policy for the purpose.

At a board meeting on 26 January, the directors were given figures calculated with the bank’s BOF4 model, which estimated the effects of lower interest rates on economic growth, consumer prices and exchange rates. Already a couple of years earlier, one of the bank’s economists Alpo Willman had developed a floating exchange rate version of the bank’s macroeconomic forecasting model. It showed that the effects of easier monetary policy would now be “substantial” and “rather favourable”. Easier money would improve the economy’s external balance and also shrink the government budget deficit.

The board met again three days later on Friday 29 January 1993 and this time the subject was explicitly monetary easing. A brief on the subject noted that “the outlook for the economy underscores the need to achieve lower real interest rates”. On the other hand “if a reduction in market interest rates leads to a further large depreciation in the markka, the contractionary effect of this on the economy will cancel out the benefits of lower interest rates”. But the danger of an exchange rate reaction could be alleviated by committing to a policy of low inflation. This commitment would be “underpinned” by Finland’s application to the EU, in which it had been stated that Finland would seek to meet EMU criteria “in the late 1990s”.

Finland’s inflation target would thus be a way to support the markka on foreign exchange markets when the almost-catastrophic state of the economy made radical monetary easing unavoidable.

Reference was now made for the first time to the examples of Britain and Sweden. The brief stated that “to put together a dependable strategy will probably require at least some numerical target, such as Britain and Sweden have set. It would be appropriate to set a long-term target, for example for 1995. This in turn means that the Bank of Finland is assuming fairly explicitly that floating will continue for a long time because it has no instruments for achieving an inflation target under a fixed exchange rate regime.”

At the same meeting the board was shown the first draft of a statement to be published about future monetary policy strategy, setting the inflation target for 1995 at 2 percent. In the same connection, the board heard predictions for upcoming inflation. In December 1992 the consumer price index had been 2.1 percent higher than a year earlier; during 1993 consumer prices were expected to rise 3¼ percent.

The actual decisions on monetary easing and an inflation target were taken at board meetings on Wednesday 3 February and the next day. The package of measures consisted of the following parts:

- reduction in base rate by one percentage point (to 7½ percent);
- money market operations to push short-term market rates (one and three-month Helibor) down about half a percentage point on the first day;
- a statement to be published on the principles for setting monetary policy in 1993–1995. This contained the 2-percent inflation target.

The board wanted to avoid large exchange rate changes but in the first days after easing monetary policy it would refrain from foreign exchange interventions unless the external value of the markka deteriorated very significantly. The board would closely monitor the markets and act accordingly.

The Bank of Finland published its inflation target on 4 February 1993, at the same time as it announced the new cut in base rate. Its statement said that “the Bank of Finland has specified the guidelines in accordance with which monetary policy will be conducted over the next few years. The aim is to stabilize the rate of inflation, measured by the annual rise in consumer prices, permanently at 2 percent by 1995. The recent increase of exchange rates may temporarily push consumer prices up faster than this in 1993 and 1994.”²¹⁸⁶⁷

As the rationale for setting of an inflation target, the statement said that, for successful (European) integration, Finland’s inflation had to

be in harmony with inflation elsewhere in Europe: "The inflation ceiling is based on anticipated European price development and the need to control long-term inflation expectations. Stable price expectations will create favourable conditions for a fall in real interest rates and for long-term economic decisions such as investment projects."

The inflation target that the Bank of Finland published concerned the consumer price index but the statement said that changes in prices resulting from public charges, taxes and house prices would not be reflected in monetary policy. Thus tax increases, for example, would not create a need for tighter monetary policy.

As a concession to monetarist tradition, the statement also accorded a certain role to money supply: "Alongside inflation pressures the Bank of Finland will pay particular attention to ensuring that the supply of money and credit and particularly the central bank's own lending do not increase in a way that would jeopardise the objective set." The reference to the Bank of Finland's own lending was obviously intended to counter the pressure to use central bank credit to fund the government's fast-widening budget deficit. There had been some discussion of this option in Finland, under the euphemism "using the printing press".

As recently as a couple of days before the inflation target was published, the Bank of Finland had hoped that, at the same time, the government would present a new medium-term programme for balancing public finances. The government had not yet done this or responded in any other way, so the Bank of Finland's inflation target was still unilateral at this stage.⁸⁶⁸

CONFIDENCE STARTS TO RETURN

Publication of the inflation target marked the turn of interest rates in Finland. Within a day all market rates fell distinctly lower and, after a few days, one and three-month Helibor settled around 9 percent and stayed there for a couple of months. This was 1½ percentage points lower than the January average. Finnish market rates may have been influenced not only by the Bank of Finland but also by the German central bank, which lowered its own rates slightly on the very same day that the Finnish inflation target was published. There is no evidence

INFLAATIO?



■ The inflation goblin illustrated a brochure published by the Bank of Finland after the announcement of its inflation target.

– Bank of Finland / drawing by Timo Mäkelä.

that the Bank of Finland was aware of what the Bundesbank intended, so the timing was evidently a fortunate coincidence for Finland.

Monetary easing at the start of February did not initially work as well on the exchange rate side as it did on interest rates. In a couple of days the markka fell about 6 percent against the German Mark. The monthly policy monitoring report, distributed to the Bank of Finland's board of management, headlined that the markka was in a "tailspin" and stated that "in essence, monetary easing has precipitated the third markka devaluation in just over a year". The Bank of Finland had to intervene forcefully in the foreign exchange market, the report said: "Market equilibrium was only maintained by Bank of Finland sales of foreign currency."

The foreign exchange market remained very shaky until early April. During the first quarter the Bank of Finland spent almost 26 billion markkaa to support the markka. Most of this currency came from government foreign borrowing, which amounted to about 23 billion markka during the same period. The balance sheet at the end of March showed foreign exchange reserves had fallen to 22.5 billion markkaa and about 10 billion of this had already been sold in forward contracts that would fall due within a few weeks. The Bank of Finland's actual currency reserves were thus very small despite large-scale capital imports by the government.

Fortunately there was a sudden and distinct turn for the better in the foreign exchange market in April 1993. Several reasons lay behind this. At the turn of April, the government had published a new austerity programme which contained a commitment that the growth of government debt would be halted by 1997, and would not then be allowed to exceed 70 percent of gross national product. At the same time the government said that it supported the inflation target announced by the Bank of Finland. It was the first time that the government had taken a stand on the target in the almost 2 months since it had been published. Another important factor underlying the improvement in the foreign exchange market was the favourable turn in exports, which was improving the trade balance. Better export prospects were boosting confidence in the markka.

A very strong signal, perhaps even epochal for market sentiment, came in April, when Masa Yards shipyard received a contract to build LNG tankers for Abu Dhabi. The employment effect of the project in

Finland was estimated at 9000 man years. Forward currency contracts to hedge the contract brought Finland nearly \$400 million (equivalent to over 2 billion markkaa), a significant amount in the current state of the foreign exchange market. As news of the contract reached the market around the middle of April, the markka rose by about 6 percent against the German Mark. It was the first time that the markka had strengthened distinctly since it had been floated. The new direction in the foreign exchange market was reflected in the money market, where rates fell about half a percentage point in a short period. The Bank of Finland could now operate in the foreign exchange market as a buyer, to replenish its shrunken currency reserves. The worst was over.

In May, just as the market was turning, a delegation of IMF experts arrived in Helsinki for the regular article 4 surveillance of the Finnish economy. The delegation's report concentrated mostly on fiscal problems because it regarded fiscal policy as crucial. The question was whether the measures agreed by the government to stabilise public finances were sufficient and credible in the market. According to the IMF experts, the planned short-term austerity measures were generally speaking adequate, but it was obvious that the market had not been convinced that the situation (for public finances) would be brought under control.

The IMF delegation had less to say about monetary policy. It regarded Finland's 2-percent inflation target as "appropriate" but warned against more monetary easing at a time when credible fiscal measures were lacking, unless there was a further deterioration in economic activity. By "fiscal measures" it naturally meant tighter budgetary policy. The rationale for its warning was that the behaviour of the exchange rate when monetary policy was eased at the start of 1993 had provided adequate proof of the fragility of expectations.

On the other hand, if fiscal policy became credible, it would lead to a decline in long-term interest rates and a strengthening of the exchange rate. Under such circumstances even short-term interest rates could be allowed to fall in order to support economic activity, the IMF experts said. This would lessen the "natural concern" about tighter fiscal policy at a time of mass unemployment. In the longer term, the exchange rate should be allowed to appreciate as the economy recovered, the report recommended.⁸⁶⁹

The next milestone in the normalisation of the Finnish money market was passed in June 1993, as Finland's short-term market rates reached the eurorate of the German Mark, and actually fell below it. The picture of stronger market confidence was reinforced by the exchange rate, as the markka continued to strengthen against the Mark even as interest rates fell. The Bank of Finland's currency reserves rose, too.

After adopting floating exchange rates and moving to monetary policy based on an inflation target, both Britain and Sweden had begun to publish special inflation reports. In these, their central banks set out their views of near-term inflation prospects and explained the monetary policy decisions they had taken. Inflation reports constituted a radical change in communications by central banks, which previously had not normally published economic forecasts, and certainly not inflation forecasts. Now inflation forecasting became the core content of information issued by the Bank of England and the Bank of Sweden, and a strategically important element in all countries that had set an inflation target.

In Finland, too, central bank communications became more active after the markka was floated and the inflation target had been announced. In June 1993 the Bank of Finland published the first edition of its new quarterly magazine *Markka ja talous* (The markka and the economy). It was similar in content to the traditional *Bank of Finland Bulletin* apart from the language. The bank was now publishing a Finnish language magazine, more than 70 years after its first English-language bulletin had seen the light of day.

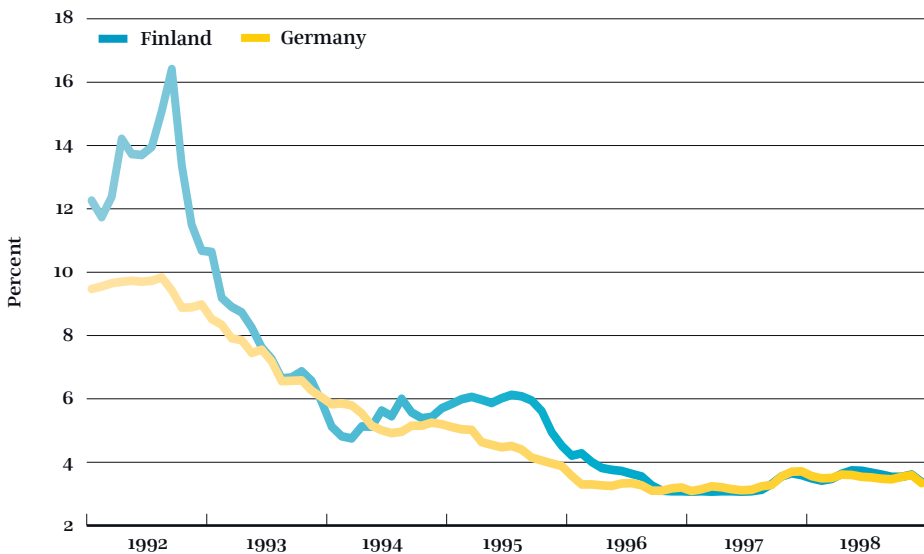
At this stage the bank moved cautiously towards developing its inflation report. The first issue of *Markka ja talous* contained an article by the economists Pentti Pikkarainen and Timo Tyrväinen on the inflation target of the Bank of Finland and the inflation outlook for the next few years. It gave a numerical forecast for inflation in 1993 and outlined fairly precisely the prospects for 1994. Subsequent editions of the magazine and the *Bank of Finland Bulletin* had regular articles dealing with economic forecasts, inflation and monetary policy. The Bank of Finland did not go so far as to emulate foreign inflation reports but generally contented itself with expressing its inflation forecasts in a qualitative way without giving precise numbers or a even a quantitative forecast range. Initially the regular articles were published under the name of one of the bank's economists, but

from the second edition of 1994 they were presented as the bank's official view.

One sign of calmer conditions in the Finnish money market was the narrowing of interest rate differentials against the traditional anchor of European foreign exchange markets, Germany. In June the situation had improved so much that the interest rate differential between the Finnish markka and the German Mark occasionally disappeared entirely. It was a significant milestone; nothing like this had been seen since the creation of the Finnish money market in the mid-1980s. Many other European countries experienced narrowing interest rate differentials against Germany during spring 1993. France in particular took advantage of the calm market and sharply reduced its interest rates after the non-socialist government of Eduard Balladur had taken office in March.

The period of calm on European foreign exchange markets in early summer ended in July when two small interest rate cuts by the German central bank failed to meet market expectations. With German

**FINNISH AND GERMAN SHORT (3-MONTH)
MONEY MARKET RATES 1992-1998**



Source: Eurostat.

monetary policy now tighter than expected, there was strong speculation against the ERM currencies regarded as weak, in particular the French franc, the Danish krone and the Belgian franc. By the end of July speculation had developed into a full-scale crisis. On the first weekend of August, the foreign ministers and central bank governors of the EU countries agreed to widen the fluctuation bands in the exchange rate mechanism to ± 15 percent around the bilateral central rates (bandwidth had previously been $\pm 2\frac{1}{4}$ percent). The other alternatives for solving the crisis, such as a French devaluation, German monetary easing or disconnecting the German Mark from the ERM had proved to be politically impossible.

The new fluctuation bands were very wide and so the character of the ERM as a system of fixed exchange rates had significantly changed. The aim of wider fluctuation bands was to make exchange rate speculation less profitable, and it worked. However, there was a danger that plans for monetary union would become less credible so, while increasing exchange rate flexibility, the ministers and central bank governors declared their continuing intention to implement the Maastricht Treaty (and its component EMU plan). In the years ahead, the core EMU countries, such as the Netherlands, Belgium, France and Denmark, continued to hold their exchange rates within a much narrower band than the permitted 15 percent.⁸⁷⁰

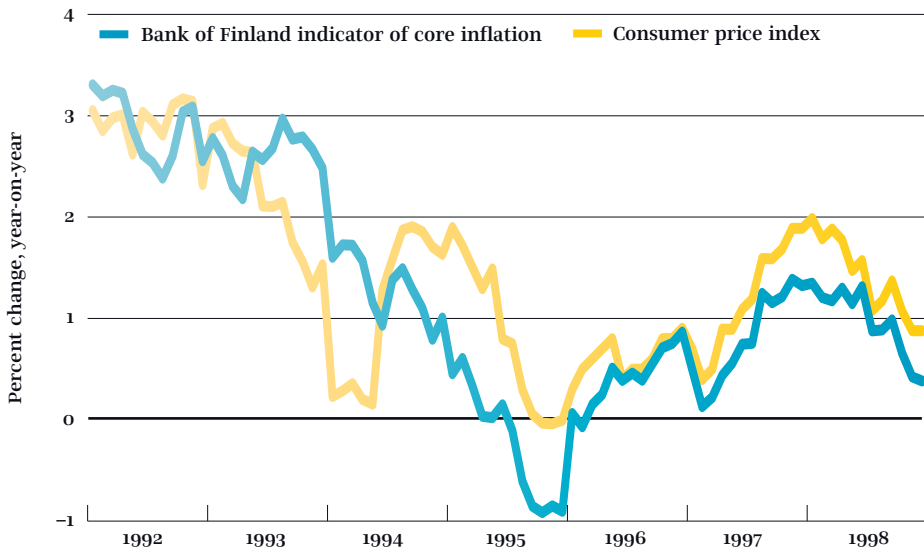
Finland was little affected by the European currency turbulence of 1993, perhaps because of its floating exchange rate, although the Bank of Finland was forced to intervene in the foreign exchange market in July and August to steady the markka. Immediately after the ERM crisis, the markka was shaken by a wave of distrust initially concerning the Swedish krona, which was sparked when news leaked that the International Monetary Fund was worried about Swedish budget deficits. The krona consequently lost value and dragged the Finnish markka down with it. In August-September the markka depreciated about 5 percent against the German Mark and the ecu. Because of unrest in the foreign exchange market, the year-long decline in Helibor rates was interrupted for a few weeks but by October the market was calmer, the markka began to strengthen and interest rates resumed their descent.

The more peaceful state of the Finnish money market towards the end of 1993 did not mean that the economic crisis was over. The banks were still struggling with large credit losses and capital adequacy

problems and their operating results for 1993 were negative. At the same time public finances were in ever deeper difficulties. The public sector deficit reached about 8% of gross national product and government debt was growing at an almost explosive rate.

There were some positive signs, however, despite the financial problems of the government and the banks. Not only were interest rates falling dramatically – three-month Helibor fell below 6% in December 1993. Exports were also climbing strongly, the current account moved into surplus in the second half of the year and inflation was slowing down. In December the Bank of Finland’s core inflation indicator showed a year-on-year rise of 3.5 percent, and headline inflation, measured by the consumer price index, was only 1.5 percent. Moreover, both rates were still falling. In the domestic markets for goods and services, however, the situation was still difficult and was not being helped by the problems of the banks. In a statement at the end of 1993 governor Hämäläinen said that reviving the domestic market was the main target of economic policy but that overheating in the export sector was already a cause of concern:

FINNISH INFLATION 1992–1998



Source: Statistics Finland.

“The central challenge of near-term economic policy is to end the slump in the domestic markets, subject to the limits imposed by export growth and foreign debt. The aim of monetary policy is to lower interest rates without creating an exchange rate reaction which would be difficult to control (...) The extent to which monetary policy can be used to support economic recovery in these conditions depends, on the one hand, on confidence that government finances will be restructured and, on the other, on the development of all domestic costs, not merely wages. As long as inflation expectations remain moderate, a general rise in confidence can be channelled into a reduction in interest rates. What is important is to avoid overheating in the export sector and runaway cost increases. The most certain way of achieving this is via an appreciating markka.”⁸⁷¹

WHOLE FINANCIAL SYSTEM IN TROUBLE

NOT JUST THE SAVINGS BANKS

For almost two years from autumn 1991 onwards, the Bank of Finland was engaged in a war on two fronts. At the same time as it battled with monetary policy to overcome a currency crisis and get the markka and interest rates under control, it was also struggling with the liquidity and capital adequacy of the Finnish banking system. There was a growing realisation that the problems of the banks were not confined to SKOP. The whole banking system was in danger of collapse. With this realisation came the insight that central bank tools and resources would not be enough. Crisis management required purposeful and unprecedentedly bold action from the government and parliament too.

An examination of the position of large commercial banks has to begin a few years earlier. When SKOP was taken over, the public perception had still been that banking problems concerned the savings banks, but in reality the onset of the slump hit all bank groups. The first manifestation of their difficulties, a liquidity crisis, was joined by a new source of concern, growing credit losses. The Bank of Finland too had initially followed events from the viewpoint of liquidity which, as the central bank, it could monitor in real-time. But, from 1990 onwards, it was increasingly worried about figures for bank profitability, which became available, after a short lag, in bank interim reports. On the income side of bank accounts, the biggest threat was the interest rate trap, meaning that a major part of lending was fixed to base rate while a growing part of funding was on market terms and therefore

tied to now high Helibor rates. Meanwhile, the expenditure side was out of control as credit losses soared while shares and real estate prices plummeted, forcing the banks to make major write-downs in their balance sheets.

A memorandum Bank profitability prospects, from the Financial markets department of the Bank of Finland, written by Heikki Solttila and dated 17 October 1991, provides a vivid picture of the gloomy mood at the central bank at the time of the SKOP takeover. The memorandum stated that many years of economic growth had culminated in a period of overheating in 1987–1989. Private consumption and private investment had both increased very strongly. Consumption had been out of proportion to income so the indebtedness of households and enterprises had increased significantly. In particular, the closed domestic market sector of the economy had been unbalanced by the strong growth in demand. Service sector investments had doubled in a few years while its borrowing had almost trebled to 170 billion markkaa. At one fell swoop Finland had become a land of shopping paradises, golf courses and tropical spas.

By autumn 1991 the country was deep in recession. In the short term no relief could be expected from exports because the collapse of the Soviet Union had halted sales to the east while a lack of Finnish competitiveness hindered exports to western markets. Only after an improvement in competitiveness could exports be expected to recover. Consequently any reduction in the current account deficit, which had become a critical problem for the economy, had to be achieved by reducing imports, that is by putting the brake on domestic demand. The proportion of foreign debt to GDP had been increasing since the 1980s and there was a danger that Finland's debt ratio would become higher than any other western country. In order to restore external equilibrium, economic policies would have to be considerably tougher than during the recession in the second half of the 1970s. This would also limit the potential for lower domestic interest rates, which was very problematic because real rates had risen about 10 percentage points since the 1970s. During the 1970s debt had still been generally regarded as the lever to wealth but from the start of the 1990s it had become a stepping stone to bankruptcy. Moreover, Finland's economic integration with Europe would create still more competition in Finland, aggravating the position of domestic companies.⁸⁷²

The memorandum shows that the central bank's view of Finland's economic situation was bleak. Ahead lay a very long and difficult period of adjustment involving bankruptcies, falling real wages and unemployment. The companies engaged in exports to Russia or serving the domestic market would find it hardest to recover. Unprecedentedly large credit losses awaited the banks. Even in 1990, their credit losses of 2.5 billion markkaa were more than twice as much as the previous year and, by autumn 1991, it was known that they would be higher still in 1991. Since the start of the year, all banks had been compiling statistics on non-performing loans, meaning loans that had not been serviced for at least three months. Based on this data it was estimated that credit losses in 1991 would rise to 5 billion markkaa and in the following year to 7 billion. At the same time the banks' income base had been greatly eroded by the interest rate trap. It was no exaggeration to say that bank prospects in autumn 1991 were abysmal. In 1990 the combined operating profit of the banks had still been 1.4 billion markkaa but in 1991 they were expected to report an operating loss of 3.9 billion and in 1992 of 6.4 billion. In the event, their losses were to be even greater – nearly 5 billion markkaa in 1991 and nearly 10 billion in 1992 (excluding the savings bank group).⁸⁷³

The Bank of Finland calculated that the whole banking system would still have enough equity in 1992 to remain within the regulations on minimum capital adequacy but the banks could not wait very long for business conditions to recover. There was also the danger of an outside casualty – the failure of a major client – which could undo a bank that seemed in good shape. A table drawn up by the financial markets department indicated the seriousness of the situation. It showed the equity buffers of the bank groups on 30 April 1991, meaning the size of the losses each could make before capital adequacy fell below the statutory limit.⁸⁷⁴

Bank/group	Union Bank	Kansallis Bank	Postbank	OKO	Savings banks	Co-operative banks
billion markkaa	3.6	0.1	1.1	1.1	< 1	> 1

The position (shown without SKOP) depicts the situation of the banks in spring 1991, which was half a year before the devaluation of the autumn.

Compared with the combined credit portfolio of the banks at this time – 387 billion markkaa – equity buffers were tiny, so the financial system was already extremely vulnerable. Only Union Bank had a decent buffer against future losses. The position of Kansallis seemed particularly difficult because it could stand losses of no more than 100 million markkaa. Other problems for Kansallis were the proportion of its corporate customers who were dependent on the domestic market and its excessive concentrations of risk in proportion to total assets. Moreover, its lending denominated in foreign currencies was more than any other bank or bank group, nearly 33 billion markkaa on 31 July 1991, compared with only 17 billion at Union Bank. The devaluation of autumn 1991 was therefore an extremely serious setback for Kansallis, which was already teetering on the edge. Devaluation hurt companies dependent on the domestic market, especially those which had taken foreign currency loans. In the course of autumn 1991 the central bank also realised that the crisis at the savings bank group was not confined to SKOP but that several other large urban savings banks were heading in the same direction. A major reorganisation of the whole group lay ahead. The cooperative bank group was in better shape. A significant difference was that its central bank OKO was relatively healthy and had the resources to support member banks in trouble.⁸⁷⁵

The divergent states of the two largest commercial banks were naturally the result of many historical factors, such as customer structure, but the different strategic choices of the banks and their associates also played a major part. Kansallis was committed to the fixed exchange rate policy pursued by the Bank of Finland, which saw no role for old-style devaluations. Editorials in the Kansallis bank magazine *Economic Review* were real signs of this commitment, as the following quote from autumn 1989 shows: “This autumn, in debate on economic policy, devaluation has frequently been brandished as a possible solution. The markets have reacted to these rumours. At the present moment devaluation would be economic madness for the simple reason that while the economy is running at full speed its only consequence would be immediate higher inflation. Nor is devaluation a solution in the future. Those who desire it are apparently still living in a closed Finland. The goal during the 80s has been to build the sensible policy of a stable markka. Finland’s reputation in economic policy largely hinges on this. It is hard to imagine that the government

would want to declare the bankruptcy of its economic policy by devaluing the markkaa.⁸⁷⁶

In the light of this article, commitment to a stable exchange rate was not merely an economic question but also had a political dimension, the endeavour to promote Finland's tighter integration with Western Europe.

The attitude of Union Bank, the main competing commercial bank, was distinctly more neutral, judging from the articles in its *Unitas* magazine. The editorials focused far less on the motives of exchange rate policies and although the magazine was satisfied with the policy orientation of the central bank, the exchange rate was not the same sort of taboo as at Kansallis Bank. In an article published in autumn 1989, entitled *Will the popularity of foreign currency loans continue?* *Unitas* openly raised the possibility of exchange rate risk – meaning devaluation – and emphasised the bank's responsibility for its customers: "The present situation reinforces the bank's role, alongside that of a financier, as an adviser. It is the duty of a financier to inform customers of the problematic side of currency loans and to actively seek sensible alternatives for supplying corporate finance. It is perfectly clear that the use of foreign credit is growing, and companies also need to increase their understanding (of it) and develop their financial management. For banks, this creates the challenge to develop various financing and hedging instruments that also suit small and medium-sized companies."⁸⁷⁷

In 1990 the difference between the two commercial banks became even more pronounced when Kansallis began granting more loans in foreign currencies while Union began to discourage them for companies not operating in the open sector of the economy.⁸⁷⁸

There was a similar difference in their attitudes towards liberalisation of the financial system in general. Kansallis under chief general manager Jaakko Lassila had, since the early 1980s, been demanding the fastest and most far-reaching liberalisation possible while Union Bank circles were more pragmatic. Kansallis' *Economic Review* was strongly critical about the supplementary cash reserve deposit system adopted in winter 1989. "The Bank of Finland's response is causing a fissure in the otherwise consistent liberalisation of the financial market. Unless the response is temporary or believed to be, our image abroad may gain questionable features. Other, sensible

methods exist to restrict the growth of lending.”⁸⁷⁹ Meanwhile, Union Bank’s *Unitas* magazine congratulated the central bank on curbing lending and certainly did not see the supplementary cash reserve system as a fateful return to old-style regulation that would blacken Finland’s reputation.⁸⁸⁰

With a little hyperbole it could be said that the major banks and banking groups split into two groups during the 1980s. The savings banks and Kansallis demanded the fastest and most complete liberalisation possible, and took issue with the Bank of Finland on several occasions. They trusted in the permanency of the fixed exchange rate regime and overlooked the risks associated with granting loans in foreign currency. Union Bank and the cooperative banks had an attitude towards liberalisation that was at least somewhat more moderate. Moreover their strategies did not depend as absolutely as the other group on the success of the stable markka policy.

BANK OF FINLAND’S POSITION CHANGES

The takeover of SKOP meant major changes for the Bank of Finland. Before the events that culminated on 19 September 1991, no one had seriously entertained the idea that a major bank in Finland could be driven into liquidation. Now it had come true, at a time when the latest data showed that the whole financial system was in danger. There was no alternative to rethinking the mechanisms for promoting financial systemic stability. It could no longer be built around the central bank alone. Parliament and the government also had to be involved, if only for the reason that the central bank had had to put its entire capital at risk in taking over SKOP.

The first indications of this conclusion came in September 1991, when the board of management of the Bank of Finland had considered alternative models for taking control of SKOP. One was the establishment by the government of a bank rescue fund and a separate asset management company. This model was derived from experiences abroad – mostly the United States – in managing bank crises. It shows that by autumn 1991 the Bank of Finland had already been examining banking crises in various countries and how they had been handled. It is no exaggeration to say that most of Finland’s expertise on the subject was at the Bank of Finland.⁸⁸¹

After the devaluation of autumn 1991, the position of the banks was worse than ever, and fears for the stability of the financial system were felt by representatives of the banks themselves, as well as officials. In an interview at the time, the chief executive of Union Bank, Ahti Hirvonen, expressed the matter with macabre realism: "The morgue at the Bank of Finland is only big enough for one corpse. Something has to be done because there are going to be more corpses. This present method for managing a banking crisis is too expensive."⁸⁸² It was not a question merely of propping up the banks. There was a real fear that soaring credit losses would reduce equity so much that the banks would no longer be able to meet statutory capital adequacy requirements. If they responded by cutting back their lending, it could precipitate a credit crunch that would disrupt the entire economy. This was a very topical question because Finnish legislation had just been tightened to meet international recommendations and, from the start of 1993, banks with international operations would require capital adequacy of 8 percent. One entirely effective way of meeting the requirement was to reduce lending.

To find ways of preventing this development, the Prime minister's office established a working group on 17 January 1992, to draw up a concrete programme to safeguard the banking system. Governor Sirkka Hämäläinen (Bank of Finland) was appointed to chair the working group. Its members were secretary of state Esko Keinänen (Finance ministry), director general Jorma Aranko (Banking inspectorate), chief executive Ahti Hirvonen (Union bank), chief executive Pertti Voutilainen (Kansallis bank), managing director Kalevi Kauniskangas (Savings bank association), chief executive Pauli Komi (OKO) and chief executive Seppo Lindblom (Postbank). Vesa Vihriälä (Bank of Finland) and Kalevi Kontkanen (Finnish Bankers' Association) were appointed secretaries. The seriousness of the situation is shown by the composition of the working group, which contained the chief executives of all major banks and banking groups. Solutions were needed quickly and the working group was given the deadline of the end of the following month.⁸⁸³

Its report, published on 16 March 1992, stated that the most important and urgent duty was to protect the ability of the banks to lend, so that the existing economic crisis would not be worsened by a credit crunch. The most effective way would be for the government to

set aside funds that could be used for capital investments to reinforce bank equity. The working group estimated that investments of 5–10 billion markkaa would be needed. It also proposed a series of other measures, some of which required government action and some which the banks could do themselves. The report conceded the inefficiency of the Finnish banking system compared with Scandinavia and noted that Finnish banks had long been unprofitable. Finland had one bank branch for every 1,500 inhabitants while in Sweden the figure was 2,600, so the banking sector was facing a major restructuring. The report was particularly self-critical, considering that the working group contained chief executives of all major banks.

Another reform proposed by the banking working group was the establishment of a Government Guarantee Fund, a major issue of principle. This crisis management model had initially been raised by the Bank of Finland in autumn 1991. It had not been implemented at that time but had been discussed between representatives of the Bank of Finland, the Finance ministry and the Bank inspectorate. The main reason why a Government Guarantee Fund was needed was that the banks' own guarantee funds were not believed to be equal to the crisis. They had been designed mainly to rescue small individual banks, not entire bank groups, and had very modest capital of a few hundred million markkaa when tens of billions were needed. A Finance ministry working group began to prepare the establishment of a guarantee fund in late autumn 1991 and the government proposal was issued in March 1992. The fund was therefore already before parliament when the banking working group urged its establishment.⁸⁸⁴

Both proposals of the banking working group were adopted rapidly. The sum of eight billion markkaa was earmarked for bank capital in the first supplementary budget of 1992. Investments totalling 7.9 billion markkaa were made in autumn 1992, allocated between the banks in proportion to the balance sheet total of each recipient. Technically this was a "capital injection" by the government that could be used to cover losses but which did not automatically mean state ownership of the bank in question. However, to accelerate repayment, the condition was attached that the government would have the right to convert its investment into bank shares, or corresponding securities with ownership rights, if interest on the investment went unpaid for 1080 days. The rationale for the three-year deadline was that it would

SIRKKA HÄMÄLÄINEN (1939–)

Sirkka Hämäläinen (née Hinkkala) was born to a farming family in a small municipality in central southern Finland and studied at the Helsinki School of Economics. In 1961 she was hired by the Bank of Finland's Institute for Economic Research as an assistant, helping researchers such as Henri J. Vartiainen, Lauri Korpelainen and Timo Helelä with statistical analyses. Within a few years she had been promoted to researcher and when the institute was disbanded at the start of the 1970s Hämäläinen became office manager at the new economics department, and later acting head of the same department. As a researcher, she specialised in the saving behaviour of households and published a dissertation on the subject in 1981.

She became head of the Finance ministry's economics department in 1981 but returned to the central bank in the following year, now with the rank of director, the level immediately below the board of management. Over the years she acquired responsibilities for monetary and exchange rate policies and for the financial markets in addition to the economics department. In practice she was in charge of all policy planning matters, while most implementation was under director Matti Vanhala.

Hämäläinen was appointed to the board of management when Markku Punttila resigned in the wake of the devaluation in autumn 1991. Just four months later, she became governor of the Bank of Finland when Rolf Kullberg was also forced to resign. She thus

took over responsibility for Finnish monetary policy under the most difficult circumstances possible. The Finnish economy was in a downward spiral, the whole banking sector was mired in problems and confidence in the Finnish markka had been undermined. It was under her governorship that equilibrium was restored.

Sirkka Hämäläinen was the first governor of the Bank of Finland who was clearly interested in developing management and in modern management doctrines. During her term the bank embarked on strategic planning and scenario analyses and discussed organisational values. To cope with change, the whole organisation needed to have a common vision. When she resigned from the Bank of Finland in June 1998 to take up a position on the executive board of the European Central Bank she declared that "compartmentalisation and the idea of protecting one's own turf no longer exist (at the bank) as they still did in the 80s". She had a reputation for being a tough and determined manager; in her farewell address to the staff she asked for "collective forgiveness for various browbeatings and my fits of temper".

Hämäläinen's magnificent career culminated on the ECB board in 1998–2003, where she was responsible for monetary policy operations. It was under her that the way that monetary policy in the euro area was implemented became established. Since her time at the ECB, she has served as an external director of various companies and as chair of the Finnish National Opera foundation.



■ ECB executive board member Sirkka Härmäläinen at her office in Frankfurt am Main. – Lehtikuva news photo archives/Arne Dedert.

provide enough time for the banks to put their houses in order, and indeed it did.⁸⁸⁵

Parliament approved the proposal on the establishment of a Government Guarantee Fund on 30 April 1992. Its function was defined as “protecting the stable operation of deposit banks and the claims of depositors”. For this purpose the fund was initially authorised to borrow 20 billion markkaa. In autumn 1993 the authorisation was raised to 50 billion markkaa. The Bank of Finland played a major role in starting up the operations of the Fund, which did not have its own personnel. Planning was done at the Bank of Finland and the Bank inspectorate. The fund was responsible to parliament and supervised by the Bank of Finland’s supervisory council. It was overseen by a six-member board. Three of the board members were bank representatives but practical matters were decided by its executive division, where Jorma Aranko, Pekka Laajanen and Esko Ollila represented the Bank inspectorate, the Finance ministry and the Bank of Finland. These three senior officials were central to the handling of the early stages of the banking crisis.⁸⁸⁶

Problems of governance worsened as the guarantee fund widened its operations. In response, parliament approved a government proposal in March 1993 to transfer the fund to the ambit of the government and another proposal on reshaping its administration. Its board would no longer contain representatives of the banks nor banking supervision officials, meaning the Bank inspectorate and the Bank of Finland. Moreover the Government Guarantee Fund would have its own staff and its own full-time executive. In practice the change sealed the transfer of responsibility for managing the banking crisis from the Bank of Finland to the Finance ministry. Under its regulations, approved by parliament, the fund was to assist the cabinet and the Finance ministry in preparing decisions about support measures and to carry out duties related to monitoring the use of support in accordance with these decisions. At the start of 1993 the government also published a proposal on establishing an asset management company alongside the Government Guarantee Fund. Political criticism about the handling of the banking crisis was so fierce at the time that the proposal was withdrawn from parliament, but the need remained and the proposal was submitted to parliament again in autumn 1993. Parliament approved it on 15 October.⁸⁸⁷

GOVERNMENT TAKES CHARGE

The board of management of the Bank of Finland had assumed from the outset that its ownership of the asset management companies, established during the SKOP takeover, would be only an interim, emergency arrangement. This assumption turned out to be correct when, in 1992, the Government Guarantee Fund, operating under the ambit of parliament, was established to manage the banking crisis. The fund's mission was to safeguard the stable operations of deposit banks and for this purpose it had the right to grant support loans and guarantees to the banks' own guarantee funds and also to give guarantees and financial support to individual banks. At the time of its founding, the maximum amount of fund support and guarantees was set at 20 billion markkaa.

The establishment of a Government Guarantee Fund offered the Bank of Finland the opportunity to disengage from SKOP. In June 1992 parliament approved the sale by Scopulus Oy, a subsidiary of the Bank of Finland, of SKOP shares and SKOP capital certificates with a nominal value of 1.5 billion markkaa to the Government Guarantee Fund. The price was 1.5 billion markkaa so the Bank of Finland suffered a loss of 4.3 billion markkaa from Scopulus.⁸⁸⁸ It had not achieved its original aim of selling SKOP as a healthy commercial bank. In 1995 the guarantee fund sold off the sound parts of SKOP and the viable parts of its loan portfolio to Handelsbank of Sweden. In fact, a bid by Unitas/Union Bank to buy SKOP shares had been discussed by the Bank of Finland board several times after spring 1992 but the position of the Bank of Finland changed after the shares had been transferred to the Government Guarantee Fund. A preliminary agreement had been reached for the sale of the shares on 15 October but the deal was called off at the last moment.⁸⁸⁹ The board of the Bank of Finland noted on 13 October 1992 that negotiations led by the Government Guarantee Fund for the sale of SKOP to Unitas had broken down.⁸⁹⁰

After this transaction, the other asset management companies Sponda and Solidium continued to operate under the auspices of the Bank of Finland. The original plan had aimed at realising the remaining assets as soon as it was financially possible. Share prices turned up in 1993, which gradually made it possible to sell off the stock exchange shares, but the recovery of the property market took considerably

longer so real estate sales were postponed to the second half of the 1990s. Because of disagreement over prices, the troubled Tampella company could not be sold in one piece but in 1992–1993 the bank managed to disengage from most of Tampella's operations and was left with little more than its real estate holdings. This allowed the rationalisation of asset management by merging Solidium with Sponda to create the Sponda group.⁸⁹¹

A key objective in taking over SKOP had been to scale down its risks, prevent bankruptcy of the Tampella group and buy time for the managed sale of Tampella or its parts. This model was not acceptable to all circles; the Justice chancellor of parliament received two complaints about the Bank of Finland. One was submitted by A. Ahlstrom Corporation, and claimed that it was inappropriate for the central bank to own private industrial companies. To do so would distort the market and cause additional costs to the public purse. The second complainant was a private individual who accused the central bank of acting against the interests of SKOP minority shareholders and wasting public funds.

The Parliamentary ombudsman asked for the Bank of Finland's response to these complaints and in both cases the central bank cited the section of its regulations that stated its function was to keep the monetary system on a stable and secure footing. Imbalances caused by the bankruptcies of SKOP and Tampella would not merely have threatened the smooth operations of the domestic financial markets but would have had additional consequence in undermining Finland's international credibility. In preventing this, the central bank had been acting in a way that was entirely in harmony with its regulations, and it had at the same time specifically sought to minimise public losses.⁸⁹² The Parliamentary ombudsman Jakob Söderman agreed and the complaints were not upheld.

The Bank of Finland did not finally separate itself from the remnants of SKOP until 23 May 1996, when Sponda was taken over by Arsenal, an asset management company operating under the Government Guarantee Fund. The government paid the Bank of Finland 1.232 billion markkaa for the Sponda shares and also took over responsibility for Sponda's loans of 4.532 billion markkaa. At the same time the government refunded the interest rate losses that the Bank of Finland had suffered in taking over SKOP. The interest rebate was

1.76 billion markkaa, but the total interest rate losses of the Bank of Finland were 2.66 billion so after this rebate the central bank's net loss was 0.9 billion markkaa. It was now finally possible to calculate how much the SKOP takeover had cost the Bank of Finland.⁸⁹³

Year	capital mill. markkaa	rebate mill. markkaa	guarantee mill. markkaa
1991	4,330		
1992	9,444		600
1993		-2,722	-100
1994		-1,220	-500
1995		-5,764	
Totals	4,068		
Interest costs	2,660		
Interest rebates		-1,760	
Interest losses	900		
Final loss	4,968		

The first informed calculations of the total cost of the operation had been made when the Bank of Finland had taken over SKOP. Esko Ollila, a member of the board, had said that it would be no more than 5 billion markkaa.⁸⁹⁴ The final calculation shows his astonishing prescience because the final loss was only 32 million markkaa less than his estimate. The losses were approximately the same as the equity capital of the Bank of Finland, which was 5.8 billion markkaa at the time. Moreover the bank's reserves had been practically used up in 1994 and 1995 and its reserve fund reduced to only 0.8 billion markkaa. All its financial latitude had thus been consumed and it had been forced to resort to accounting flexibility to meet capital requirements. It could not have handled a new bank casualty at this point but, once the Government Guarantee Fund and asset management company had been established, management of the banking crisis had been taken over by the government. The central bank's role was now mostly to manage systemic liquidity.⁸⁹⁵

In the years of its SKOP stewardship, the Bank of Finland's finances were extremely tight. At the same time most members of the board were uncomfortable with the role of a large owner of shares and real estate, which was not appropriate for a central bank. In this situation,

the management of Sponda was instructed to dispose of assets as quickly as possible. For quoted companies this meant selling the shares as soon as they reached their book value in Sponda's balance sheet. Expectations about the direction of the Finnish economy remained pessimistic even after the decision to float the markka in autumn 1992 so there were poor opportunities for realising assets. Nonetheless, deals to sell parts of Tampella were made before the end of 1992, and the Nokia shares that had been transferred to Sponda were sold in 1993. With hindsight it could be said that a slightly slower pace of realisation would have produced a better financial result for the public sector. This observation should not be regarded as a criticism but rather as evidence once more of the crucial importance of timing.

CENTRAL BANK TAKES CHARGE OF SUPERVISION

The banking crisis showed the ineffectiveness of Finnish bank supervision and triggered a complete reform of how banks were monitored. As late as the 1980s, attitudes towards the official supervision of banking had been dismissive. It was strongly believed that the market would regulate itself and that there was no need to devote more resources to public supervision. The director general of the Banking Inspectorate, Jorma Aranko, had experienced this first hand when the Finance ministry rejected his requests for extra funds for supervision.⁸⁹⁶ However by the start of the 1990s, banking problems were already apparent and supervision had a higher priority. This shows in the work of the Financial conglomerates committee that began operations in October 1990. It was established to study how closer co-operation between banks and insurance companies – financial supermarkets – affected the need for supervision. Pekka Hallberg of the Supreme Administrative Court chaired the committee and its members were drawn from the fields of banking and insurance, employer and employee organisations, the Finance ministry, which was in charge of supervising banks, and the Ministry of Social Affairs and Health, in charge of supervising insurance companies. The Bank of Finland was represented on the committee by Markku Puntila.

In establishing the Financial conglomerates committee, Finland followed Sweden's example from half a year earlier. In February 1990,

Sweden had appointed an investigator to study the merging of its Insurance Supervision Authority with its Bank Inspectorate . The investigator's report was published at the start of 1991 and the two offices were combined in the middle of the year. The reform was carried out rapidly even though it had not been fully endorsed. The General council of the Swedish central bank issued a statement in which it recommended closer cooperation between the two offices, rather than their merger. The new Swedish Financial Supervision Authority was administratively subject to the Finance ministry.⁸⁹⁷

Finland's Financial conglomerates committee delivered its report in November 1991, stressing the primacy for banks and insurance institutions of capital adequacy, liquidity and supervision. It said that the same risks should be monitored according to the same principles. In a situation where banks and insurance institutions were monitored separately, the different officials should be able to exchange information. Under legislation then in force, information sharing was prevented by confidentiality regulations.

The committee pointed out that banking and insurance were more closely connected than before but did not emulate Sweden in proposing that they should be supervised by a single authority. It believed that the necessary coordination could be achieved by eliminating the barriers to information exchange between the two supervisory authorities. However it did propose one significant organisational change: that the whole financial sector from banks and other credit institutions to the securities markets should be supervised by a single body, the Financial Supervision authority.

Administratively the Bank Inspectorate had been subordinate to the Finance ministry but the committee proposed that the new Financial Supervision authority would operate under the parliamentary supervisory council of the Bank of Finland, although in other respects it would be separate from the central bank. All the functions of the Bank Inspectorate and most of what the Bank of Finland did in the field of supervision would be transferred to the new authority. Its status would be enhanced by its having the main responsibility for supervising all financial groups except where the focus of group operations was insurance, in which case the main authority would be the insurance department of the Ministry of Social affairs and Health. The Financial conglomerates committee felt that this arrangement

would reduce overlapping parts of bank supervision (at the Bank of Finland and the Bank inspectorate) and would also prevent gaps, where financial operations were subject to supervision by neither.⁸⁹⁸

The Ministry of Finance set up a working group on 16 December 1991 to refine the idea of a new independent Financial Supervision authority. It was chaired by Seppo Kivijärvi of the Finance ministry. Its members from the Bank of Finland were Heikki T. Hämäläinen, secretary to the board, and Kaiju Kallio, an acting head of department. Representing the Bank Inspectorate on the working group was its director general Jorma Aranko.⁸⁹⁹

On 28 April 1992, the working group presented its conclusions about reforming financial supervision to the Cabinet committee on economic policy. Its model was for the transfer of responsibility for financial market supervision from the government to the parliamentary supervisory council. This would be done by creating a new institution that was legally a part of public administration but was not financed from the government budget. It would have its own financial structure and operating expenses would be covered by fees paid by the organisations supervised. Responsibility for managing the new institution would be held by a board formed from the supervisory council and, below it, a director general and a management group.⁹⁰⁰

The government ministers discussing the report amended it in a way that was significant for the Bank of Finland and, on the very next day, the Finance minister changed the working group's mandate. The model now adopted was for bank supervision to be carried out in connection with the Bank of Finland but independently of the central bank's other functions. On this amended basis, the working group completed its report on 30 September 1992.⁹⁰¹

Its final proposal was that the Bank Inspectorate should be disbanded and its duties transferred to a financial supervision unit established in connection with the Bank of Finland. The Finance ministry would continue to be responsible for granting operating licenses to the organisations supervised and for drafting financial market legislation. The supervision of insurance institutions would remain under the Ministry of Social Affairs and Health. The working group said that the necessary legislation to establish a new financial supervision authority could be in place by 1 April 1993.

It was not done quite so quickly but the legislation on financial inspection came into force at the start of October 1993. The Bank Inspectorate, established in 1922, was closed and a new Financial Supervision Authority operating in connection with the Bank of Finland began operations. The delay was caused by questions about the relationship between the Bank of Finland and the new body. In the government's proposal the Financial Supervision authority had been defined as a "unit" (akin to a department) operating within the organization of the Bank of Finland, but the chairman of the economic committee of parliament, Matti Louekoski, wanted to give more emphasis to the independence of financial supervision from central banking. The final result was that the mention of a "unit" was deleted and the law began with a statement that "Financial inspection operates in connection with the Bank of Finland".⁹⁰²

In this way Financial Supervision did not become an autonomous department or "unit" of the Bank of Finland but an independent authority, which operated under the supervisory council of the Bank of Finland and had shared support functions with the bank. Financial Supervision became an authority with its own director general but it had a board consisting of nominees from the Ministry of Social Affairs and Health, the Bank of Finland and the Finance ministry. Its officials were legally officials of the Bank of Finland and its finances were part of the Bank of Finland although its costs were covered by supervision fees. Jorma Aranko, who had headed the Bank Inspectorate since 1987, became the first director general of the Financial Supervision authority. Esko Ollila, deputy governor of the Bank of Finland, was chosen by the supervisory council to chair its board.

The change at the end of April 1992 in plans to reform financial supervision is notable. Until then it had been assumed that a separate authority would be established under the parliamentary supervisory council. The cabinet economic committee had changed the plan so that the institution would be established "in connection with" the Bank of Finland. The new formulation seems to have been designed to resolve the question of resources and possible overlapping elements of supervision. The government's proposal referred to these when it stated that "because of incoherence and overlap in supervision, as well as a lack of resources, the problems have been so severe that a complete reform of financial markets must be regarded as essential" and that

“the lack of resources or unclear chains of command, duty and responsibility cannot be allowed to be an obstacle to the effective operations of supervisory officials”.⁹⁰³

At least one reason for the change in attitude was a report on bank support by governor Sirkka Hämäläinen, published about a month earlier, in which she had said that the whole system of supervision needed to be made more effective. Views at the Finance ministry had also changed and more effective supervision was seen as vital for a more stable financial system.⁹⁰⁴ Although the costs of supervision would be covered by supervision fees, it was regarded as financially best to link its operations to the Bank of Finland so that the greater resources involved would not be counted as government expenditure. Also the director general of the Bank Inspectorate Aranko endorsed the link to the Bank of Finland as the only way to obtain more resources and the economic flexibility required so that the Financial Supervision authority could compete with private banks in recruiting competent professionals.⁹⁰⁵

The attitude of the board of the Bank of Finland also changed during 1992. While Rolf Kullberg had been governor, the board had been wary of any connection between the Bank of Finland and financial supervision. After Sirkka Hämäläinen became governor in April 1992 a new approach was taken. Now the board was in favour of the connection and regarded it as an important step towards more effective supervision. The change in board attitudes was also reflected in the supervisory council, as its statement of 29 October 1992 shows.⁹⁰⁶

The entire staff of the old Bank Inspectorate moved to the Financial Supervision authority, where they were joined by 14 people from the Bank of Finland, who had been the core of the central bank's risk monitoring department. The number of financial supervision staff amounted to 87 in 1993, the year of its foundation, whereas the Bank Inspectorate had employed 58. However the number of people involved in supervision duties increased far more because the administrative work of the new authority was taken over by the Bank of Finland. Once in connection with the Bank of Finland, the number of employees of the Financial Supervision authority rose quickly. In 1995 it reached 107 and by 1997 was 122.⁹⁰⁷

Even after the establishment of the Financial Supervision authority, the separation of supervision of banking and insurance sectors was



■ Jorma Aranko was director general of the Bank Inspectorate and first director of the Financial Supervision Authority (est. 1993) from 1988 to 1996.
– Finnish Press Agency.

perceived as a problem. The matter was raised again in spring 2007, when the programme of the new government (Matti Vanhanen's second administration) called for the merger of the two sectors of supervision. From the start of 2009, a single authority was created to supervise banking and insurance organisations. It operated in connection with the Bank of Finland but with independent decision-making, as the Financial Supervision authority had hitherto had. However, its administrative model was modernised to some extent by bringing independent members onto the board alongside nominees of the Ministry of Social Affairs and Health, the board of the Bank of Finland and the Finance ministry.⁹⁰⁸

ROLE OF THE GOVERNMENT GUARANTEE FUND

By autumn 1993 the framework for managing the banking crisis was in place and practical operations now became the responsibility of the Government Guarantee Fund and the state-owned asset management company Arsenal. Correspondingly, the decisions on how the crisis should be handled were no longer taken at the Bank of Finland but in the government and the Finance ministry. This was the division of responsibility sought by the Bank of Finland, which had wanted to be able to concentrate on safeguarding the liquidity and stability of the financial system.

After the autumn takeover of SKOP, the Bank of Finland had given some thought to the general principles to be applied when it served as the *lender of last resort* to banks in distress. First among these principles was cost effectiveness, meaning that when making loans to support a bank's liquidity, the central bank should not seek to price them more cheaply than the market would have. Secondly it was emphasized that the central bank should not perpetuate inefficiencies in the banking sector, meaning that it should avoid giving support that would prevent an unprofitable bank exiting the market. Thirdly, it should not promote moral hazard, meaning that its support should not encourage the belief that aid would automatically be available and thereby reward banks for excessive risk-taking. To address these issues – pricing on market terms, discouraging inefficiency and avoiding moral hazard – certain limitations and conditions needed

to be set on central bank aid, and these limitations and conditions were crucial when the central bank was acting as the lender of last resort.⁹⁰⁹

Amid tough political pressure, similar conditions were imposed on the operations of the Government Guarantee Fund. The political pressure came from the mood of the public who, at a time of deep economic recession, felt it to be unreasonable to use scarce public funds for rescuing banks while the government was having to prune public spending. It was not a simple matter to convince voters that upholding the financial system was vital and that an uncontrolled crisis would be even more expensive. Whenever parliamentary backing was needed for bank support, the conditions for granting it had to be toughened, or at least had to appear to be. The fundamental demand was that the support was to be transparent and public. It had to impose obligations on the recipient, a *quid pro quo*, and old shareholders had to bear financial responsibility. The support had to promote greater efficiency in the whole financial system and should not distort competition. It had to be appropriate from a macroeconomic viewpoint. The conditions of employment for executives of the recipient bank had to be reasonable and any unfairness eliminated. These principles had much in common with the emergency finance principles of the Bank of Finland. Almost the only significant difference was the higher transparency demanded of the Government Guarantee Fund.⁹¹⁰

In 1992 the Government Guarantee Fund supported a major restructuring of the savings banks, which were facing severe difficulties. A merger between 43 of them created the Savings Bank of Finland (SSP) which, following a change in the law, could be registered as a limited liability savings bank. The Government Guarantee Fund guaranteed the SSP's debts and, now that it was a limited company, the SSP could offer shares in return, thereby meeting the fund's *quid pro quo* condition. The support required rose to a massive 15 billion markkaa and the Government Guarantee Fund soon owned over 90 percent of SSP. This solution transformed the structure of the savings bank group. The banks from which SSP had been created contained over 80 percent of the assets of the entire group. The savings banks that did not participate and retained their independence, numbering 41, were mostly small rural banks. In return for its support, the Government Guarantee Fund

imposed a very strict programme of rationalisation on SSP, so as to make it profitable again by 1996.

However, using government funds to divest the risks of the savings banks created an incontestable distortion of banking competition, and the sums of money required were far greater than expected. Moreover, by the time the markka was floated in autumn 1992, the state of the whole financial system had become more vulnerable. In spring 1993 the Government Guarantee Fund began to rethink the position of SSP within the financial system and engaged the US investment bank Merrill Lynch as an outside advisor. Three options were on the table in summer 1993: keeping SSP independent, selling it intact to another bank or banking group, or selling it off in parts to Kansallis Bank, Union Bank, Postbank and the Cooperative Bank group. Merrill Lynch reported that the third option would produce the best financial result from the government's perspective. However, SSP as a whole was not to be sold; the buyers were insisting that all its problem assets should be transferred to a separate company.

The Bank of Finland first heard of the plan to sell SSP to its competitors in early October and drafted its views on the matter. The title of its memorandum on this model was suitably dramatic: '*A final solution to the savings bank problem – perspectives on the sale of SSP*'.⁹¹¹ It stated that the Bank of Finland had not been told enough about the plan for it to conclude definitively whether the breakup of SSP was desirable but its preliminary assessment was that the buyers' offer fell several billion markkaa short of the value of an independent and streamlined SSP. The main benefits from breaking up the bank were that it would rapidly rationalise the whole banking system of the country. The disadvantage was that the already centralised structure of banking would become even more concentrated and competition would be reduced. The Bank of Finland thought it was particularly problematic that SKOP was not included in the deal.

At this point, the Government Guarantee Fund wanted to resolve the question of SSP's fate quickly so it asked the Bank of Finland for an official statement. When the matter was discussed at a meeting on 11 October 1993, the board was somewhat ambiguous about the plan. On the one hand, its statement stressed that the sale of SSP to four banks would spur the rapid rationalisation of overcapacity in the banking sector and might also promote systemic stability. The negative

consequence was greater concentration in the banking market and a reduction in competition important to customers. The model also left unclear how the funding of SKOP in markkaa and foreign currencies would be safeguarded. At the end of its statement the Bank of Finland complained that the information provided by the Government Guarantee Fund had not been sufficient for it to determine that the proposed model was undisputedly superior to the two other alternatives.⁹¹²

This last sentence in the board's statement caused a storm in a teacup when the Justice Chancellor referred to it in his own statement on the sale of SSP. The Government Guarantee Fund responded by supplying the Bank of Finland with more material about the alternatives and asked the bank to revise its earlier statement urgently. At a meeting on 20 October the board agreed to do so, and the following was added to its statement: "The Government Guarantee Fund has subsequently supplied to the Bank of Finland a presentation and appendices about the Postbank and commercial bank alternatives. The Bank of Finland notes that, on the basis of information in the presentation, the Postbank and commercial bank alternatives described in the presentation are less advantageous to the government than sale to the consortium."⁹¹³ After this supplementary statement the decision to sell SSP was announced on 22 October 1993.

The deal meant that the stock of healthy deposits and loans of SSP, worth 50 billion markkaa, was divided equally and sold to Kansallis Bank, Union Bank, Postbank and the Co-operative bank group. In practice this was done by dividing SSP branches on a regional basis, while trying to take market shares into account, so that no individual bank would become dominant in its region. The total price was 5.6 billion markkaa, paid by the consortium members with 2.342 billion in cash, 1.112 billion in quoted shares, 1.446 billion in bank shares and 0.7 billion in co-operative bank capital certificates. The sale was subject to the condition was that the problem assets and associated liabilities in SSP's balance sheet would be transferred to an asset management company under the Government Guarantee Fund; a law for this purpose had just been approved in parliament. The asset management company took over problem assets, debt used for financing them and other commitments worth nearly 40 billion markkaa.⁹¹⁴

There has been much and often heated argument about the sale. The government has been accused of undercharging for a sound business and not exploring all possible alternatives. However its decision has to be seen in the context of the time when it was taken. In winter 1993 Finland was still deep in a depression and expectations remained pessimistic. Moreover the economy was splitting into two sharply divergent camps. For the first group, consisting of companies exporting to the west, business was finally picking up because of Finland's exchange rate policy (or its repeated collapse). For the impoverished second group, companies supplying the domestic market, the devaluation of autumn 1991 and the floating of the markkaa in the following autumn had made conditions worse than ever.

The banks had completed their accounts for 1992 and the picture they painted of the financial system was worse than gloomy. Even without SSP, the credit losses of the deposit banks totalled 14 billion markkaa. The combined operating result was a loss of 10.6 billion markkaa. Without the capital injections that they had received in autumn 1992 the capital adequacy of many banks would have fallen below the statutory minimum. What made conditions particularly ominous was that the financial system was divided in the same way between banks serving exporters and those specialising in domestic market companies. The rationalisation of the whole financial system apart from SSP, referred to in the report of the banking working group, had not advanced as expected.⁹¹⁵

Talk of a deep crisis of the whole financial system was no exaggeration, and the decision of the Government Guarantee Fund to break up SSP equally between its competitors must be seen in this light. The ways in which the buyers paid for it were designed to impose the smallest possible burden on their capital. The government sought a solution that would best support the whole financial system. By selling SSP's sound assets for modest compensation, the fund ensured that bank results would return to profit after a very short lag. This was underlined by an interbank agreement at the same time to limit competition, so that few customers would change bank.

Perhaps an even stronger reason for the break-up model was that it paved the way for rationalising the whole financial sector. More than a fifth of the assets of deposit banks were divided between

the remaining banks. This allowed a rapid rationalisation of bank networks. The number of bank employees had already turned down at the very start of the 1990s but, from autumn 1993 onwards, the decline accelerated. By 1996 there were fewer than 30,000 bank employees in the country as a whole, compared with the peak of almost 55,000 at the end of the 1980s. The number of bank branches fell by half at the same time. Not all of this is attributable to SSP but its breakup served to trigger the downsizing process. A background factor was the heavy investments that the banks had made in information technology during the previous two decades, but which had not led to staff reductions before the 1990s. Now that an economic impasse lay ahead, all the banks launched programmes for improving efficiency.⁹¹⁶

The agreement between the Government Guarantee Fund and the buyers supports the view that the key objective was to rescue the banking sector. According to the contract, the government asset management company would take over all non-performing corporate receivables in excess of a million markkaa, at their bookkeeping value, and all sub-rate corporate receivables, real estate, real estate shares and loans granted against them, as well as SSP shares recorded as working capital. In return, the buyers were to receive short-term government-guaranteed bonds corresponding to the bookkeeping value of the assets transferred. The banks retained the right to transfer corporate receivables regarded as problematic to the asset management company until the end of 1994.

At the insistence of parliament's economic committee, household and small business customers of SSP who got into difficulties were to be handled within the normal banking framework, but even these risks were to be transferred to the asset management company. Loans to private individuals and loans of under a million markkaa to corporate clients, which were delinquent at the moment of purchase or became so before the end of 1994, were acquired by the banks at their bookkeeping value. Each bank paid the capital amount of such assets by issuing promissory notes to SSP, which the asset management company then acquired from SSP with a non-interest bearing note. For loans subsequently recovered by the acquiring banks, the asset management company was to pay basic commission of one percent plus an additional fee to be agreed later.

In studies of bank support, the support contained in the SSP deal – a gross amount of 66 billion markkaa and a net sum of 36 billion – has been treated as support for the savings bank group. The situation can actually be seen the other way round. As an operation to ensure the sale of healthy SSP assets to the remaining banks, it significantly accelerated their financial recovery, so at least part of the sum provided by Arsenal asset management company, after deduction of the SSP deal price, can equally be seen as support for the whole banking sector. The other banks recognised this. As the history of Kansallis Bank notes: “SSP was sacrificed for the good of the others and, at the same time, 45 billion markkaa of public support, paid to atone for sins of the savings banks, flowed to its conquerors.”⁹¹⁷

RESTRUCTURING COMPLETED

A sign of the difficulties faced by the banks in spring 1993 was the mutual share subscription plan by the two largest commercial banks, Kansallis and Union. Concerned about adequacy of equity, each bank intended to subscribe the other’s shares and to buy the other’s promissory notes rated as Tier 2 equity. Both asked for a statement on this operation from the Bank of Finland, which its board of management considered on 27 April 1993.

The board responded by welcoming the endeavour of the banks to maintain capital adequacy. In this way, the banks could boost confidence in the resilience of the banking system to cope with its current difficulties, while saving public funds. However the board foresaw major problems in the model that the banks were proposing. The increase of 200 million markkaa in their share capital, carried out in this way, would not do much for their capital adequacy. Nor would the operation bring any new capital into the banking system, so it would not improve the ability of the whole system to withstand losses. On the contrary, the cross ownership that was planned would increase systemic risk. Moreover it was aimed at creating an accountancy effect, raising each bank’s capital adequacy by pooling risk. In the view of the Bank of Finland, there was a danger that the operation was more likely to raise doubts among foreign investors about the ability of Finnish banks to reinforce their capital in a genuine way. In its statement on the plan, the Bank of Finland said it would prefer the two banks to

concentrate on obtaining real new capital, by their own actions and with the support of public authorities.⁹¹⁸ The tone of the board's response shows the new distinctly tougher attitude of supervisory officials in the 1990s.

The question of bank capital returned to the agenda at the Bank of Finland in March 1994, when the board considered a memorandum from the financial markets department on consolidated bank accounts for 1993 and the prospects for 1994. The memorandum noted that the margin on financing operations was improving but there was a continuing threat from the high volume of credit losses and the rising cost of payments to bank guarantee funds. The main source of concern was Kansallis Bank. The Bank of Finland did not trust the assurances of Kansallis management about the adequacy of its capital and decided to monitor the situation.⁹¹⁹ The problems of Kansallis were specifically due to its customer structure. Bank support had failed to ensure the survival of large companies dependent on the domestic market and hit by the slump. Even in 1994 several major Kansallis customers went bankrupt, so its credit losses remained high. Moreover Kansallis had great property holdings which were producing low yields in current circumstances, at the same time as the Financial Supervision authority was demanding large write-downs in their valuations.⁹²⁰

The winter and spring brought no changes for the better, and on 7 June 1994 the board convened to hear a detailed report from Jorma Aranko, the director general of the new Financial Supervision authority, about the condition of Kansallis. He said that Finland's banks in general would be able to meet a 9-percent capital adequacy requirement at the end of the year so there was still a slight margin over the legal minimum, but the exception was Kansallis. The bank constituted a serious problem, Aranko said. "Its balance sheet contains a kitty of about 20 billion markkaa, half of which is not generating interest at all and the other half is interest-impaired in the sense that its yield is smaller than its funding costs. Moreover, there are large differences of opinion between the Financial Supervision authority and Kansallis about valuations of the bank's shareholdings and real estate." Kansallis representatives predicted that its capital adequacy would stay above the mandatory level but the Financial Supervision authority feared that it would drop to 8% at the end of the year, after which it would have no room for manoeuvre at all.⁹²¹

The board concurred with the seriousness of the situation and ordered a joint report by the Bank of Finland and the Financial Supervision authority about the state of Kansallis and ways to resolve the situation. Only a week was given for completion of the report; the matter was scheduled for discussion again on 14 June 1994. Wide-ranging memoranda were produced for the next board meeting by both the Financial Supervision authority and the Bank of Finland's own financial markets department. They described Kansallis Bank's position as critical. At the start of the meeting the board noted that its duty was to safeguard the liquidity of financial institutions; furthermore, capital adequacy and liquidity problems at an individual bank could have effects on the country's currency reserves. Kansallis was therefore a subject that deeply concerned the central bank. Aranko added that, during the spring, the Financial Supervision authority had carried out special audits on all banks and the results had focused attention on Kansallis. The bank would be able to cope until its interim report in August 1994 but after that it would have to seek a substantial amount of new capital. Old shareholders could not provide enough, so new ones would be needed. There was no time to be wasted; the programme for increasing its share capital had to be published at the same time as the interim report in October.

The memorandum drafted by the Bank of Finland's financial markets department was even more pessimistic. It said that there were three options open for Kansallis: (a) the authorities could watch from sidelines, in which case the bank would have to find its own new capital and realise assets at a profit; (b) the bank's own efforts could be aided by government action to organise a limited recapitalisation of Kansallis, by a maximum amount of 5 billion markkaa or (c) the government could give Kansallis a massive capital injection, after which the bank's majority shareholder would be the state. In practice, the most viable alternative seemed to be joint action by the bank and the government. The bank would not be able to find enough new capital on its own, but the existing shareholders would not approve its takeover by the state.

The board of the Bank of Finland agreed with the expert assessments of the seriousness of the situation. It thought that the estimate of 3–5 billion markkaa of extra capital required might even be too optimistic and the real need might exceed 10 billion. The situation was

regarded as so serious that the scenarios intended for internal use at the Bank of Finland needed be updated. The Board felt that, on the very next day, governor Hämäläinen should discuss how the matter was to be handled with Finance minister Viinanen and the senior civil servant at the ministry, and that these discussions should underline the role of the Finance ministry as the largest single shareholder in Kansallis. After these talks at the Finance Ministry, the chairman of the Kansallis management board Tauno Matomäki and its chief executive Pertti Voutilainen should be contacted.⁹²² Senior management of the Bank of Finland and the Financial Supervision authority continued to talk with Finance minister Viinanen about the situation at Kansallis and the parties were agreed about the bank's critical position. This helps explain the crucial background role of the Finance Minister when the Kansallis affair was finally resolved by merging it with the other large commercial bank, Union.⁹²³

In summer 1994 the banking authorities – the Bank of Finland and the Financial Supervision authority – were well informed about the situation, and the management of Kansallis was equally well aware of what officials expected to be done. For political reasons, any public support had to have a quid pro quo. The banks were also required to operate according to jointly approved rules of play, and not, for example, to raise their equity via “creative accounting”. The Financial Supervision authority was also entirely serious in demanding the elimination of real estate overvaluation. Kansallis' largest shareholders would not countenance allowing the state to become the majority shareholder, if only for ideological reasons. The bank had conducted its own campaigns to boost share capital in spring 1993 and autumn 1994 but the 3 billion markkaa then raised was far from the required amount, which was at least 5 billion. The solution chosen was a merger with the bank's greatest competitor, the Union Bank of Finland. The first round of negotiations was held in September 1994 but broke down on the question of the two banks' true values. Talks restarted in January 1995 and the merger was made public at a press conference on 9 February 1995. It was ultimately ratified in a general company meeting on 16 March 1995.⁹²⁴

Within the Bank of Finland, there were conflicting views about the merger. Over the past few years Kansallis had been seen as an unambiguous threat to the stability of the financial system so its

merger with the financially stronger Union Bank was expected to stabilise the whole system. In this respect the Bank of Finland had no reason to oppose the project. On the other hand it believed that the banking system was far too concentrated. The sale of SSP had already increased the degree of concentration and the Kansallis-Union merger would worsen it. However the Bank of Finland felt that extra systemic stability outweighed the disadvantages of concentration. It also expected ongoing international integration to bring foreign banks to Finland, which in turn would increase competition and reduce concentration.⁹²⁵ Finally, it recognised realities: all other solutions required public support, which was not politically feasible.

Finland's worst ever banking crisis had begun on 19 September 1991. From the Bank of Finland's perspective, it did not end until the merger of Union and Kansallis Banks. After the 1995 commercial bank merger, financial margins in banking began to recover and credit losses to end. Officials and bankers could now look to the future with confidence. It was not yet plain sailing, though, because the Government Guarantee Fund still had one more support decision to make, targeted to the state-owned Arsenal asset management company, at the end of the following year on 19 December 1996. That was the last of its kind.

The Bank of Finland's role in managing the banking crisis ended formally on 23 May 1996, when the shares of Sponda, the company set up in connection with the takeover of SKOP, were sold to Arsenal. Now the bank could finally total up its losses. The picture is completed by the calculation of final costs to the state.

**BANK SUPPORT 1992–1996 BY THE STATE AND ITS
REPAYMENT, MILLION MARKKAA***

Year	Outlay	Repaid	Guarantees**
1992	22,642	0	0
1993	9,086	4,202	3,100
1994	6,938	686	30,926
1995	8,000	734	30,890
1996	5,032	0	20,845
1997–2010	0	15,025	0
Total	51,698	20,647	
Net total***	31,051		

* Support paid via the government budget and the government guarantee fund. Imputed interest costs are not included. Data on the Bank of Finland's participation in bank support is shown on page 677.

** Guarantees provided to banks and asset management companies. The figures show the amount in force at the end of each period.

*** Net total in million markkaa as of February 2011. This is equivalent to net placement of € 5,221 million, of which € 1,528 million had been booked as a loss.

Sources: Parliamentary supervisory council report 1996, 19–20; Finance ministry, Public bank support 2/2011 (online publication).

A great deal of public attention was focused on the banking crisis and the costs it caused. The nation found it hard to accept outlays of tens of billions of markkaa to support the banking system while government spending was being cut. This was fertile ground for populism, in society and parliament too. The controversy was worsened by the way that the figures were generally reported, as gross sums and without distinguishing between the direct support paid and the guarantees given to banks or the asset management company.

Amounts as large as 80 billion markkaa were bandied about, or nearly 100 billion if the Bank of Finland was included. However, a large amount of shares and property held by the banks was transferred to the state at the same time. The realisation of these assets lasted into the early years of the new millennium and only then could the real costs of the banking crisis be calculated. Excluding the Bank of Finland, the net sum committed was 31 billion markkaa, of which the

government booked final losses to the tune of 9 billion. These figures paint a very different picture, although they do not contain the interest costs of bank support operations which the Finance ministry estimates as nearly 17 billion markkaa.

CLOSING THE ACCOUNTS ON THE SLUMP

The economic crisis experienced by Finland at the start of the 1990s was not just a brief downtick in production and employment but marked a turning point, after which the economy and society were different in many respects. But simply as an economic crisis it was acute. The collapse in gross production in 1991 was the steepest in the history of independent Finland and the decline in output continued for two more years. The most important indicators of economic development during the slump have been combined in the table opposite. Events were perceived as even gloomier by contemporaries. According to the first estimates of national income by Statistics Finland, growth had already halted in 1990 and its estimate for the drop in GNP in 1991 was more than one percentage point greater than the later estimates shown in the table.

FINLAND'S ECONOMIC CRISIS OF THE 1990S IN FIGURES

	1989	1990	1991	1992	1993	1994	1995	1996
Gross national product,								
billion markkaa	501.2	531.0	506.7	493.5	498.9	525.6	571.2	589.4
volume change%	5.1	0.5	-6.0	-3.5	-0.8	3.7	4.0	3.6
government debt:								
billion markkaa	52.9	54.0	84.5	165.6	255.8	307.5	357.5	393.1
% of GDP	10.6	10.2	16.7	33.6	51.3	58.5	62.6	66.7
unemployment:								
1,000 persons	80	82	169	292	405	408	382	363
unemployment rate%	3.1	3.2	6.6	11.7	16.3	16.6	15.8	14.6
bankruptcies								
	2,749	3,634	6,255	7,391	6,861	5,541	4,700	4,296
bank credit losses:								
billion markkaa	1.8	2.5	7.6	22.0	19.0	16.3	9.9	4.6

Sources: Official Statistics of Finland (OSF): Economic accounting (on-line publication), 2011; OSF, Finnish statistical yearbook 2002. Credit loss figure includes SSP and its successor, Arsenal asset management company.

The economic and human costs of the slump were severe. The distress of the private sector was worsened by government austerity measures and tax rises. Even so, much of the tax revenue that disappeared had to be replaced by higher government borrowing. By 1996 government debt had risen from just over 10 billion markkaa to nearly 70 billion. In relative terms, government indebtedness was at its greatest in 1996, when it reached 67 percent of GDP.

The volume of unemployment almost doubled in both 1991 and 1992 and did not peak until 1994, when Statistics Finland calculated that an average 408,000 people were out of work. The highest recorded rate of unemployment came in January when it narrowly exceeded 20 percent. The average for the year was close to 17%. Joblessness hurt the young worst; in younger age groups the unemployment rate was about twice as high as in the whole labour force.

The number of bankruptcies declared rose to three times the normal number in 1992. Bank credit and guarantee losses followed

the decline in total output with a lag of just over a year and peaked in 1992, when credit losses for the full year reached 4.5% of GDP. It is no surprise that the banking crisis was seen as a threat to the whole economy.

The slump profoundly shook the national sense of security as it interrupted the long period of growth that had continued since the close of the Second World War. Many studies have sought reasons for the exceptional severity of the recession. The first analyses were made while it was still continuing; the OECD country report on Finland in 1992 divided the causes into three main factors: the contraction of exports to Russia, the end of a clearly unsustainable trend in household indebtedness and the collapse in corporate investment.⁹²⁶

The immediate causes for the decline in aggregate demand, as listed by the OECD, are beyond dispute but are only a superficial diagnosis. More fundamental factors, both domestic and foreign, can be discerned behind them. As early as 1992 the Bank of Finland commissioned independent accounts of the crisis from three internationally renowned professors of economics, Christian Bordes of Bordeaux University, David Currie of the London Business School and Hans Tson Söderström of the Stockholm School of Economics. Their assessments, completed in summer 1993, each stressed in slightly different ways how overindebtedness in the preceding years had contributed to the collapse of household consumption and then corporate investment at the start of the 1990s. Their interpretations therefore stressed the role of a domestic credit cycle. The collapse of trade with the Soviet Union was an unfortunate coincidence that worsened the crash of gross of aggregate demand in Finland. David Currie gave particular emphasis to the part played by loans denominated in foreign currencies.⁹²⁷

The imbalance of the economy on the eve of the crisis was also reflected in the current account deficit. Juha Tarkka's study in 1994 assessed the combined effect of external factors, particularly the end of Soviet trade, in triggering the Finnish economic crisis. By 1989 the current account deficit had grown so large that it was obvious that a period of major adjustment lay ahead. New shocks to the economy at just this time – the end of exports to the Soviet Union, deterioration in the terms of trade and a rise in international interest rates – added another 18 percentage points to Finland's need to cut imports. In

practice, the current account was balanced in 1991–92 by the collapse in aggregate demand and economic activity. Tarkka believes that the accumulated current account deficit and the external shocks of the early 1990s suffice to explain the depth of the Finnish slump. He calculates that that if the legacy of the period of economic boom is summarised in terms of its effect on the current account deficit, this inherited deficit created less need for economic adjustment than the shocks of the early 1990s did.⁹²⁸

Financial factors had a key impact on the collapse of aggregate demand which plunged the economy into slump and began to balance the current account. The role of the financial markets and monetary policy in the Finnish economic crisis has been stressed in several studies. Honkapohja and Koskela in their study in 1999 gave a key role to the tightening of monetary policy in 1989, in defence of the fixed exchange rate, the 1991 devaluation in combination with high corporate and household debt, and the banking crisis caused by a collapse in asset prices. The problems of the banks restricted the availability of credit and cut investments and consumption even more.⁹²⁹

Pertti Kukkonen in his 1997 study blamed monetary and exchange rate policies for the depth of the recession and concluded that if a fixed exchange rate had been abandoned earlier, the recession would have been significantly milder.⁹³⁰ Jaakko Kiander, who led the Recession Project at the Academy of Finland, wrote in its summary in 2001 that the slump was caused by deflationary economic policy, particularly the high real interest rates, which triggered a “downward and self-sustaining spiral”. Kiander regards external factors as minor elements in the Finnish crisis and puts most of the blame for the slump on economic policy failings, in particular the excessively restrictive monetary and fiscal policies in 1991–1993.⁹³¹

Sweden’s economic development makes an interesting benchmark for studies of the Finnish economic crisis and subsequent slump. Sweden chose comparable economic policies and developed its economy in very much the same direction as Finland until 1990. The countries deregulated their financial markets at approximately the same time, leading to a very similar increase in lending. Both countries had growing current account deficits although Finland’s was proportionally greater. Both experienced an extraordinary recession at the start of the 1990s but Finland’s was more severe. Measured by the

rise in unemployment and the fall in total output, the Finnish slump was almost precisely twice as deep.⁹³²

In their comparative study of the Finnish and Swedish crises, Peter Englund and Vesa Vihriälä maintain that deregulation of financial markets was only one cause. External shocks were also important, particularly for Finland which, unlike Sweden, suffered a collapse of trade with the Soviet Union. Englund and Vihriälä regard the exchange rate policies of both countries as “fateful” and believe they clung to fixed exchange rates too long. They point out that Finland defended its exchange rate with high interest rates longer than Sweden so the consequent damage to the real economy was greater.⁹³³

Sweden is not the only interesting point of comparison. Regarding the end of Soviet trade, Finland can be compared with other European countries that conducted much trade with the Soviet Union. US researchers Gorodnichenko, Mendoza and Tesar point to the similar contemporary economic crises in the transition economies of eastern Europe (such as Czechoslovakia, Hungary and Poland) while noting that Sweden, which in other respects resembled Finland, did not suffer as deep a crisis. By their calculations, the end of trade with the Soviet Union was the main reason for the severity of the Finnish crisis.⁹³⁴

The structural character of Finland’s slump is shown by the way it recovered. The structure of the economy was now very different, growth being driven not by domestic demand and exports to the east, as in the 1980s, but by competitive exports. Export industries did not spring up overnight. Finnish businesses needed to undergo major restructuring before they were ready for open international competition. Labour had to be used more efficiently and production to be focussed on fields that required higher skills. In practice this meant that the number of people unemployed remained high even after the Finnish economy had begun to grow briskly, which, measured by gross national product, began in 1994 and then lasted till the end of the decade.

Crisis and transition create opportunities, epitomised in Joseph Schumpeter’s celebrated term “creative destruction”. So it was for Finland in the early 1990s. Underlying the economic upswing around 1994 were not only traditional export sectors like the forest industry and engineering but also the new technology sector. The symbol of change became Nokia, a company that had transformed itself in a few years from an old-fashioned conglomerate into a high-tech company

specialising in mobile telephony. Nokia was a microcosm of Finnish industrial restructuring because its transformation involved the withdrawal from many sectors in which it had previously operated. An entire cluster of partners and subcontractors, sizeable by Finnish standards, grew up around the new Nokia and provided major support for the nation's economic growth for several years.

Hardly any sector was more comprehensively restructured than banking. The economic collapse in 1991 meant the realisation of banking risks that had accumulated over many years. Ahead lay a severe crisis and a reshaping of the whole banking field. An already rather concentrated market became even more so and significant shareholdings were acquired by foreign companies. The new demands for efficiency were met by ruthlessly pruning the network of branches and slashing the workforce, which fell in a few years from 50,000 to below 30,000. In commerce, too, wholesaling and retailing became even more concentrated than before, now focused around two large central organisations.

CENTRAL BANK IN TRANSFORMATION

FIELD OF ACTIVITIES REDEFINED

Just as the late 1980s and early 1990s saw a transformation of general Finnish business conditions, they brought about a fundamental change in the operations and organisation of the central bank. During the years of comprehensive financial market regulation and of growth-oriented policies in the 1960s and 1970s, the Bank of Finland was understood to have a very wide remit. Its organisation had expanded at the same time. Now that Finland had changed from a mixed economy into an open market economy, the functions that were considered appropriate for the central bank had also changed. Evidence of this was that the Bank of Finland cut back its special finance programmes and gradually divested its accumulated shareholdings in industrial companies and special credit institutions.

During the 1980s, it still had a relatively large share portfolio, in companies that were significant for its own operations such as Tervakoski, a wholly-owned paper mill, as well as in a few large state-owned companies. Until the middle of the 1980s the Bank of Finland almost invariably subscribed its quota of new shares in rights issues, so the proportion of each company that it owned had remained stable. Its last significant share purchases were made in 1984 and 1985 when it acquired Postbank's holdings in the Mortgage Bank of Finland and subscribed the new shares offered to it when Enso-Gutzeit raised its share capital.

Over a ten-year period, the Bank of Finland moved towards a more narrowly understood role as a central bank. Shareholdings like this no

longer fitted into its operations. Most representatives of the new generation of central bankers, such as Markku Puntila, Matti Vanhala or Sirkka Hämäläinen, regarded direct holdings in private companies as unnecessary and improper for a central bank. Participation by members of the Bank of Finland's board of management in the board work of private companies, which previously had been common, also began to feel inappropriate. On this subject there was a clear generation gap at the top of the Bank of Finland. Older board members felt it was useful to be on the governing bodies of private companies because the central bank gained information about the state of the economy. The younger generation was more concerned about central bank neutrality, which could be jeopardised in this way.⁹³⁵

The bank began to divest its shares in industrial companies in 1986. In that year it sold its shares in Kemi Oy (2 percent of Kemi's share capital) to Metsäliitto Cooperative, and its shares in Oulu Oy (1.7 percent) to state-owned Veitsiluoto Oy. These divestments were part of a restructuring of forest industry companies in northern Finland, a programme in which the Bank of Finland had been involved from the outset. Its ownership of Tervakoski, which specialised in producing banknote paper, was also no longer regarded as necessary and it was sold off. Technically the company was fairly old-fashioned so it was hard to find a ready buyer. It was finally sold to Enso-Gutzeit, in a deal sweetened with unusually good financing terms. The third sale in 1986, to Postbank, was of the entire share capital of the Mortgage Bank of Finland, which the Bank of Finland had established. It showed how quickly views were changing at this stage; only a couple of years earlier, Postbank had sold its shareholding in the Mortgage Credit Bank to the Bank of Finland.

Divestiture continued in 1987. After negotiations with the government, the Bank of Finland sold its shares in Enso-Gutzeit (10 percent of the share capital) and Valmet (0.2 percent) to the Ministry of Trade and Industry. The sale of Enso-Gutzeit shares was economically the most important because the company was the second largest forest industry company in Finland in 1986 and almost equal in turnover to the largest, Kymi-Strömberg.⁹³⁶ Slightly earlier the Bank of Finland had sold its shares in the Industrialisation Fund, a development credit institution, to a SKOP subsidiary, Skofaks. The Industrialisation Fund had been a long-running special credit

institution, jointly owned by the commercial banks and the Bank of Finland. After an ownership struggle between commercial banks in 1986, the majority share had passed to SKOP, so there was no longer a reason for the Bank of Finland to continue as a shareholder. In a somewhat similar way the Bank of Finland had withdrawn from Sponsor in 1982. It was now pulling out of the whole field of development finance, in which it had invested heavily from the 1950s to the 1970s. Its active involvement in restructuring was giving way to monetary policy in a more narrowly understood way.

Sitra was a foundation established by the Bank of Finland in 1967 to commemorate the 50th anniversary of Finnish independence and it remained tightly linked to the bank until the start of 1991. It had operated alongside the bank as a non-independent foundation, its capital was recorded in the bank's balance sheet and the bank played a major role in managing it. From the start of 1991 onwards Sitra operated as an independent foundation answerable to parliament and had a board of governors consisting of the parliamentary supervisory council of the Bank of Finland.

From the perspective of central bank operations, the most important changes concerned the position of the Bank of Finland's Security Printing House. The idea of a central bank being a printer as well as a banker began to feel ever stranger in the 1980s. The history of the Security Printing House stretched back to 1885 and it had been merged with the Bank of Finland in 1921. In 1977 it had been made a separate business unit and given its own board of management. In 1990 the supervisory council approved a board proposal to convert the unit into a limited company wholly owned by the Bank of Finland. The new company, Setec, began operations from the start of 1991.⁹³⁷

Later, with the approach of the euro era, the Bank of Finland no longer felt it needed its own printing house to be an effective central bank. This was a question of efficiency and economy because there was no formal obstacle to continuing banknote production for own needs in the euro area. In 1998 the bank sold 40 percent of Setec's shares to a Finnish pension insurance company. Setec produced its last banknotes in 2003, a batch of €100 notes, after which it focused on other security products. The Bank of Finland now ordered the banknotes it required from foreign printing houses after competitive tendering. A partnership of more than a century came to a close in 2005 when the Bank of

Finland sold its remaining shares in Setec to an international group Gemplus S.A (now part of Gemalto).⁹³⁸

Members of the Bank of Finland's board of management scaled back their membership of other company boards as the bank's shareholdings declined. This happened last in special credit institutions, and bank director Pentti Uusivirta, for example, retained his positions until retiring in 1990. The position as chairman of the board of Postbank, which was traditionally held by the governor of the Bank of Finland, was terminated in 1987 when Postbank was incorporated. Company directorships finally came to an end in the 1990s after Sirkka Hämäläinen had become governor of the Bank of Finland. She took the line that the central bank's credibility required a "firewall" between it and the business world, which would best be achieved if Bank of Finland board members held no board positions in business operations outside the bank.⁹³⁹

BANKING TECHNOLOGY CUTS THE WORKLOAD

Among the most significant changes in the Bank of Finland's organisation in the early 1990s was a radical cutback of the central bank's traditionally extensive branch network. At the end of the 1980s the Bank of Finland had 12 branch offices in Joensuu, Jyväskylä, Kotka, Kuopio, Lahti, Mikkeli, Oulu, Pori, Rovaniemi, Tampere, Turku, and Vaasa. The network had remained unchanged since the Second World War apart from the closure of the Hämeenlinna office and the opening of one in Rovaniemi at the start of the 1960s. The general rule was that the Bank of Finland had a branch office in the main town of each province and this had been observed fairly scrupulously. At the start of the 1990s the only province without a branch was Åland. The other exceptions were that the province of Häme and the province of Turku and Pori had two offices each, while the province of Kymi had its office in Kotka instead of the provincial capital, Kouvola.

Technological advances in banking over the years has transformed all central bank operations but perhaps nowhere more strongly than in the activities of branch offices. This was particularly true of the adoption of new information technology. Changes in interbank clearing, handled by the central bank, are a good concrete example. Until the

mid-1970s clearing was mostly manual work and the division of labour between head office and the branch offices had barely changed for decades. The branch offices handled about a third of clearing transactions. After the mid-1970s computers replaced people in this work, with the result that most clearing functions migrated to head office in Helsinki. By 1980 head office handled 90 percent of all clearing transactions.⁹⁴⁰ Other banking work handled by the branch offices was similarly affected. Deregulation eliminated branch office jobs like exchanging foreign currency or the granting of credit. Routines involved in maintaining the supply of currency, meaning the issuance, exchange and sorting of banknotes, were transformed, reducing the amount of work at the central bank. The consequence of all these changes was that a dense branch network became a problem for the Bank of Finland. Since the closure of the branch in Hämeenlinna in 1963, over the objections of the supervisory council, the number of branches had remained unchanged at twelve. Almost a third of bank employees worked in branch offices.⁹⁴¹

It was 1981 when the board of management of the Bank of Finland first raised the question of the status and future of its branch offices. It noted how general societal changes, the decline in economic regulation and the advance of banking technology would lead to a situation where the volume of work to be done specifically in branch offices would decline. It felt the prospect to be so difficult that it set up a working group to draft proposal on functions that could be transferred to the branches. The working group was also given free hands to consider the development of entirely new operations. Fairly little emerged from the committee and the situation continued largely unchanged with no action taken. The board's autonomy in the matter was decisively curtailed by the law, which stated that a decision to close a Bank of Finland branch office was to be made by the supervisory council after the matter had been agreed with the government.⁹⁴²

In 1984 the board of management presented its policy on branch offices to the supervisory council. Ele Alenius, the board member responsible for branch offices, pointed out that developments in recent years had led the board to consider seriously the justification for its present network, consisting of twelve branch offices, although it was not proposing to radically prune it. The network

was admittedly rather large for normal conditions but emergencies might well increase the amount of work involved in maintaining the supply of currency, thus making the existing network appropriate. The cautiousness of the board's position was largely the outcome of unofficial discussions with politicians, in which it had realised how very important the branch offices were to them. The board wanted to avoid strife with the supervisory council at this time so it made no demands. Indeed, the result of the dialogue between the board and the supervisory council was a decision to keep the branch office network unchanged, while continuing to seek new things for the branches to do.⁹⁴³

However, banking technology continued to advance so rapidly that within a few years the situation became more difficult. The changing nature of branch office work was due to a variety of factors. The amount of work involved in supplying currency had declined; banknote handling was being taken over by large sorting machines; currency maintenance work was being concentrated at head office; the spread of electronic payments had curbed the growth of cash in circulation and might even reduce it; and all the banking duties of the branch offices had disappeared and they were now merely units for maintaining cash in circulation. By the mid-1980s it was felt that there were too many branch offices employing too many people, and that the upcoming introduction of new machines for sorting banknotes would worsen this disparity.

SUPERVISORY COUNCIL REPRIEVES BRANCHES

The board discussed the fate of its branches on 8 October 1987 and decided to submit the question of cutting the network once more to the supervisory council. At the same time it admitted that alternatives were no longer available. It proposed that the supervisory council should ask permission from the government to close the branch offices of the Bank of Finland in Joensuu, Jyväskylä, Lahti, Mikkeli, Oulu and Pori by the end of 1991. The board said that the supply of notes and coins could be maintained under normal conditions with an even smaller network but the model proposed would make it easiest to relocate the staff of defunct branches. About 100 people worked in the branch offices

concerned. Closing the branches would cut more than 30 million markkaa from the annual costs of maintaining branch offices.⁹⁴⁴

The board's proposal was placed before the supervisory council on 12 February 1988, which gave it a glacial reception. News of the board's plan to close six branches had spread immediately to parliament. All political groups were opposed to it and several members of parliament had already commented on the matter. The inner supervisory council was unanimous that the board's proposal was unwarranted and wanted the policy approved in 1984 of continuing branch operations to be kept in force. When the full council met on the same day, the debate was intense. The precepts of the members were well illustrated in a speech by the council chairman Erkki Pystynen (National Coalition party). He told of the great number of regional associations, towns, chambers of commerce, provincial governors and individual citizens who had contacted the supervisory council and other members of parliament about the matter and how important the preservation of branch offices was to the regions. "Parliament is a political body and all decisions made in parliament are value judgements; they should be based on broadly prevailing public values. In this sense, this is the basis for how even the supervisory council should approach and examine the matter." At least in his views on this question, councillor Pystynen saw himself as a political representative and not as an expert chosen by parliament to oversee central bank operations.⁹⁴⁵

Almost the only councillor to support, or at least sympathise with, the board's proposal was Kauko Juhantalo (Centre party). His speech highlighted the overdeveloped networks of branch offices in Finland, a problem of the whole banking sector which concretely affected the Bank of Finland too. He congratulated the board for recognising realities and seeking in this way to eliminate unnecessary costs.⁹⁴⁶ No one else on the council backed Juhantalo's view. The full council was so clearly opposed to the board's proposal that a vote was unnecessary. The position on Bank of Finland branch offices was to remain unchanged.

As had become established practice, a new working group was set up to try to find new duties to justify the existence of the branch offices. The committee completed its work in autumn 1988 and its report, sent immediately to all council members, demonstrated concretely how difficult the job had been. Alongside the maintenance of currency,

the committee had found one entirely new function for the branch offices: commercial money handling, meaning the counting and sorting of banknotes and coins for large retailers, public institutions and the like. The committee also proposed that statistical operations related to the monitoring of foreign exchange transactions should be transferred to the branch offices. Its report confirmed the impression that it had not really discovered anything new.⁹⁴⁷ The prospects for commercial money handling were studied subsequently by office manager Kari Lottanen, who reported negatively. Without central bank subsidies the service would not be viable.

The rapid development of copying machines was creating extra pressure on the board. Colour copiers made it easier to counterfeit banknotes, which now had to incorporate new security elements that copying machines could not duplicate. To recognise the security elements, new banknote sorting machines were required, equipped with special optical sensors. The new machines had such great capacity that all of Finland would need no more than three or four, and any branch office that did not have one would become a mere cash issuer, unable to perform sorting operations. The cash offices would be such small-scale operations that they would no longer need their own office managers but could be supervised from the regional sorting offices. This development came at a propitious time because the managers of several branch offices were approaching retirement age.⁹⁴⁸

The board presented these thoughts to the supervisory council on 21 April 1989 but made no proposals and was just keeping the council abreast of the situation. The council members had clearly relented and did not reiterate their demands that no changes should be made, although some stressed the importance of branch offices for regional policy and were ready to look once more for ways of handling public administration at Bank of Finland branches. The most ambitious idea was put forward by councillor Paavo Väyrynen, who proposed developing the branch offices into regional centres of business internationalisation.⁹⁴⁹

Although the council did not approve any branch office closures yet, it accepted the board's plan to order large new banknote sorting machines which, in effect, was a step away from the system of equal branch offices towards a regional model. The new machines, ordered for Tampere, Kuopio, Turku and Oulu, shrank the amount of work



■ The Bank of Finland had a branch office in Rovaniemi, Lapland from 1960 to 1992.

- Bank of Finland.

done at nearby branches even faster than expected. At the same time, Oulu was reprieved from the earlier plan to close it and was elevated to the status of a regional office.

BRANCHES CLOSED

The solution of a sparser branch office network sought by the board was finally reached in autumn 1991. When the proposal to close the offices in Joensuu, Jyväskylä, Kotka, Lahti, Mikkeli, Pori, Rovaniemi and Vaasa was presented to the inner supervisory council on 20 September 1991, it was endorsed almost as a foregone conclusion. The full council met a week later on 27 September and its members, too, were unanimous about closing the eight branches. The environment had changed so much that no single argument was now advanced for maintaining such a broad branch network. Councillor Westerman even raised to idea that the Bank of Finland could operate entirely without branch offices. On behalf of the board, Harri Holkeri responded that, if Finland was to construct a central banking system from scratch, it would certainly not build such a broad branch network, but it now had a decentralised system for maintaining the supply of currency. Consequently, branch office operations on Oulu, Kuopio, Tampere and Turku were being retained both for historical reasons and also for reasons of contingency planning.⁹⁵⁰ In addition to these offices, the Bank of Finland had created a centre for the maintenance of currency supply alongside its currency department in Vantaa, outside Helsinki. A tangible sign of the development in technology was that in 1990 over 90 per cent of banknote sorting was performed by machines.

After the meeting on 27 September, the supervisory council asked the government to approve the closure of the eight branches listed. The government gave its approval at a cabinet meeting on 17 October and the council took the final decision on 25 October. The smallest branches, in Joensuu, Mikkeli, Pori and Rovaniemi, would be closed on 30 June 1992 and the medium-sized branches of Jyväskylä, Kotka, Lahti and Vaasa by 30 June 1994. The closures meant the loss of about 50 jobs in the branch offices. After discussions with the employees' association, the bank set the objective of finding new positions for as many as possible of those who had lost their jobs, and did this fairly successfully.⁹⁵¹ The shape of the branch office network remained

unchanged until 2008, when it was decided to close the Turku branch and transfer its operations to the currency department in Vantaa.

Compared with other Bank of Finland units, the branch offices had special legal status in significant ways until the 1990s. They were established by the supervisory council and, after the matter had been agreed with the government, closed by the council. The managers of branch offices were chosen by the supervisory council, which also annually appointed two supervisors and deputies for each branch. The operations of branch offices were overseen by these supervisors as well as the board of management. Such unusual administrative structures dated from the end of the 1860s, when the Bank of Finland had been transferred from the jurisdiction of the Senate and subordinated to the Diet of the Estates. Such structures also shaped the psychology of the branch offices. Their managers clung jealously to their separate status from other department heads, directly below the board of management and the supervisory council. As long as the branches had the right to grant credit, the status of their managers had been particularly high in their localities.

Because of the special position of branch offices, the board of the Bank of Finland had real problems in fitting them into the bank's organisational structure. Resistance to change in the branch offices was extremely strong. The situation was not finally resolved until the new law on the Bank of Finland came into force on 1 January 1998. It had the effect of transferring all operational authority within the bank from the supervisory council to the board of management. This eliminated the special position of the branch offices and allowed them to be subordinated to the payment instruments (cash) department, at which time their managers got the same hierarchical position as other office managers in the bank.

The process described above, of downsizing the branch office network of the Bank of Finland, is a good illustration of the problems of managing the central bank. The decision-making process lasted 10 years and the supervisory council members, who had the final say, remained adamant right up to the end of the 1980s. The indisputable economic arguments advanced by the board of the Bank of Finland took second place in a situation where the closure of an individual branch would have caused political problems to an individual member of parliament. The timing of the crucial decision in autumn

1991 was no accident. The supervisory council had just changed because of the parliamentary elections in 1991 so it was not hostage to previous pledges to keep the branch network intact. Meanwhile, the Bank of Finland's dramatic decision to take over SKOP had awoken decisionmakers to the crisis and the supervisory council had to treat economic realities with entirely new seriousness. The Bank of Finland could no longer afford to maintain a large branch office network.

STAFF AND ORGANISATION

NUMBER OF EMPLOYEES STARTS TO DECLINE

Automated banknote handling and the slimmer branch office network that ultimately resulted were important reasons for the downturn in the number of Bank of Finland employees during the 1980s, but there were parallel contributory factors. The payroll had grown fairly steadily until 1978 when the number of permanent and supernumerary staff peaked at 993. About two-thirds worked in head office, while one in three had a job in a branch. Staffing needs at head office had been kept high by the central bank's role as the regulatory authority for the whole financial system. For example, capital controls tied up a lot of staff and the growth of foreign trade steadily increased the amount of work to be done. The granting of special forms of business credit was also rather labour-intensive. Alongside operational duties, the bank also built up a larger organisation to plan and support monetary policy. Its stronger forecasting and monitoring services showed in the growing number of economists employed after the start of the 1970s. Most of the work of the branch offices involved maintenance of the supply of currency. By the end of the 1970s, the branches had very few other central banking duties left.

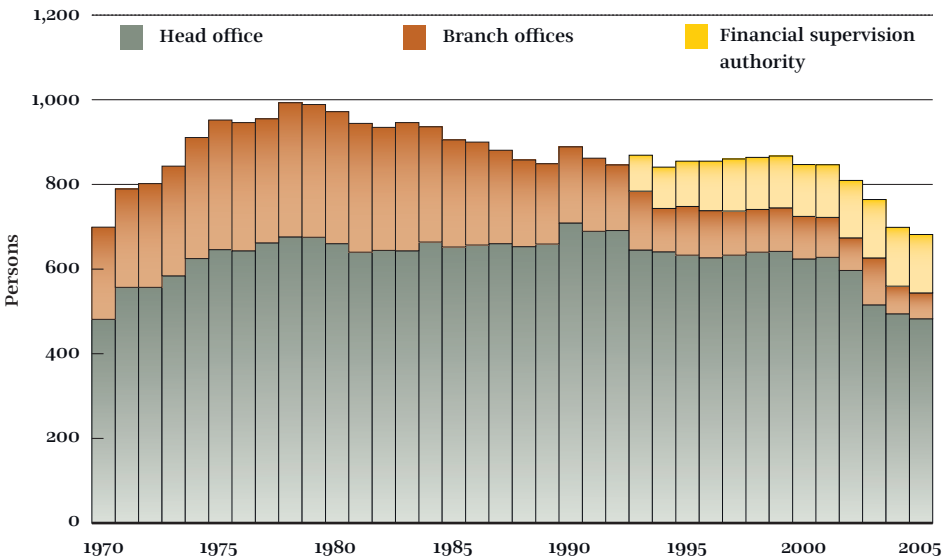
After the end of the 1970s, staff numbers began to decline and, when Finland became part of the euro area at the end of 1998, the payroll had shrunk to 741, a quarter less than its peak two decades earlier. The decline was strongest in the branch offices, where staffing

shrank from about 320 in 1978 to 100. The trend accelerated after the end of the 1980s, when machines replaced banknote sorting staff in cash handling. The number of employees continued to decline once Finland was in the euro area; by 2007, bank staffing was down to half of its peak level at the end of the 1970s.

Staffing matters were first brought up in a board meeting at the start of the 1980s, when it had already been noted that the Bank of Finland would not necessarily need such a large branch network in the future and that functions related to the supply of currency could be concentrated at fewer offices. No concrete measures were taken at that time. The board was waiting to see how the situation developed.⁹⁵²

The question of employee numbers next came up in 1987 when the head of the personnel department, Anton Mäkelä, proposed that the number of employees should be adjusted to suit the bank’s changing functions. The situation facing the board was unprecedented. Mäkelä’s memorandum, dated 7 April 1987, stated that personnel reorganisation would test the whole corporate culture of the bank. Although the matter was timely because of the board’s current proposals to downsize

NUMBER OF BANK OF FINLAND EMPLOYEES 1970–2005



Source: Bank of Finland.

the branch office network, staffing changes would also be caused by the dismantling of money and foreign exchange market controls, then underway. Mäkelä believed that more than 10 percent of the bank's employees would be affected.

His memorandum proposed the objective that every employee whose job disappeared would be relocated to a new position within the bank. To ensure this, all vacant positions would henceforth be filled by internal recruitment. This could be augmented by individual early retirement or accelerated retirement schemes, even though the average retirement age at the Bank of Finland was already exceptionally low. Other measures mentioned were severance pay and efforts to relocate redundant staff with other employers such as the State Treasury or the Social Insurance Institution. Mäkelä's memorandum marked an entirely new approach but the board had not yet truly grasped the situation. The minutes on the subject are delectable: "The board discussed the matter and noted that it was a good thing to draft reports and plans of this kind."⁹⁵³ The time was not yet ripe for concrete action, although it is interesting to note that downsizing was on the agenda at the Bank of Finland rather earlier than at private banks, which did not wake up to personnel questions until five years later, when the banking crisis struck.

In 1996 the Bank of Finland was ready to tackle the question of staff downsizing systematically, although by this time the number of bank employees had already been declining for 15 years. When Finland's entry into the euro area began to look likely, the board of management had to prepare for the new situation in a more organized way. In a report to the supervisory council it said that the bank's personnel resources would be concentrated on the emerging core functions meaning "operations to safeguard the stability of prices and the financial system, to create an efficient and secure payments system, and to maintain currency supplies". The board said that operations were being developed and automated at a strong rate, which imposed "unusually great demands on staffing modernisation". The board requested and received the supervisory council's mandate to carry out voluntary or less conventional staffing settlements, in the interests of the Bank of Finland, "with the aim of modernising the personnel structure."⁹⁵⁴

These formulations of 1996 meant an acceleration in the rate that staff numbers declined. Within 10 years, the number of Bank of Finland

employees had declined by more than 230 and was continuing to do so. Ultimately, this major downsizing in the payroll was implemented more smoothly than in many other organisations. In many cases, when old jobs disappeared the worker could be found new work within the bank. Moreover, the age structure of bank employees, in combination with the low retirement age, meant that natural wastage made a fairly good contribution to staff reduction. To a limited extent, the board also used schemes to encourage retirement or migration to other employers, as mandated by the supervisory council.⁹⁵⁵ Although dismissals were alien to the Bank of Finland's traditions and its methods were more gentle, it can be regarded as something of a pioneer in public sector rationalisation in Finland.

ORGANISATIONAL DEVELOPMENT

The organisational structure of the Bank of Finland responded fairly slowly to changes in central banking. A study of its development must start from the 1970s when an organisational model was created that, apart from a few changes, remained in force to the end of the 1980s, parts of it even longer.

For decades after the war, the bank had been organised by placing operational functions in the bank itself while advisory, statistical and communications functions were located in its Research Institute. The need to develop the bank's organisation increased at the start of the 1970s, for both internal and external reasons. An important external factor was the collapse of the system of fixed exchange rates in 1971, which caused greater volatility in the foreign exchange market. The central bank was now operating in a more complex environment, requiring a fuller grasp of the situation. Also operations required more profound understanding of central banking theory and better, faster information about changes in the economy. The bank apparently had difficulty adapting internally to the new conditions, judging from a provocative memorandum, *'What's wrong at the Bank of Finland'*, written in 1971 by Markku Puntila, head of department at the economic research institute. The memorandum made no effort to express matters diplomatically. On the contrary, Puntila sought to provoke a reaction from the board and spur it into tackling the organisational flaws he exposed.⁹⁵⁶

He said that the working practices of the board of management had to be changed so as to relieve its members from handling insignificant routines and let them concentrate on setting policy lines for the central bank. Decision making about central bank policy should proceed systematically, which in turn demanded modernisation of the whole system of planning. The bank needed to create a body for planning central bank policy, which would prepare alternative long-range policy options in advance. Economic forecasting methodology should be developed, Puntila said, and the forecasts should be based not merely on econometric modelling but also on the institutional expertise of the forecasters and qualitative information. Individual banks also needed to be monitored more effectively by collating data about their main balance sheet items on a weekly basis or even more frequently. He urged the establishment, under the board of management, of an entirely new unit to do this work.

In the final part of his memorandum Puntila concentrated on describing the working atmosphere of the Bank of Finland at this critical juncture. He said that the spirit of the bank had deteriorated continuously over a 10-year period (meaning the 1960s) and saw a danger that it would continue to do so. He blamed the bank's atmosphere on excessive secrecy. All major decisions were reached in a small circle and subordinates were excluded from preparatory work. In the absence of a central banking policy line, the bank's officials did not know what the bank's objectives were, which was demoralising. The lack of a clear organisational structure also made career planning difficult and reduced individual motivation for systematic training that would allow promotion to more demanding duties. "Because of this, the average Bank of Finland official is devoid of inspiration, outdated in education and excessively passive." To eliminate this problem the circles involved in preparing decisions needed to be enlarged. Information, about what had been decided and why, needed to be spread more effectively and the whole organisation had to be modernised so as to serve central bank policy-making effectively and strengthen the motivation of employees.⁹⁵⁷

As the assessment of one 34-year-old head of department, Puntila's description need not be taken as the whole truth, but it was very successful in spurring the board into action. The first changes were implemented in autumn of the same year, when the economic research institute was split into two parts by creating from it a new economics department, consisting of offices for the monetary economy,

international economics and forecasting. The traditions of the old research institute were continued by a small research department, given the mandate to head separate research projects. The functions of communications and publishing that had previously been handled by the research institute were transferred to a new communications department.⁹⁵⁸ The reform was completed the following autumn when the board decided to close the economic research institute of the Bank of Finland, after which the economics department and the research department became part of the normal line organisation of the bank.⁹⁵⁹

The end of the economic research institute meant that the macroeconomic monitoring, forecasting and reporting required for monetary policy were transferred to the new economics department. In practice this meant that the economists doing these jobs were deployed between the monetary policy department and the economics department. This integrated them more tightly into the bank's structure and made a clear distinction between practical studies required for monetary policy and research that was academic in nature.

The spillover from the closure of the economic research institute was significant. Since the end of the 1940s the Bank of Finland had set the pace of economic research in Finland via its economic research institute. The academic world and civil service had both turned to protégés of the institute when filling the most demanding jobs in the field of economics. This process had spread the philosophy of the Bank of Finland widely throughout society. After the early 1970s, the base of economic research and associated administration became wider, however. There were greater intellectual and material resources for academic research at the universities, and the importance grew of new economic research institutes such as Tasku economic planning centre, which served the government, ETLA economic research institute, which served business, and the Labour Institute for Economic Research, which was close to labour unions. Responsibility for educating a new generation of researchers shifted from the Bank of Finland Economic Research Institute to universities and partly also to the new economic research organisations.

A project to reshape the organisation of the bank was initiated in 1973 when Mec-Rastor, a firm of consultants, was hired to draw up a proposal for a new organisational structure by the end of 1975.⁹⁶⁰ The main focus of the project was to streamline the bank's system of

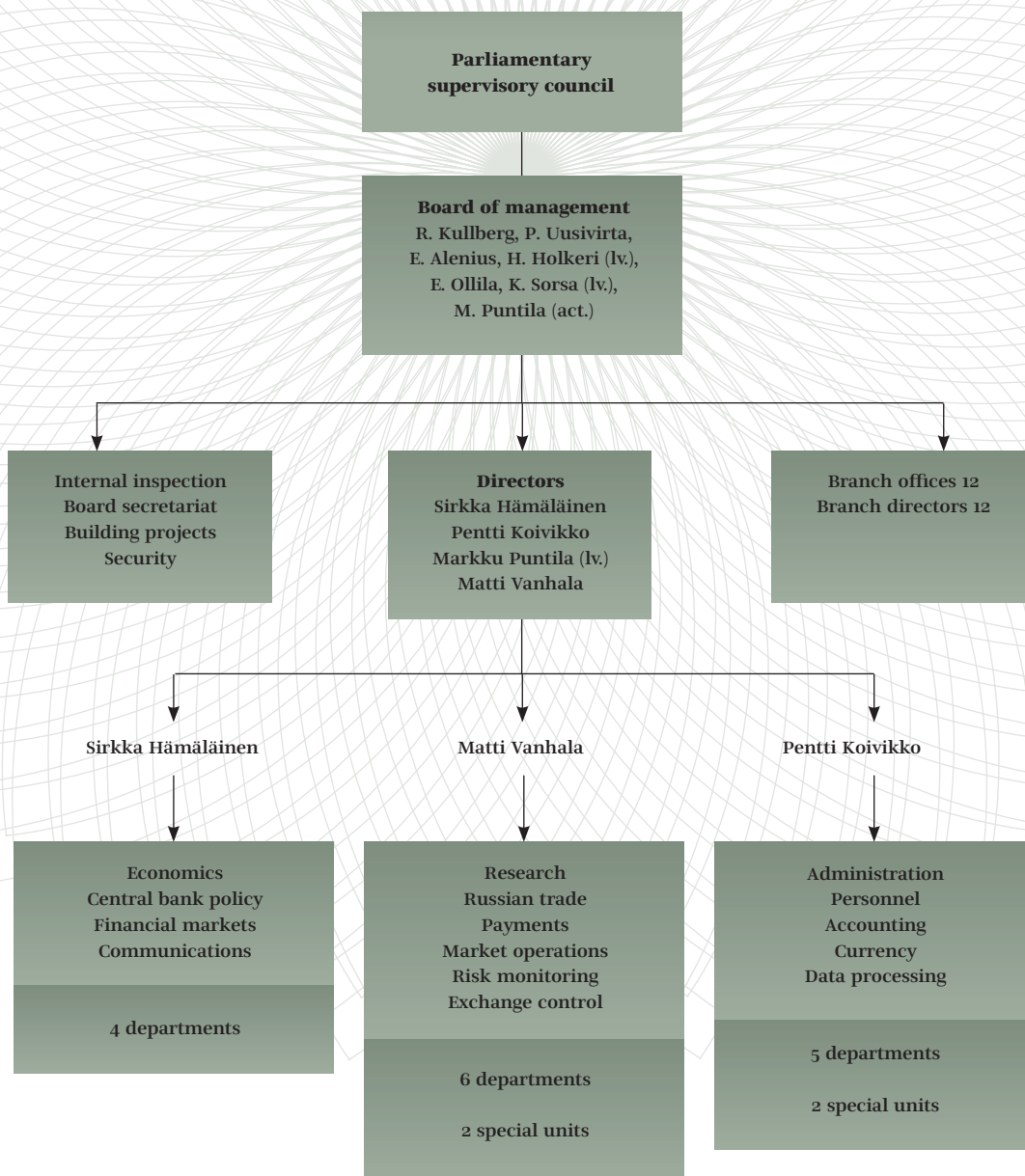
management. It proposed that the role of the board should move towards representing the bank in the outside world and participating in economic policy more widely than a literal interpretation of the Bank of Finland's duties would entail. This new emphasis meant that the operational management of the bank was more clearly in the hands of the six directors below the board, its only direct subordinates. Below the directors came the heads of department. The hierarchy was not simplified as much as this because the branch offices remained directly subordinate to the board of management; a reform of Bank of Finland legislation would have been needed in order to make them answerable to the directors.

Each director was in charge of 2–4 departments and each department consisted of 4–6 offices. The organisation was conspicuously ponderous. Including the heads of branch offices, the bank contained 18 executives appointed by the supervisory council, in addition to the six members of the board of management. Several names from the bank's future were within the bank's organisation at this time. Markku Puntila was already a director, Sirkka Hämäläinen was head of the forecasting office of the economics department and Matti Vanhala was head of the office for international organisations, part of the foreign exchange policy department.

Practical operational authority was largely in the hands of the directors, immediately below the board in the bank's hierarchy. This dynamic team was complemented by a few exceptional heads of department. From the mid-1970s onwards they attained semi-official status, as shown by their regular meetings to discuss the main issues on the central bank agenda. The bank's directors generally presented matters to the board of management, so meetings of the directors and powerful heads of department set the parameters for the board's future decisions. This remained the situation until the second half of the 1980s, although the board of management became more active after the middle of the 1980s, a change underlined by the falling number of directors in the 1980s. Matti Vanhala was the last director to be appointed, in 1983, and by this time their number had already declined to three.

After 1976 the next significant organisational change came in autumn 1987, when the board discussed a new hierarchical model drafted by Hämäläinen, Vanhala and Koivikko. The new organisation took effect from the start of 1988. Underlying the reform was current

BANK OF FINLAND ORGANIZATION 1988



Abbreviations

(act.) acting

(lv.) on leave

deregulation and past internationalisation. There was no longer a reason to separate the organisational aspects of domestic and foreign operations, so markka and foreign exchange operations were combined. However, the bank tried to keep practical operations distinct from work on policy planning. Moreover, planning of monetary and exchange rate policies was separated from work related to the general development and supervision of financial markets.⁹⁶¹

In the new organisational model, the bank's activities were divided into six sectors, two under each director. These were currency maintenance, internal services, macro-economic analysis, central bank policy, market operations and financial market supervision. The reform enhanced monetary policy planning, previously carried out in the monetary policy department and the foreign exchange policy department, but now concentrated in the new central bank policy department. In the same way, on the operational side, the market operations of the foreign exchange department and the financial markets department were combined in a new market operations department. With deregulation of the financial system, banking risks had increased and the central bank needed a more systematic picture of emergent risks. The financial market department was responsible for monitoring systemic stability while the risk monitoring department studied the stability of individual financial institutions.

The new hierarchy was very similar to the cumbersome organisational structure approved in 1976. Although the number of directors fell to only three and the number of departments to 16, there were more offices than ever, numbering as many as 40, depending on the definition. Moreover, nothing had happened yet to the position and number of branch offices. Internal audit had been transferred to a department directly under the board of management, a sign that the board was slightly stronger, but in other respects the board of management still had a very modest central staff.

The next significant organisational changes came in the early 1990s, when the network of branch offices was cut, as described earlier. At the same time, an entire hierarchical level – the directors – was eliminated, and departments now came directly under members of the board of management. This change took practical effect in 1992, when Matti Vanhala was appointed to the board of management. At this time the number of board members shrank from 6 to 5 and only one person

was left at the director level, Pentti Koivikko, who managed administration and personnel and served as chairman of the note printing company Setec. The last director resigned in 2001.

Also in the early 1990s, the central staff of the board of management was strengthened. Among other things, communications, the international secretariat, legal affairs and the development unit were all placed directly under the board. Departments were combined and in 1994 numbered only 13. By this time the number of branch offices had also shrunk, from 12 to four. These organisational changes were a response to international integration by improving efficiency and coordination of operations. The bank also began to pay more attention to management systems; a reform of the way its managers and experts were remunerated was made a part of operational planning. Other changes during the 1990s worth mentioning in this connection were the establishment of the Financial Supervision authority within the Bank of Finland in 1993, as described earlier. The pattern of organisation created in the 1990s endured in its main aspects until 2005, when it was simplified again; departments were combined, reducing their number to six, plus a small internal audit unit.

CRISIS HITS BANK OF FINLAND'S RESULT

The banking crisis of the 1990s was the most severe financial setback experienced by the Bank of Finland since the credit losses caused by the First World War. In a business sense, a central bank cannot be compared to a profit-seeking enterprise because any surplus that it makes is largely incidental to the central banking functions it performs and not an objective as such. However a central bank cannot ignore its economic result because it must ensure that it has enough capital and reserves, which can normally be increased only by retaining profits.⁹⁶² The bank's result is therefore very important for its capital adequacy and also ultimately for its ability to carry out its duties independently.

The income of the Bank of Finland consists mostly of its net interest income, the difference between its interest income and its interest expenses, as well as its exchange rate gains, the change in the value of assets and liabilities caused by exchange rate changes. These two sources of income became markedly volatile after the middle of the

1970s, and even more so in the following decade. The bank's interest income began to fluctuate more as the amount of business lending that had generated a steady return declined, while an ever-increasing amount of interest income (and expenses) came from monetary policy operations, such as providing credit for banks. Exchange rate gains and losses, in turn, became more important after the collapse of the Bretton Woods system, when exchange rates became more volatile. In the 1980s in particular, the Bank of Finland had larger convertible currency reserves so even small exchange rate changes had a bigger effect on the bank's finances.

The Bank of Finland generally tried to keep its accounting profits fairly stable. This was done until 1984 by using the value adjustment ("equalization") account and after that the reserve fund. In a good year reserves were increased, in bad years they were reduced. The transfers were quite a sizeable part of the bank's accounts. For example in the first half of the 1980s, when the accounts showed a regular profit, transfers to the value adjustment account were distinctly larger than the profits declared.⁹⁶³

In terms of the Bank of Finland's finances, the 1980s had two phases. In the first half of the decade, its results were positive and the bank was able to increase its reserves regularly. Its surpluses were also increased by divestment of holdings in industrial companies and credit institutions, although its balance sheet total increased much faster than its reserves so capital adequacy declined below its previous level. 1985 marked the start of a losing streak that lasted three years: the bank lost nearly 280 million markkaa in 1985 and although the loss was almost zero in 1986, it topped 440 million in 1987. The main reasons, once again, were exchange rate changes and a collapse in net interest income in 1985. The monetary policy tools then used by the bank – cash reserve deposits and overnight deposits – were very expensive for it. The final two years of the decade were better but not good enough to make up the previous years' losses.⁹⁶⁴

A concrete sign of the deteriorating financial state of the bank is that from 1985 it was unable to distribute any profit to the state. The profits of 1988 and 1989 were transferred entirely to the reserve fund in order to offset the losses of previous years.

In the following decade the bank's finances reached a state of genuine crisis, from which it took nearly 10 years to recover. In every

■ Erkki Liikanen was Finland's ambassador to the EU during the membership negotiations. He had previously been Finance minister and a member of the parliamentary supervisory council. After Finland's accession, he served as a member of the European Commission until he was appointed governor of the Bank of Finland in 2004.

- Lehtikuva news photo archives /
Kimmo Mäntylä.

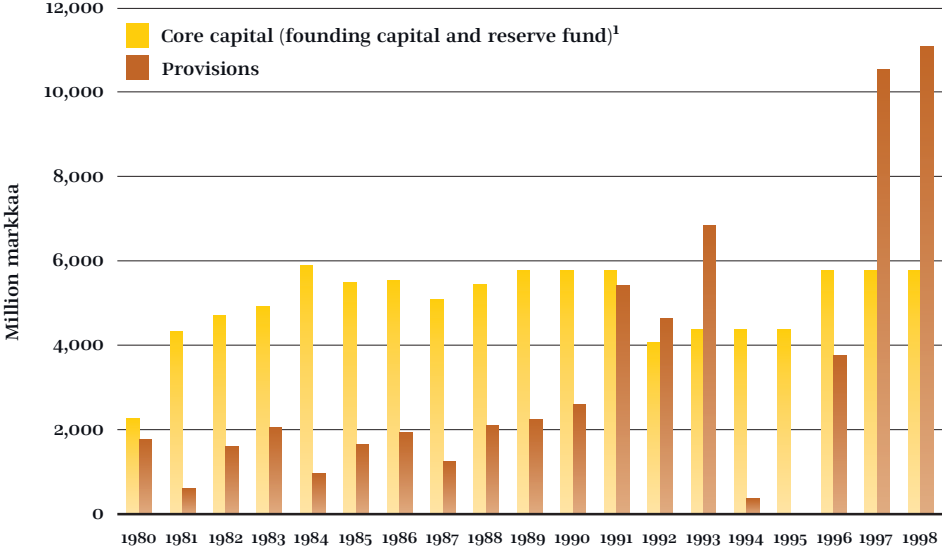


year of the 1990s the bank’s accounts recorded zero profit. In some years it made losses as high as several billion markkaa but eliminated them in its accounts by running down its reserves. The real crisis began with the takeover of SKOP in 1991 but even earlier, in 1990, the appreciation of the markka against the dollar had been very expensive. At the time the Bank of Finland’s hands were tied by the deteriorating state of the banks, which forced it to favour policy tools that were good for their finances and not its own.

This development is illustrated by the diagram below, showing the Bank of Finland’s capital (including the reserve fund) and provisions from 1980 to 1998.

According to the bank’s regulations the founding capital had to be at least 5 billion markkaa. In the diagram, however, the bank’s capital is shown net of the losses of 1.7 billion markkaa sustained in protecting financial stability, capitalised in 1992. This loss was not covered until it was written off in 1996.

BANK OF FINLAND CAPITAL ITEMS 1980–1998



¹ Minus losses capitalised in the balance sheet 1992–1995.
Source: Bank of Finland.

The diagram shows that from 1992 onwards, the Bank of Finland's actual equity had been pushed by the banking crisis below the five billion markkaa required by law. Exchange rate gains in 1993 allowed provisions to be increased but in the next two years all provisions had to be used up so that the bank could report zero losses. In the light of accounting figures, the most difficult year was 1995. At that time the Bank of Finland's foreign exchange reserves were at an exceptionally high level so the appreciation of the markka caused it major exchange rate losses. By this time, however, the national economy was growing and also the banks seemed likely to survive the crisis so the central bank could look calmly to the future despite its losses.

Its finances took a turn for the better in 1996. They were improved when the government acquired the shares and assets of Sponda, held by the Bank of Finland. The government also paid compensation of 1.76 billion markkaa for the interest costs that the bank had borne by financing its asset management companies. The capitalized losses of 1.7 billion markkaa could now be written off without pushing the bank's capital below the statutory minimum of 5 billion markkaa. The bank thus returned to normal after a four-year period. It continued to report no profits and used its entire surplus to increase reserves however.

In the history of the Bank of Finland, the years from 1985 to 1999 were an exceptional period in that it was unable to transfer any surplus to the state. This lasted until until 2000, when it reported a profit of 309 million euros, moved 180 million of that to the reserve fund and paid out the rest to the government budget. Within this meagre period, the years at the end of the 1980s, when the national economy was suffering severe disequilibrium, were expensive to the Bank of Finland because its attempts to cool down an overheated economy hurt its interest income and caused exchange rate losses. These years were followed by the banking crisis and its consequent losses. Adapting to free capital movements and an environment of market-based interest rates was painful for the whole of Finnish society, including the Bank of Finland.

A NEWCOMER TO THE UNION

EFFECTS OF EU MEMBERSHIP

When Finland became a member of the European Economic Area at the start of 1994, negotiations on joining the European Union were already on the home stretch. The last major group of problems, concerning agricultural policy, were the subject of tough negotiations in early 1994 and were eventually settled. Political agreement on Finland's accession was reached on 1 March 1994.⁹⁶⁵

The completion of negotiations was not a guarantee that Finland would become an EU member but it looked steadily more likely and began increasingly to shape views of future Finnish economic policy and the remit of the central bank. An important question for the Bank of Finland was how Finland as an EU member would participate in the exchange rate cooperation of the members. In the longer term the Bank of Finland had to prepare for economic and monetary union and for the European System of Central Banks that it would create. Even while membership talks were underway, the government had drafted a revision of legislation on the Bank of Finland to conform with EU requirements.

In joining the EU, Finland approved its plan for monetary union without reservations. The idea of a monetary union and the monetary stability that it promised was appealing to a country gradually recovering from an economic crisis but one of the central themes of economic policy debate in those years was whether Finland would be able to adapt to stable monetary conditions. The government's proposal

on accession to the European Union was sent to parliament on 25 August 1994. The bill's preamble gave the following assessment of the influence of accession on monetary policy:

“The date when the third stage of monetary union will begin is uncertain and depends on economic developments. When it is implemented, the third stage will eliminate exchange rate policy from the national economic policy toolkit. A special problem for Finland is its strongish tendency to inflation and the concentration of both its exports and its production on basic products of the forest and metal industries. A common European monetary policy will therefore increase the need for price and cost flexibility.

“With deregulated money markets and free capital movements, stability in the foreign exchange and financial markets is particularly important. It might well prove to be impossible to return to a fixed exchange rate while outside the EU and its economic and monetary union. Participation in EMU will strengthen the credibility of monetary policy and underpin efforts to achieve permanently low interest rates.”⁹⁶⁶

When the government's proposals were debated in parliament, its economic committee (30 September 1994) came out in favour of joining the EU and also participating in monetary union. Like the preamble to the government's bill, the economic committee's report judged that monetary union would bring stability to the Finnish economy and would lower interest rates:

“The committee emphasises that participation in the third stage of economic and monetary union depends solely on the desire and ability of each member state to fulfil the convergence criteria. The criteria themselves correspond to what the committee regards as essential for the stimulation of employment and the economy in Finland.

“The ongoing economic recession in Finland is due largely to home-grown factors. Sudden jumps in exchange rates and interest rates have worsened the effects of excess debt. Participation in European economic and monetary union would bring the credibility and stability that are a precondition for attracting investments in Finland that will create jobs. Commitment to the aims of economic and monetary union appear to have lowered market interest rates in the countries involved and thereby promoted employment and economic recovery.”

The committee sternly condemned the alternative of continuing to float the markka: “The policy of a flexible exchange rate traditionally

pursued by Finland has reached the end of the road. The current recession has shown that markka flexibility does not promote employment nor does it safeguard the wage level. Exchange rate expectations regarding a floating markka prone to devaluation have led to a rise in foreign currency debts. After the start of the slump, exchange rate expectations imposed a forced devaluation on the markka.

“Finland’s public debt today is largely denominated in foreign currencies. It is no longer possible to reduce the debt by means of inflation or devaluation. The only consequence is that interest costs and repayments of Finland’s debts become increasing onerous.

“A low budget deficit, low interest rates and low inflation are essential for sustainable economic growth and permanently high employment. They will be the objectives of Finnish economic policy regardless of whether our country joins the European Union. For the preceding reasons, the agreement contained in the government’s proposal has to be regarded as being in the interests of Finland, regarding its effects on the sphere of activities that is the ambit of the economic committee.”⁹⁶⁷

The committee’s report said that economic policy convergence related to EMU would have the main effect of lowering interest costs: “The Finnish economy is overindebted and the public sector is in deficit. Moreover, Finland has a reputation for high inflation and repeated devaluations. This is why real interest rates prevailing in Finland are extremely high by international standards. Expensive long-term rates raise the costs of servicing government debt, damage industrial competitiveness and lower the purchasing power of households. As the examples of indebted Spain and Italy show, a commitment to EMU convergence criteria will reduce expectations of a fall in the value of money and thereby reduce long-term real interest rates.”⁹⁶⁸

The committee was not unanimous and the representatives of the opposition issued dissenting opinions that also dissented from each other. One of them, signed by the representatives of the Left Alliance and the Christian League and some Centre Party representatives, was opposed to joining the EU. However the Centre Party was divided on the question. Two of its members on the committee, Olli Rehn and Jarmo Laivoranta, supported EU accession and Finland’s endeavour for

monetary union as well, but regarded participation in EMU as a separate (from EU membership) matter of national sovereignty.

Membership of the EU was sealed by an advisory referendum held on 16 October 1994. Of the votes cast, 56.9 percent were in favour of membership. The turnout was 74%. In accordance with the result, parliament agreed on 18 November 1994 to Finnish accession to the EU. 152 members of parliament were in favour and 45 against. In the same session, parliament approved a report from the Foreign Affairs committee, which expressed concern about the effects of monetary union on the Finnish economy's tendency to disequilibrium and expressed the hope that compensatory mechanisms of the EU would come to the rescue of countries in difficulties.

The foreign affairs committee stated: "As Finland seeks to meet the conditions of monetary union, we must make very certain that our national economy and public finances are properly ready for common monetary policy and the implementation of the common monetary unit, and that serious problems of disequilibrium in the Finnish national economy are avoided. In the same way, when we assess monetary union, we must focus on the position of employment in EU economic policy co-operation and seek to improve the EU's ability to even out externally induced differences in development between the member states. The committee demands that Finland's possible participation in the third stage of monetary union must, at a future date, be decided by parliament on the basis of a separate government proposal in which the government's assessment of Finnish participation must take into account the matters mentioned in this report."⁹⁶⁹

Finland became an EU member at the start of 1995, at the same time as Austria and Sweden. By this time it was clear that the "third stage" of monetary union, a single currency and common monetary policy, would begin in four years' time and that an EU summit in spring 1998 would decide which countries met the criteria and thus could be participants in monetary union at the start of the following year.

Parliamentary elections in March 1995 brought victory for the Social Democratic party while the biggest losses were sustained by the Centre party, which had divided over the EU question in the preceding year. After the election a "rainbow" government was formed under Social Democratic chairman Paavo Lipponen, consisting mainly of the Social Democratic party and the National Coalition party but also

containing ministers from the Left alliance, the Green league and the Swedish People's party. The government agreed to aim at Finnish involvement in EMU. Its programme stated that "economic policy will aim at meeting the criteria for economic and monetary union of the European Union so that Finland can, if it so decides, join the third stage of economic and monetary union from the start. Participation will be decided by parliament on the basis of a separate proposal from the government."⁹⁷⁰

After the economic storms of the preceding parliamentary term had died down and once EMU criteria had become a paramount political objective, doubts about the independence of the Bank of Finland were also laid to rest. In its programme, the Lipponen government was committed to central bank independence as well as the Bank of Finland's inflation target: "The government fully supports the aim of the Bank of Finland to stabilise inflation at a low level. Implementation of this aim is essential to securing low interest rates, sustainable economic recovery and an improvement of employment. It also demands the government's close co-operation with labour market organisations. Central bank independence will strengthen the political credibility of price stability."⁹⁷¹

The attention to central bank independence was probably due mainly to an effort to fulfil the Maastricht Treaty. As recently as November 1991, when parliament had debated a government economic policy report in the wake of the forced devaluation, representatives of the three largest parties had expressed very different views about the political control of the Bank of Finland. At that time, Erkki Tuomioja of the Social Democratic party had demanded that the bank, "like all other European central banks" be made into an institution clearly responsible and subordinate to the government. The representatives of the other large parties had expressed similar if less strident views. Kimmo Sasi of the National Coalition party had demanded a stronger government role in economic policy and the relocating of resources from the Bank of Finland to the Finance ministry. The then-prime minister, Esko Aho of the Centre party, had promised that the government would tighten its grip over the central bank.⁹⁷²

BANK OF FINLAND BECOMES INDEPENDENT

Preparations for getting the Bank of Finland's legal position "in shape for EMU" had in fact begun a little earlier. Finland's ETA agreement and the decision to apply for EU membership had triggered a wide-ranging legal study and then a great number of legislative initiatives to adapt the laws of Finland and other statutes in force to the *acquis communautaire* of the EU – except where Finland might negotiate for and obtain derogations in matters that were especially difficult for it. Part of this process was to adapt legislation on the position and functions of the Bank of Finland so as to meet the conditions set in the Maastricht Treaty.

As early as May 1992, the Finance ministry had set up a working group to examine how European integration and, in particular, the Maastricht Treaty would require changes in the status of the Bank of Finland.⁹⁷³ Then, in February 1993, a committee was established to draft proposals on reforming the law. Finland's negotiations on EU membership were just beginning at this time, so the mandate of the committee was cautiously defined as to propose changes in regulations concomitant to "the entry into force of a treaty on the European Economic Area and possible subsequent gradual participation in deeper European economic integration"⁹⁷⁴

The committee became rather large and its composition reflected the political weight of the matter. Chaired by Pekka Hallberg of the Supreme Administrative Court, it contained representatives not only of government ministries and Bank of Finland officialdom but also of the largest parties in parliament. The Bank of Finland was strongly represented by Esko Ollila, a member of the board of management, and Johnny Åkerholm, a head of department, both of whom had been members of the preceding working group. A former member of the board of management, Markku Punttila, was also in both the working group and the committee. The Bank of Finland's position was further reinforced by the fact that several politicians on the committee were present or former members of the parliamentary supervisory council.⁹⁷⁵

The committee's report was completed in August 1994. While it had been sitting, Finnish accession to the EU had started to look increasingly likely. Finland has signed the treaty although the referendum and

parliament's final decision on membership still lay in the future. It was no longer possible to sidestep the question of Finland's possible participation in the third stage of European economic and monetary union, meaning a common central bank and a common currency. The committee had to concentrate on the demands imposed by the Maastricht Treaty on national central banks. After the European Monetary Institute, forerunner of the European Central Bank, had begun operations at the start of 1994, the secretaries of the Bank of Finland committee had begun cooperating unofficially with EMI representatives and obtained information from them about how national legislation needed to be adapted. Among other things, the Maastricht Treaty made demands about central bank independence, the definition of price stability as the primary objective of central banks, a prohibition of central bank credit to the government or other public sector bodies, and the collateralisation of central bank lending.⁹⁷⁶

The committee's task was to define exactly how the Bank of Finland would be operationally independent. According to article 5 of the draft law it produced, the Bank of Finland was not to request or accept instructions when managing its monetary policy. Its independence would be reinforced by transferring all operational decisions from the supervisory council to the board of management. The independence of the board of management would be increased by making its members immune from dismissal. Only the president of the republic could discharge a board member and only in cases of misconduct, unsuitability or incapacity. At the same time, members of the board of management were to be appointed for fixed terms. The committee proposed a seven-year term for each member and no more than two of them. The governor was also to have a seven-year term and to serve no more than two terms, although someone who had served two terms on the board of management could still be appointed governor. The committee proposed that it would be the duty of the board of management to ensure that the bank's operations were managed in an effective and efficient way.⁹⁷⁷

Regarding the remit of the bank, the committee proposed an outright ban on public sector financing; the Bank of Finland would not be allowed to lend to the government, to a municipality or to any other public body. The committee also accepted that lending should be against adequate collateral only, although it proposed that the bank

should be allowed to ignore collateral requirements in especially weighty cases.⁹⁷⁸

The disposition of the bank's surplus was to be decided by parliament on the basis of a proposal from the supervisory council. The committee's report recommended a surplus allocation mechanism that would depend on the capital of the Bank of Finland. The main purpose of any surplus would be to increase the bank's reserve fund until its capital and reserves totalled one-third of its balance sheet total. If the bank's capital adequacy exceeded this ratio, the proportion transferred to the reserve fund could be smaller and if the total of capital and reserves was at least half of the balance sheet total, no appropriations would have to be made to the reserve fund.⁹⁷⁹

Once the committee had issued its report, progress ceased, although when Finance minister Viinanen had received the report, he had promised that a new law would be rapidly enacted. Instead, there was now a public debate about the position of the Bank of Finland and how power would be shared between its decision-making bodies. The committee report already contained the dissenting opinion of Sixten Korkman, director general of the Finance ministry's economics department. Korkman doubted the wisdom of putting the board of management alone in charge of monetary policy, and he put forward alternatives which he believed would fit into the framework set by the Maastricht Treaty. The supervisory council could be made more independent from parliament, or a separate monetary policy council could be established at the Bank of Finland to decide about monetary policy. Similar views were publicly expressed by Martti Hetemäki of the Finance ministry and Jukka Pekkarinen, head of the Labour Institute for Economic Research.⁹⁸⁰

Another committee member, Matti Louekoski, who was a social democratic member of parliament, had appended his own footnote to the report. He pointed out that the Bank of Finland was parliament's bank and wanted to preserve the main monetary policy functions of the supervisory council, specifically in setting base rate and proposing the external value of the markka. As for how the position of the supervisory council in monetary policy would be reconciled with the demands of monetary union, Louekoski said that this could be settled separately at a later date. He publicly defended this parliamentarian viewpoint and was backed by other politicians who had served on the

committee, Mauri Miittinen of the National Coalition party and Olavi Ala-Nissilä of the Centre party.⁹⁸¹

In autumn 1995 the supervisory council discussed the report and its implications in redistributing power. The council was unanimous about the need to reform the law of 1925 on the Bank of Finland, to adapt it to the framework required by European integration, but many councillors felt that the committee's report observed the Maastricht Treaty too literally. They felt that Finland did not need to be a "model student" by advancing so rapidly but should instead wait and see what the EMI's minimum demands for central banks would be.⁹⁸²

Consultation with the European Monetary Institute continued and, in a letter dated 13 May 1996, the Institute stated that the draft law on the Bank of Finland was in accordance with the Maastricht Treaty.⁹⁸³ Parliament approved the law on 24 July 1997 and it took force from the start of 1998. Decision-making arrangements in the law were as the committee had proposed. Compared with the committee's proposal, the main difference in the law concerned how long members of the board of management could serve. The final law allowed a member to sit on the board for a maximum of three 5-year terms instead of the original proposal of two 7-year terms. The law brought a significant change in ending the supervisory council's 130-year reign over interest rate policy.

After spring 1998, when it became certain that Finland would enter the third stage of economic and monetary union, the new law on the Bank of Finland that had just come into force had to be urgently amended to take monetary union into account.⁹⁸⁴ The main changes now concerned the position of the Bank of Finland, which would no longer be merely the central bank of Finland but would become part of the European System of Central Banks and act in accordance with guidelines and instructions from the European Central Bank. The Bank of Finland would no longer decide monetary policy, a function contained in the law of 1997, but would implement, for its part, the monetary policy set by the ECB council. A few technical changes were made at the same time; for example, the section on minimum reserve deposits required from banks was entirely eliminated from the law because these were contained in the statutes of the European Central Bank. Also, the rules on the disposition of the Bank of Finland's surplus, especially the part of it

to be transferred to the reserve fund, were simplified. The amended law would come into force gradually, from 1 May 1998 onwards, and would take full effect “when Finland is part of the common currency area”, meaning from the start of 1999.⁹⁸⁵

In the late 1990s, other EU countries also reformed the status of their own central banks. The reforms were not restricted to the future EMU countries. In Sweden the largest parties reached agreement in 1996 on making the Bank of Sweden independent in its monetary policy from its General Council (and the government). The law on the matter came into force at the start of 1999, the same time as the status of the Bank of Finland was reformed, although Sweden did not join the euro area. In Britain the Bank of England obtained complete independence in monetary policy in 1998. Until then British interest rate policies had been decided by the government. Underlying these reforms was the same desire to make monetary policy more credible that had influenced the content of the Maastricht Treaty.⁹⁸⁶

The reform of central banking law shows the hectic tempo of events as the Bank of Finland became part of the European System of Central Banks. The law that took force at the start of 1998, superseding a law in effect for 70 years, had to be revised again within half a year. The balance of power between Bank of Finland bodies was fundamentally changed; the supervisory council chosen by parliament was left with little more than oversight, when responsibility for monetary policy was transferred first to the board of management and, a year later, to the ECB council, in which the Bank of Finland’s governor was a single member. From the perspective of parliament the change was radical. Although Sweden and Britain gave independence to their central banks without joining the euro area, the debate in Finland suggests that the change would not have received enough political support if it had not been a condition for EMU.

MARKKA JOINS THE EXCHANGE RATE MECHANISM

After Finland had become a member of the European Union at the start of 1995, it was also formally part of its Exchange Rate Mechanism. Initially this had no implications for monetary policy because Finland had not yet linked the markka to the ERM, unlike Austria, which

adopted the ERM immediately as a sequel to its traditional fixed exchange rate policy. For the time being, the markka continued to float, but an ERM peg inevitably lay ahead because the convergence criteria of the Maastricht Treaty required a currency to be held within normal ERM fluctuation margins, without serious tensions or a devaluation, for two years. Only by joining the ERM well before the beginning of the third stage of EMU, at the start of 1999, could Finland meet the criteria.

The programme of the Lipponen government aimed at meeting EMU criteria, so ERM participation was also an objective of its economic policies. Naturally, the spectre lurking in the background was the traumatic failure of the ecu peg of 1991, although the ERM in 1995 or 1996 was a far more flexible and less fragile arrangement than what had been attempted with a unilateral ecu peg in spring 1991. For one thing, the currency fluctuation bands had been widened and were now $\pm 15\%$ around the central rates. Moreover, the Finnish economy was steadily becoming better able to cope with the requirements of the ERM, while in 1991 it had been going in the opposite direction.

In 1995 Finland's economic prospects improved strongly. Growth was fast for the second consecutive year and GDP rose about 4 percent. The economy was obviously recovering from the recession even if unemployment was falling only slowly. At the same time inflation had fallen to a very low level. The official consumer price index for the full year recorded an increase of only a few tenths of a percent, and the Bank of Finland's indicator of underlying inflation, on which its inflation target was based, was negative and showed prices falling by about 0.6 percent during the year. The inflation outlook was therefore extremely calm and the Bank of Finland reduced its tender rate during the year by about one percent. Market interest rates fell at the same pace.

An important development for Finnish membership of the Exchange Rate Mechanism was that the exchange rate between the markka and the German Mark, the anchor currency of the ERM, became significantly more stable during 1995, even though the Bank of Finland intervened less in the foreign exchange market than in previous years. The exchange rate had stabilised soon after the result of Finland's referendum on EU membership was announced. The markka had by then appreciated about 20 percent (against the German Mark) since the difficult spring of 1993. From now on, it tracked the

Mark fairly closely although a formal ERM peg lay some time in the future.

In autumn 1995, Bank of Finland experts began internal planning for ERM participation. One of their aims was to study how the Exchange Rate Mechanism would affect monetary policy operations and what role the inflation target, announced in February 1993, would have after ERM membership. The bank also wanted to assess if the markka's exchange rate level in autumn 1995 was "sustainable", meaning whether it was compatible with the objective of low inflation and macro-economic equilibrium.

In a joint memorandum on 30 October, the bank's monetary policy department and economics department concluded that national monetary policy would be significantly different within the ERM, compared to the floating rate regime. As an ERM country Finland would need to avoid large exchange rate movements. Although the ERM since summer 1993 had formally allowed fluctuations by as much as ± 15 percent, the memorandum said that, judging from the behaviour of ERM currencies since summer 1993, the markka would in practice have to be kept within a band on only 2–3 percent around its central rate against the German Mark. Consequently, exchange rate stability would constitute the main "operational" target of monetary policy after Finland joined the ERM. "Monetary policy would no longer be able to respond to inflation pressures," the report said.

For this reason the basic tone of the memorandum was reserved in its attitude to fixing the exchange rate. If the (exchange rate) fluctuation band had to be narrow, monetary policy could not be used much in pursuit of the inflation target. If the influence of the Bank of Finland over inflation declined, the other parties in economic policy would have to take more responsibility for controlling inflation. The role of the bank in this situation would be to try to explain the importance of the inflation target "as some sort of national goal", the memorandum concluded.⁹⁸⁷

The bank also tried to assess the sustainability of the present markka exchange rate. One of its researchers, Tuomas Saarenheimo, wrote a report on the matter that was later also published in the Bank of Finland Bulletin. Saarenheimo reached the conclusion that the prevailing exchange rate level was compatible with low inflation and a current account surplus. If the world economy recovered, the

prevailing exchange rate would allow Finnish economic growth at a good annual rate of about 4 percent without fanning inflation, he predicted.⁹⁸⁸

At the end of 1995 the calm outlook for inflation allowed the Bank of Finland to ease monetary policy. Thanks to its cut in tender rate, 3-month Helibor rate fell by more than one and a half a percentage points between October 1995 and March 1996, to less than 4 percent. Interest rates also fell in Germany at this time. During early 1996 the markka came under downward pressure on the foreign exchange market, for the first time in a long time. However the Bank of Finland combated this pressure by selling foreign exchange worth some 10 billion markkaa during the spring. The bank's annual report did not attribute this loss of confidence in the foreign exchange market to the monetary easing of the time; it believed that it was caused partly by adverse foreign news and partly by a temporary deterioration in Finnish economic growth expectations. Whatever the underlying reason, the downward pressure on the markka ended in May when the market realised that Finland was beginning serious preparations for ERM membership.⁹⁸⁹

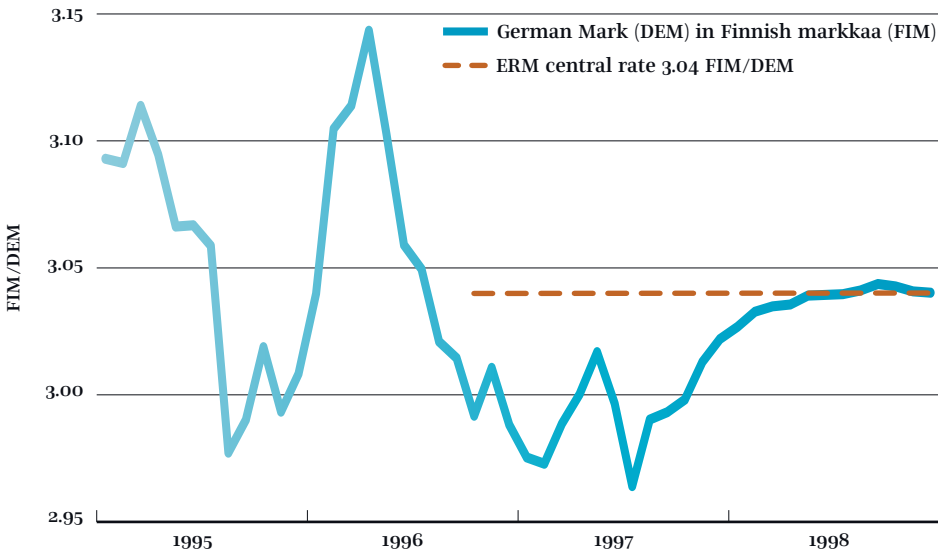
International events lent urgency to the ERM question. An EU summit in Madrid in December 1995 had confirmed the plan for transition to economic and monetary union. EMU was indeed to begin on 1 January 1999, when the currencies of the participating countries would be permanently and irrevocably locked to each other, becoming "manifestations" of the new common currency. Euro banknotes and coins would be introduced later (2002). It was decided that the name of the new currency would be the *euro* and the "generic" term *ecu* that had featured in earlier plans was abandoned. The countries that would participate in monetary union from the start of 1999 would be chosen "at the earliest occasion" in 1998 when economic data for 1997 was available, so that it would not have to be based on preliminary data. In practice, therefore, the choice would be made at the end of spring.⁹⁹⁰

After these decisions it was impossible for Finland to postpone ERM membership if it wanted to be certain of meeting all the EMU criteria in time. The government, which had committed to the aim of meeting the criteria, began its own preparations in February 1996 for pegging the markka within the exchange rate mechanism. The most urgent task was to amend the currency act to legalise ERM participation

and the government sent parliament a proposal to this end on 15 March. The act would no longer define Finland's exchange rate system and would merely state that "decisions about the external value of the markka are to be made by the government on the basis of a proposal by the Bank of Finland". No further restrictions were set on the system to be used. The government's proposal also paved the way for the outcome of EU-level negotiations, by authorising the Finance ministry to make decisions on the markka exchange rate or its fluctuation band "within the framework set by the exchange rate mechanism of the European monetary system".

The preamble to the proposal stated that its objective was "to create legislative readiness to participate in the exchange rate mechanism of the European monetary system when the correct conditions exist for pegging the markka exchange rate. The changes proposed do not alter Finland's current floating rate regime nor prevent Finland from continuing to float the markka."⁹⁹¹

**FINNISH EXCHANGE RATE DEVELOPMENT
DURING ERM ENTRY**



Source: Bank of Finland.

When parliament approved the amended currency act, it conducted a very wide-ranging and thorough debate about ERM membership. This revealed a sharp division of opinions within both the governing and opposition parties. However the government's proposal was approved by 115 votes to 21, a large majority. Many members of governing parties voted against, while many opposition members voted in favour of the government's proposal. Moreover, many members who, during the debate, had expressed doubts about fixing the markka in the ERM, voted in favour of the bill. These included Erkki Tuomioja, deputy chairman of the parliamentary group of the governing Social Democrats, and Seppo Kääriäinen, the chairman of the parliamentary group of the Centre, the largest opposition party.⁹⁹²

In Finland's decision to join the ERM, the leading role was obviously played by the government, which was committed by its programme to being active in the matter. However the Bank of Finland naturally had a key role as an executor and the bank began tangible preparations for linking the markka to the ERM soon after the currency act amendment had been approved in parliament on 4 June 1996. The bank's internal preparations advanced so much during the summer that on 21 August the board of management discussed the draft of a proposal to be made to the supervisory council on joining the ERM.

At that same meeting the members of the board also each announced their positions on joining the ERM. Governor Hämäläinen was unreservedly in favour, although she said that the timing would depend on what happened in Europe after the holiday period. No member of the board of management was opposed outright to the ERM. Most emphasised the political nature of the project and that the government was ultimately responsible for the matter. Matti Vanhala was somewhat more cautious than Hämäläinen and said that the Bank of Finland should propose it only if it felt that the exchange rate would be sustainable without serious imbalances. This should be specifically stated in any future proposal, he said.⁹⁹³

Beginning in September the markka experienced upward pressure in the market, obviously in anticipation of the expected ERM link. The Bank of Finland reacted on several occasions by purchasing foreign currency to prevent an "excessively rapid appreciation" of the markka.⁹⁹⁴ The bank also took advantage of the opportunity to lower interest rates. On 9 October it reduced its tender rate to 3 percent on the

grounds of “a continuing moderate inflation outlook, narrower differentials between market rates at home and abroad, and the confidence expressed in the markka”.⁹⁹⁵

On 10 October 1996, the Thursday preceding the weekend when the markka was linked to the ERM, the board of management of the Bank of Finland decided what it wanted the markka’s central rate to be. Expressed in German Marks the target was set at 3.04 markkaa. At the same time the board set 3.06–3.03 as the negotiable range for Finland’s representatives in the EU’s monetary policy committee. On the date in question the exchange rate was 2.9885 markka per German Mark so attainment of the target rate would have meant a slight depreciation of the markka (by about 1.7%). Finland’s opening position in the negotiations was to be 3.06, the average for the preceding six months and also the preceding two years. The other countries in the negotiations could be expected to try to set the markka at a stronger rate than Finland’s initial proposal, pushing it towards Finland’s target of 3.04, which was close to the preceding year’s average. The central rate would not formally be set against the German Mark but the ecu. The implied target rate for the ecu was 5.80661 markkaa.⁹⁹⁶

The decision on Finnish ERM membership was a fairly complex package of measures. The complexity was due to the regulations of the currency act, which required coordinated action by the board of management of the Bank of Finland, the parliamentary supervisory council and the government. The matter was further complicated by the fact that the ERM link was not, of course, a unilateral measure but required the approval of the other participating countries. The decision would be made at a meeting of the EU’s monetary policy committee. All three decision-making bodies in Finland therefore had to convene twice, before the monetary policy committee meeting and afterwards.

On Friday, 11 October 1996 the board of management of the Bank of Finland decided to ask the supervisory council to make a proposal to the government on joining the ERM. At the same time the board approved a statement that referred to the government’s programme and argued that ERM membership was consequently needed in order to meet the criteria for monetary union: “the fulfilment of the criteria, in formal terms too, is regarded in Finland as necessary, so as to be certain that the opportunity will exist for entering the third stage of monetary union. Against this backdrop the Bank of Finland has

MATTI VANHALA (1946–2004)

The formative period of Matti Vanhala's career was surely when he represented the Nordic countries at the International Monetary Fund in Washington in 1977–1980. Nordic cooperation suited Vanhala well; his mother tongue was Swedish and he was a committed believer in common Nordic values. Vanhala was also a believer in liberalism. This tendency, too, was reinforced during his years at the IMF, where he learned to appreciate the flexibility of market-based monetary policy.

He had joined the Bank of Finland young, in 1970, with a bachelor's degree in economics. Initially he worked as a researcher and office manager. On his return from Washington to Finland, he was appointed head of the Bank of Finland's foreign exchange department. Within a couple of years he had risen to the rank of director, responsible for international affairs, where he was concerned with foreign exchange controls and clearing payments in Soviet trade but also the bank's market operations and currency investments. Via these experiences Vanhala soon became convinced that Finnish capital controls had reached the end of the road and had to be dismantled.

It was his knowledge of international affairs that led to his elevation to the board of management of the Bank of Finland in 1992. The value of these skills only increased as Finland's negotiations began on

joining European monetary union. He had a comprehensive grasp not only of practical Finnish monetary policy but also the Eurosystem then under construction. Against this background the choice of Vanhala to succeed Sirkka Hämäläinen as governor in 1998 was a logical one.

His great achievement as governor was in tuning the Bank of Finland's culture to suit the membership in the Eurosystem. It was his aim that matters being presented at the European Central Bank would be understood and also broadly prepared throughout the Bank of Finland organisation. From the outset, every meeting of the ECB Council was preceded by a conference of Bank of Finland heads of department and planning advisers, that would brief the governor for the meeting. After the council had met, there would be a debriefing, where the governor explained what had been decided and opened the matter for discussion. Vanhala saw the central bank as a consultative expert organisation in which the flow of information had to be as open as possible, both horizontally and vertically. He soon became a respected figure in the ECB Governing Council and it is no exaggeration to say that he was more highly esteemed in international banking circles than at home.

His term as governor of the Bank of Finland was cut short by cancer in spring 2004 when he was only 58.



■ Governor Matti Vanhala
- Lehtikuva news photo archives /
Kimmo Mäntylä.

thoroughly examined the possibility for linking the markka to the ERM. The premise adopted is that the only solutions that can be considered are those that are in harmony with stable economic development and monetary stability.”

The reference in the board’s statement to economic preconditions met the demand put forward by Matti Vanhala in the August board meeting. The statement went on to note that the national economy was continuing to move towards equilibrium and that “favourable economic developments and consistency in economic policies are creating a good basis for stability in the markka’s external value”. After this positive assessment, however, it pointed out that “exchange rate stability demands that the country’s economic development is sustainable. In Finland this sets the particular demand that government finances are rectified and earnings developments continue to be moderate.”⁹⁹⁷

The supervisory council was not unanimously in favour of the board’s proposal and had to vote on it. Councillors Olavi Ala-Nissilä, Anneli Jäätteenmäki and Mauri Pekkarinen of the opposition Centre party and Esko Seppänen of the governing Left alliance voted against. The proposal was approved by five votes to four. The four voting against appended statements to the council’s report to the government, expressing the view that the risks associated with economic developments and employment would be less if the markka continued to float.

The government gave Finland’s negotiators, Johnny Åkerholm of the Finance ministry and Matti Vanhala of the Bank of Finland, the mandate that had been proposed by the Bank of Finland. The EU’s monetary policy committee, meeting in Brussels, reached agreement on the evening of Saturday 12 October on the rate of 3.04, exactly what Finland had sought. This result was considered in Finland once more by the board of management of the Bank of Finland, the supervisory council and the cabinet. Once more the supervisory council had to put the matter to a vote, in which the councillors of the Centre party and the Left alliance opposed entering the ERM and appended their dissenting statements to the report sent to the government. The statements were similar in content to the ones of the day before.

The Finnish markka entered the exchange rate mechanism on Monday, 14 October 1996. In an internal report written in the following

week, it was concluded that the market had been unperturbed by the news that Finland was joining the ERM although a decision on the matter had generally been expected to be delayed until after Finnish local government elections and European Parliament elections (held on 20 October). The central rate agreed for the Finnish markka was apparently in line with what the market had expected because the exchange rate remained stable and market interest rates did not react significantly either.⁹⁹⁸

On 25 November 1996 the Italian lira also re-entered the exchange rate mechanism. Its new central rate against the German Mark was 19 percent weaker than before it had been floated in autumn 1992. The bilateral central rates of other member currencies were not adjusted at this time and so the central rates for the Finnish markka remained as had been agreed. The rate of 3.04 markka to the German Mark was to stay in force until the start of 1999, when both currencies were merged into the common currency, the euro.

During the weekend when the markka entered the ERM, there was a leak of information that caused a considerable fuss at the time but had no other consequences. The Finnish Broadcasting Company had reported Finland's negotiating target in television and radio news just before the meeting of the EU's monetary policy committee. The board of management and the supervisory council, sitting at the Bank of Finland, received reports on the progress of the negotiations in Brussels that gave the impression that the French Finance minister was also aware of the mandate of Finland's negotiators. The source of the leak was believed to be Finland's second Finance minister, Arja Alho, an allegation that became public when it was aired in parliament. At the urging of Centre party members of the supervisory council, the Justice chancellor Jorma S. Aalto investigated Alho's actions and concluded that there was no evidence that the French Finance minister had been told about the mandate of the Finnish negotiators. Publication of the news by the Finnish Broadcasting Company apparently had had no effect on the course of the ERM negotiations and the Justice chancellor felt there were no grounds for him to call for an investigation into the matter. He did, however, convey a statement to Finnish Broadcasting Company in which he said that, when publishing secret information of this type, the mass media should weigh the consequences.⁹⁹⁹

IN THE FIRST WAVE

THE QUESTION OF MONETARY UNION

After the Finnish markka had joined the ERM, the next choice that needed to be made was whether Finland would participate in European monetary union. Its nearest peer was Sweden so Sweden's stand on monetary union was naturally important, both economically and politically. Like the markka, the Swedish krona had been floated in autumn 1992 and both countries had then adopted a monetary policy strategy based on an inflation target. In 1990 Sweden had surprised Finland's political leadership by announcing its intention to apply for membership of the EU. Would it do the same with EMU?

The Swedish government has appointed a committee under professor Lars Calmfors in autumn 1995 to consider monetary union from Sweden's perspective. The Calmfors committee report, issued on 4 November 1996, took a guarded stance and recommended a policy of "wait and see". If Sweden postponed its decision, it would not be one of the first wave of participants. The committee said that Sweden was not yet ripe for EMU because unemployment was still too high and public finances too weak. Moreover, the public debate in Sweden about monetary union had not progressed far enough to "legitimise" participation. The committee anticipated that many countries would initially opt out of monetary union; in this case, the political loss to Sweden from such a decision would not be unacceptable.¹⁰⁰⁰

The Calmfors committee report launched an extensive debate in Sweden. It was significant that the leadership of the Swedish central bank did not share the committee's view. The General Council of the Bank of Sweden responded to the report with a statement that "the

economic benefits and the opportunity to influence the future direction of monetary policy lead the council to the conclusion that Sweden should participate in economic and monetary union from the outset.”¹⁰⁰¹ However, the Swedish krona did not join the ERM and was not to be part of EMU either. In practice the matter was settled in autumn 1997 when a convention of the Swedish Social Democratic party came out against membership. Later, in 2003, Sweden even held a referendum on joining the euro. The result was 56% against membership to 42% in favour, even though the then-prime minister Göran Persson was now in favour.¹⁰⁰²

Soon after the Calmfors report had been published, Finnish Prime minister Paavo Lipponen established a nine-member working group of Finnish advisers to examine the implications of EMU for the Finnish economy. The team became known as the professors' group because it consisted of people with an academic background. The chairman was the head of the Labour Institute for Economic Research, Jukka Pekkarinen, who was then an acting professor at Helsinki School of Economics. Of the other members, Esko Antola, a professor of political science, and Raija Julkunen, a lecturer in social policy, were non-economists. All the others were professors of economics: Pertti Haaparanta, Seppo Honkapohja, Erkki Koskela, Heikki A. Loikkanen, Marianne Stenius and Matti Virén.

After five months' work, the group issued its report at the end of April 1997. It was very cautious and did not directly advise in favour of monetary union or against it. It noted the efficiencies that would result from monetary union but focussed on its effect on the stability of the national economy, which it regarded as a potential problem. In particular, the working group was worried about “asymmetric shocks”, meaning economic fluctuations which would not be in synchronization between Finland and the other EMU countries. Within monetary union, Finland would not be able to use monetary policy to soften the effects of these asymmetric shocks.

On the other hand, the working group believed that monetary union would not prevent the Finnish government pursuing anticyclical fiscal policies. However, if government spending was to be used to correct imbalances in the national economy, the budget would have to be brought into balance “within the next few years” and economic growth would have to continue strong so that government debt as a proportion of GNP would go into decline.

Despite its optimistic attitude towards the scope for countercyclical fiscal policy, the working group predicted that monetary union would pose challenges for the labour market, too. Nominal wage increases would have to stay below the level that Finland had become used to “in the past few decades” and labour costs would have to adapt flexibly to business conditions.

Like other EMU debate in Finland at the time, the report of Jukka Pekkarinen’s working group was dominated by the concept of a traditionally unstable Finland and concern about how such a country would adapt to the world of currency stability and low inflation that monetary union would represent. However, although this perspective was prominent in the working group’s report, it also gave some consideration to the structure of monetary union as a whole and how it would work. In this, too, it pinned its hopes on fiscal measures for countercyclical policy but saw as a potential problem that there might be little scope for fiscal policy manoeuvre in the early phase of monetary union. Because the budget deficits of participating countries were already close to the maximum set in the Maastricht Treaty (3 percent of gross national product), the budgets of the main countries participating would not be able to respond adequately to any downturn in business conditions. On the other hand, the working group foresaw the need “to be prepared for more harmonisation than at present between the fiscal policies of participating countries. This could be pursued through developing the multilateral monitoring of fiscal policies and deficits.”¹⁰⁰³

In preparations for monetary union and the related decisions to be taken, Finnish government was clearly in the driver’s seat and the Bank of Finland kept a generally very low profile. However the bank’s governor Sirkka Hämäläinen had come out clearly in favour of EMU even before the publication of the report of the Pekkarinen working group. Her opinion and reasons for it were clearly expressed in a presentation to the Trilateral Commission in Helsinki on 12 November 1996. She described participation in monetary union as a natural sequel to Finland’s consistent efforts to take part in international economic integration, and she thought that it was very realistic to expect the EMU criteria, even regarding public finances, to be met in time.

In her presentation, Hämäläinen rejected the idea that Finland had to participate in EMU in order to improve the credibility of its monetary

policy although she admitted that participation would help to cement the improvement in credibility that had been already achieved in the preceding few years (apparently 1993–1996). In her view the benefits of monetary union for credibility and efficiency were far weightier than the disadvantages stemming from the loss of policy flexibility that had caused so much discussion in Finland.

From Finland's viewpoint Hämäläinen said she hoped that the monetary union would be a broad one. She observed that about a third of Finland's foreign trade was with the EU "core countries" of Germany, France, Benelux and Austria, a third with other EU countries such as Britain and Sweden, and the remaining third with non-EU countries. With such a foreign trade structure, Finland would benefit if the EU actually reached the situation expressed in the slogan "one market – one money" (in which case Sweden and Britain would also be members) and if exchange rates were also stable at the global level (between EMU and the main world currencies).

Governor Hämäläinen's presentation stressed the importance of internal EMU discipline. She felt that Finland, having managed to improve the credibility of its economic policies so much, had a strong interest in a monetary union that would maintain "first-class economic policy discipline and stability". She thus endorsed the stability and growth pact outlined at the EU summit in Dublin in the same autumn "as a good starting point". The pact had been initially proposed by German Finance minister Theo Waigel to reinforce the Maastricht Treaty. It was approved at the EU summit in Amsterdam in June 1997, when the members committed themselves to "the medium-term budgetary objective of positions close to balance or in surplus". To implement the pact, a monitoring and coordinating mechanism was added to it.¹⁰⁰⁴

FINLAND ENTERS MONETARY UNION

The markka's entry into the ERM began a two-year period when the monetary policy of the Bank of Finland was dominated by preparations for monetary union. Tools and practices needed to be adapted to the monetary policy framework to be used by the European Central Bank to manage the money market of the euro area. The harmonisation process was steered by guidelines issued by the European Monetary

Institute, in particular its General documentation on ESCB monetary policy instruments and procedures, published in September 1997.¹⁰⁰⁵ Thanks to the development of steering systems carried out in Finland in earlier years, the changes required were not large and were mainly related to technicalities in auctions used to control the money market and in liquidity credit facilities available to banks.

Regarding monetary policy, Finland's period within the ERM was mostly very calm and the Bank of Finland's key rate stayed close to the German Bundesbank's. From spring 1997 onwards, Finland was one of the core countries – alongside Belgium, the Netherlands, Austria and France – where central bank key rates did not appreciably differ from Germany's.¹⁰⁰⁶

The markka exchange rate settled down after a little initial turbulence. The greatest challenge during the ERM period came at the very start in 1997, when there were strong expectations in the foreign exchange market that the markka would be realigned and appreciate as the result. At the time the Bank of Finland believed this speculation was caused mainly by the weakness of the German Mark, an analysis supported by the fact that the exchange rates against the Mark of other European peripheral currencies showed the same tendency to appreciate. Another reason for upward pressure on the markka was that Finland's economic outlook was improving. The Bank of Finland also suspected that the market wanted to test Finland's exchange rate policy in the ERM.

The upward pressure on the markka began with heavy buying in the second week of January. The Bank of Finland initially sought to hold the rate steady by selling large amounts of markkaa. Its market interventions were at their greatest during the third week of January, when it used 35.5 billion markkaa to purchase foreign currencies. It relieved some of the pressure by making matching contracts worth 12 billion markkaa in the forward market, so not all of its growing currency reserves showed in its balance sheet. These major market operations were fairly successful in holding the markka exchange rate stable against the German Mark.¹⁰⁰⁷

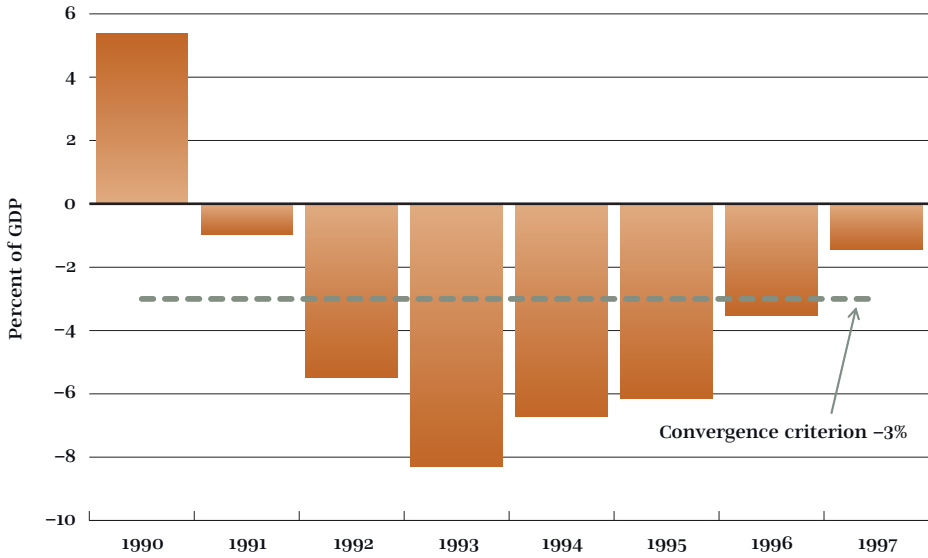
At the start of the fourth week of January the Bank of Finland allowed the markka to appreciate and it briefly diverged by nearly 5 percent from its central rate against the Mark. At the same time the bank announced that the Finnish government could in future obtain

foreign currency needed for its own operations direct from the foreign exchange market if the market situation seemed to make this advantageous; traditionally the government had obtained its foreign exchange from the reserves of the Bank of Finland. After this announcement the markka exchange rate began to weaken and, by the end of January, the brief but powerful speculative wave was over. Its legacy, however, was that the currency reserves of the Bank of Finland had increased greatly, for a while by 25 billion markkaa. In July 1997 there was another wave of upward pressure on the markka, but it was less acute than in January and soon ended. From then until the start of monetary union, the Finnish markka closely tracked the German Mark. At the end of 1997, the currency reserves, which had been boosted so much at the start of the year, fell significantly, partly because of amortisation of government foreign debt, but the reserves were still about 15 billion markkaa greater than when Finland had joined the ERM.¹⁰⁰⁸

From the perspective of the equilibrium of the Finnish economy, ERM membership was a favourable time and the loss of independence in monetary policy did not harm economic development. Preliminary statistical data available in spring 1997 supported the calculation that the Finnish public sector had already met the EMU deficit and debt criteria in 1996. On this basis the EU's Council of Economics and Finance ministers, Ecofin, officially recorded in May 1997 that Finland was no longer an excessive deficit country. In fact, adjusted figures later showed that Finland did not meet the criteria until 1997 but its public finances were developing so positively that this reversal did not upset the overall picture.¹⁰⁰⁹

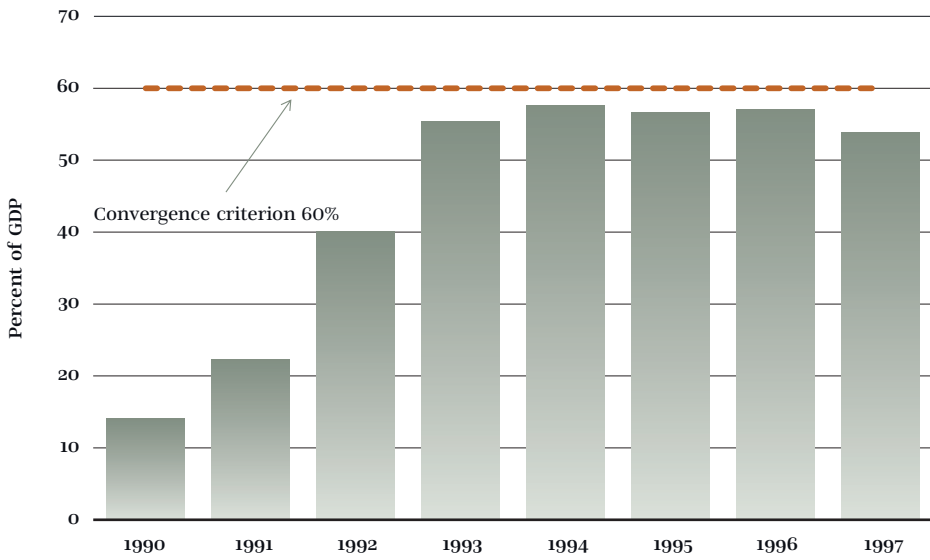
Finnish inflation and long-term interest rates also developed very favourably and, when the European Monetary Institute and the European Commission both delivered their convergence reports on the Finnish economy in March 1998, neither had any reservations about Finland's EMU eligibility. The only point of ambiguity was that, when they made their assessments, the markka had not yet been in the ERM for a full two years. In the commission's view, however, Finland's currency had "displayed sufficient stability in the last two years" and Finland had achieved "sustainable convergence". Finland was therefore in compliance with the EMU criteria, as were ten other countries.¹⁰¹⁰

FINNISH GENERAL GOVERNMENT SURPLUS/DEFICIT 1990-1997



Source: Statistics Finland.

FINNISH GENERAL GOVERNMENT DEBT 1990-1997



Source: Statistics Finland.

The question of entering monetary union was politically settled by parliament in spring 1998 when members voted on the matter following a report by the government. This procedure had been agreed in the previous summer, when the government had provided parliament with a statement entitled *Economic and Monetary Union – Finland’s alternatives and national decision-making*. In it the government had proposed that the decision on joining the euro area should be decided by parliament on the basis of a government report.¹⁰¹¹ The constitutional committee of parliament had considered the question and concluded that this procedure was possible because monetary union was already contained in Finland’s EU accession treaty. “It is a legally binding obligation of the EU treaty that members states are required to enter the third stage of economic and monetary union and – if they meet the convergence requirements – to adopt a common currency on 1 January 1999,” the committee stated. “Transition to the third stage of EMU or participation in a common currency is not an entry procedure that is at the volition of the member state itself.”¹⁰¹²

The report to parliament promised by the government was made on 24 February 1998. It stated that Finland would join the euro area in the first group of participants, meaning at the start of 1999. The report put forward both political and economic arguments for participation. It would safeguard ongoing stable economic development and provide opportunities for Finland to have an influence on its economic environment and the development of Europe.¹⁰¹³

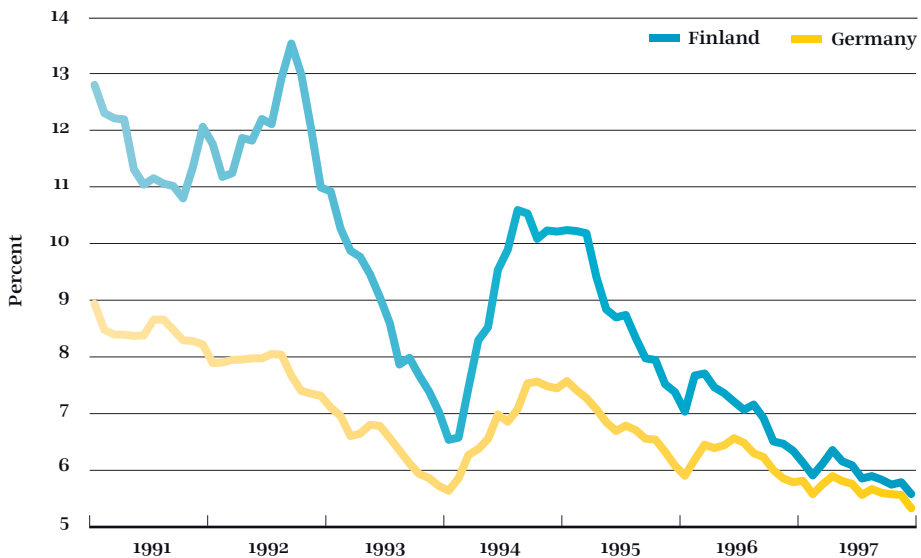
The government’s report on EMU was debated in parliament for three days. During the debate, the chairman of the grand committee of parliament, Erkki Tuomioja of the Social Democratic party, who as a representative of a governing party had voted in favour of the report in the committee, drew attention to the fact that monetary union was taking place without a common fiscal policy among member states. He said it was being born “prematurely in this sense, and for this reason there could be doubts about whether it would be durable”. He predicted that holding the monetary union together would require broader EU-level decision-making and more competence for the union institutions. Speeches from the floor by representatives of the larger parties naturally observed the division between the government and the opposition. The Social Democratic and National Coalition parties argued for endorsement of the government’s report, while the Centre party

opposed EMU on the grounds of the allegedly very great risk of asymmetric shocks to the Finnish economy, which a common monetary policy would be unable to redress.¹⁰¹⁴

On the fourth day of the debate, Friday 17 April 1998, parliament voted on the government's statement in the form of a motion of confidence. It was approved by 135 votes to 61, a majority narrowly above two-thirds. Although a simple majority would have sufficed for a confidence motion, the support of more than two-thirds of members of parliament naturally gave entry into monetary union a much stronger political foundation. Voting followed the division between government and opposition closely but not entirely. Almost all members of the governing parties (who had 144 seats in parliament) voted in favour while those against were mostly members of the Centre party and the small Christian league.

Finland was accepted as one of the 11 founding countries of the euro area at an EU summit in London on 2 May 1998. The other founding members were Austria, Belgium, France, Germany, Ireland, Italy,

**RATES ON TEN-YEAR GOVERNMENT BONDS
OF FINLAND AND GERMANY 1991-1997**



Source: Reuters.

Luxembourg, the Netherlands, Portugal and Spain. Britain and Denmark had opt-out provisions in the Maastricht Treaty, which they used to remain outside monetary union. Sweden and, at this time, Greece, also remained outside.

On the following day, the finance ministers and central bank governors of the future EMU countries agreed that monetary union would take place using the mutual central rates then in force in the ERM, which had been unchanged since Italy had returned to the fold at the end of 1996. Their decision meant that the exchange rate between the Finnish markkaa and the German Mark at the start of monetary union would be 3.04 markkaa per Mark, as set in 1996. However, the rate at which the markka would be converted into euros would not be settled until the end of 1998, because it would depend on the exchange rate of the ecu basket at that time.¹⁰¹⁵ This could not be precisely known earlier because the ecu basket contained the pound sterling and the Greek drachma, which were floating currencies. On the last day of 1998, when the pound and drachma rates were known, the conversion rate for the Finnish markkaa was set at 5.94573 markkaa per euro.

The European Central Bank was officially established on 1 June 1998, seven months before monetary union actually began. Its first six-member executive board had been appointed two weeks earlier. Governor Wim Duisenberg of the Dutch central bank became its chairman. The only female board member was governor Sirkka Hämäläinen who hailed from the Bank of Finland. During her five-year term she was to be most influential Finn of all time in European monetary policy.

MANAGEMENT CHOICES IN THE 1990S

After governor Hämäläinen had been appointed to the executive board of the European Central Bank, a new governor for the Bank of Finland had to be found. The supervisory council acted at the eleventh hour. At its meeting on Thursday 3 June 1998, council chairman Ilkka Kanerva announced that the ECB Council would convene for the first time on Monday and Tuesday of the following week and that it was unthinkable that the Bank of Finland would not be represented at the meeting by a plenipotentiary governor. An acting governor, even if one were sent, would not have a right to vote. A government plenary session was

scheduled for the following day, Friday 4 June, so the supervisory council had to make its proposal immediately, at a meeting beginning at eight in the morning. In fact the council could have chosen a new member for the board of management, too, but its chairman confined the discussion to the selection of a governor.

The council had to choose between two candidates who received an almost equal amount of support. The councillors of the National Coalition and the Centre parties backed Matti Vanhala, while those of the Social Democratic party and the Left alliance backed Dr. Jukka Pekkarinen. Vanhala's strengths were regarded as good international connections and great central banking expertise. His credibility had not been tarnished in the difficult years of the banking crisis and it was felt that his selection would best ensure continuity at the helm of the central bank. This was particularly important at a time when the only members left from the old board of management were Vanhala and Esko Ollila, of whom the latter would reach retirement age within a couple of years.

The competing candidate, Jukka Pekkarinen, was head of the Labour Institute for Economic Research at the time but had previously been working as a professor of economics. He had international experience and had worked at the OECD Secretariat in Paris. A sign of the confidence he enjoyed was that Prime minister Lipponen had earlier appointed him chairman of the "professors' group" studying the implications for Finland of EMU.

Between them, the National Coalition and Centre parties had a majority of seats on the supervisory council, which decided to propose Matti Vanhala by five votes to four. President Ahtisaari abided by the council's decision. Matti Vanhala was thereby appointed to take Finland into the euro system and to be the first governor of the Bank of Finland to exercise a vote on the ECB Council. Because the new governor hailed from the board of management, and the supervisory council made no proposal for a replacement, the size of the board of management fell to four members.

The number of board members had already begun to diminish when Sirkka Hämäläinen succeeded Rolf Kullberg in April 1992. The reason given for not replenishing the board at that time was that Ele Alenius was due to retire at the start of June in the same year. The supervisory council wanted to take its time to consider the ideal future

size of the Bank of Finland's board, so it allowed the board to shrink to five members.

The position on the board vacated by Alenius was smoothly filled because the supervisory council took the line that the only qualification was a grasp of central banking. In the same connection, governor Hämäläinen said she would like to see greater board expertise in international questions. She was not herself entirely at ease in this area, she said, so the board needed someone who was already well networked internationally. In the echelon of directors of the bank, international affairs had been the responsibility of Matti Vanhala, so his appointment to the board would ease the duties of the governor significantly. The supervisory council reached its decision to propose Vanhala for the board of management unanimously. Only one member, councillor Seppo Kääriäinen, said he would have liked a fuller discussion of the matter first, but even he expressed no reservations about appointing Vanhala.¹⁰¹⁶

Once Matti Vanhala had been elevated to the board of management, there was only one remaining person with the rank of director, Pentti Koivikko, who was in charge of administrative affairs and securities printing. No new directors were appointed after Vanhala's promotion and Koivikko was to be the final one. The composition of the board of management now remained unchanged for several years, until the start of July 1996 when Kalevi Sorsa retired. The supervisory council took up the question of Sorsa's successor in plenty of time, in March of that year, when it proposed unanimously that the vacancy should be filled by Matti Louekoski, the second deputy speaker of parliament. The position in question was clearly the mandate of the Social Democratic party on the central bank's board of management. No one in the supervisory council disputed this, so the selection proceeded amicably.¹⁰¹⁷

Matti Louekoski not only had the political credentials but also had a professional background suitable to the board of management and a degree in law. He was a long-serving member of parliament and had been a minister in four governments since 1971. His experience of banking came from his position on the board of the Workers' Savings Bank of Finland in 1979–1983. In parliament he had the reputation of being well informed about banking legislation, Finland's powerful occupational pension system and questions of banking supervision.¹⁰¹⁸

Changes in the position of the Bank of Finland in 1998 and forthcoming European monetary union did not mean that political parties in parliament lost interest in appointments to the central bank's board of management. This was clearly shown when Harri Holkeri, from the National Coalition party, announced his retirement from the board at the end of 1997. When the question of his replacement came up in the supervisory council, councillor Olavi Ala-Nissilä said that "it would be a good thing now and in the future for the board to consist both of so-called professional managers and of other competent people who have a specific social background". The three largest parties felt they were entitled to positions on the board. Council members representing the other parties believed in the same principle although they were not so explicit. In its debate, the council was especially concerned about how it could retain its role in the appointment process.

Members of parliament of the National Coalition party initially wanted to replace Holkeri on the board of management with Ilkka Kanerva, also from the National Coalition party and then chairman of the supervisory council. However, the party chairman, Finance minister Sauli Niinistö, was opposed to the idea. The National Coalition councillors then proposed Matti Korhonen, the managing director of the Forest Industries Association. Korhonen's background made him very suitable for the Bank of Finland. He had served as an economist in the Union Bank of Finland and Postbank, as a director of the Central Association of Employers, as a member of the board of Kansallis bank and as secretary of State for European affairs at the Prime minister's office during the government of Harri Holkeri. The president of the republic appointed Korhonen to the board of management of the Bank of Finland at the start of 1998.¹⁰¹⁹

Matti Vanhala was unable to fill the post of governor of the Bank of Finland for his full seven-year term and resigned because of severe illness at the start of April 2004. His successor as governor of the Bank of Finland was Erkki Liikanen, then a member of the European Commission who, before his two terms as a commissioner, had served as Finance minister in the Holkeri government and as ambassador to the EU in Brussels during Finland's membership negotiations. Liikanen's term as governor began on 12 July 2004.



■ Finland circulated the euro notes and coins on New Year's Day 2002 as one of the founding members area.
– Bank of Finland / Peter Mickelsson.

LOOKING FORWARD TO NEW CHALLENGES

When Finland entered monetary union and its central bank became a part of the Eurosystem which formulated and executed monetary policy for the euro area, the Bank of Finland's position changed in a way that had enormous significance. A national institution for determining monetary policy became part of a larger organisation and no longer had a separate policy; its main function was the implementation in Finland of decisions of the ECB Governing Council. The Bank of Finland now had the elements for an internal identity crisis at hand. Furthermore it was clear that, after the start of monetary union, there would be great uncertainty in Finnish society about the Bank of Finland's new role and identity.

Because the eurosystem was designed for centralised decision-making but decentralised operations, the immediate impact of monetary union on the everyday duties of the Bank of Finland was surprisingly little. The bank continued to issue currency in Finland. In implementing monetary policy, it remained the counterpart of Finnish banks; if they wanted to take part in Eurosystem money market auctions, by which euro area interest rates were steered, they dealt with the Bank of Finland as before. The Bank of Finland would still serve as a banker to banks in Finland, accepting their deposits, granting them credit for liquidity when necessary, mediating interbank payments, etc. The Bank of Finland would also continue to invest Finland's national foreign exchange reserves and manage them as previously, as well as investing for the European Central Bank the share of its reserves that the Bank of Finland had transferred to the ECB.

Because the operational duties of the central bank were in many

respects unchanged by monetary union, the most tangible difference would concern decision making, which would shift to the ECB council in Frankfurt. Within the council, the governor of the Bank of Finland was one of 17 members, equipped with the same right to vote as the other governors of national central banks and the six members of the ECB's executive board.

Naturally, decisions were prepared in a way that differed greatly from the era of national monetary policy. The main responsibility lay with the executive board but, in practice, the planning was done in a broad structure of committees involving all national central banks. Thirteen such committees were established at the initial stage. Such broad participation in the work of a large international organisation demanded entirely different working practices and competencies from operating in a national line organisation to which the Bank of Finland staff had previously been accustomed.

Although the bank's new practical responsibilities as an executor of monetary policy were clearly specified, there were plenty of question marks. The bank needed to be able to define its new role as a member of the Eurosystem on the one hand and within Finland on the other. How would it operate within the Eurosystem and how much influence could it wield? What objectives should it set itself in this respect? How should the Bank of Finland as the Finnish partner in the Eurosystem represent the whole system in Finland?

On his appointment as governor, Matti Vanhala had written on the prospects ahead and the opportunities for the Bank of Finland in *Pankko*, the in-house magazine: "When we are one of eleven in monetary union, the main change will be that, more distinctly than before, our influence will depend on our abilities and intellectual input. I find it an appealing perspective. It will give great power to those who are ready to make a personal investment in studying, understanding issues and coming up with new ideas." This meant a challenge to the Bank of Finland. "We will have to improve our capacity because the smaller the country, the greater the threshold it must clear in order to have an influence ... The research to be done must be excellent, not just by Finnish standards but on a European scale. We are well-prepared for this because we have a well-planned and managed research programme under way. We should not lower our targets. To strive for ambitious results will surely be a source of satisfaction for all."¹⁰²⁰

There were only 95 days left to the start of a common monetary policy when a seminar was held at the Bank of Finland, in September 1998, to present strategies for the years ahead. The preparations made in various bank departments had been wide-ranging and the strategy lines had been approved by the board of management in the preceding week.¹⁰²¹ They cemented the concept that the Bank of Finland would be an active and constructive member of the Eurosystem. The bank's objective was to be "an influential member of the European System of Central Banks and an active presence in Finland".

NOTES

Abbreviations used in the notes

BoF = Bank of Finland

BoFA = Bank of Finland archives

MFA = Ministry of Foreign Affairs of Finland

PSC = Bank of Finland's Parliamentary supervisory council

Statutes = Suomen Asetuskokoelma (Statute Book of Finland)

- 1 Tarkka, 1990, 89.
- 2 Meinander, 1964, 144.
- 3 Koivisto, 1989, 38.
- 4 Aunesluoma, 2011, 10.
- 5 Institute for Economic Research archives, Suviranta file, BoFA; Heikkinen – Tiuhonen, 2009, 178–286.
- 6 Teräs, 2005.
- 7 Institute for Economic Research archives, Suviranta file, BoFA.
- 8 Tudeer, Suomen Pankki 1937–1957 (The Bank of Finland 1937–1957, manuscript), BoFA; PSC minutes 9.3.1945, 20.3.1945, BoFA.
- 9 See e.g. Soikkanen, 1977.
- 10 Talvio, 2003, 127–128.
- 11 PSC minutes 14.11.1939, BoFA.
- 12 National Archives, Bruno Suviranta's archive, file 32.
- 13 Officials of the Bank of Finland 1811–1967, 1967, 193–220, SP; G.A. Myreen, Muistelmia vuodelta 1941 (Memoirs of 1941), BoFA.
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- 15 Auer, 1964, 253–257.
- 16 National Archives, Bruno Suviranta's archive, file 32.
- 17 Ibid.
- 18 Ibid.
- 19 Nars, 1966, 136.
- 20 BoF Yearbook 1939–1944.
- 21 PSC minutes 16.12.1940, BoFA.
- 22 Kalliala, 1950, 76–78.
- 23 Bank of Finland circulars to financial institutions 1940–1944, BoFA.
- 24 Junnila, 1946.
- 25 Tudeer, Suomen Pankki 1937–1957 (The Bank of Finland 1937–1957, manuscript), 104–106 BoFA; PSC minutes 2.10.1942, BoFA.
- 26 Wikström, 1985, 262–263.
- 27 Bank of Finland Yearbook 1938–1946.
- 28 PSC report for 1941–1944.
- 29 Bank of Finland statements 1937–1939; Sayers, 1976, 566–567 and 571–572.
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- 31 Seppinen, 1983, 25–37.
- 32 Knoellinger, 1941, 25.
- 33 Tamminen, 1947, 20.
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APPENDIX

MEMBERS OF THE PARLIAMENTARY SUPERVISORY COUNCIL OF THE BANK OF FINLAND, 1939–2011

Name	Party	Councillor	Chairman
Tanner, Väinö	SDP	1919–1945, 1951–1962	1933–1945
Kilpi, Eino	SDP	1930–1945	
Leppälä, Juhani	AL	1930–1951	
Frenckell, Erik von	SPP	1933–1945	
Helo, Johan	SDP	1937–1942	
Vesterinen, Vihtori	AL	1937–1954	1949–1954
Hackzell, Antti	NCP	1939–1945	
Pekkala, Mauno	SDP / PDL	1939–1952	1945–1948
Pilppula, Juho	AL	1939–1951	
Salmenoja, Johan	SDP	1942–1951	
Leikola, Erkki	NCP	1945–1951, 1954–1958	
Manninen, Hugo	PDL	1945–1951	
Peltonen, Onni	SDP	1945–1962	
Söderhjelm, Johan	SPP	1945–1962	
Aaltonen, Aimo	PDL	1951–1966	
Ahmavaara, Kauko	NCP	1951–1954	
Niukkanen, Juho	AL	1951–1954	1954
Murto, Yrjö	PDL	1952–1962	
Eskola, Kusti	AL	1953–1966	1954–1966
Korsimo, Arvo	AL	1954–1962	
Luukka, Eemi	AL	1954–1958	
Uoti, Olli J.	UWS	1958–1962	
Wiherheimo, Toivo	NCP	1958–1966	
Kinnunen, Toivo	AL / CP	1962–1966	
Kokkola, Veikko	SDP	1962–1970	1966–1970
Lehto, Oiva	PDL	1962–1970	
Paasio, Rafael	SDP	1962–1970	
Salo, Tuure	PP / LP	1962–1966	
Teir, Grels	SPP	1962–1966	
Junnila, Tuure	NCP	1966–1978, 1990–1991	
Kaasalainen, Nestori	CP	1966–1970	
Korsbäck, Verner	SPP	1966–1968	
Saarinen, Aarne	PDL	1966–1987	

Salonen, Olavi	SDP	1966–1971	
Uusitalo, Eino	CP	1966–1970	
Melin, Ingvar S.	SPP	1968–1975, 1976	
Hykkäälä, Heikki	SDP	1970–1975	
Ilaskivi, Raimo	NCP	1970	1970
Linnamo, Jussi	SDP	1970–1972	
Lintilä, Aaro	CP	1970–1975	
Rihtniemi, Juha	NCP	1970–1971	1970–1971
Vennamo, Veikko	RP	1970–1987	
Holkeri, Harri	NCP	1971–1978	1971–1978
Siltanen, Sylvi	SDP	1971–1975	
Sandelin, Valdemar	SDP	1972–1975	
Alenius, Ele	PDL	1975–1977	
Granvik, Ragnar	SPP	1975–1976	
Laine, Jermu	SDP	1975–1982	
Majjala, Matti	CP	1975–1991	
Pekkala, Ahti	CP	1975–1979	
Sorsa, Kalevi	SDP	1975, 1979–1982	
Sundqvist, Ulf	SDP	1975–1979	
Tiilikainen, Paavo	SDP	1975	
Väyrynen, Paavo	CP	1975, 1982–1983, 1988–1991, 1994–1995	
Björklund, Ilkka-Christian	PDL	1977–1982	
Salmenkivi, Antero	NCP	1978–1979	1978–1979
Jaatinen, Matti	NCP	1979–1987	1979–1987
Jokela, Mikko	CP	1979–1982, 1983–1987	
Miettinen, Mauri	NCP	1979–1990, 1991–1995	1987–1990
Liikanen, Erkki	SDP	1982–1987	
Loikkanen, Eino	CP	1982–1983	
Rosnell, Irma	PDL	1982–1983	
Helminen, Olli	SDP	1983–1987	
Luttinen, Matti	SDP	1983	
Työläjärvi, Pirkko	SDP	1983–1987	
Juhantalo, Kauko	CP	1987–1988	
Kalliomäki, Antti	SDP	1987–1991, 2007–2011	
Kanerva, Ilkka	NCP	1987, 1995–2006	1995–2003
Louekoski, Matti	SDP	1987	
Paasio, Pertti	SDP	1987–1988, 1996	
Perho, Heikki	NCP	1987–1991	
Pystynen, Erkki	NCP	1987–1991	1990–1991
Ranta, Jussi	SDP	1987–1997	
Westerlund, Henrik	SPP	1987–1991	
Hietala, Pertti	SDP	1988–1989	
Donner, Jörn	SPP	1991–1995	
Hämäläinen, Tuulikki	SDP	1991–1999	
Jäätteenmäki, Anneli	CP	1991–1994, 1995–2003	
Kääriäinen, Seppo	CP	1991–1993, 2007–2008	2007–2008
Mäki-Hakola, Pentti	NCP	1991–1995	1991–1995
Seppänen, Esko	LA	1991–1996	
Tenhiälä, Hannu	CP	1991–1993	

Viinanen, Iiro	NCP	1991	
Ala-Nissilä, Olavi	CP	1993–2006	2003–2006
Mattila, Kalevi	CP	1993	
Renko, Tellervo	CP	1993–1995	
Koskinen, Johannes	SDP	1995–1999	
Niinistö, Sauli	NCP	1995	1995
Pekkarinen, Mauri	CP	1995–2003	2003
Puhakka, Matti	SDP	1995–1996	
Sasi, Kimmo	NCP	1995–1999	
Vanhanen, Matti	CP	1995	
Korhonen, Martti	LA	1996–1999, 2003–2011	
Paasio, Pertti	SDP	1996	
Puisto, Virpa	SDP	1996–2003	
Kekkonen, Antero	SDP	1999–2003	
Tiuri, Martti	NCP	1999–2003	
Uotila, Kari	LA	1999–2003	
Zyskowitz, Ben	NCP	1999–2005, 2007–	2011–
Alho, Arja	SDP	2003–2007	
Andersson, Janina	GL	2003–2007	
Anttila, Sirkka-Liisa	CP	2003–2006	
Heinäluoma, Eero	SDP	2003–2005	
Kiviniemi, Mari	CP	2003–2005, 2006–2007, 2011–	2006–2007
Backman, Jouni	SDP	2005–2007, 2011–	
Kalli, Timo	CP	2005–2006, 2008–	2008–2011
Katainen, Jyrki	NCP	2005–2007	
Häkämies, Jyri	NCP	2006–2007	
Koski, Markku	CP	2006–2007	
Lankia, Eero	CP	2006–2007	
Jaakonsaari, Liisa	SDP	2007–2009	
Lintilä, Mika	CP	2007–2011	
Ravi, Pekka	NCP	2007–2011	
Saarela (Karpela), Tanja	CP	2007–2011	
Tiura, Marja	NCP	2007–2011	
Urpilainen, Jutta	SDP	2009–2011	
Matikainen-Kallström, Marjo	NCP	2011–	
Mäkipää, Lea	TF	2011–	
Ruohonen-Lerner, Pirkko	TF	2011–	
Vapaavuori, Jan	NCP	2011–	
Viitanen, Pirjo	SDP	2011–	

Political parties represented on the Parliamentary supervisory council

AL	Agrarian League until 1965,	Maalaisliitto,
CP	then Centre Party	Keskustapuolue, Suomen Keskusta
GL	Green League	Vihreä liitto
NCP	National Coalition Party	Kansallinen Kokoomus
PDL	Finnish People's Democratic League (incl. the Finnish Communist Party) until 1990,	Suomen kansan demokraattinen liitto (ml. Suomen kommunistinen puolue)
LA	then Left Alliance	Vasemmistoliitto

PP	People's Party of Finland until 1965,	Suomen Kansanpuolue,
LP	then Liberal People's Party.	Liberaalinen Kansanpuolue
RP	Finnish Rural Party until 1995,	Suomen Maaseudun puolue,
TF	then True Finns	Perussuomalaiset
SDP	Social Democratic Party	Suomen sosialidemokraattinen puolue
SPP	Swedish People's Party	Ruotsalainen Kansanpuolue
UWS	Social Democratic Union of Workers and Smallholders (leftist breakaway faction of the SDP, active in 1959–1973)	Työväen ja pienviljelijäin sosialidemok- raattinen liitto

MEMBERS OF THE BOARD OF MANAGEMENT OF THE BANK OF FINLAND AND ITS GOVERNORS 1939–2011

Name	Board member	Governor
Heurlin, Lauri af	1922–1942	
Ryti, Risto	1923–1940, 1944–1945	1923–1940, 1944–1945
Rangell, J. W.	1937–1945	1943–1944
Jutila, K. T.	1938–1958	
Kivialho, Kaaperi	1938–1954	
Raittinen, Paavo	1942–1953	
Tuomioja, Sakari	1945–1955	1945–1955
Kekkonen, Urho	1946–1956	
Waris, Klaus	1954–1967	1957–1967
Fieandt, Rainer von	1955–1957	1955–1957
Tervo, Penna	1955–1956	
Leinonen, Esko K.	1956–1970	
Simonen, Aarre	1957–1977	
Karjalainen, Ahti	1958–1983	1982–1983
Rossi, Reino	1958–1970	
Koivisto, Mauno	1968–1982	1968–1982
Valvanne, Heikki	1968–1974	
Lassila, Jaakko	1970–1973	
Hetemäki, Päiviö	1971–1978	
Kullberg, Rolf	1974–1992	1983–1992
Uusivirta, Pentti	1974–1990	
Alenius, Ele	1977–1992	
Holkeri, Harri	1978–1997	
Lindblom, Seppo	1982–1987	
Ollila, Esko	1983–2000	
Sorsa, Kalevi	1987–1996	
Punttila, Markku	1990–1991	
Hämäläinen, Sirkka	1991–1998	1992–1998
Louekoski, Matti	1996–2007	
Korhonen, Matti	1998–2000	
Salo, Sinikka	2000–2010	
Vanhala, Matti	1992–2004	1998–2004
Hakkarainen, Pentti	2002–	

Liikanen, Erkki	2004-	2004-
Honkapohja, Seppo	2008-	

Only permanent board members are listed here. Deputies are not included and leaves of absence are not recorded. (Penna Tervo was appointed to the board on 25.1.1955 but, as a member of the government, did not take up the position and died on 26.2.1956.)

NAME OF FINNISH BANKS AND BANK ASSOCIATIONS

appearing in this and the previous volume

Allied Bank of Finland	Suomen Liittopankki
Artisans Bank of Finland	Suomen Käsityöläis-Osakepankki
Bank for Foreign Trade	Osakepankki Ulkomaankauppa varten
Bank of Finnish Agriculture	Suomen Maatalous-Osake-Pankki
Bank of Finnish Farming and Industry	Suomen maanviljelys- ja teollisuuspankki
Bank of Helsinki	Helsingin Osakepankki
Bank of Southern Ostrobothnia	Etelä-Pohjanmaan Pankki
Bank of Tampere	Tampereen Osakepankki
Bank of Turku	Turun Osakepankki
Bank of Western Finland	Länsi-Suomen-Osakepankki
Central Bank of the Provinces	Maankuntain Keskus-Pankki
Central Lending Fund of the Cooperative Credit Societies	Osuuskassojen Keskuslainarahasto
Commercial Bank of Finland	Suomen Kauppapankki
Credit Bank	Luottopankki
Export Bank of Finland	Suomen Vientipankki
Farmers Bank	Landtmannabanken
Finnish Bankers' Association	Suomen Pankkiyhdistys
Finnish Town Mortgage Fund	Suomen Kaupunkien Hypoteekikassa
Helsinki Discount Bank	Helsingin Diskonttopankki
Helsinki Private Bank	Privatbanken
Industrial Bank of Finland	Suomen Teollisuuspankki
Industrial Mortgage Bank of Finland	Suomen Teollisuushypoteekkipankki
Kansallis Bank	Kansallis-Osake-Pankki
Mortgage Society of Finland	Suomen Hypoteekkiyhdistys
Nordic Bank for Trade and Industry	Pohjoismaiden Osakepankki Kauppaa ja Teollisuutta varten
Nykarleby Bank	Uudenkaarlepyyn Osakepankki
Nylands Bank	Uudenmaan Osakepankki
OKO, the Central Bank of Cooperative Banks	OKO - Osuuspankkien Keskuspankki
Post and Savings Bank	Postisäästöpankki
Postbank	Postipankki
Provincial Bank	Maakuntain Pankki
Real Estate Bank of Finland	Suomen Kiinteistöpankki
Residential Mortgage Bank of Finland	Suomen Asuntophoteekkipankki
Savings Banks Association	Säästöpankkiliitto
SKOP, the Central Bank of Finnish Savings Banks	SKOP - Säästöpankkien Keskus- Osake-Pankki

Union Bank of Finland
Nordic Union Bank
Union Bank of Finland
Vaasa Bank

Suomen Yhdys-Pankki (1862–1919)
Pohjoismaiden Yhdyspankki (1919–1975)
Suomen Yhdyspankki (1975–1995)
Vaasan Osakepankki

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