

The Devaluation of the Finnish Mark in 1967

At a time when criticism of the adjustable peg system of international payments is mounting and well-known economists go so far as to deny that devaluation can have positive results in the modern world, it may be interesting to examine the latest devaluation of the Finnish mark which took place in October 1967 and was by about 24 per cent. The present article, after touching briefly on the factors which had led to Finland's serious balance-of-payments deficit, discusses the main components in the measures which accompanied the devaluation, with particular attention to the "sliding" export levy and the incomes policy. It then describes the results obtained (by the end of 1969) in terms of economic growth, employment, external balance and price stability, and seeks to evaluate the reasons for the apparent short-term success of this experiment.

1. Characteristics of the Finnish Economy

As may be seen from Table I, the Finnish economy is characterized by a small, but relatively open internal market, relatively high living standards, a marked dependence on foreign trade and a narrowly based commodity structure in exports.

The Finnish market, after the long period when the economy was controlled by government regulations, started to open up in 1958 and to expose domestic products to foreign competition, after a devaluation by 28 per cent of the Finnish mark and other substantial economic reforms which initiated a period of considerable economic growth, with rapidly rising exports and high rates of economic growth.

The process of economic integration with the countries of Western Europe marked a further decisive step in 1961, when Fin-

land joined the European Economic Free Trade Union (EFTA) (1). By the treaty of association, Finland undertook to abolish tariffs and remove quantitative import restrictions on industrial products of EFTA origin. These objectives were achieved by the end of 1967 (2).

TABLE I
FEATURES OF THE FINNISH ECONOMY IN 1968

Number of inhabitants . . .	4.8 million	Exports to OECD . . .	73.3%
GNP at market prices . . .	8 billion US\$ (*)	Exports to EFTA . . .	40.1%
GNP per capita	1,680 US\$	Imports from OECD . . .	71.1%
Share of GNP exported . . .	24.6%	Imports from EFTA . . .	42.0%
Share of imports in total demand	18.7%	Share of wood-processing sector in all exports . . .	60%

(*) Rate of exchange 1 US\$ = Fmk 4.2 .

Before the association with EFTA, the Finnish economy was characterized by the fact that three quarters of all foreign exchange receipts were earned by the wood-processing industry alone; most other branches of manufacturing were producing only for the domestic market under substantial tariff and quota protection. The purpose of joining EFTA was to promote a more efficient use of scarce resources by encouraging foreign competition at home, and simultaneously to achieve a more diversified export structure as some domestic sectors became internationally competitive. However, this process of liberalization involved certain difficulties. The Finnish import duties were generally higher and the quantitative restrictions tighter than those of the other EFTA countries, while the competitive advantage from EFTA preferences gained by the dominating Finnish export industry, the paper mills, was limited by the fact that the country's Norwegian and Swedish rivals also formed part of EFTA. It was therefore to be expected that this liberalization would result in a current account deficit. As may be seen from Table 2, a substantial deficit, largely reflecting the negative balance of trade, appeared as early as 1964, and this trend continued throughout 1967.

The deterioration in Finland's external balance during the 60's cannot of course be attributed to the liberalization of imports alone.

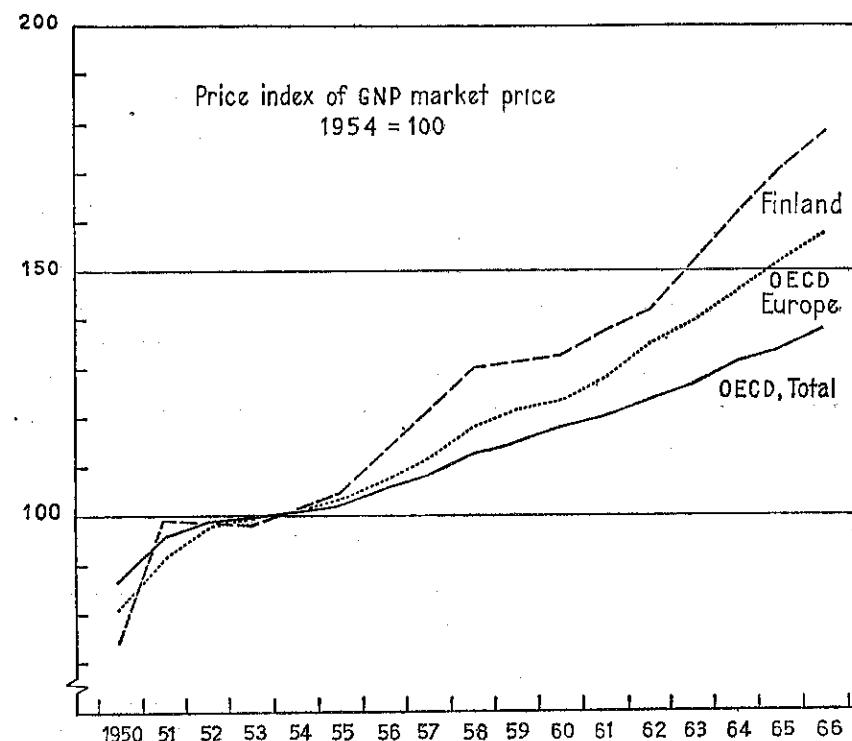
(1) Founding members: Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom.

(2) In 1969 Finland became a member of the OECD and thereby undertook far-reaching obligations not to restrict current foreign payments and capital movements.

A particular kind of "institutionalized" inflation was also a significant factor.

There had been a marked degree of inflation in the 50's as well (see Graph 1) when, owing to the lack of effective competition, wages and other production costs in the protected "infant industries"

DIAGRAM I - TRENDS IN PRICES



Source: OECD Economic Survey of Finland, 1969, p. 13.

had in general been offset by higher sales prices rather than by the rationalization of production.

As to the 60's, recent studies of Finnish price and wage developments (3) support the view that the increasing momentum of inflation has been related to cost rather than to demand factors. This conclu-

(3) AHTI MOLANDER, *A Study of Prices, Wages and Employment in Finland, 1957-1966*, Bank of Finland Institute for Economic Research, Series B 31; also "Prices and Wages in Finland since 1957", *Bank of Finland Bulletin* No. 11, 1969.

sion seems corroborated by the fact that inflationary pressures and the current account deficits did not always coincide with full capacity utilization of available resources. Structural rigidities in the economy and the specialized production structure caused the rising incomes generated by the export sector to drive up prices of goods and services not exposed to foreign competition and stimulate the imports of goods from abroad. As a result, pressure was exerted on prices and the balance of payments, even in times of relatively low economic activity.

But a factor contributing significantly to the above-average rate of cost inflation in the Finnish economy was undoubtedly an institutional peculiarity embodied in the widespread use of index-linkages.

Originally introduced for reasons of social justice in certain transactions related to the compensation of losses of property due to the war, the system of index-linking was gradually extended during the 1950's — as well as to collective wage agreements — to government bonds, national pensions, insurance contracts, rents and bank deposits. This system meant that an institutional feed-back was injected into the inflationary mechanism which at least partially explains the internationally high average increase of unit labour costs during the 1960's.

2. The Path Towards Fundamental External Disequilibrium

Naturally these structural peculiarities, weaknesses and rigidities in the Finnish economy have made it very prone to inflation. But it is equally clear that the actual movement of prices and incomes has been the result of the fiscal and monetary policies pursued in the years preceding the devaluation (1964-1967) — policies which were not very successful in controlling the rate of inflation. It is even likely that relative price stability was partly sacrificed and priority given to full employment and to some other economic or social objectives. Fiscal policy in particular remained weak until 1966, when a tightening occurred. This was engineered so as to hit savings and private investment rather than consumer spending, however, and restrained only marginally the pressure on prices and the growth of demand for imports. The scope of monetary policy was, for political and institutional reasons, largely limited to the use of quantitative restrictions on bank lending and rediscounting ceilings, which also tended to restrict investment activity rather than consumer spending.

Nevertheless, the tightening of economic policy, together with a slackening of demand for Finnish exports, did bring about a deceleration in the rate of real economic growth from over 5 per cent in 1965 to about 2½ per cent in 1966 and 1967. The contraction of domestic demand hit private investment and employment and slowed down the rate of inflation, but did not result in a corresponding improvement of the current account, where the deficit continued to grow, reaching its peak of 198 million dollars in 1966. (See Table 2). In 1964, due to the relative ease on international capital markets, a considerable current deficit could still be financed through long-term capital imports. In the subsequent years, external borrowing became more difficult, and a growing part of the deficit had to be financed from gold and foreign exchange reserves. Total reserves of gold and convertible currency fell from their peak of nearly 300 million dollars in January 1965 to no more than 58 million dollars in March, 1967 — an amount corresponding to less than two weeks imports.

TABLE 2
SELECTED INDICATORS OF THE ECONOMIC DEVELOPMENT IN FINLAND 1963-1967

	GDP volume	Cost-of-living index	Current Account Balance	Gold and Foreign Exchange end year holdings
	percentage change from previous year		(\$ mill.)	(\$ mill.)
1963	2.5	5.2	— 20	242
1964	6.6	9.9	— 175	298
1965	5.1	5.3	— 190	200
1966	2.4	3.6	— 198	103
1967	2.6	5.5	— 143	84

Source: Bank of Finland and OECD *Economic Survey*.

Although the first half-year, for seasonal reasons, normally shows a deficit in Finland's external transactions, and leads to a temporary drain on gold and foreign-exchange reserves, the developments during the spring of 1967 caused great concern to the Finnish Government and the Bank of Finland. It was becoming more and more evident that conventional and politically feasible demand-management policies would not be enough to cure the imbalances, or conversely that measures sufficiently deflationary to achieve the

objective of external equilibrium would be very costly in terms of economic growth foregone, and probably politically unacceptable as well.

In order to avoid a further decline in the gold and foreign exchange reserves, Finland negotiated a stand-by credit from the International Monetary Fund amounting to 93.75 million US-dollars in March 1967. The letter of intent requesting the stand-by arrangement contained a list of restrictive monetary and fiscal measures to be introduced, and expressed the Finnish Government's belief that the policy measures adopted would restore external balance. The stand-by credit, which included the gold-tranche plus two credit-tranches, was used in four instalments between March and September 1967, and prevented a complete depletion of the Finnish gold and foreign exchange reserves. Meanwhile, the underlying trend of the balance of payments remained towards a deficit, and the prospects for a rapid improvement were not encouraging.

The results of an investigation (4) made by the Economic Council in Finland tended to support a rather pessimistic appraisal of the medium-term economic prospects of the country. The projections of likely developments until 1970 contained in the report were based on an econometric model for the Finnish economy. By assuming varying rates of change in exports, private investment, and government expenditure (exogenously determined variables), seventeen different results were obtained showing the likely repercussions on the current account, public finance, economic growth, and unemployment. In general, the results confirmed that the prospects for external equilibrium by 1970 were slight. The sacrifices (in terms of unemployment and economic growth foregone) required to achieve balance on current-account would have been considerable.

It was recognized that the current-account deficit projected would pose serious problems, even on the most optimistic assumptions regarding export developments. The need for net capital imports would still amount to more than 100 million dollars even in 1970, and would of course be higher during the intervening years. The prospects for capital imports of this magnitude were not considered very promising, and the report concluded that: "Even if the possibilities for increased borrowing abroad improve, we consider

(4) *Prospects for the Finnish Economy until 1970 in Finnish Memorandum B 72, 1967 by the Economic Council.*

the required capital imports very high, and therefore this alternative does not meet with the objectives set as far as the balance of payments is concerned. For that reason it seems difficult, within the framework given (*i.e.*, excluding extraordinary policy measures such as devaluation or import restrictions), to find an alternative which could solve our present economic problems in a satisfactory way" (5).

Under those circumstances the Finnish Government was faced with a choice between the following courses: either to continue with, and perhaps even tighten, the contractive demand policies enforced, in spite of the uncertainty as to their ultimate success, their cost in terms of underutilized resources and economic growth foregone, and in spite of the adverse prospects for adequate capital imports to bridge the gap; or (the only other alternatives in conformity with Finland's international obligations) to introduce quantitative import restrictions or to devalue the Finnish mark.

When assessing the relative merits and drawbacks of the latter two strategies, it was felt that recourse to quantitative import restrictions was not very likely to remove or attenuate the structural weaknesses of the Finnish economy, which basically were responsible for the actual difficult situation. On the contrary, experience in Finland indicated that decreased foreign competition in the domestic market tended to promote price inflation. Nor were import restrictions likely to improve the international competitiveness of Finnish manufacturing industries and further a more diversified export structure, and for these reasons such restrictions were discarded, despite certain pressures from the labour unions in that direction.

The preconditions for a successful devaluation, on the other hand, were considered to be rather favourable. From a business-cycle point of view, the timing seemed relatively good as the contractive economic policies pursued during the year had brought about a certain slack in the economy. Also, one month before the sterling devaluation in November, 1967, conditions on international monetary markets were still fairly calm, and there had been only little speculation against the Finnish mark. On the other hand, it was widely recognized that the rapid cost-inflation in Finland, combined with the increased competition resulting from the dismantling of EFTA tariffs, had led to a severe profit squeeze in industry, which

(5) *Ibid.*, p. 35.

hampered investment activity and jeopardized the international competitiveness of most enterprises. In the final analysis, therefore, it was concluded that a well-planned devaluation, combined with the economic measures deemed necessary, would be the best way to achieve the dual objectives of external balance and rapid structural adaptation of the economy.

3. The Devaluation Package

On October 12 1967 the par value of the Finnish mark was devalued by 23.8 per cent. The value of foreign currencies in terms of marks consequently increased by 31.25 per cent, *e.g.*, the dollar rate went up from 3.20 to 4.20 marks. However, since more than one quarter of Finland's exports goes to the United Kingdom and other countries whose currencies were devalued later in 1967, the average rise in the rates of foreign currencies expressed in Finnish marks was ultimately about 26 per cent.

When determining the appropriate size of the change in the par value, the starting point was that domestic prices and costs in Finland over the past ten-year period had risen by around 15 per cent more than those of her most important trading partners. (See Diagram 1). In addition, it was recognized that the existing two-year wage agreements linking wage rates to the cost-of-living index would automatically, and irrespective of any change in the exchange rate, provide for a substantial cost push. Finally, it was quite clear that a devaluation would itself inevitably move the general level of prices and costs upward by raising import prices. Taking into account that in Finland imports of goods and services represent about 22 per cent of the gross domestic product the effect of higher import prices on the general price level resulting from a devaluation of the magnitude here contemplated was estimated at a minimum of 7 per cent, provided that a successful stabilization was pursued.

As the external deficit was thought to have both structural and institutional causes, devaluation alone was not considered to be sufficient. A number of complementary measures were taken, including monetary and fiscal as well as incomes policies. The most essential and probably the most interesting innovations were in the latter two spheres. In view of their significance, the special levy on commodity exports introduced within a week and the negotiations

leading to a comprehensive stabilization agreement six months after the devaluation will be discussed in detail. Other steps taken to dampen as far as possible any undesirable pressures on prices included: (a) price controls on a wide range of commodities and (b) elimination of remaining import duties on industrial products imported from EFTA; and (c) easier conditions for short-term import credits.

(a) *An Asymmetrically Sliding Devaluation.*

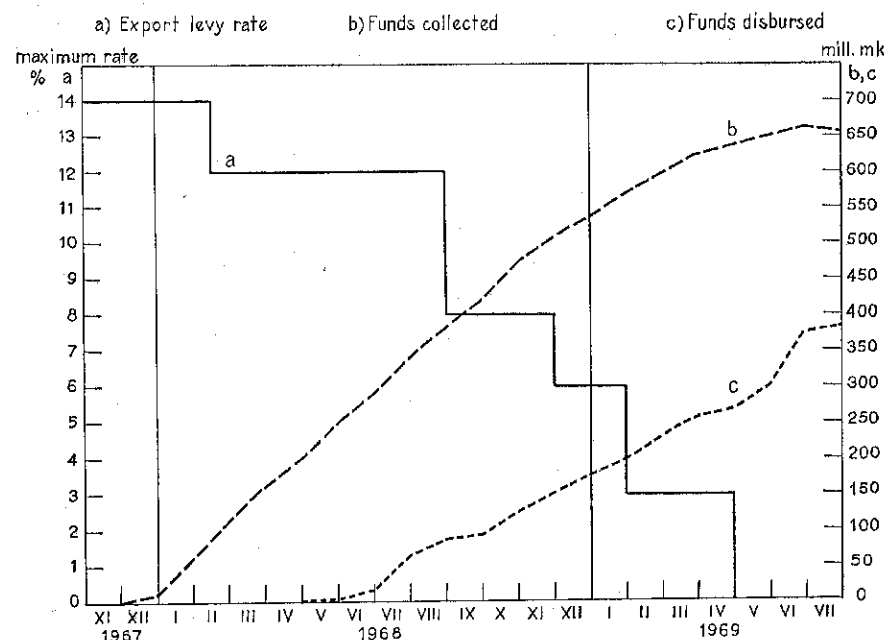
The export levy introduced in connection with the devaluation was initially fixed at a maximum rate of 14 per cent calculated on the price of exported goods. However, rates were reduced to 13, 11, 8 or 5 per cent, depending on the content of imported materials, to ensure that producers and exporters who rely heavily on imported materials were not unfairly penalized in comparison with producers using mainly indigenous materials. Such a provision was of particular importance to producers of non-traditional export goods, such as textiles, clothing, chemicals, and plastic or engineering products, for which imported materials are essential. This feature of the export levy was considered important as it was precisely these sectors which should be contributing an increased share of total exports in the future according to the targets set.

The export levy in itself, which was gradually reduced and then abolished within a period of 18 months, had a dual objective. In the short term it taxed away windfall profits resulting from the sudden increase in export earnings, mainly in the traditional export industries. Its gradual elimination, on the other hand, gave the devaluation a progressive or "gliding" character. Since the reduction of the export levy in five steps, as shown by Diagram 2, was roughly geared to the rise in production costs, the profitability of Finnish export industries progressively improved, while the domestic economy adapted itself to the new situation. While the export levy to some extent delayed the shift needed in income distribution, it was considered politically necessary and essential to the success of the whole operation as it helped to maintain internal monetary equilibrium. More specifically, the levy put pressure on the wood-processing industries not to acquiesce in any immediate large increase in wood prices. Due to the strategic position of the forestry sector in Finland, the income and demand generating effects of such an

increase would have spread rapidly to other sectors of the economy. A development along these lines would obviously have made it difficult or impossible to obtain agreement on the incomes moderating policy required in the post-devaluation period.

The immediate effect of the devaluation on Finland's terms of trade was relatively small. Average unit prices for commodity

DIAGRAM 2 - EXPORT LEVY, MAXIMUM RATE AND TOTAL FUNDS COLLECTED AND DISBURSED

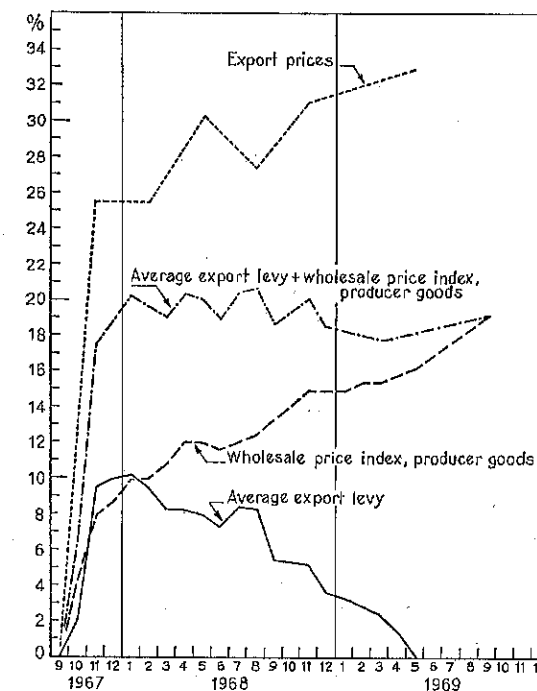


Source: Bank of Finland.

exports and imports both increased by nearly 26 per cent or by the full amount of the effective change in the exchange rate. The progressive nature of the devaluation resulting from the export levy is illustrated in Diagram 3. As the impact of rising prices of imported materials and producer equipment on average production costs was considerably less than the increase in export prices, profit margins in the exporting sector would normally have risen drastically and/or prices might have been reduced. In effect, the scope for increased profit margins or lower export prices was cut by more

than half, as the average export levy initially amounted to about 10 per cent of the value of exports. Taking the sum of the increase in wholesale prices for producer goods plus the average export levy as a measure of profit-reducing elements to be subtracted from the increase in export prices, the following observations can be made. Initially the average improvement in exporters' profit margins as

DIAGRAM 3 - EXPORT LEVY AND PRICE DEVELOPMENTS



Source: National statistics.

a result of the 26 per cent price increase was limited to some 5 percentage points. However, because the inevitable rise in production costs was completely offset by a gradual reduction of the export levy while export prices continued to rise, the system produced a progressive improvement in the competitive strength of Finnish exporters. The evidence available indicates that their international position one year and even two years after the devaluation was definitely stronger than immediately after.

It has already been indicated that the export levy had a dual objective, the second being to promote a reallocation of productive resources. Of the total \$150 million collected in a special account with the Bank of Finland, the wood-processing industries contributed nearly four-fifths. Over a period of two to three years these funds are channelled into such sectors of the economy where rapid expansion has been given priority. Thus, a considerable part is earmarked for the construction of an atomic power plant; another part is being used to finance new production capacity in mining, oil refinery, chemical and engineering industries, investments in the transport system and improvement of telecommunications. Finally one-third of the funds is used to increase the availability of export credits and investment credit for small and medium-sized industries, to finance export promotion, and to carry out an intensified forest improvement programme. The reallocation of resources mainly from the forestry sector to energy production, communications and other manufacturing industries implies a diversification of the production structure which should improve the cyclically sensitive and narrowly based export pattern.

(b) *A Milestone in Incomes Policy.*

It was clear from the outset that extraordinary steps had to be taken in the field of incomes policy in order to safeguard the advantages gained from the devaluation. The prevailing situation was rather unfavourable, in so far as collective wage agreements in force as well as most financial contracts, including bank deposits, government bond issues, and rents, were linked to the cost-of-living index; no other country had developed a more extensive index-linking system than Finland. Negotiations between the labour-market organizations and other pressure groups were initiated by the Government immediately after the devaluation with the aim of eliminating these built-in inflationary mechanisms.

During the spring of 1968 a comprehensive incomes and stabilization settlement was reached covering wages and other incomes as well as prices, fiscal policy and credit-market conditions. Without going into the details of the stabilization agreement, the salient features may be outlined as follows. First of all, the trade unions accepted a revision of the collective wage agreements in force which abolished the automatic linkage between wage rates and the cost-of-

living index. In the future, negotiated wage increases were to be limited to the rise in productivity. The main conditions for this settlement were that existing index linkages elsewhere in the economy should also be broken, that price and rent controls should be applied and that tax rates should not be increased while the agreement was in force. As a consequence, new issues of government bonds incorporating an index clause were suspended, the banks ceased to accept new deposits tied to the cost-of-living index, and the maximum lending rates applied by the banks became binding for all lending contracts.

The stabilization agreement, which initially extended to the end of 1969, has since been prolonged, in a slightly modified form, until the end of 1970. There is no doubt that the agreement, which has been called "a milestone on the road of Finnish incomes policy", was a necessary condition for reaching the objectives of the exchange-rate policy.

4. Major Short-term Results

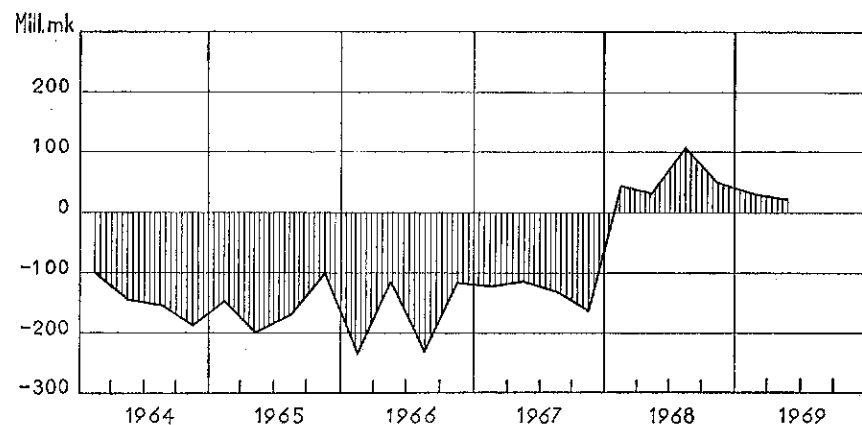
It is possible, with a two-year perspective on economic developments in Finland since the 1967 devaluation, to identify some of the short-term effects. Since the immediate objective of the operation was to correct a fundamental external disequilibrium, it is only natural to look first at the balance-of-payment effects.

(a) *Balance of Payments.*

On current account the devaluation strongly affected all major items with a relatively short time lag. Already within six months the current deficit had turned into a surplus, mainly as a result of the improved balance in commodity trade. In the year 1968, the value of Finnish exports (fob) increased by 31 per cent while imports (cif) went up by 16 per cent, leaving a trade surplus of \$40 million or an improvement over the preceding year by no less than \$175 million. By volume, imports actually declined by more than 4 per cent, due to the marked change in relative prices in favour of domestic producers, combined with the low level of domestic demand. The volume of exports rose by approximately 12 per cent, to some extent reflecting the improved competitive position of Finnish exporters, but mainly owing to a simultaneous recovery of

demand in Finland's main export markets. As economic growth in Finland started accelerating towards the end of 1968, and continued strong during the following year, the value of imports increased by no less than 26 per cent in 1969. Because of the improved competitiveness and the high level of economic activity in Western Europe, Finnish exports also expanded, but less rapidly than imports. As a consequence, the trade balance for 1969 showed a small deficit of \$38 million.

DIAGRAM 4 - BALANCE OF PAYMENTS CURRENT ACCOUNT SURPLUS/DEFICIT
1964-1969



Source: Bank of Finland Monthly Bulletin.

In line with expectations, the services balance also reacted favourably to the change in the exchange rate. Income from transport and other export services increased by 30 per cent in 1968 and yielded a surplus of \$115 million. The traditional deficit on travel account, close to \$25 million annually during the 1960's, was virtually eliminated in 1968 and 1969. Net interest payments, which represent the largest negative item in the current-account, rose sharply in terms of marks, partly because of the new conversion rate, partly because Finland's foreign indebtedness in real terms increased over the preceding years. The aggregate result of these developments was a current-account surplus for the first time in the decade of \$65 million in 1968 and equilibrium in 1969, compared with annual deficits in 1964-1967 averaging \$135 million.

Diagram 4 illustrates the dramatic swing from deficit to surplus on current account.

Finland has throughout the 1960's been a net importer of long-term capital and this trend continued also after the 1967 devaluation. Reflecting the increased international confidence in Finland's political and economic stability and the improved growth possibilities created through the devaluation, the relative importance of direct foreign investment and Finnish bond issues on international capital markets as sources of funds has risen perceptibly.

Short-term capital movements were influenced first by certain leads and lags induced by the Finnish devaluation, and later by the recurrent crises peculiar to international monetary markets in 1968 and 1969. With the basic balance in a healthy surplus, the reserves of gold and foreign exchange were nevertheless consolidated despite disturbances caused by these short-term movements. Thus, despite a \$67 million voluntary repayment of the stand-by credit granted by IMF in 1967, total gold and currency reserves during 1968 more than doubled, and continued to grow in 1969, although at a slower rate. In the light of the balance of payments prospects before the devaluation, the short-term results have been more than satisfactory.

(b) *Economic Growth, Employment and Prices.*

One of the basic aims of the devaluation was to create the wider international margin required for regaining a satisfactory rate of economic growth in Finland. The large balance-of-payments deficits and the shrinking foreign-exchange reserves had necessitated contractive demand policies in 1966 and 1967 so that GNP growth fell below 3 per cent, with a consequent under-utilization of productive resources. Private investment had been declining for a number of years, whereas private consumption, due to a fall in the savings ratio, had continued to grow despite the restrictive policies.

It is important to note that the devaluation had very little immediate impact on domestic economic activity. The stimulus imparted to import-competing and export industries through the improvement in their competitive position was to some extent neutralized by the export levy and by the continued restrictive demand policy, which aimed at relieving the inevitable pressure on prices, and thereby creating a favourable climate for the income

policy needed. The rate of economic growth therefore remained unchanged at 2-3 per cent until the latter part of 1968. Unemployment continued to rise, reaching a peak of more than 5 per cent in the beginning of 1968. During the six months following the devaluation wholesale prices rose by over 12 per cent and consumer prices by some 7 per cent as an unavoidable consequence of the higher prices for imported goods.

Taking the stabilization agreement of March 1968 as the concluding step of the devaluation package, an examination of economic developments since that date reveals the degree of success achieved in the domestic sector. It is quite clear that the objective of price stability was fairly well attained as the annual rate of both consumer and wholesale price increases has remained below 2.5 per cent. By September 1969, unemployment had been reduced to less than 2 per cent, or to a level at which shortages of manpower started to appear in certain sectors. Mainly due to the revival in private investment activity and the continued strong demand for Finnish exports, total output accelerated towards the end of 1968. This accelerating trend continued into 1969 so that the gross domestic product in that year is estimated to have grown by 8 per cent in real terms. The general conclusion seems justified that the short-term results of the Finnish devaluation in most respects correspond to the objectives formulated.

5. Longer-term Aspects

The longer-term aim of the devaluation package was to reduce the vulnerability of the Finnish balance of payments through an improvement of the economic structure. The structural weakness, it may be recalled, is the concentration of exports on forestry products, a large part of which are exported as semi-manufactures and thus subject to heavy cyclical fluctuation in volume and price. Moreover, since the domestic raw-material basis does not allow any strong expansion, future growth of export-earnings in this sector must come from a higher value added content of the products exported. On the other hand, imports of materials and investment goods are essential for most other sectors of manufacturing industry. In addition, income elasticities of demand for imports of consumer goods are, and will probably remain, relatively high in Finland.

Given the objectives of satisfactory growth and long-term external balance in an open economy, all these factors point towards the necessity of widening the export base by expansion in the non-traditional fields. There are, in fact, clear indications that the desired structural shift has been speeded up by the devaluation. Thus, for instance, the highest rates of export growth, reaching 40 per cent annually and even more for the past two years, have been recorded in manufacturing sectors outside the forestry industry, the share of which as a result has declined from 63 per cent in 1966 to 57 per cent in 1969.

In addition to this structural weakness, the institutionalized inflationary mechanism embodied in the system of index-linkages has no doubt been a major factor contributing to Finland's balance-of-payments problem. The abolition of this system in connection with the incomes policy solution, supported by the favourable short-term results obtained through the stabilization agreement, may well prove to be a by-product with extremely significant long-term implications. The final outcome in this respect will, however, depend on political rather than economic factors.

6. Reasons for the Success

There seems to be general agreement among economists that the Finnish devaluation of October 1967 is a success at least as far as the short-term effects are concerned (6).

In an attempt to list and evaluate the major reasons behind the favourable outcome, both external and internal factors may be distinguished. Turning first to factors beyond the control of Finnish policy makers, it is obvious that a change in the par value of a currency not extensively used in international payments can be made without risking chain-reactions or causing major disturbances in international monetary markets. Consequently, the magnitude of any devaluation of such a currency as the Finnish mark can be determined rather freely, without much consideration of external reactions, which is an obvious advantage.

Another factor explaining the rapid improvement on current account was that the Finnish devaluation coincided with an upturn

(6) See e.g. OECD *Economic Survey of Finland*, June 1969, p. 33.

in the trend of economic activity in most of Finland's largest export markets, leading to a growing demand for Finnish products. The growth of international demand during 1968 may, in fact, have accounted for the bulk of the expansion in Finnish exports. This notion is supported by the fact that producers in Finland generally did not reduce their export prices in terms of foreign currencies in order to increase their sales abroad.

Of the various internal decisions and circumstances contributing to the favourable devaluation results, the magnitude of the parity change was probably one crucial element. The impression that the change was at least sufficiently large to secure an improved profitability in industry even after the inevitable rise in production costs is supported by the strong, although delayed revival in business activity. On the other hand, it seems that a still larger change might have been excessive and probably would have met with internal political difficulties as well.

An essential condition for the operation to succeed was certainly the reserve of under-utilized resources and the low level of domestic demand prevailing in Finland at the time devaluation took place. Manpower and unused capacity were readily available for expanding the activity in exporting and import-competing enterprises. The slack of internal demand combined with the price-freeze simultaneously prevented excessive pressure on prices from developing in the months before the stabilization agreement was reached. The abolition of remaining duties on industrial products imported from EFTA probably also had some dampening effects on the price level.

One major element providing for a gradual adaptation of the Finnish economy to the new situation was the export levy. It is quite conceivable that a sudden increase in exporters' profit margins by the full amount of the devaluation would have seriously upset domestic monetary stability. This applies in particular to the dominating export sector, the forestry industries, for which even the possibility of any large offsetting reductions in export prices was excluded by the existing price agreements between Nordic producers. It is therefore most likely that an income increase of the magnitude in question would have been partly passed on to domestic suppliers of raw materials, thus generating higher incomes and consumer demand, which would have strengthened inflationary pressures and jeopardized the incomes policy. Instead, by means of the export levy, more than half of the increased export earnings

during the first year was taxed away and temporarily sterilized in the central bank, to be channelled gradually into investments promoting the desired reallocation of resources within the economy.

Granted that all the factors and conditions enumerated above were probably necessary for the short-term success of the Finnish devaluation, they would evidently not by themselves have been sufficient. A stabilizing incomes policy settlement was probably in this case a precondition for the favourable devaluation results so far achieved.

For clarity of exposition the various elements affecting the outcome of the devaluation have been discussed separately in this concluding section. However, they are obviously all interdependent variables, determined through a process of bargaining and compromising between various pressure groups in society. For this reason it may be wrong to single out one factor, such as the stabilization agreement, as more significant than other elements, since the latter were a precondition for the incomes policy settlement. In the longer-term it is nevertheless obvious that the maintenance of the competitive advantages secured through the devaluation will to a very large extent depend upon the future management of incomes policies in Finland.

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