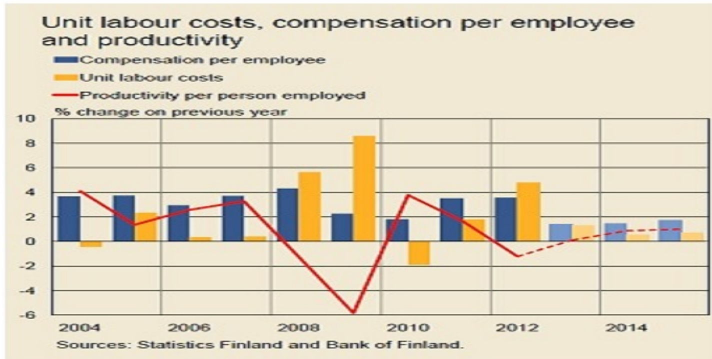
# Finland in front of the euro crisis

Patrizio Lainà - 14/04/2014 [ papers ]

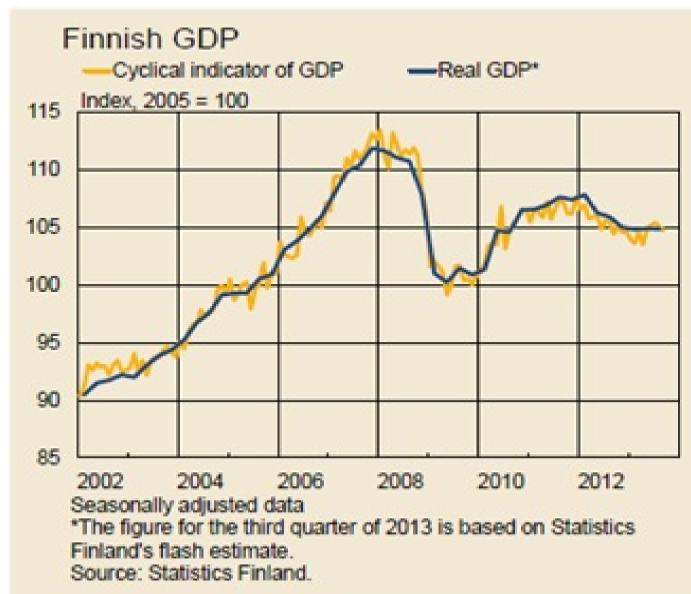
## Abstract




In this article it is examined whether Finland’s losses in cost-competitiveness and “structural problems” offer a credible explanation for the sluggish growth and whether wage moderation and fiscal austerity offer a way out of the crisis.

In 2009 Finland faced one of its biggest annual contractions in economic activity. The Finnish GDP dropped 8,5 % in real terms, which beats even the infamous Finnish Banking Crisis of the early 1990s. Figure 1 below shows that Finland has experienced recently a double-dip recession and the level of GDP is still lower than before the beginning of the Euro Crisis.

FIGURE 1. RECENT DEVELOPMENT OF FINNISH GDP




All this has forced the Finns to untangle the reasons behind this sluggish development and to seek a way out. Obviously, the Euro Crisis had something to do with it, but also other explanations have been given. Now, in the public discourse weak cost-competitiveness and “structural problems” have emerged as the most accepted explanations for the sluggish and even negative growth. Wage moderation and fiscal austerity are seen as the most reliable ways out of the crisis.

Figure 2 shows that since 2007 unit labour costs have indeed risen more rapidly in Finland than, on average, in the Euro area.

Faster growth of unit labour costs means, of course, loss in cost-competitiveness vis-à-vis other Euro area countries. The figure also shows that until 2007 unit labour costs have risen more slowly in Finland than in the Euro area. That is, Finland has gained in its cost-competitiveness during that era.

FIGURE 2. UNIT LABOUR COSTS IN SELECTED COUNTRIES

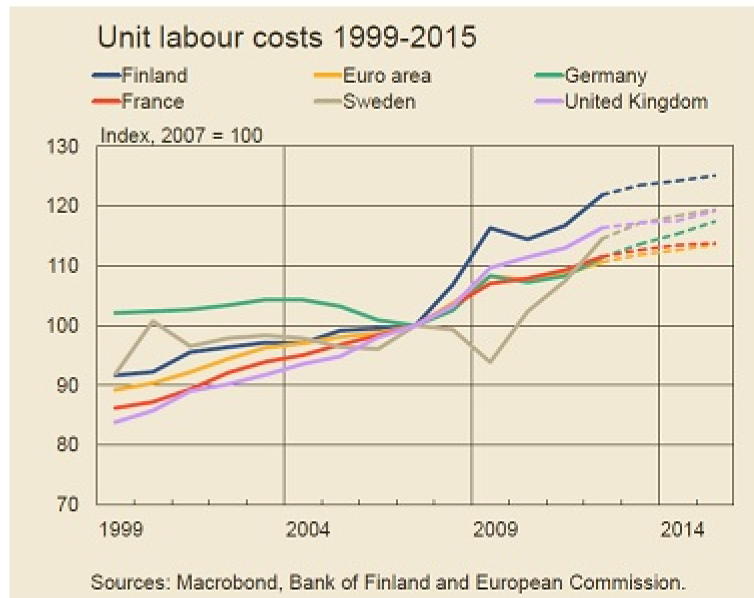
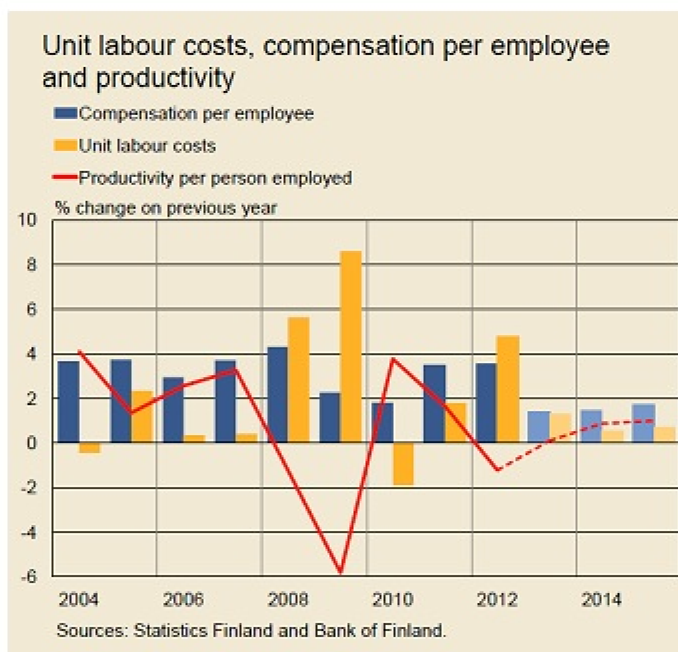



Figure 3 presents the growth rates of unit labour costs and compensation per employee (which can be roughly interpreted as the wage rate if we ignore social insurance contributions) in Finland. Finnish wages have been rising more slowly since 2009 than before the Euro Crisis.

FIGURE 3. GROWTH RATES OF UNIT LABOUR COSTS AND COMPENSATION PER EMPLOYEE IN FINLAND




Interestingly, the compensation per employee, i.e. the wage rate, increased very modestly in 2009 (at its second lowest rate since 2004 among actualized growth rates), while at the same time unit labour costs grew very fast (clearly at its fastest rate since 2004). Thus, wage increases cannot be

blamed for high growth rate of unit labour costs at least in 2009. Actually, unit labour costs do not seem to depend on wages in almost any way.

If not wages, then what caused unit labour costs to rise so quickly in 2009? The rapid increase in unit labour costs is probably best explained by plummeting aggregate demand. The Finnish GDP dropped by 8,5 % in 2009 – more than in any single year in the infamous Finnish Banking Crisis of the early 1990s, which is generally thought to be the worst economic crisis in Finland.

Unit labour costs are calculated by dividing the total costs of labour by the real value of output. Thus, unit labour costs can grow if either wages or employment increases, or the real value of output drops. As Figure 3 showed, the Finnish wage rate rose more slowly in 2009 than in any year before the beginning of the Euro Crisis. Interestingly, when wages were rising more rapidly in the pre-crisis period, Figure 2 showed that unit labour costs grew more modestly than, on average, in the Euro area. This clearly implies that the rapid increase in unit labour costs (and the drop in productivity) in Finland after the crisis is mainly due to the collapse in output. It is not a coincidence that GDP dropped the most and unit labour costs increased the most exactly in 2009. As also employment decreased, it did not contribute to rising unit labour costs. On the contrary, increasing unemployment offset some of the rising unit labour costs.

It is, however, true that there is a structural change happening in the Finnish manufacturing sector. According to Figure 4, there have been quite a lot of job losses relative to subsector's size especially in electrical engineering and electronics and in forest industries. Nevertheless, it would be quite difficult to argue that high wages did cause the structural change. Job losses in electrical engineering and electronics subsector are mainly explained by the crash of Nokia from world's number one mobile phone manufacturer. The crash of Nokia, however, was due to sticking too long to old-fashioned mobile phones instead of developing smartphones – and not due to high wages. Same is true in the forest industries, where the price of the raw material (including transportation) is higher in Finland than, say, in Brazil where trees grow many times faster than in the arctic climate. Again, high wages were not the main reason why manufacturing has moved closer to the production of the raw material.

**FIGURE 4. STRUCTURAL CHANGE IN THE FINNISH MANUFACTURING SECTOR**

Employment in manufacturing sectors

| | *Employment in the sector (thousand persons)* | | |
|---|---|---|---|
| | *2008* | *2012* | *Change* |
| *Food industry etc.* | 39 | 39 | 0 |
| *Textile, clothing and leather industry* | 13 | 12 | –1 |
| *Forest industries* | 59 | 48 | –11 |
| *Printing* | 13 | 11 | –2 |
| *Chemicals* | 39 | 35 | –4 |
| *Non-metallic mineral manufactures* | 18 | 17 | –1 |
| *Metal industry (excl. electrical engineering and electronics)* | 170 | 152 | –18 |
| *Electrical engineering and electronics* | 62 | 50 | –12 |
| *Other manufacturing (incl. furniture)* | 18 | 15 | –3 |
| **Total** | **431** | **379** | **–52** |

*Source: Statistics Finland.*

Against to this backdrop, it is peculiar that the Finnish public discussion has been derailed from insufficient aggregate demand to cost-competitiveness and "structural problems". Wage moderation and fiscal austerity will not work as there is general lack of aggregate demand in the Euro area.

Actually, fiscal austerity and wage moderation make the situation even worse as they suppress domestic aggregate demand even further.

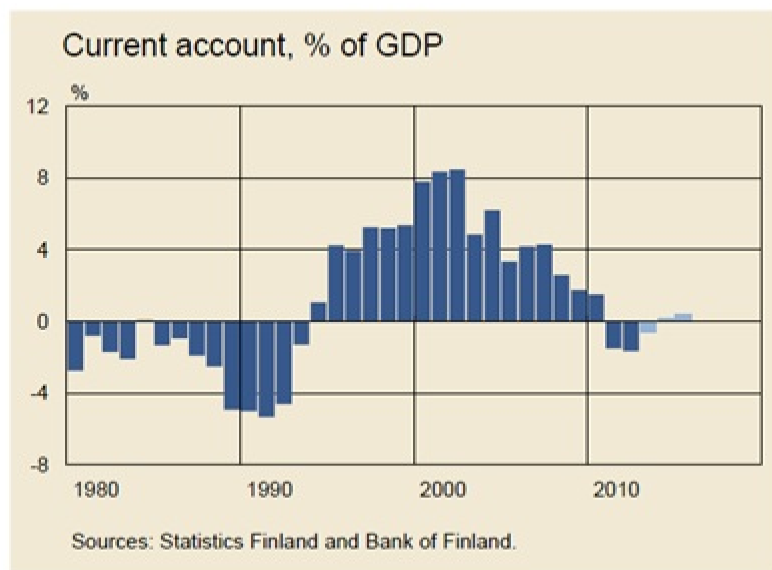
Nevertheless, the dismal design of the Euro area might still require any member country to retrench exactly when the economy should be stimulated. The adoption of Euro demanded any member country to give up its monetary sovereignty. All Euro area member countries are users of their official currency instead of issuers. Does the institutional design of the Eurosystem set a constraint on Finland's ability to stimulate its economy?

There are basically two interrelated constrains in the design of the Euro area. First, due to current account deficit a member country (as a geographical area) might be losing more Euros than it receives. In order to cope with that it must find lenders willing to lend. If lenders refuse to keep on financing the current account deficit of a member country, there will be problems immediately. Thus, current account (or net international investment position, i.e. current accounts cumulatively) should be

balanced or positive in order to avoid exposing the country to lenders' will to lend. Second, the government of a member country must have a satisfactory credit rating in order to be able to stimulate the economy without surging interest expenses.

Is Finland, after all, constrained by its government credit rating or its current account deficit? Finland has been able to maintain its triple-A credit rating and, thus, it is certainly not constrained by this condition. Figure 5 shows that Finland's current account was significantly positive from 1994 until 2010. In 2011 and 2012 it turned slightly negative, but it is expected to recover soon. Finland's net international investment position is clearly positive. Consequently, Finland is not constrained by this second condition either.

FIGURE 5. FINLAND'S CURRENT ACCOUNT




Nevertheless, Finland's policy is to moderate wages and cut public spending in order to achieve cost-competitiveness and fiscal consolidation. It is especially peculiar because Finland has been able to maintain its triple-A credit rating and its cumulative current account (net international investment position) is positive. Thus, Finland could easily afford to stimulate domestic aggregate demand through deficit spending and wage increases.

With the accumulated current account surpluses, it would be Finland's duty to support European aggregate demand, too. Finland, however, has chosen the opposite path. Finland pursues beggar-thy-neighbor policies. Similarly to Germany, Finland aims at current account surpluses also in the future. As all current accounts across all countries summed together are inevitably zero, Finland's policy does not help the GIIPS-countries (Greece, Italy, Ireland, Portugal and Spain) or Cyprus as most of them suffer from excessive current account deficits.

Finland's policy could be somehow comprehensible if it would publicly pursue institutional change to the Eurosystem. If Finland would speak for changes towards functional finance, temporary distress might be acceptable. This, however, has not yet happened.

Finland's future does not look bright, either. As has been shown, Finland is reluctant to stimulate its domestic aggregate demand. Thus, aggregate demand could only be stimulated through boost to its exports. This seems unlikely as two key manufacturing subsectors are in decline and Finland's private sector is reluctant to invest and innovate as it encounters declining domestic demand for its products. Moreover, the rest of the world and especially the Euro area are still suffering from the Global Financial Crisis and, thus, most countries are unable or unwilling to import more. Consequently, it is probable that also Finland is going to keep on groveling in crisis in the next years to come.

*University of Helsinky*