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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

REPORT ON THE
CREDITWORTHINESS OF FINLAND

December 13, 1950

Economic Department
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FINLAND'S CREDITWORTHINESS

Summary and Conclusions

1. A preliminary appraisal of the creditworthiness of Finland for a program of further Bank loans shows clearly that political considerations rather than future balance of payments prospects constitute the major element of uncertainty. Recent world events have increased the political risks involved in lending to Finland. By reason of her geographical location and commercial importance to the west, her position is somewhat more vulnerable than that of other European borrowers.

2. Internal political developments, largely the result of efforts of different economic groups to maintain their income levels at the expense of other groups, have resulted in inflation and industrial strikes. While inflation has not gone so far as to affect seriously Finland's creditworthiness, serious strikes have cost this year the equivalent of about \$30 million in terms of balance of payments effects. Frequent recurrences of these strikes and serious aggravation of the internal inflation might very well impair the long-term creditworthiness of Finland.

3. Had it not been for the effects of the strikes, Finland would probably have achieved an overall balance of payments surplus in 1950 (even excluding reparation deliveries) just as it did in 1949. However, her dollar balance of payments position was not as seriously affected as her overall position. Provided future serious strikes can be avoided, Finland should have no great difficulty in developing both overall and dollar balance of payments surpluses, particularly since production currently being devoted to reparations would be available for commercial export. These surpluses might be large enough to meet the peak principal payments on the foreign debt required in

the mid-fifties (24.5 million in 1953 to 22.2 million in 1957) but some refinancing of these loans is likely.

4. Since the future balance of payments prospects of Finland are good, apart from the international and internal political uncertainties, new borrowings by Finland to finance productive investment appears to be economically desirable, especially since Finland will be repaying old loans during this period. It is important, however, that the investment program undertaken by Finland is sufficiently productive that it not only raise the standard of living but also accomplish this result without impairing the external position of the country.

5. The Bank has not yet examined the question of the kind of investment activity which would be desirable for the Finnish economy but it does appear reasonable for this investment to be partially financed by external borrowings provided that a decision is made that the political risks are not so serious as to prevent further Bank operations in Finland.

International Political Considerations

1. In making a loan of \$12 $\frac{1}{2}$ million to Finland in August 1949, the Bank took into account the risk that the U.S.S.R. might interfere in Finland's economy or internal political affairs. At that time the risk was considered slight, provided there was no serious deterioration in international affairs generally; it was believed that the neutrality of Sweden, in which the U.S.S.R. is interested, hinges to a large extent upon Finland's retaining substantial independence.

2. Recent events have intensified the conflict between the Great Powers and increased the risk of impairment of Finland's creditworthiness by Soviet action. Finland's position is unique in that,

- (a) her geographical position is of strategic importance to the Soviet Union;
- (b) Finland's exports of wood and wood products, on which she is extremely dependent, are of great value to the West and might conceivably be interrupted if economic warfare develops;
- (c) if the international situation became very critical, closing of the Baltic might well be one of the first steps taken by the U.S.S.R.;

Finland's creditworthiness is therefore vulnerable at an earlier stage in any stepping-up of the cold war than that of most of the other European borrowers.

3. The Bank must now decide whether the international situation has deteriorated sufficiently to preclude further lending to Finland. It is difficult, however, to make a final decision until the exact extent of the repercussions of the present crisis becomes clear.

Internal Political Factors

4. The background of the present internal political conflict is the sharp deterioration in 1949 in the Finnish terms of trade which led to

devaluations of the markka totaling 40% and a distinct pause in Finnish economic recovery. At the same time there was a sharp fall in agricultural prices and the relative position of the farmers was considerably worsened. Until 1950 the Agrarian Party, which represents the farmers and has 56 seats out of 200 in the Diet, had lent its support to the minority Social-Democrat Government (54 seats) which, in competition with the Communists (38 seats), represented industrial labor. Following the customary resignation of the government after the election of the President in March 1950, however, the Agrarian Party decided to assume leadership and was able to form a coalition government with the Swedish and Liberal Parties. This government requires, however, the tacit support of the Conservative Party (33 seats).

5. The conflict of government and opposition today is, therefore, largely a conflict of economic interests between farmers and businessmen on the one hand and the urban population and industrial workers on the other. The clash has been accentuated by the fact that the Agrarian and Social-Democratic Parties are led by two rather strong personalities, Mr. Kekkonen, the present Prime Minister, and Mr. Fagerholm. Moreover, in order to retain popular support, the Social-Democrats must try to outdo the Communists, who are very powerful in the Trade Unions, in improving the position of wage earners. This fall the struggle resulted in a serious strike for higher wages which lasted two months and, at its peak, involved 180,000 workers in the metal, woodworking and other key industries. Work was only resumed after mediation and the granting of wage increases averaging 4%. Unfortunately, since there will be a presidential election in January and a general election in July 1951, the political conflict is not likely to decrease in intensity. It creates the dangers of continued inflation and interruption of production and exports by further strikes.

6. An important inflationary factor is the large volume of investment, which, at 124 billion marks, absorbs nearly 30% of the national income and is being financed partly out of the budget (which is running a deficit) and commercial bank credit expansion. Construction activity is probably on too great a scale, particularly in the field of housing and community facilities; cement consumption has increased steadily from 398,000 tons in the first three quarters of 1948 to 578,000 tons in the first half of 1950, and residential construction in urban areas, has increased by nearly 70% in the same period. Information is unfortunately too fragmentary to form the basis for a sound judgment of the suitability of the size and pattern of the remainder of investment to Finland's present economic circumstances.

7. The major cause of inflation is, however, the struggle between the industrial workers and the farmers for a larger share of the national income. Besides financing residential construction in the towns, the government has been subsidizing the farmers in various ways through the budget. The budget deficit, which was 21 billion marks in 1949, is estimated to reach 23 billion marks in 1950 compared with total expenditure of 125 billion marks even on the basis of supplementary budgets passed up to June. It is being financed to a large extent by borrowing from the Bank of Finland. Industrial labor, for its part, has won successive wage increases totaling about 22% in 1950, and these have been another very powerful factor.

8. As a result of these inflationary pressures prices have risen by 19% since the beginning of 1950; and the upward movement tends to be perpetuated by the tying of wages to a cost of living index. Unfortunately, while in the past sizeable deflationary factors were operating - declining reparations expenditures, substantial completion of the resettlement of Karelian refugees and increasing production - these are now much weaker and financial

stabilization is considerably more difficult. It is also complicated by the fact that the Governor of the Bank of Finland, though no longer a Minister, still holds a post in the government. The Bank of Finland is not able to exercise as effective a restraint on inflation as it could if it were completely independent.

9. Inflation in Finland has not so far had serious effects on the economy per se. It is true that it stimulates a high level of investment, not all of which is in economically desirable projects. Indeed, in September the Bank of Finland raised the rediscount rate from 5.75% to 7.75% in order to curb total investment and the government recently had to limit the volume of the special government ARAVA loans at 1% interest for residential construction. Nevertheless, heavy investment is prevented from having a serious adverse effect on imports by the fairly rigid import and exchange controls. Inflation has not to date been allowed to interfere with exports or reparation deliveries (devaluation has always been resorted to whenever the profitability of the woodworking industries has been threatened), but so long as the present political-economic deadlock persists there is the danger of degeneration into a runaway inflation. At the present moment, however, world prices of Finnish exports are rising sufficiently fast to make a new devaluation unlikely in the near future. On the whole, the inflationary consequences of the political struggle have not yet become in themselves a serious threat to Finland's creditworthiness.

10. The greatest danger is the succession of demands for massive increases in industrial wages backed up by the threat of widespread strikes. In September and October, the loss of production caused by strikes was equivalent to \$40 million and the 1950 trade deficit, during a period when the country normally runs an export surplus, increased from \$16½ million at the end of August to \$31 million at the end of October. Even more dangerous was the

possibility that the strikes would interfere with reparation deliveries to the U.S.S.R., late deliveries of which are penalized at the rate of 5% per month; fortunately, deliveries had previously been running ahead of schedule and no serious penalties were incurred.

11. Until this year, ways and means were always found of settling the many wage disputes before they could result in a serious loss of production and exports. One reason was the fact that strikes, when they occurred, were usually Communist-initiated and did not have the full support of the trade unions, which are controlled by the Social-Democrats with a small majority. Now, being in the opposition, the Social-Democrats as well as the Communists must support the workers' demands. Continuing inflation makes it likely that further wage demands will develop and the Agrarian-Conservative government will probably continue to resist them. The danger is that prolonged strikes will again interfere seriously with production, exports and the balance of payments. Finland's creditworthiness might then be impaired even over the long-term. It is to be hoped that, as in the past, all groups in Finnish life, with the possible exception of the Communists, will place the welfare of the country above party advantage and that such stoppages will be avoided.

12. The government is well aware of the dangers in the present situation, as is attested to by the fact that in November it brought out proposals for an economic stabilization program. This consisted mainly of elimination of the link between wages and prices; a wage stop; a capital levy; raising of rents by 20%; state control of building activity; and the establishment of an Advisory Economic Council and a State Wage Council. The obstacles the government will face in implementing the program may, however, be gauged by the fact that the Swedish party and the Conservative party both threatened recently to withdraw their support, and it was only with great difficulty and with a narrow

margin that the government obtained a vote of confidence in the Diet. Even so it had to give up its proposed capital levy in order to retain Conservative support. It seems too early, therefore, to tell whether the Agrarian Government will survive, whether it can prevent a runaway inflation, and whether it can prevent further serious strikes. It may, therefore, be a month or two before we can make a reliable appraisal of the risks arising from the uncertain political situation.

Ability to Service Additional Foreign Debt

13. In 1949, despite a slump in the world pulp and paper market which resulted in a serious deterioration in Finland's terms of trade and compelled her to devalue by 15% on July 4 and to join in the general European devaluations to the extent of 30% on September 18, the external position improved substantially. A slight surplus was achieved on the overall balance of payments, even without taking any credit for reparation deliveries valued at the equivalent of \$73 million, and the dollar deficit was cut from nearly \$50 million in 1948 to only \$10 million.

14. World markets developed favorably in the last quarter of 1949 and the first quarter of 1950 and the volume of exports revived steadily. During the summer of 1950 the volume was one-third greater than in the summer of 1949 and by the end of August the year's commercial trade deficit was the equivalent of only \$16½ million compared with \$25 million by the same date in 1949. Since the peak of the export season is reached in September through November it would have been reasonable to expect that the commercial balance of payment would, by the end of 1950, show a substantially higher surplus than was achieved in 1949.

15. Unfortunately, the serious strikes of September and October transformed the picture. Whereas under normal conditions the trade deficit would probably have been turned into a surplus, loss of production and exports caused

the deficit to increase to \$31 million by the end of October, compared with a deficit of only \$13½ million by the same date last year. As a rough approximation, the strikes had an adverse effect of nearly \$30 million on the balance of payments and it now seems unlikely that a surplus will be realized this year.

16. Basically, Finland's future external prospects seem very good. She is one of the few European countries which can confidently expect to achieve both an overall and a dollar payments surplus. Wood and wood products have shared in the upward movement of world prices of commodities which followed the outbreak of hostilities in Korea and are in great demand in Europe as dollar-savers. The Finnish balance of payments outlook has been greatly improved by the conclusion of a five year trade agreement with the U.S.S.R. which provides not only for an expanding volume of commercial trade between the two countries but also for inclusion among Finnish exports after 1952 of the goods now being delivered free of charge as reparations. This will enable Finland to import increasing quantities of wheat and petroleum, commodities which now have to be paid for in part with hard currencies, from the U.S.S.R. She can probably develop a progressively increasing surplus in the overall balance of payments without reducing the level of consumption or investment, and it would seem quite feasible for her to meet even the heavy foreign debt amortization payments of the 50's, which reach a peak of the equivalent of \$25 million in 1954 (mainly payable to the U.S. Government and Argentina), without difficulty.

17. Finland's dollar position is also basically sound. By the end of October, despite the strikes, she had a trade surplus with the U.S. of \$7½ million compared with a deficit of \$6½ million last year. In place, therefore, of a dollar balance of payments deficit of about \$10 million in 1949 she might well end this year in approximate balance on current account. This

improvement has been achieved by expanding exports to the U.S. from a rate of about \$30 million in 1949 to a rate of \$35 million in 1950 while at the same time further reducing imports. Imports from the U.S. have fallen progressively from \$59 million in 1948 to about \$23 million in 1950. That considerable room for reduction still remains is shown by the fact that over half of such imports this year consisted of machinery and automobiles. Finland could, therefore, without hardship, develop a dollar surplus. It is conceivable that, if necessary, she could meet the very heavy schedule of dollar amortization payments in 1954-1958, which requires peak payments of \$23 million per annum in 1954.

18. It should, however, be realized that the above appraisal of Finland's external prospects assumes no repetition of widespread strikes. The consequences of strikes on the Finnish balance of payments are so disastrous - this year they have been equivalent to about one and a half year's debt service - that a short period of serious strife could badly injure the creditworthiness of the country.

19. It seems clear that, in the absence of strikes, Finland can readily service her present foreign debt of the equivalent of \$314 million (of which \$186 million is in dollars and \$117 million in Swedish kroner) even if she is unable to refinance the heavy burden of scheduled repayments, totaling 52% of the total debt, in the 50's. However, in view of her favorable prospects, chief among which is the benefit to her balance of payments position of the approaching disappearance of the reparations burden, it would be natural if, after a long period of self-denial, she should seek to apply her gains to strengthening her foreign exchange reserves, which are presently inadequate, and to the further development of the economy, before embarking on so rapid a reduction of foreign debt. This would imply that Finland

finance increased investment by continued external borrowing.

20. Such borrowing could reach a substantial size without leading to any increase in overall indebtedness, since the equivalent of \$90 million (\$75 million in dollars) of existing debt will be retired over the next five years according to present amortization schedules. The strong dollar position would allow continued dollar borrowing, though obviously it would be preferable to borrow European currencies wherever possible. It would, however, be advisable, if the foreign debt were maintained at a high level, to develop an overall investment program carefully tailored to Finnish needs. This would not only have to be restricted in size, so that some building up of foreign exchange reserves would be possible, but would have to satisfy three criteria - namely, it should be based on economic use of Finnish resources, it should improve the standard of living, and it should improve, or at least not worsen, Finland's balance of payments prospects. Satisfaction of these criteria probably sets the limit to prudent Finnish borrowing. Clearly, therefore, before the Bank would wish to embark on any sizeable additional lending to Finland it would have to be satisfied that the present and prospective overall investment program is of a size and pattern which it can approve.