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Growing Risk of a "Fixit:" The Finnish Eurozone Dilemma

Patryk Toporowski

Greece is no longer the only country at risk of leaving the eurozone. A referendum on abandoning the common currency is likely to appear in the coming years in Finland, whose economy is mired in crisis. The euro is not the reason for the recession, however, the currency union's framework lacks monetary policy tools. Even so, there is no guarantee that re-adopting its own currency would help Finland.

Finland has been stuck in an economic downturn since 2012. Preliminary Eurostat estimates for 2015 are worse than previously forecast—originally, the projected increase in GDP was 0.3%—and indicates the slowdown has continued. Apart from Greece, it is the worst result in the EU.

In addition to the downturn, a serious problem is the country's growing debt and increasingly troublesome fiscal discipline. In 2015, according to Eurostat, Finland's public debt amounted to 62.5% of GDP and its deficit in 2015 was estimated at 3.2% of GDP. Those figures breach both thresholds of the Stability and Growth Pact (debt above 60% and a deficit above 3%), possibly leading to the opening of the excessive deficit procedure and further reducing the prospects of a near-term economic recovery. Credit rating agencies are re-considering their assessments of Finland. Standard & Poor's had already lowered the country's credit rating from AAA, the highest level, to AA + in October 2014.

Paradoxically, the economy is in recession despite a high level of competitiveness and innovation, as noted in international rankings (fourth out of 144 in terms of competitiveness and first in innovation, according to the 2015 World Economic Forum list), and this despite having one of the world's best educational systems. In this respect, suspicions about a "Finnish disease" have spread.

Given the malaise in their economy, a growing number of Finns point to eurozone membership as the problem. As a result, by the end of 2015 more than 50,000 had signed a petition demanding a referendum on a eurozone exit. The national debate on this issue is about to accelerate in the first half of 2016. The single currency, however, only partially explains the poor state of the economy, since it should be considered alongside other weaknesses such as excessive concentration on less-profitable sectors, the EU sanctions against Russia, and the political difficulties in carrying out structural reforms.

Curse of the Euro. A frequently cited objection among Finnish politicians to the common currency is the lack of tools for the country to conduct its own monetary policy. From the Finnish perspective, the euro remains excessively strong against other currencies in the world, leading to falling exports. There has been a deterioration in the trade balance—a surplus before the economic crisis steadily gave way to a negative balance since 2011.

It is also claimed that the common currency has discouraged structural reforms. This is the result of low interest rates, which gives the illusion that countries are able to constantly increase debt without pressure to introduce reforms. According to Finnish Minister of Economy Olli Rehn, because the government was under the "delusion" of safety because of its eurozone membership, Finland delayed the introduction of structural reforms before and during the early stages of the global economic crisis.

The need to pay to help stabilise the eurozone also contributed to weakening the economy. Finland was obliged to pay €1.5 billion in 2011 (or around 0.7% of its GDP) to set up the European Stability Mechanism. In addition, Finland lent funds for assistance to other eurozone countries in need: a loan to Spain amounted to about €1.9 billion under a Spanish aid package (or almost 1% of Finnish GDP) and another one to Greece reached around €1 billion, or about 0.5% of Finnish GDP. These funds have been frozen for many years now, and in a worst-case but possible scenario (Grexit), they will be very difficult to get back. Moreover, if Greece is declared insolvent, Finland will be exposed to a loss of about €3.8 billion due to lost collateral and losses in the euro area payment system (Target2) and on Greek bonds bought on the secondary market.

Finland's Sins. The country's economic woes have many other roots, though, which together are equally important as limitations arising from the common currency. The gravest was the lack of a state strategy to counter excessive specialisation in the economy. Consequently, this led to the state's excessive dependence on its largest industries and national champions. As the global decrease in demand for these goods took hold, the downturn in these industries affected the overall Finnish economy. For instance, along with the downturn because of the economic crisis, the paper industry was also hit hard by fierce competition from such substitutes as tablets and e-books. Similarly, Nokia, an engine of the Finnish economy, placed an emphasis on the quality of traditional mobile phones, missing the rapidly growing global interest in smartphones. As a result, it was forced to form a strategic alliance with Microsoft and to deeply restructure the company to remain in business, which in the broader picture has worsened the prospects for development of the economy.

Another reason is the EU sanctions on Russia, which prior to their introduction was the largest seller to the Finnish market (18% of imports) and the third-largest buyer of that country's goods (9.6% of exports). Once the EU trade restrictions kicked in, Russia was downgraded to the third most important supplier (14.8% of Finnish imports), and although it remained its third-largest buyer, the amount declined some (to 8.3% of Finnish exports). Estimated declines in trade with Russia in 2015 reached over 30%. Finland was particularly hard hit by the EU penalties on Russia for three reasons. First, some Finnish goods could no longer be sold in Russia. Second, because Finland is an important trade route for Russia to Western Europe, the sanctions hit the country's transit goods market. Third, Finnish tourism also suffered as fewer Russians visited.

On top of all these factors, the political and social resistance to making structural reforms is high, and this has meant excessive gradual increases in labour costs. Since the return of recession in 2011, successive governments have not had sufficient political capital to undertake an improvement in economic fundamentals (one ruling coalition was even formed from six parties). As a result, for example, the government has been unable to enact about €3 billion worth of healthcare reforms. In turn, under the current government of Juha Sipilä, trade unions in mid-2015 undertook attempts to end what reforms had been enacted, aiming to stop cuts in social spending and for overtime wages, and for halting some furloughs. They managed to get about 30,000 citizens to strike.

Hard Dilemma. The Finnish debate on Eurozone membership looks to the cost of abandoned structural reforms. The recession in Finland requires a reduction in costs in the economy, that is, prices and wages should fall or be reduced, neither of which are easy to do politically and certainly will take time. Rhetoric about losses for not having its own currency is attractive because a weaker exchange rate would have the almost immediate effect of improving the country's international competitiveness and trade balance. The arguments in this debate are similar to those of the Grexit, but in the near future may gain popularity in other countries with moderate or declining competitiveness and threatened by a slowdown, such as Italy, Spain, Portugal and even France. It should be noted, however, that in the long term, the use of exchange rates instead of structural reforms would not solve the problem of a loss of competitiveness. We must also bear in mind that an exit from the eurozone comes with costs, such as the return of exchange-rate risk and transaction costs on the exchange, as well as more expensive capital.

Even if the probable referendum in Finland determines the euro will remain, the discussion on the single currency will be of paramount importance for both the functioning of the zone itself and for its relationship to other EU members. This debate could weaken confidence in the euro as Finland is the first country in the "North" to bind its weak economic performance to the common currency. As a result, other exit referendums may appear in other countries.

The case of Finland and its debate on membership shows, in fact, one obvious weakness of the eurozone: the lack of tools with which it can correct discrepancies in the business cycles between countries. This should be a signal for the euro area to create such tools as automatic transfer mechanisms in the form of joint insurance for the unemployed. For Poland, the Finnish dilemma about the euro should be a signal to not rush to adopt the single currency, because the structure still shows significant gaps. It should not, however, obscure the fact that, at least in the post-crisis period, economic success is rather more determined by cost in a long-term view (structural reforms) than by short-term measures such as the domestic and foreign price of money.