



BANK OF FINLAND

BULLETIN

1999 Vol. 73 No. 2

Monetary policy and economic outlook

Financial stability in Finland

The performance of the Finnish banking sector
in 1998 and the outlook for the next few years

Essential features of effective banking
supervision and legislation

Highlights of the economic agenda for
the Finnish Presidency of the European Union

Contents

Monetary policy and economic outlook	3
Financial stability in Finland	16
The performance of the Finnish banking sector in 1998 and the outlook for the next few years by Heikki Koskenkylä	24
Essential features of effective banking supervision and legislation by Liisa Halme	30
Highlights of the economic agenda for the Finnish Presidency of the European Union by Lasse Aarnio	34
Items: 1999 parliamentary elections Supplementary budget Ten markka commemorative coins in honour of Finland's EU presidency Publication of the Bank of Finland	38
Monetary policy instruments	40
Recent Bank of Finland research publications	42
Finland in brief	45
Visiting Scholars Programme	47
Balance sheet of the Bank of Finland	48
Charts	C1
Bank of Finland Organization	

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Editorial Board

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Editor-in-Chief

Matti Vanhala

Edited

by the Bank of Finland's
Publication and Language Services

Mailing address:
P.O.Box 160,
FIN-00101 HELSINKI

Phone:
National (09) 1831
International + 358 9 1831

E-mail:
Internet: publications@bof.fi

Telex: 121224 SPFBF1
Fax: + 358 9 174872
Cable: SUOMENPANKKI

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Risks to the world economy have become more evenly balanced

Growth prospects for the world economy have remained broadly unchanged over the past six months. The world economy is expected to grow by more than 2 per cent this year and by about 3 per cent in 2000. By contrast, growth prospects for the world's major economic regions in the current year have changed significantly. Growth forecasts for the United States and the Asian crisis countries have been revised upwards since the beginning of the year while those for Europe, Japan and Latin America have been revised downwards.

The uncertainties surrounding the forecasts for this year have become more evenly balanced in recent months. It is now possible that the world economy will grow faster than forecast this year whereas in the final months of 1998 it was judged that the balance of risks to global economic activity was on the downside. The US economy has continued to grow at a faster pace than forecast and indicators suggest that growth will remain robust, although some slowdown in comparison with last year does seem likely. Growth prospects for the Asian crisis countries have also improved and the effects of the Brazilian crisis have been less serious than first feared.

Economic policy has made an important contribution to the more stable developments in the world economy. Towards the end of 1998 monetary policy was eased in the United States and in several of the countries that were due to join the euro area at the turn of the year. In the course of this spring interest rates have been lowered further in Europe and Japan. Structural reforms initiated in the emerging economies and Japan have helped to increase confidence in the recovery of these economies. The steps taken to solve the banking crisis in Japan have been of vital

importance for the whole of Asia. The first evidence that confidence is being restored in the crisis countries has come in the form of a fall in interest rates, stronger exchange rates and a rise in share prices. In response to these encouraging signs, the confidence of consumers and firms has also begun to strengthen. Contributing to the recovery of the Brazilian economy has been the economic programme agreed with the IMF, which the Brazilian government is committed to implementing. By contrast, the situation in Russia is likely to remain difficult for a long time to come.

There is, as yet, no firm basis for the expected pick-up in global economic growth in 2000 and downside risks still exist. The US economy has been growing at an annual rate of nearly 4 per cent for the past three years and it is probable that growth will slow in the years ahead. The unemployment rate has fallen to a record low level while inflation has remained subdued. But despite the projected 'soft landing' for the US economy, the possibility of a sharp slowdown cannot be ruled out. The forecast pick-up in economic growth in Europe in 2000 rests to a large extent on the assumption of a general recovery in the global economy. Whilst lower interest rates and a weaker euro will help to underpin growth in the euro area countries, much will depend on how soundly based the incipient recovery in the Asian countries and Japan proves to be. Although it seems that the Japanese recession may have bottomed out, output is expected to fall further this year. The resumption of growth will depend to a large degree on consumer confidence. If confidence does not strengthen appreciably, Japanese economic growth could, at best, turn out to be very sluggish in 2000. In other Asian countries, the economic upturn seems to have started already, but there are still doubts as to its sustainability. In China, economic growth in 1998 was largely sustained by

highly expansionary fiscal policy, which is being continued in the current year.

The world economic recovery could turn out to be stronger than forecast. Expectations that the Brazilian and other Latin American economies could start growing again as early as the second half of this year are not totally unfounded. Capital inflows into the emerging economies are also picking up, albeit slowly. Stronger-than-forecast growth in Asia, Japan and Latin America would improve the growth prospects for Europe and reduce the risks of a sharp slowdown in the US economy. A precondition for the creation of a sustainable growth path in the crisis countries, as indeed in Europe, is successful economic policies and structural reforms. A number of reforms have been launched in recent years, but in most countries the pace of reform has so far been rather modest.

The problem is that a return to the growth path in Asia and Latin America depends on export-led growth and that an improvement in the growth outlook for Europe also rests to a large extent on a recovery in exports. Up till now the United States, thanks to its rapid economic growth, has been the main driving force of the world economy; it alone accounted for almost half of the growth in world trade in 1998. The counterpart to this has been a widening in the US current account deficit to a record high level and a sharp fall in the household saving rate, which, if it continues, will probably lead to a slowdown in growth. If growth does slow, part of the current account deficit will be corrected automatically through slower import growth, but at the same time world economic growth will become increasingly dependent on a recovery of domestic demand in Europe and Asia.

Size of the ECB's interest rate cut took the markets by surprise

The decision by the Governing Council of the European Central Bank in April to reduce the interest rate on its main financing operations by 50 basis points was based on the view that euro area inflation would remain safely below 2 per cent over the medium term. According to the Governing Council, the possibility of some slight upward movement in inflation in the short term – owing mainly to higher energy prices – did not pose a threat to price stability in the medium term. Moreover, analysis of other economic indicators

did not, in the Governing Council's view, reveal any risk to future price stability in the euro area.

Monetary growth has been fairly modest in the first months of 1999. The growth rate of the broad monetary aggregate M3 was 5.0 per cent in the period February–April (measured as the three-month moving average of 12-month growth rates). Given the uncertainties and special factors at work in financial markets concerning the inception of the euro area, the deviation from the reference value for M3 growth (4½ per cent) is very small.

The growth of credit aggregates is, however, somewhat worrying from the point of view of euro area inflation. According to latest available data, the total amount of credit has been increasing at an annual rate of about 7.5 per cent and credit to the private sector has been expanding at an even faster pace – 9.5 per cent on average in the first months of 1999. Another noteworthy feature is the existence of large cross-country differences in the growth of credit aggregates. A twofold division seems to be emerging between rapid credit growth countries (Ireland, Portugal, Spain, Netherlands, Finland, Luxembourg) and stable or slow credit growth countries. Most of the countries in the first group are characterized by interest rates which have fallen sharply over the past year, actual and prospective economic growth that are better than the euro area average and service prices that have risen faster than in the other euro area countries. Similarly, housing prices in the first group of countries have risen by more than the euro area average.

The size of the Governing Council's interest rate cut took the markets by surprise. The market view was that interest rates would be cut by 25 basis points, as was reflected in a fall in market interest rates prior to the interest rate decision. Following the Governing Council's decision, Euribor rates fell clearly. The size of the interest rate reduction also dispelled market expectations of a further interest rate cut. Recently, the three-month Euribor has moved in the vicinity of 2.6 per cent (Chart 1), which represents a fall of 65 basis points in all since the beginning of the year.

Long-term interest rates in the euro area have been broadly stable in the first five months of this year and at historically very low levels. The ECB's interest rate reduction led to only a slight fall in long-term interest rates, which steepened the slope of the euro area yield curve to some extent. Movements in long-term interest rate have been dominated mainly by fluctua-

tions in US bond yields. The differential between US bond yields and comparable yields in the euro area has nevertheless widened since the beginning of this year to a record level of almost 150 basis points. German ten-year bond yields are the lowest in Europe (4.1 per cent at end-May). Yield differentials within the euro area are small, amounting to no more than 30 basis points.

Cross-country differences in economic conditions in euro area countries pose a challenge to economic policy at national level. The ECB's current monetary policy is very loose from the point of view of many countries. Although the interest rate reduction was justified from the point of view of the euro area as a whole, monetary policy may now be too lax with regard to credit growth and inflation expectations in some countries, such as Portugal, Spain, Ireland and the Netherlands. Nor was the rate cut necessary as far as Finland was concerned. In countries where economic growth is rapid, the safeguarding of balanced development and price stability requires tight fiscal policy, moderate wage and cost developments and measures to address structural problems impeding growth and employment.

The euro has weakened against a background of sluggish economic activity in the euro area

In nominal effective terms, the euro has depreciated by 8 per cent since its launch. The euro has weakened most against the US dollar, the Canadian dollar and some Asian currencies. In contrast, movements in the euro have been less pronounced against many European currencies, such as the Swiss franc, the Norwegian krone and the Swedish krona. The depreciation of the euro is largely the result of the slowdown in economic growth in the euro area and the economic difficulties of the core euro area countries. The Kosovo conflict has been an additional factor more recently.

The weakening of the euro has improved the average price competitiveness of the euro area in relation to many competitor countries: measured by the BIS index, the euro's real effective exchange rate is now about 8 per cent below the average level for the 1990s (Chart 2). Improved competitiveness could provide added impetus to the recovery of euro area

Chart 1.

Euribor rates, daily values

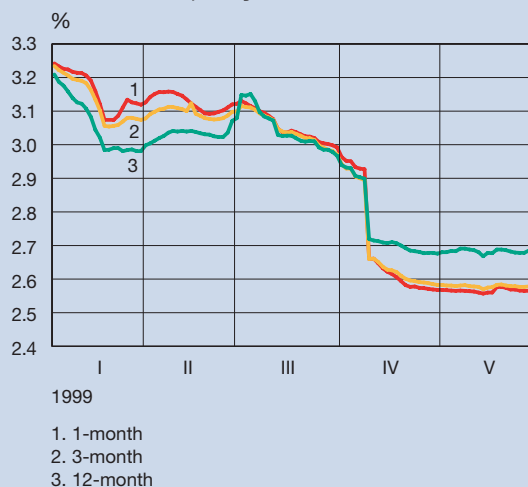


Chart 2.

Effective nominal exchange rate

Rising curve indicates currency appreciation
Index, 1990 = 100

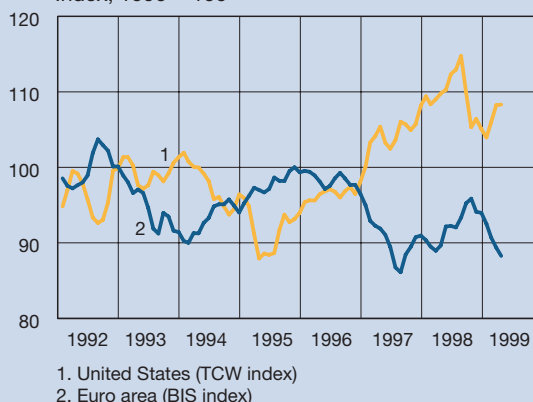
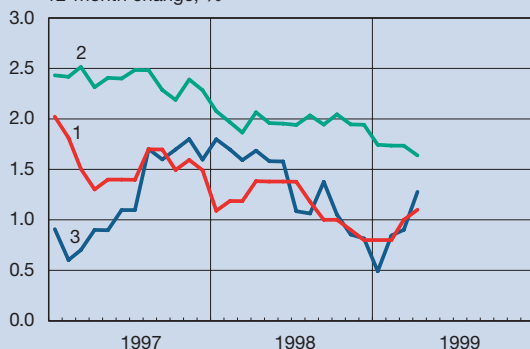


Chart 3.

Harmonized Index of Consumer Prices

12-month change, %



1. Total index for the euro area
2. Euro area services
3. Total index for Finland

exports and thus help to boost the growth of industrial production, in particular, in the course of 1999.

The depreciation of the euro has not been of quite as much significance for Finnish foreign trade as the structure of Finnish trade differs to some extent from that of the euro area as a whole. For example, the Swedish krona and Norwegian krone – against which the euro has weakened less – are of more importance for Finland than for euro area countries in general.

Inflation in the euro area is still very low

Inflation in the euro area picked up slightly in March from an annual rate of 0.8 per cent in each of the previous three months. The annual increase in the Harmonized Index of Consumer Prices (HICP) for the euro area rose to 1.0 per cent in March 1999 (Chart 3), partly because of a rise in the oil price. In April the rate of increase in consumer prices edged up to 1.1 per cent. Differences in inflation rates be-

tween euro area countries have been increasingly gradually since the second half of 1998. In April inflation in Spain and Portugal was faster than the ECB's quantitative definition of price stability for the euro area of below 2 per cent.

The rise in prices of services, which describes the domestic component of inflation in the euro area, slowed from an annual rate of about 2 per cent in 1998 to 1.6 per cent in April 1999. The slower rate of increase in prices of services was due to lower prices for telecommunications and transport services. The fall in prices in these sectors was largely related to deregulation and increased competition. Large differences nevertheless exist in the rates of increase in services prices across euro area countries. According to data for March, the downward trend in industrial producer prices continued in all euro area countries. Since then producer prices have begun to stabilize as a result of the higher oil price and the depreciation of the euro.

Finland's inflation rate has also remained relatively stable since the launch of the euro, at close to the average for the euro area. In April, however, the annual rise in prices, as measured by the HICP, accelerated to 1.3 per cent, that is slightly faster than the average rate for the euro area. The main factors behind the pick-up in inflation were a rise in rents and higher petrol prices. Services prices rose at a faster pace in Finland than in the euro area on average throughout 1998. Though the gap started to narrow towards the end of the year, the rate of increase was still nearly one percentage point faster than the euro area average in April 1999. Consumers' inflation expectations remained stable in the first quarter of this year but increased slightly in April, when consumers expected prices to rise by 1.6 per cent over the next twelve months.

The main factors contributing to a pick-up in inflation in the euro area over the months ahead will be the higher oil price and a rise in import prices as a consequence of the depreciation of the euro. Other potential risks to inflation are a rise in asset prices and higher unit labour costs. In the longer term, mergers and acquisitions, deregulation and sharpening competition associated with ongoing integration in the single market will have a dampening effect on inflationary pressures. The single currency and single monetary policy will give added impetus to this development.

Growth prospects in the euro area are heavily dependent on consumer demand

In 1998 the pace of economic growth in the euro area accelerated to 2.9 per cent from 2.5 per cent in the previous year. Economic activity slowed markedly in the second half of the year, however, as the rate of growth of exports and investment weakened. Another factor contributing to the slowing of economic growth in the euro area was inventory adjustment by firms towards the end of 1998. In contrast, the growth of private consumption remained strong in the second half of 1998. The slowdown in the growth of GDP has continued in the current year, largely because of weak export demand and global oversupply. The decline in industrial production and continued inventory adjustment in the early months of this year were, however, largely expected and consistent with earlier indicator data. For example, the industrial confidence indicator for the euro area has declined almost continuously since summer 1998. However, preliminary signs of a turnaround in industrial production have begun to appear in some euro area countries. If this development is sustained, the rate of growth in the

euro area should pick up again in the second half of this year.

The weak growth of industrial production in the euro area has been offset by the robust growth of private consumption and a recovery in construction activity. Both consumer confidence and construction confidence have risen to levels well above their long-term averages, which points to the continued strong growth of domestic demand in the current year. Underpinning consumer and construction confidence are low interest rates, a rise in real incomes and a fall in the unemployment rate. Admittedly, the downward trend in the unemployment rate has slowed in recent months along with the weaker performance of industrial production and exports.

The fall in interest rates, depreciation of the euro and more stable conditions in the international environment have improved the growth prospects for the euro area in the short term. Indeed, it is likely that the continuing very positive expectations of consumers in the euro area will help to sustain the growth of private consumption and intra-euro area trade until exports and industrial production start to expand along with the recovery in the world economy towards the end of the year. Provided the downside risks to the

Divergent trends in the growth of monetary and credit aggregates

The growth of the money stock in the euro area has been fairly stable in recent months and the annual rate of increase in the broad monetary aggregate M3 has been close to its reference value of 4½ per cent. In January the twelve-month growth rate of M3 ac-

celerated slightly as a result of an increase in liquid deposits in the euro area. The surge in the growth of liquid deposits was, however, due mainly to special factors related to the launch of Stage Three of EMU. In the February–March period the growth rates of these items slowed considerably.

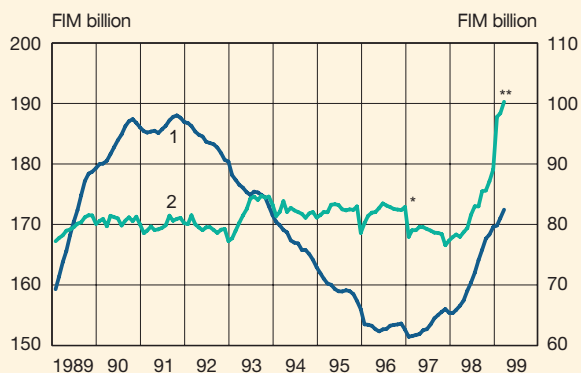
In Finland the rate of growth of the items included in the monetary aggregates for the euro area has been noticeably slower than the average for the euro area. The annual growth rate of the items included in the broad monetary aggregate has fluctuated on either side of zero in Finland during the past few months. This aggregate has typically displayed wide fluctuations in Finland owing to variations in holdings of certificates of deposit by the public.

Although the growth of the items included in the monetary aggregates has been quite slow in Finland for a long time now, the latest figures provide some evidence that the growth rate of these items is gradually starting to increase in Finland as well. In the

Finnish items included in the euro area monetary aggregates

12-month percentage change	April	March	February	January
Items included in M1	4.0	5.0	3.9	4.0
Items included in M2	5.7	5.6	6.2	3.8
Items included in M3	0.6	-1.3	1.7	0.3
<i>Euro area M3*</i>	4.9	5.1	5.1	5.4

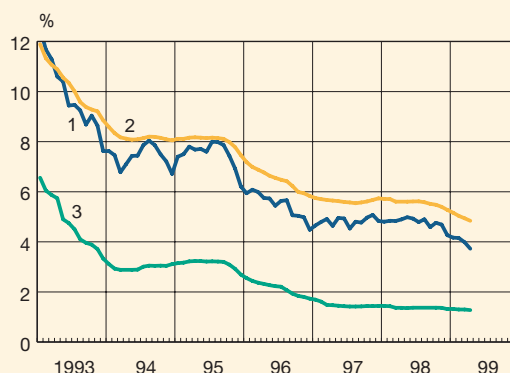
*The three-month moving average for the annual rate of increase in M3 in the period February–April 1999 was 5.0 per cent.

Chart 4a.**Finnish banks: stock of lending**

1. Stock of lending to households (left-hand scale)
2. Stock of lending to companies (right-hand scale)

* As from the beginning of 1997 excludes items treated as investment assets.

** As from the beginning of 1999 includes re-classified foreign currency-denominated lending.

Chart 4b.**Finnish banks: lending and deposit rates**

1. Rate on new lending
2. Average lending rate
3. Average deposit rate

early months of this year the annual growth rate of the items included in M2, mainly deposits held by the public, increased to about 5 per cent from 2 per cent last autumn.

The growth of credit aggregates in Finland differs considerably from the growth of monetary aggregates. The annual growth rate of credit increased to 12–13 per cent in the first months of this year, which is faster than the euro area average.

In recent months there has been a rapid expansion in bank lending to companies, in particular (Chart 4a). In March the annual growth rate of corporate lending increased to almost 20 per cent. This surge in lending can be considered surprising given the fact that, at the same time, industrial confidence indicators have been falling and there are no indications of strong investment growth. Part of the increase in corporate lending can be attributed to a further shift in the focus of economic growth towards the domestic sector of the economy. Firms in this sector have tended to rely more heavily than export firms on loans from domestic banks. Moreover, interest rates on bank loans to companies have fallen to very low levels (Chart 4b), which has increased demand for them. There has also been a clear re-

duction in firms' recourse to other sources of financing, such as TEL loans.

Housing loans are another component of the credit stock that continues to grow at a rapid pace. The annual rate of growth in housing loans increased to 15 per cent in April. After a quiet period at the turn of the year, new housing loans reached a record level of FIM 4.5 billion in April. Underlying the rapid growth in the stock of housing loans are low interest rates, strong demand for housing and a rise in housing prices. Banks' balance sheets do not reveal a corresponding increase in consumer loans but it is worth noting that finance companies provide a significant proportion of such loans.

Although the pace of credit growth has been rapid during the past six months and seems to be accelerating, the credit stock is still considerably smaller than it was at the beginning of the 1990s. Therefore part of the rapid rate of credit growth represents a return of the credit stock towards previous levels after a very large contraction. A substantial increase in lending against a background of low interest rates and relatively rapid economic growth nevertheless carries the risk that asset prices, and housing prices in particular, will rise further.

world economy do not materialize, the slowdown in growth in the euro area should be fairly short-lived, and economic growth is forecast to return to close to its long-term trend rate in 2000.

Favourable outlook for the Finnish economy over the next few years

According to the Bank of Finland's forecast, the prospects for the Finnish economy over the next few years are favourable. Among the key factors underlying this positive outlook are low interest rates, good competitiveness and the fiscal policy guidelines laid down in the Government's programme for the Government's entire four-year term. The economy is forecast to grow at a steady rate of more than 3 per cent a year over the forecast horizon, which, although slower than in recent years, is faster than the average for the euro area (Table and Chart 5). Inflation is forecast to accelerate slightly towards the end of 1999 and in the following two years. No threat to price stability is foreseen over the forecast horizon. Subdued inflation is, however, conditioned on wage and cost developments, on the one hand, and import prices, on the other. For both the risks to inflation are slightly on the upside in the years ahead.

In assessing the prospects for growth and inflation it should be noted that they are based on the central forecast, which assumes no change in monetary policy, ie the short-term interest rate and exchange rates are kept unchanged throughout the forecast period. The short-term interest rate is assumed to remain at the level to which it fell following the ECB's most recent interest rate decision (8 April 1999) while exchange rates are fixed throughout the forecast period at the levels prevailing in early April. The forecast figures are also conditioned on assumptions concerning the international economic environment, prices of oil and other world commodities and fiscal policy.

The Finnish economy has grown at an exceptionally rapid pace for the past five years, which is partly due to recovery from the severe recession at the beginning of the 1990s. The forecast of steady growth of more than 3 per cent a year over the three-year forecast period represents a return to close to the economy's long-term potential growth path and a narrowing in the difference in growth rates vis-à-vis the euro area as a whole. Strong domestic demand is

forecast to be the driving force of growth in the current year, given the generally modest outlook for the global economy and slack demand in Finnish export markets. Finland's traditional export industries suffered from the consequences of the Asian and Russian crises in the second half of 1998, and these will continue to have a dampening effect on exports and industrial investment in the current year. However, productive investment in non-industrial sectors is forecast to remain brisk this year.

In contrast to other industrial sectors, the telecommunications and electronic industries are set to continue growing rapidly throughout the forecast period. Export markets are expected to start recovering towards the end of the year, and this will gradually lead to a pick-up in activity in other industrial sectors as well in the latter part of the year. Hence the growth of the Finnish economy over the next few years will be driven by both domestic demand and exports. The growth of private consumption is forecast to slow somewhat from this year's level since the fall in the saving rate is likely to come to halt in 2000. If, however, the saving rate continues to fall, the growth of private consumption and therefore of gross domestic product could be slightly faster over the next few years than is now forecast. Activity in the housing market, where there has been some overheating, fuelled by strong credit demand, is forecast to level off.

The current low inflation rate is partly a consequence of the fallout from the Asian economic and financial crises, as reflected, for example, in lower world market prices of oil and other commodities. These prices are expected to turn up slightly as the world economy recovers. In fact, the price of oil has already risen sharply, partly as a result of OPEC's decision to scale back production. Inflation is nonetheless expected to be subdued over the next few years, although inflationary pressures are likely to increase towards the end of the forecast horizon as import prices rise. Inflation is forecast to accelerate from 1 per cent in the current year to about 2 per cent in 2001. The projected rise in prices depends very much on developments in import prices, future pay settlements and wage drift. It is assumed in the forecast that the current moderate wage developments will continue after the next pay settlements have been concluded. Unit labour costs are nevertheless projected to rise by nearly 3 per cent a year over the forecast horizon (Chart 6).

Table.

Demand and supply 1997–2001 (1995 prices)

	1997	1998	1999	2000	2001
Percentage changes on a year earlier					
Gross domestic product (market prices)	5.5	4.7	3.2	3.3	3.4
Imports	11.4	8.9	3.5	6.5	6.6
Exports	14.2	8.3	3.1	5.5	5.9
Private consumption	2.6	4.5	3.8	3.4	3.2
Government consumption	2.9	0.4	0.3	1.0	0.6
Private fixed investment	14.4	8.3	6.3	7.8	8.4
Public investment	11.8	-1.6	-7.4	-1.0	0.2
Change in inventories and statistical discrepancy, contribution to change in total demand in the previous year	-0.7	0.2	0.2	0.0	0.0
Total demand	6.8	5.7	3.3	4.1	4.2
Final domestic demand	3.8	4.5	3.4	3.5	3.5
Key economic indicators and assumptions of the forecast					
Percentage change					
Consumer prices	1.2	1.4	0.9	1.7	2.2
Unit labour costs	-0.8	2.6	1.9	3.0	2.9
Number of employed	3.5	2.4	2.6	1.6	1.9
Employment rate, 15–64 year-olds, %	62.8	64.1	65.6	66.5	67.6
Unemployment rate, %	12.6	11.4	10.3	9.3	8.5
Per cent of GDP (National Accounts)					
Central government net lending	-4.1	-1.6	-0.2	0.0	0.6
General government net lending	-1.6	1.4	2.8	3.6	4.5
Central government debt	66.4	62.2	59.6	56.1	51.8
General government debt	54.2	49.1	47.1	44.3	40.7
Trade account	9.5	9.7	9.2	9.2	9.3
Current account	5.6	5.8	5.4	5.4	5.6
Finnish export markets, percentage change	8.2	5.9	4.2	5.2	5.8
Finnish import prices, percentage change	0.6	-2.4	-3.7	1.7	2.4
3-month Euribor, %	3.2	3.6	2.8	2.6	2.6
Overall ratio of taxes to GDP, %	46.1	46.8	47.0	46.6	46.1

The assumption of continuing moderate wage developments stems from the fact that under a single monetary policy excessive wage increases lead to weaker employment rather than higher prices. Since lost profitability and competitiveness can no longer be made good by exchange rate changes, pay settlements have a key role to play in efforts to secure good growth performance, higher employment and price stability. Greater flexibility in wages over the economic cycle and at sectoral and local level, as too in terms and conditions of employment, would make it easier to adjust to economic disturbances and situations where the single monetary policy is not optimal from Finland's point of view.

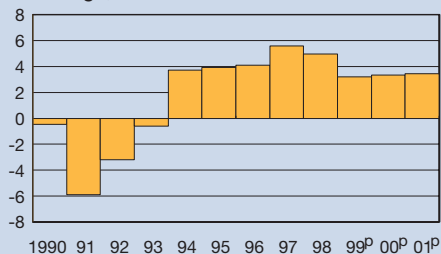
Another potential upside risk to inflation in the forecast period is a pick-up in the growth of demand for housing and loans fuelled by heavy migration and low interest rates. This could lead to a notably faster-than-forecast rise in housing prices in the greater Helsinki area and other growth centres. In recent months the lending stock has been growing faster in Finland than in the euro area on average. This partly reflects the end of the process of debt adjustment in the post-recession period and the release of pent-up demand. If the growth of lending increases further from the current rate of about 13 per cent, it will not be possible to avoid the risks associated with excessive credit expansion. As the single monetary policy

Chart 5.

Key economic indicators for Finland

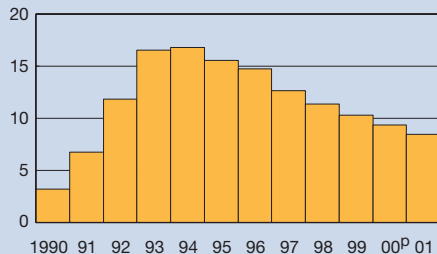
Gross domestic product

Change, %



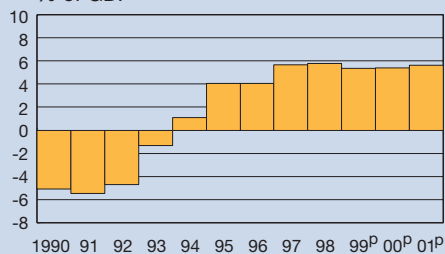
Unemployment rate

%



Current account

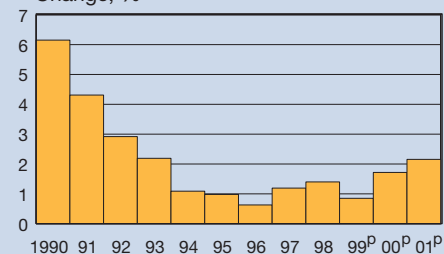
% of GDP



Inflation

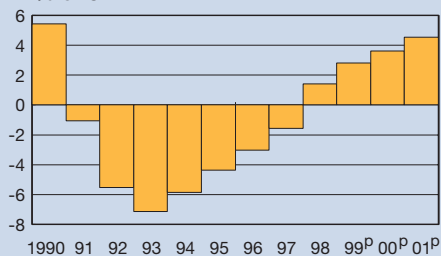
Consumer Price Index

Change, %



General government fiscal position (EMU)

% of GDP



General government debt (EMU)

% of GDP

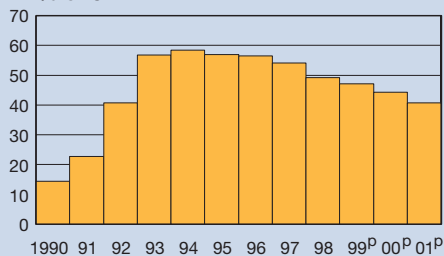


Chart 6.

Import prices and unit labour costs

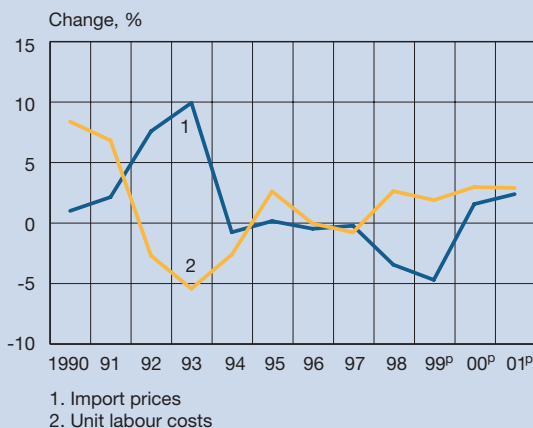
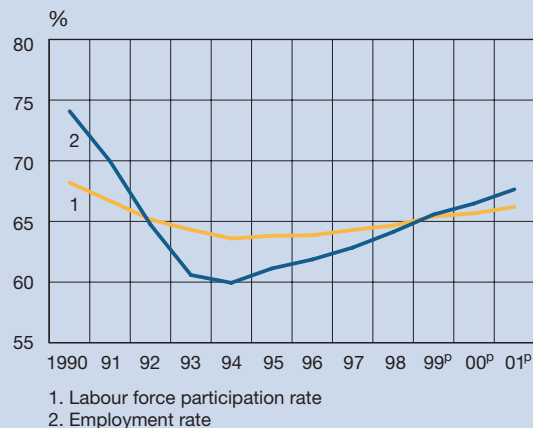


Chart 7.

Labour force participation rate and employment rate



is not framed in response to the price stability needs of individual euro area countries, the risk management and lending policies of banks and other financial institutions bear a major responsibility at national level for seeing that lending does not grow too quickly and become too risky.

The number of employed is forecast to rise by about 2 per cent a year and the labour force participation rate by about half a percentage point a year in the three-year period 1999–2001. The unemployment rate is projected to fall to 8.5 per cent and the employment rate to rise to 66 per cent in 2001 (Chart 7). Though this favourable performance can be largely attributed to robust growth, especially in the labour-intensive services and construction sectors, it also due to the reforms effected in recent years to address the problem of the unemployment trap and to increase incentives to work. If the favourable developments in employment and balanced economic growth are to continue over the next few years without the emergence of bottlenecks in the labour market, it is essential to carry on implementing reforms along the lines set out in the Government's programme.

Raising the employment rate to close to the Government's target of 70 per cent by the end of its four-year term would require the creation of some 50,000 new jobs per year in the period 1999–2003. This is a very ambitious target, which will not be possible to achieve through economic growth alone. Rather, structural measures affecting both the supply of and demand for labour are needed. In particular, it is necessary to move ahead purposefully with the reform of taxation, social security benefits and charges for public services so that they offer greater incentives than at present and are conducive to job creation. Similarly, reforms aimed at improving the functioning of goods and financial markets have a positive effect on employment and increase the flexibility of the economy and its ability to adjust to the challenges brought by globalization.

In addition to the overall functioning of the labour market, it is particularly important to make it easier for older workers to remain in work and improve the opportunities of the long-term unemployed and special groups to find jobs. The employment rate for the population in the 30–50 years age group is about 80 per cent but it drops below 20 per cent as the retirement age draws near. The situation is perhaps even more difficult as regards the unemploy-

ment rate. In particular, variations in the unemployment rate for people in the 50–60 years age group point to structural problems. Measures aimed at taxation and benefits need to be accompanied by training and housing policy initiatives designed to reduce constraints on the occupational and regional mobility of labour. Labour mobility, increasing internal migration and a changing industrial structure also place heavy demands on housing and industrial policy for action to prevent excessive disparities in regional development from leading to major economic and social problems in the future.

Fiscal policy objectives within reach

The general government fiscal position moved into surplus in 1998 and is expected to strengthen further in the years ahead. In 2001 the general government surplus is projected to increase to over 4 per cent of GDP, provided the economy grows as forecast, taxation is eased in line with the moderate reductions envisaged in the Government's programme and the ceilings set for central government spending are strictly adhered to. The ratio of general government debt to GDP is projected to fall to close to 40 per cent in 2001. In central government finances, the deficit, which amounted to 1.6 per cent of GDP in 1998, is projected to turn into a surplus at the end of the forecast period. If central government expenditure can be kept within its ceilings, a virtuous circle is likely emerge in central government finances, which will draw added strength from lower effective interest rates on central government debt. In contrast, the fiscal position of the local government sector is expected to remain weak, thus limiting the scope for investment by local authorities and their ability to adjust to the cost pressures caused by migration.

Provided the economy grows as forecast, the consolidation of central government finances (Chart 8) can only occur if, as is assumed in the forecast, central government spending, excluding interest expenditure, does not increase in real terms and tax cuts are moderate. In spite of a modest easing in taxation of wage and salary earnings, the ratio of overall taxes to GDP will fall hardly at all over the forecast horizon since it is assumed that income tax cuts will be partly financed by tightening other taxes in accordance with the Government's programme.

From the employment point of view, the planned easing in income taxation is a step in the right direction. However, it will result in only a relatively modest reduction in the tax burden on work, and hence it alone will not make a significant contribution to improving employment. The only way that larger income tax cuts can be implemented and have a greater impact on employment without jeopardizing the central government fiscal position is if they are matched by a reduction in central government spending. Increases in other taxes should be avoided so that the ratio of overall taxes to GDP can gradually be brought down closer to the level prevailing in other EU countries. Raising capital, corporate and interest income taxes is not desirable as the tax base could shrink as firms – and possibly also jobs – relocate abroad as a consequence of international tax competition and globalization.

The Bank of Finland's forecast for general government finances is in line with the expenditure ceilings set by the Government on 4 May on the basis of the fiscal policy guidelines laid down in the Government's programme. In assessing fiscal policy, it is useful to consider the spending ceilings exclusive of interest payments on central government debt. The spending ceiling on primary expenditure for 2000 is about FIM 165 billion and rises by FIM 3 billion in nominal terms up to 2003.

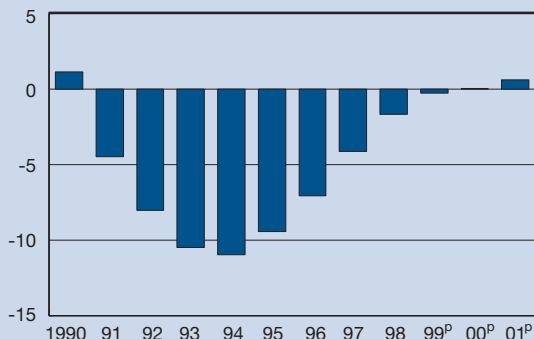
The spending limits are quite tight, but only from 2001 onwards. Central government primary expenditure is set to grow by 4 per cent in nominal terms in 2000 but by 1 per cent or considerably less in the other years. Given the prospect of continuing rapid growth over the next few years and the expansionary stance of economic policy owing to low interest rates, it would have been better to set a more stringent ceiling for spending in 2000 so as to allow more leeway in central government finances in future years in the event that economic growth slows down. It is crucial for the consolidation of the central government fiscal position that the Government's fiscal policy guidelines are adhered to.

The risks of the forecast for the general government fiscal position relate to developments in central and local government consumption expenditure and corporate tax revenue. For example, a rise in wage costs in the public sector could generate pressures for higher-than-forecast consumption expenditure. Keeping spending within the ceilings will require

Chart 8.

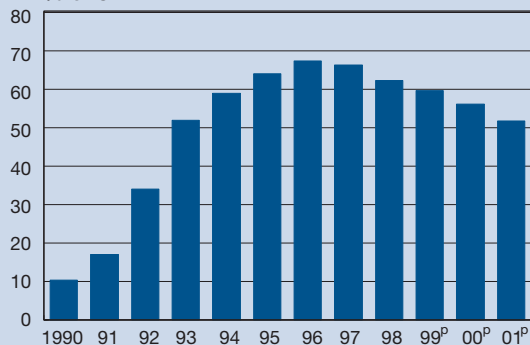
Central government fiscal balance

% of GDP



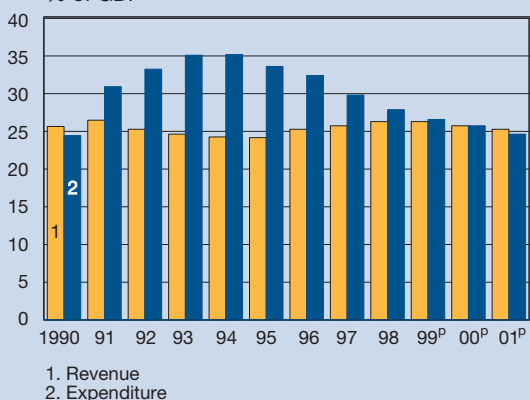
Central government debt

% of GDP



Central government revenue and expenditure

% of GDP



continued discipline with regard to costs and improved productivity and cost-effectiveness, especially in the provision of services and public administration. Company profits could turn out to be weaker than expected, in which case corporate tax receipts would be lower than forecast. This would complicate the situation of local authorities, in particular.

According to the forecast, the ratio of central government debt to GDP will fall to about 52 per cent in 2001. Though a drop of some ten percentage points in the debt-to-GDP ratio in the space of three years is a good performance as such, the level of debt is nevertheless still relatively high. Interest payments on debt are estimated to amount to FIM 27 billion in 2001, which is only some FIM 2–3 billion less than the ceiling on spending by the Ministry of Education. Therefore there is still a need to increase room for manoeuvre in fiscal policy by running down debt and reducing interest payments.

It is assumed in the forecast that the proceeds from the privatization of state-owned companies will be used to pay back central government debt. Without this revenue, the ratio of central government debt to GDP is about a percentage point higher than the forecast for 2001. However, it is assumed that the pace of privatization will be slower than in 1998 in terms of proceeds. If growth continues and the Government manages to keep spending within limits, central government debt is likely to fall below 50 per cent of GDP by the end of the Government's four-year term, in line with the Government's target.

Restraint needed if maximum benefit is to be secured from low interest rates

The ECB has to formulate monetary policy from the point of view of the euro area as a whole. Seen against this background, the decision of the Governing Council of the ECB to cut the interest rate on its main refinancing operations was well founded. In countries where economic conditions are stronger than the euro area on average, the interest rate cut is not, of course, conducive to the continuation of balanced economic development. Instead, other economic policy measures are needed at national level. Although lower interest rates may not lead to a rapid pick-up in national inflation, imbalances could emerge in the form

of a rise in asset prices, excessive credit expansion and pay increases that endanger an improvement in employment. Some countries, including Finland, face the risk of such development.

Although the forecast slowdown in economic activity in Finland will bring the growth rate closer to the average for the euro area, the Finnish economy will nevertheless continue to grow at a rapid pace over the next eighteen months or so. Whilst there is no threat to price stability in Finland in the near term, there is a risk that low interest rates, together with the prospect of continuing robust growth and a rise in import prices, could lead to an increase in inflation expectations accompanied by upward pressures on prices and wages. As price inflation in Finland cannot diverge significantly from developments in the rest of the euro area, such pressures would before long lead to a loss in competitiveness and a weakening in employment.

In the economic policy debate prior to the transition to monetary union, there was widespread agreement that in a single currency zone other areas of economic policy must be able to respond when developments in an individual country diverge from those in the monetary union as a whole. Finland can benefit from the low level of interest rates that monetary union has brought, and which in the present circumstances is good for the euro area as whole, if fiscal policy is kept tight and wage developments and the growth of lending remain moderate.

9 June 1999

■ **Key words: inflation, monetary policy, economic situation**

Following the disturbances last autumn, calm has returned to global financial markets as the contagion effects of the crises have been minimized. Given the poorer growth prospects – and with last autumn’s turmoil still fresh in the memory – caution and preparation for weaker economic developments and negative shocks are still the order of the day. On the other hand, the stable outlook for interest rates in the euro area is helping to bolster confidence in European financial markets.

Efforts to avert potential threats in global financial markets

One potential threat to global financial stability is the possibility of a sharp drop in US share prices. Realization of this threat would probably put downward pressure on share prices in other countries and cause unrest in financial markets. Because of the low saving rate in the United States, even a gradual decline in share prices might slow the pace of real economic activity, with adverse effects on other countries. For the moment however, US consumer demand remains firm.

The uncertainty caused by Japan’s still cloudy outlook is keeping investors nervous. Nonetheless, the Japanese economy is not expected to decline further and there are even some tentative signs of recovery. Furthermore, in many of the Southeast Asian countries economic conditions have improved.

Once again, the International Monetary Fund (IMF) has helped to prevent Russia’s economic difficulties from developing into a full-blown financial crisis. This is giving creditors additional time to prepare for a probable debt restructuring. The Kosovo crisis has so far been reflected mainly in occasional pressure on the exchange rate of the euro.

The recent financial crises have reinforced ‘herd-ing behaviour’, whereby instability spreads from

country to country more quickly than before via the expectations mechanism. In the search for maximum returns, investors often commit funds for only very short periods of time by accepting high levels of risk but withdraw at the very first sign of trouble. When investors pull out of one country, they trigger simultaneous and similar reactions in other countries, even though there are no obvious direct linkages between the situations in these countries.

Part of the reason for the strengthening of herd-ing behaviour could be the recent discussion on growing private sector involvement in crisis management, alongside public and international bodies. Crises and threats of crises have spurred international efforts to develop financial regulation and supervision, eg in respect of owner protection and operating procedures related to the infrastructure of the financial system.

Micro-regulation was highly developed long before the recent international crises. The crises served to further highlight the importance of transparency and market discipline. Regulation and supervision are being developed in several international fora, one such example being the Basle Committee on Banking Supervision (BCBS), which operates under the aegis of the Bank for International Settlements. In 1988 the committee issued recommendations on banks’ basic capital requirements and in 1997 it put forward basic principles for the organization of banking supervision in member countries.¹ Quite recently, the committee has published a new proposal on banks’ capital requirements.

In February the G7 countries established the Financial Stability Forum, under whose auspices representatives from regulatory and supervisory authorities and international organizations will meet regularly and hold global conferences twice a year. The

¹ *Core Principles for Effective Banking Supervision.*

first meeting was held in April in connection with a meeting of the IMF's Interim Committee.

In the euro area the pace of structural change in the financial markets is accelerating

A milestone in the development of European financial markets was reached at the start of this year with the onset of Stage Three of Economic and Monetary Union. Financial markets in the euro area had, however, already achieved a high level of stability before this. Long-term interest rates in the euro area have – more clearly than in the United States – remained at a relatively low level, despite their recent slight upward movement (Chart 1).

The adoption of the euro is providing added momentum to the structural change in European financial markets that has been in progress for several years and is, at the same time, heightening competition.² Besides the single currency, the key factors making for change are dismantling of financial regulations, financial innovations, developments in information technology and an expanding range of investment outlets. The volume of cross-border transactions can be expected to grow in the euro area because the elimination of national currencies reduces risks and costs to providers and users of financial services.

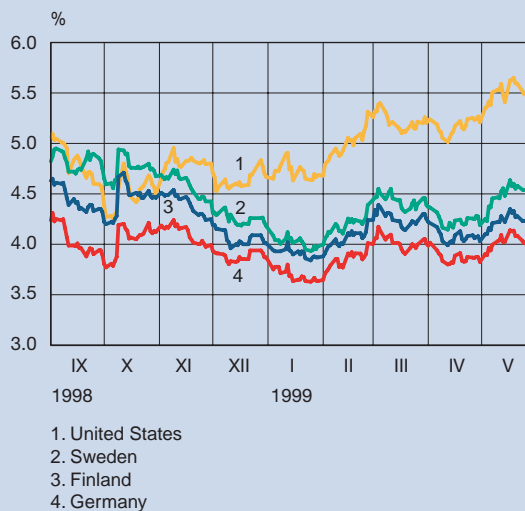
Some non-banks, such as retailers and insurance companies, have shown an interest in pursuing certain traditional banking activities. Banks likewise are expanding their product ranges in an effort to boost earnings and cover costs of service networks. The structure of banks' income is shifting away from interest earnings to greater emphasis on fees and other income sources. Banks, exchanges and other financial institutions are also preparing for tighter competition via mergers, acquisitions and alliances (see box).

In the wholesale financial markets, structural change has been going on for some years and much progress has been made. The high degree of homogeneity of the instruments traded increases the effects of economies of scale. In time, wholesale activities in the euro area may become concentrated in a few financial centres and in the largest banks, although

² See eg the article *Banking in the euro area: structural features and trends*, ECB Monthly Bulletin, April 1999.

Chart 1.

Yields on ten-year government bonds



so far mergers of financial institutions have been largely confined to the national level. Future development will also be clearly affected by the fact that risks are greater for banks whose activities are concentrated in a single country than for those that operate in wider areas. The strength of macro shocks could well vary across regions within the euro area.

In the euro environment, issuers of debt and equity have access to broad and liquid markets. As this means lower costs of raising capital, it is expected that corporate debt issuance will increase fairly rapidly at the expense of bank lending and thus the trend towards securitization will strengthen.

Retail banking, by contrast, could remain in the hands of domestic and local financial institutions for a long time to come. The marketing particularly of products that are less homogeneous and that require more individually tailored services demands knowledge of local conditions and a concern for the special needs of the customer. For this reason, scale economies are less significant than in the wholesale banking sector. Similarly, the markets for retail services are still highly segmented because of tax, legislative and cultural factors and differences in business practices.

Recent European bank mergers and planned mergers

Euro area

Belgium

Kreditbank and CERA Bank merged in summer 1998, and a Belgian-Dutch merger between General Bank and Fortis, announced in 1998, is now in progress.

Spain

In 1999 Banco Santander and Banco Central Hispanoamericano announced their intention to merge. Approval has been attained and the merger is now under way.

Netherlands

ING Bank acquired the Belgian Banque Bruxelles Lambert at the beginning of 1998.

Italy

In autumn 1998 three new banks were created via mergers. Credito Italiano and Unicredito merged in October 1998. The other two mergers were between Istituto Mobiliare Italiano (IMI) and Sanpaolo Bank and between Banca Nazionale delle Assicurazioni and Banca Nazionale del Lavoro. In spring 1999 two more large mergers were announced. UniCredito Italiano, established in autumn 1998, made a merger offer to Banca Commerciale Italiano (BCI). In another merger plan, San Paolo-IMI offered to acquire Banca di Roma but the latter rejected the offer. Moreover, the Italian central bank has not approved the proposed terms of the merger. The planned merger of UniCredito and BCI is also facing problems.

Austria

Bank Austria and Creditanstalt merged in March 1998.

France

Crédit Agricole and Banque Indosuez merged at the start of 1998. In the early part of 1999 efforts were

initiated for a large bank merger involving three large banks. Société Générale (SG) and Paribas announced that they would merge, after which Banque Nationale de Paris (BNP) made an offer – considered hostile – to purchase SG and Paribas. SG and Paribas have taken the case to court, and a decision is expected in June at the earliest. If the merger takes place, the new bank will be one of the largest in the world, having total assets nearly eight times those of MeritaNordbanken, for example.

Germany

In autumn 1998 Bayerische Vereinsbank and Bayerische Hypotheken- und Wechselbank merged and three banks, Südwestdeutsche Landesbank Girozentrale, Landeskreditbank Baden-Württemberg and Landesgirokasse, announced their intention to merge.

Germany/US

In November 1998 Deutsche Bank announced its intention to purchase Bankers Trust of the United States.

Non-euro area countries

Norway, Sweden and Denmark

In May 1999 the Swedish bank Handelsbanken made an offer to purchase Bergensbanken. Den Norske Bank intends to purchase Postbanken.

At the beginning of May 1999 the Norwegian authorities approved the sale of Fokus Bank to the Danish Den Danske Bank, which now holds nearly 99 per cent of Fokus' outstanding shares.

Unidanmark and Tryg-Baltica have merged to form what is by Nordic standards a large financial conglomerate.

Switzerland

Swiss Bank Corporation and Union Bank of Switzerland merged in June 1998 to form one of the largest banks in Europe.

Table. Banks' claims on selected regions/countries, June 1998, % breakdown

Creditor Debtor	Total, USD b	EU, % of total	Finland, % of EU	Germany, % of EU	France, % of EU	UK, % of EU	Austria, % of EU	North America, % of total	Japan, % of total	Other, % of total
Total	1119.5	56.7	0.2	30.5	18.3	19.8	4.0	13.9	12.7	16.5
Eastern and central Europe	133.4	72.8	0.4	54.1	11.5	12.8	10.2	9.7	3.1	14.3
– Russia	75.9	70.4	0.3	58.7	12.5	14.6	7.6	10.4	1.3	17.9
Latin America	295.7	56.0	0.1	23.8	15.2	38.8	1.3	25.7	5.0	13.3
– Brazil	84.6	51.4	0.1	29.4	18.2	38.6	1.5	22.1	6.1	20.4
Asia	324.8	46.9	0.2	27.7	23.2	14.8	3.6	9.0	30.3	13.7

¹ Excl. Greece and Portugal.

Source: BIS.

There are differences in the readiness of banks to cope with the challenges posed by the euro. Measured in terms of efficiency, banks in some countries in central and southern Europe, in particular, are generally not well prepared for tighter competitive conditions. Costs of banking services are quite high in these countries compared with the incomes generated.

European banks have lent heavily to Asian, Latin American and eastern European countries and hold well over half of the industrial countries' total claims on these countries (Table). The share of European banks in lending to crisis countries increased from just over 50 per cent at end-1995 to almost 60 per cent in mid-1998. During that time the share grew particularly in respect of Asia and Latin America.

The distribution of claims on crisis countries varies across EU countries. Some fairly large banks in the core area of Europe, in particular, have sizeable claims on Russia. The bulk of these are, however, government guaranteed. The uncertainty is exacerbated by a lack of transparency regarding banks' links with various other financial institutions such as hedge funds.³

As Finland will be holding the presidency of the European Union in the second half of 1999 this will give her a good opportunity to influence the development of EU regulation of the financial sector. Three goals have been set for this regulation: stability, efficiency and promotion of consumer protection. The EU coordinates its preparation of regulations with

international organizations and in this context has tried to close ranks and put forward more unified standpoints than before.

The ESCB's Banking Supervision Committee (BSC) has initiated regular monitoring and analysis of banking systems in the EU area for the purpose of anticipating future problems and risks. In this connection the committee continuously monitors EU banks' claims on crisis countries.

In Finland risks attach to the continued growth of the credit stock

The outlook for the Finnish economy is for continuing stability. Financial institutions' customers, both companies and households, are now in a relatively good position to withstand crisis, partly because of their low levels of debt and the prevailing low level of interest rates. Moreover, the financial performance of banks is good and the outlook is also fairly good. Finnish banks have also enhanced their efficiency, as a result of restructuring induced by the banking crisis, to a level comparable with the best European banks.⁴

In these circumstances, the biggest potential threats to the Finnish banking sector in the short term are therefore likely to come from outside the country. For example, counterparty risks attach to possible international recession and interbank transactions. Last

³ Cf. the case of Long Term Capital Management (LTCM) in autumn 1998, described eg in *Financial stability in Finland*, Bank of Finland Bulletin, December 1998.

⁴ For more details, see the article by Heikki Koskenkylä, *The performance of the Finnish banking sector in 1998 and the outlook for the next few years* in this issue.

Chart 2.

Household debt, debt servicing costs and saving rate

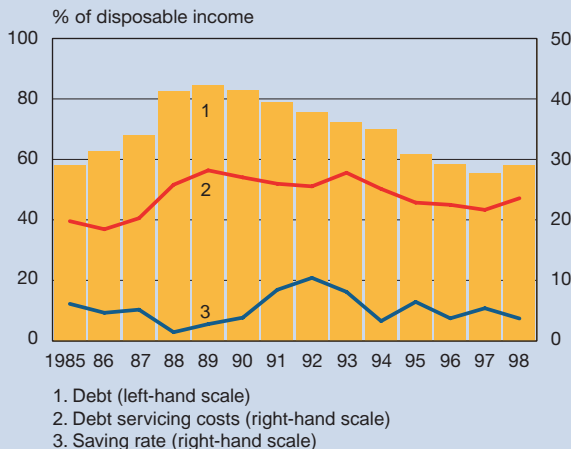
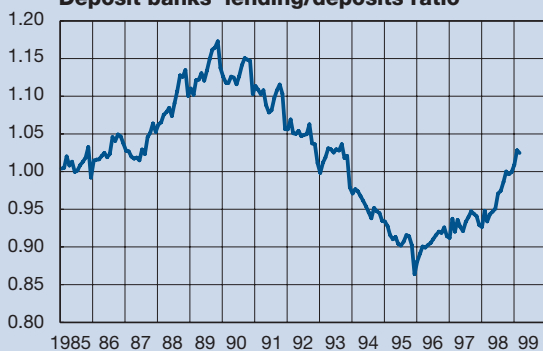


Chart 3.

Deposit banks' lending/deposits ratio



Prior to 1999, the figures used in the chart are based on markka-denominated lending and deposits. In order to maintain comparability, the amounts of foreign currency-denominated lending and deposits that were redenominated in euro on 1 January 1999 with the onset of Stage Three of EMU have been subtracted from the official figures for 1999.

autumn's LTCM crisis brought into particularly sharp focus the risks inherent in providing financing to hedge funds. Finnish banks are not known to hold direct risk positions of a similar nature. On the other hand, currency trading involves fairly large indirect risks in connection with interbank settlements. The realization of such risks is not very probable, however.

Acceleration in the growth of the lending stock, together with heightening competition, increases risks for the banks. The stock of bank lending grew by about 12 per cent in 1998, led by 15 per cent growth in corporate lending. The rapid growth is expected to continue in the near future. In the first quarter of this year, new lending doubled from the same period a year earlier, and at end-March the stock of corporate lending was about 20 per cent higher than a year earlier.⁵ Rapid growth of the lending stock and the reduction in borrower quality that this often entails tend to increase prospective loan losses.

Despite the growth in corporate lending, companies' indebtedness declined again last year. By contrast, households' debt and debt servicing costs, relative to disposable income, turned up sharply in 1998. The ratio of household debt to disposable income increased to about 58 per cent in 1998 from 55 per cent in 1997. The record high for the ratio is about 85 per cent, reached in 1989 (Chart 2). The growth of debt servicing costs was caused by a heavy increase in gross repayments as loans could be refinanced more cheaply than before, in part because of the abolition of stamp duty in 1998.

As lending has grown at a considerably faster pace than deposits, this has led to a clear rise in the ratio of bank lending to deposits. This ratio (based on euro-denominated financial market data) was 0.93 in March 1998 and 1.02 a year later. The ratio reached its lowest point in the 1990s in 1995 (0.86) and its highest point in 1990 (1.17) (Chart 3). If the ratio continues to remain at a high level, banks will have to resort increasingly to costly market-based funding.

⁵ From the beginning of 1999, euro-denominated lending, as published in the Bank's *Financial Markets Statistical Review*, is composed of markka-denominated lending and lending denominated in ECUs and currencies of other euro area countries, the latter two having previously been treated as foreign currency-denominated lending. In order to maintain comparability, the end-March 1999 stock of euro-denominated corporate lending was reduced by FIM 7.1 billion, ie the amount that was redenominated in euro at the turn of the year.

Because of tightening competition, the interest rate margin has narrowed in the last twelve months by more than 0.5 percentage point to about 3.6 percentage points in March 1999. There is some concern that if overall economic conditions – contrary to forecasts – were to weaken substantially, the present margin might not be sufficient to cover the ensuing growth in loan losses.

The squeezing of the interest rate margin is mainly a result of declining rates on household lending. This lending is generally well secured and well serviced. Interest rate margins on corporate and local government lending have been very narrow for some time, and traditionally the biggest credit risks are associated with corporate lending. Pricing of this lending may reflect to some extent banks' desire to hold on to long-standing customer relationships as well as the idea that low interest earnings can be offset by fee income from other services. If customer loyalty weakens and customers become more inclined to change banks, this strategy will entail risks.

In the interests of longer-term stability in the banking sector, a Ministry of Finance working group comprised of representatives of the relevant authorities and credit institutions has been studying the problems of credit institutions. The group issued recommendations at the end of 1998 concerning reform of procedures for the winding up and reorganization of credit institutions and creditor protection and owner responsibility in such situations. A proposal has been put forward for the enactment of a law on these issues covering all credit institutions. One of the things such a law would do is to make public capital support conditional on credit institutions' covering losses out of restricted equity. Shareholder approval would thus not be needed in order to use capital in this way.

A new Insurance Inspectorate commenced operations on 1 April 1999, under the aegis of the Ministry of Social Affairs and Health. Establishment of the new body helps to clarify supervision of the insurance industry. The Ministry will continue to be responsible for insurance regulations whereas the Inspectorate will handle supervision and inspections. Development of the financial markets requires close cooperation between the Inspectorate and the Financial Supervision Authority. This is facilitated by the fact that the boards of the two bodies include representatives of both of these authorities, as well as of the Ministry of Social Affairs and Health, Ministry of Finance and the Bank of Finland.

Structural changes in payment and settlement systems

From the standpoint of payment and settlement systems, the changeover to the euro went according to plan in Finland and the euro area in general. Payment systems in Finland are now handling transactions in both markkaa and euro whereas the securities markets have changed over completely to the euro.

With the adoption of the euro, a euro payment system for the entire EU area called TARGET also became operational. The system has generally functioned well despite larger-than-expected payment volumes. TARGET is used not only for executing banks' own payments but also their customers' payments. Because of the introduction of the euro and TARGET, the Bank of Finland's agreement with the banks on BoF-RTGS accounts was revised. In addition to TARGET, the euro payment system maintained by the Euro Banking Association, Euro 1, went live at the beginning of the year in conjunction with the EBA-Clearing system. The latter system (formerly called ECU-Clearing) previously processed ECU-denominated payment transactions. In April two Finnish Banks, Merita and Leonia, were linked to the system. TARGET and Euro 1 have substantially increased the efficiency of cross-border payment flows.

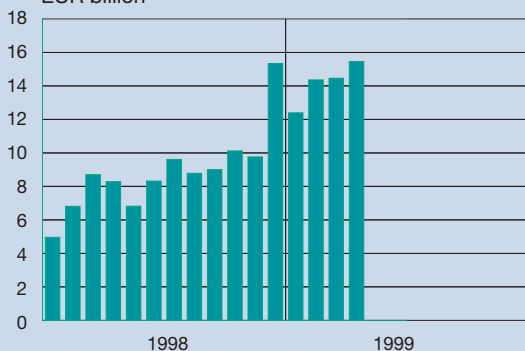
The Finnish Central Securities Depository (APK) maintains a settlement and register system for both equity (OM system) and debt securities (RM system). Smooth functioning of these systems is essential for the stability of the securities markets.

Transaction volumes in the OM system have increased substantially beyond the level it was originally designed to handle (Chart 4). Fluctuations in collateral needs and frequent occurrence of certain technical problems have caused liquidity problems for intermediaries. Although the proportion of delayed share transactions in the system has decreased, it is still rather high, despite a number of improvements in the settlement process, such as share lending and use of joint custodial accounts. The authorities have made increasing demands for upgrading the OM system. According to plans, the centralization of register keeping in the APK, due to take place in spring 2000, should enable the use of alternative settlement procedures and will greatly improve the operational efficiency of the system. The centralization of registers is a key project in terms of system efficiency and

Chart 4.

Settlement of share trades in the Finnish Central Securities Depository (APK)

EUR billion



reliability, but other parts of the system need to be improved as well.

The RM system, which serves the debt securities market, has for some time operated entirely as a real-time gross settlement system and is completely centralized. This system has functioned well, and the probability of a disturbance spreading from the RM to other systems is small. Individual transaction values are notably larger than in the OM system. In the field of securities settlement systems, several steps have been taken towards creation of a global financial market. The most recent development occurred in May when the Luxembourg-based Cedel International and Deutsche Börse Clearing AG announced their intention to merge. According to a memorandum of understanding, SICOVAM from France will also be joining the new organization. The merger will have a profound impact on the structure of the European securities market. The consolidation process is also likely to be reflected in Finnish markets, although it is too early to assess the actual scope and scale of the effects. The APK has previously established a link

with Deutsche Börse Clearing AG so as to enable book-entry transfers of debt securities between Finland and Germany. A similar link with SICOVAM is in preparation.

HEX Helsinki Exchanges focus on core areas of Europe and rely on marketplace strategy

The 'Marketplace Helsinki' strategy is the centrepiece of efforts to respond to pressures to adapt to the euro and new technologies. The strategy seeks to maintain an independent domestic marketplace with effective international connections by further developing the securities market infrastructure and improving international links.

The key domestic event in these efforts was the decision taken in December 1998 to combine the APK and the HEX Helsinki Exchanges under a newly formed parent company, the Helsinki Exchanges Group Ltd Oy. The new structure, which was established in April 1999, is based on the idea that a centralized body can better ensure the development of the whole gamut of services required by a marketplace.

The Helsinki Exchanges have worked actively to establish links with securities markets in the core areas of Europe. At the end of last year the Helsinki Exchanges reached agreement with Eurex Frankfurt AG, a derivatives exchange, on a plan to shift, starting next October, transactions in the key Finnish financial derivatives to the Eurex system, on which present members of the Helsinki Exchanges will be able to conduct business in all their products. At the same time, detailed negotiations were started on effecting transactions in listed shares on the Helsinki Exchanges via Deutsche Börse AG's Xetra trading system.

The networking of infrastructures of integrating securities markets seems to be a necessity, partly because of the scale economies associated with trading activity. For this reason, establishing international connections constitutes a key part of efforts to preserve the viability of the domestic marketplace. It is also possible that, as competition between marketplaces tightens, there will be an expansion in the services offered internationally out of Finland via such links.

A special feature of the Helsinki Exchanges is the close connection between their transaction volumes and trade in the shares of Nokia Oy. Nokia accounted for 68 per cent of total turnover of shares on HEX's main list during the first four months of 1999 and for 54 per cent of total market capitalization at end-April. Price developments in Nokia shares have had a positive effect on HEX's overall operations. On the other hand, such heavy dependence on a single company increases uncertainty regarding movements in share turnover and price indices.

Preparations for the Year 2000 continue

Much work has been done and continues to be done in preparation for the Year 2000 in various cooperative bodies, both in Finland and abroad, with the authorities (incl. the Bank) playing an active coordinating role. Testing so far has been carried out mainly by individual banks and jointly for the whole banking industry. Joint testing in the securities markets is likely to take place in summer 1999. In addition to joint testing, operators in the financial markets have focused on Year 2000 contingency planning.⁶

Year 2000 problems could cause failures not only in financial institutions' own systems but also in connections between customers and other providers of financial services. Comprehensive joint testing of these connections in the same manner as for financial institutions is not practicable. Financial institutions are aware of this problem, and each of them is taking its own precautions. Many banks are also offering testing facilities to customers. The Bank of Finland monitors Year 2000 preparations in the financial markets. The status of Year 2000 preparations in the financial industry can be viewed on the Bank's website (<http://www.bof.fi>).

Stable near-term outlook for Finnish financial markets

The outlook in the banking sector is for relatively stable conditions, and the chances of risks being realized in the short term are fairly small. In the longer term, banks are likely to experience a decline in net income from financial operations as a result of heightened competition. Since the increase in other income will not totally offset the decline in net income from financial operations and since the bulk of major cost cutting measures have already been taken, it will be difficult to match the current levels of net operating income. Banks will have to continue to keep costs under tight control.

If lending continues to grow at the present pace and interest rate margins stay narrow or shrink even further, banks' risks will increase substantially. Banks have a major responsibility for ensuring that the loans they grant do not entail excessive risks. Risks must be properly priced. The Bank of Finland is monitoring the situation together with the Financial Supervision Authority.

The APK's OM system should be made more efficient and reliable in order to ensure that Finnish stock exchange activities can remain competitive and viable. Further development of the book-entry system is essential in this regard.

The Bank of Finland's tasks include – both under law and as a member of the European System of Central Banks – helping to maintain the reliability of the payment system and promoting the stability of the overall financial system. These tasks require close cooperation between the authorities and, where necessary, there must be readiness in all areas of economic policy to respond quickly so as to keep the situation under control.

26 May 1999

⁶ See the article by Tuula Hatakka and Ari Voipio, *Finland's financial markets and the year 2000*, in the Bank of Finland Bulletin, 1/99.

■ **Key words: financial system, stability, banks, financial markets, payment and settlement systems**

The performance of the Finnish banking sector in 1998 and the outlook for the next few years

by Heikki Koskenkylä, Head of Department
Financial Markets Department
Bank of Finland

The year 1998 was the third profitable year in succession for Finnish banks since the severe banking crisis in the first half of the 1990s. The banks' combined operating profit increased appreciably, amounting to nearly FIM 8 billion. If the MeritaNordbanken Group is included in its entirety, the combined operating profit totalled FIM 12.6 billion (Table 1). Average return on equity was over 20 per cent, which was a clear improvement on the previous year and a very good performance by international standards. The total lending stock grew strongly, spurred by favourable economic develop-

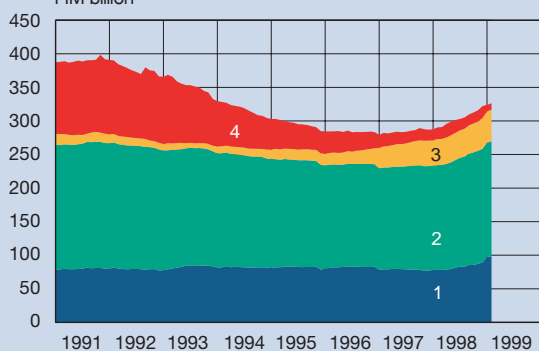
ments and low interest rates (Chart 1). Interest margins narrowed markedly since lending rates fell more than deposit rates (Chart 3).

Calculated in accordance with the Credit Institutions Act (BIS rules), the sector's capital adequacy ratio fell slightly, from 11.9 per cent at end-1997 to 11.5 per cent at end-1998, as a result of a sharp increase in risk-weighted assets (loans, etc). Overall, own funds decreased somewhat from the previous year, although Tier 1 capital grew by about 8 per cent. In particular, unrestricted equity increased from the previous year as a consequence of the sector's good financial performance. With the exception of Skopbank, banks have now redeemed in full the preferred capital certificates issued in connection with the capital injections made by the Finnish government during the banking crisis.

Chart 1.

Deposit banks' lending stock

FIM billion



1. Lending to companies
2. Lending to households
3. Other markka-denominated lending
4. Foreign-currency lending

Reasons for the improved performance

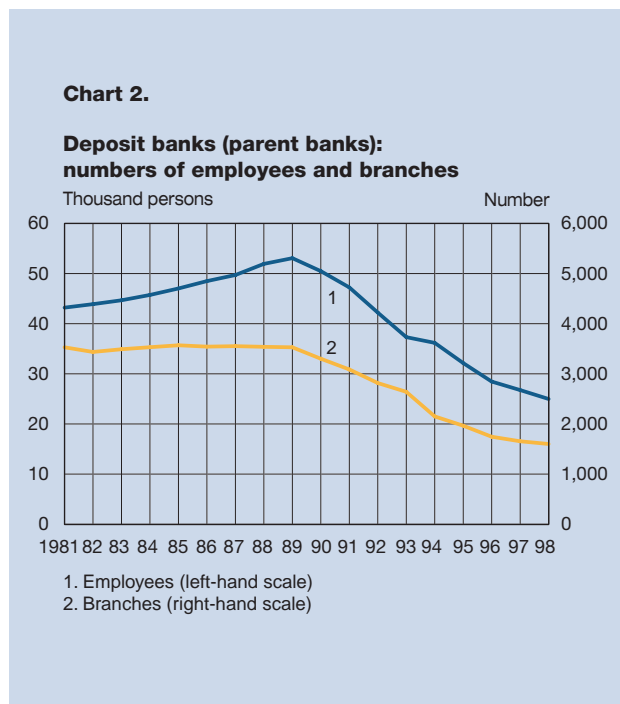
The marked improvement in the level of operating profit was mainly due to increased income: both net income from financial operations and other income grew from the previous year. In addition, there was a further modest decline in loan and guarantee losses (Table 1). Interest income increased largely because of the marked recovery in the lending stock and a decline in non-performing assets. Other income grew partly as a result of capital gains on equity sales. The stock of lending to the public and public sector entities grew considerably (12 per cent). The stock of foreign currency-denominated lending remained unchanged on the previous year. The combined stock of markka and foreign currency-denominated lending increased by 12 per cent and stood at FIM 327 billion at end-1998. This compares with a peak level of more than FIM 400 billion at end-1991. The ratio of

the banking sector's total lending stock to GDP in Finland is the lowest in the EU. An increasingly large proportion of bank lending (about 75 per cent) in Finland is tied to short-term market rates, either directly or indirectly via banks' own prime rates. Thus changes in Eurosystem interest rates are quickly transmitted to interest rates on almost all outstanding loans in Finland.

Loan and guarantee losses decreased notably and accounted for only 0.3 per cent of total assets; 0.5 per cent is considered to be a good level by international standards. Non-performing and zero-interest assets declined further in relation to total assets, from 2.4 per cent in 1997 to 1.5 per cent in 1998, and amounted to only FIM 5.6 billion at end-1998.

Operating expenses increased slightly

The operating expenses of the Finnish banking sector decreased by a total of nearly 40 per cent in the four-year period 1994–1997, which is a very large reduction by international standards. In other EU member states costs have been cut by only a few per cent or not at all. However, the downtrend in costs in the Finnish banking sector was reversed in 1998, and



operating expenses increased by some FIM 0.5 billion from the previous year. Part of the increase was of a temporary nature, reflecting changes in IT sys-

Table 1. Deposit banks*: combined financial results and balance sheet, 1993–1998, FIM billion

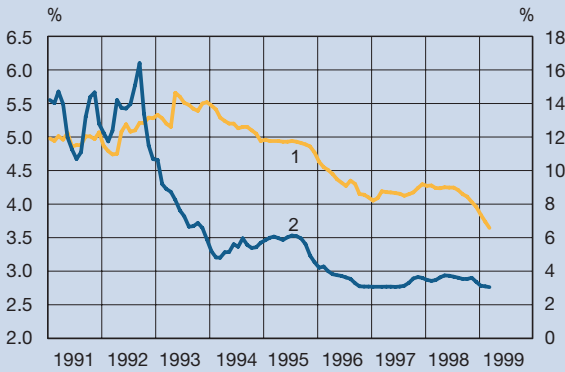
	1993	1994	1995	1996	1997	1998	1997 incl. Nord- banken	1998 incl. Nord- banken
Net income from financial operations	13.0	13.7	12.4	11.0	12.5	13.6	18.7	19.1
Other income	9.7	8.6	8.2	10.2	7.9	8.4	12.3	14.2
Total income	22.3	22.3	20.6	21.2	20.4	22.0	31.0	33.2
Operating expenses	15.3	16.4	15.5	12.8	10.9	11.5	16.5	17.3
Depreciation	1.9	1.5	1.7	2.1	1.2	1.3	1.8	2.0
Loan and guarantee losses	14.7	11.2	6.2	3.7	2.4	1.6	2.7	1.4
Operating profit	-9.2	-6.8	-2.8	3.8	5.8	7.6	10.0	12.6
Total assets	726.8	667.8	616.6	578.2	656.9	641.8	945.8	911.2
Non-performing assets, net	35.9	25.4	19.6	12.3	8.3	5.6	12.7	8.8
– % of claims on the public	8.7	7.2	6.3	4.0	2.5	1.5	2.4	1.6
Loan losses, % of claims on the public	3.6	3.2	2.0	1.2	0.7	0.4	0.5	0.3
Risk-weighted assets and liabilities	488.5	419.5	371.7	372.3	402.0	414.8	560.2	578.5
Capital adequacy ratio, %	10.7	11.7	12.0	11.4	11.9	11.5	11.8	11.1
Return on equity, %	-25.9	-20.3	-9.6	11.8	16.7	26.0	18.4	22.9
Return on assets, %	-1.35	-1.01	-0.48	0.56	0.7	1.2	0.9	1.2

* The figures for 1997 and 1998 are not fully comparable with the figures for previous years owing to the formation of MeritaNordbanken and the restructuring of the cooperative banking group. Merita Real Estate Ltd was part of the MeritaNordbanken Group in 1997–1998 and is included in the figures containing data on Nordbanken in the last two columns. Prior to that, it was part of the Merita Group. The figures for 1997 and 1998 excluding Nordbanken include data on the Merita Bank Group.

Source: Financial Supervision Authority

Chart 3.

Deposit banks' interest rate margin and three-month Helibor/Euribor



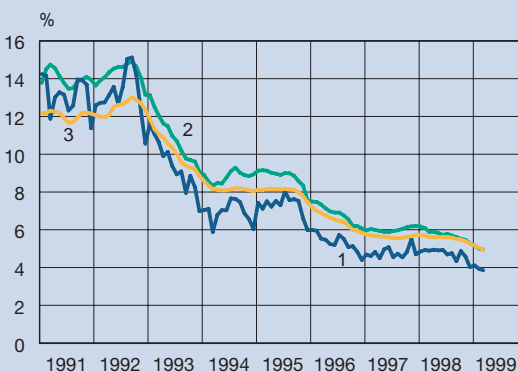
- 1. Interest rate margin (left-hand scale)
- 2. Three-month Helibor/Euribor (right-hand scale)

tems necessitated by the onset of monetary union and the Year 2000 problem. It was also due to an expansion of business operations; several small banks have increased their market share, for example by opening new branches and hiring additional staff.

The numbers of bank employees and branches in the Finnish banking sector have declined substantially from the peak levels attained at the end of the 1980s, the total number of employees by about 50 per cent and the total number of branches by almost 50 per cent (Chart 2). In no other country in the EU or the OECD area has downsizing reached such proportions. Downsizing has centred predominantly on the large banks whereas small banks have actually increased their numbers of branches and employees in recent years. The numbers of bank branches and employees in the sector as a whole decreased further in 1998. According to statistics produced by the Finnish Bankers' Association, at end-1998 a total of 24,500 persons were employed in parent banks and 29,200 in banking groups. Altogether, there were 1,570 branches (Chart 2). Contributing to the drastic reduction in the numbers of bank employees and branches have been cost cutting necessitated by the banking crisis and technological progress, whereby new banking techniques (telephone banking, Internet banking etc) have replaced traditional channels.

Chart 4.

Deposit banks: average interest rates on markka-denominated lending



- 1. New lending to companies
- 2. New lending to households
- 3. Markka-denominated lending stock

Net income from financial operations and other income increased, interest rate margins narrowed

The banks' combined net income from financial operations (interest income less interest expenses) recorded a further increase (about 10 per cent) in 1998. Lending rates fell clearly whereas deposit rates moved only slightly lower. The average rate on the markka-denominated lending stock declined from 5.73 per cent to 5.28 per cent (Chart 4). The average rate on transaction accounts fell from 1.0 per cent to 0.87 per cent and that on total markka-denominated deposits from 1.44 per cent to 1.31 per cent (Chart 5). As a result of these developments, the banks' average interest rate margin, ie the difference between the average markka lending and deposit rates, narrowed considerably from 4.30 percentage points to 3.96 percentage points. The narrowing in the margin gained momentum in the second half of 1998 and has continued

in the current year. In February 1999 the margin had already shrunk to 3.7 percentage points (Chart 3). Heightened interbank competition has pushed lending rates appreciably lower but has had less impact on deposit rates.

Despite the narrowing in the interest rate margin, net income from financial operations increased notably, buoyed by the strong increase in the lending stock and contraction in the outstanding amount of non-performing assets. Deposits were placed mostly in tax-exempt fixed-term deposits bearing up to 2 per cent interest and in taxable current and transaction accounts. Deposits held by households in tax-exempt current and transaction accounts grew by only FIM 2 billion in 1998.

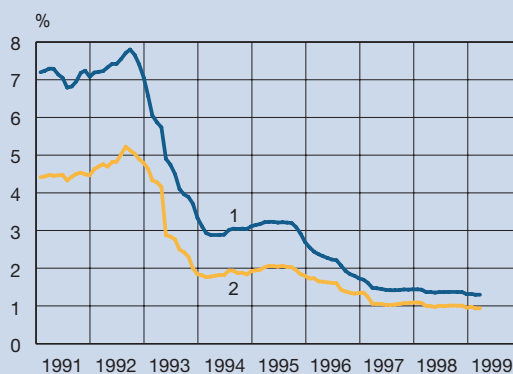
Banks' other income increased by about 6 per cent in 1998. Fee income grew clearly whereas net income from securities transactions and foreign exchange dealing decreased by about FIM 500 million. This item is subject to wide fluctuations from year to year. Fee income from securities broking and asset management recorded the strongest growth in relative terms.

Favourable outlook for the banking sector in the near term

Growth prospects for the Finnish economy are still good and inflation is expected to remain subdued. The recent sizeable cut in the European Central Bank's key main refinancing rate will push lending rates even lower. Increasing competition will work in the same direction. Though the banks' average interest rate margin is likely to continue to shrink gradually, buoyant credit demand should ensure that net income from financial operations remains at a high level. Abolition of tax exemption for transaction accounts, one of the points in the programme of the new Government, could, however, have a significant impact on banks' net income from financial operations via the interest rate margin. Removing tax exemption would lead to a rise in average deposit rates, with the result that the interest rate margin would be squeezed and net income from financial operations would decrease. Loan losses could gradually start to increase again as a consequence of the rapid growth of lending. Heightening competition and falling interest rates are forcing banks to pay more attention to risk pricing and

Chart 5.

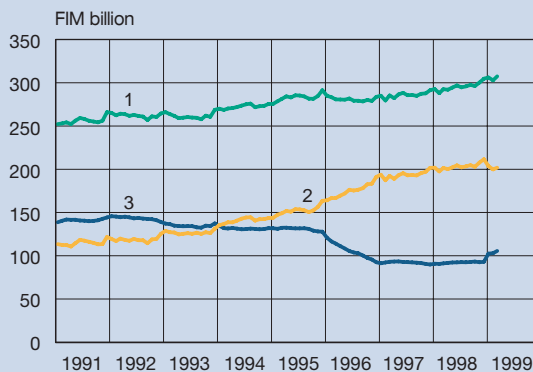
Deposit rates applied by deposit banks



1. Total markka-denominated deposits
2. Transaction accounts

Chart 6.

Markka-denominated deposits with deposit banks



1. Markka-denominated deposits
2. Transaction accounts
3. Other deposits

Table 2. Number of bank branches and employees per thousand inhabitants and cost-earnings ratio in the euro area*

	1990		1997		1996	1997
	Branches	Employees	Branches	Employees	Cost-earnings ratio	Cost-earnings ratio
Belgium	0.90	7.94	0.72	7.57	0.63	0.64
Germany	0.63	11.10	0.57	9.16	0.68	0.68
Spain	0.83	6.22	0.97	6.29	0.63	0.62
France	0.45	7.63	0.44	6.89	0.69	0.68
Ireland	0.27	4.99	0.32	6.29	0.57	0.58
Italy	0.31	5.92	0.44	6.00	0.70	0.71
Netherlands	0.54	7.86	0.44	7.19	0.69	0.70
Austria	0.58	9.86	0.58	9.43	0.66	0.67
Portugal	0.20	6.20	0.41	5.97	0.68	0.62
Finland	0.58	10.15	0.32	5.21	0.71	0.59
Weighted average	0.54	8.44	0.54	7.50	0.68	0.68

* Excluding Luxembourg

Sources: European Central Bank Monthly Bulletin, April 1999, and Bank of Finland data (cost-earnings ratio).

control. Banks should nevertheless avoid offering unduly cheap loans. Other income is also likely to develop favourably in the near term. Fee income should continue to grow whereas capital gains on sales of securities are expected to decline.

As was noted above, part of the increase in banks' operating expenses in 1998 was due to one-off factors. Even so, the modest upturn in expenses could continue (in part because of the Year 2000 problem), and attention needs to be paid to reducing them. Branch and employee numbers are expected to decline further, especially in the major banking groups.

The heaviest burden on the balance sheets of Finnish banks is the continuing high level of real estate holdings dating from the banking crisis (some FIM 30 billion, or 5 per cent of total assets). Banks' income from real estate holdings still does not correspond fully with market-based earnings, and total holdings have declined only slowly. According to data collected by the Financial Supervision Authority (FSA), banks' real estate holdings are still overvalued. The FSA has called upon the banks to remedy this situation by downward adjustment of current book values over the next few years and by reducing the level of real estate holdings as quickly as possible.

All in all, the operating profit of the Finnish banking sector is expected to remain at the present high level in the current year, but then to decrease slightly.

The Finnish banking sector is one of the most efficient in the euro area; foreign and small banks are consolidating their position

In common with the other Nordic countries, the Finnish banking sector has undergone a number of important structural changes in recent years. The trend towards increased consolidation – mainly in the form of mergers – has also been evident in the EU and the United States. Most of the mergers have taken place between banks, although there have also been cases of mergers between banks and insurance companies (eg in the United States, Switzerland, Sweden and Belgium). Structural changes have been discussed in previous issues of the Bulletin and the Bank of Finland's annual reports for 1997 and 1998.¹

In the course of the 1990s the numbers of branches and employees in the Finnish banking structure have fallen by about a half from their 1990 levels, which is more than in any other country in the EU or the OECD area. As a result, operating expenses have declined substantially (Table 1) and by more than in any other EU or OECD country. This can be considered an outstanding achievement, and it has brought about a fun-

¹ See the June–July 1997 and June–July 1998 issues of the Bulletin.

damental improvement in the efficiency of Finnish banking. A simple and widely used indicator of efficiency is the cost-earnings ratio (Table 2).

The number of branches per number of inhabitants has not declined at all in the euro area as a whole. However, the corresponding ratio for the number of employees has declined slightly. The greatest reduction, both in absolute and relative terms, has occurred in Finland. The cost-earnings ratio of Finnish banks has fallen below the average for the euro area. Overall, on the basis of these indicators it can be said that the efficiency of the Finnish banking sector is among the highest in Europe. The ratios for the numbers of branches and employees per number of inhabitants are actually the lowest in the euro area.

Together, Finland's three largest banking groups still account for a very large proportion of total lending and deposits, although their combined market share fell further in 1998. Their share of total assets fell to 88.6 per cent from 89.8 per cent one year earlier while their share of total deposits fell to 86.4 per cent from 88 per cent. The small Finnish banks and foreign banks have increased their market share, and this trend can be expected to continue.

At the end of 1998 foreign banks had 20 branches in Finland (15 in 1997), employing a total of 520

persons (492 in 1997). They had total claims on the public amounting to FIM 10.4 billion (FIM 6.7 billion in 1997) and total deposits of FIM 6.0 billion (FIM 2.1 billion in 1997), giving them market shares of 2.8 per cent (2.0 per cent in 1997) and 1.9 per cent (0.7 per cent in 1997), respectively.

With the transition to the Third Stage of Economic and Monetary Union, more foreign banks can be expected to establish branches in Finland. Structural change within and between the Nordic countries will probably continue over the next few years. There will be a further increase in competition between banks and between banks and insurance companies and investment firms. This will make for greater diversity in the supply of financial services and evidently also lower prices. Pressures from markets and owners for increasing efficiency are likely to intensify.

6 May 1999

■ **Key words: banking sector, profitability, efficiency, structural change**

Essential features of effective banking supervision and legislation¹

by Liisa Halme, Adviser
Financial Markets Department
Bank of Finland

The economic recession that Finland experienced in the early 1990s was unprecedented in its severity and its consequences were traumatic. It has been claimed that the banking crisis was one consequence of the recession. According to this view the banking crisis had its origins in external shocks, which one might call, say, ‘bad luck’. Another approach is to look for the causes of the banking crisis in possible policy errors and the behaviour of the banks themselves, especially as regards their excessive risk taking. Policy errors may refer to macro policy as well as regulation and supervision of financial markets.

There are grounds for believing that the Finnish banking crisis was due to all three factors, ie bad luck, the behaviour of banks and wrong policy. But as an explanatory factor bad luck can be regarded as differing from policy errors and the behaviour of banks in one fundamental respect. Namely, economic operators must, to a certain extent, try to take into account uncertainties concerning the future which, if they materialize, may seem to be problems or crises that have been triggered by bad luck. The success of both macro policy and regulation and supervision is measured in terms of how well the operators responsible for them succeed in anticipating actual events or adapting their decisions and actions to changing circumstances. Though the ability of economic operators to successfully foresee external shocks and changes in the actual world is inevitably limited, the responsibility for this nevertheless lies with them. In other words, there must be a readiness to deal with bad luck situations should they rise, and forward-looking risk management is the essence of good banking.

¹ The article is based on the author’s doctoral thesis *Banking regulation and supervision: A Legal Policy Study of Risk Taking by Savings Banks*, published in the Bank of Finland’s Series E (E:15), and the introductory lecture delivered by the author at the public examination of the thesis at the University of Helsinki in April 1999.

Structural distortions

The study on which this article is based applies the tools of economics to assess the effectiveness and expediency of legislation and supervision in Finland prior to the banking crisis of the 1990s. It attempts to answer the question of to what extent excessive risk taking by banks, particularly savings banks, was due to:

- distortions in the legal framework;
- the behaviour of banks;
- the behaviour of supervisors.

Underlying this three-fold division is the presumption that legislators use the legal and supervisory framework to ensure that the operating environment develops in the desired direction. The structural framework influences the behaviour of economic operators, including banks. Economic operators, by contrast, seek to influence the structural framework from the viewpoint of their own self-interest. The structural framework can therefore be seen as a set of incentives aimed at bringing about a desired form of behaviour. This generates tension between compliance with existing legal provisions and regulations, on the one hand, and the rational behaviour of operators, on the other.

Although these three factors are not independent of each other, it is assumed in the study that in some situations one of them might have been more important than the others from the point of view of excessive risk taking by banks. The study provides support for the validity of this assumption. For example, in some cases distortions in the legal framework can be considered to have been of greater significance for excessive risk taking than the behaviour of supervisors; the rules on large credit exposures and the lax capital adequacy rules are cases in point. By contrast, the analysis of the provisions restricting investment

in business undertakings indicates that banks may have endeavoured to evade what was a detailed and structurally well-founded body of legal rules and regulations, especially if the authorities were cautious about using sanctions to deal with evasion. Therefore in a situation like this excessive risk taking has more to do with banks' behaviour and the action of supervisors than with structural distortions in the existing legislation.

From the outset the aim of banking legislation and supervision has been to safeguard the stability of the financial system and thereby protect depositors, although the need for depositor protection received particular emphasis in the early years. Finnish local banks (savings and cooperative banks) have traditionally had a smaller capital base than commercial banks. Legislators counterbalanced the lower capital levels of local banks by imposing limits on the business operations of local banks that were stricter than those applicable to commercial banks. This basic difference in the scope of the business that the three types of bank were allowed to conduct persisted until the entry into force of the Deposit Banks Act in 1991. The study investigates how this difference was reflected in the behaviour of savings banks, supervisory authorities and courts and whether individual legal rules were consistent with such a state of affairs.

The study seeks to identify the harmful effects that follow if specific legal rules or their interpretation or supervision of compliance with them are at variance with the objectives of legislation. It also attempts to show in what areas major conflicts have arisen and what form they have taken. Analysis of the legislative process bears out the findings of public choice theory that legal rules have not always come into being behind the veil of ignorance in such a way that the introduction of a specific rule has been justified on the basis of the fundamental premises of law and without prior consideration of who could be affected by it and how. This, as too banks' efforts to influence the contents of legislation from the point of view of their own rationality and self-interest, has impaired the effectiveness of legal provisions and the ability to prevent excessive risk taking.

In connection with the 1969 legislative reform it seems to have become the accepted view to consider the deposit insurance funds of the various banking groups as providing additional insurance for banks' equity capital. It was this additional insurance that

was used to justify the lowering of the capital adequacy requirement for commercial banks. It is more likely, however, that the real reason for lowering the requirement was to compensate commercial banks for the fact that the legislation allowed savings and cooperative banks to operate with lower capital levels, in spite of efforts to harmonize legislation governing the business of all banks. Elements of public choice theory were discernible in the legislative process in that the entities subject to regulation influenced the contents of legislation. This is a problem if the outcome conflicts with the objective of legislation, which in this case is to safeguard system stability. According to economists, a regulatory framework which allows the use of deposit insurance funds and various kinds of safety nets more widely to 'safeguard' the capital adequacy of individual banks has the potential to undermine the stability of the entire system. This is true at least in situations where such arrangements are not accompanied by countervailing measures such as restrictions on a bank's business or the pricing of deposit insurance so that it takes into account banks' risk taking.

On the whole, the capital adequacy requirements laid down in Finnish legislation did not meet international standards as regards their contents and the timetable for their adoption. The situation did not change until the entry into force of the Deposit Banks Act and Credit Institutions Act in 1991 and 1994, respectively. When deregulation got under way in the mid-1980s, this structural distortion in the legal framework became more pronounced since banks could operate with capital levels that were too low and capital adequacy rules that underestimated the true extent of risk taking. Adequate equity capital is essential for the prevention of risk taking in that it provides a cushion against potential losses. Moreover, as the expected return on a small capital base is low, it provides owners and investors with an incentive to take risks in the hope of earning additional returns, without running the risk of incurring heavy losses.

In the analysis of the statutory duties and responsibilities of the board, managing director and delegates (authorized representatives) of savings banks the study draws attention to the lack of clarity regarding the division of responsibilities between agents and principals and the partial overlapping of these responsibilities. It is concluded that delegation of the board's duties to delegates led to a situation where the princi-

pal (board) could transfer part of his duties to the agent (managing director and delegates) whereupon one of the agents (managing director) assumed the role of principal (in the savings bank's management). With the delegation of the responsibility for day-to-day operations to the savings bank's management headed by the managing director, the original division of responsibilities became obscured, and the power of the managing director, in particular, increased, without him being subject to effective scrutiny and control.

Hence structural distortions in the legislation, associated with, *inter alia*, lack of clarity as regards responsibilities and inconsistencies between capital adequacy rules and legal provisions restricting risk taking, can be said to have contributed to the onset of the banking crisis in Finland.

It is therefore important to consider the characteristics of a regulatory and supervisory system that underpins the stability of the financial system, provides effective incentives for compliance with legal rules and commitment to legislators' objectives and redresses problems caused by the information asymmetry that is an inevitable feature of the real world. To put it another way, it is worth asking what are the criteria that ideal legislation and supervision should fulfil in a non-ideal world.

The ideal legislative process

The legislative process should be such that it leads to a sensible and well-founded division of responsibilities and sound rules on disclosure of information and competition. This is probably best achieved by ensuring that laws are enacted 'behind the veil of ignorance' in the sense that the contents of legislation are not influenced by notions of who will be subject to the legal rule being enacted and how.

The interests of the parties subject to regulation should not affect the contents of legislation unless this can be justified on grounds of the public interest and the stability of the financial system. Similarly, supervision and supervisors' decisions should not be influenced by considerations related to the interests of banks, if such interests are not compatible with the stability of the financial system.

It is important here to bear in mind that consideration of the material consequences of legal provi-

sions assumes increased importance in connection with legislation and supervision that emphasize objectives. Consideration of consequences must always be subordinate to the objectives of the law concerned, however, since the citing of other consequences is often an indication of a distorted interpretation of the law or, for example, an attempt by a bank to influence the behaviour of supervisors or legislators. This may lead to divergence from the objectives of the original agreements, such as legal provisions.

Ideal legal provisions

Lawmaking and supervision should be concerned primarily with addressing the fundamental reasons why efficient markets do not exist in the real world. Above all this involves introducing legal provisions and supervision models aimed at eliminating imperfect and asymmetric information. Legal rules and official regulations that encourage or require publication of key information on banks' financial condition and associated business risks have a particularly important role to play in increasing the transparency of information. From the supervisors' viewpoint, increasing the transparency of information means, *inter alia*, minimizing the amount of information to which only supervisors have access and publishing the findings – positive and negative – that come to light in the course of supervision.

Perfect information, a necessary condition for efficient markets, cannot be achieved in the real world; rather, it is a state that can only be approached. Thus a bank's management always knows more about the bank's condition than do supervisors, depositors, creditors or the bank's owners. Legal provisions and supervision can be used to influence the moral hazard present in various principal-agent relationships. They can also be used to maximize the agent's interest in complying with imperfect contracts (legal rules and official regulations) and thereby minimize excessive risk taking associated with moral hazard. More generally, principal-agent relationships should be organized in such a way that the roles and responsibilities of agents and principals remain clear-cut and easily distinguishable from each other. It is important that, for example, the division of labour between the board and executive management and rules on responsibility be clarified in accordance with the principles

laid down in the Companies Act. There is evidence to suggest that the internal board structure typical of many banks in Finland does not easily lend itself to effective control and guidance of executive management.

It is vitally important for increasing the responsibility of owners (responsibility for risk bearing and oversight) that there exist effective capital adequacy rules that provide a measure of actual capital levels and effective laws on liquidation and bankruptcy. Competitive markets, in which no firm is indispensable, are essential for reducing the importance of implicit safety nets, if, for example, the policy of ‘too big to fail’ cannot be abandoned in a credible fashion. But even in that case protection should not be extended to the old owners of a bank.

To strengthen the responsibility of supervisors and reduce the moral hazard associated with supervision, the discretionary powers of supervisors should be limited and supervisors should commit themselves to formal supervisory procedures that are made known to the banks. Effective supervision should, moreover, focus on monitoring structures and systemic risk, rather than seeking to guide banks’ operations on the basis of individual permits. The use of individual permits is costly and makes it difficult to detect distortions and remedy their harmful effects.

On the whole, it can be said that effective regulation and supervision presuppose the existence of conditions where:

- the *commitment* of both principals and agents is taken into account;
- there is *market discipline*; and
- the actions of agents are subject to *control*.

The existence of these conditions helps to minimize the excessive risk taking associated with moral hazard. It should be noted that this kind of legislation and supervision should not rely primarily on control but rather on commitment and market discipline.

Commitment² refers to the existence of explicit rules concerning responsibility and sanctions in the

event of non-compliance. Commitment is linked to the law-and-economics viewpoint that sees legal rules as incentives and the assumption of economic theory regarding the rational behaviour of the individual. Legal rules should pursue the ideal of perfect contracts in which the agent bears full responsibility for performing the task specified in the contract and an effective sanction is imposed for breach of contract.

Market discipline refers mainly to obligations to disclose information, which depositors, investors, supervisors and the markets in general can use as a reliable basis for assessing the activities of a bank and thus overseeing eg bank management. Market discipline is associated with first-best solutions, by which it is endeavoured to eliminate the underlying causes of problems encountered in banking, legislation governing banking and supervision. The smaller the amount of information to which a particular operator alone has access, the less that operator, in the role of agent, can act in a way that is at variance with the principal’s objectives and the less is excessive risk taking. Disclosure of information imposes discipline but discipline is effective only if there is competition. In the absence of competition there is also a need for control.

Control is needed to support commitment and market discipline. Control would not be needed at all if a state of perfect information, one of the requirements for efficient markets, could be achieved in the real world. As this objective can only be approached, the actions of agents must be supervised. However, control itself suffers from the very shortcoming that it is needed to deal with, namely imperfect information. Since the agent always knows more about his own actions than does the principal who exercises control or his representative, the potential of control alone to reduce moral hazard and excessive risk taking is quite limited.

26 April 1999

² In economics the term ‘commitment’ is normally used to refer to the duties of a principal. Here, however, the term refers both to the duties of an agent and a principal.

■ **Key words: banking regulation, banking supervision, principal-agent, commitment, market discipline**

Highlights of the economic agenda for the Finnish Presidency of the European Union

by Lasse Aarnio,
Head of Secretariat for EU Affairs
Ministry of Finance

Finland begins her first Presidency of the European Union on 1 July 1999. Having been a member of the EU for only a few years, Finland faces major challenges in taking up this demanding task. Adding to these challenges is the fact that the Presidency comes at a time when the Third Stage of Economic and Monetary Union (EMU) has just begun and the precise forms of the increased co-operation that this calls for have yet to be established.

The new Finnish Government, which took office in mid-April, has just finalized its programme for the Presidency. The Prime Minister submitted the programme to the Finnish Parliament on 17 June. The programme assigns an important role to efforts to promote employment, economic growth and stability. Action in these areas constitutes a key element of the 'Vienna Strategy for Europe'. These priorities were confirmed by the Cologne European Council in June 1999, and they will form part of the 'Millennium Declaration' on the Union's priorities for future years to be adopted by the European Council at its meeting in Helsinki in December 1999.

Policy coordination

Employment, growth and stability also figure prominently in the work programme of the Council of Economics and Finance Ministers (ECOFIN). The Third Stage of EMU involves closer cooperation in economic policy and strengthened policy coordination. The forms that this takes and the procedures applied are set out in the Stability and Growth Pact adopted by the European Council in Amsterdam in June 1997.

The key document as regards the coordination of the economic policies of the Member States and the Community is the Broad Economic Policy Guidelines. The guidelines for 1999 were drawn up during the German Presidency and discussed by the Cologne Eu-

ropean Council in June. The recommendations setting out these guidelines will be formally adopted by ECOFIN at its first meeting under the Finnish Presidency in July 1999. According to the Treaty on European Union, the Broad Economic Policy Guidelines are the general reference framework against which the ECOFIN assesses the consistency of the economic policies of the Member States.

In the multilateral monitoring and surveillance that forms a central part of the coordination of economic policies special emphasis is given to the 'excessive deficit procedure'. Under the Stability and Growth Pact, the Member States should keep the general government budget close to balance or in surplus in the medium term. The monitoring of budgetary positions is based on a regular reporting carried out twice a year. If, on the basis of the September 1999 reports, it is judged necessary for the Council to react to the budgetary situation in a particular Member State, this will have to be done without delay during the Finnish Presidency. At present, one Member State (Greece) has an excessive deficit and the question of the abrogation of the Council's decision or of a new recommendation in this regard may arise this year.

The introduction of the euro on 1 January 1999 has created a specific need for economic policy coordination in the euro area. It is vitally important for all Member States participating in the euro area to ensure that all the countries concerned pursue policies that are conducive to economic stability in the euro area and thus also the stability of the single currency. With this goal in mind, it was decided in Luxembourg in December 1997 that the ministers of the participating Member States could have informal discussions on issues connected with their shared specific responsibilities for the single currency. This led to the establishment of the Euro-11 Group immediately after the decision on the participating Member States was taken in May 1998.

Although Euro-11 discussions have been held since June 1998, the Group is still seeking to determine its working practices and procedures. One of the priorities during the Finnish Presidency will be to make the work of Euro-11 more effective by, among other things, contributing to the preparation of discussions and increasing the consistency and continuity of meetings. Euro-11 discussions will have an important part to play in preparations for the participation of the euro area in meetings of international organizations, such as the IMF, and in discussions within other fora, such as the meetings of G7 Finance Ministers' Group, in which the euro area should be able to speak with one voice. Euro-11 discussions will thus provide the President of the Euro-11 Group with the support needed for effective external representation of the euro area.

Economic policy coordination will also receive special attention during the Finnish Presidency because the Vienna European Council invited ECOFIN to report to it at the Helsinki meeting on how economic policy coordination has functioned in the Third Stage of EMU. Although this report will obviously cover coordination of macroeconomic policies, actual policy coordination by the Council is much broader in scope. It ranges from the monitoring and surveillance mechanisms under the Stability and Growth Pact to national employment action plans (Luxembourg process) and structural policies in the markets for goods and services (Cardiff process). There is therefore both a need and good grounds for extending the coverage of the report to include structural policies.

Reflecting the excessively high level of unemployment in the European Union in recent years, employment issues have attracted increasing attention within the EU. The promotion of a high level of employment has been a stated goal of the Community since the Maastricht Treaty. The Treaty was amended in Amsterdam in 1997 by adding new articles that defined the procedures according to which the intensified promotion of employment was to be implemented. The aim of the new articles is to develop a coordinated employment strategy for the Community and Member States. The Broad Economic Policy Guidelines provide a general basis and reference framework for the employment policies of Member States.

One of the new procedures is the annual adoption of the employment guidelines to be applied by the

Member States in their employment policies. The employment guidelines for 2000 will be drawn up jointly by ECOFIN and the Council of Labour and Social Affairs Ministers during the Finnish Presidency.

The aim of the European Employment Pact, which was adopted by the European Council in Cologne in June 1999, is to strengthen the Luxembourg process on employment. The Pact identifies three main ways in which this is to be done. First, the interaction between wage developments, budgetary and fiscal policies and monetary policy should be mutually supportive to the greatest possible extent. This part of the Pact is called the Cologne process. Secondly, the coordinated employment strategy within the framework of the Luxembourg process is to be developed further. Thirdly, the structural reforms implemented in accordance with the Cardiff process in order to improve competitiveness and the functioning of markets for goods, services and capital should be strengthened. The Cologne process introduces a new element, namely the macroeconomic dialogue. The ECOFIN and the Labour and Social Affairs Council will provide the general framework for this dialogue. The participants in the dialogue will be the representatives of these two Council compositions, the European Central Bank and the social partners. The procedures for implementing the Cologne process will be defined during the Finnish Presidency, when the implementation comes up for the first time.

It should be apparent from above that there are several processes within the EU that seek to promote economic growth and employment. Although the processes and the projects and programmes that they provide for complement each other to a certain extent, they have been introduced separately and at different times. As a result, a comprehensive approach is lacking and the work at practical level is fragmented.

The European Employment Pact is the first attempt to bring the various processes under one umbrella. It will not interfere in the Luxembourg or Cardiff processes as such. However, these processes must be embedded in a coherent approach that is conducive to sustainable and balanced economic development, innovation and development of training and education schemes etc. Working practices also need to be improved further by eg clarifying the division of responsibilities between the Community and Member States, developing the working methods of the

Council, eliminating overlapping and duplication and strengthening dialogue between the various partners in society.

Finland would like to initiate discussion during the Presidency on how the different growth and employment processes could be better coordinated and made more coherent. The Broad Economic Policy Guidelines provide a framework for coordination. Of course, it should be ensured that the preparation and contents of these guidelines are developed in accordance with principles agreed on earlier.

Taxation

The taxation package that the EU agreed to adopt in December 1997 will be finalized during the Finnish Presidency. The aim of this package is to combat harmful tax competition in the EU. A policy approach of this kind is needed to ensure the smooth functioning of the internal market. The introduction of the single currency has also increased pressures for closer cooperation in the field of taxation. Some observers claim that the single currency requires tax harmonization in the euro area. However, given the strength of national interests in the field of taxation, it seems unlikely that there will be much progress towards full harmonization for the time being.

The taxation package now in preparation consists of three parts. The first part deals with the reporting of national business taxation measures that are judged to be excessive or harmful from the point of view of tax competition. Assessment is based on the Code of Conduct of Business Taxation adopted by ECOFIN in December 1997. The second part of the package, which is entitled taxation of savings, concerns a proposal for a directive on the treatment of cross-border interest payments to individuals. The aim of the proposed directive is to ensure that this kind of income is brought under the scope of taxation either by levying a withholding tax at source or by requiring Member States to exchange information on interest income. To be effective, such an arrangement also requires cooperation with third countries in certain cases. The third part contains a proposal for a directive on the tax treatment of internal interest and royalty payments between associated companies. According to the directive, these payments should be exempted from taxation.

The tax package has been in preparation since December 1997 and the Vienna European Council set an explicit timetable for this work by asking ECOFIN to complete it in time for the Helsinki European Council. The timetable was confirmed by the Cologne European Council.

The Finnish Presidency is prepared to move forward in other areas of taxation as well, provided there is sufficient support from Member States. One such area is the proposal for a directive on restructuring the Community framework for the taxation of energy products. This directive is considered to be important both for the functioning of the internal market and environmental protection. Progress in this area has been rather slow so far. The Cologne European Council invited ECOFIN to pursue its work on a framework for the taxation of energy on the basis of an earlier report.

Financial services

As regards financial services, a number of projects are currently under way. One of the aims of the Finnish Presidency is to promote further progress in this field with a view to improving the functioning of the internal market. The development of the internal market for financial services is a long-standing project and the need for further development has increased with the introduction of the euro. The euro has also provided the EU with more scope for action to develop the financial markets and thus to exploit the benefits offered by the single market. The Cardiff European Council encouraged the Commission to continue this work. In May the Commission delivered a communication on this topic to ECOFIN and it was discussed further by the Cologne European Council in June. The communication includes an action plan for financial services. It is important that the action plan be launched without delay and the Finnish Presidency intends to contribute to this process.

The turmoil in international financial markets triggered by the economic and financial crises in South-east Asia, Russia and Latin America has highlighted the need to improve the functioning of the international financial system. In recent months the international financial architecture has been the subject of discussion not only within the EU but also in the International Monetary Fund and informal international

fora. A wide range of issues is involved, including increased transparency, effective supervision, international capital flows, private sector involvement, exchange rate regimes, improved functioning of the Bretton Woods institutions etc. If the EU is to play an influential part in tackling these problems at global level, it must have a common position on these issues and speak with one voice. The Cologne European Council discussed a report on these issues by ECOFIN and urged Member States to work closely together to implement the proposals. The European Council also stressed that all efforts to improve the functioning of international financial system should take place within the framework of the existing Bretton Woods institutions and highlighted the central role of the IMF. The Presidency will have an important role in ensuring the timely and comprehensive exchange and coordination of views.

Other international economic and financial issues

Clearly, much work remains to be done by the international community in addressing the problems caused by the recent economic and financial crises in Russia and other regions of the world. ECOFIN and the Euro-11 Group will be involved in dealing with these issues in the coming months. The EU will also have a central role to play as regards the post-conflict and reconstruction period in Kosovo and the Balkan area. It is too early to say what tasks this entails for the Council of the European Union in the

Balkan area. The Cologne European Council reaffirmed the willingness of the European Union and its Member States to continue to do their utmost to support countries in the region and the humanitarian aid organizations in fulfilling their important humanitarian mission. The resources requirements are immense. The view taken in Cologne was that initially resources should be allocated from the current budget, if necessary by means of a supplementary budget for 1999. Further decisions will be necessary in subsequent years. A timely response to the economic and financial crises implies a need for flexibility in the ECOFIN agenda. These tasks pose a major challenge to the Presidency since they involve the external relations of the Community, which is an area where the Presidency has a special role to play.

The results of the Finnish Presidency will be recorded at the meeting of the European Council in Helsinki in December 1999. Much hard work will be needed in the meantime. The Presidency will bring with it invaluable experience for the entire public administration in Finland. The experience gained will also be of benefit to Finland in the day-to-day management of EU affairs in the future.

18 June 1999

- **Key words:** Finnish EU Presidency, ECOFIN Council, economic policy coordination, employment, taxation, financial services

1999 parliamentary elections

Parliamentary elections were held on 21 March 1999. Of the over 3.9 million persons eligible to vote, 68.3 per cent cast votes (71.8 per cent in the last parliamentary elections).

The following table shows the percentage distribution of votes in 1999 and 1995:

	1999	1995
Social Democratic Party	22.9	28.3
Centre Party	22.4	19.8
National Coalition Party	21.0	17.9
Left Alliance	10.9	11.2
Green League	7.3	6.5
Swedish People's Party	5.1	5.1
Christian League	4.2	3.0
Reform Group	1.1	.
True Finns ¹	1.0	1.3
Others	4.2	6.9
Total	100.0	100.0

The distribution of seats in Parliament is as follows:

	1999	1995
Social Democratic Party	51	63
Centre Party	48	44
National Coalition Party	46	39
Left Alliance	20	22
Green League	11	9
Swedish People's Party	11	11
Christian League	10	7
Reform Group	1	.
True Finns ¹	1	1
Others	1	4
Total	200	200

The new Parliament assembled for its first session on 30 March 1999.

¹ 1995, Finnish Rural Party.

Supplementary budget

In June Parliament approved the first supplementary budget for 1999. New appropriations will increase central government expenditure by FIM 4.2 billion, including FIM 1.0 billion for net debt repayments. Estimated revenue is increased by FIM 4.2 billion. Taking into account the supplementary budget, total budgeted expenditure increases to FIM 191.5 billion (excl. net debt repayments), total revenue increases to FIM 192.7 billion (excl. net borrowing) and the budget surplus increases to FIM 1.2 billion. The projected surplus in the ordinary budget was FIM 0.2 billion. It is expected that the financial balance in the national accounts will remain slightly on the negative side.

As overall economic developments in the early months of the year have unfolded largely in line with forecasts on which the ordinary 1999 budget was based, it has not been necessary to make adjustments to the supplementary budget for changes in economic conditions. The supplementary budget also takes into account the ownership reorganization of Asset Management Company Arsenal Ltd and repayment to the central government for capital injections. A significant part of the supplemental budget is related to EU Structural Funds.

Ten markka commemorative coins in honour of Finland's EU presidency

The Ministry of Finance has decided on the striking of a ten markka special coin and a ten markka collector coin in honour of Finland's EU presidency. The reverse of the coins was designed by the artist Jarkko Roth. The coins will be issued starting on the first day of Finland's presidency, 1 July 1999. At most, 100,000 of the special coins and 3,000 of the collector coins will be struck.



Both coins are of the same size and obverse as the ten markka coin now in use. Embossed on the right side of the reverse is a woman's face and embossed on the left side a representation of the woman's spoken words. Inscribed around the picture are the words SUOMI, FINLAND and EU 1999. On the right-hand side of the reverse, there are also lines representing the longitudinal and latitudinal lines of the globe. The text on the edge of the coins is PUHEENJOHTAJA – ORDFÖRANDE – SÄGADOALLI.

The composition of the special coin is like that of the present ten markka coin. The centre of the collector coin is a silver alloy and the outer ring a gold alloy.

The special coin will be available from the Moneta sales outlet and banks, at a price of FIM 10. The col-

lector coin will cost FIM 1,220 (incl. VAT of FIM 220); sales will be handled by the Mint of Finland Ltd.

Publication of the Bank of Finland

The Bank of Finland Annual Report 1998 has been published. The Report contains the Governor's review, a review of monetary policy and other central bank activities in 1998, as well as the financial statements and accompanying notes. Various banking transactions undertaken by the Bank during the year under review are included in a statistical appendix. Helsinki 1999. 127 pp. ISSN 1239-9345 (print), ISSN 1456-579X (online).

Key interest rates of the Eurosystem

The Eurosystem comprises the ECB and the eleven national central banks participating in Stage Three of Economic and Monetary Union. The main refinancing operations are the principal monetary policy instrument used by the Eurosystem. Changes in the interest rate applied in the main refinancing operations signal the stance of the Eurosystem's monetary policy and have a major impact on the shortest money market rates. Pursuant to the decision taken by the Governing Council on 8 April 1999, the interest rate applied to the main refinancing operations is 2.5 per cent, effective 14 April 1999.

The Eurosystem uses the rates on its standing facilities to bound overnight market interest rates. The interest rates on the marginal lending facility and the deposit facility are set separately by the Eurosystem. Effective 9 April 1999, the interest rate on the Eurosystem's marginal lending facility is 3.5 per cent and the overnight interest rate on the deposit facility 1.5 per cent.

The Eurosystem's open market operations

Open market operations play an important role in the monetary policy of the Eurosystem. They are used for the purposes of steering interest rates, managing the liquidity situation in the market and signalling the stance of monetary policy. Open market operations are normally executed by the national central banks. Open market operations can be divided into four categories according to their purpose:

The *main refinancing operations* are weekly liquidity-providing operations executed by the national central banks on the basis of tenders and with a maturity of two weeks. They play a pivotal role in

pursuing the purposes of the Eurosystem's open market operations and provide the bulk of refinancing to the financial sector.

The *longer-term refinancing operations* are liquidity-providing tender operations with a monthly frequency and a maturity of three months. These operations aim to provide counterparties with additional longer-term refinancing. In these operations, the Eurosystem does not, as a rule, intend to send signals to the market and therefore the operations are normally executed on the basis of variable-rate tenders.

Fine-tuning operations are executed on an ad hoc basis in order to smooth the effects on interest rates of unexpected liquidity fluctuations in the market. Fine-tuning operations are executed by the national central banks primarily as reverse transactions, but they can also take the form of outright transactions, foreign exchange swaps and the collection of fixed-term deposits.

Structural operations are executed with the aim of adjusting the structural position of the Eurosystem vis-à-vis the financial sector. Structural operations can be executed through reverse transactions, outright transactions or the issuance of ECB debt certificates.

The Eurosystem's standing facilities

The standing facilities are intended to bound overnight interest rates, provide and absorb overnight liquidity and signal the general stance of monetary policy. Two standing facilities are available: the marginal lending facility and the deposit facility. Counterparties can use the marginal lending facility to obtain overnight liquidity from the national central banks against eligible assets. The interest rate on the marginal lending facility provides a ceiling for the overnight market interest rate. Counterparties can use

the deposit facility to make overnight deposits with the national central banks. The interest rate on the deposit facility provides a floor for the overnight market interest rate.

The Eurosystem's minimum reserve system

The Eurosystem's minimum reserve system applies to credit institutions in the euro area and primarily pursues the aims of stabilizing money market interest rates and creating (or enlarging) a structural liquidity shortage. The reserve base of each credit institution is defined in relation to liability items on its balance sheet. The reserve base includes deposits, debt securities issued and money market paper. However, liabilities vis-à-vis other institutions subject to the minimum reserve system are not included in the reserve base. Liabilities included in the reserve base are subject to either a 2 per cent reserve ratio or to a zero reserve ratio. Liabilities included in the reserve base and to which a zero reserve ratio is applied comprise deposits with an agreed maturity of over two years, repos and debt securities issued with an agreed maturity of over two years.

In order to pursue the aim of stabilizing interest rates, the Eurosystem's minimum reserve system enables institutions to make use of averaging provisions. Compliance with the reserve requirement

is determined on the basis of the institution's average daily reserve holdings over a one-month maintenance period. Institutions' holdings of required reserves are remunerated at the rate of the Eurosystem's main refinancing operations.

Counterparties to the Eurosystem's monetary policy operations

Institutions subject to the Eurosystem's minimum reserve system may, in general, access the Eurosystem's standing facilities and participate in the Eurosystem's main refinancing operations and longer-term refinancing operations. The Eurosystem may, however, limit the number of counterparties for fine-tuning operations and structural operations.

Assets eligible for the Eurosystem's monetary policy operations

Under the ESCB/ECB Statute, all the Eurosystem's credit operations must be based on adequate collateral. The Eurosystem accepts a wide range of securities, issued by both public sector and private sector entities, as underlying assets for its operations. A list of assets eligible for the Eurosystem's monetary policy operations is available on the ECB's website (<http://mfi-assets.ecb.int>).

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Abstracts

Series E

Pankkisääntely ja valvonta. Oikeuspoliittinen tutkimus säästöpankkien riskinotosta (Banking Regulation and Supervision: A Legal Policy Study of Risk Taking by Savings Banks)
Liisa Halme
E:15

This study considers what kind of criteria banking legislation and supervision must fulfil to be ideal in

a world where contracts, legal rules and their interpretation are inevitably imperfect because of information problems. We identify features of a regulatory and supervisory framework that would support the stability of the financial system, offer effective incentives for compliance with legal rules and commitment to lawmakers' objectives, and remedy problems caused by the asymmetry of information.

We conclude that efficient regulation and supervision require conditions where the commitment of the various parties is taken into account, there is market discipline and the actions of agents, such as bank management and regulators, are controlled. The existence of such conditions can be assumed to minimize excessive risk taking associated with moral hazard. It should be noted that we do not recommend that legislation and supervision should rely primarily on control but rather on commitment and market discipline.

Thus the *de lege referenda* conclusions focus on the issue of what kind of incentives are supported by proposed changes in legislation. The use of appropriate incentives in banking legislation and supervision underpins the stability of the financial system and stresses the responsibility of economic agents in the positive (responsibility power) and negative (responsibility sanctions) dimensions.

The empirical part of the study attempts to answer the question of the extent to which the excessive risk taking of savings banks, especially in the late 1980s, was due to structural distortions in legislation, the behaviour of the banks themselves or the behaviour of regulators. Similarly, the interpretations of legal rules by the courts are evaluated from the point of view of prevention of excessive risk taking.

Savings banks have traditionally had lower levels of equity capital than commercial banks. To counterbalance this, lawmakers imposed restrictions on the activities of savings banks that were stricter than those applicable to commercial banks. This fundamental difference persisted until the entry into force of the Deposit Banks Act. The results of the study suggest that this difference was not reflected adequately in the behaviour of banks, supervisory authorities or courts and that legal rules were not in harmony with this difference. Consequently, capital levels that were too low did not act as a sufficient incentive to prevent excessive risk taking by the savings banks nor did they safeguard the banks'

continued existence when risks started to be realized.

- **Key words:** banking regulation, banking supervision, moral hazard, principal, agent

Discussion Papers

Are there Economies of Scale in Stock Exchange Activities?

Markku Malkamäki

4/99

This is the first paper that examines economies of scale in stock exchanges. The data employed in the study include cost and output statistics for 37 stock exchanges in four continents around the world for the year 1997. The writer estimates two traditional cost functions and finds that ray (overall) scale economies exist only in the very large stock exchanges but that there are significant scale economies with respect to one of the outputs, ie the processing of trades. On the other hand, there are not equally clear scale advantages related to activities involving company-specific information. There are thus opposing forces, some tending to increase standardization and scale and others favouring the continuization of more localized facilities. The outcome of increasing competition may not be the amalgamation of exchanges but instead the centralization of certain functions, eg the trading function, and continued realization of others on a decentralized basis. There is nonetheless an obvious incentive for closer and deeper cooperation between European stock exchanges.

- **Key words:** stock exchanges, alliances, economies of scale, technology

Settlement Risks in Foreign Exchange Trading: Reduction and Management

Risto Herrala – Risto Nieminen

5/99

Because of the huge transaction volumes involved in foreign exchange trading, the associated settlement risks have grown so large that they pose a threat to

the stability of the international financial markets. The threat concerns the possibility that a payment problem of one or more currency market participants could gradually spread so as to affect the operations of more and more participants, which could in turn lead to a crisis-generating gridlocking of the international monetary system.

Institutions that engage in foreign exchange trading, cooperative groups in the field and public authorities are working in Finland and many other countries to reduce risks and improve risk management. The strategy applied in these efforts has been set out by the central bank payment and settlement systems committee of the G10 countries (CPSS). The committee's Allsop report has helped to spur similar efforts in many other countries, eg in all the Nordic countries. The Bank of Finland and the Financial Supervision Authority have worked together to clarify the situation regarding Finnish banks and have supported the development of means for reducing settlement risk.

However, international efforts to improve the management of settlement risk are still ongoing. One reason for the slow progress is the global scale and complexity of the problems involved, which have eg slowed the process of creating international institutions for settlement of currency trades. Development in the area of risk management methods has also been slowed in Finland and on the international level by the launch of the euro and preparations for the Year 2000, which require sizable inputs of banks' resources. The key factor for the pace of the development is the will of institutions that engage in currency trading to improve their own risk management.

■ **Key words:** currency trading, settlement risks, risk management, monetary stability

BOFIT Discussion Papers

Tax Evasion and Economies in Transition: Lessons from Tax Theory

Jukka Pirttilä

2/99

This study considers the pervasive tax evasion of transition economies, with particular reference to Russia's tax system. Starting with a survey of theoretical literature on tax evasion and corruption, it argues that, although standard tax theory offers many insights, certain special features of transition economies deserve attention. These include the legacy of socialism resulting in a state willing to exercise discretionary power but possibly lacking credibility and public support, the 'disorganization' phenomenon that hampers efficient tax administration, and the relationship of restructuring, speed of reform and the tax system. The paper also contains recommendations on reform of the tax system to achieve reasonable deterrence of evasion.

■ **Key words:** tax evasion, corruption, transition economies, Russia

Finland in brief

Land, climate and population

Finland covers an area of more than 338 000 square kilometres. The total area is slowly increasing because of the steady uplift of the land since the last glacial era. The country shares frontiers with Sweden in the west, Norway in the north and Russia in the east and has a coastline bordered by the Baltic Sea in the south and west. Agricultural land accounts for 6 % of the total area, forest and other wooded land for 68 % and inland waters for 10 %. Located between latitudes 60° and 70° north, Finland has warm summers and cold winters. Helsinki on the south coast has an average maximum temperature of 21° C (70° F) in July and -3° C (25° F) in February.

Finland has a population of 5 159 646 (31 December 1998) and an average population density of 17 per square kilometre. The largest towns are Helsinki (Helsingfors), the capital, with 546 317 inhabitants, Espoo (Esbo) 204 962, Tampere (Tammerfors) 191 254, Vantaa (Vanda) 173 860 and Turku (Åbo) 170 931.

There are two official languages: 93 % of the population speaks Finnish as its mother tongue and 5.7 % Swedish. There is a small Lapp population in the north. Finnish is a member of the small Finno-Ugrian group of languages, which also includes Estonian and Hungarian.

Form of government

Finland is a parliamentary democracy with a republican constitution. From the twelfth century to 1809 Finland was part of the Kingdom of Sweden. In 1809 Finland was annexed to Russia as an autonomous Grand Duchy with the Tsar as Grand Duke. On 6 December 1917 Finland declared her independence. The republican constitution adopted in 1919 remains essentially unchanged today.

The legislative power of the country is exercised by Parliament and the President of the Republic. The supreme executive power is vested in the President, who is elected for a period of six years. The President for the current term, 1 March 1994 to 1 March 2000, is Mr Martti Ahtisaari.

Parliament, comprising 200 members, is elected by universal suffrage for a period of four years. Following the parliamentary elections of 1999, the seats of the various parties in Parliament are distributed as follows:

Social Democratic Party 51; Center Party 48; National Coalition Party 46; Left Alliance 20; Swedish People's Party 12; Green League 11; Christian League 10; True Finns 1; and Reform Group 1.

Of the 18 ministerial posts in the present Government appointed in April 1999, 6 are held by the Social Democratic Party, 6 by the National Coalition Party, 2 by the Left Wing Alliance, 2 by the Swedish People's

Party, 1 by the Green League and 1 by an expert with no party affiliation. The Prime Minister is Mr Paavo Lipponen of the Social Democratic Party.

Finland is divided into 452 self-governing municipalities. Members of the municipal council are elected by universal suffrage for a period of four years.

International relations

Finland became a member of the BIS in 1930, the IMF in 1948, the IBRD in 1948, GATT in 1950, the UN in 1955, the Nordic Council in 1955, the IFC in 1956, IDA in 1960, EFTA in 1961, the ADB in 1966, the OECD in 1969, the IDB in 1977, the AfDB in 1982, the MIGA in 1988, the Council of Europe in 1989, the EBRD in 1991 and the EU in 1995.

Citizens of the five Nordic countries, Denmark, Finland, Iceland, Norway and Sweden, have enjoyed a common labour market, a passport union and reciprocal social security benefits since the mid-1950s.

Having abolished most quantitative restrictions on foreign trade in 1957, Finland first took part in European free trade arrangements under the auspices of EFTA in 1961. Finland's free trade agreement with the EEC entered into force in 1974 and agreements for the removal of trade barriers were concluded with several eastern European countries as well. The agreement on the European Economic Area (EEA) between the member countries of EFTA and the European Union came into effect at the beginning of 1994. Finland became a member of the European Union on 1 January 1995. Finland and ten other EU countries entered to Stage Three of EMU in 1999.

The economy

Output and employment. Of the gross domestic product of FIM 583 (EUR 98) billion in basic values in 1998, 2 % was generated in agriculture and fishing, 3 % in forestry, 30 % in industry, 5 % in construction, 12 % in trade, restaurants and hotels, 9 % in transport and communications, 4 % in finance and insurance, 15 % in other private services and 20 % by producers of government services. Of total employment of 2.2 million persons in 1998, 6.5 % were engaged in primary production, 27.6 % in industry and construction and 65.9 % in services.

In 1998, expenditure on the gross domestic product in purchasers' values amounted to FIM 676 (EUR 114) billion and was distributed as follows: net exports 9 % (exports 40%, imports -31%), gross fixed capital formation 19 %, private consumption 51 % and government consumption 22 %. Finland's tax ratio (gross taxes including compulsory employment pension contributions relative to GDP) was 46.9 per cent, which is

somewhat below the average for the Nordic countries.

Average annual (compounded) growth of real GDP was 4.7 % in the period 1950–59, 5.0 % in 1960–69, 3.7 % in 1970–79, 3.7 % in 1980–89 and 3.7 % in 1990–98. Finland's GDP per capita in 1997 was USD 24 537.

Foreign trade. EU countries absorb the bulk of Finnish merchandise exports. In 1994–1998 their average share was 53.5%. Over the same period, Finland's exports to other European countries (including Russia) accounted for 20.6 % and to the rest of the world for 25.9 %. The regional distribution of Finland's merchandise imports in the same period has been quite similar to that of exports: EU countries accounted for 56.4 %, other European countries for 19.6 % and the rest of the world for 24.0 %.

In 1998, the share of forest industry products in total merchandise exports was 30.5 %, the share of metal and engineering products 45.8 % and the share of other goods 23.7 %. Raw materials and intermediate goods (incl. crude oil) accounted for 56.3 % of merchandise imports, fuels for 2.7 %, investment goods for 16.7% and consumption and other goods for 24.3%.

Forest resources. Finland has abundant forest resources but only limited amounts of other raw materials. The growing stock comprises 1 937 million cubic metres, of which 46 % is pine, 36 % spruce, 15 % birch and 3 % other broad-leaved species.

According to the National Forest Inventory for 1992–1998, the annual volume increment was about 76.3 million cubic metres. Over the same period the average annual drain was about 59 million cubic metres.

Finance and banking

Currency. Finland had its own monetary system from 1865 to 1998. The currency unit was the markka (plural markkaa), which was divided into 100 penniä (singular penni). During the last decades of this period the objective of foreign exchange policy was to maintain a fixed exchange rate in relation to a given currency basket. On 8 September 1992 the markka was allowed to float. On 14 October 1996 the markka joined the Exchange Rate Mechanism of the European Monetary System. Since the beginning of 1999 Finland has participated in the single currency area, in accordance with the Treaty establishing the European Community. The conversion rate for the markka, as confirmed by the Council of the European Union on 31 December 1998, is 5.94573. With effect from the beginning of 1999 the currency unit used in Finland is the euro, which is divided into 100 cent. The markka will, however, remain as the national denomination of the euro until the year 2002, and during this time notes and coins denominated in markkaa will continue to be used.

The Central Bank. The two new laws adopted in 1997 and 1998 make Finnish legislation compatible with the requirements of the Treaty establishing the European Community and the Statute of the European System of

Central Banks and the European Central Bank. The latter law, the new Act on the Bank of Finland, integrates the Bank of Finland into the ESCB. In performing the tasks of the ESCB, the Bank of Finland acts in accord with guidelines and instructions issued by the ECB. Under the Treaty, the primary objective of the Bank of Finland is to maintain price stability. The new Act did not change the division of responsibilities between the Parliamentary Supervisory Council and the Board. The tasks of the Council are connected with supervision of the Bank's administration and operations, administrative decisions and certain other responsibilities. The Board of the Bank of Finland comprises the Chairman (Governor) and a maximum of five (currently three) other members, all of whom are appointed by the President of the Republic upon a proposal from the Council. The Chairman of the Board is appointed for a seven-year term and the other members of the Board each for a five-year term. The Bank of Finland has a head office in Helsinki and four branch offices in other towns.

Other banks (31 Dec 1998). Finland has three major groups of deposit banks with a total of about 1 600 offices. There are two big commercial banks with national branch networks and seven smaller ones. The commercial banks have a total of 13 foreign branches, subsidiaries and associate banks and 17 representative offices abroad. There are 40 savings banks and 294 co-operative banks, both with extensive branch networks. In addition, 6 foreign banks have branches and 6 foreign banks have representative offices in Finland.

Financial markets. The total stock of domestic credit amounted to FIM 717.3 (EUR 120.6) billion at end-December 1998 and was broken down by lender group as follows: deposit banks 51 %; insurance companies 6 %; pension insurance institutions 24 %; other credit institutions 9 %; central and local authorities and social security funds 10 %.

In the money market, the total value of instruments outstanding was about FIM 125.5 (EUR 21.1) billion at end-March 1999; bank certificates of deposit accounted for 71% of the total and Treasury bills, commercial paper and local authority paper for the rest.

At end-December 1998 there were 91 companies on the Main List, 40 on the Investors' List and one company on the Prelist of the HEX, Helsinki Exchanges. At end-March 1999 total market capitalization was FIM 940.7 (EUR 158.2) billion for the Main List, FIM 10.0 (EUR 1.7) billion for the Investors' List and FIM 10.4 (EUR 1.8) billion for the Prelist. Domestic bonds and debentures in circulation at end-March 1999 amounted to FIM 328.2 (EUR 55.2) billion; government bonds accounted for 82 % of the total. Share turnover on the HEX, Helsinki Exchanges amounted to FIM 323.0 (EUR 54.3) billion in 1998. In January–March 1999 share turnover amounted to FIM 123.2 (EUR 20.7) billion.



VISITING SCHOLARS PROGRAMME

BANK OF FINLAND

The Bank of Finland, the national central bank, has 750 employees, some 30 of whom are involved in research. The Bank is located in Helsinki.

The Bank of Finland welcomes applications from foreign and Finnish scholars for a post under the Bank's Visiting Scholars Programme at the Research Department. Scholarships for six months are available for faculty or post-doctoral level research projects in two main research areas:

- (1) The modelling of monetary policy
- (2) The future of the financial services sector.

In the area of monetary policy modelling, we are especially interested in incorporating the analysis of credibility and policy uncertainty in applied models that could be used to analyze monetary policy in practice. The second area aims at illuminating the ongoing structural transformation of the global financial services industry, as driven by electronification and increased competition in particular. This area includes stability and other public policy aspects of the transformation.

A visiting scholar will be expected to conduct research based on a mutually agreed research plan. Articles stemming from the research are expected to be included in the Bank's Discussion Papers and may be published elsewhere as well. A visiting scholar should normally also give a lecture at the Bank to an audience of economists on his or her research topic as well as interact with other researchers engaged in projects in the same area.

Remuneration for visiting scholars will be commensurate with their research experience.

Persons interested in applying are invited to send

- a brief research proposal concerning either of the two areas
- a CV specifying the applicant's academic and research background, with the names of two or three referees

to: Research Department
Bank of Finland
P.O.Box 160
Helsinki, Finland
Fax: +358 9 183 2560
Email: Kaisa-Liisa.Nordman@bof.fi

Inquiries: Juha Tarkka, Head of Research Department,
phone +358 9 183 2581, email Juha.Tarkka@bof.fi
or
Jouko Vilmunen, Research Supervisor, Research Department
phone +358 9 183 2594, email Jouko.Vilmunen@bof.fi

Balance sheet of the Bank of Finland. million EUR

	1999			
	26.2.	26.3.	30.4.	28.5.
Assets				
1 Gold and gold receivables	389	389	411	411
2 Claims on non-euro area residents denominated in foreign currency	7 068	7 253	7 739	7 573
2.1 Receivables from the IMF	789	788	942	938
2.2 Balances with banks and security investments, external loans and other external assets	6 278	6 465	6 797	6 636
3 Claims on euro area residents denominated in foreign currency	459	357	307	464
4 Claims on non-euro area residents denominated in euro	3 848	5 479	6 955	1 699
4.1 Balances with banks, security investments and loans	3 848	5 479	6 955	1 699
4.2 Claims arising from the credit facility under the ERM II	0	0	0	0
5 Lending to financial sector counterparties of euro area	1 644	1 053	811	750
5.1 Main refinancing operations	1 191	810	657	714
5.2 Longer-term refinancing operations	452	242	94	34
5.3 Fine-tuning reverse operations	0	0	0	0
5.4 Structural reverse operations	0	0	0	0
5.5 Marginal lending facility	0	0	59	0
5.6 Credits related to margin calls	0	0	0	0
5.7 Other lending	1	2	2	2
6 Securities of euro area residents denominated in euro	0	0	0	0
7 General government debt denominated in euro	0	0	0	0
8 Intra-Eurosystem claims	1 873	768	768	2 563
8.1 Participating interest in ECB	70	70	70	70
8.2 Claims equivalent to the transfer of foreign currency reserves	699	699	699	699
8.3 Claims related to the issuance of ECB debt certificates	0	0	0	0
8.4 Other claims within the Eurosystem (net)	1 104	0	0	1 794
9 Other assets	623	639	664	636
Total assets	15 903	15 938	17 656	14 096

Totals/sub-totals may not add up, due to rounding.

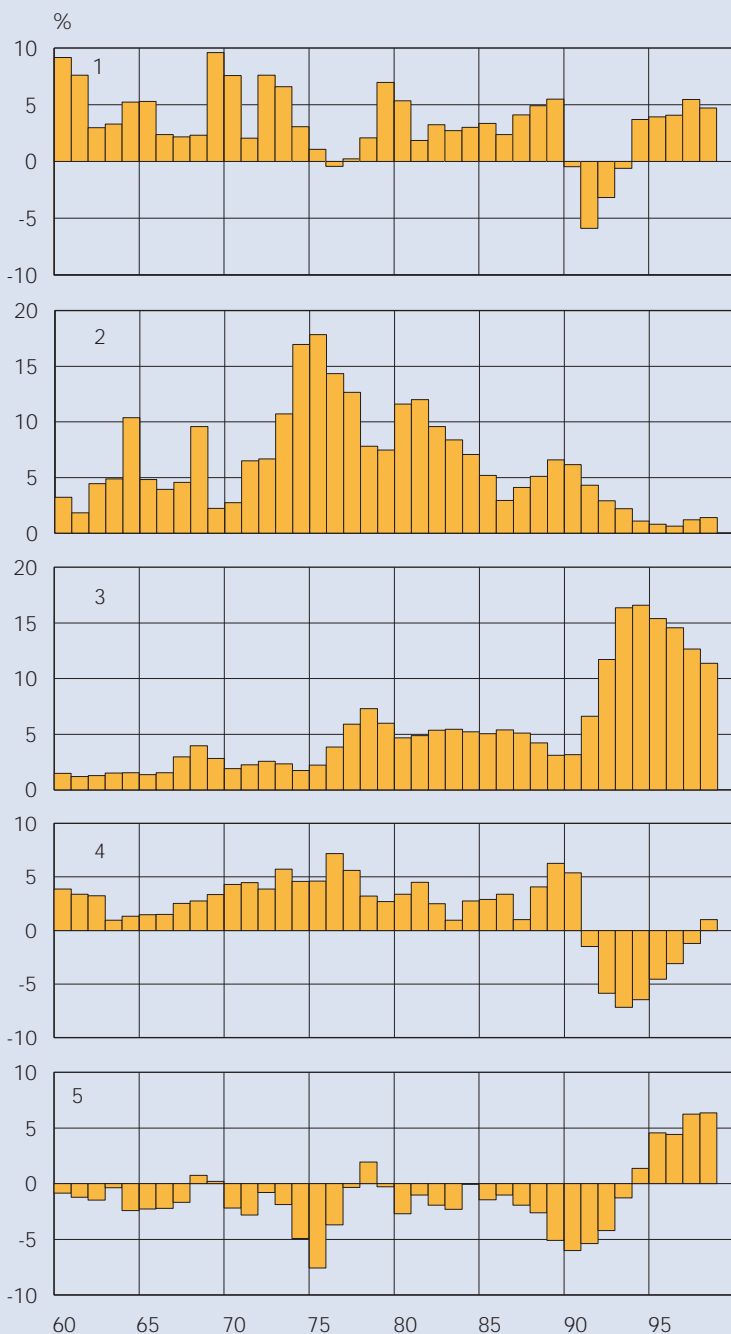
1999

	26.2.	26.3.	30.4.	28.5.
Liabilities				
1 Banknotes in circulation	2 463	2 473	2 528	2 555
2 Liabilities to euro area financial sector counterparties denominated in euro	1 962	2 120	892	2 039
2.1 Current accounts (covering the minimum reserve system)	1 962	2 120	892	2 039
2.2 Deposit facility	0	0	0	0
2.3 Fixed-term deposits	0	0	0	0
2.4 Fine-tuning reverse operations	0	0	0	0
2.5 Deposits related to margin calls	0	0	0	0
3 Liabilities to other euro area residents denominated in euro	53	77	14	2
3.1 General government	0	0	0	0
3.2 Other liabilities	53	77	14	2
4 Liabilities to non-euro area residents denominated in euro	7 544	1 497	8 886	5 043
5 Liabilities to euro area residents denominated in foreign currency	0	0	0	0
6 Liabilities to non-euro area residents denominated in foreign currency	115	193	213	185
6.1 Deposits, balances and other liabilities	115	193	213	185
6.2 Liabilities arising from the credit facility under the ERM II	0	0	0	0
7 Counterpart of special drawing rights allocated by the IMF	172	172	181	181
8 Intra-Eurosystem liabilities	0	5 811	878	0
8.1 Liabilities related to promissory notes backing the issuance of ECB debt certificates	0	0	0	0
8.2 Other liabilities within the Eurosystem (net)	0	5 811	878	0
9 Other liabilities	47	49	125	152
10 Revaluation account	430	430	823	823
11 Capital and reserves	3 116	3 116	3 116	3 116
Total liabilities	15 903	15 938	17 656	14 096

Charts

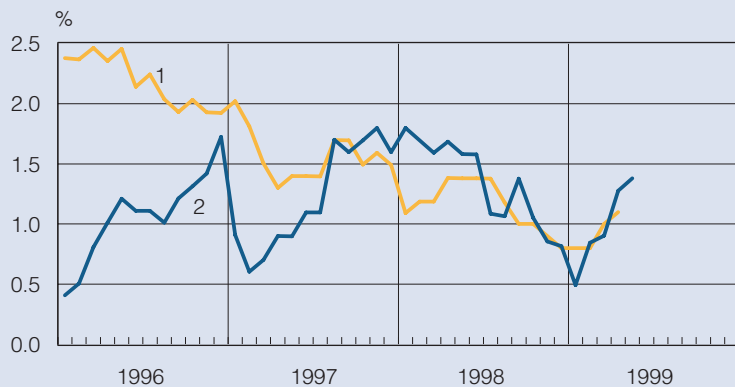
1. Finland: key economic indicators
2. Price stability in the euro area and Finland
3. Monetary aggregates for the euro area
4. Growth of the money stock in the euro area and Finland
5. Eurosystem interest rates and money market rates
6. Eurosystem (Bank of Finland) interest rates
7. Official interest rates
8. Euribor rates, daily values
9. Eurobor rates, monthly values
10. Differential between ten-year yields for Germany and selected euro area countries
11. International three-month interest rates, daily values
12. Three-month interest rates in the Nordic countries, daily values
13. International long-term interest rates, daily values
14. International three-month interest rates, monthly values
15. Three-month interest rates in the Nordic countries, monthly values
16. International long-term interest rates, monthly values
17. Yields on Finnish benchmark government bonds
18. Yields on five and ten-year Finnish government bonds
19. Bank reference rates in Finland
20. Bank deposit rates in Finland
21. Bank lending and deposit rates in Finland
22. Interest rates charged by Finnish banks on new lending to households
23. Stock of bank lending in Finland
24. Stock of bank deposits in Finland by interest rate linkage
25. Stock of bank deposits in Finland by tax treatment
26. Liabilities of Finnish monetary financial institutions included in monetary aggregates for the euro area
27. Euro area and Finnish banks: growth of deposits
28. Euro area and Finnish banks: growth of lending
29. Euro exchange rates against the US dollar and the yen, daily values
30. Euro exchange rates against the US dollar and the yen, monthly values
31. Euro exchange rates against the pound sterling and Swedish krona
32. Euro exchange rates against the Scandinavian currencies
33. Finland's trade-weighted indicator of competitiveness, daily values
34. Finland's trade-weighted indicator of competitiveness, monthly values
35. Selected stock price indices in the euro area, daily values
36. Selected stock price indices in the euro area, monthly values
37. Listed shares in Finland: total market capitalization and non-residents' holdings
38. Securities issued in Finland
39. Bonds issued in Finland
40. Mutual funds registered in Finland
41. Central government revenue and expenditure in Finland
42. Public sector balances in Finland
43. Public debt in Finland
44. Net lending in Finland by sector
45. Finland: goods account and current account
46. Finland: services account and income account
47. Regional distribution of Finnish exports
48. Finnish exports by industry
49. Finland's foreign trade: export prices, import prices and terms of trade
50. Non-residents' portfolio investment in Finnish shares
51. Finland: direct investment
52. Finland's net international investment position
53. Industrial confidence indicator in the euro area and Finland
54. Consumer confidence indicator in the euro area in Finland
55. Finland: GDP and industrial production
56. Unemployment rate in the euro area and Finland
57. Level of industrial earnings in the euro area and Finland
58. Selected asset prices in Finland

1. Finland: key economic indicators



1. GDP, volume change from previous year
2. Consumer prices, change from previous year
3. Unemployment rate
4. General government fiscal position, % of GDP
5. Current account, % of GDP

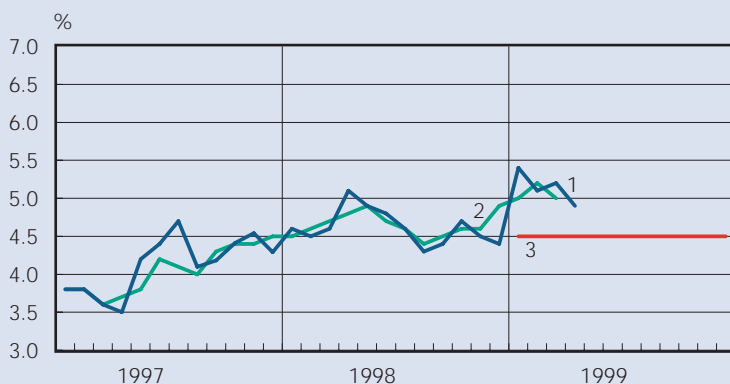
2. Price stability in the euro area and Finland



Harmonized Index of Consumer Prices, 12-month percentage change

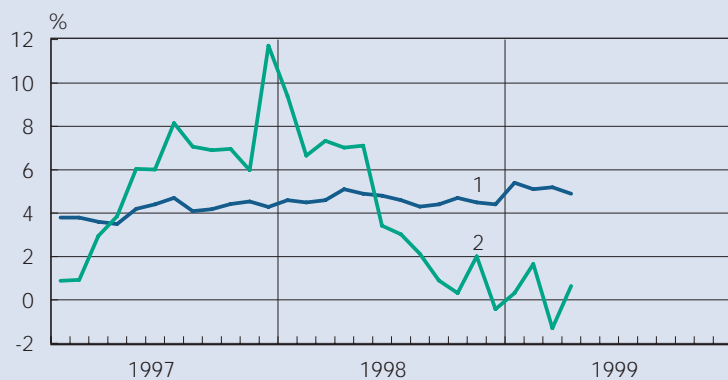
1. Euro area countries
2. Finland

3. Monetary aggregates for the euro area



1. M3, 12-month percentage change
2. M3, 12-month percentage change, smoothed by means of a 3-month moving average
3. Eurosystem's reference value for the growth of M3

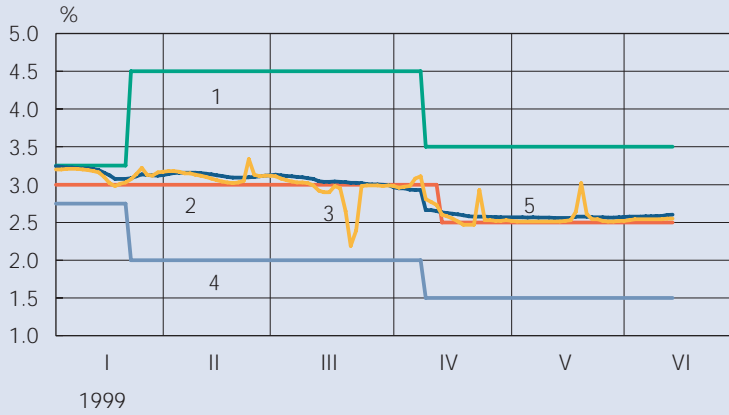
4. Growth of the money stock in the euro area and Finland



12-month percentage change

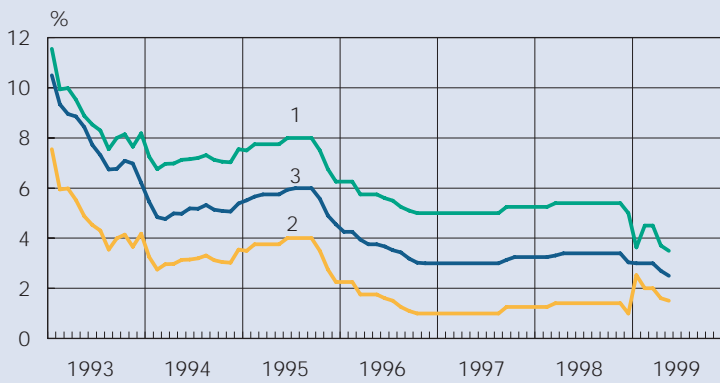
1. M3 for the euro area
2. Deposits and other liabilities of Finnish monetary financial institutions included in M3

5. Eurosystem interest rates and money market rates



1. Marginal lending rate
2. Main refinancing rate
3. Eonia rate
4. Deposit rate
5. 1-month Euribor

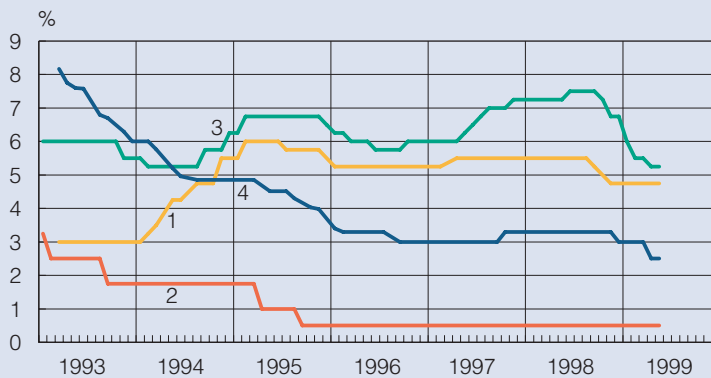
6. Eurosystem (Bank of Finland) interest rates



Bank of Finland interest rates until end-1998

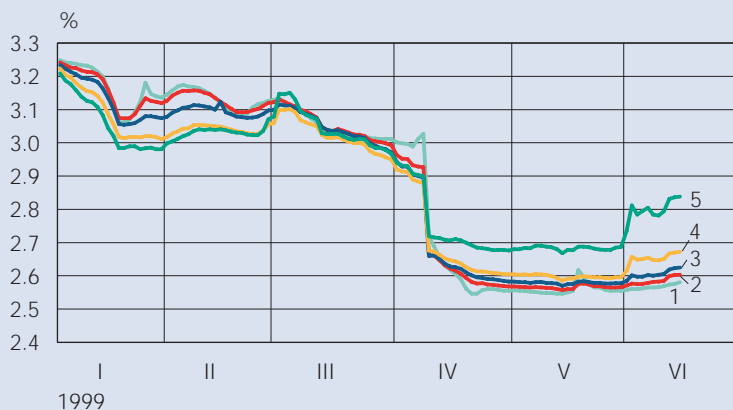
1. Marginal lending rate (liquidity credit rate until end-1998)
2. Deposit rate (excess-reserve rate until end-1998)
3. Main refinancing rate (tender rate until end-1998)

7. Official interest rates



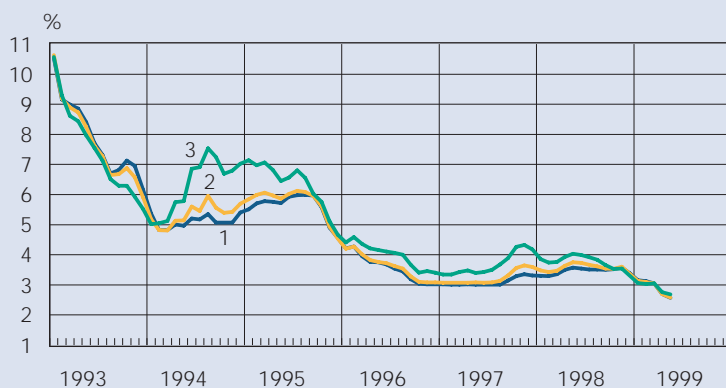
1. USA: fed funds target rate
2. Japan: discount rate
3. United Kingdom: base rate
4. Eurosystem: main refinancing rate (German repo rate until end-1998)

8. Euribor rates, daily values



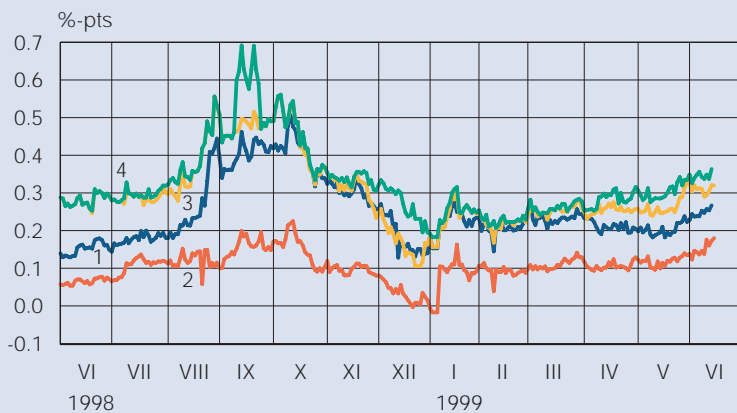
- 1. 1-week
- 2. 1-month
- 3. 3-month
- 4. 6-month
- 5. 12-month

9. Euribor rates, monthly values



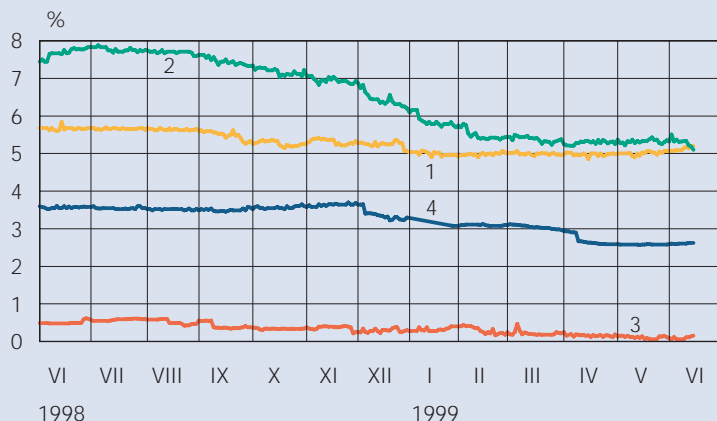
- Helibor rates until end-1998
- 1. 1-month
 - 2. 3-month
 - 3. 12-month

10. Differentials between ten-year yields for Germany and selected euro area countries



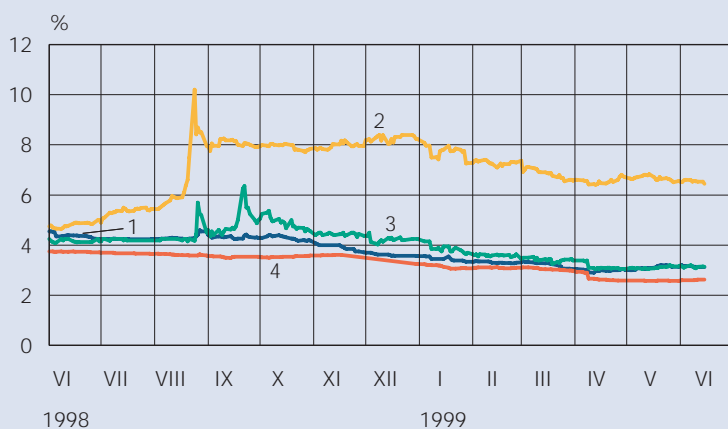
- 1. Finland
- 2. France
- 3. Italy
- 4. Largest differential

11. International three-month interest rates, daily values



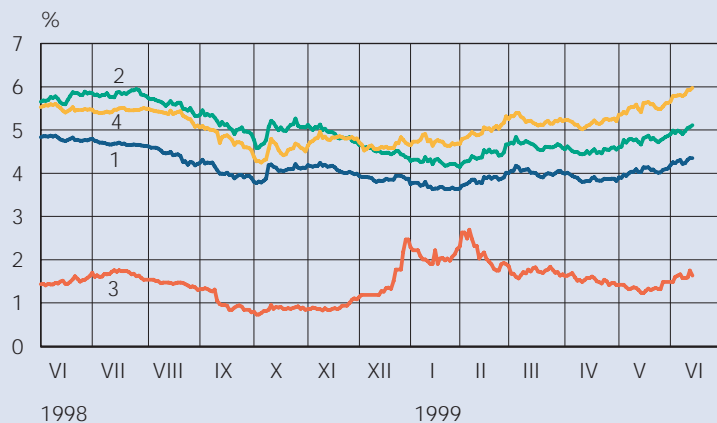
- Interbank rates
1. United States
 2. United Kingdom
 3. Japan
 4. Euro area (Germany until end-1998)

12. Three-month interest rates in the Nordic countries, daily values



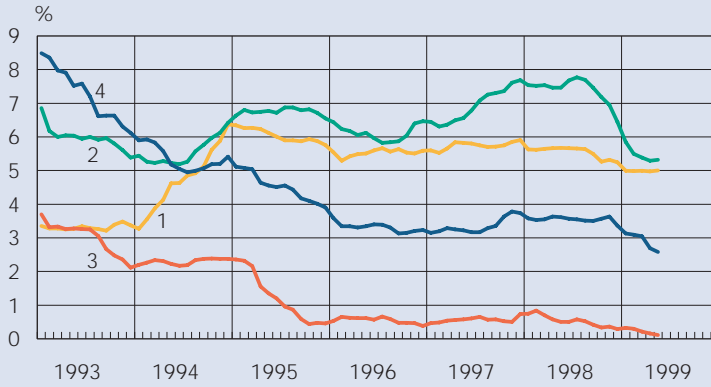
- Interbank rates
1. Sweden (Stibor)
 2. Norway
 3. Denmark
 4. Finland (Euribor; Helibor until end-1998)

13. International long-term interest rates, daily values



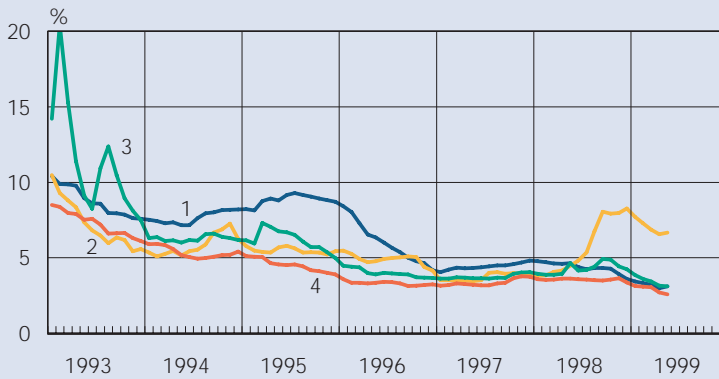
- Yields on ten-year government bonds
1. Germany
 2. United Kingdom
 3. Japan
 4. United States

14. International three-month interest rates, monthly values



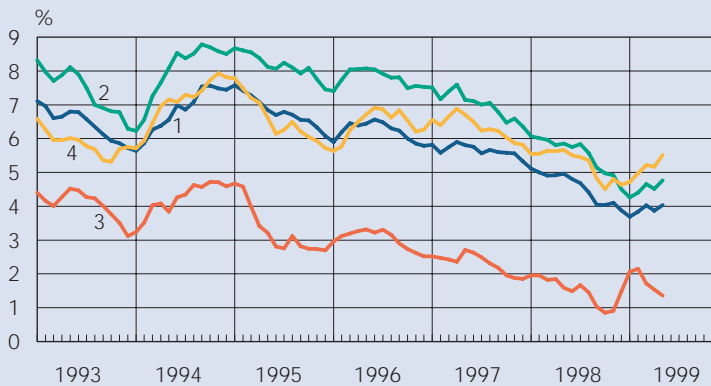
Interbank rates
 1. United States
 2. United Kingdom
 3. Japan
 4. Euro area
 (Germany until end-1998)

15. Three-month interest rates in the Nordic countries, monthly values



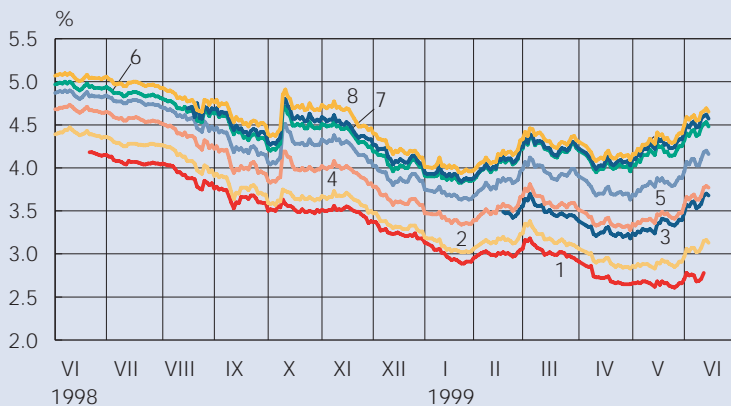
Interbank rates
 1. Sweden (Stibor)
 2. Norway
 3. Denmark
 4. Finland (Euribor; Helibor until end-1998)

16. International long-term interest rates, monthly values



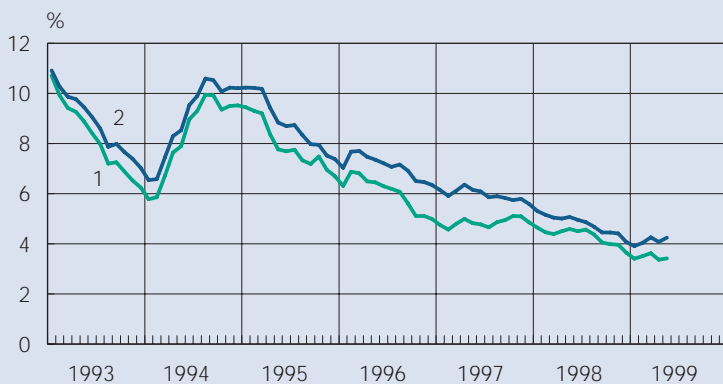
Yields on ten-year government bonds
 1. Germany
 2. United Kingdom
 3. Japan
 4. United States

17. Yields on Finnish benchmark government bonds



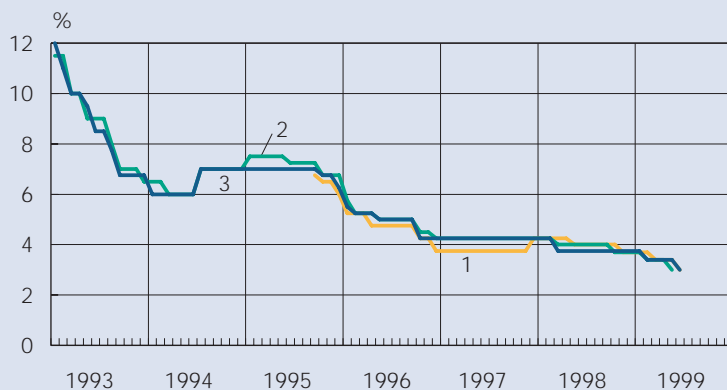
1. Bond maturing on 21 June 2000, 4 %
2. Bond maturing on 15 September 2001, 10 %
3. Bond maturing on 12 November 2003, 3.75 %
4. Bond maturing on 15 March 2004, 9.5 %
5. Bond maturing on 18 April 2006, 7.25 %
6. Bond maturing on 25 April 2008, 6 %
7. Bond maturing on 25 April 2009, 5 %
8. Bond maturing on 15 October 2010, 8.25 %

18. Yields on five and ten-year Finnish government bonds



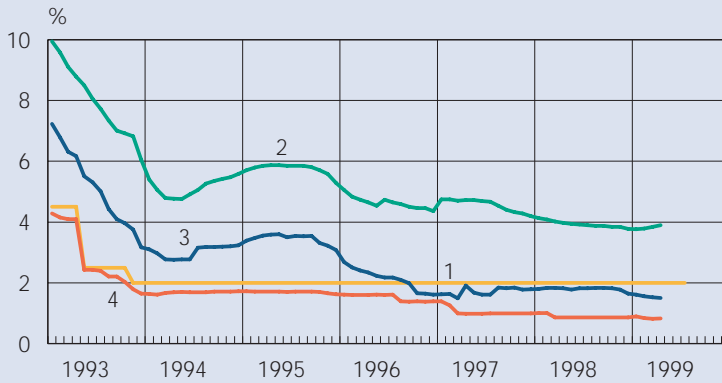
1. 5 years
2. 10 years

19. Bank reference rates in Finland



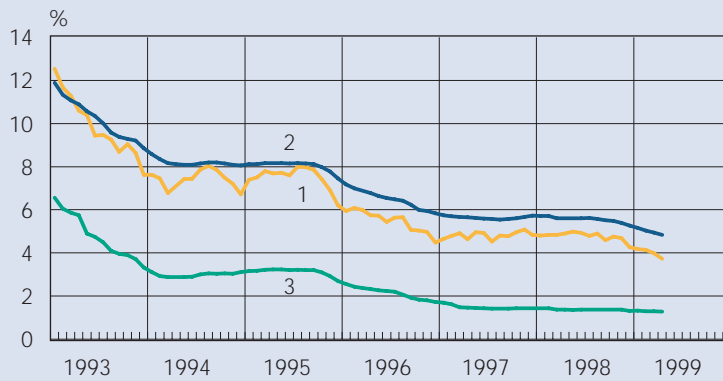
1. Merita prime
2. Leonia prime
3. OKOBANK group prime

20. Bank deposit rates in Finland



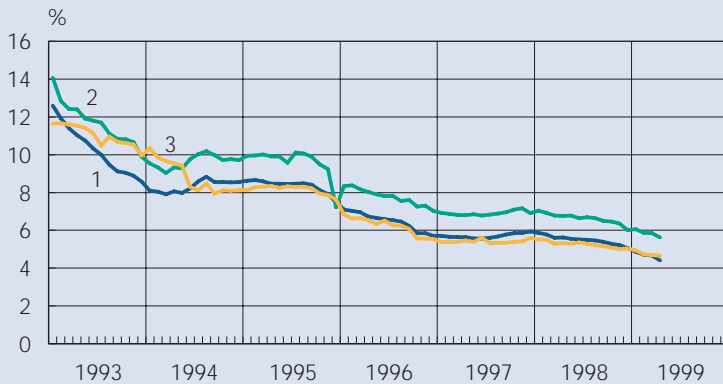
1. Rate on tax-exempt transaction accounts (upper limit)
2. Average rate on fixed-term deposits subject to withholding tax
3. Average rate on cheque and transaction accounts subject to withholding tax
4. Average rate on tax-exempt cheque and transaction accounts

21. Bank lending and deposit rates in Finland



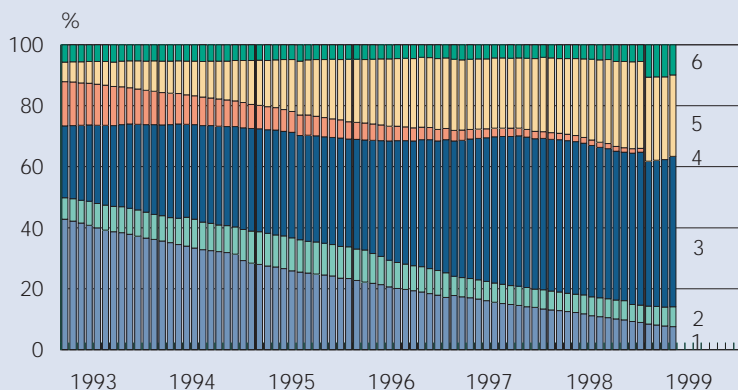
1. Rate on new lending
2. Average lending rate
3. Average deposit rate

22. Interest rates charged by Finnish banks on new lending to households



1. New housing loans
2. New consumer credits
3. New study loans

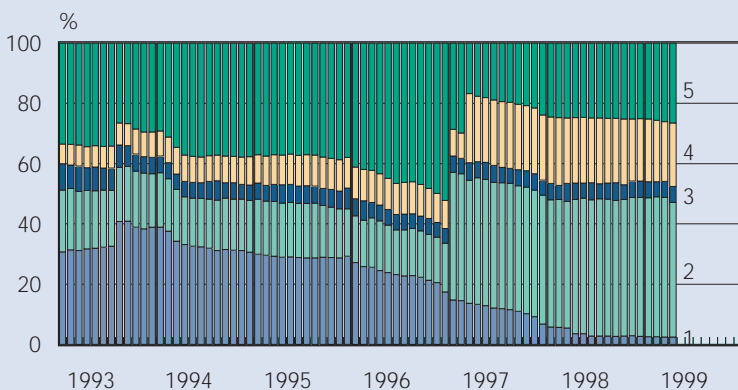
23. Stock of bank lending in Finland



Interest rate linkages, percentages

1. Linked to base rate
2. Fixed-rate
3. Linked to Euribor (Helibor until end-1998)
4. Linked to 3 and 5-year reference rates
5. Linked to reference rates of individual banks (prime rates etc)
6. Other

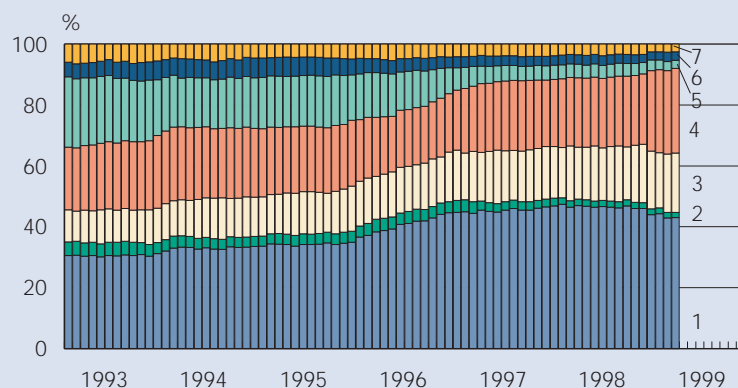
24. Stock of bank deposits in Finland by interest rate linkage



Interest rate linkages, percentages

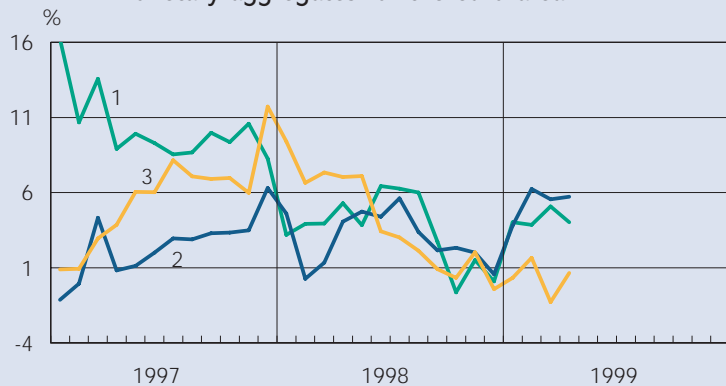
1. Linked to base rate
2. Fixed-rate
3. Linked to Euribor (Helibor until end-1998)
4. Linked to reference rates of individual banks (prime rates etc)
5. Other

25. Stock of bank deposits in Finland by tax treatment



1. Tax-exempt cheque and transaction accounts
2. Cheque and transaction accounts subject to withholding tax
3. Other taxable cheque and transaction accounts
4. Tax-exempt fixed-term accounts and other accounts
5. Fixed-term accounts and other accounts subject to withholding tax
6. Other taxable accounts
7. Foreign currency accounts

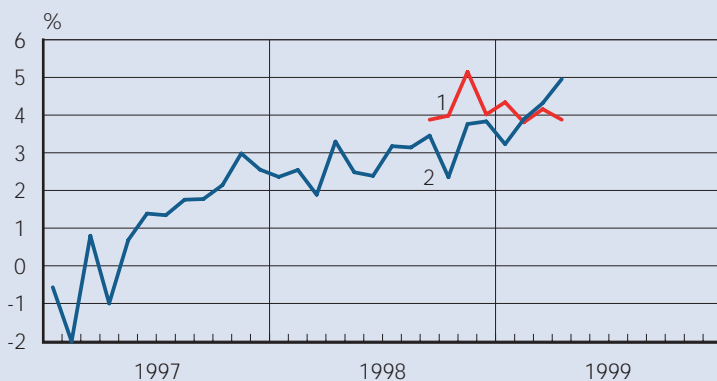
26. Liabilities of Finnish monetary financial institutions included in monetary aggregates for the euro area



12-month percentage change

1. Items included in M1: transaction accounts (=overnight deposits)
2. Items included in M2: all deposits except fixed-term deposits of over 2 years
3. Items included in M3: M2 deposits plus certain securities and other items

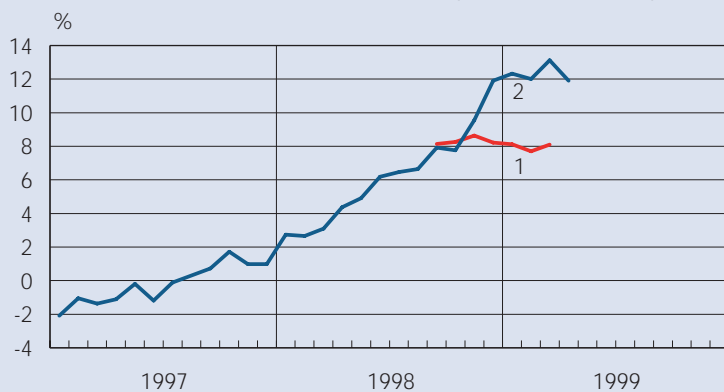
27. Euro area and Finnish banks: growth of deposits



12-month percentage change

1. Deposits of euro area residents with euro area banks
2. Deposits of Finnish residents with Finnish banks

28. Euro area and Finnish banks: growth of lending



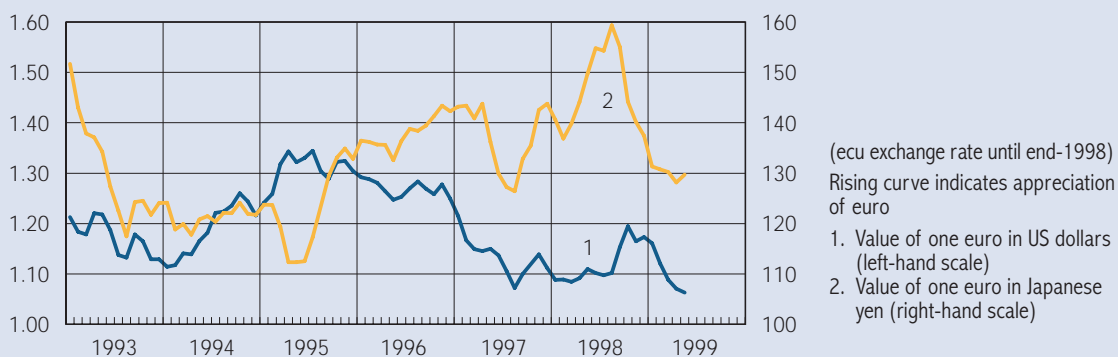
12-month percentage change

1. Lending by euro area banks to euro area residents
2. Lending by Finnish banks to Finnish residents

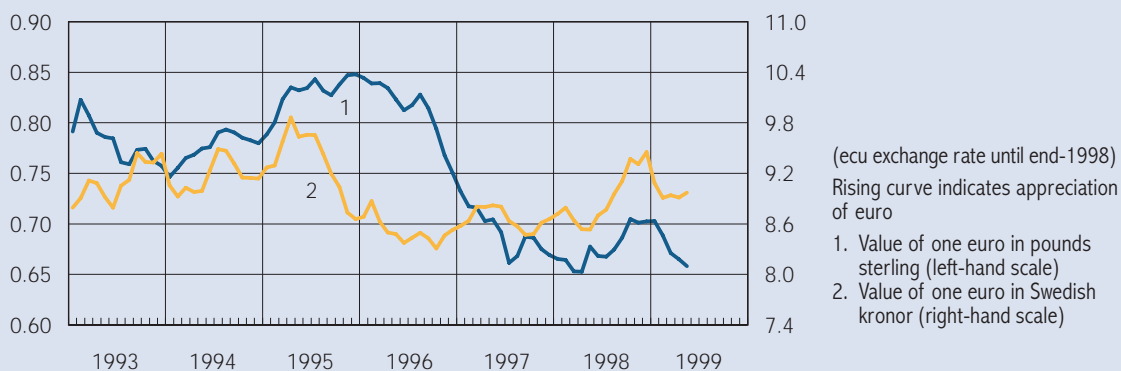
29. Euro exchange rates against the US dollar and the yen, daily values



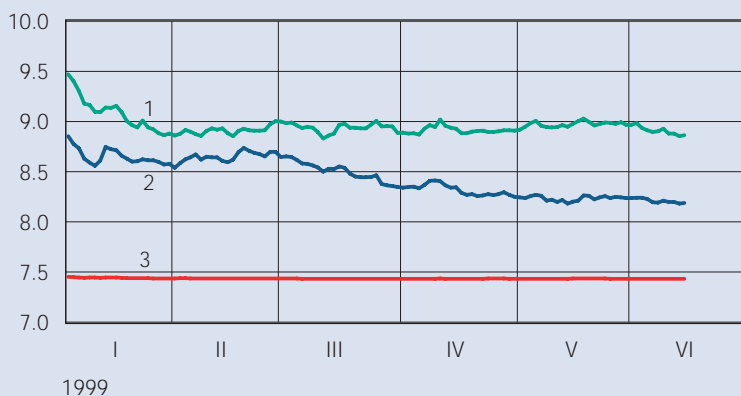
30. Euro exchange rates against the US dollar and the yen, monthly values



31. Euro exchange rates against the pound sterling and Swedish krona



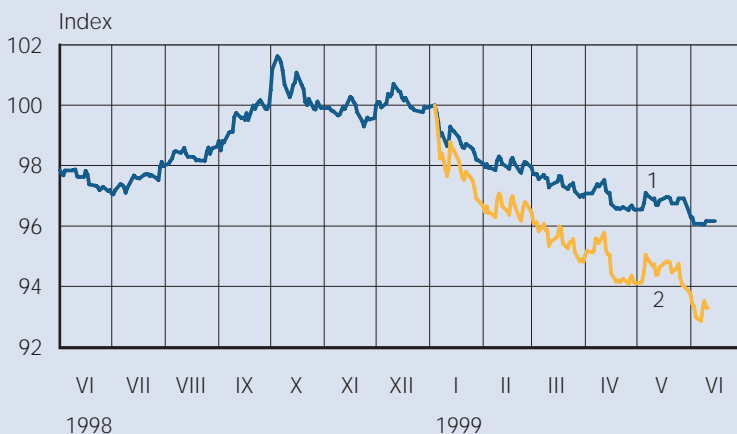
32. Euro exchange rates against the Scandinavian currencies



Rising curve indicates appreciation of euro

1. Value of one euro in Swedish kronor
2. Value of one euro in Norwegian kroner
3. Value of one euro in Danish kroner

33. Finland's trade-weighted indicator of competitiveness, daily values



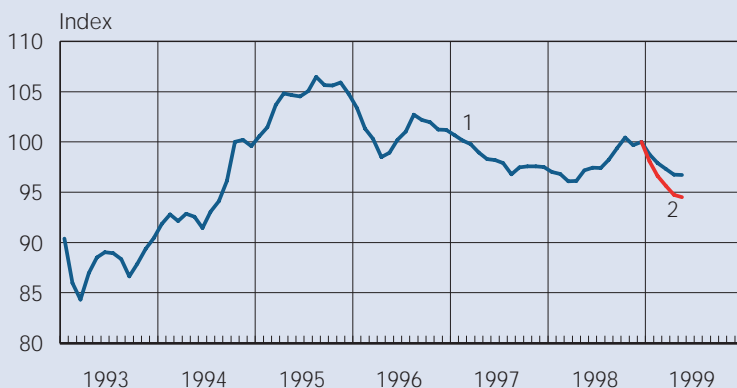
4 January 1999 = 100

Rising curve indicates decrease in Finland's price competitiveness

Former Bank of Finland currency index

1. In relation to all countries (incl. euro area)
2. In relation to countries outside the euro area

34. Finland's trade-weighted indicator of competitiveness, monthly values



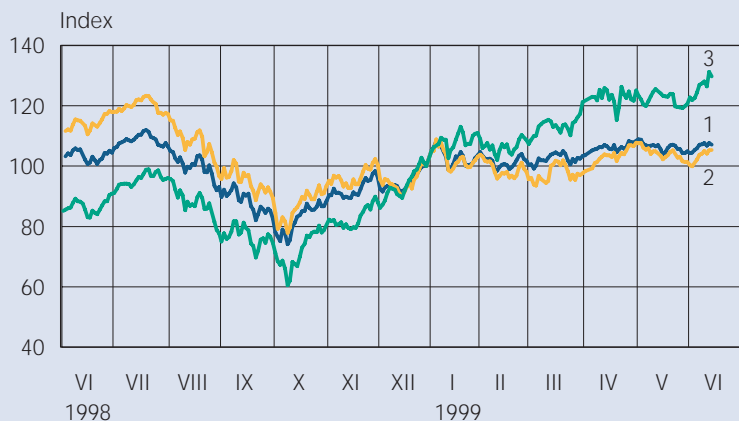
December 1998 = 100

Rising curve indicates decrease in Finland's price competitiveness

Former Bank of Finland currency index

1. In relation to all countries (incl. euro area)
2. In relation to countries outside the euro area

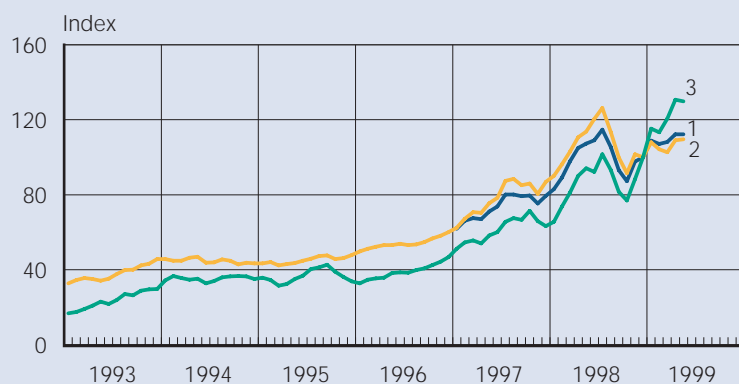
35. Selected stock price indices in the euro area, daily values



30 December 1998 = 100

1. Euro area:
Dow Jones Euro Stoxx index
2. Germany: DAX index
3. Finland: HEX all-share index

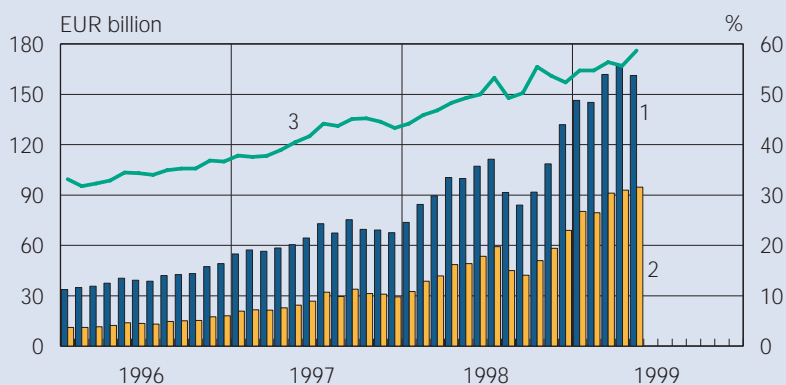
36. Selected stock price indices in the euro area, monthly values



30 December 1998 = 100

1. Total euro area:
Dow Jones Euro Stoxx index
2. Germany: DAX index
3. Finland: HEX all-share index

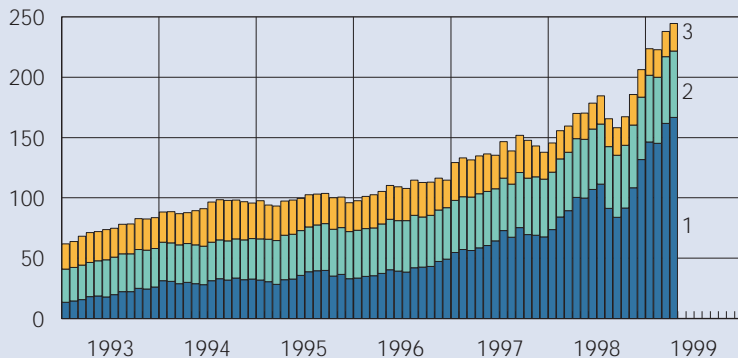
37. Listed shares in Finland: total market capitalization and non-residents' holdings



1. Market capitalization of all listed shares (left-hand scale)
2. Market capitalization of non-residents' holdings (left-hand scale)
3. Market capitalization of non-residents' holdings as a percentage of total market capitalization (right-hand scale)

38. Securities issued in Finland

EUR billion

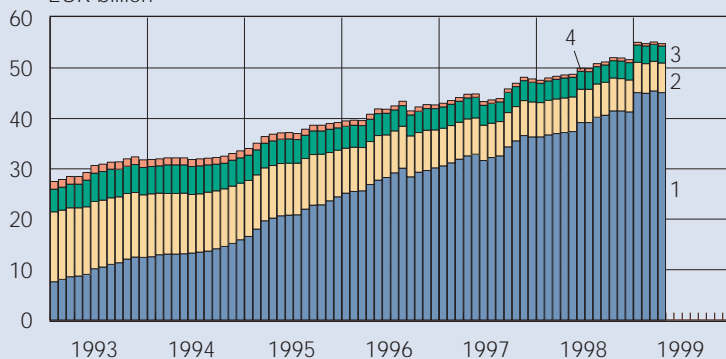


End-month stock

1. Market capitalization of shares
2. Stock of bonds, nominal value
3. Outstanding money market instruments

39. Bonds issued in Finland

EUR billion



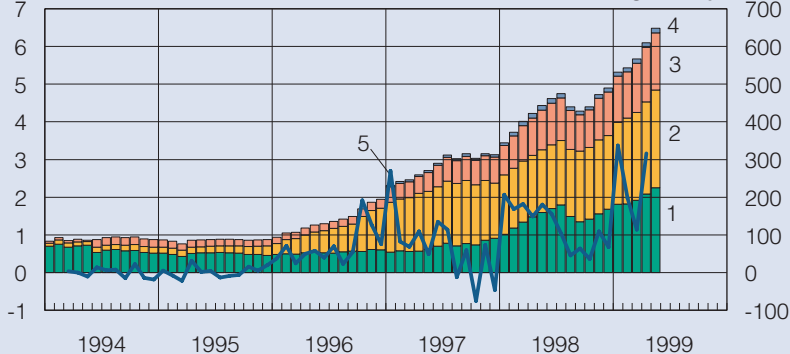
End-month stock

1. Central government
2. Financial institutions
3. Companies
4. Other

40. Mutual funds registered in Finland

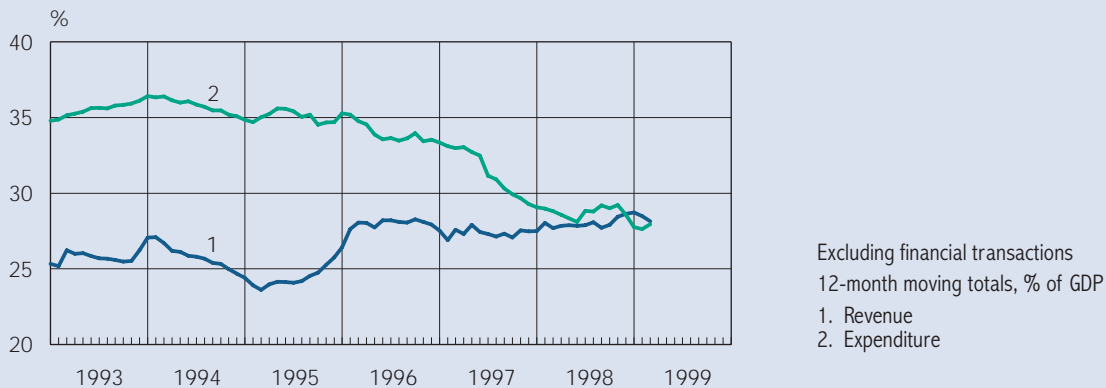
EUR billion

EUR million

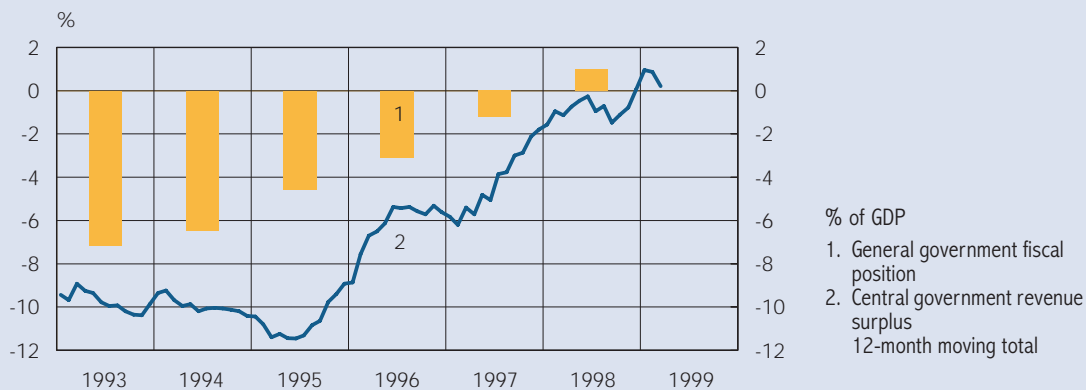


1. Equity funds (left-hand scale)
2. Fixed income funds (left-hand scale)
3. Balanced funds (left-hand scale)
4. Risk funds (left-hand scale)
5. All funds: net subscriptions (right-hand scale)

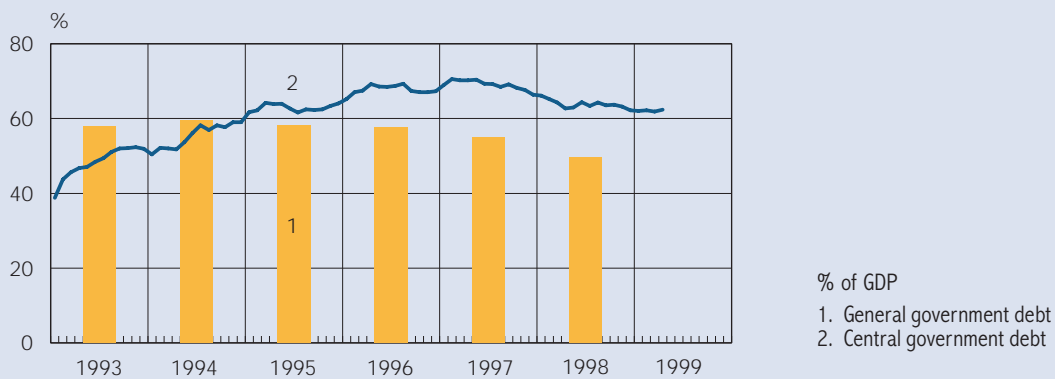
41. Central government revenue and expenditure in Finland



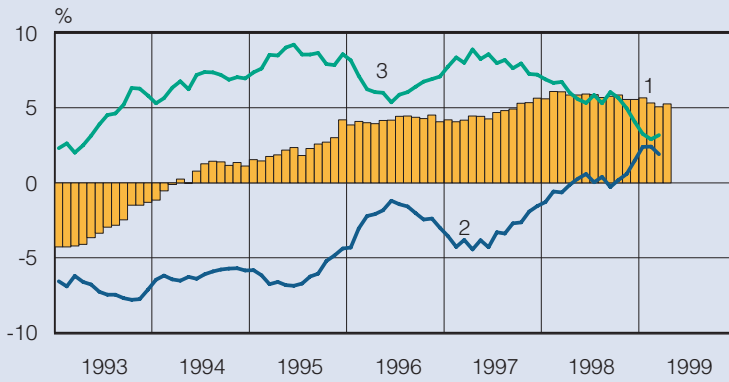
42. Public sector balances in Finland



43. Public debt in Finland



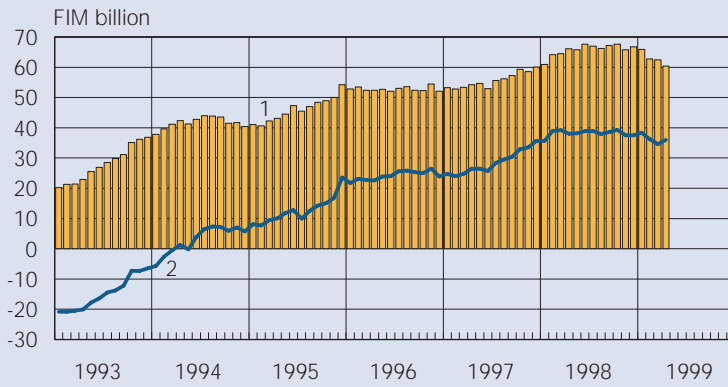
44. Net lending in Finland by sector



Main sectoral financial balances,
12-month moving total, % of GDP

1. Current account
2. General government sector
3. Private sector

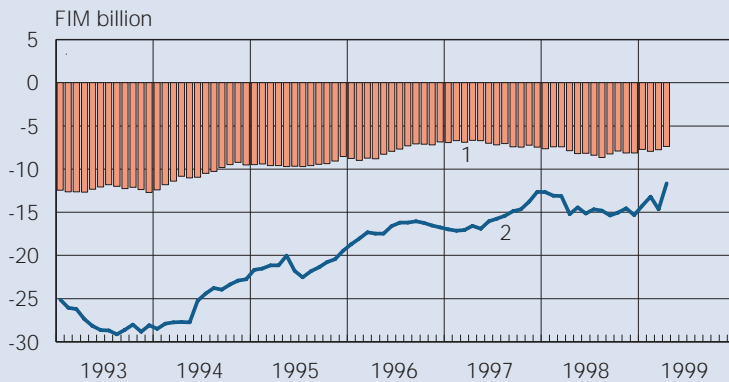
45. Finland: goods account and current account



12-month moving totals

1. Goods account, fob
2. Current account

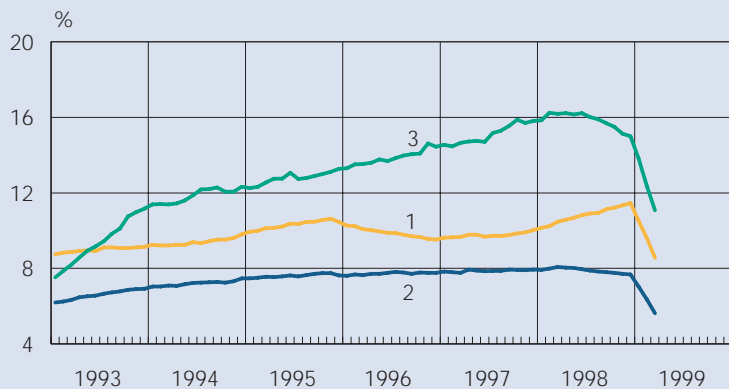
46. Finland: services account and income account



12-month moving totals

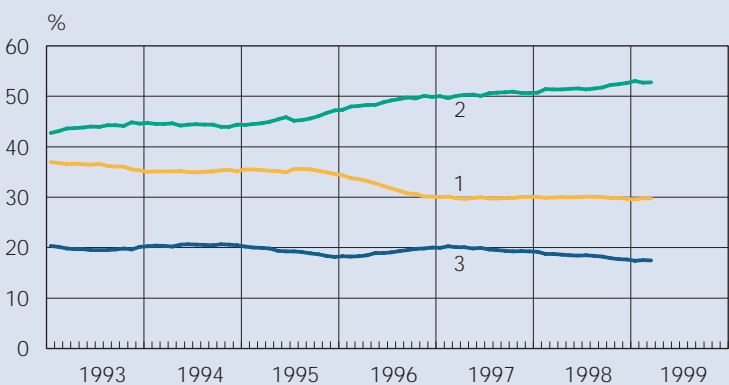
1. Services account
(trade in goods, fob)
2. Income account

47. Regional distribution of Finnish exports



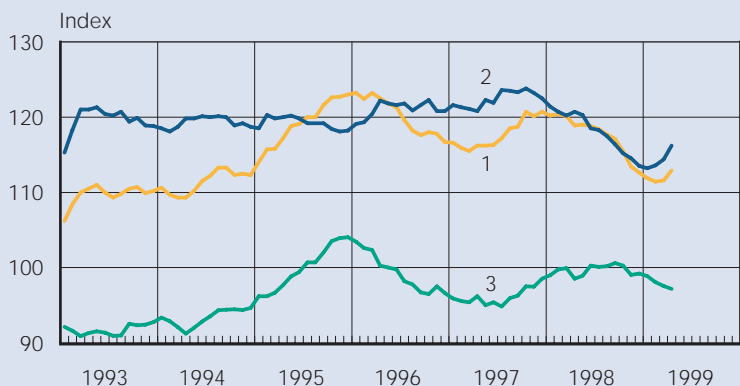
12-month moving totals, % of GDP
 1. Euro area
 2. Other EU member states
 3. Rest of world

48. Finnish exports by industry



12-month moving totals, percentage of total exports
 1. Forest industries
 2. Metal and engineering industries (incl. electronics)
 3. Other industry

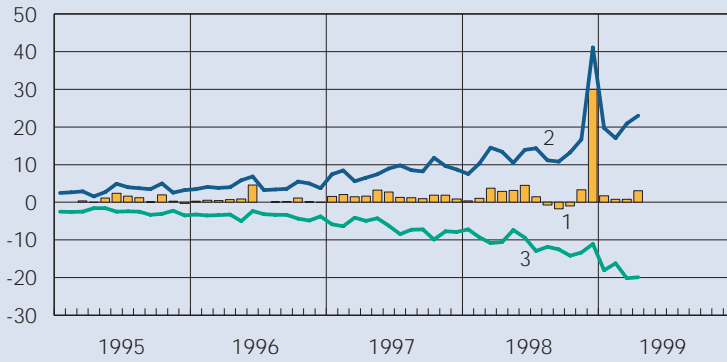
49. Finland's foreign trade: export prices, import prices and terms of trade



1990 = 100
 1. Export prices
 2. Import prices
 3. Terms of trade

50. Non-residents' portfolio investment in Finnish shares

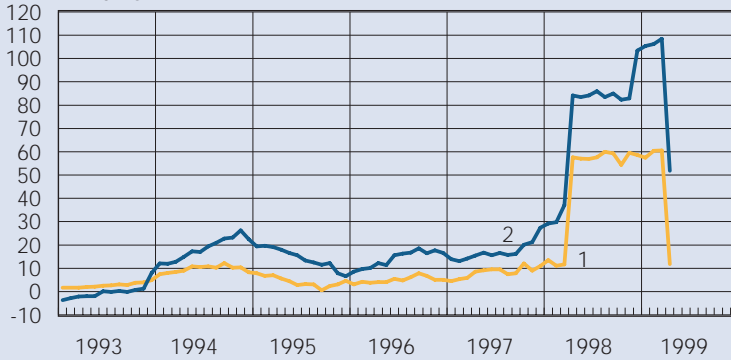
FIM billion



1. Net sales
2. Sales to non-residents
3. Repurchases from non-residents

51. Finland: direct investment

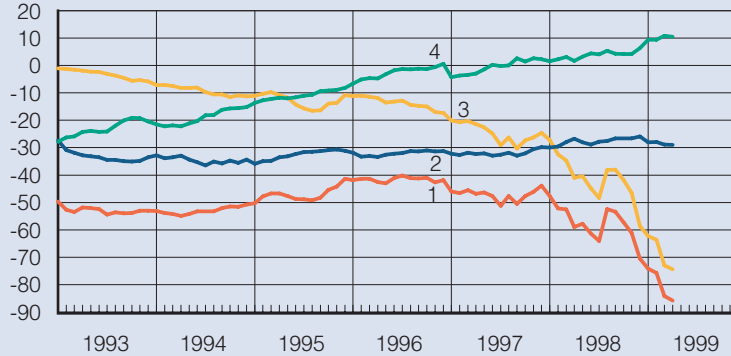
FIM billion



- 12-month moving totals
1. In Finland
 2. Abroad

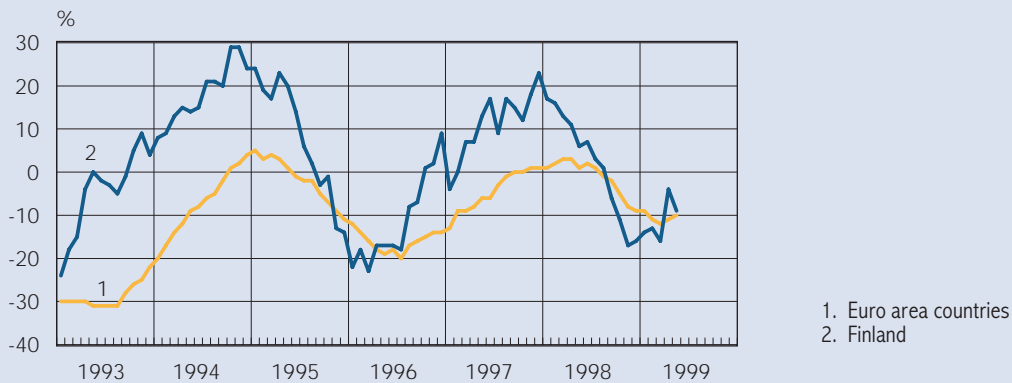
52. Finland's net international investment position

%

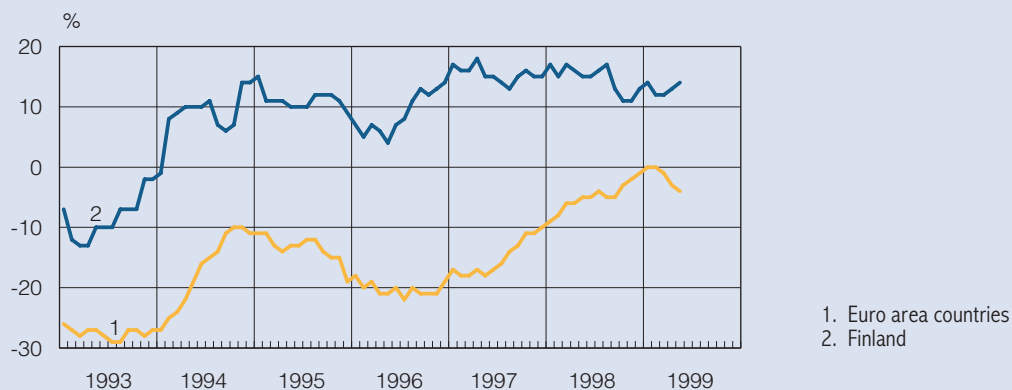


- % of GDP
1. Net international investment position
 2. Net international investment position of central government
 3. Listed shares
 4. Other items (excl. reserve assets)

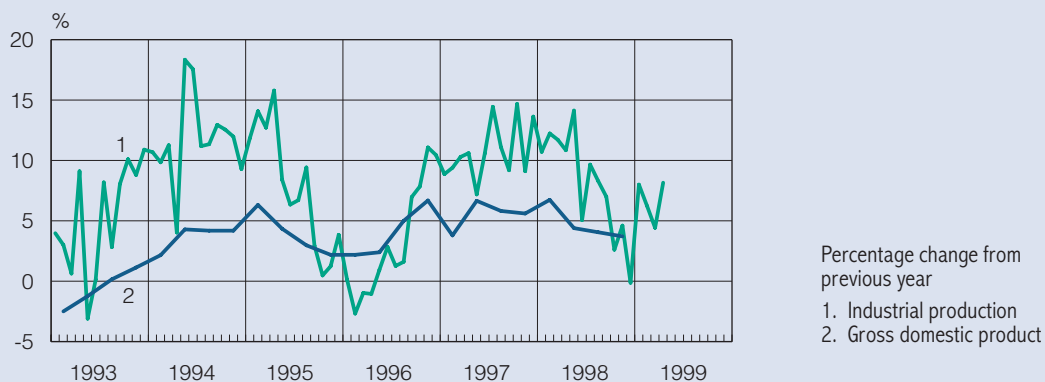
53. Industrial confidence indicator in the euro area and Finland



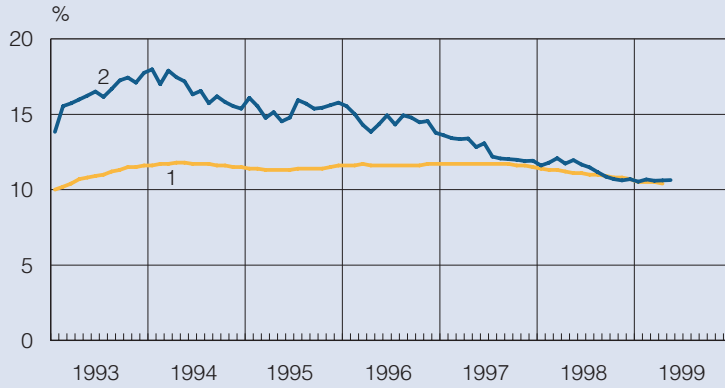
54. Consumer confidence indicator in the euro area and Finland



55. Finland: GDP and industrial production

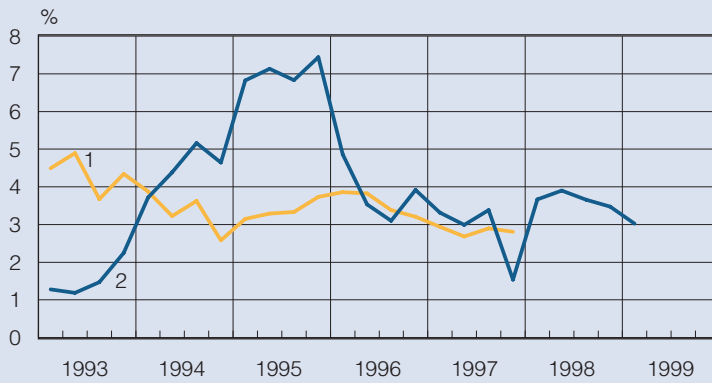


56. Unemployment rate in the euro area and Finland



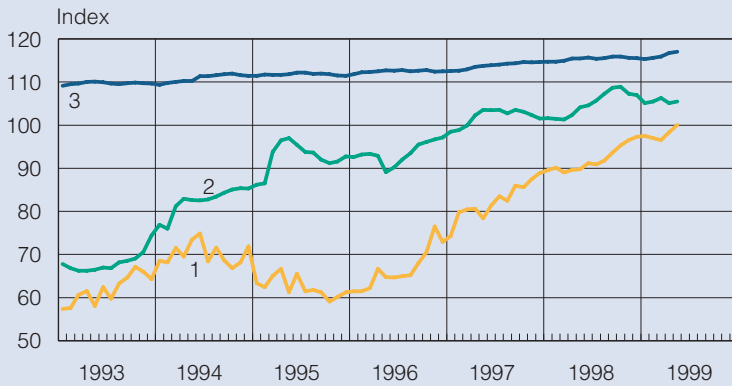
- 1. Euro area countries
- 2. Finland

57. Level of industrial earnings in the euro area and Finland



- Percentage change from previous year
- 1. Euro area countries
 - 2. Finland

58. Selected asset prices in Finland



- January 1990 = 100
- 1. Housing prices (old two-room flats; debt-free price per m²)
 - 2. Stumpage prices
 - 3. Consumer prices

The Organization of the Bank of Finland

1 June 1999

The Parliamentary Supervisory Council

Ilkka Kanerva, Chairman, Virpa Puisto, Vice Chairman,
Mauri Pekkarinen, Anneli Jäätteenmäki, Antero Kekkonen, Ben Zyskowitz,
Olavi Ala-Nissilä, Kari Uotila, Martti Tiuri

Anton Mäkelä, Secretary to the Parliamentary Supervisory Council

The Board

Matti Vanhala
Governor

Esko Ollila
Deputy Governor

Matti Louekoski
Member of the Board

Matti Korhonen
Member of the Board

Heikki T. Hämäläinen, Secretary to the Board

Pentti Koivikko, Director

Departments and other units

Pentti Pikkarainen
Economics
Kari Puumanen*
Antti Suvanto*

Markus Fogelholm
Market Operations

Antti Juusela
Communications

Taina Kivelä
Internal Audit

Heikki T. Hämäläinen
Management
Secretarial Staff

Kjell Peter Söderlund
International Secretariat

Pertti Simola
Information Technology

Jyrki Ahvonen
Security

Heikki Koskenkylä
Financial Markets
Harry Leinonen*
Ralf Pauli*

Raimo Hyvärinen
Payments and
Settlement

Arno Lindgren
Legal Affairs

Aura Laento
Personnel
Anton Mäkelä*

Terhi Kivilahti**
Development and
Budget

Urpo Levo
Payment Instruments

Juha Tarkka
Research
David Mayes*

Martti Lehtonen
Statistics

Esa Ojanen
Administration

Antero Arimo
Publication and
Language Services

* Adviser to the Board

** In addition to own duties

Pekka Sutela
Institute for
Economies in Transition

Branch offices: Kuopio, Oulu, Tampere, Turku

The Financial Supervision Authority functions as an independent body in connection with the Bank of Finland; the Director General is K. Jännäri.
