

Finland and Sweden in Cross-Country Comparison: What are the Lessons?

by

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Abstract

A comparison of the economic performance of Sweden and Finland supports three conclusions. First, it is tempting to see a causal link from crisis to reform illustrated by the developments and economic policies in Finland and Sweden following the crisis in the early 1990s. That crisis may be seen as somewhat of a blessing in disguise. It created a political situation that allowed significant structural reforms to be undertaken, and economic policies have since the crisis been more successful and “responsible” than in earlier periods. Policies have been geared towards fostering structural change and maintaining sound public finances. A second conclusion is that the (current version of the) “Nordic model” is relatively successful in combining equity and efficiency. A third conclusion is that the monetary regime may matter less for economic performance than often argued in the heated debate on the pros and cons of a single currency. While not constituting a laboratory experiment, a comparison of the performance of Finland and Sweden supports this contention. Admittedly, the jury is still out in the sense that Finland is now facing a structural weakness of its export base, and it remains to be seen whether domestic wage adjustment will allow this difficulty to be overcome within a reasonable time span.

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1. Introduction

Sweden and Finland are quite similar countries. They have a lot in common in terms of history and basic institutions of society. They have similar economic structures as well as aspirations for and ways of implementing economic policies. As will be seen, Finland and Sweden have performed in very similar ways in the past 20 years (as well as before that). Overall, the economic developments appear rather favourable in international comparison.

Finland and Sweden experienced a banking crisis and a serious recession (or a depression) in the early 1990s. That experience had profound effects on economic policies. It triggered a process of structural reform and contributed to the emphasis given to price stability and sound public finances in subsequent years. While the banking crisis and its effects were traumatic, later developments suggest that much was learnt from that experience.

Both Finland and Sweden joined the EU in 1995. In 1999 Finland also joined (Stage 3 of) EMU, while Sweden after a referendum on the matter decided to stay outside. While far from being identical twins, the economies and economic policies of these two countries are nevertheless exceptionally similar in most respects, except for the monetary regime. This paper exploits the similarity between Finland and Sweden in order to appreciate the significance of EMU-membership. However, given the uncertain outcome of the current euro area debt crisis, any appreciation of the significance of the monetary union is associated with a number of caveats.¹

2. Economic performance

Background

¹ As far as we are aware there are three other studies comparing the relative performance of Finland and Sweden since the launch of the EMU: Mayes and Suvanto (2007), Gylfason et al. (2010, Ch.8), and Suni and Vihriälä (2013).

Both Finland and Sweden went through a severe recession in the early 1990s.² GDP fell in Finland by 13 per cent from peak to trough between 1990 and 1993. The rate of unemployment increased five-fold from 3 to 16 per cent, and the government debt ratio increased four-fold from 14 to 58 per cent. Stock prices and house prices declined by one-half. Foreign indebtedness doubled, the currency lost one-third of its external value, the foreign exchange reserves of the central bank were depleted, and the banking sector was faltering.

In Sweden the fall of GDP was 5 per cent between 1990 and 1993. The decline was smaller than in Finland, but still dramatic in international as well as in historical comparison. The unemployment rate rose from 2 to 9 per cent, and the government debt ratio rose from below 40 per cent to 75 per cent. Stock prices declined by 25 per cent, as did house prices. The currency weakened by about 20 per cent soon after the decision to float the currency in November 1992.

The recession was much more severe in Finland largely as a consequence of the fact that a significant export market was lost almost overnight following the collapse of the Soviet Union in 1991.

The build-up of the Finnish and Swedish crises in the early 1990s resembles the developments in Ireland and Spain 20 years later.³ The recession was preceded by a boom associated with rapidly growing indebtedness and rising property prices. When the bust occurred in 1991-92 the balance sheets of banks weakened sharply. The high very high interest rates resulting from the speculative attacks against the currency and the credit crunch resulting from the weakening balance sheets of banks depressed the economy even further. Also, competitiveness had been eroded by excessive wage inflation during a number of years in combination with weak productivity developments. Finland and Sweden were confronted with a banking crisis as well as a cost and currency crisis.

The export-led recovery started in both countries already in 1993. Exports were boosted by exchange rate depreciation and the recovery in the rest of the world. In relation to the ECU the Swedish krona was some 25 per cent and Finnish markka around 20 per cent weaker in 1995-1999 as compared to the period 1985-1989. In Finland the exchange rate overshot immediately after the decision to allow the currency to float in September 1992. The depreciation was widely considered

² For the crisis of the Nordic countries in the early 1990s, see Jonung et al. (2009). Bordes et al. (1993) present an early analysis of the crisis in Finland. A recent assessment is found in Honkapohja et al. (2009).

³ Kindleberger and Aliber (2011, 11) include the booms in Sweden, Norway and Finland in 1985-1989 as well as the real estate bubbles in the US, Britain, Spain, Iceland and Ireland in 2002-2007 among the "big ten financial bubbles" in history. Reinhard and Rogoff (2008) include the Finnish and Swedish episodes of the early 1990s among the "big five" on the history of banking crises.

as excessive and inconsistent with the new inflation target of the central bank announced in February 1992. The expected appreciation as a consequence of the overshooting facilitated the sharp decline in short-term interest rates in 1993.⁴

It took much longer in both countries for domestic demand to return to the pre-crisis level. This is consistent with the international experience from earlier banking crises (Reinhart and Rogoff 2009). It confirms the fact that it takes many years of painful adjustment for the balance sheets to adjust to excessive indebtedness.

Economic performance since 1998

By 1998 both Finland and Sweden had more or less fully recovered from the banking crisis and the recession. By that date both countries had joined the European Union. Finland also joined the euro area, while Sweden decided to stay outside with a floating exchange rate.

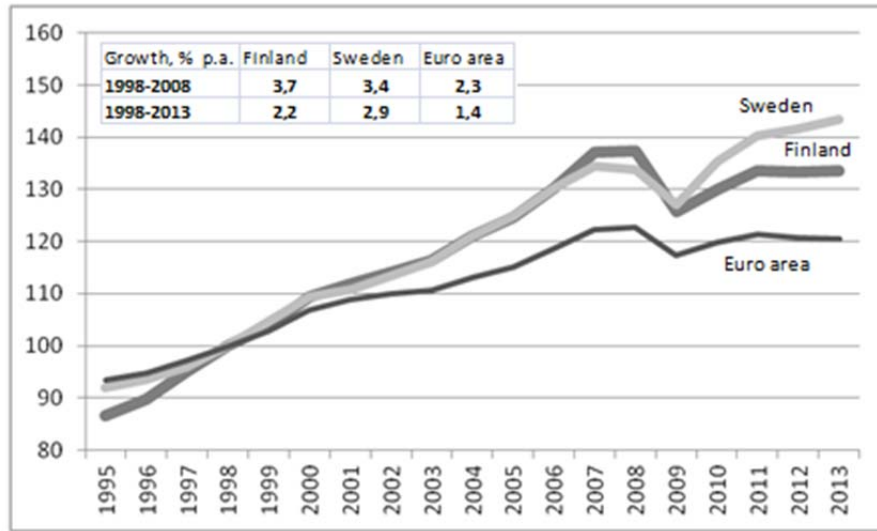
Figure 1 depicts the output performance of Finland and Sweden compared to that of the euro area average. As is seen, until recently output growth in the two Nordic countries has been almost identical and it has outperformed the euro area average by a clear margin. The recovery from the great recession of 2008-2009 was stronger and more sustained in Sweden. We will return to the recession experience below.

The same is true of inflation. As seen in Figure 2, the average rate of increase of the consumer price index (HICP) has on average been below 2 per cent (but close to it) in Sweden and Finland, while in the euro area on average the rate of inflation has been slightly above 2 per cent.

There is practically no difference between the two countries as far as the broad macroeconomic performance indicators, such as growth and inflation, are concerned. Finland and Sweden have outperformed the euro area average on both accounts, despite the different choices regarding the EMU. This implies that membership in the EMU alone can hardly explain the performance or underperformance of countries. As we will argue below, what matters is the quality of institutions and the flexibility of the economy as well as the economic policies pursued.

⁴ This is an example of the Dornbusch overshooting mechanism at work, Dornbusch (1976).

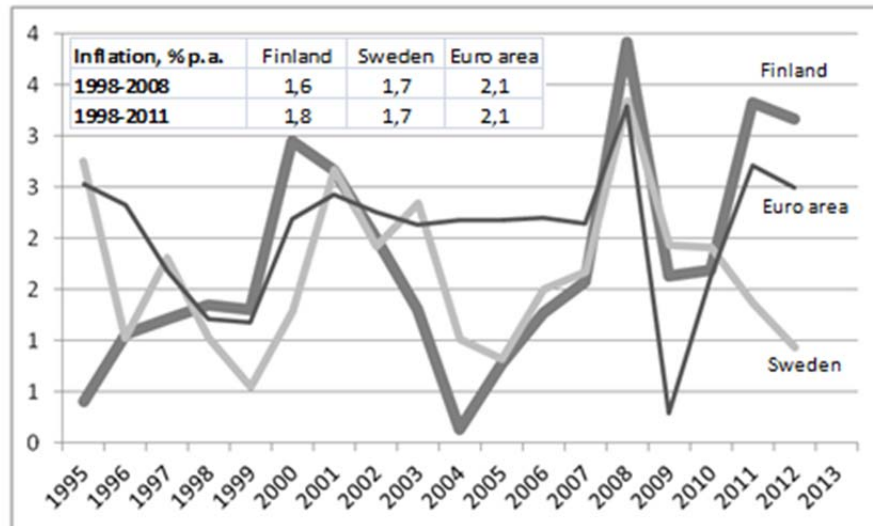
Figure 1 Economic performance: GDP level, 1998=100



Sources: Eurostat, European Commission (2013 forecast)

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Figure 2 Economic performance: Inflation, % p.a.

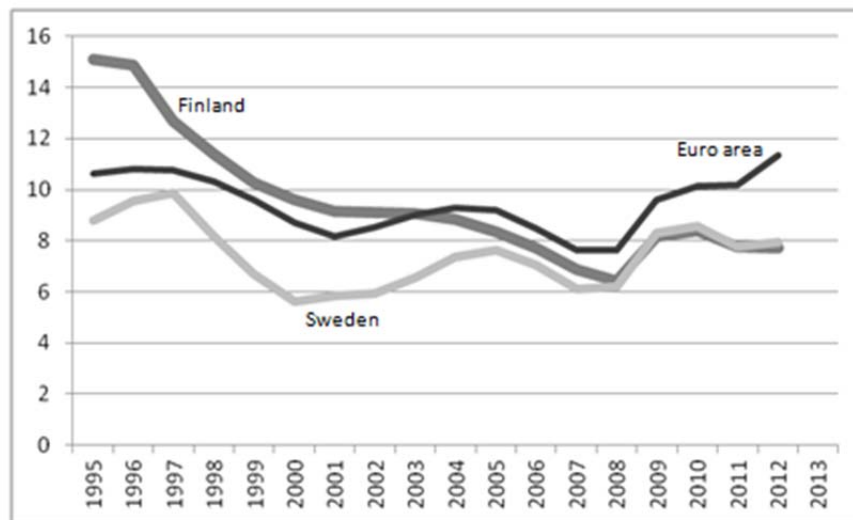


Source: Eurostat

While the overall performance of the two countries has been broadly similar in terms of growth and inflation, there are some differences regarding unemployment and current account developments. As depicted in Figure 3, unemployment was high in Finland in the mid 1990s. This was the legacy of the banking crisis and the deep recession. Unemployment was on a path of steady decline until recently, and it is now at the same level as in Sweden and below the euro area average by a large margin.

The current account, which in the past used to be persistently in the deficit, has shown sizable surpluses since the mid-1990s (Figure 4). In Sweden this has continued to be the case until now while Finland moved into a deficit in 2011. During the past ten years Finland has lost comparative advantage in two major sectors, the paper industry and the ICT-industry. Sweden has been affected by the same developments, but because of its broader industrial base these industries are not as dominant as they have been in Finland. Also, Finland has lost cost competitiveness in recent years, not only in relation to Germany but also in relation to Sweden (Figure 5).

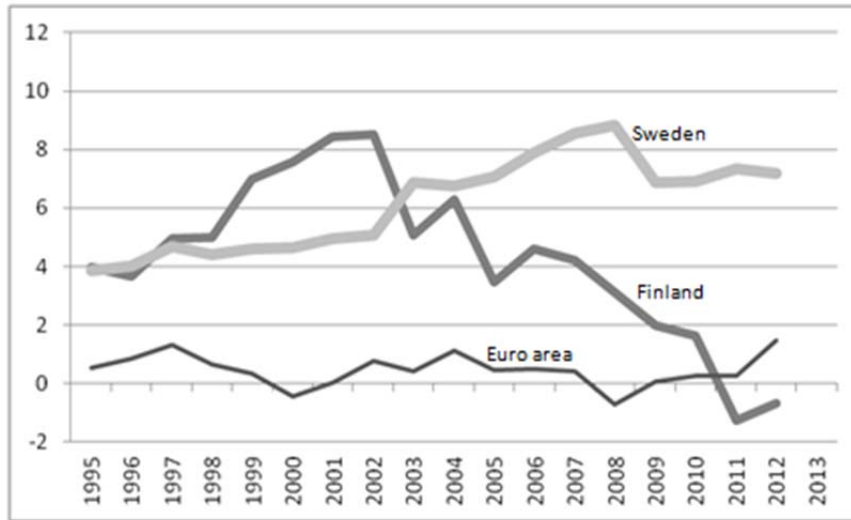
Figure 3 Unemployment rate, % of labour force



Source: Eurostat

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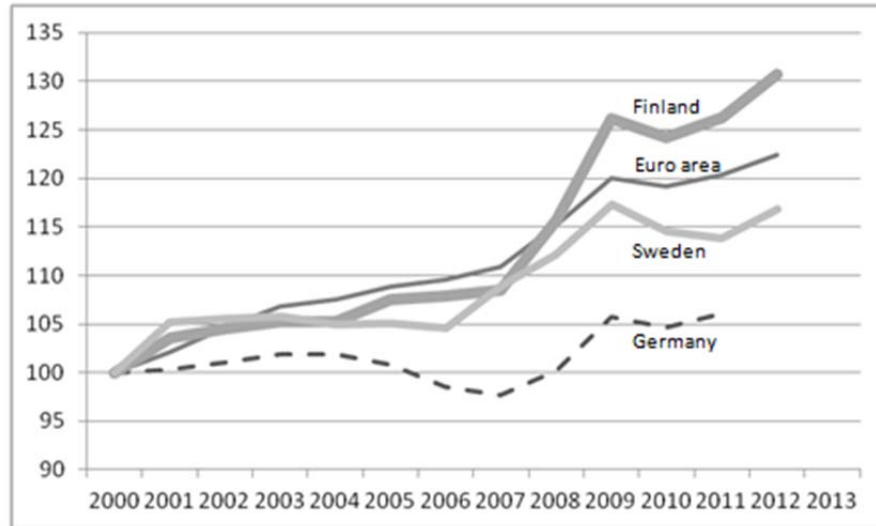
Figure 4 Current account, % of GDP



Source: Eurostat

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Figure 5 Unit labour cost, 2000=100%



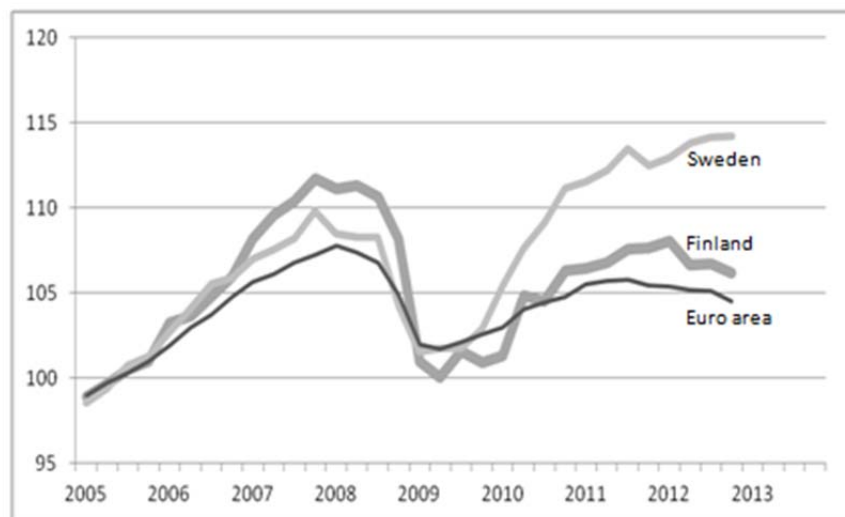
Source: Eurostat

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The recession experience

Finland and Sweden were badly hit by the global financial crisis in the fall of 2008. Both countries witnessed a sharp decline in GDP (Figure 6). In relative terms the fall of output was more pronounced in Finland than in Sweden. A noteworthy difference emerged in the recovery phase. The Swedish recovery was sharp, and total output reached the pre-recession level already in 2011, while Finland's GDP still lies below the previous peak. In fact, Finland has been in a recession since early 2012, while in Sweden the the slow down started only recently.

Figure 6 The recession experience: GDP, 2005=100



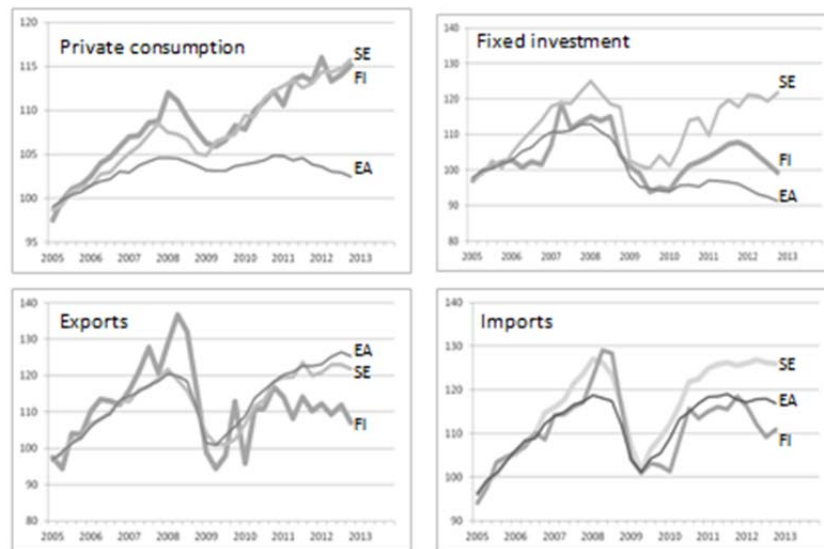
Source: Eurostat

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Both countries are highly dependent on international trade, and therefore they were hurt hard by the sharp drop in world trade. As seen in Figure 7 the fall of Finnish exports was deeper than in Sweden, partly because the preceding growth had been largely based on the exports of capital goods. These exports collapsed due to the sudden stop of investment activity globally. However, adjusted for the differences in the structure of exports (that of Sweden being more broadly-based) the decline of export volumes was of the same order of magnitude in both countries. The sharp depreciation of the Swedish currency may have supported profitability of the export industry, but this weakness of the currency proved to be short-lived and hardly had time to affect the export volumes significantly. The recovery of exports took place at the same time as the currency was

appreciating. In mid-2012 Sweden's competitiveness started to deteriorate as a result of a sharp appreciation of the currency.

Figure 7 The recession experience: GDP components, 2005=100



Source: Eurostat

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In both countries the effect of the global recession on private consumption was relatively mild and temporary. In both countries private consumption exceeds the previous peak by a clear margin, while in the euro area as a whole it has remained stagnant for more than five years. In Sweden the recovery was broadly-based with consumption, investment and exports all contributing to the recovery. The recovery of exports took place at the same time as the currency was appreciating. The decline in imports in 2009 was of the same magnitude in Finland and Sweden. In Sweden the imports have recovered above the pre-crisis level, while in Finland imports have stagnated.

Finland's relative underperformance vis á vis Sweden during the recovery phase can be accounted for mainly by weak export growth and anemic investment. The weak export performance of Finland reflects mainly the structural factors, such as the loss of comparative advantage in paper and ICT industries, as well as the deteriorated competitiveness since 2007. We have no good explanation to the recent weakness of investment except the excess capacity and weak demand.

The picture emerging from this descriptive analysis is does not contradict the one painted by Suni and Vihriälä (2013). A novelty in their study is the use of an econometric multi-country model (NIGEM) to simulate a counterfactual assuming that Sweden would have participated in the EMU

from the beginning. Under this assumption Riksbank would have pursued exactly the same monetary policy as the ECB, and that the krona exchange rate would have been in a stable relation to the euro. The simulation exercise does not point out any significant effects. The GDP is slightly lower in 2009-2011 mainly due to lower domestic demand (higher interest rate) and stronger imports. Interestingly, exports in the counterfactual deviate very little from the factual development, despite a sharp depreciation in 2009 and sharp appreciation thereafter. The overall conclusion of this study is the same as ours according to which the different choices with regard to the EMU have not affected macroeconomic performance very much (at least not so far).

3. Macroeconomic policies

This section will compare the macroeconomic or fiscal and monetary policies pursued in Finland and Sweden with each other as well as with the policies pursued in other EU15-countries. Obviously, Finland is not running a monetary policy of its own as monetary policy is decided upon by the European Central Bank (ECB).

3.1 Monetary policy

Repeated speculative attacks against the currency forced the Bank of Finland to abandon the pegged exchange rate regime in September 1992. The immediate effect of the decision to float was an effective (trade-weighted) depreciation of the Finnish markka by about 15 per cent. This came on top of the discrete devaluation by some 10 per cent in November 1991. Sweden followed suit two months later; the Riksbank abandoned the peg in November 1992. The immediate effect was a depreciation of the krona by about 10 per cent.⁵

The Finnish currency was in a free fall until February 1993, when the Bank of Finland announced an inflation target of 2 per cent to be achieved by 1995. In Sweden the central bank had made a similar move one month earlier. Thereafter the Finnish markka was on an appreciating trend until 1995. The Swedish krona continued to depreciate very gradually until 1995 when the trend turned.

⁵ The early experience of floating exchange rates and inflation targeting in Finland and Sweden is described in Pikkarainen et al. (1997) and Berg and Gröttheim (1997) both published in BIS Policy Papers No. 2 - Monetary policy in the Nordic countries: Experiences since 1992.

In both countries the inflation target of 2 per cent was achieved well before the 1995 deadline. In Finland the rate of inflation was in fact below the target (close to zero) for many years in the mid-1990s. In both countries low inflation quickly became widely accepted as a societal goal and well anchored in expectations. Interest rates declined sharply in the course of 1993. In Finland this was helped by the expectation of an appreciation of the currency as the central bank was restoring its foreign exchange reserves.

Although the floating exchange rate regime with an inflation targeting proved to be a success, Finland started to orientate itself towards EMU membership already in the mid-1990s. In October 1996 the Finnish markka was linked to the European exchange rate regime ERM. In early 1997 there was some speculation about a realignment (revaluation) of the markka before the final fixing of the conversion rates expected to take place in May 1998. The Bank of Finland engaged in huge interventions to prevent appreciation of the currency. As of the beginning of 1999 national monetary policy was history in Finland.

The Swedish central bank has successfully continued to maintain inflation targeting with a numerical target of 2 per cent and a ± 1 per cent tolerance interval. The implementation of the inflation targeting strategy has been fine-tuned over the years. Based on the ideas of Svensson (1997), the Riksbank has adopted a version of inflation forecast targeting, where the central bank forecasts the future interest rate path consistent with the achievement of the inflation target. Since 2007, the Riksbank has published its interest rate path (with uncertainty bands) together with its inflation forecast.⁶

The ECB's primary objective is price stability. The Governing Council has given an operational definition for price stability. According to this definition the rate of increase of the harmonised index of consumer prices in the euro area should stay below two per cent but close to it in the medium term. This is an asymmetric inflation target compared to the Riksbank's two per cent target with a ± 1 per cent tolerance interval.

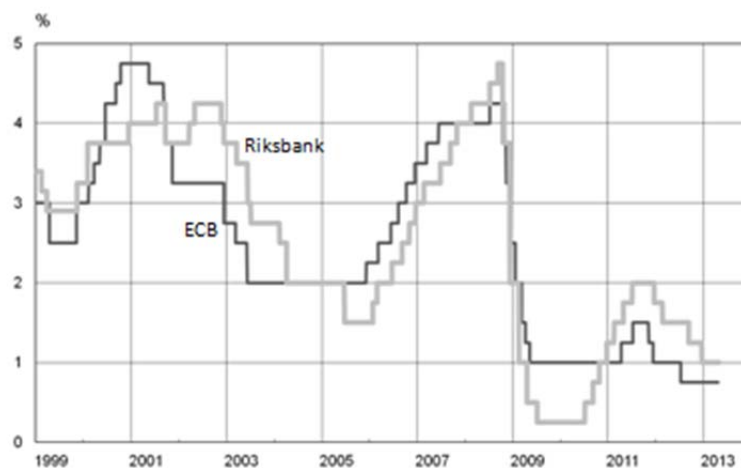
While the Riksbank publishes the interest rate path consistent with the inflation forecast, the ECB is much more restrictive regarding the details of its inflation outlook, not to speak about the likely interest rate path in the future. Quantitatively the difference between the price stability objective

⁶ This kind of approach was first adopted by the central bank of Norway. By its proponents it is called "the best practice monetary policy" (Svensson 2006).

of the ECB and the Riksbank is not large. It follows that if the cyclical development in Sweden are closely correlated with that in the euro area the interest rate policies are likely to exhibit a rather synchronous pattern.

This is what we see in the data (Figure 7). The interest rate cycle in Sweden has been broadly similar to that in the euro area. In 2000 the ECB's monetary policy was slightly more aggressive than in Sweden, which is consistent with the inflation outlook at the time. The ECB started the easing cycle in 2001 with the Riksbank following one year later. More recently Riksbank's monetary policy has been slightly more aggressive. During the tightening cycle in 2006 to 2008, the Riksbank followed the ECB with a lag of one to two months. Both central banks quickly reversed the stance once the global financial crisis erupted in October 2008. The Riksbank went all the way close to the zero lower bound, while ECB stopped at the one per cent level. In practice the shortest money market rates in the euro area were as low as in Sweden due to the unconventional monetary policy of the ECB (longer maturities and fixed rate full allocation provision of liquidity). The recent relative tightening in Sweden is consistent with differences in the cyclical situation. Sweden is recovering from the recession while the euro area is suffering from recessionary tendencies fed by the sovereign debt crisis.

Figure 8 Central bank policy rates



Sources: ECB, Reuters and Bloomberg

Despite the fact that the euro and the krona are both floating currencies, the exchange rate between them has remained fairly stable since the introduction of the euro in 1999 (Figure 8). Between 2001 and early 2008 the EUR traded in the SEK 9 to 9.50 range. At the same time both currencies appreciated trend-wise vis á vis the USD.

There are, however, three interesting episodes in the EUR/SEK exchange rate path since 1999. The first is in 1999 and 2000 when the krona appreciated rather strongly against the euro. This reflects the unexpected weakness of the euro in the beginning of its life as a currency. At the same time growth of the Swedish economy was buoyant due to the global boom in the ICT sector. If Finland had maintained its own currency it is likely that the markka would have appreciated strongly in 1999-2000, that is in the period when foreigners started to buy the stocks of the Finnish companies, especially Nokia.

The second interesting period is late 2008 when the krona depreciated sharply against the euro. This hurt some Finnish industries (e.g. paper industry) for a while. Depreciation did not prevent the Swedish exports from falling significantly; in fact the collapse of exports was of the same magnitude as in Finland if one takes differences in the export structure into account. More recently the krona appreciated strongly, reflecting the fact that Sweden was perceived as one of the few safe havens in Europe.

Figure 9 SEK exchange rates



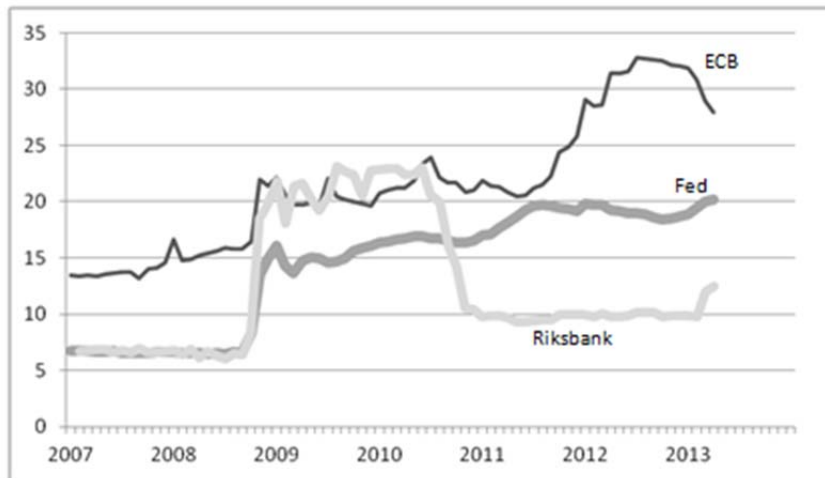
Source: Riksbank.

The Lehman Brothers episode in September 2008 marked an abrupt stop to the normal functioning of the global financial markets. The effects were felt everywhere, including in the Nordic countries. The main effect in Europe was that the banks faced increasing difficulties to refinance their assets in the market.

In order to ensure the liquidity of the banking system the central banks had to intervene. The ECB started to offer longer-term refinancing for banks (against collateral) on the fixed rate full allocation basis. This led to a sharp expansion of the Eurosystem balance sheet in October 2008. Later the Eurosystem introduced the covered bond purchasing programme and the securities market purchasing programme in order to improve the transmission of monetary policy. In the fall of 2011 the Eurosystem balance sheet further expanded as a result of two three-year operations. As a result the Eurosystem balance sheet expanded first by 5 per cent in relation to GDP and later by a further 15 per cent in the autumn of 2011.

The situation was no different in Sweden in the fall of 2008 as regards the funding situation of banks. As longer-term refinancing in the market became impossible, the Riksbank increased its lending to banks both in Swedish krona and US dollar (facilitated by the swap arrangement with the Fed). The collateral rules were relaxed for the banks' central bank financing and the number of counterparties was increased. Finally the Riksbank extended one-year lending to banks at fixed interest rates in three tranches (SEK 100 billion each). As a result the Riksbank's balance sheet expanded by 20 per cent in relation to GDP (Figure 9).

Figure 10 Central bank balance sheet, % of GDP



Source: Eurostat and Bloomberg

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The Swedish central bank succeeded to make a smooth exit from the unconventional monetary policy measures in the latter half of 2010, as the banks' funding situation improved and the three one-year operations expired. This is not the case in the euro area, where the interbank market does not function properly across borders and a large number of banks continue to face funding difficulties.

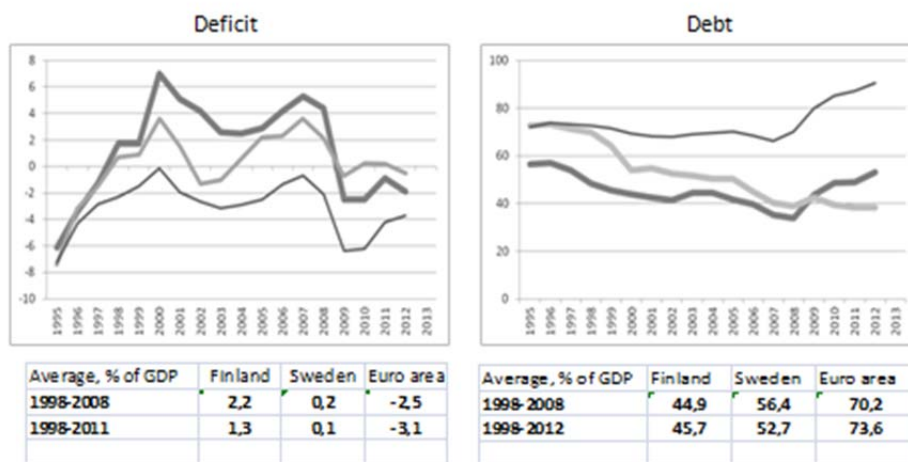
The Bank of Finland's balance sheet has expanded markedly since mid-2011. The reason, however, is not the funding difficulties of the banks operating in Finland (many of which are Swedish-owned). In fact, the banks are holding huge amounts of excess liquidity in the form of overnight and term-deposits with the Bank of Finland. The main counterpart of these deposits on the asset side of the balance sheet is the Target2-balances which are claims of the Bank of Finland on the ECB.⁷

3.2 Fiscal policy

⁷ Target 2 is the payments systems of the eurosystem. On October 2012 The Bank of Finland had in this system a receivable of EUR 61 billion, which is formally a claims of the Bank of Finland on the ECB. On the liability side were the banks's balances on their current accounts (EUR 31 billion, incl. minimum reserves), banks' overnight deposits (EUR 16 billion) and term-deposits (EUR 18 billion).

Since late 1990s until the recession in 2009 both countries were running sizable surpluses (Figure 11). As a result the public debt ratio was on a declining trend. In Finland the fiscal balance turned into the deficit during the recession, while in Sweden it has remained more or less in balance and the debt ratio has continued to fall.

Figure 11 Public deficit and debt,% of GDP

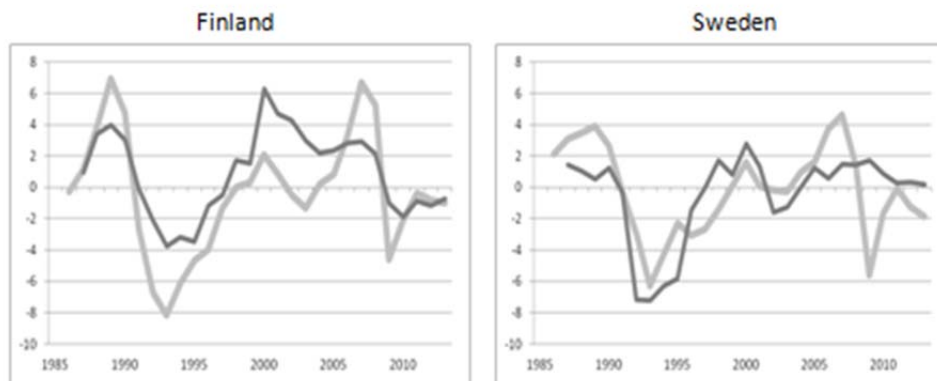


Source: Eurostat

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The problems faced in decision-making on fiscal policies have changed significantly during the past 25 years. As already noted, in the late 1980s and early 1990s Finland and Sweden experienced a period of boom and bust associated with a banking and currency crisis. Fiscal policies were tightened somewhat in the last years of the 1980s in both Finland and Sweden, but the degree of tightening was insufficient to offset the effects of rapid credit expansion. The subsequent decline of the GDP gave rise to large output gaps (Figure 11).

Figure 12 Output gap and the general government cyclically adjusted budget balance, % of GDP



Source: OECD Economic Outlook

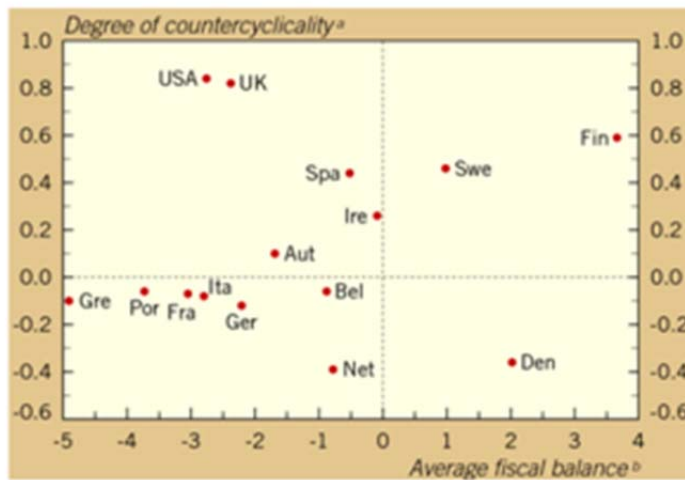
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According to the OECD's measure of the fiscal impulse (the change in the cyclically adjusted general government balance), there was some discretionary easing of fiscal policy in the same years, significantly more so in Sweden than in Finland (Figure 11). One of the reasons for the cautious fiscal policy stance in Finland was the lack of confidence on international financial markets in Finnish banks and also in the credit worthiness of the Finnish government in the light of the big current account deficit, rapidly increasing budget deficits and weak competitiveness. Emphasis on fiscal consolidation was felt to be necessary to contain further rises in interest rates and an even sharper process of deflation (declines in prices of real estate).

Starting in 1994, both countries initiated comprehensive programs of fiscal consolidation. This was made easier by the large currency depreciations and the favourable growth in world markets. By 1998 Sweden had improved its cyclically adjusted balance by close to 10 per cent of GDP and Finland by slightly above 5 per cent. In Finland the cyclically adjusted balance continued to strengthen reflecting, in part, the unexpected and extraordinary revenue growth related to the ICT boom.

The first decade of the monetary union was in many of its member states characterized by lax and pro-cyclical fiscal policies. Finland and Sweden stand out, however, as countries which have pursued mainly counter-cyclical policies and which have also maintained significant general government financial surpluses over that period (Figure 13) (Gylfason et al. 2010, p. 43).

Figure 13 Fiscal policy and consolidation 1999-2008



^a Correlation coefficient of output gap and fiscal impulse measured by change in cyclically-adjusted budget balance, % of GDP

^b General Government financial balance on average in 1999-2008, % of GDP

Source: OECD Economic Outlook No. 86, November 2009

Consequently, the level of public indebtedness declined markedly and to relatively favourable levels in these two countries. Table 1 reports the change in the level of public debt from 1996 to 2011 in terms of both the net and the gross debt, as these in some cases give quite different results.⁸ The decline in the debt ratio was large in the Nordic countries and notably so for the net debt ratio.

Also, the overall tax rate declined in the past decade, though it remains higher in Sweden than in other countries (except Denmark). Notably, the tax wedge on labour was reduced more than in other countries, which most likely helped to raise employment rates, as seen in the right hand column of Table 1.

⁸ Finland is a case in point, as the decline in the net debt ratio is much larger than in the gross debt. This partly reflects the growth of social security (pension) funds and a reallocation of pension funds from holdings of government bonds into holdings of equity. As government gross debt is reported on a consolidated basis, government debt held by social security funds is netted out. Obviously, gross debt does not consider government assets, which notably in the Nordic countries are of significant size. Valuation effects are another important factor affecting notably the net debt position; see Flodén (2012).

Table 1 Debt ratio and tax wedge on labour

	General government debt. % of GDP						Tax wedge on wage income			
	1996	Gross			Net			2000	2011	Δ
		2011	Δ	2000	2011	Δ				
Austria	68.1	72.4	+4.3	40.2	45.2	+5.0	47.3	48.4	+1.1	
Belgium	127.2	97.8	-30.5	115.3	80.4	-34.9	57.1	55.6	-1.5	
Denmark	69.4	46.6	-22.8	33.3	2.4	-30.9	44.1	38.4	-5.7	
Finland	57	49	-8.0	-6.7	-60.9	-53.8	47.8	42.7	-5.1	
France	58	86	+28.0	41.9	62.7	+20.8	49.6	49.4	-0.2	
Germany	58.5	80.5	+22.0	32.7	51.5	+18.8	52.9	49.8	-3.1	
Greece	99.4	170.6	+71.0	82.2	133.1	+50.9	35.2	38.2	+3.0	
Ireland	71.7	106.4	+34.7	42.2	65	+22.8	28.9	26.8	-2.1	
Italy	120.2	120.7	+0.5	103.9	100.2	-3.7	47.1	47.6	+0.5	
Netherlands	74.1	65.5	-8.6	52.7	37.7	-15.0	40	37.8	-2.2	
Portugal	58.2	108.1	+49.9	26.5	75.8	+49.3	37.3	39	+1.7	
Spain	67.4	69.3	+1.9	55.5	45.5	-10.0	38.6	39.9	+1.3	
Sweden	73.3	38.4	-34.9	26.6	-24.9	-51.5	50.1	42.8	-7.3	
UK	51.3	85	+33.7	27.9	61.7	+44.0	32.6	32.5	-0.1	

Sources: Floden (2012) and OECD

Fiscal policy has recently been confronted with the consequences of the global financial crisis and the euro area debt crisis. Almost all governments initiated fiscal expansion in 2008-2009 in response to the sharp decline in the economy. The amount of fiscal expansions in Finland in 2008-10 amounted to some 5 per cent of GDP. In Sweden, however, the amount of fiscal expansion was barely one per cent of GDP. This contrasts with Swedish history and may be seen as remarkable as Sweden had (and still has) a strong competitive position and is running large current account surpluses, has no inflationary pressure and a comfortable budgetary position. A rather natural interpretation is that Sweden, given the flexible exchange rate, now prefers to meet a slump by monetary easing rather than fiscal expansion.

As will be explained below, fiscal consolidation in the 1990s was associated with significant structural reform, including reforms of the fiscal framework. These reforms reinforced the process of fiscal consolidation and helped to put it on a sustainable basis. It would be tempting to conclude from the experiences of Finland and Sweden that other countries in crisis, notably today in Southern Europe, could follow the same strategy and thereby succeed in getting their economies on a path of reform and growth. As has been pointed out by, e.g., Flodén (2012), however, the situation

is far from comparable and the current problems of Southern Europe look much more severe. Not only is the current level of public debt much higher in the crisis countries today than was the case in Finland and Sweden in the 1990s, but also the demographic challenge is now much more demanding. Furthermore, the international environment is unhelpful in that external demand growth is weak. And above all, the crisis countries cannot depreciate and thereby engineer a process of export led growth as was done by Finland and Sweden in the late 1990s.

4. Institutions and structural policies

As set out by Esping-Andersen (1990), the Nordic model (or the social democratic model) differs in certain respects from the other members of the family of European socio-economic models. In our view the Nordic model is characterized by three broad features (Andersen et al. 2007 and Gylfason et al. 2010). One of these is a set of labor market institutions that include a high unionization rate, a strong role for labor market organizations and negotiations, significant elements of wage coordination, relatively generous unemployment benefits and a prominent role for active labor market policies. A second feature is the high level of public and/or private spending on investment in human capital, including child care and education as well as R&D. Third, the Nordics maintain a comprehensive and inclusive welfare state, based (largely) on universalist principles, with emphasis on transfers to households and publicly provided social services financed by high taxes. While classifications are always open to objections (as all countries are unique), it is a fact that the Nordics in international comparisons tend to form a cluster of their own, though also some other small and open countries (notably the Netherlands) share many of their characteristics.

As noted above, Finland and Sweden both experienced a banking crisis and a depression in the early 1990s. The crisis management in the early 1990s has been the focus of much attention, notably so for the handling of the banking crisis. Both countries undertook a number of important measures to safeguard the functioning of their banking systems, and this was surely instrumental in facilitating the subsequent recovery (see, e.g. Honkapohja 2009 and Gylfason 2010). By contrast, one of the most regrettable aspects of the handling of the current euro area debt crisis is that action with regard to the banking system has in many countries been lacking or insufficient. (This is also a striking difference when comparing crisis management in the US and the EU.)

One key factor in the recovery process was undoubtedly the large depreciation of the currencies which followed upon the abolition of the pegged exchange rate regime. As noted above, the large improvement in competitiveness, in combination with growth in international markets, was instrumental in creating a strong process of export-led growth in the latter part of the 1990s.

A long-lasting consequence of the crisis was that it paved the way for a number of structural reforms. Most of these were undertaken more or less in parallel and they were often rather similar, partly because they were stimulated by international developments (such as the US tax reform in the 1980s) or because authorities in Finland were encouraged by initiatives in Sweden. The most important structural reforms probably were those concerning the tax system and the pension system as well as the frameworks of monetary and fiscal policies. Many of these reforms were proposed and discussed in the report of the so called Lindbeck Commission (1994).

Both countries undertook *tax reforms* with the aim of broadening the tax bases and reducing marginal rates. Most importantly, the dual tax system was introduced, meaning that capital income was taxed at a proportional tax rate (of 30 per cent in Sweden and 25 per cent initially in Finland). Finland also introduced the “avoir fiscal” system such that the double taxation of corporate income was eliminated. (Subsequently the avoir fiscal system has been abolished but the dual tax system retained.) This constituted a big change as compared to the earlier system with generous depreciation allowances and double taxation of dividends in combination with no tax on capital gains on holdings exceeding 10 years. The new tax system made it possible to reallocate resources arising out of profits across companies and sectors, thus facilitating a process of “creative destruction” and the transformation towards an economy relying on high tech exports.

Work was started on reforms of the compulsory *pension system*. In Sweden this led to a changeover from a defined benefit to a defined contribution system that was adopted in 1999. This pension reform is a benchmark case and has attracted a lot of international interest; cf. Holzman and Palmer (2003). It is believed to have put the Swedish pension system on a sustainable footing, avoiding the need for increases in the contribution rate in coming decades in spite of aging populations. The reform of the Finnish pension system was less radical and was implemented only in 2005, but notably the introduction of a life expectancy parameter cutting monthly pensions as life expectancy increases (an idea borrowed from the Swedish reform) will help to reduce pressure on contribution rates.

The *fiscal framework* was modernized in both countries, notably by introducing multiannual expenditure ceilings. Sweden also introduced a surplus target for public finances and balanced-budget requirements for municipalities. Most importantly, a tradition has emerged in which the prime minister and the minister of finance generally cooperate to ensure that the budget ceiling is respected. This practice has been strongly established in both countries.

More recently Sweden introduced a fiscal policy council. In accordance with the requirements of the so called Fiscal Compact Finland is currently in the process of establishing such a council, although its role and position seems not to become as prominent as in Sweden. It is an open issue whether the fiscal council is essential for enhancing budget discipline. However, the fiscal policy council should be helpful in improving transparency of policies and the quality of public debate.

Both countries reformed the *monetary framework* by setting up independent central banks with inflation targets and operating in a regime of floating exchange rates. This may partly be seen as a consequence of the decision to join the EU (in 1995) but it also reflects the traumatic experiences of the preceding pegged exchange rate regime.

Other actions undertaken aimed at improving competition on markets for goods and services and to improve the functioning of labor markets. Sweden also prolonged election periods of the parliament from three to four years. A specific feature of Finnish policies was the rather strong increase in government spending on R&D in the midst of the crisis and in spite of cuts in most government spending and rises in tax rates. This contributed to a rapid structural change as a result of which the export structure became more broadly based reducing the country's dependence on the forest-based industries.

In all, these structural reforms helped to transform the economy in a liberal or market-friendly direction, something which was not a trade mark of these countries in earlier decades. The process began with the financial deregulation in the 1980s and was then followed by the reforms initiated during the depression in the 1990s. While the pace may have slowed, the Nordics have now established themselves as countries that combine a comprehensive welfare state with a low level of regulation of markets. This is illustrated in Table 1, which shows the ranking of the "old" EU member states (except for Luxemburg), which constitute a reasonable reference when making cross-country comparisons.

The first indicator is the OECD indicator of product market regulation (PMR) and the second is the OECD indicator on employment protection legislation (EPL). As is seen, the regulatory policies of the Nordic member states of the EU are in general more liberal than in other countries except for the UK and Ireland. The third indicator is the KOF index for regulation or restrictions with a bearing on globalization. The final indicator shows the Fraser index of economic freedom. The general impression is again that the Nordics are running structural policies geared towards allowing markets to function effectively.

Table 2 Structural indicators

	PMR -2008	Ranking	EPL (2008)	Ranking	KOF -2009	Ranking	FRA -2010	Ranking	Average ranking
UK	0.79	1	0.75	1	89.8	1	7.93	3	1
Ireland	0.86	2	1.11	2	87.9	6	7.98	1	2
Netherland	0.91	3	1.95	7	89.6	2	7.63	5	3
Denmark	0.99	5	1.50	3	86.1	7	7.84	4	4
Sweden	1.24	7	1.87	4	89.3	3	7.69	6	5
Finland	1.12	6	1.96	8	88.1	5	7.94	2	6
Belgium	1.37	11	2.18	10	88.3	4	7.52	9	7
Austria	1.38	12	1.93	6	84.1	10	7.61	7	8
Germany	1.27	8	2.12	9	83.8	11	7.58	8	9
Spain	0.96	4	2.98	11	81.9	13	7.42	11	10
Italy	1.32	9	1.89	5	83.7	12	6.77	13	11
France	1.39	13	3.05	13	85.6	8	7.47	10	12
Portugal	1.35	10	3.15	14	85.4	9	7.25	12	13
Greece	2.30	14	2.73	12	80.8	14	6.73	14	14

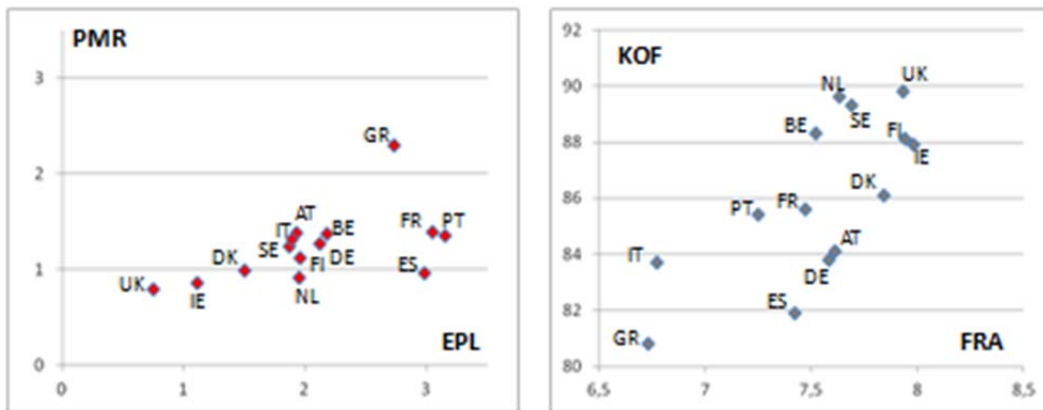
Note: The KOF index of economic globalization used in this context measures the regulatory aspect of globalization in terms of restrictions on trade and capital. The Fraser index is a summary index measuring economic freedom in terms of the size of government, the legal system and property rights, sound money, freedom of trade and regulation.

Sources: OECD, KOF Klonjunkturforschungsstelle (EHT Zurich) and Fraser Institute.

The broad picture is that the Anglo-Saxon countries are the most liberal, followed closely by the Nordics but also the Netherlands (Figure 10). The continental countries and notably the countries in Southern Europe impose more heavy regulation and rank lower in terms of globalization and economic freedom. As mentioned above, the orientation of the Nordic countries towards market-friendly policies is not a new phenomenon; it started already in the 1980s. However, the reform

process certainly received impetus from the depression in the 1990s, which created the political preconditions for reform to be undertaken and be implemented.

Figure 14 Structural indicators



Explanations, see Table 2.

5. EMU: Better to be in or out?

The setting up of an economic and monetary union in its current form, a currency without a state, is a historically unique experiment. After its first decade in existence the EMU was widely considered a success. Yet, only a few years later the euro area is risking financial collapse. Most of its member states are in a recession, some in a depression with unemployment of more than 25 per cent. Political tensions between and within member states are increasing, and there is disagreement concerning the proper mission and mandate of the ECB.

Much time and effort will be needed to disentangle the experiences with a view to drawing conclusions about the causes of the problems and the best remedies. The lack of the counterfactual

makes it very hard to assess these issues and to evaluate the degree of success or failure of the whole project.

Finland and Sweden joined the EU too late to be in a position to influence the Maastricht treaty or the main architecture of the EMU. Given that it was being set up, they nevertheless had to decide on their own attitude to the EMU. The governments of both countries set up expert committees to evaluate the likely consequences of going in or staying out of the EMU. The Swedish Calmfors commission acknowledged the efficiency advantages of a common currency but argued that the risk of mistakes in wage setting and/or in fiscal policy in Sweden spoke against joining at the time (Calmfors et al. 1997). (With the benefit of hindsight one might argue that the commission may have come to the right conclusion but not for the right reasons.) The Finnish Pekkarinen commission did not directly take a stand on whether Finland should join but rather discussed measures to improve fiscal consolidation and resilience of the economy in the face of shocks (Prime Minister's Office 1997).

The experience of Finland and Sweden of the pegged exchange rate regime were a source of frustration. In retrospect it seems almost inevitable that the regime had to be abandoned. As is well known from the "impossible trinity", a fixed exchange rate is incompatible with free capital movements and the ambition to run an autonomous monetary policy. Interestingly, Finland and Sweden would seem to have drawn different conclusions from this: Finland gave up its monetary policy, while Sweden abandoned the fixed exchange rate.

However, economic considerations or the views of these expert committees were not decisive regarding the membership in the EMU. Both countries made their decisions primarily on the basis of political factors. Finland joined the EU in order to clarify its geopolitical identity, having lived for many decades in the problematic shadow of the Soviet Union. Given the possibility, the Finnish political and economic establishment wanted to join not only the EU but also its "hard core", the EMU. In Sweden there were no similar considerations to support membership in the EMU, and after a referendum with a negative outcome the Swedish government decided to stay outside for the time being. It is our contention that the decisions on EMU-membership were not due to differences in economic structure; they rather reflect differences in political appreciations of EMU.

Which country made the better choice? As seen in section 2 above, economic developments in Finland and Sweden have been quite similar. Also, where differences emerge, these can mostly be better explained by other factors than the difference in the monetary regime. The main impression is that differences in the monetary regime have not been associated with great differences in economic performance in Finland as compared to Sweden. This is compatible with a broad interpretation of the traditional view that money is “neutral” in the long run. However, this observation contradicts claims, made in the heated debates on EMU in the years before the single currency came into operation, that EMU would be either a curse (opponents) or a salvation (protagonists). Our conclusion, with a number of caveats, is that the institutions of the socio-economic model at large and the economic policies pursued are more important than the monetary regime as such.

One caveat is that the conclusion may hold only for countries pursuing relatively “sound” economic policies; for countries unable to “keep their house in order”, being outside the euro area may be a less risky alternative than joining the euro. Given the experiences and prospects of countries like Greece and Spain it is hard to foresee a turnaround sufficiently robust to avoid thinking that the cumulative amount of problems might have been less if these countries had experienced neither the low interest rates following upon entry into the euro area nor the subsequent difficulties of restoring competitiveness and the high interest rates associated with their debt problems.

A related caveat is that a credible national central bank may help support wage moderation. Swedish labour market organizations are aware of the risk that excessive wage inflation will trigger a tightening of monetary policy of the Riksbank. In Finland there is no similar feedback from wage behaviour to interest rates. This is conceivably a factor weakening wage discipline in Finland as compared to Sweden (in otherwise comparable labour market situations). Recent developments suggest this concern may not be unfounded.⁹

A further caveat is that membership may conceivably turn into a real liability also for Finland if the debt crisis of the euro area is seriously mismanaged and the monetary union is in one way or another transformed into a “transfer union”. This could happen through OSI (official sector involvement) in debt restructurings (or through inflation). As part of the various rescue packages the Finnish government has given guarantees and loans amounting by now to some 10 per cent of

⁹ This argument has been elaborated upon by i.a. Holden (2002) and Vartiainen (2002). Interestingly, Denmark also maintains the fixed exchange rate, but has been successful in maintaining wage moderation presumably because wage formation in the traded goods sector is generally accepted as a benchmark for overall wage formation.

GDP – even if the TARGET balance of the Bank of Finland were to be disregarded.¹⁰ While the sums are large, however, they would even in a bad scenario amount to only a fraction of a per cent in terms of the sustainability gap of public finances. The main risk, for Finland as well as for Sweden, is a collapse of the EMU, which would trigger a Europe-wide banking crisis and depression.

Another path to a transfer union would be to introduce Eurobonds as an instrument of government borrowing for the euro area as a whole. However, this would require a change of the treaty and could hardly win acceptance in parliaments in Germany, the Netherlands or (perhaps particularly) Finland. Overall the conclusion remains: EMU may have been a bad idea, its design was certainly flawed¹¹ and its implementation suffered from many errors, but it is not clear on the basis of experience so far that the decisions on membership in EMU have created significant differences in the performance or prospects of Finland and Sweden.

6. Concluding remarks

A comparison of the economic performance of Sweden and Finland supports three conclusions that amount to rather sweeping generalizations. First, it is tempting to see a causal link from crisis to reform illustrated by the developments and economic policies in Finland and Sweden following the crisis in the early 1990s. With the benefit of hindsight, that crisis may be seen as somewhat of a blessing in disguise. It created a political situation that allowed significant structural reforms to be undertaken, and economic policies have since the crisis been more successful and “responsible” than in earlier periods.¹² Policies have been geared towards, inter alia, allowing or fostering structural change and maintaining sound public finances.

¹⁰ It may be noted that the current Finnish government has insisted that any guarantees or loans given by Finland must be backed up by collateral covering 40 per cent of the commitment. In effect, the collaterals have reduced the net contribution of Finland to the financial packages. On the significance of TARGET balances see de Grauwe (2012).

¹¹ There is no reason to enter into the debate about the proper design of EMU in this context. However, most economists would by now acknowledge that a single currency needs to be supported by some form of a banking union.

¹² One may add that the reorientation of economic policies in Finland and Sweden started before the crisis in the 1990s. After all, the crisis itself was triggered by the consequences of the deregulation of capital flows and financial markets in the 1980s. Also, the Swedish tax reform was prepared and even implemented already before the crisis. These developments were inspired partly by the change in economic policy thinking emphasizing deregulation and market efficiency. Another factor was the failure of the policy of recurrent devaluations and public sector expansion to generate sustainable growth, which led to the adoption of the fixed exchange rate as a key policy objective or constraint. One might also argue that the banking crisis was due mainly to the deregulation and the hard currency policy and had little to do with the problems that the structural reforms in the 1990s were meant to tackle. However, it remains the case that the crisis created the mental or political preconditions for reforms to be undertaken.

One would like to think that the current crisis in the southern part of the euro area will in a similar way trigger steps towards a reform path with large payoffs in future years. As pointed out above and discussed in some detail by Floden (2012), however, the crisis countries in the euro area are presently facing a more difficult situation than Finland and Sweden in the 1990s, when the Nordics could benefit from large currency depreciations and favourable external conditions.

A second sweeping generalization, supported by the observations above, as well as other observations, is that the (current version of the) “Nordic model” is relatively successful in combining equity and efficiency. While caveats and qualifications are necessary, it remains a pertinent observation that the Nordic countries seem to outperform many others in terms of a number of social and economic indicators.

A third conclusion, with certain caveats, is that the monetary regime may matter less for economic performance than often argued in the heated debate on the pros and cons of a single currency. While not constituting a laboratory experiment, a comparison of the performance of Finland and Sweden supports this contention. Admittedly, the jury is still out in the sense that Finland is now facing a structural weakness of its export base, and it remains to be seen whether domestic wage adjustment will allow this difficulty to be overcome within a reasonable time span.

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