

BANK OF FINLAND

ANNUAL STATEMENT 1987

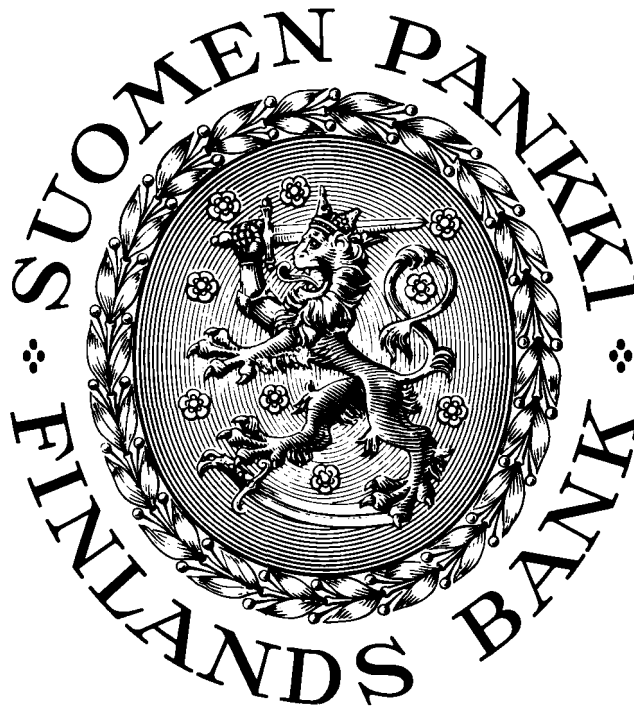
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SNELLMANINAUKIO, HELSINKI

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THE BANK OF FINLAND IN 1987

MAIN ECONOMIC DEVELOPMENTS

Economic activity picked up in 1987. As a result of strong demand in western markets and an improvement in industry's competitiveness in western Europe, the growth of exports to western markets accelerated to 6 per cent. However, the growth of total exports remained fairly modest because of the contraction of bilateral exports. Improved terms of trade clearly boosted domestic demand, which was also supported by less restrictive fiscal policy. The growth of GDP amounted to over 3 per cent inspite of the considerable losses caused by the poor harvest. Reflecting the structure of demand, import volumes grew notably faster than export volumes and the current account deficit widened to FIM 9.2 billion. Total employment remained almost unchanged. As, however, there was a decrease in the supply of labour, the unemployment rate fell slightly. Import prices fell somewhat but domestic costs continued to rise fairly rapidly. Consumer prices increased by 3.7 per cent in the course of the year.

Confidence in the external value of the markka consolidated, and the foreign exchange reserves of the Bank of Finland increased substantially. However, economic policy was confronted with a new concern that rapid growth of domestic demand could lead to an acceleration of inflation and a deepening of the current account deficit. In order to support the overall balance of the economy, the Bank of Finland sought to keep conditions in the financial markets fairly tight by tying up liquidity in the interbank market and thereby retarding the lowering of interest rates resulting from the currency inflow and the improvement in the banks' liquidity.

The methods of monetary policy implementation were further modified by shifting to a market-orientated system in which the central bank influences banks' liquidity through market operations. The Bank of Finland started to deal in certificates of deposit issued by itself and by other banks. In the foreign exchange market, the Bank of Finland introduced a more flexible policy, allowing the currency index to fluctuate more widely according to the market situation. The change did not imply any departure from the adopted policy of maintaining a stable markka.

During the past few years, Finnish financial markets have also undergone rapid change in market segments other than those for short-term deposits. Among other factors, this development reflects deregulation of banks' lending rates and partial liberalization of long-term foreign currency capital flows. The process of gradual liberalization, which has been going on for several years now, aims at a more efficient financial system which would clear the credit market at minimum margins. It is natural that adjustment to a changing environment and fiercer competition takes place over a lengthy period of time.

THE BALANCE SHEET OF THE BANK OF FINLAND

The convertible foreign exchange reserves of the Bank of Finland increased by FIM 16 756 million to FIM 27 391 million in the course of 1987. The Bank bought 1 337 kg of gold, which increased the value of gold by FIM 47 million in the balance sheet. In net terms, convertible currencies, which comprise foreign securities and deposits in foreign banks, grew by FIM 16 793 million. Holdings of convertible currencies were at their highest, over FIM 23.6 billion, at the end of November, and at their lowest, some FIM 6.6 billion, at the beginning of 1987.

The tied foreign exchange reserves fell by FIM 2 209 million and stood at FIM 1 212 million at the end of the year. The tied reserves were at their highest, FIM 4 127 million, at the end of January and at their lowest, FIM 779 million, at the end of December.

Other foreign claims increased by FIM 1 772 million to FIM 4 357 million in the course of the year. This item includes a FIM 1 930 million fixed-term claim on the Bank for Foreign Trade of the USSR, which was agreed on in early 1987. Other foreign liabilities fell by a total of FIM 197 million.

The increase in the foreign exchange reserves improved the banks' liquidity. As a result, the Bank of Finland's claims on financial institutions fell by FIM 8 926 million while liabilities to financial institutions increased by FIM 7 007 million. At the end of the year, banks did not have any call money credits; at the end of the previous year they had stood at FIM 6 818 million. In March, the Bank of Finland restricted the banks' use of call money credit with the aim of encouraging more active liquidity management by the banks. Call money deposits increased by FIM 627 million, totalling FIM 757 million at the end of the year. Cheque account claims and liabilities no longer appear in the balance sheet because the banks' daily cheque account totals are included under call money credits or deposits. As the banks' term credits and deposits were replaced by trading in certificates of deposit during the year, the item "Certificates of deposits" was added under liabilities. At the end of 1987, outstanding certificates of deposit issued by the Bank of Finland totalled FIM 4 970 million.

At the end of the year, the banks held a total of FIM 2 730 million in till-money credits, which are granted to facilitate cash management. In addition, the item "Claims on financial institutions" included a total of FIM 2 140 million in bonds held by the Bank of Finland. At the end of the year, the financial institutions' cash reserve deposits with the Bank of Finland totalled FIM 10 941 million, an increase of FIM 1 671 million on the previous year. The increase was mainly due to an expansion in the deposit base but also to an increase in the cash reserve requirement from 4.7 per cent to 4.9 per cent of the deposit base in August. During the year, the financial institutions withdrew all their capital import deposits, which had stood at FIM 255 million at the beginning of the year. At the end of the year, the Bank of Finland's net liabilities to financial institutions, including certificates of deposit, totalled FIM 11 589 million, whereas it had had a net claim on financial institutions of FIM 4 345 million at the beginning of the year.

The Bank of Finland's claims on the public sector decreased by FIM 26 million to FIM 977 million. Government bonds held by the Bank fell by FIM 56 million, while total coinage grew by FIM 32 million. The government deposit account, which had shown a balance of FIM 2 000 million at the beginning of 1987, was closed in early 1987 after the central government had started to place funds in the interbank market. On the last day of the year, the central government made a FIM 900 million counter-cyclical deposit with the Bank of Finland. Liabilities to the public sector declined by a total of FIM 1 100 million, amounting to FIM 901 million at the end of the year.

Claims on corporations decreased by FIM 1 166 million to FIM 3 678 million. Financing of exports fell by FIM 880 million and financing of domestic deliveries, which included KTR bonds as a new item, by FIM 252 million. Of the liabilities to corporations, deposits for investment and ship purchase grew by FIM 127 million, while capital import deposits fell by FIM 128 million. Capital import deposits also include cash reserve deposits made by companies in respect of short-term credits raised from foreign banks.

Accrued items under other claims and accrued items under other liabilities were previously shown in net terms and included in the item "valuation account and reserves". The corresponding balance sheet items for 1986 have been adjusted so as to be comparable with those of the 1987 balance sheet. In 1987, accrued items under other claims amounted to FIM 487 million, an increase of FIM 215 million on the previous year. Accrued items under other liabilities stood at FIM 733 million, an increase of FIM 123 million on the previous year.

Notes and coin in circulation grew by 15.3 per cent or FIM 1 323 million, totalling FIM 9 990 million at year end.

The Bank's capital accounts, before deducting the loss for the financial year, amounted to FIM 5 529 million, which is FIM 44 million higher than the total capital accounts at the end of the previous year. Capital accounts accounted for 12.7 per cent of the balance sheet total.

Forward purchase contracts, all denominated in convertible currencies, totalled FIM 1 386 million at the end of the year.

At the end of the year, guarantees granted by the Bank totalled FIM 137 million, which was FIM 106 million less than at the end of 1986.

THE PROFIT AND LOSS ACCOUNT OF THE BANK OF FINLAND

The format for the Bank's profit and loss account has been made more informative, and in its revised form the classification broadly complies with that of the balance sheet.

In 1987, domestic interest income totalled FIM 764 million. This represents a substantial decrease, a total of FIM 815 million, on the previous year and was mainly due to a sharp decline in claims on financial institutions during the year. In addition, interest rates had been exceptionally high in the previous year. The largest decrease, FIM 903 million, was recorded for interest on call money credit. The main sources of interest income were the Bank's holdings of domestic bonds and KTR credits. Interest income on certificates of deposit and term credits amounted to FIM 181 million.

Foreign interest income increased by FIM 506 million, totalling FIM 1 449 million. The increase was due to an increase in the foreign exchange reserves. Interest on securities grew by FIM 218 million and interest on other foreign currency claims by FIM 310 million. The tied foreign currency reserves do not generate any interest income for the Bank.

Domestic interest expense remained at approximately the same level as in the previous year and amounted to FIM 1 438 million. The highest interest expense arose from the cash reserve deposits, a total of FIM 679 million. Interest on investment deposits amounted to FIM 158 million. A new item, interest expense on certificates of deposit, was included in the profit and loss account. Interest paid on certificates of deposit issued by the Bank of Finland and on the term deposits included in the same item totalled FIM 461 million.

Because of the fall in interest income, the interest margin decreased by FIM 218 million to FIM 723 million.

Other income was exceptionally high, amounting to FIM 333 million. The major part of this income derived from sales of shareholdings. During the year, the Bank of Finland sold its shares in Enso-Gutzeit Oy, Teollistamisrahasto Oy (the Industrialization Fund of Finland) and Valmet Oy.

Other expense totalled FIM 364 million, an increase of 76 million on the previous year. Depreciation includes a total of FIM 74 million in respect of depreciation on new buildings, alterations to real estate and basic repairs and FIM 29 million in respect of depreciation on machinery and equipment.

Net valuation gain on foreign securities includes gains and losses realized on the sale of securities and differences due to revaluation of the securities portfolio. The net gain totalled FIM 54 million.

The change in the value of foreign currency claims and liabilities resulting from exchange rate changes and income from foreign exchange dealings were entered in net terms under net exchange rate loss. Calculated at the exchange rates as of December 31, 1987, exchange losses amounted to FIM 1 186 million.

There was no change in the reserves in the profit and loss account.

The loss for the financial year was FIM 440 million and will be covered out of the reserve fund in early 1988.

The loss is closely related to the monetary and foreign exchange policies pursued during the year. The increase in the foreign exchange reserves improved liquidity in the markets, and had to be sterilized at the central bank by selling certificates of deposit. However, interest expense on the liquidity absorbed by the Bank exceeded the interest income from the foreign exchange reserves. The loss was also attributable to the effect of the fall in the dollar and the strengthening of the markka on the markka value of the foreign exchange reserves. At the end of 1987, the exchange rate for the dollar was 17.7 per cent and the currency index expressing the external value of the markka 1.1 per cent lower than a year earlier.

THE RATES OF INTEREST APPLIED BY THE BANK OF FINLAND

The Bank of Finland kept the base rate at 7.0 per cent throughout the year. The call money credit rate was gradually lowered from 12.0 per cent at the beginning of the year to 11.0 per cent at the end of April, at which level it was kept till the end of the year. The call money deposit rate, which was separated from the call money credit rate in 1986 in order to promote the development of the interbank market, was gradually lowered from 9.0 per cent at the beginning of the year to 7.5 per cent by mid-March. The upper limit on the call money credit rate set by the Parliamentary Supervisory Board was the base rate plus 15 percentage points throughout the year.

On the basis of the decisions taken by the Parliamentary Supervisory Board on November 25, 1986 and February 24, 1987, the Bank of Finland may apply an interest rate to central bank credit granted to banks for a maximum of 6 months which is at least equivalent to the base rate but not more than the base rate plus 15 percentage points. The central bank may charge a penalty charge on banks' central bank credit exceeding a set ceiling or quota so that the penalty charge plus the interest charged, converted to an annual rate of interest, remains within these limits. As regards deposits received from banks for a maximum of six months, the Bank of Finland may apply an interest rate which equals the base rate plus 15 percentage points.

The Bank of Finland was allowed to apply the same interest rate limits in its trading with banks in certificates of deposit of up to six months' maturity and when issuing its own certificates of deposit with an original maturity of 1 to 6 months and a nominal value of at least FIM 1 million.

The interest rate powers of the Board of Management were amended with effect from November 16, 1987 so that in the case of rates of interest for periods longer than one day the Board of Management may, at its discretion, intervene in the market to control movements of market rates within a range the lower limit of which is the base rate and the upper limit the base rate plus 5 percentage points. Should market forces push market rates beyond these limits, the Board of Management is obliged to take steps to reduce the gap between market rates and these limits. In addition, the new powers were extended to include interest rates for periods longer than six months.

The limits on the rates of interest applied by the Bank of Finland to its other credits were equivalent to the base rate \pm 2.5 percentage points, i.e. 4.5 and 9.5 per cent.

The rate of interest applied to cash reserve deposits was 6.75 per cent and the rate of interest applied to the government deposit account was 5.5 per cent. The rate of interest on deposits for ship purchase and investment ranged from 3 to 5.5 per cent, depending on the act applicable and the closing date of the accounting period.

THE BANK OF FINLAND'S HOLDINGS OF REAL ESTATE AND SHARES

The Bank of Finland owns the bank premises in Helsinki and in the cities where the Bank has branch offices. The Bank owns the industrial premises in the City of Vantaa on which the Bank of Finland Security Printing House operates. The activities of this company will be described in a separate annual report. The Bank of Finland also owns SITRA (Finnish National Fund for Research and Development). In the course of the year, the Bank of Finland sold its shares in industrial enterprises and the Industrialization Fund of Finland. In keeping with the Regulations for the Bank of Finland, the value of the Bank's holdings of real estate, equipment and shares was not entered in the balance sheet but the costs of these were depreciated in full in the profit and loss account at the rate they were incurred to the Bank. The nominal values of the shares held by the Bank of Finland at the end of the year are shown in the table on page 12.

THE ORGANIZATION AND STAFF OF THE BANK OF FINLAND

In order to adapt the Bank's operations to the changes in the financial markets, an organizational reform was prepared in the course of the autumn and introduced on January 1, 1988. The Bank's departmental division and the departments' areas of responsibility were changed so that the Bank's foreign currency and markka operations were combined and policy planning was separated from general financial market operations. The number of departments remained unchanged.

At the end of 1987, 690 staff were employed at the Bank's head office and 236 at the branch offices. The number of staff at the head office remained unchanged and that of the branch offices fell by 16. Of the head office staff, 41 were employed on a fixed-term contract and 28 were non-salaried employees; the corresponding figures for the branch offices were 2 and 30. The Bank of Finland Security Printing House had 365 employees, which was 4 fewer than a year earlier.

BALANCE SHEET, FIM

ASSETS

Dec. 31, 1987

Dec. 31, 1986

Gold and foreign currency claims

Gold (1)	2 128 285 723.28		2 081 473 367.59	
Special drawing rights	898 984 060.75		982 808 877.02	
IMF reserve tranche	792 804 335.18		793 424 959.89	
Convertible currencies (2)	23 634 441 272.77		6 794 836 229.34	
Tied currencies	1 284 149 733.83	28 738 665 125.81	3 435 168 207.81	14 087 711 641.65

Other foreign claims

Markka subscription to Finland's quota in the IMF (3)	2 427 095 584.81		2 584 934 647.11	
Term credit (4)	1 929 846 435.00	4 356 942 019.81	—	2 584 934 647.11

Claims on financial institutions

Call money credits	40 664.43		6 818 080 669.95	
Term assets	—		2 381 000 000.00	
Till-money credits	2 729 887 000.00		2 305 239 000.00	
Bonds	2 140 057 800.00		2 111 055 156.00	
Other claims on financial institutions	277 260 820.80	5 147 246 285.23	458 145 574.83	14 073 520 400.78

Claims on the public sector

Bonds	3 780 217.80		59 368 866.30	
Total coinage	966 777 037.50		934 892 337.50	
Other claims on the public sector	6 208 172.54	976 765 427.84	8 121 146.98	1 002 382 350.78

Claims on corporations

Financing of exports	867 999 030.18		1 748 451 566.11	
Financing of domestic deliveries (KTR)	2 568 335 099.27		2 833 056 306.89	
Bonds: KTR credits	13 316 652.00		—	
Bonds: Other	46 102 029.48		65 274 258.24	
Other claims on corporations	182 177 487.48	3 677 930 298.41	197 051 223.61	4 843 833 354.85

Other assets

Accrued items	486 652 400.09		271 610 716.34	
Other assets	105 091 967.50	591 744 367.59	149 508 627.13	421 119 343.47

TOTAL

43 489 293 524.69

37 013 501 738.64