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Monetary Policy Department
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Viewpoints on "Three Assessments of Finland's Economic Crisis and Economic Policy"

SUOMEN PANKIN KESKUSTELUALOITTEITA • FINLANDS BANKS DISKUSSIONSUNDERLAG

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Abstract

This paper summarizes the basic arguments given by professors Christian Bordes, David Currie and Hans Söderström in their reports on the state and behaviour of the Finnish economy prior to mid 1993. The focus is primarily on the analytical frameworks or models used by the professors to organize their thoughts on the Finnish economy, and, admittedly, at some risk of over-simplification interpretes the reports through common analytical principles. The paper argues that basically each of the reports subscribes to the idea of a credit cycle as the driving force behind the development of the Finnish economy during the last ten years or so. Thus the very nature of the credit cycle is analyzed in the paper and interpreted in a way suitable for economic policy analysis. This discussion is followed by the policy analysis, which is organized through a sequence of policy issues and proposals raised by the professors in their reports. The paper tries to emphasize and evaluate those aspects of the analysis pursued by the professors which relate to the (lack of) credibility of the then prevailing policy regime and the feasibility of the various policy measures taken. Finally, the paper draws attention to some of the ideas discussed by the professors related to future policy options in Finland.

Tiivistelmä

Tässä artikkelissa arvioidaan professoreiden Christian Bordes, David Currie ja Hans Söderström raporteissaan esittämiä ajatuksia Suomen talouden tilasta ja kehityksestä ennen vuoden 1993 puoltaväliä. Tarkasteluissa painotetaan, ehkä liiallisenkin yksinkertaistamisen uhalla, professoreiden ajatusten yhteisiä analyyttisia lähtökohtia. Erityisesti pyritään argumentoimaan sen puolesta, että kukin professoreista tulkitsee Suomen talouden kymmenen viimeisen vuoden kehityksen luottosykliksi. Näin ollen artikkelin tarkastelut alkavat luottosyklin taloudellisella tarkastelulla ja sen tulkinnalla talouspolitiikan analyysin kannalta. Tätä keskustelua seuraa itse raporttien politiikka-analyysien arviointi, joka rakentuu teemoittain ja professorien raporteissa esittämien talouspoliittisten ehdotusten mukaan. Niistä professorien analyysien näkökohdista, jotka liittyvät taannoin harjoitetun talouspolitiikan uskottavuuteen (tai sen puutteeseen) ja eri politiikkatoimenpiteiden käyttökelpoisuuteen, pyritään erityisesti keskustelemaan. Artikkelin lopuksi kiinnitetään huomio joihinkin professoreiden ajatuksiin Suomen tulevista politiikkavaihtoehdoista.

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Viewpoints on "Three Assessments of Finland's Economic Crisis and Economic Policy"

At the beginning of 1993 the Bank of Finland invited three experts to participate in the public debate on Finnish economic policy. The experts called upon by the Bank of Finland were Professor Christian Bordes, Université de Bordeaux, Professor David **Currie**, London Business School, and Professor Hans Tson **Söderström**, Stockholm School of Economics and Center for Business Policy Studies. Their reports were issued on June 23, 1993 and subsequently published in the book "Three Assessments of Finland's Economic Crisis and Economic Policy", Bank of Finland C:9, 1993.

The experts were originally asked to present their views on the following questions:

- What are the short-term and long-term reasons leading to the present economic situation, including the role of economic policy?
- What are the connections between a policy aiming toward a stable currency and the structural development of the economy (growth and employment)?
- What economic policy, including monetary policy, would seem advisable today and over the medium term?

Furthermore, the experts were asked to present their views on the overall development of the economy and the significance of the various aspects of economic policy in this regard.

The appraisals of the foreign experts have not, at least for the time being, heated up the debate on Finnish economic policy appreciably. Their viewpoints have indeed been used in certain specific economic policy questions, but partly in a way that does not do justice to their work. Their views on various aspects of economic policy do not fit in very easily with the debate carried on by Finnish interest groups. Everyone finds something good in them, but since nobody having a direct bearing upon the economy has escaped criticism there is a great temptation to keep silent about the reports or, even worse, pick and choose the spots that support only their own views.

Even this appraisal of the expert's reports addresses only part of the material they present on the Finnish economy and economic policy. In this respect we are like all the other "debaters". We have nevertheless tried to familiarize ourselves with their reports as a whole and selected questions for analysis which to our minds constitute the gist of their message. We have left, for instance, their appraisal of structural issues for others to judge. In our opinion they reflect to a large extent the "voices" of the Finnish experts who have been briefing them, e.g. as regards the labour market and incomes policy, but these aspects are already well known to Finns. The handling of structural questions reveals a glaring lack of research material on Finnish structural and growth policy. We concentrate upon the views of the experts regarding the reasons and consequences of Finland's credit cycle as well as on monetary policy, especially with respect to the role of exchange rate policy.

1 Credit Cycle

At the risk of simplification, it can be said that professors Bordes, Currie and Söderström started from the idea that during the last ten years Finland has gone through a credit cycle, i.e. gone from a strong expansion of the financial markets to their contraction and even to a financial crisis and "credit crunch". Financial factors have thereby exacerbated the already wide cyclical fluctuations in the Finnish economy. Owing to the changes that took place in the conditions prevailing in the financial markets in the 1980s the professors evaluate the latter half of the 1980s and especially the deep recession from the **perspective of financing.**

There are indeed differences in the presentations, among other things, with respect to how the impact of financial factors are analyzed and which stages of the credit cycle are stressed in the reports. Thus David Currie evaluates the theoretical background of the credit cycle and behaviour of the real exchange rate in the different stages of the credit cycle, with conclusions focusing on the crucial role of the exchange rate in the depreciation of the real exchange rate. Christian Bordes provides a rather detailed overview of the various stages of the credit cycle in the Finnish economy, stressing on the other hand the significance of the deregulation of the financial markets spawned by the "liberalization shock" within the context of the growth of the 1980s. Bordes emphasised that the signs of the financial crisis that ensued after this growth period were clearly apparent already in the late 1980s. Tson Söderström in turn concentrates in his report on building a case for the (Fisherian) notion that the Finnish economy has been driven onto a debt-deflation path. It can perhaps be said that the main emphasis of his report is on the latter stages of the credit cycle.

1.1 Credit Cycle: What Is It?

The economic and institutional developments taking place in the Finnish economy in the last ten years certainly offer an opportunity to gain insight as to how immense changes in the financial conditions affect economic growth and the business cycle. The specification of the behavioral effects of these changes in line with the so-called credit cycle hypothesis or model is analytically speaking clearly the common denominator in the professors' reports. The underlying presumption in the credit cycle model is that, by and large, the deregulation of the financial markets led to a fundamental change in credit market equilibrium so that it was sought to transform a greater amount of deposits into credit. This kind of "credit shock" stimulates demand and borrowing, mainly as a result of the decline in (lending) rates spurred by the shock. Borrowing can be deemed to increase also partly due to the fact that borrowers previously subject to liquidity constraints were able to increase their borrowing. A consequence of all the expansion in demand is that it would take higher levels of output and interest rates in capital markets to balance the commodity and money markets, but if capital movements are completely free internationally and the exchange rate fixed, the domestic money supply must be increased in order to balance the economy. In the contrary case when the supply of credit in the economy begins to dwindle and lending rates rise, the economy seeks its equilibrium at a lower level of output and money supply, assuming that as above there is still a fixed exchange rate regime.

1.2 Credit Cycle and the Macro-Economy

The credit cycle thus typically strengthens the fluctuations in aggregate economic demand, and for example professor Currie asserts in his report that these fluctuations in aggregate demand are stronger when the exchange rate is fixed and capital movements free. A consequence of the latter is that the domestic money supply must adjust to a level where there are no pressures on the exchange rate. The strengthening of fluctuations in aggregate demand typically means the strengthening of fluctuations in the sheltered sector in particular so that, as professor Currie stresses, the credit cycle is supplemented by real exchange rate cycle.

It is almost self-evident that the movements in the real exchange rate must be seen as part of the balancing of the economy and that credit expansion is typically followed by problems in the external balance, in this case the deficit in the balance of trade, which is caused by the dwindling of export supply and growing import demand. On the other hand, less attention has been focused on the exacerbation of the external balance problem via the allocation of resources. The real exchange rate typically appreciates during times of an upswing and a boom as a result of domestic inflation being higher than that abroad, while during a recession the real exchange rate is lowered by a devaluation of the markka.

Of these, the latter (which is typically caused by the former) is especially problematic from the standpoint of balancing the economy for two reasons: the presumed effects on the balancing of the economy via the depreciation of the markka (primarily via resource allocation) hinges upon how the equilibrium real exchange rate changes. The depreciation of the markka does not yet mean the depreciation of the real exchange rate - the latter is an endogenous variable. Thus the equilibrium size of the open sector will not necessarily grow after the devaluation. At least Swedes know that the opposite can happen! On the other hand, it is entirely possible that seeking to alleviate the structural problems of the economy with exchange rate policy can lead to problems in the credibility of the exchange rate system as a reflection of the above-average inflation and periodic devaluations. This possibility is not analyzed sufficiently by the professors, not even by Currie, who is the most outspoken in basing his policy conclusions and recommendations on exchange rate policy and on its possibilities to permanently bolster the relative prices of the open sector.

Also, the growth-driven behaviour of asset prices is typical of credit cycles. This kind of asset price behaviour, especially of stock and housing prices behaviour, is, in addition to debt, the important factor spurring especially professor Bordes to affirm that the signs of the coming crisis were clearly visible already during the boom of the late 1980s, and giving him cause to speak of the current recession more in terms of a financial crisis.

The asset price cycle cannot be regarded as exclusively a Finnish phenomenon, as the professors point out. What factors then promoted the sharp rise in asset prices in the late 1980s and their collapse at the end of the decade? Here one should not forget the strong improvement in the terms of trade resulting from the decline in oil prices in the mid-1980s nor the easing of international money markets and the decline in interest rates after the 1987 stock market crash in the US. The analysis of these factors by the professors in their reports remains rather shallow, although professor Bordes notes that the rise in asset prices in Finland must be seen as being part of the international boom, which can be explained to a great extent by precisely this easing in monetary policy after 1987. On the other hand, the decline and collapse in asset prices toward the end of the 1980s was spurred, according to Bordes, by the tightening of international money markets and the consequent rise in interest rates. The tightening of monetary conditions occurred in conjunction with measures taken by the central banks to curb inflation.

A third factor typically associated with the credit cycle is the strong increase in borrowing by households and firms during the economic upswing. The increase in debt is not necessarily a problem as it can be seen as reflecting, on the one hand, the view of households and firms regarding the growth in their wealth and, on the other hand, their desire to smooth out their expenditures over time. The debt poses a problem when the acute financial situation of the households and firms deteriorates and the outlook for their future consumption and investment possibilities takes a turn for the worse: nothing remains from the times of swift growth and widespread optimism except "debt overhang".

The professors' views on the debt problem more or less coincide with each other: the main dilemma of the recession is high indebtedness and it is increasingly hindering the resumption of growth. Of the professors, the Swede Hans Tson Söderström concentrates his analysis on the Fisherian debt-deflation problem and his conclusions do not preclude the possibility that the solving of the problem will require some degree of "inflation". Professor Bordes, on the other hand, maintains that this is not a viable option by arguing that the situation of the debtors cannot be improved in this manner since under the present circumstances the financial markets react by raising interest rates, which only exacerbates the situation of debtors. Professor Currie, on the other hand, does not tackle this issue directly but he does address it indirectly. He asserts that the aim of monetary policy in the future should be to keep the markka competitive and interest rates low, the latter of which will support the rise in asset prices and in this way ease the situation of debtors. The professors seem many times to start from the premise that the deregulation of the financial markets has been the **primus motors** of growth in the late 1980s and that the dispelling of growth optimism at the start of the new decade was a result of the halt in the credit boom and credit contraction. In fact, Currie characterises the 1980s with the term "growth bubble" and like Bordes he emphasises, among other things, the significance of the deregulation shock vis-a-vis the terms-of-trade shock. This type of thinking about the non-fundamental growth of the economy is problematic, not least of all in Finland's case. Changes in the terms of trade of the industrialised countries, the international easing of monetary policy in 1987 and subsequent tightening in 1989 tell of the profound fundamental changes in external factors from the standpoint of the Finnish economy, the impact of which on growth in the industrialised countries cannot be underestimated. It is perhaps more reasonable to think that deregulation has exerted a powerful leverage effect on the changes in the fundamentals of the (world) economy, i.e. the changed financial conditions have altered the functioning of the propagation mechanism by which the changes in the fundamentals are transmitted to the economy.

Moreover, especially in Finland's case the shock was concentrated on the structure of foreign trade. The role played by the collapse in eastern trade is possibly underestimated in both the domestic discussion as well as in the reports. It should also be emphasised that the collapse in eastern trade meant a particularly large shock to the real exchange rate. This, together with the sizable negative terms-of-trade shock, makes Finland's situation very difficult, not least of all from the standpoint of the design economic policy. One would have hoped for a more thorough analysis of this particular matter in the reports.

1.3 Economic Policy Dilemma

The professors did not absolve the economic policy followed in Finland, even if their report is interpreted to mean that the shocks have been non-discretionary and external in nature. It can always be asked, in hindsight, whether, at that time, an optimal economic policy was followed. The situation prevailing then was a by no means simple one; very little is known even in theory about optimal economic policy when there are major shocks to the terms-of-trade, the real exchange rate and asset prices. The dependence of the optimal policy on the specific source of the disturbance makes it more difficult to work out appropriate responses. The dilemma of economic policy is not the high indebtedness of economic agents but rather the factors associated with expectations which feed pessimism and pose a threat to the upswing in the economy. As regards the latter, the vital issue is not their rationality, but rather their self-fulfilling nature.

2 Monetary Policy: Strong Markka Policy

The exchange rate plays a pivotal role in economic policy in Finland. This can be seen in the reports under consideration since the role of monetary policy, and especially exchange rate policy, is dealt with in some depth.

The Finnish markka and thus the overall monetary policy pursued have been plagued by a long history of devaluations. The professors see the old trade-weighted exchange rate system against this background. Theoretically, the choice of an rate system is typically analyzed as a choice between a fixed and floating exchange rate system. Our knowledge of the fixed exchange rate system has been enhanced considerably by the literature dealing with the credibility of exchange rate target zones and the independence and reputation of the central bank as well as by the empirical experience gained in Finland and other European countries. The Finnish markka can be treated as a fixed or floating currency depending upon the approach and objectives. The foreign experts also do this and benefit widely from the lessons of the recent literature.

2.1 Revaluation of the Markka in November 1989

The professors took a very critical view of the November 1989 revaluation of the markka in the reports. Professor Currie regarded it as a tactical error. The overheating of the economy was then already abating, and the situation would have called for a decline in interest rates. The revaluation weakened the credibility of the fixed parity and increased the potential for speculation against the markka. A revaluation would perhaps have been appropriate much earlier, but a floating exchange rate, in combination with a suitable monetary policy anchor would have worked better, Currie states in hindsight. Professor Christian Bordes also questions the appropriateness of this decision, partly for similar reasons. He asserts that asset prices had already started to fall, reflecting the end of the boom. Bordes sees that the revaluation was prompted partly by international trends prevailing at the time. Central banks round the world were concerned about the acceleration of inflation and tightened their monetary policy after having eased it previously in the aftermath of the 1987 stock market crisis.

Professor Hans Tson Söderström sees the 1989 revaluation as an unsuccessful attempt to curb credit expansion. He goes even farther and asserts that in general a revaluation cannot stem the overheating of the domestic economy, but rather it can only serve to weaken competitiveness. A revaluation should only be used to counteract an external inflationary shock. In addition a revaluation weakens the credibility of a fixed exchange rate since as domestic inflation accelerates too much valuation of the currency becomes possible. The end result is that the fixed exchange rate loses its role as an inflation norm, for which purpose it was originally adopted. In our opinion Söderström's reasoning is on target if we wish to analyze the matter purely from the standpoint of the fixed exchange rate regime.

2.2 Pegging of Finland's Markka to the ECU: the Strong Markka Policy and its Failure

The professors emphasized the significance of the pegging of the markka to the ECU in the summer of 1991 and analyze it thoroughly. They draw two conclusions in this respect. They assert that it was not until this time that Finland attempted fully to commit to a fixed exchange rate. Linking the Finnish markka to the Deutschmark entailed the choice of the so-called strong markka policy.

Professor Bordes raises the question of the failure of the strong markka policy. He suspects that pegging the markka to the ECU did not reflect a carefully considered stand on exchange rate policy but rather it was a reaction to the decisions taken previously in Sweden and Norway. He is right, given the swiftness of the decision and brief period allowed for public debate. Pegging the markka to the ECU means accepting low European inflation in a situation where Finland's inflation exceeds this level. He points to Finland's high degree of price and wage rigidity and to the limited influence of the government's budget. Moreover, the credibility of the stable markka policy suffered owing to the weak position of the Bank of Finland.

Professor Currie highlights the special features of the Finnish economy, which made it extremely difficult to maintain the parity between the Finnish markka and the Deutschmark. First, the openness of the Finnish economy was relatively small in the 1980s, which reduced the efficiency of the exchange rate band as an inflationary anchor. Second, fluctuations in the terms of trade have been relatively large compared with other OECD countries. Third, the maintenance of a fixed exchange rate is understandably difficult owing to the wide variability of the real exchange rate associated with the credit cycle.

Söderström also sees the ECU peg as signifying a "new policy", but maintains that the timing of the peg as well as its level was wrong. Söderström is brief in his appraisal of the strong markka policy in Finland. He notes that, unlike Sweden and Norway, Finland never genuinely sought to follow an anti-inflationary policy and become a strong currency country: the 1989 revaluation gave the impression that it was possible to adjust the exchange rate. The 1991 devaluation reinforced this impression and in 1992 the fixed exchange rate was abandoned without a fight. The possible price for this policy will become evident in the future. It is to Söderström's credit that he is straightforward in drawing attention to the **severe problem of credibility in Finnish monetary policy.**

Bordes notes, as did Söderström, that the fixed rate policy was not necessarily very well planned in order to achieve low inflation and stable prices. The link to the Deutschmark was not desirable and moreover it was not sustainable.

The fixed rate regime and policy of a stable or strong markka has a longer history than the peg to the ECU. It can be seen as beginning with the 1983 devaluation or at the latest with the currency speculation of 1986. The pegging of the markka to the ECU per se was not widely called into question in the public debate. It can be seen as a political decision that preceded Finland's application for membership of the EC the next spring. It was regarded as largely a technical change in the composition of the exchange rate basket. The discussion was certainly heated, but it largely revolved around the parity at which the peg to the ECU should occur. In this regard the calls were largely for a change from the low parity corresponding to the 1989 revaluation. In the economic policy debate the criticism of the "strong markka policy" did not strengthen until after the pegging of the markka to the ECU.

2.3 Exchange Rate Policy and Finland's Economic Crisis

All the professors, but Currie and Söderström in particular, count on the effect of the depreciation of the markka as a fundamental part of the recovery from the current recession. Bordes and Söderström take a more critical view of the devaluation policy over the long run. Bordes ambiguously notes that no European country can solve its economic problems at the expense of its neighbours. Professor David Currie clearly supports the use of floating rates, but in a way that hinders the pressures on the markka to appreciate.

The adoption of an economic policy based on considerable price competitiveness has gained some understanding in light of Finland's exceptionally deep recession, and, in particular, in light of the collapse in eastern trade. For this reason Finland's exchange rate policy is not widely regarded as an aggressive beggar-thy-neighbour policy. Even though the depreciation of the markka can be regarded as necessary for cyclical reasons, the conditions under which monetary policy will be conducted in the future must be addressed.

2.4 Finland's Exchange Rate Regime in the Future

As regards the general characteristics of an exchange rate regime from Finland's standpoint, Bordes is clearly the most thorough. He ends up recommending that Finland adopt a programme to fulfill criteria such as those set out in the Maastricht Treaty to pave the way for a return to a fixed rate. Currie's point of departure, as mentioned above, is to let the markka continue floating.

In the Finnish economic policy debate, attitudes towards floating exchange rate regimes were critical in the early 1970s, primarily due to income distribution and structural reasons. It was felt that the best way to protect real earnings and to enhance diversification of the business structure in the economy was offered by fixed exchange rates. It has nevertheless proved to be the case that the debate on the virtues of the various exchange rate regimes, especially in connection with Finnish incomes policy is neither constructive nor useful. The question is not one of different exchange rate regimes, of the depreciation and appreciation of the currency per se, but rather one of the economic policy regime and its credibility in general and of the credibility of monetary policy regardless of any particular exchange rate regime. Empirical findings showing no causal link from exchange rate regime to differences in economic success in different countries should be taken more seriously.

Professor Bordes recommends a return to fixed exchange rates, and, taking EMU as benchmark, maintains that floating rates cannot be optimal for Finland over the long run. He thinks that monetary policy is not efficient and credible enough to stabilize the economy and to achieve and maintain low inflation under a floating exchange rate regime.

The problem with Bordes' argument is that precisely the same logic can be used to claim that the fixed exchange rate is not appropriate for Finland. In this respect the credibility problems associated with fixed rates, in particular, are underestimated. The short period of a floating currency up until now indicates that the results of the most widely applied **Mundell-Flemming** model regarding the independence of monetary policy are not applicable. The floating rate regime does not offer complete monetary policy autonomy if the credibility of monetary policy is weak. Due to this problem Finland and several other countries with weak central banks have set **an explicit numerical inflation norm as the ultimate goal of their monetary policy.**

In the Finnish public debate, not least of all in academic circles, high hopes have been pinned on monetary policy to stem the recession. But it is particularly difficult to identify that public discussion supporting the central bank's efforts and which analyzes the prerequisites for optimal monetary policy and suggests conditions sustaining that policy. It is characteristic of the present situation that even as clear an aim as a stable currency is to the central bank, it has not gained much understanding at all in society in general and among academic economists in particular. The non-prevalence of this theme in the public debate in Finland, quite contrary to the long experience elsewhere in Europe actually shows how truly far Finland still is from Europe.

Bordes notes that switching to fixed rates cannot happen in a credible fashion "over night", but rather the establishment of a regime must be started "today". The credibility of fixed rates hinges, in his opinion, on the behaviour of the labour market. Bordes refers to the experiences of the inter-war period and asserts that Finland appeared to survive the depression better than the average since the markka was floating. This occurred because the depreciation of the markka brought deflation to a halt, i.e. the depreciation had a stabilizing effect on prices and real interest rates. Bordes doubts the efficiency of this channel of influence in the current situation on account, among other things, of wage formation, which reflects the inflationary expectations of wage setters prevailing at the time. The professors do not, however, analyze the role of Finland's inflation target from the point of view of combatting deflation. It can namely be argued that the inflation target if credible allows for expansionary monetary policy in order to curb deflation without strengthening inflationary expectations.

Bordes does not analyze the optimality of the exchange rate regime from the standpoint of the main sources of disturbances impinging on the economy. The theoretical literature namely indicates, among other things, that in cases where the main source of aggregate disturbances impinging on the economy is in export prices, then the optimal solution from the standpoint of macroeconomic stability is to adhere to flexible exchange rates.

The efficiency of devaluation policy in Finland is limited by the high elasticity of nominal wages with respect to inflation (0.67), while rigidities in the relative wage structure undermine competitiveness and are clearly an important factor as far as explaining the "devaluation cycle" is concerned. Bordes could have been more specific in his analysis on this point by taking an explicit stand on whether Finland can be regarded as a country where wages react easily to inflation but not unemployment. According to Bordes' table the elasticity of wages with respect to unemployment is -0.49. The sensitivity of wages to inflation and unemployment together determine the efficiency of monetary policy.

On the basis of estimated wage equations Bordes suspects that flexible exchange rates (or a devaluation policy) is optimal for Finland over the long run. In order to lend support to his doubts he constructs a simulation test, the purpose of which is to track Finland's past economic development under the conterfactual assumption of flexible exchange rates. The simulation is based on the assumption that

a) the aim of economic policy is annual growth of 6 % in nominal GDP,
b) in the short run monetary policy facilitates the adjustment of the economy, and
c) monetary policy takes into account the possible instability of monetary behaviour.

According to the simulations nominal GDP would have remained well on the target path. In particular nominal GDP would have returned to its long-run growth path already at the end of 1992. This would nevertheless have required that monetary policy had been especially sensitive to deviations from the target path for nominal GDP. The growth in the monetary base should have changed by 20 % for each 1 % deviation from the target path for GDP growth! Bordes concludes that monetary policy alone would not have been sufficient to stabilize the economy in the short run and the price level in the long run. He has his doubts about the efficiency of monetary policy in this respect also in the future.

When considering Finland's exchange rate regime in the future the professors also bring up the interesting question of a Nordic Monetary System. From the references to common cyclical developments and labour markets professor Bordes draws the conclusion that the optimal exchange rate regime would be a fixed exchange rate regime between Finland and the other Nordic countries, especially Sweden. Bordes starts from the premise that Europe and EMU will still be the publicly accepted goal in Finland. In this regard Bordes hopes to see clear actions by which the authorities in Finland would convey their intentions. Such actions would include, for instance, the de facto strengthening of the Bank of Finland's independence in line with the Maastricht Treaty as a signal of Finland's intension to change its main institutions and ultimately participate in the adoption of a single European currency.

3 Deregulation of Capital Markets

In section one it was noted that the deregulation of the financial markets has exacerbated the already wide cyclical fluctuations in the Finnish economy since the mid-1980s. As a result of deregulation the credit cycle has not, however, been characteristic of only Finland. The professors maintain that the problems stemming from the liberalization of the financial markets were unavoidable since the pressures to deregulate were overwhelming.

There are two features in Finland's experiences that are worth noting. First the tax deductibility of interest expenses has been regarded as a significant distortionary factor, the significance of which is reinforced in a deregulated market. Tax induced incentives to borrow increased indebtedness to a significant extent. On the other hand, debt repayment in the midst of a recession only prolongs the recession. Another distinguishing feature is the sharp growth in the foreign debt. In this respect professor Currie is very critical of those taking foreign currency loans as well as banks and regulatory authorities. Those who took foreign currency loans were foolish when they did not understand that lending rates on markka loans were higher for the very reason that the markets were aware that a devaluation of the markka was possible. The banks especially failed to appreciate the risk of credit losses in a situation where the markka depreciates. Furthermore, the authorities were at fault for not requiring that banks make provisions for this currency risk.

Professor Currie asserts that it is the sharp growth in foreign currency borrowing in particular which explains much of the problems related to the recession. The growth in foreign debt stemmed from errors in the pricing of credit, especially in the sense that the cost of borrowing did not reflect the true risks.

Bordes, like Söderström, provides an in-depth evaluation of the stages of deregulation. Bordes derives several conditions for the success of deregulation on the basis of economic theory. These include the gradual deregulation of the domestic financial markets before the deregulation of foreign capital movements. In Bordes' view the deregulation process carried out in Finland fulfilled this condition. On the other hand, the third condition, involving the view that successful deregulation of the financial markets must be rooted in a well-structured vision, was not fulfilled in all respects. At issue is the deficiency of bank supervision and outdated legislation. Bordes is also critical of the deregulation of lending rates before deposit rates and the development of the money market on the basis of bank Cds. Above all the common pricing of Cds regardless of the issuer created an incentive for banks to finance risky business (the so-called moral hazard problem). This option for the banks to generateds so-called secondary reserves, which would also include their holdings of Cds issued by the Bank of Finland, is a significant factor attecting the efficiency of monetary policy, a problem that hopefully will be dealt with before the next stage of the economic cycle.

Söderström asserts that the deregulation of the financial markets was a must for to an open economy due to the integration of the international financial markets as well as the European integration process. The alternative would have been the massive flight of business activities. He maintains that controlling credit expansion in the late 1980s would not have been possible. The growth in the volume of credit was demand-driven owing to the fixed exchange rate.

It would nevertheless have been possible, in Söderström's opinion, to have an impact on the demand for credit by lifting foreign exchange regulations sooner, moving up the timetable for implementing tax reforms and by tightening fiscal policy. The only measure taken to curb credit demand in Söderström's view was the March 1989 revaluation. Bordes sees the use of the cash reserve system as one of these measures too.

4 Fiscal Policy

The professors' evaluation of fiscal policy in the context of the growth during the 1980s and the analysis of an appropriate fiscal policy stance is rather scanty in the reports. In particular they do not analyze whether the floating exchange rate, on the one hand, and the inflationary target of the Bank of Finland, on the other hand, set any explicit constraints on the fiscal policy regime. The failure to control demand is noted almost in unison and the analysis of the fiscal policy stance is dominated by the problems of the public debt, even though Söderström addresses some questions about stimulative measures via monetary and fiscal policy.

It goes without saying that the professors view the sustainability of the public debt as the number one priority of fiscal policy. The fact that the growth of the public debt is caused by the explosive growth in the primary deficit perhaps has little information content, but the (intertemporal) sustainability of the growth of the debt has. One would have expected a deeper analysis of this issue by the professors. According to the budget arithmetics, the growth of the primary deficit and GDP has an important bearing on the sustainability of the debt. The professors have stressed the significance of public savings for reducing the deficit, but it still seems that also the sustainability of the public debt suggests that fiscal policy be designed to generate savings in public expenditures while simultaneously fostering economic growth.

It is worth emphasising that the sustainability of the debt is intrinsically a dynamic, intertemporal problem, where the leeway in fiscal policy with respect to cuts (or increases) in expenditure lies in their allocation over time or in their timing, assuming of course that the political system is able to commit itself in a credible fashion to long-term cuts in public expenditure. It would have been hoped that the professors had delved more deeply into the problems of the design of long-term fiscal policy, not least of all because the leeway in fiscal policy is the key issue in the public debate on Finnish economic policy at the moment, even though the perceived external constraints are to some extent overemphasised in this debate. The analysis of the design of fiscal policy is limited almost entirely to Söderström's observation that monetary and fiscal policy can end up in a self-fulfilling deflationary spiral owing to the worse-than-expected development of the economy so that an expansionary monetary and fiscal policy can contain the seeds of wisdom, assuming that the debt problem does not get out of hand. Of course!

5 Conclusions: What about Labour Markets, and Incomes Policy?

One cornerstone of Finnish economic policy is incomes policy - at least we are accustomed to thinking so and acting accordingly when implementing economic policy. We are accustomed to placing our faith in the possibilities of incomes policy as an instrument of economic policy. For this reason it seems worthwhile to end this appraisal with the scant views of the professors on incomes policy or actually one interesting aspect of the significance of Finnish labour markets and incomes policy regarding the possibilities and choices of economic policy.

First the professors assert that the labour market system may be faced with the need to change the wage structure in favour of the open sector given the narrow margin for overall wage increases in the economy. It may even be impossible to reach such an outcome as a centralised bargaining solution. And what in the professors' opinion is the connection between inflation and the labour market system or incomes policy in Finland? Here the views are divergent. According to Currie centralized wage formation has been moderate and it has not been the source of inflationary impulses to the economy. Söderström, on the other hand, maintains that incomes policy as a component of the "Finnish model" of economic policy has maintained inflationary pressures. Finland has not taken care of its employment with active incomes policy but rather with exchange rate policy, which has led to the low credibility of the fixed exchange rate owing to repeated devaluations. **In this respect Söderström asserts that incomes policy in Finland has failed.** This is an interesting argument, not least of all because the labour market system is viewed from the perspective of the credibility of economic policy. This may be worthy of further research from the standpoint of the feasibility of the Bank of Finland's inflation target.

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