Book Review

Economic prosperity recaptured: the Finnish path from crisis to rapid growth.


Finland’s economic performance from the mid-1990s has been remarkable in spite of its having suffered a severe financial crisis at the beginning of the 1990s leading to the economy’s worst recession. How can we explain Finland’s success in negotiating the perils of financial turmoil and concomitantly transforming itself into a high technology economy?

Economic prosperity recaptured: The Finnish path from crisis to rapid growth tackles the topic head-on. Seppo Honkapohja, Erkki A. Koskela, Willi Leibfritz, and Roope Uusitalo write a concise volume building on the authors’ previous work (e.g. Honkapohja and Koskela, 1999) and also advancing fresh insights. The authors tell stories short and tall, meeting with considerable success in throwing light on Finland’s experience.

The book contains seven chapters. Following the introduction in Chapter 1, Chapters 2 and 3 deal with the crisis and related policy mistakes. The country escaped the 1970s oil crisis relatively unharmed mainly due to agreements with the Soviet Union, and following a period of disinflation pursued liberalisation and deregulation policies during the 1980s. But reforming and liberalisation led to an overheating economy – inflation doubled between the mid-1980s and 1990 - which subsequently collapsed at the beginning of the 1990s. The downturn was worsened by the parallel disintegration of the Soviet Union; the authors estimate that the Soviet demise accounts for roughly 3% of the 7% GDP decline in 1991. Finland’s collapse was followed by recovery and a successful transition to a high-tech, thriving economy from the mid-1990s.

The Finnish crisis of the 1990s is rather similar to events in Mexico during the 1994-1995 ‘Tequila crisis’, Asia during 1997-1998 (beginning with the Thai baht’s devaluation in 1997), Russia in 1998, Brazil in 1999, Turkey in 2000, and Argentina in 2002. Finland’s crisis evolved from various factors, including an increasing private sector debt alongside capital flows encouraged by a higher domestic interest rate in relation to foreign rates.

Finland also had debt and illiquidity problems. Furthermore, the country’s monetary policy stance gave the impression that the exchange rate could be kept stable, which was a further factor encouraging bubbles in real estate and other asset prices. But these monetary and exchange rate policies were unsustainable: Finland devalued the markka in November 1991 and floated the currency in September 1992, adopting an inflation targeting regime. In explaining
The historic monetary policy setting in Finland, the study could have benefited from running a formal econometric exercise. Empirically estimated reaction functions can provide valuable information for discussing monetary policy.

The book does explain other important mechanisms operating during the crisis. Increasing bank lending tends to precede crises, as was also the case in Finland. The conclusion arises from empirically estimating a consumption function revealing that credit growth contributed to private consumption growth and collapse before and after the crisis. Econometric modeling indicates the likely existence of threshold effects in the impact from finance to consumption, but the analysis does not attempt to explore that feature of the data.

The 1991 banking crisis ended up costing around 7.5% of GDP in 1992. Growing bank lending was not the problem itself, but regulation and supervision did not advance at the same pace, and banking surveillance only improved after 1991. As a result of the crisis, the banking system was reformed and wide-ranging restructuring took place. The stabilisation attempt also benefited from Finland’s centralised wage bargaining. The book also draws attention to the positive role of labour market training programmes in setting the stage for the economy’s recovery and subsequent take-off.

Chapter 4 focuses on the growth and structural changes following the crisis. Globalisation is a theme in the chapter and Finland has benefited from opportunities arising from the increasing volume of global trade. The study explains productivity growth as resulting mainly from changing total factor productivity (TFP). TFP growth contributed to rapidly closing the output gap arising from the financial crisis.

But not all recoveries from crises rest on higher productivity growth and economic transformation. For instance, the Dominican Republic, a small emerging market economy, suffered a banking crisis with events similar to those occurring in Finland (Sánchez-Fung, 2005). As is often the case, the subsequent recovery was mainly consumption-based and fuelled by an appreciating currency after initial overshooting in the 2003-2004 crisis.

So what was behind Finland’s ability to recover from the crisis while concomitantly becoming more competitive on the basis of technological advance? Chapter 5 explains the importance of human capital in the Finnish recovery. The investigation explicates that Finland was prepared to benefit from the turning tide as it had a qualified labour force. In fact, educational attainment measured using average years of formal schooling has been increasing during the last three decades. Engineering education is of good quality and appears to be a factor in explaining the economy’s transformation. But, unlike countries such as India that also have a strong technology-focused tertiary education system, Finland has been preparing from more basic levels and the country performs very well in standardised tests. Results for 15-year old Finnish children in the Program for International Student Assessment (PISA) examinations consistently top the rankings in sciences and math.

Chapter 6 focuses on the leap towards a technology-driven economy. Information and communication technology spearhead Finland’s growing prominence in the international economy and comprise a large amount of the country’s exports. Government-supported and private investment in research and development has been critical for the success of Finland’s techno-
logy ventures -the National Technology Agency (TEKES) has been an important institution in allocating funding.

The case of Nokia is revealing: the company was successful in transforming from its origins manufacturing cables, metals, and rubber products to being a powerhouse with the largest share in the global cellular phones market. It is worth noting the extent to which the company has benefited from government financial backing. The book reports that TEKES contributed about 10% of Nokia’s research and development expenditure in 1991, even though the support has been declining over time – it was only 0.4% in 2004. The strategy of using government money to finance the private sector is paying off: Nokia contributes to the rest of the economy not only directly but also via its suppliers and the positive spillover from its research and development activities to other technology industries and to academia. Other sectors are actively endorsed, such as biosciences, but the results from that course of action are still to be seen.

Chapter 7 concludes by highlighting the challenges that Finland faces going forward. Unemployment is relatively high for an otherwise fairly successful economy, remaining above pre-crisis levels. The authors also underline issues common to other rich economies: population aging and the implications of facing an increasingly more open and competitive global economy. The book should prove illuminating for anyone interested in economic growth and development. But potential readers should be warned that there is no recipe in the book as to how other countries could follow Finland’s path to consolidating a technology-driven economy.

References


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